

DERIVATIVES – TITLE VII

Dodd Frank Act

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

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

Concerns Regulators' Proposals

- **Capital and Margin** – Regulatory agencies are erroneously concluding that all OTC swaps are automatically "riskier" than swaps accepted on exchanges. Regulators have cited the example of AIG and their use of credit default swaps (CDS) to justify this position. However, community banks do not use CDS swaps, which are insurance products. Community banks use low-risk interest rate swaps (IRS), similar to the "plain-vanilla" IRSs cleared by the exchanges.
- **The regulators propose to prohibit the repledging of initial margin (rehypothecation)** pledged from the community bank to a mid-level swap dealer from that swap dealer to the counterparty on the other side of the swap transaction.
- The prohibition on rehypothecation means mid-level swap dealers serving community banks would have to have their own capital and margin for each swap arranged for community banks. This results in pools of "dead" capital, costly capital that is not economically productive. The result will be that those who serve the community bank market will exit the market leaving community banks without access to the OTC swaps market. Many customers will leave community banks and opt for the services of larger financial players.
- The prohibition of rehypothecation, in the absence of an exchange that accepts community bank interest rate swaps, is the death knell for community bank access to the swaps market and needs to be adjusted to focus on the truly risky swaps in the OTC market instead of on all swaps.
- **Origination of Loans Exemption** – The regulators propose to exempt the swaps that banks arrange in connection with the "origination" of loans for their customers from causing banks to be considered as swap dealers. This exemption is too narrow as swaps may be implemented before or after loan origination. Without broader flexibility, community banks could be considered swap dealers.