

IBOR Transition's Impact on the Derivatives Market

July 2021



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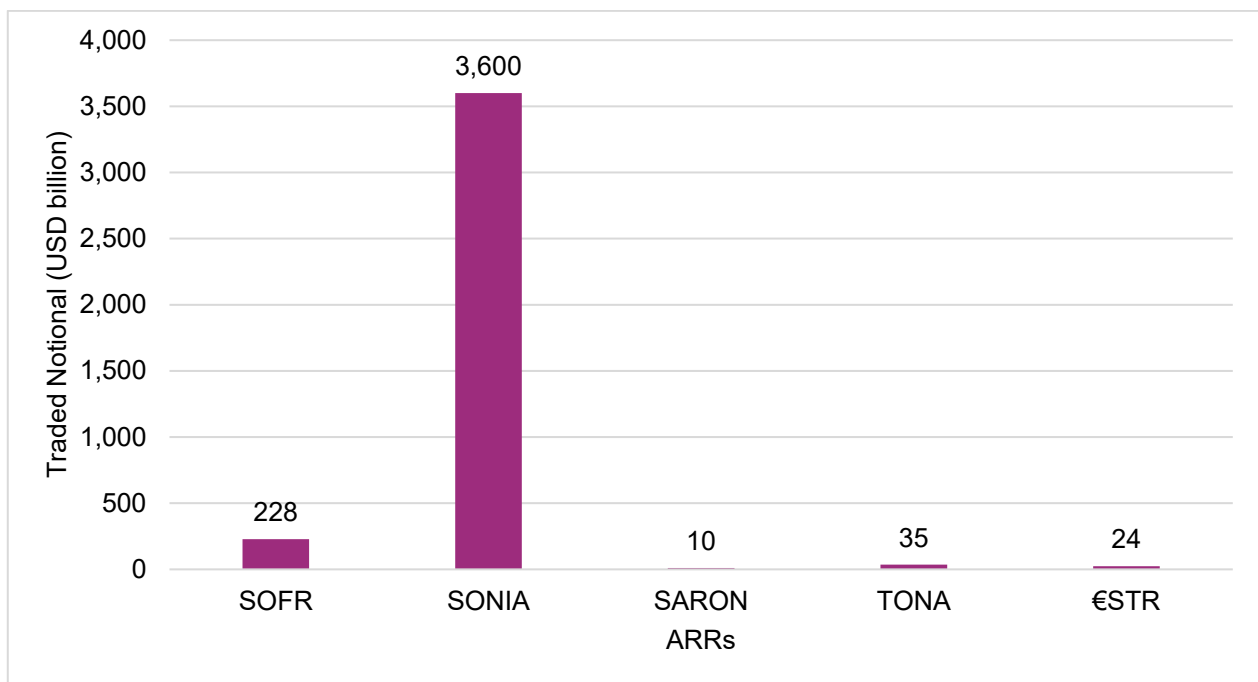
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Preparing for a World Without LIBOR

The London Inter-bank Offer Rate (LIBOR) is the most important rate globally, referencing nearly USD 370 trillion (as of 2018) equivalent of contracts that cover a myriad of products such as mortgages, bonds, and derivatives. As a result, the transition from LIBOR is accompanied by a high degree of complexity that involves negotiating existing contracts with clients, assessing the appropriateness of existing models, and upgrading existing systems to handle the change.

The development of Alternative Reference Rates (ARRs), such as Secured Overnight Financing Rate (SOFR), Sterling Overnight Index Average (SONIA), and Swiss Average Rate Overnight (SARON), only provides a partial solution in the form of possible risk-free rates. This is due to reasons such as – a) lack of term structure b) non-inclusion of risk spreads such as credit risk premia c) Timing differences in the adoption of ARR across different currencies d) difference in nature of ARRs in terms of secured vs. unsecured rates. However, the liquidity of contracts referencing the ARRs is still too thin to be considered an appropriate alternative. Among the ARRs, SONIA has the highest liquidity, followed by SOFR in the interest rate derivatives segment (Figure 1).

Figure 1. ARRs-linked Interest Rates Derivatives (IRDs) traded notional during Q3-2020 in the US (excluding futures)



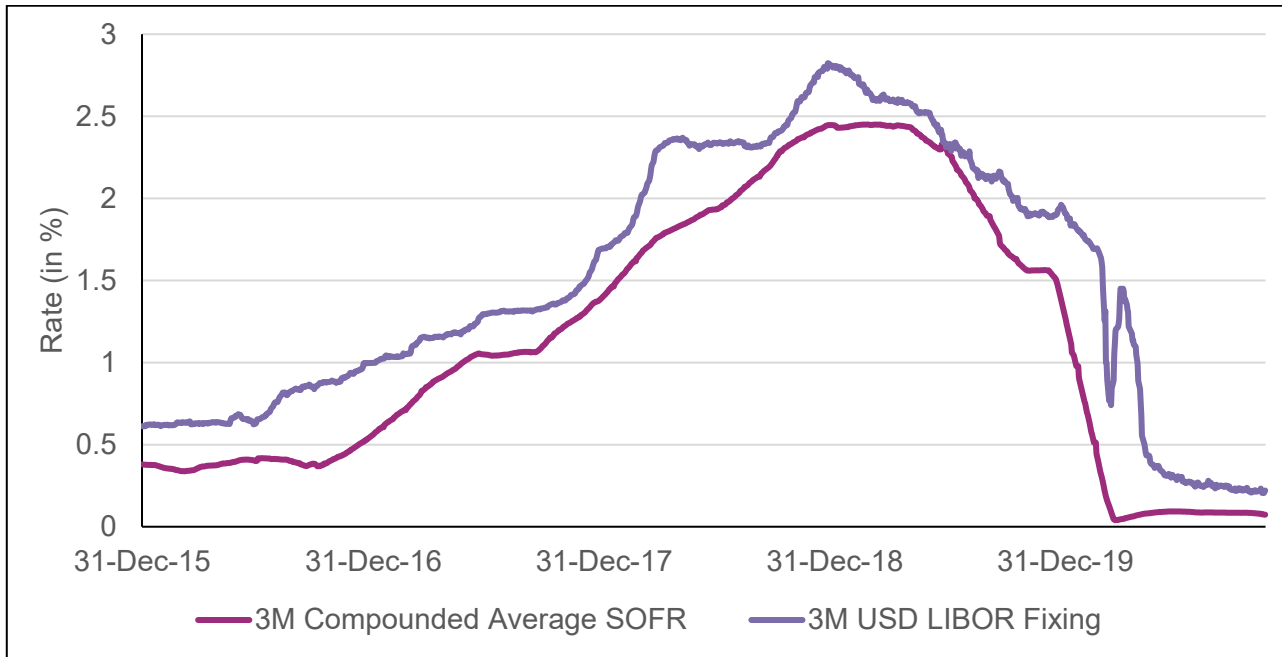
Source: [ISDA](#) (page 3)

The Financial Conduct Authority (FCA) had set the end of 2021 as a deadline for market participants to prepare for a world without LIBOR. Despite external factors such as the Covid-19 pandemic, the FCA reiterated that the deadline of publishing of LIBOR (end of 2021) has not changed. The Bank of England, FCA, and Working Group will continue to monitor and assess the impact on transition timelines and will update the market as soon as possible. The transition process will be complex and extensive since LIBOR is deeply entrenched in the financial world and is the basis for several standard interbank and commercial loans and derivative products.

During the initial period of COVID-19, central banks globally reduced their policy rates, but the LIBOR rates increased, representing the increased cost of funds for banks (Figure 2 and 3). This is contrary to popular notion and re-emphasizes the weakness of LIBOR as a benchmark. The following inferences can be drawn from Figure 2 and Figure 3.

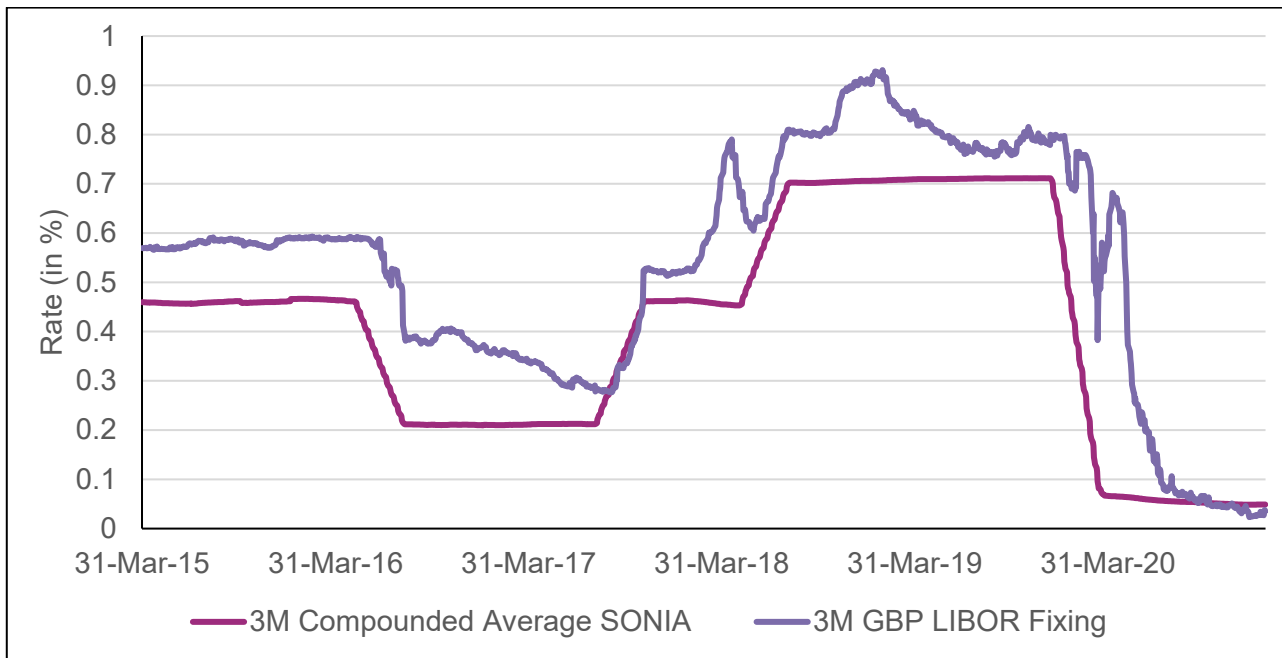
- During periods of significant market volatility, 3-month ARR's like SOFR and SONIA has proved to be more stable. Unlike LIBOR rates, the 3-month compounded average SOFR and SONIA decreased gradually during Mar-Apr 2020.
- During Mar-Apr 2020, the spread between 3-month compounded average SOFR, SONIA, and corresponding LIBOR rates increased to nearly 140 bps and 70 bps, respectively. The spread's increase was due to a gradual decrease of average ARR's compared to LIBOR rates which responded quickly to market stress.

Figure 2. Three months compounded SOFR vs. USD LIBOR 3M index



Source: Bloomberg

Figure 3. Three months compounded SOFR vs. GBP LIBOR 3M index



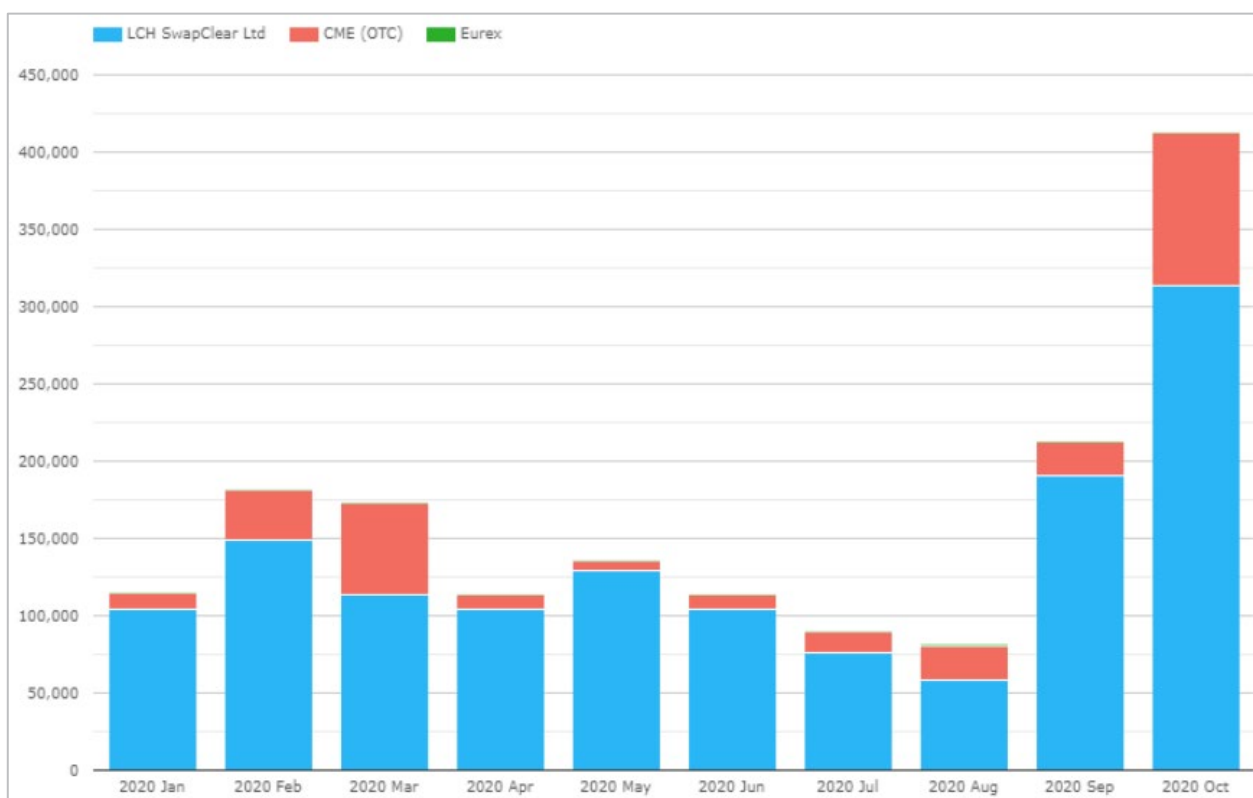
Source: Bloomberg

Recent Developments

Central Counterparties' Adoption of ARR:

- During July 2020, central counterparties (CCPs) like Chicago Mercantile Exchange (CME), London Clearing House (LCH), and EUREX transitioned to Euro short-term rate (€STR) discounting from Euro Overnight Index Average (EONIA) for EUR-denominated contracts.
- €STR transition was followed by CME and LCH transitioning to SOFR discounting from Effective Federal Funds Rate (EFFR) for USD-denominated contracts on October 16, 2020. The transition to SOFR is unique because, apart from the compensating cash component, it was accompanied by additional issuance of EFFR-SOFR basis swaps which is expected to reduce the overall risk to investors and reduce re-hedging costs.

Figure 4. USD SOFR Swap Traded Notional in 2020 (USD million)



Source: [Clarus Financial Technology](#)

- With the move, CCPs' Price Alignment Interest (PAI) has changed to SOFR for USD-based contracts. This also helps bring liquidity in the market as nearly 90% of interest rate derivatives are cleared through CCPs, and CME and LCH are the largest clearinghouses.
- The volume of SOFR-linked swaps sharply increased during October 16-19. Nearly 91% of the SOFR swaps booked on October 16 were basis swaps due to LCH's auctioning of basis swaps. Similarly, 70% of the SOFR-linked swaps booked on October 19 were fixed-float Overnight Indexed Swaps (OIS), swap pairs of EFFR, and SOFR driven by the CME auction.
- Overall, in October 2020, volumes of the SOFR swaps traded increased drastically to USD 412 billion from USD 213 billion in September 2020 due to the transition (Figure 4). As time progresses, the re-hedging requirement will further add to the liquidity of SOFR swaps.

ISDA Fallback Supplement and Protocol

Just a week later on October 23rd, 2020, the International Swaps and Derivatives Association (ISDA) published the Fallback Supplement and the Fallback Protocol. Together, these documents mark a significant step in the