



THE FARM CREDIT COUNCIL

August 14, 2012

By Electronic Submission

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

Re: Clearing Exemption for Swaps Entered Into by
Cooperatives (RIN 3038-AD47)

Dear Mr. Stawick:

On behalf of its members, the Farm Credit Council submits these comments on the notice of proposed rulemaking issued by the Commodity Futures Trading Commission (“Commission”) concerning the clearing exemption for certain swaps entered into by cooperatives.¹

The Farm Credit Council is the national trade association for the Farm Credit System (“FCS” or “System”), a government instrumentality created “to accomplish the objective of improving the income and well-being of American farmers and ranchers by furnishing sound, adequate, and constructive credit and closely related services to them, their cooperatives, and to selected farm-related businesses necessary for efficient farm operations.”² Fulfilling this mission, the FCS’s four banks and 85 associations currently account for 40% of agricultural lending in the United States. To provide tailored financing products for farmers and farm-related businesses, FCS institutions rely on the safe use of derivatives to manage interest rate, liquidity,

¹ See Clearing Exemption for Certain Swaps Entered Into by Cooperatives (“Exempt Cooperatives”), 77 Fed. Reg. 41,940 (proposed July 17, 2012) (to be codified at 17 C.F.R. pt. 39).

² 12 U.S.C. § 2001(a).

and balance sheet risk, primarily in the form of interest rate swaps. The Farm Credit Council explained the FCS's safe and sound use of derivatives in earlier comments submitted regarding, among other things, the end-user clearing exception and the swap dealer definition. Because we believe Congress intended to preserve our ability to provide dependable financing to farmers, farm-related businesses, and rural America, the Farm Credit Council appreciates the opportunity to comment.

I. The Farm Credit Council Supports Section 4(c) Relief for Cooperatives.

The Farm Credit Council strongly supports the Commission's decision to use its authority under Section 4(c) of the Commodity Exchange Act ("CEA") to permit cooperatives that meet certain qualifications to elect not to clear certain swaps that are otherwise required to be cleared under Section 2(h)(1)(A) of the CEA. As the Commission correctly recognized, FCS institutions are cooperatives that provide financial services to their members, including lending and providing swaps to members and hedging those activities with other financial entities such as swap dealers. As the Commission further noted, FCS banks make loans to FCS cooperative lending associations, which in turn lend to farmers, ranchers, rural residents, and persons furnishing farm-related services. FCS banks and lending associations meet the definition of "financial entity," and FCS banks and some FCS associations have assets exceeding \$10 billion. Accordingly, without the approach proposed by the Commission, cooperative members who on their own qualify for the end-user exception would be deprived of that exception if they use their cooperative banks as the preferred vehicle for hedging commercial risks in the greater financial marketplace. The Farm Credit Council commends the Commission for proposing a rule that recognizes the unique structure of cooperatives and their relationship to their member-owners.

In addition, the Farm Credit Council believes that the proposed exemption for cooperatives preserves competition in the market for rural and agricultural lending. Under final rules promulgated by the Commission, small commercial banks (with \$10 billion or less in assets) will qualify for the end-user clearing exception.³ However, because FCS associations hedge risk at the level of cooperative FCS banks, they would, absent the proposed rule, be faced with significant new clearing-related costs not borne by competing commercial banks. Again, the Farm Credit Council commends the Commission for appropriately addressing this issue and preserving a level field for FCS institutions and commercial banks.

³ See End-User Exception to the Clearing Requirement for Swaps ("End-User Exception"), 77 Fed. Reg. 42,560, 42,591 (July 19, 2012) (to be codified at 17 C.F.R. § 39.6(d)).

II. The Commission Should Clarify that the Exemption for Swaps Hedging or Mitigating Commercial Risk “Related to” Member Loans Includes Swaps Used to Hedge Risks of a Cooperative Bank Related to its Member Loan Business.

We appreciate the Commission’s request for comment regarding whether the provision allowing for swaps that hedge or mitigate risk “related to loans to members” is too limited or not limited enough.⁴ We believe market participants would benefit from additional clarity regarding the scope of the “related to” standard. In our view, the “related to” standard should be sufficiently broad to reach all swaps done at the level of cooperative FCS banks to hedge or mitigate interest rate, liquidity, and balance sheet risks associated with their cooperative lending business. In this regard, we agree with the Commission’s statement that this test will be satisfied by, among other things, “swaps entered into by exempt cooperatives that hedge or mitigate risks *associated with* member loans,”⁵ and with the Chairman’s statement to the same effect.⁶

Swaps entered into by FCS institutions to support lending to their members predominantly fall into five broad categories: (1) hedges involving a fixed rate bond swapped to a floating rate, which qualify for hedge accounting treatment under Generally Accepted Accounting Principles (“GAAP”), and are designed to enhance liquidity, diversify funding sources, align the floating rate index on the funding with the floating rate index on loans or required liquidity investments, and to reduce interest costs; (2) pay-fixed swaps that are GAAP hedges of floating rate debt, which provide access to synthetic fixed rate funding during periods of market turmoil, such as 2008-09, and may reduce funding costs for the benefit of members; (3) interest rate caps that are GAAP hedges of floating rate borrowings, that are intended to hedge interest rate cap risks on member loans as well as on certain investments required under FCA regulations to be held for liquidity purposes; (4) interest rate floors that are GAAP hedges of specific required liquidity investments that hedge the adverse impact of falling interest rates on bank income; and (5) swaps done directly with members, which are explicitly covered by the proposed exemption.

To fulfill FCS’s mission of providing credit to members of the cooperative FCS institutions, Farm Credit Administration regulations require each FCS bank to maintain a

⁴ See Exempt Cooperatives, 77 Fed. Reg. at 41,944; see also *id.* at 41,952 (proposed 17 C.F.R. § 39.6(f)(2)).

⁵ *Id.* at 41,942 (emphasis added).

⁶ *Id.* at 41,952 (“The proposed cooperative exemption . . . extends only to [among other things] [s]waps entered into by a cooperative to hedge or mitigate risks *associated with* member loans or member loan related swaps” (emphasis added)).

“liquidity reserve” funded from cash and eligible investments.⁷ This liquidity reserve is designed as a cushion to preserve credit for cooperative members in times of economic distress. The FCS believes that swaps transacted to hedge interest rate risk related to these required investments are covered by both the intent and the scope of the proposed cooperative exemption.

Because all of these swaps and hedging activities are integral to the FCS’s lending mission, we believe they should be viewed as hedging or mitigating the commercial risks associated with the FCS’s member loan business.⁸ This conclusion is supported by the Commission’s rationale for providing the cooperative exemption that is explained on page 41,944 of the proposed rule. As discussed above, the proposed exemption seeks to ensure that cooperative members are not deprived of the benefits of the end-user clearing exception simply because they choose to hedge risks at the centralized level of the FCS bank.⁹ In connection with fulfilling their mission of providing credit to their cooperative members, the FCS banks themselves incur risks that they may need to hedge through responsible hedging activity that might be accomplished more efficiently with derivative transactions. If FCS banks were forced to clear swaps that hedge their interest rate, liquidity, and balance sheet risks, then their cooperative members would effectively bear the very clearing-related costs that the CFTC’s proposed cooperative exemption seeks to avoid imposing on those entities or individuals.

In addition, applying the cooperative exemption to all swaps entered into by FCS banks to hedge risks associated with their lending activity is consistent with the Commission’s decision to define “hedges or mitigates commercial risk” in a broad manner “designed to allow a wide variety of potential electing counterparties to structure their swaps in a manner that fits

⁷ See 12 C.F.R. § 615.5134.

⁸ The term “hedges or mitigates commercial risk” would have the same meaning as in the end-user exception. See Exempt Cooperatives, 77 Fed. Reg. at 41,952 (proposed 17 C.F.R. § 39.6(f)(2)(ii)). Accordingly, among other things, all swaps that qualify as GAAP hedges would be exempt. See End-User Exception, 77 Fed. Reg. at 42,590 (to be codified at 17 C.F.R. § 39.6(c)(1)(iii)).

⁹ See, e.g., Exempt Cooperatives, 77 Fed. Reg. at 41,943 (“[S]ome cooperatives provide financial services to their members including lending and providing swaps to members and hedging those activities with other financial entities such as SDs. The memberships of some of these cooperatives consist of entities that each could elect the end-user exception if acting alone. However, some of those cooperatives meet the definition of ‘financial entity’ and have assets in excess of \$10 billion, and therefore the end-user exception is unavailable to them. Accordingly, the cooperative members would not benefit from the end-user exception if they use their cooperative as the preferred vehicle for hedging commercial risks in the greater financial marketplace. In light of this, the Commission is exercising its authority under Section 4(c) of the CEA to propose § 39.6(f) and establish the cooperative exemption.”).

their particular businesses.”¹⁰ Although this definition covers swaps that qualify for GAAP hedging treatment, it applies more broadly than GAAP accounting hedges to any swap that is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, where the risks arise from the potential change in value of, among other things, assets, liabilities, interest rates, or foreign exchange rates.¹¹ It further permits swaps to be used to hedge or mitigate risk on a portfolio basis.¹²

The Farm Credit Council recognizes that the circumstances existing at the time the swap is entered into will determine if a swap is transacted to hedge or mitigate commercial risk.¹³ It is important, however, that market participants and their stakeholders can rely on clear guidance regarding which swaps qualify for the cooperative exemption. For this reason, we respectfully request that the Commission clarify in the preamble to the final rules that swaps transacted by FCS banks to hedge or mitigate commercial risk “related to” their member loan business will include the full range of swaps, specifically including those described on page 3 of this letter.

The Farm Credit Council recommends that the Commission clarify that the following swaps are intended to be covered by the cooperative exemption: (1) any swaps transacted for the purposes described on page 3 of this letter to manage interest rate, liquidity, and balance sheet risk; (2) swaps that qualify as GAAP hedges of System bonds and floating rate notes; and (3) swaps that hedge eligible investments required by the Farm Credit Administration to be held for liquidity management purposes. Further clarification of these items will serve to increase the likelihood that the System’s farmer and rancher member borrowers will be able to benefit from this proposed exemption from clearing.

III. Conclusion

As described in greater detail in the Farm Credit Council’s earlier comments to the end-user clearing exception and swap dealer definition rulemakings, which we incorporate by reference, FCS institutions today have in place strong protections against counterparty default,

¹⁰ See End-User Exception, 77 Fed. Reg. at 42,571. The proposed cooperative exemption defines “hedges or mitigates commercial risk” in the same manner as the end-user clearing exception rules. See Exempt Cooperatives, 77 Fed. Reg. at 41,952 (providing exemption for swap that “hedges or mitigates commercial risk, *in accordance with paragraph (c) of this section*” (emphasis added)).

¹¹ See *id.* at 42,590 (to be codified at 17 C.F.R. § 39.6(c)).

¹² See *id.* at 42,575.

¹³ See *id.* at 42,590-91. As noted above, the term “hedges or mitigates commercial risk” would have the same meaning as it does in the end-user exception rules. Accordingly, it would cover, among other things, GAAP hedges.

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including collateral posting agreements with materially all counterparties. These arrangements are overseen by a federal regulatory agency (the Farm Credit Administration), and they have proved effective through the past several years of financial market difficulties. Accordingly, the FCS poses no systemic risk to the U.S. financial system. Because of these current practices, clearing offers very little additional protection to FCS institutions. We support the Commission's decision to exempt certain cooperatives, including FCS institutions, from mandatory clearing requirements. Notably, some FCS institutions might choose to clear certain of their swaps in order to gain some additional safety. The Commission's action, however, will ensure that the cooperative members of the FCS are not burdened unnecessarily.

We interpret the language in the proposal to indicate that not all swaps engaged in by cooperative financial institutions will necessarily qualify for the proposed exemption. We are not suggesting that every swap entered by a qualifying institution should be eligible for the exemption. However, we do believe that the FCS member institutions and associations would benefit from additional clarity with respect to those swaps that are used to manage interest rate, liquidity and balance sheet risk as we have described on page 3. These types of swaps are central to the FCS mission of providing low cost funding and lending and also support the Commission's purpose underlying this proposal.

For the reasons described above, the Farm Credit Council commends the Commission for proposing an exemption for certain cooperatives from the clearing requirement. The proposed rule will allow the members of cooperative FCS institutions to elect not to clear swaps, while preserving a level playing field in the market for rural and agricultural lending. To provide added clarity to cooperative institutions that qualify for this exemption, the Farm Credit Council urges the Commission to clarify that swaps used by cooperative banks to hedge commercial risks associated with their "cooperative loan business" – including the five swap strategies enumerated on page 3 are covered by the scope of this exemption.

We appreciate the opportunity to comment. If you have any questions or we can provide other information, please do not hesitate to contact us. We would welcome the opportunity to work with the Commission in developing the final rule.

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Sincerely,



Robert P. Boone, III
Vice President, Government Affairs
Farm Credit Council

cc: Honorable Gary Gensler, Chairman
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott D. O'Malia, Commissioner
Honorable Mark P. Wetjen, Commissioner
Erik F. Remmler, Associate Director,
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