BARCLAYS

LIBOR Transition FAQs

'Big bang' CCP switch over

1. When will CCPs switch their rates for discounting to new risk-free rates (RFRs)? What is the 'big bang' switch over?

As part of global industry efforts around benchmark reform, most systemic Central Clearing Counterparties (CCPs) are expected to switch Price Aligned Interest (PAI) and discounting on all cleared EUR-denominated products to €STR in July 2020, and for USD-denominated derivatives to SOFR in October 2020.

1a. €STR switch over: weekend of 25/26 July 2020

As the momentum of benchmark interest rate reform continues in Europe, while EURIBOR has no clear end date, the publishing of EONIA will be discontinued from 3 January 2022. Its replacement, the risk free rate €STR, commenced publication on 2 October 2019 and since this date, EONIA has been calculated daily as €STR plus a fixed spread of 8.5bps. EONIA will continue as a fixed spread to €STR until its discontinuation.

In August 2019, the EUR Working Group on RFRs released a **report**[1] containing a set of recommendations addressing the impact of the transition from EONIA to €STR. One recommendation put forward encouraged CCPs to align their discounting switch dates as much as possible to transition from an EONIA discounting regime to a €STR. As a result, clearing houses that clear EUR denominated products (LCH, Eurex and CME) have announced that they will be switching the rate for discounting and PAI for EUR-denominated products cleared on their respective platforms from EONIA to €STR as of 27 July 2020 (i.e. the switch will occur the weekend of 25/26 July). This will be for all legacy and newly cleared EUR denominated swaps.

Please note the original €STR switch over date of 20/21 June was **postponed**[2] by 5 weeks given the market impacts of COVID-19.

1b. SOFR switch over: weekend of 17/18 October 2020

In the US, as part of the transition away from USD LIBOR, SOFR was first published by the Federal Reserve Bank of New York in April 2018. As part of the ARRC's Paced Transition Plan, CCPs are set to switch the rate for discounting all USD-denominated discounted products from the Effective Fed Funds Rate (Fed Funds) to SOFR in October 2020*. Unlike EONIA/€STR, SOFR and Fed Funds are both independent rates, and as such the CCP switch will result in a change to market participants' discounting risk. This is an intended consequence of the paced transition plan, as it is hoped that discount risk hedging needs will increase market activity in SOFR derivatives.

2. €STR Switch Over

2a. What are the mechanics for the cash adjustment exchange? Why is this necessary?

Each CCP will perform a valuation using EONIA and then run the same valuation by switching to €STR. The switch to €STR discounting will lead to a change in the net present value of EUR denominated trades across all CCPs. As a result, a mandatory cash compensation mechanism will be used by the CCPs to counter this change in value so that individual participants will experience almost no 'net' changes, implemented through a one off payment. This requirement is due to the fact portfolios are switching from EONIA to €STR flat (no spread), however there is a fixed spread between EONIA and €STR (i.e. the valuation of a portfolio referencing EONIA will not be valued the same as a portfolio referencing €STR once the switch occurs due to the 8.5bps difference between the two rates).

2b. How do the CCP proposals for €STR differ?

The cash compensation mechanism used by LCH, Eurex and CME will differ, though the calculation methodology remains the same across CCPs:

LCH - LCH SwapClear will book a compensating amount on a new 1 EUR EONIA trade for settlement on Tuesday 28 July 2020 for every member and client (visible as a new trade as per existing reporting specifications). This will be booked at the clearing account level.

Eurex - At trade level, Eurex will book a fee of identical size but opposite sign of the value transfer for settlement Tuesday SOD, which settles at the same time other EUR amounts are due.

CME - CME Clearing will conduct a special valuation cycle, determining settlement variation and cash payments on positions as calculated with €STR-based discounting. This special valuation cycle will include a cash adjustment that is equal and opposite to the resultant change in the NPV of each position in EUR IRS products.

2c. Where Barclays is my clearing member, what will happen to my cleared trades?

The switch in discounting from EONIA to €STR being performed by the CCPs will result in corresponding changes to your cleared trades, in accordance with the CCP rulebooks and clearing agreement.

(1) https://www.ecb.europa.eu/pub/pdf/other/ecb.wgeurorfr_impacttransitioneoniaeurostrcashderivativesproducts~d917dffb84.en.pdf
(2) https://www.eachccp.eu/wp-content/uploads/2020/04/EACH-statement-on-the-transition-from-EONIA-to-%E2%82%ACSTR-discounting-regime.pdf
*LCH also plans to change PAI to SOFR for other USD discounted products such as MXN and non-deliverable Emerging Markets swaps

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2d. Will my bilateral (uncleared) trades also be discounted at €STR after the CCP switch?

The switch in discounting from EONIA to €STR being performed by the CCP’s will not change the discounting of bilateral (uncleared) trades. These bilateral trades will remain discounted at the rate referenced in parties’ ISDA Credit Support Annex (CSA).

In regards to the bilateral CSAs, a phased approach has been recommended by the Euro industry RFR working group as it may better cater for individual discounting/compensation considerations on a bilateral basis (as opposed to a ‘big bang’ approach). Barclays is monitoring closely any industry-wide recommendations regarding bilateral populations and will evaluate where it may seek to engage directly with counterparties on individual document negotiations.

3. SOFR Switch Over

3a. How does the EONIA to €STR change compare to the US switch in October from Fed Funds to SOFR?

Like the EONIA to €STR discounting switch, the valuation change in USD denominated trades across all CCP’s will be offset by mandatory cash compensation. The switch from Fed Funds to SOFR set to occur in the US in October 2020 differs from the European change in that it also results in a **risk profile change**, as the switch will cause dynamic Fed Funds discounting risk to become SOFR discounting risk.

3b. How do the CCP proposals for SOFR differ?

LCH - LCH SwapClear is planning to provide compensation for the valuation and risk profile change as a combination of cash and basis swaps. However, client accounts will have a choice to elect cash-only compensation. An auction will be used to determine the basis swap levels used to calculate the cash compensation amounts. This election needs to be made to the clearing broker by 4 September 2020 or the client will be defaulted to the cash and basis swaps option. Cash payments would be calculated on a full revaluation basis using mid prices from the auction process to build a pricing curve. The compensating basis swaps from client accounts who do not want to receive them will be aggregated in net notional and auctioned through markets made by LCH clearing members.

Each compensating swap would be a standardized EFFR vs SOFR basis swap on one of the major benchmark tenors (e.g. 2 years, 5 years, 10 years, 15 years, 20 years, 30 years). The size and direction of each swap will be calibrated with the intention that the compensating swaps provide an overall offset to the change in the user’s discounting risk profile at the point of conversion. The mid prices from the auction would be used to determine the required spreads on all compensating swaps to ensure zero net present value (NPV).

Based on the Cash Settlement Process auction result and Friday’s EOD reports, LCH will calculate the cash compensation amount for every Member/Client at the ‘Clearing Account Level’. LCH plans to book the compensating amount on a new 1 USD Fed Funds notional swap (T+2 settlement) for all USD and non-deliverable products in every member and client account (visible as a new trade as per existing reporting specifications). For MXN TIIE swaps LCH plans to book the compensating amount on a new 1 MXN notional swap (T+2 settlement) for every member and client account (visible as a new trade as per existing reporting specifications). Trade level breakdown will be available to ensure correct attribution is possible for any users wishing to break the fee down to a detailed level. Booking will take place on Saturday 17 October 2020.

Further details on the auction process can be found here[3].

CME - CME Clearing is planning to conduct a special valuation cycle, which would determine settlement variation and cash payments on open positions in USD IRS products as calculated with SOFR-based discounting and PAI. CME Clearing will make cash adjustments that are equal and opposite to the resulting NPV of each cleared USD IRS product.

To mitigate both the potential re-hedging costs associated with this transition and the sensitivity of valuations to closing curve marks following the transition, CME Clearing will facilitate a mandatory process to book a series of EFFR/SOFR basis swaps to participants’ accounts. These basis swaps will restore participants’ positions to their original risk profiles and will be booked at closing curve levels ($0 NPV) as of the transition date.

In the CME transition, market participants would be able to choose to have the basis swaps booked as either float-versus-float basis swaps or as pairs of fixed-versus-float swaps with equal and opposite fixed cash flows.

CME Clearing is also considering setting up an auction process for market participants that want to liquidate any EFFR/SOFR basis swap exposure arising from the mandatory discounting risk exchange process. This is expected to occur after the valuation change to SOFR (unlike LCH’s proposal in which basis swaps are auctioned ex ante to the valuation).

(3) https://lch.com/sites/default/files/media/files/SOFR%20Discounting_Auction%20Process%20Technical%20Specification.pdf

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4. Other

4a. What about GBP-denominated products, how will they be discounted going forward?

CCPs have already switched PAI and discounting for GBP-denominated products to SONIA, no further ‘big bang’ switch over is required.

4b. Where can I find further information on these changes and LIBOR transition?

Please refer to our Group LIBOR **website**[4] for further information, including key FAQs. For any other queries please contact your usual relationship point of contact.

Glossary

Acronym	Description
ARRC	Alternative Reference Rates Committee
€STR	Euro short-term rate
CCP	Central clearing counterparty
CME	Chicago Mercantile Exchange
CSA	Credit support annex
EFFR	Effective federal funds rate
EOD	End of day
EONIA	Euro overnight average rate
EUR	Euro
EURIBOR	Euro interbank offered rate
GBP	Pound Sterling
IRS	Interest rate swap
ISDA	International swaps and derivatives association
LCH	London Clearing House
LIBOR	London interbank offered rate
MXN TIIE	Interbank ‘equilibrium’ benchmark rate calculated by the Mexican Central Bank
NPV	Net present value
OIS	Overnight index swap rate
PAI	Price alignment interest
RFR	Risk free rate
SOD	Start of day
SOFR	Secured overnight financing rate
SONIA	Sterling overnight index average
US	United States of America
USD	US Dollar

(4) https://home.barclays/libor-transition/

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References/links

(1) https://www.ecb.europa.eu/pub/pdf/other/ecb.wgeurorfr_impacttransitioneoniaeurostrcashderivativesproducts~d917dffb84.en.pdf
(2) https://www.eachccp.eu/wp-content/uploads/2020/04/EACH-statement-on-the-transition-from-EONIA-to-%E2%82%ACSTR-discounting-regime.pdf
(3) https://home.barclays/libor-transition/
(4) https://home.barclays/libor-transition/
(5) https://www.isda.org/a/WhXTE/Adoption-of-Risk-Free-Rates-Major-Developments-in-2020.pdf
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