

MEMO# 31409

September 26, 2018

Prudential Regulators Adopt Amendments Conforming Swap Margin Rules to Rules on Qualified Financial Contracts

[31409]

September 26, 2018 TO: ICI Members

Derivatives Markets Advisory Committee

ICI Global Trading & Markets Committee SUBJECTS: Derivatives

Trading and Markets RE: Prudential Regulators Adopt Amendments Conforming Swap Margin Rules to Rules on Qualified Financial Contracts

The Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Farm Credit Administration, and Federal Housing Finance Agency (collectively, “Agencies”) recently adopted amendments to their non-cleared swap margin rules for registered swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants.^[1] The amendments conform the swap margin rules to rules that the OCC, Board and FDIC recently adopted that impose restrictions on certain qualified financial contracts (“QFC Rules”).^[2] Among other things, the amendments confirm that any changes to netting agreements that are required to conform to the QFC Rules will not render grandfathered swaps covered by such netting agreements to be “new” swaps subject to the swap margin rules.

I. Background

In 2015, the Agencies adopted joint final swap margin rules establishing minimum margin and capital requirements for covered swap entities. The swap margin rules apply only to non-cleared swaps between covered swap entities and their counterparties entered into on or after the applicable compliance date. Under these rules, if a non-cleared swap entered into prior to the applicable compliance date is amended or novated after the applicable compliance date, it may be subject to the swap margin rules, as the rules contain no safe harbor for legacy swaps that are amended or novated after the compliance date. The swap margin rules also permit covered swap entities to (i) calculate initial margin requirements for covered swaps under an “eligible master netting agreement” pursuant to an initial margin model; and (ii) calculate variation margin on an aggregate basis under an “eligible master netting agreement.” Further, the swap margin rules state that a netting portfolio

that contains only legacy swaps is not subject to the swap margin rules. If a netting portfolio includes any covered swap, however, the entire netting portfolio is subject to the swap margin rules.

Last year, the OCC, Board and FDIC adopted the QFC Rules to require certain non-cleared swaps and other financial contracts (“qualified financial contracts” or “QFCs”) of global systemically important bank institutions and their affiliates to contain special contractual provisions in the event of a resolution or insolvency. The QFC Rules generally provide that the rights of a failed insured depository institution’s or financial company’s counterparties to terminate, liquidate or net certain qualified financial contracts are temporarily stayed when the entity enters a resolution proceeding to allow the transfer of the covered qualified financial contracts to a solvent party. They also generally prohibit covered qualified financial contracts from allowing the exercise of default rights related, directly or indirectly, to the entry into resolution of an affiliate of the covered entity (cross default rights).

As part of the QFC Rules, the definition of “qualifying master netting agreement” was amended because the previous definition did not recognize some of the new close-out restrictions that the QFC Rules imposed on covered qualified financial contracts.

II. Final Rules

The Agencies adopted amendments to the definition “eligible master netting agreement” in the swap margin rules to conform to the QFC Rules. Specifically, the final amendments clarify that a master netting agreement meets the definition of an “eligible master netting agreement” under the swap margin rules when the agreement limits the right to accelerate, terminate, and close-out on a net basis all transactions under the agreement and to liquidate or set-off collateral promptly upon an event of default of the counterparty and to the extent necessary for the counterparty to comply with the QFC Rules. The final rule text is identical to the corresponding text used in the amended definition of “qualified master netting agreement” in the OCC, Board and FDIC’s capital and liquidity rules.

In addition, the Agencies adopted an amendment to the swap margin rules that provides that amendments made to an eligible master netting agreement solely to comply with the QFC Rules will not be considered for purposes of determining the date on which swaps subject to that agreement were entered into. This amendment should provide certainty to funds about the treatment of legacy swaps and any applicable netting arrangements in light of the QFC Rules.

The Agencies did not take comments requesting that they confirm that “non-material” and other identified amendments to a netting agreement (e.g., changes to the interest rate benchmark from LIBOR or novations or other amendments necessitated by the United Kingdom leaving the European Union) will not result in a legacy swap becoming subject to margin requirements. The Agencies thought the changes were not within the scope of the Agencies’ proposal and would be difficult to effect because the motivation for an amendment or novation generally is not observable. The Agencies did note, however, that they continue to assess industry developments, such as interest rate benchmark reform, and will consider any associated implementation ramifications surrounding the treatment of legacy swaps.

III. Effective Date

The final rules will become effective 30 days following publication in the Federal Register.

endnotes

[1] See *Margin and Capital Requirements for Covered Swap Entities*, available at <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180921a.pdf>. For a summary of the swap margin rules, please see ICI Memorandum No. 29484 (Nov. 12, 2015), available at https://www.ici.org/my_ici/memorandum/memo29484.

[2] For a summary of the QFC Rules, please see ICI Memorandum No. 30873 (Sept. 18, 2017) (summarizing the Board's final QFC Rules), available at https://www.ici.org/my_ici/memorandum/memo30873; ICI Memorandum No. 30907 (Oct. 11, 2017) (summarizing the FDIC's final QFC Rules), available at https://www.ici.org/my_ici/memorandum/memo30907; and ICI Memorandum No. 30992 (Dec. 22, 2017) (summarizing the OCC's final QFC Rules), available at https://www.ici.org/my_ici/memorandum/memo30992.

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