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May 4, 2011

Regulators Propose Capital and Margin Requirements for Uncleared Swaps; Call Scheduled May 11

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TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 23-11
DERIVATIVES MARKETS ADVISORY COMMITTEE
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 11-11
ETF ADVISORY COMMITTEE No. 28-11
EQUITY MARKETS ADVISORY COMMITTEE No. 20-11
FIXED-INCOME ADVISORY COMMITTEE No. 34-11
SEC RULES COMMITTEE No. 40-11
SMALL FUNDS COMMITTEE No. 16-11 RE: REGULATORS PROPOSE CAPITAL AND MARGIN REQUIREMENTS FOR UNCLEARED SWAPS; CALL SCHEDULED MAY 11

The Dodd-Frank Act requires regulators to adopt rules setting capital and margin requirements for uncleared swaps for swap dealers and major swap participants (together, "swap entities"). The Commodity Futures Trading Commission ("CFTC") has proposed margin and capital requirements for registered swap entities that are not banks, including nonbank subsidiaries of U.S. bank holding companies regulated by the Federal Reserve Board ("FRB"). [1] The prudential regulators [2] also have proposed margin and capital rules. The proposed rules set forth requirements for swap entities for: (1) the amount of and calculations for capital and financial reporting and (2) the amount, type and frequency of margin required to be collected. The proposals are summarized below. Comments on the proposals must be submitted to the regulators by June 24, 2011.

We will hold a conference call on Wednesday, May 11 at 2 pm ET to discuss the proposals. If you plan to participate, please contact Ruth Tadesse (rtadesse@ici.org or 202/326-5836) by the close of business on May 10, and she will provide you with the dial-in information. If you cannot participate, please provide comments to Heather Traeger (htraeger@ici.org or 202/326-5920).

I. Capital Requirements

The prudential regulators' proposal would apply existing regulatory capital rules to bank swap entities. The regulators note, however, that they anticipate such capital rules will change in the near future based on recent revisions to the framework for internationally active banks made by the Basel Committee.

The CFTC proposal also relies on existing capital rules. Specifically, any swap dealer or major swap participant that is required to register as a futures commission merchant ("FCM") would be required to comply with the CFTC's existing capital requirements for FCMs and maintain at least $20 million of adjusted net capital. Any swap dealer or major swap participant that is not a registered FCM or bank, but is part of a U.S. bank holding company, would be required to comply with the applicable bank capital requirements that are established by the FRB for bank holding companies. Such regulations generally require a minimum ratio of qualifying total capital to risk-weighted assets of 8 percent, of which at least half should be in the form of Tier 1 capital. [3] Finally, any swap dealer or major swap participant that was not required to register as an FCM and is not part of a U.S. bank holding company would be required to maintain tangible net equity [4] equal to $20 million, plus additional amounts for market risk and over-the-counter derivatives credit risk.

The CFTC proposal would provide that, subject to CFTC approval, a swap dealer or major swap participant may use internal models for conducting its capital calculations. Initially, the CFTC would only consider approving internal models already approved and subject to ongoing review by the FRB or, as applicable, the Securities and Exchange Commission. The proposal also includes reporting and recordkeeping requirements based on existing requirements for FCMs.

II. Margin Requirements

A. Counterparties

The proposals would establish four categories of counterparties each with their own margin requirements:

- Swap dealers or major swap participants (i.e., swap entities);
- High-risk financial end users;
- Low-risk financial end users; and
- Nonfinancial end users (or commercial end users).

The prudential regulators and the CFTC have proposed to use the definition of financial end user in Title VII of the Dodd-Frank Act. A financial end user would therefore include: commodity pools; private funds; ERISA employee benefit plans; persons predominately engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company Act; [5] persons that would be commodity pools or private funds if organized under the laws of the United States or any State; foreign governments or political subdivisions; and any other person that the relevant agency may designate.

A low-risk financial end user would be an end user that does not have "significant swap exposure," [6] predominately uses swaps to hedge or mitigate the risks of its business activities, including balance sheet, interest rate or other risk arising from its business, and is subject to capital requirements established by a prudential regulator or state insurance regulator. [7] A high-risk financial end user would be one that does not fall under the definition of low-risk end user.

Nonfinancial end users would include commercial end users. Prudential regulators would require bank swap entities to calculate their own credit exposure limits for nonfinancial end users and collect initial and variation margin from such user when the credit exposure exceeds the calculated limit. The CFTC proposal would not impose any margin requirements on nonfinancial end users. Instead, it would require nonfinancial end users to enter into credit support arrangements with swap entities. Swap entities would be required to calculate hypothetical initial and variation margin amounts for positions held by nonfinancial end users, to serve as risk management tools to measure exposure.

B. Initial Margin

Under the prudential regulators' proposal, swap entities would be permitted to calculate initial margin using two methods: internal models and a standardized "lookup" table. [8] The internal models would need to meet specified criteria that have been approved by a swap entity's prudential regulator. For example, the models would need to use risk factors sufficient to measure all material price risks inherent in the swap transaction, including foreign exchange/interest rate risk, credit risk, equity risk and commodity risk. The complexity of the model would need to be commensurate with the complexity of the swap and would need to be benchmarked periodically against observable margin standards to ensure that the required margin was not less than what a derivatives clearing organization ("DCO") or a clearing agency would require for similar transactions.

Initial margin could be calculated on a portfolio basis, but offsetting positions and hedging benefits could only be recognized within four broad risk categories (i.e., commodity, credit, equity, and foreign exchange/interest rates), and not across them. [9] A model could not permit the calculation of any initial margin amount to be subject to offset by any initial margin that may be owned or otherwise payable by the swap entity to the counterparty. Further, the swap entity would be required to recalibrate its initial margin model monthly and review the model at least annually, and its prudential regulator could require that the swap entity collect a greater amount than determined by its model.

As an alternative to using an internal model, the prudential regulators propose the use of a lookup table that specifies margin requirements as a percentage of the notional amount of the swap, depending on the category of swap. If the swap entity has entered into more than one swap with a counterparty, the aggregate minimum initial margin required on those swaps would be determined by summing the margin requirement for each individual swap. As proposed, this alternative would not allow for offsetting of positions.

The prudential regulators' proposal would permit a swap entity to establish a credit exposure threshold below which it need not collect initial margin for counterparties that are low-risk financial end users or nonfinancial end users. The maximum threshold amount for low-risk financial end users would be limited to the lower of (1) a range of $15 million to $45 million or (2) a range of 0.1 to 0.3 percent of the swap entity's Tier 1 capital. There would be no such limit for nonfinancial end users. Where a threshold amount is established, a swap entity would be required to calculate the initial margin under one of the two proposed alternatives and, to the extent that amount exceeds the initial margin threshold amount that has been established, collect initial margin equal to the excess amount.

The CFTC proposal would differ from the prudential regulators' proposal with respect to initial margin in several ways. The CFTC proposal would allow swap entities to use models that have been approved by the CFTC and have been: (1) used by a DCO for clearing swaps; (2) used by an entity subject to oversight by a prudential regulator; or (3) made available for licensing to any market participant by a vendor. It would not allow the use of internal proprietary models. In addition, the CFTC proposal would require that any model used conform to a set of standards including, for example, using at least one year of historic price data and incorporating a period of significant financial stress to the uncleared swap, to the extent available. A model would be required to cover exposure over a 10-day default window in 99 percent of cases and any portfolio offsets or reductions would need to have a sound theoretical basis and significant empirical support. The CFTC proposal also would prohibit a swap entity from posting as margin for another product any initial margin received by a swap entity from all counterparties, not just from other swap entities. Finally, a swap entity using a model would be required to: monitor margin daily; conduct monthly back tests; conduct monthly stress tests; document all material aspects of its valuation procedures and initial margin model; and file any model used with the CFTC.

If a model meeting the proposed standards is not available, the proposal would permit a swap entity to calculate initial margin using a “comparative” alternative. Specifically, a swap entity could collect two times the initial margin required by a DCO for a comparable cleared swap (i.e., in the same asset class for which the terms and conditions most closely approximate the terms and conditions of the uncleared swap) or, if there is no cleared swap, 4.4 times the initial margin required for a comparable cleared futures contract that would be most likely to be used to hedge the uncleared swap. Portfolio-based reductions would be permitted under this alternative but they would not be recognized across asset classes (except between currencies and interest rates), and no reduction could exceed 50 percent.

C. Variation Margin

The prudential regulators’ proposal would calculate variation margin as the mark-to-market change in value of a swap from the date it is entered into minus the value of all variation margin previously collected but not returned by the swap entity on that swap. [10] The proposal would permit a swap entity to aggregate across all swap or security-based swap transactions entered into with a counterparty under a qualifying master netting agreement. [11] Counterparties would have to specify in their trading documentation the manner in which they determine the value of swaps for variation margin purposes and how disputes would be resolved.

According to the prudential regulators’ proposal, variation margin for high-risk financial end users would be collected at least once per business day while variation margin for low-risk financial users would be collected only once per week. As with initial margin, the proposal would permit a swap entity to adopt a threshold amount below which it need not collect variation margin from counterparties that are low-risk financial end users or nonfinancial end users.

The CFTC proposal would require the collection of variation margin from counterparties that are swap entities and financial end users. The amount would be calculated using a methodology specified in the credit support arrangement and stated with sufficient specificity to allow the margin requirement to be calculated independently by the counterparty, CFTC or other regulator. The proposal would permit a swap entity to establish a threshold amount below which it need not collect variation margin from counterparties that are low-risk financial end users. Variation margin would need to be collected from swap entities or financial end user counterparties at least once per business day, and variation margin could be calculated on an aggregate basis for all swaps executed with a counterparty under a qualifying master netting agreement.

D. Collateral

The prudential regulators' proposal would require the collection of collateral in the form of:

- immediately-available cash funds;
- obligations of, or fully guaranteed by, the United States; and
- for initial margin only, certain senior debt obligations of government-sponsored entities.

Non-cash collateral would be subject to haircuts based on the remaining duration of the securities and the type and issuer of the security. Swap entities would be required to monitor the value of non-cash collateral and, to the extent the value has decreased, collect additional collateral to ensure that all initial and variation margin requirements remain satisfied.

The CFTC proposal would permit the same set of eligible collateral for initial margin. It also would allow non-traditional forms of collateral to be posted by nonfinancial end users to the extent allowed in privately-negotiated credit support arrangements so long as the value of the particular type of asset is reasonably ascertainable on a periodic basis. For variation margin, the CFTC proposal would require cash or U.S. Treasury securities for swap entities or financial end users. Once again, nonfinancial end users could use any asset for which the value is reasonably ascertainable on a periodic basis. The CFTC proposal would employ the same haircuts as the prudential regulators for non-cash assets.

E. Segregation

The proposals would impose segregation requirements on swap entities based on the type of counterparty. Under the prudential regulators' proposal, a swap entity entering a swap with a swap dealer or major swap participant counterparty would have to hold initial margin received from that counterparty at an independent, third-party custodian. Similarly, if a swap entity posts initial margin with a counterparty that is a swap dealer or major swap participant, it would be required to ensure that the counterparty segregates the initial margin at an independent, third-party custodian. The custodian would be prohibited by contract from (1) rehypothecating or otherwise transferring any initial margin it holds and (2) reinvesting any initial margin held by the custodian in any asset that would not qualify as eligible collateral for initial margin. The custodian also must be located in a jurisdiction that applies the same insolvency regime to the custodian as would apply to the swap entity. The proposed segregation requirement would not apply to variation margin or transactions with a counterparty that is an end user of any type.

The CFTC proposal would include similar segregation requirements. In addition, swap entities would be required to offer each counterparty the opportunity to select a custodian that is not affiliated with the swap entity. [12] Furthermore, the CFTC could require a swap entity to provide further data or analysis concerning any custodian, and could require a swap entity to move assets to another custodian to address risks posed by the original custodian.

F. Extraterritorial Application

The proposal by the prudential regulators generally would apply to all transactions of a swap entity subject to a narrow exception for swap transactions between a "foreign covered swap entity" and a wholly foreign counterparty (i.e., a counterparty that is not, nor is its obligations under the swap guaranteed by, an entity organized in the United States, a branch of a U.S. entity or a U.S. resident), with respect to "foreign non-cleared swaps" and "foreign non-cleared security-based swaps." The CFTC proposal would not provide an exception from margin requirements for foreign registered swap entities when effecting swaps with other foreign entities.

Heather L. Traeger
Associate Counsel

endnotes

[1] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 FR 23732 (April 28, 2011), available at http://www.cftc.gov/LawRegulation/FederalRegister/ProposedRules/2011-9598.html, and Capital Requirements of Swap Dealers and Major Swap Participants (voted on April 27, 2011), available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister042711c.pdf.

[2] Prudential regulators include the FRB, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Farm Credit Administration and Federal Housing Finance Authority.

[3] The proposal would require a minimum fixed dollar amount of at least $20 million of Tier 1 capital.

[4] Tangible net equity generally would be based on net equity as determined under U.S. GAAP, minus intangibles such as goodwill.

[5] Activities that are financial in nature would include "providing financial, investment, or economic advisory services, including advising an investment company (as defined in section 3 of the Investment Company Act of 1940)."

[6] Significant swap exposure is defined by reference to rules previously proposed by the CFTC. See Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 75 FR 80174 (December 21, 2010), available at http://www.cftc.gov/LawRegulation/FederalRegister/ProposedRules/2010-31130.html.

[7] This definition would not appear to capture mutual funds.

[8] The proposal notes that in all cases, the initial margin amount required is a minimum requirement; swap entities would not be precluded from collecting additional initial margin when they believe it is appropriate.

[9] If an entity chooses to aggregate under the prudential regulators' proposal, all existing swaps between the parties, including those entered into prior to the effectiveness of the new margin proposals ("pre-effective swaps"), could be included in the calculation. A swap entity could not, however, pick and choose among pre- and post-effective swaps in performing its calculations. It would have to include all or none or the pre-effective swaps.

[10] Variation margin would be subject to a minimum transfer amount of $100,000.

[11] The prudential regulators' proposal would apply variation margin requirements to pre-

effective swaps when calculating variation margin on a portfolio basis. The CFTC proposal would not.

[12] This provision would apply to circumstances where margin has been collected pursuant to a credit support agreement even if it was not required to be collected under the proposal (i.e., in the case of an end user).