February 22, 2011

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

RE: RIN number 3038-AD10 / End-User Exception to Mandatory Clearing of Swaps
RIN 3038–AD06 / RIN 3235–AK65 – Definitions
File Number S7–39–10

Dear CFTC Reviewers:

We are sending this letter on behalf of the Independent Community Bankers of America (ICBA) and our 5,000 community bank members[1] in response to internal deliberations within the CFTC regarding the segregation of client funds and related issues. The Dodd-Frank legislation's provisions relating to derivatives could affect over 1,000 community banks that engage in low-risk customized swaps. The Commodity Futures Trading Commission (CFTC) and the Securities Exchange Commission (SEC) are seeking comments on various proposals from the public by February 22nd. Our comments relate to several of these proposals and other concerns that we desire the agencies to consider as part of the overall rulemaking framework related to the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA).

Background -- Mandatory Clearing of Swaps and End User Exemption

The CFTC is proposing new requirements governing the elective exception to mandatory clearing of swaps available for swap counterparties meeting certain conditions under Section 2(h)(7) of the Commodity Exchange Act, as amended by the DFA. The DFA amended the CEA to require that swaps be cleared through a derivatives clearing organization (DCO) if they are of a type that the Commission determines must be cleared, unless an exception from mandatory clearing applies and that swaps subject to a clearing requirement be executed on a registered trading platform, i.e., a swap execution

[1] The Independent Community Bankers of America represents nearly 5,000 community banks of all sizes and charter types in the United States and is dedicated exclusively to representing the interests of the community banking industry and the communities and customers we serve. ICBA members represent more than 20,000 locations nationwide and employ nearly 300,000 Americans. ICBA members hold $1 trillion in assets, $800 billion in deposits, and $700 billion in loans to consumers, small businesses and the agricultural community.

facility or a designated contract market (DCM), unless no facility or market is available for execution of such swap.

The Dodd-Frank Act provides the Commission with authority to adopt rules governing an end-user clearing exception. The Commission is also required to consider whether to except small banks, savings associations, farm credit system institutions, and credit unions from the definition of ``financial entity" contained in CEA Section 2(h)(7)(C)(ii). Our comments in this section pertain to the exception for small banks.

ICBA Position on Small Financial Institutions

Congress was obviously concerned about the potential impact of forcing small financial institutions under $10 billion, including most community banks, to engage in the mandatory clearing of swaps. This is reflected not only in the insertion of the exception language in the DFA but in questions and comments made by various members of Congress during recent congressional hearings on DFA derivatives regulations.

Therefore, ICBA strongly urges CFTC and SEC to implement this exception for mandatory clearing of swaps for community banks. Community banks should generally be viewed as “end-users” in that they utilize swaps to manage risks or better serve their customers’ needs.

Most community bank swap transactions will not meet the initial criteria for clearing simply because they are “customized”. The “customization” is done to allow the swap to conform to the risks being hedged. The risk being hedged is typically associated with community bank borrowings (certificates of deposits or Federal Home Loan Bank borrowings) or commercial loans. For example, a community bank making a commercial loan that amortizes, pays monthly and is tied to 1-month LIBOR, must “customize” the swap to those characteristics to appropriately hedge their exposure.

While these types of swaps are a relatively small part of the overall swap market, they are extremely critical to the community bank market. Large swap dealers typically do not solicit business from small to medium sized community banks that fall below their thresholds for trade volume. The community bank market is typically served by middle market swap dealers who aggregate business up to the large dealers.

In a typical swap transaction, a middle market swap dealer executes a derivative transaction with a community bank (downstream counterparty) and then hedges their position with a large swap dealer (upstream counterparty). The middle market swap dealer requires the downstream counterparty to post margin (both independent and full mark-to-market) and then rehypothecates that margin to the upstream counterparty. This process has worked for years to mitigate credit risk and allows for the efficient operation of the community bank swap market.

Although the types of interest rate swaps that community banks enter into are much like the plain-vanilla swaps that will be cleared by larger financial institutions, their

customized characteristics will cause them not to be cleared by clearing organizations. The clearing organizations will focus their business model on the swaps of larger financial institutions due to the swaps being larger in notional values and the swap volume being immensely greater. In reality, the clearing organizations will not be able to accommodate the swaps of community banks for many years. Therefore, implementing an exception to mandatory clearing for community banks makes great sense.

In addition, the volume of swaps engaged in is extremely small compared to the overall swaps market. The exception would therefore not cause problems in transparency or safety for the overall swaps market. CFTC's very limited resources should be focused on the larger financial institutions and their use of complex swaps that contributed to the financial crisis. The swaps that community banks engaged in were not relevant to the financial crisis, and again, do not pose risks to the financial system.

Most of the swaps community banks use are customized to match the underlying nature of the loan the bank has made. These are not the risky swaps or the complex derivatives that Wall Street investment firms created and therefore they do not pose the risks to the financial system that warrant monitoring. CFTC's budget is limited as Chairman Gensler has stated recently, and scarce agency resources should be targeted on the real problem, namely complex derivatives of large institutions that utilize derivatives in large volumes.

Capital and Margin Requirements of Community Bank Swaps

Due to their customized nature, the swaps used by community banks will need to be traded in the over-the-counter market. The very complex derivatives products utilized and created by large financial institutions for use in the OTC market should indeed have higher capital and margin requirements as envisioned by the DFA. However, the customized swaps utilized by community banks are simply interest rate swaps and have very little risk. As such the capital and margin requirements of community bank swaps should be no greater than the capital and margin requirements of cleared swaps. In addition to being granted an exception for the mandatory clearing of swaps as discussed above, financial institutions under $10 billion should also be granted an exemption for posting higher capital and margin requirements for customized swaps – their capital and margin requirements should be the same as for cleared swaps.

We understand that many customized swaps, created largely by Wall Street firms for highly sophisticated end users, have complex features that present unique risks and therefore should result in higher capital requirements than cleared swaps. However, the customized swaps that community banks use are simply interest rate swaps that look much like standard interest rate swaps but are "customized" to match the underlying loans (i.e. payment frequencies, specific dollar amounts).

These "customized" features allow the swap to match the underlying exposure (loan, deposit, or borrowing) to create an effective hedge that meets US GAAP accounting requirements. These slight variances in terms do not cause greater risk than is posed by standard swaps.

Not all customized swaps have equal and higher economic risks than cleared swaps and this is certainly true with the swaps used by community banks. In fact, over time the clearinghouses could determine that they wanted to accept riskier swaps than those used by community banks, but these riskier – yet cleared – swaps would be granted advantageous capital and margin treatment simply because they're cleared.

Similarly, when community banks purchase or sell swaps, they have little choice but to use independent broker-dealers, who are willing to meet their banks' "high touch," low volume needs. Potentially higher capital and margin requirements could jeopardize the viability of independent broker-dealers and/or eliminate the availability of swaps provided by many of these firms. Higher capital and margin requirements would ultimately harm the farmers and small businesses that rely on community banks for credit and increase risks for community banks as they are prevented from using swaps.

If the CFTC and SEC do impose increased capital requirements for customized swaps that community banks use it will be very damaging and will result in greatly limiting or eliminating the use of these derivatives by community banks. The result would be that many community bank customers would not have access to the products they need to conduct business and would transfer their borrowing activities to large financial institutions which have the volumes to attract the attention of the clearing houses. It was clearly not congressional intent to drive community banks out of the swaps market as reflected in the statute and legislative history and subsequent comments by members of Congress. Community banks utilizing swaps should not be penalized with higher capital and margin requirements simply because clearing organizations won't accept their swaps.

Exclusion of Swaps Subsequent to Origination

In the "Definitions" regulation (17 CFR Part 240; RIN 3235–AK65) the CFTC requests comment on the proposed rule relating to the statutory exclusion for swaps in connection with originating a loan, and in particular on whether this statutory exclusion should be extended beyond swaps that are connected to the financial terms of the loan, and if so, why. The CFTC also requests comment on whether this exclusion should apply only to swaps that are entered into contemporaneously with the Insured Depository Institution's (IDI's) origination of the loan (and if so, how ``contemporaneously'' should be defined for this purpose), or whether this exclusion should also apply to swaps entered into during part or all of the duration of the loan (page 80182).

ICBA strongly believes that this exclusion should apply during the entire duration of the loan. IDIs use swaps to provide fixed rate financing to their borrowers and to mitigate the associated interest rate risk. IDIs also offer swaps on existing loans to allow borrowers to protect themselves from interest rate risk. The business purpose for offering swaps to borrowers is not related to whether the loan is newly originated or pre-existing. It is the same financing and the same risk management transaction that the swap and the loan are designed to address although they may not occur simultaneously. Therefore, whether initiated at origination or subsequently during the term of the loan, the timing of the swap is not the issue and should not be the focus of regulation, rather the purpose of the swap is the important factor regardless of when the swap is entered into.

In addition, we believe that both the CFTC and the SEC should exempt IDIs from the definition of "swap dealer" to have consistent regulations on this matter and prevent confusion. Further, any IDI under $10 billion should not be considered a swap dealer either by the CFTC or the SEC.

Hedging and Risk Mitigation

In the "Definitions" regulation (17 CFR Part 240; RIN 3235–AK65) the CFTC requests comment (page 80195) relating to "Hedging or Mitigating Commercial Risk." The CFTC requests comments to address whether the proposed "economically appropriate" standard would effectively limit positions encompassed by the definition.

ICBA strongly believes it is absolutely not appropriate to adopt standards derived from accounting principles because accounting standards (ASC-815) are currently based on arbitrary standards of effectiveness not necessarily related to the underlying economic purpose. For example, mortgage companies that own mortgage servicing rights (MSRs) often hedge these assets with interest rate swaps. The swaps provide an appropriate economic hedge of the assets, but do not qualify for "hedge accounting treatment" under current US GAAP. There are many other examples that make accounting standards inappropriate for this purpose.

Exemptions Related to Types of Entities

On page 80753 of the "End-User Exemption" proposal, the CFTC states: "The Commission preliminarily believes the question of whether an activity is commercial should not be determined solely by an entity's organizational status as a for-profit company, a non-profit organization, or a governmental entity. Instead, the determinative factor should be whether the underlying activity to which the swap relates is commercial in nature."

ICBA agrees with this principle and believes that the CFTC and SEC should not make distinctions in their proposed rule based on the type of institution involved in regards to any matter – not just the one referenced above - unless the DFA instructs the agencies to do so. For example, there should not be distinctions between IDIs and for-profit cooperatives. The key issue is the type of swap being utilized, its purpose, and its riskiness. IDIs should not be disadvantaged compared to other types of organizations. As a further example, many community banks compete against Farm Credit System institutions. It would be unfair from a competitiveness standpoint to grant FCS institutions swap exemptions that are not granted to community banks.

The CFTC states, for example: "The Commission expects that a person's overall hedging and risk management strategies will help inform whether or not a particular position is properly considered to hedge or mitigate commercial risk for purposes of the clearing exception." This principal should apply broadly to prevent any distinctions between for-profit entities whether they are IDIs, cooperatives, or other types of entities.

Other Questions Posed by CFTC

Should swaps qualifying as hedging or risk mitigating be limited to swaps where the underlying hedged item is a non-financial commodity? No, financial swaps such as interest rate swaps should also be exempted.

The Commission is interested in whether special considerations are warranted with respect to the use of non-cleared swaps by agricultural cooperatives as well as by non-profit, governmental, or municipal entities engaged in electric power or energy activities. Commenters are requested to discuss both the policy and legal bases underlying such comments. Congress inserted the exemption for institutions under $10 billion in size in the DFA and that should be the clear starting point for exemptions. Congress did not want community banks to be caught up in the mandatory clearing of swaps or the higher capital and margining requirements, as noted above. Beyond what the law clearly states, any further gradations should not make distinctions between various types of entities as that would introduce competitive disadvantages into the swaps regulatory structure. Congress did not intend for the CFTC and the SEC to make judgment calls that tilt the competitive playing field in favor of or against certain sectors of the financial industry.

Consistent with other principles laid out by the CFTC in the regulation, the ultimate issue is the nature or type of the transaction, not the nature or size of the institution – as long as the institution does not pose potential systemic risks to the financial sector or engage in complex or risky activities related to derivatives.

Should the Commission consider adopting a definition of ``hedge or mitigate commercial risk'' in proposed Sec. 39.6(c) that is different from definition of ``hedging or mitigating commercial risk'' in the major swap participant definitions rule and is specifically designed to address the circumstances of the end-user clearing exception? If so, what are the specific considerations associated with the end-user clearing exception that make a separate definition desirable? We do not see why such a distinction is necessary if the CFTC and SEC adopt the recommendations in this letter. Community banks using swaps are essentially end-users and they should be exempt from clearing and from higher capital and margin requirements for customized swaps just as other end-users.

Would such an exception (for small financial institutions) be appropriate? If so, what terms and conditions should apply? Would it be better for the Commission to simply require Small Financial Institutions to follow the same practices as other financial institutions in the future? Would such an exception pose any risks to the swap markets or the financial system? Why or why not?
As mentioned above, clearing organizations will not be interested in the swaps of community banks due to their small size and small volume and therefore community banks should be exempted from clearing since they would not be able to do so even if they desired to. Swap dealers that community banks use to arrange swaps have been told by clearing organizations that they are not ready or willing to clear the swaps of community banks.

If large and small financial institutions are treated "equally", then such an arrangement automatically gives huge advantages to large institutions which have much more capacity to have their swaps cleared. In addition, as explained above, the types of swaps used by community banks are customized to match the unique characteristics of the underlying loan(s) and therefore need to be handled in the OTC market. Although slightly customized, these swaps would not be accepted for clearing even though their risks characteristics are equal to those of plain-vanilla cleared swaps. This is also why it is important not to require higher capital and margin requirements for the customized swaps of community banks – to ensure they are not penalized and thus displaced from the swaps market simply because their swaps are not accepted by clearing organizations.

How should the Commission take into account the supervisory regimes to which Small Financial Institutions are currently subject, and whether those regulatory regimes adequately mitigate any risks associated with an exception? Should the Commission consider treating different types of swaps differently when considering whether any exception should be available for Small Financial Institutions? If so, what specific distinctions should be considered by the Commission and what would be the benefits of adopting them? As mentioned above, the types of swaps used by community banks are basically plain-vanilla, low-risk interest rate swaps. They are not the types of highly complex and risky swaps that caused AIG to lose billions of dollars or cause Wall Street investment firms to lose hundreds of billions of dollars. CFTC's limited resources need to be focused where the problem actually is – not on trying to regulate every non-risky swap in existence.

Community banks are heavily regulated and their prudential regulators closely examine their risk mitigation strategies. This fact gives further weight to the rationale that small financial institutions should be exempted from clearing requirements and higher capital and margining requirements. By contrast, large financial institutions are not only "too-big-too-fail" but also tend to be "too-big-too-regulate" and therefore merit the type of scrutiny that CFTC and SEC contemplate.

As a starting point, the CFTC should exempt swaps utilized by small financial institutions as envisioned in the DFA. If the CFTC or SEC wants to make further gradations, their focus should be on identifying the types of swaps with high risk factors that actually contributed to the financial crisis.

Should the Commission consider limiting the availability of any end-user clearing exception to only some Small Financial Institutions? Are there differences between Small Financial Institutions that should lead to differences in the availability of the exception? If so, what specific distinctions should be considered by the Commission and what would be the benefits of adopting them? Would an across-the-board application of an exception to all Small Financial Institutions create any advantages or disadvantages for certain Small Financial Institutions? Would a differentiated application of an exception create any advantages or disadvantages? Exemptions for <u>all</u> IDIs under $10 billion should be the starting point and we see no language in the DFA that distinctions should be made between small financial institutions. We see no legitimate rationale for making distinctions between small IDIs.

We do not see that an across-the-board exception for small financial institutions would create advantages if all small financial institutions are treated equally. If distinctions are made among small financial institutions, then those who do not receive the exemption would be disadvantaged in the marketplace based on arbitrary decisions made by the CFTC or SEC. Congress did not envision such distinctions.

Granting the exemption that Congress envisioned to small financial institutions would not give them an advantage in comparison to larger financial institutions due to the small volume of swaps business conducted by small financial institutions. Most of the swaps of community banks would not be accepted for clearing anyway, meaning the exemption would not advantage community banks against other market participants. Further, large financial institutions that will clear their swaps already have advantages over small IDIs in that the larger financial institutions will have a lower cost of doing business and larger counter parties to do business with. Large banks have also been granted a huge competitive advantage in the market versus broker-dealers because they are allowed to hold less capital against the same products. CFTC and SEC regulations should not favor the large financial institutions. The exception would not provide small players advantages over large ones.

Are there measures other than total assets of $10 billion, such as financial risk or capital, which could be used for determining whether an entity qualifies for an exception, and if so, what are the advantages or disadvantages of utilizing the alternative measures? Would utilizing these alternative measures create additional risks, and if so, should the Commission consider additional measures to address them? The DFA suggests that the agencies are to consider an exemption for entities under $10 billion. Differences in capital levels between different types of financial entities would not be appropriate as some institutions (i.e. Farm Credit System lenders) are given preferential treatment in accumulating capital, such as the tax-free accumulation of retained earnings and no or limited taxes on various types of lending so their capital levels would undoubtedly be higher. Taxpaying institutions may have lower levels of capital than other types of institutions, but be well capitalized by their industry's standards. Therefore, we would be quite concerned with CFTC or SEC making judgments based on capital levels, particularly because the institution's regulators already make these judgments and already require actions if institutions are not adequately capitalized.

Financial institutions may need to utilize swaps for risk mitigation strategies or to better serve their customers. The appropriate use of these swaps will help these institutions to operate successfully and generate greater capital levels. If the CFTC or SEC reduce or eliminate the ability of such financial institutions to operate successfully, risks to the institutions and therefore the institutions capital levels may be *increased*.

Again, the issue is really the type or nature of the transaction rather than the type or size of institution as long as the institution does not pose systemic risks or engage in the use of risky derivatives.

It is also important for the CFTC and SEC to understand that the community banking sector is not interconnected – the failure of one or a handful of banks will not cause the downfall of other banks. Community bank regulators ensure that community banks can stand on their own merits and regulators closely examine banks to ensure that their risk management strategies are appropriate for the institution. Examiners would not allow community banks to engage in risky swaps. Large banks, however, do pose systemic risks, as shown by the bailouts received during the financial crisis and they merit the focus of the CFTC and SEC in regards to derivatives regulations.

Chairman Gensler's February 17 testimony before the Senate Banking, Housing and Urban Affairs Committee (page 9) states: "The risk of a crisis spreading throughout the financial system is greater the more interconnected financial companies are to each other. Interconnectedness among financial entities allows one entity's failure to cause uncertainty and possible runs on the funding of other financial entities which can spread risk and economic harm throughout the economy." Such comments apply to the nation's large banks and financial institutions, not community banks, which are not interconnected to one another nor do they pose systemic risks due to their size or activities. As the Chairman's testimony notes (page 11): "the largest 25 bank holding companies currently have $277 trillion notional amount of swaps." Clearly the CFTC's and SEC's focus should be on these large institutions, particularly given the CFTC's limited budget referenced by the Chairman in the same testimony.

It is also important to understand that there are already additional capital requirements in place for community banks utilizing swaps – both those of the swaps dealer the community bank is working with as well as those contained in the ISDA master agreements.

Community Bank Advisory Group

The CFTC and SEC, either jointly or separately, should form a joint community bank advisory group comprised of community banks that utilize swaps to ensure the agencies have an ongoing understanding of how community banks participate in the swaps market and what future issues may emerge or need to be addressed as changes occur in the derivatives marketplace. Such a group could provide useful input to the agencies going forward. ICBA would be pleased to assist in the formation of such a group.

Rehypothecation Issue

We are quite concerned that rules developed for the cleared swaps market will be used inappropriately to modify how the over-the-counter swaps market functions. Margin received by a swap dealer to secure uncleared swaps will most likely be subject to rules applicable to cleared Swaps. That is, there is a material chance that rehypothecation will be prohibited. Community banks are caught in an unfortunate scenario simply because the characteristics of the swaps they use precludes them from clearing into the foreseeable future and forces them to the OTC market (uncleared) which may prohibit rehypothecation.

The prohibition against rehypothecation of margin for uncleared swaps could be catastrophic. Such a prohibition would severely curtail or possibly eliminate the community banks' access to the swap market. Most community bank swap transactions will not meet the initial criteria for clearing simply because they are "customized" as explained above. While these types of swaps are a relatively small part of the overall swap market, they are extremely critical to the community bank market.

As mentioned, middle market swap dealers typically execute derivative transactions with a community bank (downstream counterparty) and then hedges their position with a large swap dealer (upstream counterparty). The middle market swap dealer requires the downstream counterparty to post margin (both independent and full mark-to-market) and then rehypothecates that margin to the upstream counterparty. This process has worked for years to mitigate credit risk and allows for the efficient operation of the community bank swap market. Without rehypothecation, middle market swap dealers will be required to obtain marginable assets to meet their upstream margin requirements. The cost of obtaining marginable assets could force middle market swap dealers to exit the market, which in turn would effectively eliminate the community banks' access to the swap market. It is noteworthy that many capital markets allow, and rely upon, rehypothecation or similar arrangements. An obvious example is the repurchase agreement market, where securities are routinely rehypothecated among market participants.

Conclusion

We strongly urge the CFTC and SEC to adopt the recommendations contained in this letter. Additionally, there has been considerable discussion in recent weeks about the frenzied pace of the numerous regulations being produced by the CFTC and SEC. The CFTC's Feb. 17 testimony references almost forty-eight rules. Observers have stated that not only is it difficult to keep up with all of the individual regulations, it is difficult to, at times, comprehend how all of the regulations may tie together. Therefore, we suggest that a "look-back" opportunity be allowed to ensure that the public can continue to comment on various proposed regulations even after the comment deadlines to accommodate further discussions by the public and within industries due to the short timeframe in which to consider the many proposed rules.

Thank you for considering our views. Should you have any questions regarding the content of this letter, please feel free to contact Mark Scanlan at 202-659-8111.

Sincerely

/S/

Mark Scanlan
Vice President, Agriculture and Rural Policy, ICBA

CC: Securities and Exchange Commission