SUTHERLAND

SUTHERLAND ASBILL & BRENNAN LLP
1275 Pennsylvania Avenue, NW
Washington, DC 20004-2415
202.383.0100 Fax 202.637.3593
www.sutherland.com

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VIA HAND DELIVERY & E-MAIL

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

Dear Mr. Stawick:

On behalf of the Federal Home Loan Banks (FHLBanks), we are pleased to have this opportunity to provide advance comments regarding the definitions of "swap" and "major swap participant" under Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act (D-F or the Act), as you have requested pursuant to Release No. 34-62717.

The 12 FHLBanks are government-sponsored enterprises of the United States, organized under the authority of the Federal Home Loan Bank Act of 1932, as amended (FHLBank Act) and structured as cooperatives. The FHLBanks serve the general public interest by providing liquidity to members, thereby increasing the availability of credit for residential mortgages, community investments, and other services for housing and community development. The FHLBanks provide a readily available, low-cost source of funds to their members. The FHLBanks are regulated and supervised by the Federal Housing Finance Agency (FHFA).

Summary of Comments

In this letter, the 12 FHLBanks focus on the definition of "swap" and three aspects of the definition of "major swap participant." For the reasons set out in greater detail below, the FHLBanks believe that in crafting the regulations regarding these definitions the regulators should:

1) With respect to the definition of "swap," carve out transactions such as bona fide loans having variable rates or that include caps and floors that are clearly not properly viewed as part of the over-the-counter (OTC) derivatives market.

2) With respect to the definition of "major swap participant":

(A) broadly construe the phrase "positions held for hedging or mitigating commercial risk" to include OTC derivatives that are used to manage interest rate risk by commercial entities, including financial institutions;

(B) in determining whether a party's "outstanding swaps create substantial counterparty exposure," do not focus solely on notional amounts and take into account the extent to which the party reduces its counterparty's exposure by posting high quality collateral; and

(C) in determining whether a financial entity is highly leveraged, provide comparable treatment for regulated financial entities that are not subject to capital requirements established by an "appropriate Federal banking agency" so long as they are subject to robust regulation by a federal financial regulator that imposes capital requirements comparable to those imposed by an "appropriate Federal banking agency."

I. FHLBank Advances and the Definition of "Swaps"

Title VII of D-F is intended to dramatically change the regulatory regime for OTC derivatives, a market that has been widely described as consisting of bilateral, privately negotiated derivative contracts whose aggregate "notional amounts" outstanding in 2008 and 2009 were approximately $600 trillion.[1] The largest category of OTC derivatives is interest rate contracts and this category of OTC derivatives is estimated to account for slightly more than $400 trillion of the total outstanding derivative contracts (or approximately 2/3 of the OTC derivatives market).

OTC interest rate derivatives are an integral part of the FHLBanks' financial management strategies and these instruments significantly affect their financial statements. The FHLBanks routinely use the following instruments to manage their exposure to interest rate risks inherent in their normal course of business: interest rate swaps, interest rate cap and floor agreements; and swaptions.

Each of the foregoing instruments is plainly a "swap" as that term is newly defined in Sec. 721 of D-F (Commodity Exchange Act (CEA) §1a(47)). As such, the FHLBanks recognize and accept that these OTC agreements will become subject to all the requirements of Title VII of D-F

[1] See Congressional Record at S.5878 (July 15, 2010).

when those requirements become effective. As of December 31, 2009, the aggregate notional amount of such contracts outstanding for the FHLBanks was approximately $975 billion.[2]

Our comment regarding the "swap" definition in D-F focuses on other instruments that are not considered by the FHLBanks as OTC derivatives and that, in our view, should not be considered or deemed to be "swaps" for purposes of Title VII. As indicated above, the primary business of the FHLBanks is to serve as a source of funds for and provide liquidity to their members. As of December 31, 2009 the FHLBanks made loans, called "advances," to their members and eligible non-member housing associates[3] totaling approximately $631 billion. These advances represented roughly 62% of the total assets of the FHLBanks[4] and are the largest category of assets of the FHLBanks on a combined basis. By contrast, the aggregate amount of derivative assets and liabilities reported on the December 31, 2009 balance sheet of the FHLBanks was approximately $5.9 billion or less than 1% of the total assets and liabilities of the FHLBanks.[5]

FHLBank advances serve as an important low-cost funding source for a variety of conforming and nonconforming mortgage loans and thereby support the national housing market, including lending to targeted low- and moderate-income households. FHLBank advances are fully secured with high quality collateral pledged by borrowing members that is subject to appropriate haircuts. The fact that no FHLBank has ever sustained a credit loss on an advance in the FHLBank System's 78 year history is evidence of the FHLBanks' prudent collateral practices. Members use advances to fund loans that are held in portfolio, and for interim funding for loans to be sold in the secondary market. It is important for the FHLBanks to be able to continue to provide advance pricing and structures that meet the liquidity and mortgage loan funding needs of their members.

A significant percentage of FHLBank advances are variable-rate advances, where the interest rates charged reset periodically at a fixed spread to LIBOR or other standardized interest rate indices. The maturities for variable-rate advances range from less than 30 days to 10 years or more. FHLBank advances, including fixed rate advances, also can include features such as interest rate caps or floors, and prepayment terms that may or may not include a prepayment fee.

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[2] See note 11 to the audited combined financial statements of the FHLBanks as reported in the Federal Home Loan Banks 2009 Combined Financial Report (FHLBanks 2009 Financial Report) at p. 259.

[3] Members consist of federally insured depository institutions, insurance companies and certified community development financial institutions. Non-member housing associates are generally state or local housing finance agencies and tribal housing authorities.

[4] See FHLBanks 2009 Financial Report at 5 and the audited combined statement of condition of the FHLBanks as reported in the FHLBanks 2009 Financial Report at p. 194.

[5] See the audited combined statement of condition of the FHLBanks as reported in the FHLBanks 2009 Financial Report at p. 194.

We are concerned that the term "swap" not be defined or interpreted to include FHLBank advances, including advances that have variable interest rates and/or other embedded features such as caps and floors. As discussed below, it seems evident that the Congress did not intend to treat loans made by banking institutions in the ordinary course of their business as swaps.

For example, notes, bonds, or other evidence of indebtedness that are securities, as defined in section 2(a)(1) of the Securities Act of 1933" (1933 Act), are excluded from the definition of swaps.[6] However, many loans evidenced by notes, including for example variable rate mortgage loans, are not deemed to be "securities" under the 1933 Act.[7] FHLBank advances to members, which are fully collateralized, have never been found to be "securities" under the 1933 Act. As provided in Section 725(g) of D-F, loans that are not securities may nevertheless be excluded from regulation under the CEA if they are "identified banking products" as defined in Section 402 of the Legal Certainty for Bank Products Act of 2000.[8] Bank loans are included in the definition of identified banking products provided that they are made by "banks" as defined in Section 402 of the Legal Certainty for Bank Products Act. Because the FHLBanks are not banks as defined in the Legal Certainty for Bank Products Act, their advances to members may not be considered identified banking products. Moreover, even if they were covered, the exclusion from regulation under the CEA may not apply to them because the exclusion is limited to identified banking products "under the regulatory jurisdiction of an appropriate Federal banking agency" and the FHFA is not one of the enumerated regulators designated as an "appropriate Federal banking agency."[9]

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[6] D-F § 721(a) (CEA §1a(47)(B)(vii)). Section 2(a)(1) of the 1933 Act states:

> SEC. 2. (a) DEFINITIONS.—When used in this title, unless the context otherwise requires—
> (1) The term ''security'' means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness ...or, in general, any interest or instrument commonly known as a 'security' ..."

[7] See Reves. v. Ernst & Young, 494 U.S. 56, 65 (1990) (citing with approval circuit court decisions finding "instruments commonly denominated 'notes' that nonetheless fall without the 'security' category). See *Exchange Nat. Bank, supra, at 1138* (types of notes that are not 'securities' include 'the note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a 'character' loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized)'); *Chemical Bank, supra, at 939* (adding to list 'notes evidencing loans by commercial banks for current operations')."

[8] 7 U.S.C. § 27(b) (hereinafter referred to as Legal Certainty for Bank Products Act). Section 725(g) of D-F explicitly states that the CEA shall not apply to and the CFTC shall not exercise regulatory authority with respect to "identified banking products."

[9] See D-F § 725(g)(2)(amending § 403 of the Legal Certainty for Bank Products Act of 2000, 7.U.S.C. § 27a) and CEA § 1a(2)(defining "appropriate Federal banking agency").

A literal application of the broad language in the D-F definition of swaps could produce anomalous and, we believe, unintended consequences. For example, certain FHLBank advances may be considered swaps under Title VII of D-F. In addition, an advance made by an FHLBank to a community bank member may be treated as a swap while a loan containing identical economic terms made by a large commercial bank to the same member would not be treated as a swap. Such anomalous treatment would be fundamentally unfair and was not, in our view, contemplated by the Congress when it enacted Title VII of D-F.

The CFTC and SEC, as the regulators charged with the joint responsibility of further defining the key terms of D-F, should make it clear that loans, such as the advances made by the FHLBanks, are not treated as "swaps" under the OTC derivatives provisions of D-F. We believe this result is entirely consistent with the major objectives of Title VII which are:

- to require standardized swaps to be cleared by a central clearing entity and traded either on an exchange or swap execution facility;
- to require the swap activities of dealers and major swap participants to be registered and regulated by the CFTC and/or the SEC;
- to impose minimum capital and margin requirements on swap dealers and major swap participants in order to reduce the risk that such entities will fail and pose a systemic threat to the financial system;
- to increase the transparency of the swaps market by requiring the reporting of all swap transactions; and
- to ensure that swaps are only traded between eligible swap participants.

The treatment of traditional loans, including FHLBank advances with variable rates or embedded features such as interest rate caps and floors, as "swaps" under D-F does not comport with these objectives. It is unclear, for example, how an FHLBank advance could be executed and cleared on an exchange or swap execution facility. It is difficult to see how OTC market transparency would be enhanced by the reporting of all such loans to a swap repository. FHLBank advances are already fully collateralized and the FHLBanks are subject to rigorous capital requirements.

If FHLBank advances are "transactions involving swaps," D-F would appear to grant the CFTC "exclusive jurisdiction" with respect to such transactions.[10] The FHLBanks are presently supervised and regulated by the FHFA under the authority of the FHLBank Act and D-F acknowledges that the FHFA serves as the "prudential regulator" for the FHLBanks.[11] The FHFA promulgates the rules and regulations pertaining to FHLBank advances. Nothing in the

[10] CEA § 2(a)(1)(A) (Jurisdiction of the CFTC).

[11] D-F § 721 (CEA § 1a(39)).

legislative history of D-F suggests that Congress intended to shift that responsibility to the CFTC or the SEC.[12] Indeed, the provisions of D-F which preserved the right of the "prudential regulators" to set the capital and margin requirements for swap dealers and major swap participants amply demonstrate the sensitivity of the Congress to the responsibilities of the primary regulators with respect to the *lending activities* of the various financial institutions whose OTC derivative activities could be impacted by D-F.[13] In D-F, Congress provided limited authority for the CFTC and SEC to regulate certain aspects of the OTC derivatives activities of banks (specifically excluding those imposing "prudential requirements"[14]); it certainly did not intend to make the CFTC and the SEC the primary or exclusive regulator of the lending activities of those banks unless the lending activities were undertaken for the purpose of evading the requirements of D-F.[15]

II. FHLBanks and the Definition of Major Swap Participants

A derivatives market participant will be subject to regulation as a "major swap participant" if it falls within one or more of the following three categories: (1) persons who maintain a substantial position in swaps for any of the major swap categories excluding, *inter alia*, positions held for *hedging or mitigating commercial risk*; (2) persons whose outstanding swaps create *substantial counterparty exposure* that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or (3) financial entities that (i) are *highly leveraged* relative to the amount of capital they hold who are not subject to capital requirements established by an appropriate Federal banking agency and (ii) maintain a substantial position in outstanding swaps in any major swap category. As discussed below, we believe that it is important that certain terms embedded in these three categories be appropriately defined in the regulations in order to effectuate the Congressional intent of Title VII with respect to major swap participants.

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[12] See 12 C.F.R. § 900 *et seq.* for the regulations imposed by the FHFA on the FHLBanks.

[13] See CEA § 4s(e).

[14] D-F specifically provides that "The Commission may not prescribe rules imposing prudential requirements on swap dealers or major swap participants for which there is a prudential regulator." D-F § 731 (CEA § 4s(d)(2)(A))

[15] See Sec.721(c) of D-F which specifically mandates the CFTC to adopt a definition of "swap" that would "include transactions and entities that have been structured to evade this subtitle."

A. "Hedging or Mitigating Commercial Risk" Should be Broadly Construed.

The FHLBanks enter into OTC swaps transactions in order to facilitate their business objectives and mitigate financial risk, primarily interest rate risk. As previously noted, the FHLBanks are an essential part of this country's housing finance system. The ability of the FHLBanks to convert fixed rate assets or liabilities to variable rate assets or liabilities and vice versa is critical to their ability to meet the borrowing needs of their members, which are the institutions primarily responsible for providing financing to American homeowners.

The most common ways in which the FHLBanks use OTC derivatives are to:

- preserve a favorable interest-rate spread between the yield of an asset (e.g., an advance) and the cost of the related liability (e.g., the consolidated bond used to fund the advance). Without the use of derivatives, the interest-rate spread could be reduced or eliminated when a change in the interest rate on the advance does not match the change of the interest rate on the bond;
- mitigate the adverse earnings effects of the shortening or extension of certain assets (e.g., advances or mortgage assets) and liabilities;
- protect the value of existing asset or liability positions or of anticipated transactions;
- manage embedded options in assets (e.g., prepayment rights in advances) and liabilities;
- reduce the interest-rate sensitivity and repricing gaps of assets, liabilities, and interest-rate swap agreements;
- manage its overall asset/liability management; and
- reduce funding cost by combining an OTC derivative with a consolidated obligation, as the cost of the combined funding structure can be lower that the cost of a comparable, stand-alone consolidated obligation.[16]

FHFA regulations prohibit trading in or the speculative use of derivative instruments.[17] The FHLBanks believe that their OTC derivatives entered into in conformity with FHFA regulations should be considered "positions held for hedging or mitigating commercial risk" as that phrase is used in the definition of "major swap participant."[18] We believe that a broad interpretation of "hedging or mitigating commercial risk" is consistent with (1) the plain meaning of the words, (2) the legislative history of D-F, and (3) the context in which this phrase is used in different sections of Title VII.

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[16] See FHLBanks 2009 Financial Report at p. 27 and Note 11 to audited combined statement of condition of the FHLBanks as reported in the FHLBanks 2009 Financial Report at pp. 252-262.

[17] See 12 C.F.R. § 956.6(a) ("Derivative instruments that do not qualify as hedging instruments pursuant to GAAP may be used only if non-speculative use is documented by the [FHLBank].").

[18] CEA § 1a(33)(a)(i)(I).

(1) Plain Meaning. The plain meaning of the words "commercial risk" would encompass interest rate risks associated with advances made by the FHLBanks. "Commercial" is generally defined as activities related to "commerce" which has been defined as "the exchange of something of value between two entities. That 'something' may be goods, services, information, money, or anything else the two entities consider to have value."[19] Another dictionary makes specific reference to loans in its definition of "commercial"; "Of or relating to commerce: a commercial loan..."[20] Although some dictionaries offer a definition of "commerce" that refers to "the exchange or buying and selling of commodities," the term "commercial" generally has a broader meaning that encompasses transactions "viewed with regard to profit <a commercial success>".[21]

(2) Legislative History. In the version of derivatives reform legislation passed by the House of Representatives (H.R. 1473), the definition of "major swap participant" used the phrase "excluding positions primarily held for hedging, reducing or otherwise mitigating its commercial risk, *including operating and balance sheet risk.*"[22] In the Senate legislation and in the final Act, this phrase was abbreviated to "positions held for hedging or mitigating commercial risk." We do not think that the change in language reflects any Congressional determination that "operating and balance sheet risk" are not encompassed by the term "commercial risk." Clearly the House of Representatives felt that "operating and balance sheet risk" were subsets of "commercial risk" rather than some other category of risk because the House used the phrase "*including* operating and balance sheet risk." (Emphasis added.) It would be a mistake, in our view, to conclude that the omission of these words in the final version of the legislation reflects any intent on the part of Congress to exclude "operating" or "balance sheet" risk from the scope of "commercial risk." Instead, we believe that better view is that the drafters did not want to imply that other risks besides "operating" or "balance sheet" risk would not be encompassed by the term "commercial risk." Thus, they left the further definition of this important term to be articulated by the regulators.

(3) Use of "commercial risk" in context of Title VII. Further support for a broad reading of "commercial risk" is found in the exception from the requirements for mandatory clearing in Section 723 of D-F. The exception only applies to situations where one of the swap counterparties: (i) is not a financial entity; (ii) is using swaps to hedge or mitigate commercial risk; *and* (iii) notifies the CFTC how it generally meets its financial obligations associated with

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[19] See www.tvb.org/ebusiness/Glossary.asp.

[20] See http://www.thefreedictionary.com/commercial.

[21] See http://www.merriam-webster.com/dictionary/commerce?show=0&t=1283958409 and http://www.merriam-webster.com/dictionary/commercial.

[22] H.R. 4173 § 3101(a) (emphasis added).

entering into non-cleared swaps.[23] If entering into OTC derivative transactions to hedge or mitigate or reduce interest rate risk associated with financing and lending is not encompassed within the scope of "commercial risk" there would have been no need to preclude a "financial entity" from qualifying for the clearing exception. Congress, in an apparent effort to maximize the number of OTC derivatives that would become subject to mandatory clearing, made a deliberate decision to require financial entities to clear all trades eligible for clearing even if they were entered into for the purpose of "hedging or mitigating commercial risk."

The foregoing points suggesting that the regulators adopt a broad reading of the term "commercial risk" should not be read to imply that there are no derivative transactions that would fall outside the exclusion for transactions entered into to hedge or mitigate "commercial risk." Swaps entered into for speculative purposes would not be excluded.[24] For example, a financial entity that is selling credit default swaps referencing debt obligations or loans would presumably not be entering into such trades to hedge or mitigate commercial risk. Pursuant to FHFA regulations, the FHLBanks would not be permitted to enter into such transactions.

B. Substantial Counterparty Exposure Should Not Be Measured Solely On Notional Amounts And Collateralization of Exposure Should Be Considered.

The D-F definition of "major swap participant" includes any participant that is not a swap dealer "whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets."[25] We believe that the regulators should not determine or measure "substantial counterparty exposure" based solely on notional amounts of outstanding swaps or fail to take into account counterparty exposure collateralized with high quality collateral and further backed by a party's capital in determining whether counterparty exposure would create "serious adverse effects."

D-F's stated purpose for identifying "major swap participants" is to provide for the "effective monitoring, management, and oversight of entities that are systemically important or can

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[23] CEA § 2(h)(7).

[24] As noted previously, FHFA regulations prohibit the FHLBanks from entering into swaps for speculative purposes. See Note 20, supra.

[25] CEA § 1(a)(33)(A)(ii). Our comments assume that the focus of this prong of the MSP definition is on the exposure that the derivatives dealers may have to the FHLBanks—i.e., would a default by one or more of the FHLBanks create losses for one or more dealer counterparties that could pose a threat to the stability of the U.S. banking system or financial markets. The exposure of the FHLBanks themselves to a default by one or more dealers, which we do not believe is the focus of this prong, is addressed through the selection of highly rated dealer counterparties and collateral requirements.

significantly impact the financial system of the United States."[26] In effecting this purpose, we believe that determining "substantial counterparty exposure" based upon a measurement of notional amounts would provide a virtually meaningless indicator of whether or not a participant is systemically important or could significantly impact the banking or financial markets of the United States.

Like many market participants, the FHLBanks engage in swap transactions as an integral part of their hedging strategies. The notional amounts of swaps entered into by the FHLBanks correspond only to the principal amounts of the instruments being hedged, and such notional amounts are not reflective of the actual counterparty credit risk incurred by either the FHLBanks or their dealer counterparties. The notional amount of swaps represents neither the actual amounts exchanged under swap transactions nor the overall credit and market risk exposure of the counterparties to swap transactions, and the amount potentially subject to credit loss due to a counterparty default is generally a small percentage of the notional amount.[27]

Each FHLBank generally executes swaps with large banks and major broker-dealers and enters into bilateral security (collateral) agreements governing its swaps transactions with its active swaps dealer counterparties. These security agreements require each FHLBank to deliver high quality collateral to the counterparty once a specified unsecured net exposure is reached.[28] Such high quality eligible collateral includes U.S. dollars, U.S. Treasury obligations, and may include other high quality obligations subject to appropriate haircuts and daily market valuations. Because the FHLBanks post high quality collateral pursuant to their bilateral security agreements, and such collateral secures a substantial portion of the FHLBanks' swaps liabilities, in our view, the current counterparty credit exposure of dealers to the FHLBanks that exists with respect to the outstanding swap transactions should not create the "serious adverse effects" contemplated by D-F. Accordingly, we believe that the regulators should adopt rules that take into account the extent to which swap exposure is collateralized with high quality collateral in its

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[26] CEA § 1(a)(33)(B).

[27] As of December 31, 2009, the FHLBanks' aggregate notional amount of swap contracts outstanding was approximately $975 billion. See note 11 to audited combined statement of condition of the FHLBanks as reported in the FHLBanks 2009 Financial Report at p. 257. However, at that date, the maximum credit risk of the FHLBanks to their counterparties was only approximately $2.5 billion, or 0.26% of the aggregate notional amount. See Id. Clearly, the aggregate notional amount of swaps entered into by FHLBanks does not come close to showing the true counterparty credit risk to FHLBanks, nor would such a measurement accurately describe the credit risk of the FHLBanks to their dealer counterparties.

[28] See note 20 to audited combined statement of condition of the FHLBanks as reported in the FHLBanks 2009 Financial Report at page 289.

determination of the level of counterparty exposure that would create "serious adverse effects" on the banking and financial markets.[29]

As previously noted, we do not believe that the notional amount of outstanding derivatives is the proper measure of how much counterparty exposure is created by a portfolio of outstanding swaps. At the same time, we recognize that counterparty exposure may not be fully measured solely by examining the current exposure of the portfolio (i.e., based on current mark-to-market valuations). It may be appropriate to take into account some measure of the "potential exposure" of a portfolio to market movements as well.[30] However, we believe that any use of potential exposure also must consider a party's capital position. The larger the capital base of the party, the greater the amount of potential exposure it should be permitted to maintain without creating the potential for serious "adverse effects on the financial stability of the United States or financial markets."

C. The Regulation of the FHLBanks by the FHFA Should Be Taken Into Account With Respect to the Highly Leveraged Prong of the Major Swap Participant Definition

Under D-F, the definition of "major swap participant" includes any financial entity[31] that (1) is "highly leveraged relative to the amount of capital such entity holds and that is not subject to capital requirements established by an appropriate Federal banking agency" and (2) "maintains a substantial position in outstanding swaps in any major swap category."[32] As discussed above, under D-F, the FHFA will serve as the prudential regulator for the FHLBanks. The FHFA currently supervises and regulates the FHLBanks and, specifically, the FHFA ensures that each FHLBank remains adequately capitalized.[33]

1. *The capital requirements set by the FHFA should be treated in the same manner as capital requirements set by appropriate Federal banking agencies.* Under the "highly leveraged" prong of the definition of "major swap participant," financial entities that are subject

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[29] D-F specifically acknowledges the importance of the provision of collateral in determining which participants qualify as "major swap participants," stating that the Commission may consider the value and quality of collateral held against counterparty exposures in connection with its mandate to define "substantial position." CEA § 1(a)(33)(B). The value and quality of collateral posted is equally relevant to the determination of "major swap participants" under the "substantial counterparty exposure" prong.

[30] See Global Derivatives Study Group, "Derivatives Practices and Principles" (Group of Thirty, July 1993), Recommendation 10 at pages 13-14.

[31] Note that while D-F specifically defines "financial entity" as such term is used in the clearing requirements, it does not define "financial entity" in connection with the definition of "major swap participant."

[32] CEA § 1(a)(33)(A)(iii). For this purpose, swaps held to hedge or mitigate commercial risk are not excluded.

[33] See 12 C.F.R. § 905.4(a).

to capital requirements established by an appropriate Federal banking agency are not major swap participants. Although D-F does not include the FHFA in the definition of "appropriate Federal banking agency,"[34] the capital requirements that the FHFA sets for the FHLBanks are comparable to and should be treated the same as the capital requirements that regulators defined as "appropriate Federal banking agencies" set for other depository institutions and the Farm Credit Banks. We believe this view is entirely consistent with the objectives of Title VII.

With the enactment of the Gramm-Leach Bliley Act (GLB) in 1999, Congress instituted risk-based and leverage capital requirements for the FHLBanks that are similar to the capital requirements applicable to depository institutions. GLB also mandated that the FHFA issue regulations prescribing uniform capital standards applicable to each FHLBank in accordance with the provisions of GLB. In accordance with this mandate, the FHFA set capital standards that require each FHLBank to maintain at all times (1) total capital in an amount at least equal to 4.0% of the FHLBank's total assets and (2) a leverage ratio of total capital to total assets of at least 5.0% of the FHLBank's total assets.[35] Moreover, for reasons of safety and soundness, the regulations provide that the FHFA may require an individual FHLBank to have and maintain a greater amount of total capital than mandated by the percentages specified in the foregoing sentence.[36] Finally, the FHFA set specific credit risk capital requirements, market risk capital requirements and operations risk capital requirements for each of the FHLBanks and may also require an individual FHLBank to have and maintain a greater amount of permanent capital than required by these specific requirements.[37]

As discussed in 2 below, the capital requirements that the FHFA has imposed on the FHLBanks are at least as extensive and restrictive as the highest level of risk-based capital requirements set by the Board of Governors of the Federal Reserve System (FRB) and other regulators, including

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[34] Under D-F, "appropriate Federal banking agency" (A) has the meaning given the term in section 3 of the Federal Deposit Insurance Act (12 U.S.C. § 1813); (B) means the Board of Governors of the Federal Reserve System in the case of a noninsured State bank; and (C) is the Farm Credit Administration for farm credit system institutions.

[35] See 12 C.F.R. § 932.2(a). Total regulatory capital is the sum of permanent capital, Class A stock, any general loss allowance, if consistent with GAAP and not established for specific assets, and other amounts from sources determined by the FHFA as available to absorb losses. For purposes of determining the leverage ratio, total capital is defined as the sum of (i) permanent capital weighted 1.5 times and (ii) all other capital without a weighting factor. See FHLBanks 2009 Financial Report, note 18 to Audited Combined Statement of Condition at p. 270.

[36] See 12 C.F.R. § 932.2(b).

[37] See 12 C.F.R. § 932.3 – 932.6. Under the risk-based capital requirement, each FHLBank must maintain at all times permanent capital, defined as Class B stock and retained earnings in an amount at least equal to the sum of its credit risk, market risk, and operations risk capital requirements, all of which are calculated in accordance with the rules and regulations of the FHFA. See FHLBanks 2009 Financial Report, note 18 to Audited Combined Statement of Condition at p. 270.

the Federal Deposit Insurance Corporation (FDIC).[38] Moreover, the FHFA has specifically stated that it drew from and expanded upon work done by the Basel Committee on Banking Supervision and other federal financial regulators in developing the capital requirements described above.[39] We therefore believe that, just like those financial entities that are subject to capital requirements established by an appropriate Federal banking agency, the FHLBanks should be excluded from the "highly leveraged" prong of the definition of "major swap participant."

Our position is further supported by a colloquy on the Senate floor in which Senator Lincoln noted that "it may be appropriate for the CFTC and the SEC to consider the nature and current regulation of the entity when designating an entity a major swap participant."[40] Senator Lincoln went on to note that certain entities that are already subject to extensive regulation relating to their usage of swaps under other titles of the U.S. Code may not pose the same types of risk as unregulated major swap participants. The term "regulation" used by Senator Lincoln is much broader than the phrase "capital requirements set by appropriate Federal banking agencies" in the "highly leveraged" prong of the "major swap participant" definition. Senator Lincoln's use of this broader term supports our argument that the FHFA's extensive regulation of the FHLBanks should receive the same treatment as the capital requirements set by appropriate Federal banking agencies.

2. *Even if the capital requirements imposed by the FHFA do not automatically exclude the FHLBanks from the "highly leveraged" prong of the definition of "major swap participant," the FHLBanks should not be considered highly leveraged.* The FHFA's capital requirements are comprehensive and require the FHLBanks to maintain comparable leverage ratios to those imposed on similarly situated financial institutions.

As of December 31, 2009, eleven out of the twelve FHLBanks were in compliance with the FHFA's capital requirements and the twelfth FHLBank was in compliance with alternative capital requirements imposed on it by the FHFA.[41] As of December 31, 2009, each of the FHLBanks subject to the GLB capital rules had a leverage ratio of between 6.6% and 11.4% and

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[38] The minimum leverage capital requirement for banks or insured depository institutions making applications to the FDIC is between 3.0% and 4.0%, depending on the rating of the institution. See 12 C.F.R. § 325.3.

[39] See 60 Federal Register 20, 8281 (January 30, 2001).

[40] See Congressional Record at S5907 (July 15, 2010). Note that in addition to the capital requirements above, the FHFA has imposed restrictions on the FHLBanks' use of hedging instruments. See 12 C.F.R. §956.6. Notably, a FHLBank may only use derivative instruments that do not qualify as hedging instruments pursuant to GAAP if such FHLBank documents a non-speculative use.

[41] See note 18 to audited combined statement of condition of the FHLBanks as reported in the FHLBanks 2009 Financial Report at pp. 270-71.

the twelfth FHLBank had regulatory capital of 5.11%, which was in excess of its mandated level. As a result of their compliance with the FHFA's strict and extensive capital requirements, the FHLBanks should not be considered highly leveraged, regardless of how the CFTC and the SEC define "highly leveraged."

If the FHLBanks are considered "highly leveraged," then virtually every financial entity would be considered "highly leveraged" and the phrase would have no real meaning. We note that simply by complying with the minimum leverage ratio set by the FHFA, the FHLBanks should be considered "well capitalized" under the guidelines issued by the FRB. Under the FRB guidelines, a bank holding company is considered "adequately capitalized" if it has a leverage ratio of at least 4.0% and "well capitalized" if it has a leverage ratio of at least 5.0%.[42] If the FHLBanks are considered "highly leveraged" then, by implication, a bank holding company that is considered "well capitalized" under the FRB guidelines would also be "highly leveraged." This result is certainly not what Congress intended when it included "highly leveraged" financial entities in the definition of "major swap participant."

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In order to effectuate the Congressional intent of Title VII of D-F, we believe that certain clarifying regulations are necessary with respect to the definitions of "swap" and "major swap participant." In submitting these preliminary comments, we are mindful that subjecting FHLBank advances to the increased regulation meant for "swaps" or deeming the FHLBanks to be "major swap participants" under D-F would likely hinder the ability of the FHLBanks to fulfill their mission of providing low-cost financing to their members. We respectfully request that the regulators take the foregoing analysis into account as they develop regulations regarding the definitions of "swap" and "major swap participant."

Respectfully submitted,

Sutherland Asbill & Brennan LLP

By: _____
Warren Davis, Of Counsel

cc: FHLBank Presidents
FHLBank General Counsel

[42] See 12 C.F.R. § 325.103.