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CLIENT MEMORANDUM

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Regulators Propose Swap Margin and Capital Rules

Contents

Summary

On April 12, 2011, the U.S. banking regulators proposed rules regarding the capital and margin requirements applicable to uncleared swaps. In general, the proposed rules would not impose new capital requirements on bank swap entities. However, the proposed rules would require bank swap entities to collect initial and variation margin from counterparties, including, in some cases, end users. In addition, the proposed rules establish collateral eligibility and segregation requirements and methodologies for calculating initial and variation margin requirements. The proposed rules have an expansive approach to extraterritoriality, providing only a slender exception for certain wholly offshore transactions.

On the same day, the CFTC proposed rules governing margin requirements for uncleared swaps entered into by non-bank swap entities subject to its jurisdiction. Based upon the Fact Sheet and Q&As that were released by the CFTC, the CFTC's proposal appears to be similar, but not identical, to the banking regulators' proposal. The SEC has not yet released a proposal for capital or margin requirements for security-based swap entities.

The Dodd-Frank Requirements and the State of Play

Sections 731 and 764 of Dodd-Frank require regulators to adopt rules setting capital and margin requirements for uncleared swaps for swap entities (swap dealers and major swap participants) and security-based swap entities (security-based swap dealers and major security-based swap participants). The "prudential regulators" – the Federal Reserve, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Farm Credit Administration and Federal Housing Finance Authority – are required jointly to adopt these rules for the banks and related swap entities and security-based swap entities under their jurisdiction (generically, "bank swap entities"), and the CFTC and SEC are required to adopt these rules for other swap entities and security-based swap entities, respectively.

Capital Requirements

The prudential regulators' proposed rules would apply existing regulatory capital rules to bank swap entities which, in their view, already take into account the unique risks arising from swaps and security-based swaps that are not cleared. The prudential regulators caveat, however, that they expect in the near future to propose changes to existing U.S. capital rules based on recent revisions to the capital framework for internationally active banks made by the Basel Committee on Banking Supervision.

Categories of Swap Counterparties

For the purposes of the uncleared swap margin requirements, swap transactions are divided into:

- swaps between two swap entities;
- swaps between a swap entity and a "financial end user," which is further divided into "high-risk financial end users" and "low-risk financial end users"; and
- swaps between a swap entity and a nonfinancial end user.

Neither the CFTC nor the SEC have proposed capital rules for non-bank swap entities.

Initial and Variation Margin Requirements

The proposed rules require swap entities to set both initial and variation margin requirements for uncleared swaps with respect to their counterparties. Unless both counterparties are swap entities, the proposed rules require swap entities to *collect margin from* their counterparties rather than *post margin to* their counterparties.[1] The amount of margin required to be collected, the frequency of collection of variation margin and the segregation requirements for collected margin depend primarily on the type of counterparty. A summary chart of these requirements can be found at the end of this memorandum.

Swaps Between Two Swap Entities

Both sets of proposed rules would require swap entities to collect initial and variation margin from each other in amounts determined as described under "Calculating Initial Margin" and "Calculating Variation Margin" below, with no minimum "threshold" of uncollateralized swap exposure. Both sets of rules require that margin be held at a third-party custodian. The prudential regulators' proposed rules specify that the custodian must be independent and located in a jurisdiction that would apply the same insolvency law to the custodian as it would apply to the bank swap entity that is entitled to receive the collateral. The prudential regulators' proposed rules would not allow initial margin to be offset by initial margin owed by the bank swap entity to its counterparty.

The prudential regulators' proposal further specifies that segregated margin cannot be rehypothecated or invested in assets other than eligible investments, which could mean a large opportunity cost for bank swap entities. The prudential regulators require variation margin to be collected at least once per business day. Counterparties would not be required to post variation margin until the net amount owed is greater than a minimum transfer amount of $100,000. The CFTC did not indicate how it will address these points.

[1] However, entities regulated by the Federal Housing Finance Authority or the Farm Credit Administration also are required to collect margin in addition to posting margin.

Swaps Between a Swap Entity and a "Financial End User"

Under both sets of proposed rules, swap entities would be required to collect initial and variation margin from "financial end users," but would not be required to post initial or variation margin to financial end users.[2] The CFTC has stated it will use the definition of "financial entity" from Title VII of Dodd-Frank, and the prudential regulators have proposed a definition of "financial end user" (provided in the sidebar) that is similar to the Dodd-Frank definition but which explicitly includes foreign governments and political subdivisions.

The prudential regulator proposal further divides financial end users into "high-risk financial end users" and "low-risk financial end users" and applies different margin standards to each. Thus, some swap entities will be allowed to have a certain amount of uncollateralized exposure to low-risk financial end users (but not to high-risk financial end users) before the low-risk financial end user is required to post margin.

A financial end user is "low-risk" under the prudential regulators' proposed rules if it:

- does not have "significant swaps exposure";
- 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
- is subject to capital requirements established by a prudential regulator or state insurance regulator.

The CFTC has indicated that it will use similar definitions.

The prudential regulators' proposed rules require a bank swap entity to use its normal credit processes to set a credit exposure limit for its low-risk financial end user counterparties. This credit exposure limit, for each of initial and variation margin, is capped at the lesser of:

- a specific dollar amount, which will be set between $15 million and $45 million in the final rule; and
- a percentage of the bank swap entity capital, which will be set between 0.1 and 0.3 percent in the final rule.

The CFTC did not indicate whether it would address such thresholds.

Variation margin for high-risk financial end user counterparties must be collected at least once per business day by a bank swap entity, while variation margin for low-risk financial end user counterparties must be collected only once per week.

"Financial End User"

The definition of "financial end user" in the prudential regulators' proposal is largely based on the definition of "financial entity" in Title VII of Dodd-Frank. "Financial end users" include:

- commodity pools;
- private funds;
- ERISA employee benefit plans;
- persons predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company Act;
- persons that would be commodity pools or private funds if organized under the laws of the United States or any State;
- foreign governments or political subdivisions; and
- any other person that the relevant agency may designate.

[2] Special requirements apply to counterparties regulated by the Federal Housing Finance Authority or the Farm Credit Administration.

"Significant Swaps Exposure"

"Significant swaps exposure" is defined as half of the value that would constitute "substantial counterparty exposure" and require registration as a major swap participant or major security-based swap participant under the joint CFTC/SEC proposed rule on swap entity definitions, namely:

- swap positions equal to or greater than
  - $2.5 billion in daily average aggregate uncollateralized outward exposure or
  - $4 billion in daily average aggregate uncollateralized outward exposure plus daily average potential outward exposure; or
- security-based swap positions equal to or greater than
  - $1 billion in daily average aggregate uncollateralized outward exposure or
  - $2 billion in daily average aggregate uncollateralized outward exposure plus daily average aggregate potential outward exposure.

Swaps Between a Swap Entity and a "Nonfinancial End User"

Since the passage of Dodd-Frank there has been significant interest in whether nonfinancial end users, known as "commercial end users," will be subject to margin requirements. The prudential regulators' proposed rules would require bank swap entities to calculate their own credit exposure limits for nonfinancial end users and collect initial and variation margin from the nonfinancial end user when the credit exposure exceeds the calculated limit. The CFTC has stated that its proposed rules would not require nonfinancial end users to post margin, but would require nonfinancial end users to enter into credit support arrangements with CFTC-regulated swap entities.

Calculating Initial Margin

Both sets of proposed rules allow swap entities to use models to calculate the amount of initial margin they require from counterparties. The prudential regulators would allow bank swap entities to use internal models meeting specified criteria that have been approved by their prudential regulator. The CFTC would require the model to be approved by the CFTC and be:

- used by a derivatives clearing organization for clearing swaps;
- used by an entity subject to oversight by a prudential regulator; or
- made available for licensing to any market participant by a vendor.

In both cases, the models would be required to cover exposure over a 10-day default window in 99% of cases, longer than the 3-5 day window generally used by clearinghouses. This longer period could have a significant impact on the amount of initial margin required for uncleared swaps relative to cleared swaps. The prudential regulators propose that initial margin may be calculated on a portfolio basis, but that offsetting positions and hedging benefits can only be recognized within, not across, four broad risk categories (*i.e.*, commodity, credit, equity, foreign exchange/interest rates). The CFTC did not discuss whether such offsets are permissible.

The proposed rules have different fallback options if such internal margin models are not used. The prudential regulators would require the use of a grid that sets margin requirements as a percentage of the notional amount of the swap, with the percentage varying based on the type of swap. The CFTC would require CFTC-regulated swap entities to multiply the margin required for a comparable cleared swap by a specified factor to determine the amount of margin required to be posted. As a practical matter, it seems unlikely that many swap entities will use these fallback options as they do not allow for the efficiencies of offsetting positions.

Calculating Variation Margin

The prudential regulators' proposed rules calculate the amount of variation margin to be collected as the mark-to-market change in value of a swap from the date it is entered into minus the value of all variation margin previously collected but not returned by the swap entity on that swap. In general, bank swap entities may net across all swap or security-based swap transactions entered into with a counterparty under a "qualifying master netting agreement." The prudential regulators' proposed rules also require counterparties to specify in their trading documentation the "methods, procedures, rules and inputs" they use to determine the value of swaps for variation margin purposes, as well as how disputes will be resolved.

Permissible Collateral

The prudential regulators' proposed rules would require as collateral from swap entities and financial end user counterparties immediately-available cash funds, obligations of, or fully guaranteed by, the United States, and, for initial margin only, certain senior debt obligations of government-sponsored entities. Non-cash collateral will be subject to haircuts.

The CFTC has indicated that it will require as collateral cash, Treasuries and certain obligations of government-sponsored entities from swap entity and financial end user counterparties. However, the CFTC will allow non-traditional forms of collateral to be posted by commercial end users to the extent allowed in privately-negotiated credit support agreements.

Extraterritorial Application

The prudential regulators' rules generally would apply to all transactions of a "covered swap entity," subject to a very narrow exception for swap transactions between a "foreign covered swap entity" and a wholly foreign counterparty. Specifically, to fit within this exception, the counterparty may not be, nor may its obligations under the swap be guaranteed by, an entity organized in the U.S., a branch of a U.S. entity or a U.S. resident. The exception is only available to a "foreign covered swap entity" with respect to "foreign non-cleared swaps" and "foreign non-cleared security-based swaps," as defined in the sidebar.

Foreign Swap Definitions

A "foreign covered swap entity" is defined as a bank swap entity that is:

- not a company organized under the laws of the United States or any State;
- not a branch or office of a company organized under the laws of the United States or any State;
- not a U.S. branch, agency or subsidiary of a foreign bank; and
- not controlled, directly or indirectly, by a company that is organized under the laws of the United States or any State.

A "foreign non-cleared swap" or "foreign non-cleared security-based swap" is a swap or security-based swap in which:

- the counterparty is–
  - not an entity organized under the laws of the United States or any State;
  - not a branch or office of an entity organized under the laws of the United States or any State; and
  - not a person resident in the United States; and
- performance of the counterparty has not been guaranteed by an affiliate of the counterparty that is–
  - an entity organized under the laws of the United States or any State;
  - a branch or office of an entity organized under the laws of the United States or any State; or
  - a person resident in the United States.

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Pre-effectiveness Swaps

Both proposals would apply initial margin requirements only to swaps entered into after the date the relevant rules become effective. The prudential regulators' rules would allow a bank swap entity to choose to calculate initial margin based on a model on a portfolio basis under a master agreement but exclude swaps entered into before effectiveness of the rule. A bank swap entity could choose to include all swaps under a master agreement entered into before effectiveness of the rule, but could not pick and choose individual swaps.

Effective Date and Comment Deadline

The prudential regulators' rules would become effective 180 days after publication of the final rules in the Federal Register. The comment period on the prudential regulators' rules ends June 24, 2011. The proposed rules contain numerous questions, relating to, among other things, margining methodology, whether bank swap entities should be required to post rather than only receive margin, and whether the prudential regulators should create a "low-risk covered swap entity" category for which less stringent requirements would apply. The CFTC has not yet indicated the effective date for their proposed rules or their deadline for comments, but has stated that the comment deadline will not close prior to that of the capital rules, once those rules are released.

Summary Chart of Proposed Uncleared Swap Margin Requirements

	Counterparty A is a "Bank Swap Entity" (a Swap Entity under Prudential Regulator Supervision)	Counterparty A is a Swap Entity Under CFTC Jurisdiction
Counterparty B is a Swap Entity	Both swap entities must collect initial and variation margin from each other. Margin is required without a minimum threshold of swap exposure. Margin must be segregated at a third-party custodian.	Same as for bank swap entities.
Counterparty B is a "High Risk Financial End User"	The bank swap entity must collect initial and variation margin but is not required to post margin. Margin is required without a minimum threshold of swap exposure. Dodd-Frank requires the bank swap entity to allow its counterparty to opt into independent third-party segregation for initial margin.	Same as for bank swap entities.
Counterparty B is a "Low Risk Financial End User"	The bank swap entity must collect initial and variation margin but is not required to post margin. Margin will not need to be posted for uncollateralized counterparty swap exposure that does not exceed a threshold set through credit exposure limits. The threshold is capped at the lesser of: ▪ a value between $15 million and $45 million, to be set in the final rule; and ▪ a percentage of the financial end user's Tier 1 capital, to be set between 0.1 - 0.3% in the final rule. The release indicates that the staff will likely propose the midpoint of each of these ranges. Dodd-Frank requires the bank swap entity to allow its counterparty to opt into independent third-party segregation for initial margin.	Same as for bank swap entities, though the amount of the threshold is not yet indicated.
Counterparty B is a Commercial End User	The bank swap entity must set credit exposure limits and collect collateral to the extent calculated margin requirements exceed those limits. Dodd-Frank requires the bank swap entity to allow its counterparty to opt into independent third-party segregation.	No margin is required, though the counterparties must enter into a credit support agreement.