February 13, 2020

By electronic submission to regs.comments@occ.gov, regs.comments@federalreserve.gov, Comments@FDIC.gov, reg-comm@fca.gov, and RegComments@fhfa.gov

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Attention: Comment Processing
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Ms. Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
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Mr. Alfred M. Pollard
General Counsel
Attention: Comments/RIN 2590-AB03
Federal Housing Finance Agency
Constitution Center (OGC Eighth Floor)
400 7th Street, S.W.
Washington, DC 20219

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

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Ladies and Gentlemen,

The Alternative Reference Rates Committee (ARRC) is submitting this comment letter as a supplement to the ARRC’s previous comment letter1 on the above-referenced notice of proposed rulemaking2 (the Proposal) issued by the U.S. prudential regulators3 (collectively, the Agencies).


3 The U.S. prudential regulators include the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), the Farm Credit Administration (FCA), and the Federal Housing Finance Agency (FHFA).
The Proposal would amend the Agencies’ regulations that require swap dealers and security-based swap dealers under the Agencies’ respective jurisdictions to exchange margin with certain counterparties to non-cleared swaps and security-based swaps (Swap Margin Rule or the Rule). Consistent with the ARRC’s mandate, the ARRC December 2019 Letter focused on the provisions of the Proposal designed to address, and facilitate, a smooth and orderly transition away from interbank offered rates (IBORs) or other discontinued rates to the secured overnight financing rate (SOFR) or other risk-free rates (RFR). As explained in the ARRC December 2019 Letter, the ARRC strongly supports the Proposal and has offered recommendations designed to ensure that the relief granted addresses likely transition scenarios.

This supplemental comment letter identifies an additional issue that has recently come to the attention of the ARRC and that, in our view, is appropriate for the Agencies to address in their rulemaking. That the ARRC, through its members, continues to identify new issues associated with an early and orderly transition from LIBOR (and other IBORs) reiterates the need for broad-based, rather than overly prescriptive or specific, relief.

After extensive consultation with their users, LCH and CME announced plans that will change some of the steps envisioned in the ARRC’s “Paced Transition Plan,” which outlines the steps that the ARRC and central counterparties (CCPs) intend to take to encourage the issuance of, and transition to, contracts referencing SOFR. In particular, LCH and CME announced that they intend to take the following actions effective at close of business on October 16, 2020:

(i) use SOFR for price alignment interest (PAI)/price alignment amount (PAA) and discounting of new and legacy USD cleared swap contracts going forward (in place of the effective federal funds rate (EFFR)).

While these changes do not directly implicate the Agencies’ uncleared swap margin regulations, both CCPs highlighted the implications of the discounting and PAI switch on bilateral contracts that 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. A similar issue exists in euro (EUR)-denominated contracts, with LCH, Eurex and CME set to transition discounting and PAI for cleared products from the Euro Overnight Index Average rate (EONIA).

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4 For the remainder of this letter, the term “swap” should be read to include swaps and security-based swaps, unless the context requires otherwise.


6 LCH swap scope is all USD-sensitive positions (including non-deliverable currencies & Mexican peso (MXN) products) and the CME swap scope is USD denominated derivatives (non-deliverable currencies & MXN will be done at a later date).
to the Euro Short-Term Rate (ESTR) at close of business on June 19th, 2020. Because the swaption contracts are not themselves cleared through a CCP, they do not receive the benefit of the CCP’s compensation mechanism that addresses any such valuation change.

As a result of these changes, the ARRC believes that swaption counterparties may wish to, prior to exercise, amend a swaption’s terms to reflect an agreement regarding the discount curve to be applied for the settlement of the swaption or to compensate for the change in value resulting from the discounting rate change at the relevant CCP. Infrastructure providers plan to institute trade level attributes such as contractual flags that would facilitate counterparties to make such amendments and the ARRC is currently seeking feedback as to whether the ARRC should issue voluntary recommendations regarding the exchange of compensation.

The change to the use of RFR PAI and discounting by CCPs may also cause market participants to agree to amend the interest rate applicable to cash collateral in bilaterally-agreed credit support annexes to the same RFR in order to maintain a consistent approach with cleared swaps.

The Proposal provides relief from the Swap Margin Rule for legacy swaps that are amended “solely to accommodate the replacement of” an IBOR, any other interest rate that a covered swap entity reasonably expects to be discontinued or reasonably determines has lost its relevance as a reliable benchmark due to a significant impairment, or any other interest rate that succeeds any of the foregoing.\(^7\) We appreciate the focus of the Proposal on the replacement of rates referenced by swaps (e.g., the rate applicable to the floating leg of a fixed-floating interest rate swap).\(^8\) However, swaps, or their underlying or related agreements, may include terms that reference or are based on other rates, which may need to be replaced in connection with the transition to RFRs. In addition, such other rates may not be IBORs, impaired rates or any successor rates, but nonetheless would be replaced solely as part of the transition to RFRs. The ARRC has identified the following examples of scenarios not directly addressed by the Proposal:

- Interest rate swaptions and the announcement by certain CCPs that they intend to change their applicable discount rate from the daily effective federal funds rate to SOFR and from EONIA to ESTR during 2020.

- The interest rate applicable to cash collateral in a credit support annex to swap documentation may be transitioned from an IBOR, impaired rate, or other rate (e.g., the Federal Funds Rate or EONIA) to an RFR. This transition could be viewed as an

\(^7\) Proposal, § ___1(h)(3)(i).

\(^8\) See, e.g., Proposal at 59974 (“Due to the potential discontinuation of LIBOR at the end of 2021, covered swap entities face uncertainty about the way their swap contracts based on LIBOR and other IBORs will operate after the permanent discontinuation date without a reliable benchmark rate. A benchmark rate is a critical term for calculating payments under a swap contract.”); Proposal at 59975 (“To offer flexibility in the transition to a new reference rate, the proposed rule would permit the replacement of an IBOR or other discontinued reference rate in the floating leg of a fixed-floating rate swap, and would also permit the interest rate in the fixed leg to be modified in order to maintain the economics of the noncleared swap.”).
amendment that would otherwise trigger the requirements of the Swap Margin Rule but is undertaken in connection with a transition to an RFR.

These examples represent *bona fide* transition-related activities that are intended to reduce systemic risk and result in better-functioning markets. As a result, the Agencies should ensure any relief from the Swap Margin Rule also covers such transition activities. Therefore, the ARRC requests that the Agencies modify the Proposal or otherwise clarify that amendments to a swap, or any underlying or related documentation, that are made to replace a rate or to account for a rate that has been or will be replaced (e.g., by a CCP) would be covered by any final rule to the extent that such amendments are made solely as part of the transition to an RFR.

* * *

The ARRC is strongly committed to maintaining the safety and soundness of the global derivatives markets, and is therefore supportive of the global reform agenda to transition to alternative RFRs. The ARRC recognizes the importance of an inter-agency approach among the relevant U.S. financial regulators in adopting rules intended to facilitate this transition and the contemporaneous coordination of this effort at the international level to provide a level playing field for all market participants. On behalf of its member firms, the ARRC looks forward to a continued dialogue with regulatory authorities as additional regulatory clarity and guidance is needed to facilitate this transition.