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Dodd-Frank Swaps Clearing Requirement Looming for Securitizations

Beginning June 10, 2013, many securitization issuers could be required to submit newly executed interest rate swaps for clearing under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) and implementing regulations. Most securitizations are currently structured such that swap providers are secured only by receivables or other collateral securing investors in the securitization. For these securitization issuers, the clearing process and posting of cash or highly liquid securities required for clearing will be prohibitively expensive and burdensome. As of today, interest rate caps and swaps with a conditional notional amount are not required to be cleared under the CFTC's first clearing determination, but such instruments may be required to be cleared in the future. Moreover, proposed margin rules by banking regulators and the CFTC would require swap dealers to collect margin from their counterparties to uncleared swaps. The clearing requirements will not apply to securitization interest rate swaps entered into prior to June 10, 2013.

Background

Title VII of Dodd-Frank establishes a comprehensive regulatory framework for swaps. The swaps clearing requirement is a central feature of Title VII. Clearing is a process by which two parties to a swap face each other through a derivatives clearing organization (DCO) that acts as an intermediary, thereby eliminating direct default risk between the parties. Each party to the swap posts to the DCO initial liquid margin (*e.g.*, cash, Treasuries) and variation margin on a daily basis as the swap changes in value.[1] The DCO then takes on the exposure of each counterparty, but is insulated from risk through collection of margin. Congress and the CFTC adopted the clearing requirement with the intent of reducing systemic risk posed by counterparty default in the previously unregulated over-the-counter swap market. According to the Senate Report, "with appropriate collateral and margin requirements, a central clearing organization can substantially reduce counterparty risk and provide an organized mechanism for clearing transactions."[2]

The clearing rules require a swap to be cleared through a DCO if the CFTC determines that the swap or category of swaps is required to be cleared and a DCO will accept the swap for clearing, unless an exception to the clearing requirement applies.[3] The CFTC adopted its first clearing determination (the "Clearing Determination") on December 13, 2012.[4] This determination applies to "plain vanilla" interest rate swaps, basis swaps, forward rate agreements and overnight index swaps in each case denominated in a single currency of either U.S. Dollars, Euros, Pound Sterling or Yen and which reference LIBOR or Euribor in the case of Euro denominated swaps.[5] If a swap is subject to a clearing determination, the swap must be submitted to any

[1] The posted margin will be typically held through a member of the DCO who is a futures clearing merchant (FCM), and each party to a cleared swap may enter into the swap with its FCM, who in turn enters into a matching swap with the DCO.

[2] Senate Report 111-176, at 33 (April 30, 2010).

[3] Dodd-Frank Section 723; Commodity Exchange Act, 7 U.S.C. 2(h).

[4] 17 C.F.R. Part 50, at 77 Fed. Reg. 74335 (December 13, 2012).

[5] The CFTC describes each of these products as follows:

1. ''Fixed-to-floating swap'': A swap in which the payment or payments owed for one leg of the swap is calculated using a fixed rate and the payment or payments owed for the other leg are calculated using a floating rate.

DCO that would accept the swap for clearing. Swaps subject to a clearing determination that contain idiosyncratic features – such as unusual representations and warranties or atypical day counts or reset tenors – may not be accepted for clearing by any DCO and therefore may not be required to be cleared.

Interest rate cap agreements whereby a party pays the entire fixed rate value of the hedge up front are not included in the Clearing Determination. Swaps with conditional notional amounts, such as "balance guaranteed swaps" where the notional amount varies in accordance with the principal amount of the hedged liability or the asset pool also are not included in the Clearing Determination. Amortizing swaps where the notional amount on each future date is established at the outset according to a set schedule would not have a conditional notional amount under the rule. Future CFTC clearing determinations may include caps and conditional notional amount swaps, however. The Clearing Determination also applies to certain credit default swaps referencing a list of CDS indices.

Swaps subject to a clearing requirement are subject to a compliance schedule, with progressively longer compliance periods for types of market participants that the CFTC determined need additional time to comply with the clearing requirement. Swaps between dealers and financial entities must be submitted for clearing no later than 180 days following the date of publication of the related clearing determination in the Federal Register. Accordingly, all interest rate swaps that are subject to the Clearing Determination between dealers and securitization SPVs that are financial entities (and not otherwise exempt from clearing) must be submitted for clearing if entered into on or after June 10, 2013.

Commercial End-User Exception to Clearing

Certain end users of swaps (i.e. non-swap dealers) may be exempt from clearing under the commercial end-user exception to clearing established under Dodd-Frank and CFTC regulations.[6] In order to be eligible for this exception, the end user must:

1. Not be a financial entity. Financial entity includes any "person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956";

2. Use the swap to hedge or mitigate commercial risk; and

3. Report to the CFTC or to a swap data repository how it generally meets its financial obligations associated with entering into the non-cleared swap.

The CFTC further provides (as authorized to so provide under Section 2(h)(7)(C)(ii) of the Commodity Exchange Act) that any bank, savings association, farm credit system or credit union with assets not in excess of $10,000,000,000 shall not be considered a "financial entity" under the Act.

Captive Finance Company Exception to Clearing

Captive finance companies whose primary business is providing financing, and who use derivatives to hedge underlying commercial interest rate and foreign currency exposures, are not considered financial entities under Dodd-Frank if:

- 90 percent or more of the hedged exposures arise from financing that facilitates the purchase or lease of products; and

- 90 percent or more of such products are manufactured by its parent or another subsidiary of its parent.[7]

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2. ''Floating-to-floating swap'' or ''basis swap'': A swap in which the payments for both legs are calculated using floating rates.

3. ''Forward Rate Agreement'': A swap in which payments are exchanged on a pre-determined date for a single specified period and one leg of the swap is calculated using a fixed rate and the other leg is calculated using a floating rate that is set on a predetermined date.

4. ''Overnight indexed swap'': A swap for which one leg of the swap is calculated using a fixed rate and the other leg is calculated using a floating rate based on a daily overnight rate.

77 Fed. Reg. 74302 (December 13, 2012).

[6] See Dodd-Frank Section 723; Commodity Exchange Act, 7 U.S.C. 2(h)(7) and 17 CFR Part 39.6, 77 Fed. Reg. 42590 (July 19, 2012).

[7] See Dodd-Frank Section 723; Commodity Exchange Act, 7 U.S.C. 2(h)(7)(C)(iii).

Other than entities that satisfy the exception for captive finance companies, most securitization vehicles are "financial entities" as defined under Dodd-Frank and the implementing regulations and, accordingly, are not exempt from clearing under Dodd-Frank.

Impact of the Clearing Requirement on Securitization

For most securitizations with an interest rate swap, the issuer enters into the swap with a swap dealer for the purpose of hedging a mismatch between the issuer's assets that serve as collateral for the securitization and the liabilities issued under the securitization. For example, a securitization containing a significant amount of fixed rate assets that issues floating rate (e.g. LIBOR) liabilities may enter into an interest rate swap with a notional amount equal to the liabilities issued. Typically, the issuer will owe an amount equal to a fixed rate times the notional amount of the swap for a given period, and the dealer will owe an amount equal to the agreed upon floating rate times the notional amount, with the net amount being paid either by the issuer or the swap dealer on each payment date. The swap notional amount may amortize according to a pre-determined schedule designed to match the anticipated amortization of the securitization liabilities, or the notional amount may be "balance guaranteed", meaning that the notional amount will at all times be equal to the principal amount of the issued securities or the asset pool. The swap may be required by rating agencies rating the issuer's liabilities, or by investors, or both. An issuer may also purchase a pre-paid cap agreement, whereby the issuer pays up front for the right to receive payments if a floating rate index such as LIBOR exceeds an agreed upon fixed strike price for any calculation period.

In a typical securitization, the swap dealer will be secured by the securitized receivables, loans or other financial assets, usually in a senior position to the liabilities issued in the securitization.[8] While this type of collateral arrangement has become market practice among swap dealers facing securitization SPVs, it would not be acceptable margin under the regulations governing DCO's and the DCO clearing rules. Rather, DCO's will require that issuers post cash or liquid government securities as initial margin, and thereafter post margin on a daily basis if the value of the swap moves against the issuer. The requirement to post liquid margin in addition to the pledge of assets to support the securitization would create a cost inefficiency that securitizations could not support. Accordingly, a clearing requirement will make hedging untenable for most securitizations. Moreover, for securitizations seeking a rating linked to the rating of the issuer's swap counterparty, current rating agency criteria do not contemplate (and in their current form wouldn't permit) an issuer to face a DCO or FCM in a swap. In addition, standard FCM agreements may contain additional termination rights and other rights that would not be consistent with rating agency criteria or investor requirements.

Alternatives to clearing may be available for industry participants, depending upon the objectives of the parties involved, the type of assets being securitized, the degree of interest rate mismatch between the issuer's assets and its liabilities, and other structural factors. For example, an issuer that purchases a fully paid interest rate cap would not be required to clear under the Clearing Determination. In addition, balance guaranteed swaps -- swaps where the notional amount varies based on some external event -- would not be required to be cleared. If the issuer is required to terminate a portion of the swap if the securitized assets pay more quickly than anticipated, the swap may be considered a conditional notional amount swap (and therefore not required to be cleared under the Clearing Determination) because changes in the notional amount of the swap are not predicable at the outset of the swap. Either of these options could be required to be cleared in the future, however, as the CFTC adopts new clearing determinations. In addition, securitization swaps typically contain non-petition and limited recourse provisions and other provisions specific to a securitization structure that are required by rating agencies and investors. Swaps containing such provisions would not likely be accepted for clearing by any DCO and may not, therefore, be required to be cleared.

Even if a swap is not required to be cleared or is not clearable, liquid margin may be required in the future. Dodd-Frank requires the CFTC and banking regulators to adopt rules requiring swap dealers to obtain initial and variation margin from their counterparties to uncleared swaps. Final rules have not been adopted, but under proposed rules (if not modified), end-users of uncleared swaps -- including caps, balance guaranteed swaps and other swaps that are not currently required to be cleared or are not accepted for clearing by a DCO-- will eventually be required to post margin to their counterparties, and will therefore face the same impediments described above.

Transaction participants considering alternatives to cleared swaps or provisions that would render a swap not clearable should be aware that the Clearing Determination provides that it "shall be unlawful for any person to knowingly or recklessly evade"

[8] The issuer, conversely, typically relies on the credit rating of the swap provider. If that rating is downgraded below agreed upon levels, the swap provider would be required to replace itself with a new highly rated swap dealer, or post collateral in accordance with a credit support agreement.

clearing requirements, or to abuse an exception to clearing.[9] The CFTC states in the adopting release for the Clearing Requirement that in order to satisfy this standard, the person entering into the uncleared swap must have a "legitimate business purpose" for entering into the swap. The CFTC also states that "circumventing the costs of clearing may be a consideration [for entering into a swap that is not subject to the clearing requirement], but cannot be the principal consideration in order to satisfy the legitimate business purpose test."[10]

Prospective securitization issuers should discuss with their advisors, lenders and swap providers the viability of these alternatives to clearing and other options in light of their particular circumstances and current market factors.

For More Information

If you would like to discuss solutions to the upcoming clearing requirements or would like more information, please contact Kenneth Marin at 212.655.2510 or any attorney in our Asset Securitization Group. Visit us online at chapman.com.

[9] 17 C.F.R. Part 50.10; 77 Fed. Reg. at 74337 (December 13, 2012)

[10] 77 Fed. Reg. at 74319 (December 13, 2012)