BOARD OF GOVERNORS

OF THE

FEDERAL RESERVE SYSTEM

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DIVISION OF SUPERVISION AND REGULATION

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TO THE OFFICER IN CHARGE OF SUPERVISION AT EACH FEDERAL RESERVE BANK AND TO FINANCIAL INSTITUTIONS SUBJECT TO THE INITIAL AND VARIATION MARGIN REQUIREMENTS FOR NON-CLEARED SWAPS AND NON-CLEARED SECURITY-BASED SWAPS

SUBJECT: Initial Examinations for Compliance with Minimum Variation Margin Requirements for Non-Cleared Swaps and Non-Cleared Security Based Swaps

Applicability: This guidance does not apply to community banks with $10 billion or less in total consolidated assets.

The Federal Reserve is providing guidance regarding initial examinations of Federal Reserve-supervised institutions for compliance with certain provisions of the interagency rule (the "final rule") establishing initial and variation margin requirements for non-cleared swaps and non-cleared security-based swaps (collectively, "non-cleared swaps). Specifically, this guidance addresses the Federal Reserve's expectations for compliance by Commodity Futures Trading Commission (CFTC)-registered swap dealers for which the Federal Reserve is the prudential regulator[1] (referred to as a "covered swap entity") with the minimum variation margin requirements that will become applicable on March 1, 2017.

[1] Section 1a(39) of the Commodity Exchange Act defines the term ''prudential regulator'' for purposes of the margin requirements applicable to swap dealers, major swap participants, security-based swap dealers and major security-based swap participants. The Board is the prudential regulator for any swap entity that is (i) a state-chartered bank that is a member of the Federal Reserve System, (ii) a state-chartered branch or agency of a foreign bank, (iii) a foreign bank which does not operate an insured branch, (iv) an organization operating under section 25A of the Federal Reserve Act (an Edge corporation) or having an agreement with the Board under section 25 of the Federal Reserve Act (an 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, as amended, or a savings and loan holding company (on or after the transfer date established under section 311 of the Dodd-Frank Act), or a subsidiary of such a company or foreign bank (other than a subsidiary for which the Office of the Comptroller of the Currency (OCC) or the Federal Deposit Insurance Corporation (FDIC) is the prudential regulator or that is required to be registered with the CFTC or Securities and Exchange Commission (SEC) as a swap dealer or major swap participant or a security-based swap dealer or major security-based swap participant, respectively). This guidance focuses on CFTC-registered swap dealers as there are currently no major swap participants registered with the CFTC or security-based swap dealers or major security-based swap participants registered with the SEC.

Background

Sections 731 and 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) require the Federal Reserve, FDIC, OCC, Farm Credit Administration, and Federal Housing Finance Agency (collectively, the "agencies") to adopt rules jointly for swap dealers, major swap participants, security-based swap dealers and major security-based swap participants ("swap entities") that are prudentially regulated by one of the agencies that establish initial and variation margin requirements on all swaps that are not cleared by a registered derivatives clearing organization or a registered clearing agency.[2]

The agencies published the final rule establishing initial and variation margin requirements pursuant to sections 731 and 764 of the Dodd-Frank Act in November 2015.[3] The effective date for the final rule was April 1, 2016. However, the phase-in of the minimum margin requirements did not begin until September 1, 2016. Under the final rule, only the largest swap market counterparties (those with more than $3 trillion in outstanding swap activity) were required to implement both the initial and variation margin requirements for non-cleared swap trades between those largest swap counterparties by September 1, 2016. On March 1, 2017, the phase-in schedule will begin to encompass all firms that qualify as covered swap entities, regardless of their volume of outstanding swap activity, for the exchange of variation margin for all transactions with other swap entities and financial end-user counterparties.

Guidance for Initial Examinations for Compliance with Minimum Variation Margin Requirements for Non-Cleared Swaps

In exercising supervisory discretion in initial examinations for compliance with the minimum variation margin requirements for non-cleared swaps, Federal Reserve examiners should be guided by the following principles:

- Priority should be given to compliance efforts by covered swap entities based on the size of and risk inherent in the credit and market risk exposures presented by each counterparty. A covered swap entity is expected to comply with the variation margin requirements of the final rule with respect to swap entities and financial end user counterparties[4] that present significant exposures as of March 1, 2017. With respect to other counterparties, Federal Reserve examiners should focus on a covered swap entity's good faith efforts to comply with the variation margin requirements of the final rule as soon as possible, and in no case later than September 1, 2017. This focus ensures that an entity's compliance with respect to the highest risks and largest counterparties are prioritized and adequately met first.

- The scope and scale of changes necessary for each covered swap entity to achieve effective compliance for each of its non-cleared swap transactions is recognized. During initial examinations for compliance with the variation margin requirements that will

[2] *See* 7 U.S.C. 6s(e)(2)(A); 15 U.S.C. 78o-10(e)(2)(A).

[3] *See* 80 FR 74,840 (Nov. 30, 2015).

[4] The term "financial end user" is defined in the final rule. *See* 12 CFR 237.2.

phase in under the final rule on March 1, 2017, Federal Reserve examiners should evaluate a covered swap entity's management systems and program for compliance.

- A covered swap entity is expected to have governance processes that assess and manage its current and potential future credit exposure to non-cleared swap counterparties, as well as any other market risk arising from such transactions.

- Federal Reserve examiners should consider the covered swap entity's implementation plan, including actions taken to update documentation, policies, procedures, and processes, as well as its training program for staff on how to handle technical problems or other implementation challenges.

Federal Reserve Banks are asked to distribute this letter to their supervised financial institutions and to appropriate supervisory staff. Questions regarding this guidance may be directed to:

- Division of Supervision and Regulation: Anna Harrington, Senior Supervisory Financial Analyst, at (202) 452-6406, and Sean Campbell, Associate Director, at (202) 452-3760.

In addition, questions may be sent via the Board's public website.[5]

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Director

[5] *See* http://www.federalreserve.gov/apps/contactus/feedback.aspx.