THE FARM CREDIT COUNCIL

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By Electronic Submission

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Re: Margin and Capital Requirements for Covered Swap Entities (RIN 1557-AD43, RIN 7100-AD74, RIN 3064-AD79, RIN 3052-AC69, RIN 2590-AA45)

Ladies and Gentlemen:

On behalf of its members, the Farm Credit Council is pleased to submit these comments on the proposed margin and capital requirements issued by the Farm Credit Administration (the "FCA"), Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and the Federal Housing

Finance Agency (the "FHFA" and, collectively, the "prudential regulators") under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[1]

The Farm Credit Council is the national trade association for the Farm Credit System, a government instrumentality created "to accomplish the objective of improving the income and well-being of American farmers and ranchers by furnishing sound, adequate, and constructive credit and closely related services to them, their cooperatives, and to selected farm-related businesses necessary for efficient farm operations."[2] Today, the Farm Credit System comprises five banks and 87 associations, which together provide 40% of agricultural lending in the United States. To provide tailored financing products for farmers and farm-related businesses, Farm Credit System institutions rely on the safe use of derivatives to manage interest rate, liquidity, and balance sheet risk, primarily in the form of interest rate swaps. For example, Farm Credit System institutions use interest rate swaps to create synthetic floating rate funding at longer maturities and lower cost than investors would typically be willing to offer for outright floating issuance. Because derivatives allow the Farm Credit System to offer reliable, low cost, flexible funding to the farmers and ranchers that borrow from, and cooperatively own, System institutions, the Farm Credit Council appreciates the opportunity to comment on the proposed margin and capital requirements.

I. Summary of Comments

The Farm Credit Council appreciates that margin requirements for swap dealers and major swap participants ("swap entities") are an important component of Dodd-Frank's framework for reducing systemic risk. Particularly for highly leveraged, lightly regulated financial institutions, we understand that Congress expects regulators to use margin requirements to control systemic risk. In directing regulators to set margin requirements for swap entities, however, Congress did not wish to impose substantial new margin-related costs on end users, including Farm Credit System institutions. Rather, Congress intended to preserve the Farm Credit System's ability to use derivatives safely to manage risk and continue to provide a dependable source of funding for farmers, ranchers, and rural America.

This congressional intent is consistent with the low risk profile of the Farm Credit System, which already responsibly manages exposure to its counterparties. Specifically, as of March 31, 2011, the Farm Credit System's total derivatives exposure net of collateral ($204 million) represented approximately 11 to 12 basis points of the System's total loan volume

[1] Pub. L. No. 111-203, 124 Stat. 1376 (2010). The proposed rules are set forth in Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27,564 (proposed May 11, 2011) (to be codified at 12 C.F.R. pts. 45, 237, 324, 624, and 1221) (the "Notice").

[2] 12 U.S.C. § 2001(a).

($177.5 billion). Such limited Farm Credit System exposure does not rise to the level of current concerns related to systemic risk or demonstrate a significant level of interconnectedness.

To preserve the Farm Credit System's ability to hedge risk and provide low-cost, dependable financing products for farmers, ranchers, and rural America, the Farm Credit Council respectfully offers the following comments:

- With respect to the proposed rules applicable to all covered swap entities:
  - Small financial institutions, including Farm Credit System institutions, should be treated as nonfinancial end users for purposes of margin requirements consistent with congressional intent and the end-user exception to mandatory clearing.
  - The prudential regulators should not set maximum initial and variation margin thresholds for low-risk financial end users, or if they do, those thresholds for net exposure should be set no lower than $40 million.
  - To permit more meaningful comment, the prudential regulators should provide further guidance on the circumstances that might result in entities that are not swap dealers or major swap participants being designated "covered swap entities."
  - With respect to the definition of "qualifying master netting agreement," the prudential regulators should clarify that an agreement will qualify for the definition regardless of whether the insolvency scheme applicable to either counterparty effectively stays the exercise of rights under the agreement.
- With respect to the proposed special rules applicable only to FCA- and FHFA-regulated entities:
  - Low-risk financial end users should not be required to collect margin from swap entity counterparties, and the decision to collect margin should be determined by the individual entity's risk management.
  - Consistent with market practice, variation margin should not be subject to segregation and rehypothecation restrictions.
  - Low-risk financial end users should be able to rely on initial margin models used by their swap entity counterparties.

- With respect to the effective date, Farm Credit System institutions will need more than 180 days from publication of final rules to comply with new margin requirements.

II. Proposed Rules for All Covered Swap Entities

A. Small Financial Institutions, Including Farm Credit System Institutions, that Qualify for the End-User Clearing Exception Should Be Treated as Nonfinancial End Users for Purposes of the Margin Requirements

The Farm Credit Council agrees that, for purposes of imposing margin requirements, "distinctions can be made between types of derivatives counterparties that are useful in distinguishing the risks posed by each type."[3] Under the proposed rules, Farm Credit System institutions will be classified as "low-risk financial end users" because, although they are financial institutions, they do not have significant swaps exposure, they use interest rate swaps to hedge or mitigate risks arising from their business, and they are subject to capital requirements established by the FCA.[4] The Notice asks, however, whether "counterparties that are small financial institutions using derivatives to hedge their risks [should] be treated in the same manner as nonfinancial end users for purposes of the margin requirements."[5] The Farm Credit Council urges the prudential regulators to clarify that small financial institutions exempt from mandatory clearing of swaps will be treated as nonfinancial end users for purposes of the margin requirements and will be exempted from all of the proposed rules in Section ___.11 that apply only to FCA- and FHFA-regulated entities.

1. Congress Did Not Intend to Impose Costly New Margin Requirements on Farm Credit System Institutions

Congress did not intend to impose costly new margin requirements on nonfinancial end users or small financial institutions. That is why Congress created the end-user clearing exception and required the Commodity Futures Trading Commission ("CFTC") to "consider whether to exempt small banks, savings associations, farm credit system institutions, and credit unions" from mandatory clearing.[6] Senators Dodd and Lincoln explained the end-user clearing exception as follows:

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[3] Notice, 76 Fed. Reg. at 27,567.

[4] *See id.* at 27,587 (proposed § ___.2(n)).

[5] *Id.* at 27,570.

[6] Pub. L. No. 111-203, § 723, 124 Stat. at 1680 (CEA § 2(h)(7)(C)(ii)).

> The legislation does not authorize the regulators to impose margin on end users, those exempt entities that use swaps to hedge or mitigate commercial risk. If regulators raise the costs of end user transactions, they may create more risk. It is imperative that the regulators do not unnecessarily divert working capital from our economy into margin accounts, in a way that would discourage hedging by end users or impair economic growth.[7]

Senators Dodd and Lincoln further explained that their concern about costly margin requirements applied equally to small financial institutions -- like Farm Credit System institutions -- that finance economic growth without creating systemic risk:

> The end user exemption also may apply to our smaller financial entities -- credit unions, community banks, and farm credit institutions. These entities did not get us into this crisis and should not be punished for Wall Street's excesses. They help to finance jobs and provide lending for communities all across this nation. That is why Congress provided regulators the authority to exempt these institutions.[8]

In enacting Dodd-Frank, then, Congress recognized that mandatory clearing and margin requirements were not appropriate for entities that did not cause the financial crisis. That is because these requirements would divert funds from more productive uses and discourage prudent risk management by raising the cost of hedging instruments.

Further, as we have argued in greater detail in a letter to the CFTC,[9] all Farm Credit System institutions should qualify for the end-user clearing exception. Recognizing the Farm Credit System's history of safe and sound operation, Congress specifically sought to avoid imposing new costs on, or disrupting the risk management practices of, Farm Credit System institutions.[10] In our comments to the CFTC, we suggested appropriate considerations should the

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[7] Letter from Sens. Dodd and Lincoln to Reps. Frank and Peterson, *in* 156 Cong. Rec. H5248 (daily ed. June 30, 2010).

[8] *Id.*

[9] *See* Letter from the Farm Credit Council to the CFTC Re: End-User Exception to Mandatory Clearing of Swaps (Feb. 22, 2011).

[10] *See, e.g.*, 156 Cong. Rec. H5246 (daily ed. June 30, 2009) (statement of Rep. Holden) ("These are just a few of the reasons why the Agriculture Committee insisted that the institutions of the Farm Credit System not be subject to a number of the provisions of this legislation. They were not the cause of the problem, did not utilize TARP funds, (continued…)

CFTC adopt either an asset-based or a risk-based test for determining end-user status. If the CFTC were to adopt an asset-based test for determining which financial institutions may qualify for the clearing exception, we urged the CFTC to consider the average assets of a Farm Credit System bank's affiliated lending organizations. Because of the Farm Credit System's unique cooperative structure, these small lending organizations engage in the System's retail lending to fulfill its mission. Their risk, however, is hedged through derivatives at the district-wide level by the Farm Credit System bank. The CFTC must therefore look through the bank to its affiliated lending organization to get an accurate picture of the small financial institutions in the Farm Credit System that Congress intended to qualify for the end-user clearing exception. If instead the CFTC decided to adopt risk-based factors for determining which entities warranted mandatory clearing, we believe Farm Credit System institutions should be exempt because they engage in safe, collateralized interest rate transactions, already have appropriate risk-management policies in place, and are appropriately regulated by the FCA.

2. Rigid Margin Requirements Would Have Little Regulatory Benefit Because Farm Credit System Institutions Use Safe Swaps and Already Responsibly Manage Credit Risk Through Bilateral Agreements

Strict margin requirements would not only be inconsistent with Congress's intent to preserve end users' ability to hedge risk without margin-related costs. They would also offer little risk mitigation benefit in the case of Farm Credit System institutions, which use safe interest rate swaps and already tightly manage credit exposure to counterparties. For these reasons, margin requirements should distinguish between the risk profiles of different categories of swaps in setting final rules.

The Farm Credit System already tightly manages credit exposure to its counterparties through bilateral collateralization of its non-cleared swaps. Specifically, each Farm Credit System institution requires swap entities to sign a master swap agreement that provides for the legal netting of swaps and includes a credit support annex with predetermined collateral thresholds. The collateral thresholds are low relative to bank capital and contain ratings triggers that reduce non-zero thresholds to lower levels if the credit rating of either counterparty declines to predetermined levels. This practice has limited uncollateralized credit exposure resulting from interest rate swaps to approximately 11 to 12 basis points of the Farm Credit System's total loan volume as of March 31, 2011. Such a low level of exposure does not threaten the safety and soundness of either Farm Credit System institutions or the United States financial system as a whole.

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and did not engage in abusive subprime lending. We have believed that this legislation should not do anything to disrupt this record of success.").

The Farm Credit Council therefore urges the prudential regulators to refine the proposed rules to account for the low risk nature of interest rate swaps and options used for hedging or mitigating risk. To address risk effectively, margin requirements should distinguish between different types of derivatives based on their respective risk profiles. Farm Credit System institutions primarily use plain vanilla, fixed-for-floating interest rate swaps, and materially all of our derivatives qualify for hedge accounting treatment. Farm Credit System institutions do not use swaps to speculate, and do not use the credit default swaps that contributed to the financial crisis. Unlike credit default swaps, interest rate swaps and options used by the Farm Credit System had nothing to do with the recent financial crisis, the government bailout of AIG, or the bankruptcy of Lehman Brothers. In joint proposed rules defining "major swap participant," the CFTC has drawn such a distinction by proposing a higher threshold of swaps exposure for rate swaps than for more complex or speculative instruments.[11] In short, the costs of margin for safe, collateralized interest rate swaps and options are not justified to the same extent as for the riskier credit default swaps that were a major cause of the financial crisis.

3. The Proposed Margin Requirements Would Raise Costs to Farm Credit System Institutions Without Materially Reducing Risk and Have Adverse Consequences for Farmers and Ranchers that Rely on the System for Financing

Although additional, new margin requirements would have questionable benefits for the types of transactions that the Farm Credit System responsibly uses, they would have significant adverse consequences for the farmers and ranchers that rely on the Farm Credit System for financing. The sixty-day comment period has not given the Farm Credit Council sufficient time to evaluate or quantify new costs, but we expect that margin requirements may make some risk mitigating transactions prohibitively expensive. This result is contrary to Congress's instruction that "the prudential regulators[] must not make hedging so costly it becomes prohibitively expensive for end users to manage their risk."[12]

Margin payments divert funds that could be used for loans to the farmers and ranchers that borrow from, and cooperatively own, the Farm Credit System. Financing costs are also associated, among other things, with meeting variation margin calls. In the case of Farm Credit System institutions, margin costs are compounded by existing capital requirements, which

[11] *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. 80,174, 80,187-94 (proposed Dec. 21, 2010) (to be codified at 17 C.F.R. pts. 1 & 240).

[12] Letter from Sens. Dodd and Lincoln to Reps. Frank and Peterson, *in* 156 Cong. Rec. H5248 (daily ed. June 30, 2010).

require each Farm Credit System bank to achieve and at all times maintain a net collateral ratio ("NCR") of at least 103%.[13] Because the NCR effectively subtracts collateral posted as initial and variation margin from the bank's capital,[14] it is very costly for a Farm Credit System bank to post large amounts of collateral to support interest rate swap activity when the costs of raising additional capital are added.

Ultimately, new margin costs will flow through to the farmers and ranchers that borrow from, and cooperatively own, Farm Credit System institutions in the form of higher effective interest rates and/or reduced loan availability. Higher hedging costs may also reduce the variety of fixed- and floating-rate loan products available to farmers and ranchers, because the increased cost of hedging the associated interest rate and liquidity risks may be prohibitive. Higher interest rates on loans or reduced loan availability would be harmful to agricultural production in the United States, and could lead to higher prices for consumers on agricultural products.

In summary, Congress did not intend to penalize American farmers and ranchers and ultimately the American consumer for the excesses of Wall Street banks and swap dealers. Instead, Congress intended to preserve the Farm Credit System's ability to use safe interest rate swaps in a safe and sound manner to hedge risk and provide dependable, cost-effective funding for farmers, ranchers, and rural America. It is therefore critical that Farm Credit System institutions, as well as other small financial institutions that should qualify for the end-user clearing exception, be treated as nonfinancial end users for purposes of the margin requirements.[15]

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[13] 12 C.F.R. § 615.5335.

[14] *See id.* §§ 615.5050, 615.5301.

[15] Unlike the prudential regulators, the CFTC has not proposed to impose margin requirements on transactions involving nonfinancial end users. *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23,732, 23,736 & n.13 (proposed Apr. 28, 2011) (to be codified at 17 C.F.R. pt. 23) (collecting authorities and stating, "The Commission believes that such entities, which are using swaps to hedge commercial risk, pose less risk to CSEs than financial entities. Consistent with Congressional intent, the proposal would not impose margin requirements on such positions."). Dodd-Frank requires the prudential regulators and the CFTC "to the maximum extent practicable, [to] establish and maintain comparable minimum capital requirements and minimum initial and variation margin requirements, including the use of non cash collateral, for -- (I) swap dealers; and (II) major swap participants." Pub. L. No. 111-203, § 731, 124 Stat. at 1706 (CEA § 4s(e)(3)(D)(ii)). Because we think that the CFTC's approach is more consistent with congressional intent, we urge the prudential regulators to adopt comparable rules that would not impose margin requirements on entities that qualify for the end-user clearing exception.

B. The Prudential Regulators Should Not Set Maximum Initial and Variation Margin Thresholds for Low Risk Financial End Users

As noted above, Congress did not intend to impose margin requirements on end users, including low-risk financial institutions like the Farm Credit System. Any specified initial or variation margin threshold is therefore inconsistent with Dodd-Frank and the key reason for implementing an end-user clearing exception. We believe Farm Credit System institutions will qualify for the end-user clearing exception. We therefore believe that Farm Credit System institutions should be treated as nonfinancial end users for which swap entities will be free to adopt initial and variation margin thresholds consistent with individualized risk assessment and responsible credit policies. If the prudential regulators treat Farm Credit System institutions as low-risk financial end users for purposes of margin notwithstanding the clearing exception, then the maximum initial and variation margin thresholds will be inappropriate and inconsistent with congressional intent.

Ultimately, as Congress has stated, it is critically important that margin requirements do not impede responsible risk management. Low-risk financial end users should not be treated in a "one size fits all" manner. Swap entities should retain flexibility to require less collateral for counterparties that pose less credit risk. Otherwise, low-risk financial end users of higher credit standing, like Farm Credit System institutions, will not be able to obtain sufficient margin thresholds and may therefore reduce their hedging activity. Accordingly, any margin thresholds should be set near the top of the prudential regulators' proposed range. We propose that, if the prudential regulators do set maximum initial and variation margin thresholds for low-risk financial end users, those thresholds should be set at no less than $40 million.

C. The Prudential Regulators Should Provide Additional Guidance on the Definition of "Covered Swap Entity"

The prudential regulators define "covered swap entity" as, for example, "any institution chartered under the Farm Credit Act of 1971, as amended (12 U.S.C. 2001 et seq.) that is a swap entity, or any other entity that the FCA determines."[16] Nothing in the Notice explains how the FCA or the other prudential regulators will determine which other entities may be so defined. Further, the Notice fails to identify the statutory authority for imposing margin requirements on entities that are not swap dealers or major swap participants.

Section 731 of Dodd-Frank adds Section 4s to the Commodity Exchange Act. Section 4s provides, among other things, that "[t]he prudential regulators, in consultation with the Commission and the Securities and Exchange Commission, shall jointly adopt rules *for swap dealers and major swap participants, with respect to their activities as a swap dealer or major*

[16] Notice, 76 Fed. Reg. at 27,594 (proposed 12 C.F.R. § 624.2(c)).

swap participant, for which there is a prudential regulator imposing -- (i) capital requirements; and (ii) both initial and variation margin requirements on all swaps that are not cleared by a registered derivatives clearing organization."[17] This section does not provide authority for the prudential regulators to adopt rules for entities that are not swap dealers or major swap participants. Nor does this section allow the prudential regulators to use their limited authority to set capital and margin requirements to override Dodd-Frank's other provisions, including the end-user clearing exception.

Accordingly, the Farm Credit Council urges the prudential regulators to provide further guidance on how they contemplate using this additional authority to designated "covered swap entities." Only then will entities subject to regulation by a prudential regulator be able to submit meaningful comments on this provision.

D. The Prudential Regulators Should Clarify the Definition of "Qualifying Master Netting Agreement"

The proposed rules use the term "qualifying master netting agreement" to specify instances when a covered swap entity may calculate variation margin on an aggregate basis across multiple swaps or calculate initial margin requirements under an initial margin model on a portfolio basis. Section ___.2(t), in turn, defines "qualifying master netting agreement" as an agreement that satisfies certain criteria, including that

> The agreement provides the covered swap entity the right to accelerate, terminate, and close-out on a net basis all transactions under the agreement and to liquidate or set off collateral promptly upon an event of default, including upon an event of bankruptcy, insolvency, or similar proceeding, of the counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions.[18]

We understand that laws governing certain financial institutions may limit whether counterparties may exercise rights to accelerate, terminate, or close out transactions under a master netting agreement in certain insolvency or bankruptcy scenarios. These laws may, for example, prohibit a counterparty from terminating a contract until the next business day after a receiver is appointed. Entities subject to such requirements -- and their counterparties --

[17] Pub. L. No. 111-203, § 731, 124 Stat. at 1705 (CEA § 4s(e)(2)(A)) (emphasis added).

[18] Notice, 76 Fed. Reg. at 27,588 (proposed § ___.2(t)(2)).

should not be deprived of the ability to calculate margin on an aggregate or portfolio basis because of independent federal regulatory restrictions designed to ensure orderly bankruptcy.

Accordingly, we urge the prudential regulators to clarify that orderly liquidation provisions restricting a counterparty's right to terminate an agreement for one business day will not fall within the "stay" limitation on the definition of "qualifying master netting agreement."

III. Low-Risk Financial End Users Should Not Be Subject to Special Rules for FCA- and FHFA-Regulated Entities

Unlike the other prudential regulators, the FCA and FHFA proposed special rules pursuant to their role as safety and soundness regulator for their respective regulated entities. Specifically, the proposed rules require FCA- and FHFA-regulated entities that are not covered swap entities to collect initial and variation margin from swap entities.[19] These requirements are not contemplated by Dodd-Frank, which only directs prudential regulators to prescribe margin requirements for certain swap dealers and major swap participants.[20] Further, the proposed rules would require initial margin and zero thresholds, and impose segregation and rehypothecation restrictions that are inconsistent with market practice and may prove prohibitively expensive without any significant reduction in risk. Finally, the proposed rules would place the burden of developing qualifying initial margin models on FCA- and FHFA-regulated end users that will be less able to bear associated administrative costs. Although the Farm Credit Council understands that these requirements may be motivated by the need to ensure the safety and soundness of large, risky financial institutions, we believe these rules are not warranted for smaller, low risk financial end users of swaps.

A. The Proposed Special Requirements Would Substantially Raise the Cost, or Limit the Availability, of Hedging Transactions Without Materially Reducing Risk

1. Mandatory Collection of Initial Margin and Zero Thresholds for Variation Margin

The proposed requirement that FCA- and FHFA-regulated entities collect both initial and variation margin from swap entities would substantially raise the costs of non-cleared interest rate swaps for Farm Credit System institutions. As the FCA and FHFA observe, Farm Credit System institutions generally do not post or collect initial margin on swaps.[21] A new

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[19] *See id.* at 27,582-83.

[20] *See* Pub. L. No. 111-203, § 731, 124 Stat. at 1705 (CEA § 4s(e)(2)(A)).

[21] Notice, 76 Fed. Reg. at 27,583.

initial margin requirement would therefore raise costs on swap entities, which will, in turn, be forced to recover those costs by raising prices for their FCA- and FHFA-regulated customers. AgriBank, the largest district bank of the Farm Credit System, estimates that, if its portfolio of interest rate swaps remained non-cleared, the requirement to collect initial margin alone would increase AgriBank's hedging costs by as much as $1 million to $2 million each year with only a limited reduction in risk to the bank. The other four Farm Credit System banks will face similar cost increases from the collection of initial margin. These increased costs will ultimately be borne by the farmers and ranchers in the form of more expensive loans or fewer, less tailored loan products.

The proposed special rules would also require posting of variation margin with zero thresholds. Farm Credit System institutions generally enter into credit support agreements, based on the institution's own risk management process, that provide for bilateral calls for collateral at thresholds set low relative to total capital. Imposing mandatory zero thresholds for all relationships will again increase costs to swap entities, which will, in turn, be forced to recover those costs by raising prices. Further, as noted, it is costly for Farm Credit System banks to have zero thresholds, because they will need incremental capital to maintain their NCR.

2. Segregation and Rehypothecation of Variation Margin

The proposed rule that FCA- and FHFA-regulated entities require that any funds they post to a swap entity as initial or variation margin be held by a third-party custodian and subject to rehypothecation, reinvestment, and other transfer restrictions will further raise costs. In extending segregation and rehypothecation restrictions to variation margin, as well as initial margin, this rule is inconsistent with market practice, as well as with the segregation rule adopted by other prudential regulators. Because swap entities often offset their own transactions with other swaps, they typically rehypothecate variation margin to other counterparties to satisfy their own variation margin requirements. Requiring that variation margin be segregated and prohibiting rehypothecation would therefore force swap entities to bear much higher costs and to pass those costs on to Farm Credit System institutions in the form of higher prices. AgriBank estimates that the segregation and rehypothecation restrictions could add another $1 million to $2 million each year to the cost of its hedging program, and the other Farm Credit System banks will face similar increases without achieving any significant reduction in risk to the institutions. These costly new requirements are not necessary for entities, like Farm Credit System institutions, that already safely manage counterparty credit risk through existing credit support agreements.

We do not believe it is necessary to segregate variation margin. Variation margin represents the market value of a transaction, or portfolio of transactions. If a party defaults, the close-out amount will reflect the current market value of the transactions, which will be the same value as the collateral. Therefore, it is unnecessary to ensure "safety" of variation margin. Also, the market value of the transactions can be replaced in a liquid market. So, segregating the variation margin will not make these transactions less risky. Accordingly, the reasons for applying segregation and rehypothecation restrictions to initial margin do not apply to variation margin.

More importantly, segregation of variation margin puts the Farm Credit System at a competitive disadvantage that will reduce liquidity, increase the difficulty of meeting margin calls, and ultimately make Farm Credit System institutions burdensome and unattractive counterparties. Put simply, we are concerned that mandatory segregation of variation margin would make swaps so costly that better managed swap entities will no longer want to transact with Farm Credit System institutions. It is unfair to single out FCA- and FHFA-regulated end users for these special requirements. If these less risky swap entities no longer want to deal with them, Farm Credit System institutions would be unable to manage risk effectively and to provide a full range of tailored financing products for their farmer and rancher borrowers. The increased burdens of these special regulations may also force the Farm Credit System to transact with riskier counterparties.

3. Initial Margin Models

Finally, the proposed requirement that initial margin be calculated using a model independent of the swap entity would raise still additional costs. Currently, although most Farm Credit System institutions do not post initial margin, they rely substantially on counterparty models for calculating variation margin. Based on this experience, swap entity models have proved to be accurate and have not resulted in unfair terms reflecting a conflict of interest. As a result, we do not expect that counterparty models for initial margin would be biased or inaccurate. Developing initial margin models would require increased staffing and higher administrative costs that would be better borne by larger counterparties. End users, like the Farm Credit banks and their affiliated associations, do not participate in enough transactions to make it cost effective for them to develop and maintain a model. Additionally, the cost of buying a model from a third party and subjecting that model to constant monitoring and auditing for accuracy might also be overly burdensome when compared to the benefits. Further, the proposed rules already require swap entity initial margin models to be consistent with regulations and best practices and to be no less conservative than those models generally used by derivatives clearing organizations and clearing agencies.[22] To the extent there is additional concern, it could be addressed by permitting counterparties, as well as regulators, to review the reasonableness of swap entity models.[23] Accordingly, there would be no significant added benefit from requiring

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[22] *Id.* at 27,579.

[23] *See id.* at 27,583 ("FHFA and FCA preliminarily believe that permitting a swap entity to use its own model to calculate the amount of initial margin it would be required to post to a regulated entity may introduce a conflict of interest to the transaction. That concern could be addressed by establishing a process through which the regulated entity could verify the reasonableness of the counterparty's model calculation.").

Farm Credit System institutions to bear the expense of developing their own initial margin models.

B. The Proposed Special Rules Are Not Justified By Safety and Soundness Benefits

The FCA and the FHFA seek to justify the proposed special rules by stating that "this approach recognizes that a default by a swap counterparty to a regulated entity could adversely affect the safe and sound operations of the regulated entity."[24] We disagree that the proposed special rules are necessary. Farm Credit System institutions already actively manage derivative counterparty credit risk and hold collateral to mitigate that risk. The potential loss from counterparty default therefore does not justify substantial new costs and redundant risk management. For example, during the past 20 years, AgriBank has experienced only $915,000 in credit losses from the actual default of a swap counterparty, which was Lehman Brothers. When amortized over the last 20 years, this loss represents approximately $46,000 per year -- well below the millions of dollars in annual new costs that the proposed special rules would likely cause.

The Farm Credit Council respectfully submits that the annual costs of this proposal substantially outweigh the benefits for our members. As noted, the proposed rules already recognize that Farm Credit System institutions are *low-risk* financial end users. Additional collateral requirements might be warranted for much larger or riskier institutions like Fannie Mae or Freddie Mac. They are not warranted for Farm Credit System institutions due to their smaller asset size, smaller scale, appropriately managed and regulated derivatives activities, and significantly lower risk profiles.

C. The FCA and FHFA Should Focus Special Rules on Larger and Riskier Market Participants

For the reasons stated above, the Farm Credit Council proposes that the FCA and FHFA refine their special rules to focus on larger and riskier entities that might need additional safety and soundness regulation. We therefore propose that that FCA- and FHFA-regulated entities **that are designated as low-risk financial end users (or nonfinancial end users)** should be exempt from the special rules proposed in Section ___.11 for non-cleared interest rate swaps executed with swap entities, provided that the following criteria are met:

- The FCA- or FHFA-regulated entity has total assets of less than $250 billion.

[24] *Id.*

- The non-cleared interest rate derivatives executed by swap entities are documented under legally enforceable master netting agreements that include credit support annexes with two-way collateral thresholds that limit the uncollateralized variation margin with any single swap entity to 3% of the capital of the FCA- or FHFA-regulated entity.

- The FCA- or FHFA-regulated entity is not in conservatorship or receivership, is not receiving taxpayer assistance, and does not have outstanding TARP loans.

The Farm Credit Council understands that government instrumentalities must, and should, comply with heightened regulatory standards. In enacting Dodd-Frank, however, Congress intended "to distinguish between commercial end users hedging their risk and larger, riskier market participants."[25] The Farm Credit Council respectfully suggests that the prudential regulators should distinguish between end users and the riskier users of derivatives that are truly systemically significant U.S. financial institutions -- those that have total assets well above $250 billion. For example, systemically significant financial institutions had the following assets as of March 31, 2011: Fannie Mae ($3.2 trillion), Freddie Mac ($2.2 trillion), Bank of America ($2.3 trillion), JPMorgan Chase ($2.1 trillion), Citigroup ($2.0 trillion), Wells Fargo ($1.2 trillion), Goldman Sachs ($880 billion), and Morgan Stanley ($819 billion). The average size of these institutions is $1.8 trillion. Institutions with less than $250 billion in assets are less than 15% of this size. We respectfully submit that entities with less than $250 billion in assets would not be considered to be major money center institutions that are systemically significant or too big to fail and therefore should not be treated the same as larger and riskier institutions.

This proposed change would ensure that, consistent with Congress's intent, smaller end users will not have to bear prohibitive costs associated with the proposed rules. In the case of small financial end users of swaps -- including Farm Credit System institutions -- Congress sought to avoid prohibitive margin costs and preserve the availability of low cost financing by providing an exception to mandatory clearing. The FCA and the FHFA should not now frustrate this congressional purpose.

IV. End Users Will Need Eighteen to Twenty-Four Months from Publication of Final Rules to Comply with New Margin Requirements

The Farm Credit Council appreciates the prudential regulators' recognition that the dramatic operational changes required by the proposed rules will take time to implement. We do not believe that the proposed effective date of 180 days after publication of final rules

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[25] 156 Cong. Rec. S5904 (daily ed. July 15, 2010) (statement of Sen. Dodd).

would provide sufficient time for Farm Credit System institutions to comply. Although many of the required operational changes will take a significant period of time to implement, we expect that we will need more than 180 days simply to renegotiate contracts with our counterparties and implement models for calculating initial and variation margin. We recommend that final rules become effective no earlier than eighteen to twenty-four months after they are published.

First, Farm Credit System institutions will have to renegotiate contracts with swap counterparties. In our experience, the amount of time required to review and negotiate an ISDA master agreement can range from four months to eighteen months. Because some Farm Credit System banks have more than ten counterparties, this process will take more than 180 days. Additionally, our ability to negotiate with our counterparties will depend, in turn, on their ability to negotiate with us. Those counterparties with hundreds or thousands of end-user relationships may require even more time before they will be in a position to do so. Because the proposed requirements cast doubt on the acceptability of existing ISDA master agreements, it is particularly important that market participants have sufficient time to negotiate and document their rights and obligations.

Second, the special requirement that FCA- and FHFA-regulated entities collect initial margin from counterparties will require Farm Credit System institutions to implement methods for calculating initial margin. The prudential regulators note that "swap entities that wish to calculate initial margin using an initial margin model will need sufficient time to develop such models and obtain regulatory approval for their use."[26] Time is even more important for end users, who will need to acquire the resources or expertise to develop models.

Finally, given the overhaul of current derivatives practices, the market may need more time to reach a consensus about how to deal with new margin requirements. For example, there is uncertainty about how variation margin for collateralized interest rate swaps should be calculated.[27] Including details in trade documentation related to the calculation of initial and variation margin will first require some market consensus about the proper valuation approach to collateralized swaps.

In light of these concerns, the Farm Credit Council requests additional time before the new requirements become effective.

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[26] Notice, 76 Fed. Reg. at 27,570.

[27] *See, e.g.*, Barclays Capital, Interest Rates Strategy, Understanding OIS Discounting (Feb. 24, 2011).

V. Conclusion

In enacting Dodd-Frank, Congress warned that "[i]f regulators raise the costs of end user transactions, they may create more risk."[28] The Farm Credit Council respectfully submits that the proposed rules could have the unintended consequence of doing just that. In treating Farm Credit System institutions as low-risk financial end users that are subject to maximum initial and variation margin thresholds -- rather than as nonfinancial end users that are not subject to maximum thresholds -- the proposed rules are potentially inconsistent with the end-user clearing exception. Congress permitted the CFTC to exempt small financial end users from mandatory clearing specifically to preserve the ability of financial institutions to offer cost-effective, dependable financing. The prudential regulators should not override this objective by imposing costly new margin requirements on non-cleared swaps.

Further, the proposed special rules for FCA- and FHFA-regulated entities would impose substantial, and unjustified, new costs on Farm Credit System institutions without materially reducing risk. Farm Credit System institutions already effectively manage counterparty credit risk and should not be subject to new requirements for collecting initial margin, maintaining zero thresholds of credit exposure, and segregation and rehypothecation. For Farm Credit System institutions, these requirements would make non-cleared swaps prohibitively expensive to hedge risk. For swap entity counterparties, these requirements would unfairly make Farm Credit System institutions prohibitively expensive counterparties. The proposed special rules would therefore make swaps used by the Farm Credit System to hedge risk more expensive and less available. Dodd-Frank does not contemplate this result.

Finally, given the significant new changes mandated by the proposed margin requirements, the Farm Credit System and other end users will need significant time to alter their operations. The Farm Credit Council therefore requests that the prudential regulators provide a period of time longer than 180 days before the effective date of final rules.

The Farm Credit Council appreciates the opportunity to comment. If you have any questions or we can provide other information, please do not hesitate to contact us. We would welcome the opportunity to work with the prudential regulators in developing final rules.

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[28] Letter from Sens. Dodd and Lincoln to Reps. Frank and Peterson, *in* 156 Cong. Rec. H5248 (daily ed. June 30, 2010).

Sincerely,

Robbie Boone
Vice President, Government Affairs
Farm Credit Council

cc: Honorable Gary Gensler, CFTC Chairman
Honorable Michael Dunn, CFTC Commissioner
Honorable Jill E. Sommers, CFTC Commissioner
Honorable Bart Chilton, CFTC Commissioner
Honorable Scott D. O'Malia, CFTC Commissioner