September 29, 2017

Mr. Christopher Kirkpatrick
Secretary
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: U.S. Commodity Futures Trading Commission Request for Public Input on Simplifying Rules, Project KISS (RIN 3038-AE55)

Dear Mr. Kirkpatrick:

Chatham Financial Corp. ("Chatham") appreciates the efforts of the U.S. Commodity Futures Trading Commission ("CFTC") and its staff to review existing CFTC rules, regulations and practices in order to make them simpler and to reduce compliance costs that are contrary to the vibrant functioning of risk management markets ("Project KISS"). We strongly support the Commission's objectives and welcome the opportunity to provide comments.

Chatham is the largest independent adviser and technology provider to derivatives end users, advising and providing services to more than 1,800 clients annually on interest rate, currency and commodity hedging. We are a global firm with operations in the United States, Europe, Australia, and Asia. As a result of our work with end users, Chatham has closely collaborated with the Coalition for Derivatives End-Users ("Coalition") on numerous initiatives and supports the letter submitted by the Coalition in connection with Project KISS.

In addition to assisting end users with designing, implementing and managing risk management programs, Chatham provides services to approximately 150 small and mid-size banks ("bank clients") that provide risk management products to their commercial customers and that use derivatives to manage their own balance sheet risk. In this letter, we offer the following recommendations on how the CFTC might improve market functioning for such banks:

- **Recommendation #1**: Maintain the swap dealer de minimis threshold
- **Recommendation #2**: Increase the de minimis threshold for special entities
- **Recommendation #3**: Expand accommodations for insured depository institutions
- **Recommendation #4**: Expand the small bank exemption

Additionally, we offer the following recommendations for improving the market for a broader set of market participants:

- **Recommendation #5**: Increase transparency and usability of regulatory data
- **Recommendation #6**: Codify relief that addresses end user concerns

Background: How and Why Small and Mid-Sized Banks Use Derivative

Small and mid-sized banks utilize derivatives in two primary ways:

- **Satisfying Demand from Commercial Customers**: They provide derivatives to their commercial customers in connection with loans they make to them.
- **Managing Balance Sheet Risk**: They mitigate or eliminate risk that arises from mismatches between interest-sensitive assets and liabilities.

<u>Satisfying Demand from Commercial Customers</u>: Small and mid-sized banks offer swaps to their commercial customers in connection with loans they make to them in order to satisfy at least three objectives: (1) to provide such products to assist their customers in managing the customers' own risks, (2) to manage their own balance sheet risk, and (3) to compete with larger banks who offer such products in their markets.

They do not take on market risk when entering into these transactions, because they offset the risk that such transactions create by simultaneously entering into offsetting derivatives transactions with swap dealer counterparties. The combination of a swap a bank enters into with its customer and the offsetting swap that Chatham facilitates the bank entering into with a swap dealer – a so called "back-to-back" transaction – is the cornerstone of what are often called "loan level hedging" (LLH) programs.

LLH programs provide small and mid-sized banks with a competitive alternative for helping their clients' hedge financial risks associated with debt service payments, interest rate changes and other costs. When fixed rate loans were prevalent for commercial debt, they provided more predictability for loan costs.

However, such loans often shift financial risks to banks – especially those that substantially fund such loans with floating rate funding such as deposits. This is because rising short-term interest rates increase funding costs, even while customer loan payments on fixed rate loans remain unchanged. To address this, LLH programs allow banks to match the interest rate risk of floating rate assets (i.e., floating rate commercial loans) with floating rate funding. The swap provides payment predictability and thus eliminates interest rate risk for commercial borrowers – typically small and mid-sized businesses. The swap executed by the bank with a swap dealer relieves the bank from market risk they take on from swapping interest rate risks with their customers.

In addition to the risk-reducing benefits of these transactions, LLH programs have become essential for enabling small and mid-sized banks to compete in the commercial lending space. Larger banks offer such products to their customers, and Chatham's bank clients must do so as well in order to remain competitive in meeting customers' needs.[1]

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[1] In addition to interest rate derivatives, some of our clients also offer foreign currency and commodity derivatives to meet customer demand for products that afford predictability with respect to financial risk.

Managing Balance Sheet Risk: Banks rely on derivatives to minimize or eliminate risks that arise in the ordinary course of providing banking services. Banks hold both fixed- and floating-rate assets on their balance sheets, including commercial and residential loans, and securities. They also hold both fixed- and floating-rate liabilities, including retail deposits and wholesale funding, such as FHLB advances. If there are mismatches in the frequency by which fixed- and floating-rate assets and liabilities reprice, this could adversely affect banks' profitability or even viability. Derivatives are among the key tools banks use to manage such mismatches. Indeed, derivatives are often essential tools for banks in their capacities as prudent balance sheet stewards.

Consider an example in which a bank's balance sheet is comprised of floating-rate assets and fixed-rate liabilities. Such a bank would be at risk when rates fall, because its income would decline when short term rates decrease, but its costs would remain unchanged due to the fixed-rate character of its liabilities. Such a bank could reduce or eliminate this risk with interest rate swaps, which can be used to synthetically convert floating-rate assets to fixed to match the fixed-rate liabilities, or by synthetically converting fixed-rate liabilities to floating to match the floating-rate assets.

Recommendation #1: Maintain the Swap Dealer De Minimis Threshold

Title VII of the Dodd-Frank Act sought to shield entities that engage in a de minimis quantity of swap dealing "in connection with or on behalf of its customers"[2] from the substantial requirements applicable to swap dealers. The CFTC established a preliminary threshold of $8 billion in aggregate gross notional; entities transacting in swap dealing activity below this threshold are not required to register as swap dealers. This preliminary threshold was scheduled to decrease to $3 billion after five years unless a review by the CFTC established a different level. The CFTC has not yet determined whether to make adjustments to the $3 billion amount, and so has extended the date by which the threshold would decrease. Absent further Commission action, the threshold will decrease to $3 billion on December 31, 2018.

Our bank clients presently do not transact in quantities that require them to register as swap dealers, nor do they have sufficient activity in swaps to justify the significant compliance activities and expenditures that would accompany swap dealer registration. However, because LLH programs can give rise to transactions that fit within the definition of swap dealing, our bank clients must monitor their transaction activity to ensure they do not breach the swap dealing threshold. For most of our clients, a breach in the de minimis threshold would cause them to either discontinue their LLH programs or otherwise to reduce their LLH transactions to remain under the threshold, as they could not justify the costs of registering as a swap dealer. Moreover, because of the uncertainty with respect to the CFTC's ultimate determination as to the de minimis threshold, our clients generally must assume that the lower $3 billion level will ultimately prevail, and must structure their programs to ensure they remain well under that level. In some cases, this may result in a bank declining to offer certain risk-reducing

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, 124 Stat. 1670, Pub. Law 111-203 (July 21, 2010)

transactions to their customers, which limits the available counterparty options for these customers and thus inhibits their ability to hedge their financial risks.

In light of the importance of LLH programs to manage banks' balance sheet risk, the usefulness of such programs in allowing banks to meet their customers' demand for financial risk management, and the fact that LLH programs enable smaller banks to compete with larger banks in offering loans and financial risk management products, we urge the CFTC to permanently extend the de minimis threshold to $8 billion.

We believe such an action is consistent with robust oversight of OTC derivatives markets. Notably, a decision to maintain the threshold at $8 billion rather than lowering it or allowing it to fall to $3 billion affects less than 1% of additional notional activity and swap transactions.[3]

Recommendation #2: Increase the De Minimis Threshold for Special Entities

In addition to maintaining the $8 billion de minimis threshold, we urge the CFTC to consider increasing the $25 million threshold applicable to transactions with special entities. In adopting a lower swap dealing threshold for special entities, the CFTC reflected its priority for protecting special entities from potential abuse. There are numerous and noteworthy examples of such abuse, and we think it appropriate that the CFTC gave special consideration to such entities. That notwithstanding, we believe the present threshold has the potential to harm small and mid-sized banks, and we do not believe the benefits of a low threshold to special entities justify this potential harm. The de minimis threshold for special entities is set at a level where a single swap[1] could cause a small or mid-sized bank to become a swap dealer. Given problems in floating rate municipal bond markets during the financial crisis, bank loans have become increasingly prevalent in allowing municipalities and other special entities to satisfy their project funding requirements.

While certain derivatives products provided by a small or mid-sized bank to a special entity would not count as swap dealing activity – for example, if the swap hedges a loan, the loan is provided by the bank, and the swap is executed within a 180 days of the origination of the loan – other transactions would count as swap dealing. For example, if the swap is executed 181 days following loan origination, it would constitute swap dealing. If the swap would require the bank to register as a swap dealer, the bank would most likely avoid offering the swap, and possibly also the financing as a whole, to the special entity. Notably, even a minor miscalculation or error in validating the time from loan origination could result in a need for the small or mid-sized bank to register as a swap dealer, and to bear the substantial compliance obligations and costs associated therewith. Therefore, we encourage the CFTC to review how these provisions have worked in practice to determine whether additional changes are warranted

[3] http://www.cftc.gov/idc/groups/public/@swaps/documents/file/dfreport_sddeminis081516.pdf

[1] That is, a $25 million dollar swap – an amount not inconsistent with the size of a single municipal project, for example.

that would enhance the ability of special entities to hedge and would minimize the potential for harm to small and mid-sized banks, while preserving the provision's intent of preventing abuses.

Recommendation #3: Expand Accommodations for Insured Depository Institutions

When an insured depository institution ("IDI") offers a swap to a "customer in connection with originating a loan with that customer," the Dodd-Frank Act does not view such swaps as swap dealing activity and thus does not count them against the de minimis threshold. The CFTC's rule enumerates certain conditions necessary for this exclusion to apply, including that the swap must be connected to the financial terms of the loan, that it must be entered into within 90 days prior or 180 after the date of the loan agreement or any principal draw under the loan, and that the loan is within the common law meaning of "loan."

These requirements were established during a time of historically unprecedented low rates. In recent years, many commercial customers opted to enjoy these low rates and did not hedge their loans within the prescribed 180 day period following the date the loan was established. But, as the Federal Reserve has now begun to raise short-term interest rates, commercial borrowers are reconsidering whether to protect themselves from rising interest rates. While this issue is particular to the present interest rate cycle, it is indicative of circumstances that will repeat periodically. Our bank clients generally desire to accommodate such customer priorities.

However, where a customer's decision to hedge would constitute swap dealing and increase the bank's potential to breach the de minimis threshold, the bank may be reticent provide the product and thus be unable to meet its client's need.

This is because IDIs have limited capacity under the de minimis threshold for transactions that are not connected to the financial terms of the loan – including certain foreign currency and commodity risk management transactions. Consequently, excessive use of capacity under the threshold for ordinary loan hedging may adversely affect a bank's ability to offer a broader array of products to meet customer needs. Importantly, this may undermine a bank's ability to compete with larger commercial banks in our clients' domestic markets, consequently lowering the availability of financial risk management products to commercial borrowers.

Therefore, we urge the Commission to eliminate the 180 day limitation that precludes transactions entered into after the 180 day period from qualifying for the IDI exclusion. If the CFTC interprets the statute as requiring swaps under the IDI exemption to be linked to a loan origination, the CFTC could require that, to exclude a swap from counting against the de minimis threshold, the swap must hedge a loan the IDI has originated on a one-to-one basis.[4]

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[4] In other words, that the swap would not be able to be applied to another bank's loan.

Recommendation #4: Expand the Small Bank Exemption

Financial entities are required under the Dodd-Frank Act to centrally clear swaps that are subject to a clearing mandate. However, the Act granted the CFTC authority to "consider whether to exempt from the definition of 'financial entity' small banks, savings associations, farm credit system institutions and credit unions including: (I) Depository institutions with total assets of $10,000,000,000 or less; (II) Farm credit system institutions with total assets of $10,000,000,000 or less; or (III) Credit unions with total assets of $10,000,000,000 or less." The CFTC elected to grant such an exemption in a 2012 rule exempting end users from clearing.[5]

When the CFTC finalized its rule, the costs of central clearing were not fully known. We now better understand that FCM pricing structures make clearing particularly expensive for entities that transact in small volumes, including community and regional banks. In particular, FCMs charge minimum monthly fees, which typically run $10,000 per month or more, to ensure that they are being adequately compensated for the costs of providing clearing. Entities that transact in large volumes pay fees that are sufficient to easily exceed these monthly minimums and are thus subject only to regular per-transaction and portfolio fees. However, entities that transact in small volumes do not pay sufficient per-transaction and portfolio fees to exceed the monthly minimums, and their fees are thus increased to the minimum amounts. On a per transaction basis, these fees may be quite material – even prohibitive for entities that transact episodically – far exceeding fees paid by those that transact in high volumes such as swap dealers. For example, based on the $10,000 per month fee noted above, an entity transacting a single five-year interest rate swap – whether as part of an LLH program or for the purpose of managing a bank's own balance sheet risk – would be subject to approximately $600,000 over a five year period just to maintain the clearing privileges necessary to hedge its own or its customer's financial risks.

In 2012, when the CFTC chose to adopt a small bank exemption, it limited the exemption to the specific entities and asset sizes Dodd-Frank directed the CFTC to *consider* exempting, specifically banks and other financial institutions with total assets under $10 billion. Because the cost of transacting in cleared swaps is not a function of a bank's asset size, but rather depends on the size of an entity's derivatives portfolio, the small bank exemption is unduly punitive on larger banks with smaller derivatives portfolios. For example, a bank with less than $10 billion in assets may have a larger derivatives portfolio but be exempt from the clearing requirement, while a bank with greater than $10 billion in assets may have a smaller derivatives portfolio but be subject to the clearing requirement and the punitive economics thereof (i.e., minimum fees).

However, the Act did not require the CFTC to limit the small bank exemption to institutions with less than $10 billion in total assets. Instead, the Act directed the CFTC to consider exempting certain financial entities *including* those with less than $10 billion in total assets. The CFTC could, therefore, create a broader small bank exemption, for example, by augmenting it to include those that have smaller

[5] http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2012-17291a.pdf

derivatives portfolios. Such an approach could be tied to an entity's uncollateralized current exposure or some other risk-based measure.

We believe such an approach to the small bank exemption would appropriately reflect Dodd-Frank's objectives for the exemption – i.e., protecting the public – while better aligning the risks and costs of clearing in such a way as to limit cost burdens on those entities whose transaction activity does not present significant risk.

Recommendation #5: Increase Transparency and Usability of Regulatory Data

Globally, new and existing regulations have vastly increased the amount of financial transaction information available to the public. However, transparency regulations vary across jurisdictions, exchange types, and even products. For derivatives, liquidity, and thus price discovery, for particular products tends to be concentrated on one or two venues or entities. While historically, the news media were a significant additional channel for distribution of data required to be made public by regulation, today, exchange websites are the primary and often sole means for the public to obtain access to that data.

The fact that data can be made readily available electronically offers incredible potential for the public to have greater transparency into markets. We encourage the Commission to revisit Part 16 and 43 of its regulations to ensure that data required to be made available to the public is done so on a non-discriminatory basis and in a format that allows the consolidation of the information with similar data from other sources. In addition, the information should be readily available and free from undue restrictions on its use.

Recommendation #6: Codify Relief That Addresses End-User Concerns

Chatham shares the Coalition's view as to the value of codifying and refining staff guidance and no action relief where appropriate. The Coalition's letter specifically identifies staff no-action letter 13-09, focused on inter-affiliate swaps, as an example of relief valuable to end users and which could be further refined to reduce onerous conditions. Chatham's clients that utilize inter-affiliate swaps due to their corporate structures, rely upon no-action letter 13-09, and Chatham supports the Coalition's recommendations with respect to this letter.

Additionally, various of Chatham's clients rely on other no-action or interpretive letters issued after Dodd-Frank rulemaking that address key concerns raised by market participants about unintended or adverse effects of the rules. These include the following:

- 16-01, which extends the small bank exemption to include small bank holding companies.
- 12-17, which makes accommodation under eligible contract participant rules for certain business structures and for anticipatory hedging.

- 12-13, which interprets that equity REITs are not commodity pools.

We believe codifying and in some cases further refining aspects of these letters to reduce unnecessary burdens or restrictions would be in keeping with the objectives of Project KISS.

We thank you for considering these recommendations. If you would like to discuss these issues further, please contact Carla Bennett (720-746-6525 or cbennett@chathamfinancial.com) or Luke Zubrod (610-925-3136 or lzubrod@chathamfinancial.com).

Sincerely,

Luke Zubrod