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January 18, 2011

Mr. David A. Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington, DC 20581

RE: Advanced Notice of Proposed Rulemaking ("ANPR")—Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies
(RIN 3038-AD99)

Dear Mr. Stawick:

On behalf of the Farm Credit System (the "System" and the "System Banks"), we appreciate this opportunity to comment on the above-referenced ANPR. The System Banks urge the Commission to ensure end-users have an option to select Model 1 (Full Physical Segregation) as proposed in the Advanced Notice, which would require full, physical segregation of customer accounts on an individual basis. However, the System Banks want assurance that the model employed will be economically viable for both the clearinghouses and their customers. At this time, it is difficult to make such a determination based upon the information presently available.

The Farm Credit System

Congress created the Farm Credit System "to accomplish the objective of improving the income and well-being of American farmers and ranchers by furnishing sound, adequate, and constructive credit and closely related services to them, their cooperatives, and to selected farm-related businesses necessary for efficient farm operations."[1]

Fulfilling its congressionally determined mission, Farm Credit System institutions provide credit and financial services to farmers, ranchers, producers and harvesters of aquatic products, agricultural cooperatives, and other rural residents and businesses. To this end, the Farm Credit System offers a wide range of financing products tailored to meet the unique needs of its customers and owners.

Loans made by Farm Credit System institutions represent 40% of all United States agricultural lending.[2]

[1] 12 U.S.C. § 2001(a).
[2] CFTC Commissioners/FCS Representatives Meeting Discussion Document, December 14, 2010, II.A.2.

The Farm Credit System's Use of Derivatives

Farm Credit System institutions generally use derivatives as end-users to manage interest rate, liquidity, and balance sheet risk, primarily in the form of interest rate swaps.

A limited number of swaps are entered into with our customers to provide an outlet so they can manage their risk. Security for these customer swaps is incorporated in their loan agreements. These customer swaps are simultaneously offset by the System Banks by entering a mirroring swap with an external swap dealer.

The System Banks currently do not clear any of their swap transactions. Counterparty credit risk is managed using ISDA Master Agreements and Credit Support Annexes with both parties agreeing to provide collateral when credit exposures exceed pre-defined threshold amounts. In a number of these bilateral relationships the thresholds are set at $0 exposure. We feel this approach provides an efficient, flexible and cost effective tool for managing derivative counterparty credit risk.

The Dodd-Frank Act would require centralized clearing of eligible swaps, likely including the "vanilla" fixed for floating interest rate swaps that account for approximately 80 percent of the System's outstanding derivative positions. Centralized clearing would require the System to establish accounts with a Futures Commission Merchant for variation margin and would introduce a new initial margin requirement.

Description of the Models: comment on the potential account models

We are concerned that several of the four proposed models would expose end-user margin funds to the risk of loss resulting from defaults by either the Futures Commission Merchant ("FCM") or defaults by the FCM's other customers ("fellow-customer risk").

As an end-user, we prefer the protections provided by model (1).[3]

The protections afforded by model (1) approximate the protections achieved currently in the System Banks' use of bilateral swaps. By contrast, the other three models entail a greater risk of loss of a System Bank's collateral, *e.g.*, if there is a shortfall in a Derivatives Clearing Organization ("DCO") omnibus account. This risk is marginally less in models 2 and 3, and greatest when compared to model 4[4], which is based on the futures model.

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[3] *(1) Full Physical Segregation*—Each customer's cleared swaps account, and all property collateralizing that account, is kept separately for and on behalf of that cleared swaps customer, at the FCM, at the DCO, and at each depository. Each customer is protected from losses on the positions or investments of any other customer.

[4] *(4) Baseline Model*—The current approach to futures. The rights and obligations arising out of the cleared swaps positions of all cleared swaps customers of an FCM member of a DCO, as well as the money, securities and other property collateralizing such rights and obligations, are held at the DCO on an omnibus basis. The DCO has recourse to all such collateral in the event of any failure of the

The other three models (2,3,4) expose an FCM's end-user customers to a new risk – fellow customer risk – that we are not in a position to quantify, monitor or hedge. We have no interest in assuming credit exposure to an FCM's other customers and believe the baseline model is a step backward from the effective ISDA-based tools we currently employ to manage derivative counterparty credit risk.

It would indeed be ironic for Congress to have mandated clearing for many OTC swaps in order to reduce systemic risk arising from bilateral counterparty credit risk only to force swaps into a clearing system that exposes market participants to fellow-customer risk. We do not believe this is what the authors of Dodd-Frank Act intended.

Additionally, it should be recognized that many participants in the OTC swaps markets, including the System Banks, have little or no exposure to the existing U.S. futures markets. Thus, while the System Banks would endorse revisiting the model for futures contracts, we see no reason why that model should be determinative for cleared swaps transactions. The Commission has already recognized that there is a reason to distinguish between the treatment of margin for cleared swaps and futures. Moreover, the rationale for the current futures model articulated in 1985 Interpretative Statement No. 83-5, attached to the ANPR, seems dated and questionable. Our understanding is that today clearinghouses are able to, and do in fact, look through their clearing members to evaluate the positions of the clearing members' customers. Such a "look through" is necessary for, among other things, the enforcement of clearinghouse position limits.

Need for Cost and Benefit Analysis

The ANPR requests that cleared swaps customers discuss what costs they would expect to incur for each of the models relatives to the baseline model (Model 4). The System Banks are not in a position to answer this question or, as requested in the ANPR, to provide a "detail basis" for any estimate. Until all the rules are in place that will govern the treatment of clearinghouses for swaps and clearing members that elect to clear swaps, we do not see how any prospective customer would be able to do this.

The questions posed in the ANPR with respect to the costs customers may be willing to incur for each of the proposed models relative to the baseline model seems to imply that the baseline model does not involve any cost. The System Banks do not agree with the notion that the baseline model does not involve "cost." Under the baseline model, the hundreds of millions of dollars that the System Banks will likely post as initial margin and variation margin for cleared trades would be at economic risk. The System Banks

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FCM member to meet a margin call (initial or variation) with respect to the FCM's cleared swaps customer account at that DCO.

a. Impact on Customers' Risk—Each customer of the defaulting FCM is exposed to loss of their collateral due to losses on the positions of other customers. Customers also bear some risk of loss on the value of collateral (subject to the investment restrictions of Regulation 1.25).

would essentially have a contingent liability that is not quantifiable until circumstances arise in which the liability becomes actual and the dollar amount of their loss is established.

Additionally, at an open meeting in December, the CFTC proposed a dramatic reduction in the minimum capital requirements for clearing members of swaps clearinghouses. Capital requirements for clearing members will obviously be a material factor to be taken into account in assessing the risk a customer would incur under the baseline model.

Presumably, the direct costs of Models 1 and 2 should represent the actual cost of ensuring against the contingent liability that the System Banks would be carrying on their books under the baseline model. The same should be the case with respect to Model 3, but the direct costs would be less because the probability that the System Banks would incur a loss at the end of the waterfall should be considerably less than the probability of incurring a loss under the baseline model.

Finally, for end-users who currently manage counterparty credit risk using ISDA Credit Support Annexes, the more relevant cost comparison is between the existing ISDA model for OTC swaps and the various models enumerated in the ANPR. The negative carry on cash or securities posted as initial margin is expected to be a significant new cost for the System and this cost should be taken into account when determining the relative costs of different alternatives.

Proper Allocation of Responsibility

The questions posed in the ANPR regarding customers "risk managing their clearing members" are highly relevant. The System Banks believe that the Commission should consider carefully the ability of end-users to assess the financial condition and risk management practices of clearing members as compared with the opportunities for such assessment and oversight by fellow clearing members and the clearinghouses themselves.

While spreading this risk to clearing members reduces the members' overall risk, it also marginally reduces the clearing members' management of the credit risk posed by other members to the clearing house or by the clearing house itself. Moreover, given the limited ability of customers to evaluate clearing members' or clearing houses' creditworthiness, customers may be encouraged to pursue their remaining limited alternatives when faced with a clearing member's potential deterioration in credit. One option available to a customer is to transfer its positions to another clearing member which could have the unintended effect of accelerating a clearing member's credit problems through its loss of that customer's positions.

Summary

The model ultimately chosen for customer accounts will have an impact on our hedging activities and use of derivatives. If the costs or risks associated with derivative clearing are deemed unreasonable, the System Banks might be forced to consider restructuring

their balance sheets or loan product offerings to reduce dependence on derivative-based hedges. Even a partial withdrawal from the derivatives markets would unnecessarily limit loan options for our borrower-owners and hamper the System's ability to properly manage its risks.

We appreciate the opportunity to comment on these proposed rules.

Respectfully submitted,

William Whitehead
Senior Vice President – Research