Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990

September 17, 2019

MEMORANDUM TO: The Board of Directors

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

SUBJECT: NPR Regarding Swap Margin Requirements

RECOMMENDATION

Staff are presenting for approval of the Federal Deposit Insurance Corporation (FDIC) Board of Directors (the Board) and authorization for publication in the Federal Register, with a 30-day comment period, the attached notice of proposed rulemaking and request for comments titled *Margin and Capital Requirements for Covered Swap Entities* (NPR or the "proposal"). The NPR is being proposed jointly with the Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (the Federal Reserve), the Farm Credit Administration (FCA), and the Federal Housing Finance Agency (FHFA).

The NPR would make the following changes to the Swap Margin Rule:

- Provide relief by allowing legacy swaps to be amended to replace existing interest rate provisions based on certain interbank offered rates (IBORs) and other interest rates that are reasonably expected to be discontinued or are reasonably determined to have lost their relevance as a reliable benchmark due to a significant impairment, without such swaps losing their legacy status;
- Amend the Swap Margin Rule's requirements for inter-affiliate swaps. The proposal would repeal the requirement for a covered swap entity to collect initial margin from its affiliates, but would retain the requirement that variation margin be exchanged for affiliate transactions;
- Add an additional initial margin compliance period for certain smaller counterparties, and clarify the existing trading documentation requirements in the Swap Margin Rule; and
- Amend the Swap Margin Rule to permit amendments caused by conducting certain routine life-cycle activities that covered swap entities may conduct for legacy swaps, such as reduction of notional amounts and portfolio compression exercises, without triggering margin requirements.

Concur:

Nicholas Podsiadly
General Counsel

BACKGROUND

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) required the OCC, Federal Reserve, FDIC, FCA, and FHFA (each, an agency, and collectively, the agencies) to jointly adopt rules that establish capital and margin requirements for swap entities that are prudentially regulated by one of the agencies (covered swap entities).[1] These capital and margin requirements apply to swaps that are not cleared by a registered derivatives clearing organization or a registered clearing agency (non-cleared swaps).[2]

The Swap Margin Rule established an effective date of April 1, 2016, with a phased-in compliance schedule for the initial and variation margin requirements. On or after March 1, 2017, all covered swap entities were required to comply with the variation margin requirements for transactions with other swap entities and financial end user counterparties. The Swap Margin Rule presently requires all covered swap entities to comply with the initial margin requirements for non-cleared swaps with all financial end users with a material swaps exposure and with all swap entities by September 1, 2020.

THE PROPOSAL

Below is a discussion of each subject matter area being addressed by the NPR and the corresponding proposal:

Interbank Offered Rates

Proposal: to provide relief by allowing legacy swaps to be amended to replace existing interest rate provisions based on certain interbank offered rates (IBORs) and other interest rates that are reasonably expected to be discontinued or are reasonably determined to have lost their relevance as a reliable benchmark due to a significant impairment, without such swaps losing their legacy status.

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[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376 (2010). *See* 7 U.S.C. 6s; 15 U.S.C. 78o–10. Sections 731 and 764 of the Dodd-Frank Act added a new section 4s to the Commodity Exchange Act of 1936, as amended, and a new section, section 15F, to the Securities Exchange Act of 1934, as amended, respectively, which require registration with the Commodity Futures Trading Commission (CFTC) of swap dealers and major swap participants and the U.S. Securities and Exchange Commission (SEC) of security-based swap dealers and major security-based swap participants (each a swap entity and, collectively, swap entities). Section 1a(39) of the Commodity Exchange Act of 1936, as amended, defines the term "prudential regulator" for purposes of the margin requirements applicable to swap dealers, major swap participants, security-based swap dealers and major security-based swap participants. *See* 7 U.S.C. 1a(39).

[2] A "swap" is defined in section 721 of the Dodd-Frank Act to include, among other things, an interest rate swap, commodity swap, equity swap, and credit default swap, and a security-based swap is defined in section 761 of the Dodd-Frank Act to include a swap based on a single security or loan or on a narrow-based security index. *See* 7 U.S.C. 1a(47); 15 U.S.C. 78c(a)(68).

An IBOR is a benchmark interest rate that is intended to represent banks' cost of borrowing. IBORs have been used as the benchmark interest rate for a large volume and broad range of existing financial products and contracts, including for an estimated $200 trillion US Dollar LIBOR (USD LIBOR) exposure, of which $145 trillion represents over-the-counter derivatives exposure (as of year-end 2016). However, the discovery of, and numerous regulatory actions to seek redress of, market manipulation and false reporting of the IBORs, together with the post-crisis decline in liquidity in interbank unsecured funding markets, have undermined confidence in the reliability and robustness of IBORs.

As a result, the Financial Stability Board (FSB) and the U.S. Financial Stability Oversight Council (FSOC) requested that government and industry stakeholders undertake implementation of new designs and methodologies for IBORs; and where absent, the identification of viable near risk-free rates in their respective currencies (U.S. dollar in the case of the United States) with a focus on the feasibility of new rate methodologies, including identification of suitable administrators and any necessary infrastructure to support these rates.

The International Swaps and Derivatives Association, Inc. (ISDA), which produces standard documentation used by parties to derivatives contracts, indicated that it plans to amend its documentation to "include fallbacks that would apply upon the permanent discontinuation of certain key IBORs." For new non-cleared swaps, market participants will have an option to amend their documentation via an ISDA benchmark supplement. For non-cleared swaps that are already in place, market participants will have the option to utilize an ISDA protocol that will specify amended definitions, triggers, and other adjustments.

Due to the potential discontinuation of LIBOR at the end of 2021, covered swap entities face uncertainty about the way their swap contracts based on LIBOR and other IBORs will operate after the permanent discontinuation date without a reliable benchmark rate. A benchmark rate is a critical term for calculating payments under a swap contract. In many instances, these firms may decide to amend existing swap contracts to replace an IBOR before the IBOR becomes discontinued. Such amendments may also trigger follow-on amendments that the counterparties determine are necessary to maintain the economics of the contract.

The proposed rule would permit amendments that are made solely to accommodate the replacement of an IBOR, and it would also permit replacements of any other non-IBOR interest rate benchmark that a covered swap entity reasonably expects to be discontinued or reasonably determines has lost its relevance as a reliable benchmark due to a significant impairment with an alternate reference rate.

<u>Non-Cleared Swaps Between CSEs and an Affiliate</u>

<u>Proposal</u>: to amend the Swap Margin Rule's requirements for inter-affiliate swaps. The proposal would repeal the requirement for a covered swap entity to collect initial margin from its affiliates, but would retain the requirement that variation margin be exchanged for affiliate transactions.

The proposal would also supplement the definition of "affiliate" for purposes of § __.11 to include not only the definition of "affiliate" found in § __.2 of the swap margin rule, focusing on

consolidation under applicable accounting rules, but also the established "catch-all" legal standard for affiliation in banking focusing on the direct or indirect exercise of controlling influence over the management or policies of the controlled company. Absent this change, the swap margin rule would, by its general provisions, require covered swap entities to post initial margin to, and collect initial margin from, unconsolidated entities that are treated as affiliates of the covered swap entity for other legal or regulatory purposes.

Since the Swap Margin Rule was implemented, supervisory experience has shown that inter-affiliate swaps are used by covered swap entities for internal risk management purposes whereby a banking organization transfers risk to a centralized risk management function, which is considered to be a prudent risk management practice. As more covered swap entities have come into scope, the amount of inter-affiliate initial margin collected by covered swap entities has increased. This has led the affected banking organizations to borrow increasing amounts of cash in the debt markets to fund eligible collateral, placing additional demands on their asset-liability management structure and increasing their liability exposure to depositors and other creditors in the market.

The removal of the inter-affiliate initial margin requirement would provide these banking organizations with additional flexibility for internal allocation of collateral. Staff believes that such risk management practices often improve the safety and soundness of a covered swap entity, and therefore, to encourage such prudent risk management, propose to exempt inter-affiliate swaps from the Rule's initial margin requirements. The proposal does not remove the requirement that covered swap entities must collect and post initial margin with other non-affiliate covered swap entities.

Finally, staff notes certain affiliate transactions are subject to the requirements of sections 23A and 23B of the Federal Reserve Act as implemented by the Federal Reserve's Regulation W, which will continue to apply to affiliate transactions with an insured depository institution. Currently, almost all U.S. covered swap entities are insured depository institutions that would be subject to Sections 23A, 23B, and Regulation W. These provisions are specifically tailored to address risks arising from transactions, including non-cleared swaps, between affiliates. As such, staff believes that they are the more effective tools to address risks arising from transactions between affiliates. The Federal Reserve continues to consider how inter-affiliate non-cleared swaps can be addressed under Regulation W.

Additional Compliance Date for Initial Margin Requirements

Proposal: to add an additional initial margin compliance period for certain smaller counterparties, and clarify the existing trading documentation requirements in the Swap Margin Rule.

The phase-in schedule for initial margin is based on the swap level activity of the swap dealer and of the counterparty, measured by their respective "average daily aggregate notional amount" (AANA) of non-cleared swaps held in each party's market-wide portfolio. With the occurrence of the fourth phase of initial margin compliance obligations on September 1, 2019 – for covered swap entities and counterparties with an AANA of $750 billion to $1.5 trillion – the group currently scheduled for the fifth phase of compliance in the upcoming year includes all

remaining entities within the scope of the initial margin requirements, spanning AANAs from $8 billion up to $750 billion.

The swap industry has raised significant concerns about the operational and other difficulties associated with beginning to exchange initial margin with the large number of relatively small counterparties encompassed in the swap margin rule's fifth phase. In recognition of these difficulties, the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions framework has been recently revised to permit an additional phase for smaller counterparties, and the agencies believe it is appropriate to amend the swap margin rule in a similar manner.

Accordingly, the agencies are proposing to amend the compliance phase-in schedule to add a sixth phase of compliance for certain smaller entities that are currently subject to "phase five." The proposed amendments would require compliance by September 1, 2020, for counterparties with an AANA ranging from $50 billion up to $750 billion, while the compliance date for all other counterparties (with an AANA ranging from a "material swaps exposure" of $8 billion up to $50 billion) would be extended to September 1, 2021.

Complying with initial margin requirements creates regulatory obligations for covered swap entities and implications for their counterparties. Covered swap entities must calculate initial margin to be collected and posted to determine if and when collection or posting of initial margin is required. Under the swap margin rule, a covered swap entity must collect or post initial margin when it calculates an initial margin amount that, after subtracting the initial margin threshold amount (not including any portion of the initial margin threshold amount already applied by the covered swap entity or its affiliates to other non-cleared swaps or non-cleared security-based swaps with the counterparty or its affiliates), exceeds zero.

It is only at the time at which the covered swap entity is required to collect or post initial margin pursuant under the swap margin rule that it is required to have completed the initial margin trading documentation and the custody agreements that the rule requires.

The agencies are proposing to amend the swap margin rule to expressly state that a covered swap entity is not required to execute initial margin trading documentation with a counterparty prior to the time that it must collect or post initial margin under the rule.

The agencies would expect that covered swap entities will closely monitor their exposures and take appropriate steps to ensure that trading documentation is in place at such time as initial margin is required to be exchanged under the swap margin rule.

Portfolio Compression Exercises and Other Amendments

Proposal: to amend the Swap Margin Rule to permit amendments caused by conducting certain routine life-cycle activities that covered swap entities may conduct for legacy swaps, such as reduction of notional amounts and portfolio compression exercises, without triggering margin requirements

The Swap margin rule's requirements generally apply only to a non-cleared swap entered into on or after the applicable compliance date. A non-cleared swap entered into prior to an entity's

applicable compliance date is essentially “grandfathered” by the margin requirements. In other words, the legacy non-cleared swap is generally not subject to the margin requirements in the Swap margin rule.

The swap margin rule applies to non-cleared swaps entered into on or after the applicable compliance date. The agencies have previously expressed concerns about amendments to a swap that was entered into before the applicable compliance date if the amendments would have the effect of allowing covered swap entities and their counterparties to evade or otherwise artificially delay implementation of margin requirements. In particular, the agencies have been concerned whether market participants would amend legacy swaps rather than entering into new ones and exchanging margin pursuant to the Rule once the legacy swaps expire according to their original terms.

The staff is proposing amendments to clarify the agencies’ implementation of the legacy swaps provisions of the Swap Margin Rule since its adoption in 2015. These amendments are intended to permit amendments to legacy swaps arising from certain routine industry practices over the life-cycle of a non-cleared swap that are carried out for logistical reasons or risk-management purposes. The proposed amendments are those that do not raise concerns that the covered swap entity is seeking to evade or otherwise delay the application of margin requirements for non-cleared swaps.

One of these proposed amendments recognizes the legacy status of a non-cleared swap that has been amended to reflect technical changes, such as addresses, the identities of parties for delivery of formal notices, and other administrative or operational provisions of the non-cleared swap that do not alter the non-cleared swap’s underlying asset or indicator, such as a security, currency, interest rate, commodity, or price index, the remaining maturity, or the total effective notional amount. The types of technical changes described are necessary to reflect changes in a counterparty’s circumstances, but are not associated with a desire by either party to increase or decrease its exposure to market risk factors. While the technical changes listed above would be permitted, a change in the non-cleared swap’s underlying index would not be a technical change.

The second proposed amendment recognizes the legacy status of a non-cleared swap that has been amended solely to reduce the notional amount of the non-cleared swap, without altering other terms of the original non-cleared swap. For these purposes, a reduction in notional amount may be achieved through a partial termination of the original non-cleared swap, with the remaining non-terminated non-cleared swap being able to retain its legacy status. A reduction in notional amount could also be achieved by novating a portion of the original non-cleared swap’s notional amount to a third party. The original non-cleared swap, with a lower notional amount, would retain legacy status, but the novated portion would not retain legacy status.

The third proposed amendment recognizes the legacy status of non-cleared swaps that have been modified as part of certain portfolio compression exercises used as a risk management tool. In compression, offsetting trades between two or more parties are amended or torn up and replaced, which reduces the size of gross derivatives exposures and generally reduces the number or frequency of payments between parties, thus maintaining or reducing the overall risk profile of the portfolio. In general, these compression exercises make use of third party service providers

to assist in the choice of trades to be modified and the risk composition of the resulting portfolios.

REQUEST FOR COMMENT

The agencies request comment on all aspects of the proposed rule as well as on a number of specific questions. The proposed rule provides a comment period of 30 days after publication in the Federal Register.

CONCLUSION

FDIC staff recommend that the Board adopt the proposed rule and approve its publication in the Federal Register.

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