

LCH support for Clients in relation to the ARRC Buy-Side Practical Implementation Checklist for SOFR Adoption

Introduction

Since inception, LCH Ltd (“LCH”) has been a strong supporter of the Alternative Reference Rate Committee (ARRC)¹ efforts to reform interest rate benchmarks in the USD market. On 31st January 2020 the ARRC released a Practical Implementation Checklist for SOFR Adoption (“Checklist”), focused on asset managers and asset owners (“Buy side firms”). The checklist contains a series of considerations that Buy side firms should take into account as part of the transition away from USD LIBOR.

This document has been created to support Buy side firms who are also clients of LCH with USD LIBOR exposure (“Clients”). It highlights tools, planned product changes and other support LCH can provide which may be relevant for Clients to consider when evaluating themselves against the Checklist. It also highlights previous communications LCH has made in relation to USD LIBOR transition which may be relevant for Clients.

The information below focuses specifically on transition from USD LIBOR. LCH remains engaged with a wide variety of jurisdictions on Benchmark reform and continues to support these efforts.

¹ The ARRC is a group of private-market participants convened by the Federal Reserve Board and the New York Fed, comprised of a diverse set of private-sector entities and a wide array of official-sector entities, including banking and financial sector regulators, as ex-officio members.

Communication

ARRC Checklist

- 3.2 Confirm internal and external impacted groups (clients, regulators, employees, trade associations, the ARRC, and other working groups), prioritizing and segmenting as appropriate.
- 3.3 Confirm communication channels/sources to be used. Establish specific communication workstreams as appropriate, such as for regulators or clients.
- 3.6 Provide clear and consistent messaging on transition impacts to both internal and external stakeholders identified in 3.2 above, including clients, investors, shareholders and regulators. Collaborate as needed.
- 3.7 Work to understand key relationships and vendors that may have varying timelines and any potential impact to the implementation roadmap. As needed, work closely with external relationships and vendors to proactively manage legal, financial, operational, conduct, and reputational risks.

LCH Support

The LCH sales and relationship management team maintains contact details of Clients. These details are used to inform Clients of relevant services changes and upcoming working groups. Clients should consider whether the contact details they have provided remain relevant, and considering updating these if needed.

In addition, we have published several notices related to USD LIBOR transition on the LCH website² and the Client section of the LCH secure area³. It may be useful for Clients to monitor these sites for any future communications in relation to USD LIBOR transition. A list of relevant past communications is provided in the annex to this document.

LCH periodically establishes working groups on specific issues related to USD LIBOR transition, such as the recent working group on SOFR discounting changes. We welcome participation from Clients on future working groups LCH may establish.

² <https://www.lch.com/resources/rules-and-regulations/regulatory-responses/benchmark-reform/usd-market>

³ https://secure-area.lchclearnet.com/secure_area/secure/default.asp?area=16

Exposure management and valuation

ARRC Checklist

- 4.1 Conduct a product and asset and liability inventory exposure analysis to determine LIBOR-linked exposures (by asset class, tenor and maturity) including off-balance sheet exposures such as lines of credit, derivatives, as well as asset types such as loans, insurance contracts, and cash deposit accounts.
- 4.2 Prepare for issuing and/or investing in non-LIBOR-linked products.
- 4.6 Construct / obtain access to a SOFR interest rate curve to be used for pricing SOFR-based products, calculating interest on USD collateral, and discounting USD-denominated derivatives. Firms are advised to confirm vendor system readiness for pricing and risk analytics, as appropriate.

LCH Support

LCH provides several reports which Clients can use to identify their exposure to USD LIBOR products cleared by LCH. For example:

- REP84/c provides details on Swap notional and maturity at the trade level.
- REP105/c provides details on Forward Rate Agreements (FRA's) notional and maturity at the trade level.
- REP103/c provides details on tenor sensitivity under various discounting regimes at the clearing account level.
- REP308/c provides details on tenor sensitivity under a SOFR discounting regime at the clearing account level.

To access these reports, Clients can submit a request to their Clearing Broker. Alternatively, Clients can request access to Direct Client Reporting. Further details, including how to request access, can be found in the 'Direct Client Reporting' section of the SwapClear Client Secure Area⁴.

LCH provides clearing services for several non-LIBOR USD products. Such as:

- USD SOFR Overnight Index Swaps with maturities out to 51 years.
- USD Federal Funds Overnight Index Swaps with maturities out to 51 years.
- USD LIBOR vs. SOFR Basis Swaps with maturities out to 51 years.
- USD Federal Funds vs. SOFR Basis Swaps with maturities out to 51 years.
- USD LIBOR vs. Federal Funds Basis Swaps with maturities out to 51 years.

⁴ https://secure-area.lchclearnet.com/secure_area/secure/default.asp?folder=5487&view=list

Details on the specific characteristics of these products can be found in the 'SwapClear Product Characteristics Matrix' document in the 'Service Information' section of the SwapClear Client Secure Area⁵. We also intend to make 30 day, one month and three month SOFR futures eligible for clearing. These should be available from H1 2020.

SwapClear provides end of day reports on the curves used to calculate Initial Margin, Variation Margin and PAI interest, including for SOFR products. These can be found in the 'Curves' folder on the 'SwapClear Data Download' section of the SwapClear Client Secure Area⁶.

Risk management

ARRC checklist

6.1 Define the key transition risks resulting from LIBOR discontinuation (including market readiness, business impact, documentation requirements, financial and legal) and assess across the firm's risk framework.

6.3. Identify mitigating actions to address identified transition risks with focus on fund, product, hedge effectiveness, operational, client engagement and conduct.

LCH support

SOFR discounting change

LCH intends to switch the PAI/PAA and discounting on all SwapClear USD-discounted products from Fed Funds to SOFR. This will have valuation and risk profile effects on Client portfolios. See Operational and Technology resilience section below for detail on LCH's plans for SOFR discounting change.

Margin estimation

The LCH SMART margin estimation tool provides functionality for Clients to estimate the Initial Margin impact of changing their portfolio from USD LIBOR products to alternative products, such as SOFR Overnight Index Swaps. This can be accessed via the 'SMART for Margin & Compression Estimation' section of the Secure Area⁷.

Fallback provisions

LCH is a strong supporter of the International Swap and Derivative Association (ISDA's) work to include robust fallback provisions in OTC derivative contracts. We intend to make various changes to our rule book to incorporate the ISDA fallback provisions into all outstanding LCH contracts (see Contractual remediation section below).

⁵ https://secure-area.lchclearnet.com/secure_area/secure/default.asp?folder=5502&view=list

⁶ https://secure-area.lchclearnet.com/secure_area/secure/default.asp?folder=269&view=list

⁷ https://secure-area.lchclearnet.com/secure_area/secure/default.asp?folder=4963&view=list

Contractual remediation

ARRC Checklist

- 7.1 Review existing LIBOR-related contracts, service level agreements and benchmarks, including but not limited to offering memorandums, fund prospectuses, investment management agreements or similar documents, International Swaps and Derivatives Association (ISDA) agreements, insurance policies, and credit agreements, to determine the presence and financial impact of fallbacks. This should include inventorying the triggers, changes to terms, financial impact, customer impact, and potential legal interpretations. The review should assemble relevant information into a vehicle for capturing contractual data, and may entail the use of imaging or automation, depending on volumes. Please note that this information may come from third parties such as product administrators, trustees or vendors.
- 7.5 For existing contracts and benchmarks that reference LIBOR, define approach and prioritization strategy for renegotiating / repapering where needed so as to include enhanced fallbacks or amendments simplifying transition. The approach should consider the work required to remediate in advance and how to realize economies of scale. Following FASB and tax guidance, begin either (a) amending contracts to incorporate enhanced fallback language, or (b) determining if contracts can be renegotiated or closed out prior to end-2021.

LCH Support

LCH strongly supports the ongoing industry-wide efforts to include robust fallback provisions in OTC derivative contracts. ISDA has released several consultations on fallback provisions for specific benchmarks, including USD LIBOR⁸.

As stated on 28 December 2018⁹, LCH intends to make several adjustments to its rule book in relation to the proposed new & supplementary ISDA definitions incorporating the fallback provisions (“New Definitions”). In particular:

1. LCH will provide clearing eligibility for contracts incorporating the New Definitions from the date on which the New Definition in respect of that benchmark is published by ISDA (each “New Definition Eligibility Date”), provided that ISDA has pre-published a finalised supplement giving sufficient advance notice of such publication;
2. On each New Definition Eligibility Date, all outstanding contracts cleared by LCH will be amended to incorporate the corresponding New Definition;
3. From and including each New Definition Eligibility Date, only contracts incorporating a New Definition will be eligible for clearing.

⁸ <https://www.isda.org/2019/05/16/isda-publishes-two-consultations-on-benchmark-fallbacks/>

⁹ <https://www.lch.com/membership/ltd-membership/ltd-member-updates/lchs-position-respect-isdas-recommended-benchmark>

In addition, LCH has worked closely with the industry to address issues where a benchmark is still published, but has been deemed non-representative by its Administrator or Regulator (“Pre-Cessation Triggers”). As stated on 20 December 2019¹⁰, if the competent authority supervising a benchmark provider were to announce that a specific benchmark was considered non-representative we would find it challenging, from a risk management and regulatory perspective, to continue to clear swaps linked to such a benchmark.

On 10 January 2020 LCH released a consultation¹¹ on a proposed rulebook change to provide for an automatic trigger into fallback arrangements where the relevant authority determines an existing benchmark to be non-representative. In the rulebook change put forward for consultation LCH is proposing the same approach that is planned to be used in respect of permanent cessation triggers. That is, to use the adjusted Risk Free Rate (RFR) as formulated in the relevant ISDA supplemented IBOR definition together with a credit spread adjustment, as applicable at the time that the relevant benchmark is determined to be non-representative. The consultation period ends on 23 March 2020. We strongly encourage Clients to respond to this consultation.

Operational and technology readiness

ARRC Checklist

8.12. Firms that have cleared swaps should familiarize themselves with CCP plans to transition the discounting and PAI in USD-discounted products to SOFR.

LCH support

As stated on 26 July 2019¹², LCH intends to switch the PAI/PAA and discounting on all SwapClear USD-discounted products, including non-deliverable currencies¹³, from Fed Funds to SOFR. This will have two central effects on SwapClear Client portfolios:

- 1- Valuation change, giving rise to gains and losses.
- 2- Risk profile change, as the switch will cause Fed Funds discounting risk to become SOFR discounting risk.

To minimize the impact of these changes on Clients portfolios, LCH intends to apply cash and swap based compensation to all accounts with a live USD-discounted position at the point of conversion. For Clients who do not want to receive the compensating swaps, a cash

¹⁰ <https://www.lch.com/membership/ltd-membership/ltd-member-updates/lchs-position-respect-pre-cessation-triggers-relation>

¹¹ <https://www.lch.com/membership/ltd-membership/ltd-member-updates/lch-limited-rule-change-committee-10-january-2020>

¹² https://secure-area.lchclearnet.com/secure_area/secure/default.asp?folder=5382&view=list

¹³ Fed Funds discounting is used for MXN swaps and non-deliverable swaps in 8 other currencies (KRW, CNY, INR, BRL, COP, CLP, THB, TWD).

settlement process will be used to facilitate a “cash only” election. LCH is targeting a conversion process at the close of business on 16th October 2020 for these changes.

Subject to on-going legal & regulatory analysis, LCH also intends to develop a tool that will enable users to price a trade (real or hypothetical) or portfolio under the prevailing market rate for a selected discount curve (SOFR or Fed Funds). This would be added to the capabilities of our SMART Margin & Compression estimation tool which can be accessed via the Secure Area (see below). Further details on our plans for SOFR discounting, including recordings of Client working groups, can be found on the ‘SOFR Consultation’ section of the SwapClear Client Secure Area¹⁴.

¹⁴ https://secure-area.lchclearnet.com/secure_area/secure/default.asp?folder=5382&view=list

Annex

Key LCH communications in relation to USD LIBOR transition

- 2020/01/27: Proposed Changes to the LCH Limited Rulebook
<https://www.lch.com/membership/ltd-membership/ltd-member-updates/lch-limited-rule-change-committee-10-january-2020>
- 2019/12/20: LCH's Position in respect of Pre-cessation Triggers in relation to SwapClear. <https://www.lch.com/membership/ltd-membership/ltd-member-updates/lchs-position-respect-pre-cessation-triggers-relation>.
- 2019/11/22: Transition from Fed-Funds to SOFR Discounting Client Call. (See 'SOFR Consultation' section of the SwapClear Client Secure area). https://secure-area.lchclearnet.com/secure_area/secure/default.asp?folder=5382&view=list
- 2019/07/26: SwapClear USD SOFR Discounting Proposal. (See 'SOFR Consultation' section of the SwapClear Client Secure Area). https://secure-area.lchclearnet.com/secure_area/secure/default.asp?folder=5382&view=list
- 2018/12/20: LCH's position in respect of ISDA's recommended Benchmark Fallback Approaches. <https://www.lch.com/membership/ltd-membership/ltd-member-updates/lchs-position-respect-isdas-recommended-benchmark>.