

Meeting between Federal Reserve Board staff and Independent Community Bankers of America representative
Margin and Capital Requirements for Covered Swap Entities [R-1415]
September 28, 2011

Independent Community Bankers of America (“ICBA”) representative:
Mark Scanlan, Senior Vice President, Agriculture & Rural Policy

Board staff:
Michael Gibson
Sean Campbell
Jeremy Newell
Anna Harrington

A representative from ICBA met with Board staff to discuss issues related to the proposed rule of the Board and other prudential regulators on margin and capital requirements for covered swap entities under Title VII of the Dodd-Frank Act. The ICBA representative expanded on the points raised in ICBA’s comment letter on the proposed rule, dated July 11, 2011.

The ICBA representative noted that ICBA represents nearly 5000 community banks and that community banks use swaps either to hedge their own interest rate risks or to convert variable rate financing to fixed rate financing to serve the needs of their customers. According to the ICBA representative, community banks generally pledge initial margin to middle market swap dealers who repledge that margin upstream to large financial firms to complete the transaction. ICBA’s main concerns with the proposal focused on the prohibition on rehypothecation in the proposed rule (as described in the attachment). The ICBA representative also stated that community banks should be treated like nonfinancial end users.

Attachment

DERIVATIVES – TITLE VII Dodd Frank Act

Background – The Dodd-Frank Act (DFA) imposes broad-based changes on the use of derivatives by the financial services sector, including their growing use by community banks. It is possible that DFA implementing regulations could negatively impact community banks that use swaps (derivatives).

Uses of Derivatives by Community Banks (swaps) – Community banks’ use low-risk, plain vanilla interest rate swaps either to hedge their own risks or serve the needs of their customers related to loans. In serving their customer’s loan needs, a community bank swap typically is designed to convert a variable rate loan into fixed-rate financing. These swaps are “customized” to match the underlying loan for GAAP accounting purposes. The customization could include a specific notional or dollar amount; tying the loan to a specific index; establishing monthly payment terms or other basic aspects. Because the swaps are customized, they are not yet accepted by the exchanges and therefore trade in the Over-The-Counter (OTC) market.

Concerns Regulators’ Proposals

- **Capital and Margin** – Regulatory agencies are erroneously concluding that all OTC swaps are automatically “riskier” than swaps accepted on exchanges. Regulators have cited the example of AIG and their use of credit default swaps (CDS) to justify this position. However, community banks do not use CDS swaps, which are insurance products. Community banks use low-risk interest rate swaps (IRS), similar to the “plain-vanilla” IRSs cleared by the exchanges.
- **The regulators propose to prohibit the repledging of initial margin (rehypothecation)** pledged from the community bank to a mid-level swap dealer from that swap dealer to the counterparty on the other side of the swap transaction.
- The prohibition on rehypothecation means mid-level swap dealers serving community banks would have to have their own capital and margin for each swap arranged for community banks. This results in pools of “dead” capital, costly capital that is not economically productive. The result will be that those who serve the community bank market will exit the market leaving community banks without access to the OTC swaps market. Many customers will leave community banks and opt for the services of larger financial players.
- The prohibition of rehypothecation, in the absence of an exchange that accepts community bank interest rate swaps, is the death knell for community bank access to the swaps market and needs to be adjusted to focus on the truly risky swaps in the OTC market instead of on all swaps.
- **Origination of Loans Exemption** – The regulators propose to exempt the swaps that banks arrange in connection with the “origination” of loans for their customers from causing banks to be considered as swap dealers. This exemption is too narrow as swaps may be implemented before or after loan origination. Without broader flexibility, community banks could be considered swap dealers.

G. Section 7: Segregation of Collateral

The proposed rule provides that each covered swap entity must require each derivative's counterparty that it faces that is a swap entity to segregate any funds or collateral that the covered swap entity has posted as initial margin for a non-cleared swap or non-cleared security-based swap transaction at an independent, third-party custodian. 69

This independent, third-party custodian must be prohibited by contract from (i) rehypothecating or otherwise transferring any initial margin it holds for the covered swap entity and (ii) reinvesting any initial margin held by the custodian in any asset that would not qualify as eligible collateral for initial margin under the proposed rule. 70

The custodian must also be located in a jurisdiction that applies the same insolvency regime to the custodian as would apply to the covered swap entity. 71

This segregation requirement applies only to initial margin, not variation margin, and does not apply to transactions with a counterparty that is an end user of any type. 72

69 See proposed rule § 7(a).

70 See proposed rule §§ J(b), (c).

71 See proposed rule § J(d).

72 The proposed rule does not apply the **segregation requirement to variation margin because variation margin is generally used to offset the current exposure arising from actual changes in the market value of the derivative position**, rather than to secure potential exposure arising from *future* changes in the market value of the derivative position. Under section 11 of FHFA's and the FCA's proposed rules, entities regulated by FHFA and the FCA that are end users would have to require that any initial margin and variation margin they post to swap entities be segregated.

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The Agencies' preliminary view is that requiring covered swap entities to ensure segregation of initial **margin** is necessary to (i) offset the greater risk to the covered swap entity and the financial system arising from the use of swaps and security-based swaps that are not cleared and (ii) protect the safety and soundness of the covered swap entity.

In developing this proposal, the Agencies have taken into account the fact that the failure of a covered swap entity could pose significant systemic risks to the financial system and losses borne by the financial system in such a failure could have significant consequences. The consequences could be magnified if the initial **margin** posted to the failing swap entity cannot be quickly recovered by the non-defaulting party during a period of financial stress when the liquidity value of the funds is high.

Moreover, swap entities typically have roughly offsetting exposures with one another. As a result, it is to be expected that the amount of initial **margin** required to be posted by two swap entities will be similar. If swap entities exchange similar amounts of initial **margin** and these funds are available for general use and rehypothecation by the swap entities, then the net effect is as if little initial **margin** was exchanged.

To the extent that initial **margin** requirements are intended to constrain risk-taking, a lack of segregation will weaken their effect.⁷³

Swap entities that engage in cleared swap transactions will be required to post initial **margin** to the CCP.

Consequently, the initial **margin** that is posted on cleared transactions will not be available for rehypothecation by swap entities. Allowing for rehypothecation of initial **margin** by swap entities would create an incentive for swap entities to engage in non-cleared transactions even though other provisions of Dodd-Frank Act are intended to promote central clearing of swaps.

However, the segregation of initial **margin** is likely to significantly reduce the availability of liquid assets to covered swap entities to meet payment obligations, as liquid assets held or pledged as the initial **margin** would be unavailable to the swap entity for other purposes. The requirement to segregate initial **margin** could result in covered swap entities having to seek alternative methods of funding. The loss in liquidity could be severe, and could require covered swap entities to raise liquidity through other sources.

The Agencies are concerned that not requiring segregation at the outset may cause covered swap entities that incur a severe loss due to credit or market events to face liquidity challenges because their counterparties may require segregation immediately after the loss, depleting the covered swap entity's liquid assets before it can raise additional funds through other means.⁷⁴

Requiring swap entities to segregate at the outset addresses this concern at the time a swap entity suffers a loss, but depletes the liquid assets at the inception of the swap transaction—a time when the swap entity is more likely to be able to raise additional liquid funds. The Agencies request comment on whether the **proposed** segregation requirement is appropriate, or whether an alternative approach would better reflect the purposes of sections 731 and 764 of the Dodd-Frank Act. In particular, the Agencies request comment on the following questions:

Question 65(a). Is it necessary to require segregation of initial **margin** in order to address the systemic risk issues discussed above?

65(b) What alternatives to segregation would effectively address these systemic risk issues?

65(c) As an alternative to requiring segregation at the outset, should the Agencies impose **rules** that provide additional time for a swap dealer to raise funds without requiring segregation?

Question 66(a). What are the potential operational, liquidity and credit costs of requiring segregation of initial **margin** by swap entities?

66(b) What would be the expected liquidity impact and cost of the **proposed** segregation requirement on market participants? How can the impact of the **proposed** rule on the liquidity and costs of swaps market participants be mitigated?

Question 67. Is segregation of initial **margin** and not variation **margin** sufficient to achieve the purposes of sections 731 and 764 of the Dodd-Frank Act? If not, how might such purposes be achieved?

Question 68(a). Are the limitations placed on rehypothecation and reinvestment under the **proposed** rule appropriate or necessary?

68(b) What additional or alternative limitations may be appropriate?

68(c) Should certain forms of rehypothecation (e.g., the lending of securities pledged as collateral) or additional types of reinvestment be permitted?

Question 69(a). Is the **proposed** rule's requirement that the custodian must be located in a jurisdiction that applies the same insolvency regime to the custodian as would apply to the covered swap entity necessary or appropriate?

69(b) What additional or alternative requirements regarding the location of the custodian may be appropriate?