

# Approaching the end-game

## What's left for completing Libor transition?

Philip Whitehurst, head of service development, rates at LCH, discusses the International Swaps and Derivatives Association's fallback protocol, its relevance for cleared swaps, remaining transition steps and major developments to look out for in 2021

### What does the outcome of October's central counterparty (CCP) discounting switches tell us about the outlook for secured overnight financing rate (SOFR) liquidity?

**Philip Whitehurst:** The switch to SOFR discounting for cleared swaps has had a sustained positive effect on SOFR liquidity. The event itself gave rise to an immediate jump in traded volumes, and it has been great to see this continue. Until September, LCH had been clearing around 40 trades a day, with an aggregate notional of around \$10 billion in 2020 prior to the switch. It's not unusual now to have days with several hundred trades or more than \$100 billion in aggregate notional, and the post-event averages are for more than 200 trades and around \$50 billion notional. That has taken year-to-date notional to more than \$3 trillion.

Equally good news is the mix of activity. There has been an increase in outright SOFR business and in SOFR/Federal Reserve Funds basis – which is the product allocated to market participants as part of the discounting switch – but it's in SOFR/Libor that we have witnessed the strongest growth. This has a lot to do with the International Swaps and Derivatives Association's (Isda's) recent finalisation of its *libor fallbacks supplement* and *libor fallbacks protocol*. We're particularly pleased as this marries well with the reduction we were able to offer in margins associated with cleared SOFR risk – it enables something of a virtuous circle to develop. The adoption of SOFR discounting for cleared swaps – as well as in LCH's SwapAgent service, which handles bilateral swaps business under a standardised framework – has set a positive precedent for traditional bilateral swaps.

### What are the pros and cons of Isda's fallbacks protocol?

**Philip Whitehurst:** LCH is a big supporter of Isda's work on promoting more robust fallbacks. There are plenty of good materials out there that set out the benefits of signing up to the protocol. I think the strongest endorsement we can give is through our actions – LCH intends to adopt Isda's supplemented definitions, which incorporate these better fallbacks, as soon as they are available on January 25, 2021, and understand that other CCPs will do the same. We will do this via our rule book and, in doing so, the changes will apply to new trades and to our legacy contracts. However, we don't see that as the end of the road. It's great to have more robust fallbacks in place as a safety net, but we think we will need to go a step further.

### Does that mean that, once the new fallbacks are in place, you don't recommend allowing trades to experience a fallback?

**Philip Whitehurst:** When we look at the views expressed by regulators, we think it will be best to transition away from a vulnerable interbank offered rate (Ibor) by replacing or amending contracts that reference it before the fallback provisions become operational. There are a number of arguments for this, but one stands out for us: CCPs need to be able to manage defaults efficiently, and this involves neutralising the defaulters. If the defaulter had a position in a benchmark that had ceased – which is where we'd be if we were managing trades that had experienced a fallback – it would need hedges from the market in this now-ceased benchmark. We don't think that would be straightforward, and could jeopardise the safe and successful execution of our default management process.

Approaching this from the other direction, it could be better to avoid the scenario altogether by preventing any potential defaulter from having an open position in such an Ibor. CCPs have the luxury of being able to control the risk factors to which they are exposed via their eligibility criteria. Cleaning up open risks on a service-wide basis ahead of a cessation effective date seems to us to have some strong attractions. And, judging by the results of our recent euro overnight index average (Eonia) consultation, many of our participants agree.

### What were the main takeaways from LCH's Eonia consultation?

**Philip Whitehurst:** We asked market participants about their preferences for resolving any residual cleared Eonia swap contracts at or around the time of Eonia's last publication on January 3, 2022. We drew two central conclusions. First, the market expressed a preference to get this event under its belt ahead of the cessation itself. This looks like a strong signal that recourse to fallbacks isn't a favoured option. Second, the market was keen to see a contractual conversion into standardised risk-free rate (RFR)-based instruments to the maximum extent possible.

This suggests forward-looking compressibility and concentrated market liquidity are uppermost in people's minds as we enter this new RFR-based world. We should be careful not to draw undue parallels between an Eonia and the euro short-term rate (€STR) conversion and other Ibor-to-RFR conversions, but it's likely we'll get similar answers in some areas.



### What are LCH's plans for the large portfolios of Ibor contracts that are still outstanding?

**Philip Whitehurst:** We are keen to see outstanding notional and trade count drop significantly in the months ahead. There are a couple of tailwinds on this, such as the recommendations from the Alternative Reference Rates Committee on the US dollar, and the Working Group on Sterling Risk-Free Reference Rates to curtail new swaps activity linked to Libor beyond the first half and first quarter of 2021, respectively.

However, we also need to develop contingency plans in case this does not fully eliminate the exposures. We can build on the conclusions of the Eonia consultation in two areas: we can envisage a solution that clears up the exposures pre-emptively, ahead of the cessation effective date of a given Ibor, and one that converts Ibor contracts into corresponding RFR contracts. There are a lot of subsidiary decisions to make on this, and it's likely we will want to consult with our participants on the best approaches.

### Are synthetic Libor mechanisms the best option for dealing with 'tough legacy' contracts?

**Philip Whitehurst:** This is a really interesting question, but one that doesn't directly concern the cleared swaps market. Considering Isda's excellent work on fallbacks based on backward-looking RFRs, synthetic Libor need not be available for use in cleared derivatives.

### Does the exclusion of US dollar Libor from the ICE Benchmark Association's (IBA's) consultation mean a multitrack timeline for Libor's cessation is inevitable?

**Philip Whitehurst:** Although US dollar Libor was missing from IBA's mid-November announcements, it has been covered in a separate and subsequent statement. But, to the central question here, yes, we think we are looking at a multitrack timeline. This has its pros and cons.

In the same way it made sense to conduct the discounting transitions earlier this year for the euro and for the US dollar on separate dates, it may make sense to phase Libor's cessation across a number of dates. Different dates for dollar, sterling, yen and Swiss franc might make the transitions more digestible for the market.

There are other dimensions along which we might want to constrain the phasing. Different dates for cessation of three-month Swiss franc Libor and six-month Swiss franc Libor probably don't make sense. I think the industry needs to come together to find a happy medium on this, although we need to remain alert to the fact that the phasing may be dictated to the market by unfolding events.

### How is transition faring in non-linear instruments such as swaptions? What additional hurdles do these markets face?

**Philip Whitehurst:** Many of the issues in the non-linear markets are common to those in swaps. However, there are certainly some additional complications. One that has been brought to our attention is an issue facing swaptions that have a cleared swap as their underlying and that expire beyond the likely cessation effective date of the Ibor in question. It is quite possible that this type of underlying will not be eligible for clearing at a CCP at expiry. We are keen to try to support the market where possible on this. There may be solutions linked to the compensated conversion mechanisms that CCPs develop, but I think there is a good deal of work required here before we have the answers.

### What are the major developments and milestones to look forward to in 2021?

**Philip Whitehurst:** There are some great resources out there on this. All of the currency-focused RFR working groups have set out timetables for 2021, which are a great source of information. We know we are kicking off the year with the go-live date for Isda's *Ibor fallbacks supplement* and *Ibor fallbacks protocol*, on January 25, and I expect we will end the year with a number of conversion events in some of the main Ibors, at least as far as cleared swaps are concerned. One thing is for sure – 2021 is going to be busy. ■



Philip Whitehurst, LCH