Financial Services Management

Non-Cleared Derivatives Regulatory/Reference-Rate Relief

Cite

OCC, FRB, FDIC, FCA, FHFA; Final Rule, Margin and Capital Requirements for Covered Swap Entities

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https://www.govinfo.gov/content/pkg/FR-2020-07-01/pdf/2020-14097.pdf

Impact Assessment

- LIBOR transition is eased by expanded grandfather coverage for reference-rate and related amendments to existing non-cleared derivatives.
- Approximately $44 billion in margin collateral will no longer be subject to regulatory-capital requirements, expanding balance-sheet and/or capital-distribution capacity and providing an added buffer for capital adequacy.
- Banks need no longer compartmentalize capital, margin, and related activities based on whether non-cleared derivatives are housed in an IDI, branch of the IDI, or affiliate.
- Ending inter-affiliate margin requirements enhances U.S. bank international competitiveness.
- New limits constrain possible swap inflows into IDIs.
- New Fed policy generally excludes affiliate margin transactions from Sections 23A and B, increasing IDI capacity to support nonbank affiliates.
- New capital standards encouraging robust collateral are under consideration.

Overview

Reflecting strong industry pressure and growing concerns about market structure, the banking agencies have joined others with which they share jurisdiction to finalize proposed revisions[1] reducing the capital cost of the 2015 margin rule for

[1] See **DERIVATIVES35**, *Financial Services Management*, September 26, 2019.

non-cleared derivatives.[2] This is accomplished via repeal of current inter-affiliate initial-margin requirements with a new limit intended to constrain insured depository institution (IDI) risk. The rule also expands the class of swaps designated as legacy swaps grandfathered under current standards that retain their grandfather even if amended to replace LIBOR with a new benchmark rate. Rates suitable for this protection are generally not named, with the rule providing flexibility here and on other rate-transition issues to give covered swap entities leeway to handle an array of emerging issues in this complex arena. However, the agencies remain concerned that swap revisions create avenues for new-swap creation and thus include an array of restrictions designed to ensure that amended agreements are not newly advantageous to the covered swap entity or otherwise structurally different than the underlying agreement.

Impact

The 2015 rule implemented provisions in the Dodd-Frank Act designed to push market participants to central counterparties (CCPs) and impose additional safety-and-soundness restraints on the OTC market. Among the most controversial of these changes was treating initial margins related to swaps between affiliates of the same banking organization in the same fashion as non-cleared swaps with third parties. The industry complained that this required double-counting of capital for banking organizations covered by leverage and risk-based capital requirements on these margin accounts, costing them so much that regulated entities became less significant in the OTC market and the market was riskier as a result.

Reflecting these concerns, the 2015 rule includes a compromise in which inter-affiliate margin requirements applied, but banks did not need to post the capital – i.e., actually hold double capital even though banks must still allocate the required amount to be sure it is available. The FDIC felt strongly that these inter-affiliate rules were necessary to protect insured depositories from down-streamed non-cleared swaps as their holding companies sought to arbitrage market expectations of FDIC protection for transactions within IDIs versus those in a holding company's other affiliates.

Reversing much of this, the new rule ends initial-margin requirements for inter-affiliate swap exposures and thus eliminates attendant capital requirements. The relief here is substantial given that large banks now are able to free approximately $44 billion or more from their balance sheets that may now be used for capital relief or backing for other asset holdings. In contrast to the NPR, the final rule includes a limit on the initial-margin exemption (see below), but this was calculated to exceed all current inter-affiliate margin amounts and thus is not likely to be binding absent significant increases in uncleared derivatives activities on a going-forward basis. FDIC Director Gruenberg objected to this limit on grounds that it was too generous and opposed the final rule as a whole because he believes it fails to reduce incentives to house higher-risk derivatives in the insured depository, not affiliated broker-dealers or futures commission merchants.

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2 See **DERIVATIVES28**, *Financial Services Management*, November 3, 2015.

Addressing this point in response to third-party comments, the final rule counters that supervisory experience demonstrates that initial margin is used as a risk hedge across an entire banking organization operating on a cross-border basis through separate legal entities, an approach that would be undermined if exposures are simply transferred to an IDI. Further, the agencies note that, if all activities were housed in a single banking organization, then there would be no need for inter-affiliate swaps. The agencies also defend the final rule on grounds that requirements (e.g., internal tolerances, underwriting, variation margin) apply regardless of whether a swap is housed in an IDI, a branch of the IDI or an affiliate. Other risks such as those associated with fragmentation may apply to affiliates, but the agencies state that these are separate from those germane to the swap transaction that is the focus of this rulemaking.

The rule also redefines the term "affiliate" to include more entities and thus provide broader initial-margin relief. The final rule now also contains a statement from the Federal Reserve Board addressing the interaction of the margin requirements with Sections 23A and 23B of the Federal Reserve Act's restrictions on inter-affiliate transactions and the Board's Regulation W that implements them.[3] An open issue in the initial proposal, the new Fed policy statement generally absolves inter-affiliate margin transactions between IDIs and nonbanks many of from these controls. FRB Governor Brainard strongly objected to this in her dissent from the final rule on grounds not only that it increases risk to the IDI, but also that Regulation W now requires these restrictions because derivative exposures create credit risk back to the IDI.

A rationale for the decision on inter-affiliate initial margins is the fact that other nations and the regulators for non-bank covered swap entities do not consistently do so. Under the prior rule, the U.S. was an outlier in its mandate of margins for inter-affiliate swaps, with the EU for example fully exempting intra-group transactions. U.S. banks already hold a commanding lead in global derivatives transactions, but the new rule will strengthen it as well as end the costs associated with U.S. bank operations in nations that require subsidiarization, not branch operations.

The rule does, however, retain variation margins based on the view that banks use variation margins to ensure effective inter-affiliate capital allocation related to risk and also to assess unit profitability. In contrast, most inter-affiliate initial margins are for risk-mitigation purposes via centralized risk management. Further, due to market factors, initial inter-affiliate margins have increased, leading banks to borrow more to fund eligible collateral, increasing risk in ways that the agencies conclude undermine the initial risk-reduction purpose of the margin requirements. Without variation-margin requirements, the agencies argue that banks would be free to engage in imprudent internal collateral allocation.

In the 2015 rule, the agencies decided that grandfathered non-cleared swaps amended after the applicable compliance date for new swaps would be treated as new swaps in order to prevent regulatory evasion. The rule has since been amended

3 See *Client Reports* in **REGW** series.

to prevent coverage of swaps altered to comply with new qualified financial contract (QFC) standards for GSIBs[4] and to afford certain protections for U.K. entities facing Brexit dislocations. These exemptions for legacy swaps now are extended also to certain routine "life-cycle" activities (e.g., portfolio compression) and permit amendment of a grandfathered swap to reflect a new benchmark interest rate. As noted, this is intended to speed transition from LIBOR to new benchmark rates such as the Fed's preferred SOFR. Absent expanded legacy-swap coverage, uncleared derivatives would be among the most problematic assets in the already-complex LIBOR transition. According to the Federal Reserve Bank of New York, derivatives contracts account for 95 percent of exposure to the $200 trillion of financial contracts referencing U.S. dollar LIBOR.

What's Next

The FDIC approved the final rule and a related interim final rule (IFR) on June 25 by a 3-1 vote, with the Fed doing so the same day by a 4-1 vote. The OCC, FHFA, and FCA have also approved the rule. It is effective August 31. The accompanying IFR delays compliance with initial margin requirements for smaller entities by one year. It is effective September 1, with comments due August 31.

Noting ongoing concerns about uncleared-derivatives risk, the final rule states that the agencies are reviewing regulatory-capital calibrations to reflect robust collateral or its absence to protect against close-out risk.

Analysis

A. Reference-Rate Transition

As noted, a grandfathered swap amended to incorporate a new reference rate will not lose its legacy status. Adherence to a protocol such as ISDA's transition standards or to similar agreements is necessary either for an individual swap or netting set to retain this protected status as long as specified limitations are met. These include standards designed to ensure that rate adjustments are not in fact so significant as to create new swap agreements.

The rule lists the alternative reference rates eligible for legacy protection, also providing a qualitative process for additional reference rates to reflect ongoing challenges of the LIBOR transition and work under way by other authorities to establish new benchmarks. The rule recognizes that grandfathered swaps may need to be amended several times (i.e., to reflect "fallback" contractual provisions and then again with a new benchmark); doing so would not endanger legacy status as long as applicable conditions are met. Among these is the requirement that the counterparty select the new rate so that amendments do not evade the purpose of the rule by advantaging the covered company. Swap amendments may reflect not only new rates, but also administrative and operational changes to effectuate the rate change, perhaps also requiring multiple amendments that again do not endanger legacy

4 See **QFC6**, *Financial Services Management*, September 11, 2017.

status as long as stipulated conditions are met. Protection is not available if amendments extend maturity or increase the total effective notional amount.

B. Inter-Affiliate Margin Requirements

As noted, the rule repeals the requirement that covered swap entities collect initial margin from their affiliates, retaining variation-margin requirements as before. However, unlike the NPR, the final rule requires that initial margin must be collected by an IDI from its affiliates on all new, noncleared swaps if initial margin amounts exceed fifteen percent of the most recent Tier 1 capital reported on the bank's call report. As a result, margins versus capital must be calculated each day and collateral posted for all exposures above the fifteen percent threshold as long as the fifteen percent threshold is exceeded.

The final rule also clarifies that banks must collect margins if credit risk warrants doing so no matter the affiliate exception. As under current rules, the bank may hold collateral with an affiliated custodian as long as accounts are segregated.

C. Additional Changes

These include:

- clarification of certain trading-documentation requirements;
- additional flexibility related to changing legacy swaps without voiding this grandfather for portfolio compression and certain other actions; and
- various technical changes.

D. Federal Reserve Statement

Under Section 23B, the Board states that exposures with a bank's affiliates must be on terms and conditions that are substantially the same or at least as favorable to the bank as comparable transactions at the time for non-affiliates. Gov. Brainard noted in her objection that this policy in fact provides considerable 23B relief since initial margins are still required in non-affiliate transactions. Perhaps reflecting this, the FRB states that lack of initial margin will generally suffice to meet this requirement even if non-affiliates must post initial margin. However, certain facts and circumstances may affect this view. For example, cases in which the affiliate demands initial margin from the bank may void the 23B exception.

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