

Pre-cessation Ibor picture gets clearer

As the derivatives market has accepted the impending transition away from interbank offered rates, attention has turned to how best to manage it. Philip Whitehurst, head of service development, rates at LCH, explores how the clearing house is working closely with industry bodies and listening to the views of market participants to preserve integrity and robustness in a transparent manner

In recent months, the focus of the derivatives market has moved from the question of whether benchmark rates will change to how this transition will take place. This is a significant shift in sentiment that comes alongside tangible moves by the industry – alongside regulators and trade associations – to create a clearer road map for this market evolution.

The need for fallbacks to kick in when a benchmark ceases to exist is simple to understand and accept – indeed, there is little choice. The question that has been more difficult to answer is: what happens in the case that interbank offered rates (Ibors) continue to be published but are no longer representative of their underlying market?

It is generally agreed that benchmark rates need to be representative of their marketplace. Customers have complained in the past when, for example, their borrowing rate is pegged to something that doesn't truly reflect market costs. Pre-cessation triggers seek to address this issue.

In a November 19, 2019 letter, the Financial Stability Board (FSB) encouraged the International Swaps and Derivatives Association (Isda) to add a pre-cessation trigger alongside the cessation trigger as standard language for definitions for new derivatives.¹ The FSB also recommended doing this in a single protocol without embedded optionality for outstanding derivatives contracts referencing key Ibors. They argued this would help reduce systemic risk and market fragmentation by ensuring as much of the swaps market as possible falls back to alternative rates in a co-ordinated manner.

Isda had already tried to foster industry consensus on this, but it hasn't been easy. In its initial consultation, the majority of the market favoured a pre-cessation trigger but disagreed over how to make it available. And, with time of the essence, Isda wanted to forge ahead with implementing permanent triggers.

The FSB's strategy would require Isda to reconsult with the market on a single documentation approach, and Isda has subsequently announced its plan to do so. Completeness must be balanced with timeliness, but if a strong majority of market participants now supports a 'non-representativeness' fallback trigger for Ibor derivatives in response to this consultation, then Isda would have the mandate to implement it.



Philip Whitehurst

To make progress, the association's most recent letter requested clarification of information in two areas:

1. How long a rate might remain non-representative
2. The approach central counterparties would take to this scenario.

The Financial Conduct Authority and the Ice Benchmark Administration have both issued responses to the first point. To address the second, LCH has made clear to its members in recent weeks that it seeks their feedback on proposals to enact automatic pre-cessation triggers.

While LCH already has discretionary power to act as proposed, the rule changes would provide clarity to users by automating the process.

Proposed LCH changes

The draft LCH rulebook changes provide for the same planned approach to be used for permanent cessation triggers – that is, to fall back to the adjusted backward-looking risk-free rate (RFR) together with a credit spread adjustment, as formulated in the relevant Isda-supplemented Ibor definition.

Under the proposed LCH rulebook changes, following a regulator's announcement that an existing RFR is no longer representative, the effective date of the change to the new RFR would be publicly notified to all SwapClear members as the later of five days after such regulator's announcement or the date the rate ceased to be representative.

LCH is working closely with Isda and other industry bodies to provide as much clarity as possible to this process. The latest proposal would also ensure that the determination of a rate being non-representative sits with the relevant regulator, and that it leads to an automatic trigger into fallback arrangements.

The original eight-week consultation period – which was open to the entire market – had been extended by one week and closed on March 31, 2020. The rulebook changes, as always, remain subject to regulatory approval or review.

As the leading clearing house for rate swaps, LCH is ensuring it demonstrates leadership in this important industry shift while taking on board the views of market participants. By balancing systemic risk with the concerns of stakeholders, it seeks to continue to preserve the integrity and robustness of one of the world's most vital financial markets.

¹ A Bailey and J Williams (November 2019), Letter to Scott O'Malia and Katherine Tew Darras, <https://bit.ly/2SSqo0o>