



Recommendation by the working group on **euro risk-free rates**

On swaptions affected by the central clearing counterparties' discounting transition
from EONIA to the €STR

16 June 2020

Recommendation by the working group on euro risk-free rates on the legacy swaptions impacted by the Central Clearing Counterparties (CCPs) discounting transition to the €STR

The working group on euro risk-free rates (hereinafter “working group”) recommends that counterparties voluntarily exchange compensation for the legacy¹ swaption contracts affected by the central clearing counterparties (CCPs)’ discounting transition from EONIA to the €STR.

The working group also recommends that market participants contact their swaptions counterparties to determine whether they intend to consider voluntary compensation. Prompt action is recommended to: (a) avoid an extended period of uncertainty; (b) minimise any valuation difference; and (c) promote responsible risk management and market liquidity and resiliency.

The working group would also like to reiterate that its recommendations are voluntary and, as such, do not and cannot change the legal rights and obligations of any counterparty under an existing contract. Accordingly, any agreement between counterparties to make adjustments to their contracts or exchange compensation, whether based on the working group recommendations or not, would be strictly voluntary and nothing herein creates any legal obligation to do so.

The working group also acknowledges that the modalities of implementing voluntary compensation can vary, as already outlined in the public consultation on swaptions impacted by the CCP discounting transition to the €STR.² Market feedback collected during this consultation did not point to one single preferred modality for implementing voluntary compensation, which means a working group recommendation could not be established for such implementation modalities. The working group would nevertheless like to share some additional explanations relating to what appeared to be the most feasible and preferred options, so as to assist market participants in their own decisions. The next section seeks to clarify these issues.

¹ Legacy swaptions should be understood in the context of Chapter 3 of the [Public consultation by the working group on euro risk-free rates on swaptions impacted by the discounting transition from EONIA to the €STR](#).

² *ibid.*

In addition to the previous recommendation, the working group would like to provide some further clarifications to support market participants wanting to agree on the exchange of voluntary compensation:

Background

The explanations below are based on the feedback received in relation to the public consultation on swaptions impacted by the discounting transition from EONIA to the €STR.³ The main messages from respondents who provided feedback can be summarised as follows.

- 1) The respondents broadly supported (23 out of 34⁴) 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 date¹, 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.

Feasible options for the timing and methodology of voluntary compensation:

There was no clear-cut consensus in the feedback received on question 2 of the public consultation⁵. On this specific point, the working group considers that the following options⁶ to establish a voluntary compensation scheme could be the most feasible:

- 1) A single-date cash compensation⁷:
 - This compensation option represents a straightforward compensation mechanism relying on both counterparties agreeing on the cash compensation amount.

³ See [Summary of responses to the public consultation on swaptions impacted by the CCP discounting transition from EONIA to the €STR](#).

⁴ Responses to the public consultation provided sufficient geographic coverage and included representation of the buy-side market. Please see Charts 1 and 2 of the [summary of responses](#).

⁵ 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, 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."

⁶ NB: For all these options, the calculations would first be applied to trade level and then aggregated to achieve a portfolio-level compensation exchange. Options 1 and 2 would be accompanied by a compensation exchange at expiry acting as a backstop.

⁷ Corresponds to option b) of question 2 of the [public consultation](#).

- Market participants could amend the discounting assumptions either in MarkitWire or in bilateral confirmations.
- 2) A single-date notional/strike adjustment⁸:
- In order to achieve the compensation exchange, the notional and the strike of each swaption would be adjusted independently of the volatility assumptions that reflect the move from EONIA to the €STR.
 - Market participants could amend the notional, the strike and the discounting flag of each swaption either in MarkitWire or in bilateral confirmations.
 - This option could be facilitated by a third-party provider and would also allow for bulk updates for entire portfolios, potentially reducing the manual effort.
- 3) A cash compensation at the expiry date of the swaps⁹:
- This would be a simple option because the calculation of the compensation exchange would not need to take into account the volatility of its underlying swap, i.e. at expiry date the value of the option is the intrinsic value of the swap.
 - CCPs may be able to facilitate the discounting rate shift calculation.
 - This solution could extend far into the future, depending on expiry dates of individual swaptions.

The working group also acknowledges that some market participants may not see these three options as the best, and takes note that other bilateral arrangements may also be possible.¹⁰

Possible population of legacy swaptions contracts to consider for voluntary compensation:

Based on the feedback provided in the consultation, and in the absence of a consensus around one date, the following key dates could determine the relevant swaption contract population:

- a) the date on which this recommendation is published (16 June 2020);
- b) the go-live date of International Swaps and Derivatives Association (ISDA) Supplement 64 to the 2006 ISDA Definitions published on 30 March 2020;¹¹
- c) The date on which the CCPs announced the discounting switch date (from September 2019 to January 2020 for each CCP respectively);
- d) The CCP discounting switch date (27 July 2020).¹²

⁸ Corresponds to option b) of question 2 of the [public consultation](#).

⁹ Corresponds to option a) of question 2 of the [public consultation](#).

¹⁰ For example, one minority view considered that the only method viable would be to re-stamp in-scope trades as EONIA in MarkitWire, as per ISDA Supplement 64, to achieve the correct risk and price valuation.

¹¹ See ISDA announcement of the "[Agreed Discount rate](#)" [supplement to the 2006 ISDA definitions](#), 30 March 2020.

NB: The supplement issued by ISDA provided the possibility for market participants to "[...] address the change of discounting rate/PAI at various clearing houses from EONIA to €STR [...]".

© European Central Bank, 2020

Postal address 60640 Frankfurt am Main, Germany

Telephone +49 69 1344 0

Website www.ecb.europa.eu

All rights reserved. Reproduction for educational and non-commercial purposes is permitted provided that the source is acknowledged.

The European Central Bank (ECB) provides the secretariat for the working group on euro risk-free rates and is publishing the report solely in this capacity. The ECB does not however accept any responsibility or liability for the contents of the document and the fact that the ECB provides the secretariat for the working group should not be taken as implying in any way that it shares the views expressed in the document.

For most of the specific terminology, please refer to the [ECB glossary](#).

¹² NB: At the time of the publication of the public consultation, this date was set around 22 June 2020.