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## *Proposed Amendments to U.S. Prudential Regulators' Margin Rules for Non-Cleared Swaps*

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On September 17, 2019, the Federal Deposit Insurance Corporation issued a notice of proposed rulemaking (the "Proposal") prepared with the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Farm Credit Administration, and the Federal Housing Finance Agency (together, the "Prudential Regulators") that would amend their swap margin regulations (collectively referred to hereinafter as the "PR Swap Margin Rule"). The PR Swap Margin Rule requires swap dealers and security-based swap dealers under the Prudential Regulators' respective jurisdictions ("covered swap entities" or "CSEs") to exchange margin with counterparties for swaps<sup>1</sup> that are not centrally cleared ("non-cleared swaps").<sup>2</sup> The Proposal contemplates the following changes to the PR Swap Margin Rule:

1. Legacy Swaps and Transition Away from IBORs – Provide relief by allowing a non-cleared swap that was entered into prior to the applicable compliance date and generally is not subject to the margin requirements in the PR Swap Margin Rule (a "legacy swap") to retain its legacy status even if amended to replace existing interest rate provisions based on certain interbank offered rates ("IBORs") and other interest rates that may be discontinued or lose their relevance as reliable benchmarks due to a significant impairment.
2. Affiliate Transactions – Repeal the requirement for a CSE to collect initial margin from its affiliates, while retaining the requirement that variation margin be exchanged for affiliate transactions.
3. Later Compliance Date for Smaller Counterparties – Add an additional initial margin compliance period for certain smaller counterparties.
4. Trading Documentation – Clarify the timing and scope of existing initial margin trading documentation requirements.
5. Legacy Swaps and Amendments Relating to Certain Life-Cycle Events – Permit amendments caused by conducting certain routine life-cycle activities that CSEs may conduct for legacy swaps, such as reduction of notional amounts and portfolio compression exercises, without triggering margin requirements under the PR Swap Margin Rule.<sup>3</sup>

Each aspect of the Proposal is discussed in greater detail below.



## **I. Relief for Amendments to Replace Interbank Offered Rates**

### **A. Background Regarding IBORs**

IBORs<sup>4</sup> have been used as a benchmark interest rate for a large volume and broad range of financial products and contracts, including an estimated \$190 trillion in outstanding derivatives contracts referencing USD LIBOR, of which \$145 trillion represents over-the-counter derivatives exposure.<sup>5</sup> However, as a consequence of market manipulation and false reporting of the IBORs and the subsequent announcement by the LIBOR administrator, the U.K. Financial Conduct Authority, that it will not compel LIBOR panel banks to continue to contribute to LIBOR after 2021, CSEs face uncertainty about how their LIBOR-based (and other IBOR-based) swap contracts will operate thereafter, without a reliable benchmark rate.

In response to these market developments, the Federal Reserve Board and Federal Reserve Bank of New York convened the Alternative Reference Rates Committee (the "ARRC") in 2014 to identify an alternative risk-free rate for USD LIBOR and create an implementation plan to promote voluntary use of the selected alternative. In 2017, the ARRC selected the Secured Overnight Funding Rate ("SOFR"), which is designed to be representative of general funding conditions in the overnight Treasury repo market.<sup>6</sup> Since a benchmark rate is a critical term for calculating payments under a swap contract, market participants are expected to begin amending their existing swap contracts well before the relevant IBOR is discontinued.

### **B. Proposed Rule on IBORs**

The PR Swap Margin Rule's requirements generally apply only to non-cleared swaps entered into on or after the applicable compliance date. A legacy swap essentially is "grandfathered," in that it generally is not subject to the margin requirements in the PR Swap Margin Rule. However, absent an exception,<sup>7</sup> a legacy swap that is amended or novated on or after the applicable compliance date would become subject to the PR Swap Margin Rule requirements.

To provide relief to CSEs and their counterparties that are proactively amending their swap contracts to address potential IBOR discontinuation, the Proposal would amend the PR Swap Margin Rule to preserve the legacy status of non-cleared swaps that are amended to replace certain IBORs. The Proposal also would preserve a non-cleared swap's legacy status for any follow-on amendments<sup>8</sup> that the counterparties determine are necessary to maintain the economics of the contract, so long as such amendments are made solely to accommodate the replacement rate. However, the Proposal clarifies that that proposed safe harbor for legacy swaps would be unavailable if the amendments extend the maturity or increase the total effective notional amount of the non-cleared swap.

## **II. Initial Margin Exemption for Inter-Affiliate Non-Cleared Swaps**

The PR Swap Margin Rule establishes special initial margin rules for transactions between a CSE and an "affiliate," which the PR Swap Margin Rule generally defines as an entity that is consolidated with the dealer on an accounting basis, or consolidated on a common basis by another entity.<sup>9</sup> Under the current PR Swap Margin Rule, for example, a CSE is not required to use an independent custodian for most forms of initial margin collected from an affiliate and does not need to apply a \$50 million initial margin threshold amount to the CSE's affiliates on an aggregate basis. The Proposal would amend the treatment of affiliate transactions in the PR Swap Margin Rule by creating an exemption from the initial margin requirements for non-cleared swaps between affiliates and would also supplement the definition of "affiliate" to include the "catch-all" legal standard for affiliation in banking, which focuses on the direct and indirect exercise of controlling influence over the management or policies of the



controlled company.<sup>10</sup> The Proposal would not alter the PR Swap Margin Rule's uniform requirements for CSEs to exchange variation margin with their affiliates, however.

### **III. Additional Compliance Date for Initial Margin Requirements for Smaller Counterparties**

The PR Swap Margin Rule established an effective date of April 1, 2016, with a phased-in compliance schedule for the initial and variation margin requirements.<sup>11</sup> The variation margin requirements for all CSEs and counterparties were completely phased in by March 1, 2017.<sup>12</sup> With respect to initial margin requirements, the PR Swap Margin Rule requirements are implemented in five phases between September 1, 2016 and September 1, 2020, depending on the size of the CSE's and its counterparty's portfolios of non-cleared swaps. The group currently scheduled for the fifth and final phase of compliance in 2020 includes all remaining entities within the scope of the initial margin requirements, with AANAs from \$8 billion to \$750 billion.<sup>13</sup>

In recognition of the greater operational complexity associated with implementation of the PR Swap Margin Rule's initial margin requirements for the large number of relatively small counterparties encompassed in the PR Swap Margin Rule's fifth phase, the Proposal would add a sixth phase of compliance for certain smaller entities that currently are subject to the phase five compliance deadline. The Proposal would amend the PR Swap Margin Rule to require compliance by September 1, 2020 for counterparties with AANAs between \$50 billion and \$750 billion and extend the compliance deadline for all other counterparties (with AANAs ranging from \$8 billion to \$50 billion) to September 1, 2021.<sup>14</sup>

### **IV. Clarifying Trading Documentation Requirements**

In connection with a CSE and its counterparty's applicable compliance deadline, CSEs must calculate initial margin to be collected and posted to determine if and when the collection or posting of initial margin is required. Under the PR Swap Margin Rule, a CSE must collect or post initial margin when it calculates an initial margin amount that, after subtracting the initial margin threshold amount, exceeds zero.<sup>15</sup> Only when the CSE is required to collect or post initial margin is it required to have completed the initial margin trading documentation required by the PR Swap Margin Rule. Because the PR Swap Margin Rule also requires CSEs to execute variation margin trading documentation no later than when the CSE commences trading non-cleared swaps with any counterparty covered by the PR Swap Margin Rule, the Proposal would clarify the rules specifically relating to initial margin by expressly stating that a CSE is not required to execute initial margin trading documentation with a counterparty before it is required to collect or post initial margin pursuant to the PR Swap Margin Rule.

### **V. Legacy Swap Status and Certain Routine Amendments**

To address industry concerns regarding non-material amendments to non-economic terms and amendments made to reduce operational or counterparty risk, the Proposal would amend the PR Swap Margin Rule to permit retention of legacy swap status for amendments arising from certain routine industry practices over the life-cycle of a non-cleared swap that are carried out for logistical reasons or risk-management purposes.<sup>16</sup> Under the Proposal, the following types of amendments would not affect a non-cleared swap's legacy status:

1. Amendments to reflect technical changes, such as addresses, the identities of the parties for delivery of formal notices, and other administrative or operational provisions of the non-cleared swap that do not alter its underlying asset or indicator,



such as a security, currency, interest rate, commodity, or price index, the remaining maturity, or the total effective notional amount;

2. Amendments solely to reduce the notional amount of the non-cleared swap, without altering other terms of the original non-cleared swap; and
3. Amendments as part of certain portfolio compression exercises used as a risk management tool, so long as such amendments do not extend the remaining maturity of the amended non-cleared swap or increase its total effective notional amount.<sup>17</sup>

## Public Comment Period

The Prudential Regulators will be seeking public comment on the Proposal. The full text of the Prudential Regulators' Proposal can be found [here](#). Comments on the Proposal will be due within 30 days after publication in the Federal Register, which has not yet occurred.



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<sup>1</sup> Unless otherwise noted, the term "swaps" herein refers to swaps and security-based swaps.

<sup>2</sup> See Proposed Margin and Capital Requirements for Covered Swap Entities, <https://www.fdic.gov/news/board/2019/2019-09-17-notice-dis-b-fr.pdf> (hereinafter "Proposal").

<sup>3</sup> Proposal at 23.

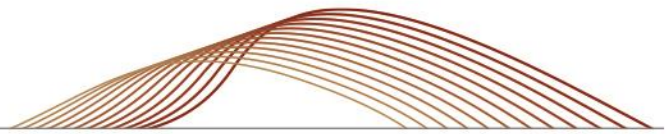
<sup>4</sup> IBOs include the London Interbank Offered Rate ("LIBOR"), the Tokyo Interbank Offered Rate, the Bank Bill Swap Rate, the Singapore Interbank Offered Rate, the Canadian Dollar Offered Rate, the Euro Interbank Offered Rate, and the Hong Kong Interbank Offered Rate.

<sup>5</sup> Proposal at 24; A Alternative Reference Rates Committee, Second Report of the Alternative Reference Rates Committee, March 2018, <https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Second-report>.

<sup>6</sup> For more information on the ARRC's USD LIBOR alternative, please see our recent publications, "ARRC Releases White Paper Regarding SOFR – The New U.S. Dollar LIBOR Alternative" (available [here](#)) and "ARRC Releases Practical Implementation Checklist for SOFR Adoption" (available [here](#)).

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- <sup>7</sup> The PR Swap Margin Rule was recently amended to permit the retention of legacy swap status for contracts that are amended (1) to achieve compliance with the “QFC Rules” (see 83 FR 50805 (Oct. 10, 2018)), or (2) to avoid the uncertainties presented by “Brexit” (see 84 FR 9940 (Mar. 19, 2019)).
- <sup>8</sup> Follow-on amendments may include a variety of spread adjustments resulting from the move from a term rate to an overnight rate or from unsecured to secured, or could result from a change in tenor or administrative and technical changes, including changes to determination dates, calculation agents, and payment dates.
- <sup>9</sup> Proposal at 32.
- <sup>10</sup> See *id.* at 36.
- <sup>11</sup> The applicable compliance date for a CSE is based on the average daily aggregate notional amount (“AANA”) of non-cleared swaps, foreign exchange forwards, and foreign exchange swaps of the CSE and its counterparty (accounting for their respective affiliates) for each business day in March, April, and May of that year. *Id.* at 37 n.29.
- <sup>12</sup> *Id.* at 37.
- <sup>13</sup> *Id.* at 37-38. The PR Swap Margin Rule does not require a CSE to exchange initial margin with any counterparty whose AANA is less than \$8 billion as of the previous June, July, and August.
- <sup>14</sup> On October 24, 2019, the Commodity Futures Trading Commission (“CFTC”) published a proposed amendment (the “CFTC Amendment”) to the CFTC’s margin requirements for uncleared swaps for swap dealers and major swap participants for which there is no prudential regulator (the “CFTC Margin Rule”). The CFTC Amendment would amend the CFTC Margin Rule’s compliance schedule for initial margin to match the compliance schedule proposed by the Prudential Regulators in the Proposal. The full text of the CFTC Amendment (84 FR 56950 (Oct. 24, 2019)) can be found [here](#).
- <sup>15</sup> Proposal at 39.
- <sup>16</sup> *Id.* at 41.
- <sup>17</sup> *Id.* at 42.