December 13, 2021

CME Conversion Proposal for Eris LIBOR Products

As the industry advances risk-free rate (RFR) indexed swaps, CME Group continues our collaborative approach to identify, understand, and create innovative solutions for hurdles faced by market participants.

Background:

IBOR Fallbacks have been widely implemented across the industry:

- ISDA IBOR Fallbacks Supplement 70 to the 2006 ISDA definitions covering new exposures and the corresponding Protocol for updating legacy contracts went into effect on January 25, 2021. ISDA's 2021 Definitions implemented in October 2021 also incorporate similar fallback provisions.
- CME has incorporated the ISDA fallbacks for both "new" and "legacy" cleared OTC IRS into its Rulebook (as is the case with other CCPs), see Clearing Advisory 21-335 for more information. However, CME reserves the right to implement alternative fallbacks in response to market participant needs.
- On March 5, 2021, the FCA made an announcement regarding the future cessation or loss of representativeness of all LIBOR benchmarks. As a result, the first London Banking Day after publication on June 30, 2023 will be the Index Cessation Effective Date for USD ICE LIBOR (all tenors).
- In March 2021 and aligned with the ISDA Fallbacks for OTC Swaps, CME adopted SOFR based fallbacks which will convert CME Eurodollar futures and options contracts into the corresponding SOFR futures and options contracts just prior to the USD ICE LIBOR Index Cessation Effective Date using ISDA's fallback spread of 26.161 bps. (SER-870).
- Following comprehensive conversations with market participants, CCPs have moved forward with plans to convert existing cleared LIBOR Swap positions into equivalent RFR positions just prior to the relevant LIBOR Index Cessation Effective Date rather than rely on ISDA fallbacks (see CME plan and December 2021 implementation for non-USD LIBOR IRS).

Complications associated with ISDA Fallbacks for Eris LIBOR contracts

Analogous to the cleared swap market, participants have identified certain challenges associated with implementing ISDA Fallbacks for Eris LIBOR contracts, including:

- **Operational –** After the USD ICE LIBOR Index Cessation Effective Date, while the IBOR-referencing Eris contracts will "fall back" to SOFR, these resulting legacy contracts will not be fungible with Eris SOFR contracts. As a result, participants wishing to unwind these "fallback legacy" contracts will need to execute and book additional Eris LIBOR contracts.
- **Risk management –** Uncertainty will remain regarding what the liquidity profile for Eris LIBOR contracts will look like in the years post the Index Cessation Effective Date

Conversion as a proposed solution:

To help address these challenges, market participants have requested CME to consider converting existing Eris LIBOR positions to Eris SOFR contracts just prior to the USD ICE LIBOR Index Cessation Effective Date.

CME Group recognizes the challenges and has been consulting with market participants to consider the merits of a mandatory conversion. Before addressing potential operational mechanics, we wish to emphasize that:

- The goal is to explore a solution that is aligned with other cleared and listed USD ICE LIBOR products in terms of approach and timing.
- The core principle of any conversion solution should be to minimize disruptions, including any impacts to valuation, duration, or discounting risk.

Following a series of bilateral conversations, we believe the market is supportive of converting Eris LIBOR positions to Eris SOFR contracts utilizing the following guidelines:

Timing: Post the June 2023 IMM date and corresponding LIBOR fixing, but prior to the USD ICE LIBOR Index Cessation Effective Date

Methodology:

- CME will close out existing Eris LIBOR positions and replace the risk by substituting positions of equal size in existing or new Eris SOFR contracts containing the same effective and underlying tenor.
- For most contracts, the fixed rate of the resulting Eris SOFR contract will be 25 bps below the corresponding Eris LIBOR contract, which difference is approximately aligned with the ISDA fallback spread of 26.161 bps for 3M USD ICE LIBOR and will minimize any changes to duration, discounting risk and the effective coupon carry between the new fixed rate of the resulting Eris SOFR futures contract and the floating SOFR rate. In the few cases where contracts have a coupon difference other than the 25 bps, the proposed adjustment methodology would incorporate the additional coupon difference when determining the value of the new Eris SOFR position.
- To prevent any changes in value as a result of the conversion process, CME will calculate the final value of the Eris LIBOR contracts in accordance with the ISDA IBOR Fallback Pricing Methodology (the industry agreed methodology, as published by Bloomberg Index Services Limited, link), using the same Eris SOFR settlement curve that is used to determine the value of the Eris SOFR replacement positions.
- On a go-forward basis following the conversion for Eris position holders, CME will utilize the B & C values (historical fixed, floating and PAI cash flows, respectively) corresponding to the Eris SOFR contracts for the calculation of daily and final settlement prices.

Example:

The below example is an illustration to show how mandatory conversion will work for Eris LIBOR futures contracts on the conversion date.

Example Eris LIBOR Futures Contract: LIYU19

Assume Conversion Date (T): 6/23/2023 (for illustration only)

On T-1 (6/22/2023):

Assume position holder has Long 100 positions of 10yr Eris LIBOR LIYU19 futures contracts (Coupon 3%, 9/18/2019 ~ 9/18/2029) in the account.

On T (6/23/2023):

1. CME will add an offset position to close out existing Eris LIBOR contracts in the relevant position account by entering a Sell of 100 positions of 10yr Eris LIBOR LIYU19 futures contracts (Coupon 3%, 9/18/2019 ~ 9/18/2029)

- Trade price for the offset position will be executed at a price which is computed based on the ISDA IBOR Fallback Pricing Methodology. Price of the offset future is equal to 100 + LiborSwapNPV + B_L – C_L
  Where:
  - LiborSwapNPV is the SOFR discounted NPV of future fixed coupon payments minus floating coupon payments with future LIBOR resets forecasted using the ISDA IBOR Fallback Pricing Methodology; where the Eris SOFR futures curve is used to forecast a rate for each LIBOR calculation period, which is then adjusted up by 26.161bp, the ISDA Fallback spread for ICE 3-month USD LIBOR. **Note that in the NPV computations, the LIBOR Eris futures will use the ICE LIBOR fixing from June 2023 and the projected value of the SOFR fixings corresponding to the LIBOR forward period may vary away from the ISDA Fallback spread of 26.161 as the fallback rate is not applicable for this period. The ISDA IBOR Fallback Pricing Methodology will be used for implying the LIBOR fixings value post the Index Cessation Effective Date after June 30, 2023.**
  - B_L is past fixed minus LIBOR payments for the corresponding Eris LIBOR futures contract, for date T.
  - C_L is PAI for the corresponding Eris LIBOR futures contract, for date T.

2. CME will add an onset position of Long 100 positions in 10yr Eris SOFR YIYU19 futures contracts (Coupon 2.75%, 9/18/2019 ~ 9/18/2029)
   - Trade will be executed at the Eris SOFR futures contract Price which is equal to 100 + SOFRSwapNPV + B_S – C_S
     Where:
     - SOFRSwapNPV is the SOFR discounted NPV of future fixed coupon payments minus floating SOFR payments, with SOFR payments forecasted using the Eris SOFR curve.
     - B_S is past fixed minus SOFR payments for the corresponding Eris SOFR futures contract, for date T.
     - C_S is PAI for the corresponding Eris SOFR futures contract, for date T.

On 6/24/2023:

Position holder will continue to have the Long 100 positions of 10yr Eris SOFR YIYU19 contracts (Coupon 2.75%, 9/18/2019 ~ 9/18/2029) in the account.

CME Group Next Steps and Timing Goals

The above items are for discussion purposes only. This proposal is subject to change based on the feedback received, subject to implementation of final rules by CME and any required regulatory approval or review. If you would like to discuss this topic further or provide feedback, please contact your CME Group sales representative or email InterestRate@cmegroup.com.