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SUBMITTED ELECTRONICALLY

David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

RE: Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant"; CFTC RIN number 3235-AK65; SEC Release No. 34-63452; File No. S7-39-10; 75 Federal Register 80174, December 21, 2010

Dear Mr. Stawick:

The American Bankers Association (ABA)[1] appreciates the opportunity to provide additional comments on the joint rules and proposed interpretations by the Commodity Futures Trading Commission (CFTC or Commission) and the Securities and Exchange Commission (SEC) to define further the terms "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant." We have had ongoing conversations with our member banks about the complexities and implications of the proposed rule, and this letter provides comments on the exemption from the swap dealer definition for swaps entered into by insured depository institutions in connection with originating loans (IDI exemption).

ABA urges the CFTC to accommodate all common lending practices in implementing an appropriate IDI exemption. We have been and will continue to discuss with our banks their use of swaps in connection with extending customer credit, and we have endeavored to capture many common lending practices in our comments. Banks commonly enter into swaps with customers so that customers can hedge their interest rate or other loan-related risks. The IDI exemption should be broad enough to ensure that banks are not discouraged from engaging in common loan-related hedging transactions.

[1] The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's $13 trillion banking industry and its 2 million employees. Learn more at www.aba.com.

Overview

The definition of swap dealer in the Dodd-Frank Act includes entities that hold themselves out as dealers or regularly enter into swaps as an ordinary course of business, but it exempts any insured depository institution "to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer."[2] This exemption shows that Congress recognized that swaps are an important risk-mitigating tool for banks and borrowers.

Banks commonly enter into swaps with customers so that customers can hedge their interest rate or other loan-related risks. While some swaps are entered into simultaneously with loans, many swaps are entered into before or after a loan is made. For example, it is common for a customer to enter into a swap to lock in an interest rate in anticipation of a future loan. If a loan has a variable interest rate, it is also common for a customer to enter into a swap during the course of the loan to convert to fixed-rate payment obligations. A loan and swap may also be purchased by another lender or assigned and novated if the lender exits certain business lines. Banks entering into these and other common loan transactions should be exempt from the swap dealer definition to the extent they would not otherwise be deemed to be swap dealers.

ABA urges the CFTC to implement an IDI exemption that encompasses all common lending transactions, in order to preserve the ability to manage risks and thereby protect a variety of credit options for businesses of all sizes working to create jobs and grow the economy. We also urge the CFTC to confirm that a bank entering into an offsetting swap to manage its own risk would not be deemed a swap dealing activity. Failing to take these steps would raise costs for banks and borrowers and discourage rather than encourage risk-mitigating transactions for ordinary business activities at a time when lending is most needed.

If all common lending practices are not taken into consideration, a bank that is not excluded from the swap dealer definition might also have to create a separate entity to conduct certain swaps activities, because swap dealers will be ineligible for "federal assistance," defined under the statute (mistakenly) as extending to FDIC insurance. Forming an affiliate to continue to provide swaps to loan customers would be expensive and require additional regulatory capital, so it would not be an option for all banks. Instead, many banks would stop entering into certain types of swaps in connection with originating loans, which would raise costs for borrowers and limit their options for using swaps to hedge risk. It might cause those banks to lose loan business as well.

I. Common Lending Practices

A. In Connection with Originating a Loan

In the rule proposal, the CFTC has asked for comment on whether the IDI exemption should be limited to swaps entered into contemporaneously with loans. We believe that such a limitation would be too restrictive, since it would not take into account common lending practices that include entering into swaps to hedge or mitigate loan-related risk at other times during the lending relationship.

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[2] Commodity Exchange Act ("CEA") Section 1a(49)(A).

Origination is a broad concept in the context of a lending relationship, since both swaps and funding can occur at many points during the term of the financing. Banks and customers need the flexibility to manage risk during the entire course of a loan, and we concur with the Office of the Comptroller of the Currency (OCC) that the IDI exemption should be "tailored to allow for ongoing hedging that is connected to an extension of credit." [3] Accordingly, we urge the CFTC to take into consideration all common bank lending practices in implementing the IDI exemption and enable banks to rely on the exemption during all phases of the lending relationship.

The Dodd-Frank Act requires that the swap must be in connection with originating a loan, but it does not require that the swap be done simultaneously with the origination or within any particular time period. Rather, it requires that the swap be entered into "in connection with originating a loan."[4]

While we understand the CFTC faces a challenge in interpreting the phrase "originating a loan," we would like to emphasize that a bank may make the decision to originate a loan for many different reasons. In many cases, the bank might not have been willing to make the loan or extend credit unless the customer hedges its interest rate, commodity, currency, or other risk. For example, the customer may want to lock in an interest rate while negotiating the terms of a loan, and the bank may be more likely to extend credit if it knows the customer has already taken appropriate measures to hedge its exposure. Alternatively, a customer may not want to enter into a swap until it draws down on a revolving line of credit.

Accordingly, while some swaps may be entered into simultaneously with a loan, common lending practices enable customers to hedge their loans at the time that makes the most economic sense from the customer's perspective. Some banks have estimated that only 50-60% of their swaps done in connection with originating loans are entered into the same day they sign loan documents with a customer.

Many customers want to separate the time that they fix the interest rate from the time that the loan funds. Some customers may need to use a swap in anticipation of a loan so that they know what their costs will be before being able to determine the amount that they can or should borrow. Other customers may need the ability to use a swap during the course of the loan to convert a floating to a fixed interest rate so that there is an upper limit on their debt obligations. Borrowers need the flexibility to evaluate changes in the interest rate and economic environment during the course of a loan in order to determine their hedging needs. A bank should be able to rely on the IDI exemption and not be designated a swap dealer – and incur significant costs and additional regulatory oversight – simply because the bank is accommodating customer needs for flexible risk hedging options.

Some common examples of swaps entered into in connection with originating loans but not the same day as the loan include—

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[3] Letter from Acting Comptroller of the Currency John Walsh to CFTC Chairman Gary Gensler regarding OCC Staff Comments on CFTC Dodd-Frank Act Proposed Rules, p. 6 (June 30, 2011) ("OCC letter").
[4] CEA Section 1a(49)(A).

- Interest rate swaps to set a fixed interest rate in anticipation of a loan. These swaps are most common for real estate, equipment, or other loans related to assets with fixed cash flows, and the swaps are typically subject to termination if the loan does not close. They are most frequently entered into within ninety (90) days before a loan closes, but it is also common for a swap to be entered into a year or more before a real estate loan closes or funds if construction must be completed.

- Swaps entered into during the course of the loan to convert from a floating to a fixed interest rate or vice versa. If interest rates rise, entering into a swap to convert from a floating to a fixed rate simultaneously enables customers to hedge loan exposure by fixing their maximum payment obligation and decreases default risk for banks. It also decreases the bank's credit exposure, because cash flows are predictable. If interest rates move lower, entering into a swap to convert from a fixed to a floating rate enables customers to lower their payment obligations, which increases their profit margins and thereby improves their ability to meet their payment obligations. Borrowers want to have the option to enter into a swap at any time during the course of a loan so that they have a low-cost way to retain a competitive cost structure in the prevailing interest rate environment.

- Swaps entered into pursuant to a hedging covenant in a loan agreement. These are most frequently entered into within ninety (90) days of the loan closing, but it is also common for them to be entered into 180 days, a year, or sometimes even longer after the loan closes. For example, the terms of a commercial loan facility may require the borrower to comply with certain conditions such as entering into a swap to hedge risk at any time before being able to draw on the facility.

- Swaps entered into at the time a borrower receives an advance or draws down on a line of credit.

- Swaps may be purchased by another lender, assigned and novated if the lender exits certain business lines, or restructured during a debt workout.

B. Financial Terms of a Loan

Generally there is a straightforward connection between an interest rate or currency swap and the financial terms of a loan or extension of credit. For example, a currency swap would likely be hedging the same currency in which loan payments must be made. An interest rate swap may, for example, have the same duration as the loan or the notional amount may be the same as the loan principal or might be used to convert a fixed to a floating rate or vice versa.

However, ABA requests that the CFTC clarify and confirm that certain common lending practices would be considered tied to the financial terms of a loan or extension of credit, including but not limited to—

- Swaps for a partial amount of the loan at the outset or during the course of the loan so long as the swap notional amount does not exceed the amount of the loan.

- Swaps with a different maturity date, including for partial or remaining term of the loan.
- Swaps entered into in connection with a portfolio of loans rather than just a single loan.
- Swaps retained by the bank if a loan is subsequently paid off, sold, or otherwise transferred away.
- Swaps with a notional amount that match the principal amount of the loan, but the duration of the swap is longer than the duration of the loan because it is done in anticipation of future financing (e.g., ten year swap done in connection with a five year loan in anticipation of additional financing after five years).

C. Loans and Other Economically Equivalent Extensions of Credit

ABA appreciates that the CFTC rule proposal would extend the IDI exemption to banks that provide funding as part of loan refinancing.[5] If refinancing were not treated the same as a loan, then banks would have an incentive to mature the loan and originate a new one in order to continue qualifying for the exemption. This alternative would needlessly increase costs for a transaction that is economically equivalent to a loan and might also subject customers to prepayment penalties.

ABA encourages the CFTC to clarify and confirm that all extensions of credit that are economically equivalent to originating loans are included in the IDI exemption. Examples of such transactions include loan renewals, increases in principal, extensions of maturity, and amendments. Other extensions of credit that should be explicitly included are leases, letters of credit, bank qualified transactions, financings documented as sales of financial assets, and any other debt or commitment to lend for a term.

D. Offsetting Swaps

Banks commonly enter into swaps with a customer and then enter into an offsetting swap with a swap dealer. ABA asks the CFTC to confirm that offsetting swaps would not be considered swap dealing activities, since they are not customer facing and do not meet the other characteristics of the proposed swap dealer definition.

In an offsetting swap, a bank that has entered into a swap with a customer turns to a swap dealer to offset the bank's loan-related risks. Under these circumstances, the bank becomes the customer and the swap dealer is arranging swap terms to accommodate the bank's interest in entering into an offsetting swap. In other words, the bank is the price taker rather than the price setter in these transactions, so it is not acting in a dealer capacity but rather as an end user of swaps to offset its own balance sheet risk. Furthermore, failing to exempt offsetting swaps from the swap dealer definition would eviscerate the IDI exemption.

[5] Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 75 Fed. Reg. 80174, 80212 (December 21, 2010) ("Entity Definitions Rule Proposal")(proposing CEA Section 1.3(ppp)(5)(ii)(D)).

E. Syndicated Loans and Participation Agreements

ABA appreciates that the CFTC explicitly includes banks that are part of a loan syndicate as eligible for the IDI exemption. This is good public policy, since loan syndicates can increase the amount of funds available to the customer and spread loan risk among participating banks, while also enabling smaller banks to participate in lending to larger borrowers. Typically one or more members of the loan syndicate will enter into hedging transactions with the customer so that the customer can hedge the entire loan balance.

ABA asks the CFTC to clarify and confirm that all members of the loan syndicate would qualify for the IDI exemption even if only one member of the syndicate enters into a swap transaction with the customer. While the swap exposure for a syndicate member may exceed the amount of its loan exposure, the overall swap exposure does not exceed the amount of the loan. In addition, this structure enables the customer to get more attractive swap terms and makes it possible for banks that do not otherwise engage in swaps to participate in a loan that carries less risk than an un-hedged loan.

ABA also appreciates that the CFTC rule proposal explicitly acknowledges that a bank that purchases or receives a participation in a loan will be eligible for the IDI exemption. However, the same bank might also purchase or receive participation in a swap transaction,[6] and that participation should also be explicitly covered by the IDI exemption if it is connected to an eligible loan participation. Participation agreements enable banks to diversify assets, reduce credit concentrations to certain customers, and increase credit availability. Furthermore, the lead bank may have originated the loan in reliance on its ability to enter into participation agreements with other banks in order to mitigate its credit risk, and the terms of the participation are often negotiated after the loan closes. Not only do the participation agreements enable the lead bank to manage the customer relationship and hedge risk, the customer only has to interact with one lender, and participating banks may also be able to participate on more attractive terms since the lead bank may have better bargaining leverage.

Accordingly, ABA seeks confirmation that both the lead bank and the banks participating in the loan or the swap will be eligible for the IDI exemption, including under circumstances when the participation agreement is not entered into simultaneously with the loan. The activities of the lead bank and the participating banks are inextricably linked and, therefore, they should both be eligible for the exemption.

F. Existing Loans and Swaps

ABA asks the CFTC to clarify and confirm that swaps entered into in connection with loans existing at the time the swap dealer registration requirements become effective will also be included in the IDI exemption. For example, a swap entered into to convert a floating to a fixed interest rate for an

[6] In a participation agreement for a swap, the participating bank receives a fee in exchange for agreeing to reimburse the lead bank for a portion of the losses in the event of customer default. In participation agreements for both a loan and a related swap transaction, the lead bank manages the customer relationship and enters into agreements directly with the customer while the participating bank enters into agreements with the lead bank.

existing loan would mitigate risk and should not subject a bank to additional regulatory requirements. A bank might also change its business policy to start entering into swaps on existing customer loans if it acquires expertise or otherwise determines it would be appropriate in light of interest rate or other market conditions. In addition, swaps entered into before the effective date may be purchased, assigned, restructured in a workout, or otherwise subject to the same types of changes that swaps entered into after the effective date will be, and they should similarly be covered by the IDI exemption.

G. Commodity Swaps in Connection with Loans

Limiting the IDI exemption to swaps entered into contemporaneously with a loan or connected to the financial terms of the loan would have unique implications for commodity swaps. Commodity swaps to hedge market risk related to agriculture, energy, metals, and other commodities are commonly made during the course of the loan rather than at the same time the loan is made. Market risk may change seasonally, annually, or at other intervals during the loan, so a customer needs the flexibility to enter into new swaps during the course of the loan to manage cash flows and capital needs by hedging against changing risks.

ABA is concerned that it may also be more challenging to characterize a commodity swap as tied to the financial terms of a loan than it is for an interest rate or foreign exchange swap. Unlike interest rate or currency swaps, commodity hedges do not match an interest rate or currency, generally do not match the loan duration, and may not match the loan principal amount or collateral. Commodity swaps generally enhance the creditworthiness of the borrower and are part of the lending relationship, but banks do not generally negotiate with a customer by extending the loan duration or lowering the interest rate if the customer agrees to enter into a commodity swap to hedge market risk.

As noted in the OCC letter, the statutory language of the IDI exemption "does not limit the loan exclusion to swaps that are connected to the financial terms of a loan, nor does it require that the swap be entered into contemporaneously with loan origination." [7] The CFTC has stated that it preliminarily believes that the IDI exemption should not include swaps that are entered into in connection with a borrower's business activities, even if the bank requires the borrower to enter into such swaps.[8] We disagree.

Banks engage in commodity swaps during the course of the lending relationship to enable the borrower to hedge market risk and manage balance sheet risk, capital needs, and cash flows as market conditions change. Banks also benefit because their default risk decreases and their cash flows also become more predictable. Commodity swaps are prudent risk management tools that reduce risk for both the borrower and the lender even if they are not connected to the terms of the loan the same way that interest rate or foreign exchange swaps might be.

Farmers and energy producers may not be able to anticipate market conditions and production plan changes years in advance and need to be able to use swaps to adjust their market risk hedge during a

[7] OCC Letter, pp. 5-6.
[8] Entity Definitions Rule Proposal at 80181.

multiyear loan. Alternatively, a bank might not make a multiyear loan, finance an acquisition, or otherwise extend attractive financing terms unless it can be assured that the customer will hedge its market risk during the life of the loan, such as through seasonal or annual reassessment of the existing hedge to determine whether a new swap or other hedging transaction would be prudent in light of changing market conditions.

While the CFTC has expressed concern that not limiting swaps to the financial terms of the loan would enable banks to make a market in swaps without being classified as dealers,[9] interpreting the IDI exemption in this manner would severely limit competition in the commodity swaps market. If the CFTC adopts a narrow IDI exemption, then it would significantly increase costs for community and regional banks with relatively modest portfolios of commodity swaps that would otherwise not be classified as swap dealers, driving some if not many of these community and regional banks from lines of business important to their customers and their communities.

Furthermore, banks that are swap dealers will not only have to register and comply with regulatory requirements applicable to all swap dealers but will also have to "push" their commodity swaps activities out of the bank into a nonbank affiliate. As discussed in more detail in the cost-benefit analysis below, forming an affiliate to conduct commodity swaps would be cost prohibitive for many banks and would hamper centralized risk management for both banks and customers. As a result, those banks might stop offering commodity swaps, which would decrease competition, increase risk, and might cause those banks to lose loan business as well if customers choose to transact with another bank that both extends credit and offers commodity swaps.

In implementing the IDI exemption, the CFTC should take into account the range of companies that have market exposure to commodities. This exemption will have significant impact not just on farmers and other energy and commodity producers. It will also affect a broader array of companies that have significant operating costs linked to commodity prices, including not just large operating companies like airlines but also other entities like taxicab companies, school boards with fleets of buses, and retailers with significant exposure to shipping operations. Many of these companies would lose access to a valuable risk-mitigating tool if community and regional banks could not afford to offer swaps to hedge market risk throughout the life of the loan.

For all of these reasons, ABA believes that the IDI exemption should include banks that offer commodity swaps to their customers with commodity market exposure if they are used to manage risk associated with a loan or other extension of credit. Such swaps may not be directly tied to the financial terms of the loan, entered into at the same time as the loan, or even contemplated during the loan underwriting process. However, swaps are an important means for both the bank and the customer to manage credit risk and cash flows throughout the duration of the loan or financing. Accordingly, it is essential that banks and customers have the ability to assess current market conditions and enter into swaps or other hedging transactions related to outstanding loans and financing. A narrow definition would reduce credit and risk-mitigating hedging alternatives for borrowers and banks, especially considering the anticipated impact of the Dodd-Frank Act "push-out" provision.

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[9] Entity Definitions Rule Proposal at 80181-80182.

II. Cost-Benefit Analysis

The CFTC is required to consider the costs and benefits of each rule that it promulgates.[10] While we recognize that it is challenging to estimate costs the costs that swap dealers may face, because they will be a new type of regulated entity, the statute places the burden on the government to provide a realistic cost-benefit analysis.[11] This analysis should take into account not just the cost of determining whether or not an entity would have to register as a swap dealer, but also the operational burdens and costs of developing and implementing a compliance program for the registration, margin, reporting, business conduct, and other regulations that will be applicable to swap dealers. The Commission should also take into consideration that swaps can play a valuable role in prudent lending and credit and that banks are already subject to comprehensive regulation.

Imposing costly registration and compliance requirements on banks that use swaps in connection with loans and other extensions of customer credit would discourage them from offering customers the option to use swaps to mitigate risk. Customers might lose an important tool to hedge risk, face additional costs, or only have access to credit on less advantageous terms. Banks are already subject to comprehensive regulation, and swaps are only one part of the overall credit relationship between a bank and its customer, so there would be little incremental benefit from adding another layer of regulation.

For many banks, the costs of becoming a swap dealer would also include forming a separate affiliate to conduct swaps activities. No swap dealers conducting swaps on bank ineligible securities and commodities will be able to receive federal assistance, which under the statute is (mistakenly) extended to include FDIC insurance.[12] As a result, banks that are swap dealers and enter into swaps on bank ineligible securities and commodities will have to "push" some of their swaps activities out of the bank into a separate entity unless they are using those swaps to hedge or mitigate risk.

If a bank has to create a separate affiliate to conduct swaps transactions, then the affiliate also will have to be funded separately and meet separate capital requirements. Bank customers generally would have to sign new loan and swap agreements with the bank *and* its affiliate. Banks and customers would also lose the ability to centralize risk management in a single regulated entity. Considering all of these costs and complexities, it is likely that only large financial institutions would be able to create, fund, and capitalize a separate affiliate to conduct swaps activities that need to be "pushed out" of a bank. For other banks, the costs would be prohibitive. If those banks stop offering commodity and certain other types of swaps to their customers, then their customers may face increased costs or be left without a way to hedge related risks.

If a community or regional bank could no longer afford to enter into swaps with its customers, then many of its customers might look to another bank to enter into a swap to hedge loan risk. Lenders have a first lien on loan collateral, so a swap dealer would not have the same security interest and might not enter into a swap unless it also extended the associated loan. So imposing additional costs

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[10] CEA Section 15(a).

[11] Business Roundtable and Chamber of Commerce v. S.E.C., No. 10-1305, p. 7 (D.C. Circuit) (July 22, 2011) (vacating proposed SEC rule finding that the SEC acted "arbitrarily and capriciously" in not performing an adequate cost-benefit analysis).

[12] Dodd-Frank Act Section 716.

on banks that enter into swaps in connection with loans might not only affect their ability to enter into swaps with their customers, it could also cause them to lose loan business.

For the reasons discussed above, ABA believes that an appropriate cost-benefit analysis would result in an IDI exemption that includes all common lending practices, including swaps in connection with extensions of credit that are economically equivalent to originating loans, and swaps that are not entered into contemporaneously with loans. Imposing burdensome costs and an additional layer of regulation on banks that offer customers the option of using swaps to hedge credit-related risks would discourage risk-mitigating transactions and would be contrary to the Dodd-Frank Act's mandate to reduce systemic risk.

Conclusion

ABA appreciates the opportunity to comment on the proposed swap dealer definition and the IDI exemption. We urge the Commission to accommodate all common lending practices in the IDI exemption and to confirm that a bank entering into a swap to offset its own risk would not be considered a swap dealing activity. Failing to implement an appropriate exemption would subject banks to significant costs with little incremental regulatory benefit and would discourage banks from offering customers the opportunity to use swaps to hedge loan-related risks.

Thank you for your consideration of our comments.

Sincerely,

Diana L. Preston
Vice President and Senior Counsel
Center for Securities, Trust & Investments
American Bankers Association

cc: Elizabeth M. Murphy
Secretary
Securities and Exchange Commission