DATE: October 16, 2015

MEMORANDUM TO: Board of Directors

FROM: Doreen R. Eberley, Director
Division of Risk Management Supervision

SUBJECT: Notice of Final Rulemaking to establish Margin and Capital Requirements for Covered Swap Entities

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Recommendation: Staff recommends that the FDIC Board of Directors ("Board") approve publication of the attached joint *Notice of Final Rulemaking* entitled "Margin and Capital Requirements for Covered Swap Entities" ("final rule"). This final rule is required by the Dodd-Frank Act, and was developed jointly by staff from the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Farm Credit Administration, and the Federal Housing Finance Agency (collectively, the "agencies"). This final rule is consistent with the international framework on margin requirements published by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions in September 2013.

The final rule would establish minimum margin requirements for the swaps of an insured depository institution or other entity that: (1) is supervised by one of the agencies; and (2) is registered with the Commodity Futures Trading Commission as a swap dealer or major swap participant, or with the Securities and Exchange Commission as a security-based swap dealer or major security-based swap participant.

Staff also recommends that the Board approve publication of the attached *Notice of Interim Final Rulemaking*, which would provide that the agencies' margin requirements shall not apply to certain swaps entered into by commercial end users and by small financial institutions, pursuant to Title III of the Terrorism Risk Insurance Program Reauthorization Act of 2015.

Concur:

Charles Yi
General Counsel

Policy Objectives

Title VII of the Dodd-Frank Act establishes a new regulatory regime for swaps and security-based swaps (collectively, "swaps").[1] Swaps that are sufficiently standardized are required to be cleared through a clearinghouse. Dealers and major participants in swaps that lack sufficient standardization for clearing are required to register with the Commodity Futures Trading Commission (CFTC) or Securities and Exchange Commission (SEC), as applicable, if their swap activities meet certain criteria and exceed certain thresholds. (Such a dealer or major participant is referred to in this memorandum as a "swap entity.")

Sections 731 and 764 of the Dodd-Frank Act also charge the agencies with establishing margin and capital requirements for a swap entity that is supervised by one of the agencies. (Such an entity is referred to in this memorandum as a "covered swap entity.")[2] Similarly, the CFTC and SEC, as applicable, are charged with establishing margin and capital requirements for swap entities that are not supervised by one of the agencies.

The primary objective of the final rule is to adopt margin rules required by the Dodd-Frank Act. In establishing margin requirements, the Dodd-Frank Act requires the agencies to impose margin requirements that: (1) help ensure the safety and soundness of the covered swap entity; and (2) are appropriate for the risk associated with the non-cleared swaps activities engaged in by covered swap entities. The agencies' standards for initial margin and variation margin are required to offset these risks to a covered swap entity and the financial system arising from the use of non-cleared swaps.

The recent financial crisis revealed that a number of significant participants in the swaps markets had taken on excessive risk through the use of swaps without sufficient financial resources to make good on their contracts. By imposing an initial and variation margin requirement on non-cleared swaps, sections 731 and 764 of the Dodd-Frank Act will reduce the ability of firms to take on excessive risks through swaps without sufficient financial resources.

[1] Pub. L. 111-203, 124 Stat. 1376 (2010). "Swaps" are defined in the CEA to include interest rate swaps, foreign exchange swaps, commodity-based swaps, and broad-based credit swaps. "Security-based swaps" are defined in the Exchange Act to include single-name and narrow-based credit swaps and equity-based swaps.

[2] 7 U.S.C. 6s(e)(2)(A); 15 U.S.C. 78o-10(e)(2)(A).

Additionally, the minimum margin requirement will reduce the amount by which firms can leverage the underlying risk associated with the swap contract.

The final rule would require a covered swap entity to comply with risk-based and leverage capital requirements already applicable to that covered swap entity as part of its prudential regulatory regime.   Compliance with these regulatory capital rules is sufficient to offset the greater risk, relative to the risk of centrally cleared swaps, to the swap entity and the financial system arising from the use of non-cleared swaps, and would help ensure the safety and soundness of the covered swap entity.

DISCUSSION

I. Background

2011 NPR: In May 2011, the agencies published proposed rules for swap margin requirements (“2011 proposal”) that would implement requirements of the Dodd-Frank Act. The agencies received over 100 comments in response to the 2011 proposal from a variety of commenters, including banks, asset managers, commercial end users, and various trade associations. The CFTC also proposed margin requirements in May 2011 for swap entities it supervises and the SEC proposed such requirements for entities subject to its supervision in November 2012. Commenters expressed concerns that given the global nature of the OTC swaps market, if similar requirements were not established in foreign jurisdictions, market participants could avoid the high costs of complying with the proposed rules by moving the activities abroad.

2013 International Framework on Margin: In July of 2012, the Basel Committee on Banking Supervision (BCBS) and International Organization of Securities Commissions (IOSCO) published a proposed framework for margin requirements on non-cleared swaps with the goal of creating an international standard for margin requirements on non-cleared swaps. Following the release of the proposed international framework, the agencies re-opened the comment period on the 2011 proposal to allow for additional comment. The proposed international framework was also subject to extensive public comment before it was finalized by the BCBS and IOSCO in September of 2013 (the "2013 international framework").[3]

2014 NPR: In September 2014, the agencies published a notice of proposed rulemaking ("2014 proposal") to supersede the 2011 proposal. The agencies received over 60 comments from the public, and staff from the agencies met with several groups to hear their views regarding the 2014 proposal.

2015 TRIPRA Legislation: On January 12, 2015, the President signed into law the Terrorism Risk Insurance Program Reauthorization Act of 2015 (TRIPRA). Title III of the TRIPRA amends statutory provisions originating in the Dodd-Frank Act relating to capital and margin requirements for non-cleared swaps. The TRIPRA provisions exempted swaps of certain commercial end users that are entered into for hedging purposes from the agencies' margin rules for non-cleared swaps. The TRIPRA exemption also applies to a covered swap entity's swap with a financial institution with total assets of $10 billion or less if the institution uses the swap to hedge commercial risk.

Section 303 of the TRIPRA requires that the agencies implement the provisions of Title III by promulgating an interim final rule with a request for public comment. The attached Notice of Interim Final Rule would satisfy this requirement.

II. Overview of the Final Rule

Consistent with the statutory requirements, the final rule would help ensure the safety and soundness of the covered swap entity and would be appropriate for the risk to the financial system associated with non-cleared swaps activity engaged in by covered swap entities. The final rule takes into account the risk posed by a covered swap entity's counterparties in establishing the minimum amount of initial and variation margin that the covered swap entity must exchange with such counterparties.

In implementing this risk-based approach, the final rule would distinguish among four separate types of swap counterparties: (i) counterparties that are themselves swap entities; (ii)

[3] See BCBS and IOSCO "Margin requirements for non-centrally cleared derivatives," (September 2013), available at http://www.bis.org/publ/bcbs261.pdf.

counterparties that are financial end users with a material swaps exposure[4]; (iii) counterparties that are financial end users without a material swaps exposure; and (iv) other counterparties, including sovereigns and multilateral development banks.[5] These categories would reflect the staff's view that risk-based distinctions can be made between these types of swap counterparties. Also, the final rule would contain special provisions for swap transactions between a covered swap entity and its affiliates.

Because of TRIPRA, a covered swap entity's non-cleared swaps with commercial end users and small financial institutions that hedge the latter's commercial risk would not be subject to the margin requirements, even if such swaps were to fall within one of the above four categories.

The final rule's initial and variation margin requirements would generally apply to the posting, as well as the collection, of minimum initial and variation margin amounts by a covered swap entity from and to its counterparties. Staff believes that imposing requirements with respect to the minimum amount of initial and variation margin to be collected is a critical aspect of offsetting the greater risk to the covered swap entity and the financial system arising from the covered swap entity's non-cleared swap exposure. However, staff also believes that requiring a covered swap entity to post margin to other financial entities could forestall a build-up of potentially destabilizing exposures in the financial system. The final rule's approach therefore is designed to ensure that covered swap entities transacting in non-cleared swaps with other swap entities and with financial end users will collect and post appropriate minimum margin amounts with respect to those transactions.

Initial Margin: The final rule would require a covered swap entity to exchange initial margin with counterparties that are: (1) swap entities; or (2) financial end users with material swaps exposure. The final rule would require a covered swap entity to calculate its minimum initial margin requirement in one of two ways:

[4] The final rule defines material swaps exposure as an average daily aggregate notional amount of non-cleared swaps, non-cleared security-based swaps, foreign exchange forwards and foreign exchange swaps with all counterparties for June, July, and August of the previous calendar year that exceeds $8 billion, where such amount is calculated only for business days.

[5] See § __.2 of the final rule for the various constituent definitions that identify these four types of swap counterparties.

1. Standardized Table: using a standardized margin schedule that is set out in Appendix A of the final rule and allows for certain types of netting and offsetting of exposures; or

2. Internal Model: using an internal margin model that satisfies the criteria outlined within the final rule and has been approved by the supervising agency.

In addition, a covered swap entity would be required to post or collect initial margin on at least a daily basis in response to changes in the required initial margin amounts stemming from changes in portfolio composition or any other factors that result in a change in the required initial margin amounts.

The final rule also would permit a covered swap entity to adopt a maximum threshold amount of $50 million, below which it need not collect or post a minimum amount of initial margin for swaps with counterparties that are: (1) swap entities; or (2) financial end users with material swaps exposures. The threshold would be applied on a consolidated basis to both the covered swap entity and its counterparty.

For transactions with: (1) financial end users without material swap exposure; or (2) other counterparties whose swaps are not excluded from the rule due to the TRIPRA exemption, the final rule would not specify a minimum amount of initial margin that must be collected or posted. Instead, the covered swap entity would be required to collect initial margin in such forms and amounts (if any) and at such times from other counterparties as the covered swap entity determines appropriately address the credit risk posed by such counterparties. As such, staff believes that the final rule would not change current industry practice with respect to these counterparties.

Variation Margin: The final rule would require a covered swap entity to exchange variation margin on swaps with all counterparties that are: (1) swap entities; or (2) financial end users (regardless of whether the financial end user has a material swaps exposure). Because of TRIPRA, however, the variation margin requirement would not apply to certain swaps that a covered swap entity enters into with commercial end users and with certain small financial institutions.

The amount of variation margin would have to be at least equal to the increase or decrease in the value of the swap since the counterparties' previous exchange of variation margin, calculated on at least a daily basis. Requiring covered swap entities to exchange variation margin with these counterparties effectively reduces systemic risk by protecting both the covered swap entity and its counterparty from the effects of a counterparty default. Importantly, unlike the treatment of initial margin, the final rule would not permit a covered swap entity to adopt a threshold amount below which it need not collect or post variation margin on swaps with a swap entity or financial end user counterparties.

Netting agreements: The final rule would permit a covered swap entity to: (i) calculate initial margin requirements for swaps under an eligible master netting agreement (EMNA) with a counterparty on a portfolio basis in certain circumstances, if it does so using an initial margin model; and (ii) calculate variation margin requirements under the final rule on an aggregate, net basis under a EMNA with a counterparty. The final rule would define EMNA as any written, legally enforceable netting agreement that creates a single legal obligation for all individual transactions covered by the agreement upon an event of default (including receivership, insolvency, liquidation, or similar proceeding), provided that certain conditions are met.

Minimum transfer amount: Under the final rule, a covered swap entity would not need to collect or post initial or variation margin from or to any individual counterparty otherwise required unless and until the required cumulative amount of initial and variation margin is $500,000 or more. The minimum transfer amount only affects the timing of margin collection; it does not change the amount of margin that must be collected once the $500,000 threshold is crossed. For example, if the margin requirement were to increase from $400,000 to $800,000, the covered swap entity would be required to collect the entire $800,000 (subject to application of any applicable initial margin threshold amount in the case of initial margin being collected).

Eligible collateral: The final rule limits the types of collateral that covered swap entities may post or collect to meet their minimum margin requirements.

For initial margin, the final rule would permit cash as well as certain assets expected to remain highly liquid during a period of financial stress such as debt securities that are issued or guaranteed by the U.S. Department of Treasury or by another U.S. government agency, the Bank for International Settlements, the International Monetary Fund, the European Central Bank, and multilateral development banks; certain U.S. Government-sponsored enterprises' ("GSEs") debt securities; certain foreign government debt securities; certain corporate debt securities; certain listed equities; and gold. The final rule also permits interests in pooled investment funds that invest in U.S. government securities or securities issued by the European Central Bank or a sovereign entity that is assigned no higher than a 20 percent risk weight under the capital rules applicable to the covered swap entity.

Regarding variation margin, for a covered swap entity's swaps with another swap entity, it would only be permitted to exchange immediately available cash funds denominated in U.S. dollars or the currency of settlement. For a covered swap entity's swaps with a financial end user with material swap exposure, in addition to funds denominated in U.S. dollars or the currency of settlement, the parties would also need to exchange funds denominated in any major currency as well as non-cash collateral that is eligible to satisfy initial margin requirements.

When determining the collateral's value for purposes of satisfying the final rule's margin requirements, a covered swap entity must apply "haircuts" set out in Appendix B of the final rule. The limits on eligible collateral and application of a haircut would not apply to margin collected in excess of what is required by the final rule.

Mismatches between the currency in which collateral is denominated and the currency of underlying swap obligations can result in a swap counterparty being undercollateralized. To address this risk, under the final rule, initial margin and variation margin would be subject to an 8 percent haircut in certain circumstances. For variation margin, the 8 percent haircut would apply where collateral is not denominated in the currency of settlement for the swap or netting set of swaps except where the collateral is in the form of currency that is U.S. dollars or another major currency. For initial margin, the 8 percent haircut would apply to collateral that is not denominated in the currency of settlement for the swap or netting set of swaps except for collateral that is denominated in the same currency as the termination currency under the eligible master netting agreement between the parties.

Because the value of collateral may change, the final rule would also require a covered swap entity to monitor the value and quality of collateral previously collected to satisfy minimum initial or variation margin requirements. If the value of such collateral has decreased, or if the quality of the collateral has deteriorated so that it no longer qualifies as eligible collateral, the final rule would require covered swap entities to collect additional collateral of sufficient value and quality to ensure that all applicable minimum margin requirements remain satisfied.

Segregation of collateral: The final rule requires a covered swap entity to require that any collateral other than variation margin that it posts to its counterparty (even collateral in excess of any required by the final rule) be segregated at one or more custodians that are not affiliates of the covered swap entity or the counterparty ("third-party custodian"). The final rule also requires a covered swap entity to place the initial margin it collects (in accordance with the final rule) from a swap entity or a financial end user with material swaps exposure at a third-party custodian.[6] In both cases, the third-party custodian must be prohibited by agreement[7] from (i) rehypothecating, repledging, reusing or otherwise transferring, any of the funds or other property it holds, and (ii) substituting or reinvesting any funds or other property it holds as initial margin pursuant to the rule in any asset that would not qualify as eligible collateral under the final rule and where the amount net of applicable discounts described in Appendix B would not be sufficient to meet the requirements for initial margin under the proposal.

Staff believes that requiring covered swap entities to segregate and limit the rehypothecation, repledging, or reuse of funds and other property held at a custodian is necessary to: (i) offset the greater risk to the covered swap entity and the financial system arising from the use of swaps that are not cleared, and (ii) protect the safety and soundness of the covered swap entity. Staff believes that requiring the protection of pledged margin bilaterally between the counterparties provides assurance that the pledging counterparty does not face additional losses (due to the loss of its transferred or pledged collateral) above the replacement cost of the non-cleared swap portfolio.

Initial margin model: The final rule permits a covered swap entity to calculate initial margin requirements using an approved initial margin model, provided certain standards and criteria are satisfied and the model is approved by the agency that supervises the covered swap entity. These standards relate to the technical aspects of the model, as well as broader oversight

[6] The segregation requirement applies only to the minimum amount of initial margin that a covered swap entity is required to collect by rule from a swap entity or financial end user with a material swaps exposure. The segregation requirement also applies to any collateral (other than variation margin) that the covered swap entity posts to any counterparty.

[7] The final rule requires the covered swap entity to enter into a custodial agreement with a custodian that is legal, valid, binding, and enforceable under the law of all relevant jurisdictions including in the event of bankruptcy, insolvency, or similar proceedings.

and governance standards, and are broadly similar to modeling standards that are already required for internal regulatory capital models. In the event that a model is not approved, initial margin calculations would have to be performed according to the standardized initial margin approach that is detailed in the final rule's Appendix A.

The internal initial margin model permitted in the final rule may reflect offsetting exposures, diversification, and other hedging benefits within, but not across, four broad risk categories (commodities, credit, equity, and foreign exchange and interest rates (as a single asset class)) for purposes of calculating initial margin for a particular counterparty if the swaps are executed under the same eligible master netting agreement. The initial margin amount calculated using an initial margin model must be set equal to a model's calculation of the potential future exposure of the non-cleared swap consistent with a one-tailed 99 percent confidence level over a 10-day close-out period. Generally, the final rule's modeling standards for the initial margin model are consistent with current regulatory rules and best practices for such models in the context of risk-based capital rules applicable to insured depository institutions and bank holding companies, are no less conservative than those generally used by central counterparties, and are consistent with the standards of the 2013 international framework.[8]

Cross-border application of margin requirements: Non-cleared swaps are transacted in global markets often between counterparties organized in different jurisdictions. Section 9 of the final rule addresses the applicability of the final rules to covered swap entities in several scenarios in which cross-border issues arise. First, certain swaps by foreign covered swap entities with foreign counterparties would be exempt from the margin requirements of the final rule.

Second, certain cross border swaps that do not meet the standards for total exemption from the rule's requirements may be eligible for substituted compliance, i.e., the covered swap entity may satisfy the rule's requirements by complying with the requirements of a foreign jurisdiction if the agencies have jointly determined that the foreign jurisdiction's requirements are comparable to the final rule. These determinations would be made on a jurisdiction-by-jurisdiction basis. In making such determinations, the agencies would expect that the foreign

[8] This conservative approach also incorporates the practices associated with model validation, independent review and other qualitative requirements associated with the use of internal models for regulatory capital purposes.

regulatory framework would be fully consistent with the principles established in the 2013 international framework. If such a determination was made, substituted compliance, that is, satisfying the final requirement by complying with the requirement of a foreign jurisdiction, would be permitted in certain circumstances.

Third, swaps transacted by U.S. covered swap entities, including those transacted out of foreign branches of U.S. covered swap entities, would not be eligible for substituted compliance. However, for swaps by such entities, the U.S. covered swap entity would be permitted to calculate the amount of initial margin it must post to its counterparty by posting the amount that the counterparty is required to collect pursuant to the host jurisdiction's requirements if that jurisdiction's requirements are determined to be comparable.

Fourth, special rules would apply when a covered swap entity enters a swap with a counterparty located in a jurisdiction where limitations in the legal or operational structure make it impracticable for the covered swap entity and the counterparty to post any form of eligible initial margin in compliance with the final rule's segregation requirements. If the covered swap entity is subject to foreign regulatory restrictions that require it to transact in non-cleared swaps through an establishment within the foreign jurisdiction and do not accommodate the posting of collateral outside the jurisdiction, then the covered swap entity would not be subject to the final rule's requirement to post initial margin to such a counterparty and the initial margin it collects is not subject to the final rule's segregation requirements. Such special rules would not apply, however, if the covered swap entity's counterparty is organized under the laws of the United States or any State, or is a branch or subsidiary of such a U.S. entity.

Inter-affiliate Swaps: In response to concerns raised by commenters, the final rule would include special rules for swaps between a covered swap entity and an affiliate. For such swaps, a covered swap entity is required to collect initial margin. While a covered swap entity would not be required to post initial margin, it must calculate the amount of initial margin it would have been required to post to its affiliate under the rule and provide documentation of such amount to each affiliate on a daily basis.

For purposes of calculating the amount of initial margin to be collected from an affiliate, the initial margin threshold amount is an aggregate credit exposure of $20 million resulting from all non-cleared swaps between the covered swap entity and that affiliate.   A covered swap entity, however, would be required to exchange variation margin with each affiliate as required by section 4 of the final rule.

The CFTC has adopted an exception from the requirement to clear certain standardized swaps that may apply to certain swaps between a covered swap entity and an affiliate. For any non-cleared swap (or netting portfolio) between a covered swap entity and an affiliate that would be subject to the clearing requirements of section 2(h)(1)(A) of the Commodity Exchange Act but for an exemption under section 2(h)(7)(C)(iii) or (D) or section 4(c)(1) of the Commodity Exchange Act or CFTC regulations, the covered swap entity's initial margin model calculation as described in § ___.8(d)(1) would be permitted to use a holding period equal to the shorter of five business days or the maturity of the non-cleared swap or non-cleared security-based swap (or netting portfolio). Similar treatment would be permitted for a non-cleared security-based swap between a covered swap entity and an affiliate that would be subject to a clearing requirement pursuant to section 3C(a)(1) of the Securities Exchange Act, but for an exemption pursuant to section 3C(g)(4) of the Securities Exchange Act or SEC regulations.

Compliance dates: The final rule includes a set of compliance dates by which covered swap entities would have to comply with the minimum margin requirements for non-cleared swaps. The final rule's compliance dates are consistent with the 2013 international framework. Variation margin requirements would apply to large covered swap entities starting on September 1, 2016 and to all remaining covered swap entities on March 1, 2017. Initial margin requirements would be phased in between September 1, 2016 and September 1, 2020, depending on the average daily aggregate notional amount of non-cleared swaps, non-cleared security-based swaps, foreign exchange forwards and foreign exchange swaps of the covered swap entity and its counterparty for March, April and May of that year.

The Final Rule and Community Banks: Staff expects that the final rule likely would have minimal impact on community banks or thrifts. Staff anticipates that community banks will not engage in swap activity to the level necessary to meet the rule's definition of covered swap entity. Because the final rule imposes requirements on covered swap entities, no community bank will likely be directly subject to the rule. Thus, a community bank that enters into non-cleared interest rate swaps with its commercial customers will not be required to apply to those swaps the final rule's requirements for initial margin or variation margin.

The TRIPRA also excluded from the final rule's scope certain swaps that a covered swap entity enters into with community banks. If a community bank with total assets of $10 billion or less enters into a swap with a covered swap entity to hedge or mitigate commercial risk, the swap will not be subject to this rule. As of June 30, 2015, of the 6,348 insured depository institutions, all but 111 institutions had total assets of $10 billion or less.[9] Staff believes that few community banks with total assets at or below the $10 billion threshold enter into swaps with covered swap entities and those that do, do so to hedge or mitigate commercial risk.

When a community bank with assets greater than $10 billion enters into a swap with a covered swap entity, the covered swap entity would be required to post and collect initial margin pursuant to the rule only if the community bank had a material swaps exposure and is not otherwise exempt pursuant to TRIPRA. Staff believes that the vast majority of community banks do not engage in swaps at or near that level of activity. Thus, for most, if not all community banks with total assets above $10 billion, the final rule will only require a covered swap entity to collect initial margin that it determines is appropriate to address the credit risk posed by such a community bank if the swap is not otherwise exempt. Staff believes covered swap entities currently apply this approach as part of their credit risk management practices.

The final rule would require a covered swap entity to exchange daily variation margin with a community bank with total assets above $10 billion, regardless of whether the community bank has material swaps exposure, if the swap is not otherwise exempt pursuant to TRIPRA. However, the covered swap entity would only be required to collect variation margin from a community bank when the amount of both initial margin and variation margin required to be collected exceeds the minimum transfer amount of $500,000, as provided for in § __.5(b) of the final rule. Staff expects that the vast majority of community banks will have a daily margin requirement that is below this amount.

Measures to Address Burden:

As described below, the burden related to the final rule has been reduced from what the proposed rule would have imposed, in large part in response to comments we received.

[9] FDIC Quarterly Banking Profile, Second Quarter 2015, p. 7. https://www5.fdic.gov/qbp/2015jun/qbp.pdf Of the 6,237 insured depository institutions with total assets of $10 billion or less as of June 30, 2015, 5,646 institutions had total assets of $1 billion or less and 591 institutions had total assets between $1 billion and $10 billion.

- Exclusion for Commercial End Users and Small Financial Institutions—Pursuant to legislation adopted earlier this year, the interim final rule excludes from the rule's requirements most non-cleared swaps that a covered swap entity enters into with a commercial end user and a small financial institution.

- Increased Amount for Financial End Users' Swap Activity—The NPR had proposed that a covered swap entity follow the requirements to collect and post initial margin for non-cleared swaps with financial end users whose annual swap activity exceeded an annual $3 billion amount. In the final rule, this amount has been increased to $8 billion.

- Aligning the "Affiliate" Definition with Accounting Standards—The NPR had proposed a definition of "affiliate" that included a "control" element of 25 percent. In response to commenters, the final rule aligns the "affiliate" definition with accounting standards for consolidation that should already be familiar to market participants.

- Expanded Eligible Collateral—For initial margin, the final rule allows interests in certain investment funds to serve as initial margin collateral. Permissible funds would be those that invest in U.S. government securities or securities issued by the European Central Bank or a sovereign entity that is assigned no higher than a 20 percent risk weight under the capital rules applicable to the covered swap entity. For variation margin, the NPR had proposed that only cash could serve as variation margin collateral. The final rule allows non-cash collateral to serve as variation margin for a covered swap entity's swaps with a financial end user.

- Inter-Affiliate Swaps—The NPR would have imposed full two-way initial margin requirements on swaps between a covered swap entity and an affiliate. The final rule contains a special provision for initial margin requirements for such swaps including:

    - Initial Margin Collect Only—A covered swap entity is required to collect initial margin from an affiliate but is not required to post initial margin to the affiliate.

    - Lower Initial Margin for Clearable Swaps—The final rule allows a covered swap entity to use a 5-day time horizon for modelling the initial margin requirement, rather than the 10-day horizon, for swaps that are required to be cleared but which are exempt because of a clearing exemption for inter-affiliate swaps.

    - Custodian Arrangements for Initial Margin—The NPR proposed to require initial margin that a covered swap entity collects pursuant to section __.3(a) to be held at a custodian that is neither the covered swap entity nor the counterparty, nor an affiliate of either counterparty. In the final rule, a covered swap entity or an affiliate may serve as custodian of non-cash collateral that a covered swap entity collects from an affiliate.

    - Threshold: In addition each affiliate may be granted an initial margin threshold of $20 million.

In addition, in response to concerns that commenters raised regarding burdens related to the 2014 proposal, the agencies made changes in the final rule. In response to concerns regarding the rule's impact on a covered swap entity's swaps with its affiliates, under the final rule, a covered swap entity would only be required to collect initial margin and not be subject to the requirement to post initial margin to such an affiliate. Further, staff recommends that the final rule allow a covered swap entity to use a five-day time horizon in its margin model for swaps with an affiliate that are eligible for clearing but are not cleared due to an exception from clearing granted by the CFTC or SEC. Staff is also recommending that a covered swap entity be permitted to serve as the custodian for non-cash initial margin collateral it collects from an affiliate or to allow such non-cash initial margin to be held at an affiliated custodian rather than a non-affiliate custodian as otherwise required by section 7.

Further, regarding eligible collateral, staff is recommending that non-cash collateral be permitted as variation margin for a covered swap entity's swaps with a financial end user. Further, staff is recommending that eligible collateral for both initial margin and variation margin be expanded to include interests in pooled investment funds that invest in U.S. government securities or securities issued by the European Central Bank or a sovereign entity that is assigned no higher than a 20 percent risk weight under the capital rules applicable to the covered swap entity.

Expected Effects of the Final Rule:

A. Overview.

The final rule would apply the initial margin and variation margin requirements to non-cleared swaps that are entered into by a covered swap entity over a substantial phase-in period that begins in September 2016. The final rule would not require an immediate or retroactive application of initial margin or variation margin for any swap entered into prior to the relevant compliance date of the final rule.

Because the requirements would not be applied retroactively, no new initial margin or variation margin requirements would be imposed on non-cleared swaps entered into prior to the relevant compliance date until those transactions are rolled over or renewed. The only requirements that would apply to a pre-compliance date transaction would be the initial margin and variation margin requirements to which the parties to the transaction had previously agreed by contract.

The quantitative impact analysis in the preamble to the Final Rule addresses the potential cost of initial margin requirements, a topic that received considerable attention from commenters. Staff also notes that the posting of initial margin is, in aggregate, not solely a cost, since for every dollar of initial margin provided by a posting entity, the collecting entity receives an additional dollar of protection from potential loss. In addition, the posting and collection of margin should reduce buildups of large unsecured derivatives positions that can adversely affect financial stability. Staff believes that, as articulated throughout the preamble, the final rule will achieve these financial stability benefits in a way that is responsive to the concerns of commenters and consistent with the statutory mandate.

The new requirements would have an impact on the costs of engaging in new non-cleared swaps after the applicable compliance date. In particular, the final rule sets out requirements for initial and variation margin that represent a significant change from current industry practice in many circumstances. Since the 2011 proposal was released, a number of analyses have been conducted that attempt to estimate the total amount of initial margin that will be required by the new margin requirements. Given the complexity of this proposal and its inter-relationship to other rulemakings, these analyses are subject to considerable uncertainty. In particular, these analyses make a number of assumptions regarding: (i) the level of market activity in the future, (ii) the amount of central clearing in the future, and (iii) the level of financial market volatility and risk that will determine initial margin requirements. These studies also make a number of additional assumptions which may have a measurable influence on the analysis. Notwithstanding these uncertainties, staff's preliminary view is that the analysis and data that appear in these studies are useful to gauge the approximate amount of initial margin that will be required by the new requirements for non-cleared swaps.

Below is a discussion of a selection of studies that have been conducted in the recent past that relate to a margin framework similar to the final rule. Specifically, each of these studies uses the 2013 international framework described above in estimating the total amount of initial margin collateral that will be required. While this final rule is largely consistent with the 2013 international framework, the two are not identical. Therefore, the results of these studies are limited by these differences.

B. Initial Margin Requirements.

The final rule would require an exchange of initial margin by many market participants, which represents a significant change in market practice. The total amount of initial margin that would be required at a point in time is an important input into an estimate of the costs of the new requirements. The table below presents estimates of the total amount of initial margin that would be required by U.S. swap entities and their counterparties once the requirements are fully implemented, that is, at the end of the phase-in period and after existing swaps are rolled into new swaps.

Estimated Initial Margin Requirements	
Source	*Initial Margin Estimate ($BN)*
BCBS-IOSCO – Model Based	315
ISDA – Model Based	280
ISDA – Standardized	3,570

The initial margin estimates provided in the table above are taken from two different studies that have examined the impact of the 2013 international framework on overall liquidity needs. The studies were conducted by the BCBS and IOSCO and ISDA. Each of these studies reports an estimate of the global impact of margin requirements. In particular, these estimates include the impact of margin requirements on foreign financial institutions and their counterparties, in addition to U.S. financial institutions and their counterparties. In order to better align the studies' estimates with the impact of the final U.S. rule, the estimates in the above Table have been reduced by 65 percent to reflect the fact that U.S. financial institutions and their counterparties account for roughly 35 percent of the global derivatives market. The estimate reported in the table above from the BCBS-IOSCO study reflects the estimate among those provided in the study that is most consistent with the final rule. Two estimates from the ISDA study are presented in the table above reflecting a high and low estimate. Both the ISDA low estimate and the BCBS-IOSCO estimate assume that all initial margin requirements are calculated according to an internal model with parameters consistent with those required by the final rule. The ISDA high estimate assumes that all initial margin requirements are calculated according to a standardized margin approach. Further, the standardized approach assumed in the ISDA study does not allow for the recognition of any offsets which would be allowed by the application of the net-to-gross ratio under the final rule.

As discussed above, these estimates represent the total amount of initial margin that will be required at a point in time once the requirements have been fully phased in and all existing non-cleared swaps have been rolled over into new non-cleared swaps. Accordingly, the full amount of initial margin estimates provided in the table above would not be realized until, at the earliest, 2020.

The amounts reported in the table above reflect estimated amounts of initial margin that will be required under the final rule, but do not reflect the cost of providing these amounts by covered swap entities and their counterparties. The cost of providing initial margin collateral depends on the difference between the cost of raising additional funds and the rate of return on the assets that are ultimately pledged as initial margin. In some cases, it may be that some entities providing initial margin, such as pension funds and asset managers, will provide assets as initial margin that they already own and would have owned even if no requirements were in place. In such cases, the economic cost of providing initial margin collateral is expected to be low. In other cases, entities engaging in non-cleared swaps will have to raise additional funds to secure assets that can be pledged as initial margin. The greater the cost of the marginal funding, relative to the rate of return on the initial margin collateral, the greater the cost of providing collateral assets. It is difficult, however, to estimate these costs due to differences in marginal funding costs across different types of entities, as well as differences in marginal funding costs over time and differences in the rate of return on different collateral assets that may be used to satisfy the initial margin requirements.

C. Variation Margin Requirements.

The final rule would also require that variation margin be exchanged between covered swap entities and certain of their counterparties. Staff’s preliminary view is that the impact of such requirements are low in the aggregate because: (i) regular exchange of variation margin is already a well-established market practice among a large number of market participants, and (ii) exchange of variation margin simply redistributes resources from one entity to another. A reduction in liquid assets available to the entity that posts variation margin is offset by an increase in the liquid assets available to the entity receiving the variation margin.

Conclusion:

Staff recommends that the Board approve publication of the attached Notice of Final Rulemaking and Notice of Interim Final Rulemaking in the *Federal Register*.

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