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Developments Concerning LIBOR and Benchmark Reform Transition - December 2019

[32115]

December 19, 2019 TO: ICI Members
Investment Company Directors
ICI Global Members
Derivatives Markets Advisory Committee
Fixed-Income Advisory Committee
Municipal Securities Advisory Committee SUBJECTS: Derivatives
Disclosure
Fixed Income Securities
Fund Accounting & Financial Reporting
International/Global
Investment Advisers
Municipal Securities
Operations
Trading and Markets RE: Developments Concerning LIBOR and Benchmark Reform Transition - December 2019

I. CFTC No-Action Relief for Transitioning from LIBOR

The CFTC Divisions of Swap Dealer and Intermediary Oversight (DSIO), Market Oversight (DMO), and Clearing and Risk (DCR) recently each issued a no-action letter[1] intended to provide relief to swap dealers and other market participants with respect to the transition from LIBOR and other IBORs to alternative reference rates.

A. CFTC Letter 19-26

In letter 19-26, DSIO granted conditional no-action relief to market participants who make "Qualifying Amendments" to uncleared Legacy Swaps[2] and Pre-Transition Swaps.[3] For purposes of the relief, a Qualifying Amendment includes the amendment of an uncleared swap that references an IRR solely to (i) include new fallback language to alternative reference rates triggered by permanent discontinuation of LIBOR or other IBORs or a determination that they are non-representative,[4] or (ii) accommodate the replacement of IRRs in the swap.[5]

Specifically, DSIO will not recommend enforcement action if:

- For purposes of making a determination of whether it exceeds the de minimis threshold of aggregate gross notional amount of swaps and meets the definition of "swap dealer,"[6] if a person excludes a swap that references an IRR to the extent the swap only would be required to be included as a consequence of making a Qualifying Amendment to the swap.
- A swap dealer does not comply with the CFTC Margin Rule[7] with respect to Legacy Swaps, to the extent such compliance would be required as a consequence of a Qualifying Amendment to such Legacy Swap.
- A swap dealer does not comply with the CFTC Margin Rule with respect to transitioning portfolios of Legacy Swaps from IRRs by using one or more new basis rate swaps[8] rather than amending the swaps, so long as the basis swap (i) references only one or more Legacy Swaps for purposes of the CFTC Margin Rule; (ii) is entered into solely to achieve substantially the same effect as would be obtained by making a Qualifying Amendment; and (iii) does not have the effect of extending the maximum maturity or increasing the aggregate total effective notional amount of the Legacy Swaps.
- A swap dealer does not comply with the external business conduct requirements with respect to Legacy Swaps, to the extent such compliance would be required solely as a consequence of a Qualifying Amendment to such swap. Swap dealers would still be required to provide material information about the new rates that will replace IRRs in the Legacy Swap so that counterparties can better understand the rates.
- A swap dealer does not comply with the CFTC swap trading relationship documentation rules[9] with respect to a Qualifying Amendment to a Legacy Swap that is made pursuant to a multilateral protocol (e.g., an ISDA protocol). This relief also extends to requirements regarding confirmations, swap trading relationship documentation, and reconciliation.
- Subject to specified conditions, if a swap dealer does not comply with the CFTC Margin Rule with respect to Qualifying Amendments to swaps with non-financial entities (i.e., commercial end-users and cooperatives) that are excepted or exempted from the CFTC's clearing requirement.[10]

B. CFTC Letter 19-27

In Letter 19-27, DMO provided time-limited no-action relief concerning the application of the trade execution requirements under Commodity Exchange Act section 2(h)(8)[11] if market participants use various mechanisms to transition swaps from IBORs to risk-free rates, including making amendments for fallback language to replace an IBOR, upon its cessation, with a risk-free rate (either pursuant to an ISDA protocol or entered into bilaterally), making replacement rate amendments before the cessation of an IBOR, or trading new swaps that reference risk-free rates (collectively, "IBOR Transition Mechanisms"). Until December 31, 2020, DMO will not recommend enforcement action for failure to comply with the section 2(h)(8) trade execution requirements for swaps that are amended or created by an IBOR Transition Mechanism for the sole purpose of replacing the applicable IBOR with a risk-free rate.

C. CFTC Letter 19-28

In Letter 19-28, DCR provided time-limited no-action relief with respect to compliance with the swap clearing requirements under Commodity Exchange Act section 2(h)(1)(A) and associated CFTC regulations when swap counterparties amend Uncleared Legacy IRS to reference risk-free rates instead of IBORs.[12]

DCR's letter provides that, until December 31, 2021:

- The Division will not recommend enforcement action for failure to comply with the CFTC's interest rate swap clearing requirements when counterparties amend an Uncleared Legacy IRS by adding a Fallback Amendment to change specified IBORs to applicable risk-free rates, in the event the existing floating rate is unavailable, permanently discontinued, or has been determined to be non-representative.[13] The no-action relief is not available if the fallback amendment (i) extends the maximum maturity of an Uncleared Legacy IRS, or (ii) increases the total effective notional amount of an Uncleared Legacy IRS. The relief also will not apply if the original counterparties to the Uncleared Legacy IRS change, or if the swap was voluntarily submitted for clearing to a derivatives clearing organization (DCO).
- The Division will not recommend enforcement action against non-financial end-users that rely on an exception or exemption from clearing if, subject to specified conditions, they fail to submit a swap that otherwise is required to be cleared to a DCO for clearing pursuant to CFTC regulation 50.2. DCR also provided related no-action relief with respect to certain documentation requirements for these end-users.

II. Financial Stability Board Report on Reforming Major Interest Rate Benchmarks

The FSB issued a report on the progress being made across the globe in the transition from IBORs to alternative risk-free rates.[14] The FSB particularly cites concerns with continued use of LIBOR, where the lack of applicable wholesale unsecured funding markets continues to exist without a likelihood to change. The FSB concludes that continued reliance of global financial markets on LIBOR poses risks to financial stability.

The report makes several additional high-level findings, including:

- The FSB notes that the transition in lending markets has been slower than that in securities and derivatives markets and must accelerate.
- The FSB warns that firms that have not yet begun their benchmark transition work in earnest run significant financial and reputational risks. Further, regulators in multiple jurisdictions have increased their oversight of regulated entities' IBOR transition.
- Firms should not delay their implementation work while waiting for the emergence of possible forward-looking term risk-free rates. The FSB believes that overnight risk-free rates can be suitable in the bulk of cases where an IBOR is currently used.
- The FSB encourages the alignment of conventions and practices across jurisdictions and products. It believes such alignment could offer the benefits of efficiency, reduction of basis risk, and simplifying operations.

III. ISDA Consultation on Fallbacks for Derivatives Referencing Euro LIBOR and EURIBOR

Finally, ISDA has issued a supplemental consultation on the spread and term adjustments that would apply to fallbacks for derivatives referencing Euro LIBOR and EURIBOR.[15] The consultation also inquires whether the same adjustments would be appropriate to use in fallback language for other, lesser-used IBORs as well.

ISDA notes its previous consultations regarding the spread and term adjustments for other IBORs.[16] Respondents to those consultations preferred the compounded setting in arrears rate and the historical mean/median approach.[17] With respect to spread adjustments for other IBORs, a majority of respondents preferred a calculation of the spread adjustment on a historical median over a five-year lookback period.[18]

ICI is not planning to comment on this consultation but encourages member firms to comment directly if you have feedback to provide. ISDA has requested feedback by January 21, 2020.

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endnotes

[1] *See* https://www.cftc.gov/PressRoom/PressReleases/8096-19. The no-action letters are *available at* https://www.cftc.gov/LawRegulation/CFTCStaffLetters/letters.htm.

[2] The letter defines "Legacy Swaps" as uncleared swaps that were entered into prior to the compliance date of a particular regulatory requirement, with the result that such requirement did not apply to those swaps.

[3] The letter defines a "Pre-Transition Swap" as an uncleared swap (including a Legacy Swap) that was entered into prior to the effective date of a Fallback Amendment or a replacement rate amendment. The letter defines a "Fallback Amendment" as an amendment to a swap solely for the purpose of including fallbacks triggered only by (i) permanent discontinuation of an Impaired Reference Rate (IRR) or (ii) a determination that an IRR is non-representative. It defines a "replacement rate amendment" as a voluntary conversion by a market participant of IRR-linked uncleared swaps to alternative reference rates prior to the permanent cessation of the applicable IRR or a determination that it is non-representative.

[4] For purposes of this letter, the Division defines these rates and any replacement rates that do not meet counterparties' commercial needs (such as temporary replacement rate) as "Impaired Reference Rates" or IRRs.

[5] For purposes of the relief, a Qualifying Amendment may include ancillary changes to existing trade terms to conform to different market conventions, resulting, for example, in different reset dates, fixed/floating leg payment dates, business day conventions, and day count fractions. However, a Qualifying Amendment may not include any amendment that (i) extends the maximum maturity of a swap or a portfolio of swaps beyond what is necessary to accommodate the differences between market conventions for an IRR and its replacement, or (ii) increases the total effective notional amount of a swap or the aggregate total effective notional amount of a portfolio of swaps beyond what is necessary to accommodate the differences between market conventions for an IRR and its replacement. These limitations are intended to harmonize the no-action relief with amendments to uncleared swap margin rules that the Prudential Regulators have proposed. The Prudential Regulators' proposal is *available at* https://www.fdic.gov/news/board/2019/2019-09-17-notice-dis-b-fr.pdf. For a summary of the Prudential Regulators' proposal, *please see* ICI Memorandum No. 31989 (Oct. 1, 2019), *available at* https://www.ici.org/my_ici/memorandum/memo31989.

[6] *See* Commodity Exchange Act Section 1a(49)(D) and subparagraph (4) of the definition of swap dealer in 17 CFR 1.3 (providing that a person shall not be a deemed to be a swap dealer until its aggregate gross notional amount of swaps connected with swap dealing activity, during the preceding 12 months, exceeds the gross notional threshold).

[7] *See* Margin Requirements for Uncleared Swaps and Major Swap Participants, 85 FR 636 (Jan. 6, 2016).

[8] Such basis rate swaps would swap the entire IRR basis for a portfolio with an alternative reference rate basis without amending any of the swaps referencing IRRs.

[9] *See* Commission Regulation 23.500 – 23.504 (CFTC swap trading relationship documentation rules).

[10] DSIO provided related no-action relief with respect to the status of certain end-users as ECPs and documentation requirements with respect to non-financial end-users.

[11] Broadly, section 2(h)(8) requires swap transactions subject to the clearing requirement to be executed on a designated contract market or swap execution facility (either registered with the CFTC or exempt from registration) unless no designated contract market or swap execution facility makes the swap available to trade or the relevant swap transaction is subject to the clearing exception under the Commodity Exchange Act.

[12] The letter defines “Uncleared Legacy IRS” as uncleared swaps that were executed prior to the compliance date on which swap counterparties were required to begin centrally clearing interest rate swaps pursuant to the CFTC’s swap clearing requirement, and are subsequently amended by adding a Fallback Amendment.

[13] The letter provides relief only with respect to Uncleared Legacy IRS being amended from—to: GBP LIBOR – SONIA; CHF LIBOR – SARON; JPY LIBOR – TONA; USD LIBOR – SOFR; and SGD SOR-VWAP – SORA. DCR notes, however, that it will consider providing additional relief for amendments to Uncleared Legacy IRS to transition from other IBOR floating rates to their identified risk-free rates when relevant authorities in foreign jurisdictions announce plans for such transitions.

[14] Reforming major interest rate benchmarks: Progress report; *available at* https://www.fsb.org/wp-content/uploads/P181219.pdf.

[15] Supplemental Consultation on Spread and Term Adjustments, including Final Parameters thereof, for Fallbacks in Derivatives Referencing EUR LIBOR and EURIBOR, as well as other less widely used IBORs, *available at* https://www.isda.org/a/xayTE/EUR-LIBOR-EURIBOR-Fallbacks-Consultation-FINAL.pdf.

[16] Specifically, BP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR, BBSW, USD LIBOR, CDOR and HIBOR.

[17] *See* Anonymized Narrative Summary of Responses to the ISDA Consultation on Term Fixings and Spread Adjustment Methodologies, *available at* http://assets.isda.org/media/04d213b6/db0b0fd7-pdf/; Summary of Responses to the ISDA Supplemental Consultation on Spread and Term Adjustments, *available at* https://www.isda.org/a/0LPTE/2019.09.18-Anonymized-ISDA-Supplemental-Consultation-Report.pdf.

[18] *See* Summary of Responses to the ISDA Consultation on Final Parameters for the Spread and Term Adjustments, *available at* https://www.isda.org/a/935TE/2019.11.15-ISDA-Final-Parameters-Consultation-Report.pdf.
