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Proposed Margin Requirements for Uncleared Swaps

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Federal banking regulators (the Prudential Regulators)[1] and the Commodity Futures Trading Commission (the CFTC) have separately proposed regulations to require certain dealers and major participants in the swap and security-based swap markets to collect initial and variation margin for uncleared swaps.[2] The express purpose driving both sets of proposals is to establish "margin requirements for uncleared swaps that are at least as stringent as those for cleared swaps" because uncleared swaps are riskier than cleared swaps.[3]

The proposals go far beyond current over-the-counter (OTC) collateral practices by:

1. imposing initial margin for all uncleared swaps exposure except for certain low-risk counterparties (compared to the relatively infrequent use of the corresponding "independent amounts" concept in International Swaps and Derivatives Association (ISDA) and other master agreements);
2. restricting margin to cash, U.S. Treasuries and, for initial margin only, government agency securities (compared to today's broader acceptance of collateral such as letters of credit, equity pledges and asset pledges);
3. requiring significantly larger amounts of margin than for cleared contracts; and
4. requiring initial margin posted by most dealers and major participants to be held by independent, third-party custodians with restrictions on rehypothecation and reinvestment.

The Prudential Regulators' proposal would apply to all dealers and major participants (Covered Swap Entities or CSEs) that are regulated by a Prudential Regulator (PR CSEs). The CFTC proposal would apply to swap dealers and major swap participants that are not PR CSEs (CFTC CSEs). A number of CSEs who initially are subject to the Prudential Regulator uncleared swaps margin requirements may, over the next few years, become subject instead to the CFTC requirements as a result of the Dodd-Frank "pushout" provision.[4]

A. Basic Questions About Uncleared Margin

1. What will be considered an "uncleared swap"? The proposals would apply to swaps that are not cleared by a derivatives clearing organization registered with the CFTC (DCO) or a clearing agency registered with the Securities and Exchange Commission (SEC).

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1 The Prudential Regulators are the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Farm Credit Administration (FCA) and the Federal Housing Finance Agency (FHFA).

2 CFTC Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, Notice of Proposed Rulemaking, 76 Fed. Reg. 23,732 (Apr. 28, 2011). The official Federal Register releases for the Prudential Regulators were not yet available at the time this summary was drafted.

3 CFTC Proposal, 76 Fed. Reg. at p. 23,734; *see also* Prudential Regulators' Proposal at p. 10. Unless otherwise specified, the term "swap" will refer generically to all swaps and/or security-based swaps.

4 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) § 716, which will push many swap dealers or security-based swap dealers into separately capitalized non-bank affiliates that, after a transition period, will come under the jurisdiction of the CFTC and/or the SEC and will no longer be subject to the jurisdiction of their respective Prudential Regulators.

2. Will the kind of counterparty matter? Yes. Margin requirements would vary based on the identity of the counterparty: (1) dealers or major participants, (2) financial end users, and (3) non-financial end users.[5]

3. How will initial margin be calculated? PR CSEs will be able to use a look-up table compiled by the Prudential Regulators. CFTC CSEs will be able to use a multiple of the initial margin required for a similar cleared futures or cleared swaps contract. Alternatively, any CSE can use an initial margin model approved by its regulator.

4. What kinds of collateral can be posted? Required margin would be limited to cash and U.S. Treasuries and, for initial margin only, senior debt obligations of certain government-sponsored entities (with specified haircuts for non-cash collateral). In all cases, a CSE would only have to collect margin when the amount of the payment exceeds $100,000.

5. Can CSEs ask for additional margin? Yes. CSEs would be required to document credit support arrangements with all counterparties and could impose more stringent margin requirements than those prescribed by the rules (generally without restrictions on the types of collateral that can be used for this additional margin).

6. What about third-party custodians? Initial margin *posted* by a CSE to a dealer or major participant would be required to be held by an independent third-party custodian located in a jurisdiction that applies the same insolvency regime as would apply to the CSE. The custodian could not rehypothecate or transfer the collateral, except to reinvest collateral in the permitted kinds of collateral. Under Dodd-Frank, all other counterparties will have the option to require a CSE to segregate initial margin posted by the counterparty (the CFTC also explicitly includes the option in its proposed rules).[6] There are no similar segregation requirements for variation margin.

B. Proposed Margin Counterparty Categories

1. Counterparty Category 1: CSE to Another Dealer or Major Participant

Both PR CSEs and CFTC CSEs would be required to collect initial margin at the time they enter into a swap with another dealer or major participant and daily variation margin.[7] (The CFTC proposal would apparently not include swaps between a CFTC CSE and a security-based swap dealer or major security-based swap participant in this category.) No thresholds would be permitted and initial margin obligations between counterparties could not offset one another.

While the rules would not explicitly require CSEs to *post* margin, their practical effect will be two-way margin requirements for swaps between a CSE and another dealer or major participant. This is because the counterparty dealer or major participant will itself be required to collect margin, either by its Prudential Regulator, the CFTC or presumably the SEC (which also is expected to propose margin rules for uncleared security-based swaps).

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5 The Prudential Regulators, but not the CFTC, propose a very narrow exception for swaps between a foreign PR CSE and a counterparty that is not a U.S. entity, not a branch of a U.S. entity, and not guaranteed by an affiliate that is a U.S. entity or branch of a U.S. entity.

6 Dodd-Frank §§ 724 (swaps) and 736 (security-based swaps).

7 The CFTC states in the preamble that Category 1 would include swaps between a CFTC CSE and another CFTC CSE or PR CSE. 76 Fed. Reg. at p. 23,735. The proposed rules, however, describe Category 1 counterparties as "swap dealers and major swap participants," both of which are defined in the proposal as entities *not* regulated by a Prudential Regulator.

2. Counterparty Category 2: CSE to Financial End User

The proposals divide financial end users into high-risk and low-risk groups (although the CFTC does not define separate groups, its proposal would effectively impose the same requirements). A CSE would be required to collect initial margin and daily variation margin from financial entities. For low-risk financial users, a CSE could adopt credit-based thresholds below which it would not have to collect initial or variation margin.

Financial end users (which the CFTC calls "financial entities") would be commodity pools or private funds (both foreign and domestic), ERISA plans, persons engaged in the business of banking or activities that are financial in nature, foreign governments and any other persons the agencies may designate.[8]

A "low-risk financial end user" would:

1. not have significant swaps exposure;[9]
2. predominantly use swaps to hedge or mitigate business risks, including balance sheet and interest rate risks; *and*
3. be subject to capital requirements established by a Prudential Regulator or state insurance regulator.

A low-risk financial end user only would be required to post initial and variation margin that exceeds credit-based thresholds determined by the CSE. The Prudential Regulators would require the PR CSE to determine these thresholds in accordance with the PR CSE's credit approval processes. In any case, the thresholds would be limited to the lesser of an absolute amount (between $15 million and $45 million) or a percentage of the CSE's regulatory capital (between 0.1 percent and 0.3 percent of Tier 1 regulatory capital).

A "high-risk financial end user" would be a financial end user that is not a "low-risk financial end user." Initial margin and daily variation margin requirements for high-risk financial end users would be the same as the first counterparty category.

3. Counterparty Category 3: CSE to Non-Financial End User

A PR CSE would be required to collect initial margin and *weekly* variation margin. However, the Prudential Regulators' proposal allows a PR CSE to establish credit-based thresholds for initial and variation margin for each non-financial end user in accordance with the PR CSE's credit approval processes. Unlike the thresholds for financial end users, the Prudential Regulators do not propose any limits on the thresholds for non-financial end users. The ability to grant unlimited thresholds could result in certain non-financial end users never posting margin.

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8 The proposals generally follow the statutory definitions of a "financial entity" that is ineligible to use the end user exemption from the clearing mandate in Dodd-Frank §§ 723 and 763, except that the regulators' definitions do not specifically include dealers and major participants and add foreign entities that would be commodity pools and private funds if organized in the U.S., foreign governments and a catchall category to designate additional entities.

9 The proposed "significant swaps exposure" would be $2.5 billion in daily average aggregate uncollateralized outward exposure, or $4 billion in daily average aggregate uncollateralized outward exposure plus daily average aggregate potential outward exposure (and, for security-based swaps, $1 billion and $2 billion, respectively). The exposure levels are lower than the rate swap exposure levels that would make an entity a major swap participant (MSP) under the CFTC's MSP proposal, but greater than the MSP exposure levels proposed by the CFTC for other types of swaps. *See* Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant," Joint Proposed Rule, 75 Fed. Reg. 80,174, 80,213 (Dec. 21, 2010). However, the exposure test here would include exposure from all swaps, even those used to hedge or mitigate commercial risk or those held by certain pension plans to hedge or mitigate risk (both of which are excluded in the CFTC's proposed tests for MSPs).

The CFTC proposal expressly states that CFTC CSEs would not be required to collect margin from non-financial entities. Any margin required from a non-financial entity would be left to the discretion of the counterparties as set forth in their credit support agreement.

C. Proposed Margin Calculations

1. Initial Margin Calculation

The Prudential Regulators propose two alternative methods for calculating initial margin: (1) a "look-up" table based upon notional value (requiring as much as 20 percent of the notional exposure of a commodity swap) that does not consider portfolio offsets; or (2) an approved internal initial margin model.

There would be extensive requirements for initial margin models, such as basing potential future exposure on a 99 percent confidence interval for a 10-day period (compared to the current practice of using a three-day to five-day period for cleared derivatives). Initial margin models could consider portfolio offsets for swaps within the same risk category — commodity, credit, equity or foreign exchange/interest rate — that are governed by the same netting agreement (*e.g.*, an ISDA). Models that permit portfolio margining would be required to consider only swaps entered into after the effective date of the rules or *all* swaps entered into both before and after the effective date of the rules.

The CFTC proposes two different alternatives for calculating initial margin. Initial margin could be a multiple of the margin required for a similar cleared swap or a cleared futures contract if there is no similar cleared swap (2.0 for similar cleared swaps or 4.4 for similar cleared futures contracts). Portfolio offsets would generally be permitted within the same asset class.[10]

Alternatively, CFTC CSEs could use an initial margin model that: (1) is used by a DCO; (2) is used by a PR CSE; or (3) is made available for licensing to any market participant by a vendor. The CFTC's standards for initial margin models are similar to those proposed by the Prudential Regulators, but would not allow models to be proprietary models or to incorporate pre-enactment swaps in portfolio margin calculations.

One potential consequence of regulators adopting alternatives for calculating initial margin is that, for inter-dealer swaps, each CSE could impose significantly different initial margin requirements on the other CSE simply because each chooses a different method (*e.g.*, a PR CSE using the lookup table while its CSE counterparty uses a margin model).

2. Variation Margin Calculation

Prudential Regulators define variation margin to be the periodic change in value of the swap from the date of execution less the value of all previously collected variation margin. Calculations may consider netting agreements so long as the calculation includes *all* swaps governed by the netting agreement, including pre-enactment swaps. The Prudential Regulators' proposed rules do not address the return of variation margin. The CFTC proposes the more typical "mark-to-market" view of variation margin as the change in value from the previous time the position was marked to market, calculated in accordance with the terms of the parties' credit support arrangements, subject to certain minimum requirements.

The Prudential Regulators' comment period closes June 24, 2011. The CFTC comment period closes June 27, 2011.

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10 The CFTC defines eight asset classes: agricultural, credit, currency, energy, equity, interest rate, metals and other. Portfolio offsets may be applied between the currency and interest rate asset classes.

Proposed Margin Requirements for Uncleared Swaps

Counterparty Type	Initial Margin	Initial Margin Segregation (Third-Party Custodian)	Variation Margin	Counterparty Thresholds (Initial and Variation)	Calculating Initial Margin	Acceptable Collateral
Dealer or major participant **(assuming SEC proposes comparable rules)**	CSE must collect (two-way requirement)	Required in all cases	CSE must collect daily (two-way requirement)	Zero	**PR CSE**: Look-up table (with no offsets) or model that can include pre-enactment swaps and portfolio offsets **CFTC CSE**: Multiple of margin for comparable cleared contract (with portfolio offsets) or non-proprietary model that cannot include pre-enactment swaps	Cash and US Treasuries. Certain government-sponsored entity obligations for initial margin only
High-risk financial end user/entity	CSE must collect	Option of financial end user/entity	CSE must collect daily	Zero	Same as above	Same as above
Low-risk financial end user/entity	CSE must collect, subject to thresholds	Option of financial end user/entity	CSE must collect daily, subject to thresholds	**PR CSE**: Credit exposure limit set by PR CSE, subject to maximum dollar amount or percentage of PR CSE's regulatory capital **CFTC CSE**: Per credit support arrangement, subject to maximum dollar amount or percentage of CFTC CSE's regulatory capital	Same as above	Same as above
Non-financial end user/entity	**PR CSE**: Must collect, subject to thresholds **CFTC CSE**: Per credit support arrangement	Option of non-financial end user/entity	**PR CSE**: Must collect weekly **CFTC CSE**: Per credit support arrangement	**PR CSE**: Credit exposure limit set by PR CSE **CFTC CSE**: Per credit support arrangement	**PR CSE**: Same as above **CFTC CSE**: Per credit support arrangement	**PR CSE**: Same as above **CFTC CSE**: Any form that can be reasonably valued on a periodic basis