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Capital Markets Risk Intelligence #1

ISDA launched the IBOR Fallbacks Supplement and IBOR Fallbacks Protocol

The issuance of the much anticipated ISDA 2020 IBOR Fallbacks Supplement and IBOR Fallbacks Protocol (collectively, the “Protocol”) on October 23, 2020, will support in accelerating rate reform and the overall IBOR transition process. With approximately one year left to the discontinuation of LIBOR, organizations are faced with greater urgency in pursuing a more proactive transition process.

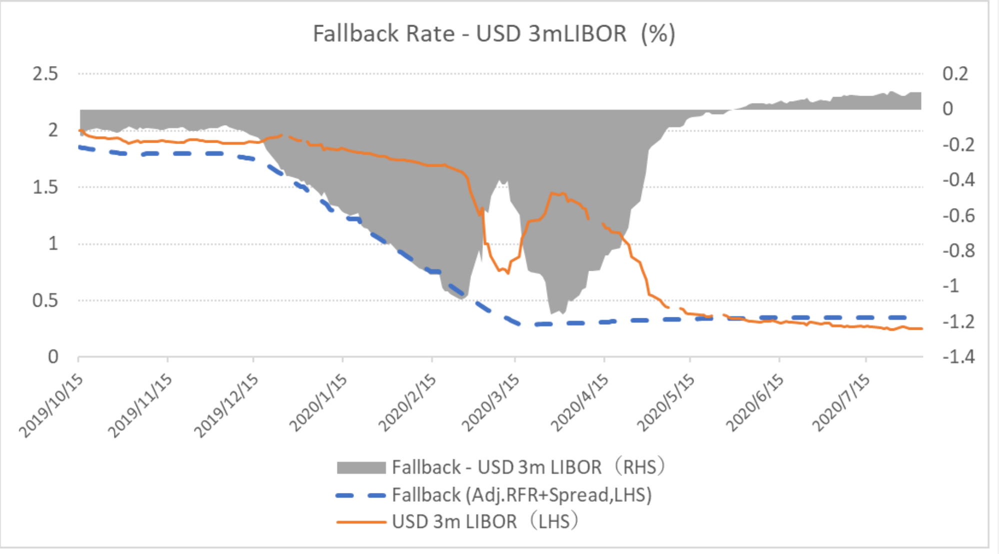
The newly issued Protocol should reduce legacy exposure for organizations that adhere to the ISDA standards for certain classes of financial instruments, insofar institutions incorporate them timely.

BACKGROUND

- Effective January 25, 2021, the IBOR Fallback Protocol and Supplement will cover all derivatives that either “clear” through a central clearinghouse or do nots.
- 257 Financial Institutions (FI) have already submitted Adherence Letters to ISDA as of October 23, 2020, including the two-week pre-launch ‘escrow period’.
- The signing off the protocol will validate adherence to ISDA Master Agreements with LIBOR Fallbacks.
- IBOR Fallbacks of the relevant currencies follow the decision of LIBOR’s permanent discontinuation (by UK FCA). Fallback Triggers encompass Pre-cessation triggers as well as holistic Fallbacks, included with temporary Pre-cessations.
- The introduction of Fallbacks is ‘a robust back-up in case of need’ in order to reduce the systemic risk posed by the abolishment of LIBOR and other IBORs.
- The 2020 IBOR Fallbacks Supplement will modify ISDA Master Agreements defined in 1991, 1998, 2000 and 2006.

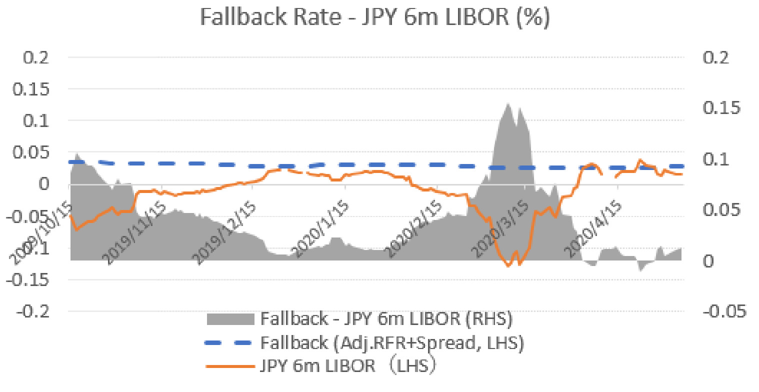
- At cessation, the Compound Rate of a new risk-free-rate ("RFR") will be calculated with a spread (recently published), based on IBOR Fallback Rate Adjustment Rules defined by Bloomberg (see chart below).

USD 3m LIBOR (Amber) vs. estimated Fallback Rate (Blue), indicates a spread (Grey). A positive value means that Fallback is higher.



Source: Bloomberg, the chart is made by DTT

JPY 6m LIBOR(Amber) vs. estimated Fallback Rate (Blue), indicates a spread (Gray). A positive value means that Fallback is higher.



Source: Bloomberg, the chart is made by DTT

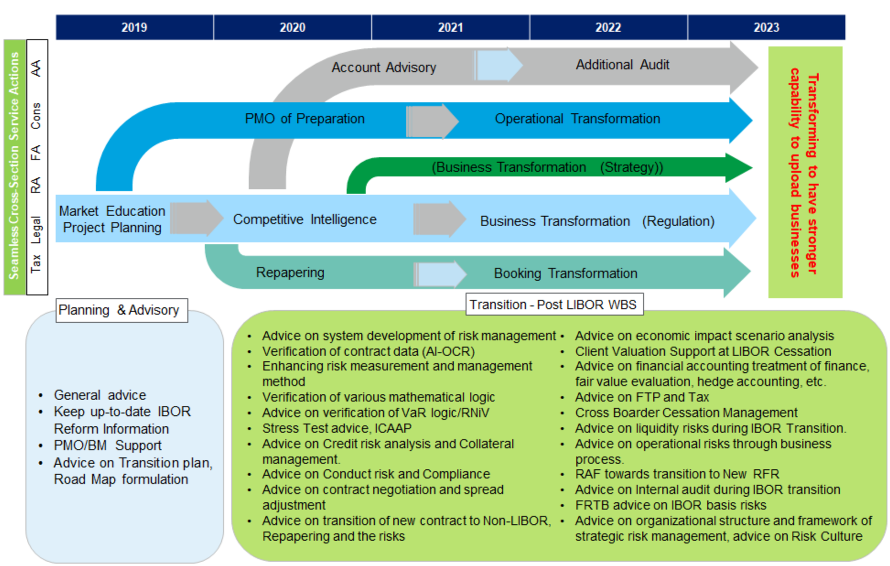
KEY CONSIDERATIONS

- Although the Protocol is expected to be widely applied, not every of FI has committed to executing the Adherence Letters. Furthermore, execution of Adherence Letters does not eliminate Operational risk, Market risk, Credit risk and Liquidity risk, among others, and as such, long-term risk mitigation measures is needed.
- Even with the Fallback Rate– LIBOR spread is approximately 10bps, the economic impact is still expected to be material given large notional values with long term duration, e.g. approx. 1% with 10yr. Therefore it could be a material consideration in terms of long-term funding and verification of hedge accounting.
- Communication and potential bilateral negotiations among FIs related to Repapering (including spread adjustments, etc.) may still be required. Legal uncertainties remain which need to be resolved. Organizations need to clearly

demonstrate how they will monitor, track and conduct oversight over different financial instruments such as Loans, Corporate bonds, Futures, Swap, Options, Structured Notes, etc. Strong program governance and conduct are critical for mitigating potential loss.

- It is unclear how many FIs have performed risk management scenarios, which supports all types of spread risks caused by the transition of IBOR to New RFRs. It is perilous to have an over-optimistic view and treat this as a “one-off” settlement adjustment. The gross derivative exposure associated with long-term contracts is substantial. Hence the valuation gains and losses can be large in a complex portfolio which consists of Long/short, Paying/Receiving, Widener/Tightener positions with complex term structures. In regards to cross-currency basis - basis transfer from LIBOR to OIS – it is likely that the convexity of the curve will change, driving higher volatility. Due to these concerns, it is imperative to consider Market risk and Liquidity risk. For Credit risk, the analysis is required to estimate the cost of Margin, Collateral and CVA/XVA etc.
- It is necessary to comprehensively perform risk management scenarios, before market disruption when LIBOR Cessation getting closer. The chart above of Fallbacks - JPY 6m LIBOR seems relatively tight, but it has been observed that in some cases (such as USD), the spread can be wider.
- Market disruption must be considered in the context of financial reporting and arriving at proper fair values. Recently, in addition to the issuance of the Protocol, the ASBJ issued a new accounting standard in September 2020. In accordance with the new standard, the application of hedge accounting will not be terminated if the hedging relationship becomes ineffective only as a result of a reference rate change due to LIBOR cessation. However, this exemption is temporary through March 31, 2023. Based on the change in the hedged relationship, there will be subsequent challenges ahead in determining the effectiveness of the hedge and ensuring the criteria under standard would be met after the temporary date. In addition to potential changes in valuation methodologies, model valuation and the impact to financial reporting, organizations should be prepared and consider conducting “dry runs” related to operational flows in regards to the changes in values that need to be recorded from the date of LIBOR cessation to the instrument’s settlement date.

OUR COMPREHENSIVE LIBOR OFFERING



The discussions and actions from various point of views through LIBOR Transtion process will be an opportnity to strengthen risk management capability to uphold businesses rather than ad-hoc event. Throughout the transition process, Deloitte Tohmatsu advises complrehensively from accounting, tax, legal, financial risk management points of views.

Prior Artcles related to LIBOR is here <link>

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Appendix (ISDA)

- The IBOR Fallbacks Protocol
- The IBOR Fallbacks Supplement
- High level general guidance in fallbacks
- Details

LIBOR Currency	IBOR	Administrator	Alternative RFR	Alternative RFR Administrator	Public-/Private-sector Working Group
Australian Dollar	Bank Bill Swap Rate (BBSW)	Australian Securities Exchange	Reserve Bank of Australia Interbank Overnight Cash Rate (AONIA)	Reserve Bank of Australia	
Canadian Dollar	Canadian Dollar Offered Rate (CDOR)	Refinitiv	Canadian Overnight Repo Rate Average (CORRA)	Bank of Canada	Canadian Alternative Reference Rate Working Group
Swiss Franc	LIBOR	ICE Benchmark Administration (IBA)	Swiss Average Rate Overnight (SARON)	SIX Swiss Exchange	National Working Group on Swiss Franc Reference Rates
Euro	LIBOR Euro Interbank Offered Rate (EURIBOR)	IBA European Money Markets Institute	Euro Short-term Rate (€STR)	European Central Bank	Working Group on Euro Risk-free Rates
Sterling	LIBOR	IBA	Sterling Overnight Index Average (SONIA)	Bank of England	Working Group on Sterling Risk-free Reference Rates
Hong Kong Dollar	Hong Kong Interbank Offered Rate (HIBOR)	Treasury Markets Association (TMA)	Hong Kong Dollar Overnight Index Average (HONIA)	TMA	Working Group on Alternative Reference Rates under the TMA
Yen	LIBOR Tokyo Interbank Offered Rate (TIBOR) Euroyen TIBOR	IBA Japanese Bankers Association TIBOR Administrator (JBATA) JBATA	Tokyo Overnight Average Rate (TONA)	Bank of Japan	Cross-industry Committee on Japanese Yen Interest Rate Benchmarks
US Dollar	LIBOR	IBA	Secured Overnight Financing Rate (SOFR)	Federal Reserve Bank of New York	Alternative Reference Rates Committee

Source: Understanding IBOR Benchmark Fallbacks (ISDA):

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