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Transitioning towards risk-free rates

An overview of Q4 2019 market publications and an outlook ahead

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January 2020

A word of welcome

It's 2020 and the race towards the finish line of risk-free rates (**RFR**s) implementation is well and truly underway, with EONIA being set to be discontinued after the end of 2021 and LIBOR continuity no longer being guaranteed from that same point in time onwards. It is not surprising then, that the fourth quarter of 2019 was a tumultuous one, bearing witness to key events such as €STR's first publication and the world's first €STR-denominated bond on October 2, discussion on if, how and what forward-looking term rates might look like, as well as a rapid flow of illuminating publications[1], notably in the EU.

Whilst these publications covered a variety of topics related to the EU's Benchmark Regulation (**EU BMR**), one important message echoed across all reports: the clock is ticking for both benchmark providers but also benchmark users – including those located outside the European Economic Area (EU plus Iceland, Liechtenstein and Norway). Equally, from January 2022 onwards, EU-supervised entities can only use third-country benchmarks provided by administrators in a third country provided the European Commission has adopted (1) an equivalence decision; (2) the benchmark administrator has been recognized by an EU competent authority; or (3) the benchmark has been endorsed by an EU supervised entity.

We have therefore compiled a selection of publications (that are relevant from a legal standpoint) issued by a variety of market bodies in the final quarter of 2019, including a short summary of each report and, where relevant, our comments or other important matters that we think might be helpful for market participants. We round off our

[1] Including ICMA's Quarterly Report for the First Quarter – Issue 56 – published January 10, 2020, which despite its specific focus of coverage contains items that are relevant for certain other sectors of financial markets and which is available here: https://www.icmagroup.org/assets/documents/Regulatory/Quarterly_Reports/ICMA-Quarterly-Report-First-Quarter-2020.pdf

selection with a short outlook for 2020 and touch briefly on developments relating to the EU's **BMR Review** that closed for consultation at the end of 2019.

If you would like to find out more about anything in relation to this topic, please reach out to our "Key Contacts" set out at the end of this publication.

01 Working Group on Euro RFRs

The Working Group on Euro RFRs (the **Euro Working Group**) was set up by the European Central Bank (**ECB**) in February 2018. Divided into seven sub-groups, it tackles all manner of issues and areas affected by the shift from the Euro Overnight Index Average (**EONIA**) to the euro short-term rate (**€STR**), as well as delivering helpful commentary on the Euro Interbank Offered Rate (**EURIBOR**)'s amended calculation methodology and its use of €STR as a fallback rate.

4 December 2019

The Euro Working Group publishes a timeline detailing its deliverables

During Q1 2020, the Euro Working Group will be occupied with the following:

In relation to the €STR transition:

- Soliciting advice on risk management & financial accounting topics;
- Communicating & educating around the EONIA to €STR transition.

In relation to EURIBOR fallbacks:

- Preparing a consultation paper on a EURIBOR legal action plan in relation to new and legacy contracts;
- Analyzing suitable fallback benchmarks for cash & derivatives;
- Analyzing suitable transition/credit spreads per identified fallback;
- Preparing a consultation paper on fallbacks & credit spreads;
- Soliciting advice on risk management & financial accounting topics;
- Communicating & educating around the EURIBOR fallbacks.

The Euro Working Group also published a "standardized" but non-exhaustive **checklist** that some firms might find a useful tool for use with internal and external stakeholders as well as further development plans.

12 November 2019

Report by the Euro Working Group on €STR fallback arrangements

In this report, the Euro Working Group recommended several methods that together will provide market participants with sufficient contingency during the transition to €STR. These methods include closely following measures taken by the ECB in relation to its review of the €STR methodology as well as the ECB's recommended procedures in case of a potential cessation of €STR, in addition to using the fallback provisions provided by the Euro Working Group within the "EONIA to €STR Legal Action Plan" (published in July 2019).

Whilst these measures may in themselves be useful, it is insufficient to simply monitor ECB activity and wait for further developments to unfold: the timeline and implementation difficulty of the steps required to ensure a successful transition should not be underestimated, notably with respect to relevant exposures with retail clients or wholesale clients in jurisdictions (notably civil law ones) that require explicit documented client consent and in certain cases limit discretion in setting rates. Implementation of recommended actions ought to be commenced as soon as possible and it must be ensured that policies (e.g. in relation to a potential cessation of €STR) can actually be implemented where a trigger event occurs. The costs of this may be substantial but are outweighed by the risks otherwise incurred, including the expected supervisory scrutiny on firms' readiness that the ECB-SSM is expected to roll-out following its "Dear CEO" letter from July 2019.[2]

6 November 2019

Report by the Euro Working Group: High level recommendations for fallback provisions in contracts for cash products and derivatives transactions referencing EURIBOR

In this report, the Euro Working Group provided several recommendations that those entering into new contracts referencing EONIA/€STR should take into consideration. Specifically, new contracts should:

- Include both permanent and temporary cessation trigger events, and should define the circumstances in which they will apply;
- Include EURIBOR fallback provisions which comply with the EU BMR, where applicable, and with any other applicable national or European law – market participants may wish to consider including generic language in their fallback provisions;
- Contemplate adjustments to address differences between the value of EURIBOR and the value of the fallback rate; and
- Where possible and applicable, include flexible provisions to facilitate the application of new fallback provisions and/or amend the consent levels required for future amendments to the agreements.

[2] See: coverage from our Eurozone Hub available here.

Whilst these comments are helpful, market participants must be aware that they are generic and may not apply to all scenarios, depending on the contractual documentation and features of the underlying product, as well as how local laws deal with the potential discontinuation of contracts. Such matters should be assessed on a case-by-case basis.

22 October 2019

Euro Working Group publishes communication toolkit

In order to enable a smooth transition, the Euro Working Group made available communication materials which interested parties could use in their own communication and education efforts. This communication toolkit currently consists of a list of frequently asked questions to help clear up any remaining uncertainties, a set of slides providing further information on the Euro Working Group and a checklist that may help all those affected by the transition review their progress.

Whilst the toolkit should not be seen as an instruction manual or a template from which to adapt contractual language, it is a helpful and clear overview of the direction in which market participants should be moving. We strongly recommend that market participants review this publication.

25 September 2019 (Q3)

Second roundtable on euro RFRs hosted at the ECB

The second roundtable on euro risk-free rates consisted of panel discussions pertaining to the following topics: (1) transitioning from EONIA to €STR; (2) establishing liquid €STR markets; and (3) €STR-based term structure methodologies as fallbacks for EURIBOR. Our Dentons colleagues were in attendance and compiled an in-depth report on the day's discussions. Please reach out to us if you would like to receive a copy.

02 European Money Markets Institute

The European Money Markets Institute (**EMMI**) is an international non-profit association founded in 1999 whose members are national banking associations in the Member States of the European Union. EMMI is the administrator of two important benchmarks: (1) EURIBOR, the money market reference rate for the euro; and (2) EONIA, the euro interbank overnight lending reference rate, which is currently being transitioned away from to €STR.

28 November 2019

EMMI confirms the successful completion of the phase-in of all EURIBOR panel banks to the hybrid methodology

EMMI confirmed successful completion of the phase-in of all panel banks to the EURIBOR hybrid methodology. The gradual phase-in commenced as far back as Q2 2019 in order to minimize operational and technological risks. Now that the implementation is complete, all panel banks have moved to new contribution and reporting guidelines. The EURIBOR Governance Framework (including the EURIBOR Code of Obligations of Panel Banks and the Benchmark Determination Methodology for EURIBOR) is now fully applicable.

The transition went seamlessly and this may bode well for the various transitions to RFRs. It must, however, be kept in mind that the latter transitions are far more complex and require action by a far greater amount of market participants.

16 October 2019

EMMI publishes its presentation on 'Building a €STR-based term structure' focusing on EMMI's approach in terms of:

- Methodology design;
- Infrastructure;
- Data quality control;
- Governance;
- Compliance;
- Distribution;
- Communication;
- Authorization.

03 Working Group on Sterling Risk-Free Reference Rates

The Working Group on Sterling Risk-Free Reference Rates (**Sterling Working Group**) was established in 2015 to implement the FSB's recommendations to develop alternative RFRs for use instead of LIBOR reference rates. It has focused on the transition from LIBOR to Sterling Overnight Interbank Average Rate (**SONIA**) across sterling markets since 2017.

On January 16, 2020 the Sterling Working Group published its:

1. Priorities and Roadmap for 2020 setting out its planned actions for 2020 including measures to:

- Reduce and cease the issuance of sterling-LIBOR linked cash products by end of 3Q 2020;
- Demonstrate that compounded SONIA is easily available and usable;
- Transition a further shift of volumes from LIBOR to SONIA in derivative markets;
- Establish systems for an orderly transition of legacy LIBOR products by 1Q 2021;
- Evaluate how to address "tough legacy" contracts.

2. "Standardized" Factsheet, Calling time on LIBOR: Why you need to act now, presenting a Q&A on LIBOR transition and grounds why market participants need to act now. a brief Q&A-style factsheet on LIBOR transition, setting out why market participants need to act now.

3. Paper, Use Cases of Benchmark Rates: Compounded in Arrears, Term Rate and Further Alternatives, setting out the Sterling Working Group's views on which types of business and client should use overnight SONIA, relative to alternatives including forward-looking term rates and concludes that SONIA compounded in arrears is fit for use and operationally achievable for 89% of new loans.

4. Paper, Progress on the Transition of LIBOR-Referencing Legacy Bonds to SONIA By Way Of Consent Solicitation, comprising a set of helpful "lessons learned" from recent conversions of legacy LIBOR contracts. The paper sets

out considerations for the conduct of consent solicitations to transition English law legacy bond contracts from LIBOR to SONIA.

18 December 2019

Letter from the Prudential Regulation Authority (PRA) on the prudential regulatory framework and LIBOR transition

The PRA responded to a letter from the Sterling Working Group regarding regulatory capital impediments in relation to the transition to RFRs. This response states that in relation to AT1 and tier 2 capital, the eligibility of instruments need not be reassessed where amendments are exclusively to replace the benchmark reference rate. The PRA's rules on Contractual Recognition of Bail-In and Stay in Resolution might be relevant where legacy contracts are "materially amended", and the PRA plans to provide an update on this in Q2 2020. We presume that this will provide a satisfactory solution.

November 2019

The Sterling Working Group's November 2019 Newsletter

In 2020, the Sterling Working Group will commence beta-testing for term SONIA in Q1 and encourage greater adoption of SONIA in cash markets in order to meet the Q3 target of discontinuing LIBOR issuances. It also announced three new task forces: (1) the Tough Legacy Task Force for contracts unable to transition away from LIBOR; (2) the Cash Market Legacy Transition Task Force to convert existing contracts or update them with robust fallback language; and (3) the Loans Flow Enablers Task Force to support the Sterling Working Group's target of discontinuing GBP LIBOR issuances by Q3 2020.

The Loans Flow Enablers Task Force has a lot of work on its hands would it like to reach the "discontinuation" goal, though all will depend on the level of adoption of SONIA in cash markets, which in turn, depends on its liquidity in derivatives markets.

23 October 2019

The Sterling Working Group sent letters to various institutions, identifying several key areas where appropriate steps could greatly facilitate the adoption of RFRs or the replacement of IBOR exposures with corresponding RFRs. The most important legal aspects from two of the letters have been summarized below.

1. Letter to the Basel Committee on Banking Supervision RE: Regulatory capital impediments to transition from IBOR to new RFR Framework:

In relation to contractual terms, a change to new reference rates could result in securities being deemed "new" instead of existing issuances.

a. Total Loss Absorbing Capacity qualification: The Sterling Working Group recommends that authorities might clarify that the transition to RFRs means that amendments to contractual terms in relation to in-scope liabilities are automatic.

b. Securitizations – Grandfathering Protection: The Sterling Working Group recommends that authorities might clarify that the transition to RFRs means that a change to contractual terms of this nature is not a "new deal".

2. Letter to the European Commission: Removal of pan-European regulatory barriers to transition away from LIBOR and other IBORs:

In relation to contractual terms, a change to new reference rates could result in securities being deemed "new" instead of existing issuances:

a. Minimum Requirement for Own Funds & Eligible Liabilities: Supervisory statements (or similar) might clarify that the transition to RFRs will not lead to securities being considered "new" and require the insertion of terms under bank resolution and recovery legislation. As above, authorities might clarify that the transition to RFRs means that amendments to contractual terms in relation to in-scope liabilities are automatic.

b. Securitizations – Grandfathering Protection: Securitizations "grandfathered" over time could lose this protection if the interest rate is amended and the deals are legally considered "new". As above, authorities might clarify that the transition to RFRs means a change to contractual terms of this nature is not a "new deal".

Ensuring continuity is clearly paramount to the Sterling Working Group, though we are sure that the institutions it has addressed feel the same way. Whilst they have not yet responded or published the proposed items, we anticipate that they will do so in the near future or otherwise take further steps to address the underlying issues.

04 National Working Group on Swiss Franc Reference Rates

The National Working Group on Swiss Franc Reference Rates (**NWG**) was formed to aid the transition to the Swiss Average Rate Overnight (**SARON**), taking into account the latest international developments. The group is made up of financial market participants and other relevant stakeholders, and co-chaired by a private sector representative as well as a representative of the Swiss National Bank.

13 November 2019

Executive summary of the November 12, 2019, meeting of the National Working Group on Swiss Franc Reference Rates

The following recommendations were issued by the NWG:

- As there is sufficient guidance available in relation to compounded SARON, corporations should individually define their product strategy;
- Index providers should introduce a calculator for compounded SARON: the NWG recommends the "lookback" option;
- Market participants are free to decide whether and at what level a floor is applied. If it forms part of the contract and the notional is constant, the floor should be applied to compounded SARON rather than each individual SARON rate.
- Market participants should review whether an "in arrears" structure complies with the laws of their local jurisdiction;
- Market participants should communicate with infrastructure providers to be ready for SARON-based products;
- Market participants should transition away from CHF LIBOR exposures prior to the end of 2021, align fallback language and, where possible, use pre-cessation triggers.

The recommendation that market participants use a pre-cessation trigger is somewhat surprising, as this has been a controversial point for other market bodies.

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05 Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks

The Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks (the Committee) was established in August 2018 to aid interest rate benchmark users with the selection and usage of Japanese yen interest rate benchmarks.

29 November 2019

Main Points of the Final Report on the Results of the Public Consultation on the Appropriate Choice and Usage of Japanese Yen Interest Rate Benchmarks

This report collates the results of a public consultation paper issued on July 2, 2019, which requested feedback in relation 18 issues, including necessary actions in preparation for the permanent discontinuation of JPY LIBOR. To this end, the Committee solicited feedback from a range of entities on five options proposed as alternative benchmarks. The respondents supported most of the recommendations by the Committee and chose benchmarks according to the nature of financial instruments/ transactions.

A. Loans: Most participants preferred Term Reference Rates (Swap) (with JPY OIS as the underlying rate) or Term Reference Rates (Futures) (with overnight call rate futures as the underlying rate) as alternative benchmarks, though banks generally tended to opt for TIBOR; even though hedging TIBOR in relation to derivatives is difficult, it is more compatible with most business operations.

With regard to spread adjustment, only slightly more than 25% of respondents expressed an opinion, and few expressed negative opinions on the Historical Mean/Median Approach. Non-financial businesses and securities companies preferred Term Reference Rates (Swap) (with JPY OIS as the underlying rate) or Term Reference Rates (Futures) (with overnight call rate futures as the underlying rate), followed by O/N RFR Compounding (Fixing in Arrears) (with uncollateralized overnight call rate (Tokyo Overnight Average Rate (TONA)) as the underlying rate). Banks preferred the first of these two options followed by TIBOR. In relation to trigger events, consistency with ISDA derivatives documentation was held to be important, and a majority of respondents agreed that permanent cessation triggers should be introduced.

Most participants preferred a hardwired approach, where a replacement rate is agreed when introducing a fallback provision, thus reducing the decision-making burden. A minority of participants preferred the amendment approach, where a replacement rate is only agreed when a trigger event occurs.

B. Bonds: A majority of respondents preferred Term Reference Rates (Swap) (with JPY OIS as the underlying rate) or Term Reference Rates (Futures) (with overnight call rate futures as the underlying rate). Furthermore, a considerable number of respondents supported O/N RFR Compounding (Fixing in Arrears) (with uncollateralized overnight call rate (TONA) as the underlying rate).

Whilst the results are not too remarkable by themselves, two points stand out: (1) the unpopularity of TONA; and (2) the desire to comply with ISDA, something that the Alternative Reference Rates Committee (**ARRC**) recommended market participants do not do when its provisions conflict with ARRC.

06 Alternative Reference Rates Committee

The Alternative Reference Rates Committee (**ARRC**) consists of various market participants gathered by the Federal Reserve Board and the New York Fed in 2014, with the aim of aiding the transition from USD London Interbank Offered Rate (**USD LIBOR**) to its recommended alternative, the Secured Overnight Financing Rate (**SOFR**).

21 November 2019

SOFR Floating Rate Notes Conventions Matrix, Appendix, and Comparison Chart

The ARRC's Floating Rate Notes Working Group released a report in August 2019 detailing considerations for those interested in using SOFR in new issuances. In November 2019, it issued an additional appendix for those market participants to consider and/or include. Aside from basic recommendations such as using term sheets with key provisions in order to provide greater clarity in relation to the issuance of, or investment in, as well as fallback language for, compounded SOFR-based floating rate notes, it issued the following recommendations:

- Using a compounded SOFR for floating rate notes, in arrears;
- Using a published compounded SOFR index or compounded SOFR calculator, once this becomes available;
- Adding a margin at the end of the compounding period;
- A 3pm observations time and the OIS standard Modified Following Business Day Convention;
- Market participants should follow ARRC-endorsed fallbacks (as modified) despite the fact that these do not precisely match ISDA fallbacks;
- SOFR should be floored for the interest rate period.

This publication serves as a useful guide for anyone who made use of the August 2019 publication. It should be noted, however, that major financial institutions have deviated from each other and from recommendations made in August 2019. Similarly, this appendix contains generic recommendations that can be deviated from.

15 November 2019

Summary of ARRC's LIBOR Fallback Language

ARRC reiterated its recommendations in its Summary in relation to a variety of products (floating rate notes, bilateral business loans, syndicated loans, securitizations and adjustable rate mortgages) and how these will be impacted by the parameters that make up fallback language (trigger events, replacement rates and spread adjustments). It lists a variety of options in relation to each parameter (e.g. permanent, pre-cessation and early "opt-in" triggers) and whether these would be appropriate for each product. As the recommendations are fairly detailed, it is best to refer to the report itself.

Most recommendations, however, are fairly self-explanatory, e.g. early opt-in triggers are recommended for loans but not for floating rate notes or securitizations, whilst the ISDA replacement rate and spread adjustment should only be used for floating rate notes or securitizations and not for loans.

19 September 2019 (Q3)

Practical Implementation Checklist for SOFR Adoption

A checklist was published to aid market participants in transitioning to SOFR. The checklist consisted of the following action points:

1. Establishing a strong governance framework for overseeing the transition, under which senior executives are held accountable;
2. Developing a company-wide and cross-sectoral program to manage the transition and help identify risks, as well as clients and products that are particularly exposed;
3. Implementing a communication strategy to educate internal and external stakeholders;
4. Quantifying and monitoring LIBOR-linked exposures and developing capabilities to value SOFR-based products as part of transitioning toward these;
5. Developing a strategy for transitioning portfolios of LIBOR products to new products based on SOFR;
6. Identifying financial and non-financial risks related to the transition; establishing oversight routines;
7. Understanding the legal impact resulting from transitioning from LIBOR to SOFR and planning / implementing fallbacks;

8. Developing a plan to address data and technology implications in terms of the LIBOR transition;
9. Determining accounting and reporting considerations;
10. Determining tax and regulatory reporting considerations.

This list needs to be adapted to individual circumstances, including firms' types of LIBOR-linked products and their size and volume, as well as risk capabilities.

19 September 2019 (Q3)

Frequently Asked Questions on LIBOR and SOFR

The document answered the following questions:

1. What is the Alternative Reference Rates Committee (ARRC)?
2. Why does the market need a new benchmark interest rate?
3. Which organizations are members of the ARRC?
4. What is the recommended alternative for USD LIBOR and what other rates were considered?
5. What is SOFR and why is it more robust than LIBOR?
6. What is the timeline for the transition from LIBOR to SOFR? Will there be a "term SOFR"?
7. Who administers and produces SOFR and how is the rate production process reviewed?
8. Is SOFR meant to co-exist with LIBOR, or is it meant to replace LIBOR?
9. Who will be impacted by this transition from LIBOR to SOFR?
10. What sort of financial products are expected to reference SOFR?
11. What is "fallback language"?
12. What should market participants do to strengthen fallback language in derivatives?
13. What should market participants do to strengthen fallbacks in cash products?
14. How do we know SOFR is here to stay?
15. How does SOFR compare to other "IBOR" alternatives selected in other countries?
16. Is SOFR too volatile to be used in financial contracts?

07 Loan Market Association

Established in 1996, the Loan Market Association (**LMA**), an authoritative voice of the EMEA syndicated loan market, works with a variety of market participant in order to educate the market and remove barriers to entry, as well as improving liquidity and transparency in syndicated loan markets across Europe and beyond.

25 October 2019

Introducing the LMA exposure draft Reference Rate Selection Agreement

In September 2019, important exposure drafts were published in relation to (i) a compounded SONIA-based sterling term and revolving facilities agreement; and (ii) a compounded SOFR-based dollar term and revolving facilities agreement. An LMA webinar discussing these drafts was held on October 25, 2019. The discussion was as follows:

As RFRs are very different to LIBOR, the transition will have the following consequences:

(1) Moving from LIBOR to a RFR might result in the creation of a new lending product; and

(2) There is a problem regarding the large number of existing lending transactions which extend beyond 2021 and which reference LIBOR. The baseline solution is the amendment of those transactions to move towards the terms and conditions developed for the use of new lending products based on RFRs.

The idea behind the Reference Rate Selection Agreement is streamlining the process of amending a large number of documents by using the same form of agreement across different transactions. The agreement will set out the main commercial terms and options that parties will need to decide on in order to transition to a new reference rate. Importantly, the agreement will also contain authorization for the agent to agree with the obligor on the changes to the underlying facility documentation to implement those commercial terms and options. The agreement contains a two-step process:

(1) Parties will agree on the Reference Rate Selection Agreement and on the commercial terms set out; and

(2) An amendment and restatement agreement will be entered into by the agent and the obligor. The LMA recommended forms will include drafting for RFRs and, in this way, the

drafting of the underlying facility agreement will incorporate the changes and will follow these.

For users of the document the "selection sheet" will be the real key element, as it is the only part of the agreement actually designed to require specific bespoke completion in the context of each individual amendment. The Reference Rate Selection Agreement seeks to agree on the underlying deal that is going to be amended. The aim is to swap LIBOR and to replace it with the LMAs drafting for the relevant RFRs and to authorize the agent to make those changes on behalf of the lenders.

Another important element is margin adjustment. RFRs are so different to LIBOR that there might be an adjustment of the margin. The selection sheet also takes this into consideration. The idea of the selection sheet is to focus the user's mind on all of these key issues and to specify them.

The final part of the exposure draft of the Reference Rate Selection Agreement focuses on its terms and conditions. These do not contain any optionality. The purpose of this is to increase standardization in order to streamline the process. It is of course open to parties to negotiate terms and amend as appropriate.

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08 International Swaps and Derivatives Association

The International Swaps and Derivatives Association (**ISDA**), made up of market participants in the market for over-the-counter derivatives, creates standardized contracts to enter into derivatives transactions.

4 December 2019

ISDA Letter to FSB OSSG on Pre-Cessation Issues

In this letter, ISDA writes to the Financial Stability Board (**FSB**) Official Sector Steering Group (one of the original drivers behind the change in reference rates) in relation to a number of matters, including that market participants should receive clarity in relation to the following:

1. A statement from the UK Financial Conduct Authority (**FCA**) and the ICE Benchmark Administration (IBA) that after the FCA announces that LIBOR is no longer representative, the "reasonable period" during which a "non-representative" LIBOR is to be published will be minimal.

2. A confirmation from central counterparties (**CCPs**) clearing LIBOR derivatives or their regulatory supervisor(s) so that they will immediately adapt or have the power to adapt to the new reference rate when LIBOR is no longer representative.

It also commented that in a letter from the FSB on November, 13, 2019, it was requested to include a pre-cessation fallback trigger alongside permanent cessation triggers as standard language in the definitions for new derivatives, but that respondents surveyed on this did not support, or even opposed, this recommendation.

Lastly, ISDA indicated that it was in the final stages of developing permanent cessation fallbacks and will implement these during the first half of 2020. These fallbacks are based on an industry consultation paper (published on November 15, 2019 – see below), and the adjustments should use a compounded setting in arrears rate with a spread adjustment calculated as the median of the historical differences between the Interbank Offered Rate (**IBOR**) and the corresponding RFR over a five-year lookback period.

15 November 2019

Industry consultation on the adjustment methodologies for permanent cessation fallbacks rates

ISDA published the results of a survey issued on September 18, 2019, relating to the spread and term adjustment in derivative fallbacks for IBORS such as GBP LIBOR, CHF LIBOR, JPY LIBOR and TIBOR, after an initial consultation in 2018 established a strong preference for compounded setting in arrears in order to address the difference in tenors between IBORs and overnight RFRs, and the historical mean/median approach for the spread adjustment to address credit risk between IBORs and corresponding RFRs.

In the September 18, 2019, industry consultation, market participants were asked 16 questions, the answers to which are summarized below:

1. 61% preferred a calculation of a spread adjustment based on a historical median over a five-year lookback period;
2. 52% stated they would not be opposed to or harmed by their non-preferred choice;
3. 86% noted that consistency across IBORs was at least somewhat important;
4. 56% preferred consistency across IBORs over the implementation of their preferred approach to the spread adjustment;
5. 71% of all respondents did not believe a transitional period should be included in the spread adjustment as it might cause unnecessary complications;
6. a majority of respondents felt outliers should be included;
7. 60% reaffirmed their preference not to exclude outliers or were unresponsive;
8. 79% found no compelling reason to exclude any negative spreads from the calculation of the spread adjustment;
9. 86% found no compelling reason not to implement an overall negative spread adjustment;
10. 70% preferred an adjustment period to facilitate payments;
11. 56% supported a two-banking day backward-shift adjustment;
12. of the respondents that supported implementing an adjustment period, approximately 81% preferred using a method other than universal banking days;
13. only 14% expressed concerns about the two-banking day backward-shift adjustment, which was preferred by the 56% of respondents in Question No. 11;
14. respondents were asked to provide information regarding products for which a backward-shift or lockout adjustment period would not work and whether a different type of adjustment would work instead. 33% discussed products they thought might not work if a proposed adjustment period were to be implemented;

15. 49% stated that they did not think using a calculation period instead of the IBOR period would be problematic;
16. 49% of respondents agreed that two banking days was the correct length of time for purposes of applying an adjustment.

These recommendations are of great importance, and mark one of the final ISDA publications aimed at ensuring a smooth transition in the derivatives market. In the first half of 2020, the adjusted RFRs will be published on Bloomberg and market participants will be able to incorporate these recommendations into new transactions and (by adhering to a protocol) legacy transactions. A strong derivatives market will be of great aid to the transition within the cash markets prior to the end of 2021.

28 October 2019

Interest Rate Benchmarks Review: Third Quarter of 2019

The ISDA Interest Rate Benchmarks Review assesses the volume of interest rate derivatives transactions (disclosed under US regulations) referencing SOFR and other alternative RFRs such as SONIA, SARON and TONA (€STR will be added once its volume picks up), as well as interest rate derivatives transactions notional referencing USD, sterling, Swiss franc, yen, euro LIBOR as well as EURIBOR and TIBOR.

Between Q2 and Q3 2019, interest rate derivatives traded notional referencing SOFR increased by 25.4% to $106.3 billion and from 188 to 478 transactions. IRD traded notional referencing SOFR still only accounted for just 0.2% of the total. Trading volume in SOFR futures increased from $4.7 trillion to $10.7 trillion between Q2 and Q3, whilst open interest in SOFR futures went from $558.0 billion to $1.6 trillion between June and September 2019.

Between Q2 and Q3 2019, IRD traded notional referencing alternative RFRs represented 3.6% of the total at $2.5 trillion, up from $1.8 trillion in the second quarter of 2019, and went from 2,934 to 4,342 trades:

• SOFR traded notional increased by 25.4% to $106.3 billion, and trades increased by 154.3% to 478;
• SONIA traded notional increased by 34.7% to $2.3 trillion, and trades increased by 39.5% to 3,704;
• SARON traded notional increased to $11.2 billion and trades to 30;
• TONA traded notional increased to $62.3 billion and trades to 130.

These developments clearly show the great strides that have been made but also how much further there is to go before the end of 2021. However, it is expected that certain events (e.g. CCPs switching to €STR in June 2020) will have a "big bang" effect, leading to exponential growth and a knock-on effect in relation to cash products.

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21 October 2019

Anonymized Narrative Summary of Responses to the ISDA Pre-Cessation Consultation

1. A majority of market participants would not be content to continue referencing a covered IBOR in existing or future derivative contracts following a public statement from the supervisor that that covered IBOR was no longer representative.

2. There were a wide variety of views on the implementation of pre-cessation triggers related to the non-representativeness for derivatives. The responses fell into four categories, without a clear majority in any:

- 14.6% of respondents generally supported adding a pre-cessation trigger to the permanent cessation triggers in a "hard wired" amendment to the 2006 ISDA Definitions but did not specify a preference regarding optionality or flexibility;
- 26.97% of respondents supported the inclusion of a pre-cessation trigger in the 2006 ISDA Definitions and were against the publication of a protocol with optionality or flexibility;
- 22.5% of respondents supported the inclusion of a pre-cessation trigger in the 2006 ISDA Definitions and supported the implementation of a protocol with optionality and flexibility;
- 28.1% of respondents opposed the inclusion of a pre-cessation trigger in the 2006 ISDA Definitions.

3. Almost all respondents favored only a single transition from the covered IBOR to a RFR+ spread adjustment, and "did not want contracts that transitioned upon a pre-cessation trigger to move again upon a permanent cessation event".[3]

Whilst the lack of consensus among participants of this survey in relation to question 2 denotes that there is no one clear solution and that preferences are likely linked to respective market sectors, it is nevertheless discouraging as ISDA can only implement one final option. We presume it will be a more rigid approach but will continue to watch this space.

[3] Section 95.

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1 October 2019

On October 1, 2019, ISDA published Supplements 59 and 60 to the 2006 ISDA Definitions

On October 1, 2019, ISDA published Supplement 59 to the 2006 ISDA Definitions, which added a compounded €STR Floating Rate Option to the 2006 ISDA Definitions, as well as Supplement 60, which embedded robust fallbacks into Floating Rate Options in the 2006 ISDA Definitions which reference EONIA. These supplements amend or add to existing rate options under Section 7.1(f) of the 2006 ISDA Definitions.

The Rate Option Amendments are intended to introduce a compounding floating rate option (**FRO**) referencing €STR and embed fallbacks into FROs which reference EONIA for use in the event that EONIA is permanently discontinued.

The Rate Option Amendments specifically introduce the "EUR-€STR-Compound" and amend the "EUR-EONIA-OIS-COMPOUND", providing new calculation methods as well as additional definitions and qualifiers for each respective rate. The "EUR-EONIA-OIS-COMPOUND" will be valid until an EONIA Index Cessation Effective Date occurs, after which time the rate will be determined as if references to EONIA were references to Modified €STR.

Importantly, both supplements introduce the ECB Recommended Rate as a fallback option in the event that a €STR Index Cessation Event were to occur. This would involve an intermediate step in the case of the "EUR-EONIA-OIS-COMPOUND".

09 Financial Stability Board

The Financial Stability Board (**FSB**) is an international body that monitors the global financial system and issues recommendations in relation to new developments.

18 December 2019

Reforming major interest rate benchmarks: Progress report

This report discusses the implementation of the FSB Report on Reforming Major Interest Rate Benchmarks (from 2014), and the FSB's 2016 initiative to improve contractual robustness in relation to important benchmarks' discontinuation. The 2014 Report contained recommendations for strengthening existing benchmarks for key IBORS in the unsecured lending markets and adopting risk-free reference rates where appropriate.

In summary, these were the key takeaways from the December 2019 progress report:

- The FSB supports ISDA's efforts to amend its 2006 ISDA Definitions and provide protocols making compounded RFRs fallbacks to IBOR-referencing derivatives. It encourages market participants to adopt these solutions;

- Businesses must stop referencing LIBOR in new contracts (and move away from LIBOR in legacy contracts) as soon as possible;

- Whilst progress has been rapid in derivative and securities markets, lending markets must catch up;

- Businesses transitioning towards RFRs must not wait for the publication of forward-looking term versions of RFRs to do so. For most products, overnight RFRs are more suitable than term RFRs. Additionally, where OIS or futures markets are illiquid, other approaches may be required than in markets with more liquid RFR derivatives;

- The parallel transition to RFRs across multiple jurisdictions and currencies provides the opportunity to streamline practices across currencies and products, specifically with regard to derivatives markets, which are in large part already benefitting from such streamlining, as well as cash markets.

Whilst certain features must necessarily be bespoke, alignment offers "longer-term benefits in terms of efficiency, reduction of basis risk and effectiveness of hedges", and simplifies "the process for incorporating […] RFRs into various front, middle- and back-office systems and processes".[4] Indeed, we recommend that market participants aim to align recommendations from various market bodies and use a unified checklist for all types of products and currencies, insofar as possible.

[4] Page 2.

10 International Capital Markets Association

The International Capital Market Association (**ICMA**) is an EU-focused trade association for capital markets participants.

19 December 2019

EU Benchmarks Regulation - European Commission Consultation – ICMA Response

The following responses were submitted in response to the European Commission's BMR Review.

A number of questions were listed, including, amongst others:

Question 1: To what extent do you think it could be useful for a competent authority to have broader powers to require the administrator to change the methodology of a critical benchmark?

ICMA response: It would be useful, as it could help to ensure the continuation of critical benchmarks and avoid market disruption. However, competent authorities and administrators are already mindful of the need to support contractual continuity as far as possible. Further, administrators should be able to compel competent authorities to publish benchmarks until they are no longer critical, rather than just for five years (the current limit).

Question 2: Do you consider that such corrective powers should apply to critical benchmarks at all stages in their existence or should these powers be confined to (1) situations when a contributor notifies its intention to cease contributions or (2) situations in which mandatory administration and/or contributions of a critical benchmark are triggered?

ICMA response: Answer (2).

Question 5: Do you consider that supervised entities should draw up contingency plans to cover instances where a critical benchmark ceases to be representative of its underlying market?

ICMA response: As actions are already being taking, the necessity of including this in the BMR should be queried. If however, any "pre-cessation" trigger were to be included, it should be done in a clear and objective manner.

Question 7: Do you consider that it is currently unclear whether a competent authority has the powers to withdraw or suspend the authorization or registration of an administrator in respect of one or more benchmarks only?

ICMA response: It is unclear and a drafting change to provide more flexibility would be welcome.

Question 8: Do you consider that the current powers of NCAs to allow the continued provision and use in existing contracts for a benchmark for which the authorization has been suspended are sufficient?

ICMA Response: Sufficient, though it would be beneficial if it were clear that these powers could apply in respect of individual benchmarks rather than the administrator.

Question 15: Do you consider that, for administrators authorized or registered in the EU, the register should list benchmarks instead of/in addition to administrators?

ICMA Response: Yes, it would be helpful if the ESMA register listed authorized benchmarks as well as administrators.

Question 24: What improvements in the above procedures [the third country benchmark regime] do you recommend?

There are issues surrounding the third-country benchmark regime. At the time of writing, only eight administrators appeared on the ESMA register. Continued efforts must be made to provide timely equivalence rulings, clear guidance and proportionate application of requirements. "The definition of 'public authority' [should] include third country administrators of FX spot rates in non-convertible and pegged currencies".[5]

The European Commission has since submitted a report containing these responses and others to the European Parliament and European Council, which will take the next steps.

[5] Page 4.

Concluding remarks: 2020 Vision

When viewed as a whole, these publications clearly show common goals but also highlight the disjointedness of several approaches taken by each jurisdiction, despite benchmarks being used by market participants across jurisdictions i.e., Swiss franc LIBOR in the EU. Whilst this can clearly be anticipated in relation to different products, it is surprising that certain jurisdictions take such different approaches in relation to similar products. Closer alignment means a smoother transition and better functioning international markets, and we therefore hope to see the removal of pan-European (and even pan-global) barriers. With so many European (and global) countries being exposed to contracts referencing a variety of currencies (frequently various denominations of LIBOR), coordination across jurisdictions on how to handle IBORs' discontinuation is vital. Overall, we hope that further consensus can be reached in 2020.

As we have seen in several publications above, the first two quarters of 2020 will be incredibly busy (both in terms of RFR market developments and new publications pertaining to them – hopefully providing more information on €STR-based term rates as fallbacks on EURIBOR), following which we hope to see RFR derivatives and cash markets become increasingly liquid after the summer. Now, more than ever, it is vital that market participants make use of the checklists provided in relation to each currency their products or contracts are linked to, especially where these can be consolidated into a uniform approach for documentation and non-documentation workstreams for supervised and non-supervised entities.

While the EU will publish the outcomes of the BMR Review[6], some of this is subject to on-going political developments, including with respect to finalizing the EU's work on

[6] Which is required to focus on:

- the functioning and effectiveness of the rules applicable to critical benchmarks, the mandatory administration and mandatory contribution rules and the definition of a critical benchmark;

climate-related benchmarks as well as the EU's report, scheduled 1 April, 2020 on the operation of third-country benchmarks within the EU. The outcomes of the EU's BMR Review are not expected to lessen the regime and nor is the supervisory scrutiny from the ECB-SSM expected to be reduced. The EU, however, is expected to take targeted measures to improve continuity by allowing temporary and limited use of non-compliant benchmarks by supervised entities where an authorization of an administrator has been withdrawn.

Other political developments are likely to impact the European Commission's ongoing review of how it grants equivalence decisions. For EU BMR equivalence assessments specifically, it has stated that it will focus on evaluating those countries that have either adopted IOSCO-compliant benchmark rules or are developing those before January 1, 2022. The European Commission has clarified that any equivalence decision may be limited to specific benchmarks, which might affect a wide-range of indices administered outside of the EU beyond the expiry of the (extended) transitional period by the end of 2021. The first decisions stating that administrators of certain interest rates and foreign exchange rates in Australia and Singapore are subject to legally binding requirements that are sufficiently equivalent to those under the EU BMR were adopted in July 2019.

Lastly, it is important to remember that the information presented in the publications discussed herein ought to in all cases be tailored to the individual entity and that obtaining professional advice is strongly recommended. There are great risks involved in falling behind but if the transition goes as smoothly as that of EURIBOR (which is easier said than done), we will have a more reliable, transparent and regulation-compliant set of benchmarks in two years' time – and that may well be worth the effort.

- the effectiveness of the authorisation, registration and supervision regime applicable to benchmark administrators, the benchmark colleges as well as the appropriateness of supervision of certain benchmarks by an EU body;
- the functioning and effectiveness of Art. 19(2) EU BMR on certain commodity benchmarks, in particular the scope of its application.

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