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Prepare Now For A New Swaps Margin Regime

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On Oct. 22, 2015, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corp., the Farm Credit Administration and the Federal Housing Finance Agency(collectively, the “agencies”) adopted (1) a joint final rule[1] to establish minimum margin requirements for registered swap dealers, major swap participants, security-based swap dealers and major security-based swap participants (collectively, “swap entities”) for which one of the agencies is the prudential regulator[2] (“covered swap entities” or “CSEs”) and (2) a companion interim final rule[3] (and request for comment) to implement margin exemptions added by the Terrorism Risk Insurance Program Reauthorization Act of 2015 (TRIPRA) for swaps and security-based swaps that qualify for the clearing exemptions and exceptions available under the Dodd-Frank Act and implementing regulations for nonfinancial entities (including commercial end users, captive finance subsidiaries and small financial institutions), treasury affiliates acting as agents and certain cooperatives. The following is a brief summary based on the initially released rule text.

Exchange of Initial and Variation Margin

In transactions with a swap entity, a CSE will be required to post and collect variation margin (VM) and collect initial margin (IM), with posting of IM to be governed by the collection obligation of the CSE’s swap entity counterparty under the margin regulations applicable to it. In transactions with a financial end user, a CSE will be required to collect and post VM, and collect and post IM if the financial end user has “material swaps exposure” (i.e., exceeds, together with its affiliates,[4] an $8 billion — increased from an earlier proposal of $3 billion — average-daily-aggregate-notional-of-derivatives threshold, including foreign exchange forwards and foreign exchange swaps, but excluding TRIPRA-exempt transactions, measured during June, July and August of the prior year). IM and VM are subject to an aggregate $500,000 minimum transfer amount.

In transactions with counterparties that are not swap entities or financial end users and, with respect to IM, transactions with financial end users without material swaps exposure, the agencies' rule does not prescribe the form or amount of margin; rather, the CSE must collect margin as it determines is appropriate to address credit and other risks, except in transactions that qualify for the TRIPRA exemptions. A newly added provision for interaffiliate transactions relieves a CSE from IM posting to affiliates and relaxes certain other aspects of the IM requirements, subject to various conditions.

Phase-In Dates

The earliest of the staged compliance dates, Sept. 1, 2016, applies for VM and IM where each of the CSE and its counterparty exceeds (together with its respective affiliates) a $3 trillion average-daily-aggregate-notional-of-derivatives threshold during March through May of 2016. Subsequent compliance dates for IM for CSEs and counterparties with smaller portfolios will occur on March 1, 2017, and Sept. 1 of 2017, 2018, 2019 and 2020. The general compliance date for VM is March 1, 2017. The margin requirements will not apply to transactions entered into before the applicable compliance date, provided that the pre-compliance date transactions are not under the same "netting portfolio" within a master netting agreement as post-compliance date transactions. The agencies declined to accommodate commenters' requests for grandfathering of nonmaterial amendments, novations and swaps resulting from portfolio compressions of pre-compliance date transactions.

Financial End Users

The "financial end user" definition encompasses entities that are not swap entities but that satisfy certain federal regulatory definitions pertaining to banking, credit, securities or commodities activities, state-licensed lending or money services entities, entities that would be investment companies (as defined in Section 3 of the Investment Company Act of 1940) but for Sections 3(c)(1), 3(c)(5)(C) or 3(c)(7) of that act, entities deemed not to be investment companies pursuant to Rule 3a-7, commodity pools, employee benefit plans as defined in Sections 3(3) and 3(32) of the Employee Retirement Income Security Act, insurance companies, a newly defined category for investing and trading firms and other investing and trading arrangements, and entities that would be financial end users or swap entities if they were organized under U.S. federal or state law. While acknowledging the greater incremental burden of this "as-if-U.S." test in classifying non-U.S. entities, the agencies did not modify this aspect of the proposed definition.

Excluded from the definition are central government sovereigns (including their agencies and central banks), multilateral developments banks, BIS and entities that qualify for a clearing exemption as captive finance companies or agent affiliates. The agencies did not accede to commenters' requests for an exemption for structured finance vehicles or covered bond issuers, stating that the financial and market activities of such entities comprise the same range of activities as the other entities encompassed in the financial end user definition. (The agencies referred to the increased amount of the "material swaps exposure" definition as a potential source of relief.)

Haircuts, Segregation and Netting

The final rule prescribes eligible collateral and haircuts, and generally requires third-party segregation of initial margin. Only cash collateral may be used for variation margin between swap entities, but in a liberalization from the proposed rule, noncash collateral (of the types permitted for IM) may be used for VM with financial end users. A CSE must enter into documentation with swap entities and financial end users that provide the CSE with the contractual right to exchange IM and VM as required by the regulation. The documentation must specify dispute resolution procedures and the methods, procedures and inputs for calculating VM and IM. If the master agreement governing transactions between a CSE and its counterparty does not qualify as an “eligible master netting agreement” (under a definition aligned with the one applicable for netting recognition under the agencies’ regulatory capital rules), the CSE must collect margin on a gross basis but may post on a net basis.

Cross-Border

The agencies’ margin requirements do not apply to “foreign” transactions of a CSE that is not an entity organized under U.S. federal or state law (a “U.S. entity”), a branch, office or subsidiary of a U.S. entity, or a U.S. branch, agency or subsidiary of a foreign bank (a CSE that is none of the foregoing, a “foreign CSE”). A “foreign” transaction is one in which none of the CSE’s counterparty or any guarantor of either party is a U.S. entity, a branch or office of a U.S. entity, a natural person resident in the United States (a “U.S. individual”), a swap entity subsidiary of a U.S. entity or a U.S. branch, agency or subsidiary of a foreign bank.

Substituted compliance (which may be conditional or unconditional) with foreign margin regimes determined to be comparable is potentially available to foreign CSEs and certain other CSEs (including U.S. branches or agencies of foreign banks but not foreign branches of U.S.-entity CSEs) in transactions with all counterparties, provided that the CSE’s obligations do not have a guarantee from a U.S. entity, a branch or office of a U.S. entity, or a U.S. individual. Substituted compliance for IM posting to a financial end user is potentially available to any CSE, except in cases where the counterparty’s obligations have a guarantee from a U.S. entity, a branch or office of a U.S. entity, a U.S. individual, or a U.S. branch, agency or subsidiary of a foreign bank. The final rule defines a guarantee as a recourse guarantee, and requires look-through to any persons against whom a guarantor has recourse. Conditional relief is available, subject to agency approval, to certain CSEs from IM posting to foreign jurisdictions where impediments to segregation exist.

Looking Forward

Although the first compliance date is nearly a year away, implementation of the agencies’ margin regime (and the Commodity Futures Trading Commission’s and U.S.Securities and Exchange Commission’s, once finalized) is likely to be a resource-intensive process for swap entities and their counterparties. Now that the final regulation is available, market participants can turn with greater certainty to assessing and planning for its impact, such as by analyzing their status as financial end users, the magnitude of their consolidated group’s swaps exposure, the extent of the documentation effort needed (which may be mitigated by industry association-developed aids), their access to eligible collateral types and the regulation’s economic consequences for planned hedging and trading activities. Certain market participants, including, in particular, securitization issuers and persons subject to insolvency regimes incompatible with an “eligible master netting agreement” determination, may find themselves fundamentally re-examining their approach to hedging due to the cost and operational impact of the margin regulations.

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[1] Margin and Capital Requirements for Covered Swap Entities, Final Rule, available at https://www.fdic.gov/news/board/2015/2015-10-22_notice_dis_a_fr_final-rule.pdf. The agencies' rule simply affirms existing capital standards applicable to CSEs.

[2] Prudential regulators, in brief, have capital and margin jurisdiction over a variety of "banking entities" that are swap entities. See footnote 4 of the agencies' rule for details.

[3] Margin and Capital Requirements for Covered Swap Entities, Interim Final Rule, available at https://www.fdic.gov/news/board/2015/2015-10-22_notice_dis_a_fr_interim-final-rule.pdf.

[4] The rules define affiliate and subsidiary status by reference to accounting consolidation under GAAP, IFRS or other similar standards (including application of such standards on as "as if" basis). In addition, the relevant agency may determine that such status exists based on its conclusion that either company provides significant support to, or is materially subject to the risks or losses of, the other company.
