National Rural Utilities Cooperative Finance Corporation

Created and Owned by America's Electric Cooperative Network

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December 2, 2014

Christopher Kirkpatrick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
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Re: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants [RIN 3038–AC97]

The National Rural Utilities Cooperative Finance Corporation ("CFC") is a nonprofit member-owned cooperative association that was incorporated under the District of Columbia Cooperative Association Act in April 1969. This letter constitutes our comments on the "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants; Proposed Rule," issued by the Commodity Futures Trading Commission (the "CFTC") on September 23, 2014 (the "Proposed Rule"). CFC provided comments[1] on the earlier 2011 margin proposal (the "2011 Proposal") of the CFTC.

It is our view that application of the Proposed Rule to nonprofit cooperatives such as CFC would be inconsistent with the purposes and policy behind, and would conflict with, the Clearing Exemption for Certain Swaps Entered into by Cooperatives (the "Cooperative Exemption")[2] issued by the CFTC last year. The Cooperative Exemption acknowledges the benefits of swaps entered into by cooperatives and recognizes that such swaps do not present the systemic risk issues that swaps of other counterparties may present. In fact, the CFTC made its position on cooperative swaps clear by explaining that without an applicable clearing exemption, members of cooperatives, whose hedging swaps are exempt from clearing, "would not receive the full benefits of the end-user exception because the cooperative would have to clear its swaps even though it is entering into the swaps to offset the risks associated with financial activities with its members or to hedge risks associated with wholesale borrowing activities, the proceeds of which are used to fund member loans."[3] The CFTC's reasoning behind the Cooperative Exemption supports a similar regulatory outcome in relation to margin requirements. As CFTC Commissioner J. Christopher Giancarlo noted in his statement on the CFTC's proposed margin rules, "[i]t makes no sense to provide . . . entities [such as cooperative financial institutions] with an exemption from clearing on the

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[1] CFC's comment letters in response to the 2011 Proposal are available at the following links: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=46728 (June 27, 2011); and http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58807 (September 14, 2012).

[2] "Clearing Exemption for Certain Swaps Entered Into by Cooperatives", 78 Fed. Reg. 52286 (August 22, 2013); *available at* http://www.gpo.gov/fdsys/pkg/FR-2013-08-22/pdf/2013-19945.pdf. While approved by the CFTC on August 13, 2013, the final rule became effective on September 23, 2013.

[3] *Id.*, p. 52287.

one hand, only to turn around and require them to bear the potentially even greater costs associated with uncleared swaps," adding that such entities "deserve the full benefit of their clearing exemption, which they may not get if they have to post margin."[4]

CFC respectfully requests that the CFTC, in the final rule for the margin requirements, respects its own approach in the Cooperative Exemption by allowing swaps entered into by cooperatives that are exempt from mandatory clearing ("qualifying cooperatives") to be exempt from mandatory margining. As set forth below, this approach can take several forms, including (i) an express exemption from the definition of "financial end user" or a similar term for qualifying cooperatives such as CFC, and/or (ii) permitting qualifying cooperatives to exclude positions entered into for the purposes of hedging or mitigating commercial risk ("hedging positions") from the threshold of "material swaps exposure." In this regard, CFC requests that the CFTC treats cooperatives in the same manner as they are treated under the Cooperative Exemption for the purposes of the initial and variation margin requirements for non-cleared swaps. CFC believes that this is the treatment that is most consistent with the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

A final rule that lacks an exemption for qualifying cooperatives, such as CFC, would be inconsistent with the Cooperative Exemption and would have no impact on the reduction of systemic risk. More specifically with respect to CFC, without such an exemption it would become more difficult for CFC to make loans to its members at competitive rates, to manage its interest rate risk and to retain flexibility in its lending practices. The consequences of such a rule could be significant as they would increase costs to cooperatives that ultimately will be borne by millions of rural American consumers in the form of higher electric rates.

As noted above, CFC provided comments on the 2011 Proposal. Given the differences between the Proposed Rule and the 2011 Proposal and other regulatory developments that have occurred since the issuance of the 2011 Proposal, we include below background information on CFC and its use of swaps. Following this we address (i) an express exemption from the definition of "financial end user" or a similar term and (ii) the exclusion of hedging positions from the "material swaps exposure" threshold.

A. BACKGROUND ON CFC AND ITS USE OF INTEREST RATE SWAPS

As noted above, CFC is a nonprofit, member-owned cooperative that was incorporated under the District of Columbia Cooperative Association Act in April 1969. CFC's main purpose is to provide its members with financing to supplement the loan programs of the United States Department of Agriculture's Rural Utilities Service. CFC's members are not-for-profit consumer-owned rural electric cooperatives that supply electric power to 42 million consumers of electricity across rural areas of the United States. CFC lends to its members so they can acquire, build and operate electric distribution, generation, transmission and related facilities throughout the country. For most of its more than 1,000 members — distribution

[4] Proposed Rule, p. 59936.

systems, generation systems, transmission systems, statewide associations and affiliated organizations — operating in 48 states, two U.S. territories and the District of Columbia, CFC serves as a major (and for approximately 200 members, the only) financial resource. Many CFC members have access to a wide variety of borrowing options, yet choose to borrow exclusively from CFC because of attractive rates and flexible products. As of May 31, 2014, CFC had loans and guarantees outstanding of $21 billion to its rural electric cooperative members. CFC is the largest non-governmental lender to rural electricity providers.

CFC does not participate in the derivatives markets for speculative, trading or investing purposes and does not make a market in derivatives. Rather, CFC is an end user that uses over-the-counter (OTC) derivatives solely to hedge the interest rate risks associated with lending to its members, primarily at fixed rates. CFC's swap counterparties are usually swap dealers registered with the CFTC, and as such are subject to a comprehensive regulatory framework. CFC believes that as of the date of this letter, most of its counterparties are regulated by one or more of the prudential regulators, as defined in Section 1a(39) of the Commodity Exchange Act. CFC uses risk management and interest rate hedging products that are otherwise unavailable to or too expensive or inefficient for most members (due to their size), were any such member to attempt itself to directly transact in the OTC derivatives market. Given CFC's strong credit metrics and history of financial performance, CFC is not required to post collateral under its current ISDA documentation.

The success of CFC's lending program is largely dependent on the cost-effectiveness and flexibility that can only be gained from the OTC interest rate derivatives market. Because CFC's interest rate swaps historically have not been subject to mandatory clearing or margin, CFC has the flexibility to structure its loans to meet its borrowing members' needs while keeping costs low. As a result, CFC members have access to a variety of credit products and terms, which results in lower fees and rates. The savings are ultimately passed down to rural consumers of electricity. Requiring CFC to collect and post margin on its swaps with covered swap entities would significantly and needlessly increase the costs of lending, which would necessarily be passed on to CFC's members and their customers.

B. EXPRESS EXEMPTION FROM MANDATORY MARGINING

An express exemption from the definition of "financial end user" or a similar term for qualifying cooperatives is the right result for the following reasons: (i) margin requirements for qualifying cooperatives would negate the benefits of the Cooperative Exemption; (ii) swaps entered into by qualifying cooperatives do not increase systemic risk; and (iii) margin requirements for qualifying cooperatives do not further the rationale underlying the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions (IOSCO) policy framework paper on "Margin Requirements for Non-Centrally Cleared Derivatives" (the "International Margin Framework"),[5]

[5] "Margin Requirements for Non-centrally Cleared Derivatives" (Sep. 2013), available at http://www.bis.org/publ/bcbs261.pdf.

which presents the final international framework to establish minimum requirements for initial and variation margin for uncleared derivatives.

Margin Requirements for Qualifying Cooperatives Would Fully Negate the Benefits of the Cooperative Exemption

The CFTC has noted that the Cooperative Exemption furthers the ability of qualifying cooperatives to act for the mutual benefit of their members, which is the sole purpose of qualifying cooperatives such as CFC.[6] Furthermore, the CFTC has acknowledged that the relationship between cooperatives and their members is not at all comparable to that between a commercial lending institution and its borrowers,[7] and that "cooperatives exist to serve their member-owners and do not act for their own profit."[8] As nonprofit cooperatives are extensions of their not-for-profit members and act for the mutual benefit of their members, a clearing mandate that increases costs for cooperatives would result in increased costs for cooperative members. The CFTC recognizes that the Cooperative Exemption, in allowing cooperatives to maintain member access to lending, is consistent with state and federal laws that establish and promote cooperative legal structures.[9] An exemption from mandatory margining for qualifying cooperatives would, in turn, be consistent with both the Cooperative Exemption and some of the reasoning behind the public interest waiver component of the Dodd-Frank Act,[10] which allows the CFTC to exempt contracts entered into between entities described in Section 201(f) of the Federal Power Act[11] from the requirements of the Dodd-Frank Act. Amongst the entities captured by Section 201(f) are nearly all electric cooperatives along with any instrumentalities thereof, which in our view can include CFC because CFC acts as an "instrumentality" of its member rural electric cooperatives.

Clearing arrangements involve the posting of collateral to central clearinghouses, and the Cooperative Exemption effectively excludes qualifying cooperatives from the requirement to post such collateral. The CFTC has therefore recognized that the Cooperative Exemption "is likely to lower operational costs for exempt cooperatives and to reduce their margin requirements," and that "[a]s a consequence, [qualifying] cooperatives will be able to provide lower-cost funding to their members, to retain more member allocable capital, or to pay out higher patronage distributions to their members."[12] A margining requirement for qualifying cooperatives would make the Cooperative Exemption effectively meaningless.

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[6] Cooperative Exemption, p. 52288 ("[b]ecause the cooperatives are established to serve their members and the net earnings they generate through their activities are returned to those members, the benefits of the cooperative exemption ultimately inure to the members of the cooperative. In the context of required clearing and the end-user exception, the cooperative exemption furthers the purpose for which financial cooperatives were established, i.e., to act for the mutual benefit of their members").

[7] *Id.*, p. 52290 ("cooperatives are, in effect, extensions of their members acting in the interests of their members in a way that is not the case for the relationship between other types of financial institutions and their customers").

[8] *Id.*, p.52287.

[9] *Id.*, p. 52297 ("[t]he Commission's recognition that the cooperatives provide a means for its members to access the financial markets in a variety of ways is consistent with the intent of Congress and state legislatures in the laws establishing cooperative legal structures").

[10] Pub. Law. 111-203, § 722(f), codified at 7 U.S.C. § 6(c)(6).

[11] 16 U.S.C. § 824(f)

[12] Cooperative Exemption, p. 52300.

The CFTC should apply its own Cooperative Exemption reasoning to the margin requirements and encourage the prudential regulators to act in a similar manner in order to develop a harmonized and meaningful approach. A mandatory margining mandate would affect the efficiency, flexibility and cost-effectiveness of CFC's lending program with its members, since CFC would be faced with posting margin in connection with its swaps, which heretofore it has not posted. The posting of margin comes with a cost – a cost that would likely be passed on to CFC members in the form of higher interest rates on their loans, which would ultimately be passed on to rural electricity customers. Increasing the costs of hedging in this manner would be inconsistent with the promotion of nonprofit public-interest cooperatives and would provide no offsetting benefit.

Swaps Entered into by Qualifying Cooperatives do not Increase Systemic Risk of the Entities Regulated by the CFTC

While the CFTC in the preamble to the Proposed Rule noted that "[b]ecause financial counterparties are more likely to default during a period of financial stress, they pose greater systemic risk and risk to the safety and soundness of the [covered swap entity]"[13], the proposed inclusion of cooperatives within the definition of "financial end user" is not based on a risk assessment but rather on the observation that such entities' "sole business is lending and providing other financial services to their members, including engaging in swaps in connection with such loans."[14] For-profit financial institutions that lend to the public are vulnerable to fluctuations in demand for financial products and the financial health of their borrowers. This is not the case for nonprofit cooperatives. For example, the nonprofit CFC has a limited universe of borrowers composed of its rural electric cooperative members and owners. CFC has provided financing to these members and owners for 45 years so that these members/owners are able to meet the increasing demand for rural electricity services.

In the cost-benefit analysis accompanying the Proposed Rule, the CFTC acknowledged that "[f]rom a regulatory perspective, minimum collateral standards introduce a trade-off between potentially lowering anticipated returns for market participants and lowering systemic risk from counterparty defaults", noting that "[a] substantial loss from a default might induce a cascade of defaults in a financial network, and perhaps, induce a liquidity crisis and the seizing up of parts of the financial system."[15] We are not aware of any evidence that swaps entered into by qualifying cooperatives such as CFC increase systemic risk. Moreover, there appears to be a lack of information regarding whether margining by qualifying cooperatives would reduce risk.[16]

The CFTC recognized in the preamble to the Proposed Rule that part of its policy with respect to margin rules is to "strike a balance between the need to capture all financial counterparties that pose significant

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[13] Proposed Rule, p. 59902.
[14] *Id.*, p. 59903.
[15] *Id.*, p. 59920.
[16] Cooperative Exemption, p. 52302 ("The Commission does not have adequate information to determine how effectively collateral arrangements may mitigate counterparty risk born by [qualifying] cooperatives and their counterparties").

risk to the financial system and the danger of being overly inclusive"[17] and used this approach to exclude certain types of entities from the definition of "financial end user," including sovereigns, multilateral development banks, captive finance companies that are exempt from clearing and entities (including for-profit entities) that are affiliates of a person that qualifies for an exemption from clearing.[18] With respect to the latter two types of entities, the CFTC noted that those entities are excluded from the definition of "financial end user" because they are exempt from mandatory clearing pursuant to Title VII of the Dodd-Frank Act.[19]

Like captive finance companies and for-profit entities that enter into inter-affiliate swaps, qualifying cooperatives such as the nonprofit CFC pose less systemic risk compared to other types of counterparties that are not exempt from clearing. The main distinguishing factor is that qualifying cooperatives' clearing exemption is the result of regulatory action by the CFTC, rather than a federal statute as is the case with captive finance companies and affiliates, but this is not a substantive distinction in light of the fact that Congress recognized that it could not conceive of every appropriate exception to mandatory clearing and gave the CFTC the authority to create additional exceptions by way of regulation. Since the signing of the Dodd-Frank Act into law, the U.S. House of Representatives has voted in broad bipartisan fashion, 411-12,[20] in favor of the Business Risk Mitigation and Price Stabilization Act of 2013,[21] which, if enacted, would exempt qualifying cooperatives from initial and variation margin requirements.

Furthermore, limiting the mandatory margining exception to the groups of entities identified in the Proposed Rule could aggravate the CFTC's stated policy to avoid overbreadth[22] in defining entities that are subject to mandatory margining. The CFTC addressed this with respect to the Cooperative Exemption by imposing conditions on the use of the Cooperative Exemption and by limiting both the number of entities and the types of swaps that would be exempt from clearing.[23] Accordingly, the CFTC can avoid overbreadth with respect to margin requirements by excluding qualifying cooperatives from the definition of "financial end user" or a similar term following its own tailored approach to the Cooperative Exemption while at the same time allowing qualifying cooperatives and their members to continue to fully enjoy the benefits of non-cleared swaps.

Margin Requirements for Qualifying Cooperatives Do Not Further the Rationale Underlying the International Margin Framework

Imposing margin requirements on qualifying cooperatives does not further the rationale underlying the International Margin Framework and, in fact, can be viewed as an inconsistent approach. The International Margin Framework gives discretion to regulators to define what constitutes a financial firm

[17] Proposed Rule, p. 59902.
[18] *Id.*, p. 59903.
[19] *Id.*, p. 59904.
[20] Roll call vote is available at http://clerk.house.gov/evs/2013/roll215.xml.
[21] H.R. 634, 113th Cong. (2013), *available at* https://www.congress.gov/bill/113th-congress/house-bill/634/text.
[22] Proposed Rule, p. 59902.
[23] Cooperative Exemption, p. 52303.

for purposes of the margin requirement.[24] The CFTC should use its discretion to apply margin requirements to target systemic risk while allowing qualifying cooperatives, such as CFC, that use derivatives for hedging purposes only and which have a public interest purpose, to be exempt from margin requirements in the same way qualifying cooperatives are exempt from mandatory clearing.

The International Margin Framework notes that an "important element of the margin requirements is their general scope of applicability – that is, to which firms do the requirements apply, and what do the requirements oblige those firms to do."[25] The scope of applicability affects "[t]he extent to which the requirements reduce systemic risk."[26] The inclusion of qualifying cooperatives, such as CFC, within the scope of financial end users subject to margin requirements does little to reduce systemic risk, since swaps entered into by qualifying cooperatives for the purposes of hedging their commercial risks do not pose the same risks as those swaps that were implicated in the recent financial crisis. Moreover, margin requirements would introduce new challenges to qualifying cooperatives trying to manage the risks posed by their counterparties. These challenges include increased costs from margin as well as operational complexities related to the monitoring of exposures in order to ensure regulatory compliance.

Furthermore, according to the International Margin Framework, the scope of applicability affects "[t]he extent to which the [margin] requirements promote central clearing."[27] The promotion of central clearing, however, has not been identified as a goal for qualifying cooperatives. Accordingly, in order to make the Proposed Rule consistent with the International Margin Framework, the CFTC ought to exclude qualifying cooperatives from mandatory margining. Otherwise, there will be disparity across jurisdictions, which will interfere with international harmonization. In that regard, CFC agrees with Chairman Massad that "[i]t is particularly important to reach harmonization in the area of margin for uncleared swaps, because this is a new requirement and [the CFTC] do[es] not want to create the potential for regulatory arbitrage in the market by creating unnecessary differences."[28]

Swaps Entered into by CFC do not Increase Systemic Risk of the Entities Regulated by the CFTC

As noted above, CFC is a nonprofit entity created to serve public-interest goals, acting as the financing arm of its member rural electric cooperatives. CFC is not a bank, savings association, credit union or other insured depository institution. Since its inception in 1969, CFC has been focused on providing its members with financing at the lowest possible cost and not with an intention to maximize profits. CFC is not operated for the purpose of making profits nor does it lend to the general public.

Neither CFC nor its members were involved in or contributed to the financial crisis in 2008. Like other participants in the cooperative sector, CFC had strong financial results in 2008 in the midst of the recession, largely because the goal of CFC is to provide cost-effective financing to its members while

[24] International Margin Framework, p. 9.
[25] *Id.*, p. 7.
[26] *Id.*
[27] *Id.*
[28] Proposed Rule, p. 59934.

prudently managing risk, regardless of market conditions. In the lead up to the financial crisis, most of the market disruption was caused by large for-profit financial institutions changing their business model and products to appeal to shareholders concerned mainly with the short-term returns on their investments. This provided an incentive to enter into riskier lines of business. Conversely, CFC's members, purpose and business model has remained fundamentally unchanged since CFC's inception in 1969. Our members are mainly concerned about ensuring that CFC remains a low-cost, long-term funding source.[29]

As stated above, CFC's member base and services have remained fundamentally unchanged since 1969. CFC provides loans and related financial products to a stable and low-risk market, rural electric cooperatives. The credit risks associated with this sector are significantly lower than others as (i) these borrowers and related entities provide an essential service, producing, transmitting and distributing electricity to end-consumers, (ii) as cooperatives, the majority are not subject to rate regulation, allowing for flexibility in managing their costs, and (iii) CFC members are geographically dispersed across the country. As a result, CFC has experienced an extremely low rate of losses in its electric lending activities over its 45-year history. For the fiscal year ended May 31, 2014, CFC experienced no charge-offs related to its electric lending activities. On a consolidated basis, CFC's non-performing loans totaled only $2 million or 0.01% of total loans outstanding as of May 31, 2014. Additionally, the vast majority of CFC's loans are provided on a senior-secured basis, with a collateral package that typically includes a mortgage on all assets and revenues of the utility. These factors highlight the unique credit strength of CFC and differentiate the organization from systemically risky entities.

In addition to the credit quality of its portfolio, CFC has diversified sources of funding that provide access to capital in all markets. Strong member support and private funding account for nearly half of CFC's total funding as of May 31, 2014, reducing its reliance on the capital markets. Even during the financial crisis, investments and equity in CFC by its members increased. CFC members' equity increased by $545 million from May 31, 2008 to May 31, 2010, the fiscal years straddling the financial crisis. This represented an increase of 13.8% in total member investments and equity in the organization compared to the corresponding amounts prior to the crisis, thus demonstrating the alignment between CFC and its member owners, even during times of market contraction.

CFC's nonprofit status and member focus and support, the strong performance of CFC's loan portfolio, diversified access to funding and strong support from CFC's members combine to make CFC a unique organization that does not pose a systematic risk to the financial system. Accordingly, the CFTC should exempt CFC together with other qualifying cooperatives from the definition of "financial end user" or a similar term.

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[29] CFC members have signed on to a letter to the CFTC, dated as of November 12, 2014, urging the CFTC to exempt CFC from margin requirements.

C. Exclusion of Hedging Positions from the Material Swaps Exposure Threshold Calculation

Section 731 of the Dodd-Frank Act requires margin requirements to "be appropriate for the risk associated with the non-cleared swaps."[30] The CFTC noted in the preamble to the Proposed Rule that "[w]ell-designed margin systems protect both parties to a trade as well as the overall financial system [by] serv[ing] both as a check on risk-taking that might exceed a party's financial capacity and as a resource that can limit losses when there is a failure by a party to meet its obligations."[31] When compared to speculation and investing activities, hedging to mitigate commercial risks poses a lower risk to swap counterparties and to the stability of the financial system. In many other contexts, the CFTC has recognized that hedging swaps have low risks and has therefore adopted rules which do not effectively apply to such swaps. For example, positions entered into for the purposes of hedging or mitigating commercial risk are not counted towards determining whether a person is required to register as a swap dealer pursuant to CFTC rules,[32] and swaps that are "bona fide hedging positions" are proposed to be exempt from position limits.[33]

Should the CFTC decline to exclude qualifying cooperatives from the definition of "financial end user" or a similar term, CFC requests that the CFTC allows nonprofit cooperative financial end users to disregard hedging positions when calculating whether they have material swaps exposure for a particular year. Instead of a one-size-fits-all approach, which would be over-inclusive and would force margin requirements onto low-risk non-cleared swaps, excluding hedging positions would allow cooperatives to continue to enjoy the full benefits of the Cooperative Exemption and the CFTC to ensure that only the swaps that contribute to systemic risk are subject to the burdens of margining.

D. Conclusion

For the reasons discussed above, CFC respectfully requests that the CFTC exempts qualifying cooperatives from the definition of "financial end user" or a similar term. CFC believes that this approach is consistent with the rationale underlying the Dodd-Frank Act, the CFTC's Cooperative Exemption and the principles of the International Margin Framework. Alternatively, CFC requests that the CFTC permits hedging positions to be excluded from the material swaps exposure calculations by qualifying cooperatives. With respect to CFC, a margin requirement would significantly hinder CFC's ability to make low-cost loans to its member consumer-owned rural electric cooperatives without any reduction of systemic risk.

We appreciate your consideration. We would welcome the opportunity to further discuss our views. Please do not hesitate to contact Brad Captain, CFC's Senior Vice President of Corporate Relations, at

[30] 7 U.S.C. § 6s(e)(3)(A).
[31] Proposed Rule, p. 59901.
[32] 17 C.F.R. § 1.3(ggg)(6)(iii).
[33] "Position Limits for Derivatives; Proposed Rule", 78 Fed. Reg. 75680, 75827-28 (December 12, 2013), *available at* http://www.gpo.gov/fdsys/pkg/FR-2013-12-12/pdf/2013-27200.pdf.

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