BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: October 21, 2015

To: Board of Governors

From: Daniel Tarullo

Subject: Draft Final Rule and Draft Interim Final Rule – Margin and Capital Requirements for Covered Swap Entities

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The Dodd-Frank Act requires the Board, 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, to adopt rules imposing capital and margin requirements on all swaps not cleared by a central counterparty that involve a financial institution supervised by one of those agencies ("covered swap entity"). The attached draft final rule contains the following features:

- **Initial margin:** A covered swap entity must, on a daily basis, collect initial margin from and post initial margin to a counterparty that is either another swap entity or a financial end user with material swaps exposure of $8 billion. Initial margin must be exchanged where the amount of margin required exceeds $50 million (calculated on a consolidated basis). Eligible collateral for initial margin includes cash, gold, certain government bonds, corporate bonds, investment funds backed by sovereign bonds, and certain listed equities. These provisions are largely as proposed except that the material swaps exposure threshold has been raised from $3 billion to $8 billion in order to address concerns raised by commenters as well as to more closely align with the international framework's recommendation of €8 billion.

- **Variation margin:** A covered swap entity must exchange variation margin on a daily basis with all swap entities and financial end user counterparties. Only cash is eligible collateral for variation margin for swaps between swap entities. The full list of collateral that is eligible for initial margin may be used for variation margin for swaps between a covered swap entity and financial end user counterparty. This provision expands the collateral eligible for posting variation margin in response to information provided by commenters.

- **Segregation and Rehypothecation Requirements:** A covered swap entity generally must segregate initial margin at a third-party custodian, and there can be no rehypothecation or reuse of collected and posted initial margin. These provisions largely reject the call of commenters to allow rehypoethcation of collateral because concerns that rehypoethcation can significantly increase risk.

- **Cross-border:** Foreign swaps that do not involve U.S. entities would not be subject to the margin requirements of the rule. In addition, certain covered swap entities, such as foreign banks, may comply with a foreign regulatory framework if the Agencies jointly determine that the requirements under the foreign regulatory framework are comparable to the requirements of the rule. These provisions are largely as proposed.

- **Commercial end user exemption:** Consistent with recently passed legislation, the Agencies would adopt, on an interim basis, and request comment on exemptions for swap transactions used for hedging purposes by commercial end-user counterparties from the margin requirements. This provision converts the proposal by the Agencies to allow covered swap entities to collect margin at their discretion as appropriate for risk management from commercial end users and certain other counterparties into an exemption for transactions with these and certain other counterparties in keeping with the new legislation.

- **Capital:** The draft final rule requires that covered swap entities comply with any existing regulatory capital regime already applicable to it as part of its prudential regulation. These provisions were not controversial.

Inter-affiliate swaps. The draft final rule also contains special rules for swap transactions between affiliates, which was an issue of concern for commenters, many of whom requested an exemption for inter-affiliate swaps. The draft final rule does not exempt inter-affiliate transactions from the initial margin requirements as advocated by many commenters. Inter-affiliate swaps pose risk to the covered swap entity, which the Dodd-Frank Act directs the Agencies to protect. However, the covered swap entity, which for the prudential regulators is generally an insured depository institution ("IDI"), is protected from the risks of a swap with an affiliate if the IDI collects margin from the affiliate; the affiliate is protected if the IDI posts margin. Accordingly, the draft final rule would require covered swap entities to collect initial margin from their affiliates on a daily basis above an initial margin threshold of $20 million for each affiliate counterparty. Covered swap entities would not be required to post initial margin. Instead, a covered swap entity would calculate the amount that it would have been required to post to an affiliate and provide that information to the affiliate on a daily basis. This reporting requirement will make the resulting risks transparent to both parties and will incentivize strong risk management. In addition, covered swap entities and their affiliates would collect and post variation margin on a daily basis, which is the current market practice. A covered swap entity could also serve as or use an affiliated IDI to act as custodian for non-cash initial margin, rather than requiring a third-party custodian, so long as the affiliated IDI abides by the segregation and rehypoethecation requirements.

The attachments explain these requirements in more detail. The Committee on Bank Supervision has been briefed on the draft final rule and the draft interim final rule. I believe the attached materials are ready for the Board's consideration.

Attachments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date:	October 20, 2015
To:	Board of Governors
From:	Staff[1]
Subject:	Draft final rule and draft interim final rule establishing margin and capital requirements for non-cleared swaps

ACTION REQUESTED: Approval of (1) the attached draft final rule 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) that would establish margin and capital requirements on all non-cleared swaps and non-cleared security-based swaps 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) (Attachment A),[2] and (2) the attached draft interim final rule to implement the requirements of Title III of the Terrorism Risk Insurance Program Reauthorization Act of 2015 (TRIPRA) that exempts swaps that meet the requirements for an exemption from clearing, such as those used for hedging by commercial end user counterparties, from the margin requirements set forth in the draft final rule (Attachment B).[3] The public would be invited to submit comments on the interim final rule for a period of 60 days. Both rules would be issued jointly with the OCC, the FDIC, the Farm Credit Administration, and the Federal Housing Finance Agency.

EXECUTIVE SUMMARY:

The draft final rule establishes minimum margin requirements for non-cleared swap activities of swap entities for which the Agencies are the prudential regulators. The amount of required margin is risk-based and depends on whether the covered swap entity's counterparty is (i) another swap entity, (ii) a financial end user with material swaps exposure, (iii) a financial

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

[2] Pub. L. No. 111-203; 124 Stat. 1376 (2010); see 7 U.S.C. § 6s; 15 U.S.C. § 78o-10.

[3] Pub. L. 114-1, 129 Stat. 3 (2015).

end user without material swaps exposure, or (iv) an "other counterparty," including certain non-financial end users and sovereigns.

- ***Margin Requirements:*** The draft final rule would set minimum amounts of initial and variation 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. The material swaps exposure threshold is set at $8 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 on a consolidated basis with all counterparties. A covered swap entity may calculate initial margin amounts using a standardized margin schedule or an internal model that is approved by the covered swap entity's prudential regulator.

- ***Margin Thresholds:*** A covered swap entity must collect or post initial margin where the amount of margin required exceeds a threshold of $50 million on a consolidated basis. There is no threshold for variation margin: a covered swap entity must collect and post the full amount whenever variation margin is required.

- ***Initial and Variation Margin Requirements for "Other Counterparties":*** The draft final rule does not specify minimum initial and variation margin amounts for a covered swap entity's swaps with "other counterparties" (including non-financial entities (such as commercial end users) that are not using swaps for hedging commercial risk and sovereigns). Instead, a covered swap entity transacting with these "other counterparties" is required to collect initial and variation margin only to the extent it deems it necessary to address the credit risk posed by the counterparty and the swap. In addition, swaps with counterparties identified in TRIPRA are exempt from the draft final rule altogether.

- ***Netting:*** A covered swap entity may calculate initial margin (using an initial margin model) or variation margin on an aggregate net basis across non-cleared swaps with a counterparty that are executed under an eligible master netting agreement (defined in the same way as "qualified master netting agreement" under the banking agencies' risk-based capital rules).

- ***Eligible Collateral:*** Eligible collateral for initial margin includes cash, gold, certain government bonds, corporate bonds, investment funds backed by sovereign bonds and equities. For swaps between a covered swap entity and another swap entity, only cash is eligible collateral for variation margin; however, for swaps between a covered swap entity and financial end user counterparty, eligible collateral for variation margin is the same as the eligible collateral for initial margin.

- ***Segregation Requirements and Collateral Rehypothecation:*** A covered swap entity generally must segregate initial margin at a third-party custodian and any custodial agreement must prohibit the rehypothecation, repledging, reusing, or otherwise transferring of collected and posted initial margin. The draft final rule does not include any segregation requirements for variation margin.

- ***Cross-Border Interactions:*** In accordance with the Act, the draft final rule applies to both U.S. and foreign swap entities. Swaps between foreign covered swap entities and certain foreign counterparties, however, would not be subject to margin requirements under the draft final rule. In addition, certain covered swap entities may satisfy margin requirements by complying 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 draft final rule.

- ***Affiliate Transactions:*** A covered swap entity is required to collect initial margin from an affiliate. However, a covered swap entity is not required to post initial margin to an affiliate. Instead, it must calculate the amount of initial margin that would be posted and provide documentation to each affiliate on a daily basis. Since covered swap entities are required to collect initial margin from their affiliates, a swap transaction between affiliated covered swap entities would result in both collecting and posting of initial margin.

- ***Phase-In:*** Both the final rule and the interim final rule would be effective on April 1, 2016. The variation margin requirements will phase in between September 1, 2016 and March 1, 2017. The initial margin requirements will phase in between September 1, 2016 and September 1, 2020, and the phase-in is based on the volume of swap activity of the covered swap entity and its counterparty.

- ***Capital Requirements:*** The draft final rule requires that swap entities comply with any existing regulatory capital regime already applicable to it as part of its prudential regulation.

- ***Interim Final Rule:*** Section 302 of TRIPRA requires that the Agencies implement its provisions by promulgating an interim final rule. The draft interim final rule implements these provisions, which exempts from initial and variation margin requirements non-cleared swaps of certain counterparties that would qualify for an exemption from clearing, including non-financial end users that use the swaps to hedge or mitigate commercial risks as well as swaps with certain cooperatives and affiliates of non-financial end users.

BACKGROUND:

A. History

In 2009, the G-20 agreed to substantial new regulation of over-the-counter (OTC) derivative markets, including margin requirements for non-centrally-cleared derivatives. In 2010, Title VII of the Dodd-Frank Act established a new regulatory framework for OTC derivatives, which the Act generally characterizes as “swaps” (*e.g.*, interest rate swaps, commodity swaps, equity swaps, and credit default swaps) and “security-based swaps” (*e.g.*, swaps based on a single security or loan or on a narrow-based security index). 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] The CFTC and SEC also are required to make determinations regarding which swaps must be 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 comparable capital and margin requirements to the maximum extent practicable.[7] The margin rules for swap entities apply only to <u>non-cleared</u> swaps; they do not apply to swaps that are cleared through a CCP (*e.g.*, a derivatives clearing organization or clearing agency registered

[4] As of October 19, 2015, 104 entities have registered as swap dealers and 2 entities have registered as major swap participants with the CFTC. The SEC has also adopted rules for registering entities that meet the definition of "security-based swap dealer," or "major security-based swap participant," however, the compliance dates for registration have yet to occur.

[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 draft final rule.

with the CFTC or SEC, respectively, or a clearing organization that the CFTC or SEC has exempted from registration by rule or order). [8]

B. Prior Proposals

The Agencies originally published proposed rules to implement sections 731 and 764 of the Act in May 2011.[9] Following the release of the 2011 proposal, the BCBS and 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),[10] after which the Agencies re-opened the comment period on the 2011 proposal.[11] The proposed 2012 international framework was also subject to extensive public comment before it was finalized in September 2013.[12]

The Agencies re-proposed swap margin rules in September 2014. The 2014 proposal revised the 2011 proposal to reflect comments received on the 2011 proposal as well as revisions designed to incorporate the 2013 international framework in order to promote global consistency and reduce regulatory arbitrage. The Agencies received over 50 comments addressing a wide variety of aspects of the proposal as described further below including the potential costs and burdens of various aspects of the proposal. The staffs of the Agencies met with a number of these commenters to understand issues relating to the proposal, and summaries of these meetings

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[8] Other changes made in Title VII of the Dodd-Frank Act require most sufficiently standardized swaps to 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. The Commodity Exchange Act and Securities Exchange Act of 1934 ("Exchange Act") allow the CFTC and SEC, respectively, to exempt clearing organizations from registration where the clearing organization is subject to "comparable, comprehensive supervision and regulation" by the appropriate government authorities in its home country.

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

[10] *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.

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

[12] *See* BCBS and IOSCO "Margin requirements for non-centrally cleared derivatives," (September 2013), *available at* https://www.bis.org/publ/bcbs261.pdf.

are available on the Agencies' public websites.[13] Staff has reviewed the comments received in response to the proposal and worked with the staffs of the other Agencies to modify the proposal to address commenter concerns in a manner consistent with the statute and its purposes.[14]

SUMMARY OF DRAFT FINAL RULE:

A. Types of Counterparties

The draft final rule establishes a risk-based approach to margin requirements for covered swap entities consistent with the Act's requirement that these rules help ensure the safety and soundness of the swap entity and 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 draft final rule, like the 2014 proposal, would distinguish among four 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 non-financial end users, sovereigns, and multilateral development banks.[15] The requirements of the draft final rule would apply to non-cleared swaps with these counterparties to the extent they are not exempt pursuant to TRIPRA.

1. Swap Entity

The draft final rule defines the term "swap entity" to mean persons that have registered as a swap dealer or major swap participant with the CFTC or as a security-based swap dealer or a major security-based swap participant with the SEC.[16]

2. Financial End User

In order to provide certainty and clarity to counterparties as to whether they would be financial end users for purposes of the final rule, the draft final rule defines "financial end user" by listing (i) entities that would be considered financial end users and, (ii) entities excluded from

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[13] A link to the Board's website is available: http://www.federalreserve.gov/newsevents/reform_derivatives.htm.

[14] A summary of the comments may be found in the Secretary's Office.

[15] *See* draft final rule § __.2 for the various constituent definitions that identify these four types of swap counterparties (pp. 227-240 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).

the definition.[17] For example, the types of entities included as financial end users include, but are not limited to, bank holding companies, broker-dealers, registered investment companies, securitization vehicles, and insurance companies. The definition of financial end user also explicitly excludes certain types of counterparties, 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. An entity that is not specifically identified in the definition is not a financial end user for the purposes of the draft final rule.

The draft final rule's definition of "financial end user" is largely similar to the 2014 proposal's definition. A number of commenters requested that particular types of financial entities be excluded from the definition of financial end user under the final rule – e.g., certain entities that the CFTC has excluded from clearing through no-action letters, financial entities guaranteed by foreign sovereigns, small financial entities, certain financial cooperatives, employee benefit plans, covered bond issuers and other structured finance vehicles. While certain of these concerns may be addressed through the exemptions provided by TRIPRA (discussed below), the draft final rule does not modify the definition of financial end user to exclude these types of financial entities as a general matter. These entities are classified as financial end users because their financial and market activities comprise the same range of activities as the other entities encompassed by the draft final rule's definition of financial end user.

3. *Material Swaps Exposure*

The draft final rule's definition of material swaps exposure is largely similar to that of the 2014 proposal except that the amount of notional swaps exposure that triggers a material swaps exposure has increased from $3 billion to $8 billion. A number of commenters indicated that the proposed lower limit of $3 billion was not consistent with the 2013 international framework's level of €8 billion and would create significant competitive inequities across jurisdictions if adopted as proposed. In addition, commenters contended that financial end users with a notional exposure below the international framework's level of €8 billion do not have the potential to create systemic risks and should therefore not be subject to minimum initial margin requirements

[17] As in the 2014 proposal, the Agencies are relying, to the greatest extent possible, on the counterparty's legal status as a regulated financial entity.

as a regulatory matter. Staff recommends that the draft final rule calibrate its definition of material swaps exposure to be broadly consistent with the international framework so as to reduce the scope for competitive inequity and regulatory arbitrage that would result with widely varying definitions across jurisdictions. A higher notional exposure level will be more likely to cover those entities that, either individually or as a group, are a source of systemic risk to the economy. Accordingly, staff recommends modifying the definition of material swaps exposure so that it is triggered at a notional exposure of $8 billion, which is broadly consistent with the international framework's level of €8 billion.

4. Other Counterparties and TRIPRA Exemptions

Entities that are neither financial end users nor swap entities were treated as "other counterparties" under the proposal. The proposal would not have imposed a specific, numerical margin requirement with respect to a swap with a counterparty that is an "other counterparty."[18] For these other counterparties, a covered swap entity would collect initial and variation margin to the extent it deems it is necessary to address the credit risk posed by the counterparty or the non-cleared swap.[19] The proposed requirements with respect to "other counterparties" are consistent with market practice, which requires little or no margin with these counterparties.

The enactment of TRIPRA in January 2015 amended statutory provisions relating to swap and security-based swap margin requirements. Specifically, section 302 of TRIPRA amends sections 731 and 764 of the Dodd-Frank Act to provide that margin requirements under those sections would not apply to a swap in which a counterparty: (1) qualifies for an exception from clearing under section 2(h)(7)(A) of the Commodity Exchange Act or section 3C(g)(1) of the Exchange Act (*i.e.*, a non-financial entity using the swap or security-based swap to hedge or mitigate commercial risk, certain small financial institutions, and captive finance companies);[20] (2) qualifies for an exemption from clearing under section 4(c)(1) of the Commodity Exchange

[18] 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.

[19] *See* draft final rule §§ __.3(d) and __.4(c) (pp. 241-42 of Attachment A).

[20] *See* 7 U.S.C. 2(h)(7)(A); 15 U.S.C. 78c-3(g).

Act for cooperative entities that would otherwise be subject to the requirement to clear;[21] or (3) satisfies the criteria for the affiliate exception from clearing pursuant to section 2(h)(7)(D) of the Commodity Exchange Act or section 3C(g)(4) of the Exchange Act for treasury affiliates. Further, section 303 requires the Agencies to implement the provisions of Title III by promulgating and seeking comment on a draft interim final rule.

The effect of the draft interim final rule is to grant an exemption from the margin requirements of the Agencies' margin rule for non-cleared swaps meeting certain criteria that covered swap entities enter into with certain "other counterparties" and certain financial end users. The draft final rule would retain the proposed rule's treatment of "other counterparties" for swaps with counterparties that are not exempt pursuant to TRIPRA, such as sovereign entities and multilateral development banks.

B. Initial Margin Requirements

The draft final rule would adopt the initial margin requirements largely as proposed, with some modifications as described below. The draft final rule would establish requirements with respect to the collection and posting of minimum initial margin amounts by a covered swap entity from and to its counterparties.[22]

1. Collecting and Posting

Consistent with the 2014 proposal, the draft final rule would establish a collect-and-post initial margin regime for all non-cleared swaps between a covered swap entity and a counterparty that is a swap entity or a financial end user with material swaps exposure.[23]

Several commenters recommended that the Agencies adopt a "collect only" approach under the final rule. Commenters representing public interest groups and asset managers supported the Agencies' approach, arguing that including a posting requirement not only would better protect financial end users from the failure of a covered swap entity but also would require a covered swap entity to be more accountable to the risks of their swaps business. A "collect-

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[21] *See* 7 U.S.C. 6(c)(1). The CFTC, pursuant to its authority under section 4(c)(1) of the Commodity Exchange Act, adopted 17 CFR 50.51 which exempts from required clearing certain swaps entered into by certain cooperatives.

[22] *See* draft final rule § __.3 (pp. 240-41of <u>Attachment A</u>).

[23] 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.

and-post" regime is an effective way to reduce overall systemic risk by providing initial margin to interconnected participants in the financial markets. Posting initial margin could forestall a build-up of potentially destabilizing exposures in the financial system. Accordingly, staff recommends that the final rule retain the collect-and-post regime.

C. Initial Margin Thresholds

1. Initial Margin Threshold

Generally consistent with the 2014 proposal and the 2013 international framework, the draft final rule would not require a covered swap entity to collect or post initial margin to the extent that the aggregate, un-margined exposure from or to its counterparty is below $50 million.[24] This threshold would apply on a consolidated basis to both the covered swap entity and the counterparty and each of their affiliates. The initial margin threshold amount of $50 million represents the amount recommended by the 2013 international framework (€50 million) adjusted for exchange rate fluctuations since the 2014 proposal.[25]

Under the draft final rule, the initial margin threshold applies on a consolidated entity level. It will be calculated across all non-exempted[26] non-cleared swaps between a covered swap entity and its affiliates and the counterparty and the counterparty's affiliates. Although some commenters suggested that the threshold should be implemented on an entity-by-entity basis and not on a consolidated basis, staff recommends that the final rule retain the threshold as applied on a consolidated basis because applying the threshold on a consolidated entity level precludes the possibility that counterparties could create legal entities and netting sets for the purpose of applying additional thresholds to evade margin requirements.

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[24] *See* draft final rule §§ __.2 and __.3 (pp. 235-36 and 240-41 of Attachment A).

[25] One commenter recommended that the $65 million initial margin threshold amount proposed in the 2014 proposal not be reduced in the final rule. At the time the Agencies issued the 2014 proposal, $65 million was broadly consistent with the euro denominated threshold recommended in the 2013 international framework. Given current exchange rates, staff recommends that the draft final rule reduce the dollar amount to be more consistent with prevailing exchange rates and to more closely align the U.S. rule with the 2013 international framework.

[26] To the extent that a non-cleared swap transaction is exempt from the margin requirements pursuant to § __.1(d), consistent with TRIPRA, the draft final rule excludes the exempted swap transaction from the calculation of the initial margin threshold amount.

Staff also recommends that the Agencies revise the definition of "affiliate" in a way that will address some concerns raised by commenters. The revised definition would use an accounting consolidation test rather than the proposed "control" test and should avoid some of the unintended over-inclusion problems raised by commenters.

D. Variation Margin Requirements

The draft final rule would adopt the variation margin requirements set forth in the 2014 proposal largely as proposed, but modifies certain aspects of the framework regarding the calculation and exchange of variation margin in response to comments. Consistent with the 2014 proposal, the draft final 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. Further, the draft final 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 entities and financial end users and would require the covered swap entity to collect or post variation margin on at least a daily basis for a period beginning on or before the business day following the day of execution and ending on the date the swap terminates or expires.[27]

E. Netting

Like the proposal, the draft final rule would permit a covered swap entity to calculate initial margin (using an initial margin model) or variation margin on an aggregate net basis across non-cleared swap transactions with a counterparty that are executed under an eligible master netting agreement (EMNA).[28] Although the proposal provided that the margin requirements would not apply to non-cleared swaps entered into before the rule's compliance dates, as a general rule, the proposal provided that if an EMNA covered non-cleared swaps that were entered into before the applicable compliance date, those non-cleared swaps would be

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[27] *See* draft final rule § __.4(b) (pp. 241 of Attachment A).

[28] This definition of EMNA in the draft final rule aligns with the definition of "qualified master netting agreement" in the banking agencies' regulatory capital rules. (*See* 12 CFR § 3.2, 12 CFR § 217.2, and 12 CFR § 324.2.) This alignment minimizes operational burden for a covered swap entity, which otherwise would have to make a separate determination as to whether its netting agreements meet the requirements of this rule as well as comply with the regulatory capital rules.

subject to the requirements of the rule and must be included in the aggregate netting portfolio for purposes of calculating the required margin.

Several commenters requested that the Agencies recognize existing market practice and permit covered swap entities and their counterparties to establish separate netting portfolios under a single EMNA. These separate netting portfolios are commonly covered by separate credit support annexes to the EMNA. The collection and posting of margin applies on an aggregate net basis separate from and exclusive of any other non-cleared swaps covered by the agreement.

Staff recommends that the Agencies adopt this change in the final rule and allow an EMNA to identify one or more separate netting portfolios that independently meet the requirement for close-out netting. This would allow the collection and posting of margin on an aggregate net basis for separate netting portfolios covered by an overall EMNA.[29] This rule would facilitate the ability of the parties to document two separate netting sets, one for non-cleared swaps that are subject to the final rule and one for swaps that are not subject to the margin requirements.

F. Eligible Collateral

1. Initial Margin

The draft final rule would include a list of eligible collateral that is largely consistent with the list described in the 2014 proposal. Eligible collateral for initial margin would include 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 redeemable government bond funds, certain corporate debt securities, certain listed equities, and gold.[30] Eligible collateral for

[29] Initial margin and variation margin amounts may not be netted against each other under the final rule. In addition, initial margin netting is only for the purposes of calculating the collection amount or posting amount under an approved initial margin model, and these amounts may not be netted against each other.

[30] A publicly traded debt security or 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* draft final rule § __.6(a)(2)(iv) and __.6(b)(5) (pp. 245 and 248 of Attachment A).

initial margin is restricted to liquid and high-quality assets with limited credit risk and is subject to robust collateral haircuts that will further reduce risk. Most commenters addressing initial margin eligible collateral generally supported the proposed categories or sought limited modifications. The draft final rule adds certain redeemable government bond funds to the list of eligible collateral.

2. Variation Margin

The 2014 proposal provided that only immediately available cash funds would satisfy variation margin requirements. Accordingly, the 2014 proposal would have limited eligible collateral for variation margin to cash denominated in either U.S. dollars or in the currency in which payment obligations under the swap are required to be settled.

Some commenters argued that limiting variation margin to cash would be inconsistent with current market practice for financial end users, incompatible with the 2013 international framework, and would burden financial end users by requiring them to hold more cash. Other commenters, however, supported the high level of liquidity afforded by the 2014 proposal's approach of permitting only cash as eligible collateral for variation margin in transactions between a covered swap entity and another swap entity.

Staff recommends that the draft final rule broaden the scope of eligible collateral for variation margin to address commenters' concerns for swaps between covered swap entities and financial end users. Some forms of collateral other than cash are highly liquid, and with appropriate haircuts, provide adequate protection. Moreover, the Dodd-Frank Act states that the prudential regulators shall permit the use of non-cash collateral as they determine to be consistent with preserving the financial integrity of markets trading swaps and preserving the stability of the United States financial system.

Under the draft final rule, eligible collateral for variation margin would depend on the type of counterparty the covered swap entity is facing. For swaps between a covered swap entity and another swap entity, eligible collateral for variation margin is limited to cash, consistent with the 2014 proposal. When a covered swap entity faces financial end user counterparties, however, a covered swap entity may exchange variation margin in any of the forms of collateral that the draft final rule would permit for initial margin (i.e., cash, gold, certain government bonds, corporate bonds, investment funds backed by sovereign bonds and certain listed equities).

Any non-cash collateral used for variation margin purposes would be subject to the same robust haircuts that are applied when it is used to satisfy initial margin requirements.

This change reflects the fact that swap entities already predominantly exchange variation margin with each other on a cash basis. Moreover, financial end users that hold significant amounts of non-cash assets that have less access to cash will be able to post certain types of non-cash collateral without having to raise significant amounts of cash. Accordingly, the liquidity cost of the requirements will be thereby reduced for financial end users.

G. Segregation Requirements and Collateral Rehypothecation

This draft final rule retains and expands on the collateral safekeeping requirements of the 2014 proposal. 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 draft final rule establishes minimum standards for the safekeeping of collateral by directing a covered swap entity to require that any collateral other than variation margin (even collateral not required by the final rule) that it posts be segregated at one or more custodians that are not affiliates of the covered swap entity or the counterparty (third-party custodian).[31] The draft final rule would also require a covered swap entity to place at a third-party custodian the initial margin it collects from a swap entity or financial end user with material swaps exposure in accordance with the rule. Further, like the 2014 proposal, the draft final rule generally would require that any custodial agreement prohibit the third-party custodian from rehypothecating, repledging, reusing or otherwise transferring (through securities lending or borrowing, repurchase agreement, reverse repurchase agreement, or other means), the funds or other property held by the custodian.[32]

Several commenters requested that custodians be permitted to continue the current market practice of holding cash collateral in a general deposit account rather than incurring the legal and operational burdens of segregating the cash in a trust or similar type of account. However, holding cash in a general deposit account would subject the posting party to the credit risk of the custodian. Instead, the draft final rule would permit cash to be posted as a general deposit for initial margin purposes for a limited period of time until the cash can be used to purchase a non-cash collateral asset.

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[31] *See* draft final rule § __.7(a) (pp. 251of Attachment A).

[32] *See* draft final rule § __.7(c) (pp. 251-52 of Attachment A).

H. Cross-Border Interactions

The Dodd-Frank Act applies margin requirements involving entities subject to U.S. regulation to swap transactions across different jurisdictions. Foreign swaps to which neither the counterparty nor the guarantor of the swap is a U.S. entity are not covered by the final rule.[33]

Reflecting the global nature of swap markets and the global participation in those markets by entities subject to the Dodd-Frank Act, the draft final rule would permit certain covered swap entities, including foreign banks, certain foreign subsidiaries of U.S. entities, and U.S. branches or agencies of foreign banks, to comply with a foreign regulatory framework for non-cleared swaps regardless of the location of the counterparty if the Agencies determine that such foreign regulatory framework is comparable to the requirements of the draft final rule, provided that the covered swap entity's obligations under the swaps are not guaranteed by a U.S. entity.[34] The draft final rule would also allow U.S. covered swap entities to defer to certain aspects of a foreign regulatory requirement. Specifically, if a foreign counterparty is subject to a foreign regulatory framework that has been determined to be comparable by the Agencies, the draft final rule would provide that a U.S. covered swap entity's posting requirement would be satisfied by posting what is required by the foreign counterparty's margin collection requirement, provided that the counterparty's obligations under the swaps are not guaranteed by a U.S. entity.[35]

In the context of cross-border swaps, a number of commenters contended that some foreign jurisdictions where U.S. entities conduct swaps do not have a legal structure that would support segregation of collateral, as would have been required to comply with the 2014 proposal. These commenters suggested that covered swap entities be allowed to conduct a certain amount of swap activity in foreign jurisdictions that do not have rules governing swap margin requirements without having to comply with the U.S. margin requirements. These commenters claimed that an exemption for transactions in these foreign jurisdictions was necessary to ensure that U.S. firms could continue to provide financial services to their clients and counterparties in these foreign jurisdictions.

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[33] *See* draft final rule § __.9(a) (pp. 259 of Attachment A).

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

[35] *See* draft final rule § __.9(d)(4) (pp. 261-62 of Attachment A).

Allowing covered swap entities to engage in unchecked swap transactions in jurisdictions lacking the basic legal framework required to comply with the rule would allow a covered swap entity to be exposed to risk from swap activities in certain foreign jurisdictions, primarily in emerging foreign markets. At the same time, there may be benefits to the covered swap entity in maintaining a diverse set of client relationships across an array of jurisdictions.

Accordingly, staff recommends that the draft final rule modify the 2014 proposal to permit a covered swap entity to engage in swap transactions in a jurisdiction that does not have the legal infrastructure required to comply with the rule if the covered swap entity obtains the consent of its primary regulator to engage in such transactions, and collects all required margin (both initial and variation margin) in cash. Additionally, in these cases, a covered swap entity would not be required to post any initial margin to the counterparty. This approach provides covered swap entities with the opportunity to maintain client relationships in certain jurisdictions without incurring undue risks as a result.

I. Affiliate Transactions

The 2014 proposal would have required collect-and-post margin requirements for all non-cleared swaps between a covered swap entity and its affiliates that are swap entities or financial end users.

Commenters generally were critical of this aspect of the proposal. Specifically, many commenters argued that requiring margin generally, and initial margin in particular, on all inter-affiliate swaps was unnecessary for systemic stability. These commenters asserted that inter-affiliate swaps often are conducted for internal risk management reasons and do not increase the overall risk profile or leverage of the group. As a result, commenters argued that requiring margin on inter-affiliate swaps could discourage effective risk-management and could be inconsistent with sections 23A and 23B of the Federal Reserve Act.

Staff recommends that covered swap entities be required to collect initial margin from their affiliates. However, the requirements of the Dodd-Frank Act that the Agencies adopt margin requirements that "help ensure the safety and soundness of the swap dealer or major swap participant," which in the case of the banking agencies is generally a bank, do not require full application of the margin requirements to transactions with affiliates. Accordingly, staff is recommending that a covered swap entity be allowed to adopt an initial margin threshold of up to \$20 million for each affiliate counterparty. In addition, staff recommends that a covered swap entity not be required to post initial margin to its affiliate (unless the affiliate has an independent requirement to collect margin). For financial end user affiliates, a covered swap entity should be required to calculate the amount that it would have been required to post to a non-affiliate financial end user and provide that information to the affiliate on a daily basis.

Notwithstanding the risk management benefits of inter-affiliate swaps discussed by commenters, affiliate swap transactions pose risk to the covered swap entity and fully exempting affiliate transactions from any initial margin requirements is inconsistent with the requirements of section 731 and 764 of the Dodd-Frank Act. Requiring covered swap entities to collect initial margin from their affiliate counterparties will protect the safety and soundness of covered swap entities. Also, requiring the covered swap entity to report the amount of initial margin that would be posted to the affiliate will make the resulting risks transparent to both parties and will incentivize strong risk management. Finally, a $20 million initial margin threshold provides a simple and transparent means by which covered swap entities can extend unsecured credit to their affiliates and will limit the liquidity costs of the requirement.

Staff also recommends allowing a covered swap entity to use an affiliated bank to act as custodian for non-cash initial margin rather than requiring a third-party custodian. Requiring the use of a third-party custodian to hold collected non-cash collateral raises the costs of such transactions and exposes the group to a degree of credit risk. However, under the draft final rule, no aspect of the arrangement may compromise or condition the restrictions on treatment of initial margin collateral, including the segregation and rehypothecation requirements or the covered swap entity's interests in the collateral.

In addition, staff recommends that the margin requirements reflect the fact that certain inter-affiliate swaps will be conducted on a non-cleared basis because of an explicit exemption from a clearing requirement. Under the 2014 proposal, all inter-affiliate swap transactions were required to have their initial margin requirements set in a manner consistent with a 10-day replacement horizon which is appropriate for swaps that are not cleared by a CCP. A number of commenters contended that a significant number of inter-affiliate swaps are eligible for clearing but are conducted as non-cleared swaps because of a specific exemption from clearing requirements. These swaps are more highly standardized and liquid than swaps that are not eligible for an exemption from clearing. Moreover, cleared swaps are typically margined on a 5-day, rather than 10-day basis. reflecting their greater liquidity. Accordingly, staff recommends that for inter-affiliate swaps that would otherwise be subject to clearing, covered swap entities may calculate initial margin according to a 5-day rather than 10-day, standard which generally has the effect of reducing the margin requirements by roughly 30 percent.

J. Capital Requirements

Consistent with the 2014 proposal, and because existing regulatory capital rules already specifically take into account and address the unique risks arising from derivatives transactions and activities, the draft final rule would require that covered swap entities comply with the existing regulatory capital regime that is already applicable to those entities as part of their prudential regulation. The Federal banking agencies implemented the market risk capital framework and the regulatory capital framework reforms in 2013, which strengthened the capital requirements for non-cleared derivatives.[36]

Impact of Margin Requirements

To the extent the draft final rule includes the provisions described above, the initial margin requirements would represent a material change to current market practice.[37] The Federal Register notice accompanying the final rule discusses the quantitative impact of the proposed margin requirements based on studies by the BCBS and IOSCO and the International Swaps and Derivatives Association (ISDA), which estimates the total amount of initial margin that will be required in third party swap transactions. Assuming all initial margin requirements were effective as proposed, the ISDA study estimates a U.S. model-based initial margin requirement of approximately $280 billion, and the BCBS and IOSCO study estimates a U.S. model-based initial margin requirement of approximately $315 billion. The economic cost associated with financing these margin amounts ranges from $600 million to $4 billion per year.

The draft final rule would also require initial margin on inter-affiliate swaps, which would result in additional costs. The costs of the inter-affiliate margin requirements are more difficult to quantify. However, estimates derived from margin estimates provided by commenters suggest that the additional requirements would increase the total costs by less than

[36] *See* draft final rule § __.12 (pp. 268 and 278-79 of Attachment A).

[37] Though the draft final rule also would require variation margin be exchanged between a covered swap entity and certain counterparties, the marginal impact of this requirement would likely 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.

fifty-percent relative to the amount required by covered swap entities on third-party swap transactions. Overall, it should be noted that any cost estimates associated with the requirements depend on a variety of factors that are difficult to forecast, including the behavior of swap market participants that are subject to the requirements. As a result, any cost estimates should be considered cautiously as the actual costs could be substantially lower or higher than those that have been estimated.

While these margin requirements will result in some costs that have been described above, margin requirements will also bring about a number of important financial stability benefits. First, both variation and initial margin requirements will promote safety and soundness by incentivizing strong risk management as covered swap entities and their counterparties bear direct costs associated with their swap activities that are scaled to their riskiness. Accordingly, covered swap entities and their counterparties will have strong incentives to dynamically evaluate whether the underlying swap activities are appropriate for their organizations as well as the size and significance of the activities' risk management benefits. Second, robust margin requirements will forestall the build-up of risk that can occur over long periods of time and are often quickly realized and add to growing instability during periods of financial stress. In addition, and importantly, margin requirements will give third parties a well-founded assurance that the default of a significant swap counterparty can be handled without materially impairing the viability of the non-defaulting counterparty. As a result, third parties and others will have less of an incentive to pull back from swap dealers and significant swap counterparties during periods of financial stress. This, in turn, will reduce the chances that contagion fears spread throughout the financial system during a period of financial stress. As a result, the amount of systemic risk that swap activities pose to the broader economy will be significantly reduced as a result of these margin requirements.

CONCLUSION:

For the reasons discussed above, staff recommends that the Board approve the attached draft materials. Staff also requests delegated authority to make minor and technical changes to the attached materials (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). In addition, staff recommends that the Board delegate authority to the Director of the Division of Banking Supervision & Regulation (who may then sub-delegate to members of his staff) to approve internal margin models for entities for which the Board is the prudential regulator, in accordance with section __.8 of the draft final rule.

Attachments