Prudential Regulators Propose Swap Margin and Capital Requirements

On April 12, 2011, the Federal Reserve Board ("FRB"), the Federal Deposit Insurance Corporation ("FDIC"), the Federal Housing Finance Agency ("FHFA"), the Farm Credit Administration ("FCA") and the Office of the Comptroller of the Currency ("OCC") (collectively, the "Prudential Regulators") proposed rules under Sections 731 and 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") governing margin and capital requirements applicable to swap dealers, security-based swap dealers, major swap participants and security-based swap participants ("swap entities") that are banks or otherwise subject to oversight by the Prudential Regulators ("covered swap entities").[1]

The Proposed Rules would generally impose a risk-based approach to margin. Covered swap entities could either adopt a standardized grid-based approach that applies an asset category-specific (and term based) multiplier to notional swap exposures or an approved internal margin model that satisfies certain prescribed parameters, including the use of a minimum 99% confidence interval and a 10-day measurement horizon in computing potential future exposure. The Proposed Rules would also distinguish among swap counterparties in determining the maximum permitted threshold for unmargined exposure as

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[1] Margin and Capital Requirements for Covered Swap Entities (Apr. 12, 2011), available at http://fdic.gov/news/board/Apr11no4.pdf (the "Proposed Rules"). A "covered swap entity" includes any swap entity that is: (a) for the FRB, any state member bank, bank holding company, savings and loan holding company, foreign banking organization, state branch or state agency of a foreign bank, or Edge or agreement corporation; (b) for the FDIC, any FDIC-insured state-chartered bank that is not a member of the Federal Reserve System or FDIC-insured state-chartered savings association; (c) for FHFA, Fannie Mae, Freddie Mac, or any Federal Home Loan Bank; (d) for the FCA, any institution chartered under the Farm Credit Act of 1971; or (e) for the OCC, any national bank, Federal savings association, or Federal branch or agency of a foreign bank.

On April 12, 2011, the Commodity Futures Trading Commission ("CFTC") also proposed rules on margin requirements for non-bank swap dealers and major swap participants. The CFTC's proposal is largely similar to the Proposed Rules, with principal differences including that (i) the CFTC would not require margin to be posted by nonfinancial entities, (ii) the CFTC would permit swap entities to use certain third-party models to calculate initial margin, (iii) the CFTC's proposed alternative to a model-based calculation of initial margin is calibrated expressly with respect to margin levels for cleared swaps and would recognize certain portfolio effects, (iv) initial margin received by a swap entity from another swap entity or a financial entity would not be permitted to be rehypothecated, and (v) the CFTC proposal does not address cross-border transactions. The Securities Exchange Commission ("SEC") has not yet proposed margin requirements for security-based swaps, and neither the CFTC nor the SEC has proposed capital requirements for swaps or security-based swaps.

well as the required frequency of mark-to-market margin calls.[2] Any initial margin provided by a covered swap entity to another swap entity would be required to be segregated by the receiving swap entity with an independent third party custodian. Taken as a whole, it is clear that the proposed margin requirement levels, which are substantially greater than comparable requirements applicable to cleared swaps, and the associated segregation requirements will very significantly increase the funding required to sustain the OTC swap market, raising the cost of risk management using uncleared swaps.

The proposed margin collection requirements would generally apply to U.S. and non-U.S. domiciled counterparties of a covered swap entity. Significantly, the margin collection obligation would not apply to a foreign covered swap entity when dealing with a non-U.S. domiciled counterparty (other than a branch or office of a U.S. person or a counterparty receiving a guarantee from a U.S. affiliate). However, for these purposes, a foreign covered swap entity would not include a branch or office of a U.S. person or an entity controlled by a U.S. person. We read this proposal to mean that, in the case of a foreign swap dealer whose only contact to the U.S. is that it is a subsidiary of a U.S. person, the application of U.S. margin requirements would depend on whether that dealer will be required by the CFTC and the SEC to register in the U.S.[3] Thus, the application of U.S. margin collection requirements in this context will depend on the scope of CFTC and SEC registration requirements for foreign swap dealers and, in particular, foreign swap dealers that are subsidiaries of U.S. persons. Depending on those CFTC and SEC requirements, the Proposed Rules could result in a significant expansion in the extraterritorial application of U.S. law that could intensify the competitive disparities faced by U.S.-domiciled bank holding companies operating outside the U.S.

As anticipated, the Proposed Rules would also establish capital rules for covered swap entities by confirming that those entities must comply with existing capital standards applicable to them under the rules of their existing Prudential Regulator. Significantly, in the case of foreign banks whose home country supervisor has adopted capital standards consistent in all respects with the Basel Accord, this would mean home country capital standards.[4]

2 Among other anomalies under the Proposed Rules, pension plans would be included in the category of high-risk financial entities for which the Proposed Rules would establish the most stringent requirements.

3 Similarly, if the foreign swap dealer conducts swap business with both U.S. and non-U.S. counterparties, the application of margin requirements would depend on whether the dealer is permitted by the CFTC and the SEC to register only with respect to its U.S.-facing business.

4 A foreign bank whose home country supervisor has not adopted capital standards consistent in all respects with the Basel Accord may still be subject to home country capital adequacy standards if it has obtained a determination from the FRB that its capital is equivalent to the capital that would be required of a U.S. banking organization.

The Proposed Rules would generally apply to transactions entered into 180 days after publication of final rules, although the Prudential Regulators have requested comment on the Proposed Rules' effective date. The comment period expires on June 24, 2011.

I. MARGIN

Under the Proposed Rules, the minimum margin required to be collected by covered swap entities, the frequency with which margin must be collected and the application of initial margin segregation requirements would depend on the type of swap and the nature of the counterparty. The matrix immediately below summarizes these requirements and their variation across counterparty categories.

Variation in Required Margin for Covered Swap Entities

	Counterparty			
Requirement	**Swap Entity**	**High Risk Financial End User**	**Low Risk Financial End User**	**Nonfinancial End User**
Segregation	Initial margin would be required to be held by an independent third-party custodian.	Not required.	Not required.	Not required.
Initial Margin Threshold Amount	Zero.	Zero.	Proposed lesser of $[15 to 45] million and [0.1 to 0.3]% of Tier 1 capital.	Credit exposure limit set by the dealer or major participant.
Variation Margin Threshold Amount	Zero.	Zero.	Proposed lesser of $[15 to 45] million and [0.1 to 0.3]% of Tier 1 capital.	Credit exposure limit set by the dealer or major participant.
Frequency of Collection of Variation Margin	At least once a day.	At least once a day.	At least once a day.	At least once a week.
Minimum Margin Transfer Amount	$100,000	$100,000	$100,000	$100,000

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A. Calculation of Initial Margin

A covered swap entity could calculate the amount of initial margin based on either (i) a standardized table specified in the Proposed Rules or (ii) an internal margin model that meets certain criteria and has been approved by the relevant Prudential Regulator.

- Standardized Table. The standardized table specifies an initial margin amount equal to a percentage of swap notional. The applicable percentage would vary based on the underlying asset category and swap term.[5] If the covered swap entity has entered into a portfolio of swaps with a counterparty, the aggregate minimum initial margin amount would be determined by summing the minimum initial margin requirement for each individual swap. Notably, under this approach, netting and other portfolio effects would not be recognized.[6]

- Internal Models. In addition to specified documentation, control, validation and other criteria, approved internal models would be required to calculate initial margin based on a measure of potential future exposure using a one-tailed 99% confidence interval and a 10-day time horizon, and assuming an instantaneous price shock to all relevant risk factors. Notably, the proposed 10-day time horizon is substantially longer than the 3- to 5-day time horizon typical of clearinghouse margin models.[7] This difference is intended to offset the lower liquidity of non-cleared swaps and to encourage the use of cleared swaps. The Proposed Rule would not distinguish between an uncleared swap that a counterparty elects not to clear and an uncleared swap that is not eligible for clearing in any clearinghouse.

  Additionally, a covered swap entity's internal margin model would be required to incorporate a stress test component to ensure the adequacy of the required initial margin level during a period of financial stress in which the

5 Asset categories would include credit swaps with 0-2 year duration (1-3% of notional), credit swaps with 2-5 year duration (2-8% of notional), credit swaps with 5+ years duration (5-15% notional), commodity swaps (10-20% notional), equity swaps (10-20% notional), foreign exchange/currency swaps (3-9% of notional), interest rate swaps with 0-2 year duration (0-2% notional), interest rate swaps with 2-5 year duration (1-3% of notional), interest rate swaps with 5+ year duration (2-6% of notional) and other swaps (10-20% of notional).

6 The Prudential Regulators request comment on methods for recognizing hedging effects, such as separately calculating initial margin for long versus short positions and using only the higher amount or adjusting gross notional positions in particular risk categories by a net-to-gross ratio or a netting factor.

7 Covered swap entities would also be required to periodically benchmark their initial margin models against observable margin standards to ensure that the initial margin required is not less than the level a clearinghouse would require for similar transactions. The Prudential Regulators request comment regarding whether such benchmarking would adequately capture portfolio effects or address transactions not similar to cleared swaps.

risk of counterparty default is heightened.[8] The Proposed Rules do not, however, provide quantitative guidance with respect to this requirement.

Approved risk models would be permitted to reflect offsets within the four broad risk categories (commodity, credit, equity, foreign exchange/interest rates), but not across those categories. Additionally, portfolio effects arising from non-swap positions would not be permitted to be taken into account. Only rights and obligations arising under swaps subject to the same qualifying master netting agreement would be permitted to be offset.[9] "Qualifying master netting agreement" is defined to require, among other provisions, that the covered swap entity has 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, and that the exercise of such rights in a bankruptcy, insolvency or similar proceeding of the counterparty will not be stayed or avoided under applicable law. Likely unintentionally, this proviso would disqualify any netting agreement with a U.S. bank, broker-dealer or other entity subject to a stay of close-out or foreclosure rights under the applicable U.S. insolvency regime (such as an entity subject to orderly liquidation under Title II of Dodd-Frank or government-sponsored enterprise conservatorship provisions).

The Proposed Rules would require initial margin to be collected on the date that the covered swap entity enters into the swap. We note that the credit risk models currently employed by many firms calculate potential future exposure, on a portfolio basis, as part of an end-of-day batch process. As a result, the requirement in the Proposed Rules to collect initial margin on the same business day that a swap is executed will present significant operational, systems and infrastructural challenges to firms wishing to use internal margin models on a real-time, swap-by-swap basis.

B. Application to Different Counterparties

The Proposed Rules would divide counterparties into four categories: other swap entities, high risk financial end users, low risk financial end users and nonfinancial end users. A covered swap entity would be required to execute margin documentation with each

8 The Proposed Rules request comment regarding whether a longer historical data sample requirement would be a better alternative to requiring the inclusion of a period of financial stress.

9 Recognizing that applying the Proposed Rules to a portfolio including pre-effective date and post-effective date swaps would result in retroactive application of the Proposed Rules, the Prudential Regulators have proposed to permit a covered swap entity to choose whether to apply its model for purposes of satisfying the Proposed Rules with respect to only those swaps entered into on or after the effective date or to apply it to all swaps governed by the relevant master netting agreement.

counterparty, regardless of its status. The required margin documentation must provide such covered swap entity with the contractual right to collect the margin required by the Proposed Rules, specify the means for determining the value of each swap to determine variation margin requirements and provide for a dispute resolution mechanism. The Proposed Rules would also impose special requirements on transactions involving Federal Home Loan Banks, Fannie Mae, Freddie Mac and other entities regulated by the FHFA or FCA, and on cross-border transactions.

i. Transactions with Other Swap Entities

Covered swap entities would be required to collect and post initial margin from and to other swap entities, so long as the transfer amount (calculated as noted above) exceeds $100,000. Moreover, although Dodd-Frank expressly contemplates that margin for non-cleared swaps may be required to be segregated only upon counterparty request, the Proposed Rules would mandate segregation of initial margin between a covered swap entity and a swap entity at an independent third party custodian located in a jurisdiction that applies the same insolvency regime to the custodian as the posting covered swap entity.[10] As a result, in the case of a cross-border transaction between a covered swap entity and another swap entity, the swap entity collecting margin would be required to hold that margin at a custodian located in the same jurisdiction as its counterparty, thereby giving rise to political, legal and other risks associated with that jurisdiction for both performance of the transaction itself and rights to the segregated margin collateral.[11]

The Prudential Regulators acknowledge that the proposed segregation requirement will impose a significant drain on liquidity but nevertheless argue that segregation is justified on a safety and soundness basis, noting that rehypothecation of initial margin could prevent recovery of margin by a non-defaulting party when one of the swap entities defaults, reduce the net amount of margin required to be posted and encourage swap entities to engage in non-cleared swaps to avoid the limits on rehypothecation resulting from posting margin to a clearinghouse.

Covered swap entities would also be required to collect and post variation margin from and to other swap entities, although variation margin would not be required to be

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[10] The custodian would be prohibited from rehypothecating or otherwise transferring such initial margin and would only be permitted to invest such margin in eligible collateral. It is unclear from the Proposed Rules how the prohibition on rehypothecation would apply to cash collateral held by a bank custodian (*e.g.*, would the bank would be required to hold the cash as a "special deposit"?).

[11] Additionally, the requirement that the jurisdiction apply the "same insolvency regime" to the custodian as the posting covered swap entity could be read, for instance, to prohibit a covered swap entity subject to resolution under the Federal Deposit Insurance Act from having its margin held by a broker-dealer or other entity subject to a different, entity-specific insolvency regime. It is unclear how this requirement would apply in the case of resolution under the orderly liquidation authority provisions of Title II of Dodd-Frank, since it is not generally known *ex ante* whether an entity is subject to resolution under Title II.

segregated. A covered swap entity would be required to collect variation margin from another covered swap entity at least once per business day (provided the transfer amount exceeds $100,000).[12]

ii. Transactions with Financial End Users

Covered swap entities would be required to collect initial and variation margin from (but <u>not</u> post margin to) counterparties that are financial end users. No segregation would be required except, at the counterparty's request, in the case of initial margin. As in the case of transactions with swap entities, variation margin would be required to be collected daily from financial end users. Both initial and variation margin would be subject to the $100,000 *de minimis* threshold for transfer amounts noted above.

The Proposed Rules would define a non-swap entity counterparty as a "financial end user" if it is

- a commodity pool, a private fund, an employee benefit plan or governmental plan,
- a person predominantly engaged in activities that are in the business of banking or in activities that are "financial in nature",
- a person that would otherwise be a commodity pool or private fund if it were organized under U.S. law, or
- a government of any foreign country or a political subdivision, agency or instrumentality thereof.

The Prudential Regulators would also have discretion to designate other persons as financial end users. While this definition is based on the "financial entity" definition used for purposes of Dodd-Frank's end user clearing exception, it is substantially broader, for example, in that it captures foreign commodity pools, foreign private funds and, notably, foreign sovereigns.

A financial end user would be considered "high risk" <u>unless</u> (1) it does not have significant swap exposure (a level designed to equal half the level of uncollateralized outward exposure that would require registration as a major swap participant under the substantial counterparty exposure prong of the proposed major swap and security-based

[12] A covered swap entity would not be in violation of the Proposed Rules if its counterparty has failed to provide the required variation margin and the covered swap entity has either made necessary efforts to attempt to collect the margin or commenced termination of the swap.

swap participant definitions),[13] (2) it predominantly uses swaps to hedge or mitigate the risks of its business activities, including balance sheet or interest rate risk, and (3) it is subject to capital requirements established by a prudential regulator or state insurance regulator. As a result of prong (3), funds and other collective investment vehicles (notably including pension plans subject to investment limitations), U.S. and foreign broker-dealers and futures commission merchants, foreign banks without U.S. banking operations and foreign sovereign entities would necessarily be considered "high risk."

If a financial end user counterparty qualifies as a "low risk" counterparty, rather than a "high risk" counterparty, a covered swap entity would be required to collect initial or variation margin only at the point at which the initial and variation margin requirements exceed the lesser of (i) $15-45 million and (ii) 0.1-0.3% of the swap entity's Tier 1 capital.[14] Consequently, many community banks and smaller regional banks whose swap activities qualify them as low risk financial end users and whose swap activities are sufficiently limited in scope may not be required to post margin.

iii. Transactions with Nonfinancial End Users

Covered swap entities would be required to establish internal credit limits for nonfinancial end user at levels consistent with the covered swap entity's internal credit risk management policies and parameters. A covered swap entity would be required to collect initial and variation margin from nonfinancial end users[15] only if the amount that the swap entity would otherwise collect exceeds the credit exposure threshold so established by the covered swap entity (and exceeds the $100,000 *de minimis* threshold noted above). Variation margin amounts (subject to the $100,000 *de minimis* threshold) would be required to be collected from nonfinancial end users on a weekly (as opposed to daily) basis. No segregation would be required, except at the request of the counterparty. Consistent with the overall framework, covered swap entities would not be required to post margin to nonfinancial end users, as had been suggested by some legislative colloquies. Covered swap entities would nevertheless be required to have margin documentation in place with nonfinancial end users.

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[13] In swaps, this threshold would equal $2.5 billion in daily average aggregate uncollateralized outward exposure or $4 billion in daily average aggregate uncollateralized exposure plus daily average aggregate potential outward exposure. In security-based swaps, it would equal $1 billion in daily average aggregate uncollateralized outward exposure or $2 billion in daily average aggregate uncollateralized exposure plus daily average aggregate potential outward exposure.

[14] For FHFA-regulated swap entities, this measurement would instead be based on total capital and, for FCA-regulated swap entities, on either core surplus or core capital, as applicable.

[15] Nonfinancial end users would include any counterparty that is neither a swap entity nor a financial end user.

iv. Transactions with FHFA/FCA Regulated Entities

FHFA and FCA, but not the other Prudential Regulators, have additionally proposed to require that any entity regulated by FHFA or FCA (which would include the Federal Home Loan Banks, Fannie Mae and its affiliates, Freddie Mac and its affiliates, and all Farm Credit System institutions including Farmer Mac), that is not itself a swap entity, collect initial and variation margin from swap entity counterparties for non-cleared swaps.[16] Both initial and variation margin posted by a FHFA or FCA-regulated entity would also be required to be segregated with an independent third party custodian located in a jurisdiction that applies the same insolvency regime as would apply to the posting FHFA or FCA-regulated entity.[17]

v. Cross-Border Transactions

Although the Proposed Rules contain a carve-out that the Prudential Regulators describe as intended to limit the extra-territorial application of U.S. margin requirements while preserving competitive equality among U.S. and foreign firms in the U.S., the relevant provision actually expands the territorial scope of U.S. requirements and gives rise to additional competitive issues for U.S.-domiciled bank holding companies.

Specifically, the Proposed Rules would apply U.S. margin requirements to any transaction by a covered swap entity (U.S. or foreign) with a U.S.-domiciled counterparty. They also would apply U.S. margin requirements to transactions by a covered swap entity (U.S. or foreign) with a non-U.S. branch or office of a U.S. person or a non-U.S. affiliate of a U.S. person where that non-U.S. affiliate's swap has been guaranteed by a U.S.-domiciled person or branch or office of a U.S.-domiciled person.[18]

The Proposed Rules would not, however, impose U.S. margin requirements in the context of a transaction between a foreign covered swap entity and a non-U.S.-domiciled counterparty (provided the counterparty also is not a non-U.S. branch or office of a U.S. person or a non-U.S. affiliate of a U.S. person in circumstances where the non-U.S. affiliate's swap has been guaranteed by a U.S.-domiciled person or branch or office of a U.S.-domiciled person). Significantly, however, for these purposes, a foreign covered swap

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[16] As in the case of covered swap entities, initial margin could be calculated using approved internal models or the proposed standardized table. FHFA/FCA-regulated entities would also be permitted to use a third-party model, so long as the provider of the model is independent of the swap entity that is the counterparty to the transaction and the model satisfies the other requirements specified in the Proposed Rules.

[17] Read literally, this requirement would prohibit a FHFA or FCA-regulated entity from having its margin held by a bank custodian subject to resolution under the Federal Deposit Insurance Act.

[18] We note that this proposed requirement contrasts with the FRB's Regulation U, which exempts credit extended outside the U.S. by a foreign branch or foreign subsidiary of a U.S. bank from the margin requirements of Regulation U.

entity would not include a non-U.S.-domiciled entity that is a non-U.S. branch, office or a separately incorporated subsidiary of a U.S.-domiciled person, whether or not the relevant transactions are effected entirely outside the U.S.

As noted above, we read this proposal to mean that, in the case of a foreign swap dealer whose only contact to the U.S. is that it is a subsidiary of a U.S. person, the application of U.S. margin requirements would depend on whether that dealer will be required by the CFTC and the SEC to register in the U.S. as a swap entity. If the foreign swap dealer conducts swap business with both U.S. and non-U.S. counterparties, the application of margin requirements would similarly depend on whether the dealer is permitted by the CFTC and the SEC to register only with respect to its U.S.-facing swap dealing activity. Accordingly, the ultimate scope of U.S. margin requirements for foreign swap entities that are subsidiaries of U.S. persons will depend on the scope of the application of the CFTC and SEC registration requirements for foreign swap entities.

Considerations of enforceability apart, it is difficult to discern a U.S. policy basis for the extraterritorial application of U.S. margin requirements to an offshore transaction between a foreign subsidiary of a U.S. person and a foreign counterparty, as contemplated by the Proposed Rules. While the application of margin requirements in the context of a foreign person controlled by a U.S. person has some analogy to Regulation X – which subjects a foreign borrower controlled by a U.S. person to U.S. margin rules – it is worth noting that, in contrast to the margin requirements under Regulation X, Dodd-Frank's margin requirements are not, under the statute, intended to limit leverage of borrowers. Rather, Dodd-Frank's margin requirements are intended to protect the safety and soundness of the U.S.-registered swap entity. It is therefore not clear that Regulation X is an appropriate analogy for the Proposed Rule. If the Prudential Regulators were to adopt the position that it is the objective of Dodd-Frank's margin requirement to regulate an end user's access to credit, one would have expected the Proposed Rules to limit the extraterritorial application of U.S. margin requirements to circumstances in which a covered swap entity's counterparty is a subsidiary of a U.S. person, so as to limit the ability of a U.S.-related counterparty to evade the margin requirements of Dodd-Frank.

In any case, if adopted in their current form, the Proposed Rules could give rise to significant competitive disparities between U.S.- and foreign-headquartered institutions, in the event that U.S. margin requirements are significantly more stringent than the requirements adopted in non-U.S. jurisdictions.

C. Eligible Collateral

The Proposed Rules restrict eligible collateral for purposes of satisfying the proposed margin requirements to (a) immediately available cash, (b) U.S. obligations or (c) for initial margin only, the debt obligations of Freddie Mac, Fannie Mae, the Federal Home Loan Banks, and Farmer Mac or insured obligations of a Farm Credit System Bank. Additionally, the Prudential Regulators have proposed specific haircuts for each of these permitted categories of eligible non-cash collateral.

Notably, at the point at which nonfinancial end users must provide margin under the Proposed Rules, that margin must be in the form of eligible collateral. Under the Proposed Rules, however, a covered swap entity would be permitted to collect margin that is not required by regulation in any form it agrees with its counterparty.

D. Legacy Portfolios

As noted above, the proposed margin requirements would apply to swaps entered into on or after 180 days following the publication of the final rule in the Federal Register. The Prudential Regulators note that the proposed margin requirements would not apply to swaps outstanding as of the effective date of the final rule and confirm that covered swap entities may, if they so elect, compute counterparty margin requirements on a portfolio basis including pre-effective date swaps or may do so on a portfolio basis restricting the portfolio to post-effective date swaps.

II. CAPITAL

As noted above, the Proposed Rules would also establish capital rules for covered swap entities by confirming that those entities must comply with existing capital standards that apply to them under the rules of their existing Prudential Regulator. Significantly, in the case of foreign banks whose home country supervisor has adopted capital standards consistent in all respects with the Basel Accord, this would mean home country capital standards.[19]

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[19] As noted in footnote 4 above, a foreign bank whose home country supervisor has not adopted capital standards consistent in all respects with the Basel Accord may still be subject to home country capital adequacy standards if it has obtained a determination from the FRB that its capital is equivalent to the capital that would be required of a U.S. banking organization.

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