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USA

CFTC lets ABS sector guess on global implementation of swap margin rules – ANALYSIS

14 September 2016 | 16:11 EDT

The CFTC approved a "comparability determination" that permits "substituted compliance" with the swap margin rules of Japan on 8 September.

The Japanese Financial Services Agency requested the determination in early June. Commissioner Bowen established the context in her opening statement.

"In a margin comparability determination, we are defining when our US dealers that are operating in the other jurisdiction can ignore our margin rule and follow the other jurisdiction's margin rule ... This determination is doubly important because this is the first one and thus sets the stage for others."

US dealers that are operating in the ABS sector in Japan cannot ignore the CFTC margin rule, based on a close read of the commission vote and supporting materials, including: commissioner statements and questions; staff responses and analysis; 85 pages of comparison with the JFSA rules; and the CFTC margin rule itself.

The takeaway for global ABS? The evolving swap margin regimes will increase issuance costs around the world and reduce selling points viz-a-viz other asset classes.

Moreover, ratings for ABS and other structured finance where an issuer is party to a swap should also be downgraded. Otherwise, inflated ratings will continue to distort investment decisions.

Debtwire ABS conducted this extensive review because the CFTC declined to respond to the following questions after spending three months closely reviewing the JFSA rules:

Do the JFSA rules differ from the CFTC rules with respect to:

asset-backed securities, securitization instruments or special-purpose vehicle instruments as eligible collateral for either variation or initial margin;

issuers of asset-backed securities or securitizations or special purpose vehicles and the daily posting and collecting of variation margin; or

treatment of uncleared swaps that contain a walk-away provision or a flip clause?

First, US and Japanese rules assign zero credit to private-label ABS collateral

By triangulating among the CFTC public data, Debtwire ABS can tackle the questions independently.

Firstly, most ABS in all sectors other than GSE ABS cannot be applied to the daily requirement for a US dealer to post or collect margin with another dealer or a financial end user in any jurisdiction.

Permissible collateral is limited to GSE ABS as well as debt that is issued or unconditionally guaranteed by the US Treasury, other US government agency or certain multilateral development banks. Debt that is issued or fully guaranteed by the European Central Bank and certain sovereigns is also permissible.

The JFSA rules don't even contain an obvious carve-out for GSE ABS. Allowable debt for margin posting is that issued "by a central government, a central bank, or an international financial institution" or by any other entity (excluding securitizations) with certain high level credit risk ratings," according to the CFTC commentary.

As a result, the largest swap dealers and banks have apparently had one less outlet for leveraging private-label ABS holdings since 1 September, the first of a series of CFTC compliance dates. This will also be the case for financial end users such as insurance companies, hedge funds, pension funds, investment funds, and money-market funds starting 1 March 2017, the second compliance date.

GSE ABS okay as long as US provides direct support

The CFTC margin rules sets out a tight definition of GSE ABS: "[a] an asset-backed security fully guaranteed as to the timely payment of principal and interest by a U.S. Government-sponsored enterprise that is operating with capital support or another form of direct financial assistance received from the U.S. government that enables the repayments of the U.S. Government-sponsored enterprise's eligible securities."

Should the GSE no longer operate with capital or direct support from the US government, its ABS will no longer qualify as permissible collateral.

The GSE definition excludes ABS such as FFELP ABS where the securitized assets rather than the securitized debt are government guaranteed. Under the CFTC rules, a swap dealer can still post and collect non-GSE ABS, as well as other instruments that are not on the list of permissible collateral, but will receive zero credit towards the margin requirements for having done so, as previously reported (see article, 18 December).

The CFTC rule has a carve-out for "publicly-traded debt that has been deemed acceptable as initial margin by a prudential regulator." However, accompanying commentary notes that non-GSE ABS are not generally within the "permissible category of publicly-traded debt securities."

The prudential regulators – the Federal Reserve Board, FDIC, FHFA, OCC and FCA – have an analogous margin rule that limits ABS collateral to the same definition of GSE ABS, as previously reported (see article, 4 November.)

Spokespersons for the Fed and FDIC did not respond to the question of whether the respective regulators had approved a non-GSE asset-backed security as acceptable initial margin.

Secondly, US dealers must exchange daily margin with Japanese ABS

The CFTC commentary does not directly address whether the JFSA rules cover or exempt Japanese issuers of ABS and other structured finance from margin posting. However, the distinction seems to be moot, based on CFTC commentary that describes circumstances in which the CFTC rule, rather than the JFSA rule, will apply to US dealers.

As result, a US dealer in Japan must observe the CFTC rule when providing a new swap to an ABS or structured finance issuer on or after 1 March 2017. The CFTC rule obligates a USD dealer to post and collect variation margin on a daily basis under such a swap, as reported on 18 December.

Any Japanese financial end user with less than USD 3bn in average notional amount of derivatives, which presumably covers most ABS issuers, is effectively exempt from margin posting under the JFSA regime. "In general, the threshold for variation margin is whether the average total amount of the notional principal of OTC Derivatives for a one-year period ... exceeds JPY 300 bn," states the CFTC commentary.

This is exactly the type of exemption that is not covered by the comparability determination. "Given the definitional differences and differences in activity thresholds with respect to the scope of application of the Final Margin Rule and the JFSA's margin requirements, the Commission notes the possibility that the Final Margin Rule and the JFSA's margin rules may not apply to every uncleared swap that a CSE may enter into with a Japanese counterparty." A CSE is a swap provider covered by the CFTC rules.

In instances where the CFTC rule does apply and the JFSA rule does not, a US swap dealer cannot claim the JFSA loophole but must instead comply with the CFTC margin rule. "[t]he Commission reiterates that no CSE may rely on substituted compliance unless it and its transaction are subject to both the Final Margin Rule and the JFSA's margin rules; a CSE may not voluntarily comply with the JFSA's margin rules where such law does not otherwise apply."

Thirdly, margin posting neutralizes a flip clause. JPY repacks of AAA CLOs at risk?

The daily exchange of variation margin neutralizes the presence of a flip clause or other walk-away provision and other rating assumptions, as previously reported (see article, 12 August).

A real-world example exists with respect to the repackaging of US ABS such as the AAA rated tranches of 14 US CLOs that were repackaged and issued as AAA rated JPY instruments in Japan between March 2014 and January 2016. CLOs aside, "the term repack applies to a wide range of structured instruments" with both cashflow and synthetic structures, according to "Moody's Approach to Rating Repackaged Securities" dated 15 June 2015.

Moody's methodology states that an interest rate or currency swap is central to most repacks. In general, Moody's evaluates a repack swap as having negligible risk based in large part on "replacement" and other assumptions for existing swaps that the CFTC margin rule invalidates, as reported.

Other rating agencies also rely on these invalidated assumptions and none has even proposed, let alone published, an update to its respective ABS swap methodology. Any such update would obligate a rating agency to immediately downgrade all ABS and repacks where an issuer is party to a swap and to assign lower ratings to new issuances in the future.

In the case of repacks generally, Moody's could no longer merely pass on the rating of an underlying ABS to a repackaged instrument issued anywhere in the world. Nor would a simple review of the corporate affiliation of a swap dealer operating outside of the US indicate once and for all whether a repack swap is or is not subject to the CFTC margin rules and thus is or is not properly evaluated using existing rating assumptions such as replacement.

Taking the 14 CLO repacks into JPY as examples: Mitsubishi UFJ Morgan Stanley Securities Co., Ltd. is the swap counterparty to eight repacks; BNP Paribas is swap counterparty to four repacks; and J.P. Morgan Securities PLC is counterparty to two re-packs, according to the respective Moody's announcements.

All 14 repack swaps are at least indirectly covered by the CFTC determination, given that US dealers in Japan are unlikely to replace a USD/JPY currency swap when doing so requires an ongoing exchange of variation margin on a daily basis. The costs for margin exchange under a currency swap are likely to be very high, as previously reported (see article, 16 May).

As a result, the pool of replacement counterparties will shrink and the rating assumption of costless replacement will be further undermined.

Setting the stage for examining the EU margin regime?

The comparability of JFSA rules is only half done – the prudential regulators still must make their own determination. "[A]s far as we know, they've not presented anything to their

principals at this point so we don't know where they will come out," stated a CFTC staffer.

The prudential regulators' process and schedule differs from the CFTC. For a start, a regulated swap provider rather than a government or national regulator must ask a prudential regulator to make a determination.

Commentary in the prudential regulator rule indicates that US swap providers will be obligated to exchange variation margin on a daily basis under new swaps with ABS issuers in jurisdictions such as Japan and the EU that exempt these issuers from margin posting.

Foreign regulations that do not obligate a US swap provider to collect margin are unlikely to qualify for "substituted compliance" and, in the absence of a joint determination, a swap provider must comply with the prudential regulator rules, as reported on 4 November.

In other words, ABS issuers the world over are unlikely to find a US institution or subsidiary that will provide a new or replacement swap that does not require both parties to exchange variation margin on a daily basis from 1 March 2017 onwards.

Future determinations by the prudential regulators and the CFTC on comparability with the EU margin regime may have a significant carve-out compared to the JFSA determination. The EU list of permissible collateral for margin posting includes senior tranches of many types of ABS.

"This breaking TRIPRA news just in – Generalissimo Francisco Franco is still dead!"

With respect to purely domestic implementation of the swap margin rules, a CFTC spokesperson also declined to comment on the following question that Debtwire ABS asked in April, August and again this week: Does the hedging swap of an SPV of a "captive finance company" benefit from the TRIPRA exemption from margin requirements?

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 a derivative structurer at Merrill Lynch and a currency analyst at Wharton Econometrics. Bill has an MBA from The Wharton School.

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