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Views on Implementation of the Dodd-Frank Act

The National Rural Utilities Cooperative Finance Corporation ("CFC") appreciates the opportunity to submit its views in connection with the CFTC's implementation of provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("DFA").

In particular, we would like to provide information about CFC's cooperative business model, social purpose, use of derivatives and capital structure. We hope the CFTC will consider these matters when crafting regulations so the important goals of the DFA may be achieved in a manner that does not result in unintended additional costs to CFC, its electric cooperative members or the 42 million consumers they serve.

In this paper, we provide:

- An introduction to CFC, as a nonprofit lender created and owned by America's consumer-owned rural electric cooperatives;
- An explanation of how and why CFC uses derivatives;
- An explanation of why we believe CFC should not be subject to margin or clearing requirements; and
- Our views on certain definitions within DFA that are subject to CFTC rulemaking, including "swap," "eligible contract participant," "swap dealer," "major swap participant," "substantial position," "commercial risk" and "highly leveraged relative to the amount of capital it holds."

We value the chance to discuss these matters with the CFTC in greater depth and answer any questions the Commission may have.

(1) Introduction to CFC

The National Rural Utilities Cooperative Finance Corporation ("CFC") is a nonprofit cooperative entity owned by America's consumer-owned electric cooperatives. CFC is not a bank, credit union or savings and loan institution. Therefore, many of CFC's metrics and motivations do not conform to those of these more commonly known financial entities.

We understand that the CFTC is currently soliciting public comments on the unique aspects of entities that serve a public purpose, such as rural electric cooperatives and other entities covered by Section 201(f) of the Federal Power Act, which includes entities such as CFC that are wholly owned by rural electric cooperatives.[1] As we discuss below, there are numerous reasons that entities such as CFC are unique among the entities that will be subject to the CFTC's DFA rules, and we encourage the CFTC to fully consider these reasons.

- **CFC was created by America's electric cooperatives to serve as their non-governmental financing arm.** CFC was created in 1969 by rural electric cooperatives through the National Rural Electric Cooperative Association ("NRECA") to provide financing to supplement the loan programs of the U.S. Department of Agriculture's Rural Utilities Service ("RUS"). Today, we continue the mission of providing our member electric cooperatives with a variety of loan programs.

- **CFC has a public purpose and mandate.** CFC was formed to meet the capital needs of America's consumer-owned electric cooperatives, which provide electricity as a public service, at affordable interest rates. Our provision of affordable loans to these cooperatives supports this public service.

- **CFC's principal purpose is to provide its members with financing so they can provide electric power services to rural Americans.** CFC is the largest non-governmental lender to rural electric systems.
    - CFC makes loans to members and also provides members with credit enhancements in the form of letters of credit and guarantees of debt obligations. At May 31, 2010, our total loans and guarantees outstanding were $20.5 billion.
    - In addition to providing the financing that supplements loans from the RUS, nearly 200 electric cooperatives across the United States rely solely on CFC for financing.

- **As a cooperative, CFC is owned by and exclusively serves its membership.** Our membership consists solely of not-for-profit entities, or subsidiaries or affiliates of not-for-profit entities. Our nearly 1,000 members serve 42 million consumers in 47 states.

    ➢ ***Please see Attachment A for a map of our members' service areas.***

- **CFC's objective is to offer its members cost-based financial products and services consistent with sound financial management, rather than to maximize net income.**
    - CFC provides loans to members based on our cost of funds, not with a view to maximize net income. As a cooperative, any net earnings remaining after our obligations are satisfied belong to our members. As a result, we have been able to provide financing to our members at attractive interest rates. A key component of keeping costs low has been our ability to use over-the-counter derivatives to hedge interest rate risk.

[1] *See* 75 FR 80183-80184 (Dec. 21, 2010).

- **CFC derives our financial strength from the underlying high credit quality of our electric cooperative owners, the security supporting our loans, and our depth of understanding and long-term view of the market in which we operate.** Consistently, the capital markets have viewed electric cooperatives as low-risk businesses that are focused on providing essential services to rural consumers and that operate in a conservative, efficient manner. The ratings agencies also recognize the financial strength of the electric cooperatives.

- **As a cooperative, CFC's structure and financial metrics differ greatly from those of other types of companies.**
    - CFC's objectives differ from other types of lending entities. CFC's primary goal is to provide competitively priced capital to our members while maintaining financial strength and soundness.

- **Given CFC's cooperative structure and tax status, CFC cannot issue traditional equity securities.** Instead, CFC has retained earnings and certain long-term subordinated debt securities that our creditors and rating agencies have treated as the functional equivalent of core capital.
    - To assess performance, we use financial metrics that adjust certain numbers presented in our GAAP-based financial statements. These adjusted metrics are well understood and accepted by the major rating agencies as well as the analysts at the banks that provide us with revolving credit lines. We fully disclose these "adjusted" metrics and reconcile the metrics to GAAP-based metrics in our public filings with the U.S. Securities and Exchange Commission ("SEC"). These non-GAAP adjustments fall primarily into two categories: (1) adjustments related to the calculation of the TIER ratio and (2) adjustments related to the calculation of the leverage and debt-to-equity ratios. These adjustments, which are more fully explained later in this paper, reflect management's perspective on our operations and, in several cases, are used to measure covenant compliance under our revolving credit agreements. We believe that reliance on only GAAP numbers does not accurately reflect how our business is evaluated by CFC management, rating agencies and creditors. **In particular, CFC should not be viewed as overleveraged simply because it does not have a capital structure identical to that of a for-profit bank.** We urge the CFTC to recognize this reality as it progresses in its rulemaking activity.

How and Why Does CFC Use Derivatives?

CFC was created to ensure access to non-governmental market capital needed by rural utilities. In order to achieve this goal at the most attractive rates and in a manner tailored to the needs of rural utilities, CFC uses risk management and interest rate hedging products that would otherwise be expensive or unavailable to most of our members.

CFC's use of derivative hedging products allows our members to manage their interest rate risk efficiently and gives them flexibility in choosing different funding methods. Thus, CFC is an end user of derivatives, chiefly in the over-the-counter swaps environment. We use derivatives very

conservatively and not for speculative purposes; we use them to mitigate risks directly related to our business.

- **CFC uses derivatives to hedge market interest rate risk.** CFC uses over-the-counter swap contracts in the context of providing credit to our members, to allow us to tailor loans to our members' needs while mitigating the impact of changing interest rates. We do this through the use of a variety of types of swaps, from "plain vanilla" interest rate swaps to non-standard contracts.
    - For example, CFC may elect to match-fund a specific fixed-rate loan or a group of fixed-rate loans with an interest rate swap agreement that matches the exact terms of the loan(s) (e.g., principal amount, amortization schedule, payment dates, etc.). By match-funding the loan(s) with an interest rate swap, CFC eliminates the interest rate risk associated with the loan(s).

        - ***Please see Attachment B for a visual representation of how our typical interest rate swaps work.***

        - ***Please see Attachment C for a table showing the number and amount of our swaps for each year since 1998.***

- **CFC's use of derivatives reduces cost and increases flexibility for our members.** Our derivatives allow us to be flexible with loan structuring to accommodate our members' needs and help us provide them with low-cost capital.
    - For instance, CFC can use interest rate swap agreements to more cost effectively match-fund the cash flows of a specific loan or a pool of loans compared to options available in the public and private debt markets.
    - CFC offers our members loan products such as forward fixed-rate loans, accreting loans, principal deferral loans and loans with optionality that can most effectively and most economically be match-funded through the use of an interest rate swap agreement.
    - CFC uses interest rate swap agreements to change the interest rate mode of an underlying debt obligation to another interest rate mode that is either not available in the cash market or is more attractive or optimal than is available in the cash market.
        - As a lending institution, CFC needs to access both the public and private capital markets to raise capital to fund its loan portfolio. CFC issues long-term debt to refinance maturing debt or to support new loan growth. Based on the fixed/floating rate composition of CFC's loan portfolio, CFC will raise either fixed-rate or floating-rate debt.
        - CFC may elect to enter into an interest rate exchange agreement associated with a debt offering if an opportunity exists that will allow CFC to more economically issue debt in one interest rate mode and convert it to a different mode.
            - For instance, if CFC determines that it needs floating-rate debt, CFC will issue a fixed-rate bond and swap it back to a floating rate if this

provides a cheaper source of funding than issuing a "plain vanilla" floating-rate note.

- Other factors that will dictate the execution of interest rate exchange agreements include situations where certain desired funding structures are not able to be executed in the cash bond market in an optimal or economic fashion, such as amortizing loans, forward fixed starting loans and accreting loans.

➢ Our owners – rural electric cooperatives – and the consumers they serve benefit as a result of the lower cost and added flexibility that result from our use of derivatives.

- **CFC also has used cross-currency swaps to eliminate its exposure to exchange rate fluctuations when foreign currency denominated debt is issued.** CFC has, at times, issued debt denominated in a foreign currency in order to take advantage of pricing opportunities. In those situations, we will enter into a cross-currency exchange agreement at the time of the debt offering that converts the foreign currency obligation to a U.S. dollar obligation including both principal and interest payments.

- **CFC does not enter into derivative transactions for speculative purposes.** We do not make a market in swaps. We do not enter into swaps that are not directly related to our own business and do not trade in swaps for the purpose of profit-making. We enter into only the minimum number of derivatives necessary to hedge the risks described above. We are primarily a hold-to-maturity issuer of derivatives.

- **We prudently manage the risk posed by our counterparties.** We use rigorous criteria to choose our counterparties, which comprise a select group of well-known financial institutions that have investment-grade credit ratings. We understand that managing counterparty risk is paramount in the over-the-counter swaps environment and have devoted significant resources to assessing and controlling such risk.
  - Each counterparty must be a participant in one of our revolving credit agreements. The derivative instruments executed for each counterparty are based on key characteristics such as notional concentration, credit risk exposure, tenor, bid success rate, total credit commitment and credit ratings.
  - Currently, our derivative counterparties have credit ratings ranging from AAA to BBB as assigned by Standard & Poor's Corporation and Aaa to Baa1 as assigned by Moody's Investors Service.
    - ➢ ***Please see Attachment D for a breakdown of our swap portfolio by rating as of May 31, 2010.***
  - We have experienced only one instance of counterparty default over our entire 27-year history of using derivatives.

- **We prudently manage the amount of our exposure to any one counterparty.**
  - At May 31, 2010, the highest percentage concentration of total notional exposure to any one counterparty was 12 percent of total derivative instruments. The largest

amount owed to us by a single counterparty was $11 million, or 26 percent of the total exposure to us at May 31, 2010.

- Based on the fair market value of our derivative instruments at May 31, 2010, there were seven counterparties that would be required to make a payment to us, totaling $43 million, if all of our derivative instruments were terminated on that day.

- **We – and our members – depend on the flexibility and cost effectiveness of the over-the-counter swaps environment.** Because our swaps are generally not subject to clearing or margin requirements, we have the flexibility to tailor each contract to meet our particular needs and are able to keep costs low, rather than having to choose from a limited universe of standard contracts or take on the expense of posting collateral. As a result, our members benefit from having a variety of credit products and terms to choose from and also pay lower rates and fees on their loans as a result.

(2) <u>CFC Should Be Exempt from DFA's Margin and Clearing Requirements</u>

CFC understands that the goals of DFA's swaps provisions include minimizing systemic risk, increasing transparency and promoting market integrity. We recognize the need for disclosure and reporting of both our existing derivatives and any new contracts entered into, and agree with the need for safety and transparency in these markets.

We also note, though, that DFA is not meant to impede the ability of end users to use swaps to hedge their own commercial risk, such as CFC does. We also observe that CFC's derivatives activities do not entail systemic risk and that the concerns underlying the derivatives provisions of DFA are already being addressed in how we manage our swaps activity. Thus, imposing margin and clearing requirements on end users such as CFC is not needed for risk management purposes and would result in increased costs to consumers.

- **CFC's use of derivatives is similar to that of entities that do qualify for an exemption from clearing under DFA. In fact, we are owned solely by such entities.** CFC uses derivatives "to hedge or mitigate commercial risk" – and only our own commercial risk, in contrast to speculative users of derivatives who make "bets" based on occurrences of events having no relation to the user's own business. We are owned by entities that also use derivatives to hedge or mitigate their own commercial risk and do qualify for DFA's end user clearing exemption. We believe not extending such an exemption to entities such as CFC would be an illogical result because we exist solely to provide financing to those end users. In addition, the ways we use derivatives parallel the activities of captive finance companies explicitly exempted in DFA.

- **Transferring risk to a clearing organization is not needed due to the effective risk management already inherent in our use of derivatives.** Margin requirements are not needed to address the risk posed by CFC's derivatives activities.
    - CFC works with a select universe of highly creditworthy counterparties, and we carefully choose our contract terms to fit the risks we need to hedge.

- We have experienced only one instance of counterparty default over our 27-year history of using derivatives.
- CFC only transacts with counterparties with which it has fully executed an ISDA Master Agreement and Schedule to Master Agreement.
- All of CFC's ISDA agreements contain a netting provision for payments and for settlement in the event of counterparty or CFC default. As previously discussed, CFC actively manages its derivative portfolio to minimize to the extent possible its net counterparty exposure. CFC does this primarily via trade allocation and individual counterparty notional concentration limits.

- **CFC has the financial strength to meet its ongoing financial obligations associated with non-cleared swaps.**
  - As of January 7, 2011, our senior unsecured credit ratings from Moody's Investors Service and Standard & Poor's Corporation were A2 and A, respectively.
  - CFC maintains several sources of liquidity.
    - As of August 31, 2010, CFC had a total of $3.34 billion in credit available under three separate revolving credit facilities with 23 banks. The credit facilities are used to provide back-up liquidity for CFC's short-term funding programs. There were no outstanding balances under the three credit facilities as of August 31, 2010.
    - CFC had access to liquidity from private debt issuances through note purchase agreements with the Federal Agricultural Mortgage Corporation. All of the note purchase agreements with the Federal Agricultural Mortgage Corporation are revolving credit facilities that allow us to borrow, repay and re-borrow funds at any time prior to the maturity date of the applicable agreement, provided that the principal amount at any time outstanding under each agreement is not more than the total available under such agreement, which was $913 million as of August 31, 2010.
    - In November 2010, CFC finalized the documentation on an additional $500 million committed loan facility with the Federal Financing Bank that is guaranteed by the Department of Agriculture's Rural Utilities Service. CFC can draw down this committed amount at any time during the period three years from the commitment date.

- **Imposing margin requirements will increase the cost of capital to electric cooperatives that serve rural America.** Our ability to use over-the-counter swaps without margin or clearing requirements allows us to keep the costs of our lending operations low. We pass on the cost savings to our members, who pay lower rates and fees on their loans as a result. If we were required to post collateral for our swaps, our costs would rise, and the costs we charge to our members also would have to rise.
  - It is difficult to predict the precise cost increase that would result for imposing margin requirements on CFC. This cost would vary based on a number of factors, including (1) whether collateral is required on a notional amount or on the net out-of-the-money position, (2) whether collateral is required for all swaps or only for swaps entered into after final regulations to implement DFA and (3) the cost associated with

pledging collateral, which will vary based on market costs. We have estimated the increases in interest rates to our member electric cooperatives to range from a low of 4 basis points to 1,212 basis points.

- ***Please see Attachment E for our estimate of additional costs based on a range of assumptions.***

- **Imposing margin requirements, in particular, on end users such as CFC would run counter to explicit Congressional intent.** In a communication to Representatives Frank and Peterson, Senators Lincoln and Dodd stated that it was not their intent that DFA impose margin requirements on end users. We agree that DFA should not be read so as to inhibit the ability of end users to use swaps to address risks related to their own businesses — productive uses of swaps rather than speculative ones.

With regard to any margin requirements that are ultimately imposed, we suggest the following approaches.

- **Margin should not be required for existing swaps.** Imposing margin on existing swap contracts would add a significant new cost that was not accounted for when the loans that are being match-funded with interest rate swap agreements were priced. To change existing contracts would impose an unfair and unanticipated cost burden on end users such as CFC.

- **Swaps entered into after enactment of DFA and prior to issuance of final regulations should be allowed a transition period.** Ideally, such swaps would be treated the same as swaps entered into prior to enactment of DFA and allowed to be grandfathered out of both margin and clearing requirements. Otherwise, the same issue of changing the terms of existing contracts would again arise. However, at the very least, we believe a transition period that allows parties a reasonable time to phase in the increased costs of compliance would be a fair approach.

    - We believe that six years would be a reasonable transition period to phase in the increased costs of compliance for swaps entered into after enactment of DFA and prior to issuance of final regulations. A phase-in period of six years would reduce the negative impact of unaccounted-for transaction costs.

        - Our swap portfolio has a weighted average life of 6.2 years as of August 31, 2010. Of the 50 percent pay-fixed swaps within our existing portfolio, 30 percent have a remaining life of greater than six years with the longest tenor stretching out to June 30, 2042.

- **Flexibility should be allowed in the nature of collateral that may be required or permitted.** For example, non-cash collateral should be acceptable, including lines of credit and other facilities.

- **For new swaps entered into after the effective date of final regulations, margin requirements should be based on the issuer's net out-of-the-money position per swap counterparty.** This is a logical measurement to use, as it represents the resulting cost if the swap had to be unwound. If notional amounts are used to determine margin requirements, the cost of compliance could be dramatically higher.

(3) Definitions and Concepts Subject to CFTC Rulemaking

We appreciate the opportunity to explain how we believe CFC should be viewed regarding a number of key terms within DFA that are subject to CFTC rulemaking. Here, we focus on the following terms:

- "Swap"
- "Eligible contract participant"
- "Swap dealer" and "Major swap participant" definitions
  - "Swap dealer"
  - "Major swap participant"
  - "Substantial position"
  - "Commercial risk"
  - "Highly leveraged relative to the amount of capital it holds"

"Swap": A Forward Rate Lock Should not be Considered a "Swap" Subject to Clearing and Margin

We understand that the DFA allows some flexibility in excluding certain contracts from the very detailed definition of "swap" in the DFA. We believe that the forward rate locks we offer our members should not be included in that definition. These are contracts with our borrowers that protect the borrower from interest rate fluctuations; they are not derivatives contracts.

- **A forward rate lock is a simple letter agreement between CFC and the borrower used to protect a borrower against rising or volatile interest rates**. Any cost charged is either in the form of an interest-rate adder or an up-front fee.

- **A forward rate lock is not structured like a swap.** In a forward rate lock agreement with a member, the member may pay for the privilege of being protected from interest rate fluctuations. CFC's obligation is to honor the locked-in rate for the underlying loan. There is no notional amount or index used as the basis for a mutual exchange of cash flows as there is with an interest rate swap agreement. If the member revokes the commitment, the member will be charged an administrative fee plus an obligation to make CFC whole.

"Eligible Contract Participant": CFC Should Continue to Be Considered Eligible to Enter Into Swaps Not Traded on an Exchange

Section 723 of DFA states, "It shall be unlawful for any person, other than an eligible contract participant, to enter into a swap unless the swap is entered into on, or subject to the rules of, a board of trade designated as a contract market under section 5" of the Commodity Exchange Act ("CEA"). CFC should be deemed to be an "eligible contract participant" able to use non-exchange-traded swaps. At the very least, the CFTC should refrain from defining "eligible contract participant" in any way that would disqualify CFC from using swaps that are not traded on an exchange.

- **CFC already qualifies as an "eligible contract participant" under existing law.** Under the CEA, the statutory definition of "eligible contract participant" includes "a corporation, partnership, proprietorship, organization, trust, or other entity…that has total assets exceeding $10,000,000" that is "acting for its own account" (7 USC § 1a(12)(A)(v)(I). CFC currently has more than $20 billion in assets. Moreover, the CEA allows the CFTC to include in the definition "any other person that the Commission determines to be eligible in light of the financial or other qualifications of the person" (7 USC § 1a(12)(C)).

- **CFC's prudent use of swaps as an end user merits continued access to the over-the-counter market.** As discussed throughout this paper, CFC's use of swaps does not raise the types of concerns that would merit disqualifying us from using over-the-counter swaps. CFC uses swaps only to hedge commercial risk. We work with a select universe of highly creditworthy counterparties and carefully choose our contract terms to suit the risk we need to hedge.

"Swap Dealer" and "Major Swap Participant" Definitions

We believe CFC does not logically fit into the concept of a "swap dealer" and is not an entity that Congress intended to subject to the restrictions, requirements and related costs that would be imposed on such entities. In particular, we caution that the term "highly leveraged relative to the amount of capital it holds" should not be defined or interpreted based solely on U.S. GAAP measurements or standard tests of bank capital. Such tests could inadvertently sweep CFC into the definition of "major swap participant," as CFC does not have the capital structure of a for-profit bank. For example, due to our cooperative structure and tax status, we cannot issue common equity as a publicly traded banking organization would.

- **"Swap Dealer."** DFA generally defines "swap dealer" as "any person who— (i) Holds itself out as a dealer in swaps; (ii) Makes a market in swaps; (iii) Regularly enters into swaps with counterparties as an ordinary course of business for its own account; or (iv) Engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps[.]"
    - **CFC does not make a market in swaps, nor do we engage in proprietary trading activities.** CFC uses swaps solely to hedge interest rate risk associated with the loans we make to our members.
    - **We enter into swaps not as investments for our own account, but to hedge risks arising from the loans we make to our members.** We caution that the concept of

"regularly enter[ing] into swaps with counterparties as an ordinary course of business for its own account" should not be defined in such a way that would capture entities that merely enter into a large volume of swaps, or that regularly enter into swaps, while their purpose for doing so is non-speculative and is done to hedge or mitigate their own commercial risk.

- Rather, the CFTC should explicitly carve out such productive uses of swaps with language such as the following:

  - *Regularly enters into swaps with counterparties as an ordinary course of business for its own account, **excluding swaps entered into to hedge or mitigate commercial risk**.*

- **"Major Swap Participant."** DFA generally defines a "major swap participant" to mean "any person who is not a swap dealer, and— (i) Maintains a substantial position in swaps for any of the major swap categories as determined by the [CFTC], excluding— (I) Positions held for hedging or mitigating commercial risk; and (II) Positions maintained by any employee benefit plan [...]; (ii) 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 (iii)(I) Is a financial entity that is highly leveraged relative to the amount of capital it holds and that is not subject to capital requirements established by an appropriate Federal banking agency; and (II) Maintains a substantial position in outstanding swaps in any major swap category as determined by the [CFTC]."
  - **CFC's use of swaps does not raise the concerns underlying the "major swap participant" concept.** DFA's concept of "major swap participant" – and the regulatory regime to which such entities will be subject – is driven by concerns that such entities' swap activities put the larger economy at risk, and thus require increased supervisory oversight.

- **"Substantial position."**
  - **CFC's swaps positions should not be considered a "substantial position" for purposes of the major swap participant definition.** The CFTC is directed to define "substantial position" at the threshold that it deems to be prudent for the effective monitoring, management and oversight of entities that are systemically important or can significantly affect the financial system of the United States. In crafting the definition, the CFTC is to consider the entity's relative position in uncleared versus cleared swaps and may take into consideration the value and quality of collateral held against counterparty exposures. We believe the CFTC should consider the fact that 100 percent of our swaps are held to hedge or mitigate commercial risk – chiefly, interest rate risk – and that our counterparty risk is extremely well managed.

  - **Positions for hedging or mitigating commercial risk should be excluded for calculating a "substantial position" for "major swap participant" purposes.** Under the first prong of the "major swap participant" definition, swap transactions

that hedge "commercial risk" are excluded. We believe that provision also should be incorporated into the third prong, as it is just as relevant for "financial entities" as for other types of entities. The mere fact that an entity is primarily engaged in lending – and thus falls under the "financial entity" definition – should not mean that entity should be penalized for holding positions in swaps that serve solely to mitigate the entity's own commercial risk and do not serve any speculative purpose.

- **"Commercial risk."** "Commercial risk" is not defined in DFA, and the CFTC is not required to define the term through rulemaking. However, defining the term is important, as the term is used in two key areas of DFA. First, the term is used in determining whether an entity holds a "substantial position" in swaps for purposes of the "major swap participant" definition. Second, the term is used in the end user clearing exemption providing that a non-cleared swap must be used to "hedge or mitigate commercial risk." Additionally, as we have proposed above, the term should be used in the context of the definition of "swaps dealer."

    - **"Commercial risk" should be defined to include any legitimate risk incurred in connection with operating a business and should explicitly include interest rate risk and currency risk.** Managing these two types of risks is integral to conducting CFC's business and is not associated with proprietary or speculative trading. We encourage the CFTC to view the concept of hedging or mitigating commercial risk as one in which there is a direct link between the derivative contract and managing the risks associated with an entity's *own* business, as opposed to speculative swaps based on risks of parties unrelated to the end user. Thus, we propose language such as the following:

        - **"Commercial risk" means any risk incurred by a person or entity in connection with its own business, including (1) interest rate risk; (2) currency risk; ..."**

- **"Highly leveraged relative to the amount of capital it holds." We fully recognize** that the failures of certain financial firms in recent history have resulted, at least in part, from problems with overleverage. However, we caution against applying a bank-like or GAAP-based capital adequacy regime to a nonprofit cooperative lender such as CFC, which has a structure that is very different from other types of financial companies and is able to manage its risk without the need for the types of capital requirements applicable to certain other types of companies, such as depository institutions. While CFC is not subject to the capital requirements to which banks are subject, many of our capital instruments are the functional equivalent of bank regulatory capital and should be considered as such.

    - **Given CFC's cooperative structure and tax status, CFC cannot issue traditional equity securities.** Instead, CFC has retained earnings and certain long-term subordinated debt securities that creditors and rating agencies have treated as the functional equivalent of core capital. Insisting on a strict GAAP measure of capital

would put CFC at an unfair disadvantage relative to for-profit entities that can freely issue common equity.

- **CFC's adjusted equity is composed of (1) members' equity and (2) certain long-term, subordinated debt obligations.**

  - Members' Equity. This amount consists of (1) fees paid by members; (2) an education fund, to which CFC contributes less than 1 percent of net earnings each year and which is used to support cooperative education programs; (3) a members' capital reserve, which constitutes retained earnings that have not been allocated to any member but could be so allocated in the future; (4) unallocated net loss; and (5) allocated net income.

  - Long-Term Subordinated Debt. CFC issues several forms of long-term subordinated debt that it includes in its adjusted equity:
    - *Subordinated Deferrable Debt* — These instruments are sold on the New York Stock Exchange and have a par value of $25.00 and a maturity of 40 years. CFC may defer interest for up to 20 quarters.
    - *Membership Subordinated Certificates* — Members of CFC may be required to purchase these certificates as a condition of membership. They are unsecured and pay interest at 5 percent semi-annually that is deferrable if CFC cannot make payments on other senior debt. All other debt is senior to these certificates, and members cannot call them before maturity. The certificates are non-transferable and have an original maturity of 100 years. The weighted average maturity for all membership subordinated certificates outstanding at May 31, 2010, was 66 years.
    - *Loan and Guarantee Subordinated Certificates* — Members obtaining long-term loans, certain short-term loans or guarantees were generally required to purchase additional loan or guarantee subordinated certificates with each such loan or guarantee based on the members' debt-to-equity ratio with CFC. CFC loans are typically 35-year loans, and the certificates tied to a loan carry the same maturity as the loan. In the event of a loan default, CFC has a right of offset on these certificates. Effective June 1, 2009, CFC changed its equity policies. Under current policy, most members requesting standard loans are not required to buy subordinated certificates as a condition of a loan or guarantee. Members meeting certain criteria or members requesting large facilities may be required to purchase member capital securities (described below) or other subordinated certificates as a condition of the loan.
    - *Member Capital Securities* — CFC began offering member capital securities to its voting members during the 2009 fiscal year. Member capital securities are subordinate to CFC's existing and

future senior indebtedness and all existing and future subordinated indebtedness of CFC that may be held by or transferred to non-members of CFC, but rank equally to the membership subordinated certificates. Members can voluntarily purchase these securities. They have a 35-year maturity and are callable at par at CFC's option five years from the date of issuance and anytime thereafter.

- **The membership subordinated certificates, loan and guarantee certificates, and member capital securities that CFC issues are the functional equivalent of core capital, and are treated as such by our creditors and rating agencies.** Like common equity and noncumulative perpetual preferred stock, these debt instruments are available to absorb losses. These debt instruments do not have redemption features that would permit a holder to withdraw funds before maturity and have long-dated maturities. Further, all of the membership subordinated instruments give CFC the right to offset the member's investment in the instrument against any amounts the member may owe CFC. This offset right has been utilized by CFC to mitigate loan losses. Because of these features, rating agencies and existing creditors have equated these instruments to core capital.

  - CFC's loan and guarantee subordinated certificates also may be viewed as the functional equivalent of nonwithdrawable accounts or pledged deposits. Current Office of Thrift Supervision ("OTS") capital regulations (12 CFR § 567.5(a)(iv)) recognize nonwithdrawable accounts and pledged deposits of mutual savings associations as components of core capital. The loan and guarantee subordinated certificates are established in connection with a loan and must remain outstanding during the term of the loan.

- **Given our unique capital structure, we have developed certain ratios that management, creditors and rating agencies use to analyze our financial condition.** For example, CFC's revolving credit agreements require CFC to maintain an "adjusted leverage ratio" of no more than 10-to-1. This and other ratios used by CFC are described below.

  - Adjusted TIER. This ratio measures CFC's ability to cover the interest expense on our debt obligations. The TIER ratio equals the sum of our interest expense plus net income, divided by interest expense. CFC's revolving credit agreements require that we achieve an adjusted TIER over the six most recent quarters of 1.025 and prohibit us from retiring patronage capital unless we have achieved an adjusted TIER of 1.05 in the preceding fiscal year. The adjusted TIER ratio adds derivative cash settlements to interest expense, adds noncontrolling interest net income to total net income, and removes derivative forward value and foreign

currency adjustments from total net income. Our adjusted TIER was 1.12 for the year ended May 31, 2010.

- Adjusted Leverage Ratio. This ratio measures the sum of total liabilities and total guarantees divided by total equity. We make adjustments based upon the terms of our revolving credit agreements. Adjustments include (1) the subtraction from debt used to fund total liabilities of loans guaranteed by the U.S. Department of Agriculture's RUS; (2) the subtraction from debt and addition to equity of instruments that have equity-like characteristics (membership subordinated subscription certificates, loan and guarantee subordinated certificates, and subordinated deferrable debt); and (3) the exclusion from total liabilities and total equity of the effect of non-cash foreign currency adjustments and non-cash adjustments under ASC Topic 815, Derivatives and Hedging. Our adjusted leverage ratio was 6.34-to-1 as of May 31, 2010.

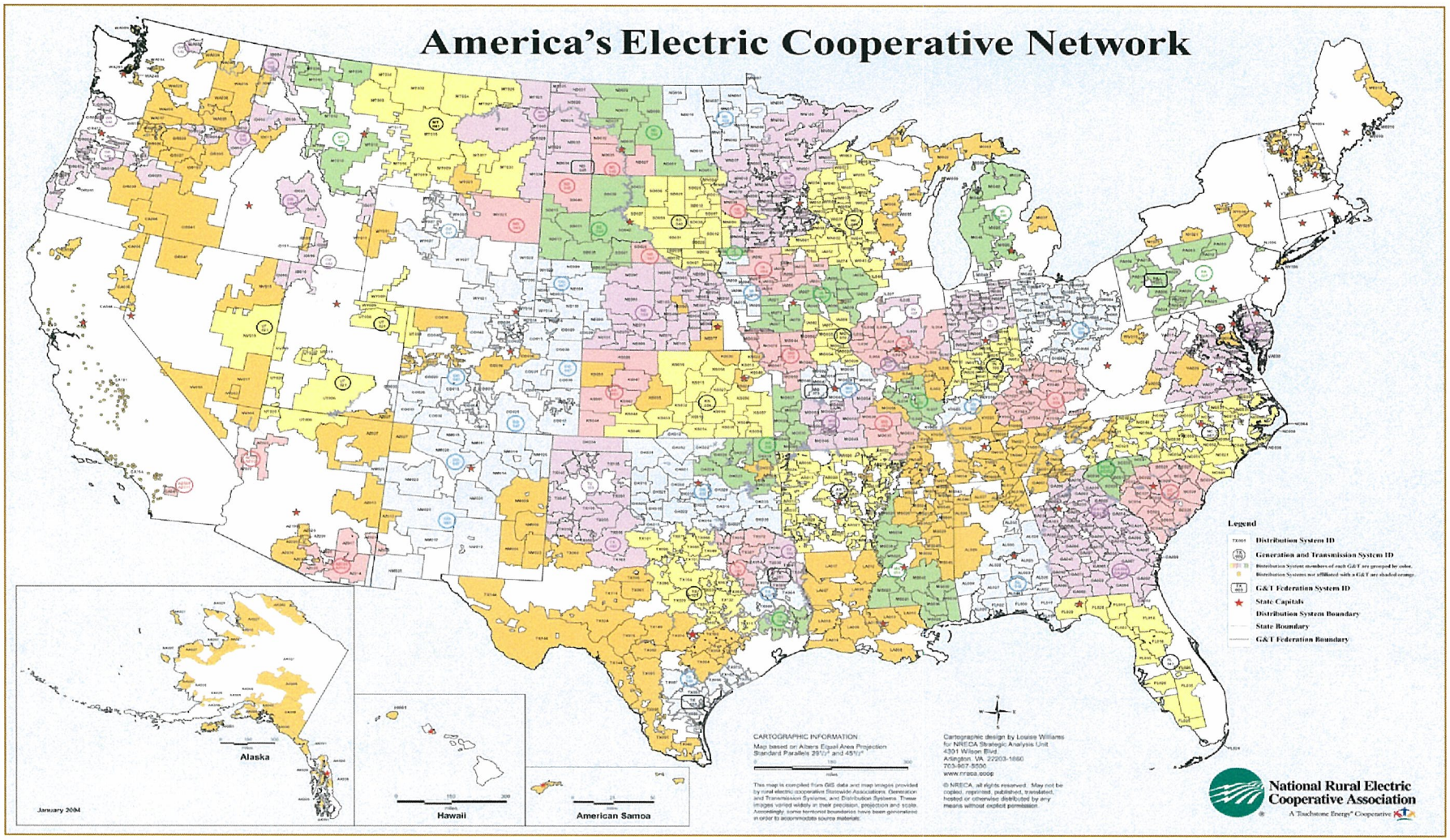
- Adjusted Debt-to-Equity Ratio. This ratio measures total liabilities divided by total equity. The only difference between this ratio and the adjusted leverage ratio is the inclusion of guarantees in the leverage ratio basis. At May 31, 2010, our adjusted debt-to-equity ratio was 5.93-to-1 as compared with a debt-to-equity ratio of 33.33-to-1 based on GAAP.

- **"Adjusted" equity should be used to evaluate our capital adequacy, not our GAAP numbers.** We make certain adjustments to financial measures in assessing our financial performance that are not in accordance with GAAP. These non-GAAP adjustments fall primarily into two categories: (1) adjustments related to the calculation of the TIER ratio and (2) adjustments related to the calculation of the leverage and debt-to-equity ratios. These adjustments reflect management's perspective on our operations and are used to measure covenant compliance under our revolving credit agreements.

- **In short, CFC's capital structure should not be viewed as overleveraged simply because it does not mirror the capital structure of for-profit banks.** For-profit banks are inherently subject to different risks and are organized to achieve different financial goals than the risks and goals applicable to CFC. We urge the CFTC to recognize this reality as it progresses in its rulemaking activity.

We appreciate the opportunity to provide this information about CFC. For any questions or additional information, please contact Rich Larochelle, Senior Vice President, at 703-709-6794 or Rich.Larochelle@nrucfc.coop.

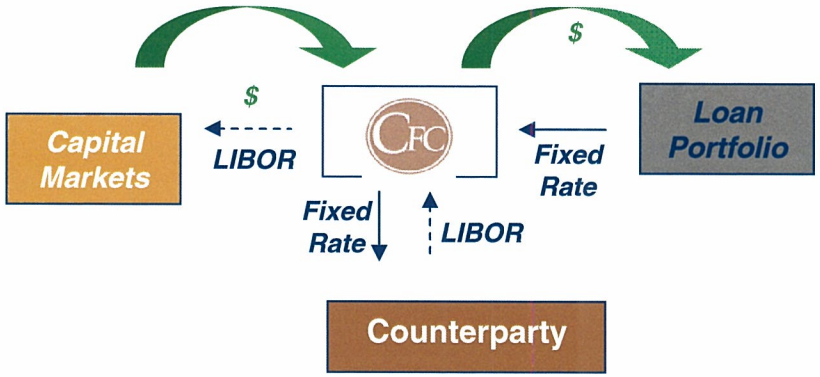
Attachment A



How CFC uses Interest Rate Swaps

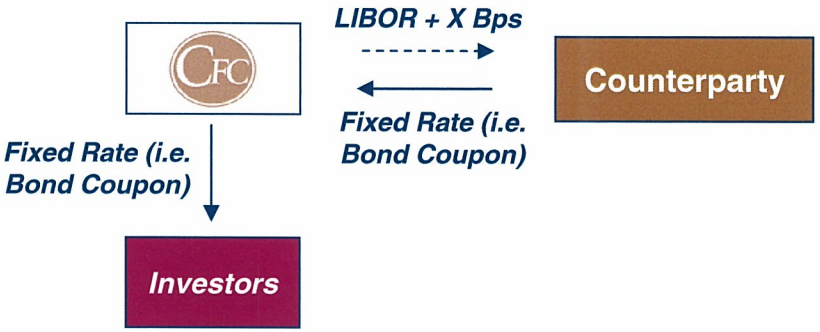
- In this example, CFC receives fixed interest from an aggregate loan portfolio but pays floating LIBOR to capital market investors. This mismatch in interest rate creates exposure, prompting CFC to swap the fixed rate from its loan portfolio to floating.

Pay-Fixed Swap



- In this example, CFC issues fixed rate notes and uses the proceeds to pay down Commercial Paper. CFC then swaps the fixed notes to floating so as to maintain its floating exposure and achieve a lower cost of funds.

Pay-Floating Swap



Attachment C

CFC's use of Derivatives, 1998 - 2010

Year	Deal Count	Notional
1998	42	1,334,710,896
1999	11	974,350,000
2000	32	3,998,853,500
2001	40	7,617,378,573
2002	21	6,514,500,000
2003	45	4,433,402,643
2004	14	1,058,531,800
2005	35	3,247,134,500
2006	20	1,451,878,525
2007	31	2,945,218,401
2008	25	2,203,708,000
2009	17	1,558,201,100
2010	14	1,091,684,925

Attachment D

CFC's Swap Portfolio by Rating as of May, 2010

S&P RATINGS					MOODY'S RATINGS			
Range	Number of Banks	Notional	% of Portfolio		Range	Number of Banks	Notional	% of Portfolio
AAA to AA-	5	2,435,992,325	22%		Aaa to Aa3	13	7,885,335,946	70%
A+ to A	12	8,069,939,046	72%		A1 to A2	5	2,800,005,425	25%
BBB to BBB+	2	508,346,000	5%		Baa1	2	508,346,000	5%
NR	1	179,410,000	2%					
	20	11,193,687,371	100%			20	11,193,687,371	100%

Attachment E

Projected Additional Costs of Margin Requirements to CFC and Electric Co-ops

Regulatory Requirement	Net MTM Collateral			Notional Collateral (at 15% of Swaps)		
	2.5% Cost Drag		6.0% Cost Drag	2.5% Cost Drag		6.0% Cost Drag
A. If Pledging Required for all Swaps, including those existing prior to DFA.	26 bps		63 bps	505 bps		1,212 bps
B. If Pledging Required only on swaps issued after DFA regulations.	4 bps		11 bps	23 bps		55 bps

* Assumes $1 Billion in new loans to spread these additional costs.