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SOFR Discounting Transition for Cleared Swaps

On October 16, 2020, central clearing houses ("CCPs") are set to transition their discounting methodology and rates used to pay interest on cash margin for USD cleared swaps from Fed Funds to SOFR. This follows a similar transition for EUR cleared swaps from EONIA to €STR on July 27, 2020.[1] The move by the CCPs is intended to leverage the cleared market space to build liquidity in the risk-free reference rates products. This Client Alert summarizes the impact of the SOFR discounting transition and key steps market participants may want to consider taking to manage their USD-discounted cleared swaps portfolios.

Liquidity Challenge for SOFR and Other Replacement Benchmarks

Although trading volume in risk-free reference rates has been growing, moving the market away from interbank-offered rates remains a Herculean task. Replacement benchmarks continue to occupy a secondary role with only 3% of USD interest rate risk for the month of June referencing SOFR.[2] While momentum has been building for risk-free reference rates in the shorter end of the curve for trades up to two years, concerns persist for longer dated maturities and transitioning cash products such as loans, securitizations and debt. The relative lack of liquidity in risk-free reference markets is holding back many market participants; however, liquidity will not improve until the risk-free reference rates are traded more widely.

CCPs' discounting transition is designed to stimulate natural supply and demand in risk-free reference rates by driving additional usage in the cleared derivatives market and beyond as market participants look to manage their cleared swaps portfolios. Given that ~90% of interest rate derivatives are cleared, the impact is expected to be significant. In the anticipation of CCP transition, market participants already witnessed increased activity in the longer-dated SOFR derivatives over the summer months.

How Does the SOFR Transition Impact Cleared Portfolios?

The transition from Fed Funds to SOFR will have a two-fold impact on USD-discounted cleared portfolios: (1) the change in discounting methodology will impact the net present value of portfolios giving rise to gains and losses on a trade by trade basis; and (2) by changing the discounting curve, CCPs will effectively move the market participants' discounting risk from Fed Funds to SOFR.

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[1] Further details on the transition can be found on the CCP's websites: CME Group and LCH.

[2] *ISDA-Clarus RFR Adoption Indicator*, ISDA, June 2020, available here.

All main cleared USD interest rate swap products are affected, including interest rate swaps, overnight indexed swaps, forward rate agreements, basis swaps, zero coupon swaps and cleared USD swaptions.

CCPs have adopted a substantively similar approach to compensation to be provided to market participants to offset the changes in swap valuations and risk sensitivities. The change to the net present value will be neutralized through a cash adjustment that is equal and opposite, booked on a trade-by-trade basis for all cleared accounts. Simultaneously, the original market risk profile of cleared portfolios will be restored through a mandatory booking to each cleared account of a series of risk transfer swaps designed to restore the original discounting risk profile at the portfolio level.

What Can I Do?

While the cash adjustment to neutralize the net present value will be booked automatically and does not require any affirmation ahead of time, market participants are given the choice to retain or liquidate the risk transfer swaps. Additionally, clients of CME Group can elect between a basis swap and a pair of outright swaps with equal and opposite cash flows for the auction process (LCH will automatically allocate a pair of outright swaps to its clients).

For market participants electing to retain the risk transfer swaps, pricing of the swaps will be done through an auction process in the week following the transition. For market participants electing to opt out of the risk transfer swap offering, the allocated swaps will be priced and offloaded to third parties in the same auction resulting in receipt or payment of additional cash compensation. It should be noted that full or partial failure of the auction process is possible - if the auction does not produce sufficient bids to cover the entire auction size within the limits set by the applicable CCP, market participants electing to opt-out from risk transfer swaps will receive full or partial allocation of their swaps. There are also minor differences in the election and auction process of each CCP.

Risk transfer swap elections must be submitted to CCPs by market participants on a portfolio basis through their clearing brokers by the following deadlines: **September 4, 2020 for LCH** and **October 9, 2020 for CME Group**. The clearing brokers require input from market participants ahead of the CCP deadlines and as early as August 12, 2020. Accordingly, market participants may want to review their USD-discounted cleared portfolios and consider which elections best suit their respective operational capabilities and risk profiles at the earliest opportunity to be in a position to meet these deadlines.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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