

Swaptions: “Agreed Discount Rate” Supplement to the 2006 ISDA Definitions Published

Supplement 64 to the 2006 ISDA Definitions was published on March 30th, 2020 to allow parties to specify a discount rate in Swaption confirmations for which “Cleared Physical Settlement” is applicable or “Cash Settlement” is applicable where “Collateralized Cash Price” is specified as the applicable Cash Settlement Method. The ISDA Collateral Cash Price Matrix was also updated on March 30th, 2020 to align the discount rates specified with expected changes in the discount rates used by clearinghouses for euro and US dollar.

A summary of Supplement 64 and updated Matrix is provided below:

A. Supplement 64 to 2006 ISDA Definitions to add Agreed Discount Rate

The main purpose of this Supplement is to address the change of discounting rate/PAI at various clearing houses from EONIA to €STR and from FedFunds to SOFR that will take place later this year. This change of CCP discounting rate impacts the value of certain swaptions. Please refer to the memorandum produced by ISDA entitled “[Outline of \(i\) the settlement of certain swaptions and \(ii\) the issues which arise from the proposed adjustment to discounting by certain clearinghouses](#)” for further information on the swaptions that are potentially impacted by this change.

Supplement 64 addresses this by introducing the concept of an ‘**Agreed Discount Rate**’ coupled with an obligation, for certain swaptions, to provide compensation if such Agreed Discount Rate differs from the discounting rate/PAI of a specified CCP (as further described below). This new Confirmation field can be populated for any Swaption that applies ‘Cleared Physical Settlement’, or ‘Cash Settlement – Collateralized Cash Price’, OR for any transaction that includes an Optional Early Termination right (OET) or Mandatory Early Termination (MET) and applies ‘Cash Settlement – Collateralized Cash Price’.

THE SUPPLEMENT WILL ONLY APPLY TO TRANSACTIONS WITH A TRADE DATE ON OR AFTER 30 MARCH 2020. IT WILL NOT APPLY TO LEGACY TRANSACTIONS UNLESS THE PARTIES AMEND THOSE TRANSACTIONS TO APPLY THIS SUPPLEMENT.

1. Swaptions specifying ‘Cleared Physical Settlement’

1.1. Scenario 1: parties specify both a Mutually Agreed Clearinghouse and an Agreed Discount Rate

In respect of a Swaption that applies Cleared Physical Settlement, in order to benefit from the compensation mechanism provided for in Supplement 64, the parties need to specify in the Confirmation both a ‘Mutually Agreed Clearinghouse’ and an ‘Agreed Discount Rate’.

If, at the time of exercise of the Swaption, the Agreed Discount Rate differs from the discounting rate/PAI applied by the specified Mutually Agreed Clearinghouse at that time, there is an obligation on the parties to agree a compensation amount to reflect the value change in the underlying swap transaction from the value that such swap transaction would have had if discounting/PAI had been at the Agreed Discount Rate.

If the parties are unable to agree the compensation amount by the date on which the underlying swap transaction is due to be cleared, then the parties fallback to Cash Settlement using Collateralized Cash Price Cash Settlement Method and using the Agreed Discount Rate to derive the discount factors used to calculate the net present value of the underlying swap transaction. No compensation is payable in this case as the parties have valued the transaction using the Agreed Discount Rate and not the discounting rate of the Mutually Agreed Clearinghouse. Either party can however elect to apply an Adjustment Amount to the Settlement Rate to account for a second order effect of the change in the Settlement Rate if the Mutually Agreed Clearinghouse discount rate/PAI were the Agreed Discount Rate.

1.2. Scenario 2: parties specify an Agreed Discount Rate but not a Mutually Agreed Clearinghouse

In respect of a Swaption that applies Cleared Physical Settlement, the parties could just specify an ‘Agreed Discount Rate’ without specifying a ‘Mutually Agreed Clearinghouse’ (although this is not expected to be market practice).

In this case, the parties need to agree on the clearinghouse at the time of exercise of the Swaption. If they can agree, the underlying swap transaction will be cleared through the agreed clearinghouse. There is no obligation for the parties to agree to a clearinghouse that discounts/pays PAI at the Agreed Discount Rate. If the parties agree on a clearing house that discounts/pays PAI at a rate that differs from the Agreed Discount Rate there is **no** obligation to agree a compensation amount. This is because the parties did not agree the Mutually Agreed Clearinghouse upfront and are not therefore obliged to clear through a clearing house that discounts/pays PAI at a rate that is different from the Agreed Discount Rate.

If the parties cannot agree on a clearinghouse (which would likely be the case if the discounting rate of the clearinghouses differs from the Agreed Discount Rate), the parties fallback to Cash Settlement using the Collateralized Cash Price Cash Settlement Method and using the Agreed Discount Rate to calculate the Cash Settlement Amount. Again, no compensation is payable in this case. There is no option to apply an Adjustment Amount as this only applies if the parties have specified a Mutually Agreed Clearinghouse.

1.3. Scenario 3: parties specify a Mutually Agreed Clearinghouse but do not specify an Agreed Discount Rate

On exercise the parties will enter into the underlying swap transaction and clear it through the Mutually Agreed Clearinghouse. No compensation is payable because no Agreed Discount Rate was specified.

This position is the same as under the current supplemented 2006 ISDA Definitions (implemented via Supplement 58) where parties specify a Mutually Agreed Clearinghouse.

1.4. Scenario 4: parties specify neither an Agreed Discount Rate nor a Mutually Agreed Clearinghouse

On exercise, the position is as per scenario 2, i.e. the parties need to agree on the clearinghouse at the time of exercise and, failing agreement, fallback to cash settlement. However, if the fallback to Cash Settlement – Collateralized Cash Price applies, the net present value will be determined using the Discount Rate in the Collateral Cash Price Matrix. See below for more information on the updated Collateral Cash Price Matrix.

This position is the same as under the current supplemented 2006 ISDA Definitions.

2. Swaptions specifying Cash Settlement and Collateralized Cash Price

2.1. Scenario 1: parties specify both a Mutually Agreed Clearinghouse and an Agreed Discount Rate

In respect of a Swaption that applies Cash Settlement and applies Collateralized Cash Price as the Cash Settlement Method, the parties can specify a Mutually Agreed Clearinghouse and an Agreed Discount Rate in the Confirmation. In this case,

- i. If, as at the time of exercise, the Agreed Discount Rate is the same as the interest rate benchmark used by the Mutually Agreed Clearinghouse, the parties use the discount factors of the Mutually Agreed Clearinghouse to calculate the present value for the purposes of Collateralized Cash Price.
- ii. If, as at the time of exercise, the Agreed Discount Rate is not the same as the interest rate benchmark used by the Mutually Agreed Clearinghouse,
 - a. the parties use the Agreed Discount Rate to calculate the present value for the purposes of Collateralized Cash Price; AND
 - b. either party can elect to apply an Adjustment Amount to the Settlement Rate to account for a second order effect of the change in the Settlement Rate if the Mutually Agreed Clearinghouse discount rate/PAI were the Agreed Discount Rate.

No compensation is payable in this instance as the parties have used the Agreed Discount Rate to calculate the net present value and, if necessary, applied an Adjustment Amount to the Settlement Rate – the compensation mechanism described above under Cleared Physical Settlement has no application to a cash settled Swaption.

2.2. Scenario 2 : parties specify an Agreed Discount Rate but do not specify a Mutually Agreed Clearinghouse

In respect of a Swaption that applies Cash Settlement and applies Collateralized Cash Price as the Cash Settlement Method, the parties can specify an Agreed Discount Rate without specifying a Mutually Agreed Clearinghouse.

In this case, on exercise, the parties use the Agreed Discount Rate to calculate the present value for the purposes of Collateralized Cash Price.

There is no option to apply an Adjustment Amount as this only applies if the parties have specified a Mutually Agreed Clearinghouse.

2.3. Scenario 3: parties specify a Mutually Agreed Clearinghouse but do not specify an Agreed Discount Rate

In respect of a Swaption that applies Cash Settlement and applies Collateralized Cash Price as the Cash Settlement Method, the parties can specify a Mutually Agreed Clearinghouse in the Confirmation without having to specify an Agreed Discount Rate.

In this case, on exercise, the parties use the discount factors of the Mutually Agreed Clearinghouse to calculate the present value for the purposes of Collateralized Cash Price, irrespective of whether the underlying interest rate benchmark used for discounting by the Mutually Agreed Clearinghouse has changed since the Trade Date.

This position is the same as under the current supplemented 2006 ISDA Definitions (implemented via Supplement 58) where parties specify a Mutually Agreed Clearinghouse.

2.4. Scenario 4: parties specify neither an Agreed Discount Rate nor a Mutually Agreed Clearinghouse

If the parties have specified neither an Agreed Discount Rate nor a Mutually Agreed Clearinghouse, the Discount Rate specified in the Collateral Cash Price Matrix for the relevant currency will apply for the purpose of determining the present value. See below for further information on application of the updated Collateral Cash Price Matrix.

This position is the same as under the current supplemented 2006 ISDA Definitions where parties do not specify a Mutually Agreed Clearinghouse.

3. Transactions applying OET or MET and specifying Cash Settlement - Collateralized Cash Price

The position for these Transactions is the same as described above under B. ‘Swaptions specifying Cash Settlement and Collateralized Cash Price’, except that Mutually Agreed Clearinghouse is not applicable and valuation is by reference to the Optional Early Termination Date (**OET Date**) or Mandatory Early Termination Date (**MET Date**), as applicable, and not the Exercise Date.

B. Updated ISDA Collateral Cash Price Matrix

The ISDA Collateral Cash Price Matrix (the **Matrix**) has been updated and bifurcated, to provide for:

1. discounting at EONIA/FedFunds prior to the date on which the CCPs switch to discounting/PAI at €STR/SOFR; and
2. discounting at €STR/SOFR after the date on which the CCPs switch to discounting/PAI at €STR/SOFR.

As described above, the Matrix only applies when:

- A. the parties are cash settling a Swaption or Transaction that applies OET/MET, where Collateralized Cash Price applies as a fallback or because it is specified in the Confirmation as the Cash Settlement Method, AND
- B. the fallback to the Discount Rate in the Matrix applies because the parties have not specified either a Mutually Agreed Clearinghouse (for Swaptions) or an Agreed Discount Rate (Swaptions or a Transaction with OET/MET).

1. Swaptions

For **swaptions**, the ‘switch’ from EONIA/FedFunds to €STR/SOFR is by reference to the Expiration Date of the Swaption.

- A EUR Swaption with an Expiration Date on or prior to the EUR CCP Transition Date (expected to be 19 June 2020) will discount at EONIA.
- A EUR Swaption with an Expiration Date after the EUR CCP Transition Date will discount at €STR.
- A USD Swaption with an Expiration Date on or prior to the USD CCP Transition Date (expected to be 16 October 2020) will discount at FedFunds.
- A USD Swaption with an Expiration Date after the USD CCP Transition Date will discount at SOFR.

2. OET/MET

For Transactions applying **OET or MET**, the ‘switch’ from EONIA/FedFunds to €STR/SOFR is by reference to the Optional Early Termination Date (**OET Date**)/Mandatory Early Termination Date (**MET Date**).

- A EUR swap Transaction applying OET/MET with an OET/MET Date on or prior to the EUR CCP Transition Date (expected to be 19 June 2020) will discount at EONIA.
- A EUR swap Transaction applying OET/MET with an OET/MET Date after the EUR CCP Transition Date will discount at €STR.
- A USD swap Transaction applying OET/MET with an OET/MET Date on or prior to the USD CCP Transition Date (expected to be 16 October 2020) will discount at FedFunds.
- A USD swap Transaction applying OET/MET with an OET/MET Date after the USD CCP Transition Date will discount at SOFR

THE ABOVE APPLIES TO ALL SWAPTIONS AND TRANSACTIONS TRADED ON OR AFTER 30 MARCH 2020.

3. Definitions of the Discount Rates

The Matrix has also been updated to include definitions for the Discount Rates that appear in the Matrix (previously these were not defined). These definitions have been matched to the equivalent definitions of the relevant overnight rates where they appear in Floating Rates Options in the 2006 ISDA Definitions.

4. Benchmark Supplement Fallbacks

The Matrix also provides that the ‘Discount Rate’ is a Relevant Benchmark for the purposes of the ISDA Benchmarks Supplement. This enables fallbacks to be determined in accordance with the ISDA Benchmarks Supplement for the Discount Rate if any such rate is discontinued. Note that:

- the Benchmarks Supplement will only apply if the parties have applied the Benchmarks Supplement to their Transaction (either by both parties adhering to the Benchmarks Supplement Protocol or by otherwise applying the Benchmarks Supplement through their ISDA Master Agreement or Confirmation for the Transaction). It will not otherwise be applicable.
- The Benchmarks Supplement fallbacks will not be needed for EONIA as a Discount Rate because of the way that the ‘switch’ to €STR operates (see above). After the CCP Transition Date no Transactions would be using EONIA as the Discount Rate in this version of the Matrix.