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THE FINANCIAL SERVICES ROUNDTABLE
Financing America's Economy

October 22, 2012

By electronic submission

Re: **Comment Letter on Capital Treatment of Exposures to the Fixed Income Clearing Corporation's Mortgage-Backed Securities Division under the Bank Capital Proposals**

The American Bankers Association, the Securities Industry and Financial Markets Association and The Financial Services Roundtable ("**Associations**")[1] appreciate the opportunity to provide comments on a narrow, but important aspect of the Agencies'[2] bank capital proposals[3]—the capital treatment of exposures to the Fixed Income Clearing Corporation's[4] Mortgage-Backed Securities Division ("**MBSD**").

Agency mortgage-backed securities ("**MBS**") trading on the "to be announced" ("**TBA**") market are a crucial component of the U.S. mortgage market. The recent introduction of a central counterparty ("**CCP**") for this market—MBSD—has raised questions for clearing member banking organizations regarding the appropriate capital treatment of exposures to MBSD under the proposals. Banking organizations currently treat TBAs as derivative exposures under the U.S. Basel II advanced

[1] The Associations have also jointly submitted a more comprehensive comment letter, which sets forth the Associations' comments and recommendations regarding many aspects of the Agencies' bank capital proposals. *See* American Bankers Association, Securities Industry and Financial Markets Association and The Financial Services Roundtable, *Comment Letter on Proposals to Comprehensively Revise the Regulatory Capital Framework for U.S. Banking Organizations* (Oct. 22, 2012), *available at* http://www.sifma.org/workarea/downloadasset.aspx?id=8589940758. Further information about the Associations is available in Annex A.

[2] The "**Agencies**" refers to the Office of the Comptroller of the Currency ("**OCC**"), the Board of Governors of the Federal Reserve System ("**Federal Reserve Board**"), and the Federal Deposit Insurance Corporation ("**FDIC**").

[3] The proposals are (i) Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action ("**Basel III Numerator NPR**"), 77 Fed. Reg. 52,792 (Aug. 30, 2012); (ii) Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements ("**Standardized Approach NPR**"), 77 Fed. Reg. 52,888 (Aug. 30, 2012); and (iii) Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule ("**Advanced Approaches NPR**"), 77 Fed. Reg. 52,978 (Aug. 30, 2012). Collectively, these are referred to in this letter as the "**proposals**."

[4] The Fixed Income Clearing Corporation ("**FICC**") is a subsidiary of The Depository Trust & Clearing Corporation ("**DTCC**").

approaches rules.[5] However, MBSD is regulated by the Securities and Exchange Commission ("**SEC**") as a CCP for *cash* transactions. Significantly, MBSD is *not* a derivatives clearing organization regulated by the Commodity Futures Trading Commission ("**CFTC**").

MBSD provides critical risk management, trade processing and market efficiencies and underpins the vast majority of trading in the critically important TBA market. It is essential that incentives to utilize MBSD be maintained, as the TBA market is the largest and most liquid market for mortgage finance in the United States.

I. Market Overview

Currently, most mortgages in the United States are securitized through the agency MBS market. The vast majority of agency MBS trading occurs in the forward market, which is known as the TBA market. In a TBA trade, the seller of MBS agrees on a sale price, but does not specify which particular securities will be delivered to the buyer on settlement day. Instead, relying upon standardized industry practices and "conforming" mortgage collateral, only a few basic characteristics of the securities are agreed upon, such as the coupon rate and the face value of the bonds to be delivered. This TBA trading convention enables an extremely heterogeneous market consisting of thousands of different MBS pools backed by millions of individual mortgages to be reduced—for trading purposes—to only a few liquid contracts. TBA prices, which are publicly observable, also serve as the basis for pricing and hedging a variety of other MBS that do not trade in the TBA market.[6]

A smaller but still significant portion of agency MBS trading volume occurs outside the TBA market. This is known as "specified pool" trading ("**SPT**") because the identity of the pool to be delivered is specified at the time of the trade, much like other securities markets. While some of these pools are not eligible for TBA trading, many others trade outside the TBA market because they are backed by loans with more favorable prepayment characteristics from an investor's point of view, allowing them to achieve a higher price.

A key characteristic of the TBA and SPT markets is that they are forward markets. TBA trades generally settle within three months, with volumes and liquidity concentrated in the two nearest months. To facilitate the logistics of selecting and delivering securities from the sellers' inventory, the Securities Industry and Financial Markets Association ("**SIFMA**") sets a single settlement date each month for each of several types of agency MBS. Depending on when it falls in the monthly cycle of settlements, the trade date will usually precede settlement by between 2 and 60 days.[7]

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[5] *See* OCC, Federal Reserve Board, FDIC and OTS, *Risk-Based Capital Standards: Advanced Capital Adequacy Framework — Basel II*, 72 Fed. Reg. 69,288, 69,344 (Dec. 7, 2007) (emphasis added) ("**U.S. Basel II Advanced Approaches Final Rule**").

[6] James Vickery and Joshua Wright, Federal Reserve Bank of New York, *TBA Trading and Liquidity in the Agency MBS Market*, 2 (Staff Report No. 468, Aug. 2010), *available at* http://www.ny.frb.org/research/staff_reports/sr468.pdf.

[7] *Id.* at 8.

II. Overview of MBSD

MBSD was recently approved by the SEC to provide guaranteed settlement and CCP services for the TBA and SPT markets.[8] The SEC approved MBSD's application to become a CCP in its role overseeing securities clearinghouses. The predecessor of the MBSD, the MBS Clearing Corporation, was also approved by the SEC as a Securities Clearing Agency over 30 years ago and functioned under SEC regulation for that entire period.

In its approval order, the SEC stated: "The Commission believes that [changes to MBSD's rules to allow it to provide guaranteed settlement and CCP services] are consistent with the Exchange Act, including Section 17A, because they should help facilitate the prompt and accurate clearance and settlement of *securities transactions* and help assure the safeguarding of securities and funds under FICC's control or for which FICC is responsible. In particular, the Commission believes that these changes to the MBSD's rules should result in a more efficient system of settlement for the mortgage-backed security market."[9]

III. Existing U.S. Basel II Treatment of TBAs

Under the U.S. Basel II advanced approaches rules, banking organizations treat TBAs and SPTs as derivative exposures subject to the counterparty credit risk framework. This approach was clarified in the preamble to the U.S. Basel II Advanced Approaches Final Rule, which stated:

> "A derivative contract is defined to include interest rate derivative contracts, exchange rate derivative contracts, equity derivative contracts, commodity derivative contracts, credit derivatives, and any other instrument that poses similar counterparty credit risks. The rule also defines derivative contracts to include unsettled securities, commodities, and foreign exchange trades with a contractual settlement or delivery lag that is longer than the normal settlement period (which the rule defines as the lesser of the market standard for the particular instrument or five business days). *This includes, for example, agency mortgage-backed securities transactions conducted in the To-Be-Announced market.*"[10]

This treatment of TBAs is uniquely specified in the U.S. implementation of the advanced approaches under International Basel II,[11] reflecting the fact that the TBA product is unique to the U.S. market.

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[8] *See* SEC, *Self-Regulatory Organizations; Fixed Income Clearing Corporation: Order Approving Amended Proposed Rule Change to Allow the Mortgage-Backed Securities Division To Provide Guaranteed Settlement and Central Counterparty Services*, 77 Fed. Reg. 15,155 (Mar. 14, 2012).

[9] *Id.* at 15,162 (emphasis added).

[10] *See* U.S. Basel II Advanced Approaches Final Rule at 69,344 (emphasis added).

[11] "**International Basel II**" refers to the international capital accord reached by the Basel Committee on Banking Supervision ("**Basel Committee**") in *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (June 2006), *available at* http://www.bis.org/publ/bcbs128.pdf.

IV. Basel III Treatment of Exposures to CCPs

In the context of International Basel III,[12] the Basel Committee has developed a framework for the capitalization of bank exposures to CCPs, which the Agencies have proposed to implement in the United States.[13] The framework applies to banking organizations' "exposures to central counterparties arising from OTC derivatives, exchange traded derivatives transactions and [securities financing transactions]."[14] The framework specifically does not apply to banking organizations' "exposures arising from the settlement of cash transactions (equities, fixed income, spot FX and spot commodities)."[15]

Under the Basel Committee's framework, exposures to qualifying CCPs ("**QCCPs**") generally receive more beneficial capital treatment than exposures to non-QCCPs. In order to be considered a QCCP, a clearinghouse must meet a number of requirements. Among other things, the clearinghouse must be licensed as a CCP and permitted to operate as such by a supervisor that substantially enforces the CPSS-IOSCO Principles for Financial Market Infrastructures[16] and must complete "hypothetical capital calculations" as described in the framework. If a clearinghouse is a non-QCCP, banking organizations must apply the Basel capital accords' standardized approach to credit risk for their trade exposures to the clearinghouse and must assign a 1,250 percent risk weight to default fund contributions to the clearinghouse.

V. Treatment of Exposures to MBSD

The Associations request that the Agencies clarify the appropriate capital treatment of exposures to MBSD under the proposals. As a preferred alternative, the Agencies should clarify that exposures to MBSD will *not* be subject to the proposed cleared transaction framework for exposures to derivatives CCPs. Instead, banking organizations should treat MBSD as a securities CCP. This clarification would:

- Align with MBSD's role as a securities clearinghouse;
- Align with MBSD's recent regulatory approval from the SEC as a securities CCP;
- Reflect the unique nature of the TBA / SPT market; and
- Provide much needed clarity to market participants.

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[12] "**International Basel III**" refers to the international capital accord reached by the Basel Committee in *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (Revised June 2011), *available at* http://www.bis.org/publ/bcbs189.pdf.

[13] *See* Basel Committee, *Capital Requirements for Bank Exposures to Central Counterparties* (July 2012), *available at* http://www.bis.org/publ/bcbs227.pdf.

[14] *Id.* at 4.

[15] *Id.*

[16] *See* Committee on Payment and Settlement Systems ("**CPSS**") and Technical Committee of the International Organization of Securities Commissions ("**IOSCO**"), *Principles for Financial Market Infrastructures* (Apr. 2012) *available at* http://www.bis.org/publ/cpss101a.pdf.

Even if exposures to MBSD are subject to the proposed cleared transaction framework for derivative CCPs there are still concerns regarding the proposed application of the current exposure method ("**CEM**") to determine a QCCP's hypothetical capital requirement. Given the large scale of the TBA market, applying a non-zero conversion factor to TBAs and SPTs under the CEM would likely result in a very large hypothetical capital requirement that would, in turn, give rise to significant capital charges for MBSD default fund exposures. This could have an adverse impact on the U.S. mortgage market by deterring clearing member banking organizations from participating in MBSD.

Should the Agencies decide to subject exposures to MBSD to the proposed cleared transaction framework, the Associations believe that a zero conversion factor should be applied under the CEM for purposes of determining MBSD's hypothetical capital. Specifically, because TBA exposures are primarily subject to interest rate risk and the contract's maturity is always less than one year, the Associations believe that the most appropriate conversion factor to use in performing MBSD's hypothetical capital calculation is the zero percent conversion factor applicable to short-term interest rate derivatives.[17] The Associations understand that applying such a conversion factor would give rise to a very low or *de minimis* hypothetical capital requirement for MBSD given MBSD's variation margining arrangements, implying that application of the International Basel III rules for derivative CCPs to banking organizations' exposures to MBSD would not yield meaningful prudential enhancements in terms of clearing member banking organization capital requirements.

[17] The U.S. Basel II Advanced Approaches Final Rule applies a zero conversion factor to interest rate contracts with one year or less residual maturity. *See* U.S. Basel II Advanced Approaches Final Rule at 69,414. *See also* Advanced Approaches NPR §___.132(c), Table 3 (Conversion Factor Matrix for Over-the-Counter Derivative Contracts).

* * * *

The Associations thank the Agencies for considering the comments and recommendations set forth in this letter. If you have any questions or need further information, please do not hesitate to contact:

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ANNEX A

About the Associations

The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's $14 trillion banking industry and its 2 million employees. Learn more at www.aba.com.

SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

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