May 14, 2020

ARRC Announces Recommendation for Voluntary Compensation for Swaptions Impacted by the CCP Discounting Transition to SOFR

The Alternative Reference Rates Committee (ARRC) released its recommendations that a voluntary exchange of cash compensation take place between counterparties to legacy swaptions referencing U.S. dollar (USD) LIBOR and that counterparties specify an agreed discount rate using the Secured Overnight Financing Rate (SOFR) for new swaptions expiring after October 16, 2020. The recommendation of voluntary compensation is intended to resolve uncertainty associated with the transition from the use of the Effective Federal Funds Rate (EFFR) to the SOFR for discounting cleared derivatives. As with all ARRC recommendations, the ARRC recommendation for compensation is strictly voluntary and, accordingly, is not intended to (and does not) change the legal rights and obligations of any counterparty under any existing contract.

Specifically, the ARRC's recommendation is that on a portfolio basis, market participants voluntarily:

- Amend legacy swaptions expiring after October 16, 2020 to be brought in-scope for ISDA Supplement 64 and to specify SOFR as the Agreed Discount Rate;
- Exchange compensation for the difference in the value of these swaptions between EFFR discounting and SOFR discounting.

The ARRC recommendation is intended to apply to swaptions traded prior to March 30, 2020, although nothing precludes counterparties from agreeing bilaterally to an earlier cut-off date. To avoid an extended period of uncertainty, the ARRC recommends that market participants reach out to their counterparties as soon as possible to determine whether they intend to follow this recommendation.

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

- The effective federal funds rate if the swaption expires on or prior to October 16th, 2020.
- SOFR if the swaption expires after October 16th, 2020.

In making a final recommendation, the ARRC incorporated feedback received on its public consultation on this matter, which received responses from more than 30 sell-side and buy-side market participants. The ARRC launched its public consultation following the announcements made in 2019 by the central counterparty clearing houses (CCPs) LCH and CME Group that they would transition to the use of SOFR for the discounting of USD-denominated interest rate swaps.

About the ARRC

ALTERNATIVE REFERENCE RATES COMMITTEE

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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