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ARRC Releases Addendum to its Recommendations for Voluntary Compensation for Swaptions Impacted by the CCP Discounting Transition to SOFR

The Alternative Reference Rates Committee (ARRC) today released an addendum to 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 initial recommendations intended to resolve uncertainty associated with the transition from the use of the Effective Federal Funds Rate (EFFR) to SOFR for discounting cleared derivatives. In addition to recommending that market participants exchange compensation, the recommendations suggested that legacy swaptions expiring after October 16, 2020 be brought in-scope for ISDA's Supplement 64 and specify SOFR as the Agreed Discount Rate.

Today's amendment was added to avoid an extended period of uncertainty and preempt potential disputes. The amended recommendation states that, if counterparties cannot reach an agreement on the exchange of compensation before October 16, 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."

"It's critical that counterparties actively work to address the value differences and other issues resulting from transitioning swaptions. These recommendations and today's amendment aim to encourage that communication," said Tom Wipf, ARRC Chairman and Vice Chairman of Institutional Securities at Morgan Stanley.

The amendment is the result of work by the ARRC's Market Structure and Paced Transition Working group. The initial recommendation resulted from a public ARRC consultation on this matter, which received responses from more than 30 sell-side and buy-side market participants.

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 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 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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