FINANCIAL STABILITY BOARD

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FSB OSSG Supports Use of the ISDA Spread Adjustments in Cash Products

The FSB's Official Sector Steering Group (OSSG) requested that the International Swaps and Derivatives Association (ISDA) undertake an initiative to strengthen contractual fallbacks in derivatives referencing key interbank offered rates (IBORs) in July 2016, and the OSSG engaged regularly with ISDA and other stakeholders during the significant programme of work that ISDA has undertaken since then.[1]

This work culminated in the launch of ISDA's IBOR Fallbacks Protocol (the Protocol) and IBOR Fallbacks Supplement (the Supplement) for IBOR-linked derivative contracts in October 2020, which became effective January 25, 2021. ISDA published the Supplement to the 2006 ISDA Definitions[2] to incorporate new fallbacks for derivatives that reference certain key IBORs. Simultaneously, ISDA published an IBOR Fallbacks Protocol that allows market participants to choose to incorporate the revisions into their legacy derivatives trades.[3] The FSB has strongly encouraged adherence to the ISDA Protocol by all affected financial and non-financial firms in order to avoid disruptions in covered derivatives contracts if the IBOR they currently reference is discontinued or, in the case of LIBOR, becomes non-representative.

The fallbacks and related triggers that are implemented via the Protocol and Supplement were based on a series of open consultations by ISDA and reflect the consensus of a broad array of market participants. Following consultation with industry participants, regulators and the FSB OSSG, ISDA determined that the primary fallbacks for IBOR-referencing derivatives would be the overnight risk-free rates (RFRs) identified by the relevant public-/private-sector working groups as an alternative to the IBORs and that a static spread adjustment would be added to these overnight RFRs when a fallback is triggered to ensure legacy derivatives contracts referenced to an IBOR continue to function as close as possible to what was intended.[4] The spread adjustments reflect the fact that the IBORs are available in multiple tenors and incorporate bank credit premiums and other factors that the overnight RFRs do not.

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1 ISDA's work on contractual fallbacks covers The ISDA IBOR protocol covers sterling LIBOR, Swiss franc LIBOR, U.S. dollar LIBOR, euro LIBOR, Japanese yen LIBOR, the euro interbank offered rate, the Japanese yen Tokyo interbank offered rate, the euroyen Tokyo interbank offered rate, the Australian bank bill swap rate, the Canadian dollar offered rate, the Hong Kong interbank offered rate, the Singapore dollar swap offer rate and the Thai baht interest rate fixing.

2 The 2006 ISDA Definitions are intended for use in confirmations of individual transactions governed by ISDA Master Agreements. The purpose of the 2006 Definitions is to provide the basic framework for the documentation of privately negotiated interest rate and currency derivative transactions. ISDA, Amendments to the 2006 ISDA Definitions to include new IBOR fallbacks ("The Supplement), (2020)

3 ISDA, IBOR Fallback Protocol (2020)

4 In the case of SOR and THBFIX, which are derived from USD LIBOR, the fallback for derivatives would be based on SOFR and the relevant USD spread adjustment as applies in USD LIBOR derivatives.

ISDA, in September 2019, consulted on final parameters of the adjustments that would be incorporated into its fallbacks[5] and subsequently published a report summarising the responses it received.[6] A majority of respondents to the consultation supported a historical median approach over a five-year lookback period for the spread adjustment. On March 5, 2021, the U.K. Financial Conduct Authority issued an official announcement on the future cessation and loss of representativeness of the LIBOR Benchmarks[7] and ISDA confirmed[8] that its spread adjustments for each of the LIBOR currencies had been fixed based on the announcement.[9]

The OSSG has recognized that other products such as syndicated loans, floating rate notes, corporate bonds, securitisations and retail and commercial mortgages, as well as exchange-traded futures contracts, also reference IBORs and that they also require robust fallbacks.[10] National Working Groups in several LIBOR jurisdictions have endorsed the use of the ISDA spread adjustments in fallbacks for cash products:

- In the United States, reflecting clear results of a public consultation, the Alternative Reference Rates Committee has confirmed that it would recommend use of the ISDA spread adjustments in cash products.[11]
- In the United Kingdom, the Sterling Risk Free Rates Working Group published a consultation paper in December 2019 considering methodologies that could be used to calculate the adjustment spread for fallback language in sterling cash instruments. The consultation produced a strong consensus in favour of the approach adopted by ISDA, and the working group has formally recommended the use of the ISDA spread adjustments in these cash instruments.[12]
- In Switzerland, the National Working Group on Swiss Franc Reference Rates recommended to use the ISDA spread adjustments in cash products such as retail loans or for bilateral loans with corporates or SME.[13] Furthermore, the working group has published a rate switch amendment agreement for syndicated loans that includes the ISDA spread adjustments as the applicable credit spread adjustments for transactions in CHF.[14]

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5 ISDA, ISDA Publishes Consultation on Final Parameters for Benchmark Fallback Adjustments, (2019)

6 ISDA, ISDA Publishes Results of Consultation on Final Parameters for Benchmark Fallback Adjustments, (2019)

7 FCA, FCA announcement on future cessation and loss of representativeness of the LIBOR benchmarks, (2021)

8 ISDA (2021) *Statement on UK FCA LIBOR Announcement*

9 Bloomberg Professional services (2021) IBOR Fallbacks - LIBOR spread adjustments

10 FSB, *Progress report on Reforming major interest rate benchmarks*, (2018)

11 ARRC, ARRC Announces Further Details Regarding Its Recommendation of Spread Adjustments for Cash Products, (2020)

12 The WG on Sterling Risk-free Reference Rate *Recommendation of Credit Adjustment Spread Methodology for fallbacks in cash market products referencing GBP LIBOR*, (2020)

13 NWG, Minutes of the 29 meeting, (2020)

14 Baker McKenzie (2021, published by NWG) Form of Rate Switch Amendment Agreement

- In Japan, the Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks has consulted on spread adjustment methodologies for cash instruments, and recommended the use of the ISDA spread adjustments in August 2020.[15]

- In the euro area, taking into account the results of a public consultation, the working group on euro risk-free rates recommended[16] the use of the spread adjustment already adopted by ISDA in fallback provisions in EURIBOR and other IBOR-linked cash products.

- Some non-LIBOR jurisdiction national working groups are also aligning their recommended IBOR fallbacks closely with ISDA's fallbacks to minimize any basis risk from hedging, including in Canada.

In light of the extensive consultations undertaken both by ISDA and many National Working Groups on use of the ISDA spread adjustments both in derivatives and cash products, and the further desirability of homogenous spread adjustments that allow derivatives and cash products to operate smoothly together, the FSB OSSG supports the potential benefits to use the ISDA spread adjustments for cash products that are to fall back or move from an IBOR to overnight RFRs or to RFR-based term rates.

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15 Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks, *Final Report on the Results of the Second Public Consultation on the Appropriate Choice and Usage of Japanese Yen Interest Rate Benchmarks*,(2020)

16 Working Group on Euro Risk-Free Rates, *Recommendations on EURIBOR fallback trigger events and €STR-based EURIBOR fallback rates*, (2021)