

**MEMO# 28371**

September 11, 2014

# **U.S. Prudential Regulators Propose Margin and Capital Requirements for Uncleared Swaps**

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TO: DERIVATIVES MARKETS ADVISORY COMMITTEE No. 57-14  
ICI GLOBAL MEMBERS No. 32-14 RE: U.S. PRUDENTIAL REGULATORS PROPOSE MARGIN AND CAPITAL REQUIREMENTS FOR UNCLEARED SWAPS

Recently, the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Farm Credit Administration, and the Federal Housing Finance Agency (together “Agencies”) re-proposed margin and capital requirements for swap entities that are prudentially regulated by one of the Agencies (“covered swap entities”). [\[1\]](#) A swap entity is a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant that enters into a non-cleared swap. The Reproposal generally is consistent with the final policy framework issued by the Basel Committee on Banking Supervision (“BCBS”) and the Board of the International Organization of Securities Commissions (“IOSCO”) establishing minimum standards for margin requirements for non-centrally cleared derivatives with certain exceptions as described below. [\[2\]](#) Comments on the Reproposal are due 60 days after publication of the Reproposal in the Federal Register.

## **General Risk-Based Approach and Threshold**

The Agencies are taking a risk-based approach to the margin requirements and taking into account the risk posed by a covered swap entity’s counterparties in establishing the minimum initial and variation margin requirements. The proposed rule, therefore, distinguishes among four types of swap counterparties: (1) counterparties that are themselves swap entities; (2) counterparties that are financial end users with a material swaps exposure; (3) counterparties that are financial end users without a material swaps exposure; and (4) other counterparties.

The Reproposal defines “financial end user” by providing a list of entities that would be financial end users and a list of entities excluded from the definition. Under the proposed rule, a financial end user includes a counterparty that is not a swap entity but is, among

others, an investment adviser, a registered investment company, a broker-dealer, a private fund, a commodity pool, a commodity pool operator, a commodity trading adviser, an entity that would be a financial end user described in the list or a swap entity if it were organized under the laws of the United States or any state, or any other entity that one of the Agencies has determined should be treated as a financial end user. [\[3\]](#) Entities that are neither financial end users nor swap entities are treated as “other counterparties.”

The Agencies define “material swaps exposure” for an entity to mean that the entity and its affiliates have an average daily aggregate notional amount of non-cleared swaps, non-cleared security-based swaps, foreign exchange (“FX”) forwards and FX swaps with all counterparties for June, July, and August of the previous year that exceeds \$3 billion. This aspect of the Reproposal differs from the BCBS/IOSCO Final Margin Policy Framework, which would not impose initial margin requirements on entities with less than €8 billion (approximately \$11 billion) of gross notional amount outstanding. According to the Agencies, its preliminary view is that defining material swaps exposure at \$3 billion rather than \$11 billion is appropriate because it reduces systemic risk without imposing undue burden on covered swap entities and is consistent with the objects of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The Reproposal permits a covered swap entity to adopt a maximum initial margin threshold amount of \$65 million, below which it need not collect or post initial margin from or to swap entities and financial end users with material swaps exposures. The threshold would be applied on a consolidated basis (together with affiliates) both to the covered swap entity and the counterparty. Consistent with the BCBS/IOSCO Final Margin Policy Framework and as advocated by ICI and ICI Global, the Agencies believe that advised and sponsored funds and sponsored securitization vehicles would not be affiliates of the investment adviser or sponsor unless the adviser or sponsor is deemed to control the fund or securitization vehicle. The Agencies intend to follow the approach of the BCBS/IOSCO Final Margin Policy Framework for funds: funds that are managed by an investment adviser would be considered distinct entities that are treated separately when applying the threshold as long as the funds are distinct legal entities that are not collateralized by, or otherwise guaranteed or supported by, other funds or the investment adviser in the event of fund insolvency or bankruptcy.

## **Two-way Margining Requirement**

Consistent with the BCBS/IOSCO Final Margin Policy Framework and as advocated by ICI and ICI Global, the proposed rule’s initial and variation margin requirements generally apply to posting and collection of minimum initial and variation margin amounts by a covered swap entity from and to its counterparty.

### **Initial Margin**

A covered swap entity would be required to collect and post a minimum amount of initial margin when transacting with another swap entity. A covered swap entity transacting with a financial end user with a material swaps exposure must collect at least the amount of initial margin required by the proposed rule and must post at least the amount of initial margin that the covered swap entity would be required by the proposal to collect if the covered swap entity were in the place of the counterparty. A covered swap entity must post or collect initial margin on at least a daily basis as required under the proposed rule in response to changes in the required initial margin amounts stemming from changes in portfolio composition or any other factors that result in a change in the required initial

margin amounts.

For financial end users without material swaps exposure and other counterparties, a covered swap entity would be required to collect initial margin at such times and in such forms and amounts (if any) that the covered swap entity determines appropriately address the credit risk posed by the counterparty and the risks of such swaps.

## **Variation Margin**

The proposed rule generally requires a covered swap entity to collect or post variation margin on swaps with a swap entity or a financial end user (regardless of whether the financial end user has a material swaps exposure) in an amount that is at least equal to the increase or decrease in the value of the swap since the counterparties' previous exchange of variation margin. A covered swap entity must collect or post variation margin with swap entities and financial end user counterparties on at least a daily basis. A covered swap entity may not adopt a threshold amount below which it need not collect or pay variation margin on swaps with a swap entity or financial end user counterparty (although transfers below the minimum transfer amount would not be required). [\[4\]](#)

## **Instruments Subject to Requirements**

The proposed rule would impose the margin requirements on all non-cleared swaps into which a covered swap entity enters with certain exceptions. Consistent with the BCBS/IOSCO Final Margin Policy Framework and as advocated by ICI and ICI Global, the Agencies do not propose to subject FX forwards and FX swaps to the proposed margin requirements. Moreover, the Agencies propose to treat that portion of a cross-currency swap that is a fixed exchange of principal in a manner that is consistent with the treatment of FX forwards and FX swaps. This treatment of cross-currency swaps is limited to only cross-currency swaps and does not extend to any other swaps such as non-deliverable currency forwards.

## **Margin Methodology**

For initial margin, the proposed rule would require a covered swap entity to calculate its minimum initial margin requirement in one of two ways. First, a covered swap entity may use a standardized margin schedule (as set forth in Appendix A of the Reproposal). The standardized initial margin under the schedule generally depends on the asset class. The proposed standardized initial margin requirement also allows for the recognition of risk offsets through the use of a net-to-gross ratio in cases where a portfolio of non-cleared swaps is executed under an eligible master netting agreement ("EMNA"). [\[5\]](#)

Second, a covered swap entity may use an internal margin model that satisfies certain criteria and is approved by the relevant prudential regulator. The Reproposal requires that the initial margin amount be set equal to a model's calculation of the potential future exposure of the non-cleared swap consistent with a one-tailed 99 percent confidence level over a 10-day close-out period. The Reproposal also permits a covered swap entity to use an internal initial margin model that reflects offsetting exposures, diversification, and other hedging benefits within seven broad risk categories when calculating initial margin for a particular counterparty if the swaps are executed under the same EMNA.

## Eligible Collateral for Margin

The Reproposal broadens the types of collateral that would be eligible for initial margin purposes. Eligible collateral for variation margin is limited to cash. Eligible collateral for initial margin includes cash, debt securities that are issued or guaranteed by the U.S. Department of Treasury, another U.S. government agency, the Bank for International Settlements, the International Monetary Fund, the European Central Bank, and multilateral development banks, certain U.S. Government-sponsored enterprises' debt securities, certain foreign government debt securities, certain corporate debt securities, certain listed equities, and gold. [\[6\]](#)

In addition, corporate securities (equity or debt) issued by a counterparty or any of its affiliates, a bank holding company, a savings and loan holding company, a foreign bank, a depository institution, a market intermediary, or any company that would be one of the foregoing if it were organized under the laws of the United States or any state or an affiliate of one of the foregoing institutions would not be eligible as initial margin collateral. The Agencies are concerned that the securities issued by these entities are likely to come under significant pressure during a period of financial stress when a covered swap entity may be resolving a counterparty's defaulted swap position and present a general source of wrong-way risk.

The recognized value of assets posted as initial margin collateral, except U.S. dollars and the currency in which the payment obligation of the swap is required, would be subject to haircuts. The proposed collateral haircuts are provided as Appendix B of the Reproposal.

## Treatment of Provided Initial Margin

Under the proposed rule, a covered swap entity must require that any collateral other than variation margin that it posts to its counterparty (even collateral in excess of any required margin) be segregated at one or more custodians that are not affiliates of the covered swap entity or the counterparty ("third-party custodian"). A covered swap entity also would be required to place the initial margin it collects (although not the excess margin it receives) from a swap entity or a financial end user with a material swaps exposure at a third-party custodian. The proposed rule would require that the third-party custodian be prohibited by agreement from rehypothecating, repledging, reusing, or otherwise transferring any of the funds or other property the third-party custodian bank holds. The custodial agreement also must prohibit substituting or reinvesting any funds or other property in any asset that would not qualify as eligible collateral. Finally, the custodial agreement must require that after such substitution or reinvestment, the amount net of applicable discounts described in Appendix B of the Reproposal continue to be sufficient to meet the requirements for initial margin.

## Cross-Border Transactions

Under the Reproposal, foreign swaps of foreign covered swap entities [\[7\]](#) would not be subject to the margin requirements. A foreign swap would be any non-cleared swap to which neither the counterparty to the foreign covered swap entity nor any guarantor (on either side) is (1) an entity organized under the U.S. or state law, including a U.S. branch, agency, or subsidiary of a foreign bank; (2) a branch or office of an entity organized under U.S. or state law or (3) a covered swap entity controlled by an entity organized under U.S. or state law.

In addition, certain covered swap entities that are operating in a foreign jurisdiction and covered swap entities that are organized as U.S. branches of foreign banks may choose to abide by the swap margin requirements of the foreign jurisdiction if the Agencies determine that the foreign regulator's swap margin requirements are comparable to those of the Reproposal. To be eligible for substituted compliance, the covered swap entity's obligations must not be guaranteed by an entity organized under the laws of the United States or any state. Finally, the proposed rule would permit a covered swap entity's posting requirement to be satisfied by posting as required by a foreign counterparty's margin collection requirement if the foreign counterparty is subject to a foreign regulatory framework that has been determined to be comparable by the Agencies. These determinations would be made on a jurisdiction-by-jurisdiction basis.

## Compliance Dates

The compliance dates under the Reproposal are consistent with the BCBS/IOSCO Final Margin Policy Framework. The proposed rule would be effective with respect to any swap to which a covered swap entity becomes a party on or after the relevant compliance date. For variation margin, the compliance date is December 1, 2015 for all covered swap entities with any counterparty. For initial margin, the compliance dates range from December 1, 2015 to December 1, 2019 depending on the average daily aggregate notional amount of non-cleared swaps, non-cleared security-based swaps, FX forwards, and FX swaps of the covered swap entity and its counterparty for June, July, and August of that year.

With respect to swaps executed prior to the applicable compliance date under a netting agreement, the proposed rule permits a covered swap entity to calculate initial margin requirements for swaps under an EMNA with the counterparty on a portfolio basis in certain circumstances if it does so using an initial margin model and calculates variation margin requirements under the proposed rule on an aggregate, net basis under an EMNA with the counterparty. The Agencies expect that the covered swap entity will comply with the margin requirements with respect to all swaps governed by an EMNA regardless of the date on which they were entered into consistent with current industry practice. A covered swap entity would need to enter into a separate master netting agreement for swaps entered into after the proposed rule's compliance date to exclude swaps entered into with a counterparty prior to the compliance date.

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### endnotes

[1] Margin and Capital Requirements for Covered Swap Entities (Sept. 3, 2014), available at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20140903c1.pdf> ("Reproposal"). The Agencies are not proposing any new capital rules for covered swap entities. The proposed rule would require a covered swap entity to comply with regulatory capital rules already applicable to that covered swap entity as part of its prudential regulatory regime. See Margin and Capital Requirements for Covered Swap Entities; Reopening of Comment Period, 77 FR 60057 (Oct. 2, 2012), available at <http://www.gpo.gov/fdsys/pkg/FR-2012-10-02/pdf/2012-24276.pdf> (comment period reopened in light of efforts by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions to develop harmonized international

margin standards for uncleared swaps); Margin and Capital Requirements for Covered Swap Entities, 76 FR 27563 (May 11, 2011), available at <http://www.gpo.gov/fdsys/pkg/FR-2011-05-11/pdf/2011-10432.pdf> (“Original Proposal”). For a summary of ICI’s comment letter in response to the reopening of the comment period, see ICI Memorandum No. 26704 (Nov. 20, 2012), available at [http://www.ici.org/my\\_ici/memorandum/memo26704](http://www.ici.org/my_ici/memorandum/memo26704).

[2] Margin Requirements for Non-Centrally-Cleared Derivatives, Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, September 2013, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD423.pdf> (“BCBS/IOSCO Final Margin Policy Framework”).

[3] See §\_\_.2 Definitions for a complete list of financial end users.

[4] Under the Reproposal, a covered swap entity need not collect or post initial or variation margin from or to any individual counterparty until the required cumulative amount of initial and variation margin is greater than \$650,000.

[5] The Reproposal defines EMNA as any written, legally enforceable netting agreement that creates a single legal obligation for all individual transactions covered by the agreement upon an event of default (including receivership, insolvency, liquidation, or similar proceeding) provided that certain conditions are met. One of the conditions requires that any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions other than (1) in receivership, conservatorship, or resolution by an Agency exercising its statutory authority, or similar laws in foreign jurisdictions that provide for limited stays to facilitate the orderly resolution of financial institutions or (2) in a contractual agreement subject by its terms to any of the foregoing laws.

[6] See Appendix B of the Reproposal for a complete description of the eligible collateral requirements.

[7] A foreign covered swap entity is any covered swap entity that is not an entity organized under the laws of the United States or any state, including a U.S. branch, agency or subsidiary of a foreign bank; a branch or office of an entity organized under the laws of the United States or any state; or any entity controlled by an entity that is organized under the laws of the United States or any state.