LCH The Markets' Partner

Key steps in the transition to SOFR

Phil Whitehurst, head of service development, rates, SwapClear at LCH, offers his insight into when a term structure for the secured overnight financing rate (SOFR) is likely to be established, what will be required for this to become a reality and what is needed in the US dollar market to successfully transition away from Federal Reserve funds price alignment interest and discounting to SOFR

Given the volatility seen in March, what can we learn about the suitability of the secured overnight financing rate (SOFR) as a viable fallback for US dollar Libor contracts?

Phil Whitehurst: SOFR was chosen by the market as the recommended alternative to US dollar Libor. While most market participants are supportive of the transition, there have also been dissenting voices. It's interesting to see both sides claiming that developments in March in the spot markets that underpin the daily benchmark resets supported their position.

For a clearing house such as LCH, it's more important to look at the swap rate variability during periods of volatility. And the behaviour observed in March was exactly as expected. The projected forward-looking basis between SOFR, and Federal Reserve funds on the one hand and Libor on the other, was largely stable – despite some spot market spread volatility. This means LCH's models performed well, and we are comfortable moving forward with our plans, which include the adoption of SOFR for price alignment interest (PAI) and discounting this October.

When are we likely to see a term structure for SOFR? What is needed to make that happen?

Phil Whitehurst: We already have a term structure in the form of projected SOFR via the swap markets and, in our role as central counterparty (CCP), we value and margin SOFR swap risk every day. We have good reason to expect further uptick in volumes and liquidity growth driven by adoption of the International Swaps and Derivatives Association's (Isda's) more robust fallbacks in or around November. This will be a significant milestone in the development of the USD Libor/SOFR relationship.

Related to this, the Alternative Reference Rates Committee (ARRC) recently added a path towards a term SOFR to its list of objectives for 2020, centred on the production of a daily fixing of a SOFR-based benchmark that relates to forward-looking periods longer than overnight. This has been a sensitive area, with some participants arguing that the dearth of trade data could lead to the conclusion that a term SOFR must inevitably suffer the structural weaknesses associated with a deposit market benchmark. LCH is more optimistic. Deposit markets are asymmetric, credit-specific and balance-sheet heavy; the markets on which a term SOFR can be based are symmetric, credit-agnostic and light on the balance sheet. So, while ARRC is some way from endorsing a rate, the fact it has made it onto the road map is a positive step.

What are the key steps market participants should be taking in preparation for Libor-to-SOFR transition?

Phil Whitehurst: LCH has already taken a number of the key steps in this process, but there are still many more to come. I will walk through the steps required in derivatives markets, since this is our core competence, but the process for cash products is just as involved, if not more so. We can take a cue from ARRC and the steps it has identified, which we summarise as:

1. Supporting SOFR usage and liquidity, which for LCH means focusing on the PAI and discounting transition for cleared swaps, but also relates to conventions in the swaptions market – both in terms of pay-off functions and underlying
2. Ensuring external service providers and internal systems are 'SOFR-savvy'
3. Finalising and adopting more robust contractual fallbacks, work on which is very advanced for derivatives and is being led through to delivery in November by Isda. The extensive education and familiarisation work needed before then is now gathering pace.

Why does the USD market need to transition from Fed funds PAI and discounting to SOFR?

Phil Whitehurst: LCH is solving the challenges associated with USD Libor, and we don't use USD Libor for PAI or discounting of USD trades. So why transition the discounting at all? One way to look at this is to work backwards. SOFR has been recommended as the alternative to USD Libor, and the great majority of USD swap trades reference USD Libor. If, in the future, all those trades are conducted with reference to SOFR, there is a huge opportunity to simplify market structure by also using SOFR for PAI, and discounting. This would restore a simpler mono-curve environment for projection and discounting – reminiscent of the early days of the swap market, but built on a much more solid foundation.

There is another reason the central counterparty (CCP) discounting transition is spoken of as the key step in moving the market towards this SOFR-based paradigm. The discounting risk on a derivatives portfolio is dynamic; it changes in response to moves in market levels. This creates both supply and demand for SOFR risk in the derivatives market. Our hope is that this 'primes the pump', creating more liquidity and enabling other SOFR-based hedging activities to proceed more confidently in the wider market.

When is that planned to happen?
Phil Whitehurst: In line with other derivatives CCPs, we are targeting the weekend starting Friday, October 16 for the transition. There is broad consensus on the date and growing momentum towards delivery.

What are the central features of the transition process?
Phil Whitehurst: When LCH first consulted the market approximately two years ago, we were asked to think about two central effects of a discounting transition. First, a transition would be likely to create a point-in-time change in valuation for margining purposes. Second, it would eliminate a forward-looking sensitivity to the Fed funds' yield curve and replace it with an equivalent exposure to the SOFR yield curve. A solution that neutralised these effects to the greatest extent possible was needed, and we believe we've found one.

The change in net present value can be compensated with a cash payment. If a portfolio experiences a drop in value upon transition, LCH pays the difference (and vice versa). For the sensitivity change, we had to be more inventive and are solving this by providing 'compensating swaps', which restore the original portfolio risk sensitivities. This additional compensation layer mitigates the impact of the transition more completely, although we are aware that certain clients are not active hedgers of discounting risk and prefer not to take their allocation of compensating swaps.

How are you dealing with clients who don't want risk compensation?
Phil Whitehurst: While we require our members to take up their allocation of swaps, we will enable clients to elect a cash alternative to the discounting risk swaps. To keep the risks balanced across the service, we need to find a new home for these unwanted allocations. So we're running a cash settlement process that aims to concentrate liquidity for the benefit of these clients. We will require the dealers most active in USD swaps to make prices to LCH, to take up the net risk of clients opting for cash settlement.

We will run this process on Friday, October 16 after determining the allocations for everyone in the service, including clients opting into the cash settlement process at close of business on Wednesday, October 14. It is worth adding that clients will be required to make their election a number of weeks ahead of the transition event. Clients are also free to dispose of their allocation of swaps outside the cash settlement process arranged by LCH at their convenience in the open market.

Phil Whitehurst

Are there any protections against an auction with limited bids?
Phil Whitehurst: Yes, we have made auction participation a requirement for the largest US primary dealer banks, ensuring there will be a good base level of support. We are also implementing an auction proceeds cap, which ensures weak bids will not be carried through to the final portfolio allocations, giving clients a quantifiable maximum cost associated with the auction process.

How would you deal with insufficient bid interest in the auction?
Phil Whitehurst: CCPs spend a lot of time planning to deal with low-probability events. We have invested heavily in designing a cash settlement process that will attract the necessary volume of bids and offer to cover net client disposals, so we think this can be considered a low probability. However, we felt it important to plan for this unlikely event and ensure clients were aware of all possible outcomes. As a fallback, we will therefore deliver any residual allocations to the relevant client accounts, and they will need to dispose of them individually – for example, with the help of their clearing brokers and their wider dealer relationships.

Our planning covers all scenarios, including insufficient interest in individual compensating swap tenors – of which there are six – and also the possibility of partial fills. Our approach is to handle as much of the risk as possible, and to be able to provide an unconditional result to participants bidding in each tenor in turn.

Are there any other focus areas for LCH right now?
Phil Whitehurst: As well as addressing a shortage of liquidity, we are putting a lot of effort into a mitigation strategy and fallback planning in case of an operational scenario that prevents us from running the process. Beyond this, our priority is education. It is extremely important that all cleared swap users understand the operational aspects of this transition. This is a highly complex exercise, and we intend to minimise the number of surprises. To support this aim, we are holding regular webinar sessions for members and clients, and have created a dedicated risk-free reference rate section on our website with links to all the key resources relating to the transition. ■