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MANAGING LIBOR DERIVATIVES - FAQs FOR CORPORATE TREASURERS

January 2021

The ISDA IBOR Fallbacks Supplement (the Supplement) and Protocol (the Protocol) were published last October, but are currently the subject of increasing focus as their effective date, 25 January, becomes imminent. Many corporate treasurers are considering whether the Supplement and/or the Protocol should be applied to their LIBOR derivatives - and if so, what action they need to take and when.

Many non-financial corporates that use LIBOR derivatives will wish to amend the terms of their trades to include the risk-free rate (RFR) based fallbacks provided for in the Supplement and the Protocol. The question will then be which mechanism to use to achieve this most efficiently. This decision will be driven by the nature and size of the company's portfolio as well as to what extent the ISDA terms require adjustment to meet its hedging needs.

This Briefing answers some of the questions we are being asked most frequently by corporate treasury teams regarding how to manage the transition of LIBOR derivatives to RFRs.

Frequently asked questions

What do the Supplement and the Protocol do?

The Supplement and the Protocol are primarily designed to facilitate the transition of derivatives from LIBOR by substituting applicable LIBOR rates for new non-LIBOR fallbacks. These non-LIBOR fallbacks comprise the relevant RFR compounded in arrears, plus a credit spread adjustment (CAS) calculated based on the five year historic average spread between the LIBOR and the

RFR. The compounded RFRs, spread adjustments and all-in fallback rates will be published by Bloomberg.

In the context of LIBOR derivatives, both the Supplement and the Protocol replace the relevant LIBOR with the fallbacks built from RFRs on the permanent cessation of the relevant LIBOR. The non-LIBOR fallbacks may also be applied if the relevant LIBOR ceases to be representative of the underlying market it is intended to measure (the so-called "pre-cessation trigger", which will be the subject of an announcement by the Financial Conduct Authority).

What is the difference between the Supplement and the Protocol?

The Supplement and the Protocol contain the same fallbacks. They are in essence, two methods of achieving the same outcome. The difference is in their scope i.e. the trades which they are designed to apply to.

The Supplement is aimed at LIBOR transactions entered into from 25 January (the effective date of the Supplement). The Supplement amends the 2006 ISDA Definitions to incorporate the new non-LIBOR fallbacks. The result is that any IBOR-referencing transactions entered into from 25 January which adopt the 2006 Definitions will therefore also include the non-LIBOR fallbacks.

The Protocol is aimed at legacy LIBOR transactions i.e. pre-existing LIBOR transactions entered into prior to the date of the Supplement (although there are some limited circumstances in which it can apply to new transactions). When two parties have adhered to the Protocol, all IBOR-referencing transactions existing between them are automatically amended to incorporate the non-LIBOR fallbacks. The Protocol applies not only to transactions governed by the 2006 ISDA Definitions but also the 2000 ISDA Definitions, amongst others. The Protocol can even apply to certain non-ISDA documents.

Do I need to do anything if I wish the terms of the Supplement or the Protocol to apply?

The terms of the Supplement (including the new fallbacks) will apply to any derivatives contracts which according to their terms, incorporate the 2006 ISDA definitions entered into from 25 January 2021, without further action. The Supplement will not apply to derivatives that do not incorporate the 2006 Definitions, although it is relatively unusual for that to be the case in the context of corporate interest rate hedging.

Legacy LIBOR deals i.e. trades entered into prior to 25 January (or those to which the Supplement does not apply) do require positive action by the

parties to ensure they are not disrupted when the LIBOR ceases or a pre-cessation event occurs. Existing fallbacks (e.g. to rates gleaned from dealer poll) were designed to deal only with the temporary unavailability of a LIBOR and are not generally considered suitable or safe to rely on upon a permanent discontinuation of the relevant rate.

This means that treasurers must take steps to amend their legacy trades – either by adherence to the Protocol or by agreeing amendments bilaterally. See "*Legacy trades: Protocol or bilateral amendments?*" below for further details on this.

Legacy trades: when do amendments need to be in place?

Whether the amendments are to be effected by bilateral agreement or by adherence to the Protocol, the short answer is as soon as reasonably practicable. LIBOR is anticipated to cease in its current form at the end of 2021. UK firms are aiming to transition the bulk of legacy LIBOR transactions to alternative rates during Q2 and Q3 of 2021, in line with the targets set by the Sterling RFRs Working Group. Pressure to transition loans and bonds during this period may prompt treasurers to deal with related derivatives at the same time (see further below). Corporates are likely to find that their financial counterparties are keen to get arrangements in place to transition their book from LIBOR as early as possible this year.

In the context of the Protocol, note that the effective date of 25 January is simply the date on which the amendments effected by the Protocol will take effect in transactions between parties that have chosen to adhere to it. 25 January is not a cut-off date for adherence. The terms of the Protocol will become effective to amend existing trades at the point both adherents have adhered to it, even if that happens after 25 January. ISDA has indicated that it will give notice if the Protocol becomes subject to a cut-off date.

Treasurers may be aware that it has recently been indicated that certain USD LIBOR rates may continue to be published beyond the end of 2021 to June 2023 (this is currently the subject of consultation). This is to facilitate the run-off of certain legacy transactions. It is not currently thought likely to push out the end 2021 transition target date for USD LIBOR derivatives, although if the Supplement or Protocol are applicable, the RFR-linked fallbacks will not be triggered in respect of USD LIBOR until the date of actual cessation (or pre-cessation, if applicable).

Legacy trades: Protocol or bilateral amendments?

Should corporates amend legacy LIBOR derivatives bilaterally or is it worth adhering to the Protocol? The answer is "horses for courses".

The decision will depend on whether the derivatives are to be amended to incorporate the standard ISDA fallback triggers and fallback rates or whether bespoke terms are required. Bespoke terms might be driven by the need for closer alignment of the terms applicable to certain derivatives with fallback triggers and rates in related loans and bonds (see further below). If bespoke terms are desirable, the contracts will need to be amended bilaterally.

If bespoke terms are concluded to be unnecessary, the company will need to decide whether the ISDA terms should be incorporated by bilateral amendment or whether it should adhere to the Protocol. The number of derivatives counterparties to be dealt with will be a consideration as will whether those counterparties have adhered to the Protocol. The Protocol provides a means for a party to adhere to its terms on a multilateral basis in respect of trades entered into with any of its counterparties. However, it will only be effective to the extent its counterparties have similarly adhered.

A combination approach is also possible. A corporate may decide to adhere to the Protocol for its vanilla trades and also to enter into specific bilateral amendments for structured transactions.

If amendments are to be made bilaterally, ISDA has published a number of template forms of bilateral amendment agreements. These allow for the most common amendments parties are likely to make, which include the exclusion of certain documents from (or including certain documents within) the scope of the Protocol.

How do the ISDA fallback triggers and rates differ from those being used in the cash markets?

A question on the mind of many treasurers is how precisely the applicable LIBOR successor rates applicable to their derivatives need to be aligned with those applicable to their loans and other post-LIBOR cash products. A related question is whether the successor rates need to apply at the same time (e.g. whether the swap and a loan it is intended to hedge need to apply the same fallback triggers).

The ISDA fallbacks are broadly, but not entirely consistent with the approach to fallbacks in the loan and bond markets. However, the differences do not

necessarily lead to the conclusion that the ISDA fallbacks are unsuitable for derivatives hedging loans and bonds. While there are some discrepancies between the approaches to the use of RFRs in the cash and derivatives markets, the fallbacks and proxy rates being used to transition to RFRs have the common feature of being designed to be as far as possible, economically equivalent to LIBOR. The scope of any basis risk arising out of the cash product fallbacks and the ISDA fallbacks not being exactly matched (either in terms of applicable RFRs or in terms of the timing of application) – and whether it is sufficiently material to warrant deviation from the ISDA Supplement/Protocol terms - is a point to be explored in context. This is an issue we are currently discussing with many of our treasurer clients. Companies may also need to consider whether any difference in basis between their derivatives and the underlying loan or bond will affect the availability of hedge accounting treatment.

Note that for transactions where close alignment is desirable, ISDA is working on new 'rate options' for daily RFRs to be added to the 2006 ISDA Definitions, reflecting more closely the compounding convention for RFRs being used in the loan market.

"Active" Transition or Transition by way of Fallback?

It is possible to transition derivatives to non-LIBOR rates prior to the application of the fallbacks by entering into new contracts linked to a non-LIBOR rate. It is also possible, although slightly more complex, to amend/replace existing LIBOR linked contracts such that a non-LIBOR linked rate is referenced from the point of amendment/replacement.

So called "active" transition to RFRs in advance of the application of the ISDA fallbacks is most likely to be a consideration for corporates which have decided to transition related cash products (loans and bonds) to RFRs during the course of this year (i.e. prior to the application of the cessation/pre-cessation triggers for the application of the ISDA fallbacks). As noted above, the need to do so will depend on how closely the hedging and the hedged item should be aligned.

Action points

- **Assess your portfolio**: A stocktake of your derivative contracts will tell you whether they reference an IBOR, what the current fallbacks are, how many counterparties are involved, when the transactions are expected to mature and the exposure of those trades. This will give

you information to decide whether to adhere to the Protocol, enter into bilateral amendments or whether you want to actively restructure your trades or compress your portfolio.

- Consider accounting, tax, operational and systems implications of the move to RFRs: Treasury, legal, tax and operational teams should be fully joined up to make sure the transition can be implemented consistently and smoothly. Tax implications will need to be confirmed in the UK and in any other relevant countries (note that HMRC has issued Guidance on the UK tax implications of LIBOR transition which references ISDA's IBOR Fallbacks documentation). Consult your advisers if anything is unclear.

- Make contact with your counterparties and advisers to discuss your preferred approach: As outlined in this Briefing, treasurers have choices regarding how to transition derivatives and exploring them sooner rather than later is likely to be beneficial.

Key ISDA documents at a glance

- **IBOR Fallbacks Supplement**: Amends the 2006 ISDA Definitions to include new IBOR fallbacks. The new fallbacks will automatically apply to new transactions incorporating the 2006 ISDA Definitions entered into on or after 25 January 2021.

- **IBOR Fallbacks Protocol**: Amends existing contracts between adhering parties to include new IBOR fallbacks. Parties can decide which of their existing contracts the Protocol can apply to.

- **Bilateral agreements**: Template bilateral agreements aimed at amendments to existing transactions that will commonly be agreed bilaterally.

Further reading

- ISDA: Benchmark Reform and Transition from LIBOR
- Bank of England: Transition to sterling risk-free rates from LIBOR ISDA
- Protocol FAQ
- ISDA User Guide to IBOR Fallbacks and RFRs

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January 2021