ISDA Safe, Efficient Markets

Submitted Electronically

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Secretary
Board of Governors of the Federal Reserve System
20th and Constitution Avenue, NW
Washington, D.C. 20551

RE: Regulation Implementing the Adjustable Interest Rate (LIBOR) Act[1]

The International Swaps and Derivatives Association, Inc. ("**ISDA**")[2] appreciates the opportunity to provide comments to the Board of Governors of the Federal Reserve System ("**Board**") on its Notice of Proposed Rulemaking ("**proposal**") for its Regulation Implementing the Adjustable Interest Rate (LIBOR) Act ("**LIBOR Act**").

ISDA has been instrumental in supporting international and regional efforts to ensure orderly transition of derivatives contracts away from LIBOR by, among other things, publishing multilateral protocols and updates to its standard documentation. While the significant majority of non-cleared derivative transactions will transition away from US dollar LIBOR after June 2023 because both counterparties have adhered to the ISDA 2020 IBOR Fallbacks Protocol ("**ISDA fallbacks protocol**")[3] or separately agreed to transition, a solution for any remaining exposure is critical to avoid cliff-edge effects, hedging dislocations and legal uncertainty. Therefore, we strongly support the LIBOR Act and the proposal.

As discussed below, the proposal reflects the Board's belief that consistency would be sensible between the Board-selected benchmark replacement for derivative transactions and the fallback rates for US dollar LIBOR under the ISDA fallbacks protocol. Our comments below point out two places in which we think the proposal would actually result in potentially material deviations between these two rates, and suggest technical revisions to the proposal that would achieve consistency. Specifically, we are concerned that the proposal would result in (ii) use of SOFR "compounded in advance" (instead of "compounded in arrears") each time that the proposal applies to a derivative transaction and (ii) use of the Board-selected benchmark replacement for derivative transactions with fixing dates at the end of June 2023 instead of the representative US dollar LIBOR settings published on those dates. We encourage the Board to consider the technical revisions suggested below in order to avoid confusion regarding differences in rates

[1] https://www.govinfo.gov/content/pkg/FR-2022-07-28/pdf/2022-15658.pdf.

[2] Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 990 member institutions from 78 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org.

[3] https://www.isda.org/protocol/isda-2020-ibor-fallbacks-protocol/.

that could apply to seemingly similar derivative transactions after the end of June 2023, as well as confusion with the Board's statements in the preamble to the proposal.

Board-Selected Benchmark for Derivative Transactions

In the preamble to the proposal, the Board states:

> The Board has reviewed the ISDA protocol and believes the rate specified in the ISDA protocol would be a reasonable, SOFR-based benchmark replacement for LIBOR for derivative transactions. Further, as derivatives markets already appear to reference SOFR compounded in arrears and there has been significant adherence to the ISDA protocol, the Board believes it would be sensible to avoid disruption to these markets' efforts to transition away from referencing LIBOR. Promoting use of a consistent approach to replace LIBOR references in derivative transactions should enhance financial stability.

Section 253.4(a) of the proposal goes on to provide that a derivative transaction shall use the benchmark replacement identified as the "Fallback Rate (SOFR)" in the ISDA fallbacks protocol.

ISDA Fallbacks Protocol

Fallback Rate (SOFR) in the ISDA fallbacks protocol is a fallback rate published by Bloomberg composed of (i) SOFR compounded over an accrual period corresponding to the relevant tenor of US dollar LIBOR; plus (ii) a spread adjustment that was frozen for US dollar LIBOR on March 5, 2021 based on the median of the differences between US dollar LIBOR in the relevant tenor and SOFR compounded over each corresponding tenor for the five years ending on March 5, 2021.[4] Per the terms of ISDA's definitions (which counterparties can apply to legacy transactions by both adhering to the ISDA fallbacks protocol) once the fallbacks for US dollar LIBOR apply, Fallback Rate (SOFR) is observed two payment business days prior to the payment date (typically at the end of the period for linear interest rate swaps with regular periods). ISDA's standard definitions and the ISDA fallbacks protocol refer to this date as the "Fallback Observation Day".

Each publication by Bloomberg of Fallback Rate (SOFR) corresponds to an "Original IBOR Rate Record Day". When observing Fallback Rate (SOFR) in accordance with ISDA's standard definitions, the rate corresponding to the date that US dollar LIBOR would have been referenced or fixed (i.e., two London banking days prior to the "Reset Date" under ISDA's standard definitions) is used. Like the Bloomberg screens, ISDA's standard definitions and the ISDA fallbacks protocol refer to this date as the "Original IBOR Rate Record Day". However, if Bloomberg has not yet published the rate for the "Original IBOR Rate Record Day" on the "Fallback Observation Day", the most recently published Fallback Rate (SOFR) is used (even if

[4] More information about the fallback rates published by Bloomberg, including Fallback Rate (SOFR), as well as the terms of the fallbacks in ISDA's standard definitions and the ISDA fallbacks protocol is available in the Fact Sheet published by ISDA, Bloomberg and Linklaters at https://www.isda.org/a/vhtgE/Factsheet-IBOR-Fallbacks_V4_Dec2021.pdf.

it corresponds to an "Original IBOR Rate Record Day" earlier than the "Original IBOR Rate Record Day" for the relevant fixing). As a result of the methodology used to calculate the fallbacks, in some cases Bloomberg does not publish any fallbacks for a particular IBOR (such as US dollar LIBOR) on a given date (even if that date is a business day under the relevant calendar) and in some cases Bloomberg publishes more than one fallback for a particular IBOR, each corresponding to a different "Original IBOR Rate Record Day". In any event, the fallback rate used is based on SOFR compounded over the relevant period ("compounded in arrears") for most linear swaps with regular periods.

Differences Between the Proposal and the ISDA Fallbacks Protocol

Compounding in Arrears versus in Advance

Section 253.4(d) of the proposal provides that "any Board-selected benchmark replacement shall be determined *as of the day that, under the covered contract, would have been used to determine the LIBOR-based rate that is being replaced* or, if the Board-selected benchmark replacement is not published on the day indicated in the covered contract, the most recently available publication should be used" (emphasis added). As described above, the day that would have been used to determine US dollar LIBOR in derivative transactions is typically at the beginning of the relevant period. Therefore, Section 253.4(d) would direct users to reference Fallback Rate (SOFR) at the beginning of the period (compounding in advance), instead of the end of the period (compounding in arrears) as is the case under the ISDA fallbacks protocol.

In addition to resulting in a different replacement rate for US dollar derivative transactions (which differences could be material if SOFR moves materially over the relevant tenor), the language in Section 253.4(d) would not provide clarity on dates that Bloomberg publishes more than one Fallback Rate (SOFR). Moreover, the result under Section 253.4(d) would conflict with the Board's statements in the preamble to the proposal regarding consistency with the fallbacks for US dollar LIBOR in the ISDA fallbacks protocol, which could cause confusion and disputes in the market.

We suggest the following revisions to Section 253.4(d) of the proposal and the addition of the following defined term to Section 253.2 to ensure consistency between the proposal and the ISDA fallbacks protocol.

> For purposes of this part, **(x) in respect of a covered contract other than a derivative transaction,** any Board-selected benchmark replacement shall be determined as of the day that, under the covered contract, would have been used to determine the LIBOR-based rate that is being replaced or, if the Board-selected benchmark replacement **in respect of that day** is not ~~published~~ **available** on the day indicated in the covered contract, the most recently available publication **as at that day** should be used, **and (y) in respect of a covered contract that is a derivative transaction, any Board-selected benchmark replacement shall be determined on the Derivative Transaction Fallback Observation Day in respect of the day that, under the covered contract, would have been used to**

> **determine the LIBOR-based rate that is being replaced or, if the Board-selected benchmark replacement in respect of that day is not available on the Derivative Transaction Fallback Observation Day, the most recently available publication on the Derivative Transaction Fallback Observation Day should be used**.
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> ***Derivative Transaction Fallback Observation Day*** **means the day that is two payment business days for the derivative transaction prior to the payment date for the relevant calculation period.**

Derivative Transactions with Fixing Dates at the end of June 2023

Section 253.4(a) of the proposal provides that "*on the LIBOR replacement date*, a covered contract that is a derivative transaction shall use the benchmark replacement identified as the 'Fallback Rate (SOFR)' in the ISDA protocol" (emphasis added). Section 253.2 of the proposal defines LIBOR replacement date as "the first London banking day after June 30, 2023" (which we understand, and the Board notes in the preamble to the proposal, is expected to be July 3, 2023 unless that is an unscheduled holiday in London).

As noted above, US dollar LIBOR derivative transactions typically reference the US dollar LIBOR rate published two London banking days prior to the reset date at the beginning of each period (this is commonly referred to as the fixing date). Therefore, on the LIBOR replacement date, derivative transactions will, by their terms, reference a US dollar LIBOR that was published on a representative basis at the end of June 2023 (June 29, 2023 for contracts with reset dates of July 3, 2023 and June 30, 2023 for contracts with reset dates of July 4, 2023 (although this may not be applicable under US law-governed contracts)). Accordingly, under the ISDA fallbacks protocol, Fallback Rate (SOFR) will only apply to derivative transactions with a reset date that is two London banking days after the LIBOR replacement date (i.e., derivative transactions with a fixing date on or after the LIBOR replacement date), which is expected to be July 5, 2023 unless there is an unscheduled holiday in London. Similar to the point above, the result under Section 253.4(a) would conflict with the Board's statements in the preamble to the proposal regarding consistency with the fallbacks for US dollar LIBOR in the ISDA fallbacks protocol, which could cause confusion and disputes in the market.

We suggest the following revisions to Section 253.4(a) of the proposal to align the use of Fallback Rate (SOFR) under the proposal and the ISDA fallbacks protocol:

> ~~**On the LIBOR replacement date, a**~~A covered contract that is a derivative transaction shall use the benchmark replacement identified as the ''Fallback Rate (SOFR)'' in the ISDA protocol **for each day on which U.S. dollar LIBOR would ordinarily be observed occurring on or after the LIBOR replacement date**. For clarity, the reference to ''spread relating to U.S. dollar LIBOR'' in the definition of ''Fallback Rate (SOFR)'' in the ISDA protocol is equal to the applicable tenor spread adjustment identified in paragraph (c) of this section.

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As always, please do not hesitate to reach out if ISDA could be of any assistance as the Board finalizes the proposal. We would welcome the opportunity to discuss with Board staff the technical revisions suggested in this letter in order to ensure maximum clarity regarding the rates that will apply to derivative transactions referencing US dollar LIBOR after the end of June 2023.

If you have any questions or would like more information, please reach out to Ann Battle, Senior Counsel, Market Transitions & Head of Benchmark Reform at abattle@isda.org.

Sincerely,

Ann M Battle

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