Despite Dodd-Frank, Interest Rate Swaps Remain a Viable and Necessary Tool for Small Community Banks

By Daniel Wheeler

Introduction

The topic of derivatives regulation under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) is a vast one. Dodd-Frank established a comprehensive new statutory framework for swaps and security-based swaps. Dodd-Frank repealed some sections of the Commodity Exchange Act, amends others, and adds a number of new provisions. Dodd-Frank also requires the Commodity Futures Trading Commission (CFTC) to promulgate a number of rules to implement the new framework.

Fortunately for community banks, if they use basic interest rate swaps only in the United States, they become subject to only a tiny fraction of Dodd-Frank derivatives regulation. This article suggests that the relatively few swaps regulations to which community banks are subject are worth mastering in light of the compelling reasons to use basic interest rate swaps.

This article defines "community banks" as those with less than $10 billion in assets. That threshold is found throughout banking regulation, including swaps regulation, and is useful, even though some larger banks, such as Umpqua Bank, have assets well over $10 billion and still refer to themselves as community banks. Banks under $10 billion generally have similar perspectives based on a common set of challenges.

Community Banks Remain Fearful of Swaps

The senior management and boards of directors of many community banks refuse to consider interest rate swaps. Some believe swaps are illegal for small banks. Many more believe that there is too much regulatory and accounting complexity for their staff to adequately manage.

Daniel Wheeler is a partner in the San Francisco office of Bryan Cave LLP and is a member of the Firm's Financial Services Client Service Group.

A factor in bankers' mistrust of interest rate swaps is their collective negative experience in the recent financial crisis. Between 2005 and 2010, there was a nearly 500 basis point drop in LIBOR rates. A drop of that magnitude left many commercial real estate borrowers heavily exposed on their interest rate swaps, and that exposure only made worse the problem of declining property values. Borrowers (and their banks) grappled, always with difficulty and often unsuccessfully, with the problem of resolving these enormous swap liabilities. The LIBOR scandal, which exposed the conspiracy (or at least the tendency) of the big banks to manipulate LIBOR (usually to reduce the LIBOR interest rate), only fueled suspicions in the popular culture and in the world of community banking that interest rate swaps were rigged against them.

Dodd-Frank, enacted in the aftermath of the financial crisis, requires an unprecedented production of regulation. The CFTC alone has so far promulgated nearly 80 final rules and orders totaling more than 2,300 *Federal Register* pages (13,800 normal pages) as of September 2013. (The *Federal Register*'s standard ratio is 1 page to 6 "regular" pages.) The sheer volume and complexity of that regulatory output, and the lack of any evidence that the regulations meaningfully enhance the safety and soundness of community banks or provide any practical benefit to their customers, are additional reasons in the minds of most community bankers to avoid swaps altogether.

As a result, the swap adoption rate among community banks is astoundingly low considering the compelling reasons discussed in this article for offering a swap capability to customers. According to this author's research, out of the 5,949 FDIC-insured US commercial banks as of September 26, 2013, only about 7 percent have a swap on their books and only about 2.7 percent of banks under $1 billion in size engage in

swaps. Clearly, this is a market almost exclusively occupied by the largest banks.

Community Banks Escape Most Derivatives Regulation

Most of the CFTC's rules and orders do not apply to community banks. For example, the voluminous Swap Dealer and Major Swap Participant regulations take up at least 500 *Federal Register* pages. Those regulations include the CFTC's External Business Conduct Rules, such as the following:

- "Know your counterparty" requirements;
- Treatment of confidential counterparty information;
- Verification of counterparty eligibility;
- Provision of disclosures regarding swaps and incentives/conflicts as well as scenario analysis;
- Providing daily marks;
- Providing clearing disclosures;
- Compliance with counterparty-specific suitability requirements;
- Requirements for swap dealers acting as advisors to Special Entities; and
- Requirements for swap dealers and major swap participants acting as counterparties to Special Entities.

Community banks are not responsible for complying with these External Business Conduct Rules.

Overall, this author's study of the approximately 80 final rules and orders promulgated by the CFTC after Dodd-Frank indicates that less than 15 percent of those publications have anything relevant to community banks doing basic interest rate swaps in the US. The relevant pages likely number less than 100. However, most community banks are not aware of the degree to which they largely escape the avalanche of Dodd-Frank derivatives regulation.

Community Banks Have Powerful Incentives to Engage in Swaps

The business case. In today's record-low interest rate environment, a community bank's most desirable customers almost universally demand something that is hard for a community bank to deliver: a long-term, fixed interest rate. Large banks are eager to accommodate this demand and usually do so by offering such a borrower an interest rate swap that, together with the loan facility, delivers the borrower a net long-term, fixed-rate obligation and the lending bank a loan with an effective variable rate.

If a community bank cannot offer a swap capability to its customers, its options for competing with the big banks are few and imperfect. The community bank can limit its product offerings to only variable-rate loans and simply lose the customers that insist on a fixed rate. Or, the bank can offer fixed-rate loans only on a short-term basis, lose some customers, and build interest rate risk in its loan portfolio from the customers it does retain. The bank can offer long-term fixed-rate loans and take the risk of rising rates gutting the value of those loans and the bank's capital. The bank will also risk regulatory citations for ignoring interest-rate risk. Alternatively, the bank can offer a long-term, fixed rate on the loan and then (1) sell the loan and lose ongoing earnings and the customer relationship, or (2) borrow long term funds from the Federal Home Loan Bank to match that asset with appropriate liabilities, a choice that significantly erodes profit on the loan and uses up precious wholesale liquidity. None of the alternatives to acquiring an interest rate swap capability are truly satisfactory.

The regulatory imperative. In addition to the business and competitive incentives to doing swaps, there is effectively a regulatory imperative for doing so. On January 6, 2010, the regulators[1] published a collective *Advisory on Interest Rate Risk*. In that *Advisory*, the regulators said that the current low-interest rate environment made it particularly important for banks to have robust processes for mitigating their exposure to interest rates.

More than three years after the regulators collectively published the *Advisory*, on October 8, 2013, the FDIC published Financial Institution Letter FIL-46-2013 to re-emphasize the importance of prudent interest rate risk management. The tone in the FIL is sharper than in the *Advisory*, which likely signals the FDIC's intent to focus intensely on the issue in upcoming examinations. The FIL describes a nationwide trend of banks with "a significantly liability-sensitive balance sheet position." The FDIC uses strong language in the FIL by saying that it "is increasingly concerned that certain

institutions may not be sufficiently prepared or positioned for sustained increases in, or volatility of, interest rates."

Some of the FDIC's specific concerns about banks with liability-sensitive balance sheets in a rising rate environment (for example, those with unhedged fixed-rate loans) include:

- Decline in net interest income;
- Run-off of deposits;
- Rate-sensitive liabilities (for example, deposits) re-pricing faster than earning assets;
- Severe depreciation in a bank's holdings of long-duration bonds;
- Liquidity shortfalls resulting from dependence on a long-duration bond portfolio for liquidity;
- Decline in regulatory and equity capital due to investment portfolio depreciation; and
- Negative publicity from drops in GAAP equity.

Community banks should carefully analyze each of these risks, prepare plans to mitigate these risks, and be able to explain those plans to their examiners, who are almost certain to be focused on these issues in the upcoming exam cycle.

The *Advisory* uses carefully worded language in instructing banks on how to use swaps. These are two key quotes:

- Using derivative instruments to mitigate IRR exposures may be appropriate for institutions with the knowledge and expertise …
- Institutions should not undertake [hedging with interest rate derivatives] unless the board and senior management understand the institution's hedging strategy … including the potential risks and benefits …

In similar but more strident language, the FDIC's FIL warns banks not to undertake interest rate swaps unless the bank's board of directors and senior management "fully understand these instruments and their potential risks," language that appears more demanding than the original multi-agency *Advisory*. Those institutions for which the FDIC is their primary regulator are advised to ensure that they "fully understand" swaps and their risks, in addition to understanding strategy, risks and benefits as required in the *Advisory*.

Fortunately, a detailed knowledge of swap accounting is not required and the examiners will not be individually testing directors and management on their knowledge of swap agreements. Knowledge is best demonstrated by having a carefully designed swap program with prudent exposure limits, effective measurement and monitoring of interest rate risk; records that document compliance with applicable laws and regulations; and financial statements that properly account for swaps. Banks can and should avail themselves of the expertise of their outside accountants, consultants, and counsel in preparing these documents and otherwise demonstrating a full understanding of swaps and their risks.

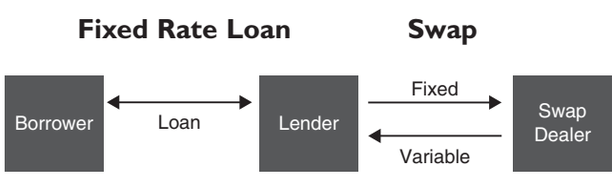
In summary, if regulators are insisting that banks hedge their interest rate risk and there really are no good options for doing so without using interest rate swaps, then regulators are, in this author's view, effectively telling banks to start doing swaps.

Selecting the Right Swap Products for a Community Bank

There are three general methods for packaging an interest rate swap with a typical loan offered by a community bank. Consistent with the *Advisory on Interest Rate Risk* and the FDIC's Financial Institution Letter on the same topic, the bank's board and senior management must understand the strategy, risks and benefits of using each method.

One-Way Swap

The first swap method is a "one-way" swap in which a community bank simply makes a long-term, fixed-rate loan to its borrower and then executes an interest rate swap with a swap dealer (such as a broker dealer affiliate of a larger commercial bank) to hedge against rising interest rates (and the resulting ire of the bank's examiners). The structure is diagrammed below.



Pros and Cons of the One-Way Swap Structure

Some of the *advantages* of a one-way swap include the following:

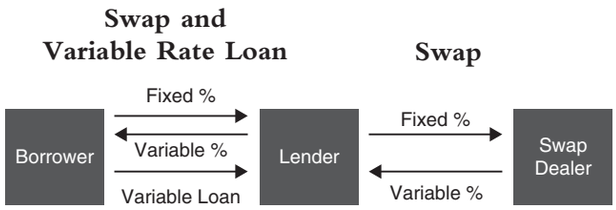
- Changes in the fair value of a swap usually offset changes in the fair value of the loan, although differences can arise from "credit valuation adjustments" due to differences in the credit quality of the borrower and the credit quality of the bank's swap dealer (generally, a large financial center bank). Thus, there usually are negligible effects on the bank's financial statements as interest rates fluctuate, although significant differences in credit quality can arise and force changes onto the bank's financial statements.
- Because the borrower is not party to swap documents, there is no need to qualify the borrower as an "eligible contract participant" or for "end user" status. A one-way swap is the only swap available to hedge a loan with an ineligible company.
- Importantly, there are no accounting, reporting, or registration burdens imposed on the borrower. This is another reason a one-way swap is a good—and sometimes the only—option to use with small or unsophisticated companies.
- The borrower is not required to understand swap documents.
- Because the borrower is not party to a swap, it simplifies the loan structure and greatly enhances the bank's flexibility in doing loan workouts, collateral transfers, and loan participations.

Some of the *disadvantages* of a one-way swap include:

- The bank is subject to the complexities of hedge accounting.
- There is no opportunity to earn substantial fee income, as there is in the two-way swap structure discussed below.
- The bank must include a yield maintenance prepayment fee in the loan documents to ensure it can cover the cost of early swap termination if the loan is prepaid or goes into default.

Two-Way Swap

The second swap structure is a "two-way" swap or a "back-to-back swap" in which the community bank makes a variable-rate loan to its borrower and enters into an interest rate swap with the borrower that, together with the loan facility, delivers the borrower an effective, fixed-rate obligation and the lending bank a loan with an effective variable rate. The bank then enters into an offsetting swap with a swap dealer, as illustrated in the diagram below.



Two-Way Pros and Cons

Some of the *advantages* of a two-way swap include the following:

- The bank can let the fair value of the two swaps offset each other, report "mark to market" fair value of both swaps each reporting period, and *avoid hedge accounting entirely*.
- The bank can earn significant *fee income* from swap dealer. Essentially, if the community bank can negotiate a sufficient interest rate with the borrower, the present value of that favorable rate can be received as an up-front fee from the bank's swap dealer.

Some of the *disadvantages* of a two-way swap include the following:

- The borrower must understand and "be sold on" ISDA swap documentation, which can be daunting for the novice borrower. Often, the bank's swap dealer counterparty, which is typically a large money center bank and possibly a competitor of the bank, must interact with the borrower to explain the swap documentation.
- The borrower must qualify as an "eligible contract participant" and qualify for "end user" status, standards many smaller companies cannot meet. This also requires the bank to engage in additional analysis, including confirming that the swap is appropriate to reduce the borrower's interest rate risk.
- The borrower must register and maintain an LEI / CICI number. Although not difficult, it is one more administrative burden for borrowers to deal with.
- The borrower must keep the specific swap records required by law.

- Often, the borrower must account for a swap in its financial statements.
- The bank must ensure that the borrower's swap obligations are secured along with the promissory note, which requires specialized title insurance endorsements for real estate collateral and other adjustments to loan documents.
- Workouts, property sales and refinances can be greatly complicated because the bank owes uninterrupted payments to the swap dealer on the "swap dealer" side, which makes it difficult or complex to allow the borrower to suspend or adjust its payments. There are workarounds, such as allowing novation by a new lender (typically only done with smaller swap termination amounts), or requiring the borrower to pledge collateral just for the swap or a sale of a portion of the loan by the incumbent lender to the new lender.
- A borrower-side swap can make a loan more attractive to loan participants. But, the bank will need to carefully administer a loan paired with a swap, particularly in foreclosure situations to ensure that it is not liable for conflicts of interest in allocating collateral and recoveries between the loan and the swap. The bank will need a specialized participation agreement to cover these contingencies.

The "Outsourced Swap"

The third way to offer swap capability is to use an outsourced swap product designed for community banks. Under this model, the community bank makes a variable-rate loan and the borrower signs a simplified swap-type agreement with the third-party swap provider, which results in the bank receiving its preferred variable rate and the borrower paying a net fixed rate. It can also offer fee opportunities for the community bank, and the bank virtually avoids all accounting and regulatory burdens associated with swaps.

Comparison Chart

To facilitate bank management's understanding of swap strategy and risks, as required by the *Advisory* and the FDIC's FIL, the following chart summarizes the comparative advantages and disadvantages of the three swap methods, with an "X" marking which method has the particular disadvantage:

Disadvantage	One-way swap	Two-way swap	Outsourced swap
Bank Accounting. In a one-way swap, the community bank is subject to fair value hedge accounting, which requires the bank to mark the swap to market on its balance sheet and run changes in fair value through its income statement. Even though the terms of the two swaps in a two-way swap may be identical economically, the two swaps can present quite different credit risks to the community bank, and the bank may still have to, under accounting rules, track a significant variance between the two swaps. (The outsourced swap option relieves the bank of all accounting obligations related to the swap.)	X	X	
Borrower Accounting. In a two-way swap, the swap with the borrower is typically a stand-alone ISDA swap and accounted for as a cash-flow hedge under ASC 815. Such swaps should qualify for special hedge accounting. (Some borrowers may be able to treat the outsourced swap instrument as an embedded derivative that need not be bifurcated from the host promissory note and accounted for separately because the swap is "clearly and closely related" to the host note.)		X	

Margin Obligations. In one-way and two-way swaps, under expected margin regulations, financial end-users such as community banks likely will have to post initial and variation margin subject to a cap on the threshold.	X	X	
Recordkeeping and Reporting. In one-way and two-way swaps, the borrower (in a one-way swap) and the community bank must maintain records that are complete, systematic, and retrievable and include, among other things, all records demonstrating entitlement to elect the clearing requirement exception. (In the outsourced swap, the hedge provider analyzes the clearing exception, the borrower agrees to elect not to clear, and the hedge provider handles the recordkeeping and reporting.)	X	X	
Third Party Involvement. In a two-way swap, the borrower must understand and sign lengthy and complex ISDA documents. Typically, a community bank must allow a third-party commercial bank (a potential competitor) to explain the documents and process. (This disadvantage does not apply to an outsourced swap because the swap provider's documents are generally simpler, and the swap provider need not be a potential competitor of the community bank.)		X	
Separate Payments. In a two-way swap, the borrower is required to calculate and make a separate swap payment in addition to the loan payment. (The outsourced swap product avoids this problem because it allows the borrower to make a single payment which the community bank allocates to itself and the swap provider.)		X	
Suitability. In a two-way swap, the community bank must ensure that the swap is economically appropriate to reduce the borrower's interest rate risk and fulfill the bank's reporting obligations to swaps clearing organizations.		X	

Community banks can use any combination of these three swap methods across a loan portfolio. Using one method on one deal never precludes using another method on another transaction. Generally, banks are well served by understanding all three methods and using the method that best suits them and a particular borrower.

Ensuring the Borrower Is Eligible to Enter into a Swap

Under the Commodity Exchange Act, it is unlawful for any person other than an eligible contract participant to enter into a swap unless it is entered into on, or subject to the rules of, a board of trade designated as a contract market. As a result, the borrower, any guarantor of swap obligations, and even the community bank itself must be eligible to enter into swaps.

The CFTC's regulations clearly describe discrete categories of "eligible swap participant." Those categories include entities with at least a $1 million net worth or entities with at least $10 million in assets. The analysis is generally straightforward and community banks are well suited for the analysis of whether a particular borrower or guarantor fits into a particular category. The only practical result of the regulations, other than the extra certifications involved, is that borrowers or guarantors

who could afford a swap of a particular dollar amount are, under the regulations, deemed ineligible for any swap and are forced to pay a higher rate or accept less favorable terms on a loan.

Using the 'End User' Exception From Clearing Requirements

Regulators cited AIG and its use of credit default swaps (similar to insurance) as a key example of why noncleared swaps are riskier. Although there is not necessarily a logical connection between credit default swaps and plain-vanilla interest rate swaps, regulators still want to incentivize market participants to move toward standardized and clearable swaps. As a result of that regulatory perspective, section 723 of the Dodd-Frank Act added section 2(h) to the Commodity Exchange Act and thereby established a clearing requirement for interest rate swaps. Now, it is illegal for a bank to enter into certain swaps without clearing them unless an exception or exemption applies.

The term "clearing" refers to the process by which an intermediary is interjected between one party and its swap counterparty. One such intermediary is a derivatives clearing organization (DCO), which is a clearinghouse, clearing association, clearing corporation, or similar entity that enables each party to an agreement, contract, or transaction to substitute, through novation or otherwise, the credit of the DCO for the credit of the parties. A DCO arranges or provides, on a multilateral basis, for the settlement or netting of obligations and can otherwise provide clearing services or arrangements that are supposed to mutualize or transfer credit risk among participants. A cleared swap is subject to continuous collateralization of swap obligations, real-time reporting, additional agreements, and other regulatory constraints.

Clearing is a much more cumbersome and expensive process than the typical "bilateral" swap directly between a bank and its counterparty, which is a purely private contractual arrangement. Thus, community banks and their customers will want to avoid engaging in swaps that must be cleared. As described below, noncleared swaps are subject to nominal reporting and recordkeeping requirements post-Dodd-Frank. But, those requirements are managed easily and usually are handled by service providers or the large swap dealers.

Fortunately for community banks, so far only LIBOR swaps are subject to clearing requirements. The CFTC's first clearing determination in November 28, 2012, (a 57-page document in which only a few words are relevant to community banks) covers typical community bank LIBOR swaps, namely "plain vanilla" fixed-to floating swaps denominated in US dollars using a LIBOR floating rate index with a termination date range of 28 days to 50 years. As a result, Prime-based and non-LIBOR swaps are not included. If a swap is not subject to clearing requirements (such as a Prime rate-based swap), then clearing is not relevant, and no analysis of the end user exception is necessary.

Assuming that a community bank is engaging in a LIBOR swap subject to clearing, the bank will want to ensure that its customer qualifies for the end user exception from those otherwise-applicable clearing requirements. This is done by having the customer certify in a questionnaire that it is not a "financial entity" such as a swap dealer or commodity pool and that it is not entering into the swap for speculative, investing, or trading purposes. That is, the customer will certify that it has a commercial purpose for the swap, such as hedging a variable rate loan. The bank must have a reasonable belief that the customer's certification is true, which is generally easy if the customer is entering into a swap with the effect of exactly hedging a related variable rate loan from the bank. The bank will also need to confirm that the customer has the means to perform under the swap, such as by confirming the borrower's cash flow is sufficient, obtaining a guarantor for the swap, or having the borrower post margin collateral. Most community banks simply rely on a cash-flow analysis or a guarantor eligible to guarantee a swap.

Finally, the CFTC imposes additional requirements on borrowers that are publicly held companies or those that have issued public debt, as well as entities that public companies control. An appropriate committee of the company's board or governing body must review and approve the company's decision to enter into uncleared swaps. That committee also must set appropriate policies regarding the use of uncleared swaps. And, that board committee must review such policies at least annually, or more often upon a "triggering event," such as a new hedging strategy that was not contemplated in the original board approval or

new trades becoming subject to mandatory clearing. A community bank should ensure that it has in hand a copy of the borrower's required board approval and swap policies.

Qualifying the bank for the end user exception is simple. Banks under $10 billion in assets as of the end of the most recent fiscal year can elect the "end user" exception to clearing requirements if the bank is using the swap to hedge commercial risk, which a bank is doing if it is hedging loans it makes in the ordinary course of business. The end user exception is found in Commodity Exchange Act section 2(h)(7) and CFTC Regulation 50.50. To qualify for the end user exception, the community bank must either (1) self-certify on an annual basis under CFTC Regulation 50.50(b)(2) that it meets small bank requirements and other provisions of the end-user exception or (2) provide enough information to its swap dealer counterparty to permit the dealer to report this information on the community bank's behalf.

Many swap dealers are requiring community banks to make the "annual 50.50 filing", which is made using forms available on the DTCC's website. Whether as part of an annual 50.50 filing or as a certification to the dealer, the community bank must (1) confirm that it has less than $10 billion in assets and is thus exempt from the term "financial entity"; (2) describe how it meets its financial obligations on the swap (such as "available financial resources"); (3) confirm that the swap(s) in question are entered into to hedge or mitigate the bank's underlying commercial risk (such as to mitigate the interest rate risk arising from entering into a fixed rate loan); and (4) if the community bank is a public company or its holding company is a public company, then an appropriate committee of the bank's board of directors must review and approve the bank's decision to use the clearing exception.

Bottom line: the CFTC's voluminous clearing regulations impose extra paperwork on a community bank but do not actually require clearing of the basic swaps in which community banks and their customers engage. The clearing regulations change absolutely nothing in the underlying economics of these swap transactions for community banks and their customers.

Avoiding Municipal Advisor Status

Community banks often extend credit to local nonprofits as part of an industrial development bond transaction or similar tax-exempt bond or direct loan transaction. These transactions are typically small in dollar amount, scaled down in complexity, and can resemble other commercial loans the bank makes. However, if the parties involved are a "municipal entity" (typically the entity issuing the bond) or an "obligated person" (typically the local nonprofit that pledges collateral and shoulders the repayment obligation) as those terms are defined in the SEC's municipal advisor registration rules, as recently amended,[2] the community bank must avoid communications about the swap that could be construed as "advice" or a "recommendation" about the swap or the issuance of a municipal security. The rules do allow the bank to provide advice about extending credit to the municipal entity or obligated person, and all communications are generally exempted if the municipal entity is represented by an independent registered municipal advisor.

Documenting an ISDA Swap

Once the community bank has confirmed the eligibility of its customer and confirmed that the exception from clearing applies, the path is clear to entering into an interest rate swap. The bank's swap with the swap dealer is invariably documented on a form developed by the International Swaps and Derivatives Association (ISDA), an organization that has worked since 1987 to develop a versatile master form with near-universal acceptance in the derivatives industry. Although market participants can effect a swap transaction with only a long-form confirmation, the best practice is to first negotiate and enter into the complete ISDA swap document package, which will then govern all swap transactions between the parties with only a brief trade confirmation needed after executing new swaps. The community bank's swap with its borrower is also typically documented on ISDA forms. In a two-way swap, using ISDA forms on both swaps helps ensure that the swaps truly offset each other and thereby simplify the bank's swap accounting. In the outsourced swap method, the parties can use a greatly simplified document and the community bank can entirely avoid the ISDA negotiations detailed in the following paragraphs.

The ISDA Master Agreement is a preprinted document that itself is not changed at all other than to fill in the parties' names. The Master Agreement is accompanied by a Schedule that is heavily negotiated to add to or modify certain provisions of the Master Agreement. In most cases between a community bank and a swap dealer, the parties will also negotiate an ISDA Credit Support Annex that governs the credit support for swap obligations, including collateral and credit support providers.

Swap dealers will insist that the community bank join the August 2012 ISDA Dodd-Frank Protocol and submit an adherence letter and related questionnaire. The Protocol is designed to supplement the Master Agreement and helps the swap dealer comply with the External Business Conduct rules and other swap rules. Although the Protocol documents are not negotiated, they are important to understand and the bank must carefully complete the questionnaire.

Even if a community bank is only entering into "plain vanilla" interest rate swaps in the United States, the bank must consider numerous issues in negotiating the ISDA Schedule and Credit Support Annex, including the following:

- Decide whether to incur the cost of segregating collateral at a third party custodian. This is the bank's right under Dodd-Frank, but comes at a price.
- Resist requests to add the bank holding company, subsidiaries, or other affiliates as "Specified Entities" and insist on doing swap business solely through the bank. This prevents defaults being triggered by events at affiliate companies. (Note that the community bank will insist on just the opposite with the swap with its borrower.)
- Negotiate an adequate "Threshold Amount" to ensure that the bank does not trigger default under the Master Agreement based on missed payments or other nonperformance on its nonmaterial debt. Three percent of shareholders equity is a common figure. Fixed dollar amounts may be better because a bank can set in place reminders that are triggered automatically if it defaults on obligations that count as debt under the Master Agreement. Also, banks with excellent credit or high capital ratios may justify higher threshold amounts.
- Resist any effort to restrict the bank's ability to modify its capital, ownership, or management structure. This can be an issue in defining a "Credit Event Upon Merger" or "Additional Termination Event."
- Resist "Material Adverse Event" for a termination trigger as applied to the bank. Most phrasings are far too broad. If absolutely necessary, a community bank might agree to a trigger based on an objective regulatory capital category, such as falling below "well undercapitalized" with respect to leverage ratio, tier 1 capital ratio, and total risk-based capital ratio. Because the swap dealer is typically a large public company, it can be held to a particular S&P or Moody's rating. That way, both sides can monitor the other's objective regulatory capital or credit rating and take action before the counterparty fails.
- In the delivery of documents section, specify that the swap dealer must deliver all documents the community bank may need for its own purposes, such as the swap dealer's financial statements and call reports, a signing authority certificate, tax compliance documents, a good standing certificate, and organizational documents.
- On credit support, ensure that the definitions of "Eligible Collateral" include collateral that the bank owns (or can readily acquire) and can pledge and insist on a high valuation percentage. The dealer should allow typical collateral such as Treasury bills, notes, and bonds, not just cash. The valuation percentage can vary based on the remaining maturity of the bill or bond, but valuation of 94 percent is common for Treasury bonds of longer than 10 years. Agency securities (Fannie, Freddie, FFCB and TVA) are typically valued up to 97 percent. A bank should insist on allowing the dealer to pledge only "plain vanilla" agency securities and not agency "structured notes."
- On the issue of initial margin and thresholds, under CFTC rules as currently proposed, swap dealers are allowed to give "low risk financial end users" like community banks up to 0.3 percent of regulatory capital as a margin threshold, far less than the 2 percent commonly demanded. Thus, a bank should resist demands for initial margin (and excessive variation margin) when discussing the appropriate "Independent Amount" and "Threshold" under ISDA. A community bank likely wants to request a low "Minimum Threshold" amount compared to what the swap dealer typically uses. Otherwise, a

small bank might have an unsecured exposure of close to $100,000 or $250,000 (if those were the designated Minimum Threshold amounts), which may be material for a small bank. In fact, arguably a community bank should not accept anything other than a $0 minimum threshold from a swap dealer. The swap dealer will be requiring that of the community bank. All of the banks that had derivatives in an asset position when Lehman failed, but held no collateral posted from Lehman due to thresholds over $0 collected about $0.15 on the dollar. The $0 threshold for swap dealers is becoming more commonly accepted in the market.

- Ensure various time frames actually work for the bank, keeping in mind that the large swap dealers typically state all deadlines and time frames in New York time.
- Confirm that the swap dealer will handle all data reporting related to swaps.

Swap Accounting

Many community banks are concerned that swap accounting is too complicated to understand or administer and, even if understood, would make their financial statements too erratic. Although it is true that the software tools and spreadsheets that are used in swap accounting are based on a complicated methodology, the process is also highly standardized and objective. As to the concern that "marking to market" swaps will create volatility in financial statements, the reality is that changes in swap values are almost always entirely offset by mirroring changes in the loan value. The actual effect on a bank's financial statements is usually negligible.

That being said, regulators expect bank board members and bank management to understand swap risks and strategy, and to have that understanding, one should know the basics of swap accounting. Certainly, it is not necessary to become an expert on swap accounting, which would be a complex and ambitious undertaking. It has been said of FASB ASC Topic 815, *Derivatives and Hedging* (ASC 815, f/k/a SFAS 133) that "if you think you understand ASC 815, you haven't read it."

ASC 815 establishes the default or baseline rule that fair value of a swap and a loan must be determined and reported each reporting period, with gain or loss recognized in earnings. A loan is always carried as an asset, but the swap must be carried at fair value as an asset or liability on the balance sheet. For almost all swaps a community bank will enter into, fair value is determined using the income method, which uses a net present-value formula factoring in a "credit value adjustment" (CVA) based on the credit quality of both parties' credit risk. In a swap between the bank and a borrower in which the borrower was the "owing" party, and thus the bank was carrying the swap as an asset, if the borrower's credit quality dramatically declined and the bank's quality stayed the same or improved, the CVA formula would require the bank to record a decline in the fair value of that swap. Conversely, the borrower in that case would report a gain because its own lower credit quality increases the discount rate, which lowers the valuation (and thus the reported liability amount) for purposes of the borrower's financial statement.

Hedge accounting is the way banks can escape the unpleasantness of the fair value rule under which gains and losses in fair value hit the financial statements every reporting period. To use hedge accounting, the bank must assess the effectiveness of the swap as a hedge of the loan both at inception of the swap and in subsequent periods. At the inception of the swap, the bank must prepare a hedge designation memo that includes a description of the swap as the hedging instrument, the hedged item or transaction, the nature of the risk being hedged, how the hedging instrument's effectiveness will be assessed, and how ineffectiveness will be measured. The format for such memos and the methodology for preparing them are well established.

The key in using hedge accounting and escaping the fair value rule is assessing the effectiveness of the swap as a hedge. There is still a shortcut method that allows the bank to assume that a hedge will be perfectly effective as long as certain conditions are met (which they normally are in the case of a typical community bank swap). But, the accounting industry expects that the shortcut method will be disallowed in the near future. To avoid the need to recast financial statements when the shortcut method goes away, it is generally recommended that banks use the long haul method. The long haul method requires periodic testing, which, as its name suggests, involves more time and analysis than the shortcut method. Again, these methods of assessing

effectiveness are well established and familiar to the bank's accountants and consultants.

Swap Reporting

The task of reporting swap data was imposed by Dodd-Frank and its implementing regulations; the regulators are still trying to find a valuable use for this data being reported to them. As a practical matter, a community bank does little in this area because the swap dealer will handle all reporting on a one-way swap and the swap dealer side of a two-way swap. In addition, community banks normally hire a service provider to handle the reporting required in connection with the borrower-side swap, as the reporting regulations expressly allow.

At the initiation of a swap, the reporting party must report the election of the end user exception from clearing, the identity of the end user, and suitability information about the end user, and the unique swap identifier must be included in all reporting. On an ongoing basis, the reporting party must report swap continuation data for all swaps that are not cleared by a derivatives clearing organization and the unique swap identifier must be included in all reporting.

Each party to a swap, including the community bank, must obtain a Legal Entity Identifier // CFTC Interim Compliant Identifier from *www.ciciutility.org*. There is a $200 initial fee plus an annual fee. The community bank can register its customer for an LEI but the customer must certify the registration.

Using Swap Service Providers

Most community banks would be well-served to select and use outside consultants and advisors to set up and manage a swap program. The regulators have outlined the steps banks should follow in conducting due diligence on, contracting with, and then managing such service providers.

The regulators' *2010 Advisory on Interest Rate Risk Management* states that reliance on outside consultants to assist in the establishment of a hedging strategy does not absolve the board and senior management of their responsibility to fully understand the risks of the derivatives hedging strategy. The regulators are clearly not prohibiting banks from using suitable swap consultants and service providers; they simply want to ensure that bank management understands the risks of their swap strategy. The Advisory should be a source of comfort to banks. Members of bank management only need to understand swap instruments and their risks; they do not need to understand the details of the fair value rule, hedge accounting, or even details related to swap reporting.

The FDIC's *Guidance For Managing Third-Party Risk* requires a bank to conduct a risk assessment of dealing with a new service provider, including an assessment of the following risks: strategic, reputation, operation, transaction, credit, and compliance. The bank should document its risk analysis in each of these areas for every new service provider relationship, although the analysis will increase in rigor commensurate with the risk presented by the provider. The FDIC's *Guidance* also requires a bank to conduct due diligence to ensure the service provider understands and can comply with the law. As illustrated by the CFPB's 2012-03 Bulletin, to be effective, such due diligence should involve (1) obtaining and reviewing the service provider's policies, procedures, controls, and training materials, (2) setting clear expectations about compliance, and (3) establishing consequences for noncompliance, including deceptive or abusive practices.

Risk-Based Capital and "In-the-Money" Swaps

Although not a major issue, banks should be aware of swaps' generally minor effects on capital. The key regulatory document is the *Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements*, which was issued in 2012 in conjunction with the Basel III proposals. Under the proposed requirements, as under the general risk-based capital rules, a bank must hold risk-based capital against swaps that are carried as an asset (that is, those for which the bank is owed money and are referred to as "in-the-money" swaps) since swaps carry counterparty credit risks.

Calculating the "risk-weighted exposure amount" is done by applying a credit-based risk weight to the exposure amount. The "exposure amount" is the bank's credit exposure (what it is owed), which is the greater of the mark-to-market value (of what the counterparty owes the bank) or zero, plus the potential future exposure. The "potential future exposure

amount" is the notional amount of the swap multiplied by the conversion factor in the table below:

Remaining Maturity	Interest Rate Swap
<1 year	0.0%
1–5 years	0.55%
>5 years	1.55%

The rules allow a downward adjustment of the required capital if a bilateral netting contract is used, such as the 2002 ISDA Master Agreement, which the community bank likely will use.

Generally, a community bank will be making only modest capital adjustments for swaps. In the future, there may be a slight increase in the required capital level for noncleared swaps but the overall amount will still be modest.

Margin Requirements

Regulation KK—*Margin and Capital Requirements for Covered Swap Entities*, was proposed in May 2011 and was made an interim final rule without the various margin and capital requirements that were in the rule in proposed form. However, those margin and capital rules likely will resurface in the future. When they do, the rules likely will apply only to "covered swap entities" such as swap dealers and major swap participants, not community banks. However, the regulation will affect community banks because they do swaps with covered swap entities, and those entities may require some margin for the swaps between the community bank and the covered swap entity.

The regulation likely will deem most community banks to be a "low risk financial end user" because community banks are a financial end user, generally do not have significant swaps exposure, use swaps to mitigate risks in their normal business of making loans, and are subject to capital requirements by a prudential regulator. As low-risk financial end users, community banks will have a decent threshold before they must post collateral. The initial and variation margin threshold amount (credit exposure limit) was proposed to be the lesser of $15 million to $45 million or 0.1 percent to 0.3 percent of regulatory capital. A community bank would have to exceed that threshold before margin collateral would be required. There likely will be elevated margin collection requirements for noncleared swaps.

Designing a Swap Program for a Particular Community Bank

Once a bank has decided which method or methods it wishes to use with interest rate swaps, the bank must supplement its policies and procedures (at least its interest rate risk, asset/liability, and accounting policies) and train its board, management, and applicable staff in several key areas, including the following:

- Effective corporate governance,
- Policies and procedures,
- Risk measuring and monitoring systems,
- Stress testing,
- Internal controls over interest rate risk measurement, monitoring and reporting, and
- Regular independent review.

The bank's accounting policies and disclosures must be expanded to cover the bank's interest rate swap activities in detail, consistent with the relatively few applicable provisions of the otherwise remarkably complex ASC Topic 815, *Derivatives and Hedging* (originally FAS 133). A community bank must establish procedures for meeting applicable margin requirements, monitoring hedge effectiveness, risk-weighting swaps, and ensuring that swaps and their valuation are properly documented in journal entries, SEC filings, and call reports. The bank's auditors will be a valuable resource in this area, and other specialized hedging consultants are available as well.

A community bank will need to develop a policy for documenting its reasonable basis for believing that its borrower is entitled to elect the commercial purpose exception from clearing and then guide the borrower through the election. The bank will also need to develop and follow policies for reporting swaps to central swap data repositories in the specific format and method required by regulation. One such policy may be to outsource the reporting and recordkeeping functions, as is expressly allowed by regulation.

Litigation Risks with Swaps

There is some liability exposure in doing swaps with a bank's customers and it is similar in nature to a

bank's exposure as a lender in making loans. Lawsuits challenging the legal structure or basic legality of swaps generally lose, with a good example being the decision of the US Court of Appeals for the Ninth Circuit in *Thrifty Oil*.[3] That decision held, among other things, that swap payments are not interest, a swap is not integrated with the loan it hedges, swaps are protected in bankruptcy, and state "bucket shop" laws are preempted by the Commodity Exchange Act. That decision also noted congressional intent to encourage the use of swaps, even if a bank could use a swap to evade Bankruptcy Code section 502(b)(2) by collecting a termination fee equal to all unmatured interest. In short, a bank's customer will almost never succeed in attacking the structure or nature of a swap.

But, a bank's swap customer could attack a swap transaction on grounds of misrepresentation, fraud, or inaccurate or inadequate disclosure about the swap. Prior to Dodd-Frank, there was no particular disclosure required by law by one party to the other party to a swap. Swaps that may be particularly vulnerable to a fraud-type challenge are swaps that were entered into before the financial crisis and before the unprecedented 500 basis point drop in LIBOR rates. The cost of terminating those swaps became astronomical and many borrowers have argued and likely will argue that they were not properly informed of the risks and costs resulting from a major swing in interest rates. These sorts of cases have had mixed results to date.

In California, there was a 2013 decision from the state's Supreme Court[4] that overruled long-standing precedent and allowed a borrower to introduce extrinsic evidence of fraud, notwithstanding the fact that the loan documents signed by the borrower stated that they were integrated documents. In short, borrowers in California have a much easier time prolonging litigation by merely alleging that they were misled in the process of understanding the loan documents. Similar tactics could be used to attack interest rate swaps.

Community banks have several ways to minimize this sort of litigation risk. They can voluntarily provide disclosures similar to those required of large banks under the CFTC's External Business Conduct rules. They can require borrowers to hire counsel to advise them on the swap documents and eliminate any misunderstanding as to their terms. They can use simpler documents and allow borrowers more time to review them. These approaches are similar to what banks can do with the loan documents.

Conclusion

Despite Congress' and the regulators' enactment of thousands of pages of burdensome and frequently counterproductive swap regulation, community banks still have compelling reasons to offer swap capability to their customers. Community bank management need not become experts in swap accounting or regulation; they merely need to understand the risks and strategy involved in the swaps they offer. The actual analysis and work involved is something all community banks are well equipped to do.

Notes

1. The financial regulators consist of the Board of Governors of the Federal Reserve System, the FDIC, the National Credit Union Administration, the OCC, the OTS, and the Federal Financial Institutions Examination Council State Liaison Committee.
2. 17 CFR §240.15Ba1-1 *et seq*.
3. *Thrifty Oil Co. v. Bank of America National Trust & Savings Ass'n*, 322 F.3d 1039 (9th Cir. 2002).
4. *Riverisland Cold Storage, Inc. v. Fresno-Madera Production Credit Association* (2013) 55 Cal.4th 1169 (overruling the Court's prior decision in *Bank of America v. Pendergrass* (1935) 4 Cal.2d 258).