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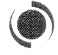

Financial Services
USA

ANALYSIS: US margin rule for swaps obliges securitization issuers to overhaul structures, add resources, and rethink capital structures

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By 1 March 2017, many issuers of rated securitizations and structured vehicles will need a lot more resources to enter into a swap contract with a regulated US swap provider. From this date on, a swap provider will be subject to a new requirement to collect and post margin with respect to new swaps with many types of financial counterparties, including securitization issuers.

Five US regulators - the FDIC, Federal Reserve Board, FCA, FHFA, and OCC - have adopted a joint rule for margin requirements for swap contracts that are not centrally cleared. Under this rule, a US swap provider must "collect and post" margin on a daily basis under a "new" non-cleared swap contract with another swap dealer, a major swap participant, or a "financial end user" -- the broad category that includes many securitization issuers.

The swap margin rule works in conjunction with SEC and CFTC rules. As such, it may be augmented by future SEC and CFTC rulemaking. Under the swap margin rule, a "covered swap entity" is a swap dealer or major swap participant that is: 1) registered with, or exempted from registration by, the SEC or CFTC; and 2) also "prudentially regulated" by the FDIC, Federal Reserve Board, FCA, or OCC. At the time of the rule's adoption, there were 100+ "covered swap entities."

Securitization issuers: Pick your poison

The big impact for issuers of securitizations and structured finance products is that "hedging" (i.e., offsetting the potential depreciation of assets such as fixed-rate residential mortgages viz-a-viz floating-rate debt) with swap contracts will be much less attractive. A give-up is in store, one in which issuer will have to weigh hedging versus ratings. Swap

hedging per industry practice will be much more expensive. Partial or no hedging will cost less, but likely result in lower ratings as debt will be more exposed to asset depreciation. Mitigating factors such as additional overcollateralization or substituting swaps for options could also come into play.

Securitization issuers may discover exclusions as they examine the swap margin rule and review future SEC and CFTC rulemaking. However, the securitization industry is taking no chances. SFIG has been lobbying Congress for an exemption from the swap margin requirements for all securitization issuers, (see article, 26 October).

For a covered swap entity (i.e., a swap provider), one impact will be that it holds "variation" margin against the market value of a swap contract with a securitization issuer when the contract is in-the-money (out-of-the-money to the issuer) and posts variation margin against the market value of the contract when it is out-of-the-money (in-the-money to the issuer).

The swap margin rule is not retroactive, i.e., it will not apply to a swap contract that was entered into prior to the applicable compliance date. The rule also exempts a swap contract that hedges the commercial risk of a "captive finance company," as previously reported by this news service.

The rule intentionally establishes a tight compliance date of 1 March 2017 with respect to variation margin under the rationale that in aggregate, daily exchange of variation margin is standard practice between swap dealers and many market participants. Most if not all securitizations covered by the rule will fall into this subcategory. (Programs that are party to an annual average of USD 8bn or more in notional amount of derivative contracts and short-dated foreign exchange trades may fall into a separate subcategory - "financial end users with material exposures" - with separate margin requirements.)

Start-up compliance costs

Being party to a swap contract under which a swap provider both collects and posts margin is not standard practice for issuers of rated securitizations, however. In order not to be shut out by swap providers from 1 March 2017 onwards, a securitization issuer will have to have set up margin financing and operations well beforehand and also to have finalized trade documentation. Under the swap margin rule, a swap provider must have all trading documentation in place to enter into a new swap.

Setting up margin financing and operations will require dedicated resources on both an upfront and ongoing basis, which in turn will impact the capital structure. In contrast, the pricing of a new swap contract itself should not be affected significantly, given that the contract will more closely mirror ones that swap providers have long entered into with other financial counterparties.

Exchanging variation margin must occur on at least a daily basis and the cumulative amount

of margin that has been either collected or posted by a swap provider (depending on whether the swap contract is in-the-money or out-of-the-money to the provider) must at least equal the market value of the swap contract. A swap provider and financial end user without material exposures are free to define market value (e.g., as the mid-market value of the swap contract) as well as to specify amounts of variation margin that exceed the margin requirement. They will also have to decide whether variation margin will be held in a segregated account and whether it can be re-used.

By design, the swap margin rule casts a very wide, very tightly knit web with respect to types of derivative contracts, swap provider, and financial counterparties. "Swaps" refers to swap contracts that reference basis rates, interest rates, currencies (other than very short-dated foreign exchange swaps and forwards), credits, commodities, and equities.

Commentary in the swap margin rule states that it will cover swap dealers and major swap participants registered in the US, their subsidiaries and overseas branches, as well as the US branches and subsidiaries of foreign companies active in the US swaps market. Furthermore, each of the five prudential regulators also has the ability to designate any other entity as a covered swap entity, i.e., as a swap provider that must comply with the rule.

Relief unlikely for offshore SPVs

Because the swap margin rule will cover overseas branches and subsidiaries of registered US swap providers, securitization issuers outside of the US may be impacted. The rule allows for the five prudential regulators to decide jointly on a jurisdiction-by-jurisdiction basis if compliance with foreign regulations can be "substituted" for compliance with the swap margin rule. However, in the absence of a joint determination, a swap provider must comply with the swap margin rule. Moreover, rule commentary states that foreign regulations that do not obligate a US swap provider to collect margin are unlikely to qualify for "substituted compliance."

The rule is more relaxed with respect to the "eligible collateral" that can be posted as variation margin between a swap provider and a financial end user without material exposures (such as a securitization issuer). Cash, US treasuries, debt guaranteed by a range of government and multi-lateral entities (such as the US Treasury, a US agency, a GSE, the European Central Bank, some sovereigns, and entities such as the IMF), as well as gold and some equities and publicly traded debt securities are all eligible (subject to specified haircuts).

However, ABS are not eligible collateral, unless "they are issued by, or unconditionally guaranteed as to the timely payment of principal and interest by, the US Department of the Treasury or another US government agency whose obligations are fully guaranteed by the full faith and credit of the US Government; or if they are fully guaranteed by a US GSE that is operating with capital support or another form of direct financial assistance received from the US government that enables repayment of the securities."

To avoid idiosyncratic "wrong-way risk", eligible collateral excludes securities issued by either party or affiliates. To avoid general wrong-way risk, eligible collateral also excludes "securities issued by a bank holding company, a savings and loan holding company, a foreign bank, a depository institution, a market intermediary, or any company that would be one of the foregoing if it were organized under the laws of the United States or any State, or an affiliate of one of the foregoing institutions." For the same reason, "securities issued by a non-bank systemically important financial institution designated by the Financial Stability Oversight Council" are also excluded.

Spotlight on flip clauses

Rather than post margin under a swap contract, issuers of rated securitizations have generally entered into swap contracts that hew closely to rating methodologies. Consistent with these methodologies, an issuer of rated securitizations generally pays amounts owed to a swap provider at a senior place in the priority of payments but also stipulates that this seniority can "flip" to a junior place in certain instances of swap provider impairment (such as bankruptcy).

For its part, a swap provider that is counterparty to a securitization issuer under a swap contract that adheres to a rating methodology typically does not post margin from the outset but instead agrees to do so (or take other remedial actions) only if it is downgraded to a specified level. However, many of these swap contracts also contain procedures to relieve a downgraded swap provider of the obligation to post margin or take other remedial actions.

Under the swap margin rule, a swap provider will have no discretion to collect or post variation margin in amounts below the margin requirement, nor to do so any less frequently than daily. Similarly, the ratings of a swap provider (or securitization obligations) will no longer activate (or deactivate) the obligation of a swap provider to post variation margin.

Accordingly, issuers of rated securitizations will have lots to decide and will have to consult with swap providers at each decision node given that it is the providers (and not securitization issuers or other financial end users) that are responsible for compliance with the swap margin rule, including finalizing trade documentation.

For instance, in developing new custodial and financing arrangements to support the daily, two-way exchange of margin, a securitization issuer will have to query swap providers on the attributes that they require to treat a swap contract as being compliant. Securitization issuers will also have to understand the rating implications from entering a swap contract with immediate, two-way margin posting.

Questions abound

Working backwards, input from swap providers and rating agencies will help securitization issuers determine the costs of financing margin and beefing up margin operations. Working backwards further still, these costs help will a securitization issuer to weigh entering into a

swap contract against other means to offset the potential depreciation of securitized assets, such as buying an option or increasing overcollateralization.

Two-way margin posting should also prompt a securitization issuer to re-examine features of industry-standard swap contracts. Given that a swap provider will be holding variation margin under a swap contract that is in-the-money (out-of-money to an issuer), will the swap provider require its payments to be made from a senior position in a securitizations' priority of payments? Is there a reason to continue "flipping" these payments to a subordinate position when a swap provider is insolvent or in bankruptcy?

This re-examination will require still more input from swap providers. How will a swap provider adjust the calculation of the market value of a swap contract to reflect holding margin when a swap contract is in-the-money (out-of-the-money to a securitization issuer)? Or the presence or absence of a flip clause? Or the unequivocal obligation to post margin against the market value of a swap contract that is out-of-the-money (in the-money to an issuer), rather than the currently contingent obligation that activates only after swap provider downgrade?

Again, the responses from swap providers and input from rating agencies may convince a securitization issuer to forego hedging in part or altogether and instead opt to expose rated liabilities to asset depreciation and in turn issue senior debt with lower ratings (and potentially new types of subordinated debt or equity).

Because the swap margin rule exempts swap contracts that hedge commercial risks of "captive finance companies", the decision to collect margin under these swaps will remain the judgment of a swap provider. (A "captive finance company" is defined as an "entity whose primary business is providing financing and uses derivatives for the purposes of hedging underlying commercial risks relating to interest rate and foreign exchange exposures, 90% or more of which arise from financing that facilitates the purchase or lease of products, 90% or more of which are manufactured by the parent comp any or another subsidiary of the parent company.")

If swap providers continue to use the current industry-standard template for swap contracts that hedge the commercial risks of captive finance companies, the securitization sector will see a bifurcation of swap contracts. Captive finance companies will continue to hedge commercial risks with swap contracts that adhere to current rating methodologies, whereas other securitization issuers will enter into swap contracts that are compliant with the swap margin rule.

Rating agency methodologies will have to assess the impacts from the two types of swap contracts. And other providers of securitization analytics will also have to boost their assessments of the potential depreciation of securitized assets relative to rated liabilities.

by Bill Harrington

[Bill Harrington has been conducting research on the obligations and risks of derivative contracts in the structured finance sector for 15 years, most recently at Debtwire ABS and previously at Moody's Investors Service. He has filed evaluations of rating processes and derivative methodologies with US and European regulators and with credit rating agencies. Bill has also worked as derivative structurer at Merrill Lynch and a currency analyst at Wharton Econometrics. Bill has an MBA from The Wharton School.]

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