

VIA CFTC Portal

12 July 2018

Mr Christopher Kirkpatrick
Commodity Futures Trading Commission
115 21st Street NW
Three Lafayette Centre
Washington DC 20581

Dear Mr Kirkpatrick

SwapClear to extend product eligibility to include SOFR Overnight Index and Basis Swaps

Pursuant to CFTC regulation §39.5(b), LCH Limited (“LCH”), a derivatives clearing organization (“DCO”) registered with the Commodity Futures Trading Commission (the “CFTC”), is submitting Overnight Index Swaps (“OIS”) and basis Swaps referencing a new market standard US Dollar (“USD”) index – the Secured Overnight Financing Rate (SOFR) for determination of whether mandatory clearing should apply.

Background

On 22nd June 2017 the US Federal Reserve Alternative Reference Rates Committee (“ARRC”) selected a Broad Treasuries repo financing rate, to be called the Secured Overnight Financing Rate (“SOFR”), as the preferred alternative rate for use in certain new USD derivatives and other financial contracts. The ARRC has developed a “Paced Transition Plan” to drive acceptance, adoption and use of derivatives referencing this new rate. The launch of the SOFR Swap is the first part in a market transition plan which is intended to be completed by 2021.

Factors for determination

The existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data

SOFR is a broad measure of overnight Treasury financing transactions recommended by the US Federal Reserve Alternative Reference Rate Committee (ARRC) last year as an alternative to USD LIBOR in certain new derivative and other financial contracts. In the fullness of time it is expected that SOFR will take over as the natural rate for discounting of all USD cash flows, however that transition does not form a part of this initial proposal¹.

¹ Later phases of the “Paced Transition Plan” will see the emergence of all USD cashflows being discounted using the USD SOFR rate, with PAI set using the same index.

As a result of the backing by the Federal Reserve and the existing long-dated USD interest rate risk within the SwapClear service, it is proposed to clear USD SOFR linked products to a maximum eligibility of 51 years (consistent with the current maximum maturity for USD LIBOR swaps²). The proposed products are:

- OIS (Fixed vs SOFR)
- Basis Swap (SOFR vs LIBOR)
- Basis Swap (SOFR vs Fed Funds)

The Federal Reserve started publishing SOFR on 3rd April 2018 with c.USD800bn of daily volume being linked to it.

Market data is available from large brokers with quotes available out to 50 years³.

The availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is then traded

LCH has a well-developed rule framework and support infrastructure for clearing interest rates swaps. LCH intends to leverage this existing operational capability when extending its offering to SOFR Swaps.

In order to prepare for the launch of these products, LCH will perform testing to ensure that it is able to clear these products in a manner which is consistent with the terms on which they are traded.

Further to this, LCH will notify its Clearing Members of a number of minor changes to the procedure documents which will be made in order to support the clearing of SOFR Swaps in the above mentioned tenors. The procedural changes will be certified with the CFTC and be made available on the LCH website.

The effect on mitigation of systemic risk, taking into account the size of the market for such contract and the resources of the DCO available to clear the contract

SOFR based products do not introduce any novel risks to LCH, as the operational capability to manage the product are already in place.

LCH expects current SwapClear Clearing Members to start clearing SOFR Swaps, once the service is live.

Following consultation with its Members, LCH does not expect this product launch to lead to an overall increase in the volume or riskiness associated with USD swaps in the clearing house, rather that users will transition their positions from the USD LIBOR swap into the USD SOFR swap over time. Therefore, the introduction of SOFR Swaps is unlikely to have a significant impact on the risk profile

² Except SOFR vs Fed Funds, where the final maturity will be 31 years, consistent with the current maximum maturity for USD Fed Funds swaps.

³ LCH will be using the existing curve building methodology for valuing SOFR Swaps

or total resources held by the SwapClear service. The systemic risk profile of LCH should thus remain unchanged as a result of this product offering.

The effect on competition, including appropriate fees and charges applied to clearing

CME Group introduced the 1-month and 3-month SOFR futures contract to the market in May 2018. The CME Group is targeting Q3 2018 for clearing SOFR swaps.

LCH's fees and charges for the above product will be in line with those charged for existing SwapClear contracts.

The existence of reasonable legal certainty in the event of the insolvency of the relevant DCO or one or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds and property

The level of legal certainty around the clearing of SOFR Swap contracts is in all material respects the same as that of the products already cleared in the SwapClear service at LCH.

Insofar as legal certainty in the event of the insolvency of the DCO is concerned, LCH would be wound up under English law.

Further information §39.5(b)(iii-viii)

Product terms for SOFR Swaps are market standard and follow **2006 ISDA Definitions** and are also part of the Financial products Markup Language (FpML) standard (specifically <http://www.fpml.org/coding-scheme/floating-rate-index> published on 21st December 2017), which is a protocol for sharing information on derivatives and other products. On 16th May 2018, ISDA published supplement 57 to the 2006 ISDA definitions, which contains the Floating Rate Option for "USD-SOFR-COMPOUND"⁴.

The participant eligibility standards for SOFR Swaps are the same as those for existing SwapClear Clearing Members.

No changes are required to the methodologies used for sizing or allocation of the Default Fund; however, the scenarios used to size the Default Fund will be extended to include SOFR Swaps.

All USD cashflows are currently discounted using the USD Fed Funds rate, with Price Alignment Interest (PAI) set using the same index. For this stage it is proposed to retain this approach for SOFR products in line with step 3 of the "Paced Transition Plan" advocated by the ARRC.

No major risk management changes are necessary for SwapClear to offer SOFR swaps, however minor adjustments will be made as follows:

⁴ <https://www.isda.org/a/kKHEE/Supplement-57-USD-SOFR-COMPOUND.pdf>

- A non-diversifiable margin add-on will be included to mitigate the risk associated with using the Fed Funds time series as a proxy for USD SOFR (the add-on is between 7-12bp depending on tenor)
- Three new historical and four new theoretical scenarios will be added to the stress testing suite

Updates will also be made to the eligibility manual and the LCH procedures in order to show SOFR based trades as eligible. The amendments will be submitted to the CFTC pursuant to §40.6(a), following notification to LCH's Clearing Members.

LCH engages its Clearing Members in the design and testing of new products at an early stage, through regular meetings and working groups. Clearing Members have been formally notified of the changes which LCH is required to make to its Rulebook.

Notice of this submission under CFTC regulation §39.5(b) was given to SwapClear Clearing Members on 18 June 2018 and a copy of this notice is provided at Appendix A. No material feedback was received. Furthermore, this submission is publicly available at: <http://www.lch.com/rules-regulations/regulatory-responses>

LCH intends to launch these products with its Clearing Members and clients no earlier than July 16, 2018.

Should you have questions please contact me at julian.oliver@lch.com.

Yours sincerely

PP 

Julian Oliver
Chief Compliance Officer
LCH Limited

Appendix A

Notice of this submission provided to SwapClear Clearing Members

Memo

To	SwapClear Clearing Members
From	David Horner, Head of In-Business Risk Rates
Date	18 June 2018
Subject	SOFR Swaps submission for determination of clearing requirements

Pursuant to CFTC regulation §39.5(b), LCH Limited (LCH), a derivatives clearing organization (DCO) registered with the Commodity Futures Trading Commission (the CFTC), is submitting Overnight Index Swaps (OIS) and Basis Swaps referencing a new US Dollar (USD) index – the Secured Overnight Financing Rate (SOFR) for determination of whether mandatory clearing should apply.

As per CFTC regulation §39.5(b)(viii), LCH is required to notify members of its submission. This note does not constitute a notification that the products are live for clearing. A notice announcing the live date and arrangements for the formal product launch will be published separately.

Factors for determination

The existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data

SOFR is a broad measure of overnight Treasury financing transactions recommended by the US Federal Reserve Alternative Reference Rate Committee (ARRC) last year as an alternative to USD LIBOR in certain new derivative and other financial contracts. In the fullness of time it is expected that SOFR will take over as the natural rate for discounting of all USD cash flows, however that transition does not form a part of this initial proposal⁵.

As a result of the backing by the Federal Reserve and the existing long-dated USD interest rate risk within the SwapClear service, it is proposed to clear USD SOFR linked products to a maximum eligibility of 51 years (consistent with the current maximum maturity for USD LIBOR swaps⁶). The proposed products are:

- OIS (Fixed vs SOFR)
- Basis Swap (SOFR vs LIBOR)
- Basis Swap (SOFR vs Fed Funds)

The Federal Reserve started publishing SOFR on 3rd April 2018 with c.USD800bn of daily volume being linked to it.

Market data is available from large brokers with quotes available out to 50 years⁷.

The availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is then traded

⁵ Later phases of the “Paced Transition Plan” will see the emergence of all USD cashflows being discounted using the USD SOFR rate, with PAI set using the same index.

⁶ Except SOFR vs Fed Funds, where the final maturity will be 31 years, consistent with the current maximum maturity for USD Fed Funds swaps.

⁷ LCH will be using the existing curve building methodology for valuing SOFR Swaps

LCH has a well-developed rule framework and support infrastructure for clearing interest rates swaps. LCH intends to leverage this existing operational capability when extending its offering to SOFR Swaps.

In order to prepare for the launch of these products, LCH will perform testing to ensure that it is able to clear these products in a manner which is consistent with the terms on which they are traded.

Further to this, LCH will notify its Clearing Members of a number of minor changes to the procedure documents which will be made in order to support the clearing of SOFR Swaps in the above mentioned tenors. The procedural changes will be certified with the CFTC and be made available on the LCH website.

The effect on mitigation of systemic risk, taking into account the size of the market for such contract and the resources of the DCO available to clear the contract

SOFR based products do not introduce any novel risks to LCH, as the operational capability to manage the product are already in place.

LCH expects current SwapClear Clearing Members to start clearing SOFR Swaps, once the service is live. Following consultation with its Members, LCH does not expect this product launch to lead to an overall increase in the volume or riskiness associated with USD swaps in the clearing house, rather that users will transition their positions from the USD LIBOR swap into the USD SOFR swap over time. Therefore, the introduction of SOFR Swaps is unlikely to have a significant impact on the risk profile or total resources held by the SwapClear service. The systemic risk profile of LCH should thus remain unchanged as a result of this product offering.

The effect on competition, including appropriate fees and charges applied to clearing

CME Group introduced the 1-month and 3-month SOFR futures contract to the market in May 2018. The CME Group is targeting Q3 2018 for clearing SOFR swaps.

LCH's fees and charges for the above product will be in line with those charged for existing SwapClear contracts.

The existence of reasonable legal certainty in the event of the insolvency of the relevant DCO or one or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds and property

The level of legal certainty around the clearing of SOFR Swap contracts is in all material respects the same as that of the products already cleared in the SwapClear service at LCH.

Insofar as legal certainty in the event of the insolvency of the DCO is concerned, LCH would be wound up under English law.

Further information §39.5(b)(iii-viii)

Product terms for SOFR Swaps are market standard and follow **2006 ISDA Definitions** and are also part of the Financial products Markup Language (FpML) standard (specifically <http://www.fpml.org/coding-scheme/floating-rate-index> published on 21st December 2017), which is a protocol for sharing information on derivatives and other products. On 16th May 2018, ISDA published supplement 57 to the 2006 ISDA definitions, which contains the Floating Rate Option for "USD-SOFR-COMPOUND".⁸

⁸ <https://www.isda.org/a/kKHEE/Supplement-57-USD-SOFR-COMPOUND.pdf>

The participant eligibility standards for SOFR Swaps are the same as those for existing SwapClear Clearing Members.

No changes are required to the methodologies used for sizing or allocation of the Default Fund; however, the scenarios used to size the Default Fund will be extended to include SOFR Swaps.

All USD cashflows are currently discounted using the USD Fed Funds rate, with Price Alignment Interest (PAI) set using the same index. For this stage it is proposed to retain this approach for SOFR products in line with step 3 of the "Paced Transition Plan" advocated by the ARRC.

No major risk management changes are necessary for SwapClear to offer SOFR swaps, however minor adjustments will be made as follows:

- A non-diversifiable margin add-on will be included to mitigate the risk associated with using the Fed Funds time series as a proxy for USD SOFR (the add-on is between 7-12bp depending on tenor)
- Three new historical and four new theoretical scenarios will be added to the stress testing suite

Updates will also be made to the eligibility manual and the LCH procedures in order to show SOFR based trades as eligible. The amendments will be submitted to the CFTC pursuant to §40.6(a), following notification to LCH's Clearing Members.

LCH engages its Clearing Members in the design and testing of new products at an early stage, through regular meetings and working groups. Clearing Members have been formally notified of the changes which LCH is required to make to its Rulebook.

Further information will form part of the full §39.5 filing which will be publicly available on the LCH website. LCH looks forward to working with Clearing Members and the CFTC in the determination of clearing requirements. Please do not hesitate to contact me regarding any questions raised by this information.