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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 AD 74, 3064-AD79, 3052-AC69, 2590-AA45

Low-Risk End User Counterparties Such as CFC Should Not Be Subject to Margin Requirements

The National Rural Utilities Cooperative Finance Corporation (CFC) appreciates this opportunity to provide comments on the proposed rule on Margin and Capital Requirements for Covered Swap Entities issued jointly by the Federal Reserve, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Farm Credit Administration, and Federal Housing Finance Agency (collectively, the Agencies).

The Agencies' proposed rule would establish margin and capital requirements for "swap entities" – namely, swap dealers, security-based swap dealers (collectively, SDs), major swap participants, and major security-based swap participants (collectively, MSPs) – that are regulated by the Agencies. The proposed rule would, among other things, require swap entities to collect minimum amounts of initial and variation margin from counterparties to non-cleared swaps. The amount of margin that would be required under the proposed rule would vary based on the relative risk of the counterparty and of the swap. A swap entity would not be required to collect margin from a "low-risk financial end user" as long as its margin exposure did not exceed a specific threshold. The proposed margin requirements would apply to new, non-cleared swaps entered into after the proposed rule's effective date.

While CFC is not a "swap entity" as defined in this proposal and is not regulated by any of the Agencies, it is likely that many or most of our counterparties will be deemed to be swap entities. Therefore, we are providing this comment letter to highlight the impact that the margin requirements proposed in this rule could have on end user counterparties of swap entities and to emphasize that the rule should not impose margin requirements on low-risk end user counterparties such as CFC.

As we discuss further in this letter:

- CFC should qualify for a "public interest waiver" from margin requirements, as explicitly contemplated by Congress.

- While CFC should be excluded from coverage by these rules via the public interest waiver, if the Agencies decide to subject CFC to these rules, CFC should be excluded from the definition of "financial entity," and should thus qualify for designation as a "nonfinancial end user" exempt from margin requirements.

- While CFC should not be deemed to be a "financial entity," if the Agencies decide to designate it as such, CFC should qualify for designation as a "low-risk financial end user." We suggest that the Agencies modify the third prong of their proposed three-part test for "low-risk financial end users."

As we explain below, CFC uses interest rate swaps in a manner no more risky than that of the "nonfinancial" or "low-risk financial" end users described in the Agencies' proposal. We use swaps solely to hedge risks that arise from our own business activities and never use swaps to speculate. We do not use credit default swaps. CFC's business – and our use of interest rate swaps – also is not interconnected with the overall economy the way that the activities of financial entities such as depository institutions, investment banks, and hedge funds, or other "high-risk" counterparties, are. The low risk posed by end user counterparties such as CFC should be accurately reflected in the Agencies' final rule.

Background on CFC

CFC is a nonprofit cooperative entity owned by America's consumer-owned rural electric cooperatives (RECs), which bring electric power to rural America.[1] It was created by those RECs in 1969 through the National Rural Electric Cooperative Association (NRECA) to provide the RECs with financing to supplement the loan programs of the U.S. Department of Agriculture. Today, our nearly 1,000 members serve 42 million rural consumers living in 47 states. CFC's loan programs help enable our members to provide electric power services to these residents of rural America.

We are not a bank or other depository institution, but we are the largest non-governmental lender to rural electric systems. At February 28, 2011, CFC had loans and guarantees outstanding of $19.1 billion to our REC members.

Background on CFC's Use of Interest Rate Swaps

We understand the concerns underlying the need to require margin for certain swaps, but those concerns are not raised by CFC's particular use of interest rate swaps.

CFC uses over-the-counter (OTC) interest rate swap contracts in the context of providing credit to our members, to allow us to tailor loans to our members' needs while mitigating the impact of changing interest rates. It is important to note that CFC does not enter into derivative transactions for speculative purposes. We are primarily a hold-to-maturity issuer of derivatives. We do not make a market in derivatives. We do not enter into derivatives that are not directly

[1] For additional information on CFC, including our history and current business activities, please see our website, *www.nrucfc.coop*.

related to our own business, and do not trade in derivatives for the purpose of profit-making. We do not use credit default swaps. We enter only into interest rate swaps, and only to hedge the risks associated with lending to our members.

CFC executes both short and long tenor interest rate swaps, and approximately 25% of these contracts are amortizing, which results in an overall weighted average life of just over 6 years. The shorter the life of the swap portfolio, the less sensitivity to changes in interest rates.

- Please see the attached spreadsheet for a quarterly breakdown of our interest rate swaps by mark-to-market amount versus notional amount, showing percentage of notional amount and total assets, from May 2007 to February 2011.

We – and our members – depend on the flexibility and cost-effectiveness of the OTC interest rate swaps environment. Because our interest rate swaps are not subject to clearing or margin requirements, we have the flexibility to tailor each contract to meet our particular needs and are able to keep costs low, rather than having to choose from a limited universe of standard contracts or take on the expense of posting collateral. As a result, our members benefit from having a variety of credit products and terms to choose from, and also pay lower rates and fees on their loans as a result. Those benefits can ultimately be passed on to the consumers our members serve. If we were required to post margin, our costs would rise significantly, and we would have to pass those costs on to our members.

Margin Requirements Are Not Needed to Manage the Risk Posed by CFC's Interest Rate Swap Activities

Imposing margin requirements on end users such as the nonprofit CFC is not warranted for the management of risk. We currently conduct our interest rate swap activities without the need for margin and have found our existing risk management methods to be very successful. Our business and our interest rate swap activities differ greatly from entities that use swaps to speculate.

- **We prudently manage the risk posed by our counterparties.** We use rigorous criteria to choose our counterparties, which comprise a select group of large, well-known financial institutions that have investment-grade credit ratings. We understand that managing counterparty risk is paramount in the OTC swaps environment, and have devoted significant resources to assessing and controlling such risk.
    - Each counterparty must be a participant in one of our revolving credit agreements.
    - The derivative instruments executed for each counterparty are based on key characteristics such as notional concentration, credit risk exposure, tenor, bid success rate, total credit commitment, and credit ratings.
    - As of February 28, 2011, our derivative counterparties have credit ratings ranging from AAA to BBB+ as assigned by Standard & Poor's Corporation and Aaa to Baa1 as assigned by Moody's Investors Service.
    - We have experienced only one instance of counterparty default over our entire 27-year history of using derivatives.

- **We prudently manage the amount of exposure to or with any one counterparty.**
    - At February 28, 2011, the highest percentage concentration of total notional exposure to any one counterparty was 12.5% of total derivative instruments.
    - If all of our derivative instruments were terminated on February 28, 2011, based upon their fair market value on that date, CFC would be required to make payments totaling $109.6 million to 13 counterparties, and CFC would receive payments totaling $56.1 million from 7 counterparties. The largest amount that would be due to us from a single counterparty would be $26.4 million, or 47.1% of the total amount due to us and the largest amount we would owe to any one counterparty would be $18.1 million, or 16.5% of the total amount CFC would owe if all swaps were terminated on February 28, 2011.

- **CFC has the financial strength to meet its ongoing financial obligations associated with non-cleared swaps, and has never defaulted on a payment to a swap counterparty.**
    - As of February 28, 2011, our senior unsecured credit ratings from Moody's Investors Service and Standard & Poor's Corporation were A2 and A, respectively.
    - CFC maintains several sources of liquidity.
        - As of February 28, 2011, CFC had a total of $3.56 billion in committed credit available under three separate revolving credit facilities with a total of 23 banks. The credit facilities are used to provide back-up liquidity for CFC's short-term funding programs. CFC may access funds through the facilities as long as CFC is not in default – our ability to do so is not limited by any "material adverse change" provisions. There were no outstanding balances under the three credit facilities as of February 28, 2011.
        - CFC has access to liquidity from private debt issuances through note purchase agreements with the Federal Agricultural Mortgage Corporation (Farmer Mac). All of the note purchase agreements with the Federal Agricultural Mortgage Corporation are revolving credit facilities that allow us to borrow, repay, and re-borrow funds at any time prior to the maturity date of the applicable agreement, provided that the principal amount at any time outstanding under each agreement is not more than the total available under such agreement, which was $3.0 billion in the aggregate as of February 28, 2010.
        - In November 2010, CFC finalized the documentation on an additional $500 million committed loan facility with the Federal Financing Bank that is guaranteed by the Department of Agriculture's Rural Utilities Service. At February 28, 2011, CFC had $350 million available under this facility.
        - CFC is a well-known seasoned issuer of debt in the capital markets and has shelf registrations on file with the U.S. Securities and Exchange Commission (SEC) that allow for an unlimited amount of debt issuance.
        - Our members have invested approximately 20% of our total debt and equity that we use for funding.
        - We are scheduled to receive $1.638 billion of principal repayments on our long-term loans over the next 12 months.

- **CFC's interest rate swap activities do not pose systemic risk to the financial system in general.** We are unlike the speculative users of derivatives whose defaults harmed numerous sectors of the economy in recent years.
    - We never use swaps to speculate. Unlike speculative users of derivatives, we never enter into risky "bets."
    - Our volume of swaps is relatively low, as we enter into swaps only to hedge commercial risk related to our business activities. We had only 7 interest rate swap transactions in 2010, and have averaged only 15 interest rate swap transactions a year since 1998.
    - As shown in the attached spreadsheet, referenced above, the net mark-to-market amount of our swaps is also very low in relation to total assets.

Congressional Intent Makes Clear that CFC Should Qualify for a Public Interest Waiver from Margin Requirements

Congress made it very clear that certain derivatives transactions should be exempt from the additional regulatory requirements imposed by DFA because those transactions are entered into by cooperatives in the public interest. We believe that CFC's use of interest rate swaps fits well within this Congressional intent, and that we should not be subject to margin requirements as a counterparty to swap entities. CFC is a nonprofit cooperative and has a public purpose as a part of the REC system, and we have continued to carry out this public purpose since our inception. Even during the financial crisis, we have continued to lend to the RECs at cost-based rates, in alignment with that purpose.

- In section 722(f) of DFA, Congress stated that public interest waivers should be provided for any "agreement, contract, or transaction" entered into between cooperatives in the public interest that are not-for-profit and provide services to the public. Transactions of the "rural electric cooperatives" were given as an example of transactions that should be exempt under the DFA, in a reference to section 201(f) of the Federal Power Act. Specifically, Congress stated: "If the Commission determines that the exception would be consistent with the public interest and purposes of the Act, the Commission *shall* . . . exempt from the requirements of this Act an agreement, contract, or transaction that is entered into . . . between entities described in the section 201(f) of the Federal Power Act. . . ." (emphasis added). The "rural electric cooperatives" are specifically described as such entities.

- The Commodity Futures Trading Commission (CFTC) provided additional guidance on the scope of this exemption in its "Further Definitions" proposal by recognizing that "some electricity services are provided as a public good rather than for profit" and referred to the Federal Power Act and to the "non-profit, public power systems such as rural electric cooperatives."[2] That preamble invited comments on "whether there are special considerations, *including without limitation special considerations* arising from

[2] 75 FR 80184 (Dec. 21, 2010).

section 201(f) of the Federal Power Act, related to *non-profit, public power systems such as rural electric cooperatives* . . . ." [3] (emphasis added).

- We request that the Agencies "look through" CFC to our member RECs, which clearly qualify for the public interest waiver described here. CFC is an extension of those RECs. We were created by the RECs and exist to provide financing to them, so that they may continue to serve the public purpose Congress described. CFC merits coverage by the public interest waiver just as our member RECs do.

- It is logical that Congress would act to exempt from the DFA swaps regulation framework the types of entities discussed here, since they do not use swaps to speculate – rather, they use swaps only to hedge risks arising from their own business activities. The RECs were also not part of the problem that led to the financial crisis. Indeed, CFC announced on July 31, 2009 that the 2008 results for RECs demonstrated "strong financial results during the economic downturn." Likewise, CFC, a nonprofit cooperative, is an integral part of those nonprofit, public power systems, with no existence or purpose outside of serving the RECs, and manages its business conservatively, with the prudent use of swaps being an important part of that management. We believe it is therefore logical to look through CFC to the RECs that own CFC.

CFC Should Not be Considered a "Financial Entity"

While we strongly believe CFC qualifies for a public interest waiver from the requirements of this rule, we recognize that the Agencies may still decide to apply this rule to counterparties such as CFC. In that case, we urge the Agencies not to treat CFC as a "financial entity" for purposes of its DFA rules. We do not believe that CFC is the type of entity meant to be included in that definition. We are not, for example, a bank, credit union, savings and loan, or other depository institution. However, the term "financial entity" is defined in DFA in a way that could include CFC, which we believe would be an inappropriate and unintended result.

The DFA definition of "financial entity" includes entities "predominantly engaged in activities that are in the business of banking, or financial in nature, as defined in section 4(k) of the Bank Holding Company Act." While such activities include lending, CFC does not engage in the business of lending in a manner akin to the way depository institutions engage in the business of lending, or in other activities in the business of banking. For instance, while commercial banks engage in lending to the public in order to make a profit, CFC is a nonprofit cooperative that exists to serve its members and lends to its members rather than to the general public.

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[3] *See* 75 FR at 80184 (referencing the "exemptive authority in section 722(f) of the Dodd-Frank Act. . . ."). That public interest waiver section provides that "Section 4(c) of the Commodity Exchange Act (7 U.S.C. 6(c)) (as amended by section 721(d)) is amended by adding at the end the following:

''(6) If the Commission determines that the exemption would be consistent with the public interest and the purposes of this Act, the Commission shall, in accordance with paragraphs (1) and (2), exempt from the requirements of this Act an agreement, contract, or transaction that is entered into— . . .
''(C) ***between entities described in section 201(f) of the Federal Power Act (16 U.S.C. 824(f)).'' Those entities include rural electric cooperatives.*** (Emphasis added.)

We believe that the term "financial entity" most aptly describes depository institutions and other for-profit entities, in contrast to a nonprofit entity like CFC that was created and is controlled by nonprofit entities for which it serves as a captive, non-governmental financing arm – essentially an extension of its nonprofit member-owners, which are not "financial entities" themselves.

Importantly, as we have discussed above, CFC does not pose the risks that the Agencies have identified as specific to financial end users. For example, the Agencies identified the following areas of vulnerability they believe are linked to financial end users:

> Among end users, financial end users are considered more risky than nonfinancial end users because the profitability and viability of financial end users is more tightly linked to the health of the financial system than nonfinancial end users. Because financial counterparties are more likely to default during a period of financial stress, they pose greater systemic risk and risk to the safety and soundness of the covered swap entity.

The concerns the Agencies express here are more relevant to true "financial entities" than to CFC. Unlike for-profit financial institutions that lend to the public and are more vulnerable to fluctuations in demand for their loans and the health of their borrowers, CFC has a closed universe of borrowers – our member RECs – that have looked to CFC to provide financing for more than 40 years. Our member RECs also enjoy a continuing demand for their services, as electricity is an essential service. Even in 2008, the median decline in electricity sales for electric cooperatives was only 1.4 percent. CFC announced on July 31, 2009 that the 2008 results for RECs demonstrated "strong financial results during the economic downturn."

Therefore, we request that the Agencies make clear through rulemaking that CFC is not meant to be included in the definition of "financial entity" – for instance, by stating that "financial entity" does not include a nonprofit tax-exempt cooperative that is not a depository institution and a majority of whose members are nonprofit tax-exempt cooperatives that are not financial entities.

If CFC Is Deemed to Be a "Financial Entity," CFC Should Qualify for Designation as a "Low-Risk Financial End User"

Even if the Agencies decide to categorize CFC as a "financial entity" – which, again, we believe is an inappropriate result – CFC should be included in the lowest-risk category of counterparties.

The Agencies' proposed rule would require swap entities to collect minimum amounts of initial and variation margin from counterparties to non-cleared swaps and non-cleared security-based swaps. The amount of margin required would differ depending on which of the following four categories is applicable to the swap entity's counterparty:

- Counterparties that are themselves SDs or MSPs
- Counterparties that are "high-risk financial end users"
- Counterparties that are "low-risk financial end users"
- Counterparties that are "nonfinancial end users"

As stated in the proposal, "These categories reflect the Agencies' preliminary belief that distinctions can be made between types of derivatives counterparties that are useful in distinguishing the risks posed by each type." While we agree that distinctions can be made among types of counterparties based on the levels of risk they pose, we encourage the Agencies to recognize that CFC should properly be considered a "low-risk financial end user" even if we do not meet all the criteria the Agencies have proposed for that definition.

- **CFC is "a counterparty whose derivatives activities are relatively limited and pose little or no risk."** We understand the rationale behind requiring more stringent margin requirements of riskier counterparties. We wish to emphasize, again, that CFC is not a risky counterparty and should not be classified as a "high-risk" financial end user simply because it does not meet every component of the Agencies' proposed definitions of "low-risk financial end user" or "nonfinancial end user."

- **The loans CFC makes are, by their nature, generally very low-risk compared to other loans made by other types of entities.**
    - The rural electric utility loans that CFC makes to our member RECs do not pose the same risk as residential mortgage loans, auto loans, credit card loans, or small business loans. The loans that CFC makes to our member RECs are used to build and maintain the infrastructure required to provide essential electric service to rural customers. The whole loans that we sell to Farmer Mac are secured by a first lien on all assets and revenues of the REC borrower. At February 28, 2011, a total of 96.6% of the $16.3 billion of long term loans outstanding to RECs were secured by a first lien on all assets and revenues.
    - Electric utility defaults are rare. In a May 2009 report, Moody's Investors Service (Moody's) stated that there were only 6 regulated electric utility bond defaults in the prior 25 years.[4] The report also states that four of the defaults were due to regulators that did not provide timely rate relief to cover costs and that one of the defaults was due to the massive amount of damage caused by hurricane Katrina. In all six cases, the bonds were secured by a lien on the assets of the electric utility, and in all six cases the investors recovered 100% of principal and interest on a nominal basis. In the report, Moody's also indicates that its past practice had been to give a one-notch ratings upgrade to secured debt obligations versus unsecured debt obligations. However, the disparity between the losses experienced on unsecured debt and the losses experienced on debt secured by liens on electric utility assets is so compelling that, at the time, Moody's proposed increasing the upgrade on first mortgage utility bonds to two notches. An April 28, 2011 report from Standard & Poor's also observed that the electric cooperative utilities "passed through the crucible of the recession generally unscathed."[5]
    - CFC also has a very strong history with its own REC member lending. We have had only 15 payment defaults in our 42 years of lending to our REC members.

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[4] "Proposed Wider Notching Between Certain Senior Secured Debt Ratings and Senior Unsecured Debt Ratings for Investment Grade Regulated Utilities," *Moody's Global Infrastructure Finance*, May 2009.

[5] "Despite the Recession and Uncertainty of Regulation, Electric Cooperative Utilities Maintain Good Credit Quality," Standard & Poor's, April 28, 2011.

Our loans outstanding to REC members totaled $18.1 billion at February 28, 2011. To date, we have incurred principal losses totaling $68 million on five of those 15 defaults and no principal loss on the other ten.

- One of the key factors limiting the amount of defaults is that the RECs provide an essential electric service to customers. Electricity is one of the last items that consumers decide to go without. This is consistent with our REC member data showing that even during 2008 and the financial crisis, there was only a median decline of 1.4% in electricity sales by our REC members. In addition, our REC members wrote off only one quarter of one percent of accounts receivable. The REC account receivable writeoffs have remained at this very low level throughout the financial crisis where there were significant defaults on mortgage loans.

- This limited default history and limited loss history on our member REC loans is significantly different from what banks and other financial institutions have experienced with residential mortgage loans, auto loans, credit card loans and even small business loans. Over the past few years there have been huge losses incurred on residential and commercial mortgage loans, credit card loans and auto loans, while CFC has not had any electric system principal losses. During the financial crisis, banks' financial results were severely impacted by the amount of loan loss reserves required to cover the decline in value and the losses experienced on residential mortgage loans, credit card loans, auto loans, home equity loans and small business loans. During that same timeframe, CFC has had only one REC member payment default (related to the cost of attempting to move to a geothermal fuel supply) and no principal writeoffs on REC member loans.

The Agencies' Proposed Definition of "Low-Risk Financial End User" and "Nonfinancial End User"

The Agencies' proposed rule includes the following definitions:

- "Low-risk financial end user": The Agencies have proposed the term "low-risk financial end user" to mean a financial end user that meets all of the following three criteria. (A "high-risk financial end user" is a financial end user that does not fall under the definition of a low-risk financial end user.) The end user must:

  - Not have a "significant swaps exposure" (defined as swap positions that equal or exceed certain specified thresholds),
  - Predominantly use swaps to hedge or mitigate the risks of its business activities, including balance sheet, interest rate or other risk arising from its business, and
  - Be subject to capital requirements established by a prudential regulator or state insurance regulator.

- "Significant swaps exposure" is defined in the proposal to mean swap positions that equal or exceed any of the following thresholds:
  - $2.5 billion in daily average aggregate uncollateralized outward exposure, or

- $4 billion in daily average aggregate uncollateralized outward exposure plus daily average aggregate potential outward exposure.[6]

- "Financial end user" would include any counterparty, other than a swap entity, that is predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in Section 4(k) of the Bank Holding Company Act of 1956.

- A "nonfinancial end user" would be any counterparty that is an end user (i.e., not a swap entity) but that does not fall under the definition of "financial entity"; this latter definition includes entities significantly engaged in activities that are in the business of banking or financial in nature. The proposed rule does not differentiate between high-risk nonfinancial end users and low-risk nonfinancial end users; rather, it assumes that all nonfinancial end users are low-risk.

CFC's Suggested New Definition of "Low-Risk Financial End User"

We suggest modifying the Agencies' proposed definition of "low-risk financial end user" to properly include end users whose swap activities pose comparatively little risk. While we generally agree with the first two prongs the Agencies have proposed, we suggest modifications to the third prong to appropriately recognize that certain end users, such as CFC, have the ability to absorb losses even though they are not subject to the capital regulations of a prudential regulator.

- Significant swaps exposure: We understand that this prong of the "low-risk financial end user" definition is intended to capture persons that, while not having swaps positions rising to the level requiring the margin requirements and comprehensive regulation applicable to MSPs, nonetheless have substantial activity in the market and are more likely to pose greater risk to covered swap entities with which they transact than persons with only minor activity in the market.
    - Our understanding from the proposal is that this threshold would be based on the end user's net out-of-the-money position rather than notional amount. We request that the Agencies confirm this and make this clear in the final rule. Presuming that this is indeed the case, we agree that the Agencies' proposed threshold is reasonable and support the inclusion of this prong.

- Predominant use of swaps to hedge or mitigate the risks of its business activities: As the Agencies noted in the proposal, this distinction reflects the fact that persons using derivatives predominantly to hedge or mitigate risks arising from their business, rather than to speculate for profit, are likely to pose less risk to the covered swap entity (e.g., because losses on a hedging-related swap will usually be accompanied by offsetting gains on the related position that it hedges).

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[6] For purposes of this definition, the terms "daily average aggregate uncollateralized outward exposure" and "daily average aggregate potential outward exposure," when used with respect to swaps, have the meaning specified for that term in 17 CFR § 1.3(uuu) for purposes of calculating "substantial counterparty exposure" under that regulation.

- We support the inclusion of this prong in the definition of "low-risk end user." This is perhaps the most important criterion in determining whether a counterparty is high-risk or low-risk. This prong should be used to recognize the low risk posed by counterparties such as CFC, which uses swaps only to hedge or mitigate the risks of our own business activities – chiefly, to hedge interest rate risk.
- We believe including interest rate risk in the list of examples of qualifying risks is appropriate. Indeed, interest rate risk unquestionably should be included in this list because it is a key type of risk arising from the business activities of many end users, and thus is a key type of risk that such end users must mitigate through the use of swaps.

- Subject to capital requirements established by a prudential or state insurance regulator: We understand the view, stated by the Agencies in the proposal, that "financial end users that are subject to regulatory capital requirements are likely to pose less risk as counterparties (e.g., because the requirements ensure that minimum amounts of capital will be available to absorb any losses on their derivatives transactions)." However, the third prong the Agencies have proposed has limited capability in segregating high-risk and low-risk financial end users.
  - The likelihood of a financial end user's failure is not grounded in the presence of prudential regulatory oversight but rather in the end user's overall riskiness and size of its portfolio related to capital at risk. Specifically, a financial end user carrying a single category derivatives portfolio with counterparties that are rated AA+ would pose little risk when calculated under standard banking capital models. In comparison, a prudentially regulated entity seeking higher risk return is likely to take on a broader range of portfolio risk (credit, commodity, and other) diversification, as well as, additional counterparty risk.
  - Accordingly, as it pertains to capital adequacy, a low-risk financial counterparty should be qualified based on its ability to evidence and efficiently manage capital and absorb potential future losses on derivative transactions, including its portfolio composition, value at risk and counterparty credit risk. The Agencies' proposed language will have the effect of excluding low risk cooperatives such as CFC that would otherwise qualify, except that they do not have a prudential regulator.

➢ We propose the following language for the third prong of the definition:

  - Subject to the capital requirements established by a prudential or state insurance regulator, *or*
  - Has an adjusted debt to equity ratio of no greater than 10 to 1.
    - **The adjusted debt to equity ratio would be calculated by dividing total liabilities by total equity, based on GAAP numbers as adjusted for terms and conditions in contracts with third parties that are material to the counterparty's business. For public companies, these adjustments would have to be consistent with the non-GAAP adjustments disclosed in SEC filings for a period of at**

least three years prior to this determination. Reliance purely on GAAP numbers would not accurately reflect the unique capital structure of CFC reflected in the adjusted ratios relied upon by our investors and lenders. Instead, total equity would include the retained earnings and long-term subordinated debt securities that CFC maintains as the functional equivalent of core capital.

- **The nature of our structure means that we cannot issue traditional equity securities.** Instead, CFC has retained earnings and certain long-term subordinated debt securities that our creditors and rating agencies have treated as the functional equivalent of core capital.
    - We have "member subordinated certificates" that have long-dated maturities. CFC has the right to offset the investment in subordinated certificates against any amounts the member-owner owes to CFC. Similar to CFC retained earnings and hybrid investments in other financial institutions, these subordinated certificates are available to absorb losses, thereby protecting capital market investments in CFC.
    - There is precedent in the bank regulatory context for treating certain debt instruments as regulatory capital. For instance, the capital regulations of the Office of Thrift Supervision (OTS) permit mutual savings associations to include pledged deposits and nonwithdrawable accounts in Tier 1 capital to the extent that such accounts or deposits have no fixed maturity date, cannot be withdrawn at the option of the accountholder, and do not earn interest that carries over to subsequent periods.[7] The banking agencies also currently allow the inclusion of hybrid securities, which possess features of both debt and equity, in Tier 2 capital without limit and in Tier 1 to a limited extent.[8]
    - The debt instruments we include as equity in our adjusted measures share characteristics with such instruments. These instruments are available to absorb losses. They also do not have redemption features that would permit a holder to withdraw funds before maturity, and have long-dated maturities. Further, CFC has the right to offset a member's investment in any of the subordinated certificates against any amounts the member may owe CFC. This offset right has been utilized by CFC to mitigate loan losses. CFC's member capital securities also have an interest deferral right.

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[7] 12 CFR § 567.5(a)(1)(iv).

[8] See, e.g., 12 CFR part 3 App. A (national banks may include in Tier 2 capital "Hybrid capital instruments, without limit. Hybrid capital instruments are those instruments that combine certain characteristics of debt and equity, such as perpetual debt"). We note that under rules to be issued pursuant to the Dodd-Frank Act, certain hybrid securities will be phased out of inclusion as Tier 1 capital but will remain eligible for inclusion as Tier 2 capital.

In evaluating whether the capital prong is even needed, we encourage the Agencies to consider CFC's particular capital structure as an example of how an entity that is not subject to prudential capital regulation nonetheless has the ability to absorb losses similar to entities that are subject to such regulation. We would also caution the Agencies against concluding that a counterparty is high-risk simply because it is not subject to capital requirements imposed by a prudential regulator.

- **While CFC is not subject to regulation by a prudential regulator, we are subject to significant oversight and are limited in the activities in which we may engage.** This mitigates concerns that the absence of a prudential regulator allows us to engage in risky behavior without limits.
    - Our tax-exempt status limits our activities to those described in our 1969 tax-exempt application, our articles of incorporation, and our bylaws. Our books and records are subject to inspection and review by the Internal Revenue Service.
    - As a cooperative organized under District of Columbia (D.C.) law, we are required to comply with laws, regulations and policies applicable to D.C. cooperatives.
    - We must maintain compliance with numerous covenants and conditions related to our revolving credit agreements and senior debt indentures. For example, we are required to maintain a minimum adjusted times interest earned ratio (TIER) of 1.025 for the six most recent fiscal quarters and an adjusted leverage ratio of no more than 10 to 1. If we were to violate any such threshold and breach any covenant, we would have to make a public disclosure of such breach.
    - Our books and records are subject to inspection and review by the Rural Utilities Service (RUS) and Federal Financing Bank (FFB). We are subject to reporting requirements regarding our participation in the RUS and FFB programs, and auditors from those programs audit CFC's compliance with the programs.
    - CFC files reports with the SEC and complies with SEC requirements in its financial accounting standards and public filings. We also comply with applicable provisions of the Sarbanes-Oxley Act.[9] Our books and records are also subject to inspection and review by the SEC.

In short, given the structure of CFC, the nature of our business and the way we use interest rate swaps, we should be treated as a low-risk end user, or exempt from margin requirements altogether.

Quantitative Impact of Margin Requirements On CFC

The Agencies have specifically requested comment on the quantitative impact that would be brought about by margin requirements imposed under this rule. CFC anticipates a significant increase in our costs if we are subject to margin requirements, including compliance costs related to obtaining additional personnel and information systems.

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[9] CFC's financial reports, annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments are available on our website at http://www.nrucfc.coop/content/cfc/investor_relations/financial_reporting.html, after they are electronically filed with the SEC.

CFC manages a portfolio of interest rate swaps that, as of February 28, 2011, totaled $11 billion (notional) and represented 131 independent trades. Because we execute in greater notional amount and less in trade volume, current CFC staff perform all front, middle, and back office operations.

The operational tasks include:

- Trade documentation
- Deal Entry
- Daily Accrual and payment calculations
- Monthly and quarterly mark to market curve construction
- Mark to market calculation
- Mark to market data collection from counterparties
- Payment processing
- Audit review analysis

These operations are currently being conducted at CFC by a Finance Manager and one Financial Analyst. Since CFC does not currently post collateral on out-of-the-money positions, CFC would have to obtain or purchase a system to calculate regulatory margin required for initial and variation margin; our current software system does not have this functionality.

Furthermore, CFC would need to hire additional personnel with financial analytical expertise to monitor collateral posting, due to the daily fair value changes and time sensitivity of depositing or withdrawing cash from the collateral agent. Current staff is already overburdened with the above daily, monthly and quarterly operations, and adding another layer of valuation on top of what we already do is not attainable with our current setup. This would also be another heavily audited area by both our internal and external auditors, which means added reporting requirements and time spent addressing questions from audit reviews.

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CFC appreciates the Agencies' consideration of our comments on this proposal and 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) 709-6700 should you wish to discuss any of our comments or need additional information.