MEMORANDUM TO: Board of Directors

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

Charles Yi
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SUBJECT: Final Rule Regarding Margin and Capital Requirements for Covered Swap Entities

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RECOMMENDATION: That the Board of Directors (the "Board") of the Federal Deposit Insurance Corporation (the "FDIC") adopt and issue the attached Final Rule (the "Final Rule") titled *Margin and Capital Requirements for Covered Swap Entities; Final Rule* (12 CFR Part 349). The Final Rule is a joint rule with the Office of Comptroller of the Currency ("OCC"), the Federal Reserve System ("FRB"), the Farm Credit Administration ("FCA") and the Federal Housing Finance Agency ("FHFA", the FHFA, the OCC, the FRB and the FCA, together with the FDIC, are referred to as the "Agencies"), that amends the rule entitled Margin and Capital Requirements for Covered Swap Entities (the "Swap Margin Rule") published by the FDIC and the other Agencies on November 30, 2015 (and codified, in the case of the FDIC, at 12 CFR Part 349) to take account of the recently adopted Qualified Financial Contracts (QFC) Stay Provision Rule described below.

INTRODUCTION: On September 27, 2017, the Board approved a final rule, *Restrictions on Qualified Financial Contracts of Certain FDIC-Supervised Institutions; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions* (establishing 12 CFR Part 382 and amending 12 CFR Parts 324 and 329, hereafter referred to as the "QFC Stay

Provision Rule"). The QFC Stay Provision Rule requires (among other items) that certain QFCs of global systemically important banks ("GSIBs") and their subsidiaries provide for stays on certain default remedies. In addition, the QFC Stay Provision Rule restricts QFCs from permitting the exercise of termination and other specified remedies based on the insolvency of an affiliate of a GSIB or GSIB subsidiary that is party to the QFC. It also generally prohibits, in the case of bankruptcy, as well as in Federal Deposit Insurance Act ("FDIA") proceedings, limitations on the transfer of QFC credit enhancements provided by GSIBs or their subsidiaries. The FRB approved a substantively identical rule on September 1, 2017 and the OCC approved a substantively identical rule on November 20, 2017. In order that the regulatory capital and liquidity treatment of covered QFCs of the covered institutions not be affected by its requirements, the QFC Stay Provision Rule (as well as the parallel FRB and OCC rules) included amendments to the definition of qualified master netting agreement in the capital and liquidity rules and certain related terms in the capital rules. The Final Rule amends the definition of Eligible Master Netting Agreement ("EMNA") in the Swap Margin Rule and adds a clarifying provision to the Swap Margin Rule in order that the margin requirements of the Swap Margin Rule also not be affected by compliance with the QFC Stay Provision Rule.

On February 21, 2018, the Agencies published a Notice of Proposed Rulemaking (the "NPR"), which set forth a proposed rule (the "Proposed Rule") that included two amendments to the Swap Margin Rule, discussed in more detail below. These amendments clarified that a master netting agreement meets the definition of EMNA under the Swap Margin Rule even if, to the extent necessary for compliance with the QFC Stay Provision Rule, it limits rights to accelerate, terminate and close-out on a net basis transactions under the agreement and to liquidate or set-off collateral promptly upon an event of default. The amendments also provided that amendments

made to an EMNA solely to comply with QFC Stay Provision Rule will not be taken into account in order to determine the date on which swaps under the agreement were entered into, for purposes of determining legacy status.

The Agencies received five substantive comment letters in response to the NPR. For the reasons discussed below, the Final Rule includes the two amendments to the Swap Margin Rule in the exact form included in the NPR.

DISCUSSION:

I. Background

The Swap Margin Rule was adopted pursuant to Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and establishes minimum margin and capital requirements for non-cleared swaps (which are swaps that are not cleared by a registered derivatives clearing organization or registered clearing agency) of swap entities (as defined in the Swap Margin Rule) that are prudentially regulated by one of the Agencies.[1]

The Swap Margin Rule became effective on April 1, 2016 and has a phased-in compliance schedule. Compliance with the variation margin requirements for all swap entities was required by March 1, 2017. Compliance with the initial margin requirements for certain swap entities was required by September 1, 2016 and will be required of all swap entities by September 1, 2020.

Under the Swap Margin Rule, if a swap is governed by an EMNA, the covered swap entity is entitled to calculate margin requirements on the applicable net basis set forth in the Swap Margin

[1] The Swap Margin Rule uses the terms "non-cleared swap" to denote a swap not cleared by a clearing organization subject to CFTC jurisdiction and "non-cleared security-based swap" to denote a swap not cleared by a clearing organization subject to SEC jurisdiction. This board case uses the term "non-cleared swap" to mean both types of non-cleared swaps, and uses the term "swap" to refer to derivatives transactions that would constitute either "swaps" or "security-based swaps" under applicable law and regulation.

Rule. The Swap Margin Rule also permits swap counterparties to identify separate netting portfolios under an EMNA under which a swap entity's non-cleared swaps entered into before the swap entity's applicable compliance date are permitted to be segregated in a netting set that is not subject to the margin requirements.

As discussed in the Introduction, the QFC Stay Provision Rule requires that certain QFCs of GSIBs and certain of their subsidiaries (including QFCs with parties not resident or organized in the U.S.) provide that they are subject to the stay applicable under the FDIA and Title II of the Dodd-Frank Act, as well as the provisions of the FDIA and Title II authorizing the transfer of QFCs. (This requirement may also be satisfied if the contract is made subject to the ISDA 2015 Universal Resolution Stay Protocol or the U.S. Protocol, as defined in the QFC Stay Provision Rule). The QFC Stay Provision Rule also generally prohibits QFCs of covered GSIB entities from allowing the exercise of default rights based on the entry into resolution of an affiliate of the GSIB entity ("cross-default rights"). Compliance with the QFC Stay Provision Rule is required on a phased-in basis, beginning on January 1, 2019.

The QFC Stay Provision Rule also amended the definition of Qualifying Master Netting Agreement ("QMNA") in the FDIC's capital rules (12 CFR Part 324) and liquidity rules (12 CFR Part 329) and certain related definitions because these definitions did not take account of the requirements of the QFC Stay Provision Rule. As in effect prior to the effectiveness of the QFC Stay Provision Rule, these definitions included a prohibition on stays governing the exercise of rights by a supervised institution under a QMNA, but also included exceptions for stays that would be applicable in a resolution under the FDIA, Title II of the Dodd-Frank Act, similar insolvency laws applicable to government-sponsored enterprises ("GSEs") and substantially similar foreign insolvency laws. The QFC Stay Provision Rule added an exception

for a limitation on rights to accelerate, terminate, liquidate collateral and exercise certain other remedies to the extent necessary for compliance with the QFC Stay Provision Rule (or the parallel FRB or OCC rules). This was viewed as necessary so that the agreements governing QFCs that comply with the QFC Stay Provision Rule can continue to be eligible for treatment as QMNAs and benefit from the ability to calculate capital and liquidity requirements relating to the applicable QFCs on a net, rather than a gross, basis.

II. **Changes to Swap Margin Rule**

A. Definition of EMNA

The Proposed Rule included a change to the EMNA definition that is substantively identical to the change to the QMNA definition included in the QFC Stay Provision Rule. The Preamble to the Swap Margin Rule stated that the definition of EMNA was aligned to the QMNA definition in order to minimize operational burden for the covered swap entity in determining whether its netting agreements met the requirements of the Swap Margin Rule and capital rules.[2] If a netting agreement of a covered swap entity does not satisfy the requirements of the definition of EMNA, it is required to measure its exposure for purposes of the Swap Margin Rule on a gross, rather than a net, basis. The Swap Margin Rule defines an EMNA as a netting agreement that creates a single legal obligation for all transactions covered by the agreement upon an event of default of the counterparty (including conservatorship, receivership, insolvency, liquidation or similar proceedings), subject to the satisfaction of certain requirements. As was the case with QMNA, one requirement of EMNA is that the exercise of rights will not be stayed other than in resolution under the FDIA, Title II of the Dodd-Frank Act, similar insolvency laws applicable to GSEs and substantially similar foreign laws. The Swap Margin Rule does not include an exception that

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[2] 80 Fed. Reg. 74861.

covers certain restrictions on cross-default rights imposed by the QFC Stay Provision Rule (or the parallel FRB and OCC rules).

It was not the intention of the FDIC in adopting the QFC Stay Provision Rule to cause a covered swap entity with a netting agreement that otherwise qualified as an EMNA to lose the benefit of EMNA status solely because it complied with the requirements of the QFC Stay Provision Rule or the parallel FRB or OCC rules. Accordingly, the Proposed Rule included, as a new exception to the prohibition on stays on the exercise of rights, an agreement that limits the right to accelerate, terminate transactions and liquidate collateral and exercise certain other remedies to the extent necessary for compliance with the QFC Stay Provision Rule (or the parallel FRB or OCC rules).

B. Specification of When a Swap Amended to Comply with the QFC Stay Provision Rule is Entered Into

The Swap Margin Rule applies only to non-cleared swaps entered on or after the compliance date applicable to the swap under the Rule.[3] The Preamble to the Swap Margin Rule clarified that swaps entered into prior to the applicable compliance date that are amended after the compliance date are considered entered into on the date they are amended.[4] In order to comply with the QFC Stay Provision Rule, a GSIB or one of its subsidiaries may be required to amend one or more of its non-cleared swaps. The FDIC, the FRB and the OCC did not intend, in requiring such amendments, that entering into the amendments would cause swaps that were not subject to the Swap Margin Rule to become subject to the Swap Margin Rule solely because of such required amendments. Accordingly, the Proposed Rule included, as a new paragraph to the Swap Margin Rule, a statement providing that, for purposes of determining the date on which a

[3] 12 CFR 349.1(c).
[4] 80 Fed. Reg. 74850-74851.

non-cleared swap was entered into, a covered swap entity will not take into account amendments to the non-cleared swap that were entered into solely to comply with the requirements of the QFC Stay Provision Rule (or the parallel FRB or OCC rules).

III. Comments on the Proposed Rule

The Agencies received five substantive comments on the Proposed Rule. The comments generally expressed support for the proposed amendment clarifying the treatment of legacy swaps, but three of the letters also recommended different treatments for legacy swaps. Two commenters expressed support for the proposed amendment to the definition of EMNA.[5]

The three letters recommending different treatment for legacy swaps suggested that the Agencies issue guidance indicating that certain "non-material" amendments will not result in a legacy swap becoming subject to margin requirements. One commenter requested that the Agencies issue more broad-based guidance that would clarify the effect of amendments as a result of requirements from other regulators and other amendments to legacy swaps that may be required in the future due to legislative and regulatory developments or public sector-driven initiatives. Examples of legislative, regulatory and public sector-driven developments provided by the commenter included amendments related to the ring-fencing of swaps in non-bank entities, interest rate benchmark reform, such as the replacement of LIBOR, and novations or other amendments necessitated by the United Kingdom leaving the European Union.

[5] In addition, two commenters raised issues unrelated to the Proposed Rule. One comment urged a change to the inter-affiliate provisions of the Swap Margin Rule. The other comment requested that the Agencies clarify that a legacy swap that is amended or novated not be subject to margin requirements if it is entered into by a special purpose vehicle in respect of certain securitizations.

The Final Rule adopts the amendments as proposed in the Proposed Rule. These changes provide clarity and certainty as to the effect of changes required by the QFC Stay Provision Rule. The Agencies considered proposals to treat legacy swaps as unaffected by non-material amendments when they adopted the Swap Margin Rule. They noted that extending legacy treatment to swaps subject to non-material amendments and "legitimate" novations would create significant incentives to enter into such arrangements to evade the margin requirements. In addition, the Agencies explained that adopting such limits would be difficult to effect because the process of identifying the swaps to which the rule would apply would be overly complex and non-transparent. In this connection, it should be noted that the Preamble to the Final Rule states that "[a]s the Agencies continue to assess industry developments such as interest rate benchmark reform, the Agencies will take into account any associated implementation ramifications surrounding the treatment of legacy swaps under the Swap Margin Rule."

CONCLUSION: Staff recommends that the Board approve the publication of the attached Final Rule titled "*Margin and Capital Requirements for Covered Swap Entities; Final Rule*" in the *Federal Register*.

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