

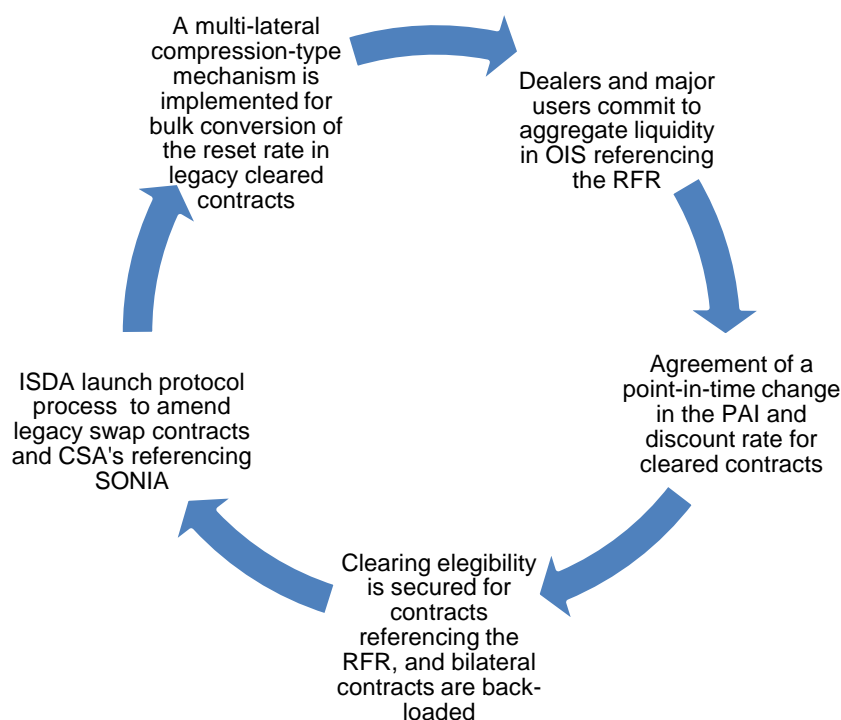
*This document was prepared in 2016 as an input to the Working Group on Sterling Risk Free Reference Rate's decision for its preferred RFR. Its aim was to consider how the OIS transition necessary to implement a secured RFR could be achieved. In the event the Group chose to recommend SONIA as the RFR, so an OIS market transition is not required. This document was published in June 2017 as part of the materials explaining the RFR WG's decision.*

## **Potential approach to transitioning the sterling OIS market to reference a secured rate**

1. The Working Group on Sterling Risk-Free Reference Rates believes that the implementation of a secured Risk-Free Rate (RFR) would require a transition of the sterling OIS market to reference the secured RFR. An important part of the Group's analysis ahead of making an RFR recommendation is therefore to consider how this could be achieved.

2. The OIS transition strategy described here was developed collaboratively between Group members, the Bank, LCH<sup>1</sup> and ISDA. The proposal is for a coordinated and consensual OIS transition, requiring a mutually interdependent, yet reinforcing, set of commitments amongst key stakeholders. In order to be successful, a consensus would need to be reached on each element of the plan in advance of initiating transition. The key steps in this process are summarised in **Figure 1**: each step would need to be agreed in advance and implemented simultaneously.

**Figure 1 – Schematic representation of a coordinated and consensual OIS transition process**



<sup>1</sup> LCH is the largest central clearing counterparty in the cleared sterling swap market; the Bank had also discussed the proposal with CME Clearing Europe.

### *Developing a market consensus*

3. The Group would first seek to achieve consensus among market participants on the choice of a secured RFR. Dealers and major users would need to commit to trade OIS which reference the RFR from a designated point in time. Such trading could begin on a bilateral basis, with the clear expectation of a change in the clearing house price alignment interest (PAI) rate and discounting methodology from the agreed future date ( $T_s$  – the switch-over date), and a presumptive timeframe for clearing eligibility.

4. Market participants may (at least initially) primarily seek to trade RFR swaps on a forward starting basis, from  $T_s$ . This could have the advantage of aggregating market liquidity on a single yield curve and support the risk management framework required for securing clearing eligibility. Early development of a listed RFR futures contract could also facilitate price discovery.

### *Changing the PAI and discounting methodology*

5. The relevant CCP would initiate a consultation process with clearing members proposing a change in the PAI rate and discounting methodology on the same designated future date,  $T_s$ .

6. In respect of changing the PAI, existing LCH rules require unanimous consent of all clearing members holding open OIS contracts, along with LCH internal risk governance and regulatory approvals. Consequently, there are two potential options for changing the PAI in respect of all new and legacy OIS:

- LCH gains consent of all members who have GBP OIS positions;
- LCH gains approval to modify the unanimity rule and reset the threshold as a given majority of members, and then gains consent of this required majority (subject to consultation with clearing members).

7. A change in the discount methodology to an RFR-referenced OIS curve would then be necessary, to avoid a discrepancy between the PAI and discounting rate. LCH would most likely pursue an analogous process to that described above for a change in the PAI rate.

### *Securing clearing eligibility for RFR-referenced contracts*

8. Clearing houses, working with their members and supervisors, would develop propositions for clearing OIS contracts referencing the RFR, with effective risk management. At a minimum, this would necessitate:

- A model of the price dynamics for the new contracts in order to calibrate initial margin and stress test exposures;
- Reliable pricing sources in order to calculate current exposures both end-of-day and intraday; and
- Sound default management arrangements in order to ensure that a matched book could be re-established on a timely basis, and with minimal market impact, following a clearing member default.

9. It will be challenging to meet these requirements in the absence of active trading, which itself might be dependent on clearing eligibility. Some combination of options, such as those listed below, could be explored in order to overcome this 'chicken and egg' problem:

- Clearing members could commit to back-load bilateral RFR-referenced swaps once these products become clearing eligible;
- Bilateral trading could be developed in basis swaps (Libor-OIS) referencing the RFR, rather than outright OIS;
- Dealers could provide streaming prices on swap trading platforms to facilitate price discovery; and
- Dealers could provide the clearing house with explicit trading commitments for the new contracts in order to facilitate risk management of RFR-referenced products, once cleared.

#### *Protocol process for amending legacy bilateral swap contracts and CSAs*

10. In addition to moving new OIS contracts to the RFR, the transition strategy contemplates a consensual process for amending the reset rate on legacy bilateral OIS contracts, and for amending the interest rate payable on cash collateral balances under bilateral CSAs.

11. Subject to consultation and governance, ISDA could launch such a protocol in order to facilitate these amendments subject to the mutual consent of contractual counterparties. A formal closing date for the protocol could incentivise counterparties to reach a decision in a timely manner.

12. Ideally, the effective date for these amendments would be  $T_s$ , the designated date agreed for a change in the PAI rate and discounting methodology. This would reinforce the ultimate objective of a point-in-time transition to the new RFR and minimise basis risk by maintaining alignment of reset and discounting rates.

#### *Process to facilitate the "bulk" transition of the reset rate for legacy cleared OIS*

13. A similar process for transition of the reset rate in legacy cleared OIS trades would be required, through amendments to the clearing house rulebook. As for bilateral markets, the effective date for these amendments would also ideally be  $T_s$ . However, this would be dependent on adequate liquidity and price transparency for the new contracts.

#### Indicative timeline for OIS transition

14. The Group believe that a 3 year forward switch-over date might be sufficient to avoid disturbing actively traded short-dated OIS markets, while being sufficiently imminent to encourage focus from market participants. In particular, over a 3-year time horizon it may be reasonable to anticipate a convergence in the SONIA and RFR forward yield curves.