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Via Electronic Submission

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

Re: Standardized Approach for Calculating the Exposure Amount of Derivative Contracts (R-1629 and RIN 7100-AF22)

Dear Ms. Misback:

I. Introduction

The Commodity Markets Council ("CMC") appreciates the opportunity to submit this comment letter in response to the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (together, the "Agencies") proposed rulemaking on the Standardized Approach for Calculating the Exposure Amount of Derivative Contracts ("proposed rulemaking").

CMC is a trade association that brings together exchanges and their industry counterparts. Its members include commercial end-users that utilize the futures and swaps markets for agriculture, energy, metal, and soft commodities. Its industry member firms also include regular users and members of swap execution facilities (each, a "SEF") as well as designated contract markets (each, a "DCM"), such as the Chicago Board of Trade, Chicago Mercantile Exchange, ICE Futures US, Minneapolis Grain Exchange, NASDAQ Futures, and the New York Mercantile Exchange. Along with these market participants, CMC members also include regulated derivatives exchanges and price reporting agencies. As a result, CMC is well-positioned to provide a consensus view of commercial end-users on the impact of the Agencies' proposed rulemaking. Its comments, however, represent the collective view of CMC's members, including end-users, intermediaries, exchanges, and benchmark providers.

We support the proposed move from the current exposure methodology ("CEM") to the standardized approach for counterparty credit risk ("SA-CCR") but ask that mandatory compliance be deferred so that the proposed rulemaking will be consistent with those of foreign jurisdictions to ensure a level playing field for U.S. commercial end-users.

CMC also writes in support of the comment letter filed by the Coalition of Derivatives End-Users ("Coalition") in its entirety and specifically with respect to the Coalition's comments regarding the impact of the proposed rulemaking on end-users with respect to uncleared swaps. CMC's points below are limited to examining the impact of the proposed rulemaking with respect to cleared futures and swaps.

II. Background

A clearing member is a member of, or direct participant in, a central counterparty ("CCP") that is entitled to enter into transactions with the CCP. Clearing members can serve two functions. First, a clearing member may act as a financial intermediary for its client with a CCP and either takes one position with the client and an offsetting position with the CCP (the "principal model"). Second, a clearing member may guarantee its client's performance to the CCP (the "agency model"). In the agency model, the clearing member is generally responsible for fulfilling CCP initial and variation margin calls irrespective of the client's ability to post collateral. In short, clearing members guarantee the end-user's performance on the transaction to the CCP.

The clearing member's guarantee, however, is not the only form of security obtained by the CCP. Rather, the CCP requires that clearing members collect a minimum level of collateral, referred to in this letter as "segregated margin,"[1] from end-users both at the time they enter into derivative transactions and on an ongoing basis thereafter. Clearing members may also impose additional segregated margin requirements on end-users. Segregated margin offsets the exposure of the clearing member on its guarantee because the clearing member only guarantees the end-user's performance to the extent that performance has not already been secured by segregated margin.

III. Discussion

CMC urges the Agencies to replace CEM with SA-CCR for cleared derivatives. However, both CEM and SA-CCR, as proposed, overstate clearing member leverage exposure because they do not account for the exposure-reducing effect of appropriately segregated client margin. CEM also overstates exposures associated with cleared derivatives generally because it applies a calculation method that does not appropriately differentiate between cleared and uncleared derivatives.

If CEM continues to be the approach for calculating the exposure amount of cleared derivative contracts under the Agencies' regulatory capital rule, it will continue to impose capital requirements on clearing members that are entirely out of proportion with the systemic risks posed by their businesses and thus require them to charge dramatically higher fees to, or all together limit the access of, commercial end-users, such as CMC members, for clearing services. Similarly, the adoption of SA-CCR without recognizing the role of segregated client margin would have negative impacts on end-users of centrally-cleared markets. Therefore, CMC implores the Agencies to allow segregated client margin to reduce leverage exposure in the supplementary leverage ratio, whether calculated under CEM or SA-CCR.

a. Calibration of the Alpha Factor

While end-users recognize the need for financial safeguards among banking entities, they remain concerned that increasing these safeguards comes at a cost. Over the last several years, end-users have experienced increased costs, and in some cases termination, of services altogether by clearing members, who attribute such actions to the CEM. We note that one area of potential relief is a calibration of the alpha factor of the SA-CCR calculation.

CMC acknowledges that regulators wish to establish conservative exposure amounts; however, we caution that because end-users' portfolios are typically directional in nature, these portfolios draw large exposure numbers which render them unattractive clients for bank-affiliated clearing members. Moreover, the add-on factors for commodity derivatives, which are typically used by CMC members, are higher than the add-on factors for all other derivatives, leaving CMC members uniquely exposed to likely increases in clearing costs and to diminished access to hedging markets.

[1] As used herein, the term "segregated margin" refers to margin that is segregated in a manner consistent with the segregation requirements imposed by the U.S. Commodity Futures Trading Commission ("CFTC").

b. Supervisory Factors

CMC's end-user members welcome the broader netting capabilities of SA-CCR; however, the Agencies' broad category of energy commodities assigns the highest supervisory factor to electricity (40 percent). This diverges from the Basel Committee's final standards which separates oil/gas from electricity with the latter being assigned an 18 percent supervisory factor.

If implemented as drafted, exposures resulting from oil/gas portfolios will be inconsistent with observed volatilities and disadvantage entities using such products. CMC further notes that some of its members, in particular power generators, use natural gas to generate electricity, often times hedging such products in the same account with a clearing member. Netting in such circumstances would be preferable/beneficial for impacted entities and allow for more cost-effective risk management. Inflating exposure amounts would presumably lead to increased costs or constrained access to perform such risk management functions.

CMC believes that the supervisory factors for all commodity derivative contracts do not appear to be specifically calibrated to the risks presented by the underlying commodities or differences in contract maturities. Because prices of commodities are often influenced by external factors such as weather and short-term supply constraints, the volatility of commodity prices tends to increase in forward markets. More so than any asset class, to the extent that the supervisory factors for commodities were influenced by observed volatility in the spot or prompt month, such supervisory factors do not reflect the true credit risk of derivative transactions that settle in the future when volatility is less. Thus, the overstated supervisory factors for commodities will have a punitive effect on CMC members that wish to hedge in the forward market. Supervisory factors for commodity derivative contracts should be calibrated to address the differences in contract maturities and volatilities of each of the sub-asset classes.

c. Margin Period of Risk

End-users are required to margin their cleared derivatives accounts daily, and the amount of such margin is determined by the CCPs, pursuant to CFTC regulations. CMC encourages the agencies to ensure that there is absolute clarity that the most favorable margin period of risk is applied for cleared derivatives, and one that is consistent with the commitments made at the Pittsburgh G-20 Summit encouraging central clearing.

Commercial end-users are exempt from the mandatory clearing requirements, so often CMC members that are end-users may choose to hedge their commercial risk with swaps, forward contracts, and other over-the-counter derivative contracts with banking organizations subject to SA-CCR. In the case of uncleared derivative contracts, these end-users are generally exempt from mandatory margin requirements. SA-CCR is likely to undermine these exemptions. Banking organizations are likely to pass the increased capital costs to their end-user counterparties through increased pricing and fees and/or by requiring initial and variation margin for uncleared derivative contracts notwithstanding the end users' exemptions.

The impact of increased capital costs for uncleared derivative contracts as a result of SA-CCR may also create a disincentive for banking organizations to continue to offer hedging services or act as market-makers in commodity derivative contracts, which would result in less liquidity in both the cleared and uncleared commodity derivative markets.

IV. Conclusion

We encourage the Agencies to replace CEM with SA-CCR for cleared derivative contracts, with leverage exposure offsets for segregated client margin, as soon as possible. CMC agrees that "the proposed implementation of SA-CCR would provide important improvements to risk-sensitivity and calibration relative to CEM, resulting in more appropriate capital requirements for derivative contracts;" however, we strongly encourage the Agencies to adopt a version of SA-CCR that allows segregated client initial margin to offset leverage exposure.

With respect to uncleared derivative contracts, implementing SA-CCR as proposed without modification, however, threatens to: (a) undermine the clearing and margin exemptions granted to end-users; (b) increase end-users' costs of hedging with uncleared derivative contracts; (c) lead to further consolidation of banking organizations acting as market-makers in commodity derivative contracts; (d) reduce end-users' access to uncleared commodities derivative contracts; and (e) lead to less liquid and more volatile markets. We acknowledge that SA-CCR is not perfect, and we support refinement going forward.

Because other jurisdictions have yet to implement the SA-CCR framework, we recommend that the Agencies defer mandatory compliance with respect to uncleared derivative transactions so that the proposed rulemaking will be consistent with those of foreign jurisdictions to ensure a level playing field for U.S. commercial end-users.

If the status quo is maintained, it will lead to: (1) more clearing members moving away from central clearing; (2) higher clearing costs; (3) further consolidation of clearing services; (4) reduced access to the market for end-users; and (5) ultimately, increased systemic risk by making global commodity markets less liquid and more volatile.

If you have any questions about these comments, or we can provide further information, please do not hesitate to contact me at Kevin.Batteh@commoditymkts.org.

Sincerely,

/s/ Kevin Batteh

Kevin Batteh
General Counsel
Commodity Markets Council