



Federal Deposit Insurance Corporation

550 17th Street NW, Washington, D.C. 20429-9990

February 26, 2019

MEMORANDUM TO: The Board of Directors

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

SUBJECT: Interim Final Rule Regarding Swap Margin Requirements—
Amendments Related to Brexit

RECOMMENDATION

Staff recommends that the Board of Directors (the Board) of the Federal Deposit Insurance Corporation (FDIC) adopt the attached interim final rule titled *Margin and Capital Requirements for Covered Swap Entities; Interim Final Rule* and authorize its publication in the Federal Register.

The interim final rule is a joint rule being adopted by the FDIC, the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, the Farm Credit System and the Federal Housing Finance Agency (collectively, the Agencies).

The interim final rule is intended to continue the grandfathered status under the Agencies' swap margin requirements for legacy swaps entered into by counterparties in the United Kingdom (U.K.) that are transferred to affiliates in the European Union (E.U.) or in the United States (U.S.). Such transfers are being contemplated by swap dealers and other counterparties if the U.K. exits from the E.U., without a Withdrawal Agreement, an event commonly referred to as hard "Brexit". The interim final rule would allow the grandfathered status of those swaps to continue after the Brexit event, currently scheduled for March 29, 2019, and the transfer of those swaps out of the U.K. The interim final rule would have no impact on any community bank or other state chartered bank that is not a member of the Federal Reserve System because none of these banks are entities subject to the rule.

BACKGROUND

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) required the Agencies to adopt rules jointly that establish capital and margin requirements for swap entities that are prudentially regulated by one of the Agencies (covered swap entities). Swaps are certain types of financial derivatives, such as interest rate swaps and commodity swaps, which the Dodd-Frank Act defines as "swaps."

Concur:

Charles Yi
General Counsel

These margin requirements apply to swaps entered into after the applicable compliance date that are not cleared by a derivatives clearinghouse (non-cleared swaps). On November 30, 2015, the Agencies published the Swap Margin Rule to establish the minimum margin requirements for the non-cleared swap portfolios of covered swap entities.

Legacy Swaps

In issuing the Swap Margin Rule in 2015, the Agencies set out a phased-in compliance schedule between September 2016 and September 2020. The compliance dates are related to the level of non-cleared swap activity, measured in outstanding notional value, of the covered swap entity and its counterparties, and their respective affiliates. The requirements initially applied on September 1, 2016 to swaps entered on or after that date where the covered swap entities and their counterparties both engage in high levels of swap activity. As the compliance schedule has progressed through 2017 and 2018, the Swap Margin Rule has applied to new swaps entered into where the covered swap entities and the counterparties are engaged in increasingly lower levels of swap activity, measured by the outstanding notional values of their respective swaps.

The Swap Margin Rule's requirements generally apply only to a non-cleared swap entered into on or after the applicable compliance date. A non-cleared swap entered into prior to an entity's applicable compliance date is essentially "grandfathered" by the margin requirements. In other words, the legacy non-cleared swap is generally not subject to the margin requirements in the Swap Margin Rule.

Cross-Border Application of the Swap Margin Rule

The Swap Margin Rule has a broad territorial reach. It applies to certain foreign banks and foreign banking organizations, certain entities established abroad by U.S. banks, and certain foreign branches of U.S. banks. Typically, such firms are registered in the foreign jurisdiction in which they are located with the appropriate financial regulatory authorities. However, these firms may also conduct swap activities with counterparties that have significant ties to the U.S. (or the dealer itself may be a branch of a U.S. bank) under circumstances that trigger dealer registration obligations with the Commodity Futures Trading Commission (CFTC) or the U.S. Securities and Exchange Commission (SEC).

U.K.-Based Swap Entities and the U.K. Exit From the E.U.

A number of entities located in the U.K. are registered with the CFTC as swap dealers. Several of these swap dealers are subject to the Agencies' margin requirements and several are subject to margin requirements of the CFTC. These entities, as well as other financial entities located in the U.K., face uncertainty about the applicable regulatory framework they will operate within after a U.K. withdrawal from the E.U. In many instances, these firms made a strategic decision decades ago to use a U.K. establishment as their base of operations to provide financial services to customers across the E.U., consistent with the E.U.'s system of cross-border authorizations to engage in regulated financial activities (known as "passporting"). These firms have been mindful that one consequence of a U.K. exit from the E.U. absent a Withdrawal Agreement will be an inability of the firms to continue providing investment services in the E.U. under the current passporting regime.

As a result, covered swap entities and other financial entities located in the U.K. might not be in a position to perform certain operations in relation to derivatives contracts they presently have with E.U. clients. In order to address this situation, these firms could transfer their derivatives to a related establishment in an E.U. Member State, which in turn would benefit from the passporting regime.

In addition, a covered swap entity that operates an establishment located outside the U.K. may be affected if the U.K. exits the E.U. without a Withdrawal Agreement. These covered swap entities may have entered into non-cleared swaps with financial entities located in the U.K. These U.K. counterparties of the covered swap entity may need to relocate certain operations, in order to continue providing financial services to their own customers in the E.U. Accordingly, a covered swap entity's counterparties with establishments in the U.K. may seek to transfer their non-cleared swaps to related establishments of their own in an E.U. Member State.

The scheduled date of the U.K. withdrawal is March 29, 2019. The Agencies believe it is appropriate to provide clarity, in order to facilitate the work of covered swap entities and their counterparties to transfer non-cleared swaps, in response to a U.K. exit from the E.U. absent a Withdrawal Agreement, without thereby converting their legacy swaps into covered swaps subject to the Swap Margin Rule. The conditions of eligibility for the transfers are described in below.

THE INTERIM FINAL RULE

The interim final rule would amend the Swap Margin Rule to add a new provision designed to preserve the status quo for legacy swaps transferred to a covered swap entity in the event of the U.K. withdrawal from the E.U. without a Withdrawal Agreement by specifying that the Brexit related amendments to the swap documentation will not result in the loss of grandfathered status for those swaps.¹

The amendment addresses the Swap Margin Rule's application to a swap entered into by a covered swap entity or other financial entity located in the U.K. before the Rule's applicable compliance date that is transferred to an affiliated covered swap entity located in an E.U. Member State or the U.S. The interim final rule clarifies that such a swap would retain its legacy status if the swap were amended solely in connection with the U.K. entity's planning for the possibility that the U.K. might exit the E.U. without a Withdrawal Agreement, or the U.K. entity's response to such event.

Narrow Scope of Permitted Amendments

Staff from the FDIC does not recommend that the relief being provided by the interim final rule for relocation purposes should be expansively applied to encompass economic changes to a legacy swap. Accordingly, the rule text would make legacy swap status unavailable if the

¹ Similarly, in October of 2018, the Agencies clarified that a legacy swap would not lose its legacy status when the covered swap entity acceded to changes to the non-cleared swap as necessary to implement the QFC Receivership Stay regulations of the Board, the FDIC, and the OCC. See 83 FR 50805 (October 10, 2018).

amendments to a non-cleared swap modify the payment amount calculation methods, the maturity date, or the notional amount of the non-cleared swap.

Limited Time Frame For Brexit-Related Swap Transfers

Staff from the FDIC also recommends that a reasonable period of time be established for the necessary work to achieve the transfers. The interim final rule would permit transfers for a period of one year after a U.K. withdrawal. The 1-year period commences at the point at which either the law of the European Union ceases to apply in the U.K. pursuant to Article 50(3) of the Treaty on European Union, without conclusion of a Withdrawal Agreement between the U.K. and E.U. pursuant to Article 50(2) or, if the present withdrawal date is extended, and withdrawal later occurs at the end of that extension without a Withdrawal Agreement, the interim final rule's 1-year period would begin at that time.

Time Frame For Transfer And Related E.U. Legislation

Staff from the FDIC believes that a provision enabling entities to transfer non-cleared swaps that are impacted by Brexit while retaining legacy status would be most effective if the timeframe allowed takes into account the timeframe under corresponding proposed E.U. legislation. The European Supervisory Authorities (ESAs) have submitted novation amendments for their margin rules in proposed form to the European Commission where non-cleared swaps transferred from the U.K. by novation into the European entities will be able to retain the legacy status. The ESA relief that would be afforded thereby has not yet been finalized under the E.U. process. The ESAs' draft Regulatory Technical Standards provides relief for one year after the amendments are finalized by official publication, after parliamentary approval.

If the E.U. amendments are not yet finalized at the time of a U.K. withdrawal, affected financial entities may delay consummation of their non-cleared swap transfers until the ESA's proposed amendments apply. Staff from the FDIC anticipates some transferring financial entities will operate under both sets of regulations and will accordingly seek to coordinate their transfer operations for compliance purposes under both sets of amendments. To facilitate this, the interim final rule has a "tacking" provision that would extend the Agencies' 1-year period by the amount of any additional time available under the ESAs' 1-year period.

REQUEST FOR COMMENT

The Agencies request comment on all aspects of the interim final rule as well as on several specific questions. The interim final rule provides a comment period of 30 days after publication in the Federal Register.

Good Cause Rationale for Proceeding By Interim Final Rule

Staff recommends that the interim final rule be issued without prior notice and the opportunity for public comment and without the 30-day delayed effective date ordinarily prescribed by the Administrative Procedure Act (APA). Pursuant to section 553(b)(B) of the APA, general notice and the opportunity for public comment are not required with respect to a rulemaking when an "agency for good cause finds (and incorporates the finding and a brief statement of reasons

therefor in the rules issued) that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest.”

As discussed above, the interim final rule addresses a potential impact of the scenario in which the U.K. exits from the E.U. in the absence of a Withdrawal Agreement. The U.K.’s exit is expected to occur on March 29, 2019. The interim final rule would facilitate the ability of a covered swap entity in the E.U. or the U.S. that is affiliated with or related to a swap counterparty in the U.K. to receive by transfer from that U.K. located related entity legacy swaps without having to treat them as new swaps to which the margin requirements would apply.

Staff recommends that the public interest is best served by making the interim final rule effective as soon as possible as a result of the expected timing of events in the U.K. Staff believes that issuing the interim final rule will provide the certainty necessary to facilitate the industry’s efforts to begin arranging their transfers immediately upon the U.K.’s withdrawal. In addition, staff believes that providing a notice and comment period prior to issuance of the interim final rule is impracticable given the need for relief to begin on March 29, 2019. For these reasons, staff recommends that the Board find there is good cause consistent with the public interest to issue the interim final rule without advance notice and comment.

The APA also requires a 30-day delayed effective date, except for (1) substantive rules which grant or recognize an exemption or relieve a restriction; (2) interpretative rules and statements of policy; or (3) as otherwise provided by the agency for good cause. Staff also recommends that the Board find good cause to publish the interim final rule with an immediate effective date for the same reasons set forth above under the discussion of section 553(b)(B) of the APA.

While staff believes there is good cause to issue the interim final rule without advance notice and comment and with an immediate effective date, staff is recommending that the Federal Register notice requests comment for a period of 30 days on all aspects of the interim final rule.

CONCLUSION

FDIC staff recommends that the Board adopt the interim final rule and approve its publication in the Federal Register.

Staff contacts:

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