Farm Credit Administration

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INFORMATIONAL MEMORANDUM

April 5, 2018

To: Chair, Board of Directors
Chief Executive Officer
All Farm Credit System Institutions

From: Gary K. Van Meter, Director
Office of Regulatory Policy

Subject: Regulatory Capital Treatment of Certain Centrally Cleared Derivative Contracts

Staff of the Farm Credit Administration (FCA) are providing Farm Credit System (System) institutions with this guidance regarding the regulatory capital treatment of certain centrally cleared derivative contracts. This guidance is issued in response to changes certain central counterparties have made to their rulebooks[1] as well as guidance issued by staff of the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), and the Federal Deposit Insurance Corporation (FDIC) (collectively, "Federal Banking Regulatory Agencies").[2]

Centrally cleared derivative contracts and netting sets of centrally cleared derivative contracts (together, Cleared Derivative Contract Netting Sets) generally are subject to margin requirements that are assessed by central counterparties at the beginning and during the life of the derivative contract. Central counterparties have rulebooks that specify how to determine the amount of margin required at the beginning and throughout the term of a Cleared Derivative Contract Netting Set – generally called initial margin (IM) and variation margin (VM), respectively.[3]

Certain central counterparties have modified their VM requirements for certain Cleared Derivative Contract Netting Sets. These modifications now treat VM for certain Cleared Derivative Contract Netting Sets as a settlement payment of the outstanding exposure of the derivative contract, with title to the VM payment transferring to the receiving party. This

[1] For example, see Chicago Mercantile Exchange (CME) Rulebook – Chapter 8 – Settlements, Settlement Variation Payments, and Option Value (814).
[2] Regulatory Capital Treatment of Certain Centrally Cleared Derivative Contracts Under Regulatory Capital Rules (OCC: Bulletin 2017-27, FDIC: FIL-33-2017, FRB: SR 17-7), dated August 14, 2017.
[3] Generally, IM protects transacting parties from the potential future exposure that could arise from future changes in the mark-to-market value of the contract during the time it takes to close out and replace the position in the event that one or more counterparties default. VM protects the transacting parties from the current exposure that has already been incurred by one of the parties from changes in the mark-to-market value of the contract after the transaction has been executed.

is also known as the settled-to-market (STM) model for characterizing VM payments. Previously, VM transferred to cover the exposure that arises from marking Cleared Derivative Contract Netting Sets to fair value was considered collateral pledged by one party to the other, and title to the collateral would remain with the posting party. This is also known as the collateralized-to-market (CTM) model for characterizing VM payments.

FCA's Tier 1/Tier 2 Regulatory Capital Framework final rule in new Part 628 of our regulations became effective on January 1, 2017.[4] Section 628.35 provides that the trade exposure amount for a Cleared Derivative Contract Netting Set must be calculated using the methodology for Over-The-Counter Derivative contracts under § 628.34.[5] To calculate this trade exposure amount under § 628.34, a System institution must determine the current credit exposure and the potential future exposure of the derivative contract or netting set of derivative contracts. Current credit exposure is determined by reference to the mark-to-fair value of each derivative contract. Potential future exposure is determined, in part, by multiplying each derivative contract's notional principal amount by a conversion factor.[6] The conversion factors vary by category and remaining maturity of the derivative contract. Section 628.34 provides that for a derivative contract that is structured such that on specified dates any outstanding exposure is settled and the terms are reset so that the fair value of the contract is zero, the remaining maturity equals the time until the next reset date.[7]

Accordingly, if after conducting an accounting and legal analysis, a System institution has determined that: (1) The VM payment on a centrally cleared STM contract settles any outstanding exposure on the contract, and (2) the terms are reset so that fair value of the contract is zero, the remaining maturity equals the time until the next reset date, which would be at the next exchange of VM on the contract.[8] More specifically, when determining which conversion factor to use when calculating the potential future exposure amount in accordance with § 628.34 on a Cleared Derivative Contract Netting Set, the remaining maturity would be the next date in which the outstanding exposure is settled and the terms are reset so that the fair value of the contract is zero (i.e., the date the next VM payment is made using the STM model).[9]

When a System institution conducts its legal analysis to determine whether VM may be considered settlement of the outstanding exposure under the capital rule, the analysis must demonstrate that: (1) the transferor of VM has relinquished all legal claims to the VM, and (2) the payment of VM constitutes settlement under the central counterparty's rulebook, any other agreements governing the derivative contract, and applicable law. The legal analysis may satisfy these requirements by demonstrating that settlement of any outstanding exposure would generally involve a clear and unequivocal transfer of ownership of the VM from the transferor to the transferee, the transferee takes possession of the VM,

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[4] 81 FR 49720 (July 28, 2016).
[5] See 12 CFR § 628.35(b)(2).
[6] See § 628.34(a)(1)(ii) for calculating the potential future exposure on a single derivative contract and § 628.34(a)(2)(ii) for calculating the potential future exposure on multiple derivative contracts subject to a qualifying master netting agreement.
[7] See footnote 2 to Table 1 in § 628.34.
[8] Id.
[9] We note that the minimum conversion factor for an interest rate derivative contract (e.g., interest rate swap) with a remaining contractual maturity that exceeds 1 year is 0.005. This minimum factor would be applicable even if the outstanding exposure is settled daily. See footnote 2 to Table 1 in § 628.34.

and termination of any claim of the transferor on the VM transferred, including any security interest in the VM. If the transferor of the VM has any right to repurchase or recover the VM from the transferee, this would generally be inconsistent with treating the derivative contract as settled.

This guidance is based on the application of the Tier 1/Tier 2 Regulatory Capital Framework to the facts and circumstances presented. This guidance does not represent new rules or regulations. Furthermore, this guidance is consistent with the August 14, 2017 interagency guidance document issued by the Federal Banking Regulatory Agencies, as well as with similar guidance issued by the Commodity Futures Trading Commission (CFTC).[10]

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If you have questions on this guidance, please contact:

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[10] CFTC Interpretative Letter No. 17-51, October 12, 2017.