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Final Rule: Margin and Capital Requirements for Covered Swap Entities

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Introduction

The Final Rule before the FDIC Board today, joint with the Federal Reserve and the OCC, would amend the 2015 swap margin rule to exempt a bank that is a dealer in derivatives from the requirement to collect initial margin from its affiliates.

This would remove a critical prudential protection from the bank. It would expose the bank to one of the most significant risks identified in the 2008 financial crisis at a time of extraordinary economic and financial uncertainty as a result of COVID-19. For that reason, I will vote against this Final Rule.

The 2015 Swap Margin Rule

Establishing margin requirements for non-cleared swaps was one of the key prudential protections of the Dodd-Frank Act.

Before the 2008 financial 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). The 2015 final rule included specific provisions for non-cleared swaps between a

bank that is a covered swap entity and its larger affiliates. For such swaps, a covered swap entity is required to collect initial margin.

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 2015 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]

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 2019 was $44 billion, which comprised almost 30 percent of all regulatory initial margin as of that date.[2]

<u>The 2020 Final Rule and the 15 Percent Tier 1 Capital Limit</u>

The Final Rule before the FDIC Board today would make a change to the Notice of Proposed Rulemaking (NPR) approved by the Board in September of last year.

The 2019 NPR simply would have eliminated the requirement that a bank that is a dealer in derivatives collect initial margin from its affiliates.[3] Today's Final Rule would require a covered swap entity to collect initial margin from its affiliates on all new non-cleared swaps if the aggregate initial margin calculation amount exceeds 15 percent of the covered swap entity's Tier 1 capital.

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

[2] ISDA Research Study April 2020, ISDA Margin Survey Year-end 2019.

[3] Notice of Proposed Rulemaking: Margin and Capital Requirements for Covered Swap Entities, 84 Fed. Reg. 59970 (Nov. 7, 2019).

As the preamble to the Final Rule states,

"The agencies are incorporating the 15 percent Tier 1 Threshold … as an augmentation to reflect safety and soundness and financial system risk concerns of the [Federal Reserve] Board, the FDIC, and the OCC surrounding the status of covered swap entities that are U.S. insured depository institutions."[4]

The preamble also states, in explaining the 15 percent Tier 1 Capital Threshold,

"…the agencies have set it at a level that exceeds the typical initial margin collection amounts at the affected covered swap entities, to accommodate expected levels and taking into consideration a range of those levels that varies somewhat across those covered swap entities."[5]

In other words, the 15 percent Tier 1 Capital Threshold exceeds, perhaps substantially, the initial margin held by the covered swap entities today.[6]

Bottom line -- this Final Rule effectively eliminates the inter-affiliate margin requirement on banks that are swap dealers.

Removing the inter-affiliate initial margin requirement will provide a meaningful economic incentive for banking organizations to lay off the risks associated with derivative activity to the insured depository institution rather than third parties. This is because an

[4] Preamble to the 2020 Final Rule at 34-35 (footnote omitted).

[5] Id. at 35.

[6] According to the ISDA survey of 20 of the largest firms subject to the 2015 final rule, the amount of initial margin held by those firms to cover inter-affiliate swaps as of year-end 2019 was $44 billion. ISDA Research Study April 2020: ISDA Margin Survey Year-End 2019. In contrast, based on 4th Quarter 2019 Reports of Condition and Income, 15 percent of the Tier 1 capital for firms that were subject to the inter-affiliate margin requirement as of that same date was over $137 billion. While these numbers are not directly analogous, the amount of initial margin at those firms (approximately one-third of the 15 percent Tier 1 Capital limit) is suggestive of how much head room remains in the aggregate before the 15 percent limit would be breached to trigger the collection of initial margin for new transactions.

affiliate would not be required to post initial margin to the insured depository institution but would be required to post initial margin to third parties.

Since a greater amount of initial margin may be required for riskier derivatives, this rule encourages the use of the insured depository institution to absorb the risks generated by the swaps and derivatives trading activities of affiliated broker-dealers and futures commission merchants. As such, the risky activities of these non-bank affiliates would be protected by the subsidy provided by the public safety net. This defeats one of the principal purposes of the 2015 final rule.

This rule also would permit insured depository institutions to return the $44 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.

Sections 23A and 23B of the Federal Reserve Act

The preamble to the Notice of Proposed Rulemaking that preceded today's Final Rule noted 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."[7]

The FDIC staff memorandum for today's Final Rule includes a statement 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.

Although that discussion of 23A and 23B will apparently be included in the preamble to today's joint Final rule that will ultimately be published in the Federal Register, it is not included in the document before the FDIC Board today.

That discussion will apparently assert that, under Section 23A, bank-affiliate derivatives generally can be valued at the bank's current exposure to the affiliate, but generally would not be required to collect initial margin to cover the bank's potential future exposure on the transactions. At a time of extraordinary uncertainty because of COVID-19, a reading of 23A that would not account for potential future exposure in margin requirements would not appear to be a prudent approach.

In addition, the discussion will also apparently conclude that, in many cases under Section 23B, a bank-affiliate swap with no initial margin requirement will roughly be at least as favorable to the bank as a comparable bank-non-affiliate swap with a two-way initial margin requirement. Absent a finding otherwise based on specific facts and circumstances, those bank-affiliate swaps would thus meet the requirement of 23B that a bank's swaps with its affiliates must be on terms and conditions that are substantially the same, or at least as

[7] 84 Fed. Reg. 59970, 59976 (Nov. 7, 2019) (footnote omitted).

favorable to the bank, as those prevailing at the time for comparable transactions with third parties.

It seems a strange approach to use Section 23B to justify eliminating a general rule requiring a bank to collect but not pay initial margin in a transaction with an affiliate, which is clearly more favorable to the bank than a no-initial margin general rule.

Further, it is worth noting that, 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 or an Edge Act subsidiary. The scope of 23B is thus narrower that the inter-affiliate initial margin requirement of the 2015 final rule. It is a complement to, but not a substitute for, the margin rule.

Conclusion

In conclusion, the 2015 inter-affiliate margin rule is a critical prudential protection for the insured bank, the financial system, and the taxpayer against one of the most significant risks identified in the 2008 financial crisis -- lack of collateral for over-the-counter derivative exposures by banks. Now is not the time, with the economic and financial uncertainty caused by COVID-19, to eliminate this requirement. For that reason, I will vote against this Final Rule.