

CFTC Market Risk Advisory Committee – Update From Subcommittee – February 23, 2021

Introduction

- Good morning 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. For those I haven't met, 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 Acting Chairman Behnam, Alicia Lewis, Nadia Zakir, the MRAC, and the rest of the CFTC for continuing to support this subcommittee.
- I'll first begin by recapping the key developments in the LIBOR transition that have occurred since we last spoke in July 2020, when we were discussing the Subcommittee's tabletop exercise.

Developments in LIBOR Transition

- Following our tabletop exercise and corresponding report that was approved by the MRAC at the July meeting, CME and LCH successfully executed their respective discounting transitions in October 2020.
 - From an operational perspective, both processes went quite well. And from a market risk perspective, the potential risks identified by the subcommittee (including the possibility of a failed auction) did not materialize. In fact, market participants that exited basis swaps via the auctions may have been able to realize cost savings relative to where they would have transacted bilaterally. In other words, the auctions worked well, and both CME and LCH are to be commended for all the work that went into that seamless execution.
- Also in October, ISDA launched their IBOR Fallbacks Protocol and Supplement, marking a major milestone in the transition away from IBORs globally.
 - These documents provide fallback language based on a clear, consistent and transparent methodology for derivative transactions, reducing the risk of market disruption if a key IBOR ceases to exist or LIBOR is deemed to be non-representative before the transition efforts are complete.
 - These fallbacks became effective on January 25th, and are therefore incorporated into any new trades executed after that date that use ISDA's standard interest rate definitions, as well as any legacy trades if both counterparties have adhered to the protocol.
 - Over 13,000 entities have adhered to this protocol, which represents broad adherence among broker dealers, institutional investors, and other types of market participants.

Opening Remarks

- Additionally, both CME and LCH have incorporated these fallback terms into their rulebooks, meaning that at this point the entire cleared market plus much of the uncleared market is operating with ISDA's fallbacks.
- This accomplishment is the result of years of work from ISDA, and I commend them for their efforts to provide a clear path forward for derivatives which form the significant majority of IBOR exposures globally and in the US.
- In the loan market, which to date has struggled with adoption of SOFR compared to other markets, we received clarity from US regulators towards the end of last year on outstanding questions related to credit-sensitive benchmark rates and appropriate benchmarks to be used in loans.
 - The official sector made it clear that they support innovation in, and development of, suitable reference rates, including those that have credit sensitive elements. However, that innovation is best left to the private sector. The official sector noted that they are not well positioned to adjudicate the selection of a reference rate between banks and their commercial customers, and thus they have not convened a group to recommend a specific credit-sensitive supplement or rate for use in commercial lending products.
 - Further, the Federal Reserve Board of Governors, Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency published a statement regarding reference rates in loans noting that banks should select suitable replacement rates for LIBOR that are most appropriate given their specific circumstances, giving due consideration to their funding costs and customer needs. They confirmed that examiners will not criticize banks solely for using a reference rate, including a credit-sensitive rate, other than SOFR for loans.
 - With these two items combined, the message to the private sector is clear: begin engaging in non-LIBOR lending business.
- The most fundamentally important developments occurred in late November, when IBA released a consultation proposing cessation dates for the 35 LIBOR settings they publish. They proposed to cease publication of all tenors of Sterling, Euro, Swiss Franc and Japanese Yen LIBOR as well as 1 week and 2 month USD LIBOR on 12/31/2021, and cease publication of the remaining tenors of USD LIBOR (overnight, 1, 3, 6 and 12 month) on 6/30/2023.
 - This consultation concluded in January, and we await the final results. Notification by IBA of the exact timeline for LIBOR cessation would serve to "freeze" the spread adjustments to be used in derivatives that use ISDA's fallback as well as cash products that use ARRC fallbacks.
- On the same day that IBA published this consultation, the Federal Reserve Board of Governors, Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency published clear supervisory guidance on LIBOR activity going forward.

- They stated that: “Failure to prepare for disruptions to USD LIBOR, including operating with insufficiently robust fallback language, could undermine financial stability and banks' safety and soundness...The agencies believe entering into new contracts that use USD LIBOR as a reference rate after December 31, 2021, would create safety and soundness risks and will examine bank practices accordingly. Therefore, the agencies encourage banks to cease entering into new contracts that use USD LIBOR as a reference rate as soon as practicable and in any event by December 31, 2021. New contracts entered into before December 31, 2021 should either utilize a reference rate other than LIBOR or have robust fallback language that includes a clearly defined alternative reference rate after LIBOR’s discontinuation.”
- The supervisory intentions are clear, and every firm needs to accelerate their LIBOR transition plans in order to comply with this guidance.
- Finally, towards the end of 2020 and earlier this year, LCH and CME provided indications on how they would approach a LIBOR cessation event from an operational and risk management perspective. These proposals, for which LCH issued a consultation in December and then published results of that consultation last week, will form the next workstream for the MRAC Subcommittee on interest rate benchmark reform.

Review of CCP Proposals and Subcommittee Discussions

- I will not go into depth on current plans for each CCP as they are still in draft form, but I will share some of the guiding principles discussed in public documents and how they have been deliberated within the subcommittee.
- Due to the way the fallbacks in the ISDA protocol and supplement are constructed, an IBOR swap under these fallback terms will fall back to an RFR swap that has slightly different conventions than what one might consider a standard RFR swap.
 - For instance, ISDA’s fallback terms contemplate a spread adjustment on the floating leg where typically one would not exist, and also create an observation shift for interest accruals that would not typically exist in a newly executed RFR swap.
- The overarching goal from the clearinghouses is to standardize these fallen-back IBOR swaps as much as practicable. Many market participants agree that creating two distinct classes of RFR swaps – one for new activity, one for fallen back IBOR swaps – may be a suboptimal outcome for the market.
 - However, different types of market participants have varying views on the most appropriate way to complete this standardization. Fortunately, the subcommittee contains an appropriately diverse set of viewpoints so that our discussion of these topics has been thorough.

Opening Remarks

- To organize the subcommittee's diverse thoughts in a way that is helpful to the clearinghouses, we are summarizing each of the views from the relevant market participant types represented on the subcommittee. Ultimately, our goal is to be additive to the independent consultation processes that both CME and LCH will complete prior to finalizing any plans.
 - We will keep the MRAC aware of our progress on this discussion, and any next steps that the subcommittee identifies.
- Although the conversion processes for USD LIBOR would not occur until after 2021, due to the 18-month extension in USD LIBOR's publication, there seems to be appetite from the clearinghouses and other market participants for a currency-agnostic approach to this transition. In other words, as the clearinghouses finalize their plans over the coming months for Sterling, Euro, Swiss Franc and Japanese Yen LIBOR, it is important for the subcommittee to be plugged into this process because the outcome will directly impact the transition for USD LIBOR at a later date.

Conclusion

- At this time, we welcome any feedback or questions from the MRAC on our workstream to consider the IBOR transitions from the clearinghouses. We would also be keen if the MRAC has views on other items the subcommittee should consider.
- 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 Acting Chairman Behnam, Alicia Lewis, Nadia Zakir and the MRAC for this opportunity for public service. I would now like to open the discussion for feedback and questions.