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Banking Agencies Finalize Margin and Capital Requirements

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Recently five federal agencies, The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency (collectively, the Agencies), issued much-anticipated joint final rules (the Final Rules) that establish minimum margin and capital requirements for registered swap dealers, major swap participants, security-based swap dealers and major security-based swap participants (Swap Entities) for which one of the Agencies is the prudential regulator (Swap Entities regulated by one or more of the Agencies are referred to as Covered Swap Entities). The Final Rules are substantially similar in many respects to the most recently proposed margin and capital rules issued by the Agencies in September of 2014 (the 2014 Proposed Rules), but there are some differences as well, including with respect to eligible collateral.

The Final Rules with respect to margin (the Final Margin Rules) address, among other things, initial margin (IM) and variation margin (VM) requirements for non-cleared swaps^[1] entered into by Covered Swap Entities. All of the direct regulatory burden of the Final Margin Rules applies to the activities of Covered Swap Entities; however, certain market participants, including nonfinancial end users and financial end users without material swaps exposure (each discussed more fully below), transacting in non-cleared swaps with Covered Swap Entities may also be affected by the Final Margin Rules.

In connection with the Final Margin Rules, the Agencies have also issued an interim final rule which provides that the requirements of the Final Margin Rules shall not apply to non-cleared swaps entered into with nonfinancial end users (sometimes referred to as commercial end users) and certain small banks in accordance with the Terrorism Risk Insurance Program Reauthorization Act (TRIPRA) signed into law by President Obama earlier this year, as more fully discussed below.

The Final Rules with respect to capital (the Final Capital Rules) require Covered Swap Entities to comply with regulatory capital rules already made applicable to Covered Swap Entities as part of the applicable Agency's existing regulatory scheme. Because the Final Capital Rules do not add any additional capital requirements with respect Covered Swap Entities, this Dodd Frank Client Alert focuses primarily on the Final Margin Rules and the related exemptions.

Final Margin Requirements

The Final Margin Rules address when and how a Covered Swap Entity must collect and post IM and VM and the types of collateral that are eligible to be posted and collected for IM and VM. The applicability and scope of the Final Margin Rules are contingent upon the nature of the counterparty entering into a non-cleared swap with a Covered Swap Entity. Under the Final Margin Rules, there are four categories of potential counterparties: (a) other Swap Entities (including other Covered Swap Entities), (b) financial end users with material swaps exposure, (c) financial end users without material swaps exposure, and (d) any other person or entity which does not fall within one of the previous three categories (collectively, Other Counterparties) (which would include, among others, nonfinancial end users), each of which is discussed in turn below.

Under the Final Margin Rules, a "financial end user" includes, among other entities, affiliates of bank holding companies, depository institutions, insurance companies, commodity pools, employee benefit plans, and any state licensed credit or lending entities that are, in each case, not otherwise Swap Entities. Deviating from the 2014 Proposed Rules, "material swaps exposure" with respect to an entity means that the entity and its affiliates have an average daily aggregate notional amount of non-cleared swaps, foreign exchange forwards and foreign exchange swaps (collectively, Covered Swaps) with all counterparties for June, July and August of the previous calendar year that exceeds \$8 billion, where such amount is calculated only for business days.

The following is a breakdown of the IM and VM requirements for Covered Swap Entities by counterparty type:

Covered Swap Entity vs. Any Other Swap Entity

IM: A Covered Swap Entity must collect IM with respect to non-cleared swaps with another Swap Entity.^[2] The collection of IM under this scenario is not required to the extent that the aggregate un-margined exposure between a Covered Swap Entity and its affiliates and a particular counterparty and its affiliates remains below \$50 million (excluding swaps exempted by the TRIPRA Exemption (defined below)) (the IM Threshold Amount).

VM: A Covered Swap Entity must collect and post VM on a daily basis with respect to non-cleared swaps with another Swap Entity.

Covered Swap Entity vs. Financial End User with Material Swaps Exposure:

IM: A Covered Swap Entity must collect and post IM with respect to non-cleared swaps with a financial end user with material swaps exposure. In this scenario, the Covered Swap Entity must collect an amount of IM that is at least as large as the IM collection amount less the IM Threshold Amount, and post at least as

much IM to the financial end user with material swaps exposure as the Covered Swap Entity would be required to collect if it were in the place of the financial end user with material swaps exposure.

VM: A Covered Swap Entity must collect and post VM on a daily basis with respect to non-cleared swaps with a financial end user with material swaps exposure.

Covered Swap Entity vs. Financial End User without Material Swaps Exposure or Other Counterparties:

IM: No minimum IM requirement would apply, however, the Covered Swap Entity is directed to collect IM at such times and in such forms and amounts (if any) that the Covered Swap Entity determines appropriately addresses the credit risk posed by the counterparty and the risks of such non-cleared swap (subject to the TRIPRA Exemption discussed below).

VM: In regard to financial end users without material swaps exposure, the Covered Swap Entity must collect and post VM on a daily basis and, in regard to Other Counterparties, no minimum VM requirement would apply, however, the Covered Swap Entity is directed to collect VM at such times and in such forms and amounts (if any) that the Covered Swap Entity determines appropriately address the credit risk posed by the counterparty and the risks of such non-cleared swap (subject to the TRIPRA Exemption discussed below).

In each case above, when the IM and/or VM requirements apply, the Final Margin Rules, among other items, provide (i) how the IM and VM should be calculated, (ii) at what times the IM and VM should be posted and/or collected, and (iii) the types of collateral eligible to be posted to satisfy IM and VM requirements including, without limitation, cash, government securities, certain foreign sovereign debt securities and certain other securities (subject to applicable haircuts). It is important to note that the Final Margin Rules expanded the list of the types of collateral that are eligible to be used to satisfy both the IM and VM requirements.

Notwithstanding the differences in treatment among different types of counterparties, there are some consistencies in how the Final Margin Rules are applied, regardless of counterparty status, including the following:

1. Required IM with respect to any counterparty must be calculated by using either an approved internal model or a standardized look-up table promulgated in the Final Margin Rules.
2. While the IM requirement may be subject to the IM Threshold, no Covered Swap Entity is permitted to establish a threshold amount below which it need not collect or post VM from any counterparty.
3. In each instance, the Final Margin Rules proscribe minimum IM and VM amounts and do not limit a Covered Swap Entity or any other counterparty from requiring higher amounts of IM and/or VM than that which is required by the Final Margin Rules.

Implementation of Margin Requirements

The IM requirements under the Final Margin Rules will be phased in over a four-year period beginning on September 1, 2016, with compliance dates ranging from September 1, 2016 to September 1, 2020, depending on the average daily aggregate notional amount of Covered Swaps of the Covered Swap Entity

and its counterparty (including their respective affiliates) for each business day in March, April and May of that year (the Calculation Period) as shown in **Chart 1** below.

Chart 1 - The VM requirements under the Final

Compliance Date

IM Requirements

September 1, 2016

Both the Covered Swap Entity (and its affiliates) and its counterparty (and its affiliates) have an average daily aggregate notional amount of Covered Swaps for the Calculation Period that exceeds \$3 trillion.

September 1, 2017

Both the Covered Swap Entity (and its affiliates) and its counterparty (and its affiliates) have an average daily aggregate notional amount of Covered Swaps for the Calculation Period that exceeds \$2.25 trillion.

September 1, 2018

Both the Covered Swap Entity (and its affiliates) and its counterparty (and its affiliates) have an average daily aggregate notional amount of Covered Swaps for the Calculation Period that exceeds \$1.5 trillion.

September 1, 2019

Both the Covered Swap Entity (and its affiliates) and its counterparty (and its affiliates) have an average daily aggregate notional amount of Covered Swaps for the Calculation Period that exceeds \$0.75 trillion.

September 1, 2020

IM requirement applies going forward to any Covered Swap Entity with respect to non-cleared swaps with any counterparty.

Margin Rules will be phased in over a six-month span, beginning on September 1, 2016 and ending on March 1, 2017, also depending on the average daily aggregate notional amount of Covered Swaps of the Covered Swap Entity and its counterparty (including their respective affiliates) for each business day in the Calculation Period as shown in **Chart 2** below.

Chart 2

Compliance Date

VM Requirements

September 1, 2016

Both the Covered Swap Entity (and its affiliates) and its counterparty (and its affiliates) have an average daily aggregate notional amount of Covered Swaps for the Calculation Period that exceeds \$3 trillion.

March 1, 2017

VM requirement applies for any Covered Swap Entity with respect to non-cleared swaps with any counterparty.

The Final Margin Rules will only apply to non-cleared swaps entered into after the compliance dates described above and will generally not be retroactively applied; however, it is important to note that to the extent a Covered Swap Entity and another counterparty enter into non-cleared swaps pursuant to one existing master netting agreement (EMNA) both before and after the relevant compliance dates, pre-compliance date non-cleared swaps entered into under the same EMNA as post-compliance date non-cleared swaps would be subject to the Final Margin Rules unless the pre-compliance date non-cleared swaps are treated under the EMNA as a separately identified netting portfolio.

Exemptions from Margin Requirements

After the 2014 Proposed Rules were issued, President Obama signed TRIPRA into law, which, among other things, amended sections 731 and 764 of the Dodd Frank Act to provide that the requirements of the Final Margin Rules do not apply to certain non-cleared swaps of counterparties that would qualify for the end user exception from the mandated clearing requirements of the Dodd Frank Act (the TRIPRA Exemption) [3], including counterparties that constitute nonfinancial end users and certain financial institutions with total assets of \$10 billion or less. Notably, the TRIPRA Exemption is transaction-based, which means that a counterparty can only take advantage of the TRIPRA Exemption if it enters non-cleared swaps that hedge or mitigate commercial risk. Thus, those nonfinancial end users or small banks with less than \$10 billion in total assets entering non-cleared swaps for speculative purposes will be considered "Other Counterparties" for the purposes of the Final Margin Rules and will not be eligible for the TRIPRA Exemption with respect to any such non-cleared swaps.

Conclusion

The Final Margin Rules constitute one of the most important remaining portions of the Dodd Frank Act to be adopted and will likely result in industry-wide changes to margining practices and related documentation. This continues to be an evolving area of the law, and the ultimate impacts of the Final Margin Rules are yet to be determined. We would be happy to discuss any questions that you have regarding the Final Margin Rules and how they will affect your business.

^[1] For purposes of this Dodd Frank Client Alert, (a) “swap” means a swap as defined in Section 1a(47) of the Commodity Exchange Act, as amended (which, for the avoidance of doubt, does not include foreign exchange spot transactions, foreign exchange swaps or foreign exchange forwards), and (b) “non-cleared swap” means a swap that is not cleared by a derivatives clearing organization registered with, or exempt from registration by, the CFTC.

^[2] While the Final Margin Rules only require that a Covered Swap Entity collect IM when it engages in a non-cleared swap with another Swap Entity, because all Swap Entities will be subject to margin regulation by one of the Agencies, the CFTC and/or the SEC, the practical result will be a collect and post system for all non-cleared swaps between Swap Entities.

^[3] The TRIPRA Exemption is an interim final rule and is subject to public comment until January 31, 2016.