Market fragmentation

The impacts of multiple rates and conventions

A forum of industry leaders discusses key developments in benchmark reform, and the strategic, operational and technological challenges involved in Libor transition

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Philip Whitehurst
Head of Service Development, Rates
www.lch.com

With Libor cessation dates now fixed, what does this mean for transition? How are market participants responding?

Philip Whitehurst, LCH: The announcements on March 5, 2021 by the UK Financial Conduct Authority (FCA), the ICE Benchmark Administration (IBA) and the International Swaps and Derivatives Association (Isda) have had a real impact. First and foremost, it has given the market certainty about two very important inputs into the transition planning: the Index Cessation Effective Date and the Spread Adjustment Fixing Date – versus the risk-free rate (RFR) – for each Libor.

This is vital information for making the transition actionable. By crystallising the timing and the spread, we lock in the relationship with RFR swaps – since a Libor swap quote now embeds a great deal of implicit RFR projection – and this has provided an upward driver on actual trading volume. LCH has now cleared more than $5 trillion nominal of secured overnight financing rate (SOFR)-linked swaps in 2021, which is more than was cleared in the whole of 2020.

It also makes the reality of the transition much more tangible and acts as a catalyst to firms at all levels as they intensify their preparations. LCH, for example, has been able to announce definite dates of December 4 (CHF/JPY/EUR Libor) and December 18 (GBP) for its conversion processes, and we have been able to specify increasing levels of detail around other aspects of the transition.

How will the extended timeline for USD Libor influence adoption of SOFR and alternative rates?

Philip Whitehurst: This is an interesting question. Arguably, uncertainty has shifted from the Index Cessation Effective Date and Spread Adjustment to the likely timing of material changes in liquidity. Many market participants continue to express their views on USD rates via USD Libor swaps, but we know this cannot continue on an open-ended basis.

There is likely to be a tipping point in liquidity and, for a central counterparty (CCP), this is critical. On the one hand, we need to maintain eligibility in support of market participants for as long as possible, since ongoing efforts to transition risk across to RFRs can temporarily boost Libor volumes. On the other, we need to attend to our own risk and default management responsibilities.

Official sector announcements have stated that trades conducted as part of a CCP default management process are permitted, and this provides a useful safe harbour. However, we need to assess this protection in the context of other exceptions, since CCP default management processes are insufficiently frequent to enable a truly vibrant marketplace.

What further clarity is needed on regulators' solutions for transitioning tough legacy products?

Philip Whitehurst: While tough legacy is an enormously important question in some quarters, cleared swaps are not tough legacy. However, there's still a big role for derivatives in the wider context. We must align outcomes in cleared swaps (and also those for uncleared derivatives) with potential outcomes elsewhere – a point that stood out in the feedback from our January Libor consultation.

Focusing briefly on sterling, if the synthetic Libor on which certain tough legacy products will be allowed to rely is, as has been suggested, a function of the forward-looking term Sonia reference rates (TSRRs), and given the reliance of these TSRRs on short-end sterling overnight index average (Sonia) swaps, this would align closely enough with both 'fallen-back' Libor trades – at least, to the extent we can predict their value today – and also with the conversion output in cleared processes.

To what extent will market participants rely on fallbacks rather than a proactive transition strategy?

Philip Whitehurst: LCH is not allowing fallbacks to become operational. Allowing them to do so may be the right approach for some products, but we believe it is best avoided for cleared swaps. Our motive is to eliminate the mismatch between the labelling – which we would argue becomes a mislabelling – of Libor swaps when their economics have switched as a result of the cessation events already announced to being driven by RFRs.

We need to perform the conversion to restore the right level of transparency to our risk and default management processes. In doing so, we are, to some extent, a standard-bearer for proactive conversion, and we hope this creates a template for how this proactive transition can be achieved.

Will the existence of multiple rates and compounding conventions lead to market fragmentation?

Philip Whitehurst: We do not think this will lead to market fragmentation. There is no debate and no question from anyone we speak to that the recommended RFRs will perform the central role for the derivatives markets as a pricing spine, for use in discounting and as the reference point for basis to other indexes.

But term RFRs have been slow to emerge, in some cases with good reason. And this has allowed the sustained interest from certain pockets of the industry in benchmarks that plug the gaps associated with RFRs – the absence of credit sensitivity and the fact that they don't look sufficiently forward – to find a foothold. That certain jurisdictions have always entertained, if not targeted, a multi-rate end-state is the best evidence for the idea that this is a sustainable future market structure.

Regarding different conventions, the most important thing is to develop consistent terminology. If we all use 'lookback' or 'observation period shift' with a common meaning, then the industry can focus its efforts on propagating the capability through different products and processing technologies. This will take some work, of course, but it will enable a functional marketplace that avoids fragmentation. ■