**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. Please refer to the "Margining of Agency MBS" section on the TMPG website for additional details.

November 26, 2012

**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.
>
> 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 margining 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."

**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 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.

**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 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?**

The TMPG agreed that a risk-based approach to margining would focus first on the margining of agency MBS forward-settling transactions because this forward exposure presents the greatest risks. 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 forward transactions in the Treasury, agency debt and agency MBS markets at a future date.

**What is the effective date of the recommended margining practice?**

Recognizing that it will take time for market participants to put in place the necessary written agreements and related operational infrastructure for margining agency MBS transactions, the TMPG recommends that firms implement the margining practice on a rolling basis beginning immediately, and complete the process by early June 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 agreements covering agency MBS forwards should also typically provide that unsettled agency MBS transactions with a counterparty that has defaulted may be canceled and otherwise liquidated.

The Securities Industry and Financial Markets Association recently released an updated version of its Master Securities Forward Transaction Agreement, providing a legal framework for agency MBS forward trading and the margining of such transactions. Market participants may also choose to use existing forward trading and margining agreements or draft their own 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.