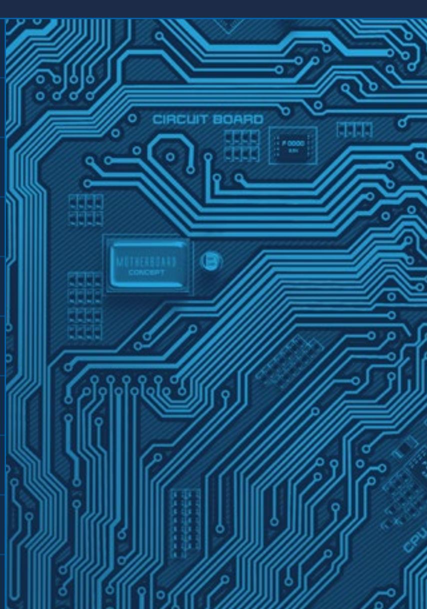
TriOptima

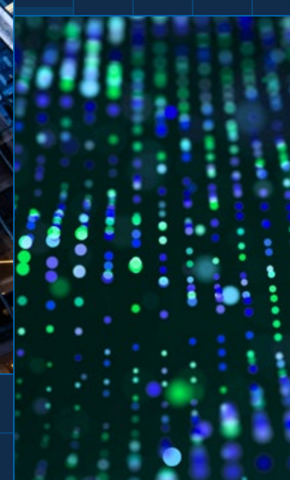
CME Group

Opening the buy-side liquidity pool

RISK.NET Q&A WITH VIKASH RUGHANI

Vikash Rughani, business manager at triReduce and triBalance, outlines a new approach enabling buy- and sell-side participants to optimise the transition of legacy ICE LIBOR over-the-counter (OTC) swaps contracts to alternative reference rates.





How will TriOptima's optimisation services assist the market in the event of the discontinuation of the ICE LIBOR benchmark?

Vikash Rughani: With banks no longer compelled to support ICE LIBOR beyond the end of 2021, the industry is focused on developing alternative benchmarks worldwide – with the US, the UK, Europe, Switzerland and Japan leading the way. While ICE LIBOR and these alternative rates will likely co-exist for some time, the next stage is facilitating the transition to trading in the new rates.

In the meantime, to help market participants mitigate risk in the transition of legacy OTC ICE LIBOR contracts, TriOptima operates a regular series of portfolio compression cycles, bringing together 20 or more buy- and sell-side participants to compress existing ICE LIBOR trades where the vast majority of trading remains for maturities beyond 2021. These compression cycles can also act as the nucleus of a liquidity pool that will be essential for delivering new conversion methodologies for migrating away from the ICE LIBOR benchmark for over-the-counter (OTC) derivatives.

TriOptima will be introducing its benchmark conversion functionality to offer a unique opportunity for new buy-side entities that traditionally may not have been involved in portfolio compression – hedge funds and asset managers with directional portfolios, for example – to join our established network of compression participants in converting their remaining ICE LIBOR transactions once compression opportunities in a given exercise have been exhausted. The addition of these new participants will be crucial to the success of benchmark conversion because they represent the cashflow and risk offset – which itself is crucial in maintaining the central counterparty's (CCP's) cashflow neutrality.

This is akin to a market participant needing to execute a new transaction that is equal and opposite to their original position to compress its position in the CCP. In multilateral services such as ours, the strength of the network provides the mechanism for finding offsets that already exist, as opposed to having to execute new transactions with liquidity providers.

Performing these benchmark conversion exercises iteratively over time means TriOptima can help the market achieve a mass conversion from legacy ICE LIBOR risk on OTC contracts maturing beyond 2021 into alternative reference rates (ARRs).

Which OTC instruments are supported?

Vikash Rughani: The new benchmark conversion functionality will initially be available in compression cycles that include plain, vanilla and fixed-float interest rate swaps, basis swaps, overnight index swaps covering all ARRs, zero coupon swaps and forward rate agreements. Further down the line, on the bilateral side, in addition to these products, TriOptima intends to include this functionality in cycles including cross-currency swaps referencing ICE LIBOR.

Benchmark conversion will be offered in all currencies as alternative risk-free rate (RFR) transition plans take effect. For now, we see momentum in US dollar, sterling, euro, Swiss franc and Japanese yen. We can expect the sterling market to be a leading indicator for conversion due to greater established SONIA liquidity when compared with the other alternative RFRs. However, we continue to wait for the tipping point in longer- dated SONIA trading volume.

What results can participants expect?

Vikash Rughani: Based on simulations TriOptima has been able to run, with sensible risk-based tolerance levels we may be able to help achieve up to a 70% reduction in cleared sterling ICE LIBOR gross notional through compression alone. Importantly, the simulations showed we can help remove up to half of the remaining 30% by enabling firms to optimise on reducing ICE LIBOR gross notional beyond 2021 and utilising risk replacement trade functionality made available by the CCPs.

How does the process work?

Vikash Rughani: After firms register for a specific compression cycle, TriOptima receives their trade population, in that currency, from the CCP. Participants then confirm which trades to include by sending us the trades they are interested in, including in the cycle. Through the same exercise, we will suggest trades to either terminate, amend or replace using risk-replacement trades. The outcome is that each trade is either left untouched, terminated fully or amended in some way, such as a change to the notional, the direction, the spread or the coupon. If none of these are suitable for maximising the objective for ICE LIBOR reduction, the result would terminate the legacy ICE LIBOR trade and replace it with a risk-replacement trade referencing the alternative RFR. This latter step facilitates the conversion of netted OTC ICE LIBOR positions.

All participants gain access to the same secure platform and risk-based constraints. The entire exercise is performed under each participant's own valuations and risk sensitivities. These constraints are defined by each firm within their own risk appetite levels. This combination means there's no uncertainty when firms verify the resulting compressions and risk-replacement trades in their own system for risk impacts.

How do you see the process evolving?

Vikash Rughani: Considering that around 85% of outstanding ICE LIBOR gross notional exists in the cleared world, TriOptima's initial focus will be on CCPs, aiming to tackle the biggest pool as early as possible and freeing up resources across the industry to focus on the more complex bilateral cash positions and non-linear products, such as swaptions.

Initially, we will be offering benchmark conversion for cleared OTC trades at LCH, CME and the Japan Securities Clearing Corporation. However, we expect sterling conversion from ICE LIBOR to SONIA could kick off as early as the second quarter of 2020, with US dollar conversion commencing once CCPs' transitions to the secured overnight financing rate (SOFR), discounting, price discovery and liquidity improve. We would then expect conversion activity to take centre stage for the industry in 2021 and will be ready to support the industry with its efforts.

How does this offering compare with other solutions?

Vikash Rughani: There's talk of auctions with the purpose of migration away from the ICE LIBOR benchmark and we're likely to see other solutions offered by brokers on the execution side, but numerous challenges remain. The market is yet to achieve sufficient comfort in pricing maturities greater than five years. Longer- dated risk exposure won't simply appear overnight. It is natural for firms to trade at the short end to begin with; the rest will depend on building momentum. The SOFR discounting change next year may help, but brokers will need to be able to quote reliably, spreads will need to tighten and the market will need to work out how ARRs behave in different conditions compared with ICE LIBOR. The market will also look for greater certainty and clarity from regulators on potential margin impacts of amending transactions or replacement, as well as from tax and accounting standards boards with regard to treatment and hedging benefit provisions.

Instead, beyond continued compression activity, TriOptima is embarking on a 12-to-18-month period of education and onboarding for buy-side firms in preparation for a full-scale roll-out of the service in 2021, or when the market indicates its desire to commence conversion if there is a ICE LIBOR fallback. What is unique to our solution is the liquidity pool and facilitating the conversion through compression in a measured way while participants maintain control of the risk effects that conversion can give rise to.

Firms may need to consider what they want to do with their legacy ICE LIBOR book. Are they prepared to rely on implementing ICE LIBOR fallbacks in the event of cessation, or do they want to participate in a proactive conversion to ARRs?

What should buy-side firms think about when preparing for benchmark conversion?

Vikash Rughani: Firms need to think about the process of adhering to triReduce's legal documentation, the data submission requirements, the consumption of output data from TriOptima or even from the CCP, and how they will adapt throughout next year to ensure they are maximising their compression potential as well as readying themselves for the conversion component. Some firms will require additional technology development to support the process for benchmark conversion, so it's important to start thinking about this now and build it into budgets for the coming year.

As a multilateral exercise, benchmark conversion will require all-or-nothing acceptance. Participants will want to review the proposed results before providing their firm's acceptance. Only once all parties accept the unwind proposal does it become legally binding and get processed by the CCP. This ensures all participants take responsibility for their submission, including the accuracy of their valuations and risk data, to maintain the integrity of the exercise.

TriOptima (www.trioptima.com) is now part of CME Group.

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