

SOFR Discounting: LCH Plan for the SwapClear Compensation Process

Q4 2019

Summary

Earlier this year, LCH announced plans to move to SOFR discounting¹ on all USD-denominated SwapClear contracts in the second half of 2020.

To address these impacts we also announced that a compensation process would be designed to minimise the impact of these changes on our users. This decision was driven by feedback received from the respondents to our consultation.

The changes to discounting will result in a *valuation* change for portfolios containing USD-denominated contracts, resulting in valuation gains and losses from the switch.

The discounting change will also change the *risk profile* of the portfolio, as Fed Funds discounting risk becomes SOFR discounting risk at the point of conversion. Note that this change will not affect the coupon payments on any trades, which remain linked to their original benchmark rates.

Details of LCH's plans (including timing of the switch and scope of trades) for the SwapClear compensation process are provided in the following slides.

1. SOFR is the Secured Overnight Funding Rate. The switch will apply to the underlying benchmark used for USD discounting (currently Fed Funds), Price Alignment Interest (PAI) and Price Alignment Amount (PAA), jointly henceforth referred to in this announcement as 'discounting'.

Introduction

LCH is keen to strike a balance between keeping momentum on this important project and ensuring users have sufficient time to prepare for the changes. We also need to avoid other significant industry events in the calendar.

The plan remains subject to further consultation, governance, legal and regulatory review. Details of the proposed process will be developed further and may change following feedback from participants. Discounting for cleared USD swaps is only one component of a much larger industry-wide initiative to transition from USD LIBOR to SOFR.

We have attempted to design a compensation process, which is as simple and straightforward as possible. While respecting these constraints, the process should operate to a high level of accuracy. The aim is to provide coverage of risk mitigation where needed, with the flexibility to opt out of certain components if required.

These slides provide users with further information on what they should expect from the SwapClear service over the next 12 months. We actively welcome your continued cooperation and further feedback on these proposals.

LCH Proposed Compensation Process

1. Compensation for the valuation and risk change will be provided as a combination of cash and compensating swaps;
2. Client accounts will be able to elect cash-only if they choose to do so via their clearing broker;
3. An auction will be used to facilitate the cash-only election and to determine the cash compensating amounts;
4. All USD-discounted positions in SwapClear are in scope, including non-deliverable currencies.²
5. We are targeting the conversion to take place over the weekend of 16-19 October 2020.

2. The main use of Fed Funds discounting in LCH today is for USD LIBOR, USD Fed Funds and USD SOFR interest rate swaps; and USD CPI zero coupon inflation swaps. However, Fed Funds is also used in discounting for MXN swaps and non-deliverable swaps in 8 other currencies (KRW, CNY, INR, BRL, COP, CLP, THB, TWD).

Combining Swaps with Cash

We propose using a *combination* of cash (to provide *value* compensation) and swaps (to provide *risk* compensation).

In this approach, the compensating swaps would be *at market* with a spread on the SOFR leg calibrated to ensure a *zero present value* with respect to market levels at the point of conversion.

Cash payments would be calculated on a full revaluation basis using mid prices from the auction process to build a pricing curve (the auction will ask for two-way quotes).

These same mid prices would be used to determine the required spreads on all compensating swaps with a view to ensuring zero present value.

This proposal is designed to maintain the benefits of both approaches while addressing the potential drawbacks.

The swaps should provide a buffer against any short-term market distortions. The cash element should ensure the value compensation is sufficiently accurate.

Client Accounts Electing Cash-only Compensation

We would strongly encourage client accounts towards acceptance of the compensating swaps. However, we recognise that SwapClear has a diverse set of users with differing requirements and have concluded it is important for us to offer an alternative.

We therefore plan to allow client accounts to elect for a purely cash-based compensation if they choose to do so.

We anticipate that any opt-out decisions for client accounts will be provided to LCH by the relevant clearing broker, potentially via the LCH Portal. However, this option will be reserved for clients only, i.e. member accounts will not be able to opt out of the swap-based compensation.

We will require this election to be made well in advance of the switch date, in order to facilitate auction preparations.

Facilitating Cash-only Election for Clients

To facilitate the cash-only election, LCH intends to run a centralised auction in order to:

1. source the off-setting swaps required; and
2. establish the market value of these positions (which determines the amount of cash payable).

The auction result will also be used to calibrate the cash amounts and the spreads on the swaps provided to other users (i.e. to members and to clients who are taking the swaps).

As previously mentioned, those users should be relatively indifferent to the outcome of the auction as any short-term gains they make on the cash amount would be offset by valuation changes in the swaps, and vice versa.

Timing

Based on feedback, we determined that a switch date in the second half of 2020 provided the right balance between maintaining momentum and ensuring users had sufficient time to prepare for the changes.

We are mindful of ensuring sufficient time to test, deploy and dry run these proposals with our users and to avoid other events impacting the industry in that timeframe.

This led us to propose a mid-October date, specifically we are targeting the conversion to take place on or around 17th October 2020, with the auction taking place 1-2 days before that.

Scope

The main use of Fed Funds discounting in LCH today is for USD LIBOR, USD Fed Funds and USD SOFR interest rate swaps; and USD CPI zero coupon inflation swaps. However, Fed Funds is also used in discounting for MXN swaps and non-deliverable swaps in 8 other currencies (KRW, CNY, INR, BRL, COP, CLP, THB, TWD).

The discounting risk on the emerging market portfolios represents a small percentage of the overall discounting risk and therefore the potential compensation amounts for these currencies is small. However, running a separate compensation process for these products would be a major logistical challenge for the industry. We therefore propose including these products into a single, comprehensive, process. This will avoid the need for a separate process later on.

We are aware that there are bilateral contracts in the market (mainly swaptions) which, subject to certain conditions, can deliver into LCH-cleared swaps. Irrespective of whether it originates from a swaption contract, any USD swap cleared by SwapClear after the conversion date will, from the point of clearing, be discounted at SOFR. However, the LCH compensation process will only apply to swaps that are registered at LCH before the conversion date.

Further Details/Questions

If you have any comments or want to discuss any aspects of the plan in more detail please contact your LCH representative or get in touch via sofr@lch.com. We actively welcome your feedback on these proposals.



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