



July 11, 2011

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20st Street and Constitution Avenue, NW
Washington, DC 20551

Re: Margin and Capital Requirements for Covered Swap Entities – Notice of
Proposed Rulemaking (RIN 3064-AD79)

Ladies and Gentlemen:

Better Markets, Inc.¹ appreciates the opportunity to comment on matters identified in the above-captioned notice of proposed rulemaking (“NOPR”) relating to certain proposed rules (the “Proposed Rules”) of the Office of the Comptroller of the Currency, the Federal Reserve Board of Governors, the Federal Deposit Insurance Corporation, The Farm Credit Administration and the Federal Housing Finance Agency (collectively, the “Agencies”), promulgated pursuant to or in accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”).

INTRODUCTION

The Dodd-Frank Act requires registration and regulation of “swap dealers,” “major swap participants,” “security-based swap dealers” and “security-based major swap participants” (collectively, “Swap Entities”).² The Dodd-Frank Act further requires the Agencies to adopt rules imposing capital requirements and requirements for initial and variation margin with respect to un-cleared “swaps” and “security-based swaps” (“Covered Swaps”) of Swap Entities subject to prudential regulation by the Agencies (“Covered Swap Entities”).³ The Commodity Futures Trading Commission and the Securities Exchange Commission are mandated to impose capital and margin requirements with respect to swaps and security-based swaps of other Swap Entities.

Counterparty credit exposures, measured by changing market values, which are embedded in all derivatives were at the epicenter of the financial crisis which started in 2008 and continues to exact a massive cost on the world economy. Two characteristics of these credit exposures are that they have no limit and that the amount can only be

¹ Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

² Dodd-Frank Act, Sections 731 and 764.

³ Id.

measured if there is a market in which comparable derivatives can be transacted at discernable prices. They are the perfect vehicle to fuel a run on the financial system and the consequential freezing of credit which has proven so difficult to recover from (both currently and during the Great Depression).

The Dodd-Frank Act seeks to protect the financial and economic system from this fate by mandating the use of central counterparty clearing for many types of derivatives. Central counterparty clearing involves management and prudent collateralization of these embedded risks by regulated entities (primarily, derivatives clearing organizations). It is intended to mitigate the risk of another run on the banks.

However, the Dodd-Frank Act permits the Swap Entities and others to enter into derivatives under the end-user exception and where clearing is not available. The Proposed Rules are critical to protect the system from the potential consequences of these un-cleared derivatives. The NOPR points out that the intent of the Dodd-Frank Act provisions on margin and capital related to Covered Swaps is to “offset” their inherent risk as compared with cleared swaps.⁴ Therefore, to fulfill this intent, the Proposed Rules must establish a system in which incremental risk is collateralized or otherwise offset through prudent margining and capital requirements.

The Proposed Rules include many prudent and well-structured concepts that will undoubtedly reduce the risk posed to the system by un-cleared derivatives. However, there are a number of issues which must be addressed if the Proposed Rules are to meet the requirements of the Dodd-Frank Act:

- The Proposed Rules deal with the *collection* of margin by Covered Entities, not the *posting* of margin by them. This is completely inconsistent with the (correct) rationale which underpins the collection requirements in the Proposed Rules. But, far more importantly, the omission of a requirement to post poses a significant risk to the financial system.
- The Proposed Rules view margin thresholds accurately as credit arrangements. The swap documentation required by the Proposed Rules must, however, also include the basic terms and price for this credit.
- The Agencies pursue several methods in the Proposed Rules to measure current and potential future credit exposures. Unfortunately, the fundamental characteristics which cause derivatives to be so dangerous mean that simplified rules, while easier to replicate, can be dramatically inadequate in real-world situations. Therefore, static tables must provide substantial cushions against changes based on market conditions.

⁴ NOPR, 76 FR at page 27566.

- The NOPR discusses methods to calculate netting ratios for initial margin exploring simplified options. Simplification risks dangerously inaccurate results. The Proposed Rules must limit initial margin netting to the use of ratios employed by registered derivatives clearing organizations. Any other method must be approved by the appropriate Agency.
- The Proposed Rules acknowledge that a counterparty to a Covered Swap Entity may refuse or otherwise fail to transfer margin in a timely fashion. This is a serious issue in a marketplace known for frequent and persistent valuation disputes. The Proposed Rules must require a “pay first and dispute later” system of margining.

DISCUSSION

The Agencies accurately view derivatives in which counterparties to Covered Swap Entities are not required to post as embedded credit transactions: “The Agencies note that this threshold-based approach is consistent with current market practices with respect to nonfinancial end users, in which derivatives dealers view the question of whether and to what extent to require margin from counterparties as a credit decision.”⁵ This is completely consistent with the best academic analysis.⁶ As a result, the Proposed Rules address credit decisions and procedures for Covered Swap Entities.⁷

Posting of Margin by Covered Swap Entities (Questions 28 and 31)

The Proposed Rules are designed to require prudent processes and procedures by Covered Swap Entities in the measurement and management of counterparty credit risk. However, the analysis makes it abundantly clear that the counterparties are extending credit to the Covered Swap Entities also. The Agencies have made the decision that their purpose is to protect the Covered Swap Entities from harm and that the collection of collateral (or the orderly process of extending credit in lieu of collection) achieves that purpose.

The Proposed Rules must take a parallel approach to the posting of margin by Covered Swap Entities. Without this, only half of the concealed credit risk embedded in derivatives is addressed. Counterparties will continue to extend unseen credit in uncertain

⁵ NOPR, 76 FR at page 2570.

⁶ Professor John Parsons of MIT and Professor Antonio Mello of the University of Wisconsin have written extensively on the forbore derivatives collateral and the embedded loan. Some of these materials can be found at:
<http://bettingthebusiness.com/2010/10/25/otc-5-the-collateral-boogeyman-%E2%80%93-packaging-credit-implicitly-and-explicitly/>
<http://bettingthebusiness.com/2010/10/07/otc-3-the-collateral-boogeyman-%E2%80%93-the-delusion-of-%E2%80%9Cfree%E2%80%9D-credit-from-your-friendly-neighborhood-derivatives-dealer/>

⁷ Proposed Rules, Section __.2(m).

amounts to Covered Swap Entities. As a result, the true cost and risk of derivatives will remain substantially in the shadows. Incentives will be distorted. An opportunity to achieve a transparent system in which risks can no longer accumulate to dangerous levels, one of the goals stated by the Agencies, will have been lost.⁸

Requiring the orderly and transparent posting by Covered Swap Entities will not only protect them, but protect the financial system and reduce the likelihood of failures and bailouts. Lack of information and the ability to know and understand risks and exposures of financial market participants was at the core of the last crisis. No one knew what derivatives were on anyone else’s books, what those derivatives were valued at, what was or was not margined or collateralized, what the quality and/or quantity of capital was, among many other informational black holes. This not only resulted in the buildup of massive unseen risks, but it also deprived market participants of critical information upon which they could make informed judgments.

As a result, liquidity hoarding, collateral calls, and runs on all sorts of financial institutions by other financial market participants seeking to protect themselves within an overall context of non-transparency were the only rational actions. Only proper margining and collateral rules, plus disclosure, will prevent this from happening again by reducing the uncertainty that can trigger precipitous behavior at critically important times. That is why requiring transparent costs and risks on both sides of derivatives transactions are so essential.

Documentation and Pricing of Embedded Credit

The Proposed Rules correctly conclude that margin thresholds constitute the extension of credit. However, the provisions which establish standards for documentation of margin matters fail to address threshold-based credit: these provisions are limited to collection of margin and valuation procedures.⁹

Documentation must clearly specify that the threshold is a credit transaction, describe the terms under which margin funding will be required (that is, the terms under which the credit will be terminated) and, most importantly, the pricing of the credit. A rational system of margining Covered Swaps requires that these fundamental elements of threshold-based credit be contractually specified. Widely used forms of credit support documentation, as required by the Proposed Rules,¹⁰ ambiguously describe thresholds allowing counterparties to characterize the transactions in ways which may suit internal or external reporting strategies. It is important that this practice be eliminated. Clarity of documentation reduces uncertainty at critical times when parties are incentivized to protect their interests by disputing the scope of their obligations under documents. Making the basic credit terms explicit limits the scope for dispute when it matters the most.

⁸ “During the financial crisis, the opacity of derivatives transactions among dealer banks and between dealer banks and their counterparties created uncertainty about whether market participants were significantly exposed to the risk of a default by a swap counterparty.” NOPR, 76 FR at page 27567.

⁹ Proposed Rules, Section _____.5.

¹⁰ Proposed Rules, Section _____.5.

Scope of “Financial End User” (Question 11(a))

The definition of “financial end user” includes a list of entities which are considered within the scope of the term:

- Commodity pools;
- Private funds;
- Certain employee benefit plans;
- Banks and financial firms;
- Entities which would be included if they were organized under domestic law;
- Foreign governments and their instrumentalities and subdivisions; and
- Others designated by one of the Agencies.¹¹

The components of the list are reasonable but incomplete. The list omits several types of entities that are not rationally distinguishable from those included in the list. For example, the following entities must also be included in the scope of “financial end user:”

- U.S. agencies and instrumentalities which are not Covered Swap Entities;
- U.S., state and local government pension funds; and
- U.S., state and local governments and agencies and instrumentalities thereof.

Calculation of Initial Margin (Questions 13 and 70(a))

The Proposed Rules provide for two alternatives for the calculation of initial margin. A Covered Swap Entity can use a model which it develops, so long as it meets the standards set out in the Proposed Rules and is approved by the relevant Agency; or the Covered Swap Entity can use a look-up table provided in the rules.¹²

The look-up table alternative is inherently a less accurate approach. Initial margin amounts are intended to reflect market liquidity and volatility which change constantly depending on conditions. In contrast, look-up tables are static. As a result, the look-up table amounts must be high enough to provide a cushion for those changing market conditions. The table in the Proposed Rules provides a range of amounts for each asset class. However, in the final rules, the amounts must be moved to the high end of the range. This will be more likely to provide the necessary cushion and prevent a Covered Swap Entity from picking the look-up table to reduce its costs by picking the low end of the range regardless of market conditions.

We recommend that the Agencies publish a standard model for each of the asset classes. The Covered Swap Entities can either adopt that model or provide the relevant Agency with the differences between the standard model and the model proposed. This process would greatly simplify the process of approving models and increase the likelihood

¹¹ Proposed Rules, Section ____2(h).
¹² Proposed Rules, Section ____8.

that the calculation of initial margin will accurately reflect the ever-changing market liquidity and volatility.

Netting of Initial Margin (Questions 16-22(b); 71(a))

The NOPR discusses a number of methodologies for the netting of initial margin in long and short positions. The goal is to provide a simplified algorithm to calculate a netting ratio based on notional value or other factors.

Netting of initial margin cannot be accurately calculated without determining historic price change correlations. Unfortunately, any simplified version which does not measure historic prices is very likely to yield a dangerously inaccurate result.

Derivatives clearing organizations (“DCOs”) routinely calculate these netting ratios. The Proposed Rules must provide that netting initial margin must use ratios that are applied by a DCO for the same products (including delivery location for physical products) and duration as the swaps being netted.

Any algorithm other than one derived from a DCO must be approved by the Agency which regulates the Covered Swap Entity and it must include, among other things, historic price change correlations.

Termination Provisions (Question 45)

The Proposed Rules provide that a Covered Swap Entity is not deemed to be in violation of its obligation to collect margin if it is proceeding to enforce rights against a non-paying counterparty.¹³ This is not sufficient, given the frequency of disputes over valuation of un-cleared derivatives. These disputes can take significant time periods to resolve.

The Proposed Rules must include a requirement that counterparties pay margin as determined by the party which is responsible for calculating value and dispute it at a later date. Absent bad faith on the part of the party calculating value, failure to pay first and dispute later would subject the counterparty to automatic next day termination.

To do otherwise would risk leaving a substantial amount of uncleared derivatives without any margin. Moreover, it would actually incentivize parties to dispute valuation, which would precipitate enforcement and relieve the party of paying the margin until the dispute is resolved. Such a system would turn logic upside down. Parties must pay first and dispute later.

¹³ Proposed Rules, Section ____ (e).

CONCLUSION

Transparent and orderly rules governing margin and capital in non-cleared derivatives are essential to address the flawed markets which led to the financial crisis. The Agencies have created a reasonable framework to achieve this goal, but the rules must be changed as proposed here to comply with the law and to reduce the likelihood of the markets failing again.

We hope that our comments are help the Agencies achieve a more complete and effective regulatory framework.

Sincerely,

A handwritten signature in blue ink, appearing to read "Dennis M. Kelleher".

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