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February 15, 2019

VIA ELECTRONIC SUBMISSION

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

Mr. Robert E. Feldman
Executive Secretary
ATTN: Comments/RIN 3064-AE80
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429

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

Re: Comments on the Proposed Rule, *Standardized Approach for Calculating the Exposure Amount of Derivative Contracts* (RIN 1557–AE44; RIN 7100–AF22; RIN 3064–AE80)

To Whom It May Concern:

I. INTRODUCTION

On behalf of The Commercial Energy Working Group (the "**Working Group**"), Eversheds Sutherland (US) LLP submits this letter in response to the request for public comment set forth in The Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency's (together, the "**Banking Regulators**"), Proposed Rule, *Standardized Approach for Calculating the Exposure Amount of Derivative Contracts* (the "**Proposed Rule**").[1]

The Working Group is a diverse group of commercial firms in the energy industry whose primary business activity is the physical delivery of one or more energy commodities

[1] *See* Notice of Proposed Rulemaking, *Proposed Standardized Approach for Calculating the Exposure Amount of Derivative Contracts*, 83 Fed. Reg. 64,660 (Dec. 17, 2018), https://www.govinfo.gov/content/pkg/FR-2018-12-17/pdf/2018-24924.pdf (the "**Proposed Rule**").

to others, including industrial, commercial, and residential consumers. Members of the Working Group are producers, processors, merchandisers, and owners of energy commodities. Among the members of the Working Group are some of the largest users of energy derivatives in the United States and globally. The Working Group considers and responds to requests for comment regarding regulatory and legislative developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

II. COMMENTS OF THE WORKING GROUP

The Working Group appreciates the efforts of the Banking Regulators, through the Proposed Rule, to update their respective derivatives-related capital requirements for advanced approaches banking institutions (each an "**AA Bank**") to be more risk sensitive and to better account for common risk-reducing practices like netting and the posting of variation and initial margin. However, we believe that the Banking Regulators could do so in a manner that would have a materially lower adverse impact on the ability of non-financial end-users to hedge.

A. The Exposure Amounts Associated with Derivatives Between AA Banks and Non-Financial End-Users Should be Reduced

According to the Banking Regulators' own analysis, the Proposed Rule would increase exposure amounts for derivatives between AA Banks and non-financial end-users.[2] Specifically, the Proposed Rule would increase the exposure amount of unmargined derivatives for AA Banks by approximately 90%[3] and a material portion of derivatives transactions between AA Banks and non-financial end-users likely fall within this category. Such a large increase is unwarranted for derivatives between AA Banks and hedging non-financial end-users, and providing a lower exposure amount or capital requirement for such transactions is entirely consistent with the Banking Regulators' safety and soundness goals for the following reasons.

First, globally, transactions with non-financial end-users comprise only approximately 5% of outstanding derivatives by gross market value and 2% of outstanding derivatives by notional value, according to data reported by the Bank for International Settlements.[4] As such, transactions between non-financial end-users and AA Banks likely make up only a very small part of such banks' derivatives portfolios. Therefore, providing a modicum of capital relief with respect to those transactions would likely not undermine the goals and intent of the Proposed Rule.

Second, any capital relief provided to derivatives between AA Banks and non-financial end-users might be limited to transactions where the non-financial end-user counterparty is hedging or mitigating commercial risk, as such term is defined in the Commodity Exchange Act (the "**CEA**") and the related Commodity Futures Trading Commission (the "**CFTC**") regulations.[5] Generally, non-financial end-users' derivatives transactions that hedge or mitigate commercial risk pose less risk than non-hedging transactions because if the non-

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2 *See* Proposed Rule at 64,685.

3 *Id.*

4 Bank for International Settlements, OTC Derivatives Outstanding, All Instruments, Non-Financial Customers and Total (All Counterparties), All Countries, All Currencies, All Maturities, https://stats.bis.org/# (Last Accessed Feb. 11, 2019).

5 *See* Section 2(h)(7) of the CEA and CFTC Regulation 50.50(c).

financial end-user is required to payout under the hedge, they likely had a positive outcome with respect to the risk that they were hedging. The CFTC has recognized this risk-reducing characteristic of hedging in similar circumstances. Specifically, the CFTC's rule requires less initial margin to be posted with respect to hedge positions than compared to non-hedge positions with respect to cleared derivatives.[6] As such, given the less risky nature of derivatives entered into by non-financial end-users to hedge or mitigate commercial risk, the Banking Regulators should amend the Proposed Rule to provide a degree of capital relief with respect to such transactions.

Third, while non-financial end-users may not always post cash initial or variation margin, they almost always post another form of high quality credit support. For example, AA Banks almost always require other credit support, such as parental guarantees, letters of credit, or liens on assets when non-financial end-users do not post cash collateral on uncleared derivatives. The AA Banks clearly see value in those types of credit support and the Proposed Rule should be amended to provide a degree of regulatory capital relief when those forms of collateral are present.

B. The Treatment of Derivatives Between AA Banks and Non-Financial End-Users Under the Proposed Rule is Contrary to Congressional Intent

The Proposed Rule should be considered in the context of Title VII of the Dodd-Frank Act, which, among other things, imposed capital and margin requirements on swap dealers.[7] The drafters of the Dodd-Frank Act took particular care to ensure that regulators implementing these and other requirements "carefully follow Congressional intent"[8] and not impose capital requirements that were "punitive to end-users"[9] and "not punish those who are trying to hedge their own commercial risk."[10]

While the Proposed Rule would not be imposed directly on non-financial end-users, it would have a material impact on their ability to hedge commercial risk as the Proposed Rule is likely to, by its own admission, increase the cost of hedging for non-financial end-users.[11] Said another way, the Proposed Rule's increase in exposure amounts as applied to non-financial end-users' unmargined hedging transactions will either result in significantly higher hedging costs for such end-users or cause them to post cash collateral, which will be a material drain on their working capital, which could be put to a more productive use. This was understood by the drafters of the Dodd-Frank Act and is seen in their directive to regulators: properly balance the cost of margin and capital requirements on derivatives with the economic impact on the ability of non-financial end-users to use derivatives to reduce and

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6 *See* CFTC Final Rule, *Derivatives Clearing Organization General Provisions and Core Principles*, 76 Fed. Reg. 68,334, 69,377 (Nov. 8, 2011), https://www.govinfo.gov/content/pkg/FR-2011-11-08/pdf/2011-27536.pdf#page=45.

7 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 731, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

8 *See* Letter from Senate Committee on Banking, Housing, and Urban Affairs Chairman Christopher Dodd and Senate Committee on Agriculture, Nutrition, and Forestry Chairman Blanche Lincoln to House Financial Services Committee Chairman Barney Frank and House Committee on Agriculture Chairman Colin Peterson (June 30, 2010), https://archives-agriculture.house.gov/sites/republicans.agriculture.house.gov/files/pdf/letters/DoddLincolnEndUserLetter.pdf (the "**Dodd-Lincoln Letter**").

9 *Id.*

10 *Id.*

11 *See* Proposed Rule at 64,685.

hedge commercial risk. The Proposed Rule does not reflect that Congressional intent and should be amended to do so, including by not imposing capital requirements that frustrate the ability of non-financial end-users to utilize credit support, such as parental guarantees, letters of credit, or liens on assets.

C. The Supervisory Factor for Energy Derivatives Should be Amended

The Proposed Rule would impose unnecessarily punitive capital requirements on all energy derivatives because of the inherent volatility of electricity markets. Specifically, the Proposed Rule would impose a supervisory factor of 40% on any energy derivative, regardless of the underlying commodity.[12] However, the Basel Committee on Banking Supervision's standardized approach for measuring counterparty credit risk exposures,[13] upon which the Proposed Rule is based, uses a more granular and appropriately risk-calibrated approach to energy-related supervisory factors. Specifically, the Basel Approach assigns a 40% supervisory factor to electricity derivatives while all other energy derivatives have a supervisory factor of only 18%.[14]

III. CONCLUSION

The Working Group appreciates this opportunity to provide input on the Proposed Rule and respectfully requests that the comments set forth herein are considered.

If you have any questions, please contact the undersigned.

Respectfully submitted,
/s/Alexander S. Holtan
Alexander S. Holtan

Counsel to The Commercial Energy Working Group

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12 *Id.* at 64,675.

13 *See* Basel Committee on Banking Supervision, *The standardized approach for measuring counterparty credit risk exposures* (Apr. 2014), https://www.bis.org/publ/bcbs279.pdf (the "**Basel Approach**").

14 *See* the Basel Approach at 23.