

CFTC Market Risk Advisory Committee – Update From Subcommittee – September 9, 2019

Introduction

- Good afternoon everyone- thank you all for making the time for this conference call outside of the normal bi-annual MRAC meeting schedule. Given the direction of travel and pace of recent developments, we felt it was important to get today's agenda items in front of the MRAC in advance of the November meeting.
- 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, Nadia Zakir, 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 also like to thank the members of the Subcommittee for their hard work over the past year – the full Subcommittee has now had 3 conference calls, with several more calls and correspondences occurring between the working groups and the working group leaders
- I'd like to begin by first recapping the key developments in the LIBOR transition that have occurred since we last spoke in June, and then discuss our three agenda items. These items are the following:
 1. Vote on the recommendation of the Subcommittee related to plain-English disclosure language
 2. Discuss proposals from central counterparties regarding adjustments to discounting and price alignment interest
 3. Discuss the clearing treatment for certain physically settled swaptions

Developments in LIBOR Transition

- Since June there have been a number of important developments in the LIBOR transition, driven by both Regulators and market participants
- Regulatory developments include the following:
 - FASB voted to provide accounting relief for contract modifications and hedging relationships impacted by the LIBOR transition. The proposal for this relief was issued last week.

Opening Remarks

- SEC released guidance on appropriate disclosures for dealers and investment managers that are trading, investing in, or selling LIBOR linked products
- FHFA suggested that they will eventually prohibit Fannie Mae and Freddie Mac from purchasing LIBOR-linked mortgages
- TBAC noted in their meeting minutes that they are supportive of the US Treasury issuing a floating rate note tied to SOFR, pending further analysis on how this may impact demand for existing US Treasury FRNs
- IOSCO issued a statement noting that the best risk mitigation to a LIBOR cessation event is moving to RFRs now – this is consistent with the message that the ARRC has been delivering for months that the best way out of a hole is to stop digging
- The Financial Stability Oversight Committee (FSOC) discussed the LIBOR transition in their September meeting last week
- Just last month, we received the first indication that the US Treasury may have guidance on tax consequences of converting legacy LIBOR positions – we are still waiting to see the final guidance but this is certainly encouraging
- Market developments include the following:
 - The ARRC provided additional details around how to construct a SOFR-based ARM product
 - This is a hugely significant development for the consumer market and shows how SOFR in its current form can be used for many products
 - The clearinghouses have come out with initial proposals for how they will adjust discounting and price alignment interest – this will be the focus of much of our conversation today

Plain-English Disclosures

- The first order of business for today's meeting is to discuss and vote on the plain-English disclosure language drafted by the subcommittee
- I will let Ann discuss this language in greater detail, but at this point you should all be familiar with it
 - Note that this language was drafted by the Disclosures working group and reviewed by the broader subcommittee
- The key motivation behind this language was to have a standard set of disclosures that market participants can incorporate in their documents that adequately inform their clients and counterparties about the implications of using LIBOR based products
- They may not be perfect for every market participant, so firms should be encouraged to amend as needed for their respective organizations
 - For instance, they are written on a transactional basis, but could be provided on a relationship basis instead

- Substantively similar disclosures developed by a particular bank are also fine
- However, all traders that continue to engage in LIBOR and other IBOR transactions should be aware of the disclosures (or other internal disclosures) and should endeavor to ensure that they are distributed to counterparties in an operationally feasible/efficient way
- After discussing these disclosures, we would like to initiate a vote by the MRAC to approve this language
 - If approved by the MRAC, these would be submitted to the Commission for consideration and would be hosted on the MRAC's section of the CFTC's website

CCP Adjustments to Discounting & Price Alignment Interest

- Another key focus from the subcommittee has been discussing areas of coordination and potential risk considerations from the current proposals put forth for Discounting & Price-Alignment Interest adjustments from LCH and CME
 - We will hear shortly from Dennis McLaughlin (LCH) and Agha Mirza (CME), who will both give brief overviews of their existing proposals
- There are certain differences between the respective proposals that the Subcommittee recognized as potentially challenging from an economic and operational perspective
 - There was desire from the Subcommittee for consistency across the clearinghouses in how they approach this adjustment, to the greatest extent possible
- A few areas of concern were the timing of the adjustments, the pricing mechanism for cash compensation, and the methodology by which ongoing basis risk was compensated
 - We would like to discuss these issues today, but recognize that the discussion is likely too extensive for a single session, and that ultimately both clearinghouses will enact plans that best represent their clients' preferences
- However, the Subcommittee would like to gauge from the MRAC on how to best approach coordination between the clearinghouses
 - Guidance regarding the appropriate forum for these discussions – whether it is within the Subcommittee, within the MRAC, or within the CFTC would be helpful
 - The Subcommittee feels that a larger degree of communication and coordination between the clearinghouses will have a highly beneficial effect on the Single Step transition for the market

Clearing Treatment for Certain Physically-Settled Swaptions

- Finally, the clearing treatment for certain physically-settled swaptions has been a point of discussion in the Subcommittee as well as the broader market

Opening Remarks

- Notably, in the current construct of the Single Step transitions at both clearinghouses, there may be valuation discrepancies that arise in these products
 - I will discuss the mechanics of this issue in greater detail later this afternoon
- The subcommittee felt that it is likely too premature to propose any sort of relief to the MRAC, but rather we would appreciate your guidance on how we should approach this issue
 - It has been suggested by certain market participants that exempting these specific swaptions from the clearing mandate could be a solution, though the implications of this have not yet been fully vetted
 - CME's presentation shortly will suggest a potential solution to this issue that they will look to gather market feedback on
- We look forward to introducing this discussion to the public domain and getting your feedback

Next Steps

- The subcommittee's work will continue after this meeting, and we intend to have another update for this group at the November MRAC meeting
- To the extent the MRAC approves the disclosure language today, we would expect to make that accessible to market participants in short order
 - The plain-English disclosures would be posted on the MRAC's section of the CFTC site, and supplementary information would be posted on ISDA's site
- I expect the discussion of coordination between the clearinghouses on their respective Single Step proposals will be ongoing for the next several weeks and months
 - Pending your input today, we will determine if the Subcommittee is the preferred venue for such coordination, or if perhaps November's MRAC or another CFTC forum may be more appropriate
 - Timely resolution of these discrepancies is important for market participants, as the operational work needed to prepare for this significant change may be time-consuming for many Firms
- For the swaptions discussion, we will take the MRAC's guidance into how this should be approached within the Subcommittee
 - The ARRC is also taking a look at this issue, but ideally we would combine forces with the MRAC to ensure a timely resolution
 - Depending on the solution reached by the market, there may be significant repapering or operational work ahead for many Firms

Conclusion

- We welcome any feedback from the MRAC on our areas of focus that we have discussed today
- The MRAC and CFTC's guidance has been helpful to our work thus far, and we look forward to further collaboration with this group
- Once again, I would like to thank Comm. Behnam, Alicia Lewis, Nadia Zakir and the MRAC for this opportunity for public service