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ISDA Publishes 2020 IBOR Fallbacks Protocol and Supplement to Address IBOR Discontinuation for Derivatives Transactions

By: Matt Frankle, Neal Kaminsky, Ellen McGinnis, Gilbert Porter, Brian Sung and Craig Unterberg

Quick Overview

- On October 23, 2020, ISDA published the ISDA 2020 IBOR Fallbacks Protocol and a related Supplement to the 2006 ISDA Definitions.
- The Protocol and the Supplement will amend ISDA's standard interest rate definitions to include robust contractual fallbacks for derivatives linked to LIBOR and other interbank offered (IBOR) rates, in anticipation of the discontinuation of such IBORs.
- The Supplement will update the industry standard 2006 ISDA Definitions with effect from January 25, 2021, and new derivatives transactions on or after such date that reference such definitions will include the new fallbacks.
- The Protocol provides an efficient, multi-lateral amendment process to allow market participants to apply the updated fallbacks into existing legacy derivatives transactions entered into with other parties adhering to the Protocol; like the Supplement, the Protocol will also apply the updated fallbacks to covered transactions between adhering parties with effect from January 25, 2021 (or, if later, the date on which both parties have adhered to the Protocol).
- Once the new IBOR fallbacks are incorporated into a particular transaction, the actual replacement of an IBOR will only occur upon the occurrence of one or more specified trigger events.
- Parties should carefully consider the details of the new IBOR fallbacks and their own need to modify legacy and new trades. Special attention should be given to the specified trigger events in the Protocol and the Supplement and other relevant details such as provisions governing spread adjustments.

Discussion

Since the development of the Eurodollar financing markets in the 1970s, the London Interbank Offered Rate ("**LIBOR**") and other interbank offered rates ("**IBORs**") have come to dominate the floating-rate debt and derivatives markets, and in many cases remain the leading benchmark rates used for both derivatives and cash market instruments such as loans and bonds. Due to increased concerns in recent years regarding vulnerability to manipulation, lack of underlying liquidity and non-representativeness arising out of the rate-fixing methodologies employed for these rates (generally based upon quotes from a dealer panel), the IBORs are anticipated to be phased out after the end of 2021. In the case of LIBOR, the U.K.'s Financial Conduct Authority has announced that it will no longer compel banks to continue providing quotes after such time. As a result, the derivatives and cash financing markets have been attempting to update their agreements to address the likely unavailability of IBOR rates thereafter.

In the U.S., as noted in our earlier alert,[1] the Alternative Reference Rates Committee, a working group of private-market participants and regulators convened by the Federal Reserve Board and the Federal Reserve Bank of New York, has recommended a risk-free rate known as "**SOFR**" (the "**Secured Overnight Financing Rate**") as the successor rate for USD LIBOR in the U.S. market.[2]

As the ARRC observed in its Second Report (March 2018),[3] as of 2018 most derivatives (as well as syndicated loans and other financing agreements) did not yet contemplate the possibility of a permanent or indefinite cessation of LIBOR, or contain robust fallback interest rate provisions to address such a cessation. Over the past few years, the ARRC has been working with loan-market participants to publish new recommended contractual fallback language for loan documentation, while the International Swaps and Derivatives Association, Inc. ("**ISDA**"), the primary derivatives industry trade association, has taken the lead on formulating analogous provisions for use in derivatives documents.

Under the documentation governing most derivatives transactions, the 2006 ISDA Definitions (the "**2006 Definitions**"),[4] the current interest rate-fixing provisions for IBORs generally contemplate only temporary unavailability of or disruption to rate sources. For example, the relevant definitions regarding USD LIBOR would provide for a calculation agent or one of the parties to determine the rate by reference to a poll of dealers if the screen rate is unavailable. Such fallback methods, however, would likely be infeasible as well as vulnerable to distortion and illiquidity if a rate were to permanently cease publication, if dealers were to cease providing such quotes, or if such quotes ceased to be representative of the relevant market. Therefore, continued industry reliance on such existing provisions without modification would create the risk of unworkable interest rate provisions across the market upon the anticipated cessation of LIBOR and other IBORs.

To avoid that outcome, after a multi-year consultation and refinement process involving working groups comprising buy-side, sell-side, regulatory and other market participants from jurisdictions around the world, ISDA published its highly-anticipated ISDA 2020 IBOR Fallbacks Protocol[5] (the "**Protocol**") and a related Supplement to the 2006 Definitions[6] (the "**Supplement**"), both on October 23, 2020. By adopting the amendments set forth in the Protocol and/or the Supplement, parties will be able to apply new robust contractual fallbacks to provide for replacement of IBORs following their discontinuation or non-representativeness.

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[1] Haynes and Boone LLP, "ARRC Releases Updated LIBOR Fallback Language for USD Syndicated Loans" (July 10, 2020), available here.

[2] See The Alternative Reference Rates Committee, "A User's Guide to SOFR," (April 2019), available here, and "ARRC Recommendations Regarding More Robust Fallback Language for New Originations of LIBOR Syndicated Loans," (June 30, 2020), available here.

[3] The Alternative Reference Rates Committee, "Second Report," (March 2018), available here.

[4] 2006 ISDA Definitions, as published by the International Swaps and Derivatives Association, Inc.

[5] The Protocol is available on ISDA's website, available here.

[6] The Supplement (formally titled "Amendments to the 2006 ISDA Definitions to include new IBOR fallbacks: Supplement number 70 to the 2006 ISDA Definitions") is available on ISDA's website, available here.

The Supplement will update the 2006 Definitions, with effect from January 25, 2021, such that new transactions entered into on or after such date that reference the 2006 Definitions will automatically include the new IBOR fallbacks.[7] In addition, the Protocol provides an efficient, multi-lateral amendment process to allow market participants to apply the updated IBOR fallbacks into existing legacy derivatives transactions entered into with other parties adhering to the Protocol. The Protocol will also apply the new IBOR fallbacks into covered legacy transactions between adhering parties with effect from January 25, 2021 (or, if later, the date on which both parties have adhered to the Protocol).[8]

The Supplement and the Protocol both provide for an IBOR to be replaced by a designated replacement risk-free rate (which will be SOFR in the case of LIBOR transactions), upon the occurrence of certain specified trigger events. Such trigger events include:

(i) a public statement or publication of information by or on behalf of the IBOR administrator (*e.g.*, ICE Benchmark Administration, in the case of USD LIBOR), announcing it has ceased or will cease publication permanently or indefinitely, with no successor administrator;

(ii) a public statement or publication of information by the regulatory supervisor for the IBOR administrator (*e.g.*, the U.K. FCA, in the case of USD LIBOR), the IBOR currency's central bank (*e.g.*, the Bank of England), or an insolvency official, resolution authority or insolvency court with jurisdiction over the IBOR administrator, stating that the administrator has ceased or will cease to publish the IBOR permanently or indefinitely, with no successor administrator;

(iii) in the case of USD LIBOR (and certain other IBORs), a "pre-cessation" trigger based on a public statement or publication of information by the IBOR administrator's regulator (*e.g.*, the U.K. FCA) that (1) the IBOR is (or as of a specified future date will be) non-representative of the underlying market, even if it has not ceased publication, and (2) such regulator intends for such statement or publication to engage contractual triggers for fallbacks activated by such pre-cessation announcements by such regulator.

Pursuant to the Supplement and the Protocol, existing fallback language is updated such that, following a specified trigger event, the IBOR will be replaced with a designated risk-free rate ("**RFR**"), and a designated spread adjustment will be applied to address structural and credit risk differences between the IBORs and the RFRs. In the case of USD LIBOR, the designated RFR will be SOFR, compounded in arrears, subject to a two (2) business day observation shift (whereby the start date and end date for each interest rate calculation period will be shifted back by two (2) business days) and a spread adjustment calculated based on the five-year historical median difference between SOFR and LIBOR as of the time of the rate replacement (Bloomberg has been engaged to publish both the SOFR RFR and the spread adjustments).

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[7] The introduction to the 2006 Definitions provides that "Unless otherwise agreed, where parties incorporate the 2006 Definitions into a Confirmation, they will incorporate the 2006 Definitions as amended and supplemented through the date on which they enter into the relevant transaction. Amendments and supplements to the 2006 Definitions will be deemed to have been made when published by ISDA." 2006 Definitions, p. (vi).

[8] As a contractual matter, as of the date on which both parties have adhered to the Protocol, both such parties will have *agreed to make the amendments* specified in the Protocol, but such *amendments will not take effect* (and the relevant *IBOR definitions will not be updated*) until the *effective date* for such amendments – the later of January 25, 2021 or the date on which both parties have adhered to the Protocol. This transitional adherence period has been set up so that the effectiveness of the amendments will occur no earlier than the January 25, 2021 effective date of the Supplement. Whether the IBOR definitions are amended via incorporation of the Supplement or via the Protocol, the *IBOR itself will not be replaced* until one of the specified trigger events occurs.

Market participants should also be aware that ISDA has published a set of bilateral amendment agreement templates that would enable parties to either modify the scope of the amendments[9] set forth in the Protocol and the Supplement, to apply them to only transactions with certain specified counterparties (either for all transactions between the specified parties, or to include (or exclude) only certain specified transactions between such parties), or to apply the relevant amendments and IBOR fallbacks into additional non-ISDA documents (or to exclude certain ISDA or other documents from such amendments).

Conclusion

With the adherence period for the Protocol now open, and with the January 25, 2021 effective date for the amendments under both the Protocol and the Supplement approaching, parties engaging in interest rate derivatives should familiarize themselves with the IBOR fallbacks and make plans to adhere to the Protocol for legacy transactions and/or plan for adoption of the amendments set forth in the Supplement to take effect for new (post-January 25, 2021) transactions.

In particular, parties using derivatives to hedge indebtedness or in conjunction with other financing arrangements will want to carefully consider the implications of IBOR replacement and spread adjustments under their derivatives and under such other financing transactions, which may be governed by ARRC-based fallback language.

For more information or questions on the matters covered in this alert, please contact a member of our Finance Practice Group, or any of the lawyers below.

Matt Frankle | Partner
212.918.5950 | matthew.frankle@haynesboone.com
Derivatives, Finance, Margin Lending and Structured Equity

Neal Kaminsky | Partner
713.547.2542 | neal.kaminsky@haynesboone.com
Energy Finance, Finance, Real Estate Finance

Ellen McGinnis | Partner
202.654.4512 | ellen.mcginnis@haynesboone.com
Finance, Fund Finance

Gil Porter | Partner
212.659.4965 | gilbert.porter@haynesboone.com
Finance, Project Finance and Development

Brian Sung | Counsel
212.659.4965 | brian.sung@haynesboone.com
Derivatives, Finance, Margin Lending and Structured Equity

Craig Unterberg | Partner
212.659.4987 | craig.unterberg@haynesboone.com
Derivatives, Finance, Margin Lending and Structured Equity

[9] One modification that parties may want to consider is to disapply the "pre-cessation" trigger described above, if the parties feel that replacement of the IBOR under such circumstances prior to its actual cessation would be inappropriate or undesirable.