

LIBOR industry developments brought to you by U.S. Bank

CCP discounting switch

Central counterparty clearinghouses (CCPs) switched to SOFR-based discounting for USD-cleared derivatives on Oct. 16. Previously, discounting was based on the effective federal funds rate. This change impacts interest paid on variation margin as well as discounting and valuation of future cash flows. For those interested in more detail, both the CME and LCH, two leading CCPs, published explanations of guidelines for moving to an alternate reference rate.

The discounting switch is a key milestone in the LIBOR transition as it is expected to promote SOFR liquidity in the market and drive the market forward in its transition to alternative reference rates. In aggregate, more than 90% of gross USD LIBOR exposure is to cleared and uncleared derivative transactions.

ISDA Protocol launched Oct. 23

The International Swaps and Derivatives Association's (ISDA) Fallbacks Supplement and Fallbacks Protocol launched on Oct. 23, 2020 and will take effect on Jan. 25, 2021. At this point, the Supplement will apply to all new derivatives contracts that leverage the 2006 ISDA Definitions. Additionally, existing derivative contracts can leverage the Protocol to amend legacy transactions.

The [announcement from ISDA](#) is another major milestone in the LIBOR transition. The Supplement and Protocol facilitate a transition away from LIBOR by giving market participants standardized fallback language for both legacy and new contracts referencing LIBOR. The [Federal Reserve also released a supervisory letter](#) stating its support for ISDA's efforts and encouraging broad adherence to the Protocol by market participants. Additionally, using "risk-free rates" identified by the Alternate Reference Rate Committee as the designated fallback rate will also lower the risk of mismatched hedges and improve the financial system's stability.

The announcement from ISDA comes after the U.S. Department of Justice (DOJ) issued its [business review letter](#) regarding the new fallbacks on Oct. 1, 2020. The DOJ letter concludes that ISDA's Protocol is unlikely to produce anticompetitive effects and can offer substantial benefits to the financial services industry; therefore, the DOJ has no present intention to challenge the proposal. Regarding the potential benefits of the Protocol adoption, the DOJ noted that the proposed fallbacks and standardized approach will likely increase the efficiency and certainty in calculating the value of fallback rates should an IBOR be discontinued.

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