DATE: September 3, 2014

MEMORANDUM TO: Board of Directors

FROM: Doreen R. Eberley, Director
Division of Risk Management Supervision

SUBJECT: Notice of Proposed Rulemaking to establish Margin and Capital Requirements for Covered Swap Entities

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Recommendation: Staff recommends that the FDIC Board of Directors ("Board") approve publication of the attached joint *Notice of Proposed Rulemaking* ("NPR" or "proposed rule") entitled "Margin and Capital Requirements for Covered Swap Entities." This NPR was developed jointly by Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Farm Credit Administration, and the Federal Housing Finance Agency (collectively the "prudential regulators" and, herein "agencies"). The proposed rule is required pursuant to sections 731 and 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). This proposal is consistent with the international framework on margin requirements published by the Basel Committee on Banking Supervision ("BCBS") and the International Organization of Securities Commissions ("IOSCO") in September 2013.

If approved, the proposed rule would establish minimum margin requirements for the swaps of an insured depository institution or other entity that: (1) is supervised by the prudential regulators; and (2) is registered with the Commodity Futures Trading Commission or the Securities and Exchange Commission as a swap dealer, major swap participant, security-based swap dealer or major security-based swap participant ("covered swap entities"). The proposed rule would be published in the *Federal Register* with a 60-day public comment period.

Concur:

Richard J. Osterman, Jr.
Acting General Counsel

I. Background

The Dodd-Frank Act Swap Reform: Title VII of the Dodd-Frank Act (Title VII) amended the Commodity Exchange Act (CEA) and the Securities Exchange Act of 1934 (the Exchange Act) to establish a comprehensive regulatory framework for derivatives that meet the Title VII definition of swaps and security-based swaps (collectively, "swaps").[1] Specifically, sections 731 and 764 of the Dodd-Frank Act requires the agencies to adopt rules jointly to establish capital requirements and initial and variation margin requirements for such entities on all non-cleared swaps and non-cleared security-based swaps in order to offset the greater risk to such entities and the financial system arising from the use of swaps and security-based swaps that are not cleared.

2011 NPR: In May 2011, the agencies published proposed rules for swap margin requirements ("2011 proposal") that would implement sections 731 and 764 of the Dodd-Frank Act. The agencies received over 100 comments in response to the 2011 proposal from a variety of commenters, including banks, asset managers, commercial end users, and various trade associations. The CFTC also proposed margin requirements in May 2011 for swap entities it supervises and the SEC proposed such requirements for entities subject to its supervision in November 2012. Commenters expressed concerns that given the global nature of the OTC swaps market, if similar requirements were not established in foreign jurisdictions, market participants could avoid the high costs of complying with the proposed rules by moving the activities abroad.

2013 International Framework on Margin: In July of 2012, the BCBS and IOSCO published a proposed framework for margin requirements on non-cleared swaps with the goal of creating an international standard for margin requirements on non-cleared swaps. Following the release of the proposed international framework, the agencies re-opened the comment period on the 2011 proposal to allow for additional comment. The proposed international framework was

1 "Swaps" are defined in the CEA to include interest rate swaps, foreign exchange swaps, commodity-based swaps, and broad-based credit swaps. "Security-based swaps" are defined in the Exchange Act to include single-name and narrow-based credit swaps and equity-based swaps.

also subject to extensive public comment before it was finalized by the BCBS and IOSCO in September of 2013 (the "2013 international framework").[2]

Staff reviewed the comments received on the 2011 proposal as well as the 2013 international framework and determined that a number of changes to the 2011 proposal were warranted in order to reflect the comments received, as well as to achieve the 2013 international framework's goal of reducing regulatory arbitrage opportunities. In light of those changes, staff has developed the attached NPR, which would supersede the 2011 proposal.

II. Overview of the Proposed Rule

The agencies are proposing to adopt a risk-based approach that would establish initial and variation margin requirements for covered swap entities. Consistent with the statutory requirement, the proposed rule would help ensure the safety and soundness of the covered swap entity and would be appropriate for the risk to the financial system associated with non-cleared swaps held by covered swap entities. The proposed rule takes into account the risk posed by a covered swap entity's counterparties in establishing the minimum amount of initial and variation margin that the covered swap entity must exchange with its counterparties. The proposed rule would be consistent with the 2013 international framework.

In implementing this risk-based approach, the proposed rule distinguishes among four separate types of swap counterparties: (i) counterparties that are themselves swap entities; (ii) counterparties that are financial end users with a material swaps exposure; (iii) counterparties that are financial end users without a material swaps exposure, and (iv) other counterparties, including nonfinancial end users, sovereigns, and multilateral development banks.[3] These categories reflect the agencies' current belief that risk-based distinctions can be made between these types of swap counterparties.

The proposed rule's initial and variation margin requirements generally apply to the posting, as well as the collection, of minimum initial and variation margin amounts by a covered swap entity from and to its counterparties. This proposal represents a refinement to the agencies'

2 See BCBS and IOSCO "Margin requirements for non-centrally cleared derivatives," (September 2013), available at http://www.bis.org/publ/bcbs261.pdf.

3 See § __.2 of the proposed rule for the various constituent definitions that identify these four types of swap counterparties.

original collection-only approach to margin requirements based on consideration of comments made on the 2011 proposal and the 2013 international framework. While the agencies believe that imposing requirements with respect to the minimum amount of initial and variation margin to be collected is a critical aspect of offsetting the greater risk to the covered swap entity and the financial system arising from the covered swap entity's non-cleared swap exposure, the agencies also believe that requiring a covered swap entity to post margin to other financial entities could forestall a build-up of potentially destabilizing exposures in the financial system. The proposed rule's approach therefore is designed to ensure that covered swap entities transacting with other swap entities and with financial end users in non-cleared swaps will be collecting and posting appropriate minimum margin amounts with respect to those transactions.

Initial Margin: The proposed rule would require a covered swap entity to exchange initial margin with counterparties that are: (1) swap entities; or (2) financial end users with material swaps exposure. The requirement that a covered swap entity post initial margin to certain of its counterparties, as well as collecting such margin from the counterparty, is a modification to the approach taken in the 2011 proposal and takes into consideration comments received both on the 2011 proposal and the 2013 international framework. Staff believes that requiring a covered swap entity to post margin to certain other financial entities may forestall a build-up of potentially destabilizing exposures in the financial system.

The proposed rule would require a covered swap entity to calculate its minimum initial margin requirement in one of two ways:

1. Standardized Table: using a standardized margin schedule that is set out in Appendix A of the proposed rule and allows for certain types of netting and offsetting of exposures; or

2. Internal Model: using an internal margin model that satisfies the criteria outlined within the proposed rule and has been approved by the supervising agency.

In addition, a covered swap entity must post or collect initial margin on at least a daily basis 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.

The proposed rule also permits a covered swap entity to adopt a maximum threshold amount of $65 million, below which it need not collect or post a minimum amount of initial margin for swaps with counterparties that are: (1) swap entities; or (2) financial end users with material swaps exposures. The threshold would be applied on a consolidated basis to both the covered swap entity and its counterparty.

For transactions with: (1) financial end users without material swap exposure; or (2) commercial end users, the proposed rule does not specify a minimum amount of initial margin that must be collected or posted. Instead, the covered swap entity is required to collect initial margin in such forms and amounts (if any) and at such times from other counterparties as the covered swap entity determines appropriately address the credit risk posed by such counterparties. As such, staff believes that the proposal rule does not change current industry practice with respect to these counterparties.

Variation Margin: The proposed rule would require a covered swap entity to exchange variation margin on swaps with all counterparties that are: (1) swap entities; or (2) financial end users (regardless of whether the financial end user has a material swaps exposure). The amount of variation margin must be at least equal to the increase or decrease in the value of the swap since the counterparties' previous exchange of variation margin, calculated on at least a daily basis. Requiring covered swap entities to exchange variation margin with these counterparties effectively reduces systemic risk by protecting both the covered swap entity and its counterparty from the effects of a counterparty default. Importantly, unlike the treatment of initial margin, the proposed rule would not permit a covered swap entity to adopt a threshold amount below which it need not collect or post variation margin on swaps with swap entity or financial end user counterparties.

Netting agreements: The proposed rule permits a covered swap entity to: (i) calculate initial margin requirements for swaps under an eligible master netting agreement (EMNA) with a counterparty on a portfolio basis in certain circumstances, if it does so using an initial margin model; and (ii) calculate variation margin requirements under the proposed rule on an aggregate, net basis under a EMNA with a counterparty. The proposed rule 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.

Minimum transfer amount: Under the proposed rule, a covered swap entity need not collect or post initial or variation margin from or to any individual counterparty otherwise required unless and until the required cumulative amount of initial and variation margin is $650,000 or more. The minimum transfer amount only affects the timing of margin collection; it does not change the amount of margin that must be collected once the $650,000 threshold is crossed. For example, if the margin requirement were to increase from $500,000 to $800,000, the covered swap entity would be required to collect the entire $800,000 (subject to application of any applicable initial margin threshold amount in the case of initial margin being collected).

Eligible collateral: The proposed rule limits the types of collateral that covered swap entities may post or collect to meet their minimum margin requirements. For variation margin, the proposed rule requires the collection or posting of immediately available cash funds, denominated either in U.S. dollars or in the currency in which payment obligations under the swap are required to be settled. Staff believes that limiting the eligible collateral for variation margin to cash is consistent with the current view among market participants that variation margin payments between counterparties to swaps transactions effectively settle each counterparty's exposure to the other. Staff also believes that limiting variation margin to cash should reduce the potential for disputes over the value of variation margin collateral.

For initial margin, the proposed rule permits a broader range of collateral to be pledged to satisfy the minimum margin requirements than was proposed in the 2011 proposal, but limits the recognition of collateral to certain assets expected to remain highly liquid during a period of financial stress. Eligible collateral for initial margin includes cash, debt securities that are issued or guaranteed by the U.S. Department of Treasury or by another U.S. government agency, the Bank for International Settlements, the International Monetary Fund, the European Central Bank, multilateral development banks, certain U.S. Government-sponsored enterprises' ("GSEs") debt securities, certain foreign government debt securities, certain corporate debt securities, certain listed equities, and gold.

When determining the collateral's value for purposes of satisfying the proposed rule's margin requirements, non-cash collateral and cash collateral that is not denominated in U.S. dollars or the currency in which payment obligations under the swap are required to be settled would be subject to an additional "haircut" as determined using Appendix B of the proposed rule. The limits on eligible collateral and application of a haircut would not apply to margin collected in excess of what is required by the proposed rule.

Because the value of collateral may change, the proposed rule also requires a covered swap entity to monitor the value and quality of collateral previously collected to satisfy minimum initial or variation margin requirements. If the value of such collateral has decreased, or if the quality of the collateral has deteriorated so that it no longer qualifies as eligible collateral, the proposed rule requires covered swap entities to collect additional collateral of sufficient value and quality to ensure that all applicable minimum margin requirements remain satisfied.

Segregation of collateral: The proposed rule would require a covered swap entity to require that any collateral other than variation margin that it posts to its counterparty (even collateral in excess of any required by the proposed rule) be segregated at one or more custodians that are not affiliates of the covered swap entity or the counterparty ("third-party custodian"). The proposed rule would also require a covered swap entity to place the initial margin it collects (in accordance with the proposed rule) from a swap entity or a financial end user with material swaps exposure at a third-party custodian.[4] In both cases, the third-party custodian must be prohibited by agreement[5] from (i) rehypothecating, repledging, reusing or otherwise transferring, any of the funds or other property it holds, and (ii) substituting or reinvesting any funds or other property it holds as initial margin pursuant to the rule in any asset that would not qualify as eligible collateral under the proposed rule and where the amount net of applicable discounts described in Appendix B would not be sufficient to meet the requirements for initial margin under the proposal.

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4 The segregation requirement applies only to the minimum amount of initial margin that a covered swap entity is required to collect by rule from a swap entity or financial end user with a material swaps exposure. The segregation requirement also applies to any collateral (other than variation margin) that the covered swap entity posts to any counterparty.

5 The proposed rule requires the covered swap entity to enter into a custodial agreement with a custodian that is legal, valid, binding, and enforceable under the law of all relevant jurisdictions including in the event of bankruptcy, insolvency, or similar proceedings.

Staff believes that requiring covered swap entities to segregate and limit the rehypothecation, repledging, or reuse of funds and other property held at a custodian is necessary to: (i) offset the greater risk to the covered swap entity and the financial system arising from the use of swaps that are not cleared, and (ii) protect the safety and soundness of the covered swap entity. Staff believes that requiring the protection of pledged margin bilaterally between the counterparties provides assurance that the pledging counterparty does not face additional losses (due to the loss of its transferred or pledged collateral) above the replacement cost of the uncleared swap portfolio.[6]

Initial margin model: The proposed rule permits a covered swap entity to calculate initial margin requirements using an approved initial margin model, provided certain standards and criteria are satisfied and the model is approved by the Agency that supervises the covered swap entity. These standards relate to the technical aspects of the model, as well as broader oversight and governance standards, and are broadly similar to modeling standards that are already required for internal regulatory capital models. In the event that a model is not approved, initial margin calculations would have to be performed according to the standardized initial margin approach that is detailed in the proposed rule's Appendix A.

The proposed rule permits a covered swap entity to use an internal initial margin model that reflects offsetting exposures, diversification, and other hedging benefits within, but not across, seven broad risk categories, agricultural commodities, energy commodities, metal commodities, other commodities, credit, equity, and foreign exchange and interest rates (as a single asset class) when calculating initial margin for a particular counterparty if the swaps are executed under the same eligible master netting agreement. The initial margin amount calculated using an initial margin model must 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. Generally, the proposed rule's modeling standards for the initial margin model are consistent with current regulatory rules and best practices for such models in the

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[6] The 2013 international framework sets out parameters for member countries to permit a limited degree of rehypothecation, repledging, and reuse of initial margin collateral when a covered swap entity is dealing with a financial end user if certain safeguard for protecting the financial end user's rights in such collateral are available under applicable law. On April 14, 2014, the European Supervisory Authorities (ESA) issued for comment a proposal to implement the international agreement. Like the proposed rule, the ESA did not propose to allow the rehypothecation, repledge, or reuse of initial margin.

context of risk-based capital rules applicable to insured depository institutions and bank holding companies, are no less conservative than those generally used by central counterparties, and are consistent with the standards of the 2013 international framework.[7]

Cross-border application of margin requirements: Non-cleared swaps are transacted in global markets often between counterparties organized in different jurisdictions. Section 9 of the proposal addresses the applicability of the proposed margin rules to an entity supervised by one of the agencies that is a covered swap entity, i.e., that is required by CFTC and SEC policies to register as a swaps entity.

Under the proposed rule, the agencies could jointly determine that the requirements of a foreign regulatory framework are comparable to the corresponding requirements of the proposed rule. These determinations would be made on a jurisdiction-by-jurisdiction basis. In making such determinations, the agencies would expect that the foreign regulatory framework would be fully consistent with the principles established in the 2013 international framework. If such a determination were made, substituted compliance, that is, satisfying the proposed requirement by complying with the requirement of a foreign jurisdiction, would be permitted in certain circumstances. However, swaps transacted by U.S. covered swap entities, including those transacted out of foreign branches of U.S. covered swap entities, would not be eligible for substituted compliance.

Entities not covered by the rule: The agencies engage in this rulemaking pursuant to sections 731 and 764 of the Dodd-Frank Act, which applies to registered swap dealers and security-based swap dealers for which one of the agencies is the "prudential regulator" for purposes of Title VII. Title VII's registration requirements are implemented by the CFTC and SEC, not the agencies. After the prudential regulators issued their 2011 proposal, the CFTC adopted guidance and the SEC adopted a rule to address cross-border issues in swap regulation, including the circumstances in which foreign firms are required to register as dealers. This guidance clarifies that foreign subsidiaries of U.S. firms engaging in swaps activities abroad are not required to register with the CFTC or SEC solely on account of their parent's presence in the

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7 This conservative approach also incorporates the practices associated with model validation, independent review and other qualitative requirements associated with the use of internal models for regulatory capital purposes.

U.S. Accordingly, there may be notable circumstances in which a foreign subsidiary may engage in non-cleared swaps activities abroad, without registering with the CFTC or SEC, and accordingly without being covered by the margin rules being proposed by the agencies in this Federal Register notice. The agencies note that a substantial amount of swaps activities are currently conducted through foreign subsidiaries that may not be subject to certain requirements of Title VII of the Dodd Frank Act.[8] In the case of this proposed margin rule, it also should be noted that even if a foreign subsidiary of a U.S. entity is not required to register with the CFTC or SEC as a swaps entity, in many cases such a subsidiary will be operating in a jurisdiction that applies the 2013 international framework, a framework that, as previously noted, is consistent with this proposed rule. The agencies are seeking public comment specifically with respect to the treatment under this proposed rule of foreign subsidiaries of U.S. entities.

Compliance dates: The proposed rule includes a set of compliance dates by which covered swap entities must comply with the minimum margin requirements for non-cleared swaps. The proposed rule's compliance dates are consistent with the 2013 international 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 respect to covered swaps 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, foreign exchange forwards and foreign exchange swaps of the covered swap entity and its counterparty for June, July and August of the previous year.

The NPR and Community Banks: The agencies anticipate that community banks will not engage in swap activity to the level necessary to meet the definition of a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant, and therefore, are unlikely to fall within the proposed definition of a covered swap entity. Because the proposed rule imposes requirements on covered swap entities, no community bank will likely be directly subject to the rule. Thus, a community bank that enters into non-cleared interest rate

[8] See, section 722 (d) and 772 (c) of the Dodd Frank Act that place certain limitations on the application of Title VII to activities outside the United States.

swaps with its commercial customers would not be required to apply to those swaps the proposed rule's requirements for initial margin or variation margin.

When a community bank enters into a swap with a covered swap entity, the covered swap entity would be required to post and collect initial margin pursuant to the rule only if the community bank had a material swap exposure. The agencies believe that the vast majority of community banks do not engage in swaps at or near that level of activity. Thus, for most, if not all community banks, the proposed rule would only require a covered swap entity to collect initial margin that it determines is appropriate to address the credit risk posed by such an institution. The agencies believe covered swap entities currently apply this approach as part of their credit risk management practices.

The proposed rule would require a covered swap entity to exchange daily variation margin with a community bank, regardless of whether the institution had material swap exposure. However, community banks that engage in OTC derivatives that are not cleared are likely already posting variation margin in the normal course of business, or in amounts too small to fall within the scope of the rule. As a result, the margin rule likely will have little, if any, impact on the current variation margining practices of the vast majority of community banks.

The NPR and Commercial End Users: Under the proposal, a covered swap entity's collection of margin from "other counterparties" that are commercial end users remains a matter for the judgment of the covered swap entity, and thus does not represent a change from current margining practice. That is, under the proposed rule, a covered swap entity is not required to collect initial and variation margin from a commercial end user as a matter of course. However, a covered swap entity should continue with the current practice of collecting initial or variation margin at such times and in such forms and amounts (if any) as the covered swap entity determines is a necessary component of its overall credit risk management of the swap entity's exposure to the customer.

Conclusion:

Staff recommends that the Board approve publication of the attached NPR in the *Federal Register* for a 60-day comment period.

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