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Capital Markets Division

September 28, 2011

The Honorable Gary Gensler, Chairman
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Via Electronic Mail

Dear Chairman Gensler:

Following on your suggestion at the conclusion of our meeting on September 22, 2011, we are writing to expand on and clarify our comments regarding the application of the insured depository institution ("IDI") exemption and specifically the "...in connection with originating a loan..." issue. Questions were also raised about the "de minimis exemption" from the definition of "swap dealer" as it might apply to regional banks. You had also invited comment on key aspects of the proposed rules pertaining to swap dealers that give rise to compliance costs for regional banks who might not qualify for an exemption under the IDI exemption.

The word "contemporaneously" is not included in the statute

We believe that imposing a time limit between the origination of the loan and the swap execution is an overly narrow interpretation of the exemption that will raise questions about the arbitrariness of any selected timing in the final rule, unduly burden commercial end-users by altering current risk management practices, and potentially reduce the ranks of regional banks offering swaps to their loan customers. To be clear, the statutory language provides the exemption to an insured depository institution that "...offers to enter into a swap with a customer in connection with originating a loan with that customer." The wording is not "when the loan is originated," which clearly would impose a temporal limit; rather the relationship between the loan and the risk management of the loan through a swap is made with the words "in connection with" the loan origination. "Origination" is the process of creating the loan comprised of its unique terms and features as negotiated between borrower and insured depository institution, a process that may, and often does, include a connected swap to manage attendant loan risks.

A close examination of the following typical loans made by regional banks highlights the risk that any time limit imposed by the Commodity Futures Trading Commission (the "Commission") to limit the IDI exemption would be arbitrary and potentially detrimental to risk mitigation and sound banking practice. Commercial loans often provide for a draw period of eighteen-months or more followed by a "permanent" phase of several years within the loan's term to maturity during which amortization occurs. A key feature of such loans for the

commercial borrower is the ability to draw only what is needed to fund the project, an amount that may be less than the loan limit. Equipment loans also provide for multiple advances in order for the commercial borrower to purchase equipment over time, or as it is installed, or when shipped. The revolving line of credit provides a further example of a common loan that is subject to timing differences between availability and funding. Large corporations, moreover, may negotiate revolving credit facilities that incorporate a sub-limit for conditional funding for specified purposes such as acquisition or capital investment, events with unspecified timing. In addition to the examples of loans that have a different closing and funding date, there are also loans and connected swaps that are designed in their origination to provide for conditional extensions at the option of either the bank or borrower that add a further deadline with respect to a logical and typical opportunity to transact a swap. Consider also those commercial borrowers who insist on an unfettered right to convert a loan from floating to fixed at any time during the life of the loan by executing a swap, as a determining factor in the origination of the loan and selection of bank. As these additional examples show, an arbitrary time limit within which the borrower and bank must execute a swap in order to apply the IDI exemption is harmful to the commercial lending function and established risk management practices, a result that we believe Congress appropriately sought to avoid in crafting the exemption for insured depository institutions in the Dodd-Frank Act.

Business owners and financial executives of the non-financial companies who rely on regional banks for credit would be adversely affected in managing loan interest rate risk, if an arbitrary time limit were imposed by the Commission on the timing of their hedging activity using swaps. Imagine a business owner being told that the hedging window had closed for the owner to transact a swap to reduce interest rate risk on a commercial loan only yesterday when the floating rate loan has seven-years remaining until maturity. Regional banks and their commercial customers understand that loans may be hedged at any time during the loan term to maturity and negotiate for such flexibility when the specific terms of the loan are agreed during the origination process [Please see our attached June 3, 2011 letter to the Commission for a description of swap use by commercial loan customers of regional banks]. We would strongly urge the Commission to interpret the statutory language of the IDI exemption to allow a regional bank and a commercial customer to enter into an interest rate swap to hedge rate exposure on a commercial loan at any time during the life of the loan, an interpretation that would be fully reflective of commercial lending markets and practice, would not restrict access by borrowers to a vital risk management product, and would not be at all inconsistent with the Dodd-Frank Act's express goals of limiting systemic risk, providing transparency, and promoting market integrity.

Regressive Cost Structure

The justification and rationale for Congress writing the IDI exemption into the statute, and for the Commission to interpret it realistically, is made clear by the cost structure imposed by Congress in regulating swap dealers.

As currently proposed by the Commission, the cost structure associated with the swap dealer designation is regressive, favoring high volume actors who take the most risk and are therefore the most profitable, and creating a substantial barrier to entry that could bar many

regional banks from the swap business, to the detriment of their commercial loan customers. The statute provides no regulatory discretion with respect to "swap dealer." One either is a swap dealer based on activity, subject to enumerated exemptions, or one is not. Notably, the costs associated with compliance are not differentiated by facts and circumstances relating to each swap dealer such as size, market position, systemic risk impact, volume of trades, track record, variety of regulators overseeing the swap dealer, type of swap in terms of risk or complexity, customers and trade motivation, to name several. Accordingly, the swap business of a regional bank that historically evolved as an ancillary business to the bank's primary commercial lending operations, scaled appropriately to safely and efficiently accommodate a modest volume of interest rate swaps for the bank's own commercial loan customers, faces an existential regulatory cost burden. Ironically for purposes of the goals of the Dodd-Frank Act, the business imperative for regional banks to operate profitable businesses poses the choice to either (1) exit the swap business because the historic revenue fails to support the higher cost structure, or (2) so alter the business risk profile, customer base and product set, so as to raise sufficient additional revenue to support the higher costs. To continue operations, regional banks that were designated as swap dealers would be compelled to market clients who are not commercial loan customers, trade non-traditional swaps whose complexity and risk provide greater profit potential, and assume significant new risks that bona fide swap dealers incur and regional banks eschew, such as market, leverage and basis risk.

Specifically, the compliance costs associated with the swap dealer designation result from investment in infrastructure, development of compliance procedures, and significant additions to staff including the hiring of a C-level executive (e.g., CEO, CFO, COO) to act as a designated compliance officer. By their nature these costs are largely fixed rather than variable, further complicating the regional bank's business reorganization, since a substantially higher transaction volume than a regional bank's swap business generates will be required to defray the added overhead.

As proposed by the Commission (see 17 CFR Parts 23 and 155 RIN 3038-AD25), a swap dealer must provide its swap counterparties whose swaps are uncleared with a "daily…mid-market value." Since the swap counterparties of a regional bank will generally be eligible for a clearing exemption, a regional bank, designated as a swap dealer, will be required to have a system that is capable of providing daily swap valuations at mid-market as such valuation concept will evolve, as determined by the Commission. Specifically, existing systems may not have the capability to provide mandated information with respect to market curves, volatility, or credit spreads, nor to verify market conditions at time of trade execution, nor be sufficiently robust to provide information in required formats, as they may change, or be accessed. Under the proposed business conduct rules for swap dealers, trading and accounting systems operated by regional banks may, therefore, not be in compliance now or in the future, necessitating investment in infrastructure. Noteworthy is the fact that regional banks generally do not operate proprietary systems, nor have dedicated software programmers to modify systems, as do the money center banks characterized as bona fide swap dealers. Indeed regional banks will likely face further competitive disadvantages in the race to upgrade systems that meet compliance standards.

Generally, the proposed business conduct rules for swap dealers create a duty for swap dealers to establish policies and procedures and a system of administration to insure compliance. For a regional bank, aspects of the new compliance obligations may not be strictly applicable, given the narrow scope of swap activity conducted, but the costs associated with maintaining a robust and comprehensive system will nonetheless apply. In spite of the relative resources available to any entity to meet this obligation, creating a compliance system from scratch, the task for a regional bank is unimaginable without substantial outside legal, compliance and regulatory consultants. The start-up costs are still unknown, but expected to be significant. Once the system is documented, staffing and training costs, together with record retention, will also be incurred and need to be absorbed by the regional bank's discrete and low volume swap business.

As proposed by the Commission (see 17 CFR Part 3 RIN 3038-AC96), a swap dealer must designate an individual reporting directly to its board of directors or to its senior officer to serve as its chief compliance officer. Moreover, the designated chief compliance officer must meet annually with the board or senior officer to discuss the effectiveness of compliance policies and prepare, sign and certify the swap dealer's annual report as to completeness and accuracy. As part of the officer's duties, the chief compliance officer is further required to provide a written description to the Commission of the swap dealer's compliance with regulations promulgated under the Commodities Exchange Act and a description of each policy and procedure, including the code of ethics and conflict of interest policies for the swap dealer. Not only does the proposed rule mandate the hiring of a C-level executive but costs to the swap dealer are further compounded by the implication contained in the proposed rule that the chief compliance officer will have dedicated resources and an independent staff and budget, since the Commission requires an annual "...description of the financial, managerial, operational, and staffing resources set aside for compliance with the CEA and the Commission's rules, including any deficiencies in such resources." The likely outcome for a regional bank in applying this rule to its swap business is a compliance staff and budget in excess of its existing sales and operations staffing and budget.

Regulatory Discretion

Congress recognized the potential for the difficult and undesirable outcomes associated with a uniform and rigid swap dealer definition and granted the Commission broad discretion to determine what constitutes a "de minimis quantity of swap dealing," to provide an exception for entities other than bona fide swap dealers. The Commission has already proposed exempting swaps having a total $100 million notional amount in aggregate, traded over the prior twelve months, surmising that with an assumed average notional amount of $5MM per swap, up to twenty swaps per year might be exempt. We respectfully suggest that the notional amount should be substantially higher, to establish a meaningful threshold for regional banks that transact hundreds of interest rate swaps with their own commercial loan customers each year, and to avoid the certain dilemma that the twenty-first commercial borrower will otherwise face. Furthermore, we believe that the size assumption will prove to be too small, so the application of the proposed rule would affect far fewer than twenty commercial borrowers in practice. It should be relatively straightforward for the Commission, with the assistance of bank regulatory

authorities, to ascertain the dimensions of regional banks' interest rate swap activities and to use that information in formulating a "de minimis exemption" that preserves the important role that those activities play in the Country's economy.

We urge the Commission in adopting final rules implementing the new regulatory framework envisioned in Title VII of the Dodd-Frank Act to establish clear and realistic rules to implement the IDI exemption. To do otherwise would make the exemption meaningless and would result in the unintended consequence of imposing a cost structure that will disproportionately impact regional banks providing loans and swaps to manage risk to their commercial borrowers. Should you or a member of your staff find it helpful to visit a regional bank's swap trading desk and operations facilities as a point of comparison with the operations of a Wall Street dealer, please do not hesitate to contact the undersigned, at challgren@mtb.com or by phone at (410) 244-4353, to make arrangements and to discuss in greater detail any of the points in this letter.

Sincerely,

Craig P. Hallgren, CFA
Managing Director
Interest Rate Risk Management
Manufacturers and Traders Trust Company

Attachment

CC: Mr. David A. Stawick, Secretary, and members of The Commodity Futures Trading Commission
D. Scott Warman, EVP and Treasurer, Manufacturers and Traders Trust Company