

July 11, 2011

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Mr. Robert E. Feldman
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Mr. Alfred M. Pollard
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Federal Housing Finance Agency
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Re: Comments on Proposed Rules Related to Margin for Non-cleared Swaps
Board: Margin and Capital Requirements for Covered Swap Entities [Docket
No. R-1415] (RIN 7100 AD74)
FCA: Margin and Capital Requirements for Covered Swap Entities (RIN
3052-AC69)
FDIC: Margin and Capital Requirements for Covered Swap Entities (RIN
3064-AD79)
FHFA: Margin and Capital Requirements for Covered Swap Entities (RIN
2590-AA45)
OCC: Margin and Capital Requirements for Covered Swap Entities [Docket
No. OCC-2011-0008] (RIN 1557-AD43)

Deutsche Bank AG ("**DBAG**" and, together with its affiliates, "**Deutsche Bank**") appreciates the opportunity to provide comments to the Board of Governors of the Federal Reserve (the "**Board**"), the Farm Credit Administration (the "**FCA**"), the Federal Deposit Insurance Corporation (the "**FDIC**"), the Federal Housing Finance Agency (the "**FHFA**") and the Office of the Comptroller of the Currency (the "**OCC**" and, together with the Board, the FCA, the FDIC, and the FHFA, the "**Prudential Regulators**") with respect to your proposal ("**Proposed Rules**") regarding margin and capital requirements for covered swap entities, as such term is defined in the Proposed Rules ("**CSEs**").¹ The Proposed Rules were issued under

¹ Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 91, 27,564 (proposed May 11, 2011) (to be codified at 12 C.F.R. pts. 45, 237, 324, 624, 1221), available at <http://www.gpo.gov/fdsys/pkg/FR-2011-05-11/pdf/2011-10432.pdf> [hereinafter *Proposed Rules*].

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“**Dodd-Frank**”).

Overview

Sections 731 and 764 of Dodd-Frank require that the Prudential Regulators adopt rules for swap dealers, security-based swap dealers, major swap participants and major security-based swap participants, imposing capital and initial and variation margin requirements on all non-cleared swaps and security-based swaps.² These sections of Dodd-Frank provide further that, to offset the greater risk to CSEs and the financial system arising from non-cleared swaps, these capital and margin requirements must “(i) help ensure the safety and soundness of the swap dealer or major swap participant; and (ii) be appropriate for the risk associated with the non-cleared swaps held as a swap dealer or major swap participant.”³ The Proposed Rules prescribe, with respect to a swap entered into between a CSE and a counterparty, minimum amounts of initial and variation margin, permissible initial and variation margin threshold amounts, requirements for segregation of margin, and frequencies of valuation and collection of margin amounts, depending on the type of counterparty. In calculating initial margin, CSEs may elect to use either a proposed “look-up” table, which would determine initial margin as a percentage of gross notional amount, or a CSE’s internal risk management model approved by the applicable Prudential Regulator. Internal models, however, would need to be benchmarked periodically against a clearinghouse model so that initial margin for non-cleared swaps generally would be no less than initial margin required by clearinghouses for similar transactions.

Deutsche Bank supports margin requirements as a means of reducing the risks to swap entities and the financial system of potential counterparty defaults. Such forms of collateralization are essential components of prudent risk management with respect to derivatives. We fully agree with the Prudential Regulators’ assessment that such risk management should be tailored to:

“take into account the relative risk of a covered swap entity’s activities in establishing . . . the minimum amount of initial and variation margin that it must collect . . . and . . . the frequency with which [it] . . . must calculate and collect variation margin” (emphasis added).⁴

We do not believe, however, that the broad-brush distinctions made in the Proposed Rules between types of derivatives counterparties are in fact useful in distinguishing among the risks posed by each type. We are concerned that the Prudential Regulators’ overly prescriptive approach will lead to unnecessary costs, inefficiencies and illiquidity without a corresponding benefit in reduced risks. Overly burdensome requirements on margin and margin segregation will generate a substantial cost to the economy due to a reduction in available liquidity and the supply of capital. The estimated hundreds of billions of dollars (if not trillions) of liquid assets to be held in

² For simplicity, we hereafter generally refer to both swaps and security-based swaps as “swaps” and major swap participants and major security-based swap participants as “major swap participants.”

³ See 7 U.S.C. § 6s(e)(3)(A); 15 U.S.C. § 78o-8(e)(3)(A) (2010).

⁴ *Proposed Rules*, *supra* note 1, at 76 Fed. Reg. 91, 27567.

collateral could otherwise be used for reinvestment in the economy and job creation. Deutsche Bank believes that applying internal models on a counterparty-by-counterparty basis will provide for optimal risk management without requiring excess margin.

We also question the implicit assumption underlying the Proposed Rules that all non-cleared swaps are *inherently* riskier than cleared swaps.⁵ In our view, Congress' reference to the "greater risk" to CSEs and the financial system arising from the use of non-cleared swaps describes the circumstances that would prevail without the imposition of requirements for heightened risk management of non-cleared swaps. Thus, the statement does not refer to the inherent nature of non-cleared swaps, but serves as the rationale for Congress to require the imposition of initial and variation margin requirements. The actual operative statutory language is found in Section 731's "Standards for Capital and Margin," which directs the regulators to impose requirements that "help insure the safety and soundness of the swap dealer or major swap participant and **[that are] appropriate for the risk associated with the non-cleared swaps . . .**" (emphasis added).⁶ The statute does not require that margin requirements for all non-cleared swaps be in excess of those applicable to cleared swaps. Rather, we believe that the objective of the statute is to expand the current practice of collecting margin to encompass all counterparties (other than nonfinancial end-users) and ensure that the amount of margin collected is appropriate for the risk actually associated with the particular non-cleared swap. Such an interpretation would fulfill the goal of Dodd-Frank by significantly mitigating the risks perceived to have contributed to the financial crisis but without needlessly trapping a vast amount of capital as excess collateral.

To the extent existing models and market practices meet the objectives of Dodd-Frank – and we believe that certain best practices of a number of swap dealers do – they should form the basis for the initial and variation margin requirements imposed by, and subject to the inspection and supervision by, the Prudential Regulators.

Calculation of Initial Margin

Deutsche Bank believes that the appropriate method to calculate initial margin is the use of valuation models developed by CSEs. These models are at the core of current market practice for margining non-cleared swaps in connection with the Credit Support Annex ("**CSA**") published by ISDA. As part of their lending businesses, well-managed and supervised CSEs are experienced at making the nuanced credit determinations necessary for unsecured lending. In the swap context, CSEs' initial margin models similarly would be designed to take account of the unique set of factors presented by individual counterparties and asset classes. Such models would reflect offsetting exposures, diversification and other hedging benefits, as well as the particular credit risk concerns, relating to a particular counterparty.

⁵ For example, the difference between a non-cleared USD interest rate swap and a cleared USD interest rate swap may be that the non-cleared USD interest rate swap has a slightly longer maturity. Both swaps may have similar risk profiles, yet the Proposed Rules would prescribe disparate treatment for the two swaps, even in the absence of any risk-based reasons for the differentiation.

⁶ 7 U.S.C. § 6s(e)(3)(A).

The Proposed Rules, while permitting the use of models, are excessively prescriptive in setting limitations on their design and use. First, the allowed models do not adequately distinguish between counterparties based on counterparty risk. Further, the Proposed Rules would only permit models when applied across transactions executed under the same qualifying master netting agreement and within the four broad risk categories (commodity, credit, equity, foreign exchange/interest rates).⁷ In addition, the Proposed Rules would require that internal models cover at least 99% of price changes over a 10-day liquidation horizon.

Currently, swap dealers rarely collect initial margin from one another. The Proposed Rules, however, would require a CSE to collect, and hold in a segregated third-party account, initial margin with a zero threshold from counterparties that are either swap dealers or major swap participants. This requirement is based on the assumption that:

“[n]on-cleared swaps transactions with counterparties that are themselves swap entities pose risk to the financial system because swap entities are large players in swap and security-based swap markets and therefore have the potential to generate systemic risk through their swap activities. Because of their interconnectedness and large presence in the market, the failure of a single swap entity could cause severe stress throughout the financial system.”⁸

This is not necessarily true in the case of swap dealers. The term “swap dealer” is defined functionally, regardless of the size of the swap dealer or its potential for financial risk to the financial system.⁹ Consequently, the requirement to collect and segregate initial margin from swap entities would cause the amount of segregated margin to double in any transaction involving two swap entities without any significant corresponding increase in risk exposure.¹⁰ The Proposed Rules should allow CSEs to use their internally designed models to determine whether initial margin should be

⁷ The Proposed Rules also provide for a standardized look-up table that we believe is overly simplistic. The table may give rise to material miscalculations, resulting in the collection of either insufficient or excessive initial margin, in each case failing to fulfill the Congressional mandate of imposing margin requirements that are “appropriate for the risk.” Consequently, the table becomes expensive to apply and punitive in nature. Deutsche Bank does not believe that the table as proposed provides an adequate alternate to modeling, or that it will be employed by CSEs calculating initial margin requirements.

⁸ *Proposed Rules*, *supra* note 1, at 76 Fed. Reg. 91, 27570.

⁹ The proposed definition of swap dealer does include a de minimis exception for persons that: (i) over the course of the preceding 12 months, enter into swap positions having an aggregate gross notional amount of no more than \$100 million and have an aggregate gross notional amount of no more than \$25 million with regard to swaps in which the counterparty is a special entity; (ii) have not entered into swaps in connection with those activities with more than 15 counterparties, other than swap dealers; and (iii) have not entered into more than 20 swaps in connection with those activities. See Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant,” 75 Fed. Reg. 80174 (proposed December 21, 2010), *available at* <http://edocket.access.gpo.gov/2010/pdf/2010-31130.pdf>. The exception is set so low, however, that it does not set a level of systemic significance, and consequently systematically insignificant entities fall under the broad definition of swap dealer.

¹⁰ The effect doubles again whenever a swap dealer acts as an intermediary between two other swap dealers. If Deutsche Bank were to be the intermediary for a swap with Dealer A on one side and Dealer B on the other, Deutsche Bank would be required to collect initial margin from both and post initial margin to both. Because that margin cannot be rehypothecated, this transaction would require four times the initial margin despite no significant change in the risk profile of the trade.

collected from counterparties, especially other swap entities, in order to prevent excessive margin from being collected.

We believe that limiting netting to a single asset class is unnecessary. In the Proposed Rules, the Prudential Regulators state their preliminary view that “the correlations of exposures across broad risk categories are not stable enough to be incorporated into a regulatory margin requirement.”¹¹ We believe that there are significant and stable correlations between certain sets of transactions across risk categories. For example, the Proposed Rules would provide no netting benefit for a counterparty that purchased credit default swap protection and entered into an equity swap on the same issuer. These two transactions have a closer correlation than do two credit default swaps or two equity swaps on different issuers. In our view, netting across broad risk categories should not be prohibited and internal models should be allowed to take into account appropriate risk offsets, regardless of the risk category.

We also believe that the “one size fits all” 10-day liquidation horizon does not adequately take into account the factors relevant to a particular transaction and the close-out periods provided for under the relevant documentation. Since the liquidation time horizon aims to capture potential price changes that may occur in the time it would take to unwind a swap, the horizon should be based on the time necessary to replace or hedge the risks of a particular swap. Current market experience shows that highly liquid swaps need less time to unwind than less liquid swaps.¹² A 10-day horizon for non-cleared swaps implies a presumption of illiquidity that is not necessarily warranted. In fact, there are reasons for the liquidation time horizon for non-cleared swaps to be shorter than those for cleared swaps. Clearinghouses operate on the basis of a matched book: for every “long” trade on its books, the clearinghouse must have an identical and offsetting “short” trade on its books. Therefore, upon a default, it must replace the terminated transaction with an identical offsetting position. In contrast, CSEs do not need to hedge through a matched book. Instead, they have the flexibility to unwind existing hedges, enter into replacement transactions or enter into new transactions that hedge the risks of the defaulted transaction, but need not be identical to the defaulted transaction.

Thus, CSEs can often offset a defaulted transaction more quickly than clearinghouses. Moreover, a rigid time horizon disregards the practical reality that many non-cleared swaps may be no more illiquid or risky than similar cleared swaps. In sum, we believe that ten days is a significantly longer time horizon than needed for many non-cleared swaps, and such a horizon would lead to significantly higher initial margins than is appropriate for the risk.¹³

¹¹ *Proposed Rules*, *supra* note 1, at 76 Fed. Reg. 91, 27580.

¹² For example, clearinghouses currently use time horizons of one day for exchange traded swaps and five days for off-exchange swaps on the reasonable presumption that unwinding an off-exchange swap may take additional days.

¹³ We note that the CFTC has proposed a minimum liquidation time horizon of one day for cleared swaps traded on exchange and five days for cleared swaps traded off-exchange, regardless of whether any actual differences in risk profile exist between the swaps. In our view, the setting of initial margin requirements should be based on the risks associated with the particular swap, and swaps with similar risk profiles should be subject to similar initial margin requirements. Otherwise, the initial margin requirements may produce arbitrary and unnecessarily punitive results.

Thresholds

Deutsche Bank is concerned that the Proposed Rules arbitrarily apply zero threshold amounts to swap dealers, major swap participants, and high-risk financial end-users and capped threshold amounts to low-risk financial end-users. Threshold amounts effectively operate as an unsecured, limited line of credit from CSEs to their counterparties. As banks, CSEs are in the business of offering uncollateralized loans and limited lines of credit and have the market experience to develop risk-sensitive models setting those limits.¹⁴ Arbitrarily imposing a zero or capped threshold requirement would represent a substantial increase in collateral requirements from what currently exists in the marketplace and would lead to a reduction in the liquidity of swap transactions.

Currently, the risks of transacting with financial end-users are assessed on a counterparty-by-counterparty basis, and thresholds are common. Under the Proposed Rules, financial end-users are categorized together as either “high-risk” or “low-risk,” where high-risk financial end-users must have zero thresholds with variation margin collected weekly, regardless of their actual risk profile, and low-risk financial end-users may have capped thresholds. These broad prescriptive categories do not sufficiently distinguish between the actual risk profiles of different types of financial end-users.¹⁵ Deutsche Bank believes that its internal models would be better able to tailor threshold requirements to counterparties. Deutsche Bank further believes that threshold amounts should not be capped, especially for truly low-risk end-users.

Additional Issues

Deutsche Bank would also like to draw the Prudential Regulators’ attention to additional issues arising out of the Proposed Rules that we believe should be reevaluated.

Certain Entities Should be Excluded from the Proposed Rules

The Proposed Rules should incorporate limitations to the definition of financial entity specified in Dodd-Frank. Section 723 excludes from the definition of financial entity certain end-users, including captive finance vehicles¹⁶ and certain of

¹⁴ The Prudential Regulators explicitly acknowledge this point in the discussion of non-financial end-users in the Proposed Rules, where they state their preliminary belief that a determination of whether to collect margin from non-financial end-users based on credit limits established “under appropriate credit processes and standards” is consistent with the statutory requirement that the margin requirements be risk-based. *Proposed Rules, supra* note 1, at 76 Fed. Reg. 91, 27570. We believe that the same approach should be applied to the question of threshold amounts for financial entities.

¹⁵ For example, registered investment companies and ERISA funds and other so-called “real money accounts” (i.e., accounts that typically have very low leverage) have low risk profiles and, in current market practice, generally do not post initial margin. On the other hand, hedge funds that employ relatively high amounts of leverage present a higher risk profile and, in current market practice, generally do post initial margin.

¹⁶ Section 723(a) of Dodd-Frank, which inserts Section (2)(h)(7)(C)(iii) into the Commodity Exchange Act (“CEA”) provides that the definition of financial entity “shall not include an entity whose primary business is providing financing, and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90 percent or more of which arises from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company.” 7 U.S.C. § 2(h)(7)(C)(iii). We refer to these entities as captive finance vehicles.

their affiliates.¹⁷ These entities do not pose significant risk to CSE counterparties or the financial system as a whole. Foreign sovereigns are also not included in the definition of financial entity under Dodd-Frank. Because foreign sovereigns represent a different credit risk analysis than financial institutions, they should not be considered financial entities under the Proposed Rules.

Furthermore, transactions with bankruptcy-remote special purpose vehicles and affiliates of the CSE should be excluded from the ambit of the Proposed Rules. These types of counterparties present low risk profiles, and current market practice is to not collect margin from these counterparties. Counterparties to special purpose vehicles are generally protected through other arrangements, such as placing counterparties at the top of the waterfall in the deal structure. Yet, under the Proposed Rules, each of these counterparty types is likely to fall outside of the limited regulatory category of “low-risk financial end-user.” Deutsche Bank strongly recommends that these entities be excluded from the definition of financial end-user.

In the same vein, the Proposed Rules should not apply to nonfinancial end-users. As the Prudential Regulators correctly noted, CSEs do not generally collect margin from these counterparties.¹⁸ Subjecting nonfinancial end-users to mandatory margin requirements, even with thresholds, would significantly and unnecessarily increase the cost of entering into swaps for nonfinancial end-users. We strongly believe that sections 731 and 764 of Dodd-Frank were not intended to require margin to be collected from nonfinancial end-users.

Timing of Collateral

Current market practice is to provide for the calculation of margin requirements as well as for the valuation of collateral at the close of business on the trade date and notify the counterparty of the required margin on the next trading day, with the margin to be posted on the following trading day. This settlement period reflects the practical limitations of the global banking and payments processing systems and allows counterparties to deliver suitable collateral to CSEs in a commercially reasonable amount of time after entering into the swap. The Proposed Rules, however, provide that CSEs must comply with initial margin requirements beginning “on or before” the date it enters into the swap. This would limit trades with domestic counterparties as the intra-day cut-off for swap execution would need to be early enough to ensure posting of collateral, and it would greatly restrict trades with foreign counterparties whose differences in time zones would make it difficult to post payment on the trade date.

In order to comply with the Proposed Rules, counterparties would have to post margin before executing the swap. Posting “pre-margin” is inefficient and

¹⁷ Section 723(a) of Dodd-Frank, which inserts Section 2(h)(7)(D) into the CEA provides that, in general, “an affiliate of a person that qualifies for an exception under subparagraph (A) (including affiliate entities predominantly engaged in providing financing for the purchase of the merchandise or manufactured goods of the person) may qualify for the exception only if the affiliate, acting on behalf of the person and as an agent, uses the swap to hedge or mitigate the commercial risk of the person or other affiliate of the person that is not a financial entity.” 7 U.S.C. § 2(h)(7)(D).

¹⁸ *Proposed Rules*, *supra* note 1, at 76 Fed. Reg. 91, 27570 n. 37 (“In the case of a nonfinancial end user with a strong credit profile, under current market practices a derivatives dealer would not require margin – in essence, it would extend unsecured credit to the end user with respect to the underlying exposure.”).

expensive for counterparties who would have to post collateral before receiving the benefits of the swap. Additionally, since the amount of initial margin is not set prior to the time of execution of a trade, any pre-margin would only be an estimated amount, requiring an adjustment on or after the trade day. Multiple transfers of collateral would be required, which unnecessarily increases transaction costs.

Deutsche Bank believes that CSEs are not exposed to such significant risk over the settlement period to warrant these additional costs and inefficiencies. Moreover, CSEs monitor against risks associated with these transactional frictions. Consequently, we strongly recommend that the Prudential Regulators modify the Proposed Rules in order to allow a customary settlement period for the posting of initial margin.

Types of Eligible Collateral Should not be Limited

Under the Proposed Rules, only a limited list of highly liquid types of property may be collected for required initial and variation margin. Deutsche Bank believes that this requirement is too prescriptive. Limiting eligible collateral to only such liquid assets is an inefficient use of capital that could otherwise be used for reinvestment in the economy. As banks, CSEs are well suited to, and well versed in, determining which types of assets should be posted as collateral for a given transaction. Both CSEs and swap counterparties should be allowed to negotiate which asset types will be accepted for a given swap, thereby not unnecessarily tying up liquidity.

Segregation of Variation Margin Posted by Regulated Entities Should not Be Required

Under the Proposed Rules, variation margin posted by entities regulated by the FHFA or the FCA ("**Regulated Entities**") to CSEs is required to be segregated. There are no such requirements for any other counterparties, and Dodd-Frank does not require it. Deutsche Bank believes there is no reason to impose such a requirement and treat these entities differently. Requiring CSEs to segregate variation margin collected from the Regulated Entities will increase costs for CSEs due to the inability to rehypothecate such collateral. Such cost increases serve as disincentives against CSEs entering into swaps with Regulated Entities, unless such additional costs are passed through to the Regulated Entities.

Internal Models Approved by Foreign Prudential Regulators Should Also Be Allowed

The Prudential Regulators should permit initial margin models approved by foreign prudential regulators. Dodd-Frank specifically aims to "promote effective and consistent global regulation of swaps" by mandating that the Prudential Regulators "coordinate with foreign regulatory authorities on consistent international standards."¹⁹ We believe that accepting margin models approved by foreign prudential regulators is precisely the type of regulation Congress intended because it harmonizes requirements across jurisdictions while leading to increased global regulatory vigilance. Not accepting these models increases costs, as CSEs would need to develop multiple models across jurisdictions.

¹⁹ Dodd-Frank § 752(a).

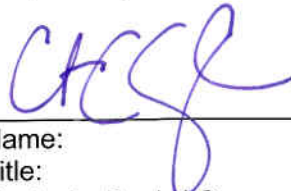
Retroactive Application of Proposed Rules to Pre-Effective Date Swaps

Swaps entered into prior to the effective date of the Proposed Rules should not be subject to the rules' margin requirements. The Proposed Rules permit a CSE to (i) calculate initial margin requirements on a portfolio basis, and (ii) calculate variation margin requirements under the Proposed Rules, for swaps under a qualifying master netting agreement with a counterparty. In the event the master netting agreement covered both pre- and post-effective date swaps, the CSE would be required to collect variation margin from the pre-effective date swaps in compliance with the Proposed Rules. Such a position changes the contractual terms of swaps in a manner not contemplated by either the CSE or the counterparty. Pre-effective swaps were entered into the years prior to the Proposed Rules, expecting to be managed and treated per the terms of their respective agreements. The Proposed Rules would unexpectedly change their terms. To avoid changing swap terms, CSEs would need to negotiate and enter into new agreements governing post-effective date swaps with every counterparty. Deutsche Bank believes that such a remedy would unnecessarily increase transaction costs to counterparties. The Prudential Regulators should modify the Proposed Rules to ensure that pre-effective date swaps will not be subject to margin requirements.

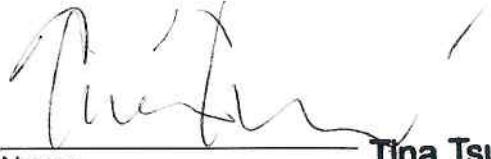
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Deutsche Bank appreciates the opportunity to provide the Prudential Regulators with the foregoing comments and recommendations regarding the Proposed Rules.

Respectfully submitted,



Name:
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