**Opening Remarks**

## CFTC Market Risk Advisory Committee – Update From Subcommittee – June 12, 2019

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### Introduction

- Good afternoon everyone- it is an honor to be presenting again in front of the Market Risk Advisory Committee on behalf of the subcommittee on interest rate benchmark reform. My name is Tom Wipf, Vice Chairman of Institutional Securities at Morgan Stanley and I represent the Firm as Chairman of the ARRC as well as a Board member of ISDA
- Before we begin, I would like to note that I will not be commenting on behalf of Morgan Stanley, the ARRC, or any other organizations today, and that any views I represent are strictly my own and those of the Subcommittee that I chair as previously established by the MRAC
- I want to take a moment to thank Commissioner Behnam, Alicia Lewis, the MRAC, and the rest of the CFTC for forming this subcommittee – the transition to alternative reference rates is a massive task ahead of us, and to achieve success it is paramount that we have close coordination between the public and private sectors
- I'd like to begin by first recapping the key developments in the LIBOR transition that have occurred since we last spoke in December 2018, and then provide an update on the progress to date of the MRAC Subcommittee on interest rate benchmark reform

### Developments in LIBOR Transition

- I will divide key developments into two buckets – Market-driven and Regulator-driven:

*Market-Driven*

- The major development out of the ARRC from the turn of the year has been the publication of fallback language for those that continue to use LIBOR in cash products
  - We completed four sets of this fallback language – for floating rate notes, syndicated loans, bilateral loans, and securitizations.
  - The goal was to create some degree of uniformity between 'optimized' fallback language across cash market asset classes going forward, while also addressing the idiosyncrasies of each market
- ISDA has also been hard at work to improve fallback language in derivative contracts, via new fallback terms that will be released by the end of this year. These new terms will apply to all new LIBOR swaps incorporating the standard ISDA interest rate definitions and to legacy LIBOR swaps via a voluntary protocol.

  - Following up on their initial consultation completed last year, ISDA is currently in the market with two additional consultations – one is on the spread methodology to be applied to additional currencies not covered in the 2018 version, and one is on the potential inclusion of a pre-cessation trigger in the ISDA protocol
  - I would note that this second consultation was in response to a letter that ISDA received from the OSSG, which is an official sector committee, encouraging such a market survey
  - ISDA will also seek feedback later this year on the market's views on the conventions to be applied on implementation of the eventual fallback spread, and by end of this year we should have final fallback terms for LIBOR swaps
- SOFR-based products continue to gain traction in the market place, among both cash and derivatives
  - SOFR futures volumes are now the 3rd best start in CME's history, and quarter-end saw significant SOFR swap volumes that we'll look to build upon
  - SOFR FRN issuance has reached $100Bn since last summer, and we continue to see this market evolve. Whereas last year's FRNs used a simple average to calculate coupon payments, some market participants are innovating to use compounded SOFR in ways that match the swaps market and should introduce hedging demand in SOFR
- The ARRC's outreach efforts have also been meaningful, both with the public and with Regulators
  - A few weeks ago we published the "User Guide for SOFR", which demystified how market participants can begin using SOFR in contracts today
  - We also hosted our 4th annual ARRC Roundtable last week, where we heard from Vice Chairman Quarles as well as many ARRC members
  - In May we followed up our July 2018 "Title VII" letter which requested certain regulatory clarification from the CFTC and other prudential regulators with an additional letter that provided an update regarding conversion approaches and an additional request for regulatory relief in order to facilitate the pace and effectiveness of the "risk free rate", or RFR, transition. I will discuss these views in greater depth in a moment.

*Regulator-Driven*

- Regulators have also played a significant role in the progress that has been made in 2019 thus far
  - In April, the FSB convened a roundtable with global Regulators and many market participants, in order to share their views on the transition to date as well as solicit feedback on how the public-private partnership can be fortified to improve the outcome of the RFR transition
    - The message at this roundtable was crystal clear – that Regulators are willing to provide relief within reason. This view has informed the MRAC Subcommittee's key updates, which I will elaborate upon momentarily.

  - Further, the Bank of England hosted their annual event last week where it was clear that they are amenable to thoughtful relief too
- This backdrop of Regulatory relief has been communicated to the MRAC Subcommittee for interest rate benchmark reform, and has helped inform our updates for this group today

## Next Steps

- When I addressed this group in December, I noted that our primary goal is to provide input and recommendations to the MRAC as it relates to potential policy changes that may impact the course of LIBOR reform
- Our key principles in this regard are the following:
  1. We aim to <u>remove hurdles</u> to the transition to SOFR and other "risk free" rates
  2. We aim to <u>provide incentives via relief</u> for market participants to transition to SOFR and the other RFRs
  3. We aim to <u>avoid the inadvertent creation of a safe harbor</u> in policy changes that we recommend
- Putting further detail around our objectives, I included in my speech at the FSB Roundtable in early April that our subcommittee had narrowed our areas of focus to three key topics and nominated a subcommittee member to serve as a working group leader specializing in these areas.  All three of these working group leaders have joined me today in case the group would like to ask any detailed follow-up questions about their work.
  1. <u>Uncleared Margin</u> – the Subcommittee is reviewing ways in which the CFTC's Uncleared Margin Rule may cause impediments to adoption of the alternative rates, and how these rules can be amended to improve the pace of adoption without creating a safe harbor.
     - Biswarup Chatterjee (Citi) has taken a lead role on this working group
  2. <u>Clearing</u> – the Subcommittee is reviewing ways in which current regulation regarding derivative clearing mandates may cause impediments to adoption of the alternative rates, including examining the appropriateness of mandatory clearing for derivatives linked to these alternative rates, also with an eye towards avoiding a safe harbor
     - Marnie Rosenberg (JPM) has taken a lead role on this working group
  3. <u>Disclosures</u> – the Subcommittee is reviewing existing risk disclosure documents used by market participants in order to understand if additional risk disclosures are appropriate
     - Ann Battle (ISDA) has taken a lead role on this working group

## Uncleared Margin

- Starting with our focus on uncleared margin, our subcommittee noted that certain legacy IBOR derivatives that may be exempted from margin requirements may lose legacy status if they are amended to include fallback provisions or transitioned to RFRs
    - The potential for losing legacy status on trades may dissuade market participants from taking the necessary steps to voluntarily convert their positions to new benchmark rates
    - As outlined in its May letter to regulators, the ARRC identified a handful of specific conversion methodologies, but there may be other ways to convert outstanding LIBOR swaps and so we aren't certain this is an exhaustive list of ways in which market participants may effect a conversion from LIBOR to SOFR in the derivatives market
        - At any rate, these nine methodologies are fairly complex and would be operationally challenging to capture and record
- In light of this, we believe the CFTC can consider broad relief to preserve a derivative's legacy status under the uncleared margin rules if it is amended to include fallback provisions or converted on a voluntary basis via one of the ARRC-identified methods or other newly developed methods
- Further, to better achieve the goal of promoting liquidity in the risk free rates, the CFTC can also consider permitting all new uncleared RFR trades executed before Jan 1, 2022 to receive blanket relief from IM requirements
    - As a broad group of market practitioners, we felt this would provide a significant boon to SOFR and other RFR liquidity, and could massively benefit the transition and the policy objective of financial stability that both we, as market participants, and the regulators and central banks seek to promote
- I would like to note that these ideas are also reflected in the ARRC letter to US Regulators (including Chairman Giancarlo of the CFTC) dated May 13, 2019
    - The MRAC Subcommittee on interest rate benchmark reform benefits from cross-pollination with the ARRC, keeping us updated on the progress that the ARRC's Regulatory Working Group has been making over the past several months
    - Importantly, our group also gives voices to market participants that do not participate in the ARRC – these other participants also concluded that the ARRC's proposals on broad uncleared margin relief were merited and would be beneficial to the market at large
- Lastly, and separately from the ARRC's requests, it was pointed out that since SOFR and certain other RFRs are new rates, some firms may not have approved SIMM models to calculate required initial margin on bilateral trades
    - As such, they may be forced to use other margin calculation methodologies that result in punitively high costs for clients interested in putting on SOFR or these other RFR trades

        - We felt this could serve as a barrier to entry for many market participants
    - Our view is that the CFTC could recommend that SIMM model enhancements that are necessary to include SOFR or other RFR based swaps in SIMM should be approved centrally and firms should not be required to provide notice of or receive individual approvals with respect to those SIMM enhancements
        - Cutting down on the operational difficulty associated with SOFR transactions should be a net benefit to liquidity

## Clearing

- Moving onto our discussion of the CFTC clearing mandate, as was also reflected in the ARRC's July letter to regulators, it was noted that legacy derivatives linked to LIBOR and certain other interest rate benchmarks, which are referred to collectively as the IBORs, that are exempt from clearing requirements may lose legacy status if amended to include fallback provisions
    - This is an additional bit of market uncertainty that may serve as a barrier to widespread adoption of the ISDA protocol
- If this is not the intended outcome, the subcommittee felt that the CFTC can issue guidance communicating that the addition of fallback provisions in an IBOR-based derivative contract will not impact "legacy" status as it relates to clearing mandate
- Additionally, the subcommittee recognized a clearing mandate does not currently exist for SOFR-based products, and both cleared and uncleared trades have occurred
    - We noted however that if our various forms of relief were to be granted, particularly the point about uncleared margin requirements, it would improve liquidity in SOFR products with much activity potentially remaining uncleared
    - As such, we feel it is prudent that the CFTC consider a framework by which to identify when it is appropriate to mandate clearing of RFR transactions
        - However, it was agreed that it may yet be too premature to determine exactly when such a mandate would be appropriate, give the nascence of the SOFR market
- Separately, it was also felt that the CFTC could consider decreasing the minimum Margin Period of Risk (MPOR) on cleared SOFR trades, which may also incentive new activity via reduced initial margin requirements for cleared trades

## Disclosure Language

- Moving onto disclosures, the Subcommittee felt that disclosures for IBOR derivatives regarding implications of benchmark reform exist in the market, but, while accurate and compliant with applicable regulations, may be too complex for average market participants to understand

  - As such, there was strong interest for the CFTC to endorse “plain-English” disclosure language for use in new IBOR derivatives to be drafted by the MRAC Subcommittee
    - We felt that ideally there would be two separate disclosures drafted: one effective before the ISDA definitions are amended to include fallbacks, and one effective after the definitions are amended to include fallbacks
  - Along with this disclosure statement, the MRAC could also consider requesting the CFTC to establish an appendix webpage including additional information alluded to in the plain-English statement
- The Subcommittee is in the process of iterating this statement and aggregating materials for a potential backup webpage, and expect to have finalized proposals later this year
- It was also agreed that the current ISDA disclosure statements, which were last updated in March 2018, may need to be refreshed to capture more recent developments in the IBOR transition
  - However, the group felt that this update should occur closer to YE-2019, when ISDA’s definitions have been amended to include fallbacks

## Conclusion

- These three buckets have been the Subcommittee’s areas of focus over the past several months
- By the time of the next MRAC meeting towards the end of this year, we intend to conclude our work in the form of final recommendations to the MRAC
- We strive to be additive to other sources of market progress, and remain focused on the scope of our mandate
- We welcome any feedback from the MRAC on our areas of focus or potential recommendations that we have discussed today
- Based on feedback we receive today, we intend to provide a letter to the MRAC detailing our recommendations in greater detail, and our group stands ready to work with all stakeholders in order to progress the stated objectives
- Once again, I would like to thank Comm. Behnam, Alicia Lewis, and the MRAC for this opportunity for public service
- With this, I will conclude my prepared remarks and let Alicia solicit questions from the room