INTEREST RATES

Benefits of Eris SOFR for private lenders

By Eric Leininger

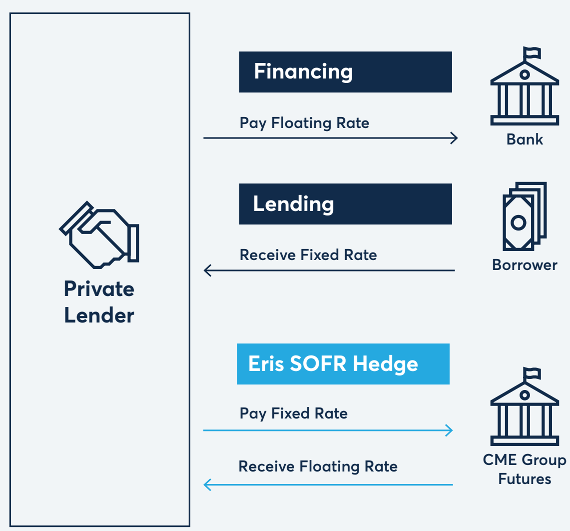
10 OCT 2023

Private lenders who borrow at floating rates indexed to the Secured Overnight Financing Rate (SOFR) and lend at fixed rates bear the risk of interest rate increases diminishing their net interest spread and impairing the resale value of the loan. Now, they can hedge this risk using Eris SOFR Swap futures (Eris SOFR) to match the rate terms of financing with the rate terms of the loan, offsetting losses from interest rate increases.

With Eris SOFR, private lenders can…

- Expand product offering to include fixed rate loans, confidently lending at competitive fixed rates while borrowing remains indexed to SOFR.
- Price loans to match hedges by referencing the transparent and executable Eris SOFR curve.
- Hedge efficiently during loan aggregation in sizes as small as $100,000, allowing for more competitive bulk pricing.
- Hold Eris SOFR hedges for the entire duration of on-balance-sheet loans (with no requirement to roll positions quarterly, unlike traditional futures) or lift hedges when loans are sold.
- Track transparent pre-trade and post-trade prices, supporting efficient risk management and operations.

Eris SOFR cash flows offset interest payments a private lender pays and receives, hedging against interest rate moves



CME Group operates the world's largest and deepest USD interest rates liquidity pool. Eris SOFR Swap futures are efficient, transparent, and simple to trade, available in contract lot sizes of $100,000. They are well suited to private lenders – large and small – and can be used to improve the overall efficiency of the entire lending life cycle. Hedging with Eris SOFR allows a lender to lock-in current expectations of interest rates, allowing the lender the flexibility to do either of the following:

1. Lock in lending spreads at current rates, then hold loans and hedges to maturity, or
2. Hedge loan fair value from a change in interest rates while aggregating loans for bulk sale, then liquidate the hedge along with portfolio

Example

- A private lender receives bank financing at SOFR + 200 basis points (approximately 7.3% as of late September 2023) and lends $10 million for three years at 9.5% to fund a development project.
- A private lender sells 100 Eris SOFR three-year contracts upon funding the loan, locking in the ~2.2% spread.
- As interest rates rise (fall), the increase (decrease) in value of the Eris SOFR position substantially offsets the corresponding loss (gain) in the value of the asset.
- With loan profitability hedged against rate moves, the private lender may choose to aggregate multiple loans before selling them in bulk or securitizing them, enabling them to secure preferable terms.
- Upon the sale or extinguishment of the loan, the private lender exits the futures position by buying back 100 Eris SOFR three-year contracts (or allowing it to expire after three years).

How does Eris SOFR work?

- Eris SOFR are futures contracts whose value is based on the performance of SOFR over time.
- Private lenders who sell Eris SOFR (or go short) will make money as interest rates rise and lose money as interest rates fall. This hedge on interest rates can offset the impact of interest rate moves on the private lender's loan profitability.
- There is no free lunch, of course: By insuring against losses from rates rising, private lenders are also forgoing profits from rates declining. Many lenders value the increased certainty hedging offers, acknowledging the peril of attempting to forecast interest rates.

How do I trade futures?

- Eris SOFR are listed for trading by CME Group, a U.S.-based futures exchange and clearinghouse regulated by the Commodity Futures Trading Commission (CFTC).
- CME Group facilitates trading of Eris SOFR contracts by distributing transparent pre- and post-trade pricing data, and determining independently the fair value of positions daily.
- Private lenders can access Eris SOFR and other CME Group futures by signing up with a futures clearing broker to facilitate trade execution and guarantee the private lender's financial performance.

How do fees and margin work for futures?

- No hidden fees: Private lenders pay fully-disclosed fees to a futures clearing broker and CME Group.
- Initial Margin (IM): Private lenders post IM as collateral during the trade holding period to ensure financial performance. Upon closing out the position, private lenders receive back the full IM amount.
- Variation Margin (VM): Private lenders experience daily mark-to-market events called VM during the trade holding period, receiving payments from the clearing broker for days when rates rise (for a short position), and making payments to the clearing broker for days when rates fall. Payments of VM earn daily SOFR interest through a price component called Eris Price Alignment Interest.

How does Eris SOFR compare to other financial instruments for hedging interest rate risk?

- Over-the-Counter Interest Rate Swaps (OTC IRS) involve complex legal agreements and fees embedded in traded prices, requiring more onboarding time and higher costs than Eris SOFR.
- Cleared IRS accounts often involve minimum monthly fees that are uneconomic for all but the largest hedgers and require posting IM amounts more than twice as high as Eris SOFR.
- Treasury futures track the value of U.S. Treasury instruments, while Eris SOFR more reliably tracks SOFR-based risk.

Use Eris SOFR swap futures to easily and efficiently hedge away interest rate volatility and lock in margin profitability all with execution and operational simplicity compared to OTC swaps.

All examples in this report are hypothetical interpretations of situations and are used for explanation purposes only. The views in this report reflect solely those of the author(s) and not necessarily those of CME Group or its affiliated institutions. This report and the information herein should not be considered investment advice or the results of actual market experience.