ISDA. Safe, Efficient Markets

British Bankers Association
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Response from the International Swaps and Derivatives Association Inc. ("ISDA") to the BBA Consultation Paper on the Proposal to Implement Recommendation Number 6 of "The Wheatley Review of LIBOR".

Dear Sirs,

ISDA represents a broad global range of over 800 OTC derivatives market participants including corporations, pension funds, insurance institutions, asset managers and other investment companies, energy and commodities firms, clearing houses, government and supranational entities, as well as global and regional banks, and is very pleased to have the opportunity to respond to the consultation paper. Since the inception of OTC derivatives in the 1980s, its members have referenced LIBOR rates as the floating rate in the majority of their interest rate transactions. ISDA views itself and its membership as being a user of LIBOR rates, as published.

As previously noted in our response to the Wheatley Review of LIBOR initial discussion paper[1] ("Wheatley Response"), ISDA fully recognises the importance of "reforming" LIBOR in terms of its governance and transparency and welcomes the opportunity to comment on the specific aspect of reducing the number of currencies and maturities for which LIBOR covers.

ISDA member firms broadly support the proposals the BBA is making in terms of the currencies and maturities which will be discontinued. However, we want to highlight the need for clear and long term arrangements for the management of the transition. Without robust transition arrangements, the ensuing market disruption could be potentially unmanageable. We would therefore suggest the introduction of a 'two step' process (described below) prior to the elimination of certain tenors, and ensuring that an agreed market solution exists prior to the elimination of any tenors or currencies.

As detailed in the Wheatley Response, most OTC derivative transactions using LIBOR rates are typically documented under an ISDA Master Agreement and a trade Confirmation, which references the relevant published ISDA Definitions. The Definitions give formal and detailed descriptions for all transaction variables that will be referenced in the trade Confirmation. Of the currencies in which LIBOR is currently published, ISDA provides definitions for all but three of them, including for two of the currencies to be discontinued. Each definition provides that where the rate is not published at all, parties will revert to the polling of specified numbers of so-called "Reference Banks" to arrive at a rate themselves. "Reference Banks" would also be the fall-back option for firms to source a rate for discontinued maturities unless the use of interpolation is stated in the Confirmation. As an overview,

[1] http://www2.isda.org/attachment/NDc2OA==/Response%20to%20Wheatley%20Review%2009-07-2012.pdf

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the "Reference Banks" mechanism works by firms conducting their own poll of the market to determine a suitable rate. However, using the "Reference Bank" mechanism can be extremely time consuming, and accordingly if required to determine many rates, it is unlikely that the industry could support this burden of activity.

ISDA has carried out an analysis of the outstanding trade population in those currencies and maturities in which LIBOR is proposed to be discontinued. It is understood that the number of outstanding trades is such that it is unlikely that the market would be able to support a trade by trade solution. In addition, the "Reference Banks" mechanism for determining rates for discontinued maturities faces the same issue that the Wheatley Review is looking to resolve, i.e. no transaction data to corroborate submissions. This essentially means that the industry needs to seek a solution to deal with this effectively. Potential solutions could include ISDA publishing a best practice or guidance encouraging firms to agree to use interpolation to generate rates for the discontinued maturities or suggest alternatives for the discontinued currencies.

The fundamental problem with this is that it would mean not following the confirmation document as it is unlikely to specify the use of interpolation for trades with discontinued maturities or the use of alternative rates for trades in discontinued currencies. The only way to legally change a confirmation retrospectively is for the parties to agree to that amendment. Agreeing and affecting such amendments bilaterally would be cumbersome, but ISDA could facilitate this process by publishing a protocol, which firms would need to adhere to in order to amend their contracts with the other parties. This would be a voluntary process and both parties would need to adhere to the protocol for it to be useful.

It is envisaged that the implementation of regulation in the US and Europe will make it difficult to get the required focus to agree a protocol in the proposed timeframe. A potential "two step" process could be for rates in currencies that ISDA does define, to continue to be published for an extended timeframe by the BBA under the existing rate references by being derived as a rate interpolated from those maturities that BBA intend to continue calculating. This would negate the immediate need for an ISDA protocol. Step two would be when the publishing of those rates is discontinued at some point in 2013 by which time a protocol could be agreed. For the rates ISDA does not define, guidance could be issued that those contracts be bilaterally renegotiated to reference an alternative source. Discussion is still on going as to the optimal solution.

In addition to the effect on interest rate derivatives, CDS trades will also be impacted by the discontinuation of certain maturities of LIBOR. LIBOR rates are used by the credit derivatives industry to discount cash flows in the determination of upfront payments on all trades (within the ISDA CDS Standard Model). The credit markets have started to look at using substitutes to LIBOR, however they are at an early stage so further work is needed. The impact of the proposed changes is predominantly in relation to the two month discontinuation for USD, GBP, JPY and CHF, and the nine month discontinuation for USD, GBP and CHF. Many firms have built systems based on this data being available; therefore, dropping tenors may break the automated checks. Coupled with the proposed short notification period and general code freezes, this is envisaged likely to cause significant market disruption.

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For the reasons stated above, ISDA would support delaying the implementation of discontinuing maturities and tenors until at the earliest the end of March 2013. This will give the industry the minimum time needed to ensure the necessary provisions can be agreed and put in place in order to avoid major market disruption.

Attached, we have provided commentary on the specific questions raised in the consultation paper.

We look forward to staying very much engaged with members of the review team as its work moves forward towards conclusion.

Yours faithfully,

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Deputy Chief Executive Officer

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Appendix – Responses to Consultation questions, in italics.

Question 1: Do respondents agree that the GBP Repo benchmark may be discontinued?
Member Firms have no objection to this.

Question 2: Do respondents agree that the end of December 2012 is a suitable date to cease calculation and publication of the GBP Repo benchmark?
Member Firms have no objection to this.

Question 3: Do respondents agree that each of these tenors (2wk, 2m, 4m, 5m, 7m, 8m, 9m, 10m, 11m) may be removed from all LIBOR currencies?
In principle, Member Firms do not object to the discontinuation of the proposed LIBOR tenors. However, as stated above, request that sufficient time is given to allow such changes to be implemented in a way that is as least disruptive as possible. An additional consideration is that LIBOR rates are used by the credit derivatives industry to discount cash flows in the determination of upfront payments on all trades (within the ISDA CDS Standard Model) and also in the calculation of the funding leg of certain equity derivatives. The discontinuation of the 2m and 9 month tenors will mean that many Member firms will need to amend systems as this data will no longer be available. A freeze across the industry on coding and technological builds will mean that timeframes will need to be extended.

Question 4: Do respondents agree that the end of January 2013 is a suitable date to make this change?
Member Firms do not agree that the end of January 2013 presents sufficient time to allow for an industry wide solution to be agreed and implemented. As discussed earlier in this response, the current legal documentation requires that most trades affected by the discontinued maturities will need to be processed on a trade by trade basis, as it is not standard market practice to include the use of interpolation for missing maturities. There is significant concern that even once a solution is agreed, firms will need time to recalibrate their internal systems to account for any agreed change. It is essential that ambiguity in the market is kept to a minimum to reduce the risk of breaks. As noted above, Member Firms would support the BBA continuing to publish rates for the maturities to be discontinued under the existing rate references by deriving rates using interpolation of the maturities that the BBA intend to continue calculating.

Question 5: Do respondents agree that these are the correct maturities (1wk, 1m, 3m, 6m, 12m) to be retained?
Member firms agree that LIBOR rates should continue to be published for the stated currencies, however highlight the imperative need to discontinue the other currencies in a way which causes minimal disruption to the market. Please refer to the responses to questions 3 and 4.

Question 6: Do respondents agree that the AUD LIBOR fixings may be discontinued?
Member firms agree that AUD LIBOR fixings can be discontinued, however highlight that there is a sufficient level of outstanding trades to cause unmanageable disruption to the market as firms will need to bilaterally agree an alternative rate to use. Relying on Reference Banks is considered inappropriate, therefore an agreed protocol would ideally be adhered to. It is envisaged that one protocol could be drafted to cover all LIBOR discontinuations if that is deemed the optimal solution.

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Question 7: Do respondents agree that the NZD LIBOR fixings may be discontinued?
ISDA does not publish a definition for NZD LIBOR. Parties using this rate will presumably have had to define these rates in their own bespoke documentation and would need to act in accordance with its terms in the event of discontinuation. Further analysis is needed into finding a solution which would prevent these trades needing to be individually bilaterally negotiated.

Question 8: Do respondents agree that the end of February 2013 is a suitable date to make these changes?
As stated above, Member firms support synchronising the implementation of the discontinuation of maturities and currencies to end of March 2013. This would allow for one protocol to be drafted to cover all discontinuations if deemed appropriate.

Question 9: Do respondents agree that the CAD LIBOR fixings may be discontinued?
Member firms agree that CAD LIBOR fixings can be discontinued, however highlight that there is a sufficient level of outstanding trades to cause unmanageable disruption to the market as firms will need to bilaterally agree an alternative rate to use. Relying on Reference Banks is considered inappropriate, therefore an agreed protocol would ideally be adhered to. It is envisaged that one protocol could be drafted to cover all LIBOR discontinuations.

Question 10: Do respondents agree that the DKK LIBOR fixings may be discontinued?
ISDA does not publish a definition for DKK LIBOR. Parties using this rate will presumably have had to define these rates in their own bespoke documentation and would need to act in accordance with its terms in the event of discontinuation. Further analysis is needed into finding a solution which would prevent these trades needing to be individually bilaterally negotiated.

Question 11: Do respondents agree that the SEK LIBOR fixings may be discontinued?
ISDA does not publish a definition for SEK LIBOR. Parties using this rate will presumably have had to define these rates in their own bespoke documentation and would need to act in accordance with its terms in the event of discontinuation. Further analysis is needed into finding a solution which would prevent these trades needing to be individually bilaterally negotiated.

Question 12: Do respondents agree that the end of March 2013 is a suitable date to make these changes?
Member firms support a synchronised implementation of the discontinuation of the proposed maturities and currencies. As stated throughout this response, the discontinuation of the stated LIBOR maturities and currencies would provide significant disruption in the industry, therefore the only viable solution at this point is considered to be a protocol for firms to adhere to. Member firms would support the BBA continuing to publish rates in those maturities to be discontinued by calculating rates using interpolation of the maturities to be continued. This could either be a temporary or permanent measure.

Question 13: Are there any other issues or concerns about any of the proposals or timescales in this paper which respondents would like to highlight?
See above.