

MEMO# 32459

May 14, 2020

LIBOR Update: ARRC Recommendations for Swaptions

[32459]

May 14, 2020 TO: Accounting/Treasurers Committee
Derivatives Markets Advisory Committee
LIBOR Transition Working Group
SEC Rules Committee
Securities Operations Advisory Committee
Security Valuation Operations Committee RE: LIBOR Update: ARRC Recommendations for Swaptions

On May 14, the ARRC issued recommendations regarding a compensation methodology for swaptions that will be impacted by central counterparty clearinghouses' (CCP) upcoming discounting transition (the "Big Bang").[\[1\]](#)

Background

On October 16, 2020, the CCPs will transition the discounting for their USD-denominated interest rate swaps from the Effective Federal Funds Rate (EFFR) to SOFR. As part of this transition, the CCPs will provide a mechanism for the exchange of cash and/or risk compensation for swap counterparties to account for the differences in valuation resulting from the discounting transition.[\[2\]](#)

The CCP Big Bang will also impact valuations for bilateral swaptions based on underlying cleared interest rate swaps. However, the CCP compensation mechanism will not be available to swaption counterparties account for these changes in swaption valuation.

ARRC Recommendations

The ARRC recommends the following voluntary measures for counterparties to consider to account for the impact on swaption valuation as a result of the CCP Big Bang for swaps.

- For swaptions traded prior to March 30, 2020, the ARRC recommends that market participants contact their swaption counterparties by June 30 to indicate if they intend to agree to:
 - On a portfolio basis, amend swaptions expiring after October 16, 2020 to be in line with ISDA Supplement 64[\[3\]](#) and to specify SOFR as the agreed discount rate; and
 - On a portfolio basis, exchange compensation for the difference in the value of

these swaptions between EFFR discounting and SOFR discounting.

- For new swaptions, the ARRC recommends that market participants specify at time of trade agreed discount date of:
 - EFFR if the swaption expires on or prior to October 16th, 2020; and
 - SOFR if the swaption expires after October 16th, 2020.

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endnotes

[1] See ARRC Recommendations for Swaptions Impacted by the CCP Discounting Transition to SOFR (May 2020), *available at* <https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC-swaptions-recommendations.pdf>; The ARRC Recommendations also provided response to its consultation regarding swaption discounting; see *also* https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC_Swaption_Consultation.pdf.

[2] See LCH Proposed next steps for transition to USD SOFR discounting in SwapClear, *available at* https://www.cftc.gov/media/3221/MRAC_LCH_SOFRDiscountingLetter121119/download; CME Group SOFR Discounting and Price Alignment Transition Plan for Cleared USD Interest Rate Swaps, *available at* <https://www.cmegroup.com/education/articles-and-reports/sofr-price-alignment-and-discounting-proposal.html>.

[3] See Swaptions: ‘Agreed Discount Rate’ Supplement to the 2006 ISDA Definitions Published (Mar. 30, 2020) (allowing parties to specify an “Agreed Discount Rate” in swaptions for with either ‘Cleared Physical Settlement’ or ‘Collateralized Cash Price Cash Settlement’ applies and updated its Collateral Cash Price Matrix to specify EFFR as the discount rate for a swaption that expires prior to October 16, 2020, and SOFR after that date), *available at* <https://www.isda.org/2020/03/30/swaptions-agreed-discount-rate-supplement-to-the-2006-isd-definitions-published/>.