Supplement number 75 to the 2006 ISDA Definitions (Compounding/Averaging Supplement) FAQs

ISDA has prepared this list of frequently asked questions ("**FAQs**") to assist in your consideration of Supplement number 75 to the 2006 ISDA Definitions (the "**Compounding/Averaging Supplement**"). Capitalized terms used in these FAQs have the meanings given to them in the Compounding/Averaging Supplement or the 2006 ISDA Definitions (the "**2006 Definitions**").

THESE FREQUENTLY ASKED QUESTIONS DO NOT PURPORT TO BE AND SHOULD NOT BE CONSIDERED A GUIDE TO, OR AN EXPLANATION OF, ALL RELEVANT ISSUES OR CONSIDERATIONS IN CONNECTION WITH THE COMPOUNDING/AVERAGING SUPPLEMENT. PARTIES SHOULD CONSULT WITH THEIR LEGAL ADVISERS AND ANY OTHER ADVISER THEY DEEM APPROPRIATE PRIOR TO USING OR INCORPORATING THE COMPOUNDING/AVERAGING SUPPLEMENT. ISDA ASSUMES NO RESPONSIBILITY FOR ANY USE TO WHICH ANY OF ITS DOCUMENTATION OR OTHER DOCUMENTATION MAY BE PUT.

Introduction

The Compounding/Averaging Supplement enables market participants to document a compounded or averaged rate using Floating Rate Options ("**FROs**") for overnight rates.[1] In tandem with the publication of the Compounding/Averaging Supplement, ISDA also published additional FROs for overnight risk-free rates ("**RFRs**") (published in Supplement number 74 to the 2006 Definitions (the "**RFR Supplement**")). Use of the provisions in the Compounding/Averaging Supplement is not, however, limited to the FROs in the RFR Supplement.

Questions and Answers

The next section sets out questions and answers that are designed to explain the basic operation and application of the Compounding/Averaging Supplement.

1 Why was the Compounding/Averaging Supplement published?

The 2006 Definitions have for some time facilitated the transacting of Overnight Index Swaps ("**OIS**") through the inclusion of FROs such as GBP-SONIA-COMPOUND and USD-SOFR-COMPOUND where the OIS compounding formula forms part of the FROs ("**Self-Compounding FROs**"). One feature of the Self-Compounding FROs is that the compounding takes place during the entirety of the Calculation Period. Given this, it is not uncommon for 'Delayed Payment' to be specified in order to build in a window between the end of the Calculation Period and the Payment Date, allowing time to calculate the rate and make the necessary payment.

However, the preference in the cash markets has been for the payment date to be aligned with the last date of the interest period for the relevant cash product. In order to achieve this, different compounding conventions have emerged, each of which effectively creates a lag between the determination of the rate for the last fixing and the payment date which falls at the end of the interest period.

Therefore, in addition to OIS compounding, the Compounding/Averaging Supplement introduces a modular approach in order to enable parties to adopt the compounding and

[1] The provisions of the Compounding/Averaging Supplement are also included in the 2021 ISDA Interest Rate Derivatives Definitions. The information in these FAQs apply to use of the provisions under those definitions as well.

averaging approaches commonly seen in the cash markets, namely 'lookback', 'observation period shift' and 'lockout'. By default, the length of the lag created by 'lookback', 'observation period shift' and 'lockout' is currently five business days, as determined by reference to the relevant financial center for the overnight rate ("**Applicable Business Days**"), but that default could change if and when standard conventions emerge for the relevant overnight rate (please see Question 8 (*How are the new approaches* reflected in Confirmations?) for further detail). Additionally, parties always have the ability to specify a different length for any applicable lag.

2 What is a Lookback?

Under the lookback approach, the rate for each Business Day in a Calculation Period is determined on the basis of the rate observed for a certain number of Business Days prior to such date (the "**Lookback**"). For each day during the Calculation Period, the rate will therefore be the rate published the Lookback number of Business Days earlier. This allows for all fixings to be known before the Payment Date.

The weighting[2] to be given to the observed rate in the compounding/averaging formula depends on whether or not the day in the Calculation Period for which the rate is being observed (rather than the day which is the Lookback number of Business Days beforehand) is or is not a Business Day. For example, if a day in the Calculation Period is a public holiday, the rate applicable to the previous day in the Calculation Period would be given a weighting of 2, even though the rate being observed for that previous day once the Lookback is applied may not have been given a weighting of 2 in a Calculation Period without a Lookback.

3 What is an Observation Period Shift?

Under the observation period shift approach, the Floating Rate for a Calculation Period is determined using rates observed during an 'Observation Period' for which both the start and end dates are shifted by a certain number of days relative to the Calculation Period. The rates for each day in the Observation Period will be compounded/averaged in order to determine the Floating Rate that applies to the relevant Calculation Period.

Under the observation period shift approach, both the rate and the weighting are determined on the basis of the relevant day in the Observation Period, rather than on the basis of the relevant day in the Calculation Period (as is the case with Lookback). The weightings of the observed rates in the compounding/averaging formula will therefore be determined on the basis of the Business Days in the Observation Period, which may differ from the Business Days in the Calculation Period. As a result, rates in the Observation Period are given the same weighting that they would have been given if they were also observed in the Calculation Period. However, the Floating Rate will be annualized and apply based on the number of days in the Calculation Period, using the day count basis applicable to the relevant overnight rate.

4 What is a Lockout?

Under the lockout approach, the parties designate a certain period prior to the Period End Date as the "**Lockout Period**". The rate is observed for every day during the Calculation

[2] A 'weighting' refers to the effect of non-business days and public holidays on the rates included in the compounding/averaging formula. On a non-business day (e.g. a Thursday public holiday) where no rate is published, the rate of the immediately preceding business day (e.g. the preceding Wednesday) will have a weighting of an additional business day.

Period and the first day of the Lockout Period and then fixed at the rate observed on the first day of the Lockout Period for each of the remaining days of the Lockout Period. Under this approach, the weighting to be given to the rate is determined by reference to each day in the Calculation Period, including during the Lockout Period, and there is no change to the weighting during the Lockout Period (although those weightings are applied to the rate that has been fixed as of the first day of the Lockout Period instead of the rates that they would have been applied to for a standard Calculation Period without a Lockout Period).

5 What is OIS compounding?

Under the OIS compounding approach, rates are observed for each day during the Calculation Period and the Floating Rate Payer Payment Date generally falls a specified number of Business Days after the end of the Calculation Period (although this does not have to be the case). As a result, the rate for each day in the Calculation Period is based on the rate observed for that day in the Calculation Period. Under this approach, the weighting to be given to the rate is determined by reference to each day in the Calculation Period. This is substantively the same as the existing approach in a standard OIS that references one of the Self-Compounding FROs.

6 What are the averaging provisions?

The Compounding/Averaging Supplement provides for various averaging approaches, all of which apply arithmetic averaging (i.e. taking the sum of the rates and dividing by the number of days in the relevant period) as opposed to compounded averaging. For all averaging approaches (overnight averaging, averaging with lookback, averaging with observation period shift and averaging with lockout), a rate for a non-Business Day would be the rate applicable to the immediately preceding Business Day (for example, the rate for Saturday and Sunday would be the rate applicable to Friday).

7 How can I provide for a daily cap and/or floor?

All of the compounding/averaging approaches (and corresponding template Confirmations) in the Compounding/Averaging Supplement include the ability to cap and/or floor the daily observed rate by including a "Daily Capped Rate" and/or a "Daily Floored Rate" in the Confirmation. In order to use this feature "Daily Capped Rate and/or Daily Floored Rate" must be specified as 'applicable' in the Confirmation together with the applicable "Daily Capped Rate" and/or "Daily Floored Rate". If a Daily Capped Rate is specified, the rate observed for each applicable day within the relevant Calculation Period will be the lower of the observed rate and the Daily Capped Rate. If a Daily Floored Rate is specified, the rate observed for each applicable day within the relevant Calculation Period will be the greater of the observed rate and the Daily Floored Rate. Any value (positive, negative or zero) can be specified as the Daily Capped Rate or Daily Floored Rate and it is possible to have both a cap and a floor.

8 What is the modular approach?

Market participants need the flexibility to construct compounded or averaged floating rates in a broad range of conventions and specifications. For example, one market participant may wish to produce a compounded in arrears SONIA rate with a 3 day lookback determined using London Business Days whereas another may wish to construct a compounded in arrears SOFR rate with a 5 day observation period shift using New York and Toronto

Business Days and a daily floor. Producing a separate set of terms for every possible eventuality is unworkable.

However, the modular approach allows for the same outcome by providing the building blocks market participants need to apply a particular compounding or averaging approach to a specified overnight floating rate by making appropriate elections in their Confirmation. The Compounding/Averaging Supplement adds new Exhibits to the 2006 Definitions, which introduce the new Confirmation fields necessary to apply the modular approach. Please see Question 12 (*How are the new approaches reflected in Confirmations?*) for further detail.

Additionally, the 2006 ISDA Definitions Matrix for use with the Overnight Rate Compounding Methods, Overnight Rate Averaging Methods and Index Methods (the "**Compounding/Averaging Matrix**") sets out default positions for rounding and the length of any Observation Period Shift, Lookback and Lockout, by reference to various FROs. The default lengths in the Compounding/Averaging Matrix would apply unless the parties negotiate a different length for any applicable Observation Period Shift, Loookback or Lockout. Version 1 of the Compounding/Averaging Matrix does not include any defaults for the length of any Observation Period Shift, Lookback and Lockout given the lack of market consensus to date. However, later versions of the Compounding/Averaging Matrix are expected to include these defaults if sufficient market uniformity develops. Until the time that any such later versions are published with a default for the relevant FRO, the default position for the length of a Lookback, Lockout or Observation Period Shift that will apply for each FRO if counterparties do not specify a different length will be five Business Days (as noted above).

9 How does the Compounding/Averaging Supplement interact with the existing Self-Compounding FROs and Self-Averaging FROs in the 2006 Definitions?

The new approaches in the Compounding/Averaging Supplement sit alongside the existing Self-Compounding FROs. This means that if market participants wish to document a transaction with OIS compounding, then they can choose to use either the Self-Compounding FROs or the OIS compounding approach in the Compounding/Averaging Supplement. However, there are some differences to be aware of:

- the Self-Compounding FROs are limited to the rates set out in those Self-Compounding FROs; whereas the overnight rates that can be used as part of the modular approach under the Compounding/Averaging Supplement include any rate for which ISDA has published an overnight FRO, including but not limited to the RFRs in the RFR Supplement;
- the approach in the Compounding/Averaging Supplement allows for the selection of a daily floor and/or cap, which is not possible under the Self-Compounding FROs;
- as the OIS compounding formula forms part of the Self-Compounding FROs, these should not be used with the Lookback, Lockout or Observation Period Shift compounding approaches in the Compounding/Averaging Supplement. If the option to apply a daily cap/floor is not required and the parties' desired currency and rate are set out in an existing Self-Compounding FRO, parties can simply refer to the Self-Compounding FRO per the existing approach in the 2006 Definitions for OIS compounding without a Lookback, Lockout or Observation Shift;
- Central clearing counterparties ("**CCPs**") that clear OIS and trading platforms that offer them for trading are expected to continue using the Self-Compounding FROs for

standard OIS. It is possible that these CCPs and trading platforms could offer the OIS compounding approach in the Compounding/Averaging Supplement as well at a future date but these conventions are not expected to replace the existing Self-Compounding FROs for standard cleared OIS.

Similarly to the Self-Compounding FROs, there are existing self-averaging FROs in the 2006 Definitions where the averaging formula forms part of the relevant FRO (the "**Self-Averaging FROs**"). These Self-Averaging FROs also should not be used in conjunction with the Lookback, Lockout or Observation Period Shift averaging approaches in the Compounding/Averaging Supplement. Instead, overnight averaging and an overnight rate can be used to document a transaction linked to an averaged rate if a Lookback, Lockout or Observation Period Shift and/or a daily floor/cap is desired. Alternatively, if the option to apply a daily cap/floor is not required and the parties' desired currency and rate are set out in an existing Self-Averaging FRO, parties can simply refer to the Self-Averaging FRO per the existing approach in the 2006 Definitions (without a Lookback, Lockout or Observation Shift).

10 What is Set-in-Advance? How do the Set-in-Advance provisions interact with stub periods?

If parties wish to know the Floating Rate in advance of the Calculation Period they can apply 'Set-in-Advance'. This feature can be used in conjunction with the 'Compounding with Observation Period Shift' and 'Averaging with Observation Period Shift' approaches. Parties can also specify a number of Business Days for the Observation Period Shift in order to effectively set the Floating Rate that number of Business Days prior to the start of the Calculation Period.

One complexity arises when Set-in-Advance interacts with Calculation Periods that are stub periods. The expectation is that any stub period is likely to be in the first or last Calculation Period. To address these stubs, the Compounding/Averaging Supplement includes provisions to ensure that the observation period for a final stub period starts by reference to a 'regular Calculation Period' immediately prior to the final stub period. The observation period for an initial stub period starts by reference to a 'regular Calculation Period' immediately prior to the observation period for the first regular Calculation Period.

11 How does the Compounding/Averaging Supplement interact with the indices and averages published for certain RFRs?

Although the Compounding/Averaging Supplement enables market participants to, in conjunction with the relevant RFR FRO, produce a compounded/averaged rate for a Calculation Period, this is distinct from compounded indices and averages that are otherwise published or to be published. ISDA has published/will publish FROs for a number of published compounded indices (such as GBP-SONIA Compounded Index and USD-SOFR Compounded Index) and averages (such as USD-SOFR Average 30D and EUR-EuroSTR Average 90D). None of these should be used with any of the approaches in the Compounding/Averaging Supplement.

The FROs for published indices will need to be used in conjunction with an index formula and ISDA has published index compounding provisions (in Supplement 76 to the 2006 Definitions) for this purpose.

12 How are the new approaches reflected in Confirmations?

The Compounding/Averaging Supplement adds four template Confirmations to the 2006 Definitions (Exhibits IV-A, IV-B, IV-C and IV-D), as follows:

(i) Exhibit IV-A: Compounding/Averaging with Lookback;

(ii) Exhibit IV-B: Compounding/Averaging with Observation Period Shift;

(iii) Exhibit IV-C: Compounding/Averaging with Lockout; and

(iv) Exhibit IV-D: OIS Compounding/Overnight Averaging with optional Payment Delay.

13 What are the new fields for Lookback, and what are the applicable default provisions?

In addition to the new fields introduced for daily caps and/or floors (please see Question 17 (*What are the new fields for daily cap and/or floor, and what are the applicable default provisions?*) for further details), the new fields for Lookback included in Exhibit IV-A (*Compounding/Averaging with Lookback*) are:

Name of Field	Election	Commentary on election
[Compounding:	[Compounding with Lookback] [Not Applicable]]	This field can be deleted or specified as Not Applicable when Averaging applies.
[Averaging:	[Averaging with Lookback][Not Applicable]	This field can be deleted or specified as Not Applicable when Compounding applies.
[Lookback:]	[[ ] Applicable Business Days]	This is an optional field, allowing parties to specify the number of Business Days' Lookback being applied. This field can be deleted if the number specified as the "Lookback" for the relevant FRO in the Compounding/Averaging Matrix is to apply. If no such number is specified in the Compounding/Averaging Matrix and the field is not populated, the default position of five Applicable Business Days is to apply.

14 What are the new fields for Observation Period Shift, and what are the applicable default provisions?

In addition to the new fields introduced for daily caps and/or floors (please see Question 17 (*What are the new fields for daily cap and/or floor, and what are the applicable default provisions?*) for further details), the new fields for Observation Period Shift included in Exhibit IV-B (*Compounding/Averaging with Observation Period Shift*) are:

Name of Field	Election	Commentary on election
[Compounding:	[Compounding with Observation Period Shift] [Not Applicable]]	This field can be deleted or specified as Not Applicable when Averaging applies.
[Averaging:	[Averaging with Observation Period Shift][Not Applicable]	This field can be deleted or specified as Not Applicable when Compounding applies.
[Set-in-Advance:	[Applicable][Not Applicable]	This field is optional and can be deleted or specified as Not Applicable if Set-in Advance is not applicable. The default position is that Set-in-Advance is not applicable.
[Observation Period Shift:	[[ ] Observation Period Shift Business Days]	This field is optional, and allows parties to specify the number of Observation Period Shift Business Days shift being applied. This field can be deleted if the number specified as the "Observation Period Shift" for the relevant FRO in the Compounding/Averaging Matrix is to apply. If no such number is specified in the Compounding/Averaging Matrix and the field is not populated, the default position of five Observation Period Shift Business Days is to apply. If Set-in-Advance is applicable and the rate is to be determined as at the Reset Date, the Observation Period Shift should be specified as zero (or left blank). If the rate is to be determined as at a number of Business Days prior to the Reset Date, then the relevant number of Business Days should be specified here in addition to applying Set-in-Advance.

Name of Field	Election	Commentary on election
[Observation Period Shift Additional Business Days:]	[[ ] [Not Applicable]]	If the Applicable Business Days for Observation Period Shift is to be only by reference to the relevant financial center for the overnight rate, this field can be deleted or specified as Not Applicable. If parties wish to specify the financial center(s) that will apply for the purposes of the observation shift (Observation Period Shift Additional Business Days) in addition to the Applicable Business Days, these additional financial centres can be listed in this field.

15 What are the new fields for Lockout, and what are the applicable default provisions?

In addition to the new fields introduced for daily caps and/or floors (please see Question 17 (*What are the new fields for daily cap and/or floor, and what are the applicable default provisions?*) for further details), the new fields for Lockout included in Exhibit IV-C (*Compounding/Averaging with Lockout*) are:

Name of Field	Election	Commentary on election
[Compounding:	[Compounding with Lockout] [Not Applicable]]	This field can be deleted or specified as Not Applicable when Averaging applies.
[Averaging:	[Averaging with Lockout][Not Applicable]	This field can be deleted or specified as Not Applicable when Compounding applies.
[Lockout:]	[[ ] Lockout Period Business Days]	This is an optional field, allowing parties to specify the number of Business Days' lockout being applied. This field can be deleted if the number specified as the "Lockout" for the relevant FRO in the Compounding/Averaging Matrix is to apply. If no such number is specified in the Compounding/Averaging Matrix and the field is not populated, the default position of five Lockout Period Business Days is to apply.
[Lockout Period Business Days:]	[[ ] [Applicable Business Days]]	If the Applicable Business Days for Lockout is to be only by reference to the relevant financial center for the overnight rate, this field can be deleted or specified as Not Applicable.

Name of Field	Election	Commentary on election
		If parties wish to specify the financial center(s) that will apply for the purposes of the observation shift (Lockout Period Business Days) in addition to the Applicable Business Days, these additional financial centres can be listed in this field.

16 What are the new fields for OIS compounding, and what are the applicable default provisions?

In addition to the new fields introduced for daily caps and/or floors (please see Question 17 (*What are the new fields for daily cap and/or floor, and what are the applicable default provisions?*) for further details), the new fields for OIS compounding included in Exhibit IV-D (*OIS Compounding/Overnight Averaging with optional Payment Delay*) are:

Name of Field	Election	Commentary on election
Fixed Rate Payer [Payment Dates] [Period End Dates]:	[ ] [, subject to adjustment in accordance with the [Following/Modified Following/Preceding] Business Day Convention]	Unless 'Delayed Payment' applies, parties must specify the Payment Dates. There is no default position for Payment Dates. Insert Period End Dates instead of Payment Dates if 'Delayed Payment' applies. The bracketed language "*[, subject to adjustment in accordance with the [Following/Modified Following/Preceding] Business Day Convention]*" is not necessary if Payment Dates and Period End Dates are to be adjusted in accordance with the Modified Following Business Day Convention, as provided in the 2006 Definitions.
Delayed Payment:	Applicable, with the specified number of days being [*specify number*] Business Days/Not Applicable]	If Delayed Payment is applied to the Fixed Rate Payer Payment Dates, this will result in the Fixed Rate Payer Payment Dates falling the specified number of days after the Period End Date.
Floating Rate Payer [Payment Dates] [Period End Dates]:	[ ] [, subject to adjustment in accordance with the [Following/Modified Following/Preceding] Business Day Convention]	Unless 'Delayed Payment' applies, parties must specify the Payment Dates. There is no default position for Payment Dates. Insert Period End Dates instead of Payment Dates if 'Delayed Payment' applies. The bracketed language "*[, subject to adjustment in accordance with the [Following/Modified Following/Preceding] Business Day Convention]*" is not necessary if Payment Dates and Period End Dates are to be adjusted in accordance with the Modified

		Following Business Day Convention, as provided in the 2006 Definitions.
Delayed Payment:	[Applicable, with the specified number of days being [five] Business Days/Not Applicable]	If Delayed Payment is applied to the Floating Rate Payer Payment Dates, this will result in the Floating Rate Payer Payment Dates falling the specified number of days after the Period End Date.
[Compounding:	[OIS Compounding] [Not Applicable]]	This field can be deleted or specified as Not Applicable when Averaging applies or if parties are using a Self-Compounding FRO. If parties are using an using an Overnight FRO, specify 'OIS Compounding'.
[Averaging:	[Overnight Averaging] [Not Applicable]]	This field can be deleted or specified as Not Applicable when OIS compounding applies or if parties are using a Self-Compounding FRO. If parties are using an Overnight FRO, specify 'Overnight Averaging'.

17 What are the new fields for daily cap and/or floor, and what are the applicable default provisions?

The new fields for daily cap and/or floor included in all four new template Confirmations (Exhibits IV-A, IV-B, IV-C and IV-D) are:

Name of Field	Election	Commentary on election
[Daily Capped Rate and/or Daily Floored Rate:]	[Applicable/Not Applicable]	This field is optional and can be deleted or specified as Not Applicable if Daily Capped Rate and/or Daily Floored Rate is not applicable.
[Daily Capped Rate:]	[[%]	Include the applicable cap for the daily rate, if any.
[Daily Floored Rate:]	[[%]	Include the applicable floor for the daily rate, if any.

18 How does the Compounding/Averaging Supplement interact with industry-standard documentation in the cash markets?

ISDA plans to publish template Confirmations prepared to illustrate how the provisions in the Compounding/Averaging Supplement interact with corresponding provisions in LMA and LSTA documentation. ISDA, LMA and LSTA also plan to record a webinar explaining how the provisions in the Compounding/Averaging Supplement can be used to hedge cash products documented using LMA/LSTA documentation.

19 How does the Compounding/Averaging Supplement interact with the IBOR Fallbacks in Supplement 70?

The fallbacks for certain interbank offered rates ("**IBORs**") implemented within the FROs for those IBORs by Supplement 70 to the 2006 Definitions are first to a rate published by Bloomberg. Bloomberg utilizes a compounding in arrears calculation that is mathematically similar to the calculation used within the Self-Compounding FROs and the OIS compounding approach in the Compounding/Averaging Supplement. Bloomberg also applies a two Business Day observation period shift (referred to in the Bloomberg IBOR Fallback Rate Adjustments Rule Book as an "Offset Lag") that is similar (in that under both the Bloomberg IBOR Fallback Rate Adjustments Rule Book and the Compounding/Averaging Supplement the observation period shifts, rather than just shifting the rate that is observed) but not identical to the Observation Period shift in the Compounding/Averaging Supplement. The calculation of the IBOR fallbacks cannot be replicated via the Compounding/Averaging Supplement. Please see the Bloomberg IBOR Fallback Rate Adjustments Rule Book and factsheet on IBOR Fallbacks produced by Bloomberg, ISDA and Linklaters.