M&T Bank

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Treasury Division

June 3, 2011

Mr. David A. Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Regarding: Global Comment on the Emerging Title VII Regulatory Framework and Definition of "Swap Dealer"

Dear Mr. Stawick:

Manufacturers and Traders Trust Company[1] ("M&T" or "we") welcomes the decision from the Commodity Futures Trading Commission ("CFTC") to reopen and extend the comment periods for certain rulemakings implementing Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and respectfully submits these comments relating to Title VII.

The reopened comment period presents regional banks like M&T with the first opportunity to consider how the proposed regulatory framework in whole rather than the individual rules in part will affect the use of customized interest rate swaps by commercial lending customers. Our objective is both to inform the CFTC (inserted by Congress through the Dodd-Frank Act into an unfamiliar role as bank regulator) of the perspective of a regional bank, and more importantly, to be an advocate for thousands of our commercial banking clients who rely on us to offer competitively priced, efficiently administered, and appropriately structured floating rate loans and related interest rate swaps, having non-standard amortization schedules matching the hedged loans, to assist them in growing their business while managing risk.

As we will highlight in greater detail, critical aspects of several proposed rules, if not modified, will substantially alter the availability, cost, and use of common interest rate swaps provided by regional banks like M&T to their commercial loan clients, who are predominantly

[1] Principal subsidiary of M&T Bank Corporation (NYSE Symbol: MTB), a bank holding company headquartered in Buffalo, New York, which had assets of approximately $78 billion as of May 16, 2011, following the acquisition of Wilmington Trust Corporation, ranking it among the top twenty U.S.-based commercial bank holding companies by assets.

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nonfinancial commercial end-users. With respect to this constituency the challenge facing the CFTC is to judiciously weigh the trade-offs between added costs and identifiable benefits of the new rules on desirable hedging activity that has not resulted in systemic risk to the financial system. Contrary to the goals of the Dodd-Frank Act, imposing an overly burdensome cost structure on regional banks that continue to provide interest rate swaps to their commercial loan clients may also inadvertently create incentives to further concentrate hedging activity in a handful of already dominant financial institutions. A worse unintended consequence would be a Dodd-Frank Act regulatory framework that (1) makes interest rate risk management impractical for middle-market borrowers due to unduly high financial and administrative costs, or (2) adversely alters the relationship between these nonfinancial end-users and their regional bank credit providers, to the detriment of the borrowers and their local and regional economies.

In this letter, we will describe the typical use of customized interest rate swaps by regional commercial bank clients, thereby providing background on a specific swap constituency, and then analyze the impact of certain elements of the proposed rules through a cost-benefit prism, noting the benefits in achieving the risk reduction objective in the Dodd-Frank Act and the costs in terms of unintended consequences. Our hope is that this perspective will provide context to the CFTC in its deliberations drafting final rules such that a favorable balance between benefits and costs may be achieved.

I. Interest Rate Swap Use

Regional bank lending is a primary source of finance for small and medium-sized businesses, which we define as businesses having annual revenue below $250 million, and real estate developers and investors (collectively in this letter, "middle-market borrowers"). Long-standing choices for these business owners and financial managers have been (1) whether to obtain a fixed or floating rate loan, and (2) whether to hedge interest rate risk through an exchange traded or over-the-counter ("OTC") interest rate swap.

Interest rate risk for these borrowers has three components. First, there is the risk of higher interest expense and even loan default, which could result from selecting a variable rate loan, in the event the variable interest rate rises. Second, there is the risk of an uncompetitive cost structure and even business failure that could result from selecting a fixed rate, in the event that market interest rates fall. Third, there is the pre-payment penalty risk of a fixed rate loan, should circumstances change and the borrower need to re-finance or repay the loan prior to maturity. The challenge in risk management, especially as the debt amount increases, is to balance these competing objectives. Having fixed debt service, for example, often runs counter to the objectives of minimizing interest rate expense and of providing pre-payment flexibility.

The flexible, cost-effective solution to managing these conflicting objectives, developed over the past twenty-plus years into an indispensible staple of bank commercial lending, is the floating rate (e.g., LIBOR-based) loan coupled with an interest rate swap that hedges the borrower's interest rate risk and is responsive to other terms of the loan. The bank underwrites the loan and the credit exposure associated with the related interest rate swap, and if the overall exposure is to be secured, the borrower provides acceptable collateral in the form of accounts receivable, equipment, inventory, real estate, intellectual property, investment property and other types of business assets.

Exchange-traded swaps, with their standardized terms and cash margining requirements, do not provide the cost advantage and flexibility of the bank-offered customized swap. Unlike an exchange-traded swap, an interest rate swap provided in the OTC market by a regional bank lender may be customized to the terms of the underlying loan. In the normal course of managing interest rate and pre-payment risk, business owners and financial managers may transact swaps having identical terms matching a particular loan when it funds; they may also choose to transact swaps having terms not matching a particular loan, or trade at a time differing from the loan funding, as explained in the following examples:

Swap Traded after Loan Funds: a borrower might choose to delay fixing the loan interest rate, if he or she believes that floating rates will not rise immediately or if he or she is not certain of the core loan amount but wants the ability to hedge the rate risk in the future.

Anticipatory Swaps: in the event the loan funds over a period of months or years (e.g., a construction loan that converts to a permanent loan), the borrower might transact a swap immediately, with a delayed start date set to coincide with a future date when the loan is expected to be fully drawn. Another example of an anticipatory swap is when a borrower transacts a swap at the time a purchase contract is signed but before the loan funds in order to hedge the risk that interest rates rise before the loan funds.

Swap Maturity Exceeding Loan Maturity: some loans are frequently extended or renewed at their maturity. Knowing this, some borrowers choose to set the interest rate swap maturity to a longer term than the underlying loan the swap hedges.

Swaps Traded Incrementally After Loan Funds: instead of hedging the loan in one transaction, many borrowers opt to spread out the timing risk of choosing a single day to trade their interest rate swap, by trading two or more swaps over a period of weeks or even longer. Employing the principle of diversification, some borrowers also reasonably choose to spread the mix of floating and fixed interest rate risk in a loan rather than have complete exposure to one risk and none to the other.

Swap Termination or Receiver Swap Offsetting a Payer Swap: one common method used by borrowers to change their mix of risk exposure or to rebalance their risk is to transact an interest rate swap having an opposite payment profile to the swap they intend to cancel. Such trading is also used in the event a portion of the underlying loan is pre-paid.

Swap Hedging Debt Other Than a Loan: in addition to loans, regional banks may also provide their clients with credit in other forms. For example, a bank might provide credit enhancement, through a letter of credit, to a tax-exempt borrower who obtains funding from a municipal entity that issues a variable rate demand bond. Borrowers routinely hedge these multi-party transactions with individually negotiated interest rate swaps.

II. Cost Benefit Analysis of Certain Elements of Proposed Rules

The importance of interest rate swaps provided by regional banks to middle-market borrowers is best exhibited by borrower preference to use these interest rate swaps to hedge their business risk, in spite of the availability of exchange traded swaps. Senators Dodd and Lincoln, citing interest rate risk as an example in their June 30, 2010 letter to Chairmen Frank and Peterson, stated that "derivatives are an important tool businesses use to manage costs and market volatility."[2] They also stated that they viewed the Dodd-Frank Act as legislation to preserve that tool.

A. Eligible Contract Participant ("ECP") Definition

Replacing the "total asset" standard with "discretionary investments" in the ECP definition would significantly reduce the availability of interest rate swaps to many middle-market borrowers, depending on the interpretation of the word "discretionary." The concept of having unencumbered assets (i.e., "discretionary assets") available to meet margin calls is antithetical to the typical bank middle-market borrower relationship we have described above. The bank, as secured lender, is willing and able to consider many forms of collateral to secure exposure to the borrower represented by the swap in a manner that meets the bank's underwriting guidelines and bank regulatory requirements.

We, therefore, request that the CFTC consider carefully the implication of setting an unduly restrictive definition of "discretionary." Having $5 million in cash on hand to meet margin calls for a speculator in a credit default swap may be appropriate. Disregarding the substance of interest rate swap use by a commercial loan client that acquires business assets funded in part by a loan secured on the purchased assets and hedged with an interest rate swap also secured on the same purchased assets would appear to be contrary to the risk reduction goal of the Dodd-Frank Act.

[2] See link http://online.wsj.com/public/resources/documents/dodd-lincoln-letter070110.pdf.

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B. Swap Dealer Definition

Focusing attention on the dominant swap dealers is consistent with the risk mitigation objective of the Dodd-Frank Act. Accordingly, adopting an activities-based definition for swap dealer, while at the same time using a quantitative approach for the definition of major swap participant, appears to have produced an ironic result in which a market participant could be a swap dealer while failing to qualify as a major swap participant. One cannot help but wonder whether a more logical outcome might result from coupling a quantitative test with the activities test in the swap dealer definition. Consider that five commercial banks accounted for approximately 96 percent of the outstanding swap notional amount in 2010.[3] M&T would have accounted for approximately .006% of the approximate $231 trillion total notional amount considered in the OCC study, and M&T's swaps are limited to interest rate swaps.

By providing an exemption from the swap dealer designation for insured depository institutions ("IDIs"), Congress recognized the important and desirable role that IDIs play in providing interest rate swaps to their commercial loan clients and made an important distinction regarding the nature and scope of an IDI's swap activity. A narrow interpretation of the statute could reveal that the exemption only applies to interest rate swaps that are transacted simultaneously with the funding of a loan, and fails to include many of the desirable and common uses of interest rate swaps by our middle-market borrowers, previously described in *Section I* of this letter. We strongly believe that the use of interest rate swaps by regional bank commercial loan clients is one of the aspects of the OTC derivatives market that Congress chose to delegate to the regulators to incorporate in the regulatory framework. We are also confident that the CFTC will be guided by the perspective we and other insured depository institutions have provided in the final rule relating to the IDI exemption from the "swap dealer" definition.

The proposed "swap dealer" definition also appears to limit the IDI exemption to the swap between the IDI and its borrower, while offering no exemption for the swap the IDI might execute to manage the resulting interest rate risk it assumed in the transaction with its commercial client. It would be a curious result indeed if M&T only entered into swaps with middle-market borrowers that satisfied the IDI exemption, yet still was deemed to be a "swap dealer" when it turned to a bona fide swap dealer in order to hedge the risk of its end-user exposures.

[3] See link http://www.occ.treas.gov/topics/capital-markets/financial-markets/trading/derivatives/dq410.pdf.

C. Business Conduct Standards and Chief Compliance Officer Mandate

As noted above, the negotiation and implementation of an interest rate swap between a bank and a middle-market borrower occurs in connection with an extension of credit by the bank. Banks are subject to significant oversight from their prudential regulators with respect to underwriting and making loans, and regional banks have developed policies and procedures over decades to address regulatory requirements and business needs. In other words, the credit relationship between a middle-market borrower and its regional bank already embodies significant due diligence on the part of the bank, substantial legal protections for both the bank and the borrower, and highly evolved conduct standards for the bank. The potential for adding a variety of costly and subjective requirements on that relationship could add unnecessary strain to the lending process and would create legal uncertainty.

A chief compliance officer may be appropriate for a large financial institution that actively buys and sells a variety of complex derivatives such as credit default swaps, energy derivatives, equity derivatives and similar instruments, but imposing a uniform cost and administrative burden that substantially favors the largest swap dealers, given the significantly higher volume of their operations is a consequence of creating a significant disparity among swap dealers in terms of size, activity, and systemic risk resulting from an activities-based definition of "swap dealer." Consider that the cost of a chief compliance officer is more likely to be economically borne by a five hundred employee swap business at a swap dealer than a five person swap business at a regional bank.

One also wonders how a middle-market company benefits from a daily mid-market value of its non-cleared swap, since the typical interest rate swap user at a regional bank has transacted the swap as a cash flow hedge and will hold the swap to maturity. Besides, the "mid-market" value is not reflective of applicable trading costs since the middle-market borrower is subject to a credit spread that may change over time. Accordingly, the regional bank client will be provided with additional unrequested information of questionable value but at increased cost.

The requirement "know your counterparty" is an example of a number of subjective standards in the proposed business conduct rule. Introducing a requirement that the bank "evaluate the counterparty's swaps experience and objectives," where the borrower is an ECP, is duplicative of the bank's existing underwriting practices and may introduce a "heads I win, tails you lose" element to the bank-borrower relationship as market rates and borrower circumstances change. Moreover, such a subjective standard could introduce legal uncertainty and rescission risks that the CFTC certainly does not intend, since we already perform extensive due diligence and product education with our clients as a matter of course.

Making the bank an "adviser" to the borrower in the offer and sale of the interest rate swap, instead of a product provider in an arms-length business transaction, is another example of a subjective standard that creates significant additional risk and cost for the bank, effectively absolves the borrower of responsibility for making its own business decisions, and does not reduce risk for the borrower or the financial system.

Again, one remedy for the increased costs and litigation risks entailed in an overly proscriptive business conduct standard for swap dealers is to provide clarity in the IDI exemption that a regional bank providing interest rate swaps to its commercial borrowers will not be designated a swap dealer.

D. Financial Entity Clearing Mandate

As a method to reduce systemic risk arising from unregulated trading activity, clearing standardized derivatives including among others credit default swaps, total return swaps, debt index swaps, commodity swaps, energy swaps, and weather swaps, through a clearing house has merit. With respect to non-standard interest rate swaps designed to match the terms of a middle-market borrower's loan, however, the imposition of a clearing mandate changes the risk and cost borne by a regional bank in hedging the risk position resulting from the interest rate swaps the regional bank trades on behalf of its commercial loan clients. Since a financial entity may not claim the end-user exception to mandatory clearing of swaps, a regional bank will be compelled to partner with a futures commission merchant ("FCM") to gain access to clearing. The costs associated with these clearing services (i.e., FCM's and clearing house's fees) will ultimately be additive to the swaps market, yet risk is arguably not reduced.

Consider the following comparison of bilateral collateral arrangements with a so-called mutualized risk arrangement. Under current practice, a regional bank might manage the risk resulting from the swap with its commercial loan client by trading a matching swap with another bank. The swap's valuation (i.e., one bank's liability and the other's asset), when secured on a bilateral basis, means the collateral moves between the two banks on a regular basis as the swap's mark-to-market position changes. In contrast, the FCM clearing model exposes the regional bank to the default risk of each of the FCM's clients, who may be clearing swaps having significantly higher risk profiles than the interest rate swap the regional bank traded. The pay-out on a credit default swap referenced to a security that rapidly changes from AAA to non-investment grade, for example, is substantially greater than the pay-out on an interest rate swap subject to a change in interest rates. Depending on the default procedures of the particular clearing house and FCM that is a member, the regional bank's posted margin may be forfeit after the defaulting FCM client's margin, the FCM's equity in the clearing house, and the FCM's guaranty fund has been exhausted. This mutualized risk exposes the regional bank to the credit underwriting standards of the FCM, the type of swap the clearing house accepts for clearing, and the risk profile of the highest risk swaps (such as credit default swaps) cleared at the clearing house.

Unfortunately, the existing concentration of risk in a small group of dominant money center banks also appears likely to continue, since the FCM gatekeepers to the clearing houses have been formed from the same money center banks. Regional banks like M&T will be subjected to new credit risks associated with the mutualized risk aspect of central clearing of all manner of derivatives, if customized interest rate swaps transacted by regional banks to hedge their middle-market borrowers' amortizing loans are excluded from the "IDI exemption." The incremental new cost burden on the regional bank and its commercial loan customer of clearing through an FCM will penalize the regional bank that otherwise would have collateralized its swap exposure on a bilateral basis while providing a new revenue source that will likely accrue to the dominant money center banks that have created FCMs.

For the regional bank, the clearing mandate imposes additional cost related to managing basis risk until amortizing interest rate swaps are available for clearing. If other banks and swap dealers no longer accept amortizing interest rate swaps that match the unique amortization schedule and payment dates of the underlying hedged loan, or will only trade at a higher swap rate than for a non-amortizing, cleared swap, then the regional bank and its middle-market borrower will incur higher costs, or the bank will be compelled to hedge its risk on a mismatched basis using swaps having standardized terms.

E. Threshold Margin for Non-Cleared Swaps

As noted above, the credit exposure to the bank of an interest rate swap with a middle-market borrower is typically secured by business assets and other collateral that also secure the loan to the borrower. The practical reality is that a middle-market borrower either does not have sufficient liquidity to engage in a cash margining process for its swap or will not sacrifice that liquidity to secure swap exposure to the detriment of its business needs. Requiring initial and variation margin when the interest rate swaps are cross-secured by the loan collateral would likely have a chilling effect on the use of interest rate swaps by middle-market borrowers, thereby increasing risk.

These borrowers view interest rate swaps as a flexible and cost effective alternative to fixed rate notes and rely on their bank lenders to manage mark-to-market fluctuations in the context of the overall lending relationship. Ironically, were margin requirements mandated, these same borrowers would likely be forced to rely on the same bank lenders to provide loans secured on the same assets to raise the required cash to meet the margin requirements. Besides, imposing a threshold amount to trigger a margin call could well introduce new risks, tipping middle-market borrowers into default, through an artificial liquidity crunch. In any event, current nonfinancial end-users of interest rate swaps could well choose not to hedge their risk, avoiding a theoretical future margin call. For these reasons, requiring documentation such as a credit support annex that could become conditionally effective for nonfinancial end-users who have pledged the same collateral securing their bank loans should be removed from the final rule.

F. Trading Requirements Associated with Swap Execution Facilities ("SEF")

The proposed SEF rules introduce substantial uncertainties when applied to the trading of a non-standard interest rate swap like the typical amortizing swap a regional bank would currently trade with other banks, assuming such a swap could even be cleared. We, therefore, urge the CFTC to make allowance in the final rule such that the request for quote platform is functional with respect to interest rate swaps with unique amortization schedules and payment dates, and that the swap counterparties are able to evaluate and approve counterparty risk prior to trading in all instances where central clearing will not apply.

G. Real-Time Reporting

Benefits associated with real-time reporting of swap prices should be weighed against costs. The informational benefit of real-time reporting on standardized contracts within the active dealer and institutional community is clear, but the informational value of relatively small notional amount interest rate swaps with unique amortization schedules and payment dates is likely low coupled with high system costs. Bear in mind that middle-market borrowers generally negotiate the unique terms of their loan and interest rate swaps within a discrete group of regional banks and already consider interest rate swap pricing in the context of publicly available swap pricing information, as well as with the pricing of fixed rate notes, as an alternative form of finance.

H. Implementation

Although the CFTC recently described the emerging regulatory framework as a "substantially complete mosaic,"[4] considerable uncertainties remain regarding the details of the final rules that could greatly impact decisions relating to implementing the Dodd-Frank Act. Regional banks that currently have business resources appropriately gauged for conducting a prudently managed interest rate swap business must have regulatory certainty before they incur the substantial, ongoing costs of new systems and of additional compliance, legal and technology support personnel. Furthermore, implementing the new rules will logically entail a progression of actions that cannot proceed without an orderly development of market infrastructure. For example, the creation of SEFs and swap data repositories ("SDR") and the communication linkages to these new organizations is a fundamental requirement of implementing the rules. Many regional banks will, of necessity, require third party vendor services to be compliant. To

[4] See link http://www.cftc.gov/LawRegulation/FederalRegister/ProposedRules/2011-10884.html.

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avoid the risk of market disruption or illiquidity, we, therefore, request that the CFTC be circumspect in setting effective dates for implementation.

I. Documentation

The proposed documentation rules introduce substantial additional costs, particularly relating to a new annual audit requirement, that have no discernible benefit with respect to a regional bank that uses standard International Swaps and Derivatives Association ("ISDA") documentation for interest rate swaps with its commercial loan customers and bank trading partners. The expectation that a middle-market company and regional bank would need to agree upon a valuation model as a pre-requisite to trading is a substantial departure from current practice that would likely be unworkable. As for retrospectively changing existing documentation, uncertain and substantial costs are likely because of the time required to complete such an endeavor. With respect to bank client documentation, renegotiating aspects of an ISDA Master Agreement and Schedule might introduce meaningful uncertainties by incenting aggressive negotiation tactics by some parties unrelated to the regulatory objectives. We are particularly troubled by the proposed requirement that institutions incorporate an orderly liquidation termination provision into their institutional swap documentation. Agreeing to refrain from exercising standard contractual rights such as termination in the event the FDIC is appointed as receiver of a trading counterparty deemed systemically important under the new resolution authority created by the Dodd-Frank Act poses additional legal uncertainties.

J. General Concerns

We are concerned that the complexity associated with drafting reasonable and effective rules that would promote the realization of the objectives of the Dodd-Frank Act could also result in unintended consequences when applied to specific customized swaps, hedging uses, or market participants, such as we have summarized in this letter. Paramount to our concerns is the potential, depending on the final rules, that as we are impacted our commercial loan clients will ultimately bear higher hedging costs and administrative burdens, resulting in reduced risk management. Additional concerns arising from the implementation of the new regulatory framework that cannot be ruled out include the following: business interruption, an illegality leading to wholesale termination events under existing ISDA agreements, lack of market liquidity, and the potential for widespread operational errors.

From the perspective of a regional bank providing its middle-market borrowers with customized interest rate swaps to hedge their loan interest rate risk, it is difficult to conclude that the potential substantial costs associated with the Dodd-Frank Act provide an offsetting benefit to either the financial system, the regional bank itself, or its customers in terms of incremental risk reduction. Regional banks focused on lending rather than trading plainly do not raise the same concerns with respect to systemic risk as the dominant money center banks. Existing

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prudent risk management practice entails securing customer swap exposure with the same collateral securing the hedged customer loans and using bilateral collateral arrangements between banks with respect to any offsetting interest rate swaps.

As the CFTC deliberates in preparing final rules, we again request that the IDI exemption be broadened to include current practice of interest rate hedging associated with bank funding of loans to commercial clients and to other similar instruments such as variable rate demand notes that are supported by a bank through a letter of credit issued on behalf of its commercial client. Hedging using interest rate swaps transacted by the bank to hedge the resulting risk position arising from providing interest rate swaps to its clients should also be exempt for purposes of the "swap dealer" definition. We also request that implementation be phased with regard to market infrastructure and participant resource constraints to avoid market disruptions.

Sincerely,

D. Scott Warman
Treasurer and EVP
Manufacturers and Traders Trust Company

✓ cc: Ms. Jennifer J. Johnson, Secretary
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