



coremont

Research & Publications

LIBOR Reform Update

January 2021

Christopher Willis

Edmund Allen

Main Updates

- The ISDA fallback protocol comes into effect on **25 January 2021**.
- Announcement on Libor discontinuation expected soon after – which will crystallise fallback spreads for all Libor benchmarks.
- USD Libor discontinuation date likely pushed back to June 2023. GBP, CHF, JPY and EUR Libor discontinuation still expected end 2021.
- LCH consulting on converting any cleared Libor trades to risk-free rate (“RFR”) equivalents at or shortly before discontinuation. FRAs will be converted to single period swaps.
- Fallback analytics available via Coremont’s portfolio management technology, Clarion
- Cliff edge apparent in market – GBP 6M Libor in particular

General

The ISDA fallback protocol comes into effect on 25 January 2021 and has seen wide spread adherence with over 8000 organisations already signed up¹ – including the top tiers of investment banks.

Regulators have long stressed that while robust fallbacks are important, and encourage market participants to adhere to the ISDA fallback protocol, it would be preferable for the market to close out its Libor exposure wherever possible, prior to a discontinuation event.

Despite last year’s clearing house changes in discounting (EFFR to SOFR) and the UK’s Financial Conduct Authority (“FCA”) and the Bank of England (“BoE”) encouraging market participants to move to SONIA as the default GBP interest rate mark², recent Libor indexed transaction volumes have not shown a noticeable reduction. Whilst it is possible the continued volumes represent market participants closing out Libor risk, there is not the corresponding pick up in RFR risk you would expect to accompany this³.

Timeline

There are two important consultations currently open:

- ICE Benchmark Administration (“IBA”) consultation respecting Libor discontinuation dates⁴
- London Clearing House (“LCH”) consultation concerning the behaviour of cleared legacy Libor trades

Both close at the end of January – and it is probable an official announcement on Libor discontinuation will be made shortly thereafter, crystallising the fallback spreads for **all Libors**.

IBA Consultation – The IBA are the Libor benchmark administrator

Based on feedback from its Panel banks the IBA announced in November last year that it would consult on its intention to cease Libor publication on;

Friday, 31 December 2021 for:

- GBP, JPY, CHF and EUR Libor (O/N, 1W, 1, 2, 3, 6 and 12 Month)
- USD (1W and 2M Tenors)

Friday, 30 June 2023 for:

- USD Libor (O/N, 1, 3, 6 and 12 Month)

The IBA consultation closes on 25 January 2021 at which point they will share the results with the FCA and publish a feedback statement shortly after.

While not an official announcement the market immediately reacted to this news with the USD Libor/SOFR basis between January 2022 and June 2023 collapsing from the fallback spread of ~26bps to ~14bps.

Despite the USD discontinuation date being pushed back, trading any Libor referencing derivatives post December 2021 is likely to be restricted to closing out existing risk – not outright risk taking⁵.

Similarly, it is expected that Libor trades will not be eligible for clearing post a discontinuation event.

LCH Consultation

LCH have launched a consultation around their plan for dealing with Libor trades, broadly they are proposing to:

- Run a conversion process at (or shortly before) a Libor cessation date to convert any Libor referencing trades to market standard RFR trades.
- Cash compensation to be paid on the difference between the two trades based on pricing using the ISDA fallback spreads post discontinuation – so effectively discounting all the fallback spread component of future cash flows to today.

Apart from discounting risk this conversion will leave risk profiles broadly unchanged – Libor swaps fixing post discontinuation will already be exposed to the underlying RFR, not Libor.

How this is done in practice still needs ironing out, but it would be an operationally attractive approach as all cleared Libor products would become their RFR equivalent, negating the need to price/maintain large portfolios of legacy Libor swaps for years to come.

For FRAs LCH are proposing to convert them to single period swaps⁶.

Clarion Analytics and the “Cliff-Edge”

In GBP Libor the “cliff-edge” effect anticipated by Coremont⁷ is already making itself felt. Spot FRA/OIS continues to trade around 0bps and then jumps up to the fallback spread of ~28bps over year-end 2021.

This poses difficulties for curve building and makes for interesting basis moves as fixings roll from pre to post (assumed) discontinuation and pick up this overnight jump. One place this is observable is in GBP FRA quotes with the 12Mx18M jumping +14bps overnight at the start of the year.

Once discontinuation has been officially announced the correct way to project Libor fixings is from a Libor curve pre discontinuation and RFR curve + fallback spread post.

Coremont's analytics are ready for this transition and the impact can be simulated using the Clarion **Rates Pricer** and selecting one of the "ISDA FALLBACK" generators available.

TRADE DETAILS										MARKET	
Trade Type	Ccy	Instrument	Expiry/Start	Tenor	Strike	Type	Notional	Collat/Clearer	Curve Shift	Fwd	
Swap	USD	LIBOR S 3M ISDA FALLBACK		10Y	a	Pay	-100m	LCH		1.322 +1.1	

<ul style="list-style-type: none"> FEDFUNDS A SOFR A <li style="border: 1px solid blue;">LIBOR S 3M ISDA FALLBACK
--

These fallback generators assume Libor discontinuation has been announced and project rate, PV and risk off the appropriate curves.

The discontinuation date is set as 31 December 2021 for GBP, JPY and CHF Libor and 30 June 2023 for USD Libor.

The fallback spreads are calculated using an assumed announcement date of 1 February 2021, and so predominately use realised Fixings (~26bps for USD 3M and ~28bps for GBP 6M).

The risk transition from Libor to RFR curve can be observed on the **Risk tab**.

Once discontinuation is announced, valuation and risk will be switched to use the fallback analytics – and risk post discontinuation dates will transition to the RFR curves.

Curve Risk				
Term	MARKET		\$ FWD DELTA	
	Rate	Pricer	3M	SOFR
TOTAL		94.6k	15.1k	79.5k
STUB	0.246 -5.9	0	0	0
H21	0.182 +0.0	0	0	0
M21	0.177 +0.0	0	0	0
U21	0.187 -0.0	0	0	0
Z21	0.222 -0.5	1.5k	1.5k	0
H22	0.197 -0.5	2.6k	2.6k	0
M22	0.212 -0.5	2.5k	2.5k	0
U22	0.235 -0.0	2.7k	2.7k	0
Z22	0.296 +0.0	2.5k	2.5k	0
H23	0.305 -0.5	2.4k	2.4k	0
M23	0.381 -0.5	2.7k	0.9k	1.8k
M23 to 3Y	0.575 -1.7	3.2k	0	3.2k
3Yx1Y	0.776 +0.8	9.8k	0	9.8k
4Yx1Y	1.108 +0.9	9.6k	0	9.6k
5Yx1Y	1.425 +1.9	9.4k	0	9.4k
6Yx1Y	1.629 +3.3	9.4k	0	9.4k
7Yx1Y	1.755 +2.3	9.2k	0	9.2k
8Yx1Y	1.859 +2.2	9.3k	0	9.3k
9Yx1Y	1.955 +3.3	9.0k	0	9.0k
10Yx1Y	2.005 +1.4	8.8k	0	8.8k
11Yx1Y	2.010 +1.4	0	0	0

Swaptions and CMS

We have not seen any new information regarding swaptions or CMS products, so uncertainty remains. Please see the November 2020 update for further details.

CME to move remaining EFR discounting to SOFR

CME will transition discounting and PAI on remaining cleared non-deliverable swaps, MXN swaps and OTC FX products still using EFR to SOFR discounting.

Target date is 26 March 2021 with cash compensation to be paid to neutralise any value transfer. CME will not be conducting a re-hedging exercise⁸.

Authors

Christopher Willis

Quantitative Analyst

Christopher.Willis@coremont.com

+44 20 7965 9532

Edmund Allen

Head of Quantitative Analysis

Edmund.Allen@coremont.com

+44 20 7965 9538

References

1. ISDA Adhering parties
<https://www.isda.org/protocol/isda-2020-ibor-fallbacks-protocol/adhering-parties>
2. FCA and BoE joint statement on SONIA interest rate swaps
<https://www.bankofengland.co.uk/news/2020/september/fca-and-boe-joint-statement-on-sonia-interest-rate-swap>
3. Calrusft – Why is so much new Libor risk being transacted
<https://www.clarusft.com/cessation-of-libor-why-is-so-much-new-risk-still-being-transacted/>
4. IBA consultation on potential cessation dates
https://www.theice.com/publicdocs/ICE_LIBOR_Consultation_on_Potential_Cessation.pdf
5. Joint statement from Board of Governors of the Federal Reserve System Federal Deposit Insurance Corporation Office of the Comptroller of the Currency re USD Libor trading post 2021
<https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20201130a1.pdf>
6. LCH proposed position in respect of FRAs
<https://www.lch.com/membership/ltd-membership/ltd-member-updates/lchs-proposed-position-respect-benchmark-fallbacks-and>
7. Coremont authored article on Risk-Net
<https://www.risk.net/comment/7649656/beware-of-the-cliff-edge-in-libor-fallbacks>
8. CME EM discounting transition
<https://www.cmegroup.com/trading/interest-rates/files/emerging-market-discounting-transition-proposal-dec-2020.pdf>

Important Information

This document (and any information accessed through links in this document) is provided for information purposes only and does not constitute the rendering of professional advice or services.

Any information in this document should be regarded strictly as guidance on matters of interest only. Coremont does not provide legal, accounting or tax advice. As such, this document should not be used as a substitute for consultation with professional legal, accounting, tax or other competent advisers. Before making any decision or taking any action relating to the subject matter of this document, the reader should always consult an appropriate professional adviser. This document does not constitute an invitation, solicitation or offer to subscribe for or purchase any of the investments, products or services mentioned herein, nor shall it, or the fact of its distribution or communication, form the basis of, or be relied on in connection with, any contract.

While every attempt has been made to ensure that the information contained in this document has been obtained from reliable sources, Coremont is not responsible for any errors or omissions, or for the results obtained from the use of this information. All information in this document is provided "as is", with no guarantee of completeness, accuracy, timeliness or of the results obtained from the use of this information, and without warranty of any kind, express or implied, including but not limited to warranties of performance, merchantability and fitness for a particular purpose. In no event will Coremont or its representatives, members, officers or employees be liable to the reader or anyone else for any decision made or action taken in reliance on the information in this document or the reliability, accuracy, or completeness thereof or for any consequential, special or similar damages, even if advised of the possibility of such damages. The information contained in this document is subject to change without notice and Coremont assumes no obligation to update any information contained in this document.

Certain links in this document connect to other websites maintained by third parties over whom Coremont has no control. Coremont makes no representations as to the accuracy or any other aspect of information contained in other websites.

In this document, "Coremont" means Coremont LLP and its affiliates. Coremont LLP is a limited liability partnership authorised and regulated by the Financial Conduct Authority of the United Kingdom and registered in England & Wales (reg. no. OC420985).