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Autorité fédérale de surveillance des marchés financiers FINMA
Autorità federale di vigilanza sui mercati finanziari FINMA
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LIBOR replacement for derivatives

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1 Introduction

The date on which LIBOR is expected to be discontinued, i.e. end-2021, is getting closer. Various authorities and the private sector have been working for some time on the necessary transition and much has already been achieved. Nevertheless, FINMA still considers the end of LIBOR as one of the principal operational risks facing its supervised institutions[1]. In this guidance it sets out its recommendations to institutions that are affected by the discontinuation of LIBOR.

Further communications on the discontinuation of LIBOR are expected in the coming months from the UK's Financial Conduct Authority (FCA) as the supervisory authority responsible for LIBOR and from the ICE Benchmark Administration (IBA) as the administrator of this reference interest rate. FINMA may publish further separate information at such time.

2 LIBOR-linked derivatives constitute the largest volume to be replaced

In Switzerland, the largest stock of legacy LIBOR-linked contracts are over-the-counter (OTC) derivatives. A survey conducted by FINMA in June 2020 shows that the volume of contracts for OTC derivatives linked to LIBOR that extend beyond 2021 amounts to over CHF 11.5 trillion cumulated for all LIBOR currencies (CHF, EUR, GBP, JPY, USD).

These derivatives contracts must be migrated to other contracts based on alternative reference rates before or upon the discontinuation of LIBOR. One approach is the early, proactive renegotiation of legacy contracts with the counterparties.

Alternatively, it should be ensured that such contracts include robust fallback clauses that set out clearly which alternative interest rates should be used and in what manner if LIBOR is discontinued, and how exactly such a discontinuation will be identified. If the OTC derivatives contracts are neither renegotiated nor adjusted, there is a serious risk of legal disputes with associated loss potential.

[1] Guidance 03/2018 *LIBOR: risks of potential replacement* and FINMA Risk Monitor 2019

3 The ISDA IBOR fallback documents represent a significant step forward in mitigating the risks

The International Swaps and Derivatives Association (ISDA) has announced the launch of its *IBOR Fallbacks Protocol* for existing LIBOR-based contracts and its *IBOR Fallbacks Supplement* for new LIBOR-based contracts[2]. FINMA welcomes the launch of these adjustments to the *ISDA Master Agreement*, as well as the corresponding adjustment of the Swiss Master Agreement for OTC derivative instruments drawn up by the Swiss Bankers Association (SBA). The adjustments to the *ISDA Master Agreement* will come into effect for all contracts under the ISDA between two counterparties as soon as both parties have signed the new ISDA fallback documents. Before the announced official launch of the fallback documents, it is already possible to agree to adhere to the adjustments; this is know as the "adherence in escrow" process.

Following the publication of these documents, there exist no further major obstacles to the migration of OTC derivatives under the ISDA or Swiss Master Agreements.

4 FINMA's recommendation to the supervised institutions: the time to act is now

To successfully minimise the high risks associated with the discontinuation of LIBOR, and in the context of the large number of derivatives contracts affected and the high total contract volume, FINMA views the broad application of the new ISDA fallback documents as essential for a successful transition from LIBOR. It recommends that the affected supervised institutions sign the new ISDA Fallbacks Protocol – ideally before its launch ("adherence in escrow" process), and wherever possible before the date of its entry into force. The adjustments to the Swiss Master Agreement for OTC derivative instruments published by the SBA, as well as similar adjustments to other master agreements, should also be signed as early as possible. In addition, all affected counterparties – i.e. financial intermediaries and also other counterparties such as companies or individuals – should be proactively contacted at an early stage to ensure that they also sign the fallback documents as soon as possible.

For any derivatives contracts that genuinely cannot be either migrated or amended (known as "tough legacy"), a risk assessment should be conducted for each contract or type of contract and specific measures

[2] https://www.isda.org/2020/10/09/isda-board-statement-on-the-ibor-fallbacks-supplement-and-protocol/

should be taken to minimise the risks, particularly in relation to legal and valuation risks.

Following the launch of the ISDA protocols, the reasons for entering into new LIBOR derivatives contracts without robust fallback clauses will cease to apply. By 25 January 2021 at the latest, supervised institutions should only enter into LIBOR derivatives contracts with robust fallback clauses[3].

These recommendations are the same as those issued by the National Working Group on Swiss Franc Reference Rates in its 29 September 2020 meeting[4].

The next few months will be crucial for the necessary minimisation of the remaining risks in connection with the discontinuation of LIBOR. FINMA will therefore continue to closely monitor the development of the contract volume linked to LIBOR. Where necessary, it will take institution-specific measures to mitigate the risks of inadequate preparation for the replacement of LIBOR.

[3] According to the ISDA announcement, the IBOR Fallbacks Protocol and Supplement will take effect on 25 January 2021.

[4] https://www.snb.ch/n/mmr/reference/minutes_20200929/source/minutes_20200929.n.pdf