Market Impact of the CCP Discounting Change to SOFR and What's Next

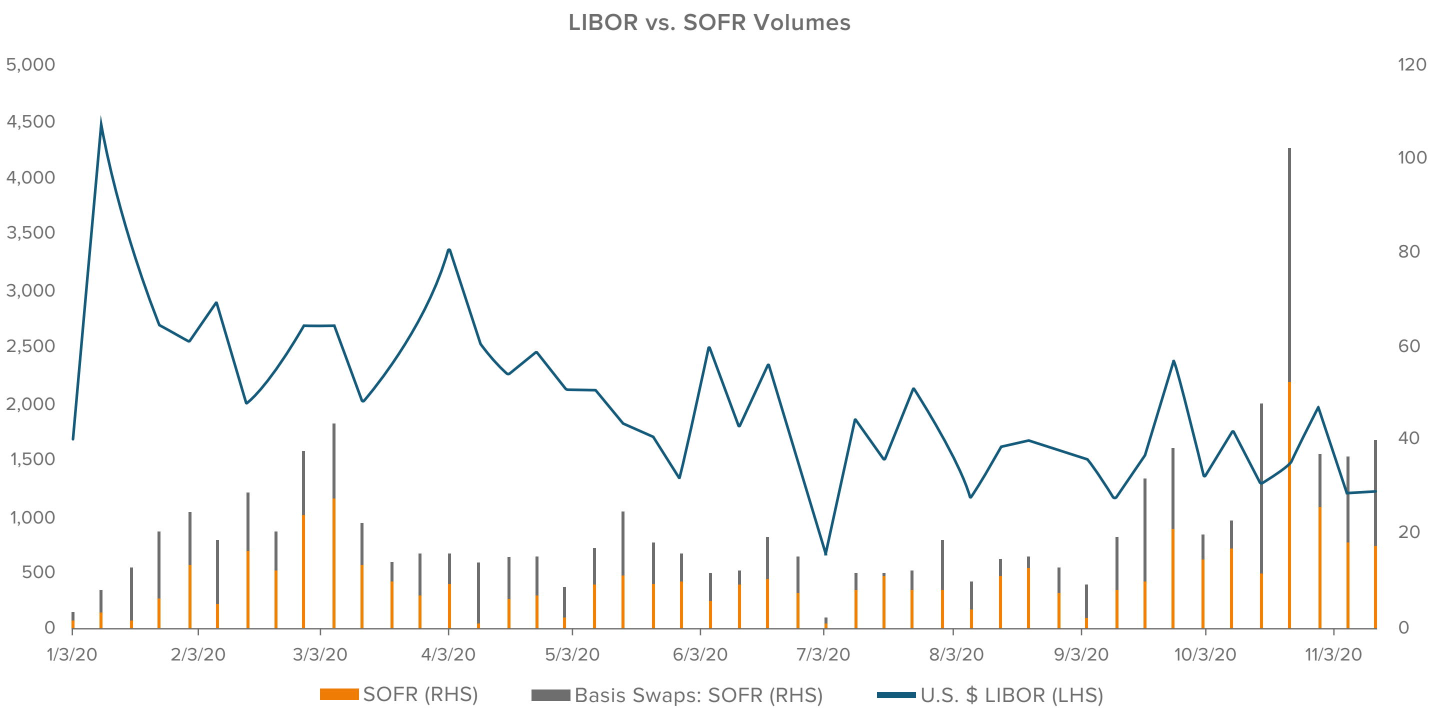
Successful transition to SOFR discounting

On October 16, 2020, the central counterparties (CCPs) of the London Clearing House (LCH) and Chicago Mercantile Exchange (CME) revised the discounting and price alignment interest (PAI) of U.S.-dollar cleared interest rate swaps to use the secured overnight financing rate (SOFR). The event affected more than $130 trillion notional of interest rate swaps, included auctions of newly created SOFR basis swaps and created greater liquidity for SOFR. LCH and CME have both reported that the auctions were orderly, with all volume absorbed. This event was a key milestone for the transition away from the London Interbank Offered Rate (LIBOR), as SOFR is the Alternative Reference Rate Committee's (ARRC) chosen replacement benchmark for U.S.-dollar-based contracts.

Perspective on SOFR market formation

While there was a modest uptick in SOFR-based transactions for the week of October 16 (Figure 1), this was almost certainly attributable to the transition to SOFR-based discounting that occurred on the CME and LCH. A similar exercise in Europe in July led to an increase in euro short-term rate (€STR) swaps — with no basis swaps, as the euro transition didn't include the DV01 risk make-whole basis swaps.[1] If the euro transition is any indication, we'd expect U.S. dollar SOFR overnight index swap (OIS) and SOFR basis swap volumes to remain elevated versus pre-transition levels. Voya IM's experience, overall, was that the transition was orderly and not disruptive. Voya IM has also been able to transact in SOFR and effective federal funds rate (EFFR) OIS positions since October 19, also in an orderly fashion.

Figure 1. SOFR Volumes are Trending Upward as LIBOR Volumes Decrease



Source: International Swaps Dealer Association (ISDA) SwapsInfo. **http://analysis.swapsinfo.org/**

[1]DV01 stands for "dollar value of a basis point (bp)," which refers to the exposure of a swap position to a move of 1 bp in the forward rate curve.

Having said that, it remains notable that all developed market alternative reference rate (ARR) swaps are based on the OIS convention, which is based on the compounding of overnight rates, observed daily, consistent with fed funds OIS. There appears to be no meaningful volume in any major market for traditional "fixed versus floating" swaps that would mirror legacy Interbank Offered Rate (IBOR) conventions (Figure 2). This is consistent with the "in-arrears" methodology — i.e., based on historical observation, as promulgated by the International Swaps and Derivatives Association (ISDA) — but leaves a disconnect between traditional credit instruments such as in-advance, one- and three-month rates; and available SOFR and EFFR-based hedging instruments.

Figure 2. Weekly Swap Volumes, November 6, 2020, U.S. $ Billions

	IBOR	ARR (OIS + Basis)	ARR % of Legacy IBOR
U.S. dollar	1,177.93	37.00	3%
UK pound	109.71	258.31	235%
Swiss franc	5.34	0.60	11%
Yen	38.40	4.76	12%
Euro	309.18	3.60	1%

Source: International Swaps Dealer Association (ISDA) SwapsInfo. **http://analysis.swapsinfo.org/**

Upcoming market milestones for the LIBOR transition

As the Voya LIBOR Transition Program continues to execute against plan, significant market milestones that will be monitored and addressed include:

- **LIBOR discontinuation announcement –** The Financial Conduct Authority (FCA) may issue notice of a definitive cessation date as early as December 2020. This announcement will offer greater economic certainty for the event by triggering the calculation of the ISDA fallback spread and establishing the target date for all remediation
- **End of LIBOR based issuance by federal agencies and government sponsored enterprises –** Agencies have provided a LIBOR cessation roadmap based on SOFR, and are expected to lead the transition for residential and commercial mortgage markets, and for short-term financing reference rates
- **ISDA IBOR fallback protocol adherence for over-the-counter (OTC) derivatives –** ISDA IBOR fallback conventions were finalized on October 23 to become effective on January 25, 2021:

  ISDA will publish a supplement amending the 2006 ISDA definitions to incorporate the new fallback rate(s) into OTC derivatives transactions

  SOFR is the designated fallback rate for U.S. dollar LIBOR

  Once the protocol is effective, SOFR will become the replacement rate for U.S. dollar LIBOR upon the occurrence of either the permanent cessation of LIBOR or a pre-cessation determination by the FCA that LIBOR is no longer representative. An overview of the ISDA protocol changes can be found at this link:

  https://www.isda.org/protocol/isda-2020-ibor-fallbacks-protocol/
- **Forward-looking term SOFR –** The ARRC issued an RFP on September 10, 2020 seeking an administrator to publish forward-looking SOFR term rates. This is the final step of the ARRC's paced transition plan for developing SOFR markets. After the outcome and availability of these rates are realized, standard product conventions will further materialize. The ARRC RFP and the ARRC paced transition plan can be found at the links below:
  - https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC_Press_Release_Term_Rate_RFP.pdf
  - https://www.newyorkfed.org/medialibrary/microsites/arrc/files/paced-timeline-plan.pdf

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