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**FINAL**

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Re: Supplemental Comments of the IECA on **Standardized Approach for Calculating the Exposure Amounts of Derivative Contracts**, as proposed by:  
DEPARTMENT OF TREASURY, Office of the Comptroller of the Currency, 12 CFR Parts 3 and 32, Docket ID OCC-2018-0030, RIN 1557-AE44;  
FEDERAL RESERVE SYSTEM, 12 CFR Part 217, Docket R-1629, RIN 7100-AF22; and  
FEDERAL DEPOSIT INSURANCE CORPORATION, 12 CFR Part 324, RIN 3064-AE80

Dear Ms. Misback, Mr. Feldman and the Comptroller of the Currency:

On March 18, 2019, the International Energy Credit Association (“**IECA**”) submitted its initial comments (“**March 18 Comments**”) to the Board of Governors of the Federal Reserve System (“**Board**”), the Federal Deposit Insurance Corporation (“**FDIC**”), and the Office of the Comptroller of the Currency (“**OCC**,” collectively with the Board and the FDIC, the “**Agencies**”) regarding the Agencies’ notice of proposed

rulemaking entitled *Standardized Approach for Calculating the Exposure Amount of Derivative Contracts*, 83 Fed. Reg. 64660, published on December 17, 2018 (“**NOPR**”).<sup>1</sup>

The IECA respectfully submits this comment letter (“**Supplemental Comments**”), as a supplement to its March 18 Comments, in order to provide additional comments to the Agencies in light of the issuance of the related EU CCR Regulation (discussed further below) on May 20, 2019, two months after the IECA submitted its March 18 Comments. In particular, the IECA respectfully requests that the Agencies reconsider their proposed implementation of the “standardized approach for counterparty credit risk (“**SA-CCR**”), as set forth in the NOPR, and make certain modifications as set forth in the IECA’s March 18 Comments and in these Supplemental Comments, including, among other things, the following with respect to the proposed “supervisory factor” of 40% for energy commodity derivative contracts:

Reduce the supervisory factor of 40% for energy commodity derivatives contracts to 10%, which is in line with Basel Committee recognition of the inherent risk differences between different energy asset classes and variations based on maturity and volatility. This will provide a supervisory factor that is much more representative of a banking organization’s counterparty credit risk exposure for uncleared and unmargined derivative contracts with commercial end-user and hedging affiliate counterparties in the energy industry, as more fully-described below.

#### **I. The Agencies’ NOPR and the IECA’s March 18 Comments.**

As more fully explained in the NOPR, the Agencies’ proposed implementation of **SA-CCR** would replace the current exposure methodology (“**CEM**”) as an additional methodology for calculating advanced approaches total risk-weighted assets under the [Agencies’ regulatory] capital rule.”<sup>2</sup> As proposed, the NOPR would “require an advanced approaches banking organization to use SA-CCR with some adjustments to determine the exposure amount of derivative contracts for calculating total leverage exposure (the denominator of the supplementary leverage ratio).”<sup>3</sup>

In short, the Agencies proposed in this NOPR to update their standards for how banking organizations measure counterparty credit risk posed by derivative contracts under the Agencies’ regulatory capital rules (“**Capital Rules**”),<sup>4</sup> which Capital Rules require a banking organization to hold regulatory capital based on the exposure amount of its derivative contracts calculated using the SA-CCR method.

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<sup>1</sup> The deadline for submitting comments on this NOPR was extended by the Agencies from February 15, 2019, to March 18, 2019 (see 84 Fed. Reg. 6107, published on February 26, 2019).

<sup>2</sup> See NOPR, 83 Fed. Reg. 64660, at 64660.

<sup>3</sup> See NOPR, 83 Fed. Reg. 64660, at 64660.

<sup>4</sup> See 12 CFR Part 3 (OCC); 12 CFR Part 217 (Board); and 12 CFR Part 324 (FDIC).

In its initial comments, the IECA acknowledged and applauded the Agencies' proposed implementation of SA-CCR for appropriately recognizing, in calculating a bank's exposure to counterparty credit risk, the reduction to such a bank's exposure to counterparty credit risk arising from the cash collateral posted by a bank's counterparties to derivative contracts subject to initial and variation margin requirements. The IECA also recognized and appreciated the appropriateness of allowing netting under the Agencies' proposed implementation of SA-CCR as a further recognition of the risk reducing nature of a bank's offsetting obligations under various netting sets of derivative contracts.

The IECA objected, however, to the Agencies' failure to recognize the risk-reducing nature of other bona fide forms of credit support typically provided by a bank's commercial end-user and hedging affiliate (collectively "CEU-HA") counterparties to derivative contracts involving energy commodities that have been given an explicit exemption by Congress and various regulators from the otherwise mandatory initial and variation margin requirements for uncleared over-the-counter swap transactions. Such alternative forms of credit support produce a no less bona fide reduction of a bank's exposure to counterparty credit risk.

Many CEU-HA counterparties entering into energy commodity derivative contracts with a bank to hedge their exposure to commercial risk, which transactions are therefore exempt from otherwise mandatory clearing and margining requirements, have earned an investment grade ("IG") rating from one or more recognized credit rating agencies. Many times, their direct or indirect parent entities, which are IG-rated, will provide a guaranty of each such CEU-HA counterparty's obligations. In certain situations, an unrated CEU-HA counterparty will be treated by a bank as if it were given an IG-rating by passing a substantial net worth test. In addition, in nearly every energy commodity derivative contract with a bank that is used to hedge a CEU-HA counterparty's exposure to commercial risk, the bank insists on and the CEU-HA counterparty agrees to provide adequate assurance of performance to the bank if the CEU-HA or its guarantor loses its IG-rating or the CEU-HA counterparty's net worth falls below a substantial level.

Typically, a CEU-HA counterparty lacking an IG-rating (or failing a substantial net worth test) for itself or its guarantor will be required to provide adequate assurance of its performance to a bank in the form of: (i) a replacement guaranty from another IG-rated entity, (ii) a letter of credit from a creditworthy commercial bank, (iii) a first-lien on "right way risk" assets (i.e., assets that increase in value in direct proportion to the increase in the amount owed to a bank, when the bank's position is "in the money" (and the CEU-HA counterparty's position is "out of the money") and the bank is exposed to the credit risk of its CEU-HA counterparty defaulting on a payment obligation), or (iv) a cash deposit.

Accordingly, in its March 18 Comments, the IECA urged the Agencies to modify their proposed implementation of SA-CCR to recognize the genuine counterparty credit

risk-reducing nature for energy commodity derivative contracts of: (i) letters of credit issued by creditworthy entities, (ii) first-liens on a counterparty's "right-way-risk" assets, (iii) a CEU-HA counterparty or its guarantor that is IG-rated by a recognized credit rating agency, and (iv) cash deposits posted by a CEU-HA counterparty that is exempt from mandatory clearing and margining requirements.

As an alternative, the IECA proposed in its March 18 Comments that uncleared and unmargined swaps with a banking organization entered into by a CEU-HA counterparty pursuant to the End-User Exception<sup>5</sup> or the Hedging Affiliate Exception<sup>6</sup> to mandatory clearing and mandatory margining under the Commodity Exchange Act ("CEA"), as modified by the Dodd-Frank Act,<sup>7</sup> be granted an exemption from application of the capital add-ons under the Agencies' proposed SA-CCR rule, so that Advanced Approaches Banking Organizations will be exempt from any obligation to set aside additional capital for any derivative contracts involving uncleared and unmargined swaps entered into with a CEU-HA counterparty that has elected the End-User Exception or the Hedging Affiliate Exception.

The IECA also objected to the Agencies' proposed imposition of high "supervisory factors" on derivative contracts involving commodities and particularly the Agencies imposing their highest supervisory factor of "40%" on derivative contracts involving "energy commodities," including oil, natural gas and electricity. These high "supervisory factors" have the effect of adding-on to (i.e., increasing) a bank's otherwise applicable determination of its exposure to counterparty credit risk for derivatives contracts by an additional 40% if such derivative contracts involve energy commodities.

The IECA objected in its March 18 Comments that imposing an add-on of 40% as a supervisory factor for energy commodity derivative contracts has not been quantitatively shown to be justified by any evidence that banks face a higher exposure to counterparty credit risk for energy commodity derivative contracts with CEU-HA counterparties.

Not only is the 40% add-on unsupported by quantitative assessment of any counterparty credit risk, the proposed imposition of a 40% capital add-on for energy commodity derivative contracts will unnecessarily increase the costs of hedging for end-users that rely on energy commodity derivative contracts with bank counterparties. Increasing the costs of hedging will produce adverse impacts on U.S. end-users that rely on such energy commodity derivative contract to hedge their exposures to commercial risk.

Such adverse impacts would include a decline in the financial health of these entities, as financial hedging is a vital component to the health of such U.S. energy commodity derivative contracts end-users. The barrier to credit resulting from the

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<sup>5</sup> See CEA Section 2(h)(7)(A).

<sup>6</sup> See CEA Section 2(h)(7)(D).

<sup>7</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")

Agencies' proposed supervisory factor of 40% would occur due to the enlarged credit risk score, the impossibility of such end-users to post margin, and the invalidation of their current alternate credit support methods, which would lead to a full inability of such end-users to hedge their commercial risks with financial institutions. This inability to hedge would lead to liquidity concerns, reduce the ability to do business due to insecurity of commodity prices, and ultimately undermine the capital budget of many U.S. end-user businesses.

## **II. The EU CCR Regulation.**

On May 20, 2019, two months after the IECA submitted its March 18 Comments, the European Union (“EU”) issued its “Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019” (“**EU CCR Regulation**”).<sup>8</sup> In its EU CCR Regulation, the EU implemented its version of SA-CCR by “amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements, and Regulation (EU) No 648/2012” (emphasis added).

### **A. The EU CCR Regulation Applies a Supervisory Factor of 40% for Electricity Commodity Derivatives that Appears to be Comparable to the Supervisory Factor of 40% for Energy Commodity Derivatives Proposed by the Agencies in their NOPR.**

In Paragraph 38 of the Preamble to the EU CCR Regulation, the EU financial regulators explained that:<sup>9</sup>

“(38) During the financial crisis, trading book losses for some institutions established in the Union were substantial. For some of them, the level of capital required against those losses proved insufficient, leading them to seek extraordinary public financial support. Those observations led the BCBS to remove a number of weaknesses in the prudential treatment of trading book positions which are the own funds requirements for market risk.”

In Paragraph 43 of the Preamble to the EU CCR Regulation, the EU financial regulators explained further that:<sup>10</sup>

“(43) The large exposures framework should be strengthened to improve the ability of institutions to absorb losses and to better comply with international standards. To that end, a higher quality of capital should be used as a capital base

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<sup>8</sup> See *Official Journal of the European Union*, L150/1 (published 7.6.2019) (“**EU CCR Regulation**”).

<sup>9</sup> See EU CCR Regulation at page L150/6.

<sup>10</sup> See EU CCR Regulation at page L150/7.

for the calculation of the large exposures limit and exposures to credit derivatives should be calculated in accordance with SA-CCR.”

In Article 274 of the EU CCR Regulation, the EU implemented its version of SA-CCR and stated that:<sup>11</sup>

“2. Institutions shall calculate the exposure value of a netting set under the standardized approach for counterparty credit risk as follows:

$$\text{Exposure value} = \alpha \times (\text{RC} + \text{PFE})$$

Where:

RC = the replacement costs calculated in accordance with Article 275; and

PFE = the potential future exposure calculated in accordance with Article 278;

$\alpha = 1.4$ .”

In Article 277 of the EU CCR Regulation, the EU explains the calculation of the PFE applicable to a netting set as follows:<sup>12</sup>

“1. Institutions shall map each transaction of a netting set to one of the following risk categories to determine the potential future exposure of the netting set referred to in Article 278:

(a) interest rate risk;

...

(e) commodity risk;

(f) other risks.”

Article 278 of the EU CCR Regulation stipulates that the potential future exposure (“PFE”) of a netting set will be calculated on the basis of a multiplier and an “AddOn,” which AddOn will be “the add-on for the risk category “a” calculated in accordance with Articles 280a to 280f, as applicable.”<sup>13</sup>

Article 279 of the EU CCR Regulation then provides a formula for calculating the “risk category add-ons” as follows:<sup>14</sup>

“For the purpose of calculating the risk category add-ons referred to in Articles 280a to 280f, institutions shall calculate the risk position of each transaction of a netting set as follows:

$$\text{RiskPosition} = \delta \times \text{AdjNot} \times \text{MF}$$

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<sup>11</sup> See EU CCR Regulation at page L150/63.

<sup>12</sup> See EU CCR Regulation at page L150/65.

<sup>13</sup> See EU CCR Regulation at page L150/67.

<sup>14</sup> See EU CCR Regulation at page L150/68.

Where:

$\delta$  = the supervisory delta of the transaction calculated in accordance with the formula laid down in Article 279a;

AdjNot = the adjusted notional amount of the transaction calculated in accordance with Article 279b; and

MF = the maturity factor of the transaction calculated in accordance with the formula laid down in Article 279c.”

This supervisory delta,  $\delta$ , is then to be calculated on a transaction-by-transaction basis for “call and put options that entitle the option buyer to purchase or sell an underlying instrument at a positive price on a single [date] or multiple dates in the future” based on a formula that relies on a “supervisory volatility” factor called “ $\sigma$ ,” which is described as follows:

“ $\sigma$  = the supervisory volatility of the option determined in accordance with Table 1 on the basis of the category of the transaction and the nature of the underlying instrument of the option.”

Table 1 then specifies “supervisory volatilities” for various “risk categories” including the following:<sup>15</sup>

“Commodity	Electricity	150%”
“Commodity	Other commodities (excluding electricity)	70%”

Article 280e of the EU CCR Regulation then obligates institutions to calculate the “commodity risk category add-on for a given netting set” as the sum of the “commodity risk category add-on for [each] hedging set “j” calculated in accordance with paragraph 4.”<sup>16</sup> Said paragraph 4 directs institutions to “calculate the commodity risk category add-on for hedging set j” based on “the add-on for the commodity reference type k calculated in accordance with paragraph 5.”

Paragraph 5 of Article 280e then directs institutions to “calculate the add-on for the commodity reference type k” using a formula that multiplies the “supervisory factor applicable to the commodity reference k” by the “effective notional amount of the commodity reference type k.”<sup>17</sup>

Finally, paragraph 5 of Article 280e stipulates the value of “ $SF_k$ ” (i.e., “the supervisory factor applicable to the commodity reference type k”) and states:

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<sup>15</sup> See EU CCR Regulation at page L150/69.

<sup>16</sup> See EU CCR Regulation at page L150/78.

<sup>17</sup> Id.

“where the commodity reference type k corresponds to transactions allocated to the hedging set referred on in point (e)(i) of Article 277a(1) [i.e., “transactions mapped to the commodity risk category shall be assigned to one of the following hedging sets on the basis of their primary risk driver or the most material risk driver in the given risk category,” which for category (e)(i) is “energy”], excluding transactions concerning electricity,  $SF_k = 18\%$ ; for transactions concerning electricity,  $SF_k = 40\%$ .” (Emphasis added.)<sup>18</sup>

**To sum up the foregoing, the EU-CCR Regulation adopts a supervisory factor for purposes of using SA-CCR to calculate the additional risk to be added-on to the potential future exposure portion of an institution’s counterparty credit risk arising from commodity derivatives. For commodity derivatives involving energy, excluding transactions concerning electricity, the credit risk add-on is calculated using a supervisory factor of 18%, and for those commodity derivatives transactions concerning electricity, the credit risk add-on is calculated using a supervisory factor of 40%, the highest supervisory factor applied by the EU CCR Regulation to any risk category, which is in turn based on a “supervisory volatility” for electricity of 150%.**

Similarly, Section 5 of the EU CCR Regulation describes the EU’s revised version of the “Original exposure method” (“OEM”) to be used for calculating the counterparty credit risk from derivative contracts of “institutions which have limited derivatives exposure and which currently use the MtMM [i.e., the Mark-to-Market Method] or the OEM.”<sup>19</sup> Paragraph 4(b) of said Section 5 of the EU-CCR Regulation includes the following requirement:<sup>20</sup>

“4. Institutions shall calculate the potential future exposure referred to in paragraph 2 as follows:  
(a) the potential future exposure of a netting set is equal to the sum of the potential future exposure of all the transactions included in the netting set, calculated in accordance with point (b);  
(b) the potential future exposure of a single transaction is its notional amount multiplied by: ... (iv) 18% for gold and commodity derivatives other than electricity derivatives; (v) 40% for electricity derivatives; ...” (Emphasis added.)

In sum, for both SA-CCR and OEM counterparty credit risk calculations, the EU CCR Regulation applies an 18% add-on to the Potential Future Exposure portion of the calculation of a bank’s exposure to counterparty credit risk for derivative contracts involving commodity derivatives other than electricity derivatives and a 40% add-on for commodity derivatives contracts involving electricity derivatives.

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<sup>18</sup> Id.

<sup>19</sup> See EU CCR Regulation at pages L150/6.

<sup>20</sup> See EU CCR Regulation at page L150/82.



**B. But The EU CCR Regulation Fails to Provide any Quantifiable Evidence Demonstrating that a Corresponding Increase in a Bank’s Counterparty Credit Risk Justifies such a High Supervisory Factor of 40% for Electricity Commodity Derivatives.**

While the EU CCR Regulation adopts its largest “supervisory factor” of 40% for purposes of calculating a credit risk add-on applicable to an institution’s counterparty credit risk arising from “commodity derivatives concerning electricity,” the EU CCR Regulation offers little or no support for imposing such a large supervisory factor on electricity commodity derivatives.

In Paragraphs (34), (35) and (36) of the preamble to the EU CCR Regulation, the other methods of calculating counterparty credit risk, namely MTMM, OEM and Standardized Method (“SM”), are identified and the following conclusions are stated:

(34) Those standardised approaches however do not recognise appropriately the risk-reducing nature of collateral in the exposures. Their calibrations are outdated and they do not reflect the high level of volatility observed during the financial crisis. Neither do they recognise appropriately netting benefits. To address those shortcomings, the BCBS decided to replace the SM and the MtMM with a new standardised approach for computing the exposure value of derivative exposures, the so-called Standardised Approach for Counterparty Credit Risk (SA-CCR). Given that the revised international standards introduced a new standardised approach that is better suited to the central clearing environment, Union law should be amended to incorporate those standards.

(35) The SA-CCR is more risk sensitive than the SM and the MtMM and should therefore lead to own funds requirements that better reflect the risks related to institutions' derivative transactions. At the same time, for some of the institutions which currently use the MtMM, the SA-CCR may prove to be too complex and burdensome to implement. For institutions that meet predefined eligibility criteria, and for institutions that are part of a group which meets those criteria on a consolidated basis, a simplified version of the SA-CCR (the ‘simplified SA-CCR’) should be introduced. Since such a simplified version will be less risk sensitive than the SA- CCR, it should be appropriately calibrated in order to ensure that it does not underestimate the exposure value of derivative transactions.

(36) For institutions which have limited derivative exposures and which currently use the MtMM or the OEM, both the SA-CCR and the simplified SA-CCR could be too complex to implement. The OEM should therefore be reserved as an alternative approach for those institutions that meet predefined eligibility criteria, and for institutions that are part of a group which meets those criteria on a

consolidated basis, but should be revised in order to address its major shortcomings.” (Emphasis added.)<sup>21</sup>

Unfortunately, this statement (which is highlighted in the above-quoted preamble text) “[t]heir calibrations are outdated and they do not reflect the high level of volatility observed during the financial crisis” is the totality of the quantitative justification provided in the EU CCR Regulation for assigning a supervisory volatility of 150% and imposing a supervisory factor add-on to an institution’s counterparty credit risk for each electricity commodity derivative of 40%, which is higher than any other supervisory factor add-on applied to any risk category in the EU CCR Regulation.

**C. The EU CCR Regulation Acknowledges that: (i) “Derivative Transactions could be Unduly and Disproportionately Impacted by the Introduction of the NSFR Developed by BCBS Without Having Been Subject to Extensive Quantitative Impact Studies” and (ii) the Need for Amendments to “Avoid Unintended Consequences such as Hindering the Good Functioning of the European Financial Markets and the Provision of Risk Hedging Tools to Institutions and End-Users.”**

The EU CCR Regulation uses the calculation of counterparty credit risk exposure from derivative contracts, as described above in Section II.(A) and(B) of these Supplemental Comments, to establish a banking institution’s “net stable funding ratio” (“NSFR”) requirement over a one year horizon as explained in Paragraph 45 of the preamble to the EU CCR Regulation, which says:

“(45) Consistent with the BCBSs [sic] stable funding standard, rules should, therefore, be adopted to define the stable funding requirement as a ratio of an institution's amount of available stable funding to its amount of required stable funding over a one-year horizon. That binding requirement should be called the net stable funding ratio (NSFR) requirement. The amount of available stable funding should be calculated by multiplying the institution's liabilities and own funds by appropriate factors that reflect their degree of reliability over the one-year horizon of the NSFR. The amount of required stable funding should be calculated by multiplying the institution's assets and off-balance-sheet exposures by appropriate factors that reflect their liquidity characteristics and residual maturities over the one-year horizon of the NSFR.”

In establishing its NSFR requirement for banking institutions, however, Paragraphs 47 and 48 of the preamble to the EU CCR Regulation recognize and acknowledge that:<sup>22</sup>

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<sup>21</sup> See EU CCR Regulation at pages L150/6.

<sup>22</sup> See EU CCR Regulation at pages L150/8.

(47) ... the rules for calculating the NSFR should be closely aligned with the BCBSs [sic] standards, including developments in those standards regarding the treatment of derivative transactions. The necessity to take into account some European specificities to ensure that the NSFR requirement does not hinder the financing of the European real economy, however, justifies adopting some adjustments to the NSFR developed by the BCBS for the definition of the European NSFR requirement. ...

(48) Beyond European specificities, the treatment of derivative transactions in the NSFR developed by the BCBS could have an important impact on institutions' derivative activities and, consequently, on European financial markets and on the access to some operations for end-users. Derivative transactions and some interlinked transactions, including clearing activities, could be unduly and disproportionately impacted by the introduction of the NSFR developed by BCBS without having been subject to extensive quantitative impact studies and public consultation. The additional requirement to hold between 5 % and 20 % of stable funding against gross derivative liabilities is very widely seen as a rough measure to capture additional funding risks related to the potential increase of derivative liabilities over a one-year horizon and is under review at BCBS level. That requirement, introduced at a level of 5 % in line with the discretion left to jurisdictions by the BCBS to reduce the required stable funding factor on gross derivative liabilities, could then be amended to take into account developments at the BCBS level and to avoid possible unintended consequences such as hindering the good functioning of the European financial markets and the provision of risk hedging tools to institutions and end-users, including corporates, to ensure their financing as an objective of the capital markets union.” (Emphasis added.)

As noted above, Paragraph 48 of the Preamble to the EU CCR Regulation explicitly recognizes that the “additional requirement to hold between 5% and 20% of stable funding against gross derivative liabilities,” including the impact of the add-ons imposed by the application of a supervisory factor of 40% for electricity commodity derivatives, is “very widely seen as a rough measure to capture the additional funding risks related to the potential increase of derivative liabilities over a one-year horizon.”

Paragraph 48 also acknowledges that “Derivative transactions and some interlinked transactions, including clearing activities, could be unduly and disproportionately impacted by the introduction of the NSFR developed by BCBS without having been subject to extensive quantitative impact studies and public consultation.” It appears to us that the **EU Regulators are warning European end-users, who use derivative transaction to hedge their exposure to commercial risks, to watch for unintended adverse consequences, because the Basel Committee developed the NSFR and these supervisory factors, which may “unduly and disproportionately impact” derivative transactions, “without having [subjected such**

**supervisory factors] to extensive quantitative impact studies and public consultation.”**

Finally, Paragraph 48 concludes with the recognition that some amendments may be required to “avoid possible unintended consequences such as hindering the good functioning of the European financial markets and the provision of risk hedging tools to institutions and end-users, including corporates.”

### **III. The Agencies’ NOPR Similarly Fails to Provide any Quantitative Impact Study Demonstrating that a Supervisory Factor of 40% for Energy Commodity Derivatives is Justified; Nor does the NOPR Provide any Evidence Demonstrating that the Capital Add-On Imposed by a Supervisory Factor of 40% for Energy Commodity Derivatives is Indicative of a Bank’s Counterparty Credit Risk Arising from Entering into Energy Commodity Derivatives Contracts with CEU-HA Counterparties.**

Table 2, Supervisory Option Volatility and Supervisory Factors for Derivative Contracts, set forth in the Agencies’ NOPR,<sup>23</sup> specifies for the Asset Class of “Commodity” and the “Subclass” of “Energy” a Supervisory Option Volatility of 150% and a Supervisory Factor of 40%.

As noted above, the EU CCR Regulation explicitly recognized in Table 1 a “supervisory volatility” of 150% for “electricity” as a subclass of the “Commodity” risk category<sup>24</sup> and a “supervisory factor” of 40% for “electricity derivatives” and 18% for “commodity derivatives other than electricity derivatives.”<sup>25</sup>

Similar to the EU CCR Regulation, the Agencies’ NOPR specifies that the Agencies have simply relied on the Basel Committee standard in setting the Supervisory Factors contained in the NOPR. Therein, the Agencies’ sole quantitative statement given in support of imposing a supervisory factor of 40% for energy commodity derivative contracts is the following:

“b. Supervisory Factor  
Table 2 to §\_\_.132 of the proposed rule provides the proposed supervisory factors. The agencies are proposing to use the same supervisory factors provided in the Basel Committee standard, with the exception of the supervisory factors for credit derivative contracts...”

The IECA submits that the application of such a high Supervisory Factor of 40% for electricity commodity derivatives by the EU in its EU CCR Regulation or such a high Supervisory Factor of 40% for all “Energy Commodity Derivative Contracts” in the

<sup>23</sup> See NOPR, 83 Fed. Reg. at 64675.

<sup>24</sup> See EU CCR Regulation, at L150/69.

<sup>25</sup> See EU CCR Regulation, at L150/78 and L150/82.

Agencies' NOPR without (i) any quantitative impact study or similar evidence of an increase in a bank's counterparty credit risk or (ii) any cost-benefit analysis studying the potential unintended and adverse consequences of hindering the functioning of the US financial markets and hindering the availability of risk hedging tools to end-users versus any quantifiable benefit from such a high supervisory factor is woefully inadequate and cannot be supported as reasoned decision making by the Agencies.

**IV. The Agencies' NOPR Also Fails to Provide any Evidence Demonstrating that the Capital Add-On Imposed by a Supervisory Factor of 40% for Energy Commodity Derivatives is Indicative of a Bank's Counterparty Credit Risk Arising from Entering into Energy Commodity Derivatives Contracts with CEU-HA Counterparties.**

The IECA submits that rather than confirming or affirming the Agencies' proposed imposition of a "supervisory factor" of 40% for energy commodity derivatives, Paragraph 48 of the Preamble to the EU CCR Regulation should be viewed realistically by the Agencies as:

(A) an explicit acknowledgement by the EU regulators that: (i) imposition of the capital add-ons required by such a supervisory factor of 40% by BCBS<sup>26</sup> has not been subject to "extensive quantitative impact studies and public consultation," and (ii) "derivative transactions ... are unduly and disproportionately impacted;" and

(B) a warning to the Agencies by the EU regulators that amendments may be required "to take into account [further] developments at the BCBS level" and "to avoid possible unintended consequences such as hindering the good functioning of the European [and U.S.] financial markets and the provision of risk hedging tools to institutions and end-users."

The Agencies have already come close to acknowledging these facts in the NOPR, when the Agencies said:<sup>27</sup>

"With respect to asset classes, the exposure amount would increase for interest rate derivative contracts, equity derivative contracts, and commodity derivative contracts, while the exposure amount would decrease for exchange rate derivative contracts and credit derivative contracts. These changes are largely due to the updated supervisory factors, which reflect stress volatilities observed during the financial crisis. With respect to counterparties, the exposure amount would decrease for derivative contracts with banks, broker-dealers, and CCPs, which are

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<sup>26</sup> Basel Committee on Banking Supervision, sometimes referred to herein as the "Basel Committee."

<sup>27</sup> See NOPR, 83 Fed. Reg. 64660 at 64685.

typically margined, hedged, and subject to QMNAs. In contrast, exposure amounts would increase for derivative contracts with other financial institutions, such as asset managers, investment funds, and pension funds; sovereigns and municipalities; and commercial entities that use derivative contracts to hedge commercial risk.” (Emphasis added.)

This acknowledgement by the Agencies that “**exposure amounts would increase for derivative contracts with ... commercial entities that use derivative contracts to hedge commercial risk**” is both a cause for concern and a source of potential hope that the Agencies and their Staffs will be willing to heed the advice of the EU as set forth in Paragraph 48 of the Preamble to the EU CCR Regulation, in combination with these Supplemental Comments by the IECA and others, to take the steps necessary to “avoid possible unintended consequences of hindering the good functioning of the [U.S.] financial system and the provision of risk hedging tools to institutions and [CEU-HA counterparties].”

If, previously, the Agencies and their Staffs viewed uncleared energy commodity derivative contracts between banks and CEU-HA counterparties as exposing banks to imprudent levels of counterparty credit risk, because those transactions were not subject to mandatory margin requirements, and therefore were not subject to any risk-reducing credit support, perhaps now the Agencies and their Staffs will prudently recognize, based on the IECA’s March 18 Comments, these Supplemental Comments and the comments of many other market participants, explaining the genuine risk-reducing nature of a bank’s energy commodity derivative contracts with CEU-HA counterparties, which CEU-HA counterparties are (i) themselves prudent IG-rated commercial end-users of financial derivatives, (ii) supported by IG-rated guarantors, (iii) secured by letters of credit from creditworthy commercial banks, and (iv) secured by first liens on “right-way-risk” assets.

The Agencies’ recognition of such genuine, bona fide risk reducing credit support should give the Agencies and their Staffs reason to reduce the level of counterparty credit risk exposure previously assumed to be incurred by banks that entered into energy commodity derivative contracts with such CEU-HA counterparties. A reduction of the underlying exposure to counterparty credit risk by itself should support a significant reduction of the “supervisory factor” of 40% applied to energy commodity derivative contracts.

In addition, the IECA is concerned that the BCBS’s assignment of “supervisory volatility” of 150% for electricity commodity derivatives and a “supervisory factor” of 40%, and the Agencies’ resulting application in the NOPR of a “supervisory factor” of 40% for all “energy commodity derivative contracts,” appears to be based on an assessment by BCBS of the spot market volatility for electricity markets. However, the typical energy commodity derivative contract entered into between a CEU-HA counterparty and a bank hedges a longer-term risk for each CEU-HA counterparty than the daily spot market volatility of electricity and other energy commodity markets in the U.S.

If the Agencies and their Staffs, and ultimately the BCBS, were to review the forward curves for electricity markets and other energy commodity markets, the volatility affecting the exposure to counterparty credit risk under most energy commodity derivative contracts used to hedge commercial risk is a much longer duration so that one day's spot market volatility is minimized in those derivative contracts.

The recent volatility in Texas' spot electricity market prices in ERCOT<sup>28</sup> during the month of August 2019, where prices spiked to the cap of \$9,000 per Mwh during the week of August 12-16, 2019, provides a good example.<sup>29</sup> While electricity prices spiked in the spot market, the forward curve for electricity prices was subject to much less volatility and electricity prices quickly returned to more normal levels.

Moreover, the existence of such price spikes in the spot markets for electricity provide the market with incentives for developers to build new generation and, if transmission constraints contributed to such price spikes, incentives to build new or expanded transmission infrastructure, all of which reduces the volatility in the forward markets for electricity.

In short, the forward price curves for electricity and other energy commodity markets, which are typically the commodity prices hedged by CEU-HA counterparties in their energy commodity derivative contracts used to hedge their exposure to commercial risk, are much less volatile than spot market volatility. This was demonstrated by Attachment 2, U.S. SA-CCR Supervisory Factors for Energy Derivatives, which was prepared and submitted by Morgan Stanley<sup>30</sup> as evidence to support its proposal that a "supervisory factor" of 10% would align with forward contract credit risk and be a much more appropriate add-on to represent the counterparty credit risk during the period addressed by the Basel Committee.

Based on that evidence, Morgan Stanley advised the Agencies that rather than looking at the spot or front month, the forward market volatility is more appropriate for the calculation of supervisory factors for energy commodity derivative contracts and the counterparty credit risk exposure faced by banks. The IECA endorses Morgan Stanley's submission in this regard.

The IECA also agrees with the other point made by Morgan Stanley in its other attachment found on the FDIC's website, a document entitled "Energy Trading Competitive Landscape" dated July 2019, which indicates that it was prepared by Coalition, a business division of CRISIL, an S&P Global Company. The CRISIL

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<sup>28</sup> Electric Reliability Council of Texas; See

<sup>29</sup> See, for example, *Price Spikes Vindicate ERCOT's Market Design*, dated August 21, 2019, on ICF's website at [www.icf.com/blog/energy/ercot-summer-forecast-scarcity](http://www.icf.com/blog/energy/ercot-summer-forecast-scarcity).

<sup>30</sup> See line 41. Morgan, Stanley, Sebastiano Visentini – PDF – Attachment 1 – PDF, Attachment 2 – PDF, found on the FDIC website, at [www.fdic.gov/regulations/laws/federal/2018/2018-exposure-amount-derivative-contracts-3064-ac80.html](http://www.fdic.gov/regulations/laws/federal/2018/2018-exposure-amount-derivative-contracts-3064-ac80.html).

Coalition document demonstrates that American financial institutions actively trade energy products, while there is virtually no energy trading by European financial institutions. The document shows that five American financial institutions are active in the energy trading markets, whereas five European financial institutions have no presence in these markets and two remaining European financial institutions are either reducing or have recently exited the energy trading markets.

As noted above, the EU regulators expressed their concern in Paragraph 48 of the EU CCR Regulation with the potential for “unintended impacts hindering the good functioning of the European financial markets and the availability of hedging tools for institutions and end-users.” Assuming the accuracy and completeness of the data collected by CRISIL Coalition, CRISIL Coalition’s findings demonstrate that European financial institutions no longer participate in energy commodity trading to any meaningful degree. Thus the concerns that gave the EU regulators pause and caused them to include Paragraph 48 in the EU CCR Regulation should give the Agencies even greater pause, because the potential for unintended adverse impacts on the U.S. financial markets and the availability of hedging tools for U.S. end-users is much greater.

As discussed on pages 4 and 5 of these Supplemental Comments, U.S. end-users that rely on energy commodity derivatives contracts with financial institutions to hedge their exposure to commercial risk, use alternative forms of credit support largely because most of their assets are not held in cash, but are held in physical assets related to their commercial business. Failure to recognize the genuine counterparty credit risk-reducing nature of such alternative forms of credit support and then adding-on regulatory capital requirements based on an unsupported 40% supervisory factor for counterparty credit risk associated with energy commodity derivative contracts will have unintended adverse impacts on such end-users and will hinder their ability to hedge their exposure to commercial risk.

The IECA, therefore, urges the Agencies to proceed with caution and re-consider their proposed imposition of unsubstantiated supervisory factors, including reducing their proposed 40% supervisory factor for energy commodity derivative contracts to a supervisory factor of 10%, in part, because the Agencies’ actions are much more likely to have adverse impacts on CEU-HA counterparties in the U.S. that rely on energy commodity derivative contracts with U.S. banks to hedge their exposure to commercial risk, and, in part, because a supervisory factor of 10% is much more indicative of the counterparty credit risk faced by U.S. banks entering into energy commodity derivative contracts with CEU-HA counterparties.

## **V. About the IECA.**

The IECA is an association of over 1,400 credit, risk management, legal and finance professionals that is dedicated to promoting the education and understanding of credit and other risk management-related issues in the energy industry. For over ninety years, IECA



members have actively promoted the development of best practices that reflect the unique needs and concerns of the energy industry.

The IECA seeks to protect the rights and advance the interests of a broad range of domestic and foreign energy market participants, representatives of which make up the IECA's membership. These entities finance, produce, sell, and/or purchase for resale substantial quantities of various physical energy commodities, including electricity, natural gas, oil and other energy-related physical commodities necessary for the healthy functioning of the energy markets and the "real economy". Many of these energy market participants rely on contracts with banking organizations to help them mitigate and manage (i.e., hedge) the risks of physical energy commodity price volatility to their commercial energy businesses, which millions of Americans and the American economy rely on for safe, reliable and reasonably-priced energy supplies.

## **VI. Communications.**

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## **VII. CONCLUSION**

The IECA respectfully requests that the Agencies reconsider their proposed implementation of SA-CCR, as set forth in the NOPR, and make certain modifications as set forth in the IECA's March 18 Comments and in these Supplemental Comments, including the following with respect to the proposed Supervisory Factor of 40% for energy commodity derivative contracts:

Reduce the Supervisory Factor of 40% for energy commodity derivatives contracts to 10%, which is in line with Basel Committee recognition of the inherent risk differences between different energy asset classes and variations based on maturity and volatility. This will provide a supervisory factor that is much more representative of a banking organization's counterparty credit risk exposure for uncleared and unmarginated derivative contracts with CEU-HA counterparties in the energy industry, as more fully-described above.

The IECA appreciates the opportunity to provide these Supplemental Comments to the Agencies and would welcome the opportunity to discuss these comments further should you require any additional information on any of the topics discussed herein.

Yours truly,  
INTERNATIONAL ENERGY CREDIT ASSOCIATION

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