MEMORANDUM TO: The Board of Directors

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

SUBJECT: Final Rule and IFR Regarding Swap Margin Requirements

RECOMMENDATION

Staff are presenting for approval of the Federal Deposit Insurance Corporation (FDIC) Board of Directors (the Board) and authorization for publication in the Federal Register the attached notice of final rulemaking (Final Rule) and notice of interim final rulemaking (IFR), both titled Margin and Capital Requirements for Covered Swap Entities. The Final Rule and IFR are being adopted jointly with the Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (the Federal Reserve), the Farm Credit Administration (FCA), and the Federal Housing Finance Agency (FHFA) (collectively, the agencies).

In November 2015, the agencies adopted a final rule establishing margin requirements for swaps (Swap Margin Rule). This Final Rule would make the following changes to the Swap Margin Rule:

1. permit swaps entered into prior to an applicable compliance date (legacy swaps) to retain their legacy status in the event that they are amended to replace an interbank offered rate (IBOR) or other discontinued rate,
2. modify initial margin requirements for non-cleared swaps between covered swap entities and their affiliates,
3. introduce an additional compliance date for initial margin requirements,
4. clarify the point in time at which trading documentation must be in place,
5. permit legacy swaps to retain their legacy status in the event that they are amended due to technical amendments, notional reductions, or portfolio compression exercises,
6. make technical changes to relocate the provision within the rule addressing amendments to legacy swaps that are made to comply with the qualified financial contract rules (QFC Rules), and
7. address comments received in response to the agencies’ publication of the interim final rule dealing with Brexit-related issues.

The IFR provides covered swap entities additional time to comply with the Swap Margin Rule’s Phases 5 and 6 initial margin implementation deadlines by delaying the effective date for Phase 5 from September 1, 2020 to September 1, 2021 and, for Phase 6, from September 1, 2021 to September 1, 2022.

Concur:

Nicholas Podsiadly
General Counsel
BACKGROUND

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) requires the agencies to jointly adopt rules that establish capital and margin requirements for swap entities that are prudentially regulated by one of the agencies (covered swap entities). These capital and margin requirements apply to swaps that are not cleared by a registered derivatives clearing organization or a registered clearing agency (non-cleared swaps).

The Swap Margin Rule established an effective date of April 1, 2016, with a phased-in compliance schedule for the initial and variation margin requirements. All covered swap entities were required to comply with the variation margin requirements by March 1, 2017 for non-cleared swaps with other swap entities and financial end-user counterparties. The Swap Margin Rule currently requires all covered swap entities to comply with the initial margin requirements for non-cleared swaps with all financial end-user counterparties with a material swaps exposure and with all swap entities by September 1, 2020.

On November 9, 2019, the agencies published in the Federal Register a notice of proposed rulemaking setting out several proposed changes to the swap margin rule (NPR). The original comment period expired on December 9, 2019 and the agencies reopened the comment period until January 23, 2020. In response to the proposal, the FDIC received 20 comments.

Below is a discussion of each subject matter area being addressed by the Final Rule and IFR as well as the corresponding changes being adopted:

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2 A “swap” is defined in section 721 of the Dodd-Frank Act to include, among other things, an interest rate swap, commodity swap, equity swap, and credit default swap, and a security-based swap is defined in section 761 of the Dodd-Frank Act to include a swap based on a single security or loan or on a narrow-based security index. See 7 U.S.C. 1a(47); 15 U.S.C. 78c(a)(68).
**Interbank Offered Rates**

**Proposal:** to provide relief to permit covered swap entities to amend the interest rates in a legacy swap contract, based on certain conditions of eligibility, and to adopt necessary follow-on amendments, without the swap losing its legacy status.

Due to the potential discontinuation of LIBOR at the end of 2021, covered swap entities face uncertainty about the way their swap contracts based on LIBOR and other IBORs will operate after the permanent discontinuation date without a reliable benchmark rate. A benchmark rate is a critical term for calculating payments under a swap contract. In many instances, these firms may decide to amend existing swap contracts to replace an IBOR before the IBOR becomes discontinued. Such amendments may also trigger follow-on amendments that the counterparties determine are necessary to maintain the economics of the contract.

In the NPR, the agencies proposed to permit amendments that are made solely to accommodate the replacement of an IBOR, and to permit replacements of any other non-IBOR interest rate benchmark that a covered swap entity reasonably expects to be discontinued or reasonably determines has lost its relevance as a reliable benchmark due to a significant impairment with an alternate reference rate.

**Comments:** Most commenters supported the proposal’s relief to amend certain legacy swaps for certain reasons and the proposal’s addition of a compliance phase for smaller entities, as a meaningful way to assist market participants in managing and prioritizing their resources, mitigating potential trading disruptions related to the transition of IBORs to other interest rates, complying with documentation requirements, and engaging in certain trade life-cycle events.

**Final Rule:** The final rule largely adopts the proposal that permits legacy swaps to retain their legacy status in the event that they are amended to replace an IBOR or other discontinued rate.

**Non-Cleared Swaps between CSEs and an Affiliate**

**Proposal:** to amend the treatment of affiliate transactions in the Swap Margin Rule by creating an exemption from the initial margin requirements for non-cleared swaps between affiliates. The agencies also proposed, however, to retain the requirement that affiliates exchange variation margin.

Currently, § __.11 of the Swap Margin Rule establishes special rules for transactions between a covered swap entity and an “affiliate,” generally defined in the Swap Margin Rule as an entity that is consolidated with the dealer on an accounting basis, or consolidated on a common basis by another entity. The rules applicable to transactions with affiliates differ from the rules applicable to transactions with non-affiliates.

**Comments:** Some commenters supported the proposal to remove the initial margin requirement for inter-affiliate transactions, while others expressed the view that the proposal would increase risks to covered swap entities individually and financial stability more broadly. For example, a few commenters shared their view that collateralization (in the form of initial margin collected from a covered swap entity’s affiliate) is a highly effective tool for reducing closeout risk. These commenters were concerned that the proposed rule would eliminate an estimated $40 billion in
collateral held by covered swap entities, which, in their view, is necessary for closeout risk-absorption. Some of the commenters also expressed the view that banking organizations are using inter-affiliate swaps for the primary purpose of concentrating the risks of the organizations’ world-wide derivatives activities onto the books of the covered swap entities subject to the Swap Margin Rule, i.e. U.S. insured depository institutions.

By contrast, commenters supporting the removal of the initial margin requirement for inter-affiliate transactions asserted that the proposal would align the Swap Margin Rule with the margin requirements of some other domestic and foreign jurisdictions and facilitate more balanced and effective risk management practices across the spectrum of risks faced within banking organizations that engage in non-cleared swaps.

**Final Rule:** After considering commenters’ range of views about the proposed rule, the agencies have determined to finalize it consistent with the proposal, with two revisions.

First, the agencies are including a limit on the aggregate amount that a covered swap entity may recognize pursuant to the inter-affiliate initial margin exemption provided under the final rule. This limit is set at 15% percent of the covered swap entity’s tier 1 capital. The agencies are incorporating the 15% Tier 1 Threshold to maintain safety and soundness of covered swap entities that are U.S. insured depository institutions.

Second, the agencies are also including an additional revision that is consistent with the Swap Margin Rule’s current treatment of counterparties that are not subject to the quantitative requirement to exchange and segregate initial margin on a daily basis. By this revision, a covered swap entity would be required to collect initial margin from an affiliate at such times and in such forms and such amounts (if any) that the covered swap entity determines appropriately addresses the credit risk posed by the affiliate and the risks of its non-cleared swaps with the affiliate.

**Additional Compliance Date for Initial Margin Requirements and Documentation Requirements**

**Proposal:** to give covered swap entities an additional year to implement initial margin requirements for certain smaller counterparties, and clarify the existing trading documentation requirements in the Swap Margin Rule.

The phase-in schedule for initial margin is based on the swap level activity of the swap dealer and of the counterparty, measured by their respective “average daily aggregate notional amount” (AANA) of non-cleared swaps held in each party’s market-wide portfolio. With the occurrence of the Phase 4 initial margin compliance obligations on September 1, 2019 – for covered swap entities and counterparties with an AANA of $750 billion to $1.5 trillion – the group currently scheduled for Phase 5 of compliance in the upcoming year includes all remaining entities within the scope of the initial margin requirements, spanning AANAs from $8 billion up to $750 billion.

The swap industry has raised significant concerns about the operational and other difficulties associated with beginning to exchange initial margin with the large number of relatively small counterparties encompassed in the swap margin rule’s fifth phase. In recognition of these
difficulties, the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions framework has been recently revised to permit an additional phase for smaller counterparties, and the agencies believe it is appropriate to amend the swap margin rule in a similar manner.

Accordingly, the agencies proposed to amend the compliance phase-in schedule to add a Phase 6 when compliance would be required for certain smaller entities that are currently subject to Phase 5. The proposed amendments would have changed the Phase 5 thresholds to require compliance by September 1, 2020, for counterparties with an AANA ranging from $50 billion to $750 billion, while establishing a new Phase 6 compliance date for all other counterparties (i.e., those with an AANA ranging from $8 billion to $50 billion) of September 1, 2021.

Complying with initial margin requirements creates regulatory obligations for covered swap entities and implications for their counterparties. Covered swap entities must calculate initial margin to be collected and posted to determine if and when collection or posting of initial margin is required. Under the swap margin rule, a covered swap entity must collect or post initial margin when it calculates an initial margin amount that, after subtracting the initial margin threshold amount (not including any portion of the initial margin threshold amount already applied by the covered swap entity or its affiliates to other non-cleared swaps or non-cleared security-based swaps with the counterparty or its affiliates), exceeds zero. It is only at the time at which the covered swap entity is required to collect or post initial margin pursuant under the swap margin rule that it is required to have completed the initial margin trading documentation and the custody agreements that the rule requires.

The agencies proposed to amend the swap margin rule to expressly state that a covered swap entity is not required to execute initial margin trading documentation with a counterparty prior to the time that it must collect or post initial margin under the rule.

Comments: Commenters generally supported the proposed amendments to the compliance schedule, specifically, the additional phase six for all other counterparties (i.e., with an AANA of $8 billion up to $50 billion) with a compliance date of September 1, 2021.

Final Rule and IFR: The final rule would largely adopt the proposal that introduces an additional Phase 6 compliance date for initial margin requirements and clarifies the point in time at which trading documentation must be in place.

The containment measures adopted in response to recent COVID-19 public health concerns have slowed economic activity in many countries, including the United States. Financial conditions have tightened markedly, with extreme volatility and general downward pressures on domestic and international financial and commodity markets. Businesses in all fields of operation, including the financial sector, have experienced a reduction in the capacity of their operations, as local governments have issued stay-at-home orders, requiring businesses to shift to remote operations, with employees having to conduct many critical functions from their homes. Under these circumstances, and taking account of the high market volatility resulting from the pandemic, market participants have diverted resources to ongoing business continuity.
In light of these circumstances, the IFR provides further relief to covered swap entities by granting additional time to comply with the Swap Margin Rule’s Phase 5 and newly created Phase 6 initial margin implementation deadlines by delaying the effective date for Phase 5 from September 1, 2020 to September 1, 2021 and, for Phase 6, from September 1, 2021 to September 1, 2022.

**Portfolio Compression Exercises and Other Amendments**

**Proposal**: to permit certain amendments, particularly non-material amendments to non-economic terms, as well as amendments that are made to reduce operational or counterparty risk, such as notional reductions and portfolio compressions, to be executed while still allowing those amended legacy swaps to remain exempt from the Swap Margin Rule. 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.

The agencies proposed amendments to clarify the agencies’ implementation of the legacy swaps provisions of the Swap Margin Rule since its adoption in 2015. These amendments were intended to permit amendments to legacy swaps arising from certain routine industry practices over the life-cycle of a non-cleared swap that are carried out for logistical reasons or risk-management purposes. The proposed amendments were those that do not raise concerns that the covered swap entity is seeking to evade or otherwise delay the application of margin requirements for non-cleared swaps.

One of these proposed amendments recognized the legacy status of a non-cleared swap that has been amended to reflect technical changes, such as addresses, the identities of parties for delivery of formal notices, and other administrative or operational provisions of the non-cleared swap that do not alter the non-cleared swap’s underlying asset or indicator, such as a security, currency, interest rate, commodity, or price index, the remaining maturity, or the total effective notional amount.

The second proposed amendment recognized the legacy status of a non-cleared swap that has been amended solely to reduce the notional amount of the non-cleared swap, without altering other terms of the original non-cleared swap. The original non-cleared swap, with a lower notional amount, would retain legacy status, but the novated portion would not retain legacy status.

The third proposed amendment recognized the legacy status of non-cleared swaps that have been modified as part of certain portfolio compression exercises used as a risk management tool.

**Comments**: Commenters were supportive of the proposal. Commenters agreed with the agencies that amendments made for logistical or risk management purposes arising from routine industry practices over the life-cycle of the swap, should not cause legacy swaps to lose their legacy status. Commenters were also generally supportive of the proposal to maintain legacy status of non-cleared swap after portfolio compression exercises. Commenters noted that portfolio
compression generally reduces gross derivative exposures and reduces the frequency of payment, reducing the portfolio’s risk profile.

**Final Rule:** The final rule permits legacy swaps to retain their legacy status in the event that they are amended due to technical amendments, notional reductions, or portfolio compression exercises.

**Brexit IFR**

The agencies issued an interim final rule, which became effective on March 19, 2019, to provide certainty for covered swap entities as they prepared for the event commonly described as “Brexit.” In particular, the interim final rule provided a covered swap entity with the ability to continue to service its cross-border clients in the event that the U.K. withdrew from the E.U. without a Withdrawal Agreement. A Withdrawal Agreement between the UK and EU was ratified in January 2020. The Withdrawal Agreement addresses certain EU-related matters that will immediately be affected by the withdrawal itself and a transition period. The transition period will run until December 31, 2020, and could be extended by one or two years.

The agencies received one comment letter on the interim final rule. The commenter requested that the agencies amend the interim final rule to exclude swaps with a flip clause. The comment raised an issue that was not within the scope of the interim final rule. Accordingly, staff recommends not making any revisions to the rule and are retaining it as a final rule as initially adopted.

**Other Matters**

Staff notes that the Federal Reserve, in its adoption of the Final Rule, is expected to provide a discussion on the applicability of Sections 23A and 23B of the Federal Reserve Act to swaps between a bank and its affiliates. The Federal Reserve has the authority to interpret these provisions of the Federal Reserve Act, and that discussion by the Federal Reserve is not presented here for the FDIC Board’s review or approval.

**CONCLUSION**

FDIC staff recommend that the Board adopt the Final Rule and IFR and approve their publication in the *Federal Register*.

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