December 18, 2015

By email

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551
Attention: Constance Horsley

Office of the Comptroller of the Currency
250 E Street SW, Mail Stop 2-3
Washington, DC 20219
Attention: Margot Schwadron

Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429
Attention: Bendetto Bosco

Re: **Regulatory Capital Treatment of Settled to Market Cleared OTC Derivative Contracts**

Dear Ms. Horsley, Ms. Schwadron, and Mr. Bosco:

We are writing to inform you of a forthcoming change in market practice for cleared derivatives that is underway. Specifically, central clearing counterparties ("CCPs") have been working with other market participants (including U.S. and European clearing member firms, law firms and accounting firms) to amend or clarify their terms, rules, and procedures to determine circumstances under which the payment of variation margin ("VM") for over-the-counter ("OTC") derivatives that are cleared through CCPs constitutes settlement of the exposure, as opposed to collateralization. While the status of implementation of these changes varies across CCPs and clearing member firms, we wanted to make you aware that they are underway, as there are regulatory capital consequences – resulting from the regulatory capital framework's recognition of settlement as exposure-reducing – about which clearing member firms may notify their supervisors in coming months.

Background on Settled to Market OTC Derivative Contracts

Standard market practice in cleared OTC derivatives markets involves the regular (typically daily) exchange of payments between the parties to a derivative to protect the parties from the

risk of loss of the current positive mark-to-market value of that derivative in the event of a default by one of the parties. Such payments can be made under either a collateralized to market ("CTM") or settled to market ("STM") model. Although both models achieve the same exposure-mitigating objective, they differ in their implications for the rights and obligations of the counterparties.

- Under the CTM model, parties exchange periodic payments (typically daily) of VM collateral. While payments of VM collateralize a party's mark-to-market exposure on a given day, the derivative exposure between counterparties carries forward through the life of the derivative contract, with its value moving over time and being collateralized by consequent VM payments. If the exposure of the party that has received VM collateral on one day decreases over the course of the next day, that party will be obligated to return collateral to its counterparty and, depending on the amount by which its exposure has decreased, may need itself to provide further collateral to its counterparty.[1]

- Under the STM model, parties also exchange daily payments.[2] Unlike the CTM model, however, these payments settle the outstanding exposure of the counterparties. Over the course of the next day, the outstanding exposure of the parties will change, and while a new payment will be needed to settle the new end-of-day exposure, neither party will be required to return any amount paid to it to settle a previous day's exposure. Outstanding exposures are settled daily, and the terms of the derivative contracts are reset so that the fair values of the contracts are zero.[3] The STM model is recognized as preferable to the CTM model within the regulatory capital framework.[4]

While historically, cleared OTC derivatives that have been entered into between clearing member firms and CCPs have been treated under the CTM model rather than the STM model, a number of CCPs have been working with market participants to amend or clarify their terms, rules, and procedures to allow for clearing member firms to transition to the STM model. External counsel has been engaged by those CCPs to evaluate and advise on the legal aspects of the STM treatment; further, these amendments are subject to regulatory approval by each CCP's primary regulator. As clearing member firms assess whether, for legal and accounting purposes, cleared OTC derivative contracts are in fact executed under the STM model for each relevant CCP, each clearing member firm may begin to record new OTC derivative contracts as STM contracts and to adjust its treatment of existing CTM model OTC derivative contracts to reflect

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[1] In addition, it is typical for a party that has received collateral to pay interest (Price Alignment Interest or "PAI") to its counterparty on that collateral.

[2] Additionally, in order to fully replicate the economics of the CTM model, the parties exchange amounts equal to the PAI payments they would exchange under CTM model derivatives (at some CCPs, currently referred to as Price Alignment Amount or "PAA").

[3] There may be certain timing differences between when the fair value of the contract is reset to zero and when the settlement payment is made, *e.g.*, in cases where variation margin payments are made on the following morning. Such timing differences are operational in nature.

[4] *See* Regulatory Capital Implications section below.

the legal changes to the terms, rules, and procedures governing such contracts that cause them to become STM contracts.

In order for a clearing member firm to consider a cleared OTC derivative contract to be executed under the STM model, the clearing member firm must determine to its satisfaction that accounting standards and applicable law and regulation support such a conclusion. The specific analysis may vary among firms, but the following steps are typically pursued by clearing member firms reviewing this issue:

- Verifying that the CCP terms, rules, and procedures, as approved by the CCP's primary regulator, and the terms of their client clearing agreements, are consistent with the STM model;

- Working with in-house and outside counsel to review such terms, rules, and procedures, and obtain legal analysis that the relevant derivative contracts are STM;

- Working with internal and independent accountants to determine the appropriate accounting treatment for relevant exposures and payments;

- Coordinating with impacted internal functions (*e.g.*, tax, operations, financial reporting, risk, etc.) to reflect derivative contracts as STM rather than CTM, as appropriate. For example:

    — Where a balance sheet entry for a CTM model OTC derivative contract would reflect a derivative exposure of 10 netted down by cash collateral VM of 10, a balance sheet entry for STM model contracts would reflect the clearing member firm's post-settlement exposure of zero. These differences must be appropriately reflected in a clearing member firm's books and records.

    — Disclosures included in the clearing member firm's financial reporting, such as those reported in its Form 10-Q and 10-K, and regulatory reporting, such as in its Form FR Y-9C and Call Report, would reflect exposures and payments for applicable cleared OTC derivatives as STM rather than CTM.

<u>Regulatory Capital Implications</u>

Cleared OTC derivative contracts that are subject to the STM model rather than the CTM model may differ in how the CCP- and client-facing derivative exposures are calculated within each clearing member firm's regulatory capital framework, in particular, under the Current Exposure Methodology ("CEM").[5]

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[5] § _.34.

Within CEM, the Potential Future Exposure ("PFE") is calculated by multiplying the notional amount by a conversion factor. The conversion factor is determined by the derivative type (*e.g.*, interest rate, foreign exchange, credit, equity) and the remaining maturity of the OTC derivative (*i.e.*, one year or less, greater than one year and less than or equal to five years, or greater than five years). In recognition of the exposure-reducing benefits of settlement, the capital rules' application of CEM allows that, "for an OTC derivative contract that is structured such that on specified dates any outstanding exposure is settled and the terms are reset so that the fair value of the contract is zero, the remaining maturity equals the time until the next reset date. For an interest rate derivative contract with a remaining maturity of greater than one year that meets these criteria, the minimum factor is 0.005."[6]

Given that, when the requirements are met such that a cleared OTC derivative is subject to the STM model, and the derivative fair value is thus reset to zero at each settlement date, the remaining maturity of such a derivative would only be as long as the time until the next settlement payment. Since most cleared OTC derivatives under the STM model are subject to daily settlement and reset, such derivatives would be subject to a conversion factor applicable for less than 1 year remaining maturities, with interest rates derivative contracts floored at a 0.005 conversion factor.

Example End-of-Day Financials	Interest rate contract that is CTM	Interest rate contract that is STM
Derivative fair value	100	0
Collateral	100	0
Current Exposure (CE)	0	0
Notional	1 bn	1 bn
Remaining maturity	7 years	1 day
Applicable conversion[7]	1.5%	0.5%
PFE	15Mn	5Mn

As a result of applying the lower conversion factors, clearing member firms' CCP- and client-facing derivative exposures under the STM model will have lower PFEs and therefore lower risk-weighted asset and leverage exposure amounts for purposes of regulatory capital calculations than comparable CTM model OTC derivative trades. All else being equal, transitioning to the STM model will, therefore, result in clearing member firms having higher capital and supplementary leverage ratios.

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[6] § _.34, tbl.1, n.2. In addition, the Basel Committee on Banking Supervision's revised framework for measuring OTC derivatives exposures – the Standardized Approach for Measuring Counterparty Credit Risk Exposures (SA-CCR) – includes parallel language. *See* Basel Committee on Banking Supervision, The Standardized Approach for Measuring Counterparty Credit Risk Exposures, ¶ 158 (Mar. 2014; rev. Apr. 2014), *available at* http://www.bis.org/publ/bcbs279.htm.

[7] § _.34, tbl.1, n.2.

Over the coming months, as clearing member firms transition to the STM model where the relevant legal and accounting conclusions are reached and, to the extent related capital and leverage ratio impacts are material, they are likely to notify their supervisors; thus, we wanted to take this opportunity to make you are aware of the impending change.

Sincerely,

Carter McDowell
Managing Director and Associate General Counsel
Securities Industry and Financial Markets Association