Statement by Martin J. Gruenberg, Member, FDIC Board of Directors on the Notice of Proposed Rulemaking: Swap Margin Requirements

September 17, 2019

The Notice of Proposed Rulemaking (NPR) before the FDIC Board today would amend the swap margin rule to repeal the requirement that a bank that is a dealer in derivatives collect initial margin from its affiliates. This would remove an important prudential protection from the bank and expose the bank to one of the most significant risks identified in the financial crisis. For that reason I will vote against this NPR.

Title VII of the Dodd-Frank Act established a new regulatory framework for certain derivatives, which the Act generally characterizes as swaps. As part of this framework, the Dodd-Frank Act required the federal banking agencies to adopt joint rules for "covered swap entities" under their jurisdiction. These "covered swap entities" are banks that serve as derivative or swap dealers. The joint rules impose initial and variation margin requirements on all swaps not cleared by a central counterparty in order to offset the greater risk that these types of derivatives pose to banks and the financial system as a whole.

Establishing margin requirements for non-cleared swaps is a critical prudential protection of the Dodd-Frank Act. Before the crisis, some insured depository institutions entered into large, non-cleared swap positions without the prudent exchange of margin —or collateral— to support those positions. As a result, there was a large buildup of leverage that exposed the financial system to significant risk.

The federal banking agencies adopted the final rule implementing margin requirements in October 2015 (the 2015 final rule). Under this rule, covered swap entities - or banks - generally must collect and post initial margin, which is collateral exchanged when the swap contract is initiated and intended to ensure the ability of both parties to perform on the swap contract. They must also collect and post variation margin, which is collateral collected from counterparties over time intended to offset credit exposures created by changes in the value of the swap contract. These margining practices promote the safety and soundness of banks by discouraging the excessive growth of risky non-cleared swap positions, and financial stability by reducing systemic leverage in the swap marketplace.

In response to concerns raised by commenters during the rulemaking, the 2015 final rule included specific provisions for non-cleared swaps between a covered swap entity and its larger affiliates. For such swaps, a covered swap entity is required to collect initial margin. While a covered swap entity is not required to post initial margin, it nonetheless must calculate the amount of initial margin that it would have been required to post to its affiliate under the rule and provide documentation of such amount to each affiliate on a daily basis so that the affiliate will understand the risk of the exposure.

As the preamble to the 2015 final rule noted, "The requirement for covered swap entities to collect initial margin from, but not to post initial margin to, affiliates should help to protect the safety and soundness of covered swap entities in the event of an affiliated counterparty default. At the same time, the final rule does not permit such inter-affiliate swaps, which may be significant in number and notional amount, to remain unmargined and thus pose a risk to financial stability."[1]

The premise of the 2015 final rule is that derivative exposures in insured depository institutions require collateral or margin protection whether or not the counterparty is affiliated with the bank because those exposures pose a risk to the Deposit Insurance Fund and ultimately to financial stability.

According to a survey by the International Swaps and Derivatives Association (ISDA) of 20 of the largest firms subject to the rule, the amount of initial margin held by those firms to cover inter-affiliate swaps as of year-end 2018 was $39.4 billion, which comprised 31 percent of all regulatory initial margin as of that date.[2]

The Notice of Proposed Rulemaking before the FDIC Board today would amend the 2015 final rule to repeal the requirement for a covered swap entity to collect initial margin from its affiliates. The preamble to the NPR makes the following argument in support of the proposal, consistent with industry comments on the 2015 final rule:

"Since the Swap Margin Rule was implemented, supervisory experience has shown that inter-affiliate swaps are used by covered swap entities for internal risk management purposes whereby a banking organization transfers risk to a centralized risk management function, which is considered to be a prudent risk management practice… . The agencies believe that such risk management practices often improve the safety and soundness of a covered swap entity, and therefore, to encourage such prudent risk management, propose to exempt inter-affiliate swaps from the Rule's initial margin requirements." [3]

The argument seems to be that the collateral or margin protection provided for the bank, when it has a derivative contract with an affiliate, should be removed on the assumption that the centralized risk management of the banking organization, including additional flexibility for

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[1] 80 Fed. Reg. 74840, 74889 (Nov. 30, 2015).

[2] See Letter from the American Bankers Association, Bank Policy Institute, Center for Capital Markets Competitiveness, Institute of International Bankers, ISDA, and Securities Industry and Financial Markets Association dated May 13, 2019, Re: Inter-Affiliate Margin Requirements, at 3.

[3] Preamble to the Notice of Proposed Rulemaking: Margin and Capital Requirements for Covered Swap Entities at 34.

internal allocation of collateral, will provide better protection to the insured depository institution.

Although there is value in centralized risk management of the banking organization, it is not a substitute for actual loss absorbing collateral held by the bank as a buffer against the risk of an inter-affiliate derivative relationship. Removing the inter-affiliate initial margin requirement would provide an incentive for banking organizations to concentrate risky derivative activity in the insured depository institution because of the subsidy provided by the public safety net. This would defeat one of the principal purposes of the 2015 final rule.

To be clear, this NPR would permit insured depository institutions to return the $39.4 billion in collateral that currently serves as a buffer for the Deposit Insurance Fund (DIF) and the taxpayer from potential losses that could arise from derivative contracts with affiliates. In addition, the capital held against these derivative contracts is insufficient to make up for the loss in initial margin requirements, putting the DIF and the taxpayer at further risk.

The preamble to the NPR before the FDIC Board today also notes that "certain affiliate transactions are subject to the requirements of sections 23A and 23B of the Federal Reserve Act as implemented by the Federal Reserve's Regulation W…. These provisions are specifically tailored to address risks arising from transactions, including non-cleared swaps, between affiliates. As such, the agencies believe that they are the more effective tools to address risks arising from transactions between affiliates. The [Federal Reserve] Board continues to consider how inter-affiliate non-cleared swaps can be addressed under Regulation W."[4]

The preamble to the NPR for the 2015 final rule specifically addressed the 23B issue: "While section 23B applies to transactions between a bank and its financial subsidiary, it does not apply to transactions between a bank and other subsidiaries, such as an operating subsidiary, an Edge Act subsidiary, or an agreement corporation subsidiary."

The 2015 final rule does not exempt a bank's swaps with these subsidiaries, which are affiliates under the Bank Holding Company Act, and would therefore impose margin requirements on all swaps between a bank and a subsidiary, including a subsidiary that is not covered by section 23B.[5]

The scope of 23B is thus narrower than the inter-affiliate initial margin requirement of the 2015 final rule. While 23B serves as a complement to the 2015 final rule, it is not a substitute for it and the protection it provides to the insured bank, the financial system as a whole, and the taxpayer.

For these reasons I will vote against the NPR before the FDIC Board today.

[4] Id. at 36 (footnote omitted).

[5] 79 Fed. Reg. 57348, 57359 (Sept. 24, 2014).