March 18, 2019

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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, DC 20551
Docket No. R-1629; RIN 7100-AF22

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

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th Street SW, Suite 3E-218
Washington, DC 20219
Docket ID OCC-2018-0030

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

Ladies and Gentlemen:

The Goldman Sachs Group, Inc. ("Goldman Sachs" or "we") appreciates the opportunity to comment on the notice of proposed rulemaking (the "Proposal") from the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the Office of the Comptroller of the Currency (the "OCC"), and the Federal Deposit Insurance Corporation (the "FDIC" and, together with the Federal Reserve and OCC, the "Agencies") to incorporate the standardized approach for calculating counterparty credit risk ("SA-CCR") into their regulatory capital rules.[1]

Goldman Sachs is a leading global market-maker in securities and derivatives, and provider of other banking and markets services to institutional, governmental and retail clients. In our capacity as a derivatives market-maker, our clients and other market participants count on us to provide liquidity in derivative markets. We couple these capabilities with our deep expertise, knowledge and unique global footprint to serve our clients. Through our derivative activities, we help U.S. companies globally in a wide range of industries manage their exposures to changes in interest rates, foreign exchange rates and commodities prices.

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1 *Standardized Approach for Calculating the Exposure Amount of Derivative Contracts*, 83 Fed. Reg. 64660 (Dec. 17, 2018).

I. Introduction

We support the Agencies' efforts to improve the regulatory capital treatment of derivative transactions and appreciate that the Proposal would meaningfully improve the overall risk-sensitivity of the capital requirements for derivatives. We also appreciate that SA-CCR is responsive to concerns that the current approach, the Current Exposure Method ("CEM"), does not appropriately recognize the risk-mitigating characteristics of margin and does not provide for sufficient netting of derivatives that have similar characteristics. Although we support the objectives of the Proposal, we believe that several aspects should be enhanced. We agree with the comment letters from the International Swaps and Derivatives Association ("ISDA") and the Financial Services Forum ("FSF"), which address a number of issues and include recommendations that we support: notably, the calibration and application of the alpha factor to replacement cost ("RC") and potential future exposure ("PFE"), the recognition of collateral, the calibration of supervisory factors, and the treatment of a netting set that has derivatives with different margin periods of risk.

We further agree with the recommendation to more carefully consider SA-CCR in the context of the broader post-crisis reform agenda. The Basel Committee finalized SA-CCR in 2014, well in advance of the finalization of other revisions to Basel III in 2017. Given the interrelated nature of SA-CCR with other pending or anticipated changes to the regulatory capital framework (such as those relating to the surcharge for global systemically important banks, the stress capital buffer, the supplementary leverage ratio and the revisions to Basel III), it is impossible to assess SA-CCR's ultimate impact in the absence of clarity on the finalization of these other reforms. We therefore urge the Agencies to conduct a comprehensive analysis of the cumulative impact of all reforms.

Finally, we also share the concerns expressed in the letters mentioned above regarding the significant increase in capital requirements for derivatives with commercial end users.[2] **Part II** of this letter describes how higher capital requirements under SA-CCR would adversely affect commercial end users. **Part III** contains our recommendations for how to address these issues and improve the role of SA-CCR in the regulatory capital framework.

II. Higher capital requirements for unmargined derivatives would disproportionately affect commercial end users

The Proposal would result in significantly higher capital requirements for U.S. banks' derivatives with commercial end users. The Agencies estimate that exposure amounts for unmargined derivatives would increase by approximately 90 percent compared to CEM.[3] We have calculated that the exposure amounts – and, therefore, the capital requirements – could be significantly higher for certain transactions. For example, a derivative used by a multinational company to hedge its interest rate risk would require capital related to PFE that is 3.7 and 7.2 times higher under SA-CCR than under CEM for a ten-year and a thirty-year transaction, respectively. We do not believe SA-CCR takes into consideration that many derivatives with commercial end users are often secured by liens on assets and letters of credit that reduce banks' credit risk. This treatment is inconsistent with risk management practices, which do take non-financial collateral into consideration.

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[2] This letter uses the term "commercial end users" to refer to non-financial entities that use derivatives to hedge or manage their risks, including those that are eligible for the exemption from margin requirements for uncleared swaps under the margin rules of the Agencies and the Commodity Futures Trading Commission ("CFTC"). *See* 12 C.F.R. § 45.1(d) (OCC); 12 C.F.R. § 237.1(d) (Federal Reserve); 12 C.F.R. § 349.1(d) (FDIC); 17 C.F.R. § 23.150(b) (CFTC).

[3] *See* Proposal, at 64685.

Furthermore, derivatives with commercial end users often present right-way risk. For example, a natural gas company may enter into a derivative with a bank to hedge its exposure to a decline in natural gas prices. As natural gas prices increase, the bank would have greater credit exposure to the company, but, at the same time, the company would be more creditworthy as the value of its underlying assets would have increased. This right-way risk associated with commercial end user derivatives is enhanced where the bank's exposure to the commercial end user is secured by a lien on its assets. As the overall value of the company increases, the value of the lien on its assets increases concurrently, reducing the bank's credit risk.

The treatment of unmargined derivatives with commercial end users under SA-CCR could have adverse effects on the derivatives market that commercial end users rely on to hedge and manage their risks. It could cause banks to charge more for entering into derivatives with commercial end users or reduce or exit certain business lines altogether. Commercial end users typically prefer to enter into derivatives with banks instead of other market participants because of banks' credit risk profiles and status as highly regulated counterparties. Commercial end users may also have concerns that other market participants – which generally are not market makers – would not stand ready to provide liquidity and enter into derivatives in adverse market conditions. If derivatives become more expensive or less readily available for commercial end users, they would find it more difficult to hedge their risks in a cost-effective manner, which could increase their costs to provide goods and services to their customers and potentially result in higher costs for their customers as well.

We believe the potentially adverse impact to commercial end users is misaligned with exemptions provided to them in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), which introduced a comprehensive regulatory framework for over-the-counter derivatives requiring mandatory clearing through central counterparties and imposing margin requirements for most derivatives that are not cleared. Derivatives with commercial end users for their hedging and risk-management purposes were expressly exempted from the margin requirements for uncleared derivatives through a 2015 amendment to the Dodd-Frank Act.[4] This represented a deliberate Congressional policy decision not to subject derivatives with commercial end users to the same requirements as those with financial counterparties.[5] If the Agencies impose higher capital requirements on derivatives with commercial end users, the margin exemption could be less effective and commercial end users may find it more expensive or challenging to use derivatives to hedge their risks, which would be inconsistent with the public policy expressed in the margin rules and the 2015 amendments to the Dodd-Frank Act.

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4 *See* Title III of the Terrorism Risk Insurance Program Reauthorization Act of 2015, also known as the Business Risk Mitigation and Price Stabilization Act of 2015.

5 In discussions surrounding the 2015 amendments, Senator Michael Crapo noted that "it is critical that we allow [commercial] end users, those who produce products or provide services – those are the ones who are using the financial system and the benefits it can provide to provide productive additions to our economy – that they not be subjected to the rigorous requirements that were put into place to control financial sector dealings in derivatives." 161 Cong. Rec. S74 (Jan. 8, 2015). He further observed that subjecting commercial end users to margin requirements "would also increase costs in the marketplace to consumers" and quoted a letter from the legislative history of the Dodd Frank Act stating that "[i]t is imperative that the regulators do not unnecessarily divert working capital from our economy into margin accounts, in a way that would discourage hedging by [commercial] end users or impair economic growth." Id.

III. Recommendations

A. Recalibrate and appropriately tailor the application of alpha

Remove the application of alpha from replacement cost

We do not believe it is appropriate to apply alpha to replacement cost within the exposure calculation under SA-CCR. The replacement cost is a balance sheet value that is subject to stringent internal controls, price verification, and external audit. We are not aware of a justification for grossing up the balance sheet by 40%, and we strongly urge the Agencies to remove the application of alpha from replacement cost and instead apply it only to potential future exposure.

Recalibrate alpha to an appropriate level in order to reflect the risks captured in SA-CCR

The Agencies originally calibrated alpha in 2006 to be applied under the Basel II modelled approach. The recent Proposal applied this same calibration in order to ensure that SA-CCR would not produce a lower exposure amount than that produced under a modelled approach.[6] The risks that the 2006 calibration was intended to address, such as model risk and stress parameters, are no longer salient because SA-CCR is not a modelled approach and it is calibrated to stress volatilities. Therefore, in order to avoid double counting of risks within the framework, the Agencies should revisit the calibration of alpha in light of updated elements of the framework.

Remove the application of alpha from derivatives with commercial end users

Removing the application of the alpha factor to derivatives with commercial end users would promote greater consistency in the treatment of commercial end users' derivatives under the Agencies' capital rules and the Agencies' and CFTC's margin rules. Further, applying the alpha factor to commercial end users is misaligned with the risks that the alpha factor was originally calibrated to address, such as correlations of defaults among financial institutions and wrong-way risk. These risks are less relevant for derivatives with commercial end users, particularly since, as mentioned, they often present right-way risk.

In addition to eliminating the alpha factor for unmargined derivatives with commercial end users, we believe the Agencies should consider developing a framework to recognize the risk-mitigating benefits of non-financial credit risk mitigants that secure those derivatives. The Agencies could reflect the secured nature of these transactions by differentiating the exposure amount.

B. Revise the supervisory factors for the commodities asset class to better reflect the underlying asset volatilities

The supervisory factors for the commodities asset class are among the highest (and, in the case of the energy subclass, the highest) in the Proposal. They are also substantially higher than the supervisory factors for the interest rate, exchange rate, credit (single name) and credit (index) asset classes in absolute terms, as well as relative to realized historical volatility within each asset class. The Basel Committee appears to have calibrated the supervisory factors for the commodities asset class based on volatility in rolling spot prices. However, many commercial end users hedge their long term business risks. Consequently, many commodity derivatives, in particular those with commercial end users, have maturities of at least one year. Using forward volatilities would more appropriately reflect the actual underlying volatility.

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[6] *See* Proposal, at 64666.

The realized annual volatility of commodity forward prices is significantly lower than the realized volatility of commodity spot prices in certain products. For example, spot prices for commodities such as electricity and natural gas can change significantly from one week or month to another as a result of changes in weather. However, this volatility declines substantially as the duration of a derivative increases. Thus, the price for natural gas or electricity to be delivered further in the future (for example, in two years) will not change materially because of current weather conditions, and a derivative settling against the two years forward contract will also not materially change in exposure.

Further, the Agencies should consider introducing a new asset class for commodity indices, similar to those for credit and equity indices. As with credit and equity index products, derivatives linked to multi-product or non-directional commodity indices are significantly less volatile than single-product commodity derivatives, as these indices benefit from diversification across commodities included in the index.

C. Revise the Proposal to provide for separate subclasses for electricity and oil/natural gas, as provided in the Basel Committee's standard

If the Agencies do not recalibrate the supervisory factors for the commodities asset class as we recommend above, the Agencies should at least revise the Proposal to be consistent with the supervisory factors in the Basel Committee standard. Under the Basel Committee standard, electricity has a supervisory factor of 40% and oil/natural gas of 18%.[7] In contrast, the Proposal includes an energy subclass, encompassing electricity and oil/natural gas, with a supervisory factor of 40%.[8] The higher supervisory factor for oil/natural gas significantly increases the capital requirements for derivatives relating to oil/natural gas in a manner divergent from the Basel Committee standard. The characteristics of the oil/natural gas markets do not warrant the application of the higher 40% supervisory factor in light of the difference in historical spot volatilities for electricity and oil/natural gas. This deviation from the Basel Committee standard could negatively affect commercial end users and lead them to seek counterparties not subject to U.S. bank regulation.

D. Perform a comprehensive review of the broader post-crisis regulatory agenda

Due to the interrelationship between the Proposal and other changes to the regulatory capital framework, such as the December 2017 revisions to Basel III and the stress capital buffer, we believe the Agencies should perform a comprehensive quantitative review to evaluate the impact, design and calibration of SA-CCR as part of a comprehensive analysis of the cumulative effect of the Proposal and these other changes. Analyzing SA-CCR and those other changes within the broader context of the Agencies' overall revisions to the regulatory capital framework will promote the development of more cohesive regulatory capital requirements and help avoid unintended effects on U.S. banks, financial markets and commercial end users.

Conclusion

We appreciate your consideration of our comments on the Proposal. We would be pleased to discuss our comments and recommendations with you in more detail and to provide additional information that may be helpful.

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7 *See* Basel Committee, *The Standardised Approach for Measuring Counterparty Credit Risk Exposures* (Apr. 2014), at 19, para. 33.

8 *See* Proposal, at 64671 and 64675.

Sincerely,

[redacted]

Brian Lee
Chief Accounting Officer