

Regulatory brief

July 2014

A publication of PwC's financial services regulatory practice

Mandatory margin on TBAs: TBD, but not for long

Overview

With over \$186 billion in average daily trading volume, the To-Be-Announced (“TBA”) market serves as a significant funding and hedging vehicle for consumer mortgage origination. Although a large portion of the TBA market is comprised of highly liquid agency MBS, the exchange of margin has not typically been required. Without the backstop of collateral, another financial crisis could spell significant turmoil for investors.

Given the TBA market's significance to lenders, in an effort to address counterparty risk, FINRA issued its long-awaited proposed margin rule requiring margin on TBA transactions for the first time (FINRA Rule 4210).

After its release in January 2014, the proposal sparked a response of 29 comment letters from broker-dealers. The comments largely focused on the proposal's impact on firms' operations and capital.

In response to these comment letters, we believe FINRA will revise the proposal's margin requirements this summer by exempting certain transactions that have shorter settlement cycles (which comprise the bulk of smaller firms' activities). We also expect FINRA to submit the revised rule for the SEC's approval by September, followed by a second comment period.¹

We suggest that firms start to prepare for the final rule soon. Although there will likely be a nine to twelve month implementation period after the rule is finalized (which will be early next year in our view), the rule is complex and its potential operational challenges are significant.

This **Regulatory Brief** provides an analysis of the proposed rule, our view of how the proposal will change this summer, and our perspective on what firms should do to meet its requirements.

¹ Although the proposed rule will be finalized as a FINRA rule, the SEC's approval (after a second comment period) is required before the rule can be finalized.

The proposed rule

TBA transactions involve forward mortgage-backed security (“MBS”) products and derive their name from the time at which particular securities will be delivered in an MBS transaction. In a TBA transaction, the parties agree to a price and to certain characteristics of the traded securities (including an estimated face value). However, the exact traded securities are not specified at the time of transaction, but are rather “announced” at a later date (commonly two days before the trade settles).

The proposed rule requires FINRA member firms to collect maintenance and variation margin from certain counterparties on TBA transactions,² and to set and apply a credit limit to each counterparty account based on the counterparty’s risk. FINRA’s proposal is largely consistent with the best practices adopted by the Treasury Market Practices Group (TMPG),³ seemingly in an effort to balance the competing goals of mitigating counterparty risk and maintaining market liquidity.

With respect to maintenance margin, the proposal requires firms to collect 2% of the market value of the securities underlying the TBA transaction. The majority of counterparties, however are exempt from this requirement, including FINRA members and non-member registered broker-dealers.⁴ The proposal also exempts mortgage bankers (that are not otherwise exempt from this requirement), but only if the mortgage banker uses the TBA transaction to hedge its loan commitments. This mortgage banker exemption adds a level of operational complexity to firms’ compliance, as the proposed rule puts the onus on broker-dealers to monitor mortgage bankers’ loan pipeline and ensure that TBA transactions are used for hedging purposes only.

With respect to variation margin, the proposed rule requires firms to mark-to-market TBA transactions on a daily basis, and to collect any resulting losses⁵ that exceed a \$250,000 *de minimis* threshold from the

counterparty. For losses below that threshold, a firm may choose not to collect the loss (based on the firm’s risk appetite vis-à-vis a counterparty) and choose instead to deduct an equal amount from the firm’s net capital (for regulatory capital purposes).⁶ If the mark-to-market variation margin remains uncollected after five business days, the firm must liquidate the TBA position, unless an extension is granted by FINRA.

In relation to the variation margin requirement, the proposed rule also requires firms to refrain from entering into new transactions that would increase their credit exposure, and to notify FINRA if total net capital charges over a five-day period exceed a “concentration threshold,” i.e., (a) for a single account or group of commonly controlled accounts, 5% of the firm’s net capital, or (b) for all accounts combined, 25% of the firm’s net capital.

Finally, the proposed rule requires firms to determine and document a credit risk limit for each counterparty. This determination must be made by a credit risk officer or a credit risk committee.

Our expected changes to the rule

Submitted comment letters outline industry’s concerns regarding the proposed rule’s potential adverse effects on operational risk (e.g., due to the complexity of accurately calculating, calling, and applying margins), capital reserves (as posting margin could substantially strain balance sheets), and liquidity, especially for smaller firms.

In response to these concerns, we expect FINRA to revise the proposed rule’s margin requirements by exempting certain transactions that have shorter settlement cycles (and comprise the bulk of smaller firms’ activities) from both the maintenance and variation margin requirements. These transactions include regular way delivery-versus-payment (“DvP”)⁷ transactions that settle within the same or the following calendar month, and have a gross notional value below \$2.5 million. We also expect that mark-to-market losses on these transactions would still be included in the computation of the firms’ “concentration threshold,” although firms would not need to collect variation margin due to these losses, nor to hold net capital against them.

⁶ Deductions must be made by the end of the next business day following the mark-to-market loss.

⁷ Relief is not expected for transactions involving dollar rolls and repos.

² In addition to TBAs, the proposed rule also applies to Specified Pool Transactions and Collateralized Mortgage Transactions, which FINRA collectively defines as Covered Agency Securities. However, TBAs constitute a majority of the Covered Agency Securities market.

³ The TMPG is an industry group composed of business and regulatory personnel who recommend best practices for the treasury and agency markets.

⁴ Exempt counterparties also include designated accounts (e.g., for banks, savings associations, insurance companies, investment firms, and state and local governments), and high net-worth individuals.

⁵ In calculating losses, firms are permitted to offset mark-to-market profit and losses within the same counterparty’s account.

How should firms prepare?

Operationalizing the process to calculate, call, and collect margins under the proposed rule can pose significant challenges to firms, especially to those that currently lack such capabilities. To be prepared for the final rule's requirements, firms must at a minimum carry out the following tasks.

Operations

Because the proposal's margin requirements are introduced to the market for the first time, most firms need to build their compliance capabilities from scratch. This effort will require:

- Putting in place infrastructure to issue margin calls at the close of business each day, and to monitor uncollected calls. Introducing firms must also ensure that their clearing firms will be able to support this process.
- Establishing a process to monitor mortgage bankers' pipelines to determine whether TBAs are being used for hedging purposes, or outsourcing this function to a specialized third-party.
- Determining how funds will be applied and reflected on the firm's books and records.
- Establishing and documenting the appropriate custodial accounts to hold securities posted as margin, especially when securities are housed outside of the firm.
- Developing policies and procedures to handle required close-outs, and establishing a process to request extensions for the close-out process.
- Classifying each sub-account managed by an investment advisor as exempt or non-exempt for margin requirements, based on the sub-account's beneficial owner.⁸

⁸ Although the current industry practice is to treat an investment advisor's account and all of its sub-accounts as one, the proposed rule requires margin to be calculated and collected for each sub-account separately, based on whether or not it is deemed exempt.

Legal

In addition to amending existing customer agreements (i.e., "MSFTAs") that already include a *de minimis* threshold to adjust the threshold to \$250,000, firms should also:

- Proactively negotiate existing or new MSFTA's to include the threshold if the agreement lacks one – do not underestimate the time that will be needed to negotiate these agreements.
- Obtain necessary documents from investment advisors to identify the beneficial owner of each sub-account under the advisor's account.

Credit

Firms should actively monitor their credit extension thresholds, and establish capital limits to inform the decision to take a net capital charge in lieu of a margin call when appropriate. In addition, firms should:

- Re-assess the process of evaluating and setting new and existing customer credit lines.
- Evaluate the credit worthiness and ability of current counterparties to meet both maintenance and variation margin calls.

Finance/Regulatory

Firms should establish a process for updating policies and procedures to reflect the eventual final rule's requirements, and outline their "concentration limit" calculations. Additional necessary steps include:

- Determining the impact of the rule on the customer reserve formula (used to calculate and deposit client funds into segregated reserve accounts).
- Establishing a process to monitor concentration thresholds and to alert the front office when a limit is approached, and to notify FINRA if the limit is reached.
- Understanding the liquidity impact of margin calls on the firm's business and determining the best strategy to mitigate the impact.

Additional information

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