Coalition for Derivatives End-Users

Margin Rules Proposed by the Prudential Regulators and the CFTC
Creating New Burdens & Unnecessary Costs for End-Users

On April 12, 2011, the CFTC and the Prudential Regulators[1] each proposed separate rules governing margin requirements for uncleared swaps. These rules would place new burdens on end-users and are a significant departure from current market practice. The Prudential Regulators' rule ostensibly applies to swap dealers (SDs) and major swap participants (MSPs) that are regulated as banks, while the CFTC's rule applies to non-bank swap dealers (SDs) and major swap participants (MSPs). The rules operate not by requiring the payment of margin, but by requiring SDs and MSPs to collect margin from their counterparties.

Dodd-Frank confers no authority for regulators to impose margin rules—directly or indirectly—on end-users.

- Dodd-Frank distinguishes between SDs/MSPs and end-users, treating both groups very differently.
- By repeatedly using only two, specific terms that are defined in Dodd-Frank—SD and MSP—to describe which entities are subject to margin requirements, the statutory text unambiguously excludes all other entities from margin—including end-users—that are not captured by those two terms.

The margin rules blatantly ignore congressional intent.

- A letter from Chairmen Dodd and Lincoln on June 30, 2010 states that "Congress clearly stated in this bill that the margin and capital requirements are not to be imposed on end users."
- The preamble of the Prudential Regulators' rule, however, states that Dodd-Frank does not "exclude a swap with a counterparty that is a commercial end user." Instead, "…margin requirements apply to all non-cleared swaps…regardless of the type of transaction or the nature of the counterparty."

No true margin exemption for the vast majority of end-user trades.

- The rules create no margin exemption for most end-users and subject virtually all end-users to the possibility of posting margin. The rules intrude into the bilateral negotiations between SDs or MSPs and nonfinancial end-users by requiring "appropriate" margin thresholds and by prescribing what models SDs and MSPs can use to calculate how much margin to collect from nonfinancial end-users.
    - Note that, according to a recent Coalition survey, nearly 40% of end-users currently do not post margin on their derivatives trades.
- Although the Prudential Regulators require collection of margin from nonfinancial end-users only to the extent that the internal calculation models of an SD or MSP require it, each internal calculation model must be regulator-approved and meet 15 quantitative requirements.
- Although the CFTC requires only that SDs and MSPs enter into credit support arrangements (CSAs), the CFTC appears to have assumed authority to dictate the margin calculation methodology used by SDs and MSPs when end-users enter into such agreements of their own accord.

SDs and MSPs must collect margin from pension funds and other financial end-users.

- Both rules force SDs and MSPs to collect initial and variation margin from all financial end-users, subject only to either extremely low thresholds or no thresholds at all.[2]
- Regulators base margin requirements on whether a person is a financial or nonfinancial end-user, but the Dodd-Frank Act does not direct regulators to make this distinction for margin purposes, as it does for clearing purposes.

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1 Includes the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency.

2 Thresholds proposed at the lesser of between $15mm to $45 mm and between 0.1% to 0.3% of tier-1 capital.

Margin thresholds for pension funds and other financial end-users are set largely by regulators and do not fully allow financial end-users that pose less risk to post less margin.

- The maximum threshold for a "low-risk" financial entity is so low that it excludes most financial end-users that pose little or no systemic risk.
- It is unclear whether regulators will permit thresholds to adjust dynamically for an end-user's changing credit profile.
- This approach is contrary to Congress's intent that regulators must set margin standards "relative to the risks associated with trading."[3]

The rules evince a bias toward higher margin requirements.

- The margin calculation models prescribed by both rules artificially isolate swaps risk instead of dynamically reassessing the counterparties' holistic credit profiles, including loan exposures.
- Under the Prudential Regulators' rule, models used to calculate end-user margin requirements must meet 15 quantitative requirements that are weighted in favor of requiring collection of more margin.
- The required 99% confidence interval for price changes over 10 days is a higher standard than the typical 5-day requirement for cleared swaps, artificially promoting use of cleared swaps.
- Both rules allow regulators to review or modify margin calculation methods at any time, leaving end-users with uncertainty and making business planning more difficult and more complex.

Use of non-cash collateral is severely restricted: a significant departure from current practice.

- Although Dodd-Frank plainly states that regulators "*shall* permit the use of noncash collateral"[4] when consistent with preserving financial integrity and stability, the Prudential Regulators allow only highly liquid assets, which include cash, treasuries, and GSE securities.
- The CFTC allows only nonfinancial end-users to use non-cash collateral (other than U.S. or GSE-guaranteed securities) and only if their CSA permits it.
- The Prudential Regulators do not allow end-users of any kind to use non-cash collateral other than U.S. or GSE-guaranteed securities to satisfy margin requirements.

The margin rules increase costs for end-users, making the end-user clearing exception less effective by potentially forcing many end-users to forgo the use of uncleared swaps.

- The margin calculation rules will cause substantially higher margin-posting requirements for uncleared swaps relative to cleared swaps, forcing many end-users to use cleared swaps that often provide only limited mitigation of commercial risk. Congress enacted the end-user clearing exception to give end-users the flexibility to use derivative products according to their commercial risk mitigation needs. The margin rules thus reduce this flexibility and run counter to Dodd-Frank's aims.
- In their rule's preamble, the Prudential Regulators acknowledge that "the proposed rule's approach to margin requirements for derivatives with nonfinancial end users could be viewed as lessening the effectiveness of the clearing requirement exemption for these nonfinancial end users…"

The financial end-user definition is overly broad, potentially capturing nonfinancial end-users.

- Regulators selectively based the definition of "financial end-user" for margin purposes on the Dodd-Frank Act's definition of "financial entity" from the clearing—not the margin—section of the Act, tracking the clearing definition when it would lead to higher margin requirements, but not when it would create exceptions. Notably, captive finance entities that are exempt from the "financial entity" definition for clearing in Dodd-Frank, are *included* in the "financial end-user" definition for margin.
- The rules also allow regulators to designate *any* person as a financial end-user for *any* reason.

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[3] 156 CONG. REC. S 6192 (daily ed. July 22, 2010) (letter from Senators Dodd and Lincoln).

[4] 7 U.S.C. § 4s(e)(3)(C) (emphasis added).