FAQ- Questions on Contractual Fallback Language, LIBOR Cessation and the ISDA Protocol

Q: What will happen to LIBOR-based contracts when LIBOR ceases or discontinues?

Many issues remain outstanding involving a wide range of legal, market and accounting questions, but these are currently under review and being discussed by regulators and market participants. For the most part, efforts have centered on 1) improving the language of new contracts ("fallback" language as discussed below) to make them more robust in handling various LIBOR cessation scenarios and 2) issues with legacy contracts. The ARRC and ISDA have both released consultations to obtain market participants input on fallbacks.

Q: Why does legacy fallback language need to be amended?

Currently the contractual language used in most contracts is not designed for a permanent or indefinite LIBOR discontinuance. Present ISDA guidelines for the OTC swap market instruct the calculation agent to poll banks, and in effect, calculate their own estimate of LIBOR if the official LIBOR rate is unavailable or not published. But if panel banks stop submitting data to ICE (the LIBOR administrator or its successor), it's highly unlikely that these banks will share this data with calculation agents.

Similar issues arise for the cash markets. For most legacy FRNs the calculation agent is supposed to poll banks to compute a best proxy for LIBOR. If this cannot be done, use the rate published on the last business day. For some securitization contracts, LIBOR transitions to Prime plus a spread if LIBOR is no longer available, while other rates will go to the last quoted LIBOR rate. For the CLO market, historical language asks investors and borrowers to agree on a new benchmark should LIBOR be discontinued.

Q: What is being done to improve fallback language?

Fallback language refers to the provisions in a contract that apply if the underlying reference rate is discontinued or unavailable. ISDA is leading the way in developing new fallback language for derivatives. ISDA has issued consultation papers obtaining market feedback on fallback language. Similarly, for the cash markets, a number of ARRC working groups are leading the efforts in developing fallback language for FRNs, syndicate and bilateral business loans, securitized products and consumer products. It issued consultations focused on two critical issues: 1) triggers (contingency events) and 2) fallback rates used in place of LIBOR if one of the triggers is engaged for FRNs, Syndicated/Bilateral Business Loans and Securitizations. The ARRC has so far published recommended fallback language for FRNs, Syndicated and Bilateral Loans, Securitizations and related products and Adjustable Rate Mortgages. Work on business loans is ongoing.

Q: What is a Fallback Waterfall?

LIBOR Replacement Waterfalls establish step-by-step fallback rate priorities to guide parties on what rate should be used at the time of transition. The Waterfalls are based on rate availability at the time of the transition. The Replacement Waterfall is:

- Comprised of two components: 1) a Replacement Benchmark and 2) Replacement Benchmark Spread. These components inform participants about what rate will be referenced and the spread adjustment that will occur;
- Product specific - different Waterfalls may exist for FRNs, Syndicated Loans, Bilateral Loans and Securitizations

Q: What is a Trigger?

A trigger refers to an event or an occurrence that precipitates the conversion from LIBOR to a new reference rate. This transition away from LIBOR is known as a Benchmark Transition Event. To date the industry has identified two types of triggers a Cessation Trigger and a Pre-cessation Trigger. Theses triggers have been considered in several consultations by market participants. Cessation triggers require a public statement or publication of information that the actual cessation of LIBOR has occurred or is expected by the administrator of LIBOR or several other bodies denoted below:

(1) a public statement or publication of information by or on behalf of the administrator of the Benchmark announcing that such administrator has ceased or will cease to provide the Benchmark, permanently or indefinitely, provided that, at the time of such statement or publication, there is no successor administrator that will continue to provide the Benchmark; or

(2) a public statement or publication of information by the regulatory supervisor for the administrator of the Benchmark, the central bank for the currency of the Benchmark, an insolvency official with jurisdiction over the administrator for the Benchmark, a resolution authority with jurisdiction over the administrator for the Benchmark or a court or an entity with similar insolvency or resolution authority over the administrator for the Benchmark, which states that the administrator of the Benchmark has ceased or will cease to provide the Benchmark permanently or indefinitely, provided that, at the time of such statement or publication, there is no successor administrator that will continue to provide the Benchmark;

The Pre-cessation trigger institutes a transition to an alternative rate upon a determination by a regulatory supervisor that the quality of the Benchmark has deteriorated such that it would likely have a significant negative impact on its liquidity and usefulness to market participants:

(3) a public statement or publication of information by the regulatory supervisor for the administrator of the Benchmark announcing that the Benchmark is no longer representative.

Q: Doesn't my ISDA Master Agreement already contain Fallback Language?

Fallback provisions for LIBOR in derivatives contracts currently trigger only if there is a temporary cessation of LIBOR and may not be workable if LIBOR permanently ceases to be published. Triggers for fallbacks are the events that result in the interest rate being determined other than in accordance with the standard approach under the contract (e.g., the rate does not appear on the screen page).

Q: What is the ISDA Protocol?

ISDA is expected to publish a Protocol to assist in the transition from IBORs to alternative reference rates (ARRs). The Protocol will facilitate the transition by enabling parties to amend certain Master Agreements, allowing an ARR to replace an IBOR and permit existing agreements to remain in place. The Protocol is expected to be published in July 2020. The Protocol will allow parties to amend ISDA Master Agreements and Non-ISDA Master Agreements – including global master repurchase agreements (GMRAs) and global master securities lending agreements (GMSLAs).

The Protocol will amend master agreements that reference an ISDA Definition Booklet (i.e. 2006 ISDA Definitions) by including the new ARR fallbacks; or master agreements which otherwise reference a relevant IBOR by including new fallbacks for the relevant IBOR. Master agreements between two parties will be amended once both parties have submitted an Adherence Letter to ISDA (agents will be able to adhere for/on behalf of their clients).

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