



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

Financial Institution Letter
FIL-25-2013
June 7, 2013

Advisory on Mandatory Clearing Requirements for Over-the-Counter Interest Rate and Credit Default Swap Contracts

Summary: New mandatory clearing requirements for certain interest rate and credit default swap contracts take effect on June 10, 2013 for all state nonmember institutions. These requirements apply to any covered transaction entered into on or after June 10, 2013, unless the end-user exception or inter-affiliate exemption under the Commodity Futures Trading Commission's (CFTC) rules applies.

Statement of Applicability to Institutions with Total Assets under \$1 billion: This letter applies to all institutions supervised by the FDIC that enter into interest rate and credit default swaps. Institutions with total consolidated assets of \$10 billion or less may opt for an exception or exemption from mandatory clearing under certain circumstances. Please refer to the CFTC's rules or guidance for more information.

Distribution:

FDIC-Supervised Banks (Commercial and Savings)

Suggested Routing:

Chief Executive Officer
Chief Financial Officer
Chief Risk Officer
Chief Compliance Officer

Attachment:

Referenced Guidance:

Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities, FIL-45-98
Counterparty Credit Risk Management: Supervisory Guidance, FIL-53-2011

Contact:

Bobby R. Bean, Associate Director; John Feid, Senior Policy Analyst; or Suzanne Clair, Senior Policy Analyst, Division of Risk Management Supervision, Capital Markets Branch, at bbean@fdic.gov, JFeid@FDIC.gov or SCLair@FDIC.gov or (202) 898-6888

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Highlights

- The CFTC has adopted final regulations to implement provisions of the Dodd-Frank Act that require certain interest rate and credit default swaps to be cleared by a derivatives clearing organization (DCO). Mandatory clearing of these swaps began on March 11, 2013 for transactions between parties that are registered swap dealers, registered major swap participants, or private funds active in the swaps market.
- On June 10, 2013, all banks, including state nonmember institutions, will become subject to the clearing requirements.
- Exceptions and exemptions to these requirements are available to institutions with total assets of less than \$10 billion, and certain inter-affiliate swaps. Institutions interested in obtaining an exemption should consult the CFTC regulation and/or contact the CFTC for information regarding the exception and/or exemption process.
- Institutions that have not already done so should review their interest rate and credit default swap activities to ensure compliance with the new CFTC regulations.
- Pursuant to long-standing supervisory expectations, financial institutions should effectively manage their derivative activities, taking into consideration associated legal, operational, and liquidity risks.

Mandatory Central Clearing of OTC Derivatives

This letter reminds FDIC-supervised institutions that they need to consider new swap clearing rules adopted by the CFTC. Section 723 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) added section 2(h) to the Commodity Exchange Act (CEA), which establishes a clearing requirement for swaps.¹ The Dodd-Frank Act makes it unlawful for any entity (including a bank) that is not subject to an exception or an exemption to engage in any swap the CFTC determines is required to be cleared, unless the person submits the swap for clearing to a registered derivatives clearing organization (DCO).

The CFTC has required certain interest rate and credit default swaps to be cleared by a DCO.² Mandatory clearing of these swaps began on March 11, 2013 for swaps between swap dealers, major swap participants, and private funds active in the swaps market and for swaps that these counterparties enter into with any other counterparty that desires to clear.

On June 10, 2013, a number of other entities, including persons predominantly engaged in banking or financial activities will become subject to mandatory clearing for these swaps with each other, with the entities that became subject to clearing on March 11, 2013, and with any other entity that desires to clear. This would apply to all banks, including state non-member banks.

An exception to the clearing requirement exists for smaller banks³ (total assets of \$10 billion or less), pursuant to the End-User Exception, and an exemption exists for certain inter-affiliate swaps, pursuant to the Inter-Affiliate Exemption.^{4, 5} Both of these exceptions/exemptions have terms and conditions.⁶ A bank wishing to use a clearing exception or exemption should review the CFTC's rules and guidance carefully to ensure it qualifies for the exception or exemption – for example by self-certifying on an annual basis that it meets small bank provision of the End-User Exception (CFTC Regulation 50.50(d)) and that it meets related requirements of either the End-User Exception or the Inter-Affiliate Exemption, as applicable.⁷

As per CFTC rules and guidance, a bank seeking to utilize the End-User Exception should determine whether it is exempt from the term "financial entity" (that is assets below \$10 billion), how it meets its financial obligations on the swap (for example, sufficient available financial resources), and that the swap is hedging or mitigating underlying commercial risk. The CFTC's rules and guidance provide details on how an end user can meet these general requirements.

If a bank is a public company or a subsidiary of a public company then the appropriate committee of the bank's board of directors must review and approve the bank's decision to use a clearing exception.⁸ In general, smaller banks that have counterparties that are swap dealers will provide the dealer with the information needed to qualify for the End-User Exception and other relevant reporting information as required by the new CFTC

rules. Many of the reporting requirements associated with the End-User Exception or Inter-Affiliate Exemption are likely to be handled by the bank's swap dealer counterparty; therefore, banks using the exception or exemption are urged to discuss the exception or exemption with their counterparty.

Institutions supervised by the FDIC that do not avail themselves of the End-User Exception or Inter-Affiliate Exemption, and that enter into swaps subject to mandatory clearing, should be actively developing the capability to clear these swaps. An institution may clear swaps through a futures commission merchant, which clears swaps on the institution's behalf, or by becoming a member of a DCO. Developing the capability to clear swaps will likely involve new legal documentation and updates to existing contracts. An institution that is not ready to meet the CFTC's requirements should adjust its activities to ensure compliance with the regulation. In addition, the FDIC expects supervised institutions to manage their derivative activities in a safe-and-sound manner, including the management of legal, operational, and liquidity risks associated with these activities.

General questions about central clearing should be directed to John Feid, Senior Policy Analyst, jfeid@fdic.gov or Suzanne Clair, Senior Policy Analyst, SCLair@FDIC.gov, Capital Markets Branch, FDIC at 202-898-6888. Technical questions regarding mandatory clearing rules can be directed to CFTC Attorney-Advisor Meghan Tente at (202) 418-5785 or mtente@cftc.gov.

¹ See Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (July 21, 2010).

² Clearing Requirement Determination Under Section 2(h) of the CEA, 77 Fed. Reg. 74284 (December 13, 2012) (codified at 17 CFR 50.1 et seq.). The list of swaps subject to mandatory clearing is in the CFTC's regulations at 17 CFR 50.4. Refer to 77 Fed. Reg. 74284 (December 13, 2012), reproduced here:
<http://www.cftc.gov/ucm/groups/public/@newsroom/documents/generic/cftcfiveswapclasses031113.pdf>

³ A bank, as defined in section 3(a) of the Federal Deposit Insurance Act, is exempt from the definition of "financial entity" and may, therefore, use the End-User Exception as if it were a non-financial entity, if it has total assets of \$10 billion or less on the last day of its most recent fiscal year. (CFTC Regulation 50.50(d)). See End-User Exception to the Clearing Requirement for Swaps," 77 FR 42560 (July 19, 2012) (recodified at 17 CFR 50.50 from 17 CFR 39.6).

⁴ Clearing Exemption for Swaps Between Certain Affiliated Entities, 78 Fed. Reg. 21750 (April 11, 2013) (to be codified at 17 CFR 50.52).

⁵ Also note that Sections 23A and 23B of the Federal Reserve Act and Regulation W would apply to interaffiliate swaps.

⁶ See CFTC Regulations 50.50 (End-User Exception) and 50.52 (Inter-Affiliate Exemption).

⁷ The Federal Register release adopting the End-User Exception is available here: <http://www.cftc.gov/ucm/groups/public/@Irfederalregister/documents/file/2012-17291a.pdf> and the Federal Register release adopting the Inter-Affiliate Exemption is available here: <http://www.cftc.gov/ucm/groups/public/@Irfederalregister/documents/file/2013-07970a.pdf>
Guidance concerning the End-User Exception is available here: http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/eue_factsheet_final.pdf and http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/eue_qa_final.pdf

⁸ See Commodity Exchange Act Section 2(j) and CFTC Regulation 50.50(b).