Freddie Mac
We make home possible℠

8200 Jones Branch Drive
McLean, VA 22102-3110

BY ELECTRONIC DELIVERY

November 24, 2014

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th St, SW, Suite 3E-218
Mail Stop 9W-11
Washington, D.C. 20219

Alfred M. Pollard, General Counsel
Attention: Comments/RIN 2590-AA45
Federal Housing Finance Agency
Constitution Center (OGC Eighth Floor)
400 7th St, SW
Washington, DC 20024

Robert deV. Frierson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Barry F. Mardock, Deputy Director
Office of Regulatory Policy
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102-5090

Robert E. Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Re: Proposed Rule on Margin and Capital Requirements for Covered Swap Entities; Docket No. OCC-2011-0008/RIN 1557-AD43; Docket No. R-1415 /RIN 7100 AD74; RIN 3064-AE21; RIN 3052-AC69; RIN 2590-AA45

Dear Gentlemen:

Freddie Mac is pleased to submit these comments in response to the notice of proposed rulemaking and request for comments (the "PR Margin Proposal") regarding margin and capital requirements for covered swap entities, published jointly by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, and the Farm Credit Administration (collectively, the "Prudential Regulators") on September 24, 2014.[1] The PR Margin Proposal is issued under Sections 731 and 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which requires the Prudential Regulators to adopt rules to establish capital and initial and variation margin requirements on non-cleared swaps and non-cleared security-based swaps.

For purposes of this letter, swap dealers, security-based swap dealers, major swap participants and major security-based swap participants are collectively referred to as "Swap Entities," and a Swap Entity that is subject to regulation by a Prudential Regulator is referred to as a "Covered

[1] 79 FR 57348.

Swap Entity" or "CSE." Also, references to "swaps" include security-based swaps unless indicated otherwise.

Freddie Mac was chartered by Congress in 1970 with a public mission to stabilize the nation's residential mortgage markets and expand opportunities for affordable homeownership and rental housing. Our statutory mission is to provide liquidity, stability and affordability to the U.S. housing market. Freddie Mac uses swaps to hedge large-scale commercial risks on an ongoing basis. Freddie Mac currently operates under the direction of the Federal Housing Finance Agency as our Conservator.

Summary and Recommendations

Freddie Mac applauds the efforts of the Prudential Regulators to implement the Dodd-Frank Act and its objective of enhancing stability and transparency in the swaps markets, and strongly supports the efforts of the Prudential Regulators and the Commodity Futures Trading Commission (the "CFTC") to effectuate the Dodd-Frank Act's mandatory clearing requirements across the industry. We recognize that the Dodd-Frank Act requires the Prudential Regulators and the CFTC to establish initial and variation margin requirements for uncleared swap transactions and that such requirements are an important complement to clearing.

As described more fully below, Freddie Mac has the following recommendations:

- The "affiliate" and "control" definitions should not include relationships that are with or through the U.S. government or its representatives.

- Eligible collateral for purposes of satisfying variation margin ("VM") requirements, as well as initial margin ("IM") requirements, should include high-quality and liquid debt securities.

- The Prudential Regulators should clarify that the parties are not required to agree to particularized valuation models or inputs for VM in advance, but rather are required to agree to terms sufficient to establish the right of a Covered Swap Entity to collect or post variation margin as required by applicable law, subject to reasonable terms for the resolution of disputes.

- The Prudential Regulators should eliminate requirements that subject legacy transactions to new margin requirements in the event that they are maintained under a single "eligible master netting agreement" with post-compliance date transactions.

- The compliance date for VM requirements should be synchronized with the phased compliance dates for IM requirements.

- A standard IM model developed by an industry association that is satisfactory to the Prudential Regulators should be approved on an industry-wide, rather than a counterparty-specific, basis to minimize the burden on Covered Swap Entities and their Counterparties.

- The Prudential Regulators should clarify that Covered Swap Entities and their counterparties must use mid-market valuations of swaps for purposes of VM requirements.

- For purposes of the definition of "eligible master netting agreement," impermissible "walkaway clauses" should be limited to provisions that reduce or eliminate payment obligations for the non-defaulting party and should exclude temporary suspensions or conditions on payment.

Discussion

1. The "affiliate" definition should exclude affiliations with or through the U.S. government.

The PR Margin Proposal imposes various restrictions and requirements on groups of market participants that are "affiliates," including when they are under joint "control" of a third party. A variety of arrangements with the government could technically be deemed to create "control" for purposes of the rules as currently drafted which could create unintended consequences. Freddie Mac's assumption is that the Prudential Regulators do not intend to treat entities as affiliates by virtue of links to the federal government.

2. Eligible collateral for VM should include securities

Proposed §_.6(a)(i) and (ii) would limit eligible collateral for VM to U.S. dollars or cash in the currency in which payment obligations are denominated and would preclude the use of securities. We respectively submit that this approach is unduly restrictive and will be harmful to financial end users such as Freddie Mac. The approach is also more restrictive that the requirements of the BCBS/IOSCO framework agreed by the G-20 regulators and the parallel rules proposed in Europe. We therefore ask that the Prudential Regulators permit securities to be eligible collateral for VM, provided that they are high-quality and have liquid trading markets.

The Prudential Regulators' approach to eligible VM seems to be based on the assumption that posting cash as VM is currently a near-universal practice and that the economic cost of mandating such a requirement would be low. We believe this assumption to be incorrect. In our experience, we routinely see U.S. Treasuries and other high-quality securities used as collateral for mark-to-market exposures. For example, approximately 28% of the collateral that we post in connection with our uncleared swaps is posted in the form of cash, while the remaining 72% is in the form of high-quality liquid securities. Correspondingly, approximately 80% of the collateral that is posted to us in connection with swaps is in the form of cash and 20% of received collateral in in the form of high-quality liquid securities.

More importantly, we believe that a substantial group of stakeholders that are important for the U.S. economy (including Freddie Mac) would be adversely affected by a cash-only requirement. While the adverse economic effect as applied to speculative hedge funds may be limited, many financial end users that use swaps to hedge operations in the real economy may not carry large cash positions and would face real liquidity constraints in posting VM as cash. Requiring VM to be posted only in cash would limit these parties' ability to manage commercial risk.

Nor do we believe that the exclusion of securities is likely to reduce systemic risk. Provided that eligibility is properly limited to high-quality and liquid securities, any increase in credit exposure to collateral volatility would be minimal and could be mitigated with appropriate haircuts. Moreover, in the event that securities are not included as eligible for VM, the consequence would likely be that market participants that currently use securities would turn to the credit markets to obtain cash financing on the securities they would otherwise post as VM. As many of the same banks that operate as swap dealers are also lenders that are active in securities financing, the ultimate credit exposures may simply attach to the same institutions in a different form.

3. <u>Documentation requirements relating to valuations should not be overly prescriptive.</u>

Proposed § _.10(a)(2) would require that trading documentation specify "(i) [t]he methods, procedures, rules, and inputs for determining the value of each non-cleared swap or non-cleared security-based swap for purposes of calculating variation margin requirements."

To the extent this language is construed to require the parties to agree to specific valuation models and/or inputs, Freddie Mac believes the proposal will be very difficult to implement and will have adverse consequences. Valuation models by their nature should not be fixed and unvarying, but rather should be flexible and dynamic. In addition, documentation of valuations is already addressed in CFTC Rule 23.504(b), and CFTC Rule 23.431(d)(3) already requires a swap dealer to disclose "the methodology and assumptions used to prepare the daily mark." Given these rules, we believe § _.10(a)(2) is unnecessary and duplicative.

Freddie Mac believes that, for purposes of calculating VM, a more adaptive approach is required. Consistent with ISDA practices, trading documentation should specify the general principles for calculating swap valuations and the resulting variation margin, and should designate the party (or agent) responsible for the calculations (typically, a swap dealer). The documentation should further provide the counterparty with reasonable dispute rights and for procedures to resolve disputes promptly. Adequate dispute resolution rights and existing CFTC requirements to conduct periodic portfolio reconciliations and report aged disputes above a materiality threshold should adequately mitigate regulatory concern with unresolved disputes.

4. <u>Legacy transactions should be fully safe-harbored unless they are materially amended.</u>

The PR Margin Proposal would generally require market participants to apply new margin requirements to legacy swaps if new swaps are entered into under the same eligible master netting agreement as the legacy swaps. We believe that this requirement is unnecessary and will actually increase systemic risk. We therefore ask that market participants be allowed to use separate CSAs rather than separate master agreements to operationally separate margin for new and legacy trades.

If adopted as proposed, the PR Margin Proposal would incentivize market participants to establish new master agreements for their post-compliance date trades in order to avoid the cost of applying additional margin requirements to legacy trades. This would, however, have the negative effect of limiting each party's ability to perform close-out netting in the event of the counterparty's default. Close-out netting is a critical tool for risk reduction, and both parties are better protected from the other's credit when such netting is provided. For example, if separate master agreements were required, IM collected by a party under one master agreement would not be available to protect that party against credit exposure created under the other master agreement. As a result, in the event of a bankruptcy, the non-defaulting party could be required to return "excess" IM (or VM) under one master agreement while owed money under the other, leaving it exposed to losses as a general creditor.

We do not believe there is any policy or operational basis for this requirement. Master agreements such as the ISDA Master provide for close-out netting only. That is, they provide that on a party's default, the counterparty can value all transactions thereunder to establish a single net payment amount and that all collateral posted under the master can be used to make the non-defaulting party whole for that payment amount. They do not dictate how margin is calculated or collected under the master agreement. IM and VM can both be calculated and delivered separately for separate buckets of trades under a single master agreement.

Specifically, with respect to IM, the relevant models could be applied exclusively to new transactions and legacy transactions can be excluded entirely in order to prevent their use to reduce requirements. At the stage of delivery, since regulatory IM will be subject to mandatory segregation, historical transactions could not be used to reduce IM delivery requirements for new trades. Similarly, as to VM, exposures can be calculated separately for new and legacy trades under a single master. Further, since cash VM is fungible and not segregated, placing trades under separate master agreements would not negate the fact that cash received as VM under one master agreement would economically offset cash delivered as VM under another master agreement.

It would be relatively straightforward to separate legacy swaps from post-compliance date swaps under a single master agreement by margining each group of swaps under a separate CSA. For these purposes, we understand that ISDA could publish a standardized and rule - compliant CSA that could operate side-by-side with existing CSAs under a single master. We therefore request that the Prudential Regulators permit market participants to separately margin legacy and new transactions in this way.

Critically, we do not believe there is any additional risk of "cherry picking" or using the existence of historical transactions in an evasive way to undermine margin requirements in such a set up. Such a result could only occur if parties were permitted to opportunistically amend their legacy transactions to create collateral offset opportunities in an evasive manner. While we believe this would actually be quite difficult to accomplish in practice, to the extent deemed necessary to eliminate any such risk, the Prudential Regulators could also establish that any material amendments to legacy swaps, including amendments to their terms and amendments to previously agreed collateral requirements, would be deemed to create a "new" swap for purposes of the margin rules and therefore subject the transaction to full regulatory margin.

5. <u>The compliance date for VM requirements should by synchronized with the phased compliance dates for IM requirements.</u>

Under the PR Margin Proposal, VM requirements would apply to Covered Swap Entities and all relevant counterparties in December 2015, while IM requirements would be phased in over several years. This appears to reflect the view that VM requirements are consistent with what many parties do today, and that compliance with VM requirements will be relatively straight-forward and logistically simple to achieve.

We believe that the Prudential Regulators are substantially underestimating the time that will be required to establish compliance with the VM requirements and the complexity that will be created if those requirements are not coordinated with IM requirements. While the proposed VM requirements may be consistent with the current practice of some market participants in broad terms, compliance with all of the various technical requirements of the rules will require re-documentation of virtually every collateral relationship in the marketplace—a process that cannot be fully engaged until the rules of the prudential regulators and other regulators with overlapping authority have been finalized and jurisdictional guidance has been provided. If not coordinated with IM, many of those relationships would then need to be re-documented a second time once IM requirements go into effect. As a consequence, many market participants, including Freddie Mac, would be forced to attempt to simultaneously manage three different books of trades (old-VM, old IM; new VM old IM; and new VM new IM), and to manage and allocate thresholds and payment flows across these three separate books of trades in legally and operationally complex ways.

Aside from the unnecessary costs that would be involved, if the compliance schedule for VM is adopted as proposed, we believe there is substantial risk of an inadequate implementation process that could lead to significant market breaks. We therefore believe it would be highly beneficial to both (i) ensure that adequate time is provided between the time rules are finalized and compliance dates begin to phase-in and (ii) synchronize VM requirements with IM requirements so that they phase in on the same schedule. Specifically, the Prudential Regulators (and other regulators) should provide at least 18 months between the time rules are fully adopted and the beginning of the compliance phase-in schedule, and should implement VM requirements according to the same phased 5-year schedule proposed for IM. Such an approach would substantially mitigate costs and the risk of market breaks. In particular, it would provide both regulators and the industry with the time and opportunity to assess implementation requirements and address potential unintended consequences of the simultaneous adoption of rules in multiple jurisdictions prior to their implementation.

6. Industry-wide IM-models should be eligible for approval for general use.

Under the PR Margin Proposal, each Covered Swap Entity would be required to individually obtain approval of its IM model in order to use the model for IM calculations in lieu of a regulatory schedule. Obtaining individualized approval will consume significant resources for Covered Swap Entities and the Prudential Regulators. It would also be prejudicial to counterparties of Covered Swap Entities such as Freddie Mac, as it would require us to separately perform due diligence on, and agree to, the separate models of each Covered Swap Entity.

To the extent practical, we therefore request that the Prudential Regulators modify the PR Margin Rule Proposal to permit one or more standard models that would be available for general use by the industry. We understand that ISDA is developing such a model, and are generally supportive of these efforts provided that the model is transparent and open to broad use by market participants.

7. VM requirements should be based on mid-market valuations.

The proposed definition of "variation margin amount" in the PR Margin Proposal provides that such amount will be calculated as the "mark-to-market change in value to a covered swap entity" of the relevant swap (emphasis added). Read literally, this language would seem to require that swaps be valued on the Covered Swap Entity's side of the market for purposes of VM requirements, rather than at mid-market. Such an approach would be inconsistent with current market practice and prejudicial to end users. It would also effectively give Covered Swap Entities control over valuations since only they would be in a position to ascertain or calculate the change in value on their side of the market (*i.e.*, their own replacement cost). We therefore request that the Prudential Regulator clarify that it is permissible to use mid-market valuations.

8. The definition of "walkaway clause" should be narrowed.

The proposed definition of "eligible master netting agreement" requires that the agreement "does not contain a walkaway clause," which includes "a provision that ... suspends or conditions payment to a defaulter." Such a prohibition would effectively nullify long-standing market practices embodied in clauses such section 2(a)(iii) of the ISDA Master Agreement, which provides that each party's obligations is subject to the condition precedent that no event of default occurred with respect to the other party. This provision is intended to protect non-defaulting parties from parties who have filed for bankruptcy by helping them to avoid an asymmetric risk scenario. Without this provision, non-defaulting parties would be subject to binding contractual obligations to deliver assets (for example VM) to the bankruptcy estate without any assurance that the bankrupt counterparty would perform on its own delivery obligations, and with knowledge that assets delivered to the estate would likely be distributable to its creditors.

Thus, the PR Margin Proposal effectively would favor defaulting bankrupt parties at the expense of solvent non-defaulting counterparties while leaving the non-defaulting parties exposed to risk from the defaulters. As this would misallocate risk, the final definition of eligible master netting agreement should exclude the phrase "or suspends or conditions". The definition would then be consistent with the proposal of the CFTC.[2]

* * * * *

Freddie Mac appreciates the opportunity to provide its views in response to the PR Margin Proposal. Please contact me if you have any questions or would like further information.

Sincerely,

Wendell J. Chambliss
Vice President and Deputy General Counsel
Mission, Legislative and Regulatory Affairs Department
Legal Division

[2] See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 FR 59898 at 59926.