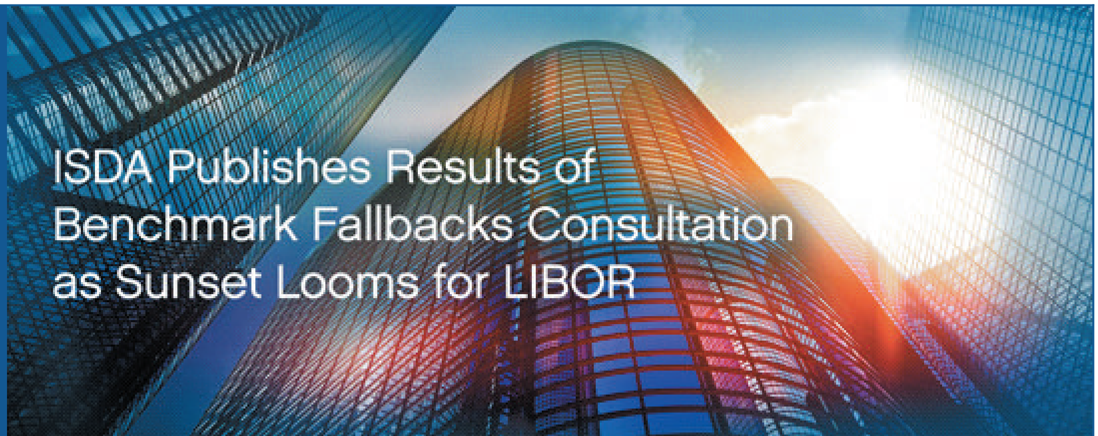
JONES DAY

COMMENTARY

DECEMBER 2018



IN SHORT

The Situation: The International Swaps and Derivatives Association, Inc. ("ISDA") has announced the preliminary results of its market consultation concerning the fallbacks rates to be relied on upon cessation of certain inter-bank offered rates ("IBORs").

The Result: ISDA reported that the market consensus appears to be that a "synthetic term" structure should be created for the overnight risk-free rates on the basis of the "compounded setting in arrears" approach, and the "historical mean/median" approach should be used to replicate the bank credit spreads implied in the IBORs.

Looking Ahead: ISDA will likely commence preparing new definitions and protocols that will seek to implement these new "fallback" rates upon the demise of the applicable IBOR.

For the past few years ISDA has collaborated with regulators and market participants globally to establish a derivatives market structure that utilizes robust, transaction-based overnight (nearly) risk-free rates ("RFRs") as the foundation for the floating rate component of transactions such as interest rate swaps, total return swaps, and equity derivatives.

Following the United Kingdom's Financial Conduct Authority's establishment of a firm time-table (year-end 2021) for the highly probable demise of the London Interbank Offered Rate(s) ("LIBOR"), ISDA launched a consultation in July to solicit market feedback on adjustments that could be made to a number of major currency RFRs so that they could serve as suitable fallbacks for certain inter-bank offered rates ("IBORs") referenced in derivative transactions. On November 27 ISDA announced the preliminary results of its consultation, which yielded 152 responses from 164 market participants. ISDA reported that an "overwhelming majority" of respondents preferred the "compounded setting in arrears" approach for deriving "synthetic term" RFRs and that a "significant majority" of respondents preferred the "historical mean/median" approach to deriving the spread adjustment.

There are two fundamental differences between RFRs and IBORs that the consultation sought to address. First, while IBORs are forward-looking rates that include a term structure (e.g., three-month or six-month LIBOR), the RFRs are overnight rates compiled and calculated on the following business day. Second, an RFR does not exhibit the bank credit spread that is implicit in the concept of an "inter-bank offered rate."

The ISDA consultation provided market participants with a choice among four means of calculating "synthetic term" or "adjusted RFRs." Each of the proposed methodologies contemplated adjustments made to "real" overnight RFRs rather than any of the yet-to-be-published term structure RFRs currently being contemplated by other areas of the capital markets.

> An 'overwhelming majority' of respondents preferred the 'compounded setting in arrears' approach for deriving 'synthetic term'

The "compounded setting in arrears rate" that was preferred by the overwhelming majority of respondents is derived by observing the RFR for each day during a calculation period and compounding on a daily basis. A consequence of applying this methodology would be that the floating amount for any given calculation period would not be known until the end of that calculation period.

To account for the loss of a bank credit risk premium, the consultation proposed three means of determining the "spread adjustment" that would need to be added to the adjusted RFR. Each of these proposed methodologies contemplated adjustments based on observed spread differentials between the relevant IBOR and RFR at the time of, or during the period leading up to, the date upon which it is announced that the applicable IBOR will permanently cease (or has ceased) to be published (the "Trigger Date").

RFRs and that a 'significant majority' of respondents preferred the 'historical mean/median' approach to deriving the spread adjustment.

The "historical mean/median" approach favored by a significant majority of the respondents involves spread adjustments based on the mean or median of the daily spot IBOR/adjusted RFR spread differential for each tenor over a significant period of time (five or ten years) prior to the Trigger Date. The spread adjustment for all affected transactions would be determined once (on the Trigger Date) on a permanent basis; however, in order to minimize "cliff risk," each transaction would have a one-year transition period over which the adjustment would be gradually phased in.

It should be noted that the U.S. dollar and the euro were excluded from the consultation for pragmatic reasons, but respondents indicated that applying a compounding setting in arrears rate and the historical mean/median approach may be appropriate for deriving fallbacks for benchmarks in those currencies as well. ISDA anticipates proceeding with the development of fallback provisions for the IBORs covered by the consultation in accordance with the foregoing, subject to the final decision of the ISDA Board Benchmark Committee. ISDA expects this final decision, which will include additional details for the historical mean/median approach together with anonymized and aggregated responses to the consultation itself, to be published by the end of the year. ISDA also expects supplemental consultation on the RFRs for the U.S. dollar and euro benchmarks early in 2019.

The fallback provisions are anticipated to be incorporated into ISDA's 2006 ISDA Definitions and will automatically be applicable to all transactions referencing those Definitions executed after the effective date of incorporation. ISDA also plans to sponsor a "protocol" process for simultaneously amending all "legacy" transactions with other adherents to the protocol(s).

THREE KEY TAKEAWAYS

1. The "compounded setting in arrears rate" would calculate coupons that will not be known until the end of any given interest period.

2. The spread adjustment would be permanently fixed once for the entire market on the Trigger Date. It remains unknown whether RFRs will respond to periods of bank credit stress in parallel with (what would have been) the relevant IBORs. Moreover, the "historical mean/median" approaches entails the construction of historic adjusted RFR forward curves on a daily basis over a lengthy period of time.

3. Although ISDA seems likely to have determined its approaches to calculating "synthetic term" RFRs and the spread adjustment for derivatives, the markets for bonds and loans rely heavily on "real" term rates and any spread adjustment is not guaranteed to match the historical mean/median approach.

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