



# coremont

Research & Publications

## LIBOR Reform Update

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## Main Updates

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- **Markets under regulatory pressure to migrate off Libor**
  - Libor discontinuation officially announced by the UK's Financial Conduct Authority (FCA) on 5th March 2021
  - Final publication dates of:
    - 31st December 2021 for GBP, EUR, CHF and JPY Libor (and 1W and 2M USD)
    - 30th June 2023 for USD Libor
  - Increasing volumes of "Risk Free Rate" (RFR) products: SONIA swaption, SONIA Futures and Options
  - Regulatory guidance/requirements growing for new risk to reference RFR
- **Legacy trade conversion**
  - Clearing Houses have laid out timelines and fees for conversion of Libor referencing trades to RFR equivalents and EONIA trades to €STR
  - ICE will convert open interest in Short Sterling Futures and Options and EuroSwiss Futures to RFR equivalents in December
- **Coremont fall back analytics**
  - Coremont's analytics show risk to appropriate curves post discontinuation
  - Curve cliff edge persisting – GBP 6M most prominent
  - USD Libor/SOFR and GBP Libor/SONIA basis not respecting ISDA fallback levels

## Consolidated Timeline 2021

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- End Q1 – No new risk on GBP Libor linear derivatives<sup>1,2</sup>
- End Q2 – No new risk on GBP Libor non-linear derivatives<sup>1,2</sup>
- End Q2 – No new risk on GBP exchange traded derivatives expiring post 2021<sup>2</sup>
- End Q2 – New CHF swaps to reference SARON instead of CHF Libor<sup>3</sup>
- End July – New JPY swaps to reference TONA instead of JPY Libor<sup>4</sup>
- During Q2/Q3 – Cease initiating new cross-currency derivatives with a GBP Libor leg<sup>2</sup>
- 30th September – LCH commence monthly charge per-ticket on outstanding CHF/EUR/GBP/JPY Libor referencing contracts (not FRAs or USD)<sup>5</sup>
- 2nd October – LCH Basis swap split<sup>5</sup>
- 16th October – LCH EONIA to €STR swap conversion<sup>5, 6</sup>
- 4th December – LCH and CME CHF, JPY and EUR (LCH only) and JSCC JPY Libor to RFR swap conversion<sup>7, 8</sup>
- 17th December – ICE, conversion of Short Sterling Futures and Options and EuroSwiss Futures into RFR equivalents<sup>9</sup>
- 18th December – LCH and CME GBP Libor to SONIA swap conversion<sup>7, 8</sup>
- 31st December – Last publication of CHF, EUR, GBP and JPY Libors
- 31st December – No new risk on USD Libor<sup>10</sup>
- 3rd January 2022 – Last publication date of EONIA

## LIBOR Reform Update

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5th March 2021 saw the widely anticipated official announcement of Libor discontinuations by the FCA<sup>11</sup>. This followed the ISDA fallbacks protocol coming into effect on 25th January 2021.

With GBP, JPY, CHF and EUR Libor scheduled to discontinue at the end of 2021 regulatory pressure to move trading activity to new reference rates has been increasing.

Whilst exceptions exist, the message from regulators is clear – new risk should not be referencing Libor.

### GBP

Regulatory pressure has been heaviest on GBP Libor, “SONIA First” in October 2020 saw the FCA and the Bank of England<sup>1</sup> encourage liquidity providers and interdealer brokers (IDBs) to make SONIA the market standard quoting convention in the interdealer market. The Working Group on Sterling Risk Free Reference Rates<sup>2</sup> scheduled end Q1 and end Q2 of 2021 for no new linear and non-linear GBP Libor referencing derivatives respectively. Further, GBP Libor linked cross-currency derivatives are expected to cease during Q2/Q3 of 2021.

The transition away from GBP Libor has taken several months to gather momentum, but has been effective and trading has shifted to SONIA swaps, swaptions as well as listed SONIA futures and options - all of which are supported by Coremont.

## USD

Similar regulatory steps are developing in USD Libor with the "SOFR First" initiative outlined by the Commodity Futures Trading Commission's Market Risk Advisory Committee<sup>12</sup> encouraging IDBs to move market conventions to SOFR from 26th July 2021, initially keeping Libor screens for reference but disabling those from 22nd October 2021.

This move has been applauded by the Alternative Reference Rates Committee who also expect to formally recommend CME SOFR term rates shortly thereafter<sup>13,14</sup>.

The Federal Reserve, Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency have also published a statement expecting new risk taking on USD Libor to cease by year end 2021 at the latest<sup>10</sup>.

Should USD Libor trading follow a similar pattern to GBP, this will result in significantly increased SOFR activity through Q3 and Q4.

## CHF

The Swiss Financial Market Supervisory Authority's (FINMA) guidelines say all new Swiss franc contracts should be based on SARON from 30th June 2021<sup>3</sup>.

## JPY

The Bank of Japan has announced their expectation for market participants to use TONA instead of Libor no later than end July 2021<sup>4</sup>.

## Clearing House conversion of OTC Libor trades

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Clearing Houses have laid out their plans<sup>7, 8, 15</sup> for converting cleared Libor swaps (as well as EONIA swaps<sup>6</sup>) to their RFR equivalents in Q4 of this year.

### LIBOR

Q4 of this year will see Clearing Houses convert outstanding Libor referencing products to their RFR equivalent. Post conversion dates Libor referencing swaps will no longer be eligible for clearing.

The conversion process will be similar between the clearing houses, with LCH, CME and JSCC converting on the same dates (see timeline):

- Using the close of business trade population on the conversion date
- Libor swaps will be unwound and replaced by market standard RFR trades
- The fixed leg will be left unchanged
- The floating leg will be adjusted by the relevant ISDA fallback spread
- Cash adjustments will be made for any valuation change

More information and Clearing House specific details are available for LCH<sup>7</sup>, CME<sup>8</sup> and JSCC<sup>15</sup>.

From 30th September 2021, LCH will charge a monthly fee per outstanding CHF/EUR/GBP/JPY Libor referencing product (excl. FRAs) and fees may also be charged by CME and JSCC.

### EONIA

Eonia will be discontinued<sup>16</sup> on 3rd January 2022 and market participants have been encouraged to switch to €STR. Similar to the IBOR conversion LCH intends to convert all cleared EONIA swaps to €STR trades:

- Conversion over the weekend of 15th October 2021
- EONIA will be replaced by €STR (no adjustment) on the EONIA leg
- The non-EONIA leg left unchanged
- Cash compensation for the change in the floating leg ( $EONIA = \text{€STR} + 8.5\text{bps}$ ) will be applied to neutralise the value difference

Unlike the Libor conversion, there will be no spread adjustment to either leg. This will potentially result in a considerable cash compensation amount due to the 8.5bp difference between EONIA and €STR.

## Exchange conversion of Libor based STIR Futures and Options

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As Eurodollar Futures and Options may continue trading until USD Libor discontinuation date in June 2023 the immediate focus is on ICE Short Sterling Futures and Options and EuroSwiss Futures.

For more information on CME's proposal for Libor fallbacks around Eurodollar Futures and Options please see footnote 17.

ICE intend to convert all open interest in Short Sterling Futures and Options and EuroSwiss Futures into contracts referencing the replacement RFR<sup>9</sup>.

- Conversion over the weekend of 17th December 2021
- Once this conversion is concluded – legacy products will be removed from trading
  - Futures
    - Libor contracts converted to notional equivalent number of RFR contracts e.g. 2x 3M Short Sterling = 1x 3M Sonia
    - Same delivery month
    - Conversion involves a value adjustment based on ISDA fallbacks
    - No additional payments relating to value change
    - Provision will be made to cash settle any odd lots (as above)
  - Options
    - Short Sterling Future Options to convert into “Flex Strike” Sonia options
    - On a 2-to-1 basis as above
    - Flex strike options will be listed until they expire
    - Flex strike  $k' = k + \text{ISDA fallback spread}$
    - New option expiry date will be 5 days less than the original
    - One off cash compensation

## Clarion Analytics

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In GBP Libor the “cliff-edge” effect anticipated by Coremont<sup>18</sup> is persisting. Spot FRA/OIS has moved from ~0bps at the start of the year to ~6bps now, and jumps up to the fallback spread of ~28bps over year-end 2021. As previously highlighted this poses difficulties for curve building and makes for large optical basis moves as fixings roll from pre to post discontinuation and pick up this overnight jump.

Implications of this jump mean offsetting swaps with a single day difference between fixings may experience a ~20bp jump – without appropriate modelling this may be hard to anticipate and difficult for clearing houses to model as they look to transition Libor trades to RFR just prior to discontinuation.

With discontinuation announced the correct way to project Libor fixings is from a Libor curve pre discontinuation and RFR curve + ISDA fallback spread post. Coremont's analytics have been updated as such:

- Curve fitting is straight forward, no “hybrid” curve fit required
- Risk is projected vs the appropriate curve

Pricing a spot starting 5Y USD 3M Libor spot in 100k DV01 as an example

	Trade Type	Ccy	Instrument	Expiry/Start	Tenor	Strike	Type	Notional	Collat/Clearer
⊗	Swap	USD	LIBOR S 3M	Optional	5y	a	Pay	d100k	LCH

The risk is seen to transition from the 3M curve to the SOFR curve post June 23.

Coremont’s analytics have also been extended to handle SONIA swaptions, as well as listed SONIA Futures, on both ICE and LSE, and SONIA Options.

A final point of interest is a persisting difference in the SOFR vs 3M USD Libor basis. With discontinuation announced this basis should match the ISDA fallback spread of 26.16bps post discontinuation date, but the spread is persistently slightly higher, ~1bp.

This is likely driven by market flows with a lack of capacity for dealers to warehouse this risk alongside a lack of interest from buy side RV traders to drive the market back to fair value.

Coremont’s analytics are being updated to capture this nuance and distinguish SOFR traded directly vs SOFR traded via the fallback for pricing purposes.

USD			⊗ CURVE & BASIS	
	MARKET	\$ FWD DELTA	3M	SOFR
Term	Rate	Pricer		
	3M	Live		
	SELECT >	×	>>	>>
<b>TOTAL</b>		<b>100.0k</b>	<b>46.1k</b>	<b>53.9k</b>
STUB	0.149 +1.4	4.6k	4.6k	0
U21	0.137 +0.5	5.1k	5.1k	0
Z21	0.207 +0.5	4.9k	4.9k	0
H22	0.205 +0.5	5.4k	5.4k	0
M22	0.269 +0.5	5.0k	5.1k	0
U22	0.352 +1.0	5.5k	5.5k	0
Z22	0.502 +2.0	4.9k	5.0k	0
H23	0.607 +1.5	4.8k	4.8k	0
M23	0.732 +2.0	5.4k	5.5k	0
U23	0.946 +1.5	5.4k	0.3k	5.1k
Z23	1.062 +1.5	4.9k	0	4.9k
Z23 to 3Y	1.213 -0.3	5.2k	0	5.2k
3Yx1Y	1.408 -0.4	19.5k	0	19.5k
4Yx1Y	1.651 +1.0	19.4k	0	19.4k
5Yx1Y	1.859 +0.2	0	0	0

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