Meeting Between Governor Kugler and Staff of the Federal Reserve Board and Representatives of the Coalition of Derivatives End Users
April 12, 2024

Participants: Governor Adriana D. Kugler and Kelley O'Mara (Federal Reserve Board)

Bjork Hupfeld (The Hershey Company); Thilo Huber and Whitney Mitchell Brennan (Honeywell); William Rigger (Willis Towers Watson); Fraser Woodford (Warner Bros. Discovery); Thomas Deas (National Association of Corporate Treasurers); Michael Bopp, Jason Cabral, and Kareem Ramadan (Gibson Dunn)

Summary: Governor Kugler and staff of the Federal Reserve Board met with representatives of the Coalition of Derivatives End Users (CDEU) to discuss their concerns regarding the agencies' Basel III endgame noticed of proposed rulemaking (Basel III endgame proposal) and the Board's GSIB surcharge proposal. Representatives of CDEU expressed concerns that higher capital charges on banks associated with derivatives exposures to nonfinancial corporates (e.g., through the credit valuation adjustment of the Basel III endgame proposal) would be passed onto end-users through higher costs and increased margin requirements. They also expressed concerns that these changes would result in reduced liquidity in the market and could cause end-users to increasingly transact with non-U.S. banks as counterparties.

Attachment

Basel III Endgame Proposal: Issues for Derivatives End-Users

April 12, 2024

Agenda

- Introductions
- High Level Impact
- Key Areas for End-Users
  - Credit Valuation Adjustment
  - Fundamental Review of Trading Book
  - GSIB Surcharge
  - Investment Grade Standard
  - International Comparison
- Summary of Recommendations
- Questions

Companies and organizations that support various initiatives of the Coalition for Derivatives End-Users

3M
A&D Insight, LLC
AB InBev
Acadia Realty Trust
AES Corporation
Aflac
Aisera Inc.
Air Products and Chemicals, Inc.
Alabama Municipal Electric Authority
Alcoa
Allegheny Energy
Allegheny Technologies Incorporated
Alliant Energy Corp.
Allstate Insurance Company
AMB Property Corporation
AMC Entertainment Inc.
Ameren Services
American Adhesive Coatings Company
American Electric Power
American Farm Bureau Federation
American Honda Finance Corp.
American Residential Communities
Anadarko Petroleum Corporation
Apexon
Applied Materials, Inc.
ARAMARK Corporation
Archer Daniels Midland Company
Arena Energy
Ascent Resources
Ashford Hospitality Trust
Associated Estates
Atmos Energy
AT&T
Aukum Group LLC
Aviation Facilities Company Management
Avista
B&B Hotels
Ball Corporation
BASA Resources, Inc.
Basin Electric Power Cooperative
Bayer Corporation
Bay Wa r.e.
Black Belt Energy
Black Diamond Minerals, LLC
Black Hills Corporation
Blyth, Inc.
Bobrick Washroom Equipment, Inc.
Bolton Emerson Americas
Boston Scientific Corporation
BP America
BPL Medical
Cabot Corporation
Callon Petroleum Company
Cargill, Inc.
Caribbean Property Group
Carroll Electric Membership Cooperative
Caterpillar Inc.
Chatham Financial
Chesapeake Energy Corporation
CIP Real Estate
Clarke-Mobile Counties Gas District
CMS Energy
CNL Financial Group
Columbia Sussex Corporation
Conoco-Phillips
Community Health Systems
Compass Minerals
Comstock Resources
ConAgra Foods, Inc.
Conexa Saude
ConGlobal Industries
Constellation Brands, Inc.
Constellation Energy
Constructel Visabeira S.A.
Cordillera Energy Partners III, LLC
Cprime, Inc.
Craton Capital Management, LLC
CSC
Cummins Inc.
Cybex International Inc.
Cyfirma
Cypress Creek Renewables
Daimler
Data.world
Dean Foods Company
Deere & Company
Devon Energy Corporation
Digibee
Direct Energy
Dominion
Donahue Schriber Realty Group L.P.
Douglas Emmett
Dow inc.
Duke Energy
DuPont Company
DuPont Fabros Technology
Dynegy Inc.
Eagle Rock Energy Partners, L.P.
Eaton Corporation
Ecolab Inc.
Edison International
El Paso Corporation
Emdeon
Energy Trading Institute
Enbridge Energy Company, Inc.
EnCana Oil & Gas (USA) Inc.
Energy Future Holdings Corp.
Entertainment Properties Trust
EOG Resources, Inc.
EQT Corporation
Exelon Corporation
First Capitol Ag
FirstMeridian Business Services Limited
FMC Corporation
Ford Motor Company
Forest City Enterprises, Inc.
Formation Capital
Fortress Information Security
FPL Group
Fuelcomm Inc. d/b/a Stackline
Gavilon, LLC
GC Infrastructure Investors LLC
General Electric Company
General Mills
General Motors
GID Investment Advisers LLC
Glimcher Realty Trust
Golden Living
Goodrich Corporation
GridPoint, Inc.
Hampshire Real Estate
HCA Inc.
Health Care REIT, Inc.
Heritage Feeders, L.P.
Hersha Hospitality Trust
Hertz
HES International B.V.
Hess Corporation
Hewlett-Packard Company
Hilton Worldwide Holdings Inc.
Honda
Honeywell
Host Hotels & Resorts, Inc.
Hydrostar Inc.
Hyundai Capital America / Hyundai Motor Finance Company
IBM
ILS Inc.
Iog Resources
Johnson Controls
Jungs Station Associates
Kaiser Aluminum
Kansas City Power & Light Company
KBS Real Estate Investment Trust, Inc.
Kelly-Moore Paint Co., Inc.
Kerzner Istithmar Limited
Kilroy Realty Corporation
Kinder Morgan Inc.
Legacy Partners Residential, Inc.
Lexmark International, Inc.
Liberty Global
Liberty Latin America Ltd.
LINN Energy
Lockheed Martin
Loews Corporation
Lower Alabama Gas
Madhive
McDonald's Corporation
Marlin Steel Wire Products, LLC
Marriott International, Inc.
Medtronic, Inc.
Metiri Group
MetLife, Inc.
Microsoft Corporation
Mid-America Apartment Communities, Inc.
MidAmerican Energy Holdings Company
MillerCoors
MoEngage Inc.
Moody's
MVP Management Corporation
National Grid
National Gypsum Company
National Retail Properties, Inc.
Nationwide Insurance
Navient
Newfield Exploration Company
Nissan North America, Inc.
NNESP LLC
NNN REIT, Inc.
Norgine BV
Northeast Natural Energy LLC
Novation Partners
Novelis Inc.
Ocean Properties LTD.
Occidental Petroleum Corp.
Oglethorpe Power Corporation
Omega Healthcare
ONEOK, Inc.
Ovinitiv Inc.
PayPal Holdings, Inc.
PBF Energy Inc.
Peabody Energy
People Corporation
PepsiCo, Inc.
Portland General Electric
Principal Financial Group
Prudential Financial, Inc.
Public Energy Authority of Kentucky
Public Service Enterprise Group
Puget Sound Energy
Quadrangle Development Corporation
Questar Corporation
Recover Fiber
Regency Centers Corporation
Rhythm Energy
Rolls-Royce North America
RWE Supply & Trading Americas LLC
Ryder System, Inc.
Sabinal energy
Sealed Air Corporation
Shell Energy North America
Seneca Resources Company
Siemens
Simon Property Group
Simons Petroleum, Inc.
Slickdeals LLC
Snyder Brothers, Inc.
Southern Union Gas Services, Ltd.
Southwest Airlines Co.
Southwestern Energy Company
Striim
Sprinkle Financial Consultants LLC
St. Mary Land & Exploration Co.
Sunin
Superior Graphite Co.
Superior Woodcraft, Inc.
Swift Energy Company
Targa Resources, Inc.
Teradata Corporation
Terra Energy Partners
Terex Corporation
The AES Corporation
The Boeing Company
The Coca-Cola Company
The Commonwealth Group
The Durst Organization
The JBG Companies
The Procter & Gamble Company
The Timken Company
The Walt Disney Company
Thomas Properties Group, Inc.
Tienda Inglesa
Timberlane Village Associates
Time Warner
Toyota
Transcendia
UM Holdings Ltd
Unico
United Technologies Corporation
U.S. Steel
Vectra Management Group
Vermeer
Vistra Energy Corp.
Visual Comfort & Co.
Vodafone
Volvo
Warner Bros. Discovery, Inc.
W. R. Grace
Walker Center Associates, LLC
Wal-Mart Stores, Inc.
Weingarten Realty Investors
Western Farmers Electric Cooperative
Whirlpool
Whiting Petroleum Corporation
WildFire Energy
Xcel Energy
Xerox Corporation
Xylem
Yum Brands
Zaxby's
Zilber Ltd
Zimmer, Inc.

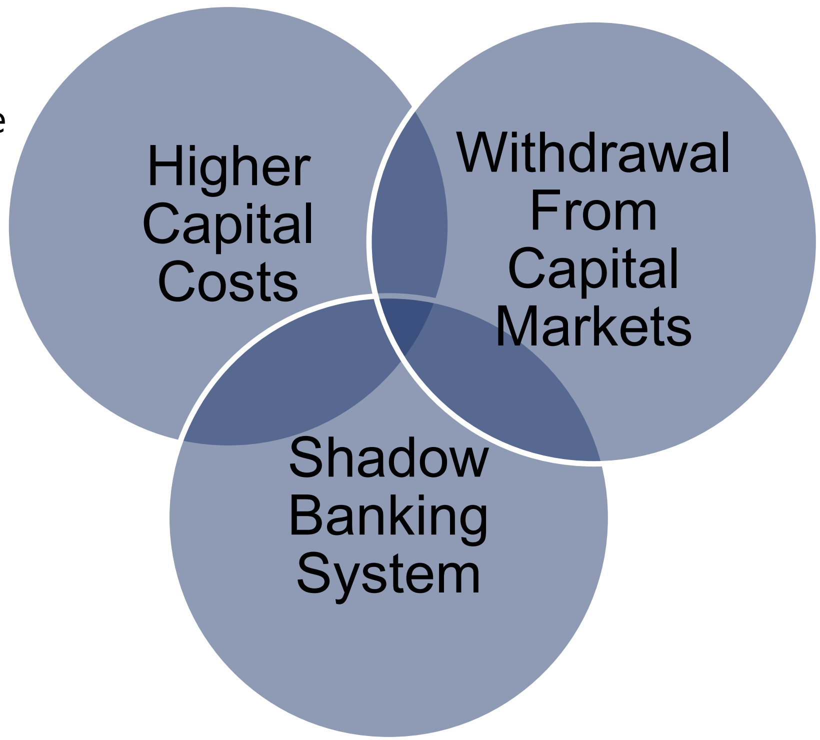
Organizations

Aerospace Industries Association of America, Inc.
Agricultural Retailers Association
American Forest & Paper Association
American Cotton Shippers' Association
American Farm Bureau Federation
American Gas Association
American Public Gas Association
American Petroleum Institute
American Soybean Association
Associated Industries of Massachusetts
Association for Finance Professionals
Business Roundtable
Commodity Markets Council
Edison Electric Institute
Electric Power Supply Association
Financial Executives International
Independent Petroleum Association of America
Independent Petroleum Association of Mountain States
Mississippi Manufacturers Association
National Association of Corporate Treasurers
National Association of Manufacturers
National Association of Real Estate Investment Trusts
National Association of Wheat Growers
National Cattlemen's Beef Association
National Corn Growers Association
National Grain & Feed Association
Natural Gas Supply Association
National Mining Association
National Rural Electric Cooperative Association
Texas Independent Producers and Royalty Owners Association
Texas Oil & Gas Association
Texas Pipeline Association
The Information Technology Industry Council
The Real Estate Roundtable
U.S. Chamber of Commerce

High-Level Impact

The current proposals would create economic instability, increasing global and domestic risk.

- As it stands, the current proposals create an uneven playing field for U.S. banks and put them at a competitive disadvantage.
- Increased capital requirements for U.S. banks will be borne by their customers, both private and public, and will put American companies at a competitive disadvantage, hurting American jobs and economic growth.
  - US corporations will have to pay more for hedges or be subject to higher input costs if risks are not hedged, e.g., cocoa as an input to chocolate.
- The proposals remove a substantial part of the benefits that Congress afforded to end-users through Dodd-Frank's clearing and margin requirement exceptions.
- The proposals would raise capital requirements on large U.S. banks and many regional banks by an estimated 20% and by as much as 70% for market risk specifically, adversely impacting lending activity, borrowing costs, market activity, and the U.S. economy as a whole.



Increased capital costs will ultimately harm consumers and create economic instability.

Why Are Derivatives Important?

Examples

- Businesses are exposed to the risk that prices and economic conditions fluctuate, impeding their ability to plan and invest for the future.
- Companies can mitigate this volatility risk by hedging using derivatives.

Commodities

- The automotive industry is exposed to the price of steel; steel prices change on a daily basis and are unpredictable.
  - If the automaker does not have certainty in the price it pays for steel as a raw material, car prices could increase with changes in steel prices.
  - However, the automaker can enter into a derivative with a bank whereby the automaker locks in a fixed price for steel purchased over a future period and passes on the uncertainty of steel prices to the bank.

FX Risk

- For U.S. companies with global operations, companies have to pay employees and buy materials in the local currency.
  - There is a risk that the value of the local currency fluctuates significantly, which could increase operating costs and in turn increase products' prices everywhere.
  - To ensure pricing and operating cost stability, companies enter into a derivative contract with a bank whereby the bank takes the risk of currency exchange rate fluctuations and provides the company a fixed price for any payments.

Interest Rate Risk

- U.S. companies require large amounts of capital to fund their operations. They may source this by issuing fixed rate debt.
  - A company may prefer to have a floating rate coupon on their issued fixed rate debt or to switch an existing floating rate loan to a fixed coupon.
  - Companies can hedge their interest rate risk arising from interest payments by entering into a derivative contract with a bank,
  - For example, a company agrees to pay the bank a floating rate of interest, and the bank agrees to pay a fixed rate of interest to service the company's debt payment.

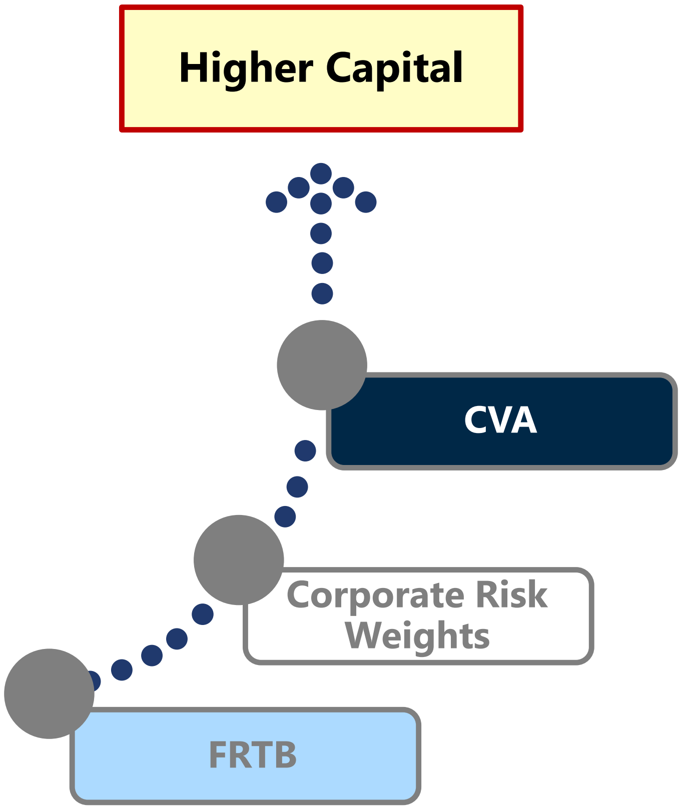
- Under the proposed rules, the capital that banks must hold to help facilitate hedging will increase significantly, which means banks must charge companies more to provide this service.

Ultimately, this higher cost of managing price risk will likely result in either: (1) companies charging customers more to purchase goods, or (2) customers experiencing more variation in the cost of goods.

Key Changes That Could Impact End-Users

Main Drivers of Increased Capital Requirements for Derivatives

1. **CVA:**
   - Increased requirements penalize non-financial end-users that utilize the clearing and margin exemptions Congress provided under the Dodd-Frank Act.
   - Includes client-clearing activity, even though banks cannot suffer CVA losses on transactions where the bank is acting in an agency capacity, penalizing pension funds, insurers, energy and agriculture companies.
2. **Corporate Risk Weights:** The NPR requires investment grade entities to be publicly traded in order to receive a preferential 65% risk weight (compared to 100%).
   - This unduly penalizes high quality private companies and is not in itself reflective of creditworthiness.
3. **FRTB:** The Non-Modellable Risk Factor ("NMRF") component limits netting and diversification recognition for derivatives that may be bespoke and tailored to a specific company's needs.
4. **G-SIB:** Includes OTC derivatives clearing under the agency model in the complexity and interconnectedness indicators of the GSIB surcharge.

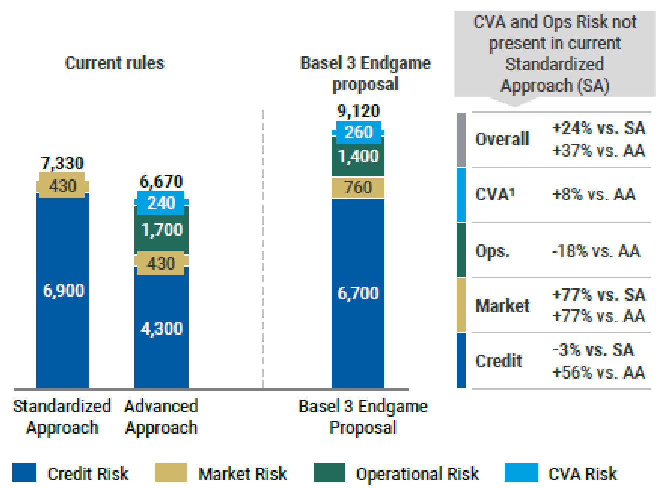


Credit Valuation Adjustment

The proposed CVA risk-capital requirements will impose undue burdens on commercial end-users and reverse policy objectives devised to support such activities.

The ERB Approach would become the de facto binding constraint in the US given the breadth and conservatism of the framework[4]. US officials estimate that for the largest banks, groupwide Market Risk RWA would rise +77% (+$330BN) and Credit Risk RWA would fall 3% (-$200BN) over the Standardized Approach in force today. However, the ERB Approach would fundamentally change the composition of the RWA stack by adding CVA (+$260BN) and Operational Risk (+$1,400BN) RWA. Based on the official estimates in the proposal, the groupwide RWA uplift for the largest US banks[5] would be $1.8TN in aggregate.

Exhibit 6: Official estimates of B3E impact on Group RWA, $BN



1. CVA = Credit Valuation Adjustment; Note: 'AA' = Advanced Approach; 'SA' = Standardized Approach. US Category I and II Bank Holding Companies. Source: US Banking Regulators, Basel 3 Notice of Proposed Rulemaking

- According to an Oliver Wyman/Morgan Stanley study, the proposals would increase CVA (+$260 BN) and Operational Risk (+$1,400 BN) risk weighted assets significantly.
  - Based on the official estimates in the proposal, the groupwide risk weighted assets uplift for the largest US banks would be $1.8TN in aggregate.
- No tailored approach for end-users will result in punitive CVA capital requirements for end-users who are not using derivatives to speculate, but to hedge and manage risk.
- Effectively reverses benefits for derivatives end-users from lower multiplier under final SA-CCR rule, contravening public policy objectives.
- CVA risk is capitalized twice through the global market shock component of stress testing and the stress capital buffer and the Basel III proposed expanded risk-based approach.

Fundamental Review of the Trading Book

The lack of diversification and hedge recognition is harmful to end-users.

- The "Non-Modellable Risk Factor" component significantly increases capital on less liquid positions, including the types of bespoke and tailored derivative hedging transactions that commercial end-users, pension funds, mutual funds and insurance companies utilize to efficiently and safely manage their business risks which, in turn, increases the costs of those hedging transactions.
- Fundamental review of the trading book (FRTB) is duplicative and redundant with aspects of the GMS component of CCAR, which is already designed to capture risks similar to those captured by FRTB.
- Implementing FRTB will lead to significantly higher than appropriate risk capital requirements, given the underlying risk.
- **Bottom Line:** Holistic review is needed to rationalize competing requirements and avoid redundancy, ensure efficiency, and better combat market risks.

Investment Grade for Unlisted Corporate Exposures

The public listing requirement penalizes creditworthy end-users by imposing a barrier that does not actually indicate an end-user's creditworthiness.

- The public listing requirement significantly penalizes eminently creditworthy companies across various sectors, including: agriculture companies, energy companies, corporate pensions, and mutual funds, as well as small and mid-sized businesses – the engine of our economy – simply because they are not publicly listed.
- The requirement is misplaced and results in an improper allocation of capital because a public listing does not directly correspond to heightened creditworthiness.
- Regulators in Europe did not include a public listing requirement in their proposals, recognizing the reality that creditworthiness and public listings are not necessarily intertwined.

GSIB Risk-Based Capital Surcharge

The current proposals would create economic instability, increasing global and domestic risk.

- The GSIB Surcharge Proposal reduces availability and increases costs for end-users in accessing cleared OTC derivatives services.
- The proposal **diverges** from G20 and Dodd-Frank clearing mandates, which would exacerbate capacity challenges facing the clearing ecosystem today and increasing transaction costs for end-users.
- Inclusion of OTC derivatives clearing under this model **does not align** with the GSIB framework:
  - The objectives of the overall GSIB framework of reducing market complexity and overall systemic risk; and
  - The international standards which excuse client clearing from the complexity indicator.

How Are Derivatives Impacted?

The proposals create an uneven playing field between the U.S. and Europe.

- End-users engage a variety of banks from different jurisdictions. If U.S. banks are less able to offer competitive pricing on uncollateralized derivatives due to increased capital requirements, the cost of hedging may rise, or availability of price competitive counterparties may fall for end-users.
- U.S. requirements under B3E are significantly more onerous than Basel standards and other jurisdictions:
  - Derivatives with corporate end users and pension funds are subject to punitive CVA capital requirements;
  - Global Basel standards are calibrated to 72.5% of RWA as output floor vs 100% in US rules; and
  - Significant double counting of risks between Basel III Endgame and CCAR Stress Testing.

		
1. Unmargined Derivatives	Capital up to **10x** higher	Exempt from CVA
2. Client- Cleared Derivatives (End users, insurance companies & pension funds clear through a bank as not direct members of a CCP)	Capital up to **3x** higher	Exempt from CVA
3. Derivatives not exempt from CVA in Europe	**100%** Calibration	72.5% Calibration
4. CCAR Stress Testing	CVA & FRTB **overlaps** with CCAR stress testing	No Direct Overlap

Summary of Recommendations

A re-proposal is required to avoid hurting derivative hedging activity

1. **The Agencies should re-propose B3E after sufficient data study is conducted and made public.**

2. **The Agencies should address the overlap between the RWA calculation and stress testing in the re-proposal.**

3. **Substantial modifications should be made to B3E to mitigate the impact on end users, consistent with the recommendations in our letter**
   - **Exempt derivatives with commercial end users and their associated hedges from CV and FRTB.**
   - **Exclude client-cleared derivatives from CVA.**
   - **Remove public listing requirement for 65% Risk weight.**
   - **Avoid double-counting between B3E and the GMS component in CCAR.**

Appendix

Investment Grade Corporate Risk Weights

The public listing requirement for investment grade entities will raise the cost of hedging for investment grade privately-owned companies.

Overview

- The NPR introduces a preferential 65% risk weight for investment grade corporate exposures that are publicly listed

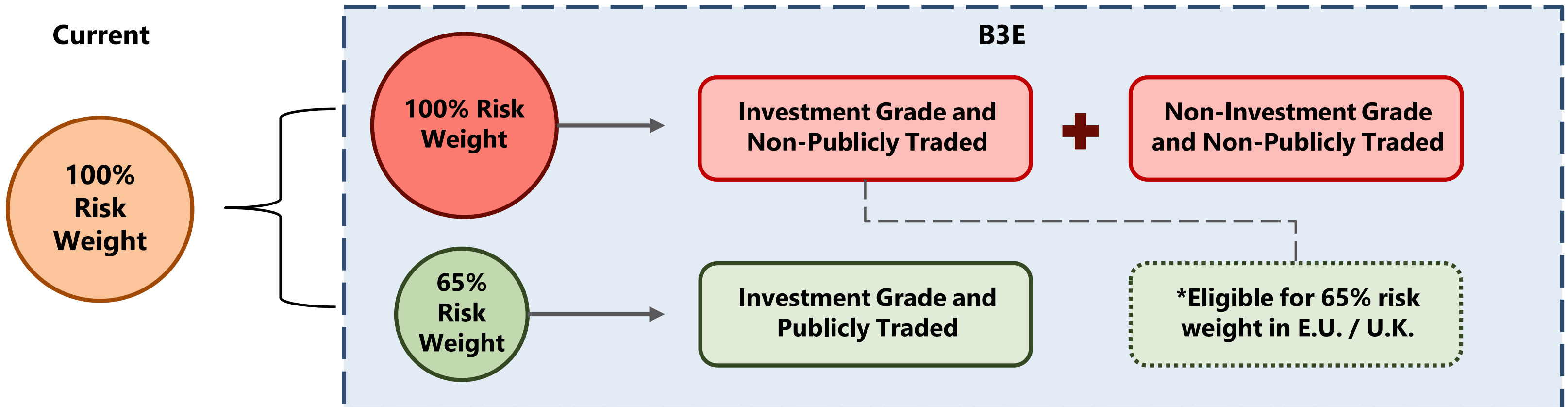
Concerns

- Banks' internal ratings are subject to robust internal risk management and supervisory oversight; there is little evidence that suggests internal ratings for unlisted corporates are less accurate versus their listed equivalents
- **This requirement has not been implemented in Europe**

Impact

- This will unduly penalize non-public companies that are highly creditworthy
- This will put institutions like pension and mutual funds at a competitive disadvantage relative to European or publicly-listed counterparts
- Small and medium business that are suppliers to major corporations.

- End-user use derivatives to hedge a wide variety of risks, contributing to economic stability and growth; this activity will be put at a competitive disadvantage for non-public companies, even if they are investment grade / highly creditworthy



Credit Valuation Adjustment (CVA)

For derivatives transactions with commercial end-users, CVA will be entirely additive to existing capital already required to be held by large banking organizations on derivatives transactions.

Undermines legislative and CFTC relief from mandatory clearing

- Commercial end-users are currently exempted from margin requirements to incentivize prudent hedging activity without limiting their ability to invest in their business

Undermines regulatory relief under SA-CCR

- Commercial end-users are currently exempted from the 1.4x “alpha” multiplier.

Inconsistent with proposal adopted in EU

- Absent a corresponding exemption, U.S. commercial end-users will face a material disadvantage.
- The PRA found these transactions to be low risk, due to high collateralization levels.

Application of CCAR’s GMS component already accounts for risks

- Including these transactions in CVA requirements is additive to existing requirements, while providing no benefit to the broader financial system.

Credit Valuation Adjustment

There is no CVA risk for large banks associated with client cleared derivatives transaction activity.

Regulators should incentivize client cleared derivatives transaction activity

- These types of transactions provide significant financial stability across markets.

U.S.-based end-users clear trades through U.S. banking organizations because they cannot become members of clearing organizations

- Reducing capacity of prudentially regulated banks from providing clearing activities will increase pricing and systemic risk, and cause harm to pension funds, U.S. farmers, and the agriculture industry.