Via CFTC Comments Portal: https://comments.cftc.gov

August 9, 2018

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

RE: De Minimis Exception to the Swap Dealer Definition – Notice of Proposed Rulemaking ("NPR"), RIN 3038-AE68, 83 Federal Register 27444

Dear Mr. Kirkpatrick:

Citizens Financial Group, Inc. ("CFG") appreciates the opportunity to comment on the Commodity Futures Trading Commission's ("Commission") NPR relating to the De Minimis Exception to the Swap Dealer Definition.

CFG is a public company and a financial holding company under The Bank Holding Company Act of 1956 with $155.4 billion in assets.[1] It serves its commercial customers ("Customers" or "Customer") primarily through its two insured depository institutions, Citizens Bank, N. A. and Citizens Bank of Pennsylvania (each, a "Bank" and together, the "Banks"). The Banks are regional banks with Citizens Bank, N. A. being the larger of the two. Their Customers typically consist of small, medium and large-sized commercial businesses. The Banks primarily provide commercial loans to their Customers, but also provide other products and services to Customers including, but not limited to, cash management, trade finance and swap services. These Customer-driven swap services are ancillary to the Banks' core commercial lending businesses. The Banks currently offer interest rate and foreign exchange swap transactions to their Customers to assist Customers in managing their risk.

I. Comments to the Proposed Rule

A. $8 Billion De Minimis Threshold

CFG supports the NPR's proposal to set the aggregate gross notional amount threshold ("AGNA") for the de minimis exception at $8 billion. We find it compelling that the Commission's

[1] Assets are measured as of June 30, 2018.

in-depth analysis of the data suggests that, on balance, "based on the likely small increase in regulatory coverage, and the potential negative market effects of a $3 billion de minimis threshold, the overall policy goals of SD registration and the de minimis exception would not be advanced by lowering the threshold from $8 billion".[2]

a. <u>Policy Considerations Favor Maintaining the AGNA at $8 Billion</u>

(1) <u>Swap Dealer Registration Policy Objectives</u>

While CFG supports the main policy objectives for swap dealer registration -- systemic risk reduction, counterparty protection, and enhanced swaps market transparency and efficiency -- we do not believe that reducing the AGNA from $8 billion to $3 billion would advance these goals.

The new entities that would need to register as swap dealers, many of which would be middle market commercial banks, as a result of such reduction pose no systemic risk and already comply with Commission rules and regulations promoting market transparency and efficiency. With respect to counterparty protections, many of these middle market commercial banks likely already perform KYC and appropriateness[3] analyses of their counterparties prior to entering into swaps with them under applicable prudential banking rules. This would be analogous to certain requirements under the Commission's rules that promote counterparty protections. Furthermore, prudential banking regulators regularly examine the safety and soundness of these banks' swap businesses. The supervision of the Banks' swap activity by their primary prudential banking regulators is a case in point.

The prudential banking regulators[4] regulate the swap activities of the Banks and periodically examine such activities to ensure they operate in a safe and sound manner. In addition, Volcker Rule restrictions on proprietary trading apply to the Banks' swap activities, and the prudential banking regulators have oversight over the Banks' Volcker compliance programs. The Banks currently offer swaps to Customers in the rates and foreign exchange asset classes.[5] When the Banks do enter into swap transactions with Customers, they are generally structured conservatively from a credit risk management perspective to assist Customers with their hedging activities. The Banks also enter into swaps to hedge the Customer transactions with registered swap dealers, which are subject to clearing rules thus providing full transparency. The following is a description of a typical interest rate swap transaction that occurs between a Bank and a Customer:

> A Customer enters into a floating rate loan with a Bank to finance its operations or to purchase commercial real estate. The Customer then enters into an interest rate swap to hedge the interest rate risk on its loan. The Bank will then hedge the market risk of the

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[2] 83 Fed. Reg. 27544 at 27545.

[3] *See* Section VII of the Interagency Supervisory Guidance on Counterparty Credit Risk Management dated June 29, 2011 issued by the prudential banking regulators.

[4] CFG, as a bank holding company and a financial holding company, is regulated by The Federal Reserve, while Citizens Bank, N. A. and Citizens Bank of Pennsylvania are regulated by the OCC and FDIC, respectively.

[5] The Banks, as a matter of internal policy, generally enter into swap transactions with Customers that have a borrowing relationship with them.

Customer swap by entering into a derivatives transaction with a registered swap dealer or in the futures market; such transactions are cleared if subject to mandatory clearing.

Because of the (1) conservative nature of the swaps that the Banks offer their Customers, (2) credit risk management policies applied to these swap activities, and (3) oversight of the prudential regulators, the Banks' swap activities simply do not pose systemic risk to the swap markets, to the broader financial markets, or to the Banks themselves.

Moreover, the Banks operate under a robust counterparty protection regime. The Banks generally know their Customers well as a result of the core lending and cash management relationships that they maintain with them. As previously noted, swaps are an ancillary business to the Banks' core lending businesses and are only offered to Customers as a risk management tool. Prior to entering into swap transactions with Customers, the Banks perform an analysis to determine that such swap transactions are appropriate for the Customers. Each Customer must understand the terms of the swap transaction and be able to assess the risks of such swap transactions, including the receipt of derivatives risk disclosures. Customers also must be eligible contract participants as required under the Commodity Exchange Act ("CEA") to enter into swaps with the Banks. Finally, the Banks do not engage in transactions with special entities, as defined in CEA rules and regulations, that would require heightened counterparty protections. Thus, the Banks' counterparty pre-trade programs behave much like the certain of the external business conduct rules applicable to registered swap dealers.

Finally, the Banks are already subject to the CFTC reporting regulations under 17 CFR Parts 43 and 45. Under these rules, the Banks act as the reporting party when transacting swaps with their Customers. In addition, Commission rules relating to mandatory clearing, transacting on swap execution facilities ("SEF") and swaps record keeping requirements under Part 45 all apply to the Banks. Consequently, the Banks are already complying with many of the Commission rules designed to create a more transparent, efficient and orderly swaps market.

(2) <u>A Reduction in the AGNA Will Not Serve to Achieve De Minimis Exception Policy Objectives</u>

CFG also does not believe reducing the AGNA to $3 billion would achieve de minimis exception policy objectives, including (1) providing regulatory certainty to market participants, (2) allowing limited ancillary swap dealing in connection with other client services, (3) encouraging new entrants into the swaps markets (potentially fostering competition, (4) lowering costs for end users and (5) diversifying risk among a greater number of market participants) and regulatory efficiency.[6] Rather, it could have the opposite effect. In the case of the Banks, the reduced AGNA would, as explained in the "Customer Impact" section of this letter (below), potentially preclude them from offering certain ancillary hedging services to their Customers as part of their core lending businesses and increase hedging costs for their Customers. A reduced AGNA could also cause regulatory uncertainty for both the Banks and their Customers in terms of whether the Banks could act as hedge providers, leading to the

[6] Swap Dealer De *Minimis* Exception Preliminary Report at 36-38 (November 18, 2015) (the "Preliminary Report").

potential loss of Customers in their lending businesses, and, in some cases, leaving Customer positions unhedged. As mentioned above, the prudential banking regulators also periodically examine and review the Banks' swap businesses. Given the Banks' lower levels of regulated swap activities, the Commission could achieve more regulatory efficiency by focusing their resources on larger registered swap dealers.

a. <u>Customer Impact</u>

Like other similarly-situated market participants, CFG is concerned that a reduction in the de minimis threshold to $3 billion may potentially lead certain entities to reduce or cease swap activity to avoid registration (and related costs) which would negatively impact end users such as our Customers.[7] We believe that Commissioner Quintenz had it right when he listed in his November, 2017 Keynote Address before the Smart Financial Regulation Roundtable the high costs registration, including NFA annual membership fees, minimum capital requirements, clearing and margin costs, IT costs for trade processing, reporting, confirmation, and reconciliation activities, costs to create and send clients daily valuation reports, costs for recordkeeping obligations, third party audit expenses, legal fees to develop and implement business conduct rules, among others. These costs will be borne by regional and smaller banks and their customers. Like Commissioner Quintenz, we believe that "[s]mall banks and businesses cannot withstand such costs, let alone regional banks and their small, mid-market and larger customers."

Moreover, these higher costs could preclude small and midsize banks from offering swaps to their customers and result in a more concentrated swap dealer pool, which would run contrary to the Commission's goal of encouraging new entrants into the swaps market. According to the "Cost-Benefit Analysis of the CFTC's Swap Dealer *De Minimis* Exception Definition" prepared by NERA ("NERA Report"), the "cost-benefit analysis demonstrates that reducing the de minimis threshold is highly costly and does not substantially increase the market coverage of the Swap Dealer regulations." [8]

While a decrease in the de minimis threshold to $3 billion would not likely force the Banks to cease entering into swap transactions permanently, it could force the Banks to cease entering into swaps with Customers that do not satisfy the requirements of the IDI Exclusion (discussed below) until their de minimis either falls below the permanent threshold or one of the Banks takes on the financial burden to register as a swap dealer. In either scenario, the Banks would likely be unable to offer certain swap transactions to their Customers for an indefinite period of time. Such a result would be detrimental to the Banks' Customers, who generally borrow money at a floating rate and expect to be able to hedge such loans with a swap from the Banks at any time during the tenor of such loans. Without the ability to hedge their loans with the Banks in some cases, the Customers may be unnecessarily exposed to interest rate risk. Also, it is likely that other swap dealers would be hesitant to provide swaps that would be used to hedge another lender's loans. At a minimum, it would cost our

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[7] Swap Dealer *De Minimis* Exception Final Staff Report at 11 (August 15, 2016) (the "Final Report").

[8] "The cost benefit analysis results indicate that the currently planned phase in of a reduction in de minimis to $3 billion would force firms to incur in aggregate approximately $129.6 million in incremental costs on a present value basis with almost no increase in programmic benefits of swap dealer regulation". This would result in a maximum increase in coverage of 0.1%. NERA Report at page 2.

Customers more in the form of higher pricing or additional collateral to hedge their interest rate risk on a Bank loan with a third party swap dealer.

B. A Higher De Minimis Threshold

While CFG supports maintaining the AGNA at $8 billion, we would also support an AGNA increase to $20 billion. Based on the Commission's analysis, such an increase from $8 billion would result in a reduction of only 15 registered swap dealers, and small declines in Estimated AGNA, Transaction, and Counterparty Coverages[9] of .01%, .05%, and 2.80%, respectively.[10] These small declines in registered swap dealer and estimated coverages would be worth the trade-off to advance de minimis policy objectives by fostering greater regulatory efficiency with respect to middle market lenders such as the Banks, encouraging new participants to enter into the market and freeing up limited Commission resources to regulate larger registered swap dealers whose swap dealing activities pose a greater systemic risk to the financial system.

C. Swaps Entered Into by Insured Depository Institutions in Connection with Loans to Customers (the "IDI Swap Dealing Exclusion")

As currently structured, CFG and its peer banks believe the IDI Swap Dealing Exclusion is too restrictive and is difficult to interpret in certain instances causing regulatory uncertainty regarding whether swaps may be excluded from the de minimis.[11] As a result, the Banks must count swaps in its de minimis that are designed to hedge floating rate loans. These are exactly the type of swap activities that the Commission intended to exclude from the scope of swap dealing registration.

CFG generally supports the NPR's IDI de minimis proposals with some suggested changes as discussed below.

a. Timing Requirements

As drafted, the "IDI De Minimis Provision"[12] does not require the Banks to enter into a swap within 180 days after the execution of the loan agreement (or date of transfer of principal to the Customer) (the "180 Day Timing Requirements"). CFG believes this would significantly increase the usefulness of the exclusion, and perhaps lead to increased swap capacity for Customers since the Banks would not have to worry about these loan-related swaps triggering swap dealer registration.

Further to this point, the Banks' Customers do not always enter into swaps to hedge loans at the inception of the loan for a number of business and economic reasons. Rather, they may hedge all or portions of their loans at strategic intervals during the tenor of such loans reflecting the realities of the commercial lending business. For example, during the first half of 2018, a number of the Banks' Customers began actively managing the interest rate risk on their floating rate loans by entering into swaps beyond the 180 Day Timing Requirements due to an

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[9] These terms have the meanings ascribed to them in the NPR.
[10] 83 Fed Reg. 27444, Table 8 at 27454 and Tables 9, 10, and 11 at 27455.
[11] ABA Comment Letter on the Swap Dealer De Minimis Exception Preliminary Report at 8 (January 19, 2016).
[12] IDI De Minimis Provision has the meaning as set forth in the NPR.

expectation that interest rates would rise. These swaps caused the Banks' de minimis to spike even though they did not reflect a structural change in the Banks' swap or lending businesses. That is, the Banks were not seeking to increase the volume of their swap services that constituted swap dealing activities, but rather they were meeting their Customers' risk management needs.

b. Total Notional Amount of Swaps and Syndicated Loan Requirement

CFG believes there are a couple of situations where it may be common for the total notional amount of loan related swaps to exceed the outstanding principal amount in connection with syndicated loans irrespective of whether the Banks hold more than the proposed five percent participation threshold.

This first situation may occur when the Bank is selected among a group of banks to do a single swap with the borrower/counterparty to hedge the entire loan because it is administratively burdensome for the borrower/counterparty to enter into multiple swaps to hedge its loans.[13] The Bank subsequently lays-off the risk of the swap by entering into swaps or risk participations with other syndicate banks for the relevant amount associated with their portion of the syndicated loan.

The second situation may occur when the Bank and other middle market commercial banks enter into a loan agreement with the Customer, and agree to lend directly to such Customer under a revolving loan. Under the same loan agreement, the Bank then arranges (rather than directly lend[14]) term loans for such Customer with non-bank lenders. However, the Customer cannot enter into swaps with these non-bank lenders to hedge the interest rate risk of these term loans because such non-bank lenders do not provide swap services. In addition, the other middle market lenders may not have ancillary swap capabilities and cannot offer swaps to customers leaving the Bank as the sole swap provider solution to the Customer.[15]

In both instances described above, the Banks includes these swaps in their de minimis even though they are simply trying to assist Customers manage the interest rate risk on their loans. Therefore, CFG advocates in favor of removing the 5% participation threshold requirements of the IDI De Mimimis Provision in connection with these syndicated loans. This would permit the Banks to provide swaps to all of their Customer segments in the manner in which our Customers expect without concern that these loan-related swaps would trigger a potential swap dealer registration. In other words, if the Bank is part of the lending syndicate, its Customers expect that the Bank has the capability to hedge parts of or the entire loan amount, irrespective of its loan participation threshold.

c. Swaps that Extend Beyond the Termination of the Loan

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[13] For example, the borrower/counterparty only needs to negotiate one ISDA master agreement with one syndicate bank thereby reducing its legal and administrative costs in connection therewith.

[14] The Bank may have credit limits which may limit the amount it can lend to a Customer.

[15] The collateral under the loan agreement securing the revolving loan may also secure swaps that hedge the term loans making the hedge solution with the Bank less expensive for the Customer relative to entering into swaps with a third party registered swap dealer that have no connection to such loan agreement.

The Commission requested comments on whether there are circumstances that can be anticipated at the time of loan origination that would support permitting the termination of the swap to extend beyond the termination of the loan. CFG believes there are a number of instances where the Commission should permit the termination date of the swap to extend beyond the termination date of the related loan. For example, the Banks have Customers who may be habitual borrowers, refinancing every three to five years and recognizing permanent financing on their books. Customers may also hedge today for longer periods to take advantage of an attractive rate environment knowing they will continue have debt outstanding. This strategy would be consistent with hedge accounting. Moreover, Customers may have a financing that amortizes based upon a longer life. For example a five year loan based upon a twenty year amortization. The Customers may also seek to hedge for longer periods knowing that there will be a refinancing event of the balloon at the maturity of the current loan.

d. Application of the IDI De Minimis Provision

CFG requests that the Commission permit insured depository institutions to apply the IDI De Minimis Provision so that they may exclude eligible swaps from their de minimis that were entered into during the 12 month period preceding the date on which the regulation becomes effective.

C. Swaps to Hedge Financial or Physical Positions

CFG supports the NPR's clarification of the treatment of swaps entered into to hedge financial or physical positions in respect of counting swaps towards a person's de minimis. The Commission acknowledges the confusion in the market caused by the lack of a defined exception for these hedging transactions. [16] We do not believe registration considerations relating to de minimis calculations should drive risk hedging strategies, which could have the unintended consequence of causing safety and soundness issues for insured depository institution market participants. Therefore, we believe an express exception will bring greater regulatory efficiency and stability to the swaps markets.

D. Methodology for Calculating Notional Amounts

CFG supports the Commission's proposal that it may approve or establish methodologies for calculating notional amounts for purposes of determining whether a person exceeds the AGNA de minimis threshold and its delegation of authority to the DSIO for purposes of making such determinations. We think the Commission should also include in any final rule more efficient procedures to determine whether (1) certain swaps would be eligible for the IDI De Minimis Provision or IDI Swap Dealing Exclusion (together the "IDI Exclusions") and (2) whether certain swaps need to be counted in a person's de minimis. The lack of clarity around notional amount interpretations and whether transactions would qualify for the IDI Exclusions has persisted for too long, and what little guidance that exists does not provide the requisite certainly that market participants need in order to run their businesses efficiently. While we agree that non financial commodity swaps notional amount calculations cause a great deal of uncertainty and warrant clarity[17], we think that there could be swaps in the remaining asset classes that also warrant clarity. We also support publication of these

[16] 83 Fed. Reg. 27444 at 27462.
[17] 83 Fed. Reg. 27444 at 27464.

interpretations in a conspicuous manner. Therefore, we welcome the greater regulatory efficiency and clarity that these proposals would bring to CFG and the swaps market.

II. Other Considerations

A. Dealing Counterparty and Dealing Transaction Count Thresholds, and Risk-Based Metrics

If proposed by the Commission in the future, CFG would not support the inclusion of dealing counterparty and dealer transaction counts into the de minimis calculation because we do not believe they accurately indicate the size of an institution's swap dealing activities. Therefore, these metrics would not advance de minimis policy objectives. For example, the Banks may originate some loans where there are multiple borrowers. To be consistent with the number of borrowers on a particular loan, the Banks may enter into a swap with the corresponding number of counterparties for certain credit related reasons. It is also possible that the Banks may decide to enter into several smaller swaps with a few counterparties rather than entering into a single large swap with one counterparty to diversify its credit exposure. In both instances, higher counterparty and transaction counts in the de minimis calculation would falsely suggest the Banks pose greater systemic risk to the financial system than in reality. In addition, adding these two metrics would unnecessarily complicate the de minimis calculations. The Banks do not as a matter of course count the number of transactions and counterparties in their swap business. Therefore, they would have to create and manage another manual calculation in addition to what is already a very manual process for calculating a single notional threshold de minimis. This introduces further regulatory inefficiencies to CFG.

The Banks, along with other market participants, believe that there is an inherent weakness in relying on the notional amount of swaps as the sole metric for determining the de minimis threshold. The notional amount of a swap is substantially larger than the actual credit exposure, which is a more accurate indicator of risk. In addition, because it is an aggregated number, it is a poor indicator of the actual number of swap transactions that an entity enters into with other counterparties. As a result, a reduction in the de minimis threshold based on notional amount is likely to ensnare entities that pose little or no systemic risk. Therefore, we think a risk-based measure (or a combination thereof), such as those identified in the NPR, would be an improved metric(s) with respect to a de minimis calculation that advances the Commission's policy objectives.[18]

B. Exchange-Traded and/or Cleared Swaps

CFG would welcome the exclusion of exchange-traded and/or cleared swaps from a person's de minimis calculations in any future rule making. We agree with the Commission's views that exchange-traded and/or cleared swaps may pose less systemic risk and require less counterparty protections than OTC, uncleared bilateral transactions.[19] In response to the Commission's request for comments as to whether this exception would increase the volume of cleared swaps or swaps executed

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[18] *See* 83 Fed. Reg. 27444 at 27448. The Commission is open to risk based metrics in determining the AGNA, including initial margin, open positions, material swaps exposure, net current credit exposure, gross negative or positive fair value, potential future exposure, and value at risk.

[19] Id. at 27468.

on an exchange or SEF, we do not think that market participants would increase these types of swaps simply because they can be excluded from the de minimis. There may be other factors that are more important in determining whether to enter into exchange-traded or cleared swaps.[20] In the case of CFG and its Banks, they tend to enter into exchange-traded and cleared swaps because certain of the swaps they use to manage financial risk are subject to mandatory clearing. Otherwise, economic incentives, such as pricing, would tend to drive their decisions whether to enter into exchange-traded and/or cleared or uncleared transactions. The Banks also do not enter into cleared rates transactions with their Customers since they typically are eligible to elect the end-user election not to clear the swaps. Finally, the Bank's Customers generally dictate whether they want to execute permissible FX transactions with us on a SEF.

C. **Non-Deliverable Forwards ("NDFs")**

In response to the Commissions request for comments on whether NDFs should be excluded from a person's de minimis calculations, CFG supports such an exclusion. CFG agrees with the Commission findings (1) that NDFs are economically and functionally similar to deliverable foreign exchange forwards in that the same net value is transmitted in either structure, and (2) that market participants treat NDFs and deliverable foreign exchange forwards as the same functional product.[21] Therefore, CFG believes it does not make any sense from a regulatory perspective to treat NDFs differently than deliverable foreign exchange forwards with regard to the calculation of a person's de minimis.

III. Conclusion

In conclusion, CFG appreciates both the opportunity to comment on the NPR and the Commission's consideration of our comments. Should you have any questions or desire further discussions, please do not hesitate to contact the undersigned at 201-356-5529 or at raymond.dorado@citizensbank.com.

Sincerely,

Raymond J. Dorado
Executive Vice President and
Deputy General Counsel

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[20] Market participants may consider factors including collateral costs, clearing fees, pricing, and FCM credit limits for non clearing members important in determining whether to enter into exchange-traded or cleared swaps.
[21] Id. at 27470.