2001 Pennsylvania Avenue NW
Suite 600 | Washington, DC 20006

T 202 466 5460
F 202 296 3184

Electronic Submission

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Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, D.C. 20551

Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, D.C. 20429

Legislative and Regulatory Affairs Division
Office of the Comptroller of the Currency
400 7th Street, SW
Suite 3E-218
Washington, D.C. 20219

Re: Standardized Approach for Calculating the Exposure Amount of Derivative Contracts[1]

The members of the Futures Industry Association ("**FIA**") who are active in physical commodities markets appreciate the opportunity to comment on the proposed rulemaking published by the Board of Governors of the Federal Reserve System (the "**Board**"), the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency (collectively, the "**Agencies**") to implement the standardized approach for counterparty credit risk ("**SA-CCR**") and related changes to the regulatory framework (the "**Proposal**").[2] This letter supplements the letter jointly submitted by FIA, the International Swaps and Derivatives Association, the Securities Industry and

[1] Docket No. R–1629 and RIN 7100–AF22; RIN 3064–AE80; Docket ID OCC–2018–0030.
[2] 83 Fed. Reg. 64,660 (Dec. 17, 2018).

Financial Markets Association, the American Bankers Association, and the Bank Policy Institute (together, the "**Trade Associations**"), also dated March 18, 2019 (the "**Trade Associations' Letter**") with additional relevant information on the Proposal's impact on commodities markets and firms that operate in those markets.

I. FIA and Its Commodities Members' Interest in the Proposal

FIA is the leading trade organization for the global futures, options and over-the-counter cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, D.C. FIA's membership includes clearing firms, exchanges, clearinghouses, and trading firms from more than 48 countries, as well as technology vendors, lawyers and other professionals serving the industry. FIA's mission is to support open, transparent and competitive markets, protect and enhance the integrity of the financial system and to promote high standards of professional conduct. Accordingly, FIA has been a leading voice on regulatory capital issues for the cleared derivatives industry.

FIA supports the Agencies' goal in the Proposal of improving risk-sensitivity in the measurement of derivatives counterparty credit risk. However, FIA is concerned that the Proposal could have a significant adverse impact on the liquidity of derivatives markets, including commodities markets. The Trade Associations recommended the following changes to SA-CCR, consistent with this concern, in the Trade Associations' Letter:

- Reconsider the supervisory factors for the commodity and equity asset classes set by the Basel Committee standards, and at a minimum recalibrate the supervisory factors for the commodities asset class so that they do not exceed the levels in the Basel Committee standards;

- Provide a more risk-sensitive treatment of initial margin for calculating RWA;

- Reconsider the application and calibration of the alpha factor;

- Avoid any disproportional impact on the cost of doing business for CEUs that may result from reduced hedging;

- Allow for netting of all transactions covered by a qualifying master netting agreement; and

- Ensure SA-CCR does not negatively impact client clearing.

FIA's members and their affiliates also include financial institutions, brokerage firms, and trading firms that are active in physical commodities markets, as well as commercial end users that rely on physical commodities, futures and over-the-counter derivatives to support their business activities (collectively, "**FIA's commodities members**"). FIA's commodities members are especially concerned about the Proposal's potential negative impacts on the physical commodities markets and corresponding effects on the related derivatives markets. This letter elaborates on the serious impacts identified in the Trade Associations' Letter that the Proposal could have on commodities markets and the broader economy. If adopted, the recommendations in this letter will enable the Agencies to meet their important policy objectives in the Proposal while preserving the integrity and vibrance of physical commodities and related derivatives markets.

II. Banking Organizations Provide Numerous Important and Unique Benefits for Commodities Markets and Commercial End Users

As an initial matter, it bears noting that banking organizations that will be subject to the Proposal provide myriad benefits to commodities markets, many of which may not be efficiently or adequately replicated by other market participants. It is imperative that the Agencies keep these benefits in mind as they consider appropriate capital standards.

Market Depth and Resilience. Banking organizations provide commercial end users with depth and breadth of scope in the type, size and tenor of derivatives in commodities markets, which has led to greater liquidity and a wider range of available hedging and risk management products. As a consequence, the markets are more resilient. The increased number and variety of counterparties reduce volatility and better position the markets to absorb and function in periods of stress, thereby mitigating systemic risk.

Intermediary, Market-Making and Principal Roles. Banking organizations perform unique functions as financial intermediaries that are unlikely to be replicated by other market participants. Banking organizations that participate in the physical commodities markets bring numerous buyers and sellers together, including many buyers and sellers that would not otherwise have an efficient means of contracting. For example, buyers and sellers often have mismatching needs concerning timing, location, product and transaction size. Often, buyers and sellers do not contract directly with each other, and banking organizations act as necessary intermediaries to bridge these gaps in needs.

Banking organizations provide both cash-settled and physically-settled alternatives for commercial end users, including custom-designed products that meet particular business needs. The services include structured finance arrangements, project finance and risk-mitigating commodity-linked swaps and other derivatives.

Banking organizations are also well-suited to serve as principal counterparties in commodities transactions with a diverse book of business that allow them to more readily absorb risk and act as counterparties to market participants who, in their absence, could struggle to find willing or suitable counterparties. Commercial end users rely on these services and products to provide essential financing for their daily business operations as well as their capital-intensive infrastructure, such as power plants and processing facilities. Banking organizations are ideal providers of these services due their unique ability to tailor these services and products to the specific needs of commercial end users and their familiarity with commercial end users' businesses from their focus on client services. Banking organizations are also able to offer the services and products on a larger scale than other market participants. These services are essential for ensuring a liquid and efficiently-priced market for the numerous commodities that are traded and hedged on a daily basis. Such efficiencies furnish critical support and reduce costs for commercial end users.

Of additional concern is that the number of banking organizations participating in these activities has steadily declined in recent years. Unnecessarily higher capital charges may result in more banking organizations electing to exit these commodity markets. If the impact of SA-CCR is to further disincentivize banking organizations to participate in these markets and thereby reduce liquidity, as well as increase the cost or limit the access commercial end users have to these services, the cost of capital for commercial end users will increase, the costs of securing access to physical commodities will increase, and as commercial end users pass these costs on to their consumers, the broader economy will suffer.

For these reasons, among others, banking organization are key contributors to the health and vitality of commodities markets. Any regulatory action that risks disincentivizing banking organizations from offering derivatives in the commodities markets will very likely limit options for market participants, especially commercial end users who have bespoke business needs, and thus hedging and risk management needs. Moreover, because banking organizations also often participate in exchange-traded and cleared derivative products in order to manage the risk they assume in over-the-counter derivative contracts with commercial end users, any action with an adverse impact on the liquidity of the over-the-counter commodity markets is bound to have a negative impact on the cleared products markets as well. The increased cost or loss of access to hedging could also curtail the production of new oil and gas reserves, as well as the development of new infrastructure, including the upgrade of power plants and the construction of renewable energy projects. Ultimately, increased costs for commercial end users in the over-the-counter and exchanged-traded and cleared derivatives markets will be passed on to retail consumers and the broader economy, with detrimental effects.

III. The Proposal Will Penalize Commercial End Users

The Proposal would have an unduly punitive impact on commercial end users, who rely on derivative contracts in the commodities markets to manage risks associated with their business operations. First, as discussed in more detail in Section IV below, SA-CCR results in high exposure amounts for un-margined derivative contracts. Yet, commercial end users are generally exempt under statute and regulations from mandatory margin requirements. This means that end users will face higher costs from the market when they seek to avail themselves of relief from burdensome margin requirements that Congress intended for these market participants.

Second, notwithstanding such exemptions, when banking organizations determine it is appropriate to collect some form of credit risk mitigation from a commercial end user, it is often market practice for the commercial end user to provide alternatives to initial and variation margin, such as a guarantee from an investment grade corporate entity, letters of credit from a highly rated financial institution, or pledges of liens on assets. SA-CCR, however, does not recognize such alternative forms of credit risk mitigation despite their prevalence in the commodities markets, thereby making it costlier for banking organizations to transact with end users.

Third, relative to derivatives counterparties in other asset classes, the SA-CCR calculation imposes extraordinarily high supervisory factors on commodity transactions in which many commercial end users concentrate. These supervisory factors do not appear to be specifically calibrated to the risks presented by the commodities asset classes. For example, while the supervisory factor for foreign exchange transactions is 4, gold and silver transactions are subject to a supervisory factor of 18 despite sharing attributes analogous to foreign exchange transactions. Even more concerning, the supervisory factor for power, oil and natural gas derivatives contracts is 40.[3]

SA-CCR's supervisory factors appear to have been driven by the observations of high volatility of the commodities in the spot market. However, SA-CCR does not accurately reflect or improve risk-sensitivity in the case of derivative contracts in the commodities markets. Applying a supervisory factor of 40 to energy derivative contracts, and even 18 to metals, agricultural and other commodities, fails to recognize that commodities, unlike other asset classes, are traditionally more volatile in the spot month than in the forward parts of the curve where pricing pressures are mitigated in the longer term by increased production, transportation, and other mitigants to supply constraints. This is particularly true in the case of electricity, which cannot be stored, but which can be readily transmitted from regions exhibiting less volatility to those

[3] 83 Fed. Reg. 64,675-76.

exhibiting more volatility in the near term and which can benefit from increased power plant output and production in the medium to longer term.[4]

FIA's commodities members fear that these factors, individually and in combination, will significantly constrain the ability of commercial end users to enter into physical commodities and related derivatives transactions, and in turn prevent end users from performing key risk-reducing and other business activities.

IV. SA-CCR Should Be Aligned with the Policy Goals Underlying the Commercial End User Exemptions from Mandatory Clearing and Margin Requirements

As proposed, SA-CCR would differentiate between margined and unmargined derivative contracts, imposing significantly higher exposure amounts for unmargined accounts. As a result, derivative contracts with commercial end users are penalized to the extent that the commercial end users are not required to post initial and variation margin. Banking organizations may seek to pass the costs of increased capital charges to commercial end users in additional fees or the pricing of the derivative contracts. Alternatively, to lessen the capital charges, banking organizations may require commercial end users to post cash margin going forward. This approach disregards the important policy goals established by Congress, the Agencies, and other regulators when granting commercial end users the exclusions and exemptions from mandatory clearing and margin requirements under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**").[5]

In the uncleared margin rulemaking, the prudential regulators, including the Agencies, the Securities and Exchange Commission (the "**SEC**") and the Commodity Futures Trading Commission ("**CFTC**"), specifically exempted commercial end users from margin requirements in recognition of the commercial end user exemption from mandatory clearing. In adopting the uncleared margin rule, the prudential regulators stated that:

> [u]nder the rule, a covered swap entity is not required to collect initial or variation margin with respect to any non-cleared swap

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[4] As recommended in the Trade Associations' Letter, FIA's commodities members urge the Agencies to revisit the supervisory factors set by the Basel Committee for the commodities asset class and recalibrate them to reflect the actual volatility of the commodity derivatives market, focusing on contracts with maturities greater than one year. If the Agencies cannot immediately recalibrate the commodity supervisory factors for U.S. implementation of SA-CCR, the Agencies should at a minimum ensure that the supervisory factors do not exceed the levels in the Basel Committee standards.

[5] See Sections 2(h)(7)(A) and 4s(e)(4) of the Commodity Exchange Act (7 U.S.C. 2(h)(7)(A) and 6s(e)(4)).

> or non-cleared security-based swap with a counterparty that is a nonfinancial end user but shall collect initial and variation margin at such times and in such forms and such amounts (if any) that the covered swap entity determines appropriately address the credit risk posed by the counterparty and the risks of such non-cleared swaps and non-cleared security-based swaps. In this respect, the Board intends for the requirements to be consistent with current market practice for such end users, with the understanding that in many cases little or no margin is, or will be, exchanged with these counterparties.[6]

In its adoption of the corresponding uncleared margin rule, the CFTC stated: "The Commission believes that [non-financial end users], which generally are using swaps to hedge commercial risk, pose less risk to [covered swap entities] than financial entities."[7] This is because commercial end users often establish directional portfolios with banking organizations that offset the opposite directional exposure the commercial end user has to the underlying commodity. For example, an oil producer anticipating future sales of the commodity typically enters into derivative contracts to hedge against the risk of falling prices. By contrast, an airline anticipating future purchases of jet fuel enters into derivative contracts to hedge against the risk of rising prices. The result is that the portfolio of derivative contracts between the banking organization and the commercial end user is primarily in one direction, whether long or short, which serves as the commercial end user's hedge of an underlying non-derivative directional exposure.

These directional exposures reflect "right-way risk." For example, a production and exploration company with oil reserves will hedge its underlying price risk by entering into a derivatives contract in which it is effectively selling the referenced commodity price. As the price of oil increases, the derivative contract is "out-of-the-money" for the company, and the banking organization's exposure to the company increases. At such time, however, as oil prices rise, the company will be more profitable as its revenues from the sale of oil increase and the value of its assets will be increasing; so the banking organization's exposure to the credit risk of the counterparty is increasing at the same time that the default risk of the counterparty is decreasing and as the counterparty's creditworthiness is strengthening. As the price of oil decreases, the derivative contract is "in-the-money" for the company, and so the banking organization has no exposure to the company under the contract at the time when the cash flow of

[6] *Margin and Capital Requirements for Covered Swap Entities*, 80 Fed. Reg. 74,840, at 74,897 (Nov. 30, 2015).

[7] *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 81 Fed. Reg. 635, at 647 (Jan. 6, 2016).

the counterparty might be negatively impacted by a decline in oil prices; yet in this case, the derivative contract is serving its purpose for the company by providing downside price protection. Consistent with the CFTC's statement above, commercial end users with directional portfolios that are hedging their underlying commercial risk generally pose less risk than other entities that may be trading a portfolio regardless of whether it involves a hedge of commercial risks. Under the Proposal, however, SA-CCR has the effect of penalizing the hedging activity by commercial end users because there frequently are few or no offsetting positions between the banking organization and the commercial end user.

If left as is, SA-CCR could significantly increase the costs to banking organizations for not collecting initial or variation margin where such margin otherwise is not mandated or current market practice allows for commercial end users to provide other forms of credit risk mitigation, such as letters of credit or liens on assets. As a result, banking organizations may require initial or variation margin in these instances, pass on the costs in the pricing of derivatives contracts, or even curtail the offering of such derivative contracts. In derogation of Congressional intent and prior agency determinations, SA-CCR will frustrate the policy-based exemptions if commercial end users are unable to access derivatives markets or the pricing of derivative contracts is increased as a result of their status as a commercial end user.

The potentially punitive impact the Proposal will have for commercial end users is further exacerbated by the broad scope of contracts subject to the rule. The Proposal would encompass not only financially settled derivatives such as swaps, but also physically settled forwards. Under the Agencies' existing regulatory capital rule, the term "derivative contract" means:

> a financial contract whose value is derived from the values of one or more underlying assets, reference rates, or indices of asset values or reference rates. Derivative contracts include interest rate derivative contracts, exchange rate derivative contracts, equity derivative contracts, commodity derivative contracts, credit derivative contracts, and any other instrument that poses similar counterparty credit risks. Derivative contracts also include unsettled securities, commodities, and foreign exchange transactions with a contractual settlement or delivery lag that is longer than the

> lesser of the market standard for the particular instrument or five business days.[8]

The Proposal further states that "derivative contracts represent agreements between parties either to make or receive payments or to buy or sell an underlying asset on a certain date (or dates) in the future."[9]

Yet, Congress explicitly excluded physically settled forward contracts from the definition of "Swaps" in Title VII when enacting the Dodd-Frank Act. Physically settled forward contracts are not subject to the mandatory clearing requirements and mandatory margin requirements under Title VII of the Dodd-Frank Act and the rules of the Agencies, SEC, and CFTC. The scope of the Proposal is thus incongruent with Congress's goals of protecting commercial end users in the treatment of physically settled forward contracts in the Dodd-Frank Act.

To align the Proposal with the protections afforded to commercial end users under the Dodd-Frank Act, FIA's commodities members recommend modifying the SA-CCR calculation to include a lower calibration for transactions with commercial end users. At a minimum, the Agencies should recalibrate the "alpha" multiplier included in the SA-CCR proposal (*i.e.*, the "alpha factor") and not apply it at all for transactions with commercial end users as discussed in the Trade Associations' Letter. This approach would create a 40% reduction in the calculation of the exposure amount. While it is not possible to calculate if these reductions are sufficient to correspond to the lost benefits of the uncleared margin exemptions, they may be sufficient to avoid the disincentive to banking organizations that the proposal would create for un-margined derivative contracts, and it would better align the calculations with the risk assessments that the regulators acknowledged are appropriate when the banking organizations are facing commercial end users.

V. The Agencies Should Align the Effective Date of Mandatory Implementation of SA-CCR with the Effective Dates of Related Revisions to the Regulatory Capital Framework

Question 2 of the Proposal seeks comment on whether the mandatory effective date of SA-CCR should be July 1, 2020, or another date.[10] FIA's commodities members recommend that the Agencies align the effective date of mandatory implementation of SA-CCR for advanced approaches banking organizations with related changes to the

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[8] 12 C.F.R. § 217.2.

[9] 83 Fed. Reg. at 64,663.

[10] *Id.* at 64,663.

regulatory capital framework that address similar policy objectives of SA-CCR. Specifically, while permitting banking organizations to adopt SA-CCR on an earlier date, the mandatory implementation of SA-CCR should be deferred to January 1, 2022.

The Basel Committee recently published a revised FRTB SA framework with the goal of an implementation date of January 1, 2022.[11] While different in design and calibration, both FRTB SA and SA-CCR are standardized approaches that would apply to the same derivatives transactions. Implementing both concurrently would eliminate the risk of confusing and unnecessary volatility in capital requirements in the 18-month period of staggered adoption between SA-CCR and FRTB SA.

As noted above, as part of the Basel Committee's revisions to the standardized counterparty credit risk framework, the risk-weight for investment grade counterparties is being reduced to 65 percent.[12] That revision is also scheduled to become effective on January 1, 2022. Requiring banking organizations to adopt SA-CCR with a risk-weight for investment grade corporate counterparties by July 1, 2020, only then to reduce such risk-weights in January 2022, risks unnecessary confusion and volatility in capital requirements during an 18-month period.

Additionally, it is not certain when and in what form SA-CCR will be adopted in other jurisdictions that participate in the Basel Committee process. If mandatory compliance with SA-CCR is required prior to its adoption in other jurisdictions, U.S.-based commercial end users may be susceptible to significant competitive disadvantages.

In light of these other U.S. regulations and international initiatives related to the capital framework for banking organizations, the mandatory implementation of SA-CCR should be deferred to January 1, 2022, while permitting advanced approaches banking organizations to adopt SA-CCR on an earlier date as in the case of non-advanced approaches banking organizations under the Proposal.

[11] Basel Committee, *Minimum capital requirements for market risk* (Jan. 2019).

[12] Revised Basel III, "Standardised approach for counterparty credit risk," ¶ 42.

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FIA's commodities members appreciate the opportunity to submit these supplemental comments on the Proposal. If the Agencies or staff have any questions regarding this submission, please contact me at 202.466.5460 or jmesa@fia.org.

Sincerely,

Jacqueline H. Mesa
COO and SVP, Global Advocacy