We make home possible℠

Lisa M. Ledbetter
Vice President and Deputy General Counsel
Legislative & Regulatory Affairs

Tel: (703) 903-3189
Fax: (703) 903-4503
lisa_ledbetter@freddiemac.com

8200 Jones Branch Drive
MS 211
McLean, VA 22102-3110

By Comments Online process at: http://comments.cftc.gov

January 18, 2011

David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Advanced Notice of Proposed Rulemaking: Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies; RIN 3038-AD99

Dear Secretary Stawick:

Freddie Mac is pleased to submit these comments in response to the Advanced Notice of Proposed Rulemaking regarding the appropriate model for protecting margin posted by customers clearing swaps, published by the Commodity Futures Trading Commission (the "Commission") on December 2, 2010 (the "Advanced Notice")[1] pursuant to Section 724 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

Freddie Mac was chartered by Congress in 1970 with a public mission to stabilize the nation's residential mortgage markets and expand opportunities for homeownership and affordable rental housing. Our statutory mission is to provide liquidity, stability and affordability to the U.S. housing market. Freddie Mac uses swaps to hedge large-scale commercial risks on an ongoing basis. Freddie Mac currently operates under the direction of the Federal Housing Finance Agency as our Conservator.

Freddie Mac supports the swap-clearing goals of the Dodd-Frank Act and has been an early advocate in favor of, and participant in, swap clearing. With regard to cleared swap collateral, we believe that requiring derivatives clearing organizations ("DCOs") to provide full physical segregation to individual customers on an optional basis provides the best method to protect customers of futures commission merchants ("FCMs") and achieve the goal of the Dodd-Frank Act to reduce systemic risk. [2]

---

[1] 75 Fed. Reg. 75162.

[2] In the Advanced Notice, the Commission requested views on whether certain language differences between Sections 4d(a) and (b) of the Commodity Exchange Act ("CEA") (regarding segregation of futures collateral) and Sections 4d(f)(2) and (6) of the CEA added by Dodd-Frank (regarding segregation of swaps collateral) evince Congressional intent to require individual segregation of swap collateral. We believe that the Dodd-Frank Act both permits individual segregation, and evinces Congressional intent for the Commission to exercise its authority to provide for protection of swap customer assets that must be left in the custody of FCMs and DCOs.

I. Individual Segregation Best Protects Customers and Reduces Systemic Risk

Freddie Mac urges the Commission to require DCOs to provide for segregation of customer collateral. Currently, Freddie Mac and other buy-side market participants can protect collateral that they provide to swap dealers in over-the-counter ("OTC") derivatives transactions through use of segregated accounts at third party custodians. By contrast, the mandatory clearing requirement of the Dodd-Frank Act constrains the ability of swap counterparties to employ contractual arrangements to protect their collateral. As a result, the custodial risks imposed on swap customers are largely dependent on the rules established by the Commission and DCOs. Such rules should enhance, or at least not diminish, the ability of swaps customers to protect their collateral.

Futures-style omnibus segregation (the "Baseline Model" as described by the Commission) exposes customers to risk that their collateral will be used by a DCO to make up shortfalls in collateral posted by other customers in the event of an FCM bankruptcy ("third-party customer risk"). Mandating third-party customer risk on cleared swap transactions would be disadvantageous for individual institutions and the markets as a whole. Under the Baseline Model, swaps customers would be forced to assume risk exposure to third parties with substantially different (and potentially much more risky) transaction profiles. Under this model, hedging parties using relatively plain-vanilla swaps, such as Freddie Mac, would be exposed to loss mutualization risk with speculators using more exotic products. While futures customers may not have experienced significant losses due to third-party customer risk in the past, neither the likelihood nor the magnitude of losses that cleared swaps customers could face due to third-party customer risk in the future can be predicted with any certainty or discounted.

In this regard, we note that clearable OTC swaps are a different asset class than futures. The risks that omnibus clearing poses for swaps customers are likely to be significantly greater than they are for futures customers (assuming swaps and futures are kept in different account classes) for several reasons. As a whole, a cleared swaps account is likely to include much more diverse products than a futures account, and some of the products in the swaps account class (for example, credit default swaps) may present risk characteristics that are difficult to model. Since DCOs will need to use different margin models for various swap types, those models could spread risk in markedly uneven ways across customers using different types of contracts. Moreover, some swaps markets may be significantly more concentrated than listed futures markets, and it is not yet clear how broad the risk pool(s) will be for cleared swaps (or even which swaps will be subject to mandatory clearing). Pooling risk among swap customers trading such different products not only would expose customers to third-party risk, it may do so in a context where the base across which risks would be spread may not be particularly broad, losses could be high, and a few high-risk customers in the pool could pose a significant danger to the collateral of others.

Moreover, customers are not in the best position to anticipate the potential loss exposures imposed on them in the Baseline Model or protect themselves from it. In addition to the inherent complexities of risk modeling for the universe of swaps products, customers do not know which other customers would be in their risk pool, nor are they able to obtain the information necessary to assess third-party risk. As a result, omnibus segregation would permit FCMs to take on risky customers and impose third-party customer risk on others without transparency. In effect, the Baseline Model subsidizes DCOs, FCMs and their riskiest customers at the expense of customers presenting less risk.

While individual margin segregation may impose additional operational requirements on DCOs and requires robust default management systems, individual customer protection would not increase overall systemic risk. Indeed, risk spreading among cleared swap customers through application of the futures-style omnibus segregation could increase systemic risk. Swap customers may be systemically significant institutions under the Dodd-Frank Act, and the potential for large losses to such institutions from non-transparent exposures is a form of potential systemic risk. Risk spreading among customers could also encourage "runs" on FCM accounts in the face of volatile markets and negative rumors, which could drain liquidity from the markets in times of stress. Additionally, such risk spreading could create moral hazard for system participants by permitting FCMs and DCOs (who are the proper managers of the risk posed by their customers) to shift risks from defaulting customers to their other customers, thereby decreasing their incentives to properly manage risk and defeating the policies behind a "defaulter pays" system of clearing.

II. Full Physical Segregation and Optional Individual Segregation are the Best Approaches

The "Full Physical Segregation" model proposed by the Commission provides the best solution to limiting customer exposure to third-party customer risk. This model is the most robust and straightforward model of customer protection. While we understand that "Legal Segregation with Commingling" could prove less operationally burdensome for DCOs during normal times, we believe that the Full Physical Segregation model would be less prone to errors and confusion that could undermine the legal advantages of segregation, particularly in times of stress. For example, recent experience shows that the books and records of failed financial intermediaries can be difficult to untangle. Since the Legal Segregation with Commingling model requires the DCO to allocate commingled assets to different customers of a bankrupt FCM based on records provided by the FCM, problems with those books and records could interfere with the DCO's allocation process.

In addition, requiring DCOs to provide individual segregation on an optional basis is the best way to achieve the Commission's twin goals of maximizing customer protection and minimizing cost. This approach will permit customers to decide for themselves whether the incremental costs of individual segregation outweigh the hidden costs of non-defaulting customer subsidization and the risks of loss mutualization under the Baseline Model. Optional margin segregation should also foster competition and provide incentives to DCOs to develop models and capacities that most efficiently deliver the protections of centralized clearing to the marketplace. Moreover, as individual segregation exists in the marketplace today, and may further develop in non-U.S. markets, it would be premature and disadvantageous to U.S. customers to foreclose such competition in the U.S.

While moving non-defaulting customer collateral to the back of a clearing organization's "risk waterfall" could provide some protection to customers not available under the Baseline Model, this solution would be less preferred than individual segregation for several reasons. First and foremost, this model would mitigate, but not eliminate, exposure of a non-defaulting customer to third-party customer risk. Non-defaulting customers would still be exposed to (and effectively forced to subsidize the margin contributions and risk positions of) riskier third-parties of which they have no knowledge. Moreover, this approach could be undermined by DCOs and FCMs by underfunding guarantee pools placed ahead of customers in the risk-waterfall and could, in fact, incent them to do so. Even under this model, customers would not truly be at the "back" of a risk waterfall since DCOs generally have rights to assess their members for additional contributions in the event that the funded assets in the waterfall are

exhausted. FCMs potentially could shift risk "behind" customers by underfunding the paid-in portion of a waterfall and moving financial commitments from pre-funded contributions to unfunded assessments.

III. Arguments Against Individual Segregation are Unpersuasive

Moral Hazard and Systemic Risk

Some observers have suggested that individual segregation will increase "moral hazard" on the part of customers by reducing incentives for customers to "risk-manage" their FCMs and direct business to FCMs based on safety and soundness. We believe this argument reverses the incentives and priorities of a properly managed clearing system. Customers do not have, and cannot obtain, the information necessary to monitor third-party customer risk inside an FCM and are under no obligation, and should not be obligated, to try to do so. As an institution, Freddie Mac is not interested in allowing other trading parties to gain visibility into our trading positions and practices, and we would not expect to gain visibility into the positions and practices of other parties. FCMs (and the DCOs of which they are members and participants) are the parties that have the information to monitor customer swap risk and are the proper parties to best manage that risk from both a policy and an economic perspective. Customers necessarily rely to a large extent on DCOs to monitor the risk of FCMs as well as the Commission to provide oversight, capital standards, and prudent risk management requirements.

In fact, the risk of moral hazard is precisely the opposite of that which sell-side institutions have suggested. Namely, in the Baseline Model, FCMs (with superior information about customer risk) have the ability to shift risks onto their customers. Permitting such risk shifting would skew the incentives of FCMs toward excess leverage and inadequate capitalization.

While it is not the job of customers to risk manage other customers, we do not believe that individual segregation would create moral hazard or inadequate incentives for customers to do business with FCMs based on safety and soundness. Bankruptcy risk is inherently unpredictable, and FCM customers would still need to be concerned about the potential for disruption or loss that would likely result from a bankruptcy. At a minimum, the trading delays and interruptions in the ability to manage assets that can attend to any FCM bankruptcy would pose significant costs and risks to an FCM's customers. Further, insolvency or the threat of insolvency inevitably impairs the efficiency of a market intermediary and multiplies its commercial, legal and operational burdens, and presents opportunities and inherent conflicts to the detriment of its customers.

Costs

A number of FCMs and DCOs have argued that individual segregation will raise costs for customers. While individual segregation could raise certain costs, customers and other market participants should determine for themselves if they would be willing to bear those costs. In the context of cleared derivatives, we do not believe that additional operational costs or increased margin requirements under a true "defaulter pays" model outweighs the cost that customers could bear as a result of assumption of third-party customer risk.

In conducting its analysis, the Commission should take care to assess costs from all relevant perspectives. In the OTC market, third-party collateral segregation is frequently an efficient

solution to exposure to collateral risk. Similarly, individual segregation for swaps customers is likely to be far less costly for such customers and the economy as a whole than a regime in which each customer is (hypothetically) required to conduct independent diligence to determine if its FCM is properly risk managing third parties and reserving against potential losses (assuming such diligence is even possible). Moreover, although margin requirements might be lower in the Baseline Model than under individual segregation, this may be the case only because customers are effectively forced to subsidize each other in non-transparent ways. To the extent that a true "defaulter pays" model increases transparency and better aligns costs with risks, it would permit for better (and more efficient) risk transfer and credit decisions.

As to operational costs, we would not expect those costs to be great. As already noted, individual segregation is routinely provided by custodian banks in the OTC markets today. We understand that DCOs already can and do generally monitor posted collateral at the customer level.

Direct Clearing

Some parties have suggested that buy-side institutions that do not want to be exposed to fellow customer risk could become clearing members of DCOs and self-clear their derivatives trades. While the potential for greater self-clearing may be worth exploring, we believe that few buy-side institutions would qualify for self-clearing under standards similar to those currently in place at most DCOs. Similarly, DCOs may have limited capacity to directly monitor large numbers of self-clearing institutions. In addition, certain buy-side institutions may have legal or regulatory restrictions making self-clearing not a viable option. Finally, we are concerned that a system based on self-clearing could simultaneously impose pressure on DCOs to lower their membership standards and create an unequal playing field among buy-side institutions, potentially resulting in increased systemic risk.

* * *

Freddie Mac appreciates the opportunity to provide our views in response to the Advanced Notice. Please contact me if you have any questions or would like further information.

Sincerely,

Lisa M. Ledbetter