January 26, 2021

SUBMITTED VIA E-MAIL

The Honorable Allison Herren Lee
Acting Chair
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: File No. SR-FICC-2020-017; Self-Regulatory Organizations; Fixed Income Clearing Corporation; Notice of Filing of Proposed Rule Change to Modify the Calculation of the MBSD VaR Floor to Incorporate a Minimum Margin Amount

File No. SR-FICC-2020-804; Self-Regulatory Organizations; Fixed Income Clearing Corporation; Notice of Filing of Advance Notice to Modify the Calculation of the MBSD VaR Floor to Incorporate a Minimum Margin Amount

Dear Acting Chair Lee:

The Independent Dealer and Trader Association ("IDTA")[1] and the Mortgage Bankers Association ("MBA")[2] submit this letter in response to your request for comment on the Fixed

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[1] The IDTA was formed to create a forum for independent dealers and traders to discuss and consider the impact of market operational issues on their industry sector and to advocate for constructive solutions that promote the liquidity and efficiency of capital markets. The objective of the IDTA is to form an interactive line of communication with regulators and other relevant policy makers, with particular emphasis on the Securities and Exchange Commission, the Treasury Department, and the Federal Reserve Bank of New York. The IDTA is composed of six organizations registered as broker-dealers or futures commission merchants (or affiliates of such organizations) that are not affiliated with a bank holding company. For additional information, visit IDTA's web site: www.idtassoc.com/.

[2] The MBA is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets, to expand homeownership, and to extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,300 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, REITs, Wall Street conduits, life insurance companies, and others in the mortgage lending field. For additional information, visit MBA's web site: www.mba.org.

Income Clearing Corporation's ("FICC") filing with the Securities and Exchange Commission ("SEC" or "Commission") of the proposed rule change SR-FICC-2020-017 (the "Proposed Rule Change") to amend the FICC Mortgage-Backed Securities Division ("MBSD") Rulebook (the "MBSD Rules") in order to modify the calculation of the Value-at-Risk ("VaR") floor through the introduction of a new "Minimum Margin Amount" charge against each clearing member.[3]

The IDTA and MBA believe that the Proposed Rule Change's Minimum Margin Amount, while intended to ensure the assessment of margin requirements for MBSD members is sufficient during times of stress, instead will burden markets during such times, resulting in limited access to affordable capital, particularly for small- to mid-sized mortgage originators. As a result, the Proposed Rule Change places burden on competition that is unnecessary and inappropriate in furtherance of the purposes of the Securities Exchange Act of 1934 ("Act"). Well-capitalized participants who cannot comply with the Proposed Rule Change's onerous requirements will be forced to transact with fewer counterparties in smaller volumes, thereby reducing the supply of services they provide and driving prices higher for the consumers that rely upon such services. The IDTA and MBA also believe that the Proposed Rule Change is inconsistent with the requirements of the Act, and the rules and regulations thereunder applicable to FICC, because the Minimum Margin Amount formula is unreasonably designed to mitigate future risk.

For the reasons further discussed below, we urge the Commission to deny the Proposed Rule Change and direct FICC to reconsider alternative measures to better respond to future market volatility and economic uncertainty.

I. The Proposed Rule Change's Burden on Competition is Unnecessary and Inappropriate in Furtherance of the Purposes of the Act.

While a proposed rule change may impose burden on competition, the burden must be necessary or appropriate in furtherance of the purposes of the Act.[4] Here, the Proposed Rule Change imposes unnecessary burden on competition by establishing margin requirements that are divorced from reasoned analysis and that will force well-capitalized yet smaller participants who cannot comply with the Proposed Rule Change's onerous margin requirements to transact with fewer counterparties in smaller volumes, thereby reducing the supply of services they provide and driving prices higher for the consumers that rely upon these services.

In particular, the Proposed Rule Change will disproportionally affect mid-sized broker-dealers that currently make up the greatest source of counterparty liquidity for smaller mortgage originators, including many that focus on providing credit to historically underserved communities. These originators must be prepared to offer consumers an affordable product and a

[3] Securities Exchange Act Release No. 34-90568 (Dec. 4, 2020), 85 Fed. Reg. 79541 (Dec. 10, 2020) ("Proposed Rule Change"), *available at* https://www.govinfo.gov/content/pkg/FR-2020-12-10/pdf/2020-27087.pdf. FICC also filed a nearly identical advance notice SR-FICC-2020-804 ("Advance Notice") on November 27, 2020. *See* Securities Exchange Act Release No. 34-90834 (Dec. 31, 2020), 86 Fed. Reg. 584 (Jan. 6, 2021) ("Advance Notice"), *available at* https://www.govinfo.gov/content/pkg/FR-2021-01-06/pdf/2020-29251.pdf. This letter responds to both the Proposed Rule Change and the Advance Notice. Capitalized terms not otherwise defined herein are defined in the Proposed Rule Change.

[4] *See* 15.U.S.C. § 78q-1(b)(3)(I).

locked interest rate, and subsequently honor that obligation through all the steps required until a loan is funded. These originators rely upon broker-dealers that can bid for and offer to sell them "to-be-announced" ("TBA") contracts that offset the potential for dramatic moves in the value of binding loan offers (interest rate locks) that are in various stages of completion. Typically, smaller originators face greater challenges in securing lines of financing, as their pipeline hedging needs may be below the minimum thresholds set by some broker-dealers or banks. Additionally, the population that can be hurt the most is Ginnie Mae borrowers, who are often served by small- to mid-sized originators. These Ginnie Mae borrowers typically include low-income, minority, rural, veteran, and Native American borrowers. Mid-sized broker-dealers, including IDTA members, offer risk management services to these smaller originators.

The onset of the COVID-19 pandemic led to significant volatility in fixed-income markets, creating additional challenges for mortgage originators as they dealt with rapid market movements, heightened margin calls, and, for those that also service mortgage loans, concerns regarding the liquidity necessary to meet advancing obligations. IDTA members, recognizing the need for these originators to continue to provide credit in underserved communities, offered forbearance assistance and helped manage their cash flows during those first few perilous months when temporary cash flow problems jeopardized established partnerships. Successfully managing these hurdles allowed both the originator community and their broker-dealer counterparts to respond appropriately without waves of defaults.

The additional margin requirements under the Proposed Rule Change, if in effect in March 2020, would have had a negative ripple effect through this entire community. By requiring additional margin, the Proposed Rule Change would have made it harder for middle-market broker-dealers to compete with larger bank-affiliated broker-dealers for which FICC's margin requirements are less consequential – and is likely to do so in the future, as well. These mid-sized broker-dealers will be forced to scale back their risk management tools and services for smaller originators, who will then turn to larger institutions for these tools and services. At best, this would result in a more concentrated market; at worst, smaller originators would not be able to obtain these tools and services, putting them in a position in which they could not implement their desired risk management approaches or fully serve their customer bases.

The burden on smaller broker-dealers caused by the Proposed Rule Change's introduction of a Minimum Margin Amount requirement is not necessary – these broker-dealers do not represent significant risk to the broader system. The liquidation of a single IDTA member in 2020, for example, caused minimal-to-no market disruption.[5] The Proposed Rule Change notes that the VaR model did not achieve a 99% confidence level for the period beginning in March 2020 through the beginning of April 2020, but does not explain which institutions (or which types of institutions) contributed the most to that shortfall.[6] We strongly believe that the movements in portfolio value of even a half dozen small, independent firms taken together were unlikely to have been responsible for most of this shortfall.

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[5] *See* Costa Mourselas, *Ronin, Felled Prop Giant, Shuts Up Shop*, RISK.NET (Aug. 28, 2020), https://www.risk.net/risk-management/7672111/ronin-felled-prop-giant-shuts-up-shop.

[6] Proposed Rule Change, *supra* note 3, at 79542.

The goal of shoring up the reserves of clearing houses certainly is a reasonable one, but not through the overestimation of their guarantee funds (as further discussed below) and at the expense of smaller market participants. This overly conservative approach stacks the odds in favor of larger institutions and can be one of the strongest drivers of horizontal consolidation. These changes are not harmless and, in fact, will have significant implications for competition and market structure.

II. The Proposed Rule Change is Inconsistent with the Requirements of the Act.

The Commission also shall not approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is inconsistent with the requirements of the Act and the rules and regulations thereunder.[7] Here, the Proposed Rule Change is inconsistent with Section 17A(b)(3)(F) of the Act and Rules 17Ad-22(e)(4)(i) and (e)(6)(i) thereunder because the reliance on historical price movements does not generate margin requirements that equate to future protections against market volatility, and, thus, the Minimum Margin Amount formula is unreasonably designed as a mechanism to mitigate future risk.

Fluctuations in the value of fixed-income securities vary greatly across different economic environments. The use of historical price data during one episode of market volatility to protect against all future volatility and uncertainty, however, provides a false sense of security. It is unreasonable, for example, to apply the same dollar price moves that occurred in March 2020 to 4% coupons and 19 months later to 1.5% coupons. This was precisely the foundation for the sensitivity-based VaR model that supplanted the margin proxy calculations that were hastily rolled out after the 2008 financial crisis and beset with problems.[8] Many of the market's expectations for macroeconomic trends and the time value of money do not scale linearly between different interest rate environments. The dearth of analysis done post-2008 to create effective models in a low-to-zero interest rate environment are a testament to this fact.

One of the goals of the sensitivity-based VaR model was to prepare the market's largest central clearer of TBA contracts to effectively assess and manage credit risk even as the Federal Reserve took momentous action to raise interest rates on the return to a more normalized interest rate environment. The VaR model did so successfully, but it was not prepared to accommodate a momentous reversal in this policy. The VaR model was well suited to the volatile environments against which it had already been tested and it sustained an acceptable coverage ratio in these environments. The lapse in the coverage ratio when new challenges arose should serve as the impetus for further enhancement of that model. The events of 2020 do not justify the return to purely price-based margin models. The newly proposed charge will dominate the margin requirements of clearing members and effectively render the sensitivity model irrelevant.[9]

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[7] 15 U.S.C. § 78s(b)(2)(C).

[8] *See* Securities Exchange Act Release No. 34-79868 (Jan. 24, 2017), 82 Fed. Reg. 8780 (Jan. 30, 2017) (SR-FICC-2016-007) (Order Approving a Proposed Rule Change To Implement a Change to the Methodology Used in the MBSD VaR Model), *available at* https://www.govinfo.gov/content/pkg/FR-2017-01-30/pdf/2017-01895.pdf.

[9] We agree with the comments submitted by SIFMA that the increased margin requirements "are not calibrated appropriately" and that the VaR model should be fixed rather than "add on a blunter instrument to ensure margin remains at the appropriate confidence levels." Letter from Christopher Killian, Managing Director, SIFMA to Vanessa Countryman, Secretary, SEC.

FICC distributed impact studies among the clearing members of MBSD.[10] Based on our analysis of the Proposed Rule Change, it would be more accurate to describe the Minimum Margin Amount as the re-introduction of the now-defunct "Margin Proxy" rather than deeming it to be a new floor calculation. FICC's stated goal with this Proposed Rule Change is to address shortfalls in the coverage ratio of the central clearing fund's pool of collected margin during times of greater market volatility.[11] Its calculations, however, rely upon the use of historical price movements to effectively increase the coverage ratios through brute force in order to satisfy the back-testing requirements. In this case, the analysis consists of historical price moves over a rolling one- to three-year window.[12] Based upon the track record of margin proxy, we know that this charge is fraught with problems, including procyclicality and a strong tendency to over and under margin clearing members and make the system less efficient. The calculation is inherently reactive to volatility in a manner that does not measure up to modern risk management standards. As volatility creates larger margin calls, it puts further pressure on the price of securities being liquidated. Instead, further development of the sensitivity model that FICC adopted just over two years ago should be the focus of any proposed changes. As a stopgap measure, the VaR sensitivity model could be modified to collect additional margin from those participants that contributed the most to the recent shortfalls.

III. FICC Could Consider Implementing Concentration Charges, with Active Input by the Commission.

The IDTA and MBA suggest FICC consider, among several approaches, a model that proportionally collects additional margin based on any one participant's contribution to the margin shortfall. One mechanism could be the further development of concentration charges, which are employed by other central clearers like the Options Clearing Corporation ("OCC").[13] When a majority of members' portfolios do not drive significant risk to the system, a concentration charge may be able to impose effective margin requirements on the portfolios that do drive the majority of the risk. This is implemented through risk measures that do not grow linearly, but rather are more stringent as volumes become more concentrated. Research suggests that these measures reflect the actual costs of liquidating large portfolios, and have been verified with real-world events – for example, after the collapse of Lehman Brothers in 2008 and the liquidation of JP Morgan Chase & Co.'s London Whale in 2012.[14]

FICC's commitment to creating stronger markets also should be reinforced by the SEC's review of any proposed rule changes where the Commission can be actively engaged in testing the impact of changes to the margining scheme (and even suggest modifications). The Commission is

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[10] Proposed Rule Change, *supra* note 3, at 79545.

[11] *See* Proposed Rule Change, *supra* note 3, at 79543 ("The Minimum Margin Amount would enhance backtesting coverage when there are potential VaR model performance challenges particularly when TBA price changes significantly exceed those implied by the VaR model risk factors as observed during March and April 2020.").

[12] *Id.*

[13] *See Margin Methodology*, OCC, https://www.theocc.com/Risk-Management/Margin-Methodology (last visited Jan. 26, 2021) (discussing a "Concentration component").

[14] *See* Peter Madigan, *Quant Congress USA: Liquidity Charge Might Have Exposed London Whale, Academic Claims*, RISK.NET (July 15, 2015) (on file with author).

in a position to collect confidential information to enable it to effectively oversee changes that – particularly here – disproportionally affect competition and will result in continued concentration of essential financial services.

IV. Conclusion

We are concerned that the practical effects of the Proposed Rule Change would be greater financial burdens on mid-sized broker-dealers, increased consolidation of critical services provided to small- to mid-sized mortgage originators, and more expensive or reduced access to mortgage credit for the communities served by these originators. As a self-regulatory organization subject to the Act, FICC must ensure that any burden on competition caused by a rule change is necessary or appropriate in furtherance of the purposes of the Act. FICC also must show that a rule change assures the safeguarding of securities and funds in its custody or control. For the reasons discussed above, the Proposed Rule Change does neither. We therefore recommend that FICC reconsider alternative measures to better respond to future market volatility and economic uncertainty.

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The IDTA and MBA thank the SEC for considering our comments. Should you have any questions, please contact the undersigned.

Sincerely,

James Tabacchi
Chairman
Independent Dealer and Trader Association

Mike Fratantoni
Chief Economist, Senior Vice President
Mortgage Bankers Association

CC: Michael Bodson, President and CEO, DTCC
Timothy Cuddihy, Managing Director, DTC