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<u>AFR Bulletin: Prudential Requirements for End User Swaps Simply Codify Existing Practice</u>

On April 13th, the FDIC and other banking regulators issued a Notice of Proposed Rulemaking (NPRM) concerning risk management requirements for major participants in the derivatives markets, such as swaps dealers. Some have depicted this rule as somehow calling into question the "end user exemption" in Dodd-Frank. But the rule simply codifies long-standing traditional practices in bank risk management and regulation. An attempt to reverse this rule could actually make risk standards for derivatives lower than they were <u>before</u> the Dodd-Frank Act was passed.

Consistent with the approach taken by other regulators, the NPRM specifically provides that end users are not subject to collateral or margin requirements for derivatives transactions used to hedge commercial risk. However, the rule does require that swaps dealers define some credit exposure limit for credit extended to commercial end users. If this limit is exceeded, the bank must begin to take collateral from its end user customer. The rule also makes clear that standard regulatory capital charges for derivatives risks will continue to be applied to swaps dealers regulated by the banking agencies.

The credit exposure limit in the rule simply codifies current practice. As the rule itself states:

> "In the case of a nonfinancial end user with a strong credit profile, under current market practices a derivatives dealer would not require margin—in essence, it would extend unsecured credit to the end user with respect to the underlying exposure. For counterparties with a weak credit profile, a derivatives dealer would likely make a different credit decision and require the counterparty to post margin." [Footnote 37]

This is because a derivative inescapably creates a credit risk for the swaps dealer – if the dealer's customer cannot fulfill its obligations, the dealer is exposed to losses. Swaps dealers appropriately treat this credit exposure like any other type of loan. The bank credit committee examines the creditworthiness of the derivatives counterparty, just as they would any business who applied for a loan. The bank will accept uncollateralized risk up to the level the credit committee approves, and will charge for it just as it would charge additional interest on any loan not backed by collateral. If the customer is not an acceptable credit risk, or if over time the dealer is exposed to risk from the customer that exceeds the bank's ability to bear the risk, the bank will ask for collateral to back the swap. To do otherwise would be completely imprudent.

By requiring that swaps dealers set some credit limit for uncollateralized exposure to a commercial end user, the regulators have simply asked that dealers follow standard risk management practices used in the market today. Regulators leave swaps dealers free to set their own credit exposure limits for commercial end users; these limits are not set in the rule. Therefore, the rule does not interfere with current market practices.

Likewise, the requirement of capital charges for derivatives simply reaffirms prudential regulatory requirements for derivatives exposures that have existed for decades. The rule simply states that banks will be required to set aside risk-based capital for derivatives, as they have for many years, and just as they do for any other credit risk exposure. The exact risk-based capital requirements will be set according to the recently negotiated Basel III accord on bank capital.

In the Dodd-Frank Act, Congress exempted end users from clearing requirements and the regulators have determined that end users will not be required to post collateral for derivatives used to hedge commercial risk. However, the Act was not intended to reverse standard risk management practices followed by dealers in extending credit through derivatives, or to force regulators to abandon their long-standing requirement that banks hold capital against derivatives risk exposures. To do so would be to mandate unsound banking practices. Giving derivatives risk some special exemption from standard risk management practices would be a serious failure to learn the lessons of the financial crisis.