Operational Considerations for Fallbacks in Uncleared Linear Derivatives

The Working Group on Sterling Risk-Free Reference Rates

April 2021

Introduction

The overall objective of the Working Group on Sterling Risk-Free Reference Rates (the "Working Group") is to catalyse a broad-based transition to SONIA by the end of 2021 across the sterling bond, loan and derivative markets, in order to reduce the financial stability risks arising from the widespread reliance of financial markets on GBP LIBOR.[1] This paper supports the Working Group's top priority for markets and their users to be fully prepared for the end of sterling LIBOR by the end of 2021.[2]

In the derivatives market, the Working Group is supportive of the work that has been conducted by the International Swaps and Derivatives Association ("ISDA") on a way to calculate fallback replacement rates for LIBOR. The methodology for calculating these fallbacks is based on a combination of the relevant overnight Risk Free Rate ("RFR"), compounded in arrears over a backward shifted period, and a fixed spread to reflect the premium associated with unsecured lending at term.[3] The work culminated in the launch of the IBOR Fallbacks Supplement ("the Supplement") which updated ISDA's standard definitions booklet for interest rate and currency derivative transactions (the 2006 ISDA Definitions) via Supplement 70, and the ISDA 2020 IBOR Fallback Protocol ("the Protocol") which incorporates the fallbacks into legacy trades of adhering parties – both of which became effective on 25 January 2021.[4]

The Working Group strongly encouraged early adherence to the Protocol by both financial and non-financial firms in order to reduce the risks associated with inadequate fallbacks at LIBOR cessation[5], echoing a similar message from global regulators via the Financial Stability Board.[6] As of 31 March, 2021 over 13,600 entities had adhered to the Protocol, and it remains open for adherence where firms have not yet done so.

In the view of the Working Group, ensuring that robust fallbacks are in place is a critical first step to reduce the risks associated with LIBOR cessation or loss of representativeness. The next step is, in the opinion of the Working Group, to ensure that firms who may rely on those fallbacks are well prepared for executing them at the point they take effect. The Working Group's Infrastructure sub-group anticipates that, even where robust fallbacks exist, LIBOR cessation presents increased operational risk to markets and their participants, due to the volume and complexity of work required to execute fallbacks. The Working Group believes that these risks can be mitigated through appropriate planning by firms and market infrastructure providers to ensure operational readiness ahead of fallbacks taking effect.

The importance of effective planning and execution in this area has also been highlighted by UK supervisors in a recent letter to regulated firms from the PRA and FCA[7]

> *The operational resiliency implications of reliance on tactical solutions should be controlled and managed within an explicit and defined firm risk appetite. Firms should also ensure that systems and processes are ready to robustly manage reliance on fall-backs post-cessation and that the firm's risk management takes full account of this reliance.*

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[1] The Bank of England and the Financial Conduct Authority (the "FCA") are each ex-officio members of the Working Group. The views and considerations set out in this document do not constitute guidance or legal advice from the Bank of England (including the Prudential Regulation Authority (the "PRA") or the FCA and are not necessarily endorsed by the Bank of England (including the PRA) or the FCA. This document is not intended to impose any legal or regulatory obligations on market participants. This document has been prepared for the purpose of highlighting to market participants some of the potential considerations. It does not constitute a comprehensive outline of all relevant considerations. Market participants should seek their own advice in relation to their legal, regulatory, tax and other obligations and as to any other considerations or risks that may arise or be relevant.

[2] https://www.bankofengland.co.uk/news/2021/january/the-final-countdown-completing-sterling-libor-transition-by-end-2021

[3] http://assets.isda.org/media/3062e7b4/b7524177-pdf/

[4] https://www.isda.org/a/a64TE/ISDA-Launches-IBOR-Fallbacks-Supplement-and-Protocol.pdf

[5] https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/statement-welcoming-isda-announcement.pdf

[6] https://www.fsb.org/2020/10/fsb-encourages-broad-and-timely-adherence-to-the-isda-ibor-fallbacks-protocol/

[7] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2021/march/transition-from-libor-to-risk-free-rates.pdf

Active Transition

Market participants are also reminded of the focus on active conversion in the Working Group's recommended milestones:

> *By end-Q1 2021, complete identification of all legacy GBP LIBOR contracts expiring after end 2021 that can be actively converted, and progress active conversion where viable through to completion by end-Q3 2021*[8]

Similarly, in their recent communication to regulated firms, UK supervisors noted that:

> *While the ISDA protocol provides a fall-back designed to enable derivative contracts to continue to function post cessation, firms should be prepared to demonstrate the steps they have taken to identify where an active transition would be more appropriate and how any residual risks from reliance on fall-backs will be managed. Mitigation of these risks requires proactive, timely and meaningful engagement with clients.*

Alongside this paper, the Working Group has therefore published a further short document setting out considerations to inform market participants if they are choosing between active transition and reliance on the ISDA fallback.[9] This highlights that active transition remains the primary method recommended by the Working Group for market participants to ensure contractual certainty and retain control over the economic outcome and timing of transition. These papers are intended to assist market participants in understanding and balancing the benefits, costs and risks of each approach in relation to their own circumstances.

Aim and Scope

This paper provides infrastructure and operational considerations for derivative market participants to consider in order to inform planning and preparation for the operationalisation of fallbacks in non-cleared linear GBP LIBOR derivatives.

- Cleared derivatives are not considered in scope of this paper as clearing houses are currently conducting their own market engagement on the best course of action for transition of cleared derivatives ahead of LIBOR cessation.[10]
- Non-linear derivatives are not considered in scope of this paper as the path to transition for these products continues to be assessed by the Working Group's Non-Linear Derivative Task Force.

This paper has been prepared for the purpose of highlighting to market participants some of the potential considerations. It should not be considered an exhaustive list of considerations and market participants are strongly encouraged to conduct their own independent assessment of the impact and preparations required ahead of fallbacks taking effect.

The Working Group is supportive of the work of ISDA and of its IBOR Fallback Implementation Working Group and encourages market participants to continue to engage via that forum to address areas of concern regarding the operationalisation of fallbacks. Enquiries should be directed to ISDAIBORFallbackImplementationSubgroup@ISDA.org.

The Infrastructure sub-group welcomes feedback from market participants on this paper via the Working Group Secretariat, at RFR.Secretariat@bankofengland.co.uk.

List of considerations

The remainder of this paper details the key themes identified along with proposed considerations and potential next steps, set out in the table below. Further background on the ISDA protocol and spread calculation is provided in the Appendix.

[8] https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/rfr-working-group-roadmap.pdf
[9] https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/active-transition-of-legacy-gbp-libor-contracts.pdf
[10] For example: Supplementary Statement on LCH's Solution for Outstanding Cleared LIBOR® Contracts | LCH Group

Theme	Background / Considerations	Suggested next Steps

Trade Booking Infrastructure	• A full assessment of all LIBOR referencing derivative transactions is required to understand fallbacks in place across trade populations.
	• As firms adhere to the Protocol or update bilateral documents the need to bifurcate trade populations by fallback type should be considered. Sizing of the trade population by fallback type should inform planning for the execution of fallbacks. Tracking of these trade populations should be established to ensure that changes to fallbacks are reflected within the system of record. There are likely to be three main fallback categories:
	    o IBOR Fallbacks (Supplement 70)
	    o Bespoke fallbacks
	    o Original 2006 Definition Fallbacks (Polling of Reference Banks)
	• Where a counterparty is yet to adhere to the Protocol:
	  o The need for split portfolios should be considered – i.e. trades executed before the ISDA supplement effective date (25 January 2021) and those executed after.
	  o Trades with non-amended provisions will require different operational steps at fallback.
	• The resultant Management Information System reporting from bifurcation of portfolios may also be of use for risk management functions (see Risk Management Infrastructure and Processes below) and to inform client outreach to counterparties.
	• Conventions will differ between fallen back trades vs OIS referencing RFRs. In addition, trades which fall back via the Protocol vs a non-amended provision will both reference USD-LIBOR-BBA and will be required to be bifurcated in booking systems (see ISDA guidance in the Annex).
	• The "all in" fallback rate published by BISL will need to be sourced into settlement systems for rate reset and repricing.
		• Assign ownership to the task of preparing the organisation for fallback. Appropriate oversight and governance may be needed to support Board level and Senior Management reporting.
		• A full impact assessment by system and processes to determine the work required to prepare the organisation for fallback across each fallback population.
		• Identify and agree adequate resources to support planning and preparation for fallback.
		• Consider continuous engagement with the ISDA IBOR Fallback Implementation Working Group in order to identify and develop consensus on trade booking approaches across fallback categories.
		• Review and monitor for updates to ISDA's RFR Conventions and IBOR Fallbacks Product Table.[11]
		• Review ISDA's proposal, once available, for including compounding/averaging conventions, such as observation period shift, lookback and lockout, in the 2006 ISDA Definitions for use with new overnight Floating Rate Options.[12]

[11] http://assets.isda.org/media/4ff1a000/b6e5395e-pdf
[12] Expected April 2021

Theme	Background / Considerations	Suggested next Steps
	• Additional booking considerations include: ○ How to book into systems the two business day cut-off prior to the payment date, and a contingency for if the rate is not available when required. ○ Potential interpolations between a continuing shorter and longer tenor for specific designated maturity discontinuations (under the Discontinued Rate Maturity provisions in the 2006 ISDA Definitions). ○ How to book the fallbacks for periods where Linear Interpolation applies – which may result in the Calculation Agent needing to compute a compounded RFR calculation and interpolating published Bloomberg spreads.	
Risk Management Infrastructure and Processes	• Bifurcation of trade populations by fallback types or trade convention will allow risk analysis and management across portfolios. • The "all in" fallback rate published by Bloomberg Index Services Limited ("BISL") will need to be sourced into risk management systems for valuation and pricing. • Management of basis between differing fallback types and across fallen back trades vs OIS referencing RFR may be required.	• A full impact assessment of risk management systems and processes to determine the work required to support pricing, valuation and VaR modelling of fallback scenarios and to manage risks post fallback. • Define risk reporting required for Board level and Senior Management.
Accounting Infrastructure and Processes	• Financial reporting within firms is generally dependent on information sourced from trade booking systems and market data providers. These systemic and procedural linkages can be complex and burdensome to change manage effectively unless planned carefully. • On 5 January 2021, the following amendments to international accounting standards were adopted for use within the United Kingdom:[13]	• Include accounting systems as part of the impact assessment for the planning of operationalisation of fallback. This should include an analysis of upstream dependencies for accounting systems to ensure any changes planned in trade booking infrastructure are appropriately managed to ensure accounting processes and reporting continue to run effectively. • Any impact assessment should also include consideration of potential system changes regarding hedge accounting documentation and market valuations.

[13] https://www.frc.org.uk/news/january-2021-(1)/uk-adoption-of-amendments-for-ibor-phase-2-and-ame

Theme	Background / Considerations	Suggested next Steps
	○ Interest Rate Benchmark Reform—Phase 2 (Amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16) ○ The Amendments are effective for annual periods beginning on or after 1 January 2021, with early application permitted. ○ The Amendments focus on the effects on financial statements when an entity replaces the old interest rate benchmark with an alternative benchmark rate as a consequence of the global regulatory reform of key interbank offered rates (IBORs). • On 21 December 2020, the FRC issued Amendments to FRS 102 – Interest rate benchmark reform (Phase 2).[14] ○ The amendments respond to the financial reporting issues arising from interest rate benchmark reform, and are intended to adapt and simplify accounting requirements in that context and provide disclosure of the nature and extent of the risks arising, thereby minimising reporting costs for entities applying FRS 102 and enabling them to provide useful information to the users of their financial statements. ○ The amendments are effective for accounting periods beginning on or after 1 January 2021, with early application permitted. • Notwithstanding the amendments above, changes to contracts may trigger discontinuance of hedge relationships, potentially resulting in financial statement volatility. For derivatives designated in hedge accounting relationships, a modification to the critical terms of a derivative will require that the hedge accounting relationship be discontinued if the modification does not fall within the exceptions established in the amendments to international and UK accounting standards referenced above. A new hedge accounting relationship could be instituted for the modified derivative if new hedge accounting documentation is put	• Review amended accounting standards and ensure reporting impacts and accounting treatments are applied where relevant.

[14] https://www.frc.org.uk/news/december-2020/amendments-to-accounting-standards-—-uk-exit-from

Theme	Background / Considerations	Suggested next Steps
	in place and the other requirements for hedge accounting are met. • Fundamental to ongoing cash flow hedging relationships is the expectation that the future hedged transactions are highly probable to occur and for fair value hedges, the value assigned to the hedged debt will need to be updated for the change in the reference rate.	

Regulatory Reporting	• The FCA published guidance on the approach to reporting references to LIBOR in OTC derivative contracts under UK EMIR in March 2021:[15]
	  ○ *Under Article 9 UK EMIR, counterparties and CCPs must report any modification of a derivative contract they have concluded to a registered or recognised trade repository no later than the working day following the modification of the contract.*
	  ○ *If the terms of a derivative contract say that, either immediately or at some other point in time, an alternative rate applies in the place of LIBOR, this would bring about a modification that is reportable under UK EMIR. We would expect this modification to be reported at the time that the alternative rate takes effect. This applies to all agreed terms that result in an alternative rate applying in place of LIBOR, including:*
	    ▪ *fallbacks agreed on a bespoke basis*
	    ▪ *fallbacks that take effect as a result of ISDA's 2020 IBOR Fallbacks documents*
	  ○ *While we expect you to make the necessary preparations to ensure the relevant UK EMIR reports are updated in a timely manner, we will apply our supervisory powers for this requirement in a proportionate and risk-based manner.*
		• Include regulatory reporting as part of the impact assessment for the planning of operationalisation of fallbacks. This should include an analysis of upstream dependencies for regulatory reporting to ensure any changes planned in trade booking infrastructure are appropriately managed meet regulatory reporting obligations.
		• Monitor output from the FCA and ISDA on reporting requirements under UK EMIR to continue to meet regulatory reporting obligations over time.

[15] https://www.fca.org.uk/firms/uk-emir/news

Theme	Background / Considerations	Suggested next Steps
Market Infrastructure Providers	• Many market participants are reliant on vendors for the delivery of tools to assist with portfolio migration and / or systems that are potentially impacted by fallback at LIBOR cessation e.g. trade booking, risk management, models, TMS providers, AM Portfolio Management Software. • The “all in” fallback rate published by BISL will need to be sourced into settlement systems for rate reset and repricing. • Firms will need to agree and implement an approach to booking fallen-back trades to reflect their specific terms, including the observation shift in payment dates, where an automated, standardised approach may not be available in systems.	• Consider dependencies on vendors for provision of services required for conversion of trades at cessation. • Engage with vendors to seek confirmation of any development and readiness timelines by end May 2021 in order to allow adequate planning time for testing and implementation ahead of conversion.
Timing of Conversion / Cessation	• The index cessation effective date for non-USD currency / tenor pairs is the first London banking day on or after 1 Jan 2022. The holiday period is a period of heightened operational risk over which change freezes and large scale program and project delivery are generally in place. • LIBOR reset dates falling on or close to cessation dates may also lead to higher operational risk. As fallbacks are effective from the first reset date after cessation, cessation in close proximity to a reset date will maximise the volume to transition the first day after cessation. As a higher proportion of reset dates may fall on or around month- or quarter-ends, this may be a relevant factor in many cases given the effective date above.	• Deliver system and process readiness well ahead of any periods of heightened operational risk. Consider additional risk mitigants over the fallback period.

Appendix

ISDA

The Protocol became effective on 25 January 2021. Any trade executed under the relevant ISDA documentation on 25 January 2021 or later will automatically contain (unless expressly excluded) the updated 2006 ISDA Definitions which includes the fallback language (via Supplement 70). Therefore, even if a counterparty has not adhered to the Protocol, any trade executed on or after that effective date includes the fallback language.

On 5 March 2021, the FCA issued an announcement[16] on the future cessation and loss of representativeness of the LIBOR benchmarks. As confirmed via a separate announcement from ISDA, 5 March 2021 is the 'Spread Adjustment Fixing Date' for all LIBOR tenors across all LIBOR currencies.[17]

Key resources in relation to the implications of these announcements include:

- List of impacted LIBOR fallbacks and spread adjustments published by Bloomberg
- Future Cessation and Non-Representativeness Guidance published by ISDA, containing a summary table of the relevant dates and other information for each LIBOR setting on pages 7-8.

ISDA also provided guidance on the terms of trade confirmations pre and post fallback in its *Benchmark Reform at a Glance* guide, extracted as follows:

"If the permanent cessation fallbacks are triggered and apply, the terms of the confirmation will remain exactly the same. Specifically, this means:

- *The Floating Rate Option referenced in the contracts will remain unchanged (e.g. US dollar LIBOR contracts will continue to reference USD-LIBOR-BBA, but the price source within the description of USD-LIBOR-BBA will move to the Bloomberg publication of the new all-in fallback rates based on SOFR). As a result, the Floating Rate Option will differ from OIS Floating Rate Options referencing the RFRs.*
- *The other conventions (e.g. payment dates, day count, payment frequency) for the original IBOR derivative will remain the same. As a result, the conventions will differ from OIS referencing the RFRs.*
- *However, in accordance with the terms of the new fallbacks embedded in the Floating Rate Options, the observation date of the fallback rate will generally move to a date that is around the end of the relevant period (two business days prior to the relevant payment date).*

If a derivative continues to reference the non-amended provisions of the Floating Rate Option for the relevant IBOR following a permanent discontinuation (i.e. the provisions that do not include the new fallbacks), then the reference bank polls will continue to apply.

- *This would occur if the counterparties continue to have exposure to the IBOR via derivatives that were entered into before the effective date of the updates to the 2006 ISDA Definitions and both parties to the derivatives do not adhere to the ISDA IBOR Fallback Protocol or bilaterally agree to include the new permanent cessation fallbacks.*
- *These derivatives will have the same Floating Rate Options as those that contain the new permanent cessation fallbacks, but the fallback rate will depend on reference bank polls as opposed to Bloomberg's publication of the all-in fallback rate."*

ISDA has produced various other resources outlining the background to the Protocol and calculation methodologies for fallback rates for use by market participants:

[16] https://www.fca.org.uk/publication/documents/future-cessation-loss-representativeness-libor-benchmarks.pdf
[17] https://www.isda.org/2021/03/05/isda-statement-on-uk-fca-libor-announcement

- Benchmark Reform and Transition from LIBOR
- ISDA IBOR Fallbacks: Methodology and Bloomberg Publication
- ISDA Benchmark Reform at a Glance
- ISDA Adhering Parties

Bloomberg

On 31 July 2019 Bloomberg Index Services Limited (BISL) was selected to calculate and publish adjustments related to fallbacks that ISDA intends to implement for certain interest rate benchmarks in its 2006 ISDA Definitions.[18]

All legacy trades covered by the Protocol and all trades executed under the 2006 ISDA Definitions post 25 January 2021 will fall back to the Bloomberg publication of the new all-in fallback rate for the relevant currency / tenor pair.

Bloomberg publishes:[19]

- Adjusted RFR: compounded setting in arrears RFR for each relevant term - daily compounding of publicly available RFRs (e.g. SOFR, SONIA)
- Spread Adjustment: median of the historical differences between the IBOR for each tenor and the compounded RFR for that tenor over a five-year period prior to an announcement constituting a Trigger Event.
- Fallback Rate: Fallback Rate Sets are published by BISL for each of the 11 IBORs.

[18] https://www.isda.org/2019/07/31/bloomberg-selected-as-fallback-adjustment-vendor/
[19] Further information: https://www.bloomberg.com/professional/solution/libor-transition/