Clients&FriendsMemo

The Federal Reserve's Proposed Rollback of Physical Commodities Authority for Financial Holding Companies

September 29, 2016

On September 23, 2016, the Board of Governors of the Federal Reserve System (the "FRB") issued a proposed regulation concerning the ability of a financial holding company ("FHC")[1] to engage in physical commodities activities (the "Commodities Proposal"). The Commodities Proposal follows an advanced notice of proposed rulemaking issued by the FRB more than two years ago in early 2014.[2]

The Commodities Proposal reflects a new approach to restrict activities that the FRB believes to impose excessive risk. Rather than attempt to restrict the commodities activities that are specifically permitted by federal statute, the FRB instead is proposing to use its capital authority to make certain physical commodities activities economically impracticable for FHCs. The Commodity Proposal focuses predominantly – but not exclusively – on certain types of physical commodities that the FRB perceives as high risk to FHCs due to environmental or related litigation risk (a "*covered physical commodity*").

Yet, only three weeks ago, in the FRB's Section 620 report to Congress regarding activities the FRB deemed to pose systemic risk, the FRB conceded that while certain of these physical commodities are believed to create systemic risk, repeal of this authority "require[s] congressional action and cannot be accomplished by the [FRB] unilaterally."[3] It is telling that the FRB did not wait for congressional action but instead used its capital authority effectively to repeal the authority granted by Congress.

---

1 A "financial holding company" is, in essence, a well-managed, well-capitalized bank holding company that has filed a notice with the FRB to engage in expanded, "financial in nature" activities.

2 *See* Board of Governors of the Federal Reserve System, Advanced Noticed of Proposed Rulemaking, *Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies Related to Physical Commodities*, 79 FED. REG. 12,414 (Mar. 5, 2016).

3 *See* Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency, *Report to the Congress and the Financial Stability Oversight Council Pursuant to Section 620 of the Dodd-Frank Act* (Sept. 8, 2016) (the "Section 620 Report") at p. 28, available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20160908a1.pdf.

Background of FHC Physical Commodities Authorities

An FHC may engage in physical commodities activities under a variety of different legal authorities:

- An FHC may use its *merchant banking authority* to acquire all or a portion of a company engaged in physical commodities activities, provided that the FHC does so with *bona fide* merchant banking intent, does not routinely operate or manage the company, generally holds the investment for not more than ten years, and complies with certain other restrictions on crossmarketing and affiliate transactions.[4]
- In addition, an FHC may apply to the FRB for permission to engage in physical commodities activities on "*complementary" authority*. The twelve FHCs that have obtained such approvals[5] may engage in physical commodities activities subject to certain limits imposed by the FRB – in particular, the physical commodity must be approved by the Commodity Futures Trading Commission for trading on a U.S. Futures Exchange or otherwise specifically approved for trading by the FRB, the FHC may not be involved in the extraction, processing, transportation, storage, or distribution of the commodities, and the amount of such commodities exposure may not exceed 5% of the FHC's Tier 1 capital.
- FHCs that first converted from a non-FRB regulated entity to a bank holding company following the 1999 passage of the Gramm-Leach-Bliley Act are permitted to retain existing physical commodities activities, referred to as *"grandfathered" commodities authority*. Grandfathered authority is subject to fewer restrictions than complementary authority, requires no special FRB approval, and the amount of allocable physical commodities activities is subject to a much higher limit of 5% of the FHC's total assets.[6] In addition, the restrictions on extraction, processing, transporting, storage, and distribution do not apply to grandfathered commodities authority.[7]
- An FHC – or even a banking holding company or a subsidiary bank – may retain physical commodities, or shares of a company engaged in physical commodities activities, if acquired in satisfaction of a debt previously contracted (for example in foreclosure or as part of a workout),

4 *See* 12 U.S.C. § 1843(k)(4)(H), 12 C.F.R. Part 225 Subpart J.

5 This authority is based on a provision of the Bank Holding Company Act, added in the Gramm-Leach-Bliley Act of 1999, which permits the FRB, by order or rule, to allow an FHC to engage in activities that are complementary to a financial activity. *See* 12 U.S.C. 1843(k)(1)(B). The authority to engage in physical commodities activities as a complementary activity was first issued in 2003. *See Citigroup Inc.,* 89 FEDERAL RESERVE BULLETIN 508 (2003). The twelve FHCs with complementary authority are: Bank of America, Credit Suisse, BNP Paribas (formerly Fortis SA/NV), Wells Fargo (formerly Wachovia), Société Générale, Deutsche Bank, JP Morgan Chase, Barclays, UBS, Citigroup, RBS and Scotiabank.

6 12 U.S.C. § 1843(o).

7 Only two FHCs have grandfathered commodities authority – Goldman Sachs and Morgan Stanley.

referred to as a *"DPC authority."*[8] Assets or shares held by an FHC under DPC authority may be held only for two years unless approved by the FRB.

- An FHC, bank holding company or bank may freely engage in physical transactions involving precious (or "bullion") metals.[9]
- Finally, bank subsidiaries of an FHC may hold physical commodities as hedges on commodity derivatives entered into by the bank.[10]

FHCs historically have relied on a variety of these authorities to engage in physical commodities activities. To the extent that these physical commodity activities now involve "covered physical commodities," the Commodities Proposal greatly increases the internal costs of engaging in such activities.

Heightened Capital Charges on Covered Physical Commodities Activities

The FRB's Commodity Proposal would significantly increase the capital charges associated with an FHC's activities with respect to *covered physical commodities* depending on the authority used. The FRB proposal does not explicitly define *"covered physical commodity"* but rather incorporates by reference certain substances that are deemed hazardous or otherwise subject to regulation under federal and state environmental protection laws and regulations. Such covered physical commodities would likely include, but are not limited to: oil, natural gas, and other petroleum products and by-products; lead; certain fertilizers and emissions; and uranium. The Commodities Proposal would <u>not</u> increase capital charges on physical commodities activities other than those involving covered physical commodities. For example, the ability to trade in agricultural, forestry, and livestock products as well as base metals (other than uranium and, as explained later, copper) would remain unchanged.

The Commodities Proposal would impose the following capital charges on covered physical commodities activities:

- A risk-based capital weighting for covered physical commodities exposure held under *grandfathered authority* of 1,250 percent (in essence, requiring the FHC to retain one dollar of capital for every dollar of exposure);
- A risk-based capital weighting of 1,250 percent for covered physical commodities exposure held under *merchant banking authority*, <u>unless</u> the merchant banking investment is in a "*covered*

---

8 *See* 12 U.S.C. § 1843(c)(2).

9 *See* 12 C.F.R. § 225.28(b)(8)(iii).

10 *See, e.g.,* OCC Interpretive Letter No. 632 (June 30, 1993); OCC Banking Circular 277 (Oct. 27, 1993).

commodity trading portfolio company",[11] in which case risk-weight assigned is 300 percent if the trading portfolio company's shares are publicly listed for trading, and 400 percent with respect to a non-listed trading portfolio company;

- A risk-based capital weighting of 1,250 percent for assets consisting of covered physical commodity "infrastructure assets" (*e.g.*, transportation, storage and processing facilities) held under *grandfathered authority*;
- A risk weight of 300 percent for exposures to covered physical commodities held under *complementary authority*. However, if the FHC's total amount of covered physical commodities exposure (including any exposure held by its subsidiary banks) exceeds 5% of the FHC's Tier 1 capital (referred to as the "*section 4(k) cap parity amount*"), then the excess is subject to a risk-weight of 1,250 percent. Exposure held under *merchant banking authority*, *grandfathered authority* or *DPC authority* would be excluded from the calculation of the section 4(k) cap parity amount, while amounts held by subsidiary banks as hedges to cover physical commodity derivatives are not. The effect of this provision is to subject physical hedges on covered commodity derivatives to a risk-weight of 1,250 percent if the amount of such hedge exposure, plus positions in covered commodities held by the parent FHC under complementary authority, exceed 5% of the FHC's Tier 1 capital.

The Commodities Proposal establishes detailed procedures regarding how each of these exposures is to be calculated for risk-based capital purposes.

Other Changes

The Commodities Proposal would make a number of other changes to an FHC's physical commodities trading authority, most of which are not limited to covered physical commodities activities:

- The Proposal would re-classify copper as a base metal rather than as a precious metal, making an FHC unable to rely on precious metals trading authority to trade in copper. The Commodities Proposal parallels a proposal that was issued earlier this month by the Office of the Comptroller of the Currency applicable to national banks and federal savings associations.[12] FHCs would have one year to conform to the new restrictions on copper trading.

[11] A *covered commodity trading portfolio company* would be defined as:

> a covered commodity merchant banking investment that engages in covered physical commodity activities that are only the purchasing and selling of one or more covered physical commodities (each of which is an approved physical commodity) in the spot market and the taking and making physical delivery of one or more covered physical commodities (each of which is an approved physical commodity) to settle forward contracts, options, futures, options on futures, swaps, or similar contracts.

[12] *See* Office of the Comptroller of the Currency, Notice of Proposed Rulemaking, *Industrial and Commercial Metals*, 81 fed. reg. 63,428 (Sept. 15, 2016).

- The Commodities Proposal would rescind the authority of five FHCs to engage in energy management and energy tolling activities under *complementary authority*.[13] According to the FRB, it no longer considers such activities truly "complementary" to financial activities and, furthermore, four of the five FHCs have already advised the FRB of their intent to terminate such activities. FHCs would have two years to conform to the elimination of energy management and tolling authority.
- The FRB would revise the quarterly FR Y-9C, the consolidated financial statement for holding companies, to require public disclosure of certain information regarding an FHC's physical commodities activities. The FR Y-9C is a publicly available document.
- Finally, the Commodities Proposal would amend the FRB's Regulation Y to include a provision regarding *complementary authority* with respect to *any* physical commodity (not just covered physical commodities). This new provision would revise the 5% cap applicable to an FHC's *complementary authority* to include physical commodity positions held by the FHC and its affiliates under any authority other than merchant banking authority and DPC authority. This would require, for example, a subsidiary bank's physical commodity hedges to be included in the 5% cap applicable to the FHC's complementary authority. FHCs would have two years to conform to this newly adjusted limit. In addition, Regulation Y would include a provision stating that an FHC may not "operate, or invest in facilities or vessels for the extraction, transportation, storage, or distribution of physical commodities" under complementary authority. Accordingly, Regulation Y would be amended to define "operate" as including:

  (1) Participation in the day-to-day management or operations of the facility;

  (2) Participation in management and operational decisions that occur in the ordinary course of the business of the facility; and

  (3) Managing, directing, conducting, or providing advice regarding operations having to do with the leakage or disposal of a physical commodity or hazardous waste or decisions about the facility's compliance with environmental statutes or regulations.

As demonstrated, the FRB's Commodities Proposal reflects a significant rollback in FHC authority to transact in certain covered physical commodities, such as petroleum products. Trading activity in other physical commodities is less impacted. However, it should not be overlooked that the FRB separately has recommended to Congress that it repeal both merchant bank authority in its entirety (including but not limited to commodities activities conducted under merchant banking authority),

[13] *See Fortis S.A. I N.V.*, 94 FEDERAL RESERVE BULLETIN C20 (2007); *The Royal Bank of Scotland Group PLC*, 94 FEDERAL RESERVE BULLETIN C60 (2008).

and grandfathered commodities authority.[14] Thus, further rollbacks may be coming, but they may be dependent on Congressional action.

Comments on the FRB's Commodities Proposal are due by December 22, 2016.

* * * *

Should you have any questions about this memo, please contact Scott Cammarn (scott.cammarn@cwt.com); Paul J. Pantano, Jr. (paul.pantano@cwt.com); Athena Eastwood (athena.eastwood@cwt.com); Vanessa Tanaka (vanessa.tanaka@cwt.com); or Jacob Dachs (jacob.dachs@cwt.com).

[14] See the Section 620 Report, *supra* note 3.