THE FARM CREDIT COUNCIL

Testimony Submitted By
Ann Trakimas, Chief Operating Officer of CoBank
On Behalf of the Farm Credit System

Before the House Committee on Agriculture

Hearing on
Defining the Market: Entity and Product Classifications Under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act

March 31, 2011

Good afternoon, Chairman Lucas, Ranking Member Peterson, and members of the Committee. I appreciate the opportunity to testify today on behalf of the Farm Credit System, and I commend the Committee for its leadership in overseeing the rulemaking process as the Commodity Futures Trading Commission ("CFTC") implements the derivatives title of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[1]

I am the chief operating officer of CoBank, a member bank of the Farm Credit System. Before joining CoBank, I served as a director of the Federal Farm Credit Banks Funding Corporation, the entity that issues debt securities that CoBank and other Farm Credit banks use to fund loans to farmers and ranchers, farm-related businesses, agricultural cooperatives, and rural electric, water, and communications providers.

As you know, the Farm Credit System provides 40% of agricultural lending in the United States. New derivatives regulation has the potential to affect the Farm Credit System's

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[1] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

ability to offer cost-effective, dependable financing to farmers, farm-related businesses, and rural America. The Farm Credit System supports Congress's goal of making the financial system safer. We believe, however, that new regulation should not impose unwarranted costs on Farm Credit System institutions, which would ultimately raise the costs of loans to our member-borrowers and diminish rural America's access to credit, without making the financial system safer.

In explaining how proposed regulations will affect the Farm Credit System and what steps we believe the CFTC should take in implementing Dodd-Frank, I would like to make three points:

First, the Farm Credit System already has in place important protections for safety, soundness, and consumer protection. These attributes illustrate that many of Dodd-Frank's regulatory concerns do not apply with equal force to the Farm Credit System. In passing the act, Congress concluded that the Farm Credit System did not pose a systemic threat and specifically excluded them from oversight by the new systemic risk regulatory agency.

Second, Farm Credit System banks and associations should qualify for the end-user exemption to Dodd-Frank's clearing requirement. Congress authorized and instructed the CFTC to consider exempting Farm Credit System institutions, regardless of size, from mandatory clearing since they do not pose a systemic risk to the financial system and they were not the cause of the problems that resulted in the recent financial crisis. Imposing higher costs, through unnecessary derivatives regulations, on Farm Credit System institutions ultimately leads to higher credit costs for farmers and ranchers, their agricultural cooperatives, rural infrastructure providers and others in rural America. While Dodd-Frank places special emphasis on exempting institutions with less than $10 billion in assets, Congress also made it clear that it should not be viewed as a limit by CFTC. If the CFTC adopts an asset test, it must be applied in a manner that appropriately recognizes the unique cooperative structure of the Farm Credit System to "look through" Farm Credit Banks to the smaller Farm Credit associations that own them. Alternatively, the CFTC should adopt a risk-based approach to mandatory clearing in a manner similar to the definition of major swap participant.

Third, no Farm Credit System institution should be considered a swap dealer. Farm Credit System institutions enter into customer derivative transactions that are linked to the financial terms of the loans they issue. All customer derivative transactions are non-speculative in nature with risk immediately eliminated through appropriate risk management activities and controls. These customer derivative transactions pose no systemic risk to the financial system and are critical to helping our customers economically manage interest rate and foreign currency risk. In this way, the Farm Credit System's customer derivatives activity is the same as the same sort of customer derivatives activity of commercial banks, which Congress has exempted from designation as a swap dealer. There is no reason that the same exemption should not apply to the Farm Credit System.

Background

I would like to begin with an overview of the Farm Credit System, which comprises five banks and 84 cooperative lending associations. As you know, 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."[2] Congress also intended "to encourage farmer- and rancher-borrowers participation in the management, control, and ownership of a permanent system of credit for agriculture which will be responsive to the credit needs of all types of agricultural producers having a basis for credit."[3] Today, the Farm Credit System is safe, sound, and responsive to its customer-owners. This is due, in part, to the following aspects of the Farm Credit System.

The Farm Credit System uses safe, non-speculative swaps and already effectively addresses counterparty credit risk. Farm Credit System institutions primarily use plain vanilla, fixed-for-floating interest rate swaps, and virtually all of our derivatives qualify for hedge accounting treatment. Farm Credit System institutions do not use swaps to speculate, and do not use the credit default swaps that contributed to the financial crisis. And Farm Credit System institutions already effectively manage counterparty credit risk. We deal with counterparties that have an investment grade or better long-term credit rating, and we monitor the credit standing of and levels of exposure to individual counterparties. Substantially all of our derivative contracts are supported by credit support agreements requiring the two-way posting of collateral in the event certain dollar thresholds of exposure are reached. These thresholds are small relative to the Farm Credit System capital. As of December 31, 2010, the net uncollateralized exposure of Farm Credit System institutions to swap dealers was only $232 million. As of that same date, Farm Credit Bank capital stood at $12.3 billion.

Farm Credit System institutions are regulated by the Farm Credit Administration, an independent federal agency that effectively mitigates the risk of Farm Credit System

[2] 12 U.S.C. § 2001(a).

[3] *Id.* § 2001(b).

institutions to the United States financial system. The Farm Credit Act gives the Farm Credit Administration broad powers "for the purpose of ensuring the safety and soundness of System institutions."[4] These powers include suspending or removing directors or officers of Farm Credit System institutions who engage in unsafe or unsound practices, and the ability to place unsafe or unsound institutions in conservatorship or receivership.

The Farm Credit Administration also effectively oversees the capital adequacy and derivatives activity of Farm Credit System institutions. The Farm Credit Administration sets minimum capital standards and rates the safety and soundness of each Farm Credit System institution, and it requires Farm Credit System institutions to limit their exposure to single or related counterparties and to establish policies that ensure that counterparty risks are consistent with the institution's risk-bearing capacity.

The Farm Credit System is not so interconnected with other financial entities to raise systemic risk concerns. Because Farm Credit System institutions do not take deposits, Farm Credit System banks and associations cannot experience a "run on the bank." And the Systemwide Debt Securities used to fund the Farm Credit System are (1) insured by the Farm Credit System Insurance Corporation, a government-controlled, independent entity, that administers a more than $3 billion insurance fund paid by premiums imposed on System institutions, and (2) issued by the five Farm Credit System banks, which are jointly and severally liable for these Systemwide debt obligations. In short, these layers of investor protection ensure that the Farm Credit System will not cause a run on the funding of other entities.

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[4] *Id.* § 2252(a)(10).

The Farm Credit System is a cooperative enterprise. Farm Credit System associations are cooperatives owned by their borrowers, and Farm Credit System banks are cooperatives primarily owned by their affiliated associations and other borrowers organized as cooperatives. Borrowers purchase equity in the institutions with which they do business, and Farm Credit System institutions return a portion of their earnings to their borrower-owners in the form of patronage distributions. Farm Credit Administration regulations further govern our standard of conduct, requiring, among other things, that Farm Credit System institutions monitor and avoid conflicts of interest.

Finally, Farm Credit System institutions are uniquely well suited to provide derivatives to their customers. To the extent that a System institution is a customer's only lender, that customer will likely be unable to enter into a swap with another party that would not have access to the loan collateral. New regulation would raise the costs of derivatives to the Farm Credit System's customers and could cause System institutions to stop offering these products. This would deprive some farmers, farm-related businesses, and rural America of the ability to manage risk, and drive others to Wall Street swap dealers that are less familiar with their unique needs.

In sum, Farm Credit System institutions are safe and sound, and they operate with high standards of conduct for their customers. Before determining that new regulation is warranted, regulators must therefore consider the Farm Credit Administration's effective current regulation of safety and soundness, the low risk profile of Farm Credit System institutions, and the unique relationship those institutions have with their borrower-owners.

With these principles in mind, I would like to discuss two significant areas of potential new regulation: (1) whether Farm Credit System institutions will qualify for the end-user exemption as we believe Congress, and this Committee, intended; and (2) whether Farm Credit System institutions will be designated as swap dealers, which we believe Congress, and this Committee did not intend and if it occurred would be unfair and unnecessary.

End-User Exemption

As you know, Dodd-Frank provides an exemption to mandatory clearing for end users entering into swaps to hedge or mitigate commercial risk. Although Dodd-Frank generally defines end users as non-financial entities, Congress also directed the CFTC to "consider whether to exempt small banks, savings associations, farm credit system institutions, and credit unions."[5] Because the Farm Credit System is already safe and sound, and because our derivatives are already collateralized, we believe Congress gave the CFTC broad authority to permit Farm Credit System institutions, including those with total assets of more than $10 billion, to use the end-user exemption. We have urged the CFTC to clarify in its final rules that Farm Credit System institutions will qualify for the end-user clearing exemption.

First, we have asked the CFTC to provide the maximum flexibility to adopt an equitable solution for exempting Farm Credit institutions from mandatory swaps clearing if they do not pose a systemic risk to the U.S. financial institutions. Consistent with what we believe to be Congress's intent, the Dodd-Frank Act authorizes CFTC to exempt any-sized Farm Credit System institution from mandatory clearing requirements, which is appropriate given Farm Credit System institutions' derivatives use does not pose a systemic risk to the financial system. More troubling to us is the CFTC may take a more narrow approach, particularly with respect to how it interprets the Dodd-Frank Act's reference to the $10 billion asset limit, which would

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[5] Pub. L. No. 111-203, § 723(a)(3), 124 Stat. at 1680 (CEA § 2(h)(7)(C)(ii)).

make even more critical that it at least recognize the unique cooperative structure of the Farm Credit System where the cooperative district banks are generally owned by cooperative lending associations, which engage in most of the System's retail lending. Under this structure, the cooperative lending associations are smaller than their affiliated banks that provide them funding and use derivatives to manage liquidity and other balance-sheet risks. For example, AgriBank, FCB, is the largest district bank, and its assets exceed $10 billion. But the 17 associations that own 99% of AgriBank have average assets of $3.6 billion. This is well below the $10 billion threshold that some have suggested.[6] Congress did not intend the $10 billion as a size limitation for exempting Farm Credit institutions from mandatory clearing. If, however, CFTC decides to implement an exemption test that included size, the agency must then also recognize the unique cooperative structure of the Farm Credit System and "look through" Farm Credit Banks to the smaller Farm Credit associations that own them. One consequence of our unique structure is that each bank centrally funds loans for its district. Centralized funding enables the associations to benefit from lower administrative and operational costs. Swaps that hedge risk on behalf of Farm Credit System associations are executed by the district bank to gain hedge accounting, to minimize administrative costs, and to minimize counterparty credit risk and margin requirements via district-wide netting of offsetting exposures. This is more cost effective and strengthens the

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[6] As the Farm Credit Council noted in its February 22 comment on the CFTC's proposed end-user exception rules, although the majority of Farm Credit System associations have assets of less than $10 billion, the few associations with greater assets do not present risk requiring mandatory clearing. Even the failure of a large association would have no material impact on the Farm Credit System's ability to meet its debt obligations because the five Farm Credit System banks are jointly and severally liable for the System's notes and bonds. Thus, no association is so large that it would impact System debt holders if it were placed in receivership. By contrast, if a standalone bank fails, its bondholders will likely face losses.

liquidity of the System. As a result, Farm Credit System associations have a lower risk profile than the small commercial banks.

We believe the increased costs of mandatory clearing will ultimately be borne by farmers and ranchers because of the higher cost of credit, and will put our cooperative lending associations at a disadvantage with respect to the small commercial banks with which they compete. The increased costs of mandatory clearing will be passed on from the banks to their associations, reducing their capital and liquidity, which in turn will either reduce the funds available for loans or increase borrowing costs. That result would be unfair and unnecessary given that Congress intended to give regulators maximum flexibility in implementing the end-user exemption.

Second, we have asked the CFTC to consider the risk of an institution's derivatives activity instead of simply its total assets. To the extent clearing is designed to address credit risk, large institutions may in fact be less risky than smaller institutions. Risk is a function of the type and amount of derivative activity after netting offsetting positions and collateral, not simply of total assets. Accordingly, we have urged the CFTC to consider a risk-based measure of which financial entities should be eligible for the end-user clearing exemption.

One such approach could draw on the framework proposed by the CFTC and the Securities and Exchange Commission ("SEC") for determining whether an entity has a "substantial position" in a major swaps category warranting regulation as a major swap participant. A similar test measuring uncollateralized current exposure or current exposure plus potential future exposure would also be appropriate for determining which financial institutions pose enough risk to warrant mandatory clearing. Specifically, we have proposed that current uncollateralized exposure of $2 billion in rate swaps and $1 billion in other categories of swaps -

- or current uncollateralized exposure and potential future exposure of $3 billion for rate swaps or $1 billion for other swaps -- would be appropriate. These proposed thresholds, which are lower than the thresholds the CFTC has proposed for identifying major swap participants, would address risk among financial entities and would more accurately capture financial institutions whose swap exposure poses risk to the financial system. We are convinced that implementing a risk-based test using current and potential exposures is more equitable and appropriate way to determine when financial institution derivative activities, including Farm Credit System institutions, may pose a systemic risk to the financial system and, therefore, require mandatory clearing of derivative transactions.

Alternatively, the CFTC could adopt a test based on an institution's uncollateralized exposure to swaps as a percentage of capital. The Farm Credit System has suggested to the CFTC that appropriate risk limits would be current uncollateralized exposure to swaps of 10% of capital, or current uncollateralized exposure plus potential future exposure to swaps of 20% of capital. These limits would appropriately identify which small financial institutions pose systemic risk warranting mandatory clearing.

In the end, it is critically important that Farm Credit System banks, associations, and their members can make use of the end-user clearing exemption. Clearing will raise costs for Farm Credit System institutions that will ultimately be borne by our agricultural borrowers in the form of higher interest rates. We do not believe that new costs on agricultural borrowers are justified.

Swap Dealer Regulation

Finally, I would like to address the issue of whether any Farm Credit System institution will be defined as a "swap dealer" and therefore will be forced to register with the CFTC and comply with potentially costly new capital, margin, and business conduct standards.

Farm Credit System institutions do not use swaps speculatively and we are not market makers. CoBank does, however, enter into swaps with customers as a service that enables them to modify or reduce their interest rate and foreign currency risk related to their loans with the bank or its related associations. For example, a floating-rate loan agreement may require the customer to hedge fluctuations in interest rates. The most efficient way for the customer to do so is to enter into an interest rate swap or cap. By requiring the customer to hedge against changing interest rates and by providing the customer a swap for that hedge, CoBank reduces the risk that higher interest rates may cause excessive interest expense that the customer cannot afford. Thus, the hedging requirement mitigates risk for both the bank and the customer.

All of the Farm Credit System's customer derivatives transactions are non-speculative, and Farm Credit System institutions offset the risk associated with them. For example, CoBank concurrently enters into offsetting agreements with approved counterparties, and customer derivatives are secured under the related loan agreements with CoBank or its related association. CoBank's customers -- which include agricultural cooperatives; rural energy, communications, and water companies; farmer-owned financial institutions including agricultural credit associations; and other businesses that serve rural America -- depend on these swaps to hedge risk and allow them to access credit. Indeed, because CoBank is the only lender to many of its borrowers, it may be the only counterparty able to enter into a swap backed by the loan collateral.

We believe that Congress intended to clarify that "community banks aren't swap dealers or major swap participants"[7] -- at least not when they enter into a swap with a customer that is linked to the financial terms of the customer's loan. To accomplish this objective, Dodd-Frank states that "in no event shall an insured depository institution be considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer."[8] Although the statute says "insured depository institution," we believe Congress intended to exclude swaps offered in connection with loans and did not intend to confer a peculiar market advantage on commercial banks. To effectuate the intent that community banks not be designated swap dealers, the members of the Farm Credit System have urged the CFTC to clarify that this exemption applies equally to Farm Credit System institutions when they offer derivatives to customers in connection with loans, even though our institutions do not accept deposits.

First, the Farm Credit System's customer interest rate derivatives are identical to swaps offered by community banks in connection with loans. For example, CoBank customizes customer swaps to match the terms of loans and to ensure that the customer is effectively hedged against changes in interest rates. Because the swaps are connected to the financial terms of the

[7] 156 Cong. Rec. S5922 (daily ed. July 15, 2010) (statement of Sen. Lincoln) ("The definition of swap dealer was adjusted in a couple of respects so that a community bank which is hedging its interest rate risk on its loan portfolio would not be viewed as a Swap Dealer. In addition, we made it clear that a bank that originates a loan with a customer and offers a swap in connection with that loan shouldn't be viewed as a swap dealer. It was never the intention of the Senate Agriculture Committee to catch community banks in either situation. We worked very hard to make sure that this understanding came through in revised statutory language which was worked out during conference.").

[8] Pub. L. No. 111-203, § 721(a)(21), 124 Stat. at 1670 (adding CEA § 1a(49)(A)).

loan. CoBank's customer interest rate swaps are consistent with the CFTC's preliminary interpretation of the community banks exemption.

Second, Farm Credit System institutions are subject to similar regulatory requirements as insured depository institutions. As an example, the Farm Credit Administration uses the same FIRS, or CAMELS, rating system for Farm Credit System institutions that the Federal Deposit Insurance Corporation uses for commercial banks.

Third, although Farm Credit System institutions do not accept deposits, the Systemwide Debt Securities they use to finance loans are insured, just as deposits of commercial banks are insured. If a bank cannot pay principal or interest on an insured debt obligation, the investors are paid from an independently administered insurance fund supported by premiums paid by Farm Credit System institutions. In the event that the entire insurance fund is exhausted, investors have further recourse to the five Farm Credit System banks, which are jointly and severally liable for Systemwide Debt Securities. All of the Farm Credit System's debt financing is insured in this manner.

Finally, unless Farm Credit System institutions were able to use it, the community bank exemption would give commercial banks an unwarranted competitive advantage in the market for agricultural lending. In determining whether an entity is a swap dealer, the rules currently proposed by the CFTC and the SEC do just that. The proposed rules exempt derivatives offered by commercial banks, while counting the same derivatives offered by the Farm Credit System, simply because System institutions do not accept deposits. This is unfair, and we do not believe that Congress intended this result in exempting community banks from additional regulation. Accordingly, we have urged the CFTC to provide this same exemption to the Farm Credit System in its final rules.

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On behalf of the members of the Farm Credit System, I thank the Committee for holding for this hearing and for considering our views on these very important issues. Farm Credit System institutions rely on the safe use of derivatives to manage interest rate, liquidity, and balance sheet risk. These instruments, in turn, help us to provide cost-effective, dependable financing to farmers, farm-related businesses, and rural America. It is essential that, in implementing Dodd-Frank, the CFTC does not impose unwarranted, duplicative, and costly regulation on the Farm Credit System. Mandatory clearing or swap dealer regulation would raise costs of financing for our borrowers. We look forward to working with the Committee, as well as with the CFTC, to strike the appropriate balance between improving the safety of the financial system and preserving rural America's access to credit. Again, I thank the Committee for its leadership on these important matters.

ANN TRAKIMAS

Chief Operating Officer

Chief Operating Officer Ann Trakimas oversees CoBank's Corporate Services Group, Finance Division, Legal Division, and the Regulatory, Legislative and Compliance Group. She is a member of the bank's Management Executive Committee and Senior Leadership Team.

Prior to joining CoBank in 2010, Ms. Trakimas served as a director on the board of the Federal Farm Credit Banks Funding Corporation, the entity which issues debt securities that CoBank and other Farm Credit institutions use to fund loans. She has more than 30 years of experience within the financial services industry, where she has worked for Chemical Bank (now JPMorgan Chase) and Morgan Stanley. Most recently, she was with Goldman Sachs, where she held numerous executive positions, including head of the firm's Financial Institutions Credit Risk Management and Advisory team.

Ms. Trakimas has a bachelor's degree in accounting from Hofstra University.

Committee on Agriculture
U.S. House of Representatives
Required Witness Disclosure Form

House Rules* require nongovernmental witnesses to disclose the amount and source of Federal grants received since October 1, 2008.

Name: Ann E. Trakimas

Organization you represent (if any): CoBank

1. **Please list any federal grants or contracts (including subgrants and subcontracts) you have received since October 1, 2008, as well as the source and the amount of each grant or contract. House Rules do NOT require disclosure of federal payments to individuals, such as Social Security or Medicare benefits, farm program payments, or assistance to agricultural producers:**

Source: None **Amount:** ______

Source: ______ **Amount:** ______

2. **If you are appearing on behalf of an organization, please list any federal grants or contracts (including subgrants and subcontracts) the organization has received since October 1, 2008, as well as the source and the amount of each grant or contract:**

Source: None **Amount:** ______

Source: ______ **Amount:** ______

Please check here if this form is NOT applicable to you: ______

Signature: Ann E. Trakimas

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