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February 13, 2012

VIA ELECTRONIC SUBMISSION

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

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

Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

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

Re: Prohibitions and Restriction on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds (OCC: RIN 1557-AD44); (Federal Reserve: RIN7100 AD 82); (FDIC: RIN 3064-AD85); (SEC: RIN 3235-AL07)

Ladies and Gentlemen:

On behalf of the Federal Home Loan Banks (the "FHLBanks"), we appreciate this opportunity to comment on the above-referenced proposed rules (the "Proposed Rules") issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Securities and Exchange Commission under Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

I. Executive Summary

Large banks that serve as derivative counterparties to the hedging transactions of the FHLBanks and others will be impacted by the Proposed Rules. The Proposed Rules effectively penalize these large banks if they retain any risk related to their derivative market-making activities. However, risk retention is an integral component of market-making, particularly when a bank is required to hedge highly customized swap transactions, such as those often entered into by the FHLBanks. The FHLBanks believe that the factors identified in the Proposed Rules for determining whether a bank's hedging transactions are permitted or prohibited activities are too complex and subjective and, as a result, will interfere with the important market-making function provided by banks.

The Proposed Rules are bad public policy for a number of reasons. Raising the costs of, and/or discouraging banks from making markets in, interest rate derivatives will raise costs for end-users such as the FHLBanks and other financial market participants. Additionally, if the Proposed Rules discourage end-users from executing swaps and other derivatives transactions for hedging purposes, such end-users could be forced to retain interest rate risk. Either of these outcomes could result in less efficient financial markets in the United States, a result that could have a negative impact on a wide range of economic activity.

II. The FHLBanks

The 12 FHLBanks are government-sponsored enterprises of the United States, organized under the authority of the Federal Home Loan Bank Act of 1932, as amended, and structured as cooperatives. Each is independently chartered and managed, but the FHLBanks issue consolidated debt obligations for which each is jointly and severally liable. The FHLBanks serve the general public interest by providing liquidity to approximately 8,000 member financial institutions, thereby increasing the availability of credit for residential mortgages, community investments, and other services for housing and community development. Specifically, the FHLBanks provide readily available, low-cost sources of funds to their member financial institutions through loans referred to as "advances."

As end users, the FHLBanks enter into a range of interest rate derivative transactions, including swaps, caps and floors, with swap dealers to facilitate their business objectives and to mitigate financial risk, primarily interest rate risk. As of September 30, 2011, the aggregate notional amount of over-the-counter ("OTC") interest rate swaps held by the FHLBanks collectively was approximately $734 billion. At present, all of these swap transactions are entered into bilaterally and none of them are cleared.

The FHLBanks are financial intermediaries for their member institutions and, in that capacity, play a key role in facilitating financing for housing and community investment across the country. The FHLBanks have substantial portfolios of OTC interest rate swaps executed for the purpose of hedging risks arising from their funding and lending activities. The FHLBanks seek to acquire funds through the issuance of consolidated debt obligations at the most favorable rates and then lend those funds to member institutions on terms consistent with the needs of their customers. Because the interest rate terms under which the FHLBanks borrow funds often differ from the needs of their member institutions (and the customers of these institutions), the FHLBanks use swaps to manage/hedge the interest rate risk associated with the differences between the terms and features of their consolidated debt obligations and the terms and features of their advances.

III. The Proposed Rules

A. Proprietary Trading by Banks

The FHLBanks look to large banking institutions to make markets in, and serve as counterparties to, their hedging transactions. The FHLBanks are concerned that the ability of these banks to perform this important banking service will be curtailed significantly as the result of the Proposed Rules intended to implement Section 619 of the Dodd-Frank Act (which adds a new Section 13 to the Bank Holding Company Act of 1956, the "BHC Act"). New Section 13 of the BHC Act generally prohibits any banking entity from engaging in proprietary trading, subject to certain enumerated exemptions in section 13(d)(1) of the BHC Act. The FHLBanks understand one of the activities that Congress clearly intended to exempt from the restrictions on proprietary trading is market-making for customers and hedging transactions necessary to support that market-making.[1] The FHLBanks are concerned that what appears to be a determined effort by the regulators to guard against the possibility that banks will engage in proprietary trading under the guise of market-making for customers may cause banks to either curtail their market-making activities or conduct them in a manner that would be much more costly for their swap customers. In either case, the likely result would be higher costs for the FHLBanks' member institutions and their customers.

The FHLBanks are concerned that the factors in the Proposed Rules meant to distinguish between permitted market-making-related activities and prohibited proprietary trading are overly complex and will impede the very conduct that the Congress intended to exempt from the ban on proprietary trading.

B. FHLBank Swaps

Many of the swaps executed between the FHLBanks and their bank counterparties are relatively illiquid and highly customized and therefore cannot be offset on a "one-for-one" basis. The duration of such swaps can vary from a few months to many years, the notional amounts from a few million dollars to hundreds of millions of dollars, and the terms from simple to highly complex. It is extremely doubtful, therefore, that many of the FHLBanks' swap transactions will be eligible for clearing in the foreseeable future.

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1 See Sec. 13(d)(1)(B) of BHC Act.

Additionally, as a result of their highly customized terms, it is highly unlikely that the bank counterparties to these swap transactions can hedge their exposures on the transactions by simply entering into offsetting trades. Instead, the bank counterparties will likely employ proprietary hedging strategies involving some combination of exchange traded futures, cleared swaps and uncleared OTC instruments to manage their interest rate risk. Given the duration and size of these transactions, the banks' hedging strategies are likely to entail some amount of retained interest rate risk for at least some period of time.

The role played by the major banks in making markets in customized swaps is critical to the management of risk by the FHLBanks. Without the opportunity to engage in such transactions on a cost-effective basis, the borrowing costs of the FHLBanks' member institutions, and ultimately the customers of such institutions, are likely to increase. The FHLBanks believe that this would be a consequence, albeit unintended and contrary to Congressional intent, of adopting the Proposed Rules in their current form. The FHLBanks therefore believe it is critical that the Proposed Rules be revised in a manner that will not disrupt the market for customized interest rate swaps or impose prohibitive costs and burdens on the derivative counterparties of major banks.

C. Exemptions

The Proposed Rules identify six factors to be considered in determining whether trading in connection with market-making is permitted or prohibited:

1. risk management—whether the trading unit "retains risk in excess of the size and type required to provide intermediation service to customers";
2. source of revenues—whether the trading unit primarily generates revenues from price movements of retained positions rather than customer revenues;
3. revenues relative to risk—whether the trading unit generates only very small or very large amounts of revenue per unit of risk taken or high earnings volatility;
4. customer-facing activity—whether the trading units transactions are primarily with customers or transacted through a trading system that interacts with orders of others;
5. payment of fees, commissions, and spreads—whether the trading unit routinely pays rather than earns fees, commissions, or spreads; and
6. compensation incentives—whether the trading unit provides compensation incentives to employees that primarily reward proprietary risk taking.[2]

With respect to each of the above factors, the Proposed Rules indicate that the determination of whether a transaction falls on the right or wrong side of the "permitted" line will be based on "all available facts and circumstances." However, the six factors call into question the proprietary nature, and therefore the permissibility, of almost every

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[2] Appendix B to Proposed Rules, Sec. III. C.

transaction that a bank would undertake to hedge its interest rate exposure on swaps transacted with the FHLBanks.[3] Additionally, bank counterparties could reasonably be concerned about their compliance with the factors in the Proposed Rules being assessed with the clarity of hindsight.

In particular, the "source of revenues" factor in the Proposed Rules could motivate the banks to widen customer spreads to better ensure that their revenue from price movements will be less than their revenue from the customer. Accordingly, from a regulatory standpoint, banks will be incentivized to trade with customers at higher costs and wider spreads in order to reduce the risk that their hedging transactions may be treated as prohibited proprietary trading. Again, this additional cost will be passed along to the FHLBanks' member institutions and ultimately to the customers of such institutions. Whether this is the intended or unintended result of the Proposed Rules, it seems to be directly contrary to Congress' intent to exempt from the general ban on proprietary trading those transactions that are entered into in connection with market-making for customers.

IV. Conclusion

The FHLBanks do not believe that their counterparty banks can sustain a market-making function in swaps necessary to satisfy the hedging needs of the FHLBanks if such banks are unduly constrained from incurring market risk. If implementation of bank hedging strategies is skewed as a result of concern about compliance with the multiple factors set out in the Proposed Rules, the clear statutory exemption for market-making for bank customers will have effectively been eviscerated. The FHLBanks respectfully suggest that the Proposed Rules be withdrawn and re-proposed in a form that is more consistent with the exemption provided in the statute. Hopefully, the new proposed rules would be clearer, considerably simpler to implement, less susceptible to application based on the clarity of hindsight, and less likely to discourage permitted market making activities by banks.

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[3] The FHLBanks do agree that compensation incentives based upon trading gains attributable to price movements rather than hedging efficiency would appear to be inconsistent with the exemption for proprietary trading related to market-making activities.

The FHLBanks appreciate the opportunity to comment. Please contact Warren Davis at (202) 383-0133 or warren.davis@sutherland.com with any questions you may have.

Respectfully submitted,

/AMB

Warren Davis, Of Counsel
Sutherland Asbill & Brennan LLP

cc: FHLBank Presidents
FHLBank General Counsel
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