AIR TRANSPORT ASSOCIATION

July 8, 2011

FILED ELECTRONICALLY

Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2-3
Washington, DC 20219

Gary K. Van Meter
Acting Director
Office of Regulatory Policy
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102-5090

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Ave, NW
Washington, DC 20551

Alfred M. Pollard
General Counsel
Attention: Comments/RIN 2590-AA45
Federal Housing Finance Agency
Fourth Floor
1700 G Street, NW
Washington, DC 20552

RE: Margin and Capital Requirements for Covered Swap Entities

- Office of the Comptroller of the Currency: Docket No OCC–2011–0008
- Board of Governors of the Federal Reserve System: Docket No. R–1415
- Federal Deposit Insurance Corporation: RIN 3064–AD79
- Farm Credit Administration: RIN 3052–AC69
- Federal Housing Finance Agency: RIN 2590–AA45

The Air Transport Association of America, Inc. ("ATA") appreciates the opportunity to comment on the Notice of Proposed Rulemaking on Margin and Capital Requirements for Covered Swap Entities ("Agency Proposal") issued jointly by the agencies listed above

("Agencies").[1] Under Section 731 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"),[2] which added new Section 4s to the Commodity Exchange Act ("CEA"), the Agencies are required to adopt joint rules relating to margin and capital requirements for swap entities for which they are the prudential regulator. The Commodity Futures Trading Commission ("CFTC") is required to issue margin and capital rules for all other swap entities.[3] Dodd-Frank requires that the Agencies consult with the CFTC and the SEC and, to the extent practicable, establish and maintain comparable requirements.[4] The CFTC has issued Notices of Proposed Rulemaking relating to margin and capital for covered swap entities ("CFTC Margin Proposal" and "CFTC Capital Proposal," respectively).[5]

The Agency Proposal provides, among other requirements, that:

1) with respect to margin on uncleared swap transactions, each covered swap entity is required to set minimum thresholds for each of its counterparties and to collect initial and variation margin for exposures with their counterparty in excess of the thresholds; the thresholds are required to be set based upon a determination of the credit worthiness of the counterparty; this requirement applies to transactions with all counterparties—including transactions by noncommercial end users that the end users enter into for risk mitigation purposes;

2) the collateral that the covered entity accepts may only be cash or a near cash equivalent; and

3) each covered entity must recognize a capital charge for all uncleared swap transactions into which it enters.

The Agency Proposal and the CFTC Margin Proposal differ significantly in that the CFTC is not proposing to require covered swap entities to collect initial or variation margin for transactions with a <u>nonfinancial end user</u>. Equally significantly, the CFTC has not proposed any restriction on the type of asset that may be used by a nonfinancial end user as collateral.

ATA strongly supports the CFTC Margin Proposal, which does not impose initial or variation margin on transactions between covered swap entities and nonfinancial end users beyond any margin that might be required pursuant to negotiated credit support agreements

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[1] Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27564 (May 11, 2011).
[2] Public Law No. 111–203, 124 Stat. 1376 (2010).
[3] The Securities and Exchange Commission ("SEC") is required to issue rules for security-based swap dealers and security-based major swap participants. The term "covered swap entities," as used in this letter, refers to those swap entities covered by either the Agency's or the CFTC's rule proposals discussed herein.
[4] Dodd-Frank Sections 731 (new CEA Section 4s(e)(3)(D)) and 764 (new Exchange Act Section 15F(e)(3)(D)).
[5] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23732 (April 28, 2011); Capital Requirements of Swap Dealers and Major Swap Participants, 76 Fed. Reg. 27802 (May 12, 2011).

between the parties, and which also permits the use of noncash collateral, as explicitly mandated by Dodd-Frank. For the reasons discussed more fully below, we urge the Agencies to amend their proposal and to adopt rules consistent with the CFTC Margin Proposal.

We also urge the Agencies to modify their rules to ensure, consistent with clear Congressional intent and the reduced risk of swaps entered into by nonfinancial end users for hedging or commercial risk mitigation purposes, that capital charges will not be applied to covered swap entities for swaps that they enter into with nonfinancial end user counterparties.

ATA

ATA is the principal trade and service organization of the U.S. scheduled airline industry.[6] It is the nation's oldest and largest airline trade association and its members account for more than 90 percent of the passenger and cargo traffic carried by U.S. airlines. Since its founding in 1936, ATA has encouraged governmental policy decisions that foster a financially stable U.S. airline industry capable of meeting the nation's travel and shipping needs while withstanding the inherently cyclical nature of the airline industry.

ATA members are major consumers of jet fuel, the price of which is tied to the price of crude oil. Fluctuations in crude oil prices significantly affect market volatility and consequently the profitability and financial health of our member airlines. Many members of ATA thus actively participate in the over-the-counter swap markets in order to hedge their price exposure to jet fuel, typically with counterparties that will be either swap dealers or major swap participants ("MSPs") subject to margin and capital rules under Section 731 of Dodd-Frank. Requiring margin and capital charges for uncleared swap transactions with nonfinancial end users, such as ATA's members, will impose substantial new costs and burdens on our members and significantly harm their businesses. These results would be contrary to the mandate of Dodd-Frank and to the clearly-expressed legislative intent that such costs not be imposed on or passed along to nonfinancial end users.

DISCUSSION

A. Dodd-Frank does not authorize the Agencies to impose margin requirements on nonfinancial end users or the higher cost of capital charges on nonfinancial end user counterparties in connection with uncleared swaps

The Agency Proposal states that the "plain language of Section[ ] 731 . . . provides that the Agencies adopt rules for covered swap entities imposing margin requirements on all non-

[6] The members of the association are: ABX Air, Inc.; AirTran Airways; Alaska Airlines, Inc.; American Airlines, Inc.; ASTAR Air Cargo, Inc.; Atlas Air, Inc.; Continental Airlines, Inc.; Delta Air Lines, Inc.; Evergreen International Airlines, Inc.; Federal Express Corporation.; Hawaiian Airlines; JetBlue Airways Corp.; Southwest Airlines Co.; United Airlines, Inc.; UPS Airlines; and US Airways, Inc. Associate members are: Air Canada; and Air Jamaica.

cleared swaps."[7] However, the Agencies are not authorized to impose margin, (*i.e.*, collect margin from) or impose capital costs on the nonfinancial end user counterparty.[8] By imposing mandatory initial and variation margin *collection* requirements upon the transactions by swap entities with nonfinancial end users, the Agencies impermissibly effectively impose initial and variation margin requirements upon such nonfinancial end users.

The first inquiry in statutory construction is to look at the plain language of the statute itself. If that language is clear, the statute's meaning should be clear without having to look beyond the statute to determine its meaning.[9] We believe that the statute plainly does not authorize the Agencies to impose margin and capital on nonfinancial end users.

The statute is not ambiguous in this regard. And, as discussed more fully below, the primary drafters did not believe that the statute was ambiguous.[10] However, even if it were ambiguous, statutory construction is a "holistic endeavor"; provisions should not be read in isolation, particularly where a holistic reading of the remainder of the statutory scheme "produces a substantive effect that is compatible with the rest of the law."[11] A reading of the text should be informed by statutory context and statutory purpose,[12] and context and purpose here clearly evidence that nonfinancial end user transactions were not intended to be caught up by mandatory margin and capital requirements.

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[7] Agency Proposal, 76 Fed. Reg. at 27570 (emphasis omitted).

[8] The plain language of the statute identifies and thereby limits those entities to which the margin and capital rules may apply, *i.e.*, registered swap dealers and major swap participants. In the subsection of Section 731 dealing with capital and margin, the statute provides that the appropriate regulators "shall jointly adopt [capital and margin] rules *for swap dealers and major swap participants, with respect to their activities as a swap dealer or major swap participant*" (emphasis supplied). Thus, while margin must be imposed on all uncleared swaps, as the Agencies note, it may only be imposed on those entities covered by the statute, i.e., registered swap dealers and MSPs, and then only with respect to *their* activities as such. While the Agencies are authorized by the statute to require swap dealers and MSPs to post margin on their side of bilateral swaps with an end user counterparty that is exempted from clearing, they are not authorized to impose margin (i.e., collect margin from) or impose capital costs on that end user counterparty.

[9] *See, Connecticut Nat'l Bank v. Germain*, 503 U.S. 249, 253-54 (1992) (*quoting Rubin v. United States*, 449 U.S. 424, 430 (1981) ("When the words of a statute are unambiguous, then, this first canon is also the last: 'judicial inquiry is complete'."), *aff'd sub nom. Germain v. Connecticut Nat'l Bank*, 988 F.2d 1323 (2d Cir. 1993).

[10] *See* Joint Explanatory Statement of the Committee of Conference, H.R. Rep. No. 111-517 (2010)(Conf. Rep.), 111th Cong. ("Regulators have authority to impose margin requirements *only on dealers and major participants* for uncleared swaps, adding safeguards to the system by ensuring dealers and major swap participants have adequate financial resources to meet obligations.") (Emphasis added); *see also,* 156 CONG. REC. H5248 (June 30, 2010) (Rep. Colin Peterson, House Agriculture Comm. Chair: "[W]e have given the regulators no authority to impose margin requirements on anyone who is not a swap dealer or major swap participant....").

[11] *United Savings Ass'n v. Timbers of Inwood Forest Associates,* 484 U.S. 365, 371 (1988) (*citations omitted). See also, United States v. Boisdoré's Heirs*, 49 U.S. (8 How.) 113, 122 (1850) (opinion of Court).

[12] *See Brotherhood of Locomotive Engineers v. Atchison, T. & S.F.R.R.*, 516 U.S. 152, 157 (1996); *See also FCC v. NextWave Personal Communications, Inc.*, 537 U.S. 293, 311 (2003) (Breyer, J., dissenting) ("It is dangerous . . . in any case of interpretive difficulty to rely exclusively upon the literal meaning of a statute's words divorced from consideration of the statute's purpose.").

Indeed, the provision that exempts nonfinancial end users from the mandatory clearing requirement does not make sense if margin and capital charges could nevertheless be imposed on uncleared swaps entered into by nonfinancial end users. Congress left no doubt in its many statements surrounding and following the adoption of Dodd-Frank that the exemption was put in place to prevent the imposition of additional costs and burdens on nonfinancial end users using swaps to hedge or mitigate commercial risk. Indeed, as we discuss below, members of the Congressional Conference Committee negotiating the final language of the statute expressed the view that the statute does not authorize the Agencies or the CFTC to impose margin on nonfinancial end users or to impose capital requirements in connection with such transactions. It would be an anomalous result if the carefully-carved out exemption from mandatory clearing resulted in higher costs to nonfinancial end users through the imposition of margin and capital on their uncleared swaps. As stated repeatedly by the leadership of both the House and Senate Committees with jurisdiction over swaps, imposing margin and higher capital costs on nonfinancial end users that hedge legitimate business risks through swaps would defeat the purpose of the end user exemption and contravene Congressional intent.[13]

Any reading of Section 731 that would require the imposition of margin and capital costs on nonfinancial end users would be inconsistent with the obvious and clearly-expressed intent of the statute to exempt these entities from mandatory clearing (and the associated costs). The only internally consistent reading of the statute is that it prohibits the mandatory imposition of margin and capital costs on nonfinancial end users. The carefully-crafted and heavily-negotiated clearing exemption only makes sense if read to mean that nonfinancial end users will not be subject to mandatory margin and capital costs for uncleared swaps. Any other reading would completely undo the benefits to a nonfinancial end user of the clearing exemption, making the exemption virtually useless.

Accordingly, and in response to ***Questions 1(a) and (b) in the Agency Proposal***, we believe that Dodd-Frank is not ambiguous in this regard, explicitly permitting the imposition of margin and capital charges only on registered swap dealers and MSPs. Nevertheless, even if the Agencies determine that the statute is not clear on this point (a point on which the CFTC obviously disagrees), we believe that, when read as a whole, the relevant provisions only make sense if uncleared nonfinancial end user transactions are exempt from margin and capital requirements.

B. The record is unequivocal that Congress intended nonfinancial end user transactions to be exempt from mandatory margin and capital

The record leaves no doubt that the drafters of Dodd-Frank recognized the critical importance of allowing nonfinancial end users, which played no role in the financial crisis and

[13] *See,* Letter from Chairmen Christopher Dodd and Blanche Lincoln to Chairmen Barney Frank and Colin Peterson ("Dodd-Lincoln Letter") (June 30, 2010); Letter from Chairman Debbie Stabenow et. al. to Treasury Secretary Timothy Geithner et. al. ("Stabenow Letter") (Apr. 6, 2011); Letter from Ranking Member Spencer Bachus, Comm. on Fin. Services, and Ranking Member Frank Lucas, Comm. on Agriculture, to Treasury Secretary Timothy Geithner, et. al. (Dec. 16, 2010).

pose minimal if any risk to the safety and soundness of covered swap entities or U.S. financial stability, to continue to hedge effectively against future risks without having to bear the added costs of mandatory margin and capital charges for their uncleared transactions. The legislative history is absolutely clear as to the intent of Congress to create an exemption for nonfinancial end users from the burdens and costs of Title VII of Dodd-Frank.

The base text on which the Dodd-Frank Conference Committee worked had explicitly provided that margin requirements would not apply to swaps where one of the parties was a nonfinancial end user.[14] However, this provision was inadvertently omitted from the base conference text, presumably because it was considered redundant.[15] Numerous colloquies during the conference indicate that the conferees believed that the text adopted in conference (which ultimately became Dodd-Frank) fully exempted nonfinancial end users from margin and that an explicit amendment was not necessary.[16] Congress's intent in this regard is again highlighted in the Dodd-Lincoln Letter, which points out that the revisions made during conference that removed the explicit exemption for end users from margin requirements were expressly made "to eliminate redundancy" and "to streamline the regulatory framework," and not to affect the "consistent Congressional directive throughout all the drafts of this legislation, and in Congressional debate, ... to protect end users from burdensome costs associated with margin requirements and mandatory clearing."

Congress also understood that capital requirements in connection with such end user transactions were within the end user exemption. The Dodd-Lincoln Letter confirms that Dodd-Frank "does not authorize the regulators to impose margin on end users, those exempt entities that use swaps to hedge or mitigate commercial risk." It goes on to say that "Congress clearly stated in this bill that the margin and capital requirements are not to be imposed on end users," and that "rules may not be set in a way that requires the imposition of margin requirements on the end user side of a lawful transaction." A colloquy between Senators Lincoln and Hagan further reinforces the intent that capital and margin requirements not apply to nonfinancial end user transactions. Senator Lincoln states: "As we point out, it is clear in this legislation that regulators only have the authority to set capital and margin requirements on swap dealers and major swap participants for uncleared swaps, not on end users who qualify for the exemption from mandatory clearing."[17]

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[14] Section 731 (adding new CEA Section 4s(e)(8)).

[15] *See* Dodd-Lincoln Letter.

[16] *See, e.g.*, 156 Cong. Rec. H5248 (June 30, 2010) (Rep. Barney Frank, responding to Rep. Colin Peterson: "[T]he gentleman is absolutely right. We do differentiate between end users and others. The marginal [sic] requirements are not on end users."); House-Senate Conference Committee Holds a Meeting on The Wall Street Reform and Consumer Protection Act, Unofficial Transcript, CQ Transcriptions, LLC Copyright 2010 (June 29, 2010) (Senator Dodd: "There is a difference of opinion on how clear the language [on end user margin] is. Our consideration, based on conversations we've had, is that the language is clear.... But I've suggested that a colloquy on the floor of the United States Senate, and it might have had a similar colloquy in the floor of the House. So it's up to the members of the House to decide to clarify what we believe is the clarity of the language." . . . "It was not decided to subject literally all of these individual's organizations to have to – to make margin requirements.").

[17] Senate Report, 156 Cong. Rec. S5907 (July 15, 2010) (colloquy of Senators Hagan and Lincoln).

C. <u>Swap activities of nonfinancial end users did not play a role in the financial crisis. Moreover, none of the swap positions of these entities poses systemic or even significant risk</u>

Exempting nonfinancial end users from mandatory margin and capital-related costs is consistent with the central goal of Dodd-Frank to mitigate systemic risk. Congress has recognized that nonfinancial end users need access to derivatives to enable them to "increase certainty in their businesses," and to engage in "prudent risk management activities" by using swaps to hedge.[18] As noted above, the Agencies and the CFTC all recognize the minimal risks that nonfinancial end users pose to the safety and soundness of covered swap entities and U.S. financial stability.[19] While we appreciate the Agencies' efforts to adopt a risk-based margin approach that attempts to recognize this minimal risk, we believe that the burdens on nonfinancial end users inherent in this approach are not justified by any marginal regulatory benefit that may accrue. Imposing additional costs on nonfinancial end users is not necessary (or even directly related) to the mitigation of risk either to counterparties or to the financial system as a whole.

This goal is instead achievable through the CFTC Margin Proposal's risk-based approach, discussed more fully below, which requires each covered swap entity to calculate hypothetical initial and variation margin amounts daily for positions held by nonfinancial end users as if those entities were covered swap entities. We believe this approach appropriately addresses the mitigation of systemic risk. The daily hypothetical calculations will "serve as risk management tools that w[ill] assist the [covered swap entity] in measuring its exposure."[20] Mandated margin and capital charges for uncleared swaps with nonfinancial end user counterparties, by contrast, will do little if anything to achieve this goal and accordingly are not justifiable burdens on these parties.

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[18] Stabenow Letter.

[19] Agency Proposal, 76 Fed. Reg. at 27570.

[20] CFTC Margin Proposal, 76 Fed. Reg. at 23737.

D. <u>The CFTC Margin Proposal is consistent with the statute and with Congressional intent</u>

Consistent with both the statutory language and clear Congressional intent, the CFTC Margin Proposal recognizes that Congress did not authorize imposition of margin on nonfinancial end users and accordingly does not impose margin requirements on such entities. The CFTC Margin Proposal instead requires that covered swap entities have credit support agreements in place consistent with the proposed rules and permits (but does not require) covered swap entities to negotiate margin arrangements with nonfinancial end users. We believe that this approach more closely follows the statute and Congressional intent. We urge the Agencies to adopt a similar approach.

Dodd-Frank requires the Agencies and the CFTC to consult with respect to capital and margin rules and to establish and maintain "to the maximum extent practicable" "comparable" requirements. The Agency Proposal and the CFTC Margin Proposal differ substantially in their treatment of nonfinancial end users and, therefore, cannot be said to be "comparable." Because the CFTC's proposal is consistent with the statute and with Congress's oft-repeated mandate that margin not be required, we urge the Agencies to modify their proposal to conform to the CFTC's proposal, which does not mandate margin on nonfinancial end user transactions.

Noncash collateral

The CFTC Margin Proposal differs from the Agency Proposal in two important respects. First, the former permits the parties to negotiate individual margin arrangements under their credit support agreements. The Agency Proposal, on the other hand, requires that initial and variation margin be collected from all nonfinancial end users that do not meet the credit exposure limit threshold set by the covered swap entity for such end users.[21]

Second, consistent with Dodd-Frank, the CFTC Margin Proposal permits the use of noncash collateral by nonfinancial end users for initial margin. The CFTC Margin Proposal provides that: "To the extent a non-financial entity and a [covered swap entity] have agreed that the non-financial entity will post initial [and/or variation] margin, [the proposed rule] provides flexibility for initial [and variation] margin . . . as to what assets are permissible. The standard is simply that the value of the asset is reasonably ascertainable on a periodic basis."[22] The Agency Proposal, on the other hand, strictly limits the assets permitted to be used for margin from a nonfinancial end user to cash or cash equivalents, *i.e.,* for initial and variation margin, immediately available cash funds or any obligation that is a direct obligation of or is fully guaranteed by the U.S., and for initial margin only, any senior debt obligation of certain government or government-sponsored entities, such as the Federal National Mortgage

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[21] A covered swap entity may also use a standardized look-up table for initial margin. Under this alternative, it must collect at least as much as is required under that table, regardless of the type (relative risk) of counterparty, subject to a threshold amount below which the covered swap entity need not collect initial margin from certain types of counterparties.

[22] CFTC Margin Proposal, 76 Fed. Reg. at 23739.

Association.[23] These cash or cash-like assets are identical to what the CFTC Margin Proposal requires for transactions with other covered swap entities, *i.e.*, those entities the Agencies agree pose the highest counterparty and systemic risk.

We believe that both elements of the CFTC Margin Proposal are consistent with Dodd-Frank and are essential to allow ATA members to continue to hedge their price exposure to jet fuel, which is critical to the survival of their businesses. Nonfinancial end users generally negotiate with their dealer counterparty the amount and form of collateral required for their swap transactions. Among other things, nonfinancial end users frequently post noncash collateral, including physical collateral such as airplanes or other tangible property.

Dodd-Frank explicitly instructs the regulators that they "*shall* permit the use of noncash collateral" when prescribing margin requirements.[24] During the Senate Debate on Dodd-Frank, Senator Hutchison emphasized the importance of protecting "end users such as airlines, utilities, manufacturers, and oil and gas companies. These companies use derivatives as a cost effective strategy to control price and risk. Many structured derivatives contracts are unique to their business, making it difficult to clear and trade on a market. I share concerns from derivatives end users that this mandate to post margins with cash, rather than collateral, will remove capital from investment and job creation."[25] The cash-like instruments permitted under the Agency Proposal are contrary to what Congress had in mind when it mandated allowance of noncash collateral. The Agencies' restrictive view of noncash collateral is not only patently inconsistent with the statutory mandate but, if adopted, will have a severe and adverse effect on the ability of many end users, including ATA member airlines, to continue to hedge their business risks.

While we agree with the Agencies that it is difficult to establish accurate haircuts by regulation for noncash collateral "given the infinite variety of potential types of noncash collateral," we do not believe that regulating haircuts is necessary to manage counterparty or systemic risk. Appropriate haircuts to collateral are regularly applied as part of the bilateral margin negotiations between the counterparties using methods that are both accurate and effective. Typically, the collateral coverage ATA member airlines (and other nonfinancial end users) provide when using noncash assets is greater than 1-to-1 because it accounts for an airline's credit rating and the fact that noncash collateral is less liquid than cash. Accordingly, when using noncash assets to collateralize a hedge position, an airline will typically post more collateral on a dollar basis than the change in the mark-to-market valuation of the uncleared contracts covered under the agreement with the counterparty.

If the Agency Proposal were adopted, nonfinancial end users, in order to continue hedging their business risks, would be required to obtain significant amounts of capital in order to post cash-like collateral. This would impair the ability of such entities to employ much of their capital to sustain their business operations. Thus, by requiring the posting of cash or cash-like

[23] Agency Proposal, proposed Common Rule §_.6 (Eligible Collateral).
[24] New CEA Section 4s(e)(3)(C).
[25] Cong. Rec. S.5881 (July 15, 2010).

(*i.e.*, "highly liquid, high value debt")[26] instruments, the Agency Proposal will force nonfinancial end users, like ATA's members, to choose between hedging their business risk and investing cash into the company, thereby growing the business and creating jobs. We do not believe that the resultant costs to the companies themselves and the economy as a whole can be justified by any marginal potential regulatory benefits, especially since the Agencies agree that hedging by nonfinancial end users poses minimal counterparty or systemic risk.

As discussed above, the CFTC Margin Proposal is not only more consistent with Dodd-Frank's dual mandates to exempt nonfinancial end-users from margin requirements and to permit the use of noncash, *i.e.,* physical collateral, but it is also less likely than the Agency Proposal to have substantial negative effects on the hedging ability and business of nonfinancial end users. For all the reasons discussed above, we respectfully urge the Agencies to follow the CFTC's approach.

E. <u>Response to Agency Proposal Question 1(c): The margin determination should not differ based on why a nonfinancial end user swap is not cleared</u>

The Agency Proposal asks:

Should that determination [of whether the end user exemption requires or suggests that the end user should or must be exempt from margin] vary based on whether a particular non-cleared swap or non-cleared security-based swap is subject to the mandatory clearing regime or not (i.e., whether the nonfinancial end user is actually using the clearing exemption)?

The question of whether margin should be required for nonfinancial end users should not be dependent on whether or not a particular swap transaction is itself subject to the mandatory clearing regime. Instead, as clearly intended by Congress, it should be based upon the relatively low-risk nature of transactions involving nonfinancial end user counterparties.

Whether or not a particular uncleared swap is subject to the mandatory clearing regime depends upon a number of factors, including whether the swap is offered for clearing by a clearinghouse, which in turn will be based upon a number of factors, including whether a swap is sufficiently standardized and traded in sufficient volumes to be offered for clearing. In contrast, an uncleared swap that is not offered in sufficient volumes or that may be non-standardized with respect to its location may be no more or less risky than a swap that is offered for clearing. The chief risk in an uncleared swap inheres in the differing degrees of risk presented by various types of potential counterparties. On the other hand, the assessment of the risk of individual counterparties and the setting of margin requirements on a transaction-by-transaction and counterparty-by-counterparty basis is a routine business decision for the covered swap entities and making those credit determinations is a completely different exercise than the manner in which a clearinghouse operates.

[26] Agency Proposal, 76 Fed. Reg. at 27568.

Clearinghouses, in contrast to making individualized credit determinations, mutualize risk and assess every position the same margin. Dealers, on the other hand, make individualized credit determinations with respect to their counterparties in choosing whether to impose margin or not in their uncleared transactions with nonfinancial end users. This determination is the same whether the transaction is exempt from mandatory clearing because the end user has chosen to make use of the exemption or whether the transaction is not a clearable transaction. In either case, the counterparties should be able to determine the margin required through individual negotiation, as the CFTC has proposed.

F. <u>The Agency Proposal should ensure that their capital rules do not adversely affect nonfinancial end users</u>

For the same reasons that Congress has directed the regulators not to impose margin on nonfinancial end users, it has also made clear that capital requirements are not to be imposed on end users. As stated in the Dodd-Lincoln letter, "Congress clearly stated in this bill that the margin *and capital* requirements are not to be imposed on end users[.]" Moreover, "changes made in Conference to the section of the bill regulating capital and margin requirements for Swap Dealers and [MSPs] should not be construed as changing this important Congressional interest in protecting end users." Indeed, "[c]apital and margin standards should be set to mitigate risk in our financial system, not punish those who are trying to hedge their own commercial risk." The Dodd-Lincoln letter reaffirms Congress' view that there is "substantial public interest in keeping [end user derivatives] costs low." [27]

Despite these directives, the Agency Proposal requires a covered swap entity to comply with regulatory capital rules already made applicable to that covered swap entity as part of its prudential regulatory regime without providing any indication of how these capital rules might affect nonfinancial end user counterparties. Nor does the Agency Proposal discuss whether nonfinancial end user counterparties that are entering into the transaction to mitigate their commercial risk will face indirect increases in the cost for that transaction because their counterparty has been assessed a capital charge in connection with that transaction.

As we understand them, prior to Dodd-Frank, the capital rules pertaining to banks were more stringent than those applying to holding company affiliates. However, Section 171 of Dodd-Frank (the so-called "Collins Amendment") increases capital requirements for affiliates of bank holding companies by applying to such entities the same capital and risk standards that apply to banks insured by the Federal Deposit Insurance Corporation ("FDIC"). In addition, the capital requirements for both banks and bank holding company affiliates are likely to increase as the Agencies propose changes to conform to the new Basel III revised and enhanced capital framework for internationally active banks.

The current relevant capital rules framework for swap dealers and MSPs that are either banks or subsidiaries of bank holding companies is Basel I with the amending market risk rules (the latter of which apply when 10% or more of the firm's assets are trading assets or the firm has

[27] Dodd-Lincoln Letter.

trading assets of $1 billion or more). Roughly, the ten top U.S. banks are subject to the added market risk rules. A number of these banks also would become subject to Basel II if and when the Agencies begin to apply that framework of rules.

The current capital rules generally establish the required minimum amount of regulatory capital as a "minimum ratio of qualifying total capital to weighted risk assets of 8 percent, of which at least 4.0 percentage points should be in the form of Tier 1 capital."[28] Assets and off-balance sheet items are weighted relative to their credit risk with greater weighting for greater risk. Adjustments must also be made for certain market risks.

Under both the Basel I with market risk rules and the Basel II rules, most banks and bank holding companies will calculate their capital to be held on swap transactions utilizing internal value-at-risk models, which the Agencies will inspect during their regulatory examinations.

Generally, under the current framework, cleared swaps are risk-rated at 0 in these internal models. For uncleared transactions, however, modeling of internal risk ratings will depend on the existence of factors such as netting arrangements and on amounts and types of margin.

If cash and cash equivalents are used as margin, the amount of capital required to be held against the swap may be reduced. The amount of such margin held may also reduce the amount of capital required to be held.

The nature of the counterparty (e.g., if the counterparty is a bank) will also affect the amount of capital that an Agency-covered swap entity will be required to hold against a transaction. If the counterparty is a bank, the transaction will be risk-weighted at 20%. However, if the counterparty is not a bank (*i.e.,* if it is a nonfinancial end user), the transaction will be risk-weighted at 100%.

While the Agency Proposal applies to the covered swap entity and not the nonfinancial end user counterparty, to the extent that the swap entity does not require margin or accepts noncash collateral from the end user, it will be required to take a higher capital charge, defeating the concessions granted to the nonfinancial end user from margin requirements.

Accordingly, even if the Agencies were to amend the Agency Proposal to exempt nonfinancial end users from margin requirements and to allow for noncash collateral to be used, which we urge, we are extremely concerned by the likely adverse impact of the capital rules. The higher capital costs required for uncleared swaps with nonfinancial end users (nonbanks), particularly where noncash collateral is posted, if passed along to the nonfinancial end user as is expected, will render meaningless the very measures meant to make nonfinancial end user transactions less costly.

Moreover, higher capital charges for such end user transactions have the potential to render the end user exemption so economically unattractive as to cause it to be an empty promise. Nonfinancial end users may find themselves forced to try to clear their swaps through a central clearinghouse notwithstanding the non-standardized nature of the risk to be hedged and the availability of the exemption. Most of the hedges entered into by nonfinancial end-users are not susceptible to standardization, but are carefully tailored to fit the specific business risk the

[28] 12 C.F.R. pt. 225, App. A, sec. II.A.

end user faces. Imposing prohibitive costs and/or forcing these swaps into central clearing would be distinctly at odds with the intent of Congress and could make continued hedging of business risk by nonfinancial end users unworkably expensive.

In addition, because the Agency Proposal permits the use of internal models but does not in any way describe what the effect of these models may be on the various swap counterparties, it is virtually impossible for us (and any other end user counterparty) to predict with precision what these additional costs might be. Thus, despite Congress' explicit concern about the effects on this category of counterparty, the Agency Proposal provides no guidance at all to nonfinancial end users to assess how the proposed rules might affect them.

What is perfectly clear is that Congress, without any doubt, intended to protect nonfinancial end users from the additional costs attendant to increased capital and margin on swap dealers and MSPs. Allowing such charges to be imposed on nonfinancial end user transactions will remove the very benefits intended by Dodd-Frank's exemption for nonfinancial end users from mandatory clearing. Indeed, to the extent that capital charges would be higher for uncleared swaps (as contemplated by Dodd-Frank and presumably as required by current bank capital rules), nonfinancial end users effectively will be penalized each time they elect to use the statutory exemption. This cannot have been what Congress intended.

For all these reasons, we respectfully request that the regulators modify their capital rules as necessary to ensure that increased capital not be held against swaps with nonfinancial end user counterparties.

CONCLUSION

ATA appreciates the opportunity to comment on the Agency Proposal. For the reasons discussed above, we respectfully urge the Agencies to modify their proposal on margin to conform to the CFTC's Margin Proposal, which does not mandate margin for transactions with nonfinancial end users and which permits the use of noncash collateral. We also urge the Agencies to modify their capital rules to ensure that additional capital is not required for uncleared swap transactions with nonfinancial end users.

We would be happy to discuss our comments at greater length with the staff. Please feel free to contact Mr. David Berg, Vice President and General Counsel, Air Transport Association of America, Inc., at (202) 626-4234 or Paul M. Architzel of Wilmer Cutler Pickering Hale and Dorr LLP, outside counsel to ATA, at (202) 663-6240, if you have any questions regarding our comments.

Respectfully submitted,

D. A. Berg

David A. Berg
Senior Vice President and General Counsel