FSB FINANCIAL STABILITY BOARD

CO-CHAIRS
OFFICIAL SECTOR STEERING GROUP

15 November 2019

Mr Scott O'Malia, Chief Executive Officer
Mrs Katherine Tew Darras, General Counsel
International Swaps and Derivatives Association
360 Madison Avenue, 16th Floor
New York, NY 10017

By email

Dear Mr O'Malia and Mrs Tew Darras

We are writing as co-chairs of the Financial Stability Board's Official Sector Steering Group (OSSG) of regulators and central banks. On behalf of the OSSG, we would like to thank ISDA for its work so far, pursuant to the OSSG's request of 7 July 2016, in consulting on more robust fallback language for derivatives referencing key Interbank Offered Rates (IBORs). An important consideration to reduce systemic risk and market fragmentation is to ensure that as much of the swaps market as possible falls back to alternative rates in a coordinated fashion. To facilitate this, we ask ISDA to include a pre-cessation trigger alongside the cessation trigger as standard language in the definitions for new derivatives and in a single protocol, without embedded optionality, for outstanding derivative contracts.

In March, we wrote to ISDA encouraging further consultation on the addition of a "pre-cessation" trigger that would take effect in the event that the Financial Conduct Authority (FCA), in its capacity as the regulator of LIBOR, found LIBOR no longer to be capable of being representative ("non-representative"), for example because of the departure of panel banks at end-2021. ISDA's published summary of the results of the subsequent consultation on this issue reports that a majority of market participants would generally not want to continue referencing LIBOR in existing or new derivatives contracts following a statement from the relevant regulatory authority that it is no longer representative of the underlying market, although there were varied views on how ISDA's documents should deal with this pre-cessation trigger. We consider it important for ISDA to find a way to accommodate the majority view and include this trigger in as straight-forward a manner as possible.

While the EU Benchmark Regulation envisages circumstances in which a critical benchmark that has infringed the provisions of the Regulation may continue to be published to avoid a disruptive cessation and potential financial instability, it also envisages that EU supervised entities would no longer be able to enter into new derivative or securities transactions referencing LIBOR in those circumstances. The two central counterparties (CCPs) clearing the largest volumes of interest rate swaps have both stated publicly that they intend, sensibly and in accord with prudent risk management, to seek to transition cleared contracts away from LIBOR in the event that LIBOR is found by FCA no longer to be capable of being representative. In case a determination of non-representative is made by FCA, market

participants should expect to see their cleared derivatives move from LIBOR to the risk-free rates identified by the National Working Groups for each LIBOR currency. Without a trigger for this event in outstanding uncleared contracts, market participants could find themselves facing a disruptive fragmentation between the outcomes for cleared and uncleared derivatives. Cleared interest rate swaps account for over 80 percent of the total notional outstanding, hence a divergence between cleared and uncleared swaps would pose substantial challenges for both individual participants and the broader financial system.[1]

In contrast, including such a trigger would offer market participants with LIBOR-referencing derivative contracts the opportunity to move to new robust benchmarks rather than remain on a non-representative LIBOR rate and to avoid an unnecessary divergence between their cleared and uncleared derivatives positions.

Likely recognising these facts, the majority of market participants preferred not to continue referencing LIBOR following a supervisory statement on non-representativeness. We note that the Alternative Reference Rates Committee (ARRC) included a trigger of this form in its consultations for cash products referencing USD LIBOR, and that a clear majority of respondents to the ARRC's consultations expressed support for this.

We believe it important for ISDA to find a way both to protect the derivatives market from a disruptive fragmentation and to accommodate the majority's preferences as expressed in the consultation. We also recognise the importance of uptake of the protocol, which will be furthered if the protocol can be kept as simply structured as practicable.

Conversely, we find it difficult to recommend models in which pre-cessation triggers are offered on an opt-in or opt-out basis given the inherent complexity, risk management and data challenges this would present to market participants. This would not, however, preclude individual parties agreeing with each other to deviate from the standard pre-cessation and cessation triggers by bilateral agreement, if they wished to do so.

As stated above, we consider that the goals of systemic risk reduction can best be met by including the pre-cessation trigger alongside the cessation trigger as standard language in the definitions for new derivatives and in a single protocol, without embedded optionality, for outstanding derivative contracts. This would keep the structure of the protocol simple enough to encourage uptake and consistent outcomes. We presume that ISDA would at the same time offer tools that allow counterparties to bilaterally adopt arrangements that differ from the standard language in the protocol for any specific uncleared derivative contracts they wish to identify.

We ask that ISDA take forward this option and, if necessary to broaden and consolidate the consensus, set it out in a further and hopefully conclusive consultation that also invites respondents to identify any critical flaws, fine-tuning improvements or viable alternatives to such an approach.

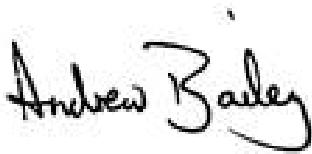
We note that ISDA may soon be in a position also to consult on robust fallback language for EURIBOR and EUR LIBOR. If this can be accomplished relatively soon, then the OSSG accepts that it may be sensible for ISDA to postpone publication of its protocol for a short

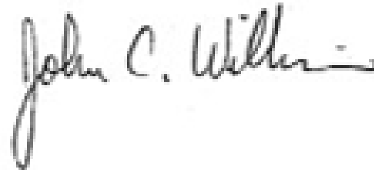
[1] Commodity and Futures Trading Commission, Weekly Swaps Report.

number of months in order to offer a single comprehensive protocol that includes this wider range of major IBORs as well as the agreed way of including the pre-cessation trigger.

We continue to appreciate the work that ISDA is leading with regard to enhancing contract robustness.

Yours sincerely,





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