

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: August 29, 2014
To: Board of Governors
From: Daniel Tarullo ^{DUT}
Subject: Draft Notice of Proposed Rulemaking – Margin and Capital Requirements for Covered Swap Entities

Attached are a memorandum to the Board and a draft *Federal Register* notice of proposed rulemaking that would implement sections 731 and 764 of the Dodd-Frank Act (the “Act”). Under the Act, the Farm Credit Administration, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Board, and the Office of the Comptroller of the Currency (the prudential regulators) are required to adopt rules jointly for prudentially regulated swap dealers, security-based swap dealers, major swap participants and major security-based swap participants imposing (i) capital requirements and (ii) initial and variation margin requirements on all swaps not cleared by a central counterparty.

- The attached proposal requires risk-based margin that depends on whether the covered swap entity’s counterparty is another swap entity, a financial end user with (or without) material swaps exposure, or an “other counterparty,” which includes commercial end users, sovereigns, and multilateral development banks, and would set minimum amounts of initial and variation margin that a covered swap entity must collect from and post to a counterparty.
- The rule contains special provisions requiring a covered swap entity to collect such initial and variation margin from “other counterparties” as it determines appropriately addresses the credit risk posed by the counterparty and the risk of the swap.
- The proposal also establishes collateral eligibility requirements, requires segregation of initial margin at a third-party custodian, and prohibits the rehypothecation of collected and posted initial margin.
- A covered swap entity must comply with any existing regulatory capital regime already applicable to it as part of its prudential regulation.

The prudential regulators originally proposed joint rules to implement sections 731 and 764 of the Act in April 2011. The attached proposal reflects (i) changes made in response to comments received on the original proposal and (ii) standards for margin requirements that were recommended

by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions in September 2013. In light of the significant changes that have been made to the proposal since April 2011, staff is recommending that the Board re-propose the April 2011 proposed rulemaking.

The notice of proposed rulemaking would be published jointly by the Board and the other prudential regulators in the *Federal Register* after all prudential regulators have completed internal review and approval procedures.

I have reviewed the notice of proposed rulemaking, and I believe it is ready for the Board's consideration.

Attachments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: August 29, 2014
To: Board of Governors
From: Staff¹
Subject: Draft proposed rule establishing margin and capital requirements for non-cleared swaps

ACTION REQUESTED: Approval to publish and request public comment on the proposed rule in the attached draft Federal Register notice (Attachment A, p. 1-207) to implement the requirements in sections 731 and 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act” or “Act”) to establish margin and capital requirements on all non-cleared swaps and non-cleared security-based swaps² of swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants (collectively, “swap entities”) for which the Board is the prudential regulator (collectively, “covered swap entities”).³ The proposal would be made jointly with the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency (each an “Agency” and, collectively, the “Agencies”). Staff also requests authority to make conforming changes (for example, to incorporate non-substantive changes requested by the other Agencies as part of the approval process) as well as minor technical changes (for example, to conform to Federal Register requests and correct non-substantive errors in the documents) to the attached draft Federal Register notice.

¹ Mr. Alvarez and Mses. Martin, Szybillo and Harrington (Legal Division); Messrs. Gibson, Van Der Weide and Mses. Hewko and MacDonald (Division of Banking Supervision and Regulation); and Mr. Campbell (Division of Research and Statistics).

² Sections 731 and 764 of the Dodd-Frank Act require the Agencies to promulgate margin rules for all non-cleared swaps and non-cleared security-based swaps. Throughout, we use the term “swaps” to refer to non-cleared swaps and non-cleared security-based swaps unless specified otherwise.

³ Pub. L. No. 111-203; see 7 U.S.C. § 6s; 15 U.S.C. § 78o-10.

EXECUTIVE SUMMARY: The main features of the joint proposed rule are briefly summarized below.

- *Background.* In 2009, the G-20 agreed to substantial new regulation of over-the-counter (“OTC”) derivative markets, including margin requirements for those derivatives that are not centrally cleared. Sections 731 and 764 of the Dodd-Frank Act, passed in 2010, require the Board to issue, jointly with the other Agencies, rules establishing margin and capital requirements for the non-cleared swap activities of swap entities for which the Agencies are the prudential regulators. The Board, jointly with the Agencies, issued a proposed rule implementing sections 731 and 764 of the Dodd-Frank Act in April 2011 (“2011 proposal”).
 - In September 2013, the Basel Committee on Banking Supervision (“BCBS”) and the International Organization of Securities Commissions (“IOSCO”) released a global framework for margin requirements on non-centrally cleared derivatives (“2013 international framework”).
 - This proposal revises the 2011 proposal to reflect comments received as well as to achieve the 2013 international framework’s goal of promoting global consistency and reducing regulatory arbitrage opportunities.
 - In light of the significant differences from the 2011 proposal, staff recommends that the Agencies seek comment on this revised proposal.
- *Swap Entity, Financial End User and Other Counterparties.* Under the proposed rule, the amount of required margin is risk-based and depends on whether the covered swap entity’s counterparty is another swap entity, a financial end user with (or without) material swaps exposure, or an “other counterparty” which includes commercial end users, sovereigns, and multilateral development banks.
- *Initial Margin Requirements.* The proposed rule would set minimum amounts of initial margin that a covered swap entity must collect from and post to a counterparty that is either a financial end user with material swaps exposure or a swap entity. This proposal represents a change from the 2011 proposal which applied only to the collection of minimum amounts of margin but did not contain a specific posting requirement. A covered swap entity may calculate initial margin amounts using an internal model if the model meets specified standards and is approved by the covered swap entity’s prudential regulator. The initial margin amounts under a model are to be consistent with a 99th percentile loss over a ten-day horizon, which is significantly more conservative than margin requirements for cleared swaps.

Initial Margin Thresholds and Material Swaps Exposure. A covered swap entity must collect or post initial margin where the amount of margin required exceeds a threshold of \$65 million on a consolidated basis. A covered swap entity may rely on its internal credit and risk management policies to determine whether initial

margin below that threshold needs to be collected or posted with financial end users with material swaps exposure and swap entities. The material swaps exposure threshold is set at \$3 billion and represents the average daily aggregate notional amount of non-cleared swaps, non-cleared security based swaps, foreign exchange forwards and foreign exchange swaps of the financial end user and its affiliates with all counterparties.

- *Variation Margin Requirements.* The rule would set minimum amounts of variation margin that a covered swap entity must collect from and post to a counterparty that is a swap entity or financial end user. This proposal represents a change from the 2011 proposal which applied only to the collection of minimum amounts of margin but did not contain a specific posting requirement.
- *Initial and Variation Margin Requirements for “Other Counterparties.”* The rule contains special provisions for a covered swap entity’s swaps with “other counterparties” that are not directly subject to the specific minimum initial and variation margin amounts (including non-financial entities often referred to as “commercial end users”). A covered swap entity is required to collect such initial and variation margin from these other counterparties as it determines appropriately addresses the credit risk posed by the counterparty and the risk of the swap. There are currently cases where a swap entity engages in swaps with other counterparties and does not collect initial or variation margin because it has determined that margin is not needed to address the credit risk posed by the counterparty and the risk of the swap. In such cases the draft proposed rule would not require a change in current practice. The scope of “other counterparties” has been broadened from the 2011 proposal and now includes sovereigns. In addition and unlike the 2011 proposal, the proposal does not require a covered swap entity to determine a specific, numerical credit threshold for each such counterparty. Rather the covered swap entity may use to its own internal credit and risk management process in determining whether and how to collect margin from these counterparties.
- *Eligible Collateral.* In the case of variation margin, only cash is eligible collateral. In the case of initial margin, the list of eligible collateral has been broadened from the 2011 proposal to include cash, gold, certain government bonds, corporate bonds, and equities, are eligible collateral. Collateral is subject to minimum haircuts.
- *Segregation Requirements and Collateral Rehypothecation.* The proposed rule expands on the 2011 proposal’s segregation requirements and requires segregation of initial margin at a third-party custodian and prohibits the rehypothecation of collected and posted initial margin. Variation margin need not be segregated and may be rehypothecated.

- *Cross-Border Interactions.* The proposal provides a provision that was not in the 2011 proposal to allow certain covered swap entities to comply with a foreign regulatory framework for non-cleared swaps if the Agencies jointly determine that the requirements under such foreign regulatory framework are comparable to the requirements of the rule. As in the 2011 proposal, foreign swaps of foreign covered swap entities would not be covered by the rule.
- *Phase-In of the Requirements.* Minimum margin requirements would apply to all non-cleared swaps entered into by a covered swap entity after the proposed rule's applicable compliance date, phased-in over a four-year period based on volume of swap activity of the covered swap entity and its counterparty.
- *Capital.* A covered swap entity must comply with any existing regulatory capital regime already applicable to it as part of its prudential regulation. The banking agencies' capital framework specifically addresses swap positions and has recently enhanced its treatment of such positions (i.e., Basel 2.5 and Basel 3).

BACKGROUND: In 2009, the G-20 agreed to substantial new regulation of OTC derivative markets, including the mandatory central clearing of standardized OTC derivatives and margin requirements for those derivatives that are not centrally cleared. Title VII of the Dodd-Frank Act, passed in 2010, established a comprehensive new regulatory framework for OTC derivatives, which the Act generally characterizes as “swaps” (which include interest rate swaps, currency swaps, commodity-based swaps, and broad-based credit swaps) and “security-based swaps” (which include single-name and narrow-based credit swaps and equity-based swaps). Under the Act, swap dealers and major swap participants must register with the Commodity Futures Trading Commission (“CFTC”) and security-based swap dealers and major security-based swap participants must register with the Securities and Exchange Commission (“SEC”).⁴ Also, the CFTC and SEC are required to make determinations regarding which swaps must be

⁴ As of July 29, 2014, 102 entities have registered as swap dealers and 2 entities have registered as major swap participants with the CFTC. The SEC has not yet imposed a registration requirement on entities that meet the definition of security-based swap dealer or major security-based swap participant.

cleared by a central counterparty (“CCP”). All swaps that are not cleared through a CCP are considered non-cleared swaps.

Sections 731 and 764 of the Dodd-Frank Act require the Board to issue, jointly with the other Agencies, rules establishing margin and capital requirements for the non-cleared swap activities of swap entities for which the Agencies are the prudential regulators.⁵ The Dodd-Frank Act requires the CFTC and SEC to adopt rules imposing capital and margin requirements for the non-cleared swap activities of swap entities for which there is no prudential regulator.⁶ In addition, the Dodd-Frank Act requires the CFTC, SEC, and the Agencies to establish and maintain capital and margin requirements that, to the maximum extent practicable, are comparable.⁷

Sections 731 and 764 of the Dodd-Frank Act provide that the margin and capital rules are intended to offset the greater risk to the swap entity and the financial system arising from the use of swaps that are not cleared.⁸ To offset this risk, sections 731 and 764 of the Dodd-Frank Act require that the margin and capital requirements imposed on a swap entity’s non-cleared swaps must (i) help ensure the safety and soundness of the swap entity and (ii) be appropriate for the greater risk associated with the non-cleared swaps held as a swap entity.⁹ The margin rules for swap entities apply only to non-

⁵ For purposes of sections 731 and 764 of the Dodd-Frank Act, the Board is the prudential regulator for any swap entity that is: (i) a state member bank; (ii) a State-chartered branch or agency of a foreign bank; (iii) a foreign bank which does not operate an insured branch; (iv) an Edge corporation or Agreement corporation; and (v) a bank holding company, a foreign bank that is treated as a bank holding company under section 8(a) of the International Banking Act of 1978, or a savings and loan holding company and any subsidiary of such company other than a subsidiary for which the OCC or FDIC is the prudential regulator or that is required to be registered with the CFTC or SEC as a swap entity.

⁶ See 7 U.S.C. § 6s(e)(2)(B); 15 U.S.C. § 78o-10(e)(2)(B).

⁷ See 7 U.S.C. §§ 6s(e)(2)(A); 6s(e)(3)(D); 15 U.S.C. §§ 78o-10(e)(2)(A), 78o-10(e)(3)(D). Staff of the Agencies have consulted with staff of the CFTC and SEC in developing the proposed rule.

⁸ See 7 U.S.C. § 6s(e)(3)(A); 15 U.S.C. § 78o-10(e)(3)(A).

⁹ See 7 U.S.C. § 6s(e)(3)(A); 15 U.S.C. § 78o-10(e)(3)(A). In addition to the relevant Dodd-Frank Act provisions, this proposal would also be issued pursuant to the existing safety and soundness authority of the prudential regulators. As a means of ensuring the safety and

cleared swaps; they do not apply to swaps that are cleared through a CCP (e.g., a derivatives clearing organization or clearing agency).¹⁰

The Agencies originally published proposed rules to implement sections 731 and 764 of the Act in May 2011.¹¹ Following the release of the 2011 proposal, the BCBS and the IOSCO proposed an international framework for margin requirements on non-cleared swaps with the goal of creating an international standard for non-cleared swaps (the “2012 proposed international framework”).¹² Following the issuance of the 2012 proposed international framework, the Agencies re-opened the comment period on the 2011 proposal to allow for additional comment in relation to the 2012 proposed international framework.¹³ The proposed 2012 international framework was also subject to extensive public comment before it was finalized in September 2013.¹⁴

This proposal revises the 2011 proposal to reflect comments received on the 2011 proposal as well as to achieve the 2013 international framework’s goal of promoting global consistency and reducing regulatory arbitrage opportunities. In light of the

soundness of a covered swap entity’s swap activities under the proposed rule, the requirements would apply to all of a covered swap entity’s swap activities without regard to whether the entity has registered as both a swap entity and a security-based swap entity. Thus, for example, for an entity that is a swap dealer but not a security-based swap dealer or major security-based swap participant, the proposed rule’s requirements would apply to all of that swap dealer’s swaps.

¹⁰ Other changes made in Title VII of the Dodd-Frank Act require most sufficiently standardized swaps be cleared through a CCP. In such cases, the CCP would impose its own requirements with respect to the margin that must be posted by parties to a cleared swap.

¹¹ See Margin and Capital Requirements for Covered Swap Entities, 76 FR 27,564 (May 11, 2011).

¹² See BCBS and IOSCO “Consultative Document - Margin requirements for non-centrally cleared derivatives” (July 2012), available at <http://www.bis.org/publ/bcbs226.pdf> and “Second consultative document - Margin requirements for non-centrally cleared derivatives” (February 2013), available at <http://www.bis.org/publ/bcbs242.pdf>.

¹³ See Margin and Capital Requirements for Covered Swap Entities; Reopening of Comment Period, 77 FR 60,057 (October 2, 2012).

¹⁴ See BCBS and IOSCO “Margin requirements for non-centrally cleared derivatives,” (September 2013), available at <https://www.bis.org/publ/bcbs261.pdf>.

significant differences from the 2011 proposal, staff recommends that the Board join the other Agencies in seeking comment on this revised proposal.

In developing the proposal, staff of the Agencies consulted with staff of the CFTC and SEC as required under the Dodd-Frank Act. The CFTC and the SEC are still developing margin rules for their respective regulated entities and are not required by the statute to join the implementing rules of the Agencies.

SUMMARY OF PROPOSED RULE:

Swap Entity, Financial End User and Other Counterparties

The Agencies have generally proposed a risk-based approach to establishing margin requirements for covered swap entities, consistent with the statutory requirement that these rules help ensure the safety and soundness of the swap entity and should be appropriate for the risk to the financial system associated with non-cleared swaps held by swap entities. In implementing a risk-based approach, the proposed rule would distinguish between four separate types of counterparties for purposes of establishing margin requirements:

- (1) counterparties that are themselves swap entities;
- (2) counterparties that are financial end users with material swaps exposure;
- (3) counterparties that are financial end users without material swaps exposure;
- and
- (4) other counterparties, including nonfinancial end users, sovereigns, and multilateral development banks.¹⁵

Similar to the 2011 proposal, this proposal defines swap entity by reference to the Commodity Exchange Act and Securities Exchange Act to include a swap dealer, major swap participant, security-based swap dealer, and major security-based swap participant.¹⁶

This proposal's definition of financial end user takes a different approach than the 2011 proposal, which was based on the definition of "financial entity" that is ineligible

¹⁵ See proposed rule § __.2 for the various constituent definitions that identify these four types of swap counterparties (pp. 46-56, 148-152, 154, and 156 of Attachment A).

¹⁶ 7 U.S.C. 1a(33); 7 U.S.C. 1a(49); 15 U.S.C. 78c(a)(67); 15 U.S.C. 78c(a)(71).

for the exemption from mandatory clearing requirements of sections 723 and 763 of the Dodd-Frank Act. The financial end user definition in the 2011 proposal included a person 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 (“BHC Act”). This approach could create uncertainty and excessive burden on entities to review the activities of each of their counterparties.

In order to provide certainty and clarity to counterparties as to whether they would be financial end users for purposes of this proposal, the financial end user definition in the new proposal provides a list of entities that would be financial end users as well as a list of entities excluded from this definition. For example, the types of entities included as financial end users include: bank holding companies; savings and loan holding companies; nonbank financial institutions supervised by the Board; depository institutions; foreign banks; state-licensed or registered credit or lending entities; broker-dealers; registered investment companies; business development companies; private funds; securitization vehicles; commodity pools; commodity pool operators; employee benefit plans; insurance companies; cooperatives that are financial institutions; similar foreign entities; and any other entity that an Agency determines should be treated as a financial end user.¹⁷ Unlike the 2011 proposal, this proposal also excludes certain types of counterparties from the definition of financial end user including: sovereign entities; multilateral development banks; the Bank for International Settlements (“BIS”); and certain captive finance companies and certain affiliates that qualify for an exemption from clearing under Title VII of the Dodd-Frank Act.¹⁸ Entities that are neither financial end users nor swap entities are treated as “other counterparties” under the proposal.

¹⁷ The proposed rule would apply to swaps between a covered swap entity and an affiliate that is a financial end user. See pp. 43-44 of Attachment A.

¹⁸ See proposed rule § __.2 for the various definitions related to the entities excluded from the definition of financial end user (pp. 53-55 and 151-152 of Attachment A). The exclusion for sovereign entities, multilateral development banks, and the BIS is consistent with the 2013 international framework which recommends that margin requirements not apply to these entities.

Initial Margin Requirements

The proposed rule would establish requirements with respect to initial margin. The proposed rule's initial margin requirements generally apply to the posting, as well as to the collection, of minimum initial margin amounts by a covered swap entity from and to its counterparties.¹⁹ This proposal represents a change from the 2011 proposal, which applied only to the collection of minimum amounts of margin but did not contain a specific posting requirement. This approach reflects the view that while imposing requirements with respect to the minimum amount of initial 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 swap exposure, 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 and reduce systemic risks.

Where a covered swap entity transacts with another swap entity (regardless of whether the other swap entity is governed by the joint Agency rule or the margin rule of the CFTC or SEC), the covered swap entity must collect at least the amount of initial margin required under the proposed rule. Likewise, the swap entity counterparty also would be required, under margin rules applicable to that swap entity (e.g. margin rules prescribed by the CFTC, SEC or the Agencies), to collect a minimum amount of initial margin from the covered swap entity.²⁰ Accordingly, covered swap entities will both collect and post a minimum amount of initial margin when transacting with another swap entity.

A covered swap entity transacting with a financial end user with material swaps exposure must collect at least the amount of initial margin required by the proposed rule and must post at least the amount of initial margin that the covered swap entity would be required by the proposal to collect if the covered swap entity were in the place of the

¹⁹ See proposed rule § __.3 (pp. 64 and 157-158 of Attachment A).

²⁰ All swap entities will be subject to the rule issued by the Agencies or one issued by the CFTC or SEC with respect to minimum margin requirements.

counterparty. Financial end users generally would not be required to collect initial margin from their counterparties. Accordingly, an affirmative posting requirement for covered swap entities is the only way to guarantee that initial margin is both collected and posted in a manner consistent with the proposed rule. In addition, a covered swap entity must post or collect initial margin on at least a daily basis to reflect changes in portfolio composition or any other factors that result in a change in the required initial margin amounts for transactions involving a swap entity or a financial end user with material swaps exposure.

With respect to initial margin, the proposed rule, like the 2011 proposal, would permit a covered swap entity to select from two alternatives to calculate its initial margin requirements:

1. A covered swap entity may calculate its initial margin requirements using a standardized margin schedule, expressed as a percentage of the notional amount of the swap that allows for certain types of netting and offsetting of exposures;²¹ or
2. A covered swap entity may calculate its minimum initial margin requirements using an internal margin model that meets criteria specified in the proposed rule and has been approved by the relevant prudential regulator.²²

The first alternative is intended to ease the burden on smaller covered swap entities in calculating initial margin requirements by providing a standardized requirement that can be applied to all swaps. The second alternative accounts for the more sophisticated risk management systems and related infrastructure already in place at larger covered swap entities for calculating initial margin for swaps.

Initial margin models must calculate initial margin amounts in a manner that is consistent with a 99th percentile loss over a ten-day holding period. This standard is more conservative than the standard for cleared swaps, which is a 99th percentile loss over a

²¹ See proposed rule § __.8 (pp. 106-112, 164 and 177-179 of Attachment A).

²² See proposed rule §§§ __.2, __.3(a), __.8 (pp. 97-106, 152-153, 157, 164-171 of Attachment A).

one to five-day holding period.²³ The longer ten-day holding period is motivated by the fact that non-cleared swaps are more complex and less liquid than cleared swaps. As a result, the amount of time required to hedge or replace a defaulted non-cleared swap would be expected to be greater than that of a cleared swap.

Further, the initial margin model must be calibrated to a period of financial stress. This requirement is intended to ensure that the margin requirements are robust. In addition, the requirement limits procyclicality so that modest increases in volatility do not result in rising margins, as minimum margins will already reflect a period of heightened risk. Initial margin models will also be constrained in their ability to recognize certain diversification and hedging benefits.

Importantly, swaps within a relatively narrow and well-defined asset class, such as equities, may be modeled jointly and may benefit from hedging and diversification effects. Swaps in disparate asset classes, such as commodity swaps and equities, however, will not be allowed to be modeled jointly and must be margined separately. In addition, initial margin models will be subject to Agency oversight, review and approval. Finally, swap entities using an internal model will be required to maintain a number of oversight and governance processes, including regular benchmarking, to ensure that internal models provide a realistic assessment of risk.

Initial Margin Thresholds and Material Swaps Exposure

As part of the proposed rule's initial margin requirements and consistent with the 2013 international framework, a covered swap entity that has established an initial margin threshold amount for a counterparty need only collect initial margin if the required amount exceeds the initial margin threshold amount, and in such cases is only required to collect the excess amount. A covered swap entity using either the standardized or the model calculation method may adopt a maximum initial margin

²³ Cleared swaps on agricultural commodities, energy commodities and metals may be margined with respect to a one-day holding period. All other cleared swaps must be margined with respect to a five-day holding period.

threshold amount of \$65 million, below which it need not collect or post initial margin from or to swap entities and financial end users with material swaps exposures.²⁴ This threshold would apply on a consolidated basis to both the covered swap entity and its affiliates and the counterparty and its affiliates.²⁵

The initial margin threshold serves two purposes. First, covered swap entities would be able to make greater use of their own internal credit and risk management assessments when making a threshold determination as to the credit and other risks presented by a specific counterparty with an exposure below the \$65 million threshold. Second, allowing the use of initial margin thresholds, to the extent prudently applied by covered swap entities, will reduce the potential liquidity burden of the proposed margin requirements.²⁶ Moreover, allowing for the use of initial margin thresholds of up to \$65 million should provide relief to smaller and less systemically risky counterparties while ensuring that initial margin is collected from those counterparties that pose the greatest systemic risk to the financial system.

As noted above, a covered swap entity would not be required to collect or post margin to or from a financial end user counterparty without a material swaps exposure. “Material swaps exposure” for an entity is defined to mean that the entity and its affiliates have an average daily aggregate notional amount of non-cleared swaps, non-cleared security based swaps, foreign exchange forwards and foreign exchange swaps (“covered

²⁴ See proposed rule §§ __.2 and __.3 (pp. 65-73, 153, 154 and 157 of Attachment A).

²⁵ Affiliate is defined to mean any company that controls, is controlled by, or is under common control with another company. Control of another company means: (1) ownership, control, or power to vote 25 percent or more of a class of voting securities of the company, directly or indirectly or acting through one or more other persons; (2) ownership or control of 25 percent or more of the total equity of the company, directly or indirectly or acting through one or more other persons; or (3) control in any manner of the election of a majority of the directors or trustees of the company. See proposed rule § __.2 (pp. 145 and 146 of Attachment A).

²⁶ According to a quantitative impact study (“QIS”) conducted by BCBS-IOSCO in developing the 2013 international framework, allowing for an initial margin threshold of \$65 million will reduce global collateral demands from roughly \$1.5 trillion to \$700 billion relative to a regime in which no initial margin threshold is permitted. See pp. 126-131 of Attachment A.

swaps”) with all counterparties that exceeds \$3 billion.²⁷ The proposal would not require the exchange of initial margin with financial end users with exposures below this level, as it is expected that these entities, in most circumstances, would have an initial margin requirement that is significantly less than the proposed \$65 million threshold amount. Accordingly, swap entities would not be required to collect or post any initial margin to these counterparties because their exposures would generally be significantly less than the permitted initial margin threshold of \$65 million. In addition, not requiring swap entities to collect or post initial margin with these smaller counterparties would reduce the burden on swap entities and these smaller counterparties as they would not be required to calculate, track and verify initial margin amounts that would generally be expected to be well below the \$65 million initial margin threshold.

Variation Margin Requirements

With respect to variation margin, the proposed rule would require a covered swap entity to collect or post variation margin on swaps with a swap entity or financial end user (regardless of whether the financial end user has a material swaps exposure) in an amount that is at least equal to the increase or decrease in the value of the swap since the counterparties’ previous exchange of variation margin.²⁸ This proposal represents a change from the 2011 proposal, which applied only to the collection of minimum amounts of variation margin but did not contain a specific posting requirement.

The proposed 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 swap

²⁷ See proposed rule § __.2 (pp. 154 of Attachment A). This amount differs from that set forth in the 2013 international framework, which defines smaller financial end users as those counterparties that have a gross aggregate amount of notional derivatives below €8 billion, which at current exchange rates, is approximately equal to \$11 billion. Based on additional data and analyses that have been conducted since the publication of the 2013 international framework, staff recommends that the Board define material swaps exposure as a gross notional exposure of \$3 billion, rather than \$11 billion. This lower amount is better aligned with the \$65 million threshold and reduces systemic risk without imposing undue burdens on covered swap entities and these smaller counterparties. See pp. 68-73 of Attachment A.

²⁸ See proposed rule § __.4(a) (pp. 76-78 and 158 of Attachment A).

entities and financial end users. The regular exchange of variation margin is a risk management best practice and can ensure that large and systemic risks are not allowed to build within the financial system. In addition, to the extent that variation margin is a transfer of resources between counterparties, the net liquidity burden is smaller than that associated with the initial margin requirements. To the extent that multiple swaps were governed by an eligible master netting agreement, the proposed rule would permit variation margin to be calculated on a net basis across such transactions.²⁹ In addition, a covered swap entity must collect or post variation margin with swap entities and financial end users under the proposed rule on at least a daily basis.³⁰

Initial and Variation Margin Requirements for “Other Counterparties”

The proposal would not impose a specific numerical initial or variation margin requirement with respect to a swap with a counterparty that is not otherwise covered by the rule.³¹ These “other counterparties” would include nonfinancial or commercial end users that generally engage in swaps to hedge commercial risk, sovereigns, and multilateral development banks. For these counterparties, a covered swap entity must collect initial and variation margin only at such times and in such forms and such amounts (if any) that the covered swap entity determines appropriately addresses the credit risk posed by the counterparty and the risks of such non-cleared swaps.³² This approach differs from that of the 2011 proposal where the Agencies proposed substantially smaller initial margin thresholds that varied based on the relative risk of the counterparty type and where a covered swap entity was not required to collect initial or variation margin from a nonfinancial end user as long as the covered swap entity’s

²⁹ See proposed rule § __.4(d) (pp. 80-81 and 159 of Attachment A); see also § __.2 (pp. 60-61 and 147-148 of Attachment A) (defining eligible master netting agreement).

³⁰ See proposed rule § __.4(b) (pp. 78-79 and 158 of Attachment A).

³¹ For initial margin, this would mean any counterparty other than a financial end user with material swaps exposure or a swap entity. For variation margin, this would mean any counterparty other than a financial end user or a swap entity.

³² See proposed rule §§ __.3(d) and __.4(c) (pp. 74-75, 79-80 and 158 of Attachment A).

exposures to the nonfinancial end user were below the credit exposure limits that the covered swap entity had established under appropriate credit processes and standards.

Although nonfinancial end users have argued strenuously since the passage of the Dodd-Frank Act that they pose no risk to the swaps market and should be exempted from any margin requirements established under the Act, the Act requires the Agencies to set margin requirements for “all swaps” that are not cleared and provides no exemptive authority. The proposed rule relies on the statutory requirement that the rule be appropriate for the risk associated with the non-cleared swap and help ensure the safety and soundness of the swap entity to provide that a swap entity determine the appropriate amount of margin to collect for these types of counterparties based on a counterparty risk review. Under this approach, it is expected that nonfinancial end users would not be required to post margin to covered swap entities unless the covered swap entity is unwilling to take uncollateralized credit exposure to that counterparty, consistent with existing market practices. In particular, there are currently cases where a swap entity engages in swaps with other counterparties and does not collect initial or variation margin because it has determined that margin is not needed to address the credit risk posed by the counterparty and the risk of the swap. In such cases, the draft proposed rule would not require a change in current practice. Also, non-financial counterparties are not expected to engage in swap activity at a level that would result in a significant source of systemic risk. Accordingly, staff believes that it is appropriate and consistent with the risk-based nature of the margin requirements to treat nonfinancial end users in this manner.

Eligible Collateral

The proposed rule would specify the types of collateral that would be eligible to satisfy both the initial and variation margin requirements.³³ Eligible collateral is generally limited to high-quality, liquid assets that are expected to remain liquid and retain their value, after accounting for an appropriate risk-based “haircut,” during a

³³ See proposed rule § __.6 (pp. 83-90 and 160-163 of Attachment A).

severe economic downturn. Eligible collateral for variation margin would be limited to cash only, which is largely consistent with current industry practice.³⁴ Eligible collateral for initial margin includes cash, debt securities issued or guaranteed by the U.S. Department of the Treasury or by another U.S. government agency, the BIS, the International Monetary Fund, the European Central Bank, 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.³⁵

This proposal broadens the scope of eligible collateral for initial margin from the 2011 proposal and should address concerns about collateral availability and market impact without exposing covered swap entities to undue risk. In particular, eligible collateral is restricted to liquid and high-quality assets with limited credit risk and initial margin collateral is subject to robust collateral haircuts that will further reduce risk. When determining the collateral's value for purposes of satisfying the proposed rule's margin requirements, non-cash collateral and cash collateral that is not denominated in U.S. dollars or the currency in which the payment obligations under the swap are required to be settled would be subject to an additional "haircut" as determined using Appendix B of the proposed rule.³⁶

Segregation Requirements and Collateral Rehypothecation

This proposal retains and expands on most of the collateral safekeeping requirements of the 2011 proposal. The 2011 proposal required a covered swap entity to require a swap entity counterparty to hold funds or other property posted as initial margin

³⁴ In this context "cash" should be understood to mean U.S. dollars, or the currency in which the swap is denominated, which is intended to include circumstances in which several swaps in differing underlying currencies are settled in a single "transport" currency.

³⁵ An asset-backed security guaranteed by a U.S. GSE is eligible collateral for purposes of initial margin if the GSE is operating with capital support or another form of direct financial assistance from the U.S. government. See proposed rule § __.6(a)(2)(iii) (pp. 161 of Attachment A).

³⁶ See Appendix B (p. 180-181 of Attachment A).

at an independent third-party custodian that was prohibited by contract from rehypothecating or otherwise transferring the initial margin it held for the covered swap entity and reinvesting any initial margin in any asset that would not qualify as eligible collateral. These requirements did not apply to transactions with a counterparty that was not a swap entity.

To address the risk of recovering posted collateral from an insolvent counterparty and to protect the safety and soundness of the covered swap entity, the proposed rule would require a covered swap entity to require that any collateral other than variation margin that it posts to its counterparty (even collateral not required by the proposed rule) be segregated at one or more custodians that are not affiliates of the covered swap entity or the counterparty (“third-party custodian”).³⁷ The proposed rule would also require a covered swap entity to place the initial margin it collects in accordance with the proposed rule from a swap entity or financial end user with material swaps exposure at a third-party custodian.³⁸ The custodian agreement must prohibit the custodian from rehypothecating, repledging, reusing or otherwise transferring (through securities lending, repurchase agreement, reverse repurchase agreement, or other means), the funds or other property held by the custodian.³⁹ Notwithstanding this prohibition on rehypothecation, the posting party may substitute or direct any reinvestment of collateral. However, with respect to collateral collected or posted as initial margin pursuant to the proposed rule, the posting party may substitute funds or other property or direct reinvestment of funds only in assets that would qualify as eligible collateral under the proposal and for which the amount, net of applicable discounts, would be sufficient to meet the initial margin requirements under the proposal.⁴⁰

³⁷ See proposed rule § __.7(a) (pp. 91-92 and 163 of Attachment A).

³⁸ See proposed rule § __.7(b) (pp. 92 and 163 of Attachment A).

³⁹ See proposed rule § __.7(c) (pp. 92-93, 93-96 and 163 of Attachment A).

⁴⁰ See proposed rule § __.7(d) (pp. 93 and 163-164 of Attachment A).

Although large dealers currently exchange variation margin, they generally do not exchange initial margin. By requiring that initial margin be exchanged and segregated at a third-party custodian, the proposed rule would likely require covered swap entities to begin dedicating a significant amount of liquid assets to meet margin requirements, and liquid assets held or pledged as initial margin would be unavailable for other purposes.⁴¹ The proposed segregation requirement may have a significant liquidity impact. However, the requirement is included in the proposed rule to help ensure that covered swap entities are adequately protected from the default of a counterparty and to help prevent financial contagion from a significant default event. The segregation requirement helps assure each counterparty to the defaulting counterparty that they have access to significant amounts of initial margin to resolve the default. This is consistent with the purpose of the Dodd-Frank Act provisions, which include helping to ensure the safety and soundness of swap entities and to offset risks to the financial system arising from the use of non-cleared swaps.

Cross-Border Interactions

Given the global nature of swap markets, the proposed margin requirements would be applied to swap transactions across different jurisdictions. The proposed rule also would address the manner in which the margin requirements apply to swap activities outside of the United States. As was the case in the Agencies' 2011 proposal, the foreign swaps of foreign covered swap entities would not be subject to the margin requirements of the proposed rule.⁴² Foreign swaps would include swaps with respect to which neither the counterparty nor the guarantor of the swap is a U.S. entity.

In addition, the proposed rule would permit certain covered swap entities to comply with a foreign regulatory framework for non-cleared swaps if the Agencies determine that such foreign regulatory framework is comparable to the requirements of

⁴¹ For example, initial margin collateral that has been posted to a counterparty by a bank would not count towards the bank's liquid asset buffer under the proposed Liquidity Coverage Ratio.

⁴² See proposed rule § __.9(a) (pp. 115 and 172 of Attachment A).

the proposed rule.⁴³ Under the proposed rule, certain covered swap entities operating in foreign jurisdictions (including certain foreign subsidiaries of U.S. entities), as well as a U.S. branch or agency of a foreign bank, would be able to meet the U.S. requirement by complying with the foreign requirement in the event that a comparability determination is made by the Agencies, regardless of the location of the counterparty, provided that the covered swap entity's obligations under the swaps are not guaranteed by a U.S. entity.⁴⁴ In addition, under the proposal, if a foreign counterparty is subject to a foreign regulatory framework that has been determined to be comparable by the Agencies, a covered swap entity's posting requirement would be satisfied by posting what is required by the foreign counterparty's margin collection requirement.⁴⁵

The development of the 2013 international framework makes it more likely that regulators in multiple jurisdictions will adopt margin rules for non-cleared swaps that are similar to each other. The proposed rule provides that the Agencies will jointly make a determination regarding the comparability of a foreign regulatory framework that will focus on the outcome produced by the foreign regulatory framework as compared to the U.S. framework. As margin requirements are complex and have a number of related aspects (e.g., posting requirements, collection requirements, model requirements, eligible collateral and segregation requirements), the substituted compliance determination would take a holistic view of the foreign regulatory framework that appropriately considers the outcomes produced by the entire framework. Where appropriate, however, the Agencies could determine that certain provisions of a foreign regulatory framework are comparable to the U.S. rule, while other provisions are not. This proposed approach is intended to limit the extraterritorial application of the margin requirements while preserving, to the extent possible, competitive equality among U.S. and foreign firms in the United States.⁴⁶

⁴³ See proposed rule § __.9(d) (pp. 115-119 and 173-174 of Attachment A).

⁴⁴ If the swap is guaranteed by a U.S. entity, such swaps would be subject to the U.S. requirement.

⁴⁵ See proposed rule § __.9(d)(4) (pp. 118 and 174 of Attachment A).

⁴⁶ See proposed rule § __.9(d) (pp. 115-119 and 173-174 of Attachment A).

Phase-In of the Requirements

In order to mitigate any burdens on market participants and potential effects on the market, the proposal phases in the margin requirements gradually. Specifically, the proposal includes a set of compliance dates by which a covered swap entity must comply with the minimum margin requirements for non-cleared swaps. These dates are consistent with the 2013 international framework.⁴⁷ For variation margin, the compliance date is December 1, 2015, for all covered swap entities with respect to non-cleared swaps with any counterparty.

By December 1, 2019, the initial margin requirements are effective for all covered swap entities with respect to their swaps with any counterparty. For initial margin, the compliance dates range from December 1, 2015, to December 1, 2019, depending on the average daily aggregate notional amount of covered swaps of the covered swap entity and its counterparty. For example, if both the covered swap entity (combined with its affiliates) and the counterparty (combined with its affiliates) have an average daily aggregate notional amount of covered swaps for June, July, and August of 2015 that exceeds \$4 trillion, the compliance date is December 1, 2015. If this were a lower amount, such as \$2 trillion, the compliance date would be extended to December 1, 2017.

The compliance dates have been structured to ensure that the largest and most sophisticated covered swap entities with counterparties that present the greatest potential systemic risk to the financial system comply with the requirements first. These swap market participants should be able to make the required operational and legal changes more rapidly and easily than smaller entities that engage in swaps less frequently and pose less risk to the financial system. In addition, variation margin requirements are scheduled to become effective at the first possible compliance date, December 1, 2015, reflecting the view that the regular exchange of variation margin is a risk management best practice, reduces the potential for a build-up of risk in the financial system, and presents a low liquidity burden on net.

⁴⁷ See proposed rule § __.1(d) (pp. 40-42 and 144-145 of Attachment A).

Capital Requirements

Because existing regulatory capital rules already specifically take into account and address the unique risks arising from derivatives transactions and activities, the proposed rule's capital requirements simply require covered swap entities to comply with the existing regulatory capital regime that is already applicable to those entities as part of their prudential regulation. The Federal banking agencies recently implemented Basel 2.5 and Basel 3 reforms in 2013, which strengthened the capital requirements for non-cleared derivatives.⁴⁸

Liquidity Impact of Margin Requirements

As described above, the proposed rule will require an exchange of initial margin by many market participants, which represents a significant change to current market practice. The proposal discusses the quantitative impact of the proposed margin requirements based on studies by the BCBS/IOSCO and the International Swaps and Derivatives Association ("ISDA") that use the 2013 international framework to estimate the total amount of initial margin that will be required. Assuming all initial margin requirements were effective and using an internal model that has parameters roughly consistent with the proposed rule, the ISDA study estimates a U.S. initial margin requirement of approximately \$280 billion and the BCBS/IOSCO study estimates a U.S. initial margin requirement of approximately \$315 billion. Using a standardized approach, the ISDA study also provided an estimate for initial margin requirements which would result in a U.S. initial margin requirement of \$3.57 trillion. The amounts resulting from the standardized methodology are significantly higher than the other, model based, initial margin estimates because the standardized methodology does not provide for any significant netting or hedging benefits among related swaps in the same portfolio.

⁴⁸ See proposed rule § __.11 (pp. 123-126, 176, 188-189 of Attachment A).

The proposal also requires variation margin be exchanged between a covered swap entity and certain counterparties. Staff believes that the marginal impact of this requirement will be low in the aggregate because the regular exchange of variation margin is already a well-established best practice among a large number of market participants.

Any estimate of the quantitative impact of the margin requirements depends on a number of quantities, such as the fraction of the swaps market that is cleared and the intensity with which swaps are used once these and other regulations become effective, which are difficult or impossible to precisely forecast. Accordingly, the proposal seeks broad and detailed comment on the potential impact of the proposed margining requirements.

CONCLUSION:

The attached Federal Register notice invites comment on the proposed rule establishing margin and capital requirements for covered swap entities and explains the proposal in more detail. Staff recommends that the Board invite public comment on the attached proposed rule, which is explained in the attached draft Federal Register notice. If approved, public comment on the proposed rule would be solicited for 60 days. Staff also requests authority to make minor and technical changes to the draft proposed rule and Federal Register notice prior to publication (for example, to incorporate changes requested by other Agencies as part of the approval process, or to address any changes that may be requested by the Federal Register).

Attachment