Margin Rules for Non-Cleared Derivatives: Ready or Not, They Are Coming

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Without argument, one of the pillars of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) was to require the central clearing of certain categories of swaps. For those categories of swaps that were not required to be cleared, lawmakers recognized the need to create a broad margining system because of the perception that non-cleared swaps pose greater risks than cleared swaps. As a result, the Dodd-Frank Act mandated the creation of a new section of the Commodity Exchange Act requiring rules establishing margin requirements for swap dealers and major swap participants (Covered Swap Entities) to ensure their safety and soundness and to reduce risk and increase transparency in the market.

With less than a year to go before U.S. regulators require margin to be exchanged on non-cleared swaps, end users seem to be puzzled about whether they will need to comply with the onerous requirements, adding weight to industry efforts to ward off the new rules until 2017. According to an industry survey issued on January 6, 2015 by the International Swaps and Derivatives Association (ISDA), a third of respondents to the ISDA survey indicated they were unsure whether they would have to comply. Of that third, nearly two-thirds indicated that they were concerned or somewhat concerned about their ability to meet the requirements, which are currently slated to take effect in December 2015.

This article discusses the ISDA survey in general terms and provides some simple recommendations to market participants that are concerned about the impact of new margin requirements for non-cleared swaps.

Statutory Background

On September 17, 2014, the Commodity Futures Trading Commission (CFTC) re-issued rules to establish margin collection requirements for non-cleared swaps entered into by Covered Swap Entities. The proposal is substantially similar to the proposal promulgated collectively by the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency (collectively, the Prudential Regulators) on September 3, 2014 concerning swap margin and capital requirements. The CFTC's re-proposed rule replaces the agency's previous proposal originally issued in April 2011 and integrates the comments received by the CFTC in response to the 2011 proposal. The Prudential Regulators' re-proposal also replaces their original proposal from April 2011 and accounts for comments they received. Both re-proposals mirror, to a certain degree, the promulgation of the international framework for margin requirements of non-cleared swaps, finalized in September 2013 by a conglomerate of international regulators, the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions (BCBS/IOSCO), with the goal of creating an international standard for margin requirements for non-cleared swaps. The Prudential Regulators' rules apply to participants that are subject to their supervision; the CFTC's rules apply to participants that are not subject to its jurisdiction but subject to the jurisdiction of the Prudential Regulators.

While an in-depth review of the re-proposals from both groups is not the subject of this article, it is helpful to have some highlights. Notably, the re-proposals require posting and collecting of variation margin for all non-cleared swaps entered into between Covered Swap Entities and (i) other Covered Swap Entities or (ii) financial end users;
require posting and collecting of initial margin for all non-cleared swaps entered into between Covered Swap Entities and (i) other Covered Swap Entities or (ii) financial end users with a "material swaps exposure" (i.e., an average daily aggregate notional amount of non-cleared swaps in excess of US$3 billion for all business days in June, July and August of the previous calendar year);

do not require a Covered Swap Entity to post or collect initial or variation margin for non-cleared swaps entered into with non-financial end users;

significantly revise the definition of "financial end user";

require Covered Swap Entities to post and collect margin for non-cleared swaps entered into with affiliates;

permit Covered Swap Entities to use internal models or standard tables for initial margin;

require Covered Swap Entities to segregate all initial margin collected with an independent custodian;

limit eligible collateral for variation margin to cash; and

set forth a proposal for cross-border application of margin requirements.

The comment periods for the re-proposals have recently closed. While finalized rules are anticipated in the first quarter of 2015, the industry is concerned with several aspects of the rules, including providing for implementation without excessive market disruption, appropriately addressing systemic risk and ensuring a coherent cross-border framework.

**Discussion**

The re-proposals provide for a compliance go-live date of December 1, 2015 for variation margin and a phased compliance schedule for initial margin, running from December 1, 2015 to December 1, 2019 (with compliance timing dependent on the average daily aggregate notional amount of non-cleared swaps (including FX forwards and FX swaps) for the Covered Swap Entity and its affiliates and its counterparty and its affiliates). ISDA has warned that once the rules are finalized, participants will need to make significant changes to their systems and processes.

"The survey results indicate that many market participants may struggle to meet the December 2015 effective date, especially given that a large number of end-user firms still appear unsure whether the rules apply to them," said ISDA CEO Scott O’Malia in a press release issued by ISDA on January 6, 2015. "Once the margin rules are finalized, it is vital that market participants have sufficient time to allow for the legal, operational and technological enhancements necessary to effectively and safely implement these new requirements."

As stated in the press release, the top three concerns flagged by end users were increased costs of hedging (59 percent), regulatory uncertainty (38 percent) and concerns about the scope of cross-border derivatives regulation (36 percent). ISDA is calling for a two-year delay in implementing the rules to allow the industry to make the necessary documentation changes to allow market participants to exchange collateral on a global basis. The survey also highlighted the importance of derivatives in respondents' risk management strategies. According to the results, 81 percent of respondents believe derivatives are important or very important to their firm's strategy, while 78 percent expect their use of derivatives to increase or stay the same over the first quarter of 2015.

**Practical Considerations**

The lynchpin of the re-proposals is that if you are a "financial end user," you will have a daily variation margin requirement (without regard to a minimum exposure amount) and possibly an initial margin requirement. The initial margin requirement will apply if your "material swaps exposure" under any non-cleared trades opposite a Covered Swap Entity (and its affiliates) exceeds $3 billion in gross notional amount, calculated on a daily basis for all business days in June, July and August of the previous calendar year. This amount is inclusive of all swap exposure across that financial end user's affiliates (currently defined as 25 percent owned or controlled).

While the re-proposals are a significant improvement from the original proposals, there is concern among many in the industry that the more restrictive nature of the re-proposals will lead to greater administrative and economic burdens on market participants and further market fragmentation. It is therefore recommended that you (1) determine or understand your "material swaps exposure" as of June, July and August of 2014 for all of your non-cleared swaps with a Covered Swap Entity (and its affiliates)\(^4\); and (2) stand ready to make substantial changes
to documentation that may be required, which includes negotiation of agreements for separation of initial margin and variation margin collateral flows; negotiation of third-party custodial agreements and their inclusion as credit support documents; aggregating thresholds across affiliates; and amendments to ISDA Master Agreements and associated Credit Support Annexes to include permitted collateral types and new minimum transfer amounts and to address margin transfer timing.

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