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USA

ANALYSIS: CFTC swap margin rule denies relief for ABS; shines light on "flip clauses"

18 December 2015 | 16:19 EST

The 1 March 2017 deadline for many securitization issuers to post margin under new swap contracts remains intact. Per earlier reporting, the obligation to post margin will apply to most securitization and structured product issuers, although an exemption exists for swap contracts that hedge commercial risks of "captive finance companies" (see analysis, 4 November 2015).

On 16 December, the CFTC voted 2-1 to adopt a final rule on margin posting, as reported. Per commentary in the rule, it "essentially provide(s) for the same treatment as the rules recently adopted by the Prudential Regulators with a few exceptions." (The prudential regulators are the FDIC, Federal Reserve Board, FCA, FHFA, and OCC.) As they affect securitization and structured product issuers, the potential exceptions are technical, for instance with respect to "the model approval process" and "the calculation of variation margin and related documentation requirements."

The CFTC rule adds swap dealers and major swap participants to those already required by the prudential regulator rule to collect and post margin with financial counterparties, including many securitization issuers. The CFTC rule applies to swap entities that are not "subject to a Prudential Regulator." These include nonbank subsidiaries of bank holding companies, as well as certain foreign swap dealers and major swap participants.

In her dissenting statement, Commissioner Sharon Bowen objected to the rule "because of its treatment of interaffiliate margin", which concerns margin posting by entities within the same corporate family and does not relate to securitization issuers.

Commentary in the CFTC rule suggests that, as was the case with the prudential regulator rule, industry lobbying to exclude "structured finance vehicles including special purpose vehicles ("SPVs") and covered bond issuers" failed. However, this author's own counter-lobbying that "requiring SPVs and other asset-backed security issuers to post full margin against all swap contracts would defuse commonly used "flip clauses" and decrease the loss

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exposure of investors in asset-backed securities" was apparently heeded.

The CFTC and prudential regulators have each promulgated an interim final rule that exempts certain transactions, such as swap contracts that hedge commercial risks of "captive finance companies", and requested comment on whether the interim final rule should be made permanent.

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

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