



NEWS RELEASE

FOA SAYS THAT THE CRD SHOULD NOT BE IMPOSED ON COMMODITY MARKET PARTICIPANTS UNAMENDED

London Thursday 29 March 2007 : The Futures and Options Association (FOA) has long held the view that the quantum of risk posed to the financial system by commodity market participants, the commercial nature of their underlying business and the kind of assets held by them call for a differentiated prudential regime. More particularly, the Capital Requirements Directive (CRD), designed for deposit-taking and investment businesses, is not aligned to the risks faced by commodity market participants; and the regulatory framework does not take adequate account of the differences between commercial business and investment business.

The FOA's position is the result of consultation with its members and is supported by a report commissioned by it from KPMG. In this report, KPMG observes that the capital requirements based on Pillar I of Basel 2 appear to be aligned specifically to the structure and practices of the banking industry and as such are not proportionate to the risks and market practices of specialists in the commodity derivatives markets.

The report highlights several specific areas of concern relating to the core Pillar I risk categories of market, credit and operational risk:

Market risk calculations for commodity firms are impacted by a combination of spot price volatility on the physical underlying and seasonal peaks in commodity price, neither of which is considered by the current, bank-focused requirements.

Calculations for *credit risk* fail to consider settlement periods of at least 15 days often seen in physical markets, with significant penalties imposed on firms exceeding a 5 day settlement period. The relatively low number of industrial counterparties with external credit ratings creates further penalties, with no allowance made for the long established market experience of specialist firms within their own markets.

Existing capital calculations provide an incentive for commodity firms to adopt the less sophisticated Basic Indicator Approach over the more advanced Standardised Approach for *operational risk*.

EEC regulators have already expressed the view that some form of 'light touch' regime may be appropriate for commodity market participants, and the FOA hopes that this paper will provide additional focus for the ongoing review currently being undertaken by the Committee of European Banking Supervisors (CEBS) and the recent Call for Evidence on the same issue by the European Commission.

Anthony Belchambers, Chief Executive of the FOA, said: "This report vindicates our longstanding view that the CRD should not be applied to commodity market participants in unamended form. That said, it is equally important that the need to set a proportionate regulatory regime for one group of market participants should be extended to other market participants, where appropriate, and should be sufficiently risk-based to meet the need for fair and proportionate treatment of all commodity market participants."

Bill Wellbelove, Director, KPMG said: "We noted wide consistency of views across the firms that participated in the survey – some were more advanced in their thinking than others, but there was general agreement on the difficulties in translating the financial sector risk framework for the commodities sector. Our brief was to outline issues not to devise solutions, so we await with interest the outcome of the review that is now in progress at the EU Commission. We are very grateful to the FOA for giving us the opportunity to work on this report. "

Notes for Editors and Contact Information attached.

NOTES FOR EDITORS & CONTACT DETAILS

1. CAPITAL REQUIREMENTS DIRECTIVE (CRD) / BASEL 2

What is the CRD?

The original Basel Accord was agreed in 1988 by the Basel Committee on Banking Supervision. The 1988 Accord, now referred to as Basel 1, helped to strengthen the soundness and stability of the international banking system as a result of the higher capital ratios that it required.

Basel 2 is a revision of the existing framework, which aims to make the framework more risk sensitive and representative of modern banks' risk management practices. There are four main components to the new framework:

- greater sensitivity to the risks that firms face: the new framework includes an explicit measure for operational risk and includes more risk sensitive risk weightings against credit risk.
- the introduction of an internal ratings based approach (IRB) that allows firms to rely to a certain extent on their own estimates of credit risk.
- incentives for firms to improve their risk management practices, with more risk sensitive risk weights as firms adopt more sophisticated approaches to risk management.
- The new framework aims to leave the overall level of capital held by banks collectively broadly unchanged.

This revised capital adequacy framework is expected to reduce the risk of consumer loss or market disruption as a result of prudential failure. It will do so by seeking to ensure that the financial resources held by a firm are commensurate with the risks associated with the business profile and the control environment within the firm. The new Basel Accord has been implemented in the European Union via the Capital Requirements Directive (CRD). It will directly affect banks and building societies and certain types of investment firms.

The new framework consists of three 'pillars':

Pillar 1 which sets out new standards for the minimum capital requirements firms will be required to meet for credit, market and operational risk.

Pillar 2 which requires firms and supervisors to consider whether a firm should hold additional capital against risks not covered in Pillar 1 and take any necessary action.

Pillar 3 improves market discipline by requiring firms to publish certain details of their risks, capital and risk management.

Source FSA

2. CORPORATE SUMMARIES & CONTACT DETAILS

The Futures and Options Association (FOA)

The FOA is a European industry trade association for firms and institutions carrying on business in futures, options and other derivatives or which use such products in their business. Its principal role is to represent the interests of its members in the public and regulatory domain and deliver a wide range of support services to the core membership, which includes banks and financial institutions, brokers, commodity trade houses, energy and power market participants, fund managers, exchanges and clearing houses.

The FOA fulfils its role by:

- constructive liaison with regulators, government and other political and trade bodies at national, European and international levels;
- raising public awareness and understanding of the futures and options industry;
- producing standardised industry documentation, publications and guidelines;
- delivering training courses and workshops.

In Brussels the FOA was a founder member of the European Parliamentary Financial Services Forum (EPFSF) and is an active member of the EPFSF Advisory Committee. In the United Kingdom the FOA has supported the establishment of an Associate Parliamentary Group (APG) on Wholesale Financial Markets & Services, which was formally registered at Westminster in December 2002.

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About KPMG:

KPMG is the global network of professional services firms who provide audit, tax and advisory services. KPMG LLP operates from 22 offices across the UK with over 10,000 partners and staff. KPMG recorded a UK turnover of £1.45 billion in the year ended September 2006. KPMG LLP, a UK limited liability partnership, is the UK member firm of KPMG International, a Swiss cooperative.

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