Date: June 18, 2020
To: Board of Governors
From: Staff
Subject: Final Rule to amend Regulation KK (Margin and Capital Requirements for Covered Swap Entities) and Interim Final Rule to Extend the Implementation Deadline

ACTIONS REQUESTED

Staff requests Board approval of (1) the attached draft interagency final rule to amend the swap margin provisions of the Board’s Regulation KK2 and (2) the attached draft interagency interim final rule to delay the implementation of initial margin requirements for the final two phases of the swap margin rule as a result of the coronavirus response. Following completion of the Board vote on these two matters, this Board memorandum, the final rule and interim final rule, and Federal Register notice will be posted to the Board's public website.

The final rule would be issued jointly by the Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency (agencies) once they have completed their internal review and approval procedures and would become effective upon its publication in the Federal Register. Staff also requests authority to make technical, non-substantive changes to the attached draft materials prior to publication in the Federal Register.

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1 Michael Gibson, Anna Lee Hewko, Constance Horsley, David Lynch, Elizabeth MacDonald, John Feid, and Lesley Chao (Division of Supervision and Regulation); Mark Van Der Weide, Stephanie Martin, Patricia Yeh, Jason Shafer, and Justyna Bolter (Legal Division).
2 12 CFR part 237.
EXECUTIVE SUMMARY

- In November 2019, the agencies jointly proposed certain revisions to the swap margin rule, which requires certain entities to collect and post collateral when they engage in swaps not cleared by a central counterparty.

- The proposed rule\(^3\) included changes to address implementation challenges presented by market developments and encourage prudent risk-management practices by swap entities. The proposal would have:
  - Removed the requirement that inter-affiliate swaps -- swaps between affiliates of the same banking organization -- be subject to initial margin;
  - Allowed certain amendments to legacy swaps relating to transition to alternative reference rates without triggering regulatory consequences;
  - Provided additional time for smaller counterparties to come into compliance with margin requirements; and
  - Clarified the timing of documentation requirements.

- The draft final rule is generally consistent with the proposal, with a few changes described below.

- Additionally, in light of the coronavirus response measures, the draft interim final rule would further extend the implementation deadline for initial margin requirements with the smallest and least complex counterparties by one year, consistent with international implementation timelines.

- The draft final rule and the interim final rule will be effective 60 and 61 days, respectively, after publication in the Federal Register.

DISCUSSION

A. Background on the Swap Margin Rule

In November 2015, the agencies issued the swap margin rule, which requires a covered swap entity to collect and post initial margin for swaps that are not centrally cleared (non-cleared swaps). A covered swap entity must collect and post variation margin for non-cleared swaps

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\(^3\) 84 FR 59970 (Nov. 7, 2019).
with all swap entities and financial end user counterparties. Beginning March 1, 2017, all covered swap entities were required to comply with the variation margin requirements for swaps entered into on or after that date. Initial margin requirements phase in from September 1, 2016, to September 1, 2020.

B. Final Rule Amendments to the Swap Margin Rule

(1) Amendment of inter-affiliate initial margin requirements

The proposed rule in November 2019 would have eliminated the requirement that affiliates within the same banking organization be subject to initial margin requirements when entering into non-cleared swaps, while retaining the variation margin requirement. This change would further align the requirements for interaffiliate initial margin across market regulators.4 The proposed amendment of inter-affiliate initial margin requirements received the largest number of comments. A number of commenters supported the elimination of inter-affiliate initial margin requirements, whereas other commenters opposed this aspect of the proposal. Commenters opposed the change on a number of legal and policy grounds. Some of these commenters asserted that the Dodd-Frank Act requires initial margin and variation margin on all non-cleared swaps entered into by a covered swap entity, and thus the agencies lacked authority to eliminate inter-affiliate margin requirements. Some commenters asserted that the proposal would increase risks to individual covered swap entities and overall financial stability. Other commenters, however, asserted that the proposal would facilitate inter-affiliate swaps, which are an important centralized risk management tool for banking groups, and suggested that the risks

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4 The Dodd-Frank Act requires that the swap margin rules of the agencies and the U.S. market regulators be “comparable.”
of inter-affiliate swaps are better addressed through other means, such as capital requirements, credit risk limits, and variation margin requirements.

Inter-affiliate swaps are typically used by banking organizations to transfer risk to a centralized risk-management function. Such risk-management practices generally improve the safety and soundness of a banking organization. Importantly, risks associated with non-cleared swaps entered into between U.S. banks and their affiliates are addressed under multiple supervisory and regulatory frameworks. For example, non-cleared swaps entered into between U.S. banks and their affiliates will continue to be subject to resolution planning requirements and regulatory capital requirements. Importantly, a bank’s regulatory capital requirements generally will increase to reflect the lack of initial margin on its swaps with affiliates.

Section 165(d) of the Dodd-Frank Act generally requires bank holding companies with more than $250 billion in total consolidated assets to have a plan for the rapid and orderly resolution of the bank holding company in the event of material financial distress or failure. In connection with this requirement, some bank holding companies have determined to pre-position capital and liquidity at material entities and to maintain supplemental resources in a central location that could be down-streamed to material entities to continue critical operations in the event of bankruptcy. The Board and the FDIC also have issued guidance applicable to the resolution plans of the largest bank holding companies; the guidance includes information on the treatment of inter-affiliate derivative exposures in the resolution context. These provisions are

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6 E.g., Guidance for § 165(d) Resolution Plan Submissions by Domestic Covered Companies, 84 Fed. Reg. 1438 (February 4, 2019).
specifically tailored to address risks arising from transactions, including non-cleared swaps, between banks and their affiliates.

In a change from the proposal, the draft final rule includes a requirement to ensure that depository institutions’ inter-affiliate swap exposures are not sizeable in relation to their loss absorbing resources. In particular, an insured depository institution will be required to collect initial margin from any affiliate should the depository institution’s aggregate amount of calculated inter-affiliate initial margin exposure exceed 15 percent of its tier 1 capital (“15 percent tier 1 threshold”). After the 15 percent tier 1 threshold is exceeded, the depository institution must collect initial margin on any new trades executed with any affiliate. The collected initial margin would be subject to the segregation requirements of the swap margin rule.

The draft final rule fully exempts foreign firms -- including foreign banks, their non-U.S. subsidiaries, and their U.S. branches and agencies -- from the requirement to collect initial margin from their affiliates (even if beyond the 15 percent tier 1 threshold). This would align the U.S. initial margin collection requirement for the foreign firms with the laws of their home counties.

Although the final rule exempts non-cleared swaps between a bank and its affiliates from the initial margin requirements of the swap margin rule under the conditions described above, swaps between a bank and its affiliates are also subject to sections 23A and 23B of the Federal Reserve Act and the Board’s Regulation W. The notice for the final rule would contain a statement from the Board with respect to the applicability of sections 23A and 23B and Regulation W to certain non-cleared swaps to reflect the following:

Under section 23A, bank-affiliate derivatives generally can be valued at the bank’s current exposure to the affiliate. Accordingly, a bank must collect variation margin from its
affiliates to cover its current exposure on bank-affiliate derivatives but generally is not required to collect initial margin to cover the bank’s potential future exposure on the transactions.

Under section 23B, a bank’s swaps with its affiliates must be on terms and conditions that are substantially the same, or at least as favorable to the bank, as those prevailing at the time for comparable transactions with third parties. Some cases of specific bank-affiliate swap arrangements without initial margin could raise issues under 23B; however, in many other cases, it is reasonable to conclude that a bank-affiliate swap with no initial margin requirement is at least as favorable to the bank as a comparable bank-nonaffiliate swap with two-way initial margin requirements. This conclusion can be supported by relevant facts for the section 23B analysis such as the relative creditworthiness of a bank vs its affiliate, whether the bank-affiliate swap portfolio is more likely to create potential future exposure of the bank to the affiliate or vice versa, and whether or not the affiliate requires initial margin from the bank under the swap arrangement.

(2) Legacy Swaps

A. Permitted amendments to replace an Interbank Offered Rate (IBOR)

Legacy swaps entered into prior to the applicable compliance date are not subject to the swap margin rule. A legacy swap that is amended after the applicable compliance date, however, would generally become subject to the swap margin rule. Due to the potential discontinuation of the London Interbank Offered Rate (LIBOR) and other IBORs, the draft final rule would add, as proposed, a provision to the swap margin rule that identifies specific IBOR-related changes that may be made to a legacy swap without altering the swap’s legacy status. This change to the

7 See 12 CFR 237.1(e).
swap margin rule is consistent with the March 5, 2019, statement of the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO), which asked jurisdictions to consider permitting amendments to legacy swaps resulting from the potential discontinuation of an IBOR. Consistent with the proposal, the draft final rule would permit amendments that are made solely to accommodate the replacement of an IBOR or any other interest rate benchmark that a covered swap entity reasonably expects to be discontinued or reasonably determines has lost its relevance as a reliable benchmark due to a significant impairment.

A number of additional contractual changes could be necessary to maintain the economics of the non-cleared swap after a rate has been replaced, and the draft final rule would permit those ancillary changes, such as the addition of a credit or market risk spread or change in term structure. However, the flexibility being provided for rate replacement purposes could not be expansively applied to encompass unrelated changes to a legacy swap.

B. Permitted amendments due to portfolio compression exercises, technical changes, and notional reductions

As with the proposed rule, the draft final rule would permit the continued legacy status of legacy swaps that have been modified as part of certain portfolio compression exercises that reduce gross exposures among parties and are used as a risk management tool. In addition to providing overall risk management benefits, permitting compression exercises for legacy swaps could reduce the operational burden associated with IBOR replacements.

In addition, the draft final rule would identify certain routine industry amendments that may be made to a legacy swap over its lifetime without altering its legacy status. The permitted amendments are those that are carried out for logistical reasons or risk-management purposes and do not raise concerns that the covered swap entity is seeking to evade or otherwise delay the
application of margin requirements or change the economic characteristics of the non-cleared
swap. The draft final rule would also retain the legacy status of a non-cleared swap that has been
amended solely in order to reduce the notional amount, without altering other terms of the
original swap.

(3) Additional compliance date for initial margin requirements

The draft final rule would adopt the proposed changes to the phase-in schedule for initial
margin requirements. In addition, the attached draft interim final rule would give covered swap
entities an additional year to implement initial margin requirements for certain smaller
counterparties in recognition of the challenges arising from the coronavirus.

Banking entities have raised concerns about the operational challenges associated with
beginning to exchange initial margin with the large number of relatively small counterparties
encompassed in the swap margin rule’s “phase five.” In recognition of these difficulties, the
BCBS and IOSCO revised the international framework in July, 2019 to permit an additional
sixth phase-in period for smaller counterparties. The draft final rule would likewise amend the
swap margin rule’s compliance schedule to add a sixth phase of compliance for certain smaller
counterparties that are currently subject to “phase five.”

In light of the coronavirus dislocations, the BCBS and IOSCO announced in April 2020,
a delay of the “phase five” and “phase six” compliance dates for one year. The attached draft
interim final rule, together with the draft final rule, would align the swap margin rule with the
international compliance dates. This extension would give covered swap entities additional time
to meet their initial margin requirements under the rule so as not to hamper any efforts underway
to address exigent circumstances caused by the coronavirus response measures.

The draft final rule would require compliance by September 1, 2021, for counterparties
with an average daily aggregate notional amount (AANA) of non-cleared swaps ranging from
$50 billion up to $750 billion, while the compliance date for all other covered counterparties (with an AANA ranging from $8 billion up to $50 billion) would be extended to September 1, 2022.

(4) Documentation requirements

A covered swap entity must collect or post initial margin under the swap margin rule when it calculates an initial margin amount for a counterparty that exceeds a specified initial margin threshold amount. To remove an existing ambiguity in the rule, the draft final rule would clarify that a covered swap entity is not required to execute initial margin trading documentation with a counterparty prior to the time that it is required to collect or post initial margin with the counterparty under the swap margin rule. This change to the swap margin rule would be consistent with the March 5, 2019, statement from the BCBS and IOSCO, which clarified that the relevant documentation requirements must be in place only at the time the initial margin threshold is exceeded and parties begin to exchange initial margin.

(5) Brexit Interim Final Rule

The agencies issued an interim final rule in March 2019 to provide certainty for covered swap entities as they prepare for the United Kingdom leaving the European Union, also known as Brexit. The interim final rule provided a covered swap entity with the ability to continue to
service its cross-border clients in the event that the UK withdraws from the EU without a Withdrawal Agreement. The draft final rule would include this provision.

(6) Commodity Futures Trading Commission (CFTC) Consistency

The draft final rule also would include an interpretation related to the swap margin rule’s exemption for commercial and cooperative end users that qualify for the Dodd-Frank Act exemption from clearing. The CFTC has issued no-action relief that protects the clearing exemption for end users that make LIBOR-related amendments to their swaps under certain conditions. The preamble to the draft final rule would state that the Board and the other prudential regulators will continue to treat commercial and cooperative end user swaps as exempt under the swap margin rule if their swap amendments are consistent with the terms of the applicable CFTC no-action letters.

RECOMMENDATION

Staff recommends that the Board approve the attached draft Federal Register notices setting forth the attached (A) final rule, and (B) interim final rule. Staff also requests authority to make technical, non-substantive changes to the attached draft materials prior to publication in the Federal Register.

Attachments

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8 A Withdrawal Agreement between the UK and EU was ratified in January 2020. The Withdrawal Agreement addresses certain EU-related matters that will immediately be affected by the withdrawal itself and a transition period. The transition period will run until December 31, 2020, and could be extended by one or two years.

9 Id. The agencies’ determination would be specific to these two CFTC no-action letters, and more specifically to section V.A. of CFTC Letter No. 19-28 and section E.1. of CFTC Letter No. 19-26. The agencies would not apply CFTC no-action letters to modify the terms of the swap margin rule in any other regard.