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US dollar Libor transition
A new countdown in motion

With almost all Libor settings discontinued at the end of 2021, Philip Whitehurst, head of service development, rates at LCH, addresses what's ahead for the final US dollar Libor transition to risk-free rates, what has and hasn't been achieved so far, and the outlook between now and the final mid-2023 deadline

What are the outstanding challenges for US dollar Libor transition?

Philip Whitehurst: For central counterparty (CCP) clearing USD Libor swaps in 2022, the biggest question is what the outlook for swaps market liquidity will be between now and June 2023. The answer is important because it allows us to provide clarity to participants of the cleared swaps market as they plan ahead.

It is clear that official sector guidance on continued trading of USD Libor swaps amounts to something approaching a prohibition. It's helpful and important that there are carve-outs for risk-reducing trades and for market-making in support of customer activity, and CCPs are pleased to see that participation in a CCP default management process is allowed. But the constraints point to greatly reduced volumes, which is already evident.

So does that mean CCPs will need to bring a USD Libor swap conversion event forward and withdraw eligibility well before USD Libor cessation in June 2023? We don't think so. We have seen strong gains in secured overnight financing rate (SOFR) swap liquidity all the way along the yield curve, as well as a robust basis (or spread) between forward SOFR and Libor projections beyond the cessation date.

When this is coupled with a risk management framework that can flex to address these liquidity changes and price relationships, we are confident we can manage the relevant risks into 2023 and therefore take advantage of a smooth glide-path into the cessation itself in mid-2023.

Philip Whitehurst

What can we learn from the successful non-USD Libor conversions executed at the end of 2021?

Philip Whitehurst: We can take a lot of positives from those events. LCH converted approximately 350,000 contracts in total, with an aggregate notional of around $35 trillion across three euro overnight index average (Eonia) and non-USD Libor conversion events. In doing so, we've had to handle the vast majority of the issues that might arise in an equivalent USD conversion.

We've road-tested everything from the contractual conversion as a legal matter to the economic form of the output risk-free rate (RFR) contracts, the preservation of representative Libors, the determination and settlement of appropriate cash compensation, right through into the various reporting obligations associated with the events.

From our conversations with customers and other operators of market infrastructure, we know that not only were the events themselves completed successfully, but there was also remarkably little disruption to trading when markets reopened. That is testament to an incredible amount of communication, planning and preparatory work from everyone involved.

Looking forward to USD, we believe we have many of the important building blocks in place. Developing and delivering them has come at considerable cost to the industry, so we hope to be able to leverage those investments, and will look to implement changes that result in demonstrable improvements. And, inevitably, there are some specifics in USD that require solutions that are yet to be developed.

We're busy collating detailed feedback from our customers, and will be able to get more specific as we head into the second quarter of 2022. And let's also not forget that, although the conversion of USD Libor contracts is going to be the biggest cleared interbank offered rate (Ibor) swap transition, it certainly won't be the last.

How will the relationship between standards and conventions in SOFR cash products and those in derivatives evolve?

Philip Whitehurst: I think there's an interesting parallel here relating to the use of term SOFR in derivatives. The Alternative Reference Rates Committee's guidance is that dealers should be

able to effectively manage the basis between term SOFR products offered to clients versus straight SOFR hedges in the interdealer market. You might argue that a similar approach could work for any different standards that emerge in SOFR cash products – such as lockouts – versus the standard SOFR swap conventions.

This is all about the number and the materiality of each fixing. Libor trades have very few fixings per year, and each carries a lot of weight (and therefore risk). In contrast, SOFR trades have literally 100 times as many fixings, and each carries a correspondingly lower weight. Managing a mismatch between the fixings and weights in a cash SOFR product (versus a standard SOFR swap) is probably more palatable than with Libors.

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Philip Whitehurst, LCH

Do the US legislative plans affecting legacy contracts go far enough, or will a synthetic Libor be needed?
Philip Whitehurst: While there may be legitimate uses for a synthetic USD Libor in support of certain tough legacy product types, it’s safe to say that a synthetic Libor will not be needed for cleared swaps. That would be consistent with the picture in other currencies.

In light of regulatory criticism, is there a future for credit-sensitive alternative rates?
Philip Whitehurst: We are not in a position to judge this from first principles, but our customers are telling us there is a need for credit-sensitive rates (CSRs). And that’s why we created a clearing capability for short-term bank yield swaps, for example.

The future development of CSRs hinges on two questions: (1) Can such rates be produced in line with the standards required of benchmarks now? If so, (2) would the use of such a rate suit the context of a given transaction and its counterparties?

Regardless of the answer to the first question, volumes in RFR-based swaps seem to indicate that a lot of market participants don’t need a CSR to express the views and manage the risks they have in swaps.

To what extent should firms be concerned about operational risks associated with fallbacks being triggered on trillions of dollars of contracts in June 2023?
Philip Whitehurst: I think firms will have learned a lot in recent weeks about the operational risks of fallbacks, although we probably need to get deeper into 2022 to experience an uplift in the number of coupon periods that directly require a fallback fixing.

And, just as we have done for the other Libor currencies, CCPs are likely to convert their cleared USD Libor swaps into SOFR equivalents ahead of any fallbacks. That should eliminate a big pool of contracts from the possibility of such operational risks. ■

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