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July 11, 2011

Submitted Electronically to:
Commodity Futures Trading Commission ("CFTC")
Federal Deposit Insurance Corporation ("FDIC")
Board of Governors of the Federal Reserve System ("FRB")
Office of the Comptroller of the Currency ("OCC")
Federal Housing Finance Agency ("FHFA")
Farm Credit Administration ("FCA")

RE: I. Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27,564 (May 11, 2011) (the "Prudential Regulators' NPRM")

- OCC - Docket No. OCC-2011-0008, RIN 1557-AD43
- FRB - Docket No. R-1415, RIN 7100 AD74
- FDIC – RIN 3064-AD79
- FCA – RIN 3052-AC69
- FHFA – RIN 2590-AA45

II. Capital Requirements of Swap Dealers and Major Swap Participants, 76 Fed. Reg. 27,802 (May 12, 2011) (the "CFTC Capital Requirements NPRM")

- CFTC – RIN 3038-AD54

III. Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23,732 (April 28, 2011) (the "CFTC Margin Requirements NPRM")

- CFTC – RIN 3038-AC97

Dear Reviewers:

On behalf of the Independent Community Bankers of America (ICBA)[1], we are writing to respond to various notices of proposed rulemakings (NPRM) of the Commodity Futures Trading Commission (Commission or CFTC) and the prudential regulators specified in the Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or DFA) and listed above. These

[1] The Independent Community Bankers of America represents nearly 5,000 community banks of all sizes and charter types throughout the United States and is dedicated exclusively to representing the interests of the community banking industry and the communities and customers we serve. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever changing marketplace. With nearly 5,000 members, representing more than 20,000 locations nationwide and employing nearly 300,000 Americans, ICBA members hold $1 trillion in assets, $800 billion in deposits, and $700 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

NPRMs all pertain to capital and margin requirements related to title VII of the DFA. Section 731 and 764 of the DFA amend the Commodity Exchange Act and the Securities and Exchange Act by establishing a new regulatory framework for swaps. The DFA requires the agencies listed above, and the Securities and Exchange Commission (SEC) to collaborate on capital and margin requirements.

ICBA appreciates the opportunity to comment publicly and we appreciate the many long hours and extreme hard work put into the overall rulemaking process by the staffs of the CFTC and the SEC and the staffs of the prudential regulators. Given the complexity of this and other proposed regulations and the need to "get it right" in terms of how new regulations will impact the derivatives marketplace, in particular, the over-the-counter (OTC) marketplace, we urge the agencies to be extremely cautious in implementing new regulations. Due to the many detailed and complex questions posed by the agencies regarding capital and margin requirements, ICBA may offer additional comments subsequently in addition to this letter to further elaborate on our views regarding the issues involved in these NPRMs.

Given the customized nature of the OTC marketplace, we believe the CFTC and prudential regulators should delay implementation of regulations impacting certain segments of the OTC market for 12-24 months after a final rule is issued to ensure the continued smooth functioning of these markets, particularly in regards to any potential impact on interest rate swaps utilized by small financial institutions such as community banks.

Proposed Margin Regulations

The CFTC asserts that all swaps traded in the OTC market are riskier than swaps cleared through a clearing house. CFTC makes two points to back up this assertion. First, CFTC asserts[2] that this notion is explicit in the Dodd Frank Act. Second, CFTC states, "During the recent financial crisis . . . significant sums were expended as the result of losses incurred in connection with uncleared swaps, most notably at AIG. A key reason for this difference is that DCOs all use variation margin and initial margin as the centerpiece of their risk management programs while these tools were often not used in connection with uncleared swaps."

The CFTC also states: "Concern has been expressed that the imposition of margin requirements on uncleared swaps will be very costly for SDs and MSPs . . . Given the Congressional reference to the ``greater risk'' of uncleared swaps and the requirement that margin for such swaps 'be appropriate for the risk,' the Commission believes that establishing margin requirements for uncleared swaps that are at least as stringent as those for cleared swaps is necessary to fulfill the statutory mandate."

It is important to keep in mind that community banks need to use swaps to either hedge their own interest rate risks or to convert variable rate financing to fixed rate financing to serve the needs of their farm and small business customers. The types of swaps community banks utilize are low risk interest rate swaps that did not contribute to the financial crisis as did the risky and highly complex credit default swaps issued by AIG.

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[2] Page 23733, CFTC NPRM, Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, Federal Register, Vol. 76, No. 82, April 28, 2011

Further, we do not agree that all swaps traded in the OTC market are automatically riskier than swaps that are cleared in a clearing house. In fact, ICBA successfully urged Congress to insert into Title VII of the Dodd-Frank Act language which states that regulators are to impose requirements that "are appropriate to the risk associated with the non-cleared swaps[3]." The law's reference "appropriate to the risks" was intended to provide clear guidance to regulators to distinguish between low risk swaps, such as interest rate swaps, and the more complex, highly structured swaps like credit default swaps used by AIG, Lehman Brothers and Bear Stearns in the OTC market. That is also why this section of the law bases the concerns related to risks in the OTC market as risks that could adversely impact the overall financial system. CFTC's proposal appears to be ignoring the focus of the "appropriate risks" to the overall financial system in an effort to regulate all swaps. Such a bias ignores the clear reading of the statute.

Proposed regulations have noted the problems of AIG in the OTC market as a reason to generally assert that swaps traded in the OTC market are supposedly riskier than those traded in clearing houses. However, AIG's problems resulted from using credit default swaps (CDS), an insurance-like product, not from the low-risk interest rate swaps used by community banks.

Furthermore, the Chairmen of the House and Senate Agriculture Committees recently sent the CFTC and prudential banking regulators a June 20 letter reinforcing this notion. The letter stated, *"Lastly, we urge regulators to ensure that any new capital requirements are carefully linked to the risk associated with the uncleared transactions, and not used as a means to deter over-the-counter derivatives trading (italics added)."*

The NPRM[4] issued by the prudential regulators acknowledges that all uncleared swaps do not have the same levels of risk and do not pose systemic risks to the financial system. In referencing this risk-based approach, their proposed rule states, "the Agencies preliminarily believe that this approach (not requiring CSEs to collect initial or variation margin from nonfinancial end users) is *consistent with the statutory requirements that the margin requirements be risk based and is appropriate in light of the minimal risks* that nonfinancial end users pose *to the safety and soundness of covered swap entities and U.S. financial stability*, particularly in cases of relatively small margin exposures (italics added)."

The NPRM asks whether small financial institutions should receive the same treatment as nonfinancial end users for purposes of the margin requirements. ICBA believes that small financial institutions should receive the same treatment as nonfinancial end users and should be exempted from higher capital and margin requirements. While the NRPMs will not impose margin requirements on nonfinancial end users, small financial institutions should also be exempt from posting higher margin requirements as a result of these regulations or that would differ from current practices.

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[3] Section 4s(e)(3)(A)(ii) –This section states that regulations should be "risk appropriate" in relation to the uncleared swaps in the context of the risks to the swap dealer and the overall financial system.

[4] Prudential Regulators Notice of Proposed Rulemaking, Margin and Capital Requirements for Covered Swap Entities, May 11, 2011 Federal Register, Vol. 76, No. 91, page 27570.

The prudential regulators' NPRM also states, "Because the Dodd-Frank Act requires that the margin requirements be based on the risks posed by the non-cleared derivatives and derivatives counterparties, firms that take significant risks through derivatives will face more stringent margin requirements with respect to non-cleared derivatives, while firms that take lower risks will face less stringent margin requirements[5]."

It is revealing that the prudential regulators' NPRM also states, ". . . *swap entities are large players* in swap and security-based swap markets *and therefore have the potential to generate systemic risk through their swap activities* (emphasis added)[6]." Our concern with this statement is that the NPRMs of federal regulators relating to capital and margin may be appropriate for large financial institutions but do not take into account the necessary distinctions of how small financial institutions, such as community banks and the middle market swap dealers they use, actually participate in the OTC market. Neither community banks nor the middle market swap dealers they use are "large players" that pose systemic risks.

Therefore, ICBA believes the focus of these regulations should be risk-based to ensure that community banks can continue to economically use interest rate swaps to hedge their balance sheets or to offer their customers fixed-rate financing. To be consistent with the statute and with Congressional intent, the regulations should focus on protecting the overall financial system while preserving the flexibility of market participants without tying up capital from productive uses that drive and sustain our economy. The focus of these and related regulations should not be on community banks and the middle market swap dealers they utilize to access the swaps market.

Unless distinctions between the riskiness of swaps in the OTC marketplace are made, we fear that community banks and the swap dealers they utilize will bear the brunt of regulations that should be focused on the riskier swaps, such as credit default swaps used by AIG, which were the cause of the problem that CFTC referenced in its NPRM.

We are not aware of instances in which community banks' use of derivatives posed risks to the financial system, a key criteria for the risk-based approach referenced in the DFA as previously cited. In addition, community banks are not interconnected and therefore do not pose systemic risks. Further, community banks' use of derivatives is a minor portion of the OTC market and should not be the focus of CFTC's regulations. ICBA would be interested in learning from any or all of the regulators of examples where community banks' involvement in the swaps markets has posed systemic risks to the financial marketplace.

Treatment of Small Financial Institutions

The CFTC and prudential regulators ask whether nonfinancial end users should be exempt from both clearing and margining requirements and whether small financial institutions should be treated in the same manner. For clarification, regulators ask for comments on the statutory basis for these exemptions.

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[5] Ibid, page 25567
[6] Ibid, page 27570

Should counterparties that are small financial institutions using derivatives to hedge their risks be treated in the same manner as nonfinancial end users for purposes of the margin requirements?[7]

Clearly, Congress exempted nonfinancial end users from clearing requirements and also provided authority for the agencies to at minimum exempt small financial institutions[8] of up to $10 billion of assets from the clearing requirements. ICBA believes the intent of these exemptions were to also exempt these institutions from the margin requirements since the swaps activities of small financial institutions and their end user customers pose no systemic risks to the overall financial system – a fundamental and basic reason that Congress incorporated Title VII into the DFA.

Congress obviously did not intend to disrupt the activities of small financial institutions such as community banks in the swaps markets. Community banks and the middle market swaps dealers they utilize pose no systemic risks, are not interconnected, did not engage in risky activities or use risky swaps that fueled the financial crisis, and did not require a federal bailout. They should be exempted from the regulatory regime being considered to deal with riskier derivatives and their potential impact on the financial system. The statute clearly references those uncleared swaps that pose a risk to swap dealers or major swap participants *and the financial system* (emphasis added). Interest rate swaps used by community banks and middle market swap dealers simply don't fit those characterizations. Beyond the size of institutions, agencies should consider the actual riskiness of the different types of swaps being used in the OTC marketplace.

If regulators require community banks to post significant or new initial margin for uncleared swaps it will add greatly to the cost and complexity of utilizing swaps and of doing business generally for community banks. The result will be to increase risks for community banks which will become mismatched in funding and lending activities. Community banks will have fewer risk management tools and will likely be unable to offer their small business and farmer/rancher clients fixed rate financing due to the nature of their funding sources (primarily short term deposits). Further, if the nonfinancial end-users that community banks serve are exempt from posting margin, then community banks should be as well in order to keep the transactions costs economical for all participants in the swap.

This situation could endanger community banks' efficiency in providing banking services and in particular, their ability to prudently structure many types of loans to serve their farm and small business customers. An additional impact will be to place community banks at a competitive disadvantage relative to their larger financial institution competitors. Furthermore, the dramatically higher costs and complexities resulting from requiring initial margin on small financial institutions will have little to no affect in actually accomplishing the goals and policy objectives of the DFA. In actuality, such a regulatory burden on small financial institutions could exacerbate their risks.

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[7] 76 FR, pg 26740; 76 FR, pg 25570
[8] Dodd-Frank Act, Sec. 723(2)(7)(C)(ii)

USDA Report on Derivatives

A recent USDA report on derivatives[9] is also useful in pointing out the fallacy in simply assuming that all OTC swaps are automatically riskier than all cleared swaps. The reason that interest rate swaps used by community banks are not cleared is not because they are riskier, but rather because they are customized to match the terms of the underlying loan in order to serve customers' specific financing needs. The clearing houses have not yet geared up to accept the swaps of community banks for clearing due to their customized features[10] (italics added).

> *"Clearing highly customized OTC derivatives is more time-consuming and expensive than for traditional, standardized exchange-traded derivatives."*
>
> *"A swap can also go uncleared if no derivatives-clearing organization chooses to clear it."*

The report also notes that the clearing system is not free of significant risks and does not necessarily provide the tools needed by financial markets:

> *"Moreover, the clearing system is not without its drawbacks . . . clearing reduces the potential for counterparty defaults as well as the losses associated with those defaults, improving the allocation of default risk—but those benefits may lead to an expansion of trading and a greater level of risk-taking."*
>
> *"Another concern about the clearing process is that if it is fragmented through the establishment of multiple specialized clearing houses, the benefits of netting are reduced, while counterparty and systemic default risks are increased."*
>
> *"OTC derivatives offer some unique advantages over exchange-traded instruments. To facilitate trading expediency, exchanges standardize futures and options contracts. OTC swaps, on the other hand are more flexible because they can be customized to meet the risk management desires of the individual traders."*

Prohibition on Rehypothecation

The CFTC proposes to prohibit rehypothecation[11] and the agency asks: "*Are the limitations placed on rehypothecation and reinvestment under the proposed rule appropriate or necessary? Would additional or alternative limitations be appropriate?*" Prudential regulators also would prohibit rehypothecation and ask similar questions.[12]

It is important to understand that community banks use low-risk interest rate swaps designed to hedge the underlying risk exposure associated with their balance sheets and/or to convert variable rate loans into fixed rate loans on behalf of their customers.

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[9] The Dodd-Frank Wall Street Reform and Consumer Protection Act, Changes to the Regulation of Derivatives and Their Impact on Agribusiness, AIS-89, November 2010, Michael Adjemian and Gerald Plato, www.ers.usda.gov
[10] Ibid, pgs 5-6; pg 11
[11] CFTC NPRM, Margin Requirements, pg 23739
[12] Prudential regulators NPRM, Margin and Capital Requirements, pgs 27578, 27579

These interest rate swaps are customized to meet the underlying characteristics of their customers' individual loans, and are often much smaller than standardized swap agreements.

However, regulators have proposed to prohibit rehypothecation or the repledging of initial margin. Community banks now pledge initial margin to middle market swap dealers who repledge that margin upstream to large financial firms to complete the transaction. Large financial firms, with rated debt, will be not be required to post collateral as part of the swap transaction. Instead, middle market swap dealers will be required to post their own initial margin to large financial firms, based on how the marketplace functions.

This outcome will force middle market swap dealers to come up with costly capital – hard-earned, scarce resources being set aside that will dramatically increase the costs of swap transactions for those serving the community banking market. This will either make the cost of utilizing these swaps economically prohibitive or ultimately force middle market swap dealers out of the business of facilitating swaps for community banks, leaving community banks without access to the swaps market and denying an important source of fixed-rate financing to their customers. Large swap dealers have not been and will not be interested in the low volume, highly customized swaps transactions of community banks.

Once again, it must be emphasized that the middle market swap dealers used by community banks do not pose the types of risks that the prohibition on rehypothecation is intended to address (e.g. the failure of a covered swap entity could pose significant systemic risks[13]).

Further, Congress opted **not** to include language in Dodd-Frank prohibiting rehypothecation and in fact deleted such language when it first surfaced in an earlier draft of the Senate's derivatives title. There is therefore no statutory basis to prohibit rehypothecation. Without a clear statutory basis, it is not the role of government to interject itself into the negotiations of private sector individuals. All model master agreements designed to facilitate swaps in the OTC market allow for rehypothecation. Individual parties to these agreements can negotiate contract details.

If federal regulators intend to ensure institutions utilizing derivatives do not "game the system" by preventing discrepancies between the exchange traded swaps and OTC swaps, they could simply require all swaps eligible for trading in clearing houses actually be traded in clearing houses and not in the OTC market. However, until such time as the clearing houses accept the low-risk interest rate swaps used by community banks, rehypothecation should not be prohibited for these types of swaps in the OTC market as they pose no systemic risk.

The proposed prohibition on rehypothecation would be disastrous for the community bank swaps market as it would force the exit of the middle market swap dealers that facilitate community bank participation in the OTC market. Without rehypothecation – the repledging of initial margin – these middle market swap dealers would be unable to provide the necessary capital or initial margin to pledge upstream to large financial players to complete the swap transactions. Prohibiting rehypothecation would force these swap dealers to exit the business of serving community banks, leaving our institutions without access to the swaps market to manage their risks and those of their customers.

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[13] Ibid, pg 27579

Broadly prohibiting rehypothecation of initial margin in the OTC market without distinguishing between appropriate risks of different types of swaps will not only drive middle market swap dealers out of the business of serving community banks, leaving community banks without access to the swaps market, but will unnecessarily lead to the concentration of assets in the hands of fewer participants in the derivatives marketplace, thereby increasing risks. This will harm community banks and benefit the remaining participants in the OTC market and is not what Congress intended.

ICBA believes that community banks and middle market swap dealers should be exempted from the prohibition on rehypothecation. Regulators should make distinctions between products within the OTC market instead of assuming that all swaps in the OTC market are risky simply because they are not accepted for clearing by clearing houses.

The use of interest rate swaps by community banks are quite different than the CDSs used by large institutions and clearly does not pose a risk to the financial system. Low risk interest rate swaps in the OTC market should therefore have significantly less regulatory burden, in addition to lower margin requirements, than CDSs used by systemically significant institutions.
The CFTC should make distinctions between different types of swaps in the OTC market to ensure that rehypothecation is not prohibited for interest rate swaps used by community banks.

We emphasize that prohibiting rehypothecation would eliminate the ability of community banks to access the swaps market and this was not the intent of Congress in title VII of the DFA. Without the ability to access the swaps market, community banks will lose an important tool to hedge their interest rate risks and serve their customers and this result will increase safety and soundness risks to community banks. These results starkly contradict the intent of the DFA. Regulatory agencies should be seeking to enhance risk management tools and enhance safety and soundness options in this volatile economic climate, not eliminate risk management tools while increasing safety and soundness risks. Regulators should not ignore the clear meaning of the statute which relates the expected regulatory outcome: "Be appropriate to the risk associated with the non cleared swaps."

Segregation

Regulators have also proposed to require the segregation of initial margin, which they acknowledge will significantly reduce the availability of liquid assets to covered swap entities (CSEs) to meet payment obligations since these assets would be unavailable to the swap entity for other purposes. ICBA believes that segregation of initial margin should not be required for the interest rate swaps utilized by community banks and the middle market swap dealers they utilize. To do so will increase costs and have many of the same negative affects as the prohibition on rehypothecation.

Regulators should preserve the option of counterparties to avoid the transaction costs resulting from requiring CSEs to identify, monitor, and transfer funds back and forth from independent third party custodians. We note the regulations would require swap dealers to have multiple accounts for customers to differentiate between or separate initial margin and variation margin. We view this segregation regime as accomplishing little in reality while adding to the complexity and costs of the swaps marketplace.

Further, we disagree with the assertion made in the prudential regulators NPRM[14] that the net effect of segregation and prohibiting rehypothecation would be small, "as if little initial margin was exchanged." This may be accurate in the case of large swap dealers. However, small community banks and the middle market swap dealers they engage to handle their swap transactions will not be receiving pledges of initial margin from large financial institutions, which as noted earlier, are rated institutions and do not pledge margin to smaller, not-rated financial institutions such as community banks.

Again, we note the apparent bias of these regulations in considering the swaps marketplace only from the standpoint of large financial institutions while neglecting the manner in which small financial entities utilize the swaps market, yet painting with a broad brush in such a way that the new regulatory framework could unfairly catch almost all swaps market participants.

Swap Dealer Exemption

Although not a part of the NPRMs, we wish to take this opportunity to communicate to all federal agencies involved in developing swaps regulations an issue commented on earlier by ICBA in relation to the Dodd-Frank's exemption of commercial banks being classified as swap dealers to the extent they enter into a swap with a customer in connection with originating a loan with that customer. The CFTC and SEC earlier requested comments as to whether this exclusion should apply only to swaps entered into contemporaneously with the bank's origination of the loan or whether "contemporaneously" should be defined more broadly to relate to the life of the loan.

We believe regulators need to ensure this exemption applies to swaps entered into before, during or after origination of loans to provide enough flexibility for banks to serve their customers' timing and needs for swaps to facilitate fixed rate financings. Otherwise, community banks will be considered swap dealers and will stop using swaps. We stress the importance of avoiding any regulatory proposal that could have the effect of counting community banks as swap dealers when this is not their fundamental or primary business.

Conclusion

We urge regulators not to prohibit rehypothecation of initial margin utilized to facilitate the interest rate swaps of community banks. Instead, we urge the agencies to make distinctions between the truly risky and highly complex swaps that some large financial institutions utilized in the OTC market that actually contributed to the financial crisis versus the low risk interest rate swaps used by community banks which do not pose systemic risks.

It was not congressional intent to count community banks as swap dealers if they utilize swaps for hedging their own risks or serving their customers' needs. If community banks are unable to access the swaps market due to the unintended consequences of over-reaching regulations, both community banks and their customers will be needlessly harmed. It is important that community banks not be erroneously classified as "swap dealers."

[14] Ibid, pg 27579

We also urge the agencies not to impose a burdensome and costly segregation regime that unnecessarily imposes new costs upon the swaps market.

In general, there is no need to abolish the ability of community banks to access the swaps market as these regulations would do. Such an outcome directly contradicts the policy objectives that Title VII is designed to address. Such an outcome will diminish legitimate risk management tools and increase safety and soundness risks at a time when the opposite outcome is needed.

Thank you for considering our views. Should you desire more information on our views please feel free to contact Mark Scanlan at: 202.659.8111 or mark.scanlan@icba.org.

Sincerely,

/s/

Mark Scanlan
Vice President, Agriculture and Rural Policy