Public consultation on swaptions impacted by the CCP discounting transition from EONIA to the €STR

Summary of responses

May 2020

Contents

1 Executive summary

The public consultation by the working group on euro risk-free rates ("working group") on whether to issue recommendations to address the impact on swaptions of the CCP discounting transition from EONIA to the euro short-term rate (€STR) closed on Friday, 17 April 2020. The consultation attracted some interest from the financial sector. A total of 34 market participants submitted responses in relation to the consultation document, with the vast majority (26) of respondents originating from the banking sector. The respondents provided sufficient geographic coverage. The main messages from the respondents may be summarised as follows.

1) The respondents broadly supported (23 out of 34) a working group recommendation that bilateral counterparties to legacy swaption contracts voluntarily exchange compensation.

2) Half of the respondents (17 out of 34) were in favour of the working group recommending that voluntary compensation exchange take place at a pre-agreed date prior to the CCP discounting switch date[1], with compensation exchange for each swaption at expiry as a backstop.

   One-third of respondents (11 out of 34) prefer the voluntary compensation exchange to be calculated at trade level and at the time of each swaption's expiry.

3) The respondents had split views on which contracts should be covered by the voluntary compensation mechanism.

One-third of the respondents (11 out of 34) supported the working group recommending that voluntary compensation be exchanged in the case of swaptions traded prior to the effective date of the International Swaps and Derivatives Association (ISDA) "Agreed Discount Rate" amendments to the 2006 ISDA definitions (30 March 2020)[2].

An equal number of respondents, i.e. another third of the respondents (11 out of 34), supported the voluntary compensation mechanism covering contracts that are traded before the date on which CCPs will switch their discount rate from EONIA to the €STR (now 27 July 2020).

The remainder of the respondents that had an opinion (nine) were equally divided (three for each option) between favouring (i) the compensation mechanism applying to swaptions traded prior to the issuance of a future recommendation of the working group (now expected in May 2020[3]), (ii) the compensation mechanism applying to swaptions traded prior to the CCP announcements regarding their plans for the discounting switch and compensation mechanism (between September 2019 and

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[1] The switch date was postponed from June to July: see EACH statement on the transition from EONIA to €STR discounting regime, 17 April 2020.
LCH Circular No 4052, 27 September 2019 and LCH Circular No 4088, 17 April 2020.
Eurex Clearing Circular 096/2019, 23 October 2019 and Eurex Clearing Circular No. 032/2020, 17 April 2020.
CME announcement, 31 January 2020 and CME announcement, 20 April 2020.

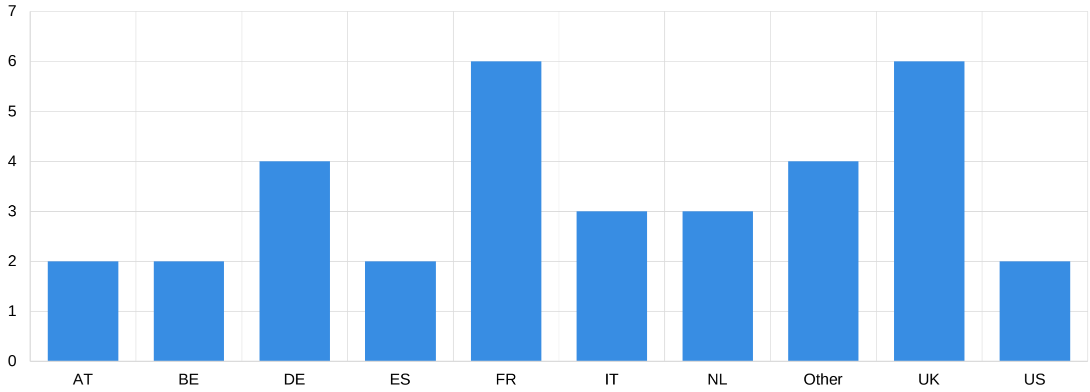
[2] ISDA announcement of its publication of the "Agreed Discount Rate" Supplement to the 2006 ISDA Definitions, 30 March 2020.

[3] At the time of the consultation, this was expected at the beginning of Q2 2020.

January 2020[4]), and (iii) the working group not issuing a recommendation regarding a cut-off trade date after which compensation would no longer be recommended.

Chart 1: Geographic coverage of the response sample

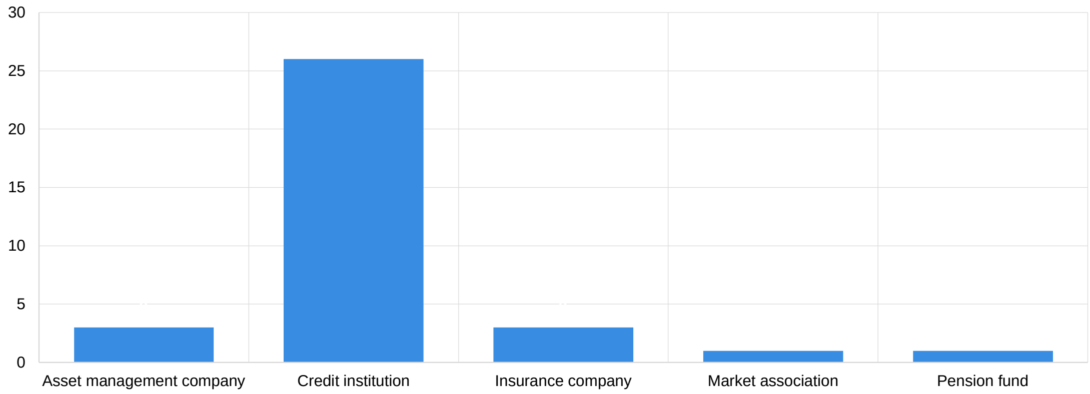
(April 2020; number of respondents by geographic area)



Source: ECB Secretariat to the working group on euro risk-free rates.

Chart 2: Representation of stakeholder groups in the response sample

(April 2020; number of respondents by sector)



Source: ECB Secretariat to the working group on euro risk-free rates.

4 LCH and Eurex Clearing plans were updated on 17 April 2020: see LCH Circular No 4088 and Eurex Clearing Circular No. 032/2020. CME Clearing plans were update on 20 April 2020: see CME announcement.

2 Should the working group recommend a voluntary compensation mechanism?

Question 1 of the public consultation asked:

In the light of the considerations discussed in Chapter 3 and as it relates to legacy swaptions specifically, do you support:

a) the working group on euro risk-free rates recommending that voluntary compensation should be exchanged;

b) the working group on euro risk-free rates recommending that voluntary compensation should not be exchanged;

c) the working group on euro risk-free rates not issuing a recommendation regarding voluntary compensation.

Please explain.

The respondents broadly supported (23 out of 34) the working group recommending that voluntary compensation be exchanged as regards legacy swaptions.

A broad majority of the respondents (23 out of 34) supported the voluntary compensation scheme (**option a**), as such a mechanism would help to avoid unfair windfall wealth transfer between market participants, safeguarding the fair value of those contracts and reflecting the intentions and assumptions maintained by the parties at the time they entered into them. In addition to this, a few respondents argued that such a mechanism would ensure consistency with the valuation of the swaption underliers, as usually their valuation is based on a CCP discount curve, and, in the case of swaptions registered in CCPs, it would also ensure consistency with the compensation mechanism defined for cleared interest rate swaps.

A few respondents noted that the lack of a compensation scheme would erode market confidence and potentially reduce liquidity, while its existence would limit the market impact of the transition. In this regard, one respondent indicated that a distinction should be made between the older trades and the more recent ones, given that in the case of the former the discounting switch was unforeseeable. Finally, one respondent indicated that the discounting switch methodology will have a rather limited economic impact on the majority of swaptions based on the collateralised cash price methodology since it was only introduced in 2018.

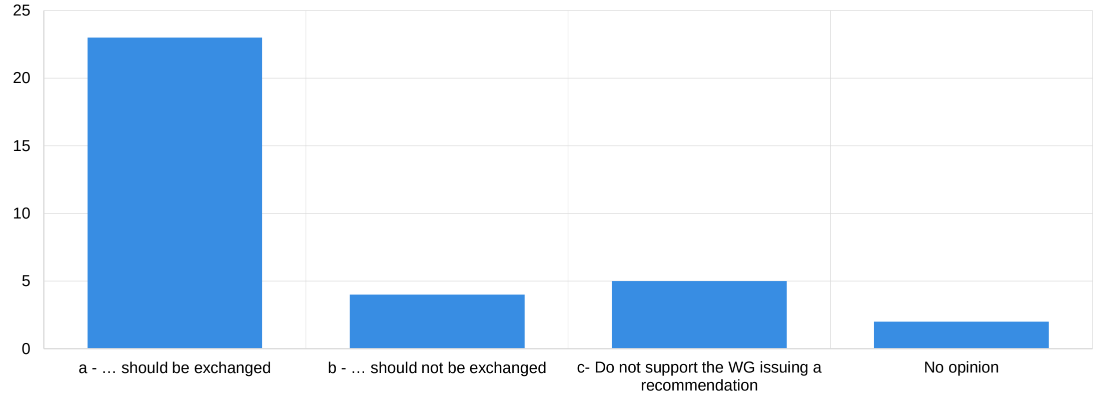
Five respondents were of the opinion that the working group should not issue a recommendation on the exchange of voluntary compensation (**option c**). They highlighted that the non-mandatory nature of the compensation scheme could result in adverse selection. In other words, affected parties would be able to exploit the scheme’s voluntary nature on a contract-by-contract or relationship-by-relationship basis where this is beneficial to them. One respondent noted that the potential benefits of the voluntary compensation mechanism should be weighed against significant implementation costs for the affected counterparties such as those relating to negotiation, system upgrades and third-party valuation of compensation.

Four respondents expressed their support for the working group recommending that voluntary compensation not be exchanged (**option b**). Respondents indicated that (i) it might create additional uncertainty, (ii) the market itself has been pricing trades under the assumption of a non-compensation scheme, (iii) its economic impact would be rather limited, and (iv) implementing the voluntary compensation exchange might prove to be operationally complex.

Finally, two respondents did not express an opinion.

Chart 3: Extent of support for the working group issuing a recommendation that voluntary compensation …

(April 2020; number of responses)



Source: ECB Secretariat to the working group on euro risk-free rates.

3 What timing should the working group recommend for such a compensation exchange?

Question 2 of the public consultation asked:

If the working group on euro risk-free rates recommended that voluntary compensation should be exchanged for legacy swaptions, would you support:

a) the working group on euro risk-free rates recommending that the compensation exchange apply to the entire relationship's portfolio but be calculated at the trade-level and at time of each swaption's expiry;

b) the working group on euro risk-free rates recommending that the compensation exchange take place at a pre-agreed date prior to 22 June 2020[5]*, with compensation exchange for each swaption at expiry acting as a backstop;*

c) the working group on euro risk-free rates not issuing a recommendation regarding the timing of the compensation exchange.

Please explain.

Half of the respondents (17 out of 34) were in favour of the working group recommending that voluntary compensation exchange take place at a pre-agreed date prior to the CCP discounting switch date[6], with compensation exchange for each swaption at expiry as a backstop. One-third of respondents (11 out of 34) prefer the voluntary compensation exchange to be calculated at trade level and at the time of each swaption's expiry.

The option of the working group recommending that the exchange of voluntary compensation take place at a pre-agreed date prior to the CCP discounting switch, with compensation exchange for each swaption at expiry acting as a backstop (**option b**), drew the most support from the respondents (17 out of 34). A few respondents noted that this approach is the cleanest and the easiest to implement from an operational standpoint while acknowledging that engaging all parties on a given date may prove challenging.

Respondents also emphasised that this one-time portfolio-level amendment approach would be coherent with approaches taken for other derivatives products and that a backstop in the form of a compensation exchange for each swaption at expiry would be sensible as some counterparties might not be able to follow this approach or might disagree on the value before expiry. One respondent,

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[5] This date was postponed from June to July: see EACH statement on the transition from EONIA to €STR discounting regime, 17 April 2020.

LCH Circular No 4052, 27 September 2019 and LCH Circular No 4088, 17 April 2020.

Eurex Clearing Circular 096/2019, 23 October 2019 and Eurex Clearing Circular No. 032/2020, 17 April 2020.

CME announcement, 31 January 2020 and CME announcement, 20 April 2020.

[6] See footnote 4.

however, considered that it would not be desirable to allow for the backstop in the form of a compensation exchange for each swaption at expiry.

Some respondents indicated that option b would reduce counterparty credit risk and prevent the chance of adverse selection and arbitrage. One additional respondent noted that if the P&L impact of the change in swaption valuation is not offset through compensation prior to the specified date, it would need to be cleared up through operational workarounds. Finally, one respondent mentioned that a tool should be available before the pre-agreed date to facilitate comparison of compensation calculations done by dealers.

The option of the working group recommending that the compensation exchange be applied to the entire relationship’s portfolio but calculated at trade level and at the time of each swaption expiry (**option a**) was supported by one-third of the respondents (11 out of 34).

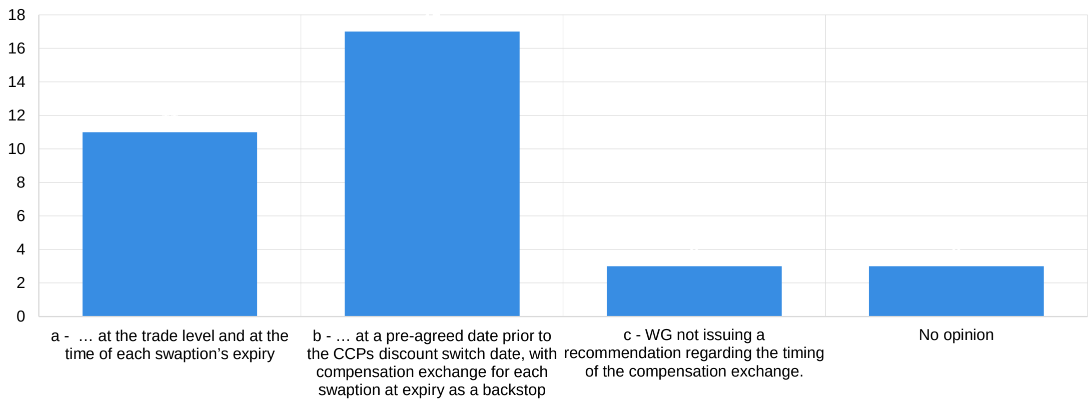
Some respondents noted that in practice counterparties might fail to agree on the compensation amount when valuing certain swaptions, making a one-time portfolio-level amendment difficult, and felt it would be easier to reach agreements with counterparties if option a was followed. In support of that view, a few respondents highlighted that owing to the crisis relating to the coronavirus (COVID-19) and the short period remaining until the CCP discounting switch date, it is unlikely that there will be time for the compensation to be exchanged prior to that date, which makes the compensation exchange calculated at trade level and at the time of each swaption’s expiry more appropriate. Finally, one respondent questioned the operational feasibility of calculating the compensation at the time of each swaption’s expiry, while another respondent noted this approach as the easiest to implement.

Three respondents expressed support for the working group not issuing a recommendation regarding the timing of the compensation exchange (**option c**) as this would allow firms to agree on the timing of any compensation exchange amongst themselves, depending on transaction specifics and operational ability.

Finally, three respondents did not express an opinion.

Chart 4: Extent of support for working group recommending that the compensation should be calculated and exchanged …

(April 2020; number of responses)



Source: ECB Secretariat to the working group on euro risk-free rates.

4 Which contracts should the working group recommend be covered by the voluntary compensation mechanism?

Question 3 of the public consultation asked:

If the working group on euro risk-free rates recommended that voluntary compensation should be exchanged for legacy swaptions, would you support:

a) *the working group on euro risk-free rates recommending that this only apply to swaptions traded prior to the date on which the working group on euro risk-free rates issues its recommendation (beginning of Q2 2020)*[7]*;*

b) *the working group on euro risk-free rates recommending that this only apply to swaptions traded prior to the effective date of the incoming ISDA amendments*[8]*;*

c) *the working group on euro risk-free rates recommending that this only apply to swaptions traded prior to the CCP announcements regarding their plans for the discounting switch and compensation mechanism (from September 2019 to January 2020)*[9]*;*

d) *the working group on euro risk-free rates recommending that this only apply to swaptions traded before the date on which the CCP will switch their discount rate from EONIA to the €STR* (from 19 to 22 June 2020)[10]*;*

e) *the working group on euro risk-free rates not issuing a recommendation regarding a cut-off trade date after which compensation would no longer be recommended.*

Please explain.

NB: If you selected C, which announcement date would you support for a given CCP, recognising that LCH, Eurex and CME released their final plans on different dates[11] *and each of them also released preliminary plans prior to that?*

The respondents had split views on which contracts should be covered by the voluntary compensation mechanism. One-third of the respondents (11 out of 34) supported the working group recommending that voluntary compensation exchange apply to swaptions traded prior to the effective date of the ISDA amendments. An equal number of respondents, i.e. another third of

7 Now expected in May 2020.

8 https://www.isda.org/2020/03/30/swaptions-agreed-discount-rate-supplement-to-the-2006-isda-definitions-published/

9 LCH and Eurex Clearing plans were updated on 17 April 2020: see LCH Circular No 4088 and Eurex Clearing Circular No. 032/2020. CME Clearing plans were updated on 20 April 2020: see CME announcement.

10 Now 27 July 2020.

11 27 September 2019 for LCH: LCH Circular No 4052.
23 October 2019 for Eurex: Eurex Clearing Circular 096/2019.
31 January 2020 for CME Group: CME announcement.

the respondents (11 out of 34), supported the voluntary compensation mechanism covering contracts that were traded before the date on which the CCP will switch their discount rate from EONIA to the €STR (now 27 July 2020). The remainder of the respondents that had an opinion (nine) were equally divided (three for each option) between favouring (i) the compensation mechanism applying to swaptions traded prior to the possible issuance of the recommendation of the working group (now expected in May 2020), (ii) the compensation mechanism applying to swaptions traded prior to the CCP announcements regarding their plans for the discounting switch and compensation mechanism (between September 2019 and January 2020), and (iii) the working group not issuing a recommendation regarding a cut-off trade date after which compensation would no longer be recommended.

One-third of the respondents (11 out of 34) supported a recommendation that voluntary compensation exchange apply only to legacy swaption contracts traded prior to the effective date of the ISDA amendments (30 March 2020) (option b). In terms of advantages of this approach, respondents noted that it would give clarity on the date of the shift as well as on the trades covered, and would impact swaption contracts in all currencies at the same time.

Respondents also highlighted that from the publication date of ISDA's amendments, the ISDA convention on the discounting curve for the underlying swap switched to the €STR, with all swaptions trades being priced accordingly; as such, only swaption trades executed before 30 March 2020 should be considered as legacy swaptions.

Furthermore, one respondent pointed out that firms may have already started considering the impact of the discounting switch from the time at which preliminary plans related to the discounting switch were announced by the respective CCPs, therefore incorporating their own assessment of the transition in the pricing of swaptions. Given that these plans evolved, the identification of a single, discrete and sufficiently communicated date such as 30 March 2020 may be in the interest of clarity.

In addition to this, one respondent emphasised that an "official" framework such ISDA's should be relied on instead of "private" actor decisions on the most appropriate date.

An equal number of respondents, i.e. another third (11 out of 34), supported that all contracts traded prior to the date of the CCP discount switch (now on 27 July 2020) be covered (**option d**).

A few respondents highlighted that neither choosing a date in the past nor opting for a date prior to the switch would prove appropriate; the former would go against current market pricing of options, while the latter would result in a binary legacy book. It was also noted that, in order to ensure valuation consistency between the swaption and its underlier, the compensation should be exchanged at the same time the rate switch at the clearing houses takes place. This way, the compensation amount could be calculated using the same discount curves as those used by CCPs, ensuring simplicity.

The following arguments were also mentioned in favour of option d: (i) it would simplify operational issues and reduce disputes while ensuring a uniform approach among trades, (ii) from an economic point of view the CCP discount switch is the only relevant date, and after the switch date there will no longer be ambiguities for new trades, and (iii) it would be the cleanest solution to implement. However, one respondent noted that the CCP discount switch date has been subject to uncertainty due to the adverse effects of market volatility in March and April.

The remainder of the respondents that had an opinion (nine) were equally divided between the rest of the options put forward for this question, with three respondents favouring each of the following scenarios:

(i) the compensation mechanism applying to swaptions traded prior to the possible issuance of the recommendation of the working group (**option a**) – cited as beginning of Q2 2020 in the question and now expected around May 2020;

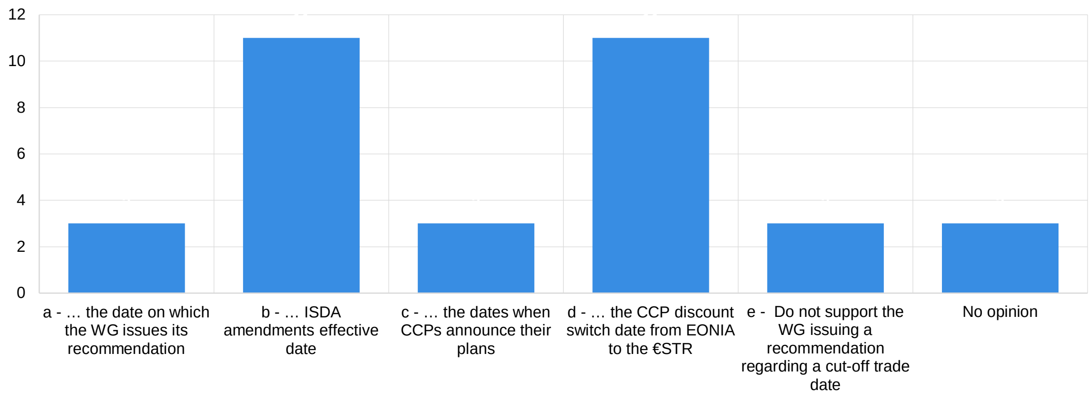
(ii) the compensation mechanism applying to swaptions traded prior to the CCP announcements regarding their plans for the discounting switch and compensation mechanism (**option c**). Respondents favoured this option because since the CCP announcements market participants have had the opportunity to agree bilaterally on the discount rate in their trade documentation in order to avoid issues connected with the rate switch. In support of this view, one respondent specified that the recommendation should not cover the period in-between the announcements made by the respective CCPs and the ISDA amendments publication on 30 March 2020, the latter being the absolute latest cut-off date any recommendation for compensation should specify; and

(iii) the working group not issuing a recommendation regarding a cut-off trade date after which compensation would no longer be recommended (**option e**), as, in the opinion of one of the respondents, having such a date would not simplify the process, and a mandatory compensation mechanism would be preferred to facilitate the transition.

Finally, three respondents did not express an opinion.

Chart 5: Extent of support for working group recommending that the compensation exchange should apply to swaptions traded prior to …

(April 2020; number of responses



Source: ECB Secretariat to the working group on euro risk-free rates.

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For most of the specific terminology, please refer to the ECB glossary.