Risks Related to the Use of Benchmarks in Derivatives

This section shall be read in conjunction with the section entitled “General Risks Related to the use of Benchmarks”.

Typically, derivative transactions that reference interest rate Benchmarks incorporate standard terms such as the 2006 ISDA Definitions, published by the International Swaps and Derivatives Association, Inc. (ISDA). Under the 2006 ISDA Definitions, if a Benchmark ceases to be available, the fallback for a number of Benchmarks is for the calculation agent to determine a rate based on quotations provided by reference banks.

The 2006 ISDA Definitions generally do not provide any further fallback if insufficient or no quotations are provided by reference banks. Thus, the payments under, and the value of, the relevant derivative transactions would be uncertain in such circumstances. For derivatives transactions that are cleared through central clearing counterparties (CCP), the rulebook of such CCPs may allow the clearing house to determine a substitute or fallback rate. Certain CCPs, including LCH and CME, have issued statements supporting the industry-wide moves to reform Benchmarks, including the work ISDA has been doing on contractual fallbacks.

ISDA has undertaken the following to enhance contractual robustness:

1. ISDA has published the ISDA Benchmarks Supplement (Benchmarks Supplement) and a related protocol. Amongst other things, the Benchmarks Supplement, when used in combination with the relevant ISDA definitional booklets, incorporates fallback arrangements which apply if a benchmark ceases to be provided, fallback arrangements which apply if a benchmark or administrator is not authorised in accordance with applicable law, and acknowledgements regarding the consequences following a change to benchmark.

2. ISDA has also consulted the market to create more robust fallbacks for derivatives transactions referencing LIBOR and certain other IBORs under the 2006 ISDA Definitions. Based on the ISDA consultations, there is support for fallbacks based on the relevant identified RFR, adjusted for term using the ‘compounded setting in-arrears approach’, plus a spread adjustment using the ‘historical mean/median approach’. The ‘term adjustment’ is applied as the RFRs are overnight rates whereas IBORs are term rates, and the ‘spread adjustment’ is applied to reflect the bank credit risk premium (and various other factors) incorporated in an IBOR but absent from an RFR. Once details on the fallback methodology are finalised, ISDA will publish one or more Supplements to the 2006 ISDA Definitions, that will incorporate the new fallbacks, for use in new transactions (Revised 2006 ISDA Definitions). ISDA will also publish a related protocol (ISDA Protocol) that market participants can adhere to amend legacy derivatives transactions that adherents have entered into prior to the publication of such Supplement.

You may want to consider either adhering to the ISDA Protocol or bilaterally amending such derivative contracts to include the new fallbacks for your legacy contracts. Adherence to the ISDA Protocol will amend contracts with other adhering parties so that such contracts include the fallbacks but will not result in inclusion of the fallbacks in contracts with counterparties that do not adhere. The ISDA Protocol will provide for standard amendments to include the new fallbacks but bilateral amendments could be used...
to amend contracts with all counterparties that agree to the bilateral amendments on terms that are mutually agreeable to the relevant counterparties. Even after ISDA implements the fallbacks in the 2006 ISDA Definitions, the application of the fallbacks in the 2006 ISDA Definitions may result in a mismatch between the rate referenced in your derivatives and your other financial instruments, including potentially those that are intended as hedges. You should review the terms of your derivatives and your other financial instruments to determine if adhering to the ISDA Protocol or entering into appropriate bilateral amendments will meet your hedging objectives. You should also consider the tax, accounting and regulatory implications of executing and then potentially amending your derivatives.

If you enter into new derivatives under the Revised 2006 ISDA Definitions, in the event that LIBOR and certain other IBORs are discontinued, such derivatives will reference an adjusted version of the relevant RFR, a rate that is inherently different from IBOR in the event that the relevant IBOR is discontinued. LIBOR, and certain other IBORs, are forward looking term rates that are meant to represent a bank’s cost of funding over various tenors, whereas the alternative RFRs are overnight nearly-risk free rates and the relevant adjustments will not perfectly account for these differences on an ongoing basis. Timing for any discontinuation of LIBOR may vary across different currencies and tenors in which LIBOR is currently produced and such timing may differ from the timing for any discontinuation of other IBORs. In addition, the discontinuation of LIBOR may result in a mismatch between the rate referenced in your derivatives and your other financial instruments, including potentially those that are intended as hedges (even if the hedged instruments contain updated fallback provisions, unless those provisions are based on the fallbacks in the Revised 2006 ISDA Definitions).

For derivative transactions that are traded other than under the 2006 ISDA Definitions, you should understand the potential legal, regulatory and financial impact on those transactions of possible changes in, or disruption to, Benchmarks referenced in those transactions, and that it may be necessary to take additional action in relation to such transactions since solutions such as those made available by ISDA may not be available.

Parties to derivative transactions may also have entered into (or will enter into) related credit support documentation (such as ISDA credit support annex). These documents may also reference certain interest rate Benchmarks and consideration must be given to the consequences of any change in, disruption to, and cessation of, any such Benchmarks, or the transition of any such Benchmarks to another Benchmark.