Opening Remarks

CFTC Market Risk Advisory Committee – Update From Subcommittee – July 21, 2020

Introduction

- Good morning 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. For those I haven't met, 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.
- I want to take a moment to thank Commissioner Behnam, Alicia Lewis, Nadia Zakir, the MRAC, and the rest of the CFTC for continuing to support this subcommittee. In particular, the subcommittee membership has expanded materially since we last spoke, and we feel it covers a diverse set of views and perspectives – we thank the CFTC for their support in this expansion.
- I'd also like to thank the members of the Subcommittee – both preexisting members and newly added members – for their hard work over the past several months. The tabletop exercise we conducted on June 2nd was made possible by countless hours of work from all members. I continue to be appreciative of the group's commitment towards the MRAC's goal for us to be additive to the LIBOR transition efforts from the ARRC and other groups.
- I'd like to begin by first recapping the key developments in the LIBOR transition that have occurred since we last spoke in December, and then provide an overview of the Subcommittee's tabletop exercise that explored the proposals from CME Clearing and LCH Limited regarding the single step transition for discounting and price alignment interest for certain products, scheduled for October 2020.

Developments in LIBOR Transition

- Since December there have been a number of important developments in the LIBOR transition, driven by both Regulators and market participants.
- Regulatory developments include the following:
    - The Financial Stability Board and Basel Committee on Banking Supervision published a report on Supervisory issues associated with benchmark transition.
    - The Federal Financial Institutions Examination Council on behalf of its members issued a statement to highlight the financial, legal, operational, and consumer protection risks that will result from the expected discontinuation of LIBOR and to encourage supervised institutions to continue their efforts to prepare for this change and address its associated risks.
    - US Treasury published and received comments on a Request for Information exploring the possibility of issuing a SOFR-indexed floating rate note.

- The Financial Accounting Standards Board issued an Accounting Standards Update to provide temporary optional guidance to ease the potential burden in accounting for reference rate reform.
- I would also note a few UK-specific regulatory updates that have global implications for the LIBOR transition:
  - The UK Government announced their intention to legislate to amend and strengthen existing regulatory framework for critical benchmarks such as LIBOR, rather than directly to impose legal changes on LIBOR-referencing contracts that are governed by UK law. In particular, they suggested that they will introduce amendments to UK BMR to ensure that the FCA's powers are sufficient to manage an orderly transition from LIBOR. This may enable the FCA to direct a methodology change for a critical benchmark, in circumstances where the regulator has found that the benchmark's representativeness will not be restored and where action is necessary to protect consumers and/or to ensure market integrity.
  - The FCA & Bank of England released a statement on the impact of the Coronavirus on Firms' LIBOR transition plans, noting that the ultimate YE'2021 deadline persists. Other global regulators have corroborated this view in clear terms.

- Market developments include the following:
  - The ARRC has been hard at work this year, increasing the frequency of our meetings substantially. Some of the products we've published are:
    - Best Practices on continued use of USD LIBOR, which provide date-specific guidance to the market on when it is appropriate to end production of new contracts referencing USD LIBOR.
    - A Tool to help Firms move internal systems and processes away from LIBOR.
    - Fallback language for LIBOR-indexed student loans and recommended conventions for using SOFR in new student loans.
    - Updated recommended hardwired fallback language for syndicated loans.
    - Details around the calculation of the ARRC recommended spread adjustment for cash products utilizing ARRC fallback language.
    - Recommendations for swaptions impacted by the CCP discounting transition to SOFR.
    - A webinar providing an overview of the ARRC's proposal for New York State Legislation to deal with certain "tough legacy" cash products.
  - Away from the ARRC, ISDA is in the final stages of publishing a protocol to incorporate new fallback language into legacy derivative contracts, which is based on input from several market consultations over the past 2 years.

  - It also should not be understated how valuable the MRAC subcommittee's contributions have been to the ongoing transition away from LIBOR, especially in light of our tabletop exercise.

Review of Tabletop Exercise

- At the December 2019 MRAC meeting, the MRAC voted to hold a tabletop exercise regarding CME Clearing and LCH Limited's single-step proposals for the transition of discounting and price alignment interest for certain products to the secured overnight financing rate, scheduled for October 2020. The MRAC's Interest Rate Benchmark Reform Subcommittee was tasked with the planning and execution of the exercise. Due to COVID-19, the Subcommittee opted to have a "virtual" table top discussion because of the complexities associated with conducting a "virtual" trading simulation.
- In this format, the subcommittee reviewed potential implications of the discounting transition for market participants under seven different scenarios:
  - Scenario 1: Processes at Both CCPs go According to Plan *(base case)*
  - Scenario 2: Failed Auction for Discounting Risk Swaps
  - Scenario 3: Operational Failure
  - Scenario 4: Member Default
  - Scenario 5: FCM Not Operationally Prepared for CCP Discounting Transition
  - Scenario 6: Prefunding Needs / Risk Limits
  - Scenario 7: COVID-19 Related Interruptions
- Entering the tabletop exercise, the subcommittee laid out key objectives for the discussion.
  - Of utmost importance, we wanted the tabletop to be an educational experience for those involved, and to identify areas of weakness or misunderstanding of the CME and LCH plans that could impair the success of the discounting transition in October.
  - We also sought to address issues raised during the tabletop via recommendations to market participants as well as points of consideration to the US official sector.
- During this robust roundtable discussion, a couple of key issues became apparent:
  - There are some gaps in understanding among market participants about precise timing of discounting transition milestones, as well as dynamics of CME and LCH auction processes.
  - An auction in which some or all of allotted discounting risk swaps are not liquidated despite end user's election to offload these swaps could be potentially disruptive to the pricing and liquidity of SOFR instruments potentially leading to unanticipated volatility for the market overall.
  - A lack of congruency between CCP-mandated dates by which market participants must finalize elections to offload discounting risk swap compensation may create confusion or perceived advantages for certain market participants.

  - Major differences between the CCP plans may create significant operational and market risk for participants over the discounting transition period.
- To help mitigate these potential issues, the subcommittee decided on 3 guiding insights that market participants should consider as they approach the October transition:
  - Enhanced education regarding the discounting transition is needed for all involved parties.
  - Risk mitigation strategies ahead of discounting transition should be considered; examples include trade compression and re-couponing.
  - Internal preparation and proactive engagement by all impacted stakeholders in industry preparations is critical to produce a positive outcome for the market.
- Taking this a step further, the subcommittee has provided actionable recommendations for different types of market participants, broken down between CCPs, FCMs, buy-side firms, and Regulators.
  - All of the recommendations, summarized on page 6 of our report, attempt to provide next steps that market participants can take to better improve education, risk management, and internal preparation – in line with our guiding insights.
- For the broader Regulatory community in particular, we arrived at three recommendations to be considered as market participants work on their preparations:
  - Consider implications of Part 43 and other global real-time public reporting requirements for discounting risk swaps vis-a-vis potential concerns that broader market transparency into auction portfolios may disincentivize aggressive bidding and therefore potential benefits of the auctions. Also consider implications of reporting / not reporting on transactions that are purely intended to give effect to cash compensation payment.
  - Confirm treatment and consider relief from tax and accounting implications of pre-hedging auction related exposures.
  - Consider other areas for no action or interpretive relief that would facilitate the discounting transition, potentially including relief in the uncleared market for swaptions and amendments to credit support annexes as proposed by the ARRC in its June 16th letter to the Division of Swap Dealer and Intermediary Oversight. The ARRC also looks to continue its active dialogue with the Commission and staff as we work collaboratively to fine tune existing relief and identify new areas for relief that will facilitate adoption of the ISDA protocol and voluntary conversions. The ARRC's most recent filing underscores the continuing collaborative work with the Commission and the staff.
- We look forward to sharing the full report with the broader market today, as we believe it will provide important guidance to be considered as every firm plans for this critical transition in October.
- It cannot be forgotten that the CCP discounting transition is a fundamental part of the ARRC's paced transition plan, and will ultimately have a significant positive impact on the adoption of SOFR in the

derivatives markets. However, this event does not come without certain risks, and it is important that we help provide the clarity needed by market participants to prepare for these risks.

Conclusion

- At this time, we welcome any feedback or questions from the MRAC on our tabletop exercise and resulting recommendations.
- 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. And the tabletop could not have been a success without the integral work of Bob Wasserman from the CFTC, who served as facilitator. I would now like to open the discussion for feedback and questions.