EUREX Architects of trusted markets

Virtual Roundtable

SARON® – Embracing the new risk-free rates

SARON® – Embracing the new risk-free rates

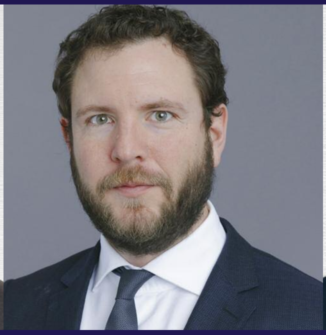
CHF LIBOR is supposed to cease to exist at the end of 2021. What progress has been made so far and how smoothly is the transition happening?

Eurex paved the way on the derivatives side, launching the Three-Month SARON® futures in October 2018 and enabling clearing of SARON® swaps since 2017 with the key aim to establish a solid trading infrastructure and promote the resilience of the Swiss money market.

Since its inception, the adoption of the SARON® rate has grown steadily, in cash as well as derivatives.

For the roundtable, Francesca Dell'Era, Fixed Income Derivatives Sales at Eurex sat down with **Martin Bardenhewer**, Head of Institutional Clients & Multinationals, Zürcher Kantonalbank and Co-chair of the Swiss National Working Group on Reference Rates (NWG), Zürcher Kantonalbank, **Christof Schlenk**, Head of Interest Rates Derivatives Trading at Basler Kantonalbank, **Pascal Anderegg**, Interest Rates Derivatives Trading at Zürcher Kantonalbank and **Eveline Hunziker**, Partner, Financial Services at EY to get their views.

Martin Bardenhewer
Head of Institutional Clients & Multi-nationals, Zürcher Kantonalbank and Co-chair of the Swiss National Working Group on Reference Rates (NWG), Zürcher Kantonalbank



Christof Schlenk
Head of Interest Rates Derivatives Trading at Basler Kantonalbank

Pascal Anderegg
Interest Rates Derivatives Trading at Zürcher Kantonalbank

Eveline Hunziker
Partner
Financial Services at EY

As the 2022 decommissioning date for the Swiss LIBOR rate approaches, how are Swiss financial entities getting ready to welcome and accept the SARON® rate?

What have been the main aspects that the NWG has been working on? What achievements have been made?

Francesca Dell'Era
Fixed Income Derivatives Sales at Eurex

Martin Bardenhewer, ZKB: The focus of the NWG is on recommendations, not on hard decisions, as there is no Swiss benchmark regulator. The recommendations are based upon standards that emerged out of discussions in various sub-working groups. Such standards are key for a smooth transition from LIBOR to SARON®.

The development of templates for SARON® derivatives was one of the main aspects. Here we could build upon standards already in place in the overnight index swap markets. The development of standards for SARON® cash products was more cumbersome since a compounded overnight rate, up till then, was uncommon in loans and bonds. Having a standard for compounded SARON® in cash products that is well understood, fully compliant with local law and easily available for all market participants is one of the main achievements.

Which segment of the Swiss market was fastest in adopting the new rate and why?

Martin Bardenhewer, ZKB: In 2019, the cash market transition was behind the derivatives market transition. From Q3 2020, cash market development in general and mortgages, in particular, overtook the derivatives market development. All major Swiss banks are now live with loan products – and customer feedback has been very positive. The loss of momentum in the growth of SARON® swaps might be related to the delay in incorporating the fallback language into ISDA documentation. Now, the new ISDA documentation has been published and has taken effect in January 2021, which will boost the transition in the swap market.

Eveline Hunziker, EY: New product enablement is progressing well, and we have seen many institutions launching SARON® mortgages and other cash products. However, it will take some time to build up volumes in these new products, which will then drive the need for associated hedging derivatives.

How important is the role of CCPs and the derivatives market?

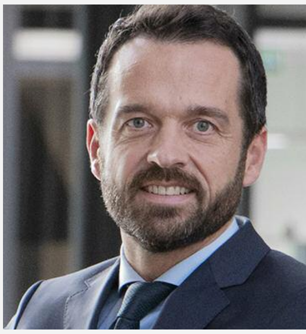
Martin Bardenhewer, ZKB: The role of CCPs in the SARON® transition can hardly be overstated. The start of SARON® swaps clearing and adopting a SARON®-based discount curve as early as 2017 gave a clear and unambiguous signal to market professionals that the transition was underway. And, I expect CCPs to play a key role in the 2021 LIBOR end game. The CCP's legacy swap conversion strategy will dominate how the market will move towards a pure SARON® swap world.

Comment from Andreas Franke

“SARON® has been around for quite some time now in clearing. It looks like the market has embraced the new rate, making it a viable anchor point for derivatives. As it currently stands, the next milestone on the agenda is the move away from CHF LIBOR altogether by the end of this year. We will embark on this journey together with our members.

The first important step we have taken in this regard was to support the fallback framework as defined by ISDA. All legacy and new cleared trades now fall under this set of robust rules.

In a second step, we will explore if the market should make actual use of the fallback regime for cleared swaps or if viable alternatives are facilitating an early conversion of LIBOR into RfR swaps. We believe that such a conversion is unavoidable at some point in time; it is really more a question of “when” than “if”. Therefore, exploring an early conversion route at, or shortly before, the LIBOR cessation reduces the complexity and number of steps in the LIBOR transition.”



Andreas Franke
Head of Risk
Methodology OTC
Eurex Clearing AG

Both ZKB and BKB (together with other Swiss leading banks and international Liquidity Providers) have been trading Three-Month SARON® futures since inception in 2018. They are also already trading and clearing SARON® swaps. The Eurex Three-Month SARON® futures saw increased activity, especially in the very short term expiries. 2020 saw the highest traded volume in SARON® futures, with close to CHF 9 billion in traded notional as of December 2020.

Christof Schlenk

We see the increased activity as a signal that the market is starting to embrace the SARON® transition. Do you expect liquidity in this market to continue growing in the next months?

Christof Schlenk, BKB: The mere fact that the share of SARON® futures is still small compared to the established futures markets should lead to some growth in volumes. One of the drivers could be a change in sentiment regarding IR expectations. Nevertheless, markets do not expect any significant changes in rates, and the curve is still relatively flat. Additionally, fixing risks are way smaller under the new SARON® products. Therefore, we expect volume growth potential limited in the near term.

Pascal Anderegg, ZKB: The increased volume is a sign that more market participants are entering the Three-Month SARON® futures market or that existing market participants see more benefits trading the SARON® futures instead of the OTC swaps. In any case, it's clearly a positive signal for the SARON® futures market. There is still a lot of liquidity stuck in the LIBOR swaps and futures markets, and the Corona pandemic didn't help the transition in 2020. However, there is not too much time left from now until the expected LIBOR discontinuation. Therefore, we expect a rapid acceleration in the SARON® derivatives volumes in the next year while the liquidity in the CHF LIBOR derivatives market could deteriorate to the extent that it could pose a risk to market participants that cannot process SARON® derivatives yet.

Pascal Anderegg

Christof and Pascal, you have different views on the development in the futures market. What about swaps? Do you see more client demand for SARON®?

Christof Schlenk, BKB: Although LIBOR swaps still have the largest market share, SARON® swaps are clearly rising. We are seeing more and more customers who are now only trading SARON® Swaps. Most of them are banks, but some corporate customers have also completed the transition. We expect the SARON® volume to pick up exponentially as soon as there is clarity about the transition, especially regarding the spread adjustment.

Pascal Anderegg, ZKB: Client demand for SARON® swaps is growing steadily, and we expect it to accelerate next year. While some financial institutions have already wholly switched to SARON®, some are still completing this process and making sure that they are prepared for a permanent cessation of LIBOR. Now that SARON® cash products are available, we see more corporate clients switching from LIBOR to SARON® derivatives as well.

How did the SARON® derivatives market fare during the market distress period that resulted from the COVID19 outbreak in March?

Christof Schlenk, BKB: Of course, the risks and uncertainties associated with COVID19 were clearly felt in the market, but the impact on the SARON®-based derivatives market was no different from the established LIBOR market. However, due to corporate customers' increased financing needs, we saw a shift to SARON®-based funding products. However, we could clearly see that SARON® was more stable than LIBOR during the crisis, not least because the SNB is trying to keep SARON® close to the key interest rate.

Pascal Anderegg, ZKB: We didn't see any exaggerated moves in the longer-term SARON® LIBOR basis due to a liquidity break down in the SARON® derivatives market. For a young market like the SARON® swaps market, that is a very positive sign. Moreover, it became apparent that having a reference rate that is based on actual transactions proves to be the better underlying for the hedging instruments and proved to be more resilient and stable. That should be very encouraging for market participants to transition from CHF LIBOR to SARON® if they haven't done so yet.

The transition to the new risk-free rate is a phenomenon common to several jurisdictions around the globe. How would you compare the SARON® adoption in the derivatives market to other jurisdictions, such as the U.K?

Eveline Hunziker, EY: We see Switzerland in the middle, lagging the U.K. but ahead of the U.S. The Eurozone is a special case as Euribor is being reformed and not replaced.

The U.K. market benefitted as SONIA was chosen early on in the process and had existed for some time before that, meaning that market participants were already familiar with the rate. In addition, the U.K. FCA has been actively pushing the GBP LIBOR transition by establishing interim milestones for the transition instead of just looking at the end date.

Martin Bardenhewer

Martin Bardenhewer, ZKB: The focus now is on transition of legacy products onto SARON®, where limited progress has been made to date. Compared to other jurisdictions, the SARON® transition is expected to be easier given the lower stock of products and limited challenging legacy population, together with a more friendly legal environment. Simultaneously, this may have removed some of the urgency in the SARON® market.

What hurdles/key challenges are we still facing ahead of the 2022 decommissioning deadline for the Swiss LIBOR?

Martin Bardenhewer, ZKB: Well, it can hardly be expected that CHF LIBOR will continue to exist after 2021 since there is absolutely no underlying market data and such a small panel size. All relevant SARON® products are live. The biggest remaining hurdle is the way how legacy LIBOR contracts will be phased out exactly. An example: A SARON® swap which has been restricken from a LIBOR swap is not precisely the same as a standard SARON® swap. This sounds like a technical detail, but it results in a basis risk and complexity that is too expensive to run forever. That's where the CCPs way of handling legacy swaps will pave the way.

Eveline Hunziker, EY: We have not seen any conceptual issues with SARON®-indexed products. The challenges are more operational in nature: the need to repaper or transition legacy contracts, the issue of systems not being able to process SARON®-indexed products automatically and therefore requiring manual workarounds, a lack of engagement / demand from certain client segments.

Eveline Hunziker

In closing, what are the essential next steps Swiss financial institutions will have to act on to ensure a smooth transition to SARON® on 1 January 2022?

Eveline Hunziker, EY: The next big step is signing up to the ISDA 2020 IBOR Fallback and the related Swiss Master Agreement for OTC Derivatives protocols that will be important to transition legacy SARON® stock and give further momentum to the transition.

Linked to this, institutions then need to develop and execute a plan to transition remaining legacy contracts that are not in the scope of the above protocols, such as the cash products. This should include governance over client outreach plans and exception flows, ensuring all clients are treated fairly and a process should clients reject or counter the institution's transition offer.

Once these contracts have been updated, which is an off-line process, a significant operational process follows, ensuring these changes are reflected appropriately and can be processed in systems.

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