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The Re-Proposed Margin Rules for Non-Cleared Swaps: Some Issues and Suggestions for End Users

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BACKGROUND: The US banking regulators and the Commodity Futures Trading Commission (CFTC) have each recently re-proposed margin rules for non-cleared swaps (the "Proposed Rules") that are virtually identical in substance and are generally consistent with the international standards for non-cleared swap margins published by the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions in September 2013 (the "International Standards").[1] (A bank engaging in swap activity will be subject to the margin rules set by the banking regulators. A nonbank whose swap activity is regulated by the CFTC will be subject to the CFTC margin rules.) The comment period for the Proposed Rules is open until November 24 for the proposal from the banking regulators and December 2 for the CFTC proposal.

Under the Proposed Rules from the banking regulators (which cover banks that are registered as dealers and major participants with the CFTC and/or the Securities and Exchange Commission (SEC) (each, a "swap entity")), the extent to which a particular party to a swap must post initial margin ("IM"), variation margin ("VM"), or both, will be determined by the regulatory status of that party viewed in conjunction with the regulatory status of its counterparty. There are four categories of regulatory status for this purpose: 1) swap entities; 2) Financial End Users (as defined in Exhibit B) with material swaps exposure (each, a "Financial End User+", or "FEU+"); 3) financial end users without material swaps exposure (each, a "Financial End User –", or "FEU-"); and 4) all other counterparties of swap entities (each, a "Non-financial End User").

SUMMARY OF PROPOSED MARGIN REQUIREMENTS: The margin requirements applicable to swaps between different pairs of counterparties under the Proposed Rules are identified in the table attached as Exhibit A to this advisory. The highlights are:

1. Every Financial End User will have to exchange VM with a swap entity.

2. Every Financial End User with material swaps exposure will also be subject to mandatory IM for a swap with a swap entity.

3. There is no mandatory margin for Non-financial End Users. However, every swap entity must perform a credit risk analysis before trading with a Non-financial End User and must impose its own IM and VM requirements on the Non-financial End User to the extent the swap entity deems necessary to address the credit risk posed by the counterparty.

4. End users are neither required to exchange margin with other end users nor to perform a credit analysis of an end user counterparty.

PROPOSED EFFECTIVE DATE: Consistent with the International Standards, the Proposed Rules contemplate that variation margin requirements will apply from December 1, 2015 while initial margin requirements will be implemented in annual stages starting on that same date (depending on swap portfolio size), with full implementation for all swaps commencing on December 1, 2019. Both parties to a swap have to surpass the phase-in threshold (applied on an aggregate basis to each party and all of its affiliates) for a particular year before they become subject to the initial margin rules (if applicable). Unless a party has more than $1 trillion in aggregate notional amount of swaps, the earliest it will become subject to mandatory IM (if at all) will be December 1, 2019.

ACTION STEPS: Any entity other than a swap entity that is currently a counterparty to one or more swaps or security-based swaps should take the following steps in connection with the Proposed Rules:

1. Confirm its categorization under the Proposed Rules.

2. Identify issues in the Proposed Rules that materially affect it.

3. Consider making comments on the Proposed Rules, either individually or as part of an industry or trade group.

SELECT END USER ISSUES: The points set forth below are intended to help end users identify issues that might be significant for them.

1. The term "financial end user" is different from the term "financial entity" used in the clearing rules. Although many financial entities that are ineligible to opt out of mandatory clearing will also be financial end users, the two terms are not synonymous. The definition of "financial end user" is intended to be more objective because it depends on categorization against a list of specific types of entities and intentionally omits the catch-all for persons "predominantly engaged in" banking or financial activities found in the definition of "financial entity." The Proposed Rules include an explicit exemption from the definition of "financial end user" (and thus from the Proposed Rules) for sovereigns, certain enumerated multi-national financial institutions, captive finance companies exempt from clearing under Section 2(h)(7)(C)(iii) of the Commodity Exchange Act (CEA) and an agent affiliate that qualifies for the exemption from clearing pursuant to Section 2(h)(7)(D) of the CEA. There is no exemption for small financial institutions with less than $10 billion in total assets.

2. The test for "material swaps exposure" includes foreign exchange forwards and swaps, and is

an aggregate calculation that includes for the calculating entity all of its transactions with its affiliates and the transactions of its affiliates with third parties. There is no explanation other than consistency with the International Standards as to why the concept of "swaps exposure" includes foreign exchange forwards and foreign exchange swaps even though these transactions are excluded from the definition of "swap" by the determination made by the Secretary of the Treasury in 2012. The test will consequently require new and different calculations from any that are currently made in the ordinary course of business by swap market participants.

3. Affiliation for purposes of the Proposed Rules is created by ownership by one entity of 25 percent or more of the shares of any class of voting securities of another entity. The definition of "control" in the Proposed Rules is consistent with the broad definition of that term that is used in the Bank Holding Company Act (BHCA), and is very different from the 50 percent ownership test found in most traditional definitions of affiliation. As in the BHCA, the definition of "control" also picks up any arrangement which gives a party actual control over the election of a majority of the directors or trustees of another entity.

4. The test for "material swaps exposure" for a Financial End User operates with a four-month lag. Material swaps exposure is defined for a Financial End User as an average daily notional amount of relevant outstanding transactions in excess of $3 billion (measured throughout all the business days in June, July and August of any year). If a Financial End User has a material swaps exposure based on a calculation for June, July and August in a given year (Year 1), it will not become an FEU+ until January 1 of the next calendar year (Year 2), but it will be an FEU+ for the whole of Year 2 even if its notional amount of swaps is equal to or less than $3 billion when tested for June, July and August in Year 2.

5. The material swaps exposure threshold in the Proposed Rules is significantly lower than that in the International Framework. The International Standards use Euro 8 billion (approximately $11 billion) in "gross notional outstanding amounts" to identify entities that should be subject to IM. As noted above, the "material exposure test" threshold into the Proposed Rules is only $3 billion. (This is the same number that is expected to be the post-phase-in level for the de minimis test for swap dealing, but since the two tests are very different in substance, the choice of $3 billion does not seem to have any significance except the potential to cause confusion.)

6. There is no exception in the Proposed Rules for swaps between affiliated parties. Swaps with affiliates all count towards the material swaps exposure threshold and must be margined in accordance with the Proposed Rules.

7. The test for the phase-in threshold is the same as the test for material swaps exposure. When a swap entity calculates its material swaps exposure for a given year from 2015-2019 it will therefore also find out automatically whether it exceeds the phase-in threshold for IM compliance on December 1 in that year.

8. A swap entity can calculate IM using an IM model only if the model has been approved by the swap regulator for that entity and meets numerous detailed conditions. The banking regulators have extensive experience evaluating swap models for banks, so in the short run it may be easier for a bank to obtain approval for an IM model than for a swap entity regulated by the CFTC to obtain model approval from that regulator. To qualify for approval, a model must meet numerous detailed requirements. In particular, a model must estimate potential

future exposure to a 99 percent confidence level assuming a 10-day holding period (unless the maturity of the swap is less than 10 days). In addition, a swap entity using a model must verify periodically that the IM requirements generated by its model are at least equal the amounts that a derivatives clearing organization would require for similar cleared transactions. It may be difficult for a swap entity to meet this standard if the types of uncleared swaps that it executes vary significantly from the types of swaps that are cleared by derivatives clearing organizations.

9. An IM model may allow for calculation of IM on a portfolio basis among all the swaps covered by an enforceable master netting agreement. However, buried within the more detailed specifications for acceptable models is the limitation that "empirical correlations under an eligible master netting agreement" may only be recognized "within each broad risk category", not "across" such categories. The broad risk categories are "agricultural commodity, energy commodity, metal commodity and other commodity, credit, equity, and foreign exchange or interest rate." (The odd punctuation and conjunctions in the list of risk categories leave room for confusion, but the banking regulators state clearly in the preamble to the Proposed Rules that there are seven risk categories, with "other commodities" being a category on its own and foreign exchange and interest rates being one combined category, and the CFTC proposal makes that clear in the text of the Proposed Rule itself.) The exact import of this limitation will not be clear until the first models are submitted for approval.

10. If a swap entity does not have an approved IM model, it must calculate IM by using percentages from a table provided in the Proposed Rules (See Exhibit C). This approach calculates IM as a percentage of notional amount for each type of swap identified. Whether intentionally or by mistake, there is no exception in this approach for the calculation of the IM collection amount for fully paid swaps. The Proposed Rules consequently would even require the purchaser of an option for which the premium is paid up front to post IM (if IM is otherwise applicable).

11. Some netting is permitted in calculating IM by reference to the Table in the Proposed Rules. The IM requirement for multiple swaps subject to an enforceable master netting agreement can be reduced using the following formula that provides some netting benefit:

    Initial Margin = 0.4 x Gross Initial Margin + 0.6 x NGR x Gross Initial Margin

    where;

    Gross Initial Margin = the sum of the product of each non-cleared swap's or non-cleared security-based swap's effective notional amount and the gross initial margin requirement for all non-cleared swaps and non-cleared security-based swaps subject to the eligible master netting agreement;

    and

    NGR = the net-to-gross ratio (that is, the ratio of the net current replacement cost to the gross current replacement cost). In calculating NGR, the gross current replacement cost equals the sum of the replacement cost for each non-cleared swap and non-cleared security-based swap subject to the eligible master netting agreement for which the cost is positive. The net current replacement cost equals the total replacement cost for all non-cleared swaps and non-cleared security-based swaps subject to the eligible master netting agreement.

VM can also be calculated on an aggregate net basis for all swaps covered by an eligible master netting agreement, but the calculating entity can use standard market netting methodology for doing so.

12. The Proposed Rules allow a variety of assets with prescribed haircuts as IM, but only cash as VM. The only collateral acceptable as VM between a swap entity and a Financial End USer is US dollar cash or cash in the termination currency of the relevant swap. Specified non-cash collateral such as gold and fixed income and equity securities can be used for IM if it appears on the list of permitted collateral and is valued using specified haircuts. (See Exhibit D.) Cash in any major currency (as defined in the Proposed Rules) can be used as IM collateral even if it is not the settlement currency for the relevant swaps, but in that case it will be subject to an eight percent haircut.

13. Margin requirements will apply on a daily basis. IM for a swap starts on the business day after the trade date for the swap. VM applies at least once per business day "on and after the date" on which "it enters into" a swap. There is no discussion in the Proposed Rules or the preamble as to how margin applies when the effective date of a swap is later than the trade date.

14. IM for each party must be segregated in an account with an independent custodian. The custodian must be a party that is not affiliated with either party to the swap (using the 25 percent test for affiliation). Substitution of collateral is permitted, but not rehypothecation even though some limited re-use of initial margin collateral is permitted in the International Standards. (The banking regulators have requested specific comments on this issue.) The Proposed Rules require that the custody agreement with the custodian must be legal, valid, binding and enforceable even in the event of the bankruptcy of one of the parties. It is unclear how this standard can be achieved.

15. The Proposed Rules allow a swap entity to agree a threshold of up to $65 million before IM must be delivered. The threshold is applied on a consolidated entity level so it represents the maximum aggregate unsecured IM exposure that one party and all its affiliates (using the 25 percent test for affiliation) can have to the other party and all its affiliates. Allocation of the threshold among entities in the same group creates numerous practical issues. The Proposed Rules also set a minimum transfer amount of $650,000 (or one percent of the threshold amount), which applies to IM and VM combined. The threshold and the minimum transfer amount are roughly equivalent to the ones set in the International Standards.

16. Swaps in existence when the Proposed Margin Rules go into effect will be subject to the new rules if they are documented in the same agreement as a party's post-effective date swaps. If a party that uses ISDA master agreements wants to avoid that result, it will have to create separate new agreements for its post-effective date swaps (although these new agreements would presumably be exact clones of its original master agreements). The use of two master agreements will prevent optimal netting of swap risks.

17. The detailed requirements that are applicable to mandatory IM and VM are not applicable to voluntary IM or VM. If the parties voluntarily agree to exchange collateral to an extent not required specifically by the Proposed Rules they may do so in any mutually agreed form and manner except that a swap entity must require segregation with an independent custodian for

"any collateral other than variation margin" that it agrees voluntarily to deliver to a counterparty. A swap dealer may accordingly continue to use traditional forms of margining with Non-financial End Users, such as having a loan and a swap secured by the same package of collateral.

18. The Proposed Rules do not apply to "any foreign non-cleared swap or non-cleared security-based swap" of a "foreign covered swap entity." As a practical matter, a "foreign" swap is one in which neither party (nor any guarantor of either party) is a US person, which for these purposes is any entity organized under US or state law (including a non-US branch or office of such an entity). A swap transaction loses its foreign character if either party is 1) guaranteed by a US person, 2) operating through a branch or an office in the US, or 3) a swap entity that is controlled by a US person. This exclusion is not completely in synch with the concepts in the CFTC's cross-border guidance because it does not consider an entity's principal place of business in determining its status as a US person. The Proposed Rules also provide for substituted compliance under the rules of another jurisdiction in certain limited cases if a US regulator has determined that the other rules are comparable to the otherwise applicable requirements of the Proposed Rules.

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[1] For the sake of convenience, this advisory will focus on the Proposed Rules from the banking regulators (the Board of Governors of the Federal Reserve System, the Office of Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the federal Housing Finance Agency).

EXHIBIT A

To view Exhibit A, click here.

EXHIBIT B

"Financial End User" means any party to a derivative that is not a Swap Entity but is:

1. A bank holding company or an affiliate thereof; a savings and loan holding company; a nonbank financial institution supervised by the Board of Governors of the Federal Reserve System under Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. 5323);
2. A depository institution; a foreign bank; a federal credit union, state credit union as defined in section 2 of the Federal Credit Union Act (12 U.S.C. 1752(1) & (6)); an institution that functions solely in a trust or fiduciary capacity as described in section 2(c)(2)(D) of the Bank Holding Company Act (12 U.S.C. 1841(c)(2)(D)); an industrial loan company, an industrial bank, or other similar institution described in section 2(c)(2)(H) of the Bank Holding Company Act (12 U.S.C. 1841(c)(2)(H));
3. An entity that is state-licensed or registered as a credit or lending entity, including a finance company; money lender; installment lender; consumer lender or lending company; mortgage lender, broker, or bank; motor vehicle title pledge lender; payday or deferred deposit lender; premium finance company; commercial finance or lending company; or commercial mortgage company; but excluding entities registered or licensed solely on account of financing the entity's direct sales of goods or services to customers;

4. An entity that is state-licensed or registered as a money services business, including a check casher; money transmitter; currency dealer or exchange; or money order or traveler's check issuer;

5. A regulated entity as defined in section 1303(20) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4502(20)) and any entity for which the Federal Housing Finance Agency or its successor is the primary federal regulator;

6. Any institution chartered and regulated by the Farm Credit Administration in accordance with the Farm Credit Act of 1971, as amended, 12 U.S.C. § 2001 et seq.;

7. A securities holding company; a broker or dealer; an investment adviser as defined in section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)); an investment company registered with the SEC under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.); or a company that has elected to be regulated as a business development company pursuant to section 54(a) of the Investment Company (15 U.S.C. 80a-53);

8. A private fund as defined in section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80-b-2(a)); an entity that would be an investment company under section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a-3) but for section 3(c)(5)(C); or an entity that is deemed not to be an investment company under section 3 of the Investment Company Act of 1940 pursuant to Investment Company Act Rule 3a-7 of the Securities and Exchange Commission (17 CFR 270.3a-7)

9. A commodity pool, a commodity pool operator, or a commodity trading advisor as defined in, respectively, sections 1a(10), 1a(11), and 1a(12) of the Commodity Exchange Act (7 U.S.C. 1a(10), 7 U.S.C. 1a(11), 7 U.S.C. 1a(12)); or a futures commission merchant;

10. An employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974 (29 U.S.C. 1002);

11. An entity that is organized as an insurance company, primarily engaged in writing insurance or reinsuring risks underwritten by insurance companies, or is subject to supervision as such by a state insurance regulator or foreign insurance regulator;

12. An entity that is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in loans, securities, swaps, funds or other assets for resale or other disposition or otherwise trading in loans, securities, swaps, funds or other assets;

13. An entity that would be a financial end user as described above if it were organized under the laws of the United States or any state thereof; or

14. Notwithstanding the specified exclusions described below, any other entity that a banking regulator has determined should be treated as a financial end user.

Exclusions:

The term "financial end user" does not include any counterparty that is:

- A sovereign entity;
- A multilateral development bank [as defined in the Proposed Rules];
- The Bank for International Settlements;

- A captive finance company that qualifies for the exemption from clearing under section 2(h)(7)(C)(iii) of the Commodity Exchange Act and implementing regulations; or

- A person that qualifies for the affiliate exemption from clearing pursuant to section 2(h)(7)(D) of the Commodity Exchange Act or section 3C(g)(4) of the Securities Exchange Act and implementing regulations.

EXHIBIT C

Standardized Minimum Gross Initial Margin Requirements for Non-cleared Swaps and Non-cleared Security-Based Swaps	
Asset Class	Gross Initial Margin (% of Notional Exposure)
Credit: 0-2 year duration	2
Credit: 2-5 year duration	5
Credit: 5+ year duration	10
Commodity	15
Equity	15
Foreign Exchange/Currency	6
Cross-Currency Swaps: 0-2 year duration	1
Cross-Currency Swaps: 2-5 year duration	2
Cross-Currency Swaps: 5+ year duration	4
Interest Rate: 0-2 year duration	1
Interest Rate: 2-5 year duration	2
Interest Rate: 5+ year duration	4
Other	15

EXHIBIT D

Margin Values for Cash and Non-cash Initial Margin Collateral[2]	
Asset Class	Haircut (% of market value)
Cash in same currency as swap obligation	0.0
Eligible government and related (e.g., central bank, multilateral development bank, GSE securities identified in §_.6(a)(2)(iii)) debt: residual maturity less than one-year	0.5
Eligible government and related (e.g., central bank, multilateral development bank, GSE securities identified in §_.6(a)(2)(iii)) debt: residual maturity between one and five years	2.0
Eligible government and related (e.g., central bank, multilateral development bank, GSE securities identified in §_.6(a)(2)(iii)) debt: residual maturity greater than five years	4.0
Eligible corporate (including eligible GSE debt securities not identified in §_.6(a)(2)(iii)) debt: residual maturity less than one year	1.0

Eligible corporate (including eligible GSE debt securities not identified in §_.6(a)(2)(iii)) debt: residual maturity between one and five years:	4.0
Eligible corporate (including eligible GSE debt securities not identified in §_.6(a)(2)(iii)) debt: residual maturity greater than five years:	8.0
Equities included in S&P 500 or related index	15.0
Equities included in S&P 1500 Composite or related index but not S&P 500 or related index	25.0
Gold	15.0
Additional (additive) haircut on asset in which the currency of the swap obligation differs from that of the collateral asset	8.0

[2]The value of initial margin collateral will be computed as follows: the value of initial margin collateral for any collateral asset class will be computed as the product of the total value of collateral in any asset class and one minus the applicable haircut expressed in percentage terms. The total value of all initial margin collateral is calculated as the sum of the value of each type of collateral asset.

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