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July 11, 2011

VIA ELECTRONIC SUBMISSION

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Board of Governors of the Federal
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Executive Secretary
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Gary K. Van Meter
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Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102-5090

Re: Margin and Capital Requirements for Covered Swap Entities (OCC: RIN 1557-AD43); (Federal Reserve: RIN 7100-AD74); (FDIC: RIN 3064-AD79); (FCA: RIN 3052-AC69); (FHFA: RIN 2590-AA45)

Ladies and Gentlemen:

On behalf of the Federal Home Loan Banks (the "FHLBanks"), we appreciate this opportunity to comment on the above-referenced proposed rules (the "Proposed Rules") issued by the Office of the Comptroller of the Currency (the "OCC"), the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the Federal Deposit Insurance Corporation (the "FDIC"), the Federal Housing Finance Agency (the "FHFA") and the Farm Credit Administration (the "FCA"; and together with the OCC, the Federal Reserve, the FDIC, the FHFA and the FCA, the "Prudential Regulators"). The Proposed

Rules address margin and capital requirements for swap dealers, major swap participants and certain other financial entities, including the FHLBanks, under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

I. The FHLBanks

The 12 FHLBanks are government-sponsored enterprises of the United States, organized under the authority of the Federal Home Loan Bank Act of 1932, as amended, and structured as cooperatives. Each is independently chartered and managed, but the FHLBanks issue consolidated debt obligations for which each is jointly and severally liable. The FHLBanks serve the general public interest by providing liquidity to approximately 8,000 member institutions, thereby increasing the availability of credit for residential mortgages, community investments, and other services for housing and community development. Specifically, the FHLBanks provide readily available, low-cost sources of funds to their member institutions.

The FHLBanks enter into swap transactions as end-users with swap dealers to facilitate their business objectives and to mitigate financial risk, primarily interest rate risk. As of March 31, 2011, the aggregate notional amount of over-the-counter interest rate swaps held by the FHLBanks collectively was $759.6 billion. At present, all of these swap transactions are entered into bilaterally and none of them are cleared. Certain of the FHLBanks also provide their member institutions, particularly smaller, community-based institutions, with access to the swap market by intermediating swap transactions between the member institutions and the large swap dealers, thus allowing such members to hedge interest rate risk associated with their respective businesses.

II. General Comments

As a general matter, the FHLBanks are concerned that the Proposed Rules will materially increase the cost of entering into uncleared swap transactions (*e.g.,* through wider bid/ask spreads) and reduce liquidity in the marketplace (*e.g.,* through higher margin requirements). These additional costs and reduced liquidity, in turn, would adversely impact the FHLBanks' member institutions and their respective customers, including homeowners and small businesses, through increased borrowing costs and decreased access to credit and risk management products. While the Dodd-Frank Act requires the Prudential Regulators to consider the additional risks associated with uncleared swap transactions when imposing capital and margin requirements,[1] it is not clear that the Prudential Regulators have adequately balanced such risks against the foregoing costs and liquidity concerns or taken into account the impact of the proposed margin requirements on the larger economy. To the extent that the Proposed Rules reduce swap activity, they will consequently increase the amount of unhedged risk in the financial system. The FHLBanks believe that instead of imposing stringent margin requirements that will tie up unnecessarily large amounts of liquid assets, the Prudential Regulators' statutory mandate to consider the greater risk posed by uncleared swaps

[1] Dodd-Frank Act §731.

when setting capital and margin requirements would be better addressed by adjusting the capital requirements for swap dealers and major swap participants who engage in uncleared swaps.[2]

In addition to the foregoing, the FHLBanks are concerned that the Proposed Rules' prescriptive requirements regarding eligible collateral may make it even more difficult for market participants to satisfy the proposed margin requirements. Rather than limiting eligible collateral to cash and a narrow class of instruments, the FHLBanks believe the Prudential Regulators should take a more flexible, principles-based, approach by establishing the standards for eligible collateral, but allow market participants to apply those standards to particular situations. As discussed in Section VII below, the FHLBanks believe that eligible collateral for both initial and variation margin should include all assets that are low-risk, highly liquid and readily valued. As a specific example, while it is obvious that certain letters of credit issued by entities that lack significant credit standing should not qualify as eligible collateral, letters of credit issued by financially strong and highly regulated institutions may well satisfy the standards for acceptable collateral and should therefore be permitted as such.[3] Any risk, liquidity or valuation concerns regarding such collateral could be appropriately addressed by contractual limits and haircuts rather than by entirely precluding certain types of collateral. In addition, compliance with collateral standards could be part of the regulatory oversight to which all swap dealers and major swap participants will be subject as a result of the Dodd-Frank Act.

III. Responses to Specific Questions and Effective Date

Attached hereto as Annex A are responses to specific questions posed by the Prudential Regulators. Based on these responses and the issues addressed in this comment letter, including the Proposed Rules' requirements for new initial margin models and the amount of documentation (including, in some instances, agreements with third parties) that would be required to comply with the Proposed Rules, the FHLBanks do not believe that an effective date of 180 days after publication of the final rules would allow sufficient time for market participants, including the FHLBanks, to comply with such final rules.

Although the FHLBanks are not currently swap dealers, the Proposed Rules would essentially require them to undertake many obligations of swap dealers including

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[2] Margin requirements are intended to address counterparty credit risk in the over-the-counter derivatives markets. However, there are situations in which swap dealers face minimal counterparty credit risk and, alternatively, it is the swap dealer's counterparty that assumes the greater credit risk. The FHLBanks believe they fall into this category of counterparties. The prescriptive nature of the Proposed Rules as applied to financial institutions does not afford flexibility to adjust margin requirements for entities, such as the FHLBanks, that pose minimal default risk to swap dealers and major swap participants.

[3] Note that while the FHLBanks generally do not use letters of credit as collateral for their swaps, certain FHLBanks issue letters of credit to their members for such members to use as collateral for swaps. The FHLBanks believe that they should continue to be able to provide this service to their members.

developing models for initial margin requirements and entering into additional documentation. With respect to the Proposed Rules' initial margin requirements, assuming that the FHLBanks and their swap dealer counterparties conclude that a robust initial margin model will yield initial margin calculations that are more appropriate than those provided in Appendix A to the Proposed Rules, the FHLBanks will be required to undertake either the development of an internal model for initial margin or the acquisition of a model from one or more third parties. Any such model would have to be approved by the FHFA and also be acceptable to each of the FHLBanks' swap counterparties. To date, the FHLBanks have never been required by regulation to post or collect initial margin, and only a few of the FHLBanks have negotiated such provisions. Thus the proposed regulatory requirements would represent a material change in the way the majority of the FHLBanks conduct and document their interest rate swap activities.

The Proposed Rules would also require the FHLBanks to enter into tri-party custodial agreements to comply with segregation requirements for both initial and variation margin. To date, only one of the twelve FHLBanks has entered into such agreements for over-the-counter derivatives. Tri-party custodial agreements are not currently standardized and the FHLBanks understand that they are frequently the subject of protracted negotiations between the swap counterparties and prospective custodians.[4]

Compliance with the Proposed Rules cannot be considered in isolation, but must be viewed in the context of the implementation of other provisions of the Dodd-Frank Act. The Proposed Rules' capital and margin requirements would be in addition to all the other documentation (and associated negotiation) necessary to comply with mandatory clearing requirements for certain swaps and other derivatives reforms under the Dodd-Frank Act. The FHLBanks estimate that implementation of the Dodd-Frank Act's derivatives provisions will require them to enter into hundreds of new agreements and amendments to existing agreements.

Given that in many instances the FHLBanks will need the assent of third parties (both regulators and swap counterparties), which is outside the control of the FHLBanks, it is simply not realistic to expect the FHLBanks to be able to fully implement all the required changes mandated by the Proposed Rules within 180 days of the date when final regulations are published. The consequences of a short implementation period could be materially adverse to the FHLBanks' business, leaving them exposed to greater interest rate risk than they face today. **Accordingly, the FHLBanks believe the effective date for the Proposed Rules should be no earlier than 360 days following publication of the final rules.**

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[4] There is currently an ISDA working group that is attempting to develop a menu of standardized terms that could be utilized by swap counterparties and prospective custodians seeking to negotiate tri-party agreements. It is hoped that this effort will expedite the process of putting such agreements in place, but at this time it is uncertain whether this effort will actually prove successful in reducing the time and effort required to negotiate tri-party custodial agreements.

IV. Treatment of Pre-Effective Date Swaps

The preamble to the Proposed Rules states that the Proposed Rules "provide that the margin requirements apply only to swap and security-based swap transactions that are entered into on or after the date on which the proposed rules become effective." The FHLBanks agree this is the proper application of the new margin requirements and that such requirements should not retroactively change the economics of pre-effective date swaps.[5] However, the FHLBanks are concerned that the Proposed Rules regarding variation margin are inconsistent with this application and may require the FHLBanks to enter into new master netting agreements for swaps entered into after the effective date of final rules in order to avoid subjecting pre-effective swap transactions to the Proposed Rules' new variation margin requirements.

As the FHLBanks understand the Proposed Rules, the default requirement is that variation margin is collected on a transaction-by-transaction basis without netting in-the-money swaps against out-of-the money swaps.[6] At the election of the covered swap entity (CSE)[7], variation margin may alternatively be determined on an aggregate net basis with respect to swaps executed pursuant to a qualifying master netting agreement. However, unlike the Proposed Rules' requirements for initial margin,[8] if variation margin is calculated pursuant to this netting election, the new variation margin requirements must be applied to *all* swaps entered into under the master netting agreement (*i.e.,* pre- and post-effective swaps).[9] Thus, the Proposed Rules for variation margin potentially penalize any counterparty required to post variation margin who is either paying no variation margin on pre-effective date swaps or is paying less variation margin than

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[5] *See* Letter dated June 9, 2010 regarding "Issues Regarding Retroactive Application of Certain Provisions Pertaining to Swaps in the Pending Derivatives Regulatory Reform Legislation (H.R. 4173)" from Nathaniel Doliner, on behalf of the American Bar Association Section of Business Law, to The Honorable Christopher J. Dodd, Chairman of the Committee on Banking Housing, and Urban Affairs of the United States Senate; The Honorable Barney Frank, Chairman of the Committee on Financial Services of the U.S. House of Representatives; The Honorable Richard C. Shelby, Ranking Member of the Committing on Banking, Housing and Urban Affairs of the United States Senate; and The Honorable Spencer Bachus, Ranking Member of the Committee on Financial Services of the U.S. House of Representatives, available at http://apps.americanbar.org/buslaw/committees/CL620000pub/comments/20100609.pdf.

[6] *See* Proposed Rules §__4(a).

[7] As used in the Proposed Rule, a CSE is a swap dealer or major swap participant that is regulated by one of the Prudential Regulators. *See* "Background" in the Preamble to the Proposed Rules, 76 Fed. Reg. at 27566.

[8] If initial margin is determined pursuant to an approved initial margin model, the Proposed Rules do not force a choice between no netting and retroactive application of initial margin requirements to swaps entered into before the effective date of the Proposed Rules. Instead, it permits the computation of initial margin on an aggregate net basis based on either (1) only post-effective swaps or (2) all swaps (pre- and post-effective) governed by a qualifying master agreement. *See* Proposed Rules §__8(b)(1),(2). In contrast, calculation of initial margin for post-effective swaps using Appendix A to the Proposed Rules would not allow for netting. *See* Proposed Rules §__2(k)(1).

[9] *See* Proposed Rules §__4(d).

would be required for post-effective date swaps (*e.g.,* because the thresholds for pre-existing swaps are greater than those afforded post-effective date swaps).[10]

The FHLBanks believe that the Proposed Rules' requirements for variation margin should be the same as for initial margin, namely, that a CSE may, at its option, compute variation margin on an aggregate net basis either excluding pre-effective date swaps entirely or, alternatively, including all pre- and post-effective date swaps. The FHLBanks agree that the CSE should not be allowed to "cherry pick" pre-effective date swaps. However, there is no valid reason to require the CSE to include pre-effective date swaps in order to obtain netting with respect to post-effective date swaps unless the objective is to impose variation margin requirements retroactively on pre-effective date swaps. In addition, the FHLBanks believe that the decision regarding whether to calculate margin requirements for post-effective date swaps on a gross basis or to net pre- and post-effective date swaps together under a single master netting agreement should not be left to the sole discretion of the CSEs. Instead the decision should be a joint determination between a CSE and its end-user counterparty, particularly in the case of an FHLBank which, unlike other end-users, will be required to collect margin from its CSE counterparties.

Although the foregoing netting issues could arguably be avoided if CSEs enter into new master netting agreements covering only post-effective date swaps with each of their counterparties, the FHLBanks do not believe that such a solution makes sense from an operational or a risk management standpoint. CSEs (and their counterparties) benefit from netting the largest possible number of swap transactions. Unless all swap transactions with a counterparty can be netted pursuant to a single agreement, there is risk that a party would be required to make payments with respect to one portfolio of swaps but would be unable to collect amounts owing to it on another portfolio of swaps. Such an outcome could materially increase counterparty credit risk. The benefit of having all swaps documented under a single International Swaps and Derivatives Association, Inc. ("ISDA") master agreement is recognized in the FHFA's regulations, which discourage FHLBanks from entering into more than one master agreement with a counterparty.[11] Moreover, the netting requirements that the Proposed Rules apply to <u>initial</u> margin, as discussed above, were presumably designed to avoid the problems associated with having two master agreements with a single counterparty.

V. <u>Definition of "Qualifying Master Netting Agreement"</u>

A number of important netting issues arising under the Proposed Rules are keyed to transactions entered into under a "qualifying master netting agreement." These include

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[10] The potential adverse impact of the Proposed Rules with respect to variation margin is illustrated by a example attached hereto as Exhibit A.

[11] Federal Home Loan Bank Investments—Use of Hedging Instruments Rule, 12 C.F.R. § 956.6(b) (2011), available at <u>http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr;sid=8ec2b12683d5940a286b06f0b799ecca;rgn=div8;view=text;node=12%3A7.0.1.7.16.0.1.6;idno=12;cc=ecfr</u>.

the ability to calculate initial and variation margin on a portfolio basis.[12] The definition of "qualifying master netting agreement" in the Proposed Rules provides, in relevant part, that:

> The [qualified master netting agreement] provides the covered swap entity the right to accelerate, terminate, and close-out on a net basis all transactions under the agreement and to liquidate or set off collateral promptly upon an event of default, including upon an event of bankruptcy, insolvency, or similar proceeding, of the counterparty, **provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions**;[13]

However, a counterparty's ability to exercise its contractual rights to terminate, liquidate and accelerate covered contracts with entities subject to the insolvency regime applicable to the FHLBanks is effectively stayed for one business day.[14] The FHLBanks urge the Prudential Regulators to clarify that the proviso highlighted above does not cause contracts subject to a one-day stay under the insolvency regime applicable to the FHLBanks (and under insolvency regimes applicable to financial institutions subject to the Federal Deposit Insurance Act or the new orderly liquidation authority contained in Title II of the Dodd-Frank Act) to fail to satisfy the requirements for a "qualifying master netting agreement." Otherwise, few master netting agreements will qualify as a "qualifying master netting agreement" under the Proposed Rules.

VI. FHFA Requirements for Third-Party Custodians

The FHFA would require that margin posted to CSEs by entities that are regulated by the FHFA, including the FHLBanks, "be held by a third-party custodian that is independent of the [CSE] and the regulated entity, is located in a jurisdiction that applies the same insolvency regime to the third-party custodian as would apply to the regulated entity, and is subject to the rehypothecation, reinvestment and other transfer restrictions of § 1221.7."[15] However, none of the United States banks and trust companies most likely to act as collateral custodians for uncleared swaps are subject to the same insolvency regime that applies to FHFA-regulated entities. In the case of the FHLBanks, this requirement would appear to limit eligible custodians to other FHLBanks and other government sponsored enterprises subject to the FHFA's insolvency regime. However, none of these institutions are in the business of providing "custodial" services. The FHLBanks recommend that the Proposed Rules be modified to allow creditworthy United States banks and trust companies to serve as third-party custodians for margin posted by

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[12] *See* Proposed Rules §§__.4(d) & __.8(b).

[13] *See* Proposed Rules §_.2(t) (emphasis added).

[14] 12 U.S.C. § 4617(d)(10) (2010). Similar requirements are imposed under other insolvency regimes applicable to commercial banks and insured depository institutions.

[15] *See* FHFA Proposed Rules §§1221.11(d) (emphasis added); *see also* Proposed Rules § __.7.

the FHLBanks, notwithstanding the different insolvency regimes to which they are subject.[16]

VII. Eligible Collateral

The Dodd-Frank Act explicitly provides that the Prudential Regulators and the Commodity Futures Trading Commission "shall permit the use of noncash collateral" as the regulators determine "to be consistent with—(i) preserving the financial integrity of markets trading swaps; and (ii) preserving the stability of the United States financial system."[17] However, the FHLBanks believe that the limitations on "eligible collateral" in the Proposed Rules[18] are unduly restrictive and do not fulfill the intent and purpose of this statutory mandate. Instead, the FHLBanks believe that it would be appropriate for the Prudential Regulators to take a more flexible, principles-based, approach to defining "eligible collateral." Specifically, as indicated in the general comments at the beginning of this letter, swap counterparties should be permitted to accept as collateral assets that they determine to be low-risk, highly liquid and readily valued and to address any concerns regarding such matters through appropriately negotiated limits and haircuts. Additionally, the FHLBanks believe that the foregoing standards should apply to both initial margin and variation margin (*i.e.,* collateral that is eligible to be posted as initial margin should be eligible to be posted as variation margin). The policies and procedures of the CSEs with respect to eligible collateral would, of course, be subject to regulatory review and oversight. However, various types of low-risk, highly liquid and readily valued collateral (*e.g.* certain letters of credit, mortgage backed securities) should not be precluded by regulation unless there is demonstrated evidence that reliance on such collateral poses a threat to the over-the-counter financial markets or the United States financial system.

VIII. Collateral Thresholds[19]

The Proposed Rules permit low-risk financial end-users such as the FHLBanks to negotiate uncollateralized thresholds for the initial and variation margin that they post to their CSE counterparties, subject to limits set by the Prudential Regulators. According to the Proposed Rules, such thresholds may not exceed the lesser of (1) a fixed dollar amount to be stipulated in the final capital and margin rules (which will be between $15 million and $45 million) and (2) a percentage of the CSE's capital. The FHLBanks agree

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[16] The FHLBanks understand that custodial agreements can be structured to minimize, if not entirely eliminate, the risk that amounts held in custodial accounts would be exposed to risk of loss in the event that the custodian becomes bankrupt. The use of tri-party agreements with an independent custodian also addresses the risk associated with obtaining the return of collateral posted directly to a bankrupt swap counterparty.

[17] Dodd-Frank Act §731 (emphasis added).

[18] Proposed Rules § __.6 .

[19] See Section IX.B below for a discussion of thresholds for the margin that the FHLBanks will be required to collect from their CSE counterparties pursuant to the FHFA's special requirements for swaps between FHLBanks and CSEs.

that low-risk financial end-users such as themselves should be able to negotiate uncollateralized thresholds, but believe that the maximum thresholds should relate to the creditworthiness of the low-risk financial end-user. Instead of imposing hard caps on threshold levels, the FHLBanks believe that it would be appropriate to take a more flexible approach that gives deference to appropriately negotiated thresholds and allows very creditworthy low-risk financial end-users to have thresholds in excess of $45 million. Similar to the overall collateral policies of CSEs, the policies and procedures of CSEs in this regard would, of course, be subject to regulatory oversight and review.

IX. Special Requirements Proposed by FHFA for Transactions Between CSEs and Regulated Entities (*e.g.*, the FHLBanks)

A. Requirement that FHLBanks Collect both Initial and Variation Margin from CSEs

The Proposed Rules require CSEs to collect initial and variation margin from certain swap counterparties. However, except for the supplemental portions of the Proposed Rules issued by the FHFA and the FCA, the Proposed Rules do not require CSEs to post either initial or variation margin to their swap counterparties (other than to other CSEs). The supplemental margin requirements proposed by the FHFA would require those FHLBanks that are not CSEs to collect both initial and variation margin from their CSE counterparties.[20] The FHLBanks currently collect or post, as the case may be, variation margin from all their counterparties, subject to agreed-upon thresholds. However, the FHLBanks generally do not collect initial margin from, or post initial margin to, their swap dealer counterparties. Because the FHLBanks will be required to post both initial and variation margin to their CSE counterparties, the FHLBanks support the FHFA proposed requirement that the FHLBanks also collect both initial and variation margin from such counterparties.

The collection of initial margin provides a measure of additional protection against loss in the event of a counterparty's insolvency. As discussed below, in such event, initial margin protects against two situations: (1) if the party holding initial margin is "in-the-money," the initial margin provides a cushion against loss should the variation margin it is holding turn out to be less than the amount owed to it by its insolvent counterparty and (2) if the party holding initial margin is "out-of-the-money," initial margin provides a cushion against the failure of the insolvent counterparty to return variation margin that exceeds the amount that the party owes to its insolvent counterparty. For a more detailed explanation of these situations, see the examples set out in the presentation illustrating "How Parties Are Protected with Initial Margin/Independent Amounts (IA)," which is attached hereto as Annex B.

The FHLBanks believe that there are valid reasons why CSEs should be required to post initial margin to the FHLBanks. From the standpoint of financial soundness, the FHLBanks have been rated higher than most, if not all, of their CSE counterparties.

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[20] *See* Proposed Rules § 1221.11(a)(1) & (2).

Indeed, history shows a greater likelihood of financial failure, or near financial failure, among entities that would qualify as CSEs (e.g., Lehman Brothers and Bear Stearns) than among the FHLBanks, none of which have ever failed. Thus, the FHLBanks are more likely than the CSEs to need the protection afforded by the collection of initial margin. Although there is undoubtedly some cost associated with initial margin requirements, it does not seem reasonable to impose such cost on the FHLBanks, but not their CSE counterparties. Absent a regulatory requirement, there is no assurance that the CSEs would voluntarily agree to post initial margin to the FHLBanks.[21]

B. Thresholds for Margin Collected by FHLBanks from CSEs

While the FHLBanks agree that they should be required to collect initial and variation margin from their CSE counterparties, the FHLBanks believe that they should be able to offer uncollateralized thresholds for such margin collected from certain of their CSE counterparties, based on creditworthiness of such CSEs. As noted, above, the variation margin that the FHLBanks currently collect from their swap dealer counterparties is generally subject to agreed-upon thresholds. These thresholds are based on an individualized credit analysis of each of the FHLBanks' respective counterparties and are subject to reduction or cancellation upon the deterioration of a counterparty's financial condition. As discussed above, the Proposed Rules would permit CSEs to negotiate uncollaterlized thresholds for the initial and variation margin that they collect from the FHLBanks but it is unlikely that CSEs will actually negotiate such thresholds if the margin they post to the FHLBanks is not also subject to thresholds. Without such thresholds, assets of the FHLBanks and their CSE counterparties will be tied up unnecessarily. As long as uncollateralized thresholds are based on an adequate credit assessment and properly monitored, the additional exposure incurred as a result of such thresholds is minimal. In addition, the protection provided to the FHLBanks from the initial margin that they will be collecting (in most cases for the first time) from their CSE counterparties will more than compensate for any uncollateralized exposure resulting from variation margin thresholds.

C. Requirement that both Initial and Variation Margin Posted by FHLBanks to CSEs be Segregated with an Independent Custodian

The FHFA's supplemental portion of the Proposed Rules would require that both initial margin and variation margin posted by an FHLBank to a CSE be segregated with an independent third-party custodian. The FHLBanks agree that initial margin should be

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[21] The collection of initial margin is one of several measures available to a counterparty to address counterparty credit risk. It is noteworthy that efforts to negotiate early termination provisions that would permit a swap counterparty to early terminate outstanding trades before a counterparty becomes insolvent have not proven particularly effective. Although counterparties often negotiate provisions allowing for early termination upon a material credit rating downgrade, these provisions have generally not facilitated early termination of swap agreements because the ratings downgrades have historically seriously lagged the deterioration of the swap counterparty's financial condition. Lehman Brothers, for example, had an "A" credit rating at the time it became insolvent. Holding initial margin provides a measure of protection in situations where early termination of outstanding trades is not possible prior to a counterparty's insolvency.

segregated with an independent custodian, but strongly disagree with the proposed requirement that variation margin also be segregated with a third-party custodian. The FHLBanks note that among the many thousands of participants in the over-the-counter derivatives markets, only the institutions regulated by the FHFA and the FCA would have to require their counterparties to segregate variation margin with third-party custodians.[22]

The requirement that counterparties segregate initial margin with a third-party custodian is consistent with the new statutory right of all end-user counterparties to insist upon segregation of the initial margin they post to swap dealers or major swap participants.[23] Initial margin posted to a counterparty is particularly "at risk" in the event that the counterparty becomes insolvent because initial margin generally represents an amount over-and-above the mark-to-market value of outstanding swaps (and, as discussed below, this mark-to-market value would be roughly equal to the close-out payment that would be owed to the counterparty holding the variation margin upon a termination of the applicable swap transactions). If the counterparty holding initial margin becomes insolvent and the initial margin (as well as any variation margin posted to cover the mark-to-market exposure of the counterparty) is held by the bankruptcy trustee as part of the insolvent estate, it may be difficult to obtain the return of the excess initial and variation margin (*i.e.*, the initial and variation margin that exceeds the termination payment owed to the insolvent party). In this case, the party posting the initial margin may only have a general creditor's claim against the estate of the insolvent party.[24] Segregation of initial margin with an independent third-party custodian ensures that such margin will be promptly returned to the posting party and will not become part of the estate of the insolvent counterparty.

On the other hand, there is generally less risk that posted variation margin will not be returned in the event of a counterparty's insolvency. Variation margin represents the

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[22] Early versions of the House of Representatives bill that ultimately became the Dodd-Frank Act required swap dealers, at the request of a swap counterparty, to segregate both initial and variation margin received for uncleared swaps. *See* H.R. 4173, 111th Cong., §3108 (1st Sess. 2009). However, subsequent versions of the bill (and ultimately, the Dodd-Frank Act) removed the segregation requirement with respect to variation margin.

[23] Dodd-Frank Wall Street Reform and Consumer Protection Act , H.R. 4173, 111th Cong. §724 (2010) (enacted).

[24] "Risks to Parties Posting Independent Amounts [(IA)]—

While a Dealer receiving IA will benefit from the resulting buffer of additional collateral the End User may assume added risk of loss in the event the Dealer becomes insolvent.

In a Dealer insolvency, if an End User delivered IA directly to such Dealer and such IA was rehypothecated or commingled with such Dealer's assets, and such Dealer is overcollateralized by virtue of such IA, then the End User will have a general unsecured claim for the recovery of such IA and would be entitled to a pro rata distribution along with all other general unsecured creditors. This type of claim ranks behind other creditor claims of higher priority, and thus in many insolvencies general unsecured creditors get paid less than 100% of their claim amount."

Independent Amounts (Release 2.0, March 1, 2010) at pp. 6-7, published by ISDA, Managed Funds Association and Securities Industry and Financial Markets Association ,a copy of which white paper is available at http://www.isda.org/c_and_a/pdf/Independent-Amount-WhitePaper-Final.pdf.

mark-to-market value of outstanding transactions between the two counterparties and will have to be adjusted daily under the Proposed Rules. Accordingly, variation margin generally equates to the "close-out" value of the swaps between two counterparties. Thus, if party X is "out-of-the-money" by $1M under its swaps with party Y and therefore posts $1M of variation margin to party Y, there is less risk (as compared to initial margin posted by party X, all of which will be at risk) that party X's $1M will be at risk if party Y should default and, as discussed below, any such risk would be mitigated by party X holding initial margin from party Y. Upon a default of party Y there would be a close-out payment owing by party X to party Y that should be approximately equal to $1M.[25] Of course, there is some risk that due to market movement between the time of party Y's insolvency and the date on which the close-out payment is determined, the close-out amount could be somewhat less than $1M, in which case party X would be exposed for the "over-collateralized" amount.[26] However, because variation margin is adjusted on a daily basis and the termination provisions of the ISDA Master Agreement contemplate only a short period of time before the close-out determination, this risk should be limited to potential market movements over the few days between the time of party Y's default and the early termination of the outstanding swaps. Stated differently, the amount of variation margin posted to party Y that is not in excess of the amount owing by party X to party Y upon a close-out is not at any risk. In addition, as discussed below, the risk associated with excess variation margin is mitigated to the extent that party X collects initial margin from party Y. By contrast, if party X had also posted initial margin to party Y (and such margin is not segregated with an independent third-party custodian), then the entire amount of such initial margin is potentially at-risk because it would likely represent excess collateral over-and-above the amount owed by party X to party Y upon the close-out.

There will be a material cost to the FHLBanks (as well as their member institutions and customers thereof) if the FHLBanks' CSE counterparties are required to segregate variation margin posted by the FHLBanks. This is because the CSE would be required to fund the variation margin that it would be required to post to either a clearinghouse or another CSE counterparty for the "offsetting" swaps that the CSE enters into in order to hedge its interest rate exposure resulting from the swap with an FHLBank. Stated differently, if a CSE is receiving variation margin from an FHLBank with respect to outstanding swaps, the CSE is likely posting a similar amount of variation margin to its hedging counterparties (likely also CSEs) or a clearinghouse. If the CSE does not have access to the variation margin posted by the FHLBank, it must either utilize internal capital or borrowed funds to satisfy its own variation margin obligations. In either case, this represents an additional cost of doing business with an FHLBank that the CSE would not incur on trades with counterparties not required to segregate variation margin. It is difficult to quantify this cost precisely, but in discussions with a number of dealer counterparties, the FHLBanks have been advised that this requirement would lead to higher pricing on swaps between the FHLBanks and CSEs. The FHLBanks have been

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[25] See Annex B, Example 1.

[26] See Annex B, Example 3.

advised that swap dealers utilize internal models to estimate the funding costs associated with not receiving variation margin. These models take into account a swap dealer's funding costs as well as other factors that would influence the amount of variation margin that could be anticipated over the life of a swap (*e.g.,* the duration of the swap, historic volatility, etc.). Given the volume of swaps entered into by the FHLBanks, the FHLBanks believe that the additional costs that would be incurred if the FHLBanks' CSE counterparties are required to segregate variation margin could be tens of millions of dollars and could thus put the FHLBanks at a competitive disadvantage by raising the cost of their lending products. In addition, the segregation requirements for variation margin could result in a further concentration of swaps with a limited number of swap counterparties as the FHLBanks seek to minimize increased costs by entering into swaps with only those counterparties that have the lowest cost of funds.

Finally, the FHLBanks believe that the proposed requirement to segregate variation margin fails to take into account the protection that will be afforded to the FHLBanks by collecting initial margin from their CSE counterparties. As noted above, the FHLBanks do not presently receive initial margin, but this will change if the supplemental requirements proposed by the FHFA (and supported by the FHLBanks) in this regard are adopted. Several FHLBanks did indeed incur losses with respect to variation margin posted to Lehman Brothers as a result of market movements occurring during the close-out process for swaps with Lehman Brothers entities. However, those losses were small relative to the expected amount of initial margin that would have been posted by the Lehman Brothers entities to the FHLBanks in question had the Proposed Rules been in effect at the time Lehman Brothers failed.[27] Said differently, these losses would likely have been avoided entirely if the FHLBanks in question had been receiving initial margin from their Lehman Brothers counterparties.

Initial margin is generally thought of as affording protection to the party receiving such initial margin (*i.e.,* the secured party) in the event that the value of its "in-the-money" trades with a defaulting counterparty exceed the amount of variation margin it has received from the counterparty. However, initial margin also protects the secured party in the event that its "out-of-the-money" trades with a defaulting counterparty leave it in an "over-collateralized" position with that counterparty (*i.e.*, the variation margin posted to the counterparty exceeds the amount owed to the defaulting counterparty). Attached hereto as Annex C is a memorandum to the FHLBanks that explains how initial margin (*i.e.,* Independent Amounts) posted to an independent custodian pursuant to the 1994 ISDA Credit Support Annex affords such protection. This result is also illustrated by examples 4, 5 and 6 of the presentation attached hereto as Annex B.

In summary, assuming that the FHLBanks are required to collect <u>initial</u> margin from their CSE counterparties, the FHLBanks do not believe there is any incremental

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[27] One FHLBank that found itself over-collateralized by more than $100 million due to market movements immediately following the Lehman insolvency has concluded that it would have incurred no loss whatsoever if it had received initial margin from Lehman Brothers equal to just one percent of the notional amount of its terminated Lehman trades.

benefit to be derived from a requirement that variation margin posted to such CSE counterparties be segregated with an independent, third-party custodian. Such a requirement would fail any cost/benefit analysis that recognizes the protection afforded to the FHLBanks by the collection of initial margin.[28]

D. Requirement for Initial Margin Model

The FHFA's supplemental portion of the Proposed Rules would permit those FHLBanks that do not have their own initial margin model to utilize a model from a third party "provided that the third party is itself independent of the swap entity that is the counterparty in the transaction at issue."[29] The FHLBanks believe this limitation is operationally difficult and will likely make it materially more difficult and expensive for the FHLBanks to implement the Proposed Rules' new initial margin requirements. If a CSE's or a third party vendor's initial margin model has received regulatory approval, there are sound reasons why such model should also be available to calculate the initial margin to be collected by the FHLBanks. Swap dealers make markets on both sides of the market (*e.g.*, as fixed rate payers and receivers) and therefore an initial margin model approved for usage by such swap dealers would presumably neither favor nor disadvantage the swap dealers entering into a swap on either side of the market. Accordingly, the FHLBanks believe that utilization of their swap dealer counterparty's approved initial margin model should be an option available to the FHLBanks. The FHLBanks would not object to a regulatory requirement that the FHFA perform reasonable and appropriate due diligence on any third party initial margin models utilized by the FHLBanks.

E. Alternative Initial Margin Lookup Table (Appendix A to the Proposed Rules)

The alternative initial margin lookup table, as proposed in Appendix A to the Proposed Rules, does not consider netting effects of offsetting swap transactions. As a result, the application of the lookup table would likely have a significant adverse effect on pricing, funding, and liquidity. In addition, uncleared swaps are likely to be more complex in structure than cleared swaps and may have embedded option features. Appendix A to the Proposed Rules should be revised to reflect the benefits of netting and the asymmetric mark-to-market profiles and initial margin requirements associated with such complex swaps.

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[28] For additional discussion of these issues, *see* Letter dated July 6, 2011 regarding "Docket No. OCC-2011-0008/RIN 1557-AD43; Docket No. R-1415/RIN 7100 AD74; RIN 3064-AD79; RIN 3052-AC69; RIN 2590-AA45 Margin and Capital Requirements for Covered Swap Entities," from Robert Pickel, Executive Vice Chairman of ISDA, and Kenneth E. Bentsen, Jr., Executive Vice President, Public Policy and Advocacy of SIFMA, at IV.6. (pp. 24-25), available at http://www.regulations.gov/#!documentDetail;D=OCC-2011-0008-0022.

[29] Proposed Rules § 1221.11(a)(1)(ii)

The FHLBanks appreciate the opportunity to comment. Please contact Warren Davis at (202) 383-0133 or warren.davis@sutherland.com with any questions you may have.

Respectfully submitted,

Warren Davis, Of Counsel
Sutherland Asbill & Brennan LLP

cc: FHLBank Presidents
FHLBank General Counsel

Exhibit A

Example Illustrating Potential Adverse Impact of the Proposed Rules for Variation Margin

Assume a CSE has entered into two pre-effective and two post-effective date swaps with financial institution X and the swaps have been marked-to-market as follows:

Pre-Effective Date Swap 1—$2M in-the-money
Pre-Effective Date Swap 2—$1.5M out-of-the-money

Post-Effective Date Swap 3—$3M in-the-money
Post-Effective Date Swap 4—$2M out-of-the-money

Also assume that financial institution X is either not required to post variation margin for its pre-effective swaps or that financial institution X has negotiated uncollateralized thresholds for such swaps that are higher than the amount by which it is out-of-the money to the CSE.

If the CSE follows the general transaction-by-transaction rule, it must collect $3M in variation margin for Post-Effective Date Swap 3 because there is no credit/offset for Post-Effective Date Swap 4. In order to determine variation margin on an aggregate net basis, the Proposed Rules provide that the CSE must include Pre-Effective Date Swap 1 and Pre-Effective Date Swap 2. The result is that it must collect $1.5M in variation margin for all four swaps. If variation margin could be calculated on a net basis for post-effective swaps only, however, the result would be that the CSE collects $1M ($3M-$2M) in variation margin. Thus, forcing the CSE to include pre-effective swaps (and thus to apply new variation margin requirements to such swaps) means that the CSE must effectively collect $.5M of additional variation margin with respect to pre-effective swaps in order to net. This is inconsistent with the principle that the economics of pre-effective date swaps should not be changed retroactively by the new margin rules.

Annex A

Responses from the Federal Home Loan Banks (the "FHLBanks")

to

Questions Posed in

Margin and Capital Requirements for Covered Swap Entities (OCC: RIN 1557-AD43); (Federal Reserve: RIN 7100-AD74); (FDIC: RIN 3064-AD79); (FCA: RIN 3052-AC69); (FHFA: RIN 2590-AA45) (the "Proposed Rules")

Section ___.1: Authority, Purpose and Scope

Effective Date

Question 3(a). What changes to internal risk management and other systems, trading documentation, collateral arrangements, operational technology and infrastructure or other aspects of a covered swap entity's derivatives operations will likely need to be made as part of the implementation of the proposed rule, and how much time will likely be required to make such changes?

Covered swap entities will need to develop initial margin models, establish segregated initial (and possibly variation) margin accounts, amend existing bilateral netting and security agreements with all counterparties, adapt liquidity management policies, practices and management information systems to accommodate margin segregation. Financial end-users will need, at a minimum, to amend existing bilateral netting and security agreements, and adapt liquidity management practices to handle margin requirements, and may be required to implement significant system upgrades. The FHLBanks believe that these changes will likely take the FHLBanks a year or more to implement across all existing counterparties.

Question 3(b). Is the proposed rule's 180-day period sufficient?

No. See above.

Question 4(a). How much time will covered swap entities that wish to calculate initial margin using an initial margin model need to develop such models?

The FHLBanks cannot speak for covered swap entities on this question. However, if the FHLBanks were to attempt to develop an initial margin model, the FHLBanks believe it would take in excess of a year for the FHLBanks to research initial margin model "best practices," develop a model, validate it, and obtain regulatory approval for it.

Question 4(b). Is the proposed rule's 180-day period sufficient?

No. See above.

<u>Section .3: Initial Margin</u>

Calculation Alternatives

Question 13. As an alternative to Appendix A, should the rule allow an alternative calculation method that would link the margin on a non-cleared swap or noncleared security-based swap to the margin required by a derivatives clearing organization for a cleared swap or cleared security-based swap whose terms and conditions closely resemble the terms and conditions of the non-cleared swap or non-cleared security-based swap?

No. See answer to Question 14 below for more detail.

Question 14. Would there be enough similarity between cleared and non-cleared swaps or security-based swaps to make this approach workable?

- *The risks associated with cleared and non-cleared swaps will be substantially different and therefore using a derivatives clearing organization's ("DCO's") initial margin requirement as a proxy would be inappropriate.*
- *Upon the effective date of the Proposed Rules, there will likely be some vanilla interest rate swaps that are not eligible for clearing (e.g., swaps with unsupported non-economic terms such as accrual pay convention, etc.) but it is reasonable to expect that over a short period of time, all vanilla interest rates swaps will be cleared. Given this expectation, uncleared swaps will have substantially different risks than cleared swaps (e.g., callable versus non-callable). As a result, it would be inappropriate to use the DCO initial margin model that does not consider option or non-linear risk.*
- *At the very least, a robust internal initial margin model should be benchmarked against a DCO model to ensure that for a similar swap the internal model generates an initial margin requirement at least as great as the DCO initial margin requirement.*

Question 15. With respect to either alternative for calculating initial margin requirements, should swap or security-based swap positions that pose no counterparty risk to the covered swap entity, such as a sold call option with the full premium paid at inception of the trade, be excluded from the initial margin calculation?

- *Yes. The purpose of initial margin is to provide an additional buffer above and beyond variation margin to mitigate credit exposure in a credit event scenario. There is no counterparty credit risk if a counterparty has paid the full premium or up-front cash flow at inception of a transaction like a sold call option and, therefore, it is unnecessary for the selling counterparty to collect initial margin for such transactions.*

- *If the full premium has been paid for swaps and the probability of a negative market value is zero, then no initial margin should be required.*

Question 16. Would calculating the standardized initial margin for a particular risk category by separately calculating the initial margin required on the long positions and short positions and then using only the higher of these two amounts adequately account for offsetting exposures, diversification, and other hedging benefits within a standardized initial margin framework?

- *With respect to linear transactions:.*
    - *Assuming that "calculation" in this question means to use a standardized initial margin lookup table for long and short positions, such as Appendix A, then this proposal is an improvement over Appendix A because its gives some benefit for off-setting pay and receive swaps.*
    - *However, this may not be a sufficient solution because second (yield curve twist) and third (yield curve butterfly) order yield curve movements are largely ignored. Additionally, defining long and short positions within even a single risk category is not straightforward. For example, would interest rate swaps with two floating indices be bucketed as long or short?*
- *For non-linear transactions (e.g., options with one-way exposure), however, note that a standardized initial margin lookup table will not be an adequate solution.*

Question 17. Would the method described above systematically overestimate or underestimate offsetting exposures, diversification, and other hedging benefits? Is this method prone to manipulation or other gaming concerns?

- *Generally, the method above underestimates offsetting exposures.*
    - *Conceptually, a gross notional methodology (Appendix A) underestimates offsetting exposures.*
    - *Conceptually, a methodology based on the net notional amount of a swaps portfolio governed by a single master netting agreement may more closely resemble a robust initial margin model.*
    - *The proposal described in Question 16 would fall between the gross and net methods described in the previous two bullet points.*
- *However, because uncleared swaps are complex by definition, systematically identifying a bias in this approach is likely dependent on portfolio composition.*

Question 18. Should the Agencies consider some degree of offset across risk categories? If so how should these offsets be determined?

No. Offsets across broad risk categories (e.g., IRS and CDS) should not be considered because correlations of exposures across risk categories are not stable and that would compromise the integrity of the initial margin calculations. Secondarily, DCOs establish initial margin requirements at an individual risk category level. This standard should hold for uncleared derivatives.

Question 19. Would adjusting the gross notional amount of swap positions in a particular risk category (e.g., commodity, credit, equity, or foreign exchange/interest rate) by a net-to-gross ratio or a netting factor in a manner that is similar to the method used for adjusting potential future exposure calculations for purposes of the Federal banking agencies' risk-based capital rules adequately capture offsetting exposures, diversification, and other hedging benefits?

Adjusting gross notional amount in a single risk category for offsets would be an improvement over Appendix A. Using the net-to-gross ratio or a netting factor is one such alternative but there are shortcomings with this approach. See answer to Question 20 below for more detail.

Question 20. Would adjustment of gross notional amounts with a net-to-gross ratio or a netting factor systematically overestimate or underestimate offsetting exposures, diversification, and other hedging benefits?

Using a net-to-gross ratio ("NGR") likely overestimates offsetting exposures. To reiterate, uncleared swaps are complex and bias is dependent on portfolio composition.

- *Assume a one interest rate swap portfolio with 3 different counterparties where the swaps have the similar durations (price sensitivities) but different coupons and therefore different market values. See table below:*

CP	***TENOR***	***MTM***	***NGR = MAX(MTM,0)/SUM(+MTM)***
A	*5*	*-5*	*0*
B	*5*	*0*	*0*
C	*5*	*5*	*1*

- *The initial margin should be equivalent for each portfolio since the riskiness of the positions is approximately equal. Using NGR would result in unequal initial margin requirements and overestimate the benefits of offsets.*

Question 21. Are there additional methods that could be used in conjunction with a standardized lookup initial margin table that adequately recognize offsetting exposures, diversification, and other hedging benefits?

- *For a standardized lookup initial margin table to be adequate it must consider (1) the riskiness of all uncleared positions within a single risk category with a single counterparty and (2) the portfolio effects of offsetting exposures within that portfolio. A simple standardized lookup initial margin table will likely have shortcomings when compared to a robust internal initial margin model that has been approved by a prudential regulator.*

- *An alternative to Appendix A (which uses gross notional amount) would be to create an initial margin lookup table for interest rate swaps based on net portfolio DV01 at the counterparty level. Net DV01 for interest rate swaps recognizes the offsetting exposures, diversification, and other hedging benefits inherent in a swap portfolio with a single counterparty with a master netting agreement. This alternative methodology assumes initial margin is exchanged on a daily basis among counterparties.*

- *Although beneficial for its simplicity, a standardized initial margin lookup table would not be appropriate for certain complex transactions, including options with asymmetric payouts, for which there is no practical or reasonable substitute for an initial margin model.*

- *For an interest rate swap transaction between a covered swap entity and an FHLBank, the requirement for both parties to have an internal initial margin model which is approved by their prudential regulator is not necessary.*

- *There is a large expense associated with the initial development and the ongoing maintenance of an internal initial margin model for an FHLBank, where no model currently exists. Additionally, the benefit of having an internal model is very low because (1) initial margin models currently exist with FHLBank derivative counterparties, (2) other simpler and more cost effective alternatives exist, and (3) an internal model will have diminishing benefit as the universe of uncleared swaps will decline over time as DCOs increase the types of swaps they clear.*

- *Instead of using a simple initial margin lookup table and developing a new internal initial margin model, the FHLBanks could agree to pay initial margin based on the* *covered swap entity's internal initial margin model and require the covered swap entity to post a perfectly symmetrical amount of initial margin.*[1]

Questions 22(a) and (b). Are such methods transparent and implementable? Can they be generalized across multiple risk categories and swap types?

- *Net DV01 is transparent and implementable since it is industry practice (both buy-side and sell-side accounts) to calculate DV01 for all interest rate swap transactions.*
- *Net DV01 is not applicable for other risk categories, such as CDS.*

As an alternative, the Agencies request comment on whether Appendix A should be revised to adopt a method that more fully reflects the offsetting of positions at default. For example, such a method might rely on a calculation of an adjusted gross notional amount that would reduce the amount of initial margin required when a counterparty has many offsetting trades under a qualifying master netting agreement. To calculate the adjusted gross notional amount for an asset class, one would first calculate the net notional to gross notional ratio. This netting factor would be the absolute value of the difference between the long notional contracts and the short notional contracts divided by the total gross notional amount of the contracts. This value would then be used as a type of correlation factor among the contracts. The adjusted gross notional amount would then be calculated as follows, where n is the gross notional value of trades in an asset class and "NF" is the netting factor:

$$adjusted\ gross\ notional = n \times \frac{\sqrt{n + n(n-1)NF}}{n}$$

The adjusted gross notional amount, rather than the gross notional amount, would then be used to calculate initial margin using Appendix A. When the netting factor is zero, initial margin would still be required to be collected, and when the net to gross ratio is one (all positions are one way) the netting factor is also one so that the adjusted gross notional is equal to the gross notional. This method would allow offsetting transactions that reduce risk to reduce initial margin, but would not allow the offset to ever be perfect, so that initial margin would always be required to be collected. The adjusted gross notional method would be applied to the initial margin calculation by using gross notional amounts within an asset class. The Agencies seek comment

[1] See the FHLBanks' comment letter for a more detailed discussion of why the FHLBanks believe that counterparties of covered swap entities should be able to utilize initial margin models developed by such covered swap entities. The existence of certain derivatives transactions (*e.g.*, options with asymmetric payouts) for which there exists no practical or reasonable substitute for an initial margin model underscores the need to allow market participants to rely on models developed by covered swap entities.

on these methods, as well as alternative methods for calculating initial margin requirements under Appendix A and potential ways in which Appendix A might better capture the offsetting exposures, diversification, and other hedging benefits.

- *It is unclear what the adjusted gross notional formula is intended to capture.*

- *For uncleared swaps, the FHLBanks believe using a simple initial margin lookup table that is based on estimating the net notional amount (or adjusted gross notional amount) is not the best approach. Instead, a lookup table based on estimating the net price sensitivity of a swap portfolio with a single counterparty would lead to a more robust result which captures the offsetting exposures and diversification.*

Initial Margin Thresholds

Question 23(a). Does the maximum initial margin threshold amount proposed for counterparties that are low-risk financial end users strike an appropriate balance between traditional credit extension practices and the potential for systemic risk or risk to the safety and soundness of a covered swap entity?

Yes. The initial margin threshold for low-risk financial end users strikes an appropriate balance between traditional credit extension practices and the potential for systemic risk or risk to the safety and soundness of a covered swap entity.

Question 23(d). Do the derivatives activities and exposures of nonfinancial end users have the potential to create systemic risk, either individually or in aggregate?

Yes. Depending on the size, structure and activities of a nonfinancial end user, or group of nonfinancial end users in a particular line of business, it is possible, though unlikely, that it could create systemic risk.

Question 24. Is it appropriate for the threshold amounts to be capped at a fixed dollar amount?

Yes. From a systemic risk viewpoint, we believe that a fixed dollar cap on thresholds would serve to contain systemic exposure to very large, systemically significant derivatives market participants, without constraining smaller market participants that would not likely create systemic risk.

Question 25. Should the rule also place a limit on the threshold amounts that a covered swap entity establishes for all counterparties in the aggregate?

No. The covered swap entities are regulated entities and individual assessment of risk should be addressed at the portfolio level by entity.

Question 26(a). Is it appropriate for the threshold amounts to be determined by reference to the tier 1 or other measure of capital of a covered swap entity?

Yes. Capital is a critical buffer against default, and threshold amounts should bear some proportion to the amount of capital a market participant has to absorb potential losses.

Question 26(b). What other measures might be used to determine appropriate threshold amounts?

Total capital, applicable core surplus or core capital, or DV01 analysis.

Question 27(a). Should the various threshold amounts be subject to an automatic adjustment for inflation on a periodic basis?

No. The notional of the trade will be impacted by inflation and is already incorporated within the trade structure of the underlying swap.

Alternative Approach to Initial Margin Requirements

Question 28. Would requiring a covered swap entity to post initial margin to end user counterparties reduce systemic risk (e.g., by reducing leverage in the financial system or reducing systemic vulnerability to the failure of a covered swap entity)?

Yes. Covered swap entities can cause significant systemic risk due to the concentration of market share of outstanding derivatives attributable to them and their large size. Requiring them to post initial margin to end-users will reduce this risk.

Question 29. Are there alternatives that address those risks more efficiently or with greater transparency?

The FHLBanks are not aware of any alternatives that would address these risks as effectively as requiring covered swap entities to post margin to end-users.

Question 30. Would requiring a covered swap entity to post initial margin to end user counterparties raise any concerns with respect to the safety and soundness of the covered swap entity, taking into consideration the requirement that initial margin be segregated and held with a third party custodian?

If all covered swap entities were required to post initial margin with end-users, then there would be no signaling effect as there would be if a particular covered swap entity were required to post initial margin, which would presumably be perceived as a sign of financial weakness.

Question 31. Would requiring a covered swap entity to post initial margin to end user counterparties remove one or more incentives for that covered swap entity to choose, where possible, to structure a transaction so that it need not be cleared through a CCP in order to avoid pledging initial margin?

Yes. By requiring initial margin on uncleared trades that is at least as great as that on cleared trades, the incentive to find loopholes through uncleared structuring is reduced.

<u>Section ___.4: Variation Margin</u>

Alternative Approach to Variation Margin Requirements

Question 44. Would requiring a covered swap entity to post variation margin to end user counterparties reduce systemic risk (e.g., by reducing leverage in the financial system or reducing systemic vulnerability to the failure of a covered swap entity)?

Yes. Variation margin posting requirements should be mutual. Variation margin is designed to eliminate net credit exposures by securing obligations on a daily basis. This reduces the potential contagion effect that a large covered swap entity might pose in the marketplace if it were to default on its obligations.

Question 45. Are there alternatives that address those risks more efficiently or with greater regulatory transparency?

The FHLBanks are not aware of any.

Question 46. Would requiring a covered swap entity to post variation margin to end user counterparties raise any concerns with respect to the safety and soundness of the covered swap entity?

No. It is common practice for covered swap entities to post variation margin under their bilateral, uncleared derivative netting agreements with financial end-users now. Requiring all covered swap entities to do so would reduce any stigma that might be associated with such a requirement.

Question 47. Would requiring a covered swap entity to post variation margin to end user counterparties remove one or more incentives for that covered swap entity to choose, where possible, to structure a transaction so that it need not be cleared through a CCP in order to avoid pledging variation margin?

Yes. If covered swap entities do not have to post margin for uncleared swaps with their end user counterparties then such swaps will be much less expensive for the covered swap entities than cleared swaps and covered swap entities will thus have financial incentives to structure such swaps so that they do not have to be cleared.

Question 48. Would this approach be consistent with the statutory factors the Agencies are directed to take into account under sections 731 and 764 of the Dodd-Frank Act?

Yes. Sections 731 and 764 require that the margin and capital requirements offset the greater risk to the swap dealer or major swap participant ***and the financial system*** *from the use of swaps that are not cleared. With the exception of the special requirements proposed by the Federal Housing Finance Agency and the Farm Credit Administration with respect to their regulated entities, the proposed regulations seem entirely focused on protecting swap dealers and major swap participants. Yet the Dodd-Frank Act contemplates that no institution, including swap dealers and major swap participants, is "too big to fail." Thus, it would seem consistent with the legislation to require swap dealers and major swap participants to post variation margin to end users to minimize the risk to the financial system should one or more swap dealers or major swap participants become insolvent in the future.*

<u>Section .6: Eligible Collateral</u>

Question 59(a). Should the types of eligible collateral listed be broadened to include other types of assets (e.g. securities backed by high-quality mortgages or issued with a third-party guarantee)?

Current proposed collateral, consisting of cash, treasuries/agencies, would be adequate if agencies are expanded to include mortgage-backed securities and FHLBank issuances.

Question 59(b). If so, how might the systemic risk issue described above be effectively mitigated?

Expanding the definition of "agency collateral" would provide market participants with flexibility and support broader market efficiencies.

Question 61. What criteria and factors could be used to determine the set of acceptable non-cash collateral?

- *Highly liquid with relatively narrow bid-offer spread.*
- *Credit quality – investment grade or higher.*
- *Eligible as collateral at Federal Reserve Bank discount window.*
- *Ability to model and price.*

Question 62. How could appropriate haircuts be determined for valuing these assets for margin purposes?

Historical price volatility and liquidity for securities can be considered to calculate appropriate haircuts for securities. Value at risk methodology measured at a certain confidence level will be the primary methodology to determine haircuts. For Price VaR, historical prices over a long enough time period (usually > 10 years and one that covers many different price regimes and stress scenarios) can be used to calculate a Value-At-Risk over an appropriate holding period and confidence level (90%-99%). Liquidity risk can be ascertained based on trading volume, bid-ask spread and price variability. Haircuts can vary by security classifications, remaining terms, or remaining weighted average lives.

Question 64(a). Should fixed income securities issued by a well-known seasoned issuer that has a high credit standing, are unsubordinated, historically display low volatility, are traded in highly liquid markets, and have valuations that are readily calculated be added to the list of eligible collateral for initial margin?

Yes. Haircuts may be adjusted to reflect any incremental risk related to a particular issuer.

Section __.7: Segregation of Collateral

Question 65(a). Is it necessary to require segregation of initial margin in order to address the systemic risk issues discussed above?

Yes. The FHLBanks believe that initial margin should be posted by both parties under bilateral credit support agreements so that in the event of a default, the non-defaulting party has some degree of protection against adverse market movements while it seeks to liquidate and replace its positions with other counterparties. Such protection can only be assured if the collateral has been segregated and placed out of the control of the defaulting party. However, the FHLBanks do NOT believe that variation margin needs to be segregated, as these funds are offset by the current exposure of the associated derivatives.

Question 65(b). What alternatives to segregation would effectively address these systemic risk issues?

The FHLBanks are not aware of any.

Question 65(c). As an alternative to requiring segregation at the outset, should the Agencies impose rules that provide additional time for a swap dealer to raise funds without requiring segregation?

The FHLBanks believe that initial margin posted by entities that do not currently post initial margin to their swap dealer counterparties should be segregated immediately. However, the FHLBanks would support a delayed effective date for new initial margin requirements (and corresponding segregation requirements) so that markets are not disrupted.

Question 66(a). What are the potential operational, liquidity and credit costs of requiring segregation of initial margin by swap entities?

This will depend on the funding cost attributable to each entity, but the cost for most entities is expected to be significantly higher than its secured funding cost. For FHLBanks, the incremental cost should not be very large, as the FHLBanks enjoy a very low funding cost.

Question 66(b). What would be the expected liquidity impact and cost of the proposed segregation requirement on market participants? How can the impact of the proposed rule on the liquidity and costs of swaps market participants be mitigated?

See answer to Question 66(a) above. The cost can be mitigated by managing the exposure through such techniques as flattening net exposures or "recouponing" existing transactions to reduce their margin impact. However, such techniques may have consequences that market participants cannot accept. For example, re-couponing swaps may cause their hedging effectiveness to deteriorate, thus reducing or eliminating their usefulness as risk mitigation tools.

Question 67. Is segregation of initial margin and not variation margin sufficient to achieve the purposes of sections 731 and 764 of the Dodd-Frank Act? If not, how might such purposes be achieved?

Yes. Unlike initial margin, which generally represents overcollateralization (i.e., an amount over-and-above a swap dealer's current exposure to its counterparty, or vice versa), variation margin represents the mark-to-market value of outstanding swaps between the counterparties and is therefore roughly equal to the close-out amount that would be owed upon a default and termination of the counterparties' swaps. The only amount of variation margin that would be "at risk" if it were held by an insolvent counterparty would be the amount over and above the close-out amount due upon termination as a result of market movements immediately prior to the counterparty's insolvency and subsequent termination of the swap.[2] *On the other hand, if a party holding initial margin becomes insolvent, then the entire amount of the initial margin would likely be "at risk" and it would be difficult or impossible to obtain the return of the initial margin.*

Accordingly, requiring segregation of initial margin is consistent with the statutory provisions of sections 731 and 764, which require that capital and margin requirements offset the greater risk to the swap dealer or major swap participant and the financial system arising from the use of

[2] The FHLBanks note that in some cases, the excess variation margin held by an insolvent counterparty as a result of recent market movements could be substantial, especially when the market is in flux (which is likely to be the cause if counterparties are failing.) See the FHLBanks' comment letter for an explanation of how bilateral initial margin requirements would address this issue.

uncleared swaps, but segregation of variation margin is unnecessary to satisfy these statutory mandates.

Question 68(a). Are the limitations placed on rehypothecation and reinvestment under the proposed rule appropriate or necessary?

The FHLBanks believe that certain limitations on rehypothecation and reinvestment are helpful in reducing systemic risk. However, they will also likely increase the cost of hedging or make hedging less viable for certain market participants.

Question 68(c). Should certain forms of rehypothecation (e.g., the lending of securities pledged as collateral) or additional types of reinvestment be permitted?

The FHLBanks believe that rehypothecation should be allowed with respect to variation margin held by a secured party, assuming that the pledgor has a perfected interest in initial margin pledged to it by the secured party.

Question 69(a). Is the proposed rule's requirement that the custodian must be located in a jurisdiction that applies the same insolvency regime to the custodian as would apply to the covered swap entity necessary or appropriate?

*While the FHLBanks agree that custodians should be subject to an insolvency regime under United States laws, see the FHLBanks' comment letter for an explanation of why it is not feasible for the FHLBanks to use a custodian that is subject to the "**same** insolvency regime" as the FHLBanks.*

Section __.8: Approved Initial Margin Models

Question 70(a). Should such models be limited to models based on value-at-risk concepts, or are other models appropriate to measure initial margin?

Value-at-risk models use Monte Carlo simulation which calculates statistics on price changes. An alternative methodology would be to calculate statistics on changes in risk factors, such as interest rates.

Question 71(a). Should offsetting exposures, diversification, and other hedging benefits be recognized more broadly across substantially dissimilar asset classes?

While the FHLBanks have concerns that correlations across asset classes and products may not be stable in stressed markets, the FHLBanks are not opposed to the recognition of offsetting exposures where they can be demonstrated clearly.

Question 72(a). Should the minimum time horizon vary across swaps?

The time horizon should be variable based on the liquidity of the asset class and underlying transactions in question.

Question 72(b). For example, should it vary based on the broad asset classes: commodity, credit, equity, and foreign exchange/interest rate?

They could also vary within each of these classifications.

Question 72(c). If so, how should the horizons differ and what would be the basis for the different horizons?

For example, increased structural complexity or thinly-traded underlying indices might require a longer time horizon than 10 days, while less complex, widely-traded structures might be allowed shorter time horizons.

Annex B

Collateral for
Uncleared Swaps
Presentation

July 11, 2011

How Parties Are Protected with Initial Margin/Independent Amounts (“IA”)

SUTHERLAND

Example 1 In-the-Money, No IA

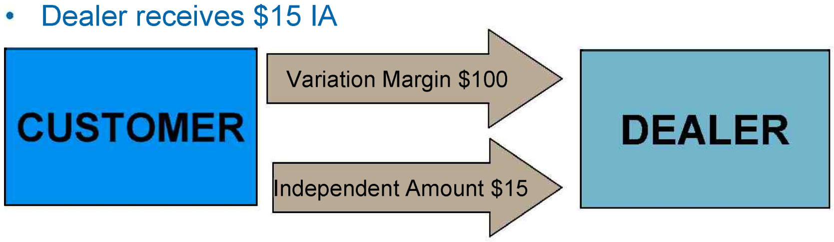
SUTHERLAND

- Dealer enters into swap trade with Customer
- Trade moves $100 in-the-money for the Dealer
- Dealer receives variation margin (threshold is zero)
- Dealer receives no IA

- Upon termination, the Dealer is owed $110:
  - Dealer keeps $100 and looks to the Customer for $10 balance
- Dealer has $10 potential shortfall

Example 2
In-the-Money, Dealer Receives IA

- Dealer enters into swap trade with Customer
- Trade moves $100 in-the-money for the Dealer
- Dealer receives variation margin (threshold is zero) plus
- Dealer receives $15 IA



- Upon termination Dealer is owed $110:
  - Dealer keeps $100 variation margin plus $10 from IA
  - Dealer returns $5 to Customer
- Dealer is fully protected

Example 3 Out-of-Money, No IA

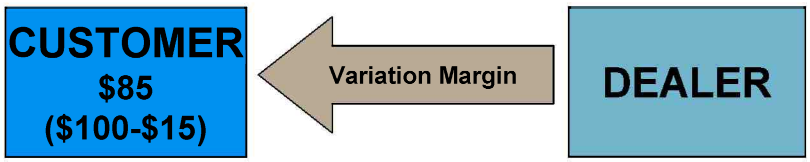
- Dealer enters into swap trade with Customer
- Trade moves $100 out-of-the money for the Dealer
- Dealer pays variation margin (zero threshold) but does not receive any IA

- Upon termination Dealer owes the Customer $90:
  - Dealer is $10 "over-collateralized" and if Customer is insolvent, Dealer must assert a general creditor claim to receive excess variation margin
  - Dealer has $10 potential shortfall

Example 4 Out-of-Money, Dealer Entitled to IA (single “pot”)

SUTHERLAND

- Dealer enters into swap trade with Customer
- Trade moves $100 out-of-the-money for the Dealer
- Dealer pays variation margin, but is entitled to $15 of IA
- In this case: IA is not segregated, but lumped with variation margin in single “pot”

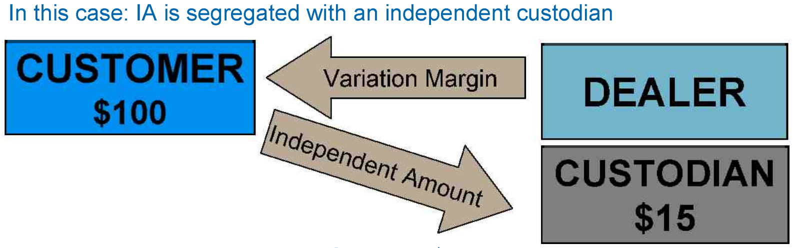


- Upon termination Dealer owes Customer $90:
  - Customer has $85 and Dealer pays Customer additional $5
  - Dealer has no loss for $10 (difference between $100 and $90)
  - Dealer is fully protected

Example 5 Out-of-Money, Dealer Entitled to IA (two “pots”)

SUTHERLAND

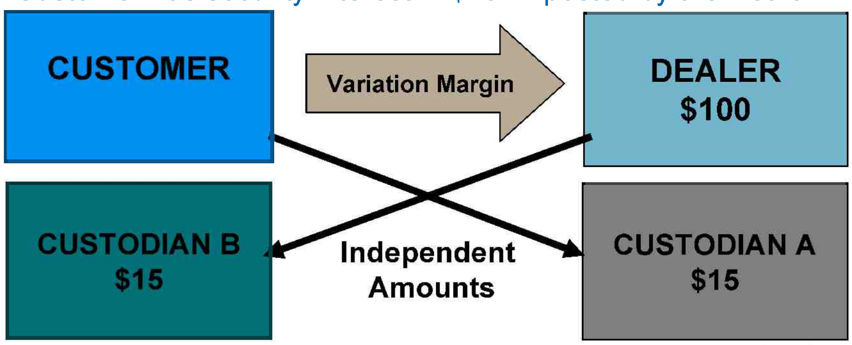
- Dealer enters into swap trade with Customer
- Trade moves $100 out-of-the-money for the Dealer
- Dealer pays variation margin, but is entitled to $15 of IA
- In this case: IA is segregated with an independent custodian



- Upon Termination Dealer owes Customer $90
  - Customer has $100, so it should return $10 to the Dealer
  - If Customer fails to return $10 to Dealer, Dealer will exercise its security interest in the $15 IA by receiving $15 from the Custodian, keeping $10, and remitting $5 to the Customer
- Dealer is fully protected and has no loss with respect to $100 variation margin posted to Customer

Example 6: Customer Out-of-Money, Per Proposed Rule, Both Parties Entitled to IA

- Dealer enters into swap trade with Customer
- Trade moves $100 out-of-the-money for the Dealer
- Dealer receives $100 variation margin plus a security interest in $15 IA posted by the Customer
- Customer has security interest in $15 IA posted by the Dealer



Example 6: Customer Out-of-Money, Per Proposed Rule, Both Parties Entitled to IA (continued)

- Upon Termination Customer owes Dealer $90:
  - Customer sets off $90 owed against $100 held by Dealer, so Dealer should return $10
  - If Dealer does not return $10, Customer recovers $15 IA posted to Custodian B, keeps $10, and returns $5 to the Dealer
  - Customer receives $15 IA posted to Custodian A upon insolvency of the Dealer
- Result:
  - Customer has no loss with respect to $10 excess variation margin posted to Dealer. (Customer has $10 of the $15 IA posted by Dealer and all of the IA which the Customer posted.)

Annex C

Sutherland Memorandum

SUTHERLAND

MEMORANDUM July 11, 2011

TO: The Federal Home Loan Banks

FROM: Sutherland Asbill & Brennan LLP

RE: Initial Margin And Protection Against Over-collateralization

The purpose of this memorandum is to discuss in detail how initial margin received by a Federal Home Loan Bank ("FHLBank") under the existing 1994 ISDA Credit Support Annex subject to New York Law (the "CSA") may protect the FHLBank in the event that its "out-of-the-money" trades with a defaulting counterparty leave it in an over-collateralized position with that counterparty (i.e. the variation margin posted by the FHLBank to the counterparty exceeds the amount owed to the counterparty). In order to avail itself of this protection, the FHLBank must collect initial margin from its counterparty and either hold it directly or have a perfected security interest in such margin held pursuant to a tri-party custodial agreement by an independent custodian. The memorandum also addresses how, under the CSA, the FHLBank obtains the return of any initial margin that it has posted to the defaulting counterparty. The memorandum assumes that any such initial margin is also held by a third-party independent custodian pursuant to a tri-party custodial agreement.[1] A scenario under which this protection may be beneficial is described below.[2]

I. Counterparty Default Scenario; Recovery of Loss by Securing Initial Margin

In this scenario, both parties post initial margin/independent amounts to a third party custodial account, in which the other party has a perfected security interest. Variation margin is posted directly to the other party. This scenario involves the FHLBank being "out-of-the-

[1] The initial margin posted by both parties may be held by one or two independent custodians. The memorandum assumes that the parties have elected to eliminate the offset of independent amounts per Appendix C of the User's Guide to the 1994 ISDA Credit Support Annex. As discussed herein, the tri-party custodial arrangement with respect to initial margin posted by the FHLBank to the counterparty is essential to the favorable outcome in this scenario.

[2] The scenario addressed herein is somewhat analogous to the margining structure set forth in the prudential regulators' proposed rules on Margin and Capital Requirements for Covered Swap Entities (the "Proposed Margin Rules"), a copy of which may be found at http://www.occ.treas.gov/news-issuances/federal-register/76fr27564.pdf. The Proposed Margin Rules as currently drafted require initial margin and variation margin posted by the FHLBanks to a Covered Swap Entity (a Swap Dealer or Major Swap Participant) to be held by an independent third-party custodian. However, this memorandum assumes that the FHLBanks would not be required to insist that their counterparty hold variation margin in a segregated account with an independent custodian. This memorandum also assumes that each of the FHLBanks' Covered Swap Entity counterparties would similarly request that initial margin posted by them to the FHLBanks be held by an independent third-party custodian, although this outcome would not be required by the Proposed Margin Rules.

money" with respect to its counterparty that has become bankrupt. Following the close-out procedures of the ISDA Master Agreement, the FHLBank determines that it has posted variation margin to its counterparty that is in excess of the amount owed by the Bank to the bankrupt counterparty. Thus, the FHLBank is "over-collateralized" with respect to its bankrupt counterparty. As discussed below and pursuant to the CSA and the terms of the tri-party custodial agreement, the initial margin posted by the FHLBank to the counterparty is required to be returned to the FHLBank upon the bankruptcy of such counterparty. As such, only the variation margin posted directly to the counterparty is at risk.

As noted above, the scenario begins when a FHLBank's counterparty becomes insolvent and defaults under its swaps with the FHLBank. The termination payment owed by the FHLBank to its counterparty is calculated and determined to be to be less than the variation margin posted by the FHLBank and held by the counterparty. However, the counterparty refuses to return the excess variation margin and informs the FHLBank that it must file a claim against the bankruptcy estate as a general creditor for the amount of such excess variation margin. This memorandum explains why and how, pursuant to the terms of the CSA, the FHLBank may obtain possession of the initial margin posted to it by its bankrupt counterparty and held with an independent custodian. If the initial margin posted by the counterparty to the FHLBank is in an amount greater than the claim against the bankruptcy estate, then the FHLBank may recover the entire amount of its claim for excess variation margin posted to the bankrupt counterparty.

II. **Rights under the CSA**

The favorable outcome discussed above is based directly upon certain provisions contained in the CSA. Under the CSA, a party may exercise its rights as a Secured Party with respect to the initial margin posted to it by its counterparties to offset the unreturned excess variation margin owed by a defaulting counterparty.[3] The provisions that create this mechanism are discussed below.[4] Similarly, under the CSA, a party may exercise its rights as Pledgor to obtain the return of the initial margin posted to a bankrupt third party where such initial margin is held by an independent custodian and is therefore not an asset of the bankruptcy estate.

A. Rights of Secured Party

The FHLBank in our scenario is a Secured Party with respect to the initial margin posted to it by the bankrupt counterparty. Paragraph 2 of the CSA provides that a Secured Party has a continuing security interest in, lien on and right of Set-off against all Posted Collateral Transferred or received by such Secured Party, as security for all Obligations of the Pledgor.[5]

[3] The CSA defines the rights and obligations of the party pledging margin (the Pledgor) and the party receiving/holding margin (the Secured Party). The scenario in question assumes that each party is both a Pledgor and a Secured Party. The FHLBank is a Pledgor with respect to the initial and variation margin posted to its counterparty and is also a Secured Party with respect to the initial margin posted by its counterparty. Conversely, the counterparty is the Pledgor with respect to the initial margin posted to the FHLBank and a Secured Party with respect to the initial and variation margin received from the FHLBank.

[4] Capitalized terms used in this section that are not otherwise defined have the meanings ascribed to them in the CSA.

[5] Paragraph 2 provides, "Each party, as the Pledgor, [e.g., counterparty with respect to initial margin posted to the FHLBank] hereby pledges to the other party, as the Secured Party [e.g., the FHLBank] as security for its

The Obligations of the Pledgor include all present and future obligations under the CSA and related ISDA Master Agreement under which swaps are executed.[6] The operative provisions of the CSA regarding rights related to such security interests upon a counterparty default are set forth in Paragraphs 8(a), (b) and (c).

Paragraph 8(a) of the CSA provides that upon a default by a Pledgor and designation of an Early Termination Date by the Secured Party (in this case, the FHLBank), the Secured Party may (i) exercise all of its rights and remedies under applicable law with respect to Posted Collateral held by the Secured Party (which generally includes taking possession of the Posted Collateral held by the Custodian on behalf of the Secured Party) and (ii) utilize such Posted Collateral to Set-off any amounts owed to it by the defaulting Pledgor, in each case in order to satisfy the Obligations of the counterparty to the FHLBank.[7] Additionally, Paragraph 8(b) provides that, upon a default, the FHLBank's counterparty, in its own capacity as Secured Party, is required to return both the initial margin (held by its independent custodian) and variation margin (held directly by the counterparty) that it has received from the FHLBank.[8]

As such, the return of variation margin to the FHLBank by the bankruptcy counterparty upon its default is an Obligation under the CSA. Further, since the FHLBank is the non-defaulting party, it has no obligation under Paragraph 8(b) to return the initial margin posted to the independent custodian by the defaulting counterparty. So, the FHLBank is therefore entitled to exercise its security interest in the initial margin held by the custodian and posted by the bankrupt counterparty to satisfy that counterparty's Obligation to return any excess variation

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Obligations and grants to the Secured Party a first priority continuing security interest in, lien on and right of Set-off against all Posted Collateral Transferred to or received by the Secured Party hereunder."

[6] Pursuant to the CSA, "'Obligations' means, with respect to a party [e.g., the counterparty] all present and future obligations of that party under this Agreement and any additional obligation specified for that party in Paragraph 13."

[7] Paragraph 8(a) provides, in part, "If at any time (1) an Event of Default or Specified Condition with respect to the Pledgor [e.g., the counterparty with respect initial margin posted to the FHLBank] has occurred and is continuing or (2) an Early Termination Date has occurred or been designated as the result of an Event of Default or Specified Condition with respect to the Pledgor, then, unless the Pledgor [counterparty] has paid in full all of its Obligations that are then due, the Secured Party [the FHLBank with respect to initial margin posted to it by its counterparty] may exercise one or more of the following rights and remedies:

(i) all rights and remedies available to a secured party under applicable law with respect to Posted Collateral held by the Secured Party [e.g. the FHLBank].
…
(iii) the right to Set-off any amounts payable by the Pledgor with respect to any Obligations against any Posted Collateral or the Cash equivalent of any Posted Collateral held by the Secured Party …."

[8] Paragraph 8(b) provides, in part, "If at any time, an Early Termination Date has occurred or been designated as the result of an Event of Default or Specified Condition with respect to the Secured Party [e.g. the counterparty holding initial margin and variation margin], then …:

(i) the Pledgor may exercise all rights and remedies available to a pledgor under applicable law with respect to Posted Collateral held by the Secured Party;…[and]

(iii) the Secured Party will be obligated immediately to Transfer all Posted Collateral and the Interest Amount to the Pledgor [e.g. the FHLBank]…"

margin posted to it by the FHLBank. Assuming that the FHLBank has a perfected security interest in the initial margin held by the independent custodian pursuant to a tri-party custodial agreement, the initial margin may therefore be directly accessed by the FHLBank. It should be noted that any initial margin recovered by the FHLBank that is in excess of amounts owed to the FHLBank by the bankrupt counterparty (e.g. the excess variation margin) is required to be returned to that counterparty pursuant to Paragraph 8(c) of the CSA.[9]

B. Rights of Pledgor

In addition to being able to obtain possession of the initial margin posted by the defaulting counterparty to the FHLBank's independent custodian, the FHLBank may, in its capacity as Pledgor, also regain possession of the initial margin that the FHLBank has posted to the defaulting counterparty's independent custodian under this scenario. As discussed above, Paragraph 8(b)(iii) of the CSA provides that the defaulting counterparty, in its capacity as Secured Party, is required to Transfer back to the FHLBank (as Pledgor) all Posted Collateral (including both initial margin and variation margin) posted to the defaulting counterparty as Secured Party. Additionally, the FHLBank, in its capacity as Pledgor, may exercise all of its rights and remedies as a pledgor under applicable law with respect to the initial margin that it has posted to the defaulting counterparty.[10] Consistent with these provisions of the CSA, a Pledgor may take action to terminate the security interest of the defaulting party by taking control of the initial margin held by the custodian pursuant to the terms of the tri-party custodial agreement. Since the initial margin posted by the FHLBank is held separately from the assets of the defaulting counterparty, the initial margin would not be a part of the defaulting counterparty's bankruptcy estate, thus precluding the bankruptcy trustee from objecting to the transfer of the initial margin from the custodian back to the Pledgor.[11]

III. **Conclusion**

The traditional view of initial margin is that it affords protection to the party receiving such margin (i.e. the secured party) in the event that the value of its "in-the-money" trades with a defaulting counterparty exceed the amount of variation margin it has received from the counterparty.[12] However, initial margin may also protect the secured party in the event that its "out-of-the-money" trades with a defaulting counterparty leave it in an over-collateralized position with that counterparty (i.e. the variation margin posted to the counterparty exceeds the amount owed to the counterparty). The CSA is clear in requiring that a defaulting counterparty return any excess variation margin held by it to a non-defaulting counterparty. The CSA also

[9] Paragraph 8(c) provides, "The Secured Party [e.g. the FHLBank] will Transfer to the Pledgor [e.g. the counterparty] any proceeds and Posted Credit Support remaining after the liquidation, Set-off and/or application under Paragraphs 8(a) and 8(b) after satisfaction in full of all amounts remaining unpaid after any liquidation, Set-off and/or application under Paragraphs 8(a) and 8(b)." (Under Paragraph 12 of the CSA, "'Posted Credit Support' means Posted Collateral and Other Posted Support.")

[10] CSA, ¶ 8(b)(i)

[11] Generally, tri-party custodial agreements provide that a party may issue a "Notice of Exclusive Control" under certain circumstances (usually including the default or insolvency of its counterparty), which formally eliminates any rights of the defaulting counterparty to attempt to instruct movement of the margin posted and gives the issuing party exclusive control to direct the transfer of such margin.

[12] See, e.g., "Independent Amounts" (ISDA / MFA / SIFMA, 2010), a copy of which white paper is available here.

allows the non-defaulting counterparty party to exercise its security interest in any initial margin posted to the custodian by the bankrupt party to secure its obligations under the CSA. Accordingly, the non-defaulting party (the FHLBank in our scenario) is able access the initial margin posted by the defaulting party and held by a custodian to satisfy the defaulting party's failure to return such excess variation margin. Similarly, the initial margin posted to the defaulting party by the non-defaulting party (the FHLBank) and held in a separate custodial account would not be considered part of the defaulting party's bankruptcy estate and would, pursuant to the terms of the CSA and the tri-party custodial agreement, be returned to the non-defaulting party (the FHLBank).