Purpose and Summary of HR 3336

BRIEF EXPLANATION

HR 3336 amends section 1a(49)(A) of the Commodity Exchange Act (CEA) to clarify the "swaps in connection with loans" exemption included in the definition of 'swap dealer.' The bill clarifies that farm credit system institutions, and domestic, uninsured branches of foreign banks, in addition to insured depository institutions, may qualify for exemption. In addition, it clarifies that the exemption applies when a swap is done in connection with an extension of credit, and that any swaps the delineated financial institutions enter into to offset the risks associated with the swaps provided in connection with an extension of credit, will not be considered swap dealing.

In addition, the bill amends the definition of swap dealer to clarify that in determining whether an entity is a swap dealer, the Commission shall not consider swaps entered into to hedge the entity's commercial risks, or swaps entered into for the purpose of complying with state or local governmental requirements. Similarly, the bill directs the Commission not to consider swaps that involve capacity contracts, renewable energy credits, emission allowances or emissions offsets if they are entered into to comply with state or local regulations.

In addition, HR 3336 amends Section 2(h)(7)(C)(ii) to direct the Commodity Futures Trading Commission (CFTC) to exempt from the definition of "financial entity" small banks, savings associations, farm credit system institutions, non-profit cooperative lenders controlled by electric cooperatives and credit unions if their aggregate uncollateralized outward exposure plus aggregate potential outward exposure with respect to their swaps does not exceed $1,000,000,000.

HR 3336 also amends section 1a(33)(D) of the Commodity Exchange Act to clarify that certain captive finance entities are not included in the definition of 'major swap participant'. These same entities then are exempt from the definition of "financial entity" for the purposes of the end-user exception to the mandatory clearing requirement of the Commodity Exchange Act.

PURPOSE AND NEED

Section 1a(49)(A)(iv) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203) (the Dodd-Frank Act) provides 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." It is common for banks, for example, to lend at variable rates to commercial customers, and in connection with that loan, provide an interest rate swap so that the customer is able to achieve a fixed rate on the loan. The "swaps in connection with loans" exemption included in the swap dealer definition was intended to permit banks to continue providing this service to their customers without being designated as swap dealers. Congress recognized that the efficiency created by pairing these transactions facilitates the flow of credit.

HR 3336 extends the exemption to farm credit institutions that provide similar services to their customers but that do not fall within the definition of "insured depository institution." In addition, the bill clarifies that the exemption is to be applied when the institutions enter into swaps in connection with an extension of credit, and that it is not limited to a swap that is provided exactly at the point of origination and only when the credit extended to the customer is a loan. This clarification is intended to accommodate common transactions between small and mid-size banks and farm credit institutions and their customers whereby the swap may be provided before or after the credit is originated, and when the credit may be in the form of a guarantee, or letter of credit, for example, rather than just a traditional loan.

The second provision modifies the exemption for small financial institutions from the definition of financial entity for the purpose of the clearing exemption in Section 723(a)(7)(C)(ii). Financial entities are prohibited from qualifying for the end-user exception. Congress authorized the regulators to provide an exemption from the definition of "financial entity" for small banks, credit unions and farm credit institutions, including those with $10 billion or less in assets. The $10 billion asset test is not an explicit requirement, but a test for the regulators' to consider. Congress provided for this exemption in recognition that many community banks and farm credit system institutions enter into simple derivative transactions to manage the interest rate risk inherent to the business of banking – taking deposits and making commercial loans. The bank's ability to hedge its exposure to interest rate risk enhances the stability of the bank, and ensures that it can continue to provide credit to businesses at rates that are competitive with their much larger bank competitors. It is important to note that because this exemption only avails a small financial institution from designation as a "financial entity," there are still criteria that they will need to meet in order to qualify for the clearing exception – most importantly, they must be hedging commercial risk and they cannot be speculating or engaging in any non-hedging swaps activity. In addition, a small financial institution would need to notify the CFTC how it will satisfy its financial obligations to its counterparties for uncleared swaps, and if a publicly traded institution, it would need the approval of its Board.

In the CFTC's proposed rule "End-User Exception to Mandatory Clearing of Swaps," the CFTC did not propose to provide an exemption as authorized by Congress. In order to ensure that small financial institutions are afforded the relief that Congress intended, HR 3336 requires the CFTC to exempt small financial institutions that have exposure that is less than $1 billion in current uncollateralized exposure plus potential future exposure. Collectively, small banks engage in only a fraction of the swaps activity in the U.S. banking system. In fact, 25 of the largest bank holding companies hold 99.86% of the total notional held by all banks in the U.S, leaving only .14% of the total notional spread across the remaining 1,046 banks.

In addition, the exposure metric is the same metric the CFTC proposed to use in designating Major Swap Participants (MSPs), except that the CFTC proposed that a Major Swap Participant would not be designated as such unless they reach $2 billion in each applicable category of swaps, and $6 billion in interest rate swaps for non-hedges. For all categories of swaps, including hedges, a Major Swap Participant would not be designated as such unless they reach $5 billion in current uncollateralized exposure or $8 billion in current uncollateralized exposure plus potential future exposure. The exposure test in the discussion draft would apply to all categories of swaps cumulatively.

This bill is necessary to ensure that small and mid-size financial institutions can continue to provide important hedging tools to small businesses, and that the banks themselves can continue to use swaps to hedge their own interest rate risk. The bill acknowledges and upholds the important relationship between risk management tools and the flow of credit in the economy. At the same time, there are important safeguards in place to prevent any small financial institution from engaging in speculative or highly risky activity, or to engaging in swaps to a level that their positions could pose a threat to the financial system.

The bill also clarifies an exemption provided for captive finance entities that exist to facilitate the sale of goods manufactured by their parent company. The exemption ensures that captive finance entities are not deemed major swap participants, or "financial entities".

Lastly, the bill ensures that the contracts entities enter into to comply with state or local regulations, such as capacity contracts, renewable energy credits, emissions allowances, or emissions offsets, as long as they are entered into for the entity's own account, will not be considered "swap dealing." This provision will ensure that entities, particularly utilities, are not unnecessarily deemed "swap dealers" for meeting state and local regulatory requirements.