

Rule Proposal Regarding Margin and Capital Requirements for Uncleared Swaps

June 3, 2011

On April 12, 2011, the Board of Governors of the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Farm Credit Administration and the Federal Housing Finance Agency jointly issued a notice of proposed rulemaking (the “Proposed Rules”) requiring institutions within their respective jurisdictions that are swap dealers, security-based swap dealers, major swap participants and security-based swap participants (“covered swap entities”) to collect initial and variation margin from counterparties to non-cleared swaps and security-based swaps. The Proposed Rules also require a covered swap entity to comply with existing capital standards set by its prudential regulator. The margin and capital requirements are intended to offset the risk to covered swap entities and the financial system from the use of uncleared swaps. Comments on the Notice are being sought through June 24, 2011.

The Proposed Rules would apply to non-cleared swap and security-based swap transactions entered into by covered swap entities, whether U.S. or foreign, with counterparties that are: (i) U.S. persons or branches or offices of U.S. persons (wherever located), (ii) non-U.S. affiliates of U.S. persons, if performance is guaranteed by the U.S. person or any of its branches or offices, or (iii) persons otherwise resident in the United States. The requirements would apply to new, non-cleared swaps and security-based swaps entered into after the effective date of the Final Rule (180 days after publication thereof).

The Proposed Rules advocate a risk-based approach to margin that would require covered swap entities to assess and collect margin based on the relative risk of the counterparty and of the swap. Counterparties would fall into one of four categories – (1) other swap entities; (2) high-risk financial end users (including private funds, commodity pools, employment benefit plans and governmental plans, persons predominantly engaged in the business of banking or activities that are financial in nature, and governments of foreign countries and political subdivisions thereof); (3) low-risk financial end users (entities that (a) do not have a “significant swaps exposure” (defined as \$2.5 billion in daily average aggregate uncollateralized outward exposure or \$4 billion in daily average aggregate uncollateralized exposure plus daily average aggregate potential outward exposure (or \$1 billion or \$2 billion, respectively, for security-based swaps), (b) predominantly use swaps to hedge or mitigate the risks of their business activities, and (c) are subject to capital requirements established by a prudential regulator or state insurance regulator); and (4) nonfinancial end users. Swap risk would be assessed based on the asset class and term of the swap.

Initial Margin

The Proposed Rules provide covered swap entities with two approaches for calculating initial margin requirements. A covered swap entity may utilize the regulators’ standardized “look-up” table (contained in Appendix A of the Proposed Rules) to determine minimum margin (a percentage of notional swap exposure that varies according to asset class and term). If using this method, a covered swap entity generally must collect at least the requisite margin amount irrespective of the nature of the counterparty. Alternatively, a covered swap entity may develop an internal initial margin model, approved by its prudential regulator, that meets prescribed modeling standards, including stress-test and benchmarking elements (notably, the proposed standards set a minimum 10-business day horizon for estimating potential future exposure, compared with the 3-5 business days typically used by derivatives clearinghouses). A covered swap entity using a model-based calculation must collect at least the amount of initial margin required under its model.

Variation Margin

Variation margin is required to be collected daily in the case of all counterparties that are not commercial end users. Margin calls to commercial end users must be made at least once per week. Variation margin requirements may be calculated on an aggregate basis across all transactions with a counterparty that are executed under the same qualifying master netting agreement.

Both the standardized table and internal model methods permit a covered swap entity to set a credit exposure limit below which it need not collect initial or variation margin from counterparties that are low-risk financial end users or commercial end users. A covered swap entity may not establish initial or variation margin threshold amounts for other swap entities or high-risk financial end users.

The Proposed Rules specify maximum permitted initial and variation margin threshold amounts. For low-risk financial end users, the maximum threshold amount would be the lower of: (i) a sum in the range of \$15-\$45 million, and (ii) a percentage (in the range of 0.1 to 0.3) of the covered swap entity's Tier 1 capital. The final figures will be determined in the Final Rules, although the regulators' preliminary view is that the midpoint of each range would be appropriate. For commercial end users, no specific limit is set, although covered swap entities must establish appropriate limits taking into account the credit risk posed by the counterparty and the transaction. Limits must be reviewed, monitored and approved in accordance with the covered swap entity's credit processes. The Proposed Rules also specify a minimum transfer amount of \$100,000, below which margin (initial or variation) need not be posted by *any* counterparty. The Proposed Rules mandate that initial margin posted by any swap entity be segregated and held at a third-party custodian.

[Related Professionals](#)

- **Steven O. Weise**
Partner