

# ARRC Recommendations for Contracts Linked to the USD LIBOR ICE Swap Rate

## Part I. Background

The Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York (“FRBNY”) convened the [Alternative Reference Rates Committee](#) (“ARRC”) in 2014 to identify alternative reference rates for U.S. dollar (USD) LIBOR (“LIBOR”), identify best practices for contract robustness in the interest rate market, and create an implementation plan to support an orderly adoption of new reference rates. After accomplishing its initial set of objectives by selecting an alternative reference rate (which is the Secured Overnight Financing Rate or “SOFR”) and setting out a [Paced Transition Plan](#) with respect to derivatives, the ARRC was reconstituted in 2018 with an expanded membership to help ensure the successful implementation of the Paced Transition Plan and to serve as a forum for cash and derivatives market participants to address the risks of severe market disruption that could result from the cessation of LIBOR and develop and support liquidity in SOFR-based products across cash and derivatives markets.

### A. ICE Swap Rates

The [ICE Swap Rates](#), formerly known as ISDAFIX and sometimes referred to as the CMS (constant-maturity swap) rates, represent the mid-market fixed rates for fixed/float interest rate swaps for a set of tenors at a specified time of the day.

They are published by the ICE Benchmark Administration (IBA), using a waterfall methodology:

- [Level 1](#): Executable levels on electronic trading venues
- [Level 2](#): Indicative dealer-to-client levels on electronic trading venues
- [Level 3](#): Movement interpolation<sup>1</sup>
- If none of these steps succeeds, no rate is published

These rates are primarily used to:

- Compute the settlement amount for cash-settled swaptions that use Collateralized Cash Price
- Compute the cashflows / payouts of CMS-linked derivatives (e.g. curve options)
- Compute the cashflows / payouts of CMS-linked debt instruments (e.g. structured notes)

For U.S. dollar (USD), the version of the ICE Swap Rates that has been used most commonly prior to year-end 2021 is the 11am USD LIBOR ICE Swap Rate (“**USD LIBOR ISR**”). It is calculated around 11am Eastern time and references a standard fixed/float cleared interest rate swap with the floating leg referencing 3m USD LIBOR and paying quarterly with an ACT/360 day count convention and with the fixed leg paying semi-annually with a 30/360 day count convention. It is therefore dependent on transactions and/or quotations referencing USD LIBOR and therefore on the availability of a representative USD LIBOR.

On November 8, 2021, IBA [launched](#) the USD SOFR ICE Swap Rate (“**SOFR ISR**”), which is calculated around 11am Eastern time and references a standard fixed/float cleared interest rate swap with the floating leg referencing SOFR on a compounded basis and both legs paying annually with an ACT/360 day count convention.

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<sup>1</sup> Movement interpolation is the linear interpolation of the daily rate movement between adjacent tenors and the preceding day's rate if they have been calculated based on the Level 1 or Level 2 methodologies

## B. Impact of LIBOR Cessation

On March 5, 2021, IBA [announced](#) their intent to cease the publication of the overnight, 1m, 3m, 6m and 12m USD LIBOR settings immediately after June 30, 2023. In addition, it is expected that LIBOR swaps will no longer be eligible for clearing at major clearinghouses (including LCH and CME) starting on or shortly prior to this cessation date.

Consequently, it is likely that there will be no available cleared USD LIBOR swap data that can be used to compute and publish the USD LIBOR ISR after June 30, 2023. Under similar circumstances in GBP, IBA [decided](#) to cease the publication of the GBP LIBOR ISR after GBP LIBOR ceased to be published as a representative rate at year-end 2021.

As a result, market participants will likely need to use USD LIBOR ISR contractual fallbacks after June 30, 2023 for USD LIBOR swaptions that are settled using Collateralized Cash Price settlement as well as USD LIBOR CMS-linked derivatives and debt instruments.

In addition, if clearinghouses do not allow USD LIBOR swaps for clearing after that date (even if they are the result of the physical settlement of a swaption), then swaptions using Physical Cleared settlement would fall back to Collateralized Cash Price settlement and be impacted as well by the cessation of the USD LIBOR ISR.

In many cases, existing contractual USD LIBOR ISR fallbacks consist in conducting a dealer poll and/or in relying on calculation agent determination. Neither of those would be practical or desirable in the context of a cessation of the USD LIBOR ISR.

There is a small number of outstanding debt instruments tied to the USD LIBOR ISR with more problematic fallbacks, for example debt instruments which would fall back to the prior period fixing if the dealer poll(s) were to fail.

## C. Fallback Formula Suggested by the ARRC

To avoid disruption to these contracts that could result from the cessation of LIBOR, the ARRC Market Structure and Paced Transition Working Group worked to develop a suggested fallback formula for the USD LIBOR ISR.

The suggested fallback formula is presented below. More details on how it was developed are available in the [ARRC White Paper](#) which was published in March 2021.

At a high level, this fallback formula consists in using the SOFR ISR, adding the ISDA fallback spread adjustment for 3m USD LIBOR (26.161bps) and applying technical adjustments to account for differences in payment frequency and day count conventions between USD LIBOR and SOFR swaps.

$$\begin{aligned} & \text{Fallback USD LIBOR ISR} \\ &= \frac{365.25}{360} * \left[ 2 * (\sqrt{1 + \text{SOFR ISR}} - 1) + \text{ISDA Spread (3m LIBOR)} * \frac{1}{2} * (\sqrt[4]{1 + \text{SOFR ISR}} + 1) \right] \end{aligned}$$

Where

- *SOFR ISR* is the USD SOFR ICE Swap Rate for the same tenor as the USD LIBOR ISR being considered
- *ISDA Spread (3m LIBOR)* is the ISDA fallback spread adjustment for 3m USD LIBOR (26.161bps)

Note that this formula is only intended to be used for USD LIBOR ISR fixings after 3m USD LIBOR has been discontinued or become non-representative, even if the USD LIBOR ISR has been discontinued prior to that.

#### **D. Subsequent Developments**

In June 2021, ISDA [launched](#) a consultation to seek feedback on the incorporation in the ISDA Definitions of the fallback formulas for the GBP and USD LIBOR ICE Swap Rates. For USD, ISDA consulted on using the fallback formula developed by the ARRC.

In July 2021, ISDA [announced](#) the results of this consultation, which indicated that a significant majority of respondents agreed with these fallback formulas and that the conditions were satisfied for them to be incorporated in the ISDA definitions.

After a “beta” period, IBA [launched](#) the SOFR ISR for use as a benchmark in financial contracts on November 8, 2021.

On November 10, 2021, ISDA published [Supplement 88](#) to the 2006 ISDA Definitions and a corresponding update to the 2021 ISDA Definitions. Any derivative trade entered into on or after that date and referencing the prevailing version of either the 2006 or 2021 ISDA Definitions would include a fallback for LIBOR ISR consistent with the formula suggested by the ARRC.

ISDA published a [bilateral amendment template](#) to facilitate the inclusion of this fallback in LIBOR ISR derivative transactions entered into prior to that date.

In addition, ISDA intends to launch a protocol by the end of Q2 2022, providing a scalable, multilateral mechanism to include this fallback in legacy derivative transactions (as long as both parties to the relevant transaction(s) adhere to the protocol).

Finally, IBA [launched](#) a “beta” version of the USD SOFR Spread-Adjusted ICE Swap Rate, which is computed by applying the fallback formula suggested by the ARRC. If it is made available for use in financial contracts as a “live” benchmark, then market participants could directly use this published spread-adjusted rate as a fallback for the LIBOR ISR rather than having to apply the fallback formula to the SOFR ISR themselves.<sup>2</sup>

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<sup>2</sup> IBA made the equivalent GBP rate (the GBP SONIA Spread-Adjusted ICE Swap Rate) available for use on January 4, 2022 as a “live” benchmark after GBP LIBOR ceased to be published as a representative rate.

## Part II. Recommendations

While the work of the ARRC and of ISDA has allowed for the incorporation of robust, hardwired fallbacks in new transactions tied to the USD LIBOR ISR entered into since November 2021, it does not have retroactive effect on transactions entered into prior to that.

In addition, neither Federal or state legislation cover transactions tied to the USD LIBOR ISR.

As a result, the ARRC is making the following recommendations:

- 1) Market participants should inventory their contracts tied to the USD LIBOR ISR and identify the fallback provisions that they contain. For contracts whose primary fallback is a dealer poll, particular attention should be paid to the secondary fallback, i.e. the fallback that would apply if the dealer poll(s) were to fail.
- 2) Where practical, market participants should take proactive steps to address the impact of the cessation of the USD LIBOR ISR on their legacy positions (e.g. USD LIBOR swaptions, USD LIBOR CMS-linked derivatives and debt instruments) by:
  - Converting these positions to their SOFR or SOFR ISR equivalent, or
  - Incorporating hardwired fallbacks consistent with the approach [suggested](#) by the ARRC and included in the prevailing version of the ISDA Definitions – for example by using ISDA's [bilateral amendment template](#) or its upcoming protocol for derivatives, or
  - Considering calling or buying back debt instruments with problematic fallback provisions
- 3) If a legacy position cannot be proactively converted to SOFR or the SOFR ISR and its contractual fallbacks cannot be amended:
  - The ARRC believes that, once 3-month USD LIBOR has ceased to be published as a representative rate, the fallback formula that it has suggested would accurately represent the at-the-money rates of standard interest rate swaps which are tied to it and which incorporate the fallback provisions introduced in the ISDA 2020 IBOR Fallbacks Protocol
  - As a result, if the contractual fallbacks involve calculation agent determination, the ARRC recommends that calculation agents consider the fallback formula that it has suggested in determining a successor rate