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香港場外結算有限公司  
(香港交易及結算所有限公司附屬公司)

**OTC CLEARING HONG KONG LIMITED**  
(A subsidiary of Hong Kong Exchanges and Clearing Limited)

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Subject: Transition plan for switching to SOFR<sup>1</sup> and €STR<sup>2</sup> discounting  
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*This circular sets out OTC Clear's proposals in connection with the transition to SOFR and €STR discounting. It contains statements of intent which remain subject to ongoing consultation and analysis and should not be treated as final or binding.*

In the course of preparation for transitioning to SOFR and €STR discounting, OTC Clearing Hong Kong Limited (**OTC Clear**) organized working groups with Clearing Members and consulted other central clearing counterparties (**CCPs**) in 2H 2019. Based on feedback collected, OTC Clear would like to outline below its high-level transition plan for switching to SOFR and €STR discounting.

OTC Clear will adopt a single-day transition (Big Bang) approach for switching to SOFR and €STR discounting. Under the Big Bang approach, OTC Clear will switch the discounting curve and Price Alignment Interest (**PAI**) calculation reference rate to SOFR and €STR for both new and legacy contracts on the respective transition day.

For the discounting switch which applies to legacy contracts, OTC Clear will adopt a combination of cash (to provide value compensation) and swaps (to provide risk compensation), as appropriate, designed to address the resultant valuation and risk profile changes to the extent practicable. Details of the compensation process will be further developed and may change to reflect further feedback from market participants. However, this circular provides members with information on OTC Clear's proposals to transition discounting and price alignment while addressing any potential risks and resultant valuation changes.

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<sup>1</sup> Secured Overnight Financing Rate

<sup>2</sup> Euro Short-Term Rate

## 1. Timing

The discounting switch from EONIA<sup>3</sup> to €STR will take place over the period of 19-21 June 2020.

The discounting switch from FedFund<sup>4</sup> to SOFR will take place over the period of 16-19 October 2020.

## 2. Scope

FedFund to SOFR Discounting Switch	EONIA to €STR Discounting Switch
<ul style="list-style-type: none"> <li>▪ USD Interest Rate Swaps (including Fixed/Float and basis swaps)</li> <li>▪ Non-deliverable interest rate swaps</li> </ul> <p><i>(OTC Clearing is consulting Clearing Members with regard to the transition plan for Cross Currency Swap (CCS) and Deliverable FX swaps and forwards. CCS and Deliverable FX swaps and forwards will not be included in the discounting switch in Oct 2020)</i></p>	<ul style="list-style-type: none"> <li>▪ EUR Interest Rate Swaps (including Fixed/Float and basis swaps)</li> </ul>

## 3. Cash Compensation Process

After the close of business on the respective transition day, in order to neutralize the valuation changes attributable to the use of the new discounting curve, OTC Clear will make a cash adjustment that is equal and opposite to the resultant change in each cleared swap's Net Present Value (**NPV**) as part of a special end-of-day valuation cycle.

The cash compensation process will be applied on both the EONIA to €STR discounting switch and the FedFund to SOFR discounting switch.

## 4. Swap Compensation Process

The transition would effectively move the discounting risk for all members from FedFund to SOFR at closing curve levels on the FedFund to SOFR transition day. To compensate for the effect of changing the risk profile resulting from the discounting curve switch, OTC Clear will offer a swap compensation option to Clearing Members. For Clearing Members who decide to opt-in to the swap compensation process, OTC Clear will book a series of FedFund/SOFR basis swaps to Clearing Members' accounts. For Clearing Members who decide to opt-out of the swap compensation process, OTC Clear will run a centralized auction

<sup>3</sup> Euro Overnight Index Average

<sup>4</sup> Effective Federal Funds Rate

to liquidate the unwanted basis swaps. There will be a non-zero auction cost for Clearing Members who opt-out of the swap compensation process.

With the FedFund to SOFR discounting switch, the spread between FedFund and SOFR is not static and the switch would effectively change the discounting risk. Clearing Members may make use of the basis swaps between FedFund and SOFR to hedge the basis risk and thereby restore their positions to their original risk profiles.

However, with the EONIA to €STR discounting switch, as the spread between EONIA and €STR is static at 8.5 basis points, there is no basis risk, so hedging is not necessary. Accordingly, the swap compensation process is not applicable in respect to the EONIA to €STR switch.

## **5. Next Steps**

OTC Clear will continue to discuss with Clearing Members regarding details of the swap compensation exercise, including but not limited to the opt-in / opt-out procedures, the mechanism of swap bookings, and the timing and logistics of the auction. We will provide further details of our plans as they evolve to ensure a smooth transitioning to SOFR and €STR discounting in 2020.

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