The Risk Based Capital Directive:
The concerns of the commodity industry

The aim of this paper is to highlight the concerns of commodity market participants regarding the application (through the Risk Based Capital Directive – RBCD) of the Second Basel Accord to firms active in the European commodity and commodity derivatives markets, in the hope that it will raise awareness of the issues and help foster possible resolutions. The paper represents the combined efforts of commodity firms, commodity exchanges and certain trade organisations (all listed in the attached Appendix). The paper covers a broad range of issues, not all of which are relevant to every firm or exchange who contributed to this paper.

The International Swaps and Derivatives Association (ISDA) and The Futures and Options Association (FOA) will, over the coming months, be addressing some of the issues raised in this paper in submissions of their own. The commodity firms and exchanges contributing to this paper fully support the efforts being made by ISDA and the FOA.

<u>Introduction</u>

1. European commodity markets are developing at a rapid pace with the European Commission (the Commission), Council of Ministers and European Parliament pursuing a programme of liberalisation of the European gas, power and energy markets – and possibly, in due course, liberalisation of Europe's soft commodity and agricultural markets (dependant upon the review of the Common Agricultural Policy). We fully support the Commission's aim of devising a single, liquid and internationally competitive pan-European market in commodities and commodity derivatives. However, we are concerned that the regulatory developments currently being discussed (in the Markets in Financial Instruments Directive (MIFI) and RBCD) will hamper this aim.

2. The Basel Capital Accord, devised by the Basel Committee on Banking Supervision, was designed with the specific aim of addressing the regulatory risks of investor protection and systemic risk in the financial sector. The Commission has decided to extend the application of the Basel Capital Accord via MIFI and the RBCD to 'investment firms' (including commodity firms actively trading in commodity and commodity derivatives markets) without any adequate or meaningful prior consultation or consideration to the impact or proportionality of this regime or any consideration of the presence of these regulatory risks in commodity and commodity derivative markets. Contributors to this paper are concerned that the proposed regime is unsuitable in many respects, has not been the subject of a full cost benefit analysis and fails to reflect the lower level of regulatory risks posed by commodity firms.

3. There is a general concern that affected firms will be forced to set aside large amounts of unnecessary capital for regulatory purposes which could cause them, by

virtue of the increased operating costs, to reduce their levels of trading activity. In a worst-case scenario, firms may be forced to withdraw from the market entirely (particularly likely for EU affiliates of US groups or EU groups with Swiss affiliates). Both developments would be disastrous for the liquidity and competitiveness of EU markets and could hamper the Commission's aims of liberalisation and increasing market participation. Reduced market size, and a re-focus of risk management from ensuring security of supply to compliance with regulatory capital requirements, could impact ability to meet legal duties ensuring security of supply which some firms in some of the Member States have. This is an issue of particular sensitivity in the current political climate.

4. It is our belief that the concerns highlighted in this paper present very real risks and therefore efforts should be made to address them. We would appreciate the opportunity to work with the Commission to devise an appropriate regime for commodity market participants, which would avoid any of these risks crystallising.

Differing Business Models – consumer protection v investor protection

5. The incoming MIFI will, for the first time, seek to regulate on a pan-European basis trading in commodities and commodity derivatives – the core business of the firms contributing to this paper. While this brings with it benefits – most notably the ability to offer services across Member States by virtue of a 'European passport', the cost will be the requirement to set aside regulatory capital in accordance with the Risk Based Capital Directive (RBCD). The RBCD is drawn from the Basel Capital Accord – a regime designed for deposit taking and securities business i.e. financial services business where, unlike the case with commodity market practitioners, the customers are investors and not consumers (being end users or commercial/professional participants in the markets). The Commission is alone in extending the application of the regulatory capital regime to non-banking firms who have traditionally operated in markets into which some banks have now decided to extend their activities. The industry hopes that it will be able to take some comfort from the Commission's public commitment to regulatory proportionality (as stated in Recital 50 of the draft MIFI), and its readiness to depart from the Basel Capital Accord where a good case for differentiation exists (as we believe it does with respect to commodity market participants).

6. There is concern that the Commission is imposing a 'one size fits all' regulatory capital regime, without considering the differing nature of the entities captured, the markets in which they operate and the difference in the regulatory risks that they pose. Unlike banks, the primary concern for commodity market participants is improving productivity from tangible assets to meet physical requirements or to enable operatives in the physical commodity markets, be they producers, refiners, traders or fabricators to manage their risks through derivative products. This is achieved via efficient risk management and integrated trading strategies. Commodity firms have an obligation (through the contracts they enter into) to supply the commodity to consumers. Traditionally, commodity market regulators have rightly concerned themselves with consumer protection – ensuring the commodity is available (security of supply) and that it is fairly priced. These risks are already regulated and managed by organisations such as the UK's Office of Gas and Electricity Markets (Ofgem) or Germany's REGTP. Commodity and commodity derivatives markets are generally

wholesale markets and are grounded in physical markets. There are no retail 'investors' in these markets and hence there is no need to regulate the markets under a financial regulatory regime in the interests of investor protection.

7. It is worth noting that comprehensive rules for the regulation of commodity derivative business already exist in some Member States and have done so since 1986. One such example is in the UK where the Financial Services Authority has devised, with the aid of market participants, separate regimes for firms transacting in oil, energy and metals contracts. These rules were designed specifically to regulate such business and have been refined over the years in the light of experience to ensure that they are appropriate for these markets. Other Member States are already reacting to the concerns of the commodity industry regarding the new pan-European regulatory proposals and are devising separate proposals to address these concerns. For example, in Germany we understand that BaFin is of the opinion that a typical electricity firm (whose main business revolves around supplying electricity to end users) has only negligible market and credit risk for regulatory capital purposes. BaFin has devised a regime that allows some companies (which are dealing only in electricity and deliver to end users) to identify "non-risk or low risk departments" (e.g. the end user section of a portfolio) which are exempt from requiring regulatory capital.

8. We welcome the Commission's proposal for a 30-month review (provided under Article 65 of MIFI) of the appropriateness of applying the regime more widely. We would urge the Commission to use this time to undertake a full cost benefit analysis of the impact of widening the scope of RBCD application to consider more fully the risks that they are attempting to address by applying the regime and to consider whether any alteration to the regime (with respect to commodity firms) is necessary. We recognise that this is a considerable task and therefore would welcome the opportunity to work with the Commission in doing this.

Systemic Risk

9. The basis of the Basel Capital Accord is equal treatment for equal risks. However, the wholesale nature of commodity and commodity derivative markets and the customers they serve, means that the regulatory risks presented by such markets (security of supply and price to end users) are significantly different to those presented by financial markets (systemic risk and investor protection). A key driver for establishing a regulatory capital regime is to control the level of systemic risk that is structurally present in the financial sector. Systemic risks in the commodity sector are a second degree risk and the failure of a participant in that sector will have very limited impact on the systemic risk levels present in the financial sector – it is the quality of the systems and controls that are required to be in place within a regulated financial institution that will determine the level of risk to the financial system when a corporate customer/counterparty defaults, it is not the fact of the default itself that will endanger the financial sector. The collapse of Enron, which did not lead to any firm or banking failures, is a good example of this.

10. Therefore, given the comments above, it is very difficult to discern the presence of systemic risk in commodity and commodity derivative markets. In the absence of reliable economic argument or historical evidence/data that dealings in the wholesale

commodity markets can pose a real threat to the financial system, we believe that the need for such high levels of regulatory capital (as would be required under the proposed regime) is unjustified and that greater consideration should be given to capital levels and risk mitigation practices that currently exist, and have been proven to work, in the commodity and commodity derivative industry.

Market Risk

11. The Basel Capital Accord has been devised for application to banks. However, the Commission is going beyond the envisaged scope of the Accord by applying it to 'investment firms', including commodity firms (as defined in MIFI). In reaching this decision the Commission has assumed that commodities and securities behave in the same way. In reality they do not. The costs of carry for a commodity future are greater than those of a financial future, which impacts upon the shape and behaviour of the forward curve in a manner different to that observed in securities contracts. Commodity firms use well developed volumetric and/or VaR models to measure these effects. These VaR models may not comply fully with the requirements placed on VaR models by CAD, yet they are robust, relevant and proportionate to the needs of the firms who employ them. There is concern in the industry that differences in the behaviour of products and the differences in risk management that they require are not being appreciated and that enforcement of an inappropriate standard may only serve to increase the risks faced by firms. We welcome the Commission's recognition of the need for proportionality in the approach to determining regulatory capital (Recital 50 and Article 60 of MIFI) and urge that a review of the standard practices of commodity market participants be conducted prior to the imposition of a market risk standard (NB: ISDA is conducting a survey around this issue and will report to the Commission in due course).

12. There is further concern regarding the general lack of externally available data that is necessary under the proposed regime to verify a model. Traditionally, data providers have concentrated on providing data services mainly to the banking sector and the securities side of the investment services industry. There is a risk that, in the absence of such data for the commodity and commodity derivatives markets, firms and regulators may be forced to verify models using inappropriate data, potentially resulting in inappropriate models. However, the difficulty in verification has not been a problem in the past, nor has it meant that models currently in existence are less robust than those adopted by other sectors.

13. Finally, there is an additional problem for integrated commodity firms (i.e. production through to sales) in that for such firms it can be extremely difficult to clearly differentiate the 'trading book', as defined, from the hedging book. Such firms can legitimately enter into the same activities, including the use of derivative contracts, for different purposes. BaFin have, for example, recognised this as a problem and are currently allowing commodity firms to classify their commodity activities as banking book activity, not trading book activity. We urge the Commission to work to find a pan-European solution to this pan-European issue.

Acceptable Capital and Collateral

14. The RBCD definition of collateral, and the calculation of financial resources under the CAD regime, recognise liquid assets (in general terms cash and primary market instruments), but generally place constraints on the use of 'illiquid' physical assets. The stock in trade of a commodity firm is commodities, therefore the majority of the assets it holds on its books (audited in accordance with local accounting standards) are warrants for physical metal or soft and agricultural commodities and physical assets - oil, petroleum products, LPG's, petrochemicals, gas in storage, coal in stock, electricity in storage (e.g. hydropower water storage facilities, nuclear loaded uranium fuel), generation, grid capacity, etc. These physical assets, although valuable and marketable, are discounted heavily by banking regulators and, in the case of intangible assets, are discounted completely. As a result, many firms would be forced to raise additional regulatory capital at a significant cost, to meet the requirements of the regime.

15. With regards to collateral, the acceptance of non-liquid (as defined by RBCD) collateral – letters of credit, appropriately managed parent company guarantees and warrants or commodities as listed above - is common practice in commodity and commodity derivative markets and this is a practice that has been in existence for many years - having been proven to be robust. Although these forms of collateral are recognised in the RBCD, strict constraints are placed on the rating of the guarantor under both the Standardised and foundation Internal Ratings Based (IRB) approaches to credit risk. As a result, most of the guarantees obtained by commodity firms would only be acceptable if a firm adopts the Advanced IRB approach. A significant number of commodity firms do not have the resources to use the advanced model approval approach and in many cases it would be a wholly unnecessary 'gold plated' approach when compared with the underlying economic activity and core business.

Operational risk

16. The industry has concerns with both the concept and the capital cost associated with operational risk. The concept of formally measuring operational risk, as a component of capital adequacy, originated in the banking industry and focuses on control risks around banking activities. The commodity industry is inherently different from banking. The importance of physical assets to our industry has given rise to the view that the risks associated in operating (or failure of) these physical assets represent the key operational concern for commodity firms. Advanced methods for managing these risks have been developed and are often reviewed by the physical regulators e.g. Ofgem. The proposed regime fails to recognise this as the key risk for commodity firms and provides no credit for the efforts made to mitigate these key risks. With regards to cost, to build a model that meets with the proposed regulatory requirements would take several years (given that loss data needs to be gathered first) and would result in a significant investment cost. However, there is no incentive for firms to do this as under the proposed approach the resulting capital charge could be subject to a higher risk weighting than under the standard approach. This represents a conflict with the Commission's aim of encouraging firms to move to more sophisticated methods of risk management.

Credit risk management

17. Commodity market participants typically have a different client base to those observed in financial markets. For example, banks typically have a large spectrum of counterparties ranging from retail clients to investment grade companies and we understand the capital charges for both retail and investment grade companies are going to be reduced. Commodity firms, however, do not trade with retail clients but typically trade with industrial companies who are usually funded by project and trade finance rather than bond issues and therefore are unlikely to have an investment grade rating. Consequently, commodity companies will not be able to benefit from the reduction in capital charges being considered, unless they are applied to such industrial companies. We urge the Commission to do this.

18. There are further concerns amongst participants regarding the potential impact of the Large Exposures Directive (LED) and the 'hard' group trading limits that this Directive enforces. Many commodity groups have structured their business to create a single trading entity that presents one face to the market and centralises risk management expertise. This entity will enter into a large number of transactions with group companies, which under the LED could either give rise to additional capital requirements, or at worst reduce the potential for intra-group trading, thereby destroying the risk management benefits that go with it. The potential consequences of applying the LED to commodity firms have not been considered sufficiently by the Commission and we urge them to consider an alternative regime.

<u>Treatment of unsettled transactions</u>

19. We understand that the Basel Committee is considering changing its approach to the additional credit exposure arising when a transaction is unsettled. Of concern is the proposal that would require capital to be set aside from trade date, not payment due date, in lieu of a potential credit risk that has yet to crystalise. This proposal would lead to a significant increase in regulatory capital (for credit risk purposes) for commodity markets where the contracts are typically long dated (many years) and payment can occur 30 days post delivery (or one month plus 20 days post delivery in Germany) - reflecting the payment terms used in the underlying physical market. Under the proposal being discussed by the Basel Committee, firms would be required to set aside significant amounts of unnecessary capital, which could give rise to a liquidity constraint in the markets.

<u>Summary</u>

20. The Second Basel Accord is not designed to increase the overall regulatory capital requirement to the industry, but to set regulatory capital requirements at a level that is no higher than the regulatory risks actually posed by different types of business. However, this underlying discipline has not been applied to commodity market participants and we would urge the Commission to take the issue of regulatory proportionality very seriously. In the absence of a proportionate approach, the simple extension of the RBCD will force firms to significantly increase regulatory capital levels (even for those firms that are currently operating under a regulatory capital regime), with no commensurate increase in regulatory risk posed.

21. Further, if commodity market participants are forced to follow the same rules as financial firms, European commodity firms will undoubtedly be at a huge competitive

disadvantage with their competitors outside of Europe, who will not be regulated in the same manner or to the same degree and this will force some firms to re-locate their international trading activities outside of the EU and will reduce liquidity and participation in the European commodity markets.

22. It is vital that regulatory proportionality is adhered to if the objective of liquid and efficient commodity markets is to be delivered; otherwise a number of commodity firms are marginalised. It is imperative that the Commission not only works to address the concerns raised in this paper, but also strives to ensure that an appropriately priced (in terms of capital) regulatory passport is delivered as soon as possible to those firms affected by the capital regime. We would welcome the opportunity to work with the Commission in doing this.

Appendix 1

Contributors to this paper

Firms
Amalgamated Metal Trading
BP
ConocoPhillips
Endesa
Entergy Koch
E.ON Sales and Trading GmbH
Gaselys
Koch Supply & Trading
Powergen
Royal Dutch Shell
RWE Trading
Scottish Power Energy Management Agency Limited
Sydkraft
Vattenfall

Exchanges
Euronext.Liffe
International Petroleum Exchange
Powernext

Organisations
The BaFin Group – represented by Becker Buttner Held
European Federation of Energy Traders
The Futures and Options Association
The International Swaps and Derivatives Association