

**Meeting between Federal Reserve Board Staff
and Representatives of Viking Sparks, Lubbock National Bank
and the Independent Community Bankers of America
February 16, 2012**

Participants: Sean Campbell and Anna Harrington (Federal Reserve Board)

John Crawford and Rick Remond (Viking Sparks), Keith Mann (Lubbock National Bank), and Mark Scanlan (Independent Community Bankers of America)

Summary: Representatives of Viking Sparks, Lubbock National Bank, and the Independent Community Bankers of America met with Board staff to discuss issues related to the proposed rule of the Board and other prudential regulators on margin and capital requirements for covered swap entities under Title VII of the Dodd-Frank Act.

The representatives expressed their concerns with the prohibition on rehypothecation as described in the attachment. The representatives of Viking Sparks, a broker-dealer focused on providing services to community banks, noted that the company acts as a counterparty to community banks on swap transactions and enters into hedges on those positions with larger, upstream dealers. The representatives explored how the prudential regulator rules would apply in cases where a prudentially regulated swap entity transacts with a second swap entity, whether regulated by a prudential regulator or by the Commodities Futures Trading Commission.

Attachment

DERIVATIVES – TITLE VII **Dodd Frank Act**

Background – The Dodd-Frank Act (DFA) imposes broad-based changes on the use of derivatives by the financial services sector, including their growing use by community banks. It is possible that DFA implementing regulations could negatively impact community banks that use swaps (derivatives).

Uses of Derivatives by Community Banks (swaps) – Community banks’ use low-risk, plain vanilla interest rate swaps either to hedge their own risks or serve the credit needs of their customers. In serving their customer’s loan needs, a community bank swap typically is designed to convert a variable rate loan into fixed-rate financing. These swaps are “customized” to match the underlying loan for GAAP accounting purposes. The customization could include a specific notional or dollar amount; tying the loan to a specific index; establishing monthly payment terms or other basic aspects. Because the swaps are customized, they are not yet accepted by the exchanges and therefore trade in the Over-The-Counter (OTC) market.

Concerns with Rehypothecation

- **Regulators propose to prohibit the transfer of initial margin (rehypothecation)** provided from the community bank to a mid-level swap dealer from that swap dealer to the counterparty on the other side of the swap transaction. However, the proposed rule asks if such a prohibition is appropriate and whether there are other alternatives.
- **Impact of Prohibiting Rehypothecation:** The prohibition on rehypothecation means mid-level swap dealers serving community banks would have to post their own collateral on each community bank customer for each of their swaps transactions, significantly raising the costs of community bank swaps and likely preventing access to the swaps market for most community banks. Due to their relatively small size, most community banks need to use middle market swap dealers to complete their swaps transactions.
- Swap dealers that serve the community bank market will exit the market leaving community banks without access to the swaps market. Many customers will leave community banks and opt for the services of larger financial players. The prohibition of rehypothecation, in the absence of an exchange that accepts community bank interest rate swaps, is the death knell for many community banks seeking to access the swaps market.
- **Addressing Regulator Concerns with Systemic Risk and Transparency:** Community banks should be able to choose whether to segregate their funds or transfer (rehypothecate) these funds as intended in the Dodd-Frank Act. One option would be to provide for a **narrowly targeted exemption** from this prohibition for community banks **for the specific purpose** of completing swaps transactions to serve their customers or hedge their interest rate risks. **Transparency** of these transfers can be provided by an appropriate reporting regime.
- Such an outcome would allow regulators the flexibility to address systemic risk issues posed by the largest financial institutions while not painting with such a broad brush as to force community banks out of the swaps market.