Margin and Capital Requirements for Covered Swap Entities

Dodd-Frank Act

Sections 731 and 764 of the Dodd-Frank Act instruct regulators to establish minimum margin requirements for initial and variation margin for uncleared swaps and security-based swaps (collectively, swaps) entered into by certain registered swap dealers and major swap participants. The Dodd-Frank Act requires the registration of dealers and major swap participants with the Commodity Futures Trading Commission (CFTC) and the Securities Exchange Commission (SEC); therefore, the CFTC and SEC define what banking organizations will be included as covered swap entities. The Act also requires the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency (collectively, the Agencies) to issue initial margin, variation margin, and capital requirements for covered swap entities that fall within their jurisdiction with respect to swaps that are not cleared through central counterparties or derivative clearing organizations. Under the proposed rule, the Agencies establish minimum margin collection requirements for covered swap entities.

For a covered swap entity, the proposed rule would impose initial margin and variation margin requirements for uncleared swaps held by the covered swap entities. The Agencies' existing regulatory capital rules take into account and address the unique risks arising from derivatives transactions. Therefore, the proposed rule is based on a preliminary conclusion by the Agencies that these existing rules are appropriate and sufficient to offset the greater risk to the covered swap entity and the financial system arising from the use of uncleared swaps.

The Dodd-Frank Act requires that initial margin and variation margin requirements adopted by the Agencies must help ensure the safety and soundness of the covered swap entity and be appropriate for the risk associated with the covered derivatives. Consistent with that requirement, the proposed rule's initial margin, variation margin, and capital standards are intended to offset the risk to covered swap entities and the financial system arising from the use of uncleared swaps.

The Proposed Rule

The proposed rule would require covered swap entities to calculate and collect initial margin and variation margin from all counterparties. For covered swap entities, this would require reciprocal collection from other covered swap entities for all initial and variation margin requirements. However, the proposed rule would provide a series of risk-based margin collection thresholds for covered swap entities designed to limit the impact of margin collection requirements on lower-risk financial end users. As such, the proposed initial margin and variation margin collection requirements for covered swap entities would change as the characteristics of the counterparties change. Specifically, the collection requirements would change if the covered swap entity's counterparty is a high- or low-risk financial end user or a commercial end user.

For a high-risk profile financial end user (for example, a hedge fund), covered swap entities would be required to collect the entire initial margin amount and variation margin amount required from such counterparty, as calculated under the proposed rule. However, for a low-risk profile financial end user (for example, an insured depository institution under certain circumstances), an initial margin threshold and variation margin threshold may apply. For transactions with a low-risk profile financial end user, the proposed rule would require a covered swap entity to collect initial margin and variation margin to the extent that such amount exceeds the applicable threshold. For low-risk financial end user counterparties, the threshold would be

the lesser of the range of $15-45 million or 0.1-0.3 percent of the covered swap entity's tier 1 capital.

The proposed rule would require a covered swap entity to calculate a credit exposure limit for a commercial end user and collect initial margin and variation margin from a commercial end user when the credit exposure exceeds the calculated limit. No explicit minimum supervisory threshold for margin collection would apply to commercial end users.

Under the proposed rule, a covered swap entity to would be required to calculate the initial margin requirement using either of two alternatives. Under the first alternative, the covered swap entity may calculate minimum initial margin requirements through the use of a standardized "lookup" table that specifies the minimum initial margin that must be collected as a percentage of a swap's notional amount. Under the second alternative, a covered swap entity may calculate minimum initial margin requirements through the use of an internal model approved by the primary regulator. Given the greater risk sensitivity of models as well as the ability to recognize the benefits of netting, the Agencies expect a covered swap entity to seek approval for the use of an internal model to calculate the minimum initial margin requirements. In addition, the proposed rule would require that the internal model used in the calculation of the margin requirement be at least as conservative as those used by swap clearinghouses.

The proposed rule limits the types of collateral eligible to satisfy the initial margin or variation margin requirements to immediately available cash funds; obligations of, or fully guaranteed by, the United States; and senior debt obligations of government-sponsored entities. Other than immediately available cash funds, all types of eligible collateral are subject to haircuts for determining the value for margin purposes. The proposed rule also would require the covered swap entity to require the covered swap entity counterparty to segregate and hold the collateral posted as initial margin at a third-party custodian. The segregation requirement is based on a preliminary conclusion by the Agencies that requiring a covered swap entity's initial margin to be segregated is necessary to offset the greater risk to the covered swap entity and the financial system arising from the use of uncleared swaps, and protect the safety and soundness of the covered swap entity. Collateral collected from end users may be segregated at the discretion of the end user.

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