Dodd-Frank Act Push-out
Planning the right strategy

Produced by the Center for Regulatory Strategies

Overview

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) outlines a framework for U.S. regulatory agencies to regulate the over-the-counter (OTC) swaps market and, at the same time, creates a higher degree of clarity and transparency amongst market participants. Section 716 specifically prohibits any federal assistance, including access to the Federal Reserve Board's (Fed) credit facility, discount window, or Federal Deposit Insurance Corporation (FDIC) insurance, to "swap entities." Under the Dodd-Frank Act, banks had until July 16, 2013 to "push out" certain swaps into an affiliate unless they were granted a two-year extension. Applying for that extension required filing an explanation of the bank's plans relative to push-out of eligible swaps as defined in Dodd-Frank. As a result of the extension process, many banks are now focused on the decisions that they need to make and determining the best course of action to be in compliance with "push-out" in 2015. Outlined below are some impacts and considerations around swap dealing activities, as well as key decisions banks may face.

Market impact

Legal entity options and capital analysis will be essential to push-out

- To remain eligible for the federal assistance, entities, including bank holding companies, must “push out” credit default swaps and all other swaps[1] out of their FDIC-insured entities. For many banks, this means that credit default, equity, energy, commodity, and other swaps will have to be traded as a Commodities Futures Trading Commission (CFTC) and/or Securities and Exchange Commission (SEC) registered swap dealer.
- The type of swap will determine whether it is governed by SEC or CFTC regulations. Generally, the SEC has jurisdiction over securities-based swaps and the CFTC authority over other swaps.
- If banks choose to push out their swap business to a separate SEC-registered securities-based swap dealer (SBSD) or swap dealer (SD), they will be required to capitalize this entity per the applicable proposed SEC and CFTC capital rules.
- In order to develop the business case to determine the preferred course of action, pro forma calculations will be essential in determining how much capital will be required under the proposed rules.

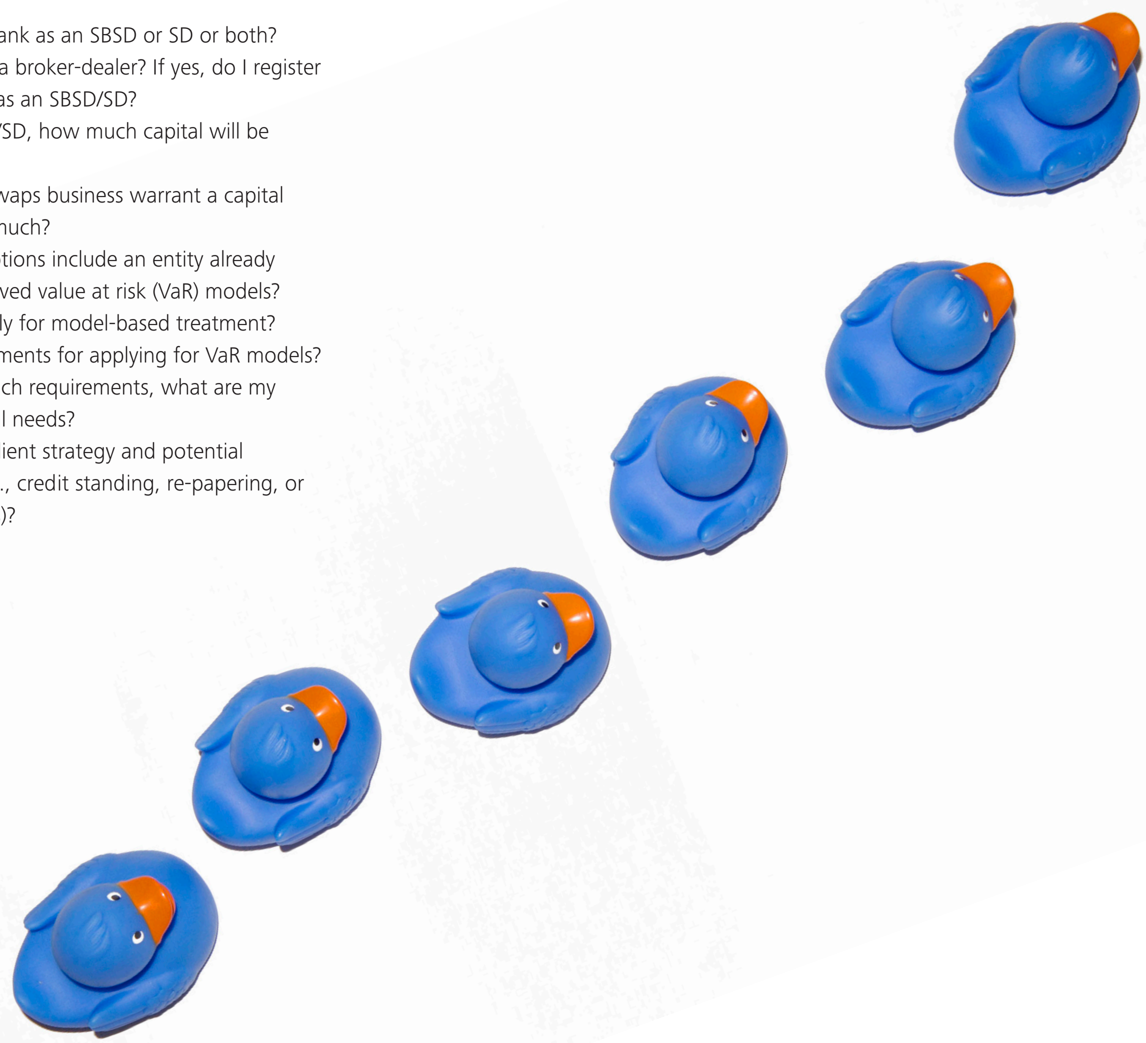
The amount of capital that is required will likely determine whether the bank goes forward with the business and, if so, in what form (e.g., establish a separate dealer). If the amount of the bank’s dealing is significant, the affiliate would be required to register as an SD with the CFTC and/or an SBSD with the SEC and capitalize such entities in accordance with the CFTC and SEC requirements.

[1] Except for swaps used to mitigate risk and other swaps involving rates or national bank-eligible assets (e.g., interest rate swaps and swaps that reference currencies, bullion metals, loans, or bank-eligible debt securities).

Business case decision

Banks dealing in swaps should develop a business case to assist in the decision of how to proceed with their swaps dealing. This would involve a review of their legal entity options that addresses some fundamental questions about the process. Key questions when thinking through potential legal entity structures can include the following:

- What does my current inventory of swaps look like?
- What are my legal entity options?
  - Are swaps booked in a bank, its U.S. branch or non-U.S. branch?
  - Do I register the bank as an SBSD or SD or both?
  - Do I operate with a broker-dealer? If yes, do I register the broker-dealer as an SBSD/SD?
- If I establish an SBSD/SD, how much capital will be required?
- Will the amount of swaps business warrant a capital infusion? If so, how much?
- Do my legal entity options include an entity already operating with approved value at risk (VaR) models?
  - If no, should I apply for model-based treatment?
- What are the requirements for applying for VaR models?
  - If I do not meet such requirements, what are my options and capital needs?
- What is the current client strategy and potential customer impact (e.g., credit standing, re-papering, or loss of client business)?



Registration and potential capital implications

There are multiple permutations of swap dealer registration and each impacts the capital requirements. See Figure 1 for some of the various registration combinations.

Figure 1. Various registration combinations

SEC only	CFTC only	Both SEC and CFTC
• "Stand-alone" SBSD • Securities broker-dealer that is also an SBSD	• Stand-alone SD • Futures commission merchant (FCM) that is also an SD	• SDs that are also SBSDs • SDs that are also BDs • SDs that are also SBSDs and BDs • SDs that are also BDs and FCMs • SDs that are also registered as SBSDs and FCMs • SDs that are also SBSDs, BDs, and FCMs • SBSDs that are also registered as BDs and FCMs • SBSDs that are also registered as FCMs

The amount of capital needed to support an SBSD or SD is dependent on the type of registration as well as if the entity is approved to use models. The SEC's and CFTC's proposed capital rules come under two varieties:

1. Proposed rules that offer the ability for firms to apply to use their own internal models, VaR models, to compute market and credit risk charges; and
2. SEC and CFTC rules that require those charges to be computed using prescribed percentage-based formulas or haircuts.

A large SD or SBSD should receive a more beneficial capital requirement using VaR models due to the more precise alignment with the risk of the positions and the more dynamic hedging that internal VaR models consider. The Fed and other banking agencies generally offer the use of VaR models to most large banks; however, using a U.S. bank or branch is **not** an option for pushed-out swaps.

Under its proposal, the CFTC would not approve VaR models, but would recognize those that are approved by the Fed and the SEC, if the SD is also registered with the SEC. Under the proposal, the use of Fed-approved models is only allowed for SDs that are either, **systemically Important Financial Institutions (SIFI); or subsidiaries of U.S. bank holding companies.**

Entities that do not calculate capital using internal models must apply specific standardized capital charges based on "haircut" deductions,[2] which are more punitive in nature. Note that the SEC has its own approval process for models that applies regardless of whether or not those models have been approved by other agencies.

Specifically SEC Rule 15c3-1 sets haircut percentages for most securities and futures. The proposed rules would establish new standardized deductions for certain security-based swaps such as credit default swaps (CDS) where the haircut charges will be based on a maturity and the current spread of the CDS. The proposal offers some relief in that it would allow for the netting of long and short CDS positions and the netting of CDS positions against the underlying position.

[2] As outlined in the proposed amendments to SEC Rule 15c3-1 and proposed appendix B of 18a-1

Some key considerations

Capital – Firms that have complex legal entity structures now have the opportunity to evaluate the options for consolidating legal entities to optimize funding and capital. The proposed requirements are likely to make it suboptimal to conduct derivatives activity in multiple entities. Consolidating derivatives activity in as few entities as allowed by the business strategy would allow institutions to deploy funding and capital where they provide increased return and reduce the likelihood of trapped capital. Accordingly, preparing a pro forma capital computation would assist in understanding options and capital implications.

Credit rating – Since the swaps market is a credit intensive business, counterparties to swap contracts want comfort that the swap dealer they transact with has the financial strength and stability to be able to honor the contract through its term. Prior to the enactment of Dodd-Frank, counterparties primarily transacted with the legal entity in the swap dealer's enterprise with which they were most comfortable from a credit standpoint, which was typically a bank. The prospect of providing initial margin to swap dealers is now likely to make firms even more focused on credit rating since the counterparties are dealing directly with the swap dealer and not a bank. As a result, many firms will need to further consider the credit worthiness of their swap dealer counterparties.

Legal contracts – Registering a different (or a brand new) legal entity as a swap dealer means that existing contracts must be renegotiated (perhaps at unfavorable terms to the client) with the new entity that the counterparty may not see as "preferable," which may cause clients to close their accounts and result in increased costs due to massive repapering.

Central clearing membership – Membership in various central clearing parties is also a critical consideration in a legal entity structure analysis. Firms should seek to become clearing members of central clearing parties (CCPs) that make the most sense for their clients. The choice of where to clear swaps is a client-driven decision as different CCPs will impose additional capital and margin requirements on their members so firms should have a robust understanding of the implications on operating costs.

Operational infrastructure – If the entity decides to compute standardized charges, a tool will need to be created or purchased from a vendor to calculate the charges. If the decision is made to either apply for VaR model approval or leverage an existing VaR model, additional system/infrastructure enhancements will be required.

How Deloitte[3] can help

Deloitte's proactive approach to these complex rules, combined with our insight of the rule making process, positions us to assist banks in navigating their decisions and identifying the anticipated impact on their organizations. It is our understanding that the development of internal bank models is a rigorous exercise and requires highly specialized skills, as well as proper technology infrastructure and governance. From a legal entity standpoint, coupled with less punitive capital charges, dealers that are large enough to apply for approval of internal models may want to consider the tradeoff between the operational cost and rigorous application process as compared to the capital savings. Dealers that do not have models, or sufficient capital to apply for model-based treatment, may want to consider the operational infrastructure required for computing the standardized charges.

Deloitte continues to assist firms with developing their business case for swaps "push-out" including:

- Analyzing whether swap activity meets the CFTC's de-minimis test[4] for registration
- Providing a detailed understanding of the proposed capital and other rules that impact the business case analysis
- Analyzing the various legal entity options by helping institutions navigate through the number of registration options and the applicable capital rules for each legal entity option under consideration
- Calculating what the capital requirements would be under the prescribed charges to assess whether an application for VaR model approval is warranted

Furthermore, Deloitte assists many firms with their SEC VaR model applications. That assistance includes comparing the requirements to the client's practices and procedures in the following areas:

- Market risk
- Credit risk
- Funding and liquidity
- Financial and regulatory reporting

Lastly, if the entity decides to register as an SBSD or SD, Deloitte is able to assist with the following self-assessments related to registration:

- Compliance with business conduct standards
- Trade reporting and recordkeeping requirements
- Capital, margin, and segregation requirements as an SBSD/SD
- Design and implementation of key controls required to support applicable regulatory requirements (e.g., front office to back office reconciliations for swaps, swap inventory reconciliations into market risk and credit risk systems if model-based haircuts are used, and inventory reconciliations for standardized haircut calculations)
- Technology and systems enhancements required to operate as an SBSD/SD

[3] As used in this document, "Deloitte" means Deloitte & Touche LLP, as subsidiary of Deloitte LLP Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.

[4] Entities are required to register if they meet specified thresholds. The rule requires that, in order for a person to be exempt from the definition on the basis of de minimis activity, the aggregate gross notional amount of the swaps that the person enters into over the prior 12 months in connection with dealing activities must not exceed $3 billion. A phase-in period was also enacted in which the de minimis threshold is $8 billion, this phase-in period is expected to last until the end of 2015/early 2016.

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