DATE: April 12, 2011

MEMORANDUM TO: Board of Directors

FROM: Sandra L. Thompson, Director
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SUBJECT: Minimum Margin and Capital Requirements for Certain Dealers and Major Participants of Swaps and Security-based Swaps: Notice of Proposed Rulemaking to Implement Sections 731 and 764 of the Dodd-Frank Act

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Recommendation: Staff recommends that the Board approve a *Notice of Proposed Rulemaking* (NPR) to implement section 4s(e) of the Commodity Exchange Act (CEA)[1] and section 15F(e) of the Securities Exchange Act of 1934 (Exchange Act)[2], as amended by sections 731 and 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The NPR addresses minimum initial margin, variation margin, and capital requirements for certain derivatives that are not cleared through a clearinghouse. The NPR will be issued jointly by the "prudential regulators," which include the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Farm Credit Administration, and the Federal Housing Finance Agency (collectively, Agencies) in the *Federal Register* with a public comment period that will run through June 24, 2011, a date that is 73 days after the Board's vote.

I. Introduction

Title VII of the Dodd-Frank Act significantly revised the regulatory framework for swaps and security-based swaps.[3] These revisions were designed to reduce risk, increase transparency, and promote market integrity within the financial system.

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[1] 7 U.S.C. § 6s(e).

[2] 15 U.S.C. § 78o-10(e).

[3] "Swaps" are defined in section 721 of the Dodd-Frank Act to include interest rate swaps, foreign exchange swaps, commodity-based swaps, and broad-based credit swaps. "Security-based swaps" are defined in section 761 of the Dodd-Frank Act to include single-name and narrow-based credit swaps and equity-based swaps.

One of the goals of Title VII is to reduce counterparty credit risk in the over-the-counter (OTC) derivatives markets by requiring that standardized swaps be cleared through a clearinghouse. A clearinghouse interposes itself between counterparties to a derivative transaction by taking on the credit risk that each party poses to the other. Title VII's clearing mandate reflects the consensus of the G-20 leaders at the 2009 Pittsburgh Summit: "All standardized OTC derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end of 2012 at the latest."[4]

Congress anticipated, however, that certain swaps would lack the standardization necessary to be cleared. The Dodd-Frank Act recognizes that uncleared swaps pose a greater risk to the safety and soundness of a dealer and to the financial system than cleared swaps. To address the higher risk, the Act requires the registration of dealers and major participants of swaps and security-based swaps (collectively, "swap entities").

The Act also requires the Agencies to issue initial margin, variation margin, and capital requirements for swap entities that fall within their jurisdiction with respect to swaps and security-based swaps they enter into that are not cleared through central counterparties ("covered derivatives"). The Act does not expressly require parity between the initial margin and variation margin requirements for uncleared and cleared swaps. However, requiring initial margin and variation margin levels for uncleared swaps that are higher than or at least high as the margin for cleared swaps is implicit in the Act's reference to the "greater risk" of uncleared swaps and its mandate that initial margin and variation requirements for uncleared swaps be "appropriate for the risk" posed by uncleared swaps.

The Dodd-Frank Act defines a dealer as an entity that: (1) holds itself out as a dealer of derivatives; (2) makes a market in derivatives; (3) regularly engages in the purchase or sale of covered derivatives in the ordinary course of business for its own account; or (4) engages in any activity causing the entity to be commonly known as a dealer or market maker of such instruments.

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[4] G20 Leaders, June 2010 Toronto Summit Declaration, paragraph 24.

A major participant is defined to include an entity that is: (1) not a dealer; and (2) meets one of the following three tests:

(a) maintains a substantial position in covered derivatives for any of the major derivatives categories as determined by the applicable Commission (i.e., Securities and Exchange Commission (SEC) or Commodity Futures Trading Commission (CFTC)), excluding positions held for hedging or mitigating commercial risk; and positions held by any employee benefits plan for the primary purpose of hedging or mitigating substantial counterparty exposures;

(b) whose outstanding swaps create substantial counterparty exposure that could have a serious adverse effect on the financial stability of the U.S. banking system or financial markets; or

(c) is a financial entity that: (i) is highly leveraged and is not subject to capital requirements established by an appropriate Federal banking agency (AFBA); and (ii) maintains a substantial position in outstanding derivatives in any major derivatives category as determined by the applicable Commission.

The CFTC is charged with issuing regulatory definitions of "swap," "swap dealer," and "major swap participant," and the SEC is charged with issuing regulatory definitions of "security-based swap," "security-based swap dealer," and "major security-based swap participant." The SEC and CFTC issued a joint notice of proposed rulemaking with respect to these definitions in December, 2010.[5] For purposes of the proposed rule, the term "covered swap entity" covers any entity that meets the definition of "swap dealer," "security-based swap dealer," "major swap participant," or "security-based major swap" that is regulated by one of the Agencies.

For a covered swap entity, the proposed rule would impose: (i) initial margin and variation margin requirements for non-cleared swaps and security-based swaps; and (ii) capital requirements on all non-cleared swaps held by the swap entities. The Agencies' existing regulatory capital rules currently take into account and address the unique risks arising from derivatives transactions. Therefore, the proposed rule would be based on a preliminary conclusion by the Agencies that these existing rules are appropriate and sufficient to offset the

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[5] See 75 Fed. Reg. 80,174 (Dec. 10, 2010).

greater risk to the swap entity and the financial system arising from the use of covered derivatives.

The CFTC and SEC are separately required to adopt rules imposing capital and margin requirements for swap entities for which there is no prudential regulator. The Dodd-Frank Act requires the CFTC, SEC, and the Agencies to establish and maintain, to the maximum extent practicable, capital and margin requirements that are comparable, and to consult with each other no less than annually regarding these requirements.

The Dodd-Frank Act requires that initial margin and variation margin requirements adopted by the Agencies must: (i) help ensure the safety and soundness of the swap entity; and (ii) be appropriate for the risk associated with the covered derivatives. Consistent with that requirement, the proposed rule's initial margin, variation margin, and capital standards are intended to offset the risk to swap entities and the financial system arising from the use of swaps and security-based swaps that are not cleared.

The terms "initial margin" and "variation margin" are widely used in the business and regulation of exchange-traded commodities. "Initial margin," which a party collects from a counterparty at the outset of a swap or security-based swap, is viewed as a performance bond that is expected to cover a dealer's close out costs as well as the reduction in the value of collateral between default and closeout. "Variation margin," which a party collects from a counterparty over the course of a swap or security-based, is viewed as covering the changes to the mark-to-market values of the transaction or the underlying collateral during the course of a transaction.

II. Summary of the Proposed Rule

The proposed rule would require covered swap entities to calculate and collect initial margin and variation margin from all counterparties. For swap entities, this would require reciprocal collection from other swap entities for all initial and variation margin requirements. However, the proposed rule would provide a series of risk-based margin collection thresholds for covered swap entities that are designed to limit the impact of margin collection requirements on lower risk financial end users. As such, the proposed initial margin and variation margin collection

requirements for covered swap entities would change as the characteristics of their counterparties change. Specifically, the collection requirements would change for: 1) covered swap entity-to-swap entity transactions; 2) covered swap entity to high- and low-risk financial end users; and 3) covered swap entity to commercial end users. Attachment A provides a matrix that outlines the key provisions of the proposed rule, which are discussed in more detail below.

Covered swap entity-to-swap entity transactions

Currently, the industry practice is to exchange variation margin between swap entities, but not require initial margin. The proposed rule would change the current industry practice by requiring a covered swap entity to collect initial margin when it enters into a swap or security-based swap transaction with another swap entity. The proposed rule would also require the covered swap entity to require its swap entity counterparty to segregate and hold the collateral posted as initial margin at a third-party custodian.[6] The segregation requirement would be based on a preliminary conclusion by the Agencies that requiring a covered entity's initial margin to be segregated is necessary to: (i) offset the greater risk to the swap entity and the financial system arising from the use of non-cleared swaps; and (ii) protect the safety and soundness of the swap entity.

The proposed rule would require a covered swap entity to collect variation margin from another swap entity no less than once per business day. If a qualifying master netting agreement is in place, a covered swap entity may calculate the variation margin requirement on an aggregate basis according to the terms of that agreement.

Under the proposed rule, a covered swap entity's obligation to collect initial and variation margin from another swap entity would apply without any threshold. However, to reduce operational burden, the proposal would not require collection unless the amount to be collected exceeds a $100,000 minimum payment amount.

[6] When a covered swap entity enters into a swap or security-based swap transaction with another swap entity, both counterparties will be subject to initial margin collection requirements. While the proposed rule will apply to covered swap entities, comparable regulations issued by the CFTC and SEC will apply to other swap entities, as appropriate. Because both counterparties are subject to initial margin collection requirements, margin will be effectively exchanged bi-laterally.

Financial end users

The proposed rule would require a covered swap entity to collect initial and variation margin from a financial end user. Generally, the proposed rule defines a financial end user as an entity predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in 4(k) of the Bank Holding Company Act of 1956.[7] Financial end users would include, but not be limited to, commodity pools, hedge funds, and banking organizations. The term "financial end user" would also include a non-U.S. sovereign counterparty.

The proposed rule also would establish low- and high-risk profiles for financial end users. A low-risk financial end user would be one that:

1. does not have a "significant swaps exposure;"
2. predominantly uses swaps to hedge or mitigate the risks of its business activities, including balance sheet, interest rate, or other risk arising from its business; and
3. is subject to capital requirements established by a prudential regulator or state insurance regulator.

Determining "significant swaps exposure" is necessary to evaluate if an end user is low- or high-risk for the purposes of the proposed rule. The proposed rule would define "Significant swaps exposure" as either:

1. Swap positions that equal or exceed any of the following thresholds:
    a. $2.5 billion in daily average aggregate uncollateralized exposure; or
    b. $4 billion in daily average aggregate uncollateralized exposure plus daily average potential exposure; or
2. Security-based swap positions that equal or exceed any of the following thresholds:
    a. $1 billion in daily average aggregate uncollateralized exposure; or
    b. $2 billion in daily average aggregate uncollateralized exposure plus daily average aggregate potential outward exposure.[8]

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[7] See 12 U.S.C. § 1843(k).

[8] A financial end user would be considered to have significant swap exposure with a lower level of exposure to security-based swaps than to swaps. This distinction would be based on a preliminary view that uncollateralized

The proposed rule's applicable minimum supervisory initial margin threshold and variation margin collection threshold are dependent on whether a counterparty falls within the definition of low-risk end user or high-risk end user. For a high-risk profile financial end user (e.g., a hedge fund), a minimum supervisory initial margin collection threshold or variation margin collection threshold applies. Covered swap entities would be required to collect the entire initial margin amount and variation margin amount required from such counterparty, as calculated under the proposed rule. However, for a low-risk profile financial end user (e.g., an insured depository institution under certain circumstances), an initial margin threshold and variation margin threshold may apply. For transactions with a low-risk profile financial end user, the proposed rule would require a covered swap entity to collect initial margin and variation margin to the extent that such amount exceeds the applicable threshold.

For a low risk financial end user, the proposed rule would impose the following threshold for initial margin and variation margin, independently: the lesser of (i) between $15 million and $45 million; and (ii) between 0.1 to 0.3 percent of the swap entity's tier-one capital. For the final rule, staff anticipates recommending specific median numbers in place of these two ranges, i.e., the lesser of $30 million or 0.2 percent of the swap entity's tier-one capital.

The proposed rule would also require a covered swap entity to collect variation margin from a financial end user no less than once per business day.

Commercial end users

The proposed rule would require a covered swap entity to calculate a credit exposure limit for a commercial end user (CEU) and collect initial margin and variation margin from a commercial end user when the credit exposure exceeds the calculated limit. Unlike with low risk financial end users, no explicit minimum supervisory threshold for margin collection would apply to CEUs. This approach is aligned with the approach that CFTC Chairman Gary Gensler has

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security-based swap exposure (which include single-name and narrow-based credit default swaps) pose a significant risk at lower levels than uncollateralized swap exposure.

discussed and that CFTC staff indicates they plan to recommend to the CFTC for its proposed rule in this area.

Initial margin

The proposed rule would permit a covered swap entity to calculate their initial margin requirement using either of two alternatives. Under the first alternative, the covered swap entity may calculate minimum initial margin requirements through the use of a standardized "lookup" table that specifies the minimum initial margin that must be collected as a percentage of a swap's notional amount. Under the second alternative, a covered swap entity may calculate minimum initial margin requirements through the use of an internal model that is approved by its primary regulator. Given the greater risk sensitivity of models, as well as the ability to recognize the benefits of netting (as discussed below), staff expect that a covered swap entity will seek approval for the use of an internal model to calculate its minimum initial margin requirements.

The proposed rule would require initial margin models to calculate an amount of initial margin that is equal to the potential additional loss on the swap or portfolio of swaps during a period of closeout of the portfolio in the event of the counterparty's default. The proposed rule would impose modeling standards that are generally consistent with current regulatory rules and risk management best practices for such models in the context of the risk-based capital rules applicable to insured depository institutions and bank holding companies.

In addition, the proposed rule would require that the internal model used in the calculation of the margin requirement be at least as conservative as those used by swap clearinghouses. As a result, the proposed modeling standards would incorporate the greater risk posed by uncleared swaps compared to cleared swaps. Because uncleared swaps, particularly certain credit default swaps, are expected to be less liquid than cleared swaps, the proposed rule specifies a minimum time horizon for the initial margin model of 10 business days, compared with a typical requirement of 3 to 5 business days required by swap clearinghouses. As a result, an uncleared swap would generally require a greater amount of initial margin than would a cleared swap in order to account for differences in liquidity. An internal model for an uncleared swap would also result

in a higher initial margin requirement because of the absence of risk mitigants applicable to a cleared swap.

The proposed rule would permit an initial margin model to calculate initial margin for a portfolio basis and reflect offsetting exposures, diversification, and other hedging benefits for swaps governed by the same qualifying master netting agreement. However, offsetting positions and other hedging benefits may be recognized within each asset category, but not across asset categories. For example, the proposed rule would not permit exposures generated by interest rate swaps to be used to offset or hedge exposures generated by commodity swaps with the same counterparty.

Additionally, the proposed rule would require the initial margin model to be calibrated to a period of financial stress. Staff believes that calibration to a stress period ensures that the resulting initial margin requirement is robust to a period of financial stress during which swap entities and financial counterparties are more likely to default. Furthermore, staff believes that calibrating the initial margin model to a stress period reduces the systemic risk that can arise if margin requirements were to escalate in response to a large increase in volatility during a period of financial stress.

Permissible collateral

The proposed rule limits the types of collateral that are eligible to satisfy either the initial margin or variation margin requirements to (i) immediately-available cash funds, (ii) obligations of, or fully guaranteed by, the United States, and (iii) senior debt obligations of government-sponsored entities. Other than immediately-available cash funds, all types of eligible collateral are subject to haircuts for determining their value for margin purposes.

III. Effect on Commercial End Users

Following passage of the Dodd-Frank Act, a number of commentators expressed concerns in meetings with staff regarding margin requirements with respect to transactions between a swap entity and a commercial end user. They argued that swap transactions with commercial end

users should be excluded from the scope of margin requirements because commercial end users pose little if any risk to their counterparties and U.S. financial stability.

Historically, dealers have viewed whether to require margin as a credit decision, and where a commercial end user had a strong credit profile or an ongoing credit relationship, a dealer would not require margin—in essence extending unsecured credit to the end user. In the Dodd-Frank Act, Congress gave commercial end users the choice to be exempt from the clearing mandate for swaps that it uses to manage its business risk. As the posting of initial margin and variation margin is a major consequence of clearing a trade through a clearinghouse, choosing this exemption would insulate the end user from the margin requirement of a clearinghouse.

The NPR would address CEU concerns by requiring a covered swap entity to calculate a credit exposure limit but not impose any minimum threshold that would require the collection of margin when the credit exposure was below the limit.

IV. Effect on Community Banks

The Dodd-Frank Act requires the CFTC and the SEC to consider whether to give small financial institutions, including those with total assets of $10 billion or less, the option not to clear a swap for which clearing is available. Call report data indicates that insured depository institutions with total assets at or below the $10 billion threshold enter into interest rate swaps and foreign exchange swaps. Such institutions make virtually no use of credit derivatives.

The proposed rule establishes thresholds for low-risk profile financial end users to temper the impact of initial and variation margin requirements. A swap entity would calculate the initial and variation margin requirement for a low-risk profile financial end user; however, the swap entity would only be required to collect the amount of initial and variation margin that exceeds between $15 million and $45 million. For the final rule, staff anticipates recommending specific numbers in place of this range. Because most community banks will have uncollateralized swap exposure below the proposed threshold, the Agencies believe that community banks will not be materially affected by the proposed rule. However, the Agencies will seek comment on the adequacy of the proposed thresholds in addressing concerns of small financial institutions.

Conclusion

Staff recommends that the Board approve for publication in the *Federal Register* the attached NPR after all Agencies have completed their review and approval procedures. The NPR would establish margin standards that help ensure the safety and soundness of the swap entity and the financial system.

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Proposed Minimum Margin Requirements for Dealers and Major Participants Based on Counterparty Type

Counterparty Type	Initial Margin	Counterparty Threshold ($)	Initial Margin Segregation	Variation Margin	Counterparty Threshold ($)
Another Dealer or Major Participant	Yes (collect)	Zero	Must require 3rd party custodial segregation on all initial margin posted.	Yes (collect)	Zero
Financial End User					
High Risk Profile	Yes (collect)	Zero	Not required.	Yes (collect)	Zero
Low Risk Profile	Yes (collect)	Proposed lesser of [$15 – 45M] and [0.1 – 0.3%] of swap entity's tier 1 capital. Staff anticipates recommending the midrange points in final rule: **$30 million or 2% of tier 1 capital.**	Not required.	Yes (collect)	Proposed lesser of [$15 – 45M] and [0.1 – 0.3%] of swap entity's tier 1 capital. Staff anticipates recommending the midrange points in final rule: **$30 million or 2% of tier 1 capital.**
Commercial End User	Yes (collect)*	Credit exposure limit set by the dealer or major participant.	Not required.	Yes (collect)*	Credit exposure limit set by the dealer or major participant.

Note: Covered entities are required to collect margin from counterparties but are not required to post margin to counterparties.

* A dealer or major participant would be required to collect initial margin and variation margin from a commercial end user when the total of those amounts exceeds the dealer's or major participant's credit exposure limit.