



**National Rural Utilities
Cooperative Finance Corporation**

Created and Owned by America's Electric Cooperative Network

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September 20, 2013

Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Farm Credit Administration
Federal Housing Finance Agency

Re: Margin and Capital Requirements for Covered Swap Entities
RIN 1557-AD43, 7100 AD74, 3064-AD79, 3052-AC69, 2590-AA45

Introduction

The National Rural Utilities Cooperative Finance Corporation (CFC), a nonprofit member-owned organization, appreciates the consideration given to our previous comments¹ to the notice of proposed rulemaking, “Margin and Capital Requirements for Covered Swap Entities,” (the NPR)² issued by the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Farm Credit Administration, and Federal Housing Finance Agency (collectively, the Agencies). In CFC’s November 21, 2012, comments to the NPR (the CFC November Comment Letter), CFC requested that the Agencies adopt a final rule on margin requirements for non-cleared swaps that is consistent with the non-financial end-user pass-through approach taken by the Commodity Futures Trading Commission (CFTC) in its proposed rule, “Clearing Exemption for Certain Swaps Entered Into by Cooperatives” (the Proposed Cooperative Exemption).³ On August 13, 2013, the CFTC issued final rules (the Final Cooperative Exemption) that are virtually identical to those proposed in the Proposed Cooperative Exemption and reiterating the reasoning articulated in the Proposed Cooperative Exemption.⁴ In addition, in September 2013, the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions (IOSCO) issued their policy framework paper on “Margin Requirements for Non-Centrally Cleared Derivatives” (the International Margin Paper), which presents the final international policy framework to establish minimum margin requirements for non-centrally cleared derivatives.

For the reasons articulated in the CFC November Comment Letter, and as supplemented by this letter, CFC respectfully requests that the Agencies, in any future margin requirement NPR and

¹ Our June 21, 2011, August 2, 2012, November 1, 2012 and November 21, 2012 comment letters are attached as an exhibit for your convenience.

² See 77 Fed. Reg. 60057-60059 (October 2, 2012), reopening the comment period for the NPR and “Margin and Capital Requirements for Covered Swap Entities,” Fed. Reg. 27564-27596 (May 11, 2011). The comment period closed on November 26, 2012.

³ 77 Fed. Reg. 41940-41952 (July 17, 2012), implementing the action taken by the CFTC on July 10th.

⁴ “Clearing Exemption for Certain Swaps Entered into by Cooperatives” (“Final Cooperative Exemption”), 78 Fed. Reg. 52286-52308 (August 22, 2013).

final rule, take an approach similar to that taken by the CFTC with respect to the end user exception applicable to qualifying cooperatives.⁵ Specifically, CFC requests that swaps entered into by qualifying cooperatives be afforded the same treatment as swaps entered into by a qualifying cooperative's non-financial end-user members, i.e. that the final rule pass through the end-user exception available to a cooperative's members to the cooperative entity itself, subject to the same limits imposed on end-users in the end-user exception to clearing.⁶ In this regard, we request that the Agencies treat cooperatives qualifying under the Final Cooperative Exemption as "non-financial end users" for purposes of the initial and variation margin requirements for non-cleared swaps. We believe that this is the correct treatment required under the DFA and the only result consistent with both the CFTC's Final Cooperative Exemption and the International Margin Paper, which excludes certain "non-covered entities" from margin requirements (both initial and variation margin) on non-centrally cleared derivatives. However, in the alternative, if the Agencies decide not to treat qualifying cooperatives as non-financial end users, CFC requests that the Agencies modify the definition of a low-risk financial end user in the NPR to include cooperatives that qualify for the Cooperative Exemption. In making this request, we note that both approaches are consistent with the International Margin Paper which excludes certain "non-covered entities" from margin requirements (both initial and variation margin) on non-centrally cleared derivatives, although the second approach is inconsistent with the CFTC's Final Cooperative Exemption.

Background on CFC

CFC is a nonprofit, member-owned cooperative that was incorporated under the District of Columbia Cooperative Association Act in April 1969. As a cooperative, CFC is 100% owned by and serves its membership, which consists solely of member-owned nonprofit entities or subsidiaries or affiliates of nonprofit entities. The great majority of CFC members are member-owned cooperatives, with a small number being public corporations, utility districts or national, regional or statewide associations of cooperatives.

From its inception, CFC's purpose has been to provide its members with loans and financing to supplement the loan programs of the Rural Utilities Service (RUS), an agency of the U.S. Department of Agriculture. With the help of CFC financing, its members acquire, construct, maintain, and operate electric distribution, generation, transmission and related facilities. As a nonprofit cooperative, CFC's objective is to offer its members cost-based financial products and

⁵ As the Agencies noted in the NPR, the DFA requires the CFTC, the Securities and Exchange Commission, and the Agencies to establish and maintain, to the maximum extent practicable, capital and margin requirements that are comparable, and to consult with each other periodically (but no less than annually) regarding these requirements. 77 Fed. Reg. 27566.

⁶ 78 Fed. Reg. 52286-52308 (August 22, 2013).

services consistent with sound financial management, not to maximize net income. CFC's members provide reliable, affordable electricity in 48 states to individuals, families, public agencies, farmers, and businesses encompassing a population of approximately 42 million people.

We – and our members – depend on the flexibility and cost-effectiveness of the over-the-counter interest rate swaps market. A key component of CFC's ability to keep funding costs low and provide members with attractive interest rates has been CFC's ability to utilize over-the-counter derivatives to hedge interest rate risk, never to speculate. As a result, our members benefit by paying lower rates on their loans. Those benefits are ultimately passed on to the rural ratepayer consumers our members serve. If we were required to post margin, as contemplated in the NPR, our costs would rise significantly, and these higher costs would ultimately be passed on to the rural ratepayers through our members without any substantial offsetting public interest being enhanced.

The Cooperative Exemption

The CFTC's Final Cooperative Exemption provides an exemption from the clearing requirements, imposed by the Commodity Exchange Act (CEA), as amended by Title VII of the Dodd-Frank Wall Street Reform and Consumer Financial Protection Act (DFA), for certain swap transactions entered into by qualifying cooperatives. The CFTC in the preamble to the Final Cooperative Exemption acknowledges the unique member-owner structure of cooperatives and the merits of effectively passing through the end-user exception available to a cooperative's members to the cooperatives themselves.

In the Proposed Cooperative Exemption, the CFTC explained in detail why the Cooperative Exemption makes sense, represents good policy, protects the public interest, and is consistent with both Congressional intent⁷ and the specific provisions of the DFA. The preamble to the CFTC's Proposed Cooperative Exemption rule specifically listed CFC as an example of a qualifying cooperative.⁸ The CFTC further noted that CFC was formed, and still operates under, the authority of the CFC "Articles of Incorporation" filed under the District of Columbia

⁷ For instance, in addition to the rationale for the Final Cooperative Exemption described in this letter, section 722(f) of the DFA states that public interest waivers should be provided for certain swap transactions involving rural electric cooperatives. Section 722(f) states that: "If the Commission determines that the exemption would be consistent with the public interest and purposes of this Act, the Commission shall...exempt from the requirements of this Act an agreement, contract, or transaction that is entered into...between entities described in section 201(f) of the Federal Power Act..." Entities described in 201(f) can include CFC because CFC acts as an "instrumentality" of its member rural electric cooperatives. The Federal Power Act defines 201(f) entities to include, "an electric cooperative that receives financing under the Rural Electrification Act of 1936 (7 U.S.C. 901 et seq.) or that sells less than 4,000,000 megawatt hours of electricity per year, or any...instrumentality of any one of more of the foregoing." (emphasis added).

⁸77 Fed. Reg. at 41943, fn. 20.

Cooperative Association Act of 1940. The CFTC estimated in the Proposed Cooperative Exemption that approximately ten cooperatives would be eligible for the exemption and that most of those enter into less than 50 swap transactions per year.⁹

The Final Cooperative Exemption is structured to assure that it can only be used in certain circumstances. The Final Cooperative Exemption sets forth qualifying cooperative requirements, including membership requirements, swap transaction requirements, and reporting requirements, each of which we summarize below.

Qualifying Cooperatives. The Final Cooperative Exemption is narrowly constructed and applies only to cooperatives that:

- (i) are financial entities as defined in section 2(h)(7)(C)(i) of the CEA, solely because of section 2(h)(7)(C)(i)(VIII) of the CEA;¹⁰
- (ii) are formed and existing as a cooperative pursuant to federal or state law; and
- (iii) consist only of members that are entities that could elect the end-user exception themselves.¹¹

Swap Transaction Restrictions. In addition to limits on qualifying cooperatives, the Final Cooperative Exemption imposes restrictions on the types of swaps that may be exempt from clearing requirements. A qualifying cooperative may elect to not clear a swap subject to the clearing requirement if the swap:

- (i) Is entered into with a member of the exempt cooperative in connection with originating a loan or loans for the member, which means the requirements of 17 C.F.R. § 1.3(ggg)(5)(i), (ii), and (iii) are satisfied; or
- (ii) Hedges or mitigates commercial risk, in accordance with section 39.6(c), related to loans to members or arising from a swap or swaps that meet the requirements of paragraph (i) (above).¹²

⁹ 77 Fed. Reg. at 41946.

¹⁰ That section defines a financial entity for purposes of the CEA as “a person predominately engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in section 1843(k) of title 12.” Section 1843(k) includes lending activities within its list of enumerated activities that are financial in nature.

¹¹ § 39.6(f)(1) would provide that each member of the cooperative seeking to elect the cooperative exemption must be a non-financial entity, a financial institution to which the small financial institution exemption applies, or itself a cooperative each of whose members fall into those categories. This assures that the Final Cooperative Exemption will not be available to cooperatives that have members that are non-exempt financial entities as defined in Section 2(h)(7)(C) of the CEA. For example, the CFTC noted that the Cooperative Exemption would not be available to the Federal Home Loan Banks, whose membership includes financial entities that are not small financial institutions. 77 Fed. Reg. at 41942, fn. 15. Also excluded from qualifying cooperative membership would be certain types of entities, as listed in section 2(h)(C)(i)(I)-(VII) of the CEA.

Reporting. The Final Cooperative Exemption imposes the same reporting requirements that are imposed by the end-user exception. Title VII of the DFA amended Section 2(h)(7)(A) of the CEA to require one of the counterparties to a swap relying on the end-user exception to notify “the Commission, in a manner set forth by the Commission, how it generally meets its financial obligations associated with entering into non-cleared swaps.” Part 39 of the CFTC’s regulations implements those reporting requirements for end-users. The Final Cooperative Exemption proposes to apply those same requirements to entities relying on the Final Cooperative Exemption.

Qualifying Cooperatives Should Qualify as “Non-financial End Users”

We request that the Agencies amend the proposed definition of non-financial entity to include a cooperative qualifying under the Final Cooperative Exemption. This would be consistent with both the CFTC’s approach and the International Margin Paper. The Agencies emphasized that the NPR adopts a risk-based approach in proposing rules to establish margin requirements for covered swap entities. The International Margin Paper also emphasizes a risk-based approach. Entities that qualify for the Final Cooperative Exemption offer no greater risk to the financial system than entities that qualify for the end-user exception directly.

The CFTC has recognized that the cooperative member owner structure—comprised of entities that themselves would qualify as non-financial end users—warrants special consideration, and that non-financial entities that use swaps to hedge commercial risk pose less risk to their counterparties than financial entities.¹³ On a risk basis, qualifying entities under the Final Cooperative Exemption would offer no greater risk to their counterparties than entities electing to take the end-user exception directly because they are only entering into non-speculative swaps in the same manner as permitted for end-users. As a result, entities qualifying for the Final Cooperative Exemption should be treated in the same manner for purposes of initial and variation margin requirements, an approach that is consistent and in accordance with both the International Margin Paper and the Final Cooperative Exemption.

If Qualifying Cooperatives are Treated as Financial End Users they Should be Treated as “Low-Risk Financial End Users”

We believe that the correct approach is for Qualifying Cooperatives to be treated as non-financial end users, as this is consistent with both the International Margin Paper and the Final Cooperative Exemption, while treating Qualifying Cooperatives as “low-risk financial end users” would only

¹² Section 39.6(c) of the CFTC’s regulations note that a swap is used to hedge or mitigate commercial risk if such swap is economically appropriate to the reduction of risks arising from, among other things, “any fluctuation in interest, currency, or foreign exchange rate exposures arising from a person’s current or anticipated assets or liabilities;...”

¹³ 77 Fed. Reg. at 23736.

be consistent with the International Margin Paper and not the CFTC’s Final Cooperative Exemption. However, were the Agencies to deem the Qualifying Cooperatives to be “financial end users,” for the reasons below we believe that the appropriate categorization for them would be “low-risk financial end users”.

As noted above, in the NPR the Agencies sought to apply the margin and capital requirements based on risk, and the International Margin Paper also emphasizes risk. The CFTC, the primary regulator of the swap markets, has determined that swaps subject to the Final Cooperative Exemption pose a low risk to the financial system. The Final Cooperative Exemption effectively passes through the end-user exception available to members of a qualifying cooperative to the cooperative entities themselves, subject to the same types of limits on qualifying swaps activities as well as the same reporting and monitoring requirements. For this reason, qualifying cooperatives should qualify as low-risk financial end users if they are not treated as non-financial end users.

We note that the Agencies’ proposed definition of a “low-risk financial end user” requires an entity to be subject to capital requirements established by a prudential regulator or state insurance regulator. As we stated in our previous comment letter, the Agencies should reevaluate that approach and consider other alternatives. Such an approach is not consistent with the Final Cooperative Exemption. Moreover, the approach advanced in the NPR offers preferential treatment to entities that are subject to certain types of regulatory regimes (e.g., depository institutions).¹⁴ We would suggest a more inclusive approach that, while consistent with a risk-based approach, would not disadvantage qualifying cooperatives that are not structured in a similar manner. While we believe it unnecessary, as we have previously suggested the Agencies could instead require that qualifying cooperatives that are not subject to specified regulatory regimes, maintain a particular debt-to-equity ratio or some other relevant measure of financial soundness that takes into account the unique nature of the cooperatives.¹⁵

Given the CFTC’s narrow construction of the Final Cooperative Exemption and the reporting requirements contained therein, from a prudential risk management perspective (as well as from a historical perspective as demonstrated by the recent financial crisis) it is apparent that qualifying cooperatives and their non-cleared swap activities do not pose a greater risk to the financial system than the non-cleared swaps of an entity subject to capital requirements, such as those entities regulated by the Agencies. Therefore, we suggest that the Agencies redefine “low-risk financial end user” to include qualifying cooperatives such that swaps entered into by qualifying cooperatives qualify for the same treatment as swaps entered into by other low-risk financial end users.

¹⁴ See June 21, 2011 and November 21, 2012 comment letters.

¹⁵ For additional clarification on this suggestion, please see our June 21, 2011 comment letter.

Either Alternative is Consistent with the International Margin Paper, but only Treating Qualifying Cooperatives as Non-Financial Entities is also Consistent with the CFTC's Final Cooperative Exemption

Requirement 2.1 of the International Margin Paper states that “[a]ll covered entities that engage in non-centrally cleared derivatives must exchange, on a bilateral basis, the full amount of variation margin (i.e. a zero threshold) on a regular basis (eg daily)”. Requirement 2.2 states in part that “[a]ll covered entities must exchange, on a bilateral basis, initial margin with a threshold not to exceed 50 million Euros”. Covered entities include all financial firms and systemically important non-financial firms. Requirement 2.6 of the International Margin Paper leaves national regulators with the discretion to apply these terms: “[t]he precise definition of financial firms, non-financial firms and systemically important non-financial firms” will be determined by appropriate national regulation.”

Accordingly, in accordance with the International Margin Paper, the Agencies have the discretion to either treat Qualifying Cooperatives as “Non-financial End Users” or “Low-Risk Financial End Users”.

Conclusion

For the reasons noted above, we urge the Agencies to treat a cooperative that is entering into a swap that qualifies for the Final Cooperative Exemption the same as non-financial end users, and allow the covered swap entity to establish an initial margin threshold it deems appropriate for such qualifying cooperative without the requirements imposed on financial end users. This could be accomplished in the final rule by including cooperatives entering into a swap that qualifies for the Final Cooperative Exemption in the definition of “non-financial end user.” In the alternative, if qualifying cooperatives are not treated as non-financial end users, CFC requests that the Agencies modify the definition of a low-risk financial end user in the NPR to include cooperatives that qualify for the Final Cooperative Exemption.

We appreciate your consideration. We would welcome the opportunity to further discuss our views. Please do not hesitate to contact Richard E. Larochelle, CFC’s Senior Vice President of Corporate Relations, at (703) 467-7406, rich.larochelle@nrucfc.coop should you wish to discuss any of our comments or need additional information.

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Attached are the four letters referenced in the letter dated September 20, 2013:

- June 21, 2011
- August 2, 2012
- November 1, 2012
- November 21, 2012