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March 21, 2011

VIA ELECTRONIC DELIVERY

Mr. David A. Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington, DC 20581

Re: Risk Management Requirements for Derivatives Clearing Organizations (RIN 3038-AC98)

Dear Mr. Stawick:

On behalf of the Federal Home Loan Banks (the "FHLBanks"), we appreciate this opportunity to comment on the Commodity Futures Trading Commission's ("CFTC" or the "Commission") above-referenced proposed rules to implement several of the core principles for derivatives clearing organizations ("DCOs") contained in the Commodity Exchange Act ("CEA"), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or the "Act").

Subject to an appropriate exception for end-users, the FHLBanks support the Dodd-Frank Act's mandatory clearing requirement as a means of reducing risk, increasing transparency, and promoting market integrity within the financial system.[1] The FHLBanks also generally support the CFTC's adoption of bright-line regulations, including the proposed Risk Management Requirements for DCOs that are the subject of this letter, as a means of facilitating compliance with the DCO core principles and protecting the integrity of the U.S. clearing system. The FHLBanks are concerned, however, that some aspects of the proposed rules will adversely impact market participants that will use cleared swaps to hedge or mitigate their commercial risks. The FHLBanks urge the CFTC to amend the proposed rules so as to: (i) increase the minimum capital requirement for membership in a DCO, (ii) afford DCOs greater discretion with respect to initial margin requirements, (iii) provide greater protection for customer collateral held

[1] The FHLBanks's views with respect to the end-user exception to the mandatory clearing of swaps are contained in a comment letter submitted to the CFTC on February 22, 2011 (on file with the CFTC).

by DCOs and their clearing members (hereinafter "clearing members"), and (iv) provide more specificity with respect to portfolio compression requirements.

1. The FHLBanks

Each of the 12 FHLBanks is a government-sponsored enterprise of the United States, organized under the authority of the Federal Home Loan Bank Act of 1932, as amended, and structured as a cooperative. The FHLBanks serve the general public interest by providing liquidity to their financial institution members, thereby increasing the availability of credit for residential mortgages, community investments, and other services for housing and community development. Specifically, the FHLBanks provide readily available, low-cost sources of funds to their members.

The FHLBanks enter into swap transactions with traditional swap dealers to facilitate their business objectives and to mitigate financial risk, primarily interest rate risk. As of September 30, 2010, the aggregate notional amount of over-the-counter interest rate swaps held by the FHLBanks collectively was $804.4 billion. At present, all of these swap transactions are entered into bilaterally and none of them are cleared. Although it is uncertain what percentage of the FHLBanks' swaps will be subject to mandatory clearing under the Dodd-Frank Act and how much initial margin will be required to support the cleared swaps, the amount could be substantial. Each of the FHLBanks will individually post initial margin in order to protect its clearing member, and thereby the DCO, against a default, thereby reducing systemic risk.

1. The Proposed Rules

a. Minimum Capital Requirement – Proposed Rule 39.12(a)(2)

Proposed Rule 39.12(a)(2) prohibits DCOs from setting a minimum capital requirement of more than $50 million for any person that seeks to become a clearing member. Although the FHLBanks support the Commission's efforts to ensure fair and open access to DCOs, the FHLBanks believe that a $50 million threshold is too low and would undermine the stability that DCOs are intended to provide; the FHLBanks suggest that the Commission establish a higher minimum capital threshold. Underscoring the FHLBanks' concerns is the continued uncertainty regarding the Commission's willingness to address "fellow-customer" risk.[2] The FHLBanks also believe that the proposed rules should require that DCOs set minimum capital requirements in proportion to risk: such scaled capital requirements should match the degree of risk involved with the swaps that a clearing member seeks to clear (CME currently employs this model[3]) as

[2] *See infra* note 5.

[3] The CME imposes a $50 million minimum capital requirement for clearing members seeking to clear commodity swaps, a $500 million minimum capital requirement for clearing members seeking to clear credit default swaps or rate swaps and a $300 million minimum capital requirement for clearing members seeking to clear commodity swaps and all other types of swaps. Rule 8F04 of the CME Rulebook, *available at*

well as the clearing member's risk profile. The Commission should also include in its rule the specific criteria that a DCO is to look to when determining a clearing member's risk profile. The proposed rule's requirement that DCOs set capital requirements that "are based on objective, transparent and commonly accepted standards that appropriately match capital to risk" does not provide sufficient guidance for market participants.

b. Flexibility to Waive Initial Margin – Proposed Rule 39.13(g)

Proposed rule 39.13(g) requires DCOs to collect customer initial margin posted to clearing members in gross. The FHLBanks believe that it may be appropriate, in some circumstances, for a DCO to waive its initial margin requirements with respect to certain highly creditworthy customers of a clearing member. Accordingly, the FHLBanks urge the CFTC to grant DCOs discretion to waive initial margin requirements when doing so would not pose risk to the DCO or its clearing members. The FHLBanks recognize that the Dodd-Frank Act requires the removal of reliance on credit ratings and, as such, recommend that the CFTC adopt alternative criteria by which a DCO may exercise such discretionary waivers. The CFTC could alternatively grant DCOs discretion to establish their own criteria, subject to CFTC approval or to guidelines established by the Commission in the final rule.

c. The Acceptability of Letters of Credit as Initial Margin – Proposed Rule 39.15(c)(1)

Proposed rule 39.15(c)(1) expressly prohibits DCOs from accepting letters of credit from clearing members to meet initial margin requirements. The CFTC's rationale for this prohibition is that letters of credit are "unfunded financial resources with respect to which funds might be unavailable when most needed."[4] The proposed rule does not exclude any other type of asset from being eligible collateral, but rather affords a DCO discretion to set its own eligible collateral requirements. The FHLBanks believe that a hard and fast prohibition against letters of credit is inappropriate because it fails to take into account that a letter of credit issued by a highly creditworthy entity could contain terms that would make the letter of credit just as liquid as a funded asset. Also, the proposed rule may unnecessarily constrain certain end-users from clearing eligible swaps because they are precluded for various reasons, including loan covenants, from pledging other assets.

d. Collateral Segregation – Proposed Rule 39.15(b)

Under proposed rule 39.15(b), DCOs and their clearing members will be required to segregate customer funds received in connection with swap transactions. The proposed rule adopts the segregation model for customer funds that is employed in the futures markets:

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http://www.cmegroup.com/rulebook/CME/I/8F/.

[4] Risk Management Requirements for Derivatives Clearing Organizations, 76 Fed. Reg. 3,698, 3,710 (Jan. 20, 2011) (to be codified at 17 C.F.R. pt. 39.13(h)(4).

customer funds are segregated from the funds of the clearing member or DCO, but are comingled with other customers' funds.

The FHLBanks support full physical segregation of customer funds.[5] To the extent that the CFTC does not adopt rules that require physical segregation of customer funds, the FHLBanks believe that proposed rule 39.15(b) should, at a minimum, require the physical segregation of customer funds at the clearing member level. Segregation at the clearing member level will facilitate a DCO's management of a clearing member default and would not be unduly burdensome or costly given that there are and will only be a handful of clearing members available (*e.g.*, LCH's SwapClear Futures Commission Merchant ("FCM") service currently has only 12 FCM clearing members).

e. Portfolio Compression – Proposed Rule 39.13(h)(4)

Proposed rule 39.13(h)(4) requires DCOs to "offer multilateral portfolio compression exercises, on a regular basis."[6] All of a DCO's clearing members must participate in such exercises to the extent that a swap is eligible for portfolio compression and portfolio compression is not reasonably likely to significantly increase the risk exposure of the clearing member. The proposed rule does not define the term "regular basis", however, nor does it provide guidance on how a DCO is to determine which swaps are eligible for portfolio compression and when compression is "reasonably likely" to increase risk exposure to a clearing member.

The FHLBanks are concerned that the proposed rule's ambiguities will cause the internal risk management strategies of entities that are not swap dealers or major swap participants to be adversely affected. Specifically, the FHLBanks believe that portfolio compression could potentially jeopardize hedge accounting treatment for customers' swap transactions and disrupt anticipated cash flows.[7] Such a result would run counter to the intent of the Dodd-Frank Act which, as demonstrated by the inclusion of an end-user clearing exception, seeks to protect end-users' ability to hedge or mitigate their commercial risks. In addition, the FHLBanks are concerned that the proposed rule is not sufficiently detailed so as to allow market participants to accurately assess how they will be impacted. As a result it is difficult for market participants to meaningfully participate in the rulemaking process via the submission of substantive comments to the proposed rule.

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[5] *See* FHLBanks comment letter to the CFTC supporting proposed model 1 contained in the CFTC's Advanced Notice of Proposed Rulemaking pertaining to collateral segregation for cleared swaps, dated January 18, 2011 (on file with the CFTC).

[6] *Supra*, note 4 at 3,722.

[7] The FHLBanks submitted a comment letter on this topic, dated February 28, 2011, in response to the CFTC's Confirmation, Portfolio Reconciliation and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants proposed rule, 75 Fed. Reg. 81.519 (Dec. 28, 2010) (to be codified at 17 C.F.R. pt. 23) (on file with the CFTC).

The FHLBanks urge the CFTC to clarify the ambiguities contained in the proposed rule so that market participants can determine how mandatory portfolio compression will affect them. Specifically, the FHLBanks urge the CFTC to further define "reasonably likely to increase risk exposure to a clearing member" to include the risk exposures of a clearing member's customers. The FHLBanks believe that a clearing member's customers must have the ability to "opt-out" of portfolio compression requirements to the extent that those customers' swap positions need to be retained for hedge accounting and other business purposes. In addition, the CFTC should specify how often portfolio compression exercises are to take place and what types of swaps are to be included in such exercises.

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We appreciate the opportunity to comment. Please contact Warren Davis at (202) 383-0133 or warren.davis@sutherland.com with any questions you may have.

Respectfully submitted,

Warren Davis
Of Counsel

cc: FHLBank Presidents
FHLBank General Counsel