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Bank Regulators Approve Joint Final Rule on Uncleared Swap Margin Requirements

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd Frank Act”) intends that all swap dealers, major swap participants, security-based swap dealers and security-based major swap participants (each, a “Swap Entity” and, collectively, “Swap Entities”) be subject to rules on minimum margin for all swaps¹ and security-based swaps² not cleared by a registered central clearing house (“Uncleared Swaps”).³ The Federal Reserve, the Federal Deposit Insurance Corporation (“FDIC”), the Office of the Comptroller of the Currency (“OCC”), the Farm Credit Administration, and the Federal Housing Finance Agency (each, a “Prudential Regulator” and, collectively, “Prudential Regulators”),⁴ the Commodity Futures Trading Commission (“CFTC”) and the Securities and Exchange Commission (“SEC”)⁵ have been tasked with promulgating these rules.

The Prudential Regulators first proposed a rule in April 2013 to deal with Uncleared Swap margin and then re-proposed the rule in September 2014 to reflect the international guidelines for uncleared margin put forth by the Basel Committee of Banking Supervision and the International Organization of Securities Commissions in September 2013 (the “Proposed Rule”). On October 22, 2015, the FDIC, the OCC and the Farm Credit Administration⁶ approved a final rule establishing margin requirements for Uncleared Swaps (the “Final Rule”) and the Federal Reserve and Federal Housing Finance Agency followed suit on October 30.⁷ The Final Rule becomes effective on April 1, 2016.

What’s Required by the Final Rule

The Final Rule applies to entities supervised by a Prudential Regulator that are registered with the CFTC or the SEC as a Swap Entity (each, a “Regulated Entity” and, collectively, “Regulated Entities”).

The Final Rule requires Regulated Entities to post and collect initial margin on Uncleared Swaps entered into with a Swap Entity or with a financial end user that has “material swaps exposure”.⁸ Regulated Entities may adopt a maximum threshold of \$50 million for posting or collecting initial margin.⁹ The Final Rule requires Regulated Entities to post and collect variation margin on Uncleared Swaps entered into with a Swap Entity or with **any** financial end user on a daily basis but does not allow Regulated Entities to adopt a variation margin threshold.¹⁰ Furthermore, for swaps between a Regulated Entity and its affiliates, the Regulated Entity is required to collect initial margin but is not required to post initial margin.¹¹ However, the Regulated Entity must calculate the amount of initial margin it would have been required to post to its affiliate under the Final Rule and provide documentation of such amount to each affiliate on a daily basis.¹² The

Regulated Entity may grant its affiliate a maximum threshold of \$20 million for initial margin.¹³

It is important to note that the Final Rule requirements apply to all of a Regulated Entity’s swap and security-based swap activities without regard to whether the Regulated Entity is registered as a swap dealer, a security-based swap dealer, major swap participant or major security-based swap participant. Thus, as stated as an example in the Final Rule “for an entity that is a swap dealer but not a security-based swap dealer or major security-based swap participant, the final rule’s requirements would apply to all of that swap dealer’s non-cleared swaps and non-cleared security-based swaps.”¹⁴

The Final Rule also specifies what is eligible collateral for initial and variation margin purposes¹⁵ and requires that initial margin collateral be segregated at third-party custodians.¹⁶ The custody agreements must prohibit rehypothecation of the collateral.¹⁷ The Final Rule does not apply to swaps entered into by non-financial commercial end users for purposes of hedging commercial risk¹⁸ or to community banks that enter into Uncleared Swaps with their commercial customers.¹⁹ The initial margin requirement is scheduled to be phased in from

September 1, 2016, to September 1, 2020²⁰ and variation margin will be phased in on September 1, 2016 and March 1, 2017 depending on the average daily notional amount of covered swaps.²¹ The Final Rule will not be applied retroactively.²²

Although it is unlikely that Regulated Entities will put themselves at a competitive disadvantage by asking for more than the minimum margin requirements, it should be noted that the Final Rule makes it clear that its provisions establish only minimum initial and variation margin requirements and “[n]othing in the final rule is intended to prevent or discourage a covered swap entity from collecting or posting margin in amounts greater than is required under the final rule.”²³

Lastly, an interim final rule and request for comment²⁴ was also published to clarify that the minimum margin requirements do not apply to swaps entered into for hedging purposes by certain commercial end users and financial institutions with \$10 billion or less in assets. While this interim final rule becomes effective immediately upon publication, the Prudential Regulators may make changes to the rule if warranted by public comments. Comments on the interim rule are due by January 31, 2016.

Implications

As with the rest of Title VII of the Dodd Frank Act, the Final Rule mandates significant changes to the bilateral OTC swaps market that will most probably increase the cost of trading across the board.

It has been estimated that the Final Rule will force Regulated Entities to put up approximately 30 percent more collateral if they trade outside central clearing houses.

In addition, requiring collateral segregation, prohibiting collateral rehypothecation and forcing Regulated Entities to collect margin from affiliates on inter-affiliate transactions (even without a requirement to post) is predicted to raise transaction funding costs, reduce liquidity and lead to higher costs.

The regulators probably intended this result in order to incentivize Regulated Entities to clear derivatives through central clearing houses.

Further complicating the matter, the CFTC, the SEC and foreign jurisdictions have not yet published their versions of uncleared transaction margin rules so the impact of

potential harmonization issues with those rules on the Final Rule remains to be seen.

- 1 “Swaps” are defined in section 721 of the Dodd Frank Act and include interest rate swaps, commodity swaps, equity swaps, and credit default swaps.
- 2 “Security-based swaps” are defined in section 761 of the Dodd-Frank Act and include a swap based on a single security or loan or on a narrow-based security index.
- 3 A swap may be uncleared either because it is not subject to mandatory clearing under the Dodd Frank Act, or because one of the parties to the swap is eligible for an exemption from mandatory clearing.
- 4 Sections 731 and 764 of the Dodd Frank Act require the Prudential Regulators to jointly adopt rules to impose capital requirements and initial and variation margin requirements on the Swap Entities they regulate.
- 5 Sections 731 and 764 of the Dodd Frank Act require the CFTC and SEC to separately adopt rules to impose capital and margin requirements on the Swap Entities for which there is no Prudential Regulator.
- 6 MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES AGENCIES, DEPARTMENT OF THE TREASURY Office of the Comptroller of the Currency 12 CFR Part 45, Docket No. OCC-2011-0008, RIN: 1557-AD43s, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM 12 CFR Part 237, Docket No. R-1415, RIN: 7100 AD74, FEDERAL DEPOSIT INSURANCE CORPORATION 12 CFR Part 349, RIN: 3064-AE21, FARM CREDIT ADMINISTRATION 12 CFR Part 624, RIN: 3052-AC69, FEDERAL HOUSING FINANCE AGENCY 12 CFR Part 1221, RIN: 2590-AA45.
- 7 This memo focuses on margin requirements as the Rule allows the Prudential Regulators to rely on existing regulatory capital rules. See Rule at 27-28.
- 8 An entity has “material swaps exposure” if it and its affiliates have more than \$8 billion average daily aggregate notional in Uncleared Swaps and foreign exchange forwards and foreign exchange swaps for June, July and August of the previous calendar year. The threshold for financial end users was increased from \$3 billion of notional in the Proposed Rule to \$8 billion in the Rule.
- 9 Final Rule at 17.
- 10 Id. at 18.
- 11 The Proposed Rule required Regulated Entities to collect and post collateral in inter-affiliate trades.
- 12 Final Rule at 24.
- 13 Id.
- 14 Id. at 11.

- 15 Id. at 20.
- 16 Id. at 21 and 243.
- 17 Id. at 22 and 243.
- 18 Id. at 33.
- 19 Id. at 28.
- 20 Id. at 37-38.
- 21 Id. at 39-40.
- 22 Id. at 41-42.
- 23 Id. at 16.
- 24 MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES AGENCIES, DEPARTMENT OF THE TREASURY Office of the Comptroller of the Currency 12 CFR Part 45, Docket No. OCC-2015-0023, RIN: 1557-AD00, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM 12 CFR Part 237, Docket No. R-1415, RIN: 7100-AD74, FEDERAL DEPOSIT INSURANCE CORPORATION 12 CFR Part 349, RIN: 3064-AE21, FARM CREDIT ADMINISTRATION 12 CFR Part 624, RIN: 3052-AC69, FEDERAL HOUSING FINANCE AGENCY 12 CFR Part 1221, RIN: 2590-AA45.

For More Information

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