# ARRC Recommendations for Swaptions Impacted by the CCP Discounting Transition to SOFR

**Updated: September 11, 2020**

The Alternative Reference Rates Committee ("ARRC") issued a public consultation in February regarding swaptions referencing U.S. dollar (USD) LIBOR that could be affected by the discounting change for cleared derivatives from the effective federal funds rate ("EFFR") to the Secured Overnight Financing Rate ("SOFR") that will implemented by both the CME Group and LCH on October 16, 2020. The consultation sought views from market participants as to whether the ARRC should recommend the voluntary exchange of cash compensation between bilateral counterparties to legacy interest rate swaptions that could be exercised after October 16, 2020 and also recommend conventions for new interest rate swaption contracts traded before October 16, 2020.

This document summarizes the responses to the consultation and, reflecting the views received, makes several recommendations for market participants to consider. All ARRC recommendations are voluntary and, as such, do not and cannot change the legal rights and obligations of any counterparty under any existing contract.[1] Accordingly, any agreement between counterparties to make adjustments to their contracts or exchange compensation, whether based on the ARRC recommendations or not, would be strictly voluntary and nothing herein creates any legal obligation to do so.

In line with the results of its consultation, on May 14, 2020 the ARRC made two recommendations related to legacy swaptions traded prior to March 30th, 2020:

1) Market participants amend USD swaptions expiring after October 16th, 2020 to be brought in-scope for ISDA Supplement 64 and to specify SOFR as the Agreed Discount Rate, and that, at the same time, market participants exchange compensation for the difference in the value of these swaptions

2) Market participants contact their swaptions counterparties no later than June 30, 2020 to determine whether they intend to follow Recommendation (1) above.

In subsequent months it has become clear that, although a majority of respondents believed that the exchange of compensation was in the market interest and the ARRC stands by its recommendation in this regard, a number of market participants may choose to forgo an exchange

---

[1] The ARRC consultation and its recommendations apply only to USD-denominated contracts. The Working Group on Euro Risk Free Rates undertook a similar consultation for euro-denominated contracts which are set to transition discounting and PAI for cleared products from the Euro Overnight Index Average rate ("EONIA") to the Euro Short-Term Rate ("€STR") at close of business on June 19, 2020. A summary of the results has been made available.

of compensation. In order to avoid an extended period of uncertainty and to preempt potential future disputes, the ARRC is now adding a third recommendation regarding legacy swaptions

3) If no agreement regarding the voluntary exchange of compensation has been reached by the counterparties before the date of the clearinghouse discounting switch (October 16th, 2020), then the counterparties should amend their legacy swaptions to bring them into scope for ISDA's Supplement 64 and specify an Agreed Discount Rate consistent with the swaptions' existing contractual terms.

The ARRC's recommendations for legacy and new swaptions are described in full below, along with background information and a description of the ARRC's consultation.

## Background

The Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York ("FRBNY") convened the Alternative Reference Rates Committee ("ARRC") in 2014 to identify alternative reference rates for U.S. dollar (USD) LIBOR ("LIBOR"), identify best practices for contract robustness in the interest rate market, and create an implementation plan to support an orderly adoption of new reference rates. After accomplishing its initial set of objectives by selecting an alternative reference rate (which is the Secured Overnight Financing Rate or "SOFR") and setting out a Paced Transition Plan with respect to derivatives, the ARRC was reconstituted in 2018 with an expanded membership to help ensure the successful implementation of the Paced Transition Plan and to serve as a forum for cash and derivatives market participants to address the risks of severe market disruption that could result from the cessation of LIBOR and develop and support liquidity in SOFR-based products across cash and derivatives markets.

Steps 4 and 5 of the original Paced Transition Plan called for Central Counterparty Clearing Houses ("CCPs") to:

4. Begin allowing market participants a choice between clearing new or modified swap contracts (swaps paying floating legs benchmarked to EFFR, LIBOR, and SOFR) into the current PAI/discounting environment or one that uses SOFR for PAI and discounting (anticipated completion: 2020Q1)

5. No longer accept new swap contracts for clearing with EFFR as PAI and discounting except for the purpose of closing out or reducing outstanding risk in legacy contracts that use EFFR as PAI and discount rate. Existing contracts using EFFR as PAI and the discount rate continue to exist in the same pool, but would roll off over time as they mature or are closed out (anticipated completion: 2021Q2)

In 2019, after extensive consultation with their users, LCH and CME announced plans to take the following actions effective at close of business on October 16, 2020:

(i) use SOFR for PAI/discounting of new swap contracts going forward (in place of EFFR);

and

(ii) modify outstanding swap contracts to replace EFFR with SOFR for PAI/ discounting.

Both CCPs highlighted the implications of the discounting and PAI switch on bilateral contracts which can result in either the physical delivery of a cleared interest rate swap or in a cash settlement computed using the discount curve prevailing at a CCP. The most commonly used such contracts are interest rate swaptions. If the exercise date of these contracts is after the date on which the relevant CCP makes the changes described above, their valuation will change as a result of the discounting switch from EFFR to SOFR.

Further discussion on the potential implications of the discounting change for swaptions can be found in the ARRC's consultation.

The ARRC's consultation requested feedback from all market participants as to whether the ARRC should issue a recommendation regarding:

- The voluntary exchange (or lack thereof) of a cash compensation between bilateral counterparties to such legacy contracts; and

- Conventions for new contracts traded before the October 16 transition date.

In order to offer tools that can help market participants prepare for the change in CCP discounting, on March 30, 2020, ISDA released a supplement (supplement 64) to the Definitions that allowed parties to specify an "Agreed Discount Rate" and updated its Collateral Cash Price Matrix to specify EFFR as the discount rate for a swaption that expires prior to the date (expected to be October 16, 2020) on which a global CCP switches discounting to SOFR, and SOFR after that date.[2] The primary affirmation platform for USD swaptions includes a flag to allow for specification of the Agreed Discount Rate and the ISDA supplement allows for discount rate specification in both 'Cleared Physical Settlement' and 'Collateralized Cash Price Cash Settlement Method.

## Summary of Responses to the Consultation

The ARRC received responses from 35 institutions to its consultation. Of these, 66 percent (23 firms) were provided by dealers and 34 percent (12 firms) were provided by buy-side firms which included asset managers, government sponsored enterprises and insurance companies. Individual responses are available on the ARRC website. The responses to each of the four questions in the consultation are summarized below:

[2] See the ISDA press release, April 3, 2020, for more information on the supplement.

**Question 1**.

Do you support:

A. The ARRC recommending that voluntary compensation should be exchanged
B. The ARRC recommending that voluntary compensation should not be exchanged
C. The ARRC not issuing a recommendation regarding voluntary compensation

More than 2/3rds of the respondents (24 firms) supported an ARRC recommendation for the exchange of voluntary compensation reflecting the changes in valuations of legacy swaptions that may be caused by the change in CCP discount curves from EFFR to SOFR. Almost all buy-side firms supported an ARRC recommendation for voluntary compensation and 61 percent of dealers did as well.

**Question 2.**

If you support the ARRC recommending that voluntary compensation should be exchanged for legacy swaptions, do you support:

A. The ARRC recommending that the compensation exchange be at the trade-level and at time of swaption expiry
B. The ARRC recommending that the compensation exchange be a one-time, portfolio-level amendment prior to expiry, with compensation exchange at expiry acting as a backstop
C. The ARRC not issuing a recommendation regarding the timing of the compensation exchange

Citing a desire for a clear and consistent approach to compensation, 63 percent of respondents recommended that the compensation exchange be a one-time, portfolio-level amendment prior to expiry, with compensation exchange at expiry acting as a backstop. Most dealers were supportive of the compensation as a one-time, portfolio-level exchange of compensation and half of buy-side firms supported this option as well, with others evenly split across the alternatives.

**Question 3.**

If the ARRC issues a recommendation that voluntary compensation should be exchanged for legacy swaptions, do you support:

A. The ARRC recommending that this only apply to swaptions traded prior to the date on which the ARRC issues its recommendation
B. The ARRC recommending that this only apply to swaptions traded prior to the effective date of the ISDA amendments describe above for “new” swaptions
C. The ARRC recommending that this only apply to swaptions traded prior to CCP announcements regarding their plans for the discounting switch and compensation mechanism
D. The ARRC not issuing a recommendation regarding a cut-off trade date after which compensation would no longer be recommended

Views on which legacy swaptions these recommendations should apply to were spread across the four options presented in the consultation for both dealers and buy-side firms. The largest number of respondents (48 percent) supported an ARRC recommendation that applied to swaptions traded prior to the effective date of the relevant ISDA Supplement (March 30, 2020), with more limited support (20 percent or less) for any other option.

**Question 4.**

If you support the second proposal in Question 3, do you support:

A. The ARRC recommending that the default should be to <u>not</u> specify a discount curve
B. The ARRC recommending that the default should be to specify a discount curve that is the prevailing discount curve at time of trade (i.e. EFFR for all swaptions <u>traded</u> prior to the CCP discounting switch date and SOFR afterwards)
C. The ARRC recommending that the default should be to specify a discount curve that is expected to be the prevailing discount curve at time of expiry (i.e. EFFR for all swaptions <u>expiring</u> prior to the expected CCP discounting switch date and SOFR afterwards)
D. The ARRC not issuing a recommendation regarding specification of default discount curve

Almost ¾ of dealers, and 63 percent of respondents overall, supported an ARRC recommendation that the default for new swaptions trades should be to specify an EFFR discount curve for all swaptions expiring prior to October 16, 2020 and a SOFR discount curve after that.

**ARRC Recommendation on Compensation for Legacy Swaptions Contracts**

(1) Unless otherwise previously agreed to by swaption counterparties, and as soon as operationally feasible, the ARRC recommends that, on a portfolio basis:

- Market participants amend USD swaptions expiring after October 16th, 2020 to be brought in-scope for ISDA Supplement 64 and to specify SOFR as the Agreed Discount Rate, and that, at the same time,

- Market participants exchange compensation for the difference in the value of these swaptions between EFFR discounting and SOFR discounting.

The ARRC recommends that this only apply to swaptions traded prior to March 30th, 2020, unless counterparties agree to an earlier cut-off date.

(2) The ARRC recommends that market participants contact their swaptions counterparties no later than June 30, 2020 to determine whether they intend to follow Recommendation (1) above. Prompt determination is recommended to: (a) avoid an extended period of uncertainty; (b) minimize any valuation difference because the market-implied basis between EFFR and SOFR is currently fairly narrow (in absolute value); and (c) promote responsible risk management and market liquidity and resiliency.

(3) To avoid an extended period of uncertainty and to preempt potential future disputes, the ARRC recommends that if no agreement regarding the voluntary exchange of compensation has been reached by the counterparties before the date of the clearinghouse discounting switch (October 16th, 2020), then the counterparties should amend their legacy swaptions to bring them into scope for ISDA's Supplement 64 and specify an Agreed Discount Rate consistent with the swaptions' existing contractual terms.[1]

(4) For new swaptions, the ARRC recommends that market participants specify at time of trade an Agreed Discount Rate of:

- EFFR if the swaption expires on or prior to October 16th, 2020.

- SOFR if the swaption expires after October 16th, 2020.

The recommendations set forth above are voluntary, are not intended to change the rights and obligations of counterparties under any existing contract, and create no legal obligation to exchange compensation related to the upcoming CCP discounting change recommended herein. Any agreement between counterparties to make adjustments to their contracts or exchange compensation would be strictly voluntary.

[1] Note that for a subset of swaptions expiring after the clearinghouse discounting switch, the existing contractual terms would involve using Fed Funds discounting, not SOFR discounting. For a summary of the ISDA definitions applicable to legacy swaptions, refer to ISDA's memo included in the ARRC consultation.