

TO: Clearing Member Firms
Back Office Managers

DATE: May 22, 2020

FROM: CME Clearing

NOTICE #: 20-210

SUBJECT: **Transition to €STR Price Alignment and Discounting for Euro OTC IRS**

Background

In September 2018 the European Central Bank (“ECB”) convened a private sector working group on Euro (“EUR”) risk free rates (the “ECB Working Group”), which determined that the Euro Short-Term Rate (“€STR”) should replace the European Money Markets Institute (“EMMI”) Euro overnight index average (“EONIA”) as the new Euro risk free rate for all products and contracts in cash and derivatives markets. €STR is calculated by the ECB and is based on the money market statistical reporting of the Eurosystem. €STR provides a broad measure of the cost of borrowing unsecured EUR cash on an overnight basis in wholesale markets based on a large number of banks contributing data and based on a high transaction volume.¹

In August 2019 the ECB Working Group recommended that EUR cleared derivatives contracts should transition from utilizing EONIA to utilizing €STR for the purposes of calculating price alignment (the adjustment used to reflect the overnight cost of funding collateral for a bilateral swap contract to mitigate the basis risk between cleared and uncleared swaps) and for the applicable discounting rate (used for the discount curve to calculate swap value) (together, “PA/discounting”). The ECB Working Group noted that this transition should occur as early as possible, and preferably towards the end of the second quarter of 2020. The ECB Working Group anticipates that updating the PA/discounting environment for cleared swaps from EONIA to €STR will help promote liquidity in €STR cash and derivative contracts.

In order to support the market transition from EONIA to €STR, and consistent with the wider industry initiative to switch to €STR discounting in line with the recommendations of the ECB Working Group, Chicago Mercantile Exchange Inc. (“CME” or “CME Clearing”), pending CFTC approval, proposes to update the PA/discounting protocol for CME cleared EUR interest rate swap products from EONIA to €STR² (the “Transition”). In accordance with the recommendation of the ECB Working Group and with broader industry initiatives, the Transition will follow a “single day” approach and will take effect on July 24, 2020 (the “Transition Date”), from which date all existing and new positions in such products will be subject to €STR PA/discounting.

¹ Further details on the administration of €STR are available on the ECB website at www.ecb.europa.eu.

² CME’s cleared OTC EUR interest rate swap products currently utilize EONIA for PA/discounting.

CME has consulted with a diverse cross-section of market participants to obtain feedback on the proposals for the Transition. A summary of CME's Transition plan was provided to market participants and made publicly available on January 31, 2020 on the CME website.³ Feedback from market participants has encouraged CME to align its approach with the wider industry initiative to transition to €STR PA/discounting for EUR interest rate swaps, both in terms of scope and timing. CME believes that its methodology and timing for the Transition of CME cleared EUR interest rate swaps is consistent and coordinated to an appropriate extent with the wider industry approach, such that a single day orderly transition to €STR PA/discounting for cleared EUR interest rate swaps by CME can be achieved while mitigating any ensuing valuation changes for market participants, thereby minimizing the risk of market disruption.

Based on feedback from market participants, the Transition includes a mechanism designed to mitigate valuation changes for market participants arising from the change in discounting environment. The Transition seeks to accomplish this by way of a cash adjustment process designed to neutralize value transfers attributable to the change in the discounting basis from EONIA to €STR,⁴ further details of which are set out in this Advisory Notice.

This Advisory Notice sets out the binding rules and operational processes under which CME Clearing will implement the transition of the price alignment and discounting protocols from EONIA to €STR with respect to open cleared trades in affected CME cleared products at the Transition Date, and for the calculation of price alignment and discounting in relation to such products following the Transition.

Terms used but not defined in this Advisory Notice shall have the meaning set out in the rules of CME (the "Rulebook").

CME cleared contracts subject to this Advisory Notice

The Transition will apply to the following CME cleared EUR interest rate swap products (the "Affected Contracts"):

- Fixed / Float IRS
- Zero Coupon Swaps
- Overnight Index Swaps
- Basis Swaps
- Forward Rate Agreements

Uncleared swaptions contracts that exercise into CME cleared swaps in Affected Contracts prior to the Transition will be subject to the Transition with respect to those Affected Contracts. Any Affected Contract accepted for clearing by CME after the Transition will be subject to €STR PA/discounting from acceptance by the Clearing House and will not be subject to the cash adjustment process.⁵

³ <https://www.cmegroup.com/education/articles-and-reports/euro-str-discounting-price-alignment-plan.html>

⁴ Valuation changes will be determined by the EUR discounting risk for the portfolio and the relative levels of the EONIA and €STR forward curves on the Transition Date.

⁵ We recognize that the Transition for Affected Contracts may create ambiguities with respect to the exercise of legacy uncleared swaption contracts that expire after the date of the Transition and which anticipate EONIA PA/discounting for the resulting cleared interest rate swap on exercise. While this remains an issue for market participants and cannot be resolved directly by CCPs (which are not counterparties to the uncleared swaptions), we encourage the industry to resolve these ambiguities by agreeing to a set of industry protocols and practices to address the issue.

Terms and Operation of Transition Process

1. From close of business (“COB”) on the Transition Date, CME Clearing will subject each open cleared trade in an Affected Contract to the following Transition process to update the EONIA PA/discounting protocol of such contract to €STR PA/discounting:
 - (a) CME Clearing will calculate the net present value (“NPV”) utilizing EONIA (at closing curve levels on the Transition Date) for valuation and calculation of discounting and price alignment amount for each cleared trade in an Affected Contract. CME Clearing will then conduct an additional calculation to calculate the NPV utilizing €STR (at closing curve levels on the Transition Date) for valuation and calculation of discounting and price alignment amount for each cleared trade in an Affected Contract (the “Transition Calculation”).
 - (b) CME Clearing will determine settlement variation for each cleared trade in an Affected Contract on the Transition Date utilizing EONIA (at closing curve levels on the Transition Date) for valuation and calculation of discounting and price alignment amount for the end of day clearing cycle on the Transition Date.
2. At the next end of day clearing cycle following the Transition Date, for each cleared trade in an Affected Contract, CME Clearing will:
 - (a) determine settlement variation utilizing €STR for valuation and calculation of discounting and price alignment amount;
 - (b) apply to each position in a cleared trade in an Affected Contract an offsetting cash adjustment that is equal and opposite to the change in such position’s NPV resulting from the change from EONIA to €STR discounting, as determined by CME Clearing during the Transition Calculation (“Cash Adjustment”); and
 - (c) settle outstanding exposures and payments from the end of day clearing cycle (including for the avoidance of doubt, settlement variation and the Cash Adjustment) in accordance with CME Rule 814. The relevant Cash Adjustment will offset the change in NPV for each position arising from the discounting change such that the net cash flow in respect of the discounting change will be zero for each cleared trade in an Affected Contract per account.
3. Following the Transition Date, CME Clearing will apply €STR PA/discounting to cleared trades in all Affected Contracts. The Cash Adjustment process will apply only to open cleared trades in Affected Contracts at COB on the Transition Date. Any trade in an Affected Contract accepted for clearing by CME after the Transition Date will be subject to €STR PA/discounting.
4. Coupon payments on Affected Contracts are not affected by the Transition and will remain linked to the relevant original interest rate index, e.g. EURIBOR in the case of a EUR Fixed/Float IRS.
5. The terms of this Advisory Notice and the Transition process are binding on Clearing Members and position holders in all Affected Contracts as at and following the effective date of the proposal pending CFTC approval. To the extent that there is any conflict between the Rulebook and the terms of this Advisory Notice with respect to the Transition process, this Advisory Notice shall prevail.

The Cash Adjustment process is a mandatory process. The Transition and the Cash Adjustment will therefore apply to all positions in cleared trades in Affected Contracts on the Transition Date. Market participants should consider the terms and impact of the Transition as set out in this Advisory Notice and

take appropriate action prior to the Transition Date. Position holders that do not wish to participate in the Transition must close out any positions in Affected Contracts prior to the Transition Date.

Operational information

CME Clearing will update the relevant information on the applicable PA/discounting rate applicable to Affected Contracts in each case in:

- the end of day operational report (PAA Report and Trade Register report) made available by CME Clearing only to IRS clearing members via an sFTP site; and
- the CME OTC IRS Bookkeeping document, made available to IRS Clearing Members and their customers on request.

Inquiries regarding the aforementioned may be directed to:

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