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Derivatives in Secured Lending: The Impact of Dodd-Frank


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Derivative products can be used in various ways, often to hedge interest rate or foreign exchange risks. Over the past decade, derivatives have become an integral part of secured lending transactions, commonly required by lenders to mitigate the risk that a borrower's credit may be adversely affected due to fluctuations in currency or interest rates. The Dodd-Frank Wall Street Reform and Consumer Protection Act[1] amended the Commodity Exchange Act (CEA),[2] which is implemented, administered and enforced by the Commodities Future Trading Commission (CFTC) through regulations,[3] and introduced major changes to many aspects of the financial system in the United States, especially swaps and other derivatives. Congress passed Dodd-Frank's derivatives provisions largely to bring stability and transparency to the largely unregulated swaps market in the wake of the 2008 financial crisis. The new rules change in fundamental ways who can enter derivatives, how they go about it, and how much derivatives cost. Today we discuss how these rules have changed the ways in which derivatives can be used in secured transactions and what new issues they have introduced.

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Background

The most common forms of derivatives in secured lending transactions are interest rate swaps, since most commercial loans bear interest based on a floating rate. In floating rate-based loans, a rise in interest rates increases the amount of the borrower's interest payment obligations and, accordingly, may adversely affect the borrower's liquidity. A swap addresses this credit risk to borrowers and their lenders through a structure in which a counterparty (typically one of the financial institution lenders or its affiliates) agrees to pay a floating rate of interest to the borrower matched to the loan's floating rate, based on a "notional amount" that is usually the principal amount of the loan, in exchange for a fixed interest rate payment by the borrower on the same notional amount. This form of swap is referred to as a fixed-to-floating interest rate swap, and its effect is to have the counterparty bear the risk of changes in interest rates rather than the end-user (i.e., the borrower).

Until recently, no definition of the term "swap" existed under the CEA. Dodd-Frank amended the CEA by adding, among other things, a definition of "swap"[4] and brought traditional swaps, including interest rate swaps used in domestic bank lending transactions, within the scope of regulation under the CEA. As a result, under the CEA certain interest rate swaps (which currently include, for example, fixed-to-floating interest rate swaps that reference LIBOR or EURIBOR and are denominated in U.S. dollars, euros, pounds sterling or yen) must now be cleared[5] (meaning that a regulated clearinghouse interposes itself as principal between the two participants in the transaction and administers payments and margin calls) unless the hedging party (e.g., the borrower) qualifies for an exemption such as the "end user" exemption (see the discussion below).[6] In addition, as further discussed below under the heading "Eligible Contract Participants," §2(e) of the CEA prohibits any party from entering into a swap unless it and all guarantors of its obligations are "eligible contract participants."[7]

Clearing and Trade Execution

As a result of Dodd-Frank amendments to the CEA, the CFTC is now required to establish which types of swaps must be cleared. Accordingly, the CFTC has determined that certain interest rate swaps, among others, be submitted for clearing through a clearinghouse that acts as a derivatives clearing organization (DCO).[8]

Clearing is a process by which two parties who wish to enter into a swap consummate their transaction through a centralized entity—the DCO—rather than between themselves, as was typical in the over-the-counter off-exchange transactions that were prevalent pre-Dodd-Frank. Under these mandatory clearing rules, the DCO assumes the counterparty risks by entering into separate contractual arrangements with each counterparty, as principal, becoming buyer to one and seller to the other. Each party thereby avoids direct credit exposure to the other. The DCO's rules also set collateral requirements for its clearing members. Using a DCO provides comfort to counterparties that the transaction will settle because they do not rely directly on each other. Once a swap is accepted for clearing, the original bilateral swap is extinguished and replaced by equal and opposite swaps with the DCO. All terms of the swap must conform to the product specifications for cleared swaps established under the DCO's rules, as discussed below. This may deprive a borrower of a perfect hedge if no DCO offers a product that matches its risk profile.

In determining which products it accepts for clearing, a DCO must take into account its ability to manage the risks associated with clearing such products. In the event that no DCO offers a trade that must otherwise be mandatorily cleared, a swap may be entered into on an uncleared basis, although CFTC anti-evasion rules would still apply (preventing changes to non-material terms to avoid clearing requirements).[9]

As noted above, the CEA mandates that the CFTC review all swaps to determine whether they should be subject to mandatory clearance.[10] Because interest rate swaps are some of the most commonly used swaps in secured lending, this determination is of tremendous importance to lenders. Currently, only certain interest rate swaps (such as those discussed above) and index credit default swaps (specifically, North American CDX and European iTraxx untranched CDS index swaps) must be cleared,[11] although the CFTC may add to this list as DCOs make more swaps available (for example, interest rate swaps denominated in less common international currencies, such as Australian or Canadian dollars or the Danish Krone).

Dodd-Frank also introduced CEA §2(h)(8),[12] which provides that any swap subject to mandatory clearing must be traded on a designated contract market (DCM) or swap execution facility (SEF), unless no DCM or SEF makes the swap "available to trade."[13] DCMs, such as the Chicago Board of Trade, are the traditional markets for commodity futures and options, while SEFs are a new type of venue introduced by the Dodd-Frank amendments to the CEA.[14] DCMs and SEFs are platforms on which trades are executed, but unlike a DCO, they do not become principals to the transaction.

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CEA §2(h)(7) creates an exception, commonly called the "end-user" exception, to the requirement that swap counterparties use a DCM or SEF to enter into swaps.[15] It provides that the clearing requirement does not apply to a swap if one of the counterparties is not a financial entity (described below) and is using the swap to hedge business risk. As a further condition to electing the end-user exception, §50.50(b) of CFTC's implementing regulations requires that the reporting counterparty report certain information about the entity electing the exception, including a notice of the election of the exception, to a registered swap data repository (SDR) (or if no registered SDR is available to receive the information, to the CFTC).[16]

This end-user exception to the clearing requirement is particularly relevant to secured lenders because many borrowers will be able to enter into swaps on a bilateral basis, even if the swap is of a type that is subject to mandatory clearing, thus saving the costs and complications of clearing and trade execution. Additionally, because end-users can enter into fully-bespoke swaps, they may be able to obtain more complete hedges than can parties who are restricted to the standard contracts available from DCOs. As noted above, this exception is generally not available to "financial entities."[17] Financial entities include, among other things, private funds and persons engaged predominantly in financial activities. Thus, borrowers who provide financial services, such as finance and leasing companies, cannot use this exception.

The new clearing and trade execution mandates can make participation in the swaps market considerably more operationally complex by introducing new parties such as DCOs and execution platforms, as well as futures commission merchants if their participation is required for access to such platforms. As a result, borrowers who are not eligible for an exception from the clearing mandate may be unwilling or unable due to the increased costs to enter into swaps.

Eligible Contract Participants

In addition to its requirements in respect of DCO's, Dodd-Frank amended CEA §2(e) to require entities that are not eligible contract participants (ECPs)[18] to execute all swaps, including interest rate swaps, solely through a DCM. The definition of ECP generally seeks to identify counterparties that are sufficiently sophisticated and financially responsible to enter into swaps without the protections of a DCM's rules. To that end, the statute limits ECP status to regulated institutions such as banks or insurance companies and to entities that meet various asset thresholds. For example, corporate entities and individuals must generally have assets greater than $10 million, while commodity pools and pension funds must generally have assets greater than $5 million. Additionally, a corporate entity may qualify as an ECP without independently satisfying the minimum asset requirements if its obligations are guaranteed or supported by a letter of credit, keepwell, support agreement or similar arrangement with an ECP.

This severely restricts a non-ECP borrower's execution options and, because CFTC rules require all transactions executed on a DCM to be cleared, completely precludes the use of uncleared swaps.[19] Borrowers would be prohibited from using a SEF or entering into over-the-counter swaps, whether cleared or uncleared. As discussed above, the clearing process can make the use of swaps significantly more cumbersome. Thus, borrowers who are not eligible contract participants may be unwilling or unable to enter into a swap as part of their loan, as with borrowers who fail to satisfy the end-user exception, due to increased costs.

An even more difficult issue arises when the obligations of a borrower which is an ECP are guaranteed by an affiliate that is not an ECP. Under §2(e) of the CEA, it is "unlawful" for any person "other than an eligible contract participant" to enter into a swap unless the swap is entered into on, or subject to the rules of," a DCM.[20] It is typical, however, under syndicated loan facilities for the lenders to require most of a borrower's wholly-owned subsidiaries to guarantee that borrower's obligations, and for the obligations guaranteed to include the borrower's exposure under any interest rate swaps required by the terms of such facilities. In many circumstances, although the borrower may be a substantial size company (and, accordingly, satisfy the requirements of an ECP), its subsidiaries may not. While not obvious from the language of §2(e), in October 2012 the Office of the General Counsel of the CFTC stated in No-Action Letter 12-17 that the definition of "swap" included any guaranty of a swap. Accordingly, in such event, if a guarantor is not an ECP, its guaranty would be in violation of the CEA and therefore is likely both illegal and unenforceable.

Lenders have tried to address this problem by having "keepwell" agreements from affiliates who are ECPs with respect to guarantors who are not ECPs. Under these agreements, the ECP would agree to maintain the minimum net worth of the non-ECP guarantor sufficient to enable it to qualify as an ECP.[21] However, some borrowers have expressed concern about the periodic monitoring and capital contribution requirements that may be implicit in a keepwell arrangement, and have proposed instead alternative structures such as cross-guaranty arrangements of non-ECP's from other ECP's.

Collateral and Margin

Finally, Dodd-Frank added §4s(e) to the CEA requiring, among other things, that swap dealers and major swap participants hold margin on uncleared swaps. This law mandated the promulgation of three margin rules, one each by the CFTC, the SEC, and a group of prudential bank regulators. None of the rules have been finalized. If finalized, these rules potentially could affect secured lenders adversely by making the use of swaps to hedge risks in loan transactions more expensive and considerably less liquid.[22]

Conclusion

Dodd-Frank has profoundly affected swaps and their usefulness in secured lending. In addition to increasing the cost of swaps for many borrowers, the regulations that implement many provisions of the law have yet to be finalized. Many borrowers that do not actively trade in swaps may not have experience with the various provisions of Dodd-Frank and the related CFTC rules, requiring lenders to help borrowers to understand their status and responsibilities. Nevertheless, and despite the uncertainty, swaps remain powerful tools that can enhance secured transactions by reducing a borrower's credit risk and providing interest rate stability.

1. Pub. L. 111-203, 124 Stat. 1376 (2010).
2. 7 U.S.C. §1 et seq.
3. 17 C.F.R. Ch. 1.
4. The CEA defines "swap," with certain exclusions and qualifications, as:

> (A) In general
>
> …the term "swap" means any agreement, contract, or transaction—
>
> (i) that is a put, call, cap, floor, collar, or similar option of any kind that is for the purchase or sale, or based on the value, of 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind;
>
> (ii) that provides for any purchase, sale, payment, or delivery (other than a dividend on an equity security) that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence;
>
> (iii) that provides on an executory basis for the exchange, on a fixed or contingent basis, of 1 or more payments based on the value or level of 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind, or any interest therein or based on the value thereof, and that transfers, as between the parties to the transaction, in whole or in part, the financial risk associated with a future change in any such value or level without also conveying a current or future direct or indirect ownership interest in an asset (including any enterprise or investment pool) or liability that incorporates the financial risk so transferred…

7 U.S.C. §1a(47).

5. 17 C.F.R. §50.4 (providing a list of interest rate and credit default swaps subject to mandatory clearing).
6. 7 U.S.C §2(h)(7) (providing exemption from clearing requirements for end users).
7. 7 U.S.C. §2(e); see CFTC Letter No. 12-17, Staff Interpretations and No-Action Relief Regarding ECP Status: Swap Guarantee Arrangements; Jointly and Severally Liable Counterparties; Amounts Invested on a Discretionary Basis; and "Anticipatory ECPs," Oct. 12, 2012, (stating that swap guarantors generally must be ECPs).
8. 7 U.S.C. §2(h)(7).
9. 17 C.F.R. §1.6.
10. 7 U.S.C. §2(h)(2).
11. 17 C.F.R. §50.4.
12. 7 U.S.C. §2(h)(8).
13. A swap is "available to trade" after a SEF or DCM has made such determination, based on enumerated factors relating to liquidity and market size, submitted its determination to the CFTC as a rule, and that rule is deemed approved by the CFTC or deemed self-certified by the SEF or DCM.
14. 7 U.S.C. §1a(50) (defining "swap execution facility"); 7 U.S.C §7b-3 (providing registration and core principle requirements for SEFs).
15. 7 U.S.C. §2(h)(7).
16. 7 U.S.C. §2(h)(7), 17 C.F.R. §50.50.
17. 17 C.F.R §39.6(a)(i). The term "financial entity" means—(i) a swap dealer; (ii) a security-based swap dealer; (iii) a major swap participant; (iv) a major security-based swap participant; (v) a commodity pool; (vi) a private fund as defined in §80b-2(a) of Title 15 of the U.S.C.; (vii) an employee benefit plan as defined in paragraphs (3) and (32) of §1002 of Title 29 of the U.S.C.; (viii) a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in §1843(k) of Title 12 of the U.S.C. with certain exceptions for captive financial companies small banks with assets of $10 billion or less. See 7 U.S.C. §2(h)(7)(C).
18. 7 U.S.C. §1a(18).
19. 17 C.F.R. §38.601.
20. 7 U.S.C. §2(e).
21. See 7 U.S.C. §1a(18)(v)(II).
22. See Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions, Second Consultative Document, Margin Requirements for Non-Centrally Cleared Derivatives, Appx. C, (February 2013) (assessing that the BCBS and IOSCO near-final proposal for margin requirements on non-centrally cleared swaps would reduce the gross notional amount of non-centrally cleared interest rate derivatives by 53 percent, equity derivatives by 56 percent, foreign exchange derivatives by 13 percent and other derivatives by 21 percent); see also Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions, Consultative Document, Margin Requirements for Non-Centrally Cleared Derivatives, Part C (July 2012) (finding that universal two way margin requirements with low thresholds are likely to significantly increase liquidity impact and overall impact on market function while exemptions from margin requirements may significantly reduce such impacts).