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ARRC Releases Consultation on Swaptions Impacted by Central Counterparty Clearing Houses' Discounting Transition to SOFR

Seeks Input on Whether to Recommend a Compensation Methodology for Swaptions Referencing U.S. Dollar LIBOR; Consultation is Open for Feedback through March 9

The Alternative Reference Rates Committee (ARRC) today released a consultation on swaptions based on U.S. dollar (USD) LIBOR that could be affected by the discounting change for cleared derivatives from the use of the Effective Federal Funds Rate (EFFR) to the Secured Overnight Financing Rate (SOFR) effective at the close of business on October 16, 2020.

"The ARRC has long worked to smooth the transition away from LIBOR. The discounting change from EFFR to SOFR will have economic impacts on swaptions, so we're seeking feedback as to how market participants believe these changes can be best addressed," said Tom Wipf, ARRC Chair and Vice Chairman of Institutional Securities at Morgan Stanley. "I urge market participants with USD LIBOR-based swaptions to study the effects of the discounting change and respond to the consultation."

In 2019, the central counterparty clearing houses (CCPs) LCH and CME Group individually announced that, effective at the close of business on October 16, 2020, the discounting and price alignment interest for USD-denominated interest rate swaps will transition from EFFR to SOFR. The transition will involve the exchange of cash (equal to the difference in valuation between the two discounting regimes) and risk compensations (in the form of at-market EFFR vs. SOFR basis swaps).

This change also impacts swaptions that expire after October 16, 2020, 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. However, the CCP compensation mechanism would not apply to these swaptions, even though the switch would also change their valuations.

Given the potential economic impacts on swaptions, today's consultation focuses on whether the ARRC should issue recommendations regarding:

- The voluntary exchange (or lack thereof) of cash compensation between bilateral counterparties to legacy interest rate swaptions that could be exercised after October 16, 2020; and,
- Conventions for new interest rate swaption contracts traded before October 16, 2020.

For legacy swaptions: The consultation outlines legal and operational considerations surrounding the potential cash compensation for legacy swaptions and asks whether market participants believe that the ARRC should recommend that counterparties exchange compensation. Any ARRC recommendation on compensation to promote a market convention would be voluntary and must be bilaterally agreed between counterparties to the contract based on their own analysis and negotiation regarding the justifications for doing so.

For new swaptions: The consultation discusses amendments that the International Swaps and Derivatives Association (ISDA) plans to make to the 2006 ISDA definitions aimed at providing clarity for swaptions entered into after the amendments take effect. The consultation seeks views on whether it would be useful to the market for the ARRC to recommend a default discount curve in relation to these amendments. As for legacy swaptions, any ARRC recommendations would be voluntary and would need to be bilaterally agreed between counterparties.

Submitting Feedback about this Consultation

The ARRC welcomes responses to the consultation from the widest possible range of stakeholders, who may be impacted by these changes. The release of the consultation marks the start of a public comment period during which the ARRC intends to work closely with stakeholders to solicit and incorporate their input. Following this comment period, the ARRC plans to determine whether it should recommend a compensation methodology for swaptions referencing USD LIBOR.

Responses to the consultation may be submitted by email to the ARRC Secretariat (arrc@ny.frb.org) no later than March 9, 2020. Please coordinate internally and provide only one response per institution. Please attach your responses in a PDF document and clearly indicate "Consultation Response" in the subject line of your email.

Comments will be posted on the ARRC's website as they are received without alteration except when necessary for technical reasons. Comments will be posted with attribution unless respondents request anonymity. If your institution is requesting anonymity, please clearly indicate this in the body of your email and please ensure that the PDF document you submit is anonymized. Questions regarding the consultations should also be sent to the ARRC Secretariat (arrc@ny.frb.org) and will not be posted for attribution.

About the ARRC

The ARRC is a group of private-market participants convened by the Federal Reserve Board and Federal Reserve Bank of New York in cooperation with the Consumer Financial Protection Bureau, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Office of Financial Research, the Office of the Comptroller of the Currency, the Commodity Futures Trading Commission, the Securities and Exchange Commission and the U.S. Treasury Department. It was initially convened in 2014 to identify risk-free alternative reference rates for USD LIBOR, identify best practices for contract robustness, and create an implementation plan with metrics of success and a timeline to support an orderly adoption. The ARRC accomplished its first set of objectives and identified the SOFR as the rate that represents best practice for use in certain new USD derivatives and other financial contracts. It also published its Paced Transition Plan, with specific steps and timelines designed to encourage adoption of the SOFR. The ARRC was reconstituted in 2018 with an expanded membership to help to ensure the successful implementation of the Paced Transition Plan, address the increased risk that LIBOR may not exist beyond 2021, and serve as a forum to coordinate and track planning across cash and derivatives products and market participants currently using USD LIBOR.

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