Pension Plans and Derivatives in the New Regulatory Environment: Capital and Margin Concerns and Possible Solutions

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Introduction

- Key Takeaways:
  - New margin and capital requirements may significantly increase costs and collateral requirements for public and private pension plans and impose significant capacity constraints on banks in connection with listed and over-the-counter derivatives.
  - This is due to uncertainty regarding the treatment of creditors' rights to close out, net and apply collateral in a pension plan insolvency proceeding.
  - We discuss several solutions – all of which will require industry participation – to these issues.
- Outline of Presentation:
  - Basel's Capital Requirements
  - Prospective Margin Requirements for Uncleared Swaps
  - Legal Challenges Concerning Pension Plan Insolvency
  - How these Challenges Increase Costs for Pension Plans and their Counterparties
  - Possible Solutions
    - FDICIA and Regulation EE
    - An Advisory Opinion from the PBGC
    - Changes to the Capital and Margin Rules

Basel's Capital Requirements

- Banks must hold capital against actual and potential credit exposures arising from cleared and uncleared derivatives.
- These include exposures arising from the derivatives positions that clearing members affiliated with banks clear for their clients.
- The amount of capital required is a function of both the economic and legal risks arising from the derivatives positions.

Mechanisms Allowing Banks to Reduce Capital Requirements

- Basel III allows banks to reduce the amount of capital they are required to hold against derivatives-related credit exposures to a client where:
  - They have a “Qualifying Master Netting Agreement” (QMNA);

    and/or
  - The credit exposures are collateralized by qualifying high quality collateral.

- In order for a netting agreement to qualify as a QMNA, Basel III requires that there be robust legal comfort (*e.g.*, an opinion from counsel) that the bank would be able to exercise its rights to close out and net the client’s positions upon default, notwithstanding insolvency proceedings.

- Likewise, for a bank to reduce its capital requirements in respect of a derivatives-related credit exposure by virtue of collateralization, the bank must have robust legal comfort that the bank would be able to exercise its rights with respect to the collateral upon the client’s default, notwithstanding insolvency proceedings.

Margin Requirements for Uncleared Swaps

- Under proposed rules recently published by the Commodity Futures Trading Commission (CFTC) and U.S. bank regulators:
  - Banks would be required to exchange initial margin (IM) with respect to uncleared swaps with pension plans and other “financial end users” with a “material swaps exposure.”
  - The proposed rules would define a “material swaps exposure” as $3 billion in average daily aggregate notional outstanding for a financial end user and its commonly-controlled affiliates.
  - Banks and their financial entity counterparties would be required to exchange <u>cash</u> variation margin (VM) daily.
- However, the proposed rules would allow banks to post and collect less margin based on risk offsets/netting if the bank and its client have an “eligible master netting agreement” (EMNA).
  - As in the capital context, an agreement would only qualify as an EMNA if the bank had legal comfort (*e.g.*, an opinion from counsel) that the bank would be able to exercise its right to close out and net the customer’s obligations, even in the event of insolvency proceedings.
- CFTC margin requirements would also apply to non-bank entities.

Legal Challenges with Pension Plan Insolvency

- In the case of both ERISA and non-ERISA pension plans, there is a lack of certainty as to whether banks would in fact be able to close out and net the positions and exercise rights with respect to collateral in the event of insolvency.
  - It is unclear whether pension plans are subject to the Bankruptcy Code, which contains "safe harbors" that generally protect derivative counterparties' contractual rights to terminate positions, net and apply collateral in bankruptcy.
- If the "safe harbors" do not apply with respect to pension plans, banks could be subject to a stay that would prevent them from closing out and netting all transactions with a pension plan and liquidating collateral upon the pension plan's insolvency.
- As a result, counsel has generally been unable to give the robust legal comfort Basel and the proposed margin rules require.

How these Challenges Increase Costs for Pension Plan Counterparties

- Without legal comfort on netting or collateral rights, banks have significantly:
  - Increased capital requirements;
  - Heightened initial margin requirements.

- These requirements will likely translate into greater costs for pension plan clients. Note that, because favorable netting comfort can be achieved for many non-pension plan counterparties, those counterparties will not face such costs.

- Further, banks will have substantial capacity constraints, limiting the number of derivative transactions they may enter into with pension plans.

- Pension plans will also experience greater direct costs with respect to uncleared derivatives since they will have to provide greater amounts of qualifying collateral than they would if favorable insolvency treatment were available.

Possible Solutions

- Petition the Federal Reserve to include pension plans as "financial institutions" under Regulation EE under the Federal Deposit Insurance Corporation Improvement Act (FDICIA).
  - This solution would cover both public and private plans.

- Seek an Advisory Opinion from the Pension Benefit Guaranty Corporation (PBGC) as to the treatment of close-out rights in insolvency.
  - This solution would only cover private plans.

- Seek amendments to capital and margin rules from the U.S. bank regulators and the CFTC (and, prospectively, the SEC).
  - This solution would cover both public and private plans.

Possible Solution 1: Petition the Federal Reserve to Include Pension Plans as "Financial Institutions" under FDICIA

- Under FDICIA, the payment obligations and entitlements under a netting contract between two "financial institutions," including the right to liquidate collateral, are enforceable, notwithstanding any other provision of law.
  - The Federal Reserve has issued a regulation, called Regulation EE, that defines which entities qualify as "financial institutions."
  - Under Regulation EE, a pension plan would need to meet certain quantitative and qualitative tests.
    - Quantitative: A pension plan would need to have $100 million mark-to-market or $1 billion notional in swaps, futures or other specified financial contracts during a specified fifteen-month period.
    - Qualitative: A pension plan would need to represent to the bank that the plan will engage in swaps, futures or other specified financial contracts on both sides of the market.
- Pension plans and their trade associations could advocate that the Federal Reserve, presumably in consultation with the Department of Labor, relax the Regulation EE requirements with respect to both public and private pension plans.

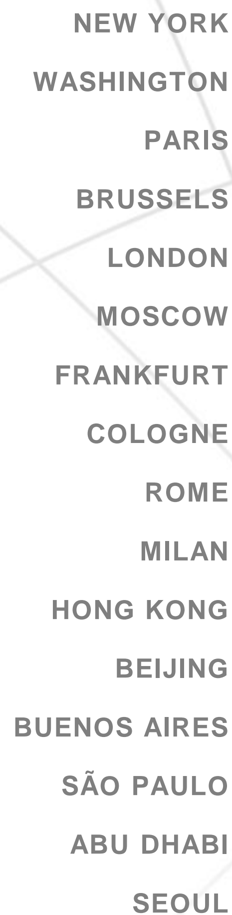
Possible Solution 2: Seek an Advisory Opinion from the PBGC as to the Treatment of Close-Out Rights in Insolvency

- Under ERISA, the PBGC administers the “termination” of pension plans in distress situations.
  - In such proceedings, the PBGC and a U.S. District Court have certain powers akin to those of bankruptcy trustees and courts, respectively.
  - However, the extent and nature of those powers is not clear, especially with respect to derivative close-out rights.
- Pension plans could ask the PBGC to issue an Advisory Opinion that ERISA would not prevent derivative counterparties from closing out and netting positions and exercising rights with respect to collateral in the event of termination proceedings.
- The DOL has issued Advisory Opinions saying that, in certain circumstances, margin is not a “plan asset” and emphasized in its most recent opinion the importance of equal treatment for pension plan counterparties.
- Again, this solution would not cover public plans.

Possible Solution 3: Seek Amendments to the Capital and Margin Rules for Transactions Involving Pension Plans

- Although the capital and margin rules are the direct source of the increased costs, they may be difficult to change in today's regulatory environment.
- The requirements reflect specific policy choices of Dodd-Frank and Basel to increase capital requirements and to incentivize the clearing of swaps.

Next Steps



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