

Regulatory brief

August 2016

A publication of PwC's financial services regulatory practice

Broker-dealers: TBA margin clarity, but not simplicity

On August 15th, the Financial Industry Regulatory Authority (FINRA) issued a regulatory notice adopting a requirement that US-registered broker-dealers collect margin on To-Be-Announced (TBA) transactions (FINRA Rule 4210).¹ FINRA's action follows the Securities and Exchange Commission's approval of FINRA's earlier proposal² which was amended several times.

TBA transactions serve as a significant funding and hedging vehicle for consumer mortgage originations and provide liquidity in the secondary market for mortgage loans. These products have over \$184 billion in average daily trading volume, second only to US Treasuries, and have historically not been subject to margin requirements. The Rule is designed to reduce the counterparty credit risk TBAs expose broker-dealers to as a result of TBAs' long settlement durations.

Under FINRA Rule 4210, broker-dealers will have to collect margin from most customers for the majority of TBA transactions (unless the transaction is centrally cleared through a registered agency, among certain other exceptions). The broker-dealer will also have to deduct from its regulatory net capital any required margin that is not collected by the close of the next business day.

The Rule generally implements recommendations from the Treasury Market Practices Group (TMPG) made in 2012. Several of the largest broker-dealers have been preparing for the Rule since the TMPG issued its recommendation; however, most firms have a great deal to do before the Rule's upcoming compliance deadlines.

The Rule divides compliance into two phases. The first phase requires that credit risk limits be assigned to each counterparty by December 15, 2016 (consistent with the broker-dealer's risk policies and procedures). The second phase applies the rest of the Rule's requirements (e.g., margin and net capital deductions) by December 15, 2017. We suggest that firms begin implementation efforts now, as the rule is complex and likely to present significant operational challenges.

This **regulatory brief** provides an analysis of FINRA Rule 4210 and our view on what firms should be doing now.

¹ In addition to TBAs, FINRA Rule 4210 (or "the Rule") applies to Specified Pool Transactions and Collateralized Mortgage Transactions, which FINRA collectively defines as "Covered Agency Transactions." However, TBAs constitute the majority of Covered Agency Transactions market, so this brief refers to all of these as "TBAs" for simplicity.

² See PwC's *Regulatory brief, Mandatory margin on TBAs: TBD, but not for long* (July 2014).

The Rule

The Rule requires FINRA member firms to collect margin from most counterparties for the majority of their TBA transactions. These transactions are forward mortgage-backed security (MBS) trades in which the parties agree to a price and certain characteristics of the MBS (including estimated face value), but the actual MBS that will be delivered to fulfill the trade is not designated until two days before the settlement date. As a result, the broker-dealer is exposed to credit risk for an extended period, often several months.

The Rule first requires that FINRA member firms set and apply a credit risk limit to each counterparty based on the counterparty's risk, as determined by a credit risk officer or a credit risk committee. These limits are also required for transactions beyond TBAs, as further prescribed by the Rule.

More impactfully, the Rule requires that member firms collect both maintenance margin and mark-to-market losses (MTM) from *smaller* counterparties³ and collect only MTM from most other counterparties.⁴ These margins must be posted by the close of business on the next business day after a margin deficiency arises. However, if the margin deficiency is less than a \$250,000 *de minimis* threshold, the broker-dealer may choose not to collect the margin (depending on the broker-dealer's risk appetite vis-a-vis the counterparty) and may similarly choose not to collect margin for TBAs involving multifamily housing or project loan programs.

Finally, the Rule calls for net capital deductions and concentration limits related to uncollected margin, as further described below. The **Appendix** to this brief provides a graphic representation of the Rule's requirements.

Margin

The requirement to collect margin will be a heavy lift for firms that have historically booked these transactions in cash and delivery-versus-payment (DVP) accounts because these types of accounts are generally not

operationally equipped to deal with margin. The margin requirements will be especially problematic for broker-dealers with investment adviser (IA) counterparties because the broker-dealer will have to "look through" the IA to calculate and collect margin for each of the IA's underlying customers. However, for the purpose of establishing credit risk limits, the broker-dealer need not "look through" the IA but may assign this limit to the IA as a whole.

MTM is generally required on TBA transactions with broker-dealers, banks, insurance companies, IAs, and private funds (e.g., hedge and private equity funds), or individuals, with financial assets of more than \$40 million and a net-worth of more than \$45 million, among others.⁵ MTM must be calculated daily, and any outstanding MTM calls that exceed the \$250,000 *de minimis* threshold must be collected by the broker-dealer. When calculating outstanding margin, broker-dealers are permitted to net mark-to-market profit and losses within the same counterparty's account.

Maintenance margin is essentially only required from smaller private funds (e.g., hedge funds and private equity firms), or individuals, with financial assets less than \$40 million and a net-worth less than \$45 million. As an added wrinkle, maintenance margin must also be collected from mortgage bankers that are not using TBA transactions to hedge loan commitments. This adds another level of operational complexity to firms' compliance, as the rule puts the onus on broker-dealers to monitor mortgage bankers' loan pipelines and ensure that TBAs are used for hedging purposes only.

Net capital deductions and concentration

The rule accounts for the possibility that a broker-dealer may fail to immediately collect margin. In such situations, the broker-dealer must then deduct the uncollected amount from its regulatory net capital by the end of the next business day. If the margin remains uncollected after five business days, the broker-dealer must then liquidate the portion of the TBA transaction necessary to meet the margin deficiency, unless the

³ The Rule refers to these smaller counterparties as "non-exempt" counterparties. These counterparties must post maintenance margin, in addition to having to post MTM like most other counterparties. These counterparties are generally small private funds (e.g., hedge and private equity funds), or individuals, with financial assets less than \$40 million and a net-worth of less than \$45 million.

⁴ The Rule refers to these other counterparties as "exempt" counterparties because they do not have to post maintenance margin. These counterparties must still post MTM and are described in more detail below (and in the next footnote). However, the Rule explicitly excludes the following entities from any margin requirements: federal banking agencies, central banks, multinational central banks, foreign sovereigns, multilateral development banks, and the Bank for International Settlements. Furthermore, the broker-dealer need not collect margin from counterparties with gross open positions of \$10 million or less if (a) the transaction settles and trades in the same month (or settles in the month after it trades) and (b) the counterparty regularly settles its TBAs on a DVP basis or for cash and does not engage in certain financing techniques such as dollar rolls or round robin trades in its TBA transactions with the broker-dealer.

⁵ Other "exempt" counterparties (see prior note) that only need to post MTM include savings associations, investment companies, state and local government entities, and mortgage bankers that transact in TBAs for hedging purposes.

broker-dealer requests and is granted an extension by FINRA.

Broker-dealers must also notify FINRA, and cease engaging in new TBA transactions,⁶ if total net capital charges (i.e., uncollected margin) over five business days exceed a “concentration threshold.” The concentration threshold is exceeded if the uncollected margin for a single account (or group of commonly controlled accounts) reaches 5% of the firm’s tentative net capital or reaches 25% of the firm’s tentative net capital for all accounts combined. Any margin deficiencies resulting from the \$250,000 *de minimis* threshold also count towards the concentration threshold,⁷ as detailed in the **Appendix**.

How should firms prepare?

Implementing the processes to calculate and collect margin under the Rule will pose significant challenges to firms. To prepare, broker-dealers should do the following.

Operations

Most firms need to enhance their operational capabilities. This effort will require firms to:

- Determine for each counterparty whether it must collect MTM, or both MTM and maintenance margin (i.e., determine requirements based on whether the counterparty is “exempt” or “non-exempt” as described by the Rule). Proper counterparty coding will be critical.
- Classify each account managed by an IA-counterparty as “exempt” or “non-exempt” based upon the account’s owner. Consideration should be given to seeking attestation from the IA that all of their accounts meet the definition of an “exempt” counterparty, unless the broker-dealer is informed otherwise.
- Put in place infrastructure to calculate and collect margin, and to net mark-to-market profit and losses within the same counterparty’s account.
- Establish a process to capture outstanding margin below the \$250,000 *de minimis* level, in order to determine if margin should be collected and to track it against concentration thresholds.

- Implement infrastructure to track and code transactions for which margin is not required (e.g., centrally cleared transactions, and TBAs involving multi-family housing or project loan programs).
- Establish processes to ensure margin is collected within the required five business days, TBAs can be liquidated if needed for margin that goes uncollected beyond five business days, and extensions can be obtained from FINRA as applicable.
- Establish a process to increase margin requirements beyond the Rule’s minimum in the event the market becomes volatile.

Legal

Amend existing customer agreements in order to:

- Ensure agreements include the \$250,000 *de minimis* threshold.
- Consider obtaining an attestation from each mortgage banker using TBAs to hedge, which states that the securities in their account are used solely for hedging. These attestations should be renewed regularly.

Credit

Firms should assign risk limits to each counterparty and actively monitor their credit exposure (even beyond TBA transactions):

- Designate a credit risk officer or credit risk committee to establish risk limits in accordance with risk policies and procedures.
- Establish a daily process to ensure limits are not breached.

Finance

Firms should update policies and procedures to reflect the Rule’s requirements and also:

- Enhance processes to incorporate margin deficiencies into daily net capital calculations.
- Establish a process to monitor and report to FINRA when the Rule’s concentration thresholds are breached (and restrict TBA activity).

⁶ If the concentration threshold reaches 5% by a single account, the broker-dealer must cease doing additional business with the account. If the threshold reaches 25% across all accounts, the broker-dealer must put a hold across all accounts on any new TBA transactions.

⁷ Deficiencies from daily MTM and maintenance margin requirements for accounts with gross open positions of \$10 million or less also count towards the concentration threshold if they generally settle on a DVP basis. See note 4 for further detail.

Appendix – Is your TBA transaction subject to margin requirements?

The following chart depicts from which counterparties broker-dealers must collect margin and the associated net capital deductions and concentration thresholds. The chart also depicts the types of transactions that obviate the need for collecting margin regardless of counterparty.

		Broker-dealer requirements				
	Counterparty or transaction	Maintenance margin?	MTM?	Net capital deductions?	Concentration thresholds?	Rule reference
Counterparty-based requirements	Smaller private funds, and individuals, with net-worth < \$45mm and financial assets < \$40mm	Yes	Yes	Yes	Yes	(e)(2)(H)(ii)(e)
	Mortgage bankers <i>not</i> using the TBA to hedge loan commitments					
	Larger private funds, and individuals, with net-worth > \$45mm and financial assets > \$40mm					
	Broker-dealers Banks Insurance companies Investment advisers Investment companies State/local gov't entities Savings associations	No	Yes	Yes	Yes	(e)(2)(H)(ii)(d)
	Mortgage bankers using the TBA to hedge loan commitments					
	Counterparties with gross open positions < \$10mm, and certain other characteristics	No	No	No	Yes	(e)(2)(H)(ii)(c).2
	Federal banking agencies and similar entities	No	No	No	No	(e)(2)(H)(ii)(a).1
Transaction-based exceptions	<i>De minimis</i> margin outstanding (< \$250,000)	No	No	No	Yes	(e)(2)(H)(ii)(f)
	Multi-family housing or project loan programs	No	No	No	No	(e)(2)(H)(ii)(a).2
	Centrally cleared TBAs	No	No	No	No	(e)(2)(H)(ii)(c).1

Additional information

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