

Markets

# Banks Brace for 'Big Bang' Switch on \$80 Trillion Worth of Swaps

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October 15, 2020, 6:00 AM CDT

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- ▶ Portfolios will switch to SOFR benchmark rate this weekend
  - ▶ 'Price action could get very disorderly,' JPM's Younger says
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It's being called the "big bang," and it has derivatives traders on high alert.

In a critical development in the global shift away from old benchmarks that was triggered by Libor's shortcomings, interest-rate swaps on more than \$80 trillion in notional debt will transition this weekend to a new rate for determining their value.

While the switch to the secured overnight financing rate, or SOFR, is expected to boost longer-term liquidity in the new benchmark, it also is fueling concerns about unruly price action because it is expected to trigger the sale of swaps on tens of billions of dollars of debt.

"The big bang is one of the most important steps in the Libor transition," said Marcus Burnett, director of SOFR Academy, an education technology firm whose clients include banks and asset managers. "We expect rates desks from the largest banks in New York to be participating."

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The reset, which will see SOFR replace the effective federal funds rate in calculations that value swaps, is part of a push to make SOFR a standard U.S. reference rate in debt and derivatives markets. SOFR is intended to replace dollar Libor, which still underpins hundreds of trillions of dollars of assets such as mortgages in the U.S. and syndicated loans in Asia. The big bang follows a smaller-scale pivot in Europe this July, a less-complicated switch that occurred without much impact on the market.

Interest rate swaps allow two parties to trade one stream of payments for another, over a set period of time. The most common variety, known as a vanilla swap, involves exchanging payments from a fixed rate for payments from an adjustable rate that is based on Libor or some other reference rate. Another kind, known as a basis swap, involves two adjustable rates.

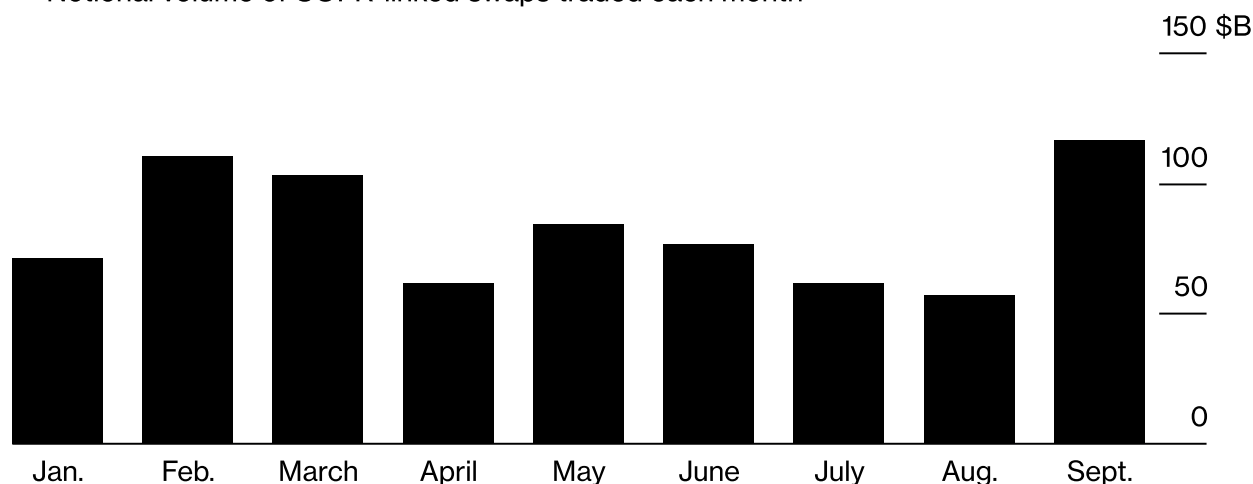
While SOFR has struggled to gain traction since its introduction in 2018, analysts say the upcoming big bang has already triggered a shift toward more trading in SOFR-linked swaps.

This could help pave the way for a curve that reflects expectations for where the rate will be in the future, addressing one of the new benchmark's key weaknesses.

## SOFR Is Coming

Trading activity in swaps tied to new benchmark jumped in September

Notional volume of SOFR-linked swaps traded each month



Source: Bloomberg/ Depository Trust & Clearing Corporation

The big bang “will have a very, very good impact on liquidity,” said Jason Granet, chief Libor transition officer at Goldman Sachs Group Inc.

## Compensation

Still, in the immediate future there will be turbulence in pricing. Clearing houses are planning to effectively neutralize the changes in swap values caused by the big bang, and traders will see their positions automatically adjusted. LCH Ltd. and CME Group Inc. are preparing to distribute compensation from clients whose position values go up to those who see them decline.

LCH will facilitate payment of hundreds of millions of dollars in cash to cover lost value, and at least tens of billions of dollars in basis swaps to compensate for risk, said David Horner, head of risk at SwapClear, which is part of LCH.

However, some firms do not use basis swaps to hedge their discount-rate risk or are otherwise incapable of keeping them on their books, so they are expected to sell them. This Friday LCH will hold auctions in which 18 banks can close out \$25 billion in unwanted basis swaps.

Buyers, ideally, would snap them up either as hedges against risk or for their own value. But the approach is largely untested since basis swaps were not distributed in the European version of the big bang.

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“For about six months our members and clients have been able to look on their screens and see a forecast for the compensating cash payments and compensating swaps they will receive, so they are familiar with what’s about to happen,” said Horner. “It’s important for the market that it runs smoothly.”

CME will hold a [similar auction](#) on Monday. Clients have agreed to a maximum loss, said Sunil Cutinho, president of CME Clearing, and “if their positions cannot be auctioned off then they are fully protected and they can use their own private means to dispose of their positions.”

However, there are concerns about price swings in the market amid a surge in supply as some banks ditch basis swaps they received as compensation.

The big question is how well the auctions go. Clearing houses are not guaranteeing the minimum prices for the basis swaps, which could fall below the maximum that firms are prepared to tolerate, said Joshua Younger, a strategist at JPMorgan Chase & Co.

“Many would then likely unwind them in the open market and the price action could get very disorderly,” he said.

Firms need to understand they are facing more risk from this change first before they eventually get less risk, said Pieter Van Vredenburg, a principal at Market Alpha Advisors and previously a member of the Alternative Reference Rates Committee, which is guiding the U.S. Libor transition, when he worked for HSBC Holdings Plc in 2016.

“The big banks are very prepared for the big bang,” said Van Vredenburg. “But do I think the smaller banks are ready for this? Not even close.” When it comes to the overall switch to SOFR, he said, “there are so many nuances to the transition and the devil is in the details. There is nothing simple in all this.”

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## In this article

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CME

**CME GROUP INC**

165.76 USD ▼ -0.95 -0.57%

GS

**GOLDMAN SACHS GP**

209.19 USD ▼ -2.05 -0.97%

DBK

**DEUTSCHE BANK-RG**

7.62 EUR ▼ -0.08 -1.00%

JPM

**JPMORGAN CHASE**

100.40 USD ▲ +0.18 +0.18%

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