

Consultation on credit
adjustment spread
methodologies for fallbacks
in cash products
referencing GBP LIBOR -
Summary of Responses

The Working Group on Sterling Risk-Free Reference Rates

Consultation on credit adjustment spread methodologies for fallbacks in cash products referencing GBP LIBOR – Summary of Responses¹

The Working Group on Sterling Risk-Free Reference Rates (**RFRWG**) issued a consultation seeking the views of cash market participants on the credit adjustment spread methodology to be applied in respect of contractual fallbacks from GBP LIBOR to SONIA in cash products maturing beyond end-2021. The consultation was open from 16th January 2020 until 6th February 2020 and attracted 39 responses from a range of market participants (see Chart 1). Respondents included: members of the RFRWG; trade associations; banks; corporates; and other financial firms including asset managers and real estate investment firms.

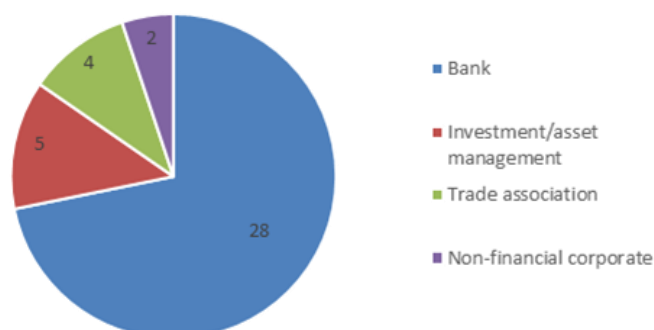
Respondents commented on: their preferred credit adjustment spread methodology and the characteristics influencing their choice; the types of cash products this methodology would be appropriate for; whether any additional credit adjustment spread methodologies should be considered; whether different spreads should be applied depending on when the fallbacks take effect; any anticipated operational challenges in adopting a credit adjustment spread into fallback language; and any other challenges if different currencies were to apply different methodologies.

This paper summarises the responses received. The RFRWG will discuss these results at its forthcoming meetings, including consideration of potential next steps on how these results can help catalyse further transition in sterling cash markets.

Key takeaways:

- **The consultation identified a strong consensus in favour of the historical 5 year median approach (option 1), in line with the approach adopted by ISDA, as the preferred methodology for credit adjustment spreads across both cessation and pre-cessation fallbacks for cash products maturing beyond end-2021.**
- The primary reasons identified by respondents for favouring this approach were simplicity and transparency, and that it was considered a robust rate which could not be easily manipulated. The majority of respondents stated there were no other methodologies that should have been included in the consultation paper to be considered for use in contractual fallbacks for cash products maturing beyond end-2021.
- The majority of respondents felt it would be problematic to have different credit adjustment spreads based on when the fallbacks take effect. However, a small minority thought that the credit adjustment spread following a pre-cessation fallback trigger should subsequently be changed to the credit adjustment spread calculated following the permanent cessation of GBP LIBOR, should that take place at a later date.
- The majority of respondents also highlighted the benefits of an internationally consistent spread methodology to be applied in fallbacks across different currencies.

Chart 1: Distribution of respondents



¹ This Summary of Responses is prepared by the Bank of England and the Financial Conduct Authority ("FCA") as the Secretariat of the Working Group on Sterling Risk-Free Reference Rates (RFRWG). The Bank of England and the FCA are each ex-officio members of the RFRWG. The views and outputs set out in this Summary do not constitute guidance or legal advice from the Bank of England (including the Prudential Regulation Authority ("PRA")) or the FCA and are not necessarily endorsed by the Bank of England (including the PRA) or the FCA.

Summary of Responses²

Question 1: Please indicate whether the ISDA historical median approach is your preferred credit adjustment spread methodology for cash products in respect of: (a) fallbacks which apply on cessation of GBP LIBOR; and (b) pre-cessation fallbacks for GBP LIBOR that trigger as a consequence of a regulatory announcement of non-representativeness.

- (i) For cessation fallbacks, all respondents (100%) stated that the ISDA historical 5 year median was their preferred approach to calculate the credit adjustment spread.
- (ii) For pre-cessation fallbacks, a large majority (92%) also preferred the ISDA historical 5-year median approach to calculate the credit adjustment spread. The remainder (8%) gave no preference in this respect.³

Question 2: Are there any other methodologies for calculation of a credit adjustment spread which should be considered in the cash markets? If so, please indicate which of the situations outlined in (a) and (b) in Question 1 above this methodology would be most applicable to.

- (i) A majority (90%) of respondents stated there was no other credit adjustment spread methodologies that should be considered for use in contractual fallbacks for cash products maturing beyond end-2021. The remaining 10% of respondents cited a range of potential additional methodologies, with no individual option supported by more than two respondents. Suggestions included the ISDA historical approach with different parameterisations⁴ (2 respondents), the ISDA forward approach for use in pre-cessation fallbacks⁵ (1 respondent), and, if it were possible to construct, a dynamic credit spread methodology in a robust and transparent form (1 respondent).
- (ii) Whilst outside the scope of the consultation, three respondents noted that credit adjustment spread methodologies would also need to be considered to support cash products where the contractual fallback was not SONIA (e.g. Bank Rate). One respondent felt doing so would support the active conversion of cash products where Bank Rate was the contractual fallback.

Question 3: Please comment on the characteristics of the proposed methodologies that most influenced your decision (including whether alignment with related hedging formed a part of your decision-making process).

- (i) All respondents (100%) choosing the ISDA historical five year median as their preferred spread methodology for fallback at cessation stated that this approach would afford them the ability to be consistent with hedging derivatives and minimise basis risks between derivative and cash products. In addition to this:
 - 56% (22 respondents) noted the alignment of the approach between cash and derivative markets also offered simplicity and wide recognition. Respondents anticipated this would support smoother adoption in infrastructure and IT systems. Alignment would also facilitate clearer communication strategies for clients and end-users.
 - 38% (15 respondents) identified the methodology as more robust and resistant to manipulation.
 - 26% (10 respondents) reported the transparency of the ISDA historical 5 year median influenced their decision, particularly as the methodology uses available information. ISDA's announcement that this would be published by an independent vendor was also cited.

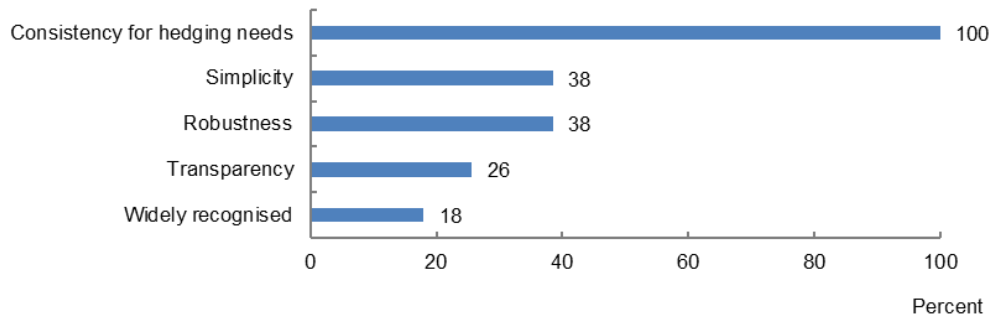
² Percentages in this section may not sum to 100% due to rounding.

³ These respondents stated they either did not agree with the concept of a pre-cessation trigger in fallback language or they felt unable to comment until the findings of ISDA's latest consultation on the pre-cessation trigger were available.

⁴ A 15 year lookback, either with the ISDA historical median approach, or the historical trimmed mean approach considered but not taken forward in the December 2018 consultation, for closer alignment with the relevant cost of funds for cash products.

⁵ An alternative methodology based on forward rates, as previously considered but not taken forward following the results of ISDA's July 2018 benchmark fallback consultation for derivative products which covered GBP LIBOR.

Chart 1: Characteristics of the ISDA approach that influenced respondents' decisions



Note: some respondents to this question cited multiple characteristics, so may contribute to the total in more than one category

Question 4: Please indicate whether your comments apply to all cash products, or whether there are different considerations for different cash products.

- (i) 95% (37 respondents) stated their preference for use of the ISDA historical 5 year median could apply across all cash products.⁶ Of the remaining 5% (2 respondents):
- One response noted the complexity of the ISDA methodology may not be appropriate for retail products; and
 - One response noted the current market practice of using SONIA-LIBOR basis curves to calculate a fair present value for the credit spread on the day of cessation, and felt this could be also be used in fallbacks for securitisations.

Questions 5 and 6 sought views on the application of the credit adjustment spread in relation to differing triggers for contractual fallbacks and so responses to these two questions have been combined.

Question 5: In respect of fallbacks, would it be problematic to have different credit adjustment spreads apply based on when fallbacks take effect (i.e. prior to cessation or upon cessation of GBP LIBOR)?

Question 6: In respect of fallbacks, should the credit adjustment spread following a pre-cessation fallback trigger subsequently change (should GBP LIBOR be discontinued) to the credit adjustment spread calculated following the permanent cessation of GBP LIBOR? Alternatively, should it remain at the credit adjustment spread for the pre-cessation event?

- (i) The majority of respondents felt it would be problematic to have different credit adjustment spreads take effect for products with a pre-cessation trigger relative to those with a cessation trigger only. However, only a small minority of respondents felt the credit adjustment spread for products with a pre-cessation fallback trigger should subsequently be changed to the credit adjustment spread calculated following the permanent cessation of GBP LIBOR, should that take place at a later date. Instead, the majority considered the credit adjustment spread applied at the point of a pre-cessation event should remain.
- (ii) Within the 87% (34 respondents) who reported it would be problematic to apply different spreads based on when fallbacks take effect, the range of reasons provided included that:
- A misalignment in the spread approach could introduce operational complexity;
 - The application of different spreads could result in conduct risks, potentially causing confusion amongst participants and could give rise to dissatisfaction amongst borrowers and present challenge from customers; and

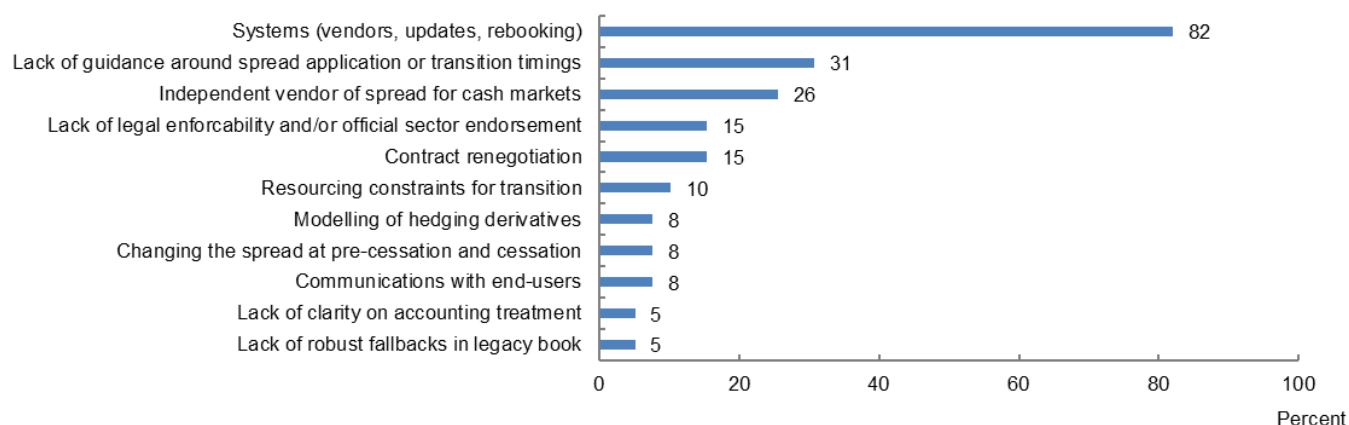
⁶ Some respondents noted that their comments were based only on consideration of the cash products relevant to their business.

- The difference in timing between the 'trigger' of different fallbacks could present opportunities for arbitrage.
- (iii) A further 5% (2 respondents) did not anticipate that the application of a different spread when fallbacks take effect would be problematic, due to two main factors:
- It was anticipated there would be a short window between pre-cessation and cessation so the difference in spreads was expected to be minimal; and
 - The same consistent and transparent methodology would be applied when fallbacks take effect.
- (iv) The remaining 8% (3 respondents) did not identify a clear preference for whether different spreads should apply based on when fallbacks take effect.
- (v) In respect of whether the credit adjustment spread applied at the point of a pre-cessation event should be subsequently changed (Question 6), 82% (32 respondents) felt that it should not. Of those:
- 77% (30 respondents) noted that the credit adjustment spread applied at the point of a pre-cessation event should remain.
 - 3% (1 respondent) felt the credit adjustment spread should only be calculated at a cessation event and 3% (1 respondent) did not offer any additional considerations.
- (vi) 10% (4 respondents) were of the view the spread should be calculated separately at the point of pre-cessation and again at cessation and the remaining 8% (3 responses) did not answer this question.

Question 7: *Please comment on anticipated operational challenges and elaborate on how long you feel it would take to overcome such challenges.*

- (i) While the consultation overall found strong support for use of a credit adjustment spread based on the agreed ISDA methodology, 92% (36 respondents) anticipated an operational challenge of some form in implementing this. Of the remainder, one respondent reported they anticipated no operational challenges and two respondents did not provide an answer.
- (ii) Among those respondents that did anticipate operational challenges, the key examples cited included:
- the updating of internal and external systems, in particular treasury management systems, to support a fixed credit adjustment spread in interest accrual calculations (82%; 32 respondents);
 - a lack of certainty or guidance as to when and how cash products could transition (31%; 12 respondents); and
 - challenges identifying an independent vendor to publish the transparent and public credit spread for cash market participants (23%; 10 respondents).

Chart 2: Anticipated operational challenges to implement credit adjustment spread into fallback language



Note: some respondents to this question cited multiple characteristics, so may contribute to the total in more than one category.

Question 8: *Would it be problematic for market participants to use different approaches to calculate credit adjustment spreads in fallbacks or for transitioning legacy documentation across different currencies? Please explain why or why not, commenting specifically on the potential implications of using different approaches across different currencies.*

(i) 77% (30 respondents) stated it would be problematic if different approaches were taken to calculate the spread in fallbacks. Amongst these respondents:

- 31% (12 respondents) noted a consistent methodology across markets would support the ease of implementation of the spread, with 28% (11 respondents) commenting that consistency would reduce operational risks as manual system intervention would otherwise be required.
- 23% (9 respondents) anticipated that different credit adjustment methodologies across both currencies and products may prevent parties reaching an agreement and thereby increase litigation risk.
- 18% (7 respondents) felt that differing approaches could impact transparency and credibility, and that uncertainty around which spread to use could slow transition efforts.
- 18% (7 respondents) commented that differing approaches would be problematic to justify and communicate to clients.
- 10% (4 respondents) noted different approaches could create bifurcation across markets leading to in unintended basis risk in cross-currency markets.

(ii) 15% (6 respondents) did not anticipate that different approaches to the credit spread adjustment across currencies would be problematic for their firm or the market. Respondents stated different approaches could be accepted by market participants, but it remains more important that they are considered robust and/or an independent vendor published the credit adjustment spread. 5% (2 respondents) noted that the fallback in legacy contracts already differs across currencies and were of the view that resolving to align this language would be considerable work.

(iii) The remaining 8% (3 respondents) did not answer this question.