Sterling RFR WG

Transition Planning from OIS and LIBOR markets to the new RFR

Introduction

The Working Group (WG) on sterling risk free reference rates has been convened to identify and implement a near-risk free reference rate (RFR) as an alternative to sterling LIBOR.

The Group has focused its attention on two possibilities for its preferred RFR – an unsecured overnight index or a secured overnight index. It anticipates that a decision will be made between these two options in 2016. That decision will depend both on the basic properties of the available secured and unsecured benchmarks, and the viability and likely success of implementation and transition plans in each case.

The ultimate transition from LIBOR referenced contracts to the new RFR will be voluntary and market led. However, the transition path will depend on the choice of RFR. If an unsecured overnight index (reformed SONIA) is chosen, transition would be more straightforward as SONIA is already the established reference rate for an actively traded sterling OIS market. However, choosing a secured RFR would require, as a first step, the transition of the existing SONIA referenced OIS market onto the new RFR.

The questions below explore issues relating to a transition of the OIS market (relevant for a secured RFR) and the transition of OTC derivatives referencing LIBOR (relevant for both a secured and unsecured RFR).

I. OIS Transition

The working group has identified the following key action points to facilitate a successful transition from SONIA to RFR, where the RFR is a secured rate.

- RFR Swaps are clearing eligible, and RFR is the PAI rate
- Interest rate swaps referencing SONIA are switched to reference RFR
- Interest paid on cash collateral on CSAs reference RFR

The group has discussed two approaches for the transition, a gradual approach and a big bang approach.

A. The Gradual Approach

The RFR instrument is introduced, and the market transitions over time to trading derivatives referencing the RFR rate and switching legacy portfolios.

In a gradual approach, we expect the following transition process

Stage 1: RFR swaps are less liquid than SONIA swaps, and have higher IM requirements

- A new clearing pod is set up and RFR Swaps are clearing eligible and the PAI is RFR (RFR pod)
- Market begins to find the right clearing level for SONIA vs RFR basis trades

Stage 2: RFR swaps activity picks up but are relatively less liquid than SONIA swaps, with similar IM requirements

- CSA renegotiations begin, and interest paid on cash moves from SONIA to RFR
- First movers switch RFR referenced swaps to SONIA swaps

Stage 3: RFR swaps are equally liquid to SONIA Swaps

- Market has established a well-supported clearing level for SONIA vs RFR basis

Stage 4: RFR swaps are equally or more liquid than LIBOR Swaps

B. The Big Bang Approach

In a "big bang" approach, which is designed to encourage liquidity at the early stage of RFR adoption, the conversion from SONIA to RFR for financial contracts occurs simultaneously at a conversion rate to be determined, namely for the following items:

- Clearing house PAI rate
- Existing interest rate swaps referencing SONIA
- Interest paid on cash collateral on CSAs

C. Questions

In a gradual approach

1) At what stage would you shift existing derivative positions vs the clearing house from the SONIA pod to the RFR pod?

2) At what stage would you switch SONIA referenced derivatives to RFR referenced derivatives?

3) At what stage would you change the CSA reference rate from SONIA to RFR?

4) What is your estimate for the ETA for changing the bulk of such CSAs?

In a "big bang" approach,

5) Instead of renegotiating every CSA, could you adhere or sign up to a protocol that supersedes CSAs, and defines the interest paid on GBP cash as the RFR rate?

6) Would you adhere or sign up to such a protocol?

7) Which method to determine the conversion level would you be most supportive of?

   a. A level determined by the RFR working group
   b. A level determined by another party (e.g. independent committee, public authority , or the clearing house etc)
   c. No determined level, RFR replaces/supersedes SONIA (similar to examples of ISDA successor rate guidance)

II. LIBOR Transition

A. Assumptions

In order to facilitate a successful transition from LIBOR to the RFR, where the RFR could be a secured or unsecured rate, the following assumptions have been made:

- A 'liquid' market has already been established in the risk-free rate

- The transition of discounting risk and CCP collateral to the risk-free rate has already occurred

- The transition is a gradual approach: the market transitions over time from LIBOR to the RFR

- The risk-free rate may be either secured or unsecured

B. Questions

1) Could you transition your portfolio referenced to LIBOR into a risk-free-rate portfolio?
2) Could you transition only certain parts of your portfolio and which parts are easier to transition?

3) If you could not, what would need to change to allow you to do so (external factors, internal systems, etc)?

4) What concerns, if any, would you have from transitioning away from existing reset and payment conventions in OTC derivatives referencing LIBOR?

5) What criteria would you use to determine whether the market in risk-free rate instruments is 'liquid'? (bid/ask spread, size achievable, clip size, market concentration, trade frequency etc)

6) What would be your expected timescale for transition?