Collateral Changes for US Dollar and Euro Derivatives

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Overview

- Central counterparty (CCP) discounting changes for US dollar and euro derivatives
- The ISDA Collateral Agreement Interest Rate Definitions
- Bilateral templates for amending US dollar and euro collateral agreements for non-cleared derivatives
- A demonstration of ISDA Create for bilateral templates
- Q&A
CCP Discounting Transition: EONIA to €STR

- CCPs switched discounting and price alignment on all euro-denominated products from EONIA to €STR flat
- CCP Transition Date: July 24, 2020
- Compensation:
  - **Value compensation**: Cash compensation was paid between the CCP and each clearing member (CM) to compensate for the change in value of each euro-denominated position (house and client) on the transition date as a result of the switch from EONIA to €STR discounting
  - **Risk compensation**: Not applicable (EONIA is currently a tracker of €STR)
CCP Discounting Transition: Fed Funds to SOFR

- CCPs will switch discounting and price alignment on all US dollar-denominated products from fed funds to SOFR.
- Expected CCP Transition Date: October 16, 2020.
- Compensation:
  - **Value compensation**: Cash compensation will be payable between the CCP and each CM to compensate for the change in value of each US dollar-denominated position (house and client) on the transition date as a result of the switch from Fed funds to SOFR discounting.
  - **Risk compensation**: Fed funds vs SOFR basis swaps will be allocated to all accounts at the CCP (other than, in the case of LCH, client accounts who have opted out of receiving such swaps).
  - **Auction process**: CMs may dispose of/bid for discounting risk swaps which are not wanted by clients in an auction held by the CCP.
## Comparison of CME and LCH Approaches: Fed Funds to SOFR

### CME

<table>
<thead>
<tr>
<th><strong>Transition Date:</strong></th>
<th>October 16, 2020</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Transition Process:</strong></td>
<td>At COB on October 16, CME will value all US dollar-denominated trades using fed funds discounting. CME will then generate a discounting transition report that provides the net present value (NPV) of all trades using SOFR discounting.</td>
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<tr>
<td><strong>Cash Compensation:</strong></td>
<td>The discounting transition report will include details of cash adjustment amounts payable between CMs and the CCP in respect of all contracts (house and client) to account for the valuation change as a result of switching from fed funds to SOFR.</td>
</tr>
<tr>
<td><strong>Re-hedging process:</strong></td>
<td>CME will book a mandatory series of NPV neutral fed funds/SOFR basis swaps to all CMs' house and client accounts.</td>
</tr>
<tr>
<td><strong>Auction:</strong></td>
<td>On October 19, 2020, CME will hold an auction which CMs can use to dispose of unwanted fed funds/SOFR basis swaps allocated to client accounts.</td>
</tr>
<tr>
<td><strong>Deadline for opting into auction:</strong></td>
<td>October 2, 2020 (with CM approval of opt-ins due by October 9, 2020).</td>
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### LCH

<table>
<thead>
<tr>
<th><strong>Transition Date:</strong></th>
<th>October 16, 2020</th>
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<tbody>
<tr>
<td><strong>Transition Process:</strong></td>
<td>LCH will hold a mid-setting auction on October 16, 2020 to provide a reference for constructing the SOFR curve. At COB on October 16, LCH will value all US dollar-denominated trades using fed funds discounting and SOFR discounting.</td>
</tr>
<tr>
<td><strong>Cash Compensation:</strong></td>
<td>The mid price generated via the mid-setting auction will be used to determine cash compensation payable between CMs and the CCP in respect of all contracts (house and client) to account for the valuation change as a result of switching from fed funds to SOFR.</td>
</tr>
<tr>
<td><strong>Re-hedging process:</strong></td>
<td>LCH will book a series of NPV neutral fed funds/SOFR basis swaps to all CMs' house and client accounts. Clients can opt-out of receiving swaps and instead receive cash compensation.</td>
</tr>
<tr>
<td><strong>Auction:</strong></td>
<td>Two auctions will be held on October 16, 2020:</td>
</tr>
<tr>
<td></td>
<td>&gt; A mid-setting auction to generate the mid price for constructing the SOFR curve and determining cash compensation payable.</td>
</tr>
<tr>
<td></td>
<td>&gt; A second auction for disposal of unwanted fed funds/SOFR basis swaps and determining the alternative cash compensation payable to or by opted-out clients.</td>
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<tr>
<td><strong>Deadline for opting out of receiving compensating swaps:</strong></td>
<td>September 4, 2020</td>
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Collateral Changes for US Dollar and Euro Derivatives

[ISDA Logo]
## Key Issues for CMs, Clients & Market Participants to Consider: Fed Funds to SOFR

| Clearing Members | Members need to familiarise themselves with (and inform their clients of) the differing processes at each CCP and, in particular, the different deadlines for client elections in respect of discounting risk swaps.  
| | Certain CMs will be required to participate in the discounting risk swap disposal auction (either as a result of the election of their clients or due to the size of their own US dollar cleared portfolios). |
| Clients | Clients that opt out of receiving discounting risk swaps may nevertheless be allocated such swaps if the auction is not successful. Clients will need to discuss strategies with their CMs, and ensure operational readiness, for disposal of these swaps in the market, noting the potential impact of a failed auction on liquidity in the SOFR market. |
| Other Market Participants | An auction in which some or all of the allotted discounting risk swaps are not liquidated could be potentially disruptive to the pricing and liquidity of SOFR instruments, leading to a negative outcome for the market overall. |
Additional Information In Relation to CCP Discounting Transition: Fed Funds to SOFR

Key Contacts

• CME:
  • For general questions about the SOFR discounting transition: Onboarding.Clearing@cmegroup.com
  • For indicative impacts from the SOFR discounting transition: CMEOTCA@cmegroup.com

• LCH:
  • SwapClear Customer Services RatesClientServices@lch.com
  • SwapClear Sales and Relationship Management LCHGlobal.SRM@lch.com

The US CFTC Market Risk Advisory Committee (MRAC) Interest Rate Benchmark Reform Subcommittee Report on CCP Discounting Transition Tabletop Exercise: https://www.cftc.gov/media/4276/MRAC_TableTopExercise072120/download
Collateral Agreement Interest Rate Definitions (CAIRD)

**Standalone Definitional Booklet**

**Standardized Set of Interest Rate Definitions**
- To date, no standardized approach to how interest rates for the purposes of cash collateral are expressed in ISDA published collateral agreements for variation margin (VM)
- CAIRD set out standardized definitions for overnight rates on cash in key currencies

**Inclusion of Fallbacks**
- Increased focus on robustness of contractual fallbacks.
- CAIRD enables parties to include suitable permanent cessation fallbacks to the specified interest rates.

**Forward-looking**
- New tool to enable parties to use rates included in future versions of CAIRD
- “Interest Rate Override – [specified rate]” and “Interest Rate Override – All Rates”
Collateral Agreement Interest Rate Definitions

ISDA has published two versions of the Collateral Agreement Interest Rate Definitions (CAIRD)

Version 1 contains collateral rate definitions of €STR and EONIA

Version 2 contains collateral rate definitions of AONIA, CORRA, SARON, €STR, EONIA, SONIA, HONIA, TONA, SORA and SOFR

Subsequent versions may contain collateral rate definitions for other rates

- Parties specify in their collateral agreement an interest rate as the collateral rate. For instance, SONIA (Collateral Rate)
- Use of the suffix collateral rate distinguishes the rate from similarly defined terms in other ISDA definitional booklets (e.g. 2006 Definitions)

- Each rate has a set of permanent cessation fallbacks.
- Fallbacks are triggered by an index cessation event
- The triggers (index cessation event) and fallbacks (except for SORA) are designed to track those used as “fallbacks to the IBOR fallbacks” in the IBOR Fallbacks Supplement to the 2006 Definitions. These fallbacks will also be used in subsequent rate options that are added or amended for the risk-free rate themselves

Collateral Changes for US Dollar and Euro Derivatives
Interest Rate Override

Parties can incorporate:

- the most recent version of CAIRD prior to entry into the relevant agreement – this means the rates defined using a defined term in CAIRD will remain static i.e. there will be no automatic update to reflect any changes to such rates in subsequent versions of CAIRD;
- CAIRD as amended from time to time – rates within the collateral agreement defined using a term in CAIRD on the date of entry into of the collateral agreement will update automatically to reflect any changes to those rates in subsequent versions of CAIRD; or
- CAIRD as amended from time to time and apply “Interest Rate Override” if parties want to benefit from the standardized definitions and fallbacks included for new rates in any subsequent versions of CAIRD.

This option can be exercised:
1. for all rates – “Interest Rate Override – All Rates” or
2. one or more specified rates – e.g. “Interest Rate Override – SONIA”

“Interest Rate Override (SONIA)

If the parties have incorporated the Collateral Agreement Interest Rate Definitions as amended from time to time into a document or agreement and specified that Interest Rate Override: All Rates or Interest Rate Override: SONIA is applicable, then if that document or agreement already provides for SONIA (however defined or described) as an Interest Rate or a benchmark that is referenced as, or forms part of, an Interest Rate, such reference to “SONIA” shall be replaced with a reference to “SONIA (Collateral Rate) as the relevant Interest Rate or benchmark that is referenced as, or forms part of, the Interest Rate, and the provisions of the Collateral Agreement Interest Rate Definitions as amended from time to time will apply.”
Bilateral Amendment Agreements

- ISDA has published four template amendment agreements for use in conjunction with CAIRD.
- Each amendment agreement enables parties to replace existing rates in collateral agreements with collateral rates (as defined in the Collateral Agreement Interest Rate Definitions) and to switch to those collateral rates on a particular date.

The EONIA Amendment Agreement enables parties to update references to EONIA in confirmations, collateral documents, master agreements and transaction documents.

The €STR Amendment Agreement enables parties to replace any euro interest rate in Covered Credit Support Documents with €STR (collateral rate).

The SOFR Amendment Agreement enables parties to replace any US dollar interest rate in Covered Credit Support Documents with SOFR (collateral rate).

The €STR and SOFR Amendment Agreement (Combined Amendment Agreement) enables parties to replace any euro interest rate and US dollar interest rate in Covered Credit Support Documents with €STR (collateral rate) and SOFR (collateral rate).

Collateral Changes for US Dollar and Euro Derivatives
Bilateral Amendment Agreements

Each of the:
- EONIA Amendment Agreement,
- €STR Amendment Agreement,
- SOFR Amendment Agreement, and
- Combined Amendment Agreement

- incorporates the Collateral Agreement Interest Rate Definitions;
- allows parties to apply the amendments to all or some of their collateral agreements (including those not published by ISDA);
- allows parties to provide for broken interest periods;
- allows parties to provide for compensation noting that this is left entirely to the parties;
- allows parties to choose the effective date of the amendments;
- distinguishes between Amendment Effective Date and Relevant Date—Amendment Effective Date is when the relevant agreement comes into effect; “Relevant Date” is when the switch to the new interest rate (€STR and/or SOFR) takes effect. Parties can elect for both dates to be the same;
- and allows parties to choose the governing law and jurisdiction of the amendment agreements.

- The EONIA Amendment Agreement

- Also enables parties to amend:
  - EONIA FROs in Confirmations, and
  - references to EONIA in Master Agreements and transaction documentation
**EONIA Amendment Agreement**

> A bilateral template amendment agreement to replace EONIA or embed fallbacks for EONIA in legacy transactions and collateral agreements

> The EONIA Amendment Agreement provides parties with various options in respect of confirmations, credit support documents and master agreements

<table>
<thead>
<tr>
<th>Confirmations</th>
<th>Credit Support Documents</th>
<th>Master Agreements</th>
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<tbody>
<tr>
<td>Options to:</td>
<td>Options to amend EONIA interest rate or interest rate (VM) to:</td>
<td>Options to replace any other EONIA reference with:</td>
</tr>
</tbody>
</table>
| • update definition of EONIA in EONIA FROs | • EONIA (collateral rate) or  
• Replace EONIA FRO with €STR FRO or  
• replace EONIA FRO with €STR FRO plus 8.5bps spread  
| • €STR (collateral rate) from the Collateral Agreement Interest Rate Definitions | • EONIA (collateral rate) or  
| | • €STR (collateral rate) from the Collateral Agreement Interest Rate Definitions | |

Collateral Changes for US Dollar and Euro Derivatives
## Bilateral Amendment Agreements

### Covered Documents
- List of 16 ISDA published VM credit support documentation
- Plus Additional Documents listed in Annex – option for parties to include in scope non-ISDA documentation
- Three Collateral Amendment Agreements:
  - EONIA Amendment Agreement
    - Additional Credit Support Documents
    - Additional Master Agreements
    - Additional Transaction Documents

### Party Agreed Excluded Documents
- Parties can exclude from scope specified documents either:
  1. By listing those documents as Party Agreed Excluded Document in Annex, or
  2. By specifying in that document that such document is a Party Agreed Excluded Document
- Three Collateral Amendment Agreements:
  - Party Agreed Excluded Credit Support Documents
  - EONIA Amendment Agreement
    - Party Agreed Excluded Credit Support Documents
    - Party Agreed Excluded Master Agreements
    - Party Agreed Excluded Transaction Documents

### Specified Covered Documents
- Option for parties to apply the change to only certain listed documents
- Parties select “Specified Covered Documents” – “Applicable” and list the covered documents in Annex
- Three Collateral Amendment Agreements:
  - “Specified Covered Credit Support Documents”
- Combined EUR/USD Amendment Agreement: election made only once for both euro and US dollar amendments.
- EONIA Amendment Agreement – election made for each set of documents:
  - Party Agreed Specified Credit Support Documents
  - Party Agreed Specified Master Agreements
  - Party Agreed Specified Transaction Documents
ISDA Create: A Digital Approach to Interest Rate Reform

> ISDA Create is an **online solution** that allows organizations to produce, deliver, negotiate and execute derivatives documentation completely online

> First launched in January 2019, ISDA Create is a **collaboration** between ISDA and Linklaters

> In addition to ISDA publishing initial margin documentation, recent additions include the **ISDA Amendment Agreement** and **EONIA Bilateral Template Amendment Agreement**

> The **SOFR, EUROSTR and SOFR+EUROSTR Amendment Agreements** are in the process of being added and the **bilateral IBOR fallbacks templates** will be **added soon** and the Schedule to the ISDA Master Agreement later in 2020

> More than **60** buy-and-sell side firms have joined the platform. In addition, more than **200** market participants are currently testing ISDA Create
Collateral Changes for US Dollar and Euro Derivatives
A sandbox version is also available for testing.

For more information please get in touch with your relationship contact at ISDA or Linklaters, or drop us a line at

ISDACreate@isda.org
or
ISDACreate@nakhoda.ai
Q&A

• Participants may submit a question for the panel in the “Questions” box in their GoToWebinar control panel