ISDA/SIFMA AMG Benchmark Strategies Forum
February 12, 2020

Opening Remarks
Scott O'Malia, ISDA Chief Executive

Good morning, everyone. Welcome to the Benchmarks Strategies Forum. I'd like to take this opportunity to thank SIFMA AMG for partnering with us on this event. I would also particularly like to thank CME, our founding sponsor, for making it possible for us to run this forum in New York today and London later in the month.

So, why are we doing this event, and why now? The answer is simple. The coming year will be a critical one for benchmark reform. With no guarantee that LIBOR will be published after the end of 2021, this will be the year that counts when it comes to preparing for the shift to risk-free rates.

We need to expand liquidity and trading activity in RFRs, make the necessary changes to systems and processes, and reduce the volume of new trades linked to LIBOR.

Too much trading activity in the swaps market is currently short-dated, and there's little indication that the RFRs are challenging the IBORs in terms of primacy.

We now face some critical questions – on how to improve market liquidity, how best to manage basis risk, and how to prepare for the operational changes necessary to support RFR-based products. None of this can be left to chance. We all have a role to play to ensure a smooth transition.

Our event today will cover all these points. We'll look closely at current liquidity and trends in trading, progress in adapting to RFRs, how firms are tackling legacy portfolios – and what more needs to happen to get us to where we need to be.

Fortunately, there are some important developments set for 2020, which should encourage greater liquidity in RFRs – not least, the publication of new benchmark fallbacks for derivatives contracts later this year.

In my remarks this morning, I'll briefly summarize the progress made so far in establishing RFRs as alternatives to the IBORs. I'll then turn to new derivatives fallbacks, and will outline the timetable for our work in the months ahead.

Progress

So, let's start with the positives. Liquidity has improved in the new RFRs, and trading volumes are increasing.

According to data from the DTCC's US swap data repository, interest rate derivatives traded notional referencing SOFR last year jumped by 62 times, albeit from a low base in 2018. In the SOFR futures market, open interest rose by around 7 times between January and December last year.

We've also seen increasing issuance of cash products linked to SOFR – more than $300 billion so far. Not bad for a benchmark that's less than two years old.

Other, more established RFRs have also seen decent trading activity. While US SDR data for last year shows interest rate derivatives traded notional referenced to SONIA failed to grow much beyond 2018 levels, we saw nearly 50% of the total for 2019 traded last month alone.

The SONIA futures market has also been an important avenue for people to trade and hedge their exposures, with open interest increasing by approximately 75% between January and December last year.

Meanwhile, SONIA-linked bond issuance has continued to grow, and has exceeded £40 billion so far, according to FCA figures. Last year saw the first SONIA loan, the first LIBOR to SONIA bond switch and the first LIBOR to SONIA loan amendment.

So, progress is undoubtedly being made. But a further look at the data shows there is still a way to go.

For one thing, most trading activity in the RFRs is dominated by short maturity trades, with much less activity in longer-dated transactions. For example, about three quarters of SOFR interest rate derivatives traded notional in 2019 had a tenor of up to one year.

What's more, LIBOR trades continue to be executed by market participants, including trades with maturities beyond end-2021. Of the nearly $120 trillion notional in US dollar LIBOR traded in 2019, about a quarter had a maturity after end-2021. In fact, interest rate derivatives referencing IBORs comprised nearly 62% of total IRD derivatives traded notional in 2019.

Fortunately, several important developments will occur in 2020 that should help spur trading and liquidity.

In the UK, the FCA and the Bank of England are encouraging a change in the market convention for sterling swaps from LIBOR to SONIA on March 2, while a target has been set for ceasing sterling LIBOR cash issuance by the end of the third quarter.

In the US, one of the major changes will be the move by CME and LCH in October to SOFR PAI and discounting for all US dollar cleared interest rate derivatives. This should drive more hedging of SOFR risk and increase liquidity right across the curve.

Our clearing panel later in the day will delve more into the planned changes and the implications for trading activity.

Fallbacks

Another big development will be the publication of new fallback rates for derivatives. As many of you know, this is an initiative led by ISDA, so I'd like to spend a few minutes describing why this is important and setting out the timetable for our work.

Later this month, ISDA will publish a new consultation on how to implement pre-cessation fallbacks that would take effect following a statement from a regulator that an IBOR is no longer representative of its underlying market.

This is a very important consultation, so it's vitally important that you all read through it closely and have your say. It will essentially determine whether pre-cessation fallbacks should be linked with permanent cessation fallbacks as standard language in the amended 2006 ISDA Definitions and in a single protocol, with no optionality.

If there is sufficient support for this approach, it would mean a fallback would take effect if a covered IBOR ceases to exist or a regulator announces it is no longer representative of the underlying market, whichever comes first.

Many of you may be aware, but we consulted on pre-cessation issues last year. That consultation found there was no consensus on how to implement pre-cessation fallbacks, even though most respondents generally agreed they would prefer not to continue referencing an IBOR in existing or new derivatives contracts following a statement from a supervisor that it is no longer representative.

So, why are we running another consultation? Well, a number of things have changed since then.

In a letter sent to the FSB OSSG last December, we said we would press ahead with our work on permanent cessation fallbacks, but would consider re-consulting on pre-cessation fallbacks if certain new information came to light. Specifically, we said that further clarity on two points would help to increase market understanding of a non-representative LIBOR scenario – the 'reasonable period' during which a non-representative LIBOR would be published, and the specific action CCPs would take if the FCA determines that LIBOR is non-representative.

More information has recently emerged on these two points. Last month, we published two letters from the FCA and IBA that provide useful insight on the length of time a non-representative LIBOR may be published, while LCH introduced a rule book change to implement pre-cessation fallbacks that is open to consultation until March 23.

Given this additional clarity, we felt a new market-wide consultation on pre-cessation fallbacks was necessary.

The timing for publication of the fallbacks will now depend on the results of the new consultation, but you can see an outline of our timetable on this slide.

Whatever the results of the consultation, we aim to publish amendments to the 2006 ISDA Definitions to introduce the new fallbacks this year. Simultaneously, ISDA will publish a protocol that will enable market participants to include fallbacks within their legacy IBOR trades if they choose. That protocol will be free for buy-side firms to adhere during the approximately three to four months before it takes effect.

From the point the changes become effective, all new derivatives trades linked to the relevant IBORs that incorporate the 2006 ISDA Definitions will include the new fallbacks as a matter of course. For those who adhered to the protocol, the changes will be made to all outstanding trades with other adhering parties from the effective date. Major CCPs have also said they will incorporate the fallbacks for new and legacy cleared IBOR derivatives.

In the meantime, ISDA will work with Bloomberg to publish the relevant fallback adjustments, based on the methodology developed by ISDA following a series of market consultations. In the first half of 2020, Bloomberg will start publishing indicative spread and term adjustments, as well as all-in fallback rates for each of the IBORs covered so far.

Look out for these – by publishing the fallback rates, market participants will have the information they need to value their portfolios, potentially sparking more trading and hedging. In fact, there has already been reasonable activity in the LIBOR-RFR basis markets in anticipation of the publication of the fallback methodology.

The launch of new robust fallbacks will be an important step in the overall benchmark reform initiative. They will go a long way to mitigating the systemic risk posed by ongoing exposure to IBORs, and will help minimize market disruption following an IBOR's demise.

Next Steps

Let me now turn to next steps.

Specifically with regards to fallbacks, spend the time between publication of the new fallbacks and the three or four months before they take effect to get to grips with the changes being made to the 2006 ISDA Definitions, and understand the implications of adhering to the ISDA protocol.

Factors that may influence the decision of whether to adhere to the protocol include a preference to maintain consistency between legacy books and new non-cleared trades that incorporate the amended 2006 ISDA Definitions, as well as between cleared and non-cleared trades. That's because the major CCPs have announced they will make changes to their rule books to incorporate the ISDA fallbacks for new and legacy cleared trades.

Make sure the necessary infrastructure is in place. The fallback methodology includes a compounded setting in arrears calculation, so firms need to make sure their systems and processes are set up to cope with a rate that is known at the end of the period instead of the start in the event that fallbacks apply.

Importantly, make sure you know how to access the adjustments and fallback rates and the terms of use.

More broadly, it's important to remember that fallbacks aren't meant to be the primary route for benchmark transition. Instead, fallbacks are more like seatbelts or parachutes. You hope you won't need them, but they exist as a fail safe. If firms do have continued exposures to IBORs, for whatever reason, the existence of fallbacks will ensure an alternative rate will take effect.

Even with the adjustments, however, the fallback rates will not exactly match the IBORs they replace. It's therefore important that market participants implement the fallbacks and then use the time before cessation to negotiate with counterparties and transition voluntarily.

Conclusion

Benchmark reform is one of the biggest challenges this industry has ever had to face. The scale of existing IBOR exposures is significant, and use of LIBOR and other IBORs continues to dominate the interest rate derivatives market.

The situation is changing – big strides have been made in developing RFR liquidity in a relatively short amount of time. But this is the critical year.

I'll finish with what I said at the start. We all have a responsibility to help develop active markets in the alternative RFRs.

Hopefully, today's event will set out a clear path for what needs to be done, and will serve as an important forum for sharing ideas and experiences.

Finally, I'd like to thank our founding sponsor CME once again for making this event possible.

Thank you very much for attending – I hope you enjoy the day.