LIBOR transition

Key October updates

ISDA protocol

A. On 23 October 2020, ISDA launched the IBOR Fallbacks Supplement to the 2006 ISDA Definitions along with the ISDA 2020 IBOR Fallbacks Protocol. The supplement and the protocol will take effect on 25 January 2021.

ISDA also published template agreements, facilitating the parties' freedom to modify certain trades or master agreements, or alter certain fallback provisions (such as pre-cessation triggers) in a bilateral manner.

BoE in its press release stated, "This new fallback language has been developed by ISDA at the request of the Financial Stability Board (FSB), working with a wide range of market participants and international authorities, and the FSB has strongly encouraged its widespread adoption"

CRISIL's IBOR Transition Think Tank's view on the protocol is that, while this change is slightly delayed, it will still be an important catalyst for market participants to accelerate transition plans especially for those who have large volume of existing derivative contracts. Publishing it 3 months early gives participants enough time to adhere without losing its impact.

ISDA confirmed that 257 derivatives market participants had adhered to the protocol during the two-week pre-launch 'escrow period'. **CRISIL foresees more participants to sign-up for the protocol thus exhibiting preparedness and willingness to change and ensuring smooth transition to RFRs. We expect this will also lead to substantial increase in demand for new issuance of debt linked to RFRs and surge in derivatives trading volumes based on RFRs.**

Source: https://www.isda.org/2020/10/23/isda-launches-ibor-fallbacks-supplement-and-protocol/

Tough legacy

B. On 21 October 2020, the UK Government introduced the Financial Service Bill to Parliament as part of its support in managing risk of 'tough legacy' LIBOR referencing contracts.

The Bill amends the UK Benchmarks Regulation (BMR), includes the option for the FCA to direct a change in the methodology of a critical benchmark (i.e. LIBOR) and extends its publication for a limited time period.

CRISIL's IBOR Transition Think Tank has emphasised that market participants should quickly adapt to regulatory timelines in offering alternative RFRs and plan their strategies accordingly.

Considering the latest industry developments, CRISIL foresees a possibility of rising transition risk caused by few market participants who are still considering the wait-and-watch approach instead of focusing on milestones set by the regulatory bodies.

Source: https://www.gov.uk/government/publications/amendments-to-the-benchmarks-regulation-to-support-libor-transition

SOFR discounting transition

C. On 16 October 2020, major CCPs, Chicago Mercantile Exchange (CME) and London Clearing House (LCH) completed the switch from the Effective Federal Funds Rate (EFFR) to SOFR as the rate used for calculating price alignment interest (PAI, the interest paid on variation margin) and discounting for cleared USD interest rate derivatives.

CRISIL's view on the SOFR Discounting Transition is that COVID-19 had already caused delay in transition milestones, and SOFR-based derivatives adoption remained relatively low compared with the USD LIBOR derivatives market.
According to DTCC, on the day of the switch, a combined 762 SOFR swaps were reported to the DTCC Swap Data Repository, comprising over $61 billion in notional. Trading activity on 16 October (the day of the LCH auction), was dominated by basis swaps that accounted for 91.3% of the notional in SOFR swaps.

CRISIL's IBOR Transition Think Tank notes that this switch from EFFR to SOFR will certainly boost SOFR adoption in the derivatives market and increase primary market liquidity.

CRISIL encourages market participants to take immediate action to switch their valuation methodology from OIS to SOFR discounting and also expects all uncleared USD transactions to be SOFR-discounted very soon.

Source: https://www.lch.com/resources/news/lch-successfully-completes-transition-sofr-discounting

RFR adoption

D. ISDA's RFR indicator provides a monthly snapshot of RFR trading activities in interest rate derivatives (IRD) markets, based on global cleared over-the-counter (OTC) and exchange-traded derivatives (ETD) data from seven central counterparties spanning six currencies.

The indicator is intended to help derivatives market participants keep tabs on progress to shift to RFRs ahead of end-2021, when the UK Financial Conduct Authority will no longer compel or persuade banks to make LIBOR submissions

In its latest report of ISDA-Clarus RFR Adoption Indicator-September 2020, the RFR Adoption Indicator stood at 9.5% (versus 6.4% in August 2020), RFR-linked exchange-traded IRD (notional transacted) stood at $14.2 trillion (versus $8.3 trillion in August 2020), Global trading activity (DV01) of RFR-linked IRD stood at $2.6 billion (versus $1.4 billion in August 2020) and split of RFR activity OTC versus ETD was at 79.4% (versus 68.1% in August 2020)

CRISIL's IBOR Transition Think Tank foresees month-on-month increase of IRD activity, and EUR will continue to be the highest percentage of RFR-linked IRD DV01 executed as transactions with tenors over 2Y

Source: https://www.isda.org/a/furTE/ISDA-Clarus-RFR-Adoption-Indicator-2020-09.pdf

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