TMPG | Treasury Market Practices Group

Frequently Asked Questions: Margining Agency MBS Transactions
The following frequently asked questions refer to the Treasury Market Practices Group (TMPG) recommendation to margin forward-settling agency MBS transactions and represents an update to the frequently asked questions previously released by the TMPG on October 25, 2013. Please refer to the "Margining of Agency MBS" section on the TMPG website for additional details.

June 13, 2014

How has the TMPG strengthened the *Best Practices for Treasury, Agency Debt, and Agency Mortgage-Backed Securities Markets* to recommend that forward-settling agency MBS transactions be margined?
The TMPG updated its guidance regarding forward-settling transactions to reflect the following:

> "Trading desk management and individuals responsible for the determination of credit management policies should be sure to consider the counterparty and market risks associated with transactions and to develop robust risk management processes.
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> Consistent with prudent management of counterparty exposures, forward-settling transactions, such as agency MBS transactions, should be margined. To help both parties mitigate counterparty risk owing to market value changes, two-way variation margin should be exchanged on a regular basis. Written master agreements should describe the parties' agreement on all aspects of the margining regime, including collateral eligibility, timing and frequency of margin calls and exchanges, thresholds, valuation of exposures and collateral, and liquidation."

Should I implement the TMPG's MBS margining recommendation for all of my counterparty exposures?
Yes, the TMPG recommends the regular exchange of two-way variation margin in respect of forward-settling agency MBS transactions as a means to reduce counterparty and systemic risk. Recognizing the operational challenges and legal resources needed, the TMPG expects that participants will take a risk-based approach to implementation of the best practice, whereby market participants implement the practice on a rolling basis and prioritize their most material counterparty exposures, and substantially complete this process by December 31, 2013. The best practices were developed to assist all market participants in fostering strong controls and reinforcing overall market integrity.

Why does the TMPG recommend widespread use of margining for agency MBS transactions?
The forward-settling nature of most agency MBS transactions exposes trading parties to counterparty credit risk between trade and settlement. Given the size of the forward-settling agency MBS market, unmargined trades also pose systemic risks to overall market functioning if one or more market participants were to default. Counterparties can help mitigate these risks by exchanging margin as the market value of the transaction in deliverable securities fluctuates.

The TMPG recommends that market participants exchange two-way variation margin on a regular basis to prudently manage these risks. Widespread use of margining for unsettled agency MBS transactions enhances financial system stability and supports market function during periods of market stress**.** This is not unlike other markets where market participants manage such risks through the use of collateral agreements such as the ISDA Credit Support Annex.

Why does the practice recommend two-way variation margining?
The TMPG recommends an exchange of two-way variation margin to mitigate the risks associated with unmargined agency MBS transactions identified by the TMPG. When both parties are subject to counterparty credit risk, exchanging variation margin two ways will help protect both parties if the market value of the transaction in deliverable securities fluctuates. Moreover, widespread two-way margining should increase the resiliency of the agency MBS market more broadly, helping to prevent rapid and potentially destabilizing price volatility.

Does the margining practice recommendation apply to all forward-settling transactions in the Treasury, agency debt and agency MBS markets?
Yes, the TMPG recommends that the margining practice recommendation apply to all forward-settling agency MBS transactions, including To-Be-Announced (TBA) transactions, specified pool transactions, adjustable-rate mortgage (ARM) transactions, and collateralized mortgage obligation (CMO) transactions.

For the avoidance of doubt, agency multifamily and project loan securities such as Freddie Mac K Certificates, Fannie Mae Delegated Underwriting and Servicing bonds, Ginnie Mae Construction Loan/Project Loan Certificates, are all within the scope of the margining practice recommendation.

Trading desk management and individuals responsible for the determination of credit management policies should be sure to consider the counterparty and market risks associated with all transactions and to develop robust risk management processes, including applying a margining practice where needed to prudently manage counterparty exposures. The TMPG intends to review margining for other categories of forward-settling transactions in the Treasury, agency debt and agency MBS markets at a future date.

For the purpose of the TMPG margining practice recommendation, what does "forward-settling" mean?
The TMPG recommends that margining be applied based on the type of agency MBS transaction and the existing market trading and settlement conventions for each transaction type. Given that TBA, specified pool and ARM transactions typically settle forward based on the regular class settlement date for a given month, the TMPG recommends that, at a minimum, all trades for these transaction types for which the difference between trade date and contractual settlement date is greater than one business day be subject to margining.

CMO, agency multifamily MBS and project loan securities transactions have a different market convention for the settlement of spot secondary market trades, which is three business days between trade date and contractual settlement date. The TMPG recommends, at a minimum, that all CMO, agency multifamily MBS and project loan trades for which the difference between trade date and contractual settlement date is greater than three business days be subject to margining.

What type of collateral should be eligible for margining purposes, and should there be any constraints around the re-use of collateral?
The TMPG recommends that market participants address collateral eligibility and re-use in their written agreements, subject to good faith negotiation between market participants and consistent with the prudent management of counterparty risk. While the TMPG does not recommend any particular collateral type, most generally accepted collateral frameworks recommend that the range of acceptable collateral be highly liquid, have an appropriate risk-sensitive haircut and be able to hold their value in a time of financial stress. The TMPG encourages market participants to recognize the different preferences and capabilities of counterparties with regard to each of these terms and, where consistent with their risk management parameters, show appropriate flexibility in identifying acceptable arrangements.

Does the TMPG recommend that agency MBS transactions of the categories described above that are failing at settlement be margined?
The TMPG recognizes that margining forward transactions that have failed to settle may be operationally challenging to implement in bilateral agency MBS trading between counterparties, and therefore at this time the TMPG has not included this as a part of its practice recommendation. At the same time, the TMPG recognizes that many participants already margin fails; for those able to margin fails, doing so would be consistent with the spirit of TMPG market best practice and reducing systemic risk. The TMPG plans to review the benefits and costs of recommending margining for settlement fails at a future date.

What is the effective date of the recommended margining practice?
The TMPG recommends a risk-based approach whereby market participants should continue to implement the practice recommendation on a rolling basis and prioritize their most material counterparty exposures. Recognizing the operational challenges and legal resources required, the TMPG modified the implementation timeline in March 2013 and recommends that market participants make significant progress towards margining forward-settling agency MBS exposures by early June 2013 and substantially complete the process by December 31, 2013.

What kind of legal agreement should be used for implementing the margining practice?
The TMPG recommends that written agreements describe the parties' agreement on all aspects of the margining regime, including collateral eligibility, timing and frequency of margin calls and exchanges, thresholds, valuation of exposures and collateral, and liquidation. Written master agreements covering agency MBS forwards should also typically provide that unsettled agency MBS transactions with a counterparty that has defaulted may be terminated and liquidated.

The Securities Industry and Financial Markets Association released an updated version of its Master Securities Forward Transaction Agreement in November 2012, providing an up-to-date standard legal framework for agency MBS forward trading and the margining of such transactions. While market participants may also choose to use existing forward trading and margining agreements already in place or draft their own forms of agreements, the TMPG encourages the use of up-to-date industry standard documents as a starting point to provide a sound mutual basis for conducting financial market transactions.

Does the TMPG provide guidance for recommended thresholds or minimum transfer amounts?
The TMPG recommends that market participants address these terms in their written agreements. The TMPG expects that market participants will evaluate the appropriateness of the levels of any thresholds and minimum transfer amounts consistent with the prudent management of counterparty risk and will negotiate in good faith. Consistent with these principles, TMPG expects that market participants will exchange two-way variation margin on a regular basis in respect of their forward-settling agency MBS transactions. It would not be consistent with the TMPG's recommended best practice if, despite meaningful credit exposures, the agreed upon thresholds or minimum transfer amounts do not result in a regular exchange of variation margin by both counterparties, or resulted in a one-way exchange only.

Does the TMPG provide guidance for the timing and frequency of margin calls?
The TMPG recommends that market participants address these terms in their written agreements, subject to good faith negotiation between market participants and consistent with the prudent management of counterparty risk. In addition, the TMPG encourages all market participants to negotiate reasonable timeframes for the timing and frequency of margin calls and, where consistent with their risk management guidelines, take into consideration operational constraints of their counterparties when drafting bilateral agreements.

Won't the margining practice represent a significant burden for market participants' back offices and legal support?
While many market participants already have systems and legal agreements in place to manage a margining process, the TMPG expects that some market participants may experience an increase in operational and legal resource requirements, including initial infrastructure investments, in order to implement the margining practice. However, the TMPG believes that the benefits of widespread margining of agency MBS transactions – including enhancements to counterparty risk management and the reduction of systemic risks – significantly outweigh these costs.