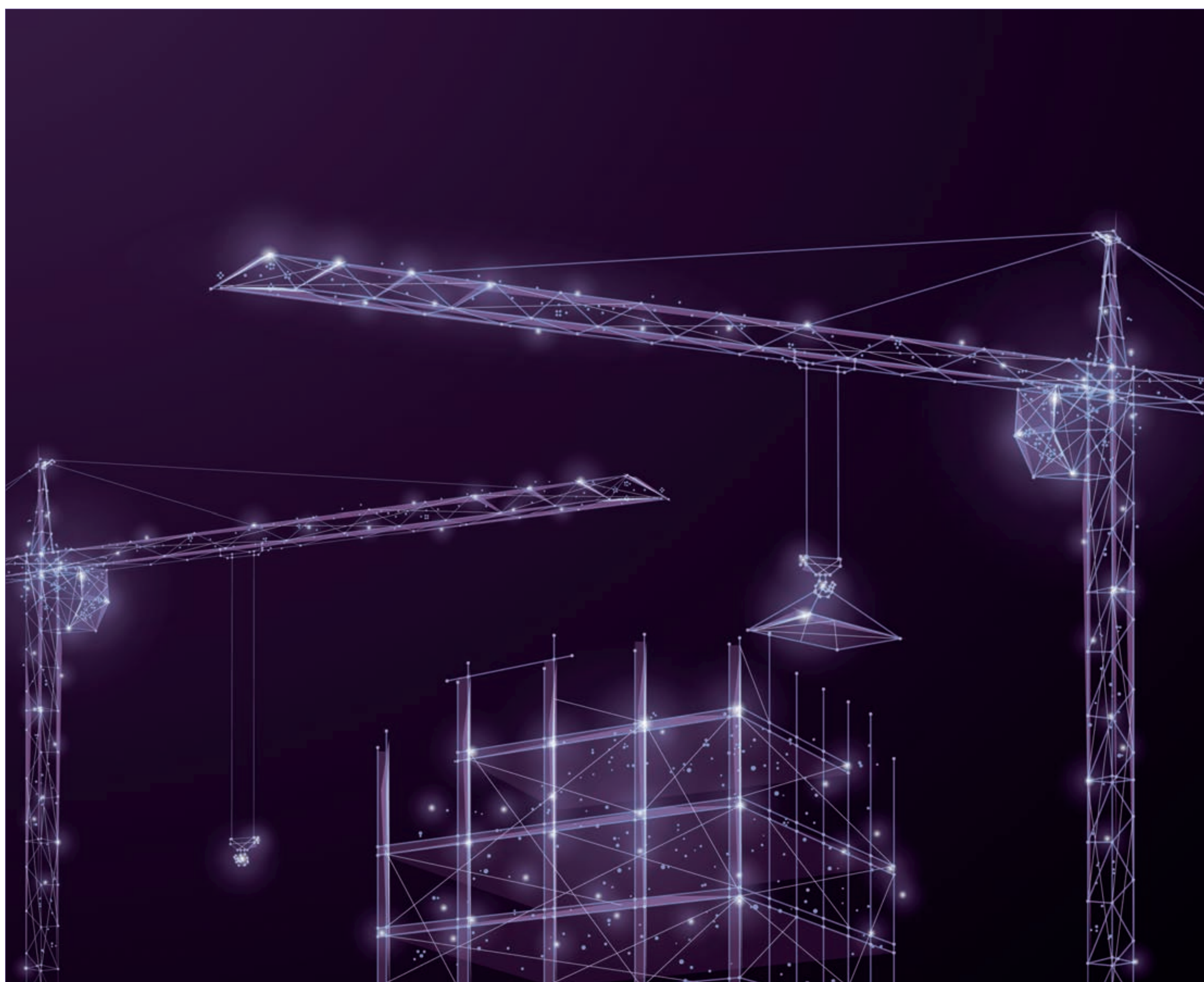
LCH The Markets' Partner

Solid foundations
Bridging the transition gap

Phil Whitehurst, head of service development, rates, SwapClear at LCH, explores the potential parallels between forward-looking term Sonia rates and term SOFR rates. He presents his thoughts on the recent announcement of increased powers for the Financial Conduct Authority and offers insight into LCH's progress on the SOFR discounting switch



What are your views on the recent announcements of the UK Financial Conduct Authority's (FCA) enhanced powers, in regard to 'tough legacy', for example?

Phil Whitehurst: The announcements are really positive for the industry, but it's important to first be clear about what tough legacy contracts are. They're contracts that lack appropriate fallbacks and cannot realistically be renegotiated. In other words, they are 'stuck' as they are. This isn't true of swaps contracts, which can benefit from the International Swaps and Derivatives Association's (Isda) supplemented definitions and protocol, so derivatives markets are in good shape.

But this is much more relevant on the cash product side. If your contract is stuck as it is, then an abrupt cessation of the benchmark could be highly disruptive. In this context, it makes sense for the FCA to have the ability to provide continuity, and this is where the concept of a 'synthetic' Libor could present a powerful remedy.

Phil Whitehurst

The FCA would have the power to command a change in the benchmark methodology to something more sustainable, which then legally substitutes for the original. Importantly, this change would not restore the benchmark's representativeness, which means it can't be used for new business. The regulator has itself posited that forward-looking term risk-free rates (RFRs) could be one input to such a synthetic Libor, and that would help resolve some of the timing problems that are relevant for tough legacy.

This is all very constructive, and the fact that the presence of a synthetic benchmark does not restore the representativeness of the original helps to limit the scope. But there could be some jealous glances toward this solution from pockets of the market for which it is not intended, and the FCA will need to take care around the perimeters.

A number of providers have begun publishing forward-looking term sterling overnight index average (Sonia) reference rates (TSRRs). Do you see any parallels with the development of a term secured overnight financing rate (SOFR), and how do you see the outlook for it?

Phil Whitehurst: Term RFRs are generally not going to be allowed to become as critical and non-substitutable as prior generations of benchmark. But term rates can be much more robust than previous benchmarks. We think they could be the healthy basis of products necessary to support the real economy. That seems the ultimate conclusion of the various regionally focused groups addressing the question: that they are helpful and necessary.

It's interesting to look at the different currency-specific approaches emerging. In sterling, for example, the Working Group on Sterling Risk-Free Reference Rates has concluded that executable overnight index swaps (OISs) are the best basis for TSRRs, and a number of providers are already out there with indicative rates.

In the US, the Federal Reserve and the Alternative Reference Rates Committee (ARRC) have published materials on a futures-based methodology. On September 10, the ARRC launched a request for proposals to identify potential providers of a TSRR before the end of the year.[1]

Whether futures- or swaps-based, you can boil this down to a discussion of whether relative-dated market information, in the form of spot quotes, or absolute-dated information, via forward-starting prices, is your best data input. Put another way, who does the interpolating: a trader or an algorithm? It will be interesting to watch developments in this area.

What can you say about credit-sensitive benchmarks?

Phil Whitehurst: We can see that, as an intermediary, you might want a benchmark that rises and falls in response to your own borrowing rates and therefore hedges through to your income stream. But we also appreciate why end-users might want a rate that responds more exclusively to monetary policy and less to its transmission mechanisms. Ultimately, the role of a clearing house is to clear the products that our members want to trade. It's up to the market more broadly to establish liquidity in specific products.

What developments have you seen in the RFRs that have been selected?

Phil Whitehurst: Sterling is a very positive story in reference rate reform. The fact there was already a liquid market in Sonia products has provided a great foundation to build on. All the right elements are in place, and LCH is working to ensure Sonia product eligibility maps across from sterling Libor, such as with LCH's recent launch of variable notional Sonia capability.

With the euro short-term rate (€STR), we were expecting more of a step-up in activity following the discounting switch in late July, but that hasn't happened. €STR OISs have stayed around 5% of our euro OIS volumes, but of course Euribor swaps represent most euro market liquidity. That's a bit of a puzzle, but is perfectly sustainable for now.

For SOFR, we've seen consistent activity throughout the year, although volumes did briefly drop off at the height of the market volatility in March 2020. SOFR clearing has been live for more than two years, and we've seen more than $3 trillion in volume over that time – with more than half of that trading this year.

There has been a nice balance between outright OIS, focused on the shorter dates, and SOFR/effective Fed funds rate basis trades, which are happening all along the curve. SOFR/Libor trades have been less prevalent, but are picking up. The introduction of the hard-wired link to USD Libor via the Isda fallbacks, along with the discounting switch in October, are both likely to stimulate further growth.

How are LCH's plans progressing on the SOFR discounting switch?

Phil Whitehurst: We have finalised the last elements of the process, so it is now very much about execution. The areas that have had the most attention of late in the market are the client elections and the cash settlement process. LCH has announced the outcome of these elections, and further information is available on LCH's website.[2]

On client elections, this relates to the choice we gave end-users of whether to accept their allocation of risk compensating swaps or to cash settle them via LCH's process. To rewind, the change in discounting regime switches a portfolio's discounting risk from Fed funds to SOFR – and the risk compensating swaps provide a good proxy to neutralise this. Taking the swaps gives you coverage for that change in profile, and allows you to manage it on an ongoing basis. But we identified several reasons why end-users might want to cash settle on the switch date and catered for that. ■

[1] *ARRC (September 2020),* ARRC releases request for proposals for the publication of forward-looking SOFR term rates, *https://nyfed.org/33uP99a*

[2] *LCH SwapClear (September 2020),* Service notification – SOFR discounting auction indicative portfolio, *https://bit.ly/3hYQidn*