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January 19, 2016

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

RE: Comments on the Swap Dealer *De Minimis* Exception Preliminary Report

Dear Mr. Kirkpatrick:

The American Bankers Association[1] (ABA) and ABA Securities Association[2] (ABASA) (together, ABA) appreciate the opportunity to provide comments on the Commodity Futures Trading Commission's (CFTC or Commission) Swap Dealer *De Minimis* Exception Preliminary Report (Preliminary Report). The Commission has recognized that its decision about the proper level of the *de minimis* threshold must be informed by a robust analysis of swaps market data.[3] Therefore, given the acknowledged current swaps data quality issues, ABA recommends that the Commission immediately issue an interim final rule that maintains the swap dealer *de minimis* exception threshold at $8 billion gross notional amount or raises it above that amount. An interim final rule would send a message of stability to market participants while at the same time preserving the ability of the Commission to make adjustments as appropriate based upon a thorough review of data.

This approach is also consistent with Congressional intent. In December 2015, Congress directed the CFTC to establish the *de minimis* threshold at $8 billion or greater within 60 days of enactment of the Appropriations Act, *i.e.*, by February 16, 2016.[4]

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[1] The American Bankers Association is the voice of the nation's $15 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard $12 trillion in deposits and extend more than $8 trillion in loans.

[2] The ABA Securities Association is a separately chartered affiliate of the American Bankers Association, representing those holding company members of the American Bankers Association that are actively engaged in capital markets, investment banking, swap dealer and broker-dealer activities.

[3] "I believe it is vital that our actions be data-driven, and so we have started work on a comprehensive report to analyze this issue, which will look at the consequences of setting the threshold at different levels." Keynote Address of Timothy G. Massad before the District of Columbia Bar (Washington, DC), July 23, 2015 (*available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-26).

[4] Congressional Directives, Division A – Agriculture, Rural Development, Food and Drug Administration, and Related Agencies Appropriations Act of 2016, p. 32, available at http://docs.house.gov/meetings/RU/RU00/20151216/104298/HMTG-114-RU00-20151216-SD002.pdf.

Banks and Their Customers Primarily Use Swaps to Manage Risk

Maintaining or raising the *de minimis* threshold is the right outcome to ensure that banks and bank holding companies are able to meet their customers' risk management needs. Failure to at least maintain the current $8 billion threshold would likely limit the ability of many commercial end users to access the swaps market to manage their risk in a responsible manner and would effectively counter the broad based regulatory relief that was intended to be afforded to end-users in the Dodd-Frank Act. That is to say, that such failure would undermine rather than promote proper risk management

Commercial banks enter into swaps transactions ancillary to their primary business of providing credit to small and mid-sized end user customers. For many middle market bank customers, entering into swaps with regional, non-dealer banks is the preferred transaction to hedge their business risk because of the customizable nature of swaps as compared to other hedging instruments. Examples of how banks use swaps to serve customers include -

- Entering into floating rate loans coupled with interest rate swaps that hedge the borrower's interest rate risk;
- Entering into interest rate swaps (and other types of swaps, such as non-financial commodity swaps) with corporate end users in connection with the financing activates of those entities;
- Entering into non-financial commodity swaps with energy and agricultural companies needing to hedge the risk of changing oil, gas, or agricultural commodity prices;
- Entering into interest rate swaps with community banks for the purpose of hedging the community banks' interest rate risk.

Following the execution of a swap with its customer(s), most non-dealer banks neutralize their swaps exposures by entering into offsetting swaps with larger dealers, most, if not all, of which are currently registered with the Commission as swap dealers.

Large banking organizations and community banks would also benefit from clarity and certainty if the current *de minimis* threshold is maintained. Community banks are regional bank customers. If a regional non-dealer bank limits its offering of swaps products so as not to trigger swap dealer (SD) registration, access to swaps could become impaired, requiring community banks to use other hedging instruments that are sub-optimal. Maintaining the *de minimis* threshold also would permit global banking organizations that must aggregate swap positions among affiliates to assess swap dealer obligations in order to continue to provide customers' access to swaps.

Commercial Banks and Bank Holding Companies Enter into Swap Transactions in a Safe and Sound Manner

All banks and bank holding companies that engage in swaps transactions do so subject to their primary regulator's approval and in accordance with applicable bank regulations.[5] Moreover, all bank swap transactions must be conducted according to safe and sound principles and subject to supervisory oversight of the federal banking agencies. On-site examiners assigned to larger banks or bank holding companies continually evaluate a bank's risk management program, operations, capital adequacy, and collateralization standards.[6] Regular examinations of smaller banks and bank holding companies include the same assessments. In addition to reporting under Parts 43 and 45 of the CFTC's regulations, banks and bank holding companies report derivatives activities – including swaps activities – in Call Reports and other financial reports. These data are used by Office of the Comptroller of the Currency to compile its OCC Quarterly Report on Bank Trading and Derivatives Activities (OCC Quarterly Bank Derivatives Report)[7] and all the federal banking agencies in conducting their supervisory activities.

Maintaining or Raising the *De Minimis* Threshold Promotes the Policies Advanced by a *De Minimis E*xception without Undermining the Policies of Swap Dealer Registration

The policy aims of swap dealer registration would not be undermined if the *de minimis* threshold were maintained or raised above the current $8 billion gross notional amount. As listed in the Preliminary Report, the policy objectives of swap dealer registration includes reduction in systemic risk, counterparty protections, and swap market transparency, orderliness, and efficiency.[8] Commercial banks that engage in $8 billion gross notional amount of swaps pose no systemic risk,[9] enter into swaps ancillary to some other relationship with their customers, report derivatives activities in Call Reports and other financial regulatory reports, and are subject to examinations by bank regulators. A review of the existing data on commercial banks' and bank holding companies' derivatives activities in the OCC Quarterly Bank

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[5] *See* OCC publication, Permissible Activities for National Banks at 54 (April 2010); See also OCC Interpretive Letter No. 725, reprinted in [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) 81,040 (May 10, 1996). See also OCC Interpretive Letter No. 1071, 2006 WL 490641 (September 6, 2006); OCC Interpretive Letter 1026, 2005 WL 1939863 (April 27, 2005); OCC Interpretive Letter No. 626, reprinted in Fed Banking L. Rep 83,508 (July 7, 1993); and OCC No-Objection Letter No. 90-1 (February 16, 1990), reprinted in Fed. Banking L. Rep. (CCH) 83,095 (bank acting as riskless principal in commodity index swaps); OCC Interpretive Letter No. 371, 1986 WL 85084 (June 13, 1986) (riskless principal transactions are permissible for national banks and their subsidiaries); OCC Handbook, Risk Management of Financial Derivatives (January 1997) ("OCC Derivatives Handbook"); OCC Banking Circular No. 277, reprinted in 5 Fed. Banking L. Rep. 62-152) ("BC-277"); *See also* 12 C.F.R. § 225.25(b)(7) ("Regulation Y"); *See also* Federal Reserve Exam Manual on Trading and Capital Markets, *available at http://www.federalreserve.gov/boarddocs/supmanual/supervision_trading.htm*; *See also* FDIC Manual on Securities and Derivatives, *available at* https://www.fdic.gov/regulations/safety/manual/section3-3.pdf.

[6] "The OCC and other supervisors have examiners on-site at the largest banks to evaluate continuously the credit, market, operational, reputation, and compliance risks of bank derivatives activities." *Infra* note 7.

[7] Office of Comptroller of the Currency Quarterly Report on Bank Trading and Derivatives Activities, *available at* http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/derivatives-quarterly-report.html.

[8] *See* Preliminary Report at 35-36.

[9] This statement is true for banks that engage in an even greater amount of swaps as measured by gross notional amount, a point that will be clarified as better data are made available to the CFTC.

Derivatives Report shows that the policy aims of swap dealer registration would not be furthered by requiring commercial banks with less than $8 billion of gross notional swaps to register. The most recent OCC Quarterly Derivatives Report found that "Four large commercial banks represent 90.8 % of the total banking industry notional amounts and 80.5% of industry net current credit exposure."[10] In the third quarter of 2015, the average total notional activity at the top four commercial banks was approximately $25.6 trillion[11] and the average total notional activity at the top four bank holding companies was approximately $27.3 trillion.[12]

In addition, by maintaining or raising the *de minimis* threshold, the policies of a *de minimis* exception are promoted. As listed in the Preliminary Report, the policy objectives of a *de minimis* exception include regulatory certainty, allowing limited ancillary dealing, encouraging new participants, and regulatory efficiency.[13] Swap transactions are not a major source of revenue for most non-dealer banks. Initial assessments indicate that the costs associated with registering as a swap dealer will likely be greater than the revenue from entering into customer-driven swap transactions. As a result, uncertainty about the *de minimis* threshold – and certainly any lowered threshold – would prompt many non-dealer banks to reduce swaps activities, leading to increased concentration of firms offering swaps and some customers facing few or no options to manage risk. In the absence of the certainty provided by an adequate *de minimis* threshold, decisions by non-dealer banks are complicated by their need to balance current customer-driven swaps activity with planning for future potential customer risk mitigation needs.

Until the CFTC is able to complete a thorough analysis of reliable data across sufficient business cycles to demonstrate customer hedging needs under changing market conditions, the Commission should take a "do no harm" approach and maintain or raise the current $8 billion threshold, as Congress recently recommended.

A Decrease in the Swap Dealer *De Minimis* Threshold According to the Existing Schedule Would be Destabilizing

An informal survey of some of our members indicated that it would take two years to implement fully the regulatory requirements associated with SD registration. The need for an adequate implementation period is especially relevant for those members not already affiliated with a registered SD. In other words, were the phase-in period to terminate on December 31, 2017, as per the existing rule, firms would have needed to know by December 31, 2015, whether they must prepare for SD registration. An interim final rule, as recommended, would remove the dark shadow of such a precipitate change. Otherwise, banks would need to have already begun the SD registration process in order to avoid a disruption of their swap activities, leaving affected

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[10] OCC Quarterly Bank Derivatives Report, Third Quarter 2015, page 1, *available at* http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq315.pdf.

[11] These numbers do not differentiate between dealing and non-dealing swaps, cross-border swaps, and inter-affiliate swaps. *Id.* at Table 1.

[12] *Id.* at Table 2.

[13] *See* Preliminary Report at 37-38.

banks (and their customers) with the only practical alternative of the cessation of some swap services at the time of the current deadline.

Moreover, the process described in Regulation 1.3(ggg)(4) is not a statutory requirement, but rather it was an agency decision made at a time when the Commission had incomplete information about the swaps market and how Title VII implementation would work in practice. The CFTC has the authority to revisit and revise its current phase-in process and can do so without prejudice to any later determination of adequate *de minimis* levels.

<u>The Commission Should Not Use Counterparty Count or Transaction Count to Measure Dealing Activity</u>

ABA is committed to working with the CFTC as it continues to assess the appropriate level of the *de minimis* threshold and the appropriate methodology for determining dealing activity. However, for the reasons discussed below, counterparty count and transaction count are arbitrary and potentially misleading measurements for determining whether a bank or bank holding company is engaged in dealing activity. As described in the Commission's "Swap Dealer Final Rule" and interpretive guidance,[14] ABA believes the Commission should continue to apply a facts-and-circumstances test when determining whether a person's activities fall within one the enumerated categories of swap dealer.[15] Application of a facts and circumstances test would benefit from the clarity provided by an expansion of the exclusions from swap dealing activities, including an expansion of the exclusion for swaps entered into by insured depository institutions (IDI) in connection with originating loans to customers (IDI Exclusion), and a recognition that swaps that are referenced in loan documentation as being considered part of the cash flows in the loan credit underwriting can be excluded, regardless of the date the swap is entered into.[16]

As previously noted, commercial banks enter into swaps with their commercial customers for the purpose of hedging risks related to lending relationships. Commercial banks often engage in loan-level hedging (meaning they enter into swaps on a loan-by-loan basis, rather than on an aggregate basis) and will typically enter into a back-to-back swap with a dealer to hedge the exposure of the original customer-driven swap enabling the commercial bank to run a matched swaps book. The customer-facing swap and the back-to-back swap are each reported with a unique swap identifier (USI). Moreover, the commercial lending business naturally disperses risk amongst multiple borrowers, counterparties, or guarantors – given the multiplicity

[14] *See* Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 Fed. Reg. 30596 (May 23, 2012).

[15] The enumerated categories of swap dealer are someone who "(i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps." *Id. See also* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376, section 721 (2010).

[16] This exclusion is particularly important for those swaps that do not fit into the current construct of the swap dealing exclusions. For example, non-financial commodity swaps that are referenced in the loan documentation as being considered part of the cash flows do not qualify for the exclusions (since non-financial commodity swaps by nature do not line up with the metrics of a loan) even though the policy rationales for the current exclusions are applicable to such swaps as they are reducing risk for both the customer and lending bank.

of business borrowers. Bank regulation also restricts aggregation of risk with a few borrowers, counterparties, or guarantors through lending and concentration limits. Therefore, multiple guarantors may guarantee the obligations under a swap in connection with a single loan. Such a swap would be reported as a single unique swap identifier (USI), but the legal entity identifiers (LEIs) associated with each guarantor would be reported because each guarantor to a swap requires its own LEI. Commercial banks' loan-level hedging programs, including the execution of swaps, have a positive correlation with the economic and lending activity in their respective markets, whether regional or national. During periods of economic growth, lending activity increases and banks would likely execute a greater number of swaps with customers and dealers. If the CFTC looked at the data during a period of economic growth, the data might show that a commercial bank has executed swaps with a significant number of LEIs in a month (since each guarantor requires its own LEI) and potentially a significant number of USIs (a USI each for the customer-facing and back-to-back swap). However, these counterparty and transaction "counts" are not indicative of "dealing" activity and instead are indicative of underlying economic activity and related risk management activity.[17]

Banks Enter Into Non-Financial Commodity Swaps to Serve Customers

Commercial banks enter into non-financial commodity swaps with customers that are engaged in energy and agricultural production and distribution (e.g., oil and gas drilling, cattle feeding and corn growing or storing). These customers are typically smaller, non-investment grade firms with secured loan agreements which benefit from executing hedging swaps with their lenders. By managing exposure to commodity price fluctuations, clients increase their borrowing capacity. From the commercial bank's perspective, the ability to provide these swap hedges to their borrower clients stabilizes and protects the value of the commodity loan collateral, allowing their customers to expand their business because the bank will be able to lend more to these clients than it would in the absence of the risk management provided by the non-financial swap hedges.

If the Commission fails to maintain or raise the *de minimis* threshold, banks will likely have to curtail their hedging services to customers to avoid the costs of becoming a swap dealer. This reduces risk mitigation services to companies that need it. These clients will (a) have less access to capital as a function of the negative impact of exposure to commodity price fluctuations, and (b) likely have higher hedging costs through less competition. While they could execute hedges with counterparties that were not lenders, the need to cash-collateralize the hedges counteracts any liquidity benefit. If borrowers cannot, or choose not to, hedge their risks because other hedge providers are unwilling to transact with them or the hedging products are too expensive, the risk of loan losses to banks increases. Smaller energy and agricultural

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[17] The Commission's recently published Draft Technical Specifications for Swap Data Repository (SDR) Reporting includes a new data element titled "Counterparty Dealing Activity Exclusion Type," which would be helpful as the CFTC analyzes dealing activity. Per the Draft Technical Specifications document, this data field would identify the exclusion on which a counterparty relies to exclude the swap from dealing activity, including exclusions for "IDI," "Inter-affiliate," "Activities of a cooperative," "Hedging Physical Positions," "Floor Trader Exception," "Non-US Person," "Compression exercise," "International Financial Institutions," "Treasury Determination or FX Exclusion," and "Commodity Trade Options." *See* Draft Technical Specifications for Certain Swap Data Elements (Dec. 22, 2015), *available at* http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/specificationsswapdata122215.pdf.

producers will face higher market risk and lose access to credit, thereby exasperating an already struggling industry sector.

The notional threshold impacts non-financial swaps differently from financial swaps. Risk mitigating commodity swaps are not entered into at the inception of the loan, and are of a shorter tenor and a smaller average notional size as compared to other asset classes. With risk mitigating commodity swaps, customer financial risk management needs drive the timing and number of transactions. As energy customers drill or acquire new wells, they will enter into additional risk mitigating swaps. As they pare back, their activity lessens. The level and frequency of trading is tied to collateral value and covenants.

Measuring notional for non-financial swaps differs from that for financial swaps. For non-financial swaps, notional is a function of both volume of the underlying and price of the underlying. In periods like 2015 with low commodity prices and scaled back production, the average notional size is lower than for interest rate swaps. Within a twelve month period, this could reverse quickly. With no increase in volume, but an increase in commodity prices, asset classes with previously low average notional swap size could show larger notional production. Similarly, holding commodity prices steady while production increases could raise average notional in a short period of time.

Finally, given the shorter tenor of commodity swaps, customers enter into them frequently throughout the term of the loan. Customers of commodity swaps use this strategy because they need to manage changing volatility in the underlying commodity - for example, in the past 2 years, the price for WTI crude oil has gone from over $90 per barrel to less than $35 per barrel. These prices require significantly different hedging strategies, and the CFTC should be thoughtful about how dramatically markets can change, and with them hedging strategies, as they analyze SDR data.

<u>Responses to Staff Questions</u>

In response to the questions asked in the small to mid-sized bank discussion we offer the following comments:

1. What has been the impact of the current *de minimis* threshold on the swap activity of small and mid-sized banking enterprises?

The current *de minimis* threshold has enabled most small to mid-sized banks to continue to serve customers that seek to manage interest rate, credit, currency, equity and commodity risk. As economic conditions change, there is concern about whether small and mid-sized banks will be able to accommodate future business growth and maintain a notional reserve for potential macro hedging strategies. This combination creates trouble balancing current derivative activity (internal and correspondent) with the potential needs of future risk mitigation strategies.

2. Have small and mid-sized banking enterprises limited swap dealing activity to remain below the *de minimis* threshold?

As discussed above, small and mid-sized banks do not typically engage in swap dealing activity and therefore did not limit dealing activity to remain below the *de minimis* threshold.

However, because of the limitations of the exclusions and the conservative approach banks take in deciding whether to count swaps as "dealing," some non-dealing swaps are nonetheless counted toward the *de minimis* threshold. Therefore, although most small and mid-sized banks have been able operate under the current *de minimis* threshold without significantly curtailing their customer-driven swaps activity, banks are concerned that a lower *de minimis* threshold will affect their ability to offer swaps to commercial customers.

3. Would an expansion of the IDI exclusion address small to mid-sized banking enterprises' concerns? If so, what sort of expansion would be appropriate given the relevant statutory constraints and competing policy goals?

The current IDI exclusion limits the ability of IDIs to serve customers that execute loan-level hedges and should be expanded as a matter of policy to recognize how commercial bank customers use swaps. However, even if the IDI exclusion is expanded, ABA recommends that the Commission maintain or raise the current $8 billion *de minimis* threshold until additional analysis is undertaken.

The IDI exclusion's 180-day count convention limits the ability of commercial end users to manage risk in a proactive manner and has resulted in a reduction of hedging options for end users as banks limit activity that counts toward the *de minimis* threshold, a concern that would be exacerbated if the *de minimis* threshold is lowered. Some customers might opt to observe market conditions for an extended period of time before entering into a hedging transaction. For example, if an IDI underwrites a ten year commercial real estate loan to a developer and the developer hedges at the origination of the loan, this swap qualifies for the IDI exclusion. If the same developer opts not to hedge his liability for 180 days and then hedge the remaining 9.5 years of the loan, this swap will not qualify for the IDI exclusion and would be considered "dealing" activity. An additional example is the nature of revolving credit facilities used as the backstop to client hedging transactions. Hedges are in place to manage cash flows that ultimately are used to make payments on the outstanding portion of the loan and should not be restricted by timing of the draw or closing of a loan. Therefore, rather than apply an arbitrary 180 day limitation, which is not determinative of whether a swap is "in connection with an originating loan," the conditions for the IDI exclusion should focus on the remaining term of a loan and/or whether hedges for that loan do not exceed the client's production. As long as the terms and structure match the remaining tenor of the underlying liability, the hedging swap should qualify for the IDI exclusion.

In addition, the minimum commitment percentage that requires an IDI be responsible for at least in 10% of a syndicated loan to exclude the swap from its calculation should be eliminated.[18] Eliminating the 10% requirement will increase competition in the markets furthering a goal of the *de minimis* exception.

<u>Additional Detail is needed on the Proposed Alternatives in order to Provide Substantive Comments</u>

[18] One element of the IDI Exclusion is "[T]he IDI is the source of money to the borrower in connection with the loan either directly, or (so long as the IDI is the source of at least 10% of the entire amount of the loan) through syndication, participation, assignment, purchase, refinancing or otherwise."

The lack of details makes it difficult to comment with any confidence as to which, if any, of the approaches noted in the Preliminary Report may be better able to further the policy aims of swap dealer registration without undermining the policies of the *de minimis* exception. By maintaining the current $8 billion notional threshold, the Commission will provide certainty to the market in the immediate term. As previously stated, a rigorous analysis of accurate data on a longer time horizon will confirm that a higher notional threshold is appropriate as a policy matter.

Preliminarily, ABA does not support different *de minimis* notional thresholds for different asset classes. Such an approach will likely introduce unnecessary confusion to market participants who would need to set up compliance and surveillance programs by asset class. In addition, the Preliminary Report does not provide a compelling justification for why a multi-tiered approach would be better at promoting the policy aims of swap dealer registration versus the current approach. In fact, such an approach is also likely to lead to confusion to market participants that would need to determine which category they fall into and the associated requirements that they would be responsible for. Additionally, the exclusion of cleared swaps for the calculation of the *de minimis* threshold is sensible. As Commissioner Giancarlo wrote in his accompanying statement, "[i]f the true goal of Dodd-Frank is to reduce systemic risk, counting cleared swaps towards the registration threshold is of questionable value."[19]

The Commission Should Perform a Robust Cost-Benefit Analysis Before permitting a Lower Threshold

As the Commission continues to deliberate on the appropriate level of the *de minimis* threshold, we urge it to perform a robust cost-benefit analysis (CBA) of the impact of any revised threshold on the market. Performing a CBA would be consistent with Section 15(a) of the Commodity Exchange Act[20] and would help guide the Commission in its efforts to minimize unintended negative consequences on the market. There are several legal, compliance and staffing costs associated with dealer registration, including establishing an IT infrastructure, onboarding clients, preparing and providing disclosures, and legal staffing. In addition, there are the unknown costs of several recently finalized or yet to be finalized rules, including capital and uncleared swap margin rules applicable to swap dealers. Finally, as described above, a lower *de minimis* threshold will likely result in less competition among hedging providers which could reduce borrowers access to hedging products and credit, reduce liquidity, and increased hedging costs for commercial bank customers, all without a reduction in systemic risk.

If you have any questions or need further information, please contact Jason Shafer at (202) 663-5326 (email: jshafer@aba.com) or Cecelia Calaby at (202) 663-5325 (ccalaby@aba.com).

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[19] *See* Statement of Commission J. Christopher Giancarlo Swap Dealer *De Minimis* Exception Preliminary Report, November 18, 2015, *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/giancarlostatement111815.

[20] 7 U.S.C § 19(a).

Respectfully Submitted,

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