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VIA ELECTRONIC SUBMISSION

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Re: Margin and Capital Requirements for Covered Swap Entities Proposed Rule (OCC: Docket ID OCC-2011-0008/RIN 1557-AD43); (Federal Reserve: Docket ID R-1415/RIN 7100-AD74); (FDIC: RIN 3064-AE21); (FHFA: RIN 2590-AA45); (FCA: RIN 3052-AC69)

Ladies and Gentlemen:

On behalf of the twelve 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 FCA

and the FHFA, the “Prudential Regulators”).¹ Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), the Proposed Rules address margin and capital requirements for swap dealers, major swap participants and any additional entities designated by the Prudential Regulators (“Covered Swap Entities” or “CSEs”).² The Proposed Rules will require CSEs to collect margin from, and post margin to, certain other financial entities, including the FHLBanks.

I. The FHLBanks

The 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 FHLBank is independently chartered and managed, but the FHLBanks issue consolidated debt obligations for which each FHLBank is jointly and severally liable. The FHLBanks serve the general public interest by providing liquidity to approximately 7,000 member financial institutions, including banks, thrifts, credit unions, insurance companies and community development financial institutions. In doing so, the FHLBanks help increase 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 financial institutions through loans referred to as “advances.”

The FHLBanks, as end-users, enter into swap transactions with swap dealers to facilitate their business objective of safely and soundly providing liquidity to their member financial institutions and to manage and mitigate financial risk, primarily interest rate risk. As of September 30, 2014, the aggregate notional amount of over-the-counter interest rate swaps held by the FHLBanks collectively was approximately \$564 billion. 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 their member institutions and the large swap dealers, thus allowing such members to hedge interest rate risk associated with their respective businesses. At present, the FHLBanks are clearing a significant and growing percentage of their interest rate swap transactions. However, a significant percentage of FHLBank swaps are not currently eligible for clearing and it is anticipated that, even as the types of swaps that can be cleared expands, the FHLBanks will, for the foreseeable future, depend on the over-the-counter (“OTC”)³ swaps market to meet their hedging needs. Accordingly, the new margin rules for uncleared swaps are of the utmost importance and interest to the FHLBanks.

¹ Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. 57,348 (proposed Sept. 24, 2014) (the “Proposed Rules”).

² See *id.* at 57,350 (Security-based swap dealers and major security-based swap participants are also included in the CSE definition.).

³ Note that we view the term “OTC” as synonymous with the term “noncleared” that is used in the Proposed Rules.

II. General Comments

As a general matter, we appreciate that the Proposed Rules respond affirmatively to several important positions advanced by the FHLBanks in connection with the originally proposed margin rules.⁴ Specifically, we are very pleased to find that the Proposed Rules address the FHLBanks' comment favoring two-way margining for both variation margin ("VM") and initial margin ("IM"), and our comment objecting to the mandatory segregation of VM with an independent custodian. The FHLBanks greatly appreciate the Prudential Regulators' attention to these comments.

The FHLBanks believe, however, that certain provisions of the Proposed Rules require particular attention including, among others:

- The requirements to document trades under separate master agreements in order to avoid retroactive application of the new margin rules (addressed in Section III.A below);
- The classification of FHLBank debt obligations and GSE asset-backed securities (addressed in Section III.B below);
- The proposed restriction that VM be posted only in cash (addressed in Section III.C below);
- The method of calculating VM (addressed in Section III.D below);
- New documentation requirements that arise under the Proposed Rules (addressed in Section III.E below);
- The compliance timeline for implementing margin requirements (particularly VM) (addressed in Section III.F below);
- The calculation of material swaps exposure (addressed in Section III.G below); and
- Transparency for IM calculation (addressed in Section III.H below).

We address each of these provisions, among others, in more detail below.

⁴ See Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27,564 (May 11, 2011) (the "Original Proposed Rules"); see also FHLBank Comment Letter, *Margin and Capital Requirements for Covered Swap Entities* (July 11, 2011).

III. Comments

A. The Prudential Regulators Should Reexamine the Potential for Retroactive Margin Treatment of Legacy Trades; Netting and Related Documentation Issues Should be Addressed to Permit All Counterparty Trades to be Executed Under a Single Master Agreement.

In order to retain the benefit from portfolio netting, the Proposed Rules would force counterparties to apply the IM and VM requirements not only to all swap transactions entered into after the effective date of the new margin requirements but also to all other pre-effective swaps documented under the same master agreement.⁵ As portfolio netting is critical to achieving the appropriate amount of IM, because it takes into account offsetting positions, this would effectively result in retroactive application of the IM and VM requirements to all such pre-effective swaps, even though the Rule purports to apply only prospectively. This is a highly undesirable result because it would impose changes that, if they had been effective on the trade date of the legacy swap, would have resulted in a different execution level (*i.e.*, most dealers have adopted CSA-specific pricing for swaps). Under the Proposed Rules, the only way to avoid such retroactive treatment is to have post-effective swaps documented under a new separate master agreement. It appears, therefore, that in order for the FHLBanks to avoid retroactive treatment for their OTC swaps they would be required to enter into at least three master agreements with each of their counterparties: (1) a master agreement for swaps entered into prior to the effective date of the new VM requirements; (2) a master agreement for trades entered into after the VM requirements become effective and before the initial margin requirements take effect (presumably in 2019 for the FHLBanks); and (3) a master agreement for all swaps entered into after the IM requirements become effective.⁶

Margin terms are integral to the economics of a swap transaction. A swap that does not require margining will likely have different economics than a swap that does require margining (or where margining is subject to a threshold). Margin terms are also critical to how the FHLBanks manage their liquidity risk and counterparty credit risk. Thus, imposing new margin terms retroactively is essentially the same as changing the basic economics of a swap. We do not believe that, in adopting the Dodd-Frank Act, Congress intended to rewrite the underlying economics of existing swaps. The Prudential Regulators have recognized this, but the proposed solution (separate master agreements for legacy trades) is not a workable solution.

Requiring multiple master agreements with each counterparty in order to avoid retroactive application of the margin rules is unnecessary and could well result in heightened counterparty and systemic risk. Master agreements are a critical tool utilized by the FHLBanks to manage counterparty credit risk because they provide for close-out netting of all outstanding positions with a counterparty upon a default or other early termination. If the FHLBanks must enter into

⁵ See Proposed Rules, 79 Fed. Reg. at 57,392-57,393.

⁶ The Prudential Regulators are obligated by statute to review and consult on minimum margin requirements no less frequently than annually. 7 U.S.C. §4s(e)(3)(D) (2012). If as a result of that consultation, there is a decision to modify the margin requirements, parties may be required to enter into still more master agreements in order to avoid retroactive application to existing swaps.

multiple master agreements with each counterparty, there will be no assurance that close-out netting will apply to all outstanding positions with that counterparty. Although an enforceable umbrella “master-master” netting agreement between the parties would, ordinarily, facilitate close-out netting across individual master agreements, it may also present a “Catch-22” situation depending on whether such an arrangement would be considered a “single” master agreement under the Proposed Rules.

The FHLBanks do not believe that there is a compelling reason to force market participants to enter into multiple master agreements with a counterparty in order to avoid retroactive application of the new margin requirements. Besides potentially increasing counterparty risk, such a result will clearly entail significant additional costs and complexity.

The FHLBanks would encourage the Prudential Regulators to allow all trades with a particular counterparty (both legacy trades and new trades) to be documented under a single master agreement that (1) allows, at the discretion of the parties, for either separate or combined margining buckets for legacy and new trades; and (2) assures closeout netting across all trades.⁷ This could be achieved by allowing more than one credit support arrangement to be used within the framework of a single master netting agreement. We believe it is feasible and highly desirable for the industry to revise documentation of collateral arrangements in a manner that would accommodate such a result. We also understand that the International Swaps and Derivatives Association (“ISDA”) concurs with this assessment.

B. FHLBank Debt Obligations Should Not Be Classified with “Eligible Corporate Debt” in the Appendix B Haircut Table, and GSE Asset-Backed Securities Should Not Be Excluded from “Publicly Traded Debt” that is Eligible Collateral.

1) GSE Securities Should Have Lower Haircuts than Corporate Debt Obligations

In Appendix B to the Proposed Rules, securities issued by a U.S. Government-sponsored enterprise (“GSE Securities”) that are not fully guaranteed by the full faith and credit of the U.S. Government (or issued by a Government-sponsored enterprise (“GSE”) operating with capital support or other direct financial assistance from the U.S. Government) are classified with publicly traded corporate debt for purposes of determining the margin “haircut” for posted IM collateral.⁸ Accordingly, the haircut for FHLBank Consolidated Obligations ranges from 1% (for obligations maturing in less than one year) to 8% (for obligations maturing in more than five years), as opposed to a range of 0.5% to 4% for GSE Securities considered to be “Eligible government and related debt.”⁹

⁷ Note that this concept of a single master netting agreement is consistent with FHFA regulation 1267.4(c)(1), which requires that, when practicable, FHLBanks document all derivatives with a particular counterparty under one master agreement. See 12 C.F.R. 1267.4(c)(1). Adopting multiple master agreements would contravene best practices suggested under the FHFA regulations.

⁸ See Proposed Rules, 79 Fed. Reg. at 57,396 (Table B of Appendix B).

⁹ As defined in Table B of Appendix B to the Proposed Rules (79 Fed. Reg. at 57,396), “Eligible government and related debt” includes GSE securities with the backing of the full faith and credit of the U.S. and the debt obligations of GSEs that are operating with capital support or another form of direct financial assistance received from the U.S.

Although the FHLBanks do not propose that they be able to post their own publicly traded debt securities (without regard to applicable haircuts), they believe that the haircuts applied to their debt obligations are excessive and completely disproportionate to the risks associated with holdings of such securities by unrelated third parties. Historically, FHLBank Consolidated Obligations have maintained the same ratings as U.S. government obligations and have been viewed in the markets as low-risk, high-quality investments. In addition to having performed well during historical periods of stress, FHLBank Consolidated Obligations are generally considered by investors to be highly liquid and readily marketable. They are currently underwritten and sold by over 65 active dealers.

FHLBank Consolidated Obligations, like U.S. Treasuries, are recognized in the market as safe and highly liquid investments and have performed extremely well during periods of severe liquidity stress. Historical data shows that FHLBank Consolidated Obligations have been treated similarly to U.S. Treasuries during high-stress periods in the markets and thus have performed in a manner consistent with “eligible government and related debt” even though the FHLBank Consolidated Obligations are not obligations of the United States and are not directly guaranteed by the United States or any government agency. Chart 1 of Exhibit A illustrates the correlation between the volume of FHLBank discount notes and U.S. T-bills during the first decade of the 21st century, including during the 2007-2009 financial crisis. During that financial crisis, demand for FHLBank Consolidated Obligations increased as investors sought what they considered to be the most stable, highest quality investments available in the market. Chart 2 of Exhibit A shows a significant spike in the issuance of FHLBank Consolidated Obligations during the most critical period of the recent financial crisis.

An analogous situation is the final rule recently adopted by certain of the Prudential Regulators that will implement a quantitative liquidity requirement consistent with the liquidity coverage ratio (“LCR”) standard established by the Basel Committee on Banking Supervision.¹⁰ Although GSE debt obligations were not classified in the LCR Rule as “Level 1” liquid assets, the top level of high quality liquid assets (“HQLAs”), the final rule “continues to recognize U.S. GSE securities as highly liquid instruments that trade in deep and active markets by including them as a level 2A liquid asset.”¹¹ Corporate bonds, on the other hand, were determined to be less liquid and were classified as Level 2B liquid assets. Level 1 liquid assets are not subject to haircuts and may be included in the HQLA calculation without limit. Level 2A liquid assets are subject to a 15 percent haircut and are capped at 40 percent of total HQLAs when combined with level 2B liquid assets. Level 2B liquid assets are subject to a much larger 50% haircut and are capped at 15% of total HQLAs.

The FHLBanks believe that the Prudential Regulators should reconsider the decision to exclude high quality FHLBank Consolidated Obligations from the highest category of noncash collateral

government that enables the payment of such GSE securities. Proposed Rule §__.6(a)(2)(iii), 79 Fed. Reg. at 57,396.

¹⁰ The regulators adopting this final rule were The Federal Reserve System, the FDIC, and the OCC. *See* Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, 79 Fed. Reg. 61,440 (Oct. 10, 2014) (the “LCR Rule”).

¹¹ *Id.* at 61,458. The preamble to the final LCR Rule also acknowledges that “the obligations of U.S. GSEs are currently effectively, but not explicitly, guaranteed by the full faith and credit of the United States.” *Id.*

in Appendix B. However, even if that suggestion is not accepted, the FHLBanks believe that GSE Securities should not be placed in the same category as corporate debt.¹² Using the same analytical analysis employed in finalizing the LCR Rule, there are compelling reasons to create a new category of eligible GSE Securities that would include FHLBank Consolidated Obligations and reside between government guaranteed debt and corporate debt. The haircuts for such GSE Securities could be: 1% for securities having residual maturity of less than one year; 3% for securities having residual maturity between one and five years; and 6% for securities having residual maturity greater than five years.

2) GSE Asset-Backed Securities Should Not Be Excluded from the Definition of Eligible Collateral Solely on the Basis that They are not Unconditionally Guaranteed by a GSE Whose Obligations are Fully Guaranteed by the U.S. Government.

Under the proposed definitions of eligible collateral for IM, publicly traded asset-backed securities fully guaranteed as to timely payment of principal and interest by a GSE are eligible only if the GSE “is operating with capital support or another form of direct financial assistance” from the U.S. Government.¹³ If a resolution of Fannie Mae and Freddie Mac occurs that eliminates such direct financial assistance, asset-backed securities guaranteed by those GSEs would no longer be eligible collateral. Section __.6(a)(2)(vii)(A) of the Proposed Rules, which would then apply, specifically excludes asset-backed securities.

FHLBanks have significant holdings of asset-backed securities issued and guaranteed by Fannie Mae or Freddie Mac. Such securities are currently eligible collateral for many FHLBanks under their credit support agreements for OTC swaps. Such securities are generally regarded as high quality and liquid debt obligations and, in this regard, generally compare favorably to non-GSE corporate debt obligations.¹⁴ We are not aware of any data which would indicate that this will not continue to be the case following the resolution of these two GSEs. Consequently, the Proposed Rules should be modified to make clear that asset-backed securities guaranteed by GSEs should continue to be eligible collateral after a resolution of Fannie Mae and Freddie Mac.¹⁵

¹² The treatment of GSE debt obligations requested here is consistent with the treatment accorded debt obligations for purposes of eligible investment of customer funds by a futures commission merchant or clearinghouse. Corporate bonds are not eligible investments unless they are “fully guaranteed as to principal and interest by the United States under the Temporary Liquidity Guarantee Program as administered by the Federal Deposit Insurance Corporation.” Compare CFTC Reg. § 1.25(a)(iii)(permitting GSE debt obligations) with CFTC Reg. § 1.25(a)(vi) (limiting corporate obligations).

¹³ Proposed Rule § __.6(a)(2)(vii)(A), 79 Fed. Reg. at 57,392.

¹⁴ We note that the Prudential Regulators have inserted “[RESERVED]” in Section § __.6(a)(2)(vii)(A) with respect to specifying additional terms that must be met in order for corporate debt obligations to qualify as eligible collateral. If there are certain categories of GSE asset-backed securities that the Prudential Regulators believe should not be eligible collateral they can make that clear at such time as these “RESERVED” terms are specified. The FHLBanks would welcome the opportunity to comment on such additional terms at such time as they are published.

¹⁵ The haircuts for such asset-backed GSE securities should also be the same as for other GSE debt obligations.

C. FHLBanks Oppose the Proposed Cash-Only Limitation for VM

Key principle “seven” of the agreed upon 2013 international framework for margin requirements for uncleared swaps states that “regulatory regimes should interact so as to result in sufficiently consistent and non-duplicative regulatory requirements for non-centrally cleared derivatives across jurisdictions.”¹⁶ Key principle “four” articulates the international consensus on the types of assets that should be “eligible collateral” for margin purposes.¹⁷ That international consensus approved as eligible collateral, in addition to “the most liquid top-quality assets” (e.g., cash and high-quality sovereign debt), a broader set of assets including liquid corporate bonds and no distinction was drawn between assets eligible for VM and assets eligible for IM. The proposed prohibition on noncash VM not only departs from the IOSCO Final Framework, but also from the proposed European requirements for eligible VM collateral under the European Market Infrastructure Regulation.¹⁸

The FHLBanks propose that eligible collateral for VM be expanded to include high quality liquid securities, such as U.S. Treasury securities, GSE securities, and supra-national debentures.¹⁹ Such expansion would afford market participants the flexibility to post high quality liquid securities that they either hold in the ordinary course of business and would otherwise be forced to sell in order to meet their margin obligations, or that they might acquire for this purpose when the interest paid on cash collateral is unreasonably low.

The prohibition on the use of noncash assets for VM also seems to be at odds with the statutory mandate to the Prudential Regulators and the CFTC. Section 4s(e)(3)(C) of the Commodity Exchange Act (“CEA”) states that:

[i]n prescribing margin requirements under this subsection, the prudential regulator with respect to swap dealers and major swap participants for which it is the prudential regulator and the [Commodity Futures Trading] Commission with respect to swap dealers and major swap participants for which there is no prudential regulator ***shall permit the use of noncash collateral, as the regulator or the [Commodity Futures Trading] Commission determines to be consistent with—***

¹⁶ See Basel Committee on Banking Supervision and Board of International Organization of Securities Commissions (“IOSCO”), *Margin Requirements for Non-Centrally Cleared Derivatives* 22 (Sept. 2013), available at <http://www.bis.org/publ/bcbs261.pdf> (the “IOSCO Final Framework”).

¹⁷ See *id.* at 16.

¹⁸ See European Securities Market Authority, *Draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012*, Consultation Paper 46 (Apr. 14, 2014), available at <http://www.esma.europa.eu/documents/10180/655149/JC+CP+2014+03+%28CP+on+risk+mitigation+for+OTC+derivatives%29.pdf>.

¹⁹ The FHLBanks do not propose that they be able to post their own Consolidated Obligations, but rather high quality securities issued by other GSEs.

- (i) *preserving the financial integrity of markets trading swaps; and*
- (ii) *preserving the stability of the United States financial system.*²⁰

Under the “plain meaning rule” of statutory construction, as well as other recognized rules of statutory interpretation that apply where a statute is ambiguous, it is the view of the FHLBanks that this provision mandates that the Prudential Regulators approve the use of noncash VM for uncleared swaps unless the Prudential Regulators make a clear determination that such approval would negatively affect the financial integrity of the swaps market or threaten the stability of the United States financial system.²¹ There is no indication in the preamble to the Proposed Rules that the Prudential Regulators have made such a determination.²² Moreover, as discussed below, the factors that the Prudential Regulators point to in explaining the proposed prohibition on noncash VM are not persuasive.

The Prudential Regulators essentially offer the following as supporting their proposed noncash prohibition:

- 1) VM for uncleared swaps can be regarded as a “settlement payment,” as is the case for futures and cleared swaps, and clearinghouses generally require that VM for futures and cleared swaps be paid in cash;²³
- 2) Cash-only VM is consistent with industry market practice;²⁴
- 3) Limiting VM to cash should sharply reduce the potential for disputes over the value of VM;²⁵ and
- 4) The Prudential Regulators’ “preliminary view” is that the impact of the proposed requirements with regard to the exchange of VM “are low.”²⁶

²⁰ 7 U.S.C. § 6s(e)(3)(C) (2012).

²¹ We believe this interpretation is supported by traditional rules of statutory construction, including (i) the “Plain Meaning Rule” wherein courts will apply the plain meaning of the text without further judicial inquiry or interpretation; (ii) the “Meaningful Variation Rule” wherein different words used in the same statute are assigned different meanings whenever possible; and (iii) the “Rule Against Surplusage” wherein the “effect must be given, if possible, to every word, clause and sentence of a statute.” See *Connecticut Nat’l Bank v. Germain*, 503 U.S. 249, 253-54 (1992) (discussing the Plain Meaning Rule); see also WEBSTER’S THIRD NEW INTERNATIONAL DICTIONARY 2085-86 (3rd ed. 1993), *Lexecon, Inc. v. Milberg Weiss Bershad Hynes & Lerach*, 523 U.S. 26, 35 (1998) (the word “shall” “creates an obligation impervious to judicial discretion.”); see also 2A SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION § 46:6 (Norman J. Singer ed., 7th ed. 2014 rev.) (discussing the Meaningful Variation Rule and Rule Against Surplusage).

²² Indeed, the only reference to this two-prong statutory provision is a background reference in footnote 10 of the preamble to the Proposed Rules. Proposed Rules, 79 Fed. Reg. at 57,351 n.10.

²³ *Id.* at 57,369, 57,371.

²⁴ *Id.*

²⁵ *Id.* at 57,371.

²⁶ *Id.* at 57,383.

Each of these points is addressed below.

1) VM for Uncleared Swaps Are Not Settlement Payments and the Comparison to Clearinghouse Requirements is Unhelpful.

First, VM for uncleared swaps are not viewed by market participants as “settlement payments,” and the role of clearinghouses with respect to VM for futures and cleared swaps is fundamentally different than that of a counterparty to an uncleared OTC swap with respect to VM. One of the key functions of a clearinghouse is to act as an intermediary between the two parties who have entered into a cleared swap, receiving VM from the out-of-the money party and promptly crediting it to the in-the-money party. The clearinghouse does not retain VM and, once delivered to the in-the-money party, the clearinghouse has no ongoing security or other interest in the VM.²⁷ The party posting the VM to the clearinghouse has no claim against the party receiving VM from the clearinghouse. In the case of OTC swaps, on the other hand, the party receiving the VM retains it as security for future performance of the swap by the out-of-the money party, but the VM remains an asset of the posting party. The recipient may or may not be under a separate obligation to fund a related hedging transaction. Typically, end-users will simply retain, VM as security for the swap dealer’s performance. If the party holding VM defaults, it is immediately obligated to return the VM to the non-defaulting party.²⁸

The idea that it is appropriate to think of VM for OTC swaps “as settling daily exposures” also ignores the reality of OTC swap pricing. Swaps that are liquid and actively traded may well be eligible for clearing (on a mandatory or optional basis) and daily pricing by a clearinghouse, but this is not the case with respect to most OTC swaps that are not eligible for clearing. Such swaps must be priced based on various pricing inputs and models and/or by obtaining quotes from market participants that trade comparable instruments. The absence of publicly accessible prices for comparable transactions also explains why VM in OTC trades has historically been based on estimates of mid-market prices rather than actual transaction prices, and why the procedure for resolving disputes regarding VM determinations has entailed seeking market quotes from multiple dealers. The bid-ask spread for OTC swaps can, and in most cases will, be materially larger than for futures or cleared swaps.

²⁷ We also note that in the case of futures and cleared swaps, valuation of the transaction for the purpose of determining VM is made by the clearinghouse, a “neutral party” having no direct economic interest in how the transaction is valued. Moreover the clearinghouse generally has extensive pricing data for executed arm’s length transactions, either identical or highly comparable to the trades being valued, on which to base its VM determinations. The situation for OTC swaps is entirely different. Valuations are not made by an unbiased, independent third party, nor is there any established market entity in a position to provide this service. Because OTC swaps are generally more bespoke and not actively traded, there generally is no pool of pricing information comparable to the data that forms the basis for VM valuations by clearinghouses. Again, the significance of the difference here is that it explains why in most collateral agreements for OTC swaps (1) there is no designation of a single party to make VM determinations and (2) there is a robust procedure for resolving disputes regarding VM transfers.

²⁸ See ¶ 8(b)(iii) of the ISDA New York Credit Support Annex (CSA) (Upon default by the Secured Party “the Secured Party will be obligated immediately to Transfer all Posted Collateral and the Interest Amount to the Pledgor”).

The significance of the bid-ask spread in OTC swaps is apparent in a close-out situation. The cost of replacing a defaulted OTC swap will differ (often by a material amount) depending on which side of the transaction defaults. The documentation for master agreements and collateral arrangement for OTC swaps underscores this point. First, the value of swaps for purposes of VM transfers is determined using estimates of mid-market prices, whereas the value of swaps for close-out purposes is determined at the side of the market of the non-defaulting party.²⁹ Thus, the close out determination will invariably be less or greater than the amount of VM that has been exchanged. Second, upon a default, a defaulting party holding VM is obligated to immediately return the VM to the non-defaulting party.³⁰ This is completely inconsistent with the idea that the VM it holds should be viewed as a “settlement payment.” Finally, earnings on securities posted as VM (as well as interest on cash VM) in OTC swap transactions are returned to the party posting VM.³¹ This is contrary to the practice with regard to futures and cleared swaps and is inconsistent with the notion that VM payments in respect of OTC swaps are settlement payments.³² In summary, the suggestion that VM payments should be restricted to cash because they are analogous to settlement payments for futures or cleared swaps lacks merit. VM for OTC swaps provides a measure of security to the in-the-money counterparty at mid-market valuations; it does not settle anything.

2) Cash-only VM is Not Consistent with Market Practice.

The Prudential Regulators cite the recent 2013 Standard ISDA CSA, which calls for all VM payments to be made in cash.³³ However, this document does not in any way represent market practice. It has gained little, if any, traction outside the swap dealer community. None of the FHLBanks has entered into the 2013 Standard CSA and none of the FHLBanks has plans to do so in the foreseeable future. Indeed, a draft ISDA publication summarizing the history and explaining the operation of the 2013 Standard CSA specifically acknowledges why it may not be an attractive alternative for many end-users:

“It is important to note that the Standard CSA offers a new alternative to the existing CSA, but does not replace it in any sense. In fact, because the Standard CSA necessarily standardizes many terms that are variable under the CSA, it is anticipated that some

²⁹ Compare ¶12 of the ISDA New York Credit Support Annex (“CSA”) (definition of “Exposure”) with Sections 6 and 14 of the 1992 ISDA Master Agreement (definitions of “Market Quotation” and “Loss”) and the Sections 6(e) and 14 of the 2002 ISDA Master Agreement (definition of “Close-out Amount”).

³⁰ See ¶8(b)(iii) of the ISDA New York CSA. Any posted collateral not so returned may be set off by the non-defaulting party against any amounts owed to the Secured Party. *Id.* at ¶8(b)(iv).

³¹ See ¶4(d) of the ISDA New York CSA.

³² The practice of paying interest with respect to VM has continued with regard to cleared swaps in the form of price alignment interest (PAI).

³³ See Proposed Rules, 79 Fed. Reg. at 57,369 (“This perception is reinforced by the current market practice among swap participants of requiring variation margin, where required under the parties’ negotiated agreements” be provided in cash.”); see also *id.* at 57,371 (“Additionally, this proposed change is consistent with regulatory and industry initiatives to improve standardization and efficiency on the OTC swaps market. For example, in June 2013, ISDA published the 2013 Standard Credit Support Annex (“SCSA”), which provides for the sole use of cash for variation margin.”).

market participants will continue to use the classic CSA because it affords useful flexibility. For example, market participants who are natural holders of long security positions that can be cost-effectively deployed as collateral may find problematic the Standard CSA's restriction of VM collateral to cash only."³⁴

The FHLBanks, like most other financial end-users, continue to document their collateral requirements under the NY CSA and the overwhelming majority of these agreements permit the posting of noncash VM.

3) Limiting VM to Cash Will Not Have Any Material Impact on VM Disputes.

The valuation of noncash collateral has not been a significant source of disputes in the OTC market. There were numerous collateral valuation disputes during the financial crisis (some of which remained unresolved over significant periods of time), but these disputes generally centered on the changing value of underlying trades, not on the value of collateral that had been delivered or offered. The FHLBanks have had few disputes regarding the value of assets posted as collateral for VM, and all such disputes have been resolved expediently in accordance with the provisions of their CSAs, either by agreeing on a value for the disputed collateral or by substituting collateral for which both parties can agree on a value.

4) There is Insufficient Data Concerning the Economic Impact of the Proposed VM Requirements to Conclude that the "impact of the requirements are low in the aggregate."

The assessment of the Prudential Regulators that the impact of the proposed VM requirements will be "low in the aggregate" is based on the observation that: (i) the exchange of VM is a well-established market practice and (ii) the exchange of VM "simply redistributes resources from one entity to another in a manner that imposes no aggregate liquidity costs."³⁵

The FHLBanks do not agree with this assessment. First, many current collateral agreements provide for VM thresholds. Because the new rules would completely eliminate thresholds for VM, there will be an observable increase in liquidity costs. Based on the Third Quarter 2014 FHLB System Combined Financial Report ("CFR"), it appears that the additional margin required to cover the FHLBanks' aggregate uncollateralized exposures on non-cleared swaps would be approximately \$1 billion. Second, as underscored by all the comments above, the proposed prohibition of noncash margin represents a departure from the current market practice of a number of FHLBanks. While some financial end-users, including certain FHLBanks, may post VM in cash to some or even most of their OTC counterparties, there is no industry-wide data that measures the aggregate amount of noncash collateral being posted for OTC swaps. Based on the Third Quarter 2014 CFR, the FHLBanks posted approximately \$425 million of

³⁴ ISDA, "The Annotated ISDA 2013 Standard Credit Support Annex for New York law and English law forms", 4 (Draft of 6/10/13) available at <http://www.fpml.org/wgroup/scsawg/First-Draft-Annotated-SCSA.pdf> (emphasis added).

³⁵ Proposed Rules, 79 Fed. Reg. at 57,383.

noncash collateral in connection with non-cleared swaps. Obviously, the requirement that all financial end-users post only cash VM will have a liquidity impact on those who are accustomed to posting noncash VM.³⁶ All of the economic studies concerning the potential impact of the new margin requirements that are cited by the Prudential Regulators in the preamble to the Proposed Rules focus on the imposition of new IM requirements. There is no discussion of how, or whether, the studies addressed VM requirements and, in particular, there is no data provided relative to limiting VM to cash-only transfers.

D. The Prudential Regulators Should Clarify the Method Specified for Calculating VM.

The definition of “variation margin amount” should be revised to make it clear that VM is to be determined with reference to mid-market pricing. In the “definitions” section of the Proposed Rules, “variation margin amount” is defined to mean “the cumulative mark-to-market change in value to a covered swap entity of a non-cleared swap or non-cleared security based swap ...”³⁷ As referenced above, “covered swap entity” or CSE refers to swap dealers and major swap participants, among others.³⁸ A plain reading of this definition is that VM is to be determined with reference to the value of the swap *to the CSE*, a dramatic departure from industry practice which has long determined VM on the basis of an estimate of mid-market swap values. Both the ISDA NY CSA and the more recent SCSA clearly contemplate that VM will be determined at mid-market prices.³⁹ As discussed above, the difference between valuing a swap at mid-market as opposed to either side of the bid-ask spread can be material in OTC swap transactions.⁴⁰ It would be fundamentally unfair to require the transfer of VM based on the valuation at either party’s side of the market. The determination of VM based on a valuation at the swap dealer’s side of the market, as appears to be required by the plain language of the Proposed Rules, is highly biased to the disadvantage of the end-user party. The VM paid to an end-user that is in-the-money will more likely be insufficient to cover the replacement cost of the swap should the

³⁶ See *supra* note 34 (ISDA commentary on why SCSA will not be attractive to end-users that have an inventory of long-dated securities which can be efficiently utilized to satisfy VM requirements under the NY CSA.).

³⁷ Proposed Rule § 2, 79 Fed. Reg. at 57,391. The CFTC’s proposed margin rule for non-cleared swaps does not contain a similar definition and presumably leaves undisturbed the existing market practice with respect to determining VM at mid-market prices. See *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 79 Fed. Reg. 59898, 59928 (October 3, 2014)(definition of “Variation Margin”) (emphasis added).

³⁸ See *id.* at 57,350.

³⁹ See ¶12 of NY CSA (definition of “Exposure” as “estimates at mid-market of the amounts that would be paid for Replacement Transactions?”); ¶12 of ISDA 2013 SCSA (definition of Exposure” which provides that “Close-out Amount will be determined using estimates at mid-market of the amounts that would be paid for transactions collateralized using an ISDA 2013 Standard Credit Support Annex ...”).

⁴⁰ For plain vanilla interest rate swaps the bid-ask spread is generally very small, often a ½ of one basis point or less. However, for longer term swaps that are more bespoke, precisely the swaps that are likely to be entered into in the OTC market, the bid-ask spread can be much larger. A three basis point bid-ask spread on a five-year bespoke swap with a \$75 million notional would not be unusual. In this swap, the value of each basis point could be approximately \$37,500, which would make the determination of the VM at the swap dealer’s side of the market \$56,250 more adverse for the end-user than a mid-market valuation. For a large portfolio of bespoke uncleared swaps, the difference in VM calculated at the swap dealer’s side of the market versus mid-market could be very material. See discussion of pricing of OTC swaps *supra* Section III.B.1.

swap dealer default than would be the case under existing mid-market pricing. For an end-user that is out-of-the-money, the VM payment will be excessive (again as compared to mid-market pricing) in that it will likely be greater than the amount owed upon a swap dealer default, thus leaving the end-user with a general creditor's claim against the defaulting swap dealer for the excess.⁴¹ The Prudential Regulators have provided no rationale for mandating such a material departure from existing industry practice with respect to the determination of VM.

In addition, adopting a market-wide practice of CSE-side valuations will likely increase the number of VM disputes. A counterparty facing a CSE in uncleared swap transactions will be unable to determine the bid/ask spread assumption that the CSE uses for each of the customized uncleared swaps in that portfolio. As a result, the end user counterparty will be forced to make its own assumptions about the magnitude of the bid/ask spreads, which will vary by swap, and dispute the CSE's valuations when differences arise. Furthermore, bid/ask spreads are not constant over time, but evolve as liquidity conditions change and with overall market activity and conditions.

E. Documentation Requirements, Including Dispute Resolution, with Respect to Both VM and IM, Should be Clarified⁴²

The Proposed Rules contain requirements for “documentation of margin matters.”⁴³ Specifically, CSEs would be required to execute trading documentation with other CSEs or financial end-users regarding credit support arrangements that:

1. Provide contractual rights to collect and post IM and VM as required by the new margin rules;
2. Specify “the methods, procedures, rules, and inputs for determining the value of each non-cleared swap ... for purposes of calculating variation margin requirements”; and
3. Procedures by which disputes “concerning the valuation of non-cleared swaps” or the “valuation of assets collected or posted as initial margin or variation margin, may be resolved.”⁴⁴

These proposed requirements seem both too prescriptive and not prescriptive enough. The requirement that the documentation specify “inputs” seems particularly onerous as the inputs may vary from swap to swap and will change over the life of the swap. As a practical matter, the result of imposing this requirement will likely be documentation containing a very generic description of what inputs will be utilized in any dispute resolution procedure when what is

⁴¹ By contrast, the swap dealer would have less counterparty exposure upon default of the end-user whether it was in-the-money or out-of-the-money at the time of the default.

⁴² We would not expect IM disputes where the parties in question are using a standardized margin look-up table that is contemplated in the Proposed Rules.

⁴³ Proposed Rules, 79 Fed. Reg. at 57,395-57,396.

⁴⁴ *Id.*

really needed is an obligation for the parties to share the actual “inputs” being used to determine IM and VM at any particular point in time upon request (and particularly at such time as a dispute arises). At the same time, the Proposed Rules seem materially deficient in their failure to address either inputs or dispute resolution procedures related to IM. The inputs for determining IM are completely different from those required to value non-cleared swaps.⁴⁵ They relate more to the volatility of pricing for non-cleared swaps than to determining the value of a swap at any particular point in time.

In discussing the Proposed Rules, the Prudential Regulators request comment on whether they should deem compliance with CFTC documentation requirements as compliance with the Proposed Rules.⁴⁶ For the reasons noted below, we do not believe that this is desirable. The CFTC documentation requirements, which are set out in CFTC Reg. § 23.504(b)(4)(i), focus almost exclusively on methods and procedures:

The swap trading relationship documentation between swap dealers, between major swap participants, between a swap dealer and a major swap participant, between a swap dealer or major swap participant and a financial entity, and, if requested by any other counterparty, between a swap dealer or major swap participant and such counterparty, shall include written documentation in which the parties agree on the process, which may include any agreed upon methods, procedures, rules, and inputs, for determining the **value of each** swap at any time from execution to the termination, maturity, or expiration of such swap for the purpose of complying with the margin requirements under section 4s(e) of the [CEA] and regulations under this part, and the risk management requirements under section 4s(j) of the [CEA] and regulations under this part. To the maximum extent practicable, the **valuation of each swap** shall be based on recently-executed transactions, valuations, provided by third parties, or other objective criteria.⁴⁷

Further, under the CFTC’s documentation rule, the requirement for dispute resolution focuses exclusively on the process by which the value of the swap shall be determined.⁴⁸ Thus, it appears that the CFTC documentation requirement is materially deficient in that it fails to address disputes regarding (1) the determination of IM, which is not based on the “value of the swap” or (2) the value of collateral posted or collected.

In summary, the final rule should require swap dealers to have documentation that provides for resolution of disputes regarding: (1) calculation of VM and IM requirements, and (2) the value of collateral collected or posted. Each involves different procedures and inputs. The rule should not require specification of the “inputs” that will be required, but instead should require the

⁴⁵ The Standardized Minimum Gross Initial Margin Requirements for Non-Cleared Swaps and Non-Cleared Security-Based Swap in Table A of the Proposed Rules reflects this fact. The table is based on percentages of the notional amount of outstanding swaps, not their values. Proposed Rules, 79 Fed. Reg. at 57,396.

⁴⁶ *Id.* at 57,387.

⁴⁷ 17 C.F.R. § 23.504(b)(4)(i) (2014) (emphasis added).

⁴⁸ *Id.* at § 23.504(b)(4)(ii).

parties to share the inputs that they may use over the life of the swap to determine VM, IM and the value of collateral posted and collected. With respect to swap valuations for purposes of determining VM requirements and the valuation of posted or collected collateral, the rule should require the parties to seek prices based on recently-executed transactions, valuations provided by independent third parties, or other objective criteria. With respect to determinations of IM requirements, swap dealers should be required to share or provide access to any approved models used to determine IM requirements, as well as all inputs utilized by the CSE in determining IM, and end-users should be entitled to reasonably dispute all such inputs.⁴⁹

F. The Timeline for Compliance with the VM Requirements Should be Phased-in and Extended⁵⁰

Under the Proposed Rules, the compliance date for the new VM requirements is December 1, 2015. The FHLBanks are concerned that a December 1, 2015 compliance date would not afford market participants sufficient time to come into compliance, given the magnitude of changes to current industry practices that will be necessary. Moreover, in light of the substantial number of the industry-wide operational, technological and legal changes that will be necessary, the FHLBanks are concerned that establishing a single date upon which all market participants must comply could (1) pose a risk to the non-cleared swaps market, because market participants would not have sufficient time to ensure that all of the changes have been appropriately made, and (2) affect end-users' ability to play an active role in the implementation of the required changes.

Accordingly, the FHLBanks respectfully request that Prudential Regulators provide additional time for the implementation of new VM requirements. Our preference would be for VM to become effective no earlier than two years after a final version of the Proposed Rules is published in the Federal Register. In the alternative, IM could be phased-in over a two-year period commencing on the date the final rules and published and using thresholds that correspond to the IM phase-in, but on an expedited basis (*i.e.*, the threshold could start at \$4 trillion and decrease to \$3 trillion, \$2 trillion, \$1 trillion and \$0 in six month increments).

The Prudential Regulators have solicited comments that "commenters believe would be appropriate to better align the VM requirements applicable with arrangements that are currently observed in the OTC swap market."⁵¹ Below we summarize a significant number of provisions in the Proposed Rules for VM that, consistent with the above discussion, could be better aligned with market practice. Were the Proposed Rules to be adopted in their current form, each of these

⁴⁹ If the parties elect to utilize the standardized amounts for IM determined in accordance with Appendix A to the Proposed Rule, there should be few IM disputes, provided that the parties have reconciled their swap portfolios. *See* Proposed Rule § __.8(a) 79 Fed. Reg. at 57,393; *Id.* at 57,396 (Appendix A, Table A). However, if the parties utilize one or more approved models to determine IM, it should be anticipated that there will be disputes regarding the operation of the models and the inputs used to generate the IM amounts.

⁵⁰ Because the FHLBanks do not anticipate being required to post and receive IM before the margin rules are fully implemented on December 1, 2019 they do not object to the proposed timeline for IM. However, the FHLBanks recognize that the magnitude of work required to implement the new IM rules is also great and would thus expect that parties required to implement IM provisions before 2019 may also question the IM timeline.

⁵¹ Proposed Rules, 79 Fed. Reg. at 57,371.

requirements would require changes to existing market practices and have documentation, operational and technological implications, among others.

- 1) The Proposed Rules mandate zero thresholds.⁵² Although there has been a trend towards CSAs with zero thresholds for VM, many CSAs continue to provide for fixed or laddered thresholds.⁵³

While zero thresholds for VM is consistent with the IOSCO Final Framework and the FHLBanks do not oppose zero thresholds for VM, it does not reflect current industry practice and we believe that such a change requires a longer implementation timeline.

- 2) The Proposed Rules require VM to be exchanged every business day, subject to a minimum transfer amount.⁵⁴ Current market practice is generally to allow, but not require, either party to request the transfer of VM on any business day (either to increase collateral to cover its in-the-money position or to request the return of collateral to correct an over-collateralized position).⁵⁵

The VM Rules should allow the parties to designate one party to be responsible for determining, on a daily basis, the amount of VM to be exchanged on a daily basis, but should explicitly allow the other party to request the transfer of VM (or the return of excess VM) where it believes that such transfer is appropriate. Obviously, this will require recognition of robust dispute rights to resolve any differences between the VM determinations of the parties.⁵⁶

- 3) The Proposed Rules allow for no exceptions to the requirement that VM be exchanged every business day. Current market practice and industry standard documentation recognizes various events that would excuse a party to a swap from the obligation to transfer VM. These “conditions precedent” include situations where an “Event of Default, Potential Event of Default or Specified Condition has occurred and is continuing with respect to the other party.” Specified Conditions can include various events involving taxes, illegality, credit events upon merger and other agreed upon early termination events.⁵⁷

The VM rules should expressly recognize the right of parties to agree upon appropriate conditions precedent to the exchange of VM. Such conditions should be limited to situations where there are objective and bona-fide concerns about a party’s ability or intention to perform its swap obligations.

⁵² *Id.* at 57,391(§__2 Definitions-Variation Margin Amount).

⁵³ NY CSA ¶13(b)(iv)(B). The Form of NY CSA, which is negotiated by counterparties, affords discretion for this.

⁵⁴ Proposed Rule §__4(b) and §__5(a), 79 Fed. Reg. at 57,392.

⁵⁵ NY CSA ¶¶ 3, 4 and 13(c).

⁵⁶ See discussion *supra* Section III.E.

⁵⁷ NY CSA ¶¶ 4(a) and 13(d).

- 4) As discussed in Section III.D above, the Proposed Rules indicate that VM calculations are to be based upon the “cumulative mark-to-market change in the value [of the non-cleared swap] to a covered swap entity.”⁵⁸ This requirement indicates that changes in the value of a swap are to be determined at the CSE’s side of the market, a marked change from longstanding market practice that provides for VM to be calculated based on estimates at mid-market of replacement transactions.⁵⁹

The definition of “Variation margin amount” should be revised to make it clear that the amounts are to be determined with reference to estimates of mid-market pricing.⁶⁰

- 5) As discussed in Section III.C above, the Proposed Rules require all payments of VM to be in cash.⁶¹ The overwhelming majority of CSAs currently in use allow for transfer of noncash assets, subject to agreed-upon haircuts, to satisfy margin requirements. In addition to U.S. Treasury securities, CSAs generally allow for various high quality, liquid assets to be eligible collateral, including agency obligations and high quality corporate obligations.⁶²

The VM rules should allow for the exchange of high quality noncash securities, including liquid securities, such as treasuries, agency debentures and supranational debentures.⁶³

- 6) The Proposed Rules require documentation that provides contractual rights for both the CSE and its counterparty to pay or collect VM as required by the Proposed Rules.⁶⁴ The documentation must specify: “[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” and the procedures by which any disputes concerning the valuation of such swaps may be resolved.⁶⁵ The NY CSA and the 2013 SCSA provide a method for resolving collateral disputes, and arguably address the methods and procedures for determining the value of each non-cleared swap, but do not specify the “inputs” to be used.⁶⁶

The Prudential Regulators should require parties to uncleared swaps to agree upon robust dispute resolution provisions that ensure a fair and prompt resolution of any VM disputes. The industry is well aware of regulatory concerns about the adequacy of existing dispute resolution provisions and has steps underway to develop and implement a more robust

⁵⁸ Proposed Rule § __.2 Definitions-Variation Margin Amount, 79 Fed. Reg. 57,391 (emphasis added).

⁵⁹ NY CSA, ¶ 12-Definition of “Exposure”; May 2003 Amendment to NY CSA used in connection with the 2002 ISDA Master Agreement-Definition of Exposure; 2013 Standard CSA, ¶ 12-Definition of “Exposure.”

⁶⁰ See discussion *supra* Section III.D.

⁶¹ Proposed Rule § __.6(a)(1), 79 Fed. Reg. at 57,392.

⁶² NY CSA ¶ 13(b)(ii) (specifically provides for U.S. Treasury obligations to be eligible collateral and then allows the parties to specify “other” noncash collateral as eligible collateral).

⁶³ See discussion *supra* Section III.C.

⁶⁴ Proposed Rule § __.10(a)(1), 79 Fed. Reg. at 57,395.

⁶⁵ Proposed Rule § __.10(a)(2)(i) & (ii), 79 Fed. Reg. at 57,395-57,396.

⁶⁶ NY CSA, ¶ 5 Dispute Resolution and ¶ 12 Definition of “Exposure; 2013 Standard CSA, ¶¶ 5 and 12 Definition of “Exposure”.

dispute resolution procedure. The Prudential Regulators should encourage this effort to move forward, but should not attempt to dictate particular terms until such time as it is demonstrated that the industry has failed to take appropriate steps to address the issue.

- 7) The Proposed Rules require that parties to non-cleared swaps post and receive IM without regard to the VM that has been exchanged.⁶⁷ Under the NY CSA, Independent Amount⁶⁸ and VM calculations are generally integrated so that the amount of Independent Amount paid to a counterparty is reduced by the amount of VM due from the counterparty.

The FHLBanks recognize that under the proposed IM and VM regime it will be necessary to independently calculate and assess the two types of collateral. The FHLBanks understand that new industry documentation to accommodate the splitting of IM and VM is being developed.

Given the significant departures from current market practice described above, the FHLBanks believe it is appropriate to delay phase-in of the VM requirements in the manner set forth above. This would permit market participants to make the necessary arrangements with respect to documentation and otherwise to prepare for the VM requirements.

G. Material Swaps Exposure

In addition to swap transactions between CSEs, the IM requirements contemplated by the Proposed Rules would apply to swap transactions between CSEs and financial end-users with “material swaps exposure.” “Material swaps exposure” is defined as an average daily aggregate notional amount of non-cleared swaps, non-cleared security-based swaps, foreign exchange forwards and foreign exchange swaps with all counterparties for June, July and August of the previous calendar year that exceeds \$3 billion. In determining material swaps exposure, a financial end-user must take into account its and its affiliates’ positions, and the notional amount would only be calculated for business days.⁶⁹

- 1) The FHLBanks believe it is necessary that the final margin rules adopted by the Prudential Regulators be consistent with similar rules adopted by comparable jurisdictions.

The IOSCO Final Framework recommended an €8 billion level of swaps exposure before entities would become subject to initial margin requirements.⁷⁰ The European Supervisory Authorities’ (“ESA”) margin proposal, issued in April 2014, adopted the same threshold.⁷¹ The \$3 billion

⁶⁷ Proposed Rule § __.8 Initial models and standardized amounts, 79 Fed. Reg. at 57,394.

⁶⁸ NY CSA ¶3(b) Definition of “Credit Support Amount”. Under existing OTC swap practices and documentation, IM is generally referred to as “Independent Amounts” (“IA”). In some instances parties to non-cleared swaps modify the CSA and provide that IA will be posted without regard to exchanges of VM.

⁶⁹ See Proposed Rule § __.2 Definition, 79 Fed. Reg. at 57,390.

⁷⁰ See *supra* note 17.

⁷¹ See *supra* note 18.

threshold for material swaps exposure contained in the Proposed Rules is inconsistent with the IOSCO Final Framework recommendation and the ESA proposal. In order to avoid competitive imbalances in the swap markets and regulatory arbitrage, the FHLBanks respectfully request that the Prudential Regulators adopt the dollar equivalent to the €8 billion material swaps exposure threshold so that material swaps exposure thresholds may be harmonized across jurisdictions. We recognize that currency fluctuations will preclude these thresholds from always being exactly equal, but adopting the dollar equivalent threshold should be sufficient to minimize regulatory arbitrage.

- 2) The FHLBanks request that the Prudential Regulators clarify the impact of falling below the material swaps exposure threshold.

The FHLBanks request clarification as to the implication of falling below the material swaps exposure threshold. Specifically, the FHLBanks request clarification whether trades for which a financial end-user with material swap exposure has posted and collected initial margin must remain margined under the Proposed Rule if the financial end-user subsequently falls below the material swaps exposure threshold. The FHLBanks propose that once a counterparty falls below the material swaps exposure threshold, all IM should be returned to the margin posting party until such time as the posting party again exceeds the material swaps exposure threshold.

H. The FHLBanks request that the Prudential Regulators ensure transparency in the calculation of IM by CSEs.

Under the Proposed Rules, the responsibility for determining IM that is to be collected and posted for non-cleared swaps seems to be placed on CSEs.⁷² It is important for end-users to understand what their IM requirements will be both at the time they enter into a new transaction and throughout the period when the transaction remains outstanding. So long as the CSE is utilizing the standardized look-up table set out in the Proposed Rules, this should not be an issue. However, if (as is likely) the CSE is utilizing an approved IM model, an end-user would not know at the time of a new trade what its IM impact may be on its existing portfolio of trades with that CSE counterparty unless it was voluntarily disclosed by the CSE or unless the CSE used an industry standard IM model. More importantly, for the life of the trade, there may be no realistic way for an end-user to challenge a demand for IM collateral or insist on the return of excess IM unless it has access to: (1) the IM model used by the CSE and (2) the inputs utilized by the CSE to compute the IM amount. Uncertainty regarding the magnitude of IM demands made pursuant to CSE IM models could result in unacceptable liquidity and credit risk for many end-users. Transparency of the IM model and access to the model and model inputs is clearly needed in order for end-users, such as the FHLBanks, to manage the liquidity risk associated with the new IM requirements.

⁷² Proposed Rules §§ __.3(a), __.8(a), and __.8(b)(1), 79 Fed Reg. at 57,393 (“A covered swap entity may calculate the amount of initial margin required to be collected or posted for one or more non-cleared swaps with a given counterparty pursuant to § __.3 on a daily basis using an initial margin model only if the initial margin model meets the requirements of this section.”).

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We 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,

A handwritten signature in black ink, appearing to read "Warren Davis". The signature is fluid and cursive, with the first name "Warren" and last name "Davis" clearly distinguishable.

Warren Davis
Of Counsel

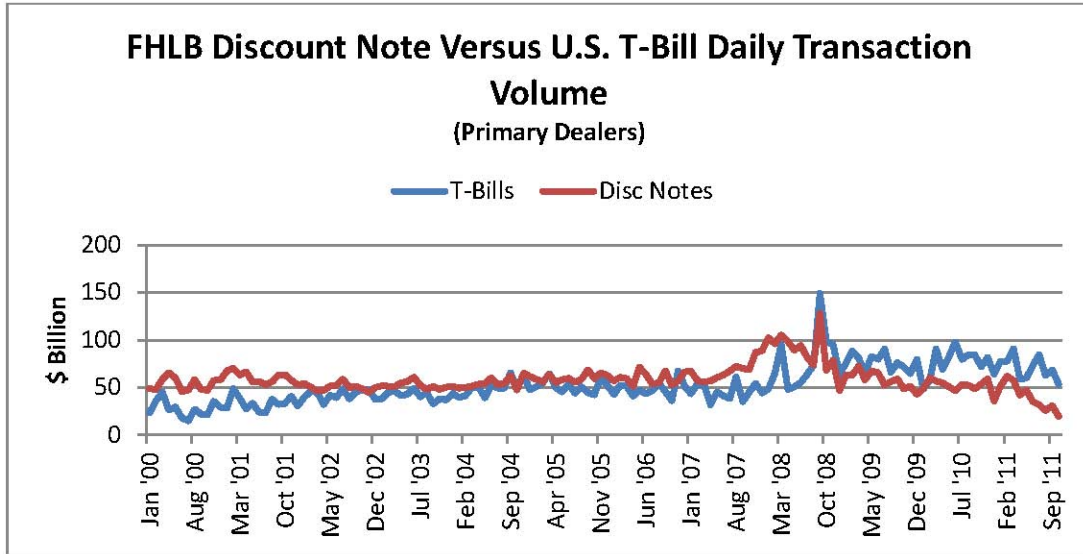
cc: FHLBank Presidents
FHLBank General Counsel

Exhibit A

EXHIBIT A

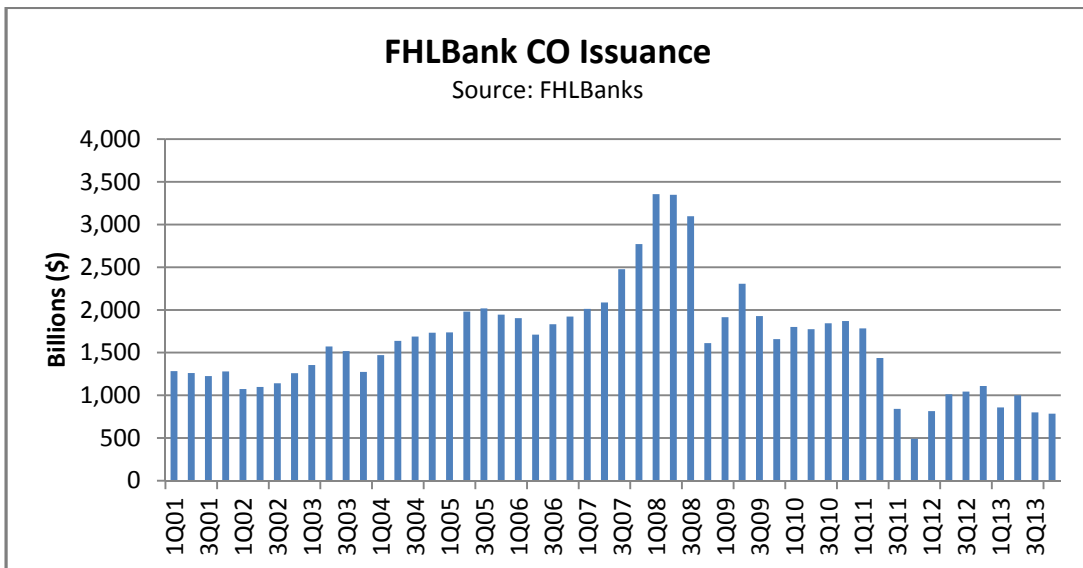
Supporting Analytical Data

Chart 1



Source: Bloomberg

Chart 2



Source: FHLBanks