Opening Remarks

CFTC Market Risk Advisory Committee – Update From Subcommittee – December 11, 2019

Introduction

- Good afternoon everyone- it is an honor to be presenting again in front of the Market Risk Advisory Committee on behalf of the subcommittee on interest rate benchmark reform. My name is Tom Wipf, Vice Chairman of Institutional Securities at Morgan Stanley and I represent the Firm as Chairman of the ARRC as well as a Board member of ISDA
- I want to take a moment to thank Commissioner Behnam, Alicia Lewis, Nadia Zakir, the MRAC, and the rest of the CFTC for forming this subcommittee – the transition to alternative reference rates is a massive task ahead of us, and to achieve success it is paramount that we have close coordination between the public and private sectors
- I'd also like to thank the members of the Subcommittee for their hard work over the past year – I have been impressed by the group's commitment towards the MRAC's goal for us to be additive to the LIBOR transition efforts from the ARRC and other groups.
- I'd like to begin by first recapping the key developments in the LIBOR transition that have occurred since we last spoke in September, and then discuss our three agenda items. These items are the following:
    1. Discuss the CFTC's and MRAC Subcommittee's findings on the uncleared margin impact of transitioning certain legacy IBOR-linked derivatives to RFRs
    2. Discuss recent developments from ISDA as they progress towards the publication of a voluntary protocol to amend fallback language in legacy derivatives
    3. Discuss updated proposals from central counterparties regarding adjustments to discounting and price alignment interest

Developments in LIBOR Transition

- Since September there have been a number of important developments in the LIBOR transition, driven by both Regulators and market participants
- Regulatory developments include the following:
    - Treasury and the IRS have proposed broad relief from tax implications of converting trades to new RFRs
    - US Prudential Regulators published proposed amendments to their uncleared margin rules to provide broad-based relief for interest rate reform
    - The CFTC received a letter from the ARRC regarding regulatory issues associated with the transition of derivatives contracts from IBOR rates to alternative risk free rates. The letter

    updates and consolidates earlier letters from the ARRC to the CFTC requesting regulatory interpretive guidance
    - FHFA sent a letter to the FHLBs indicating that effective March 31, 2020 they can no longer enter into new assets, liabilities or derivatives referencing LIBOR and maturing after YE’2021
    - The New York Fed published a consultation on the proposed publication of SOFR averages and a SOFR Index, which could both be quite useful to market participants
    - The OSSG sent a letter to ISDA reiterating its preference to include a pre-cessation trigger in ISDA’s new fallback language
    - FRB published its semiannual Supervision and Regulation Report, which mentioned the LIBOR transition as a supervisory priority for each type of organization covered within the report
- Market developments include the following:
    - ISDA published the results of its consultation on final parameters for benchmark fallback adjustments, which Ann will discuss in greater detail
        - ISDA also responded to the OSSG’s letter on pre-cessation issues
    - The ARRC published a practical implementation checklist to help market participants with the LIBOR transition
    - The ARRC published recommended fallback language for residential adjustable rate mortgages, which Fannie Mae and Freddie Mac subsequently endorsed
    - The clearinghouses have continued to refine their proposals for how they will adjust discounting and price alignment interest – this will be discussed in depth shortly

Legacy LIBOR Swaps and Initial Margin Findings

- In the June 2019 MRAC meeting, the Subcommittee presented its views on how certain uncleared margin requirements may have an adverse impact on the LIBOR transition, absent any relief from the CFTC
- The MRAC’s feedback from that discussion was that in order to best inform the CFTC’s actions, the Subcommittee should attempt to quantify the impact to uncleared margin if no relief was granted
    - Responding to this request, the MRAC Subcommittee worked with the Office of the Chief Economist at the CFTC to approximate this impact
    - A report was published by the Office of the Chief Economist in November 2019, which Richard Haynes is here to discuss in detail. This report calculated notional amounts for uncleared legacy IBOR swaps, and used the Regulatory grid method to estimate initial margin that would be posted if these swaps lost their legacy status

    - The Subcommittee then used the findings from this report to extrapolate what the margin impact may look like using the SIMM approach. Bis Chatterjee will discuss this additional analysis.
- The findings from the Office of the Chief Economist and Subcommittee are approximations meant to be useful to the CFTC as they deliberate on relief from uncleared margin requirements in order to aid the LIBOR transition

ISDA Developments

- ISDA has also made excellent progress since we last spoke as it relates to the finalization of benchmark fallback language
    - When published, this language can be agreed to on a voluntary basis for legacy trades
    - As of a certain date post-publication of the protocol, ISDA will amend its definitions to include these fallbacks for all new trades
- ISDA consulted the market on the preferred calculation parameters for a historical average credit adjustment to be included in the new fallbacks, and the market preferred a 5-year median calculation
- At the request of the OSSG, ISDA also consulted the market on the inclusion of a pre-cessation trigger
    - The consultation results were inconclusive, prompting the OSSG to send another letter to ISDA reiterating its request for inclusion of such a trigger
- Ann will discuss ISDA's progress to date in greater detail, as well as ongoing work to be completed before the protocol can be published

CCP Adjustments to Discounting & Price Alignment Interest

- We will also look to continue the discussion from the September MRAC meeting around areas of coordination and potential risk considerations from the current proposals put forth for Discounting & Price-Alignment Interest adjustments from LCH and CME
    - We will hear from Dennis McLaughlin (LCH) and Agha Mirza (CME), who will both give brief overviews of their current proposals
- There are certain differences between the respective proposals that the Subcommittee recognized as potentially challenging from an economic and operational perspective
    - There was desire from the Subcommittee for consistency across the clearinghouses in how they approach this adjustment, to the greatest extent possible
- Since the September MRAC meeting, both clearinghouses have coalesced around a single transition date. This is now scheduled for mid-October 2020.

    - It was also mentioned at the September meeting that differences in compensation methodologies between the clearinghouses could be problematic
    - Dennis and Agha will confirm, though it is believed that in the current proposals, these differences in compensation methodologies still exist
    - We note that ultimately both clearinghouses will enact plans that best represent their clients' preferences
- The Subcommittee discussed the operational challenges and potential market turbulence that could arise from separate methodologies as currently envisioned
    - To improve market transparency into the economic and operational dynamics occurring at the time of the Single Step, the Subcommittee asks that the MRAC consider the benefits and considerations of a "table-top" demonstration involving both clearinghouses in 2020, well before the October switch date
    - A public demonstration of this type could help market participants think through their respective risks to the Single Step event, so that they can risk manage appropriately
    - The Subcommittee's recommendation is that the MRAC host such an event.

Clearing Treatment for Certain Physically-Settled Swaptions

- Finally, at the September MRAC meeting we also discussed the clearing treatment for certain physically-settled swaptions, particularly after the Single Step transition has occurred in the clearinghouses
- It was the MRAC's view that the ARRC would be the most appropriate venue to work on this issue
- In my capacity as chairman of the ARRC, I can report progress and current thinking from the ARRC on these topics:
    - The ARRC has established a swaptions working group to focus on this issue.
    - There are no easy answers. These are bilateral contracts that are not cleared by the CCPs, and so CCPs are reluctant to and do not view themselves as having authority to require that compensation be exchanged on any swaps that are delivered from an uncleared swaption after the PAI/discounting move.
    - One area where progress may be made is in adding transparency to new bilateral swaption contracts as to what will happen regarding PAI/discounting and any exchange of compensation. The ARRC group is discussing that with ISDA.
    - For legacy swaptions, the group is looking at a model in which CCPs could provide pricing tools to let people calculate the difference in valuation between a EFFR and SOFR discounted swap. If swaps came to the CCP with a flag indicating that compensation should

be exchanged, they could help to facilitate an exchange subject to confirmation or other requirements.

- However, this would not fully address the issue that counterparties who would receive compensation would advocate for a compensation mechanism while those that would pay compensation might be less inclined to support it. The ARRC could recommend compensation as a best practice, if there was general market support, but the ARRC cannot require or enforce any compensation mechanism.
- Market participants need clarity fairly soon on these issues, and we will keep working to provide this clarity wherever possible.

Next Steps

- The subcommittee's work will continue after this meeting, and we intend to have another update for this group at the next MRAC meeting
- I expect the discussion of coordination between the clearinghouses on their respective Single Step proposals will be ongoing for the next several weeks and months
    - I would reiterate our request for the MRAC to consider the merits of hosting a public table-top demonstration, and how that transparency into the Single Step transitions may benefit the market

Conclusion

- We welcome any feedback from the MRAC on our areas of focus and recommendation
- The MRAC and CFTC's guidance has been helpful to our work thus far, and we look forward to further collaboration with this group
- Once again, I would like to thank Comm. Behnam, Alicia Lewis, Nadia Zakir and the MRAC for this opportunity for public service