FHC Physical Commodity Activities

Cite

FRB, Advance Notice of Proposed Rulemaking (ANPR), Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies related to Physical Commodities

Recommended Distribution

Capital Markets, Commodities, Corporate Planning, Policy, Legal, Government Relations

Website

http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20140114a1.pdf

Impact Assessment

- The FRB is asking questions, not proposing specific requirements pertaining to non-trading physical-commodity operations at several very large U.S. FHCs. The rulemaking process means that any restrictions will take time to implement. However, individual FHCs may still come under FRB pressure to revise their operations.
- Higher capital charges and more operational constraints are the most likely FRB responses.
- Non-bank SIFIs could face tough new rules, standards that would have even more dramatic impact on their physical-commodity operations than on FHCs.
- Grandfathering for two large FHCs could be sharply constrained if the FRB decides it gives them an unfair advantage over banks and FHCs engaged in comparable activities under other authorizations.

Overview

Confronted with negative press coverage and Congressional hearings on the physical-commodity activities of large financial holding companies (FHCs),[1]the FRB has sought views on what it might due to address risks in this high-profile arena. Trading in this sector would not be directly affected, but "complementary," merchant banking, and grandfathered transport, operational, warehousing, and other commodity activities could be subjected to higher capital, stricter limits, or other constraints up to and including a flat prohibition were the FRB to decide that comments warrant action.

Impact

The ANPR details the array of authorities under which banks and FHCs undertake physical-commodity activities, including OCC approvals, FRB authorizations for merchant-banking and complementary activities under the Gramm-Leach-Bliley Act[2] and subsequent FRB orders, as well as under grandfathering allowed for non-banks that become FHCs. In the course of the financial crisis, various actions – most notably JPMorgan's acquisition of Bear Stearns and the transformation into FHCs of Goldman Sachs and Morgan Stanley – led to a far larger integration of banking and physical commodities than might have been envisioned in prior regulatory actions. Given all this, the FRB is now reviewing the state of play and the prudential rules governing it to determine if new standards – including tougher overall exposure limits – are warranted.

The ANPR includes only the questions discussed below, drawing no initial FRB conclusions on them. However, the background discussion – especially regarding the tail risk to FHCs resulting from environmental and reputational damage – suggests areas of concern to the FRB perhaps not fully reflected in current rules and activity authorizations. A series of questions based on this is posed, focusing particularly on capital and insurance to determine the extent to which they provide sufficient risk buffers.

Even as the FRB studies this issue, the market is changing. Perhaps under regulatory pressure, JPMorgan is reportedly selling its physical-commodity operations and Morgan Stanley recently sold a significant operation to a Russian firm. In the absence of over-arching standards, constraints on a firm-by-firm basis may address FRB supervisory worries, but also result in an unequal competitive landscape among large U.S. FHCs and that vis-à-vis foreign banking organizations. These divestitures may reduce risk to U.S. FHCs, but perhaps raise broader systemic concerns, particularly if private-sector activities are increasingly housed in sovereign or sovereign-affiliated entities that may undertake physical-commodity operations not only

[1] See Client Reports in the **COMTRADE** series.

[2] See *Financial Services Regulation & Legislation*, November 29, 1999.

for profit, but also to advance national objectives or obtain significant holdings exempt from antitrust or other rules seeking to prevent cartelization in key commodities. Conflicts of interest could also result from greater market concentration, as non-banking firms could own substantial trading and physical positions that create market-integrity concerns. The Board notes, however, that FHC divestitures to date may simply be forced by market changes, seeking comment on this and the extent to which changes should affect its view of how complementary physical-commodity operations are to financial and permissible trading ones.

Advocates of strict restrictions and/or prohibitions on FHC physical-commodity activities believe them warranted because of what they see as the inappropriateness of these operations in concert with gathering insured deposits and other "traditional" banking activities. The U.S. Congress addressed this to some degree in the Volcker Rule[3] and the European Union is now considering "ring-fencing" certain activities from traditional banking.[4] The FRB is seeking views on both approaches – i.e., prohibitions and inter-affiliate activity restraints – potentially creating a very different landscape for FHCs now engaged in this activity and/or differences in cross-border treatment of it.

As noted, another major issue here is capital, with the FRB seeking views on whether additional capital requirements, perhaps including surcharges, should apply to commodity operations. The ANPR notes that eleven of the twelve FHCs now allowed to engage in U.S. physical-commodity activities are global systemically-important banks (G-SIBs) and thus subject to a systemic surcharge[5] soon to be implemented in the U.S.[6] The FRB could decide this is sufficient, or perhaps add another capital surcharge specifically for physical commodities, increasing still more the capital burden of affected FHCs.

Operational risk-based capital (ORBC) standards also govern this type of risk, although these rules do not expressly address specific commodity concerns such as a bank or a FHC's exposure to massive environmental damage following an event like the BP spill in the Gulf of Mexico.[7] Again, views are sought about new capital requirements, which would affect FHCs in this activity exempt from G-SIB treatment. The Board also cites other capital issues, including seeking views on whether the current value-at-risk (VaR) framework addresses holding physical commodities. VaR capital has recently

3 See Client Reports in the **PROPTRADE** series.

4 See Client Report **REFORM93**, October 2, 2012.

5 See **CAPITAL180**, *Financial Services Management*, November 6, 2011.

6 See **SYSTEMIC54**, *Financial Services Management*, January 3, 2012.

7 See **OPRISK9**, *Financial Services Management*, July 28, 2004.

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been significantly hiked in the U.S. rewrite of the market-risk rules[8] and is pending a fundamental revision in Basel.[9] Views are sought on whether VaR or alternative approaches (perhaps including the expected-shortfall approach out for Basel comment) might work better. Any revision would almost surely hike applicable capital, although the FRB's questions here are neutrally phrased and appear only to apply to complementary, not grandfathered activities.

The Board's review affects not only covered FHCs, but also S&L holding companies and non-bank financial institutions designated as SIFIs.[10] So far, only three such designations have been made, but the FSOC is considering others, including possible designation for asset managers. Comment is sought on whether commodity activities in non-bank SIFIs, especially those that control insured depositories, may be different than that in FHCs and, if so, how the rules germane to them should be structured. Non-bank SIFIs are largely exempt even from current capital and prudential rules governing FHC physical-commodity operations, let alone from any more stringent ones that the Board might institute. Thus, the issue has significant strategic impact on designees and those facing this prospect.

What's Next

The ANPR was released on January 14, a day before another Senate Banking hearing[11] at which Subcommittee Chairman Sherrod Brown (D-OH) and other Democrats lambasted what they called the vague tone of the ANPR and pushed for more specific and severe sanctions. No legislation to date has been introduced to govern physical-commodity activities, although Sen. Warren (D-MA) used this issue to push for a flat prohibition on non-traditional activities.[12] Legislation specific to physical commodities might also advance if the FRB concludes that it would like to contain activities, especially those of grandfathered FHCs, but lacks clear statutory authority to do so.

Comments on the ANPR are due by March 15, following which the FRB will determine if a specific proposal is warranted. This is likely to take considerable time, meaning that final action – if any – is unlikely to affect the industry and broader markets until 2015 at the earliest.

[8] See **CAPITAL199**, *Financial Services Management*, July 7, 2013.

[9] See **CAPITAL202**, *Financial Services Management*, November 15, 2013.

[10] See **SYSTEMIC29**, Financial Services Management, July 13, 2010.

[11] See Client Report **COMTRADE3**, January 15, 2014.

[12] See **FHC21**, *Financial Services Management*, August 15, 2013.

Analysis

A. Current Requirements

Potential inadequacies in the current framework related to BHCs engaging in these activities cited by the FRB include:

- legal liability resulting from reliance on third parties, advisory services, and other operations in this arena;
- run-risk resulting from public concern about an FHC or its subsidiary banks in a catastrophic incident linked to commodity operations;
- risk exclusions in current insurance and the uncertainty of claims payment;
- inadequacies in the FHC's insulation from legal risk in the event a physical-commodity subsidiary is exposed to tail risk; and
- reputational risk to an FHC or its insured depository institutions (IDIs), a risk perhaps exacerbated at FHCs due to the absence of any catastrophic problems to date.

B. Merchant Banking

The FRB's concerns related to FHCs engaging in these activities through this authority are similar to those germane to complementary activities. However, specific actions on which comment is solicited include:

- more restrictive holding periods;
- additional restrictions on "routine management"; and/or
- enhanced reporting.

C. Questions

Additional questions on which views are solicited include:

- relevant risk criteria;
- additional restrictions for complementary physical-commodity operations (e.g., higher capital, increased insurance, greater exposure limits, legal/reputational/environmental safeguards, liquidity assurance, concentration-risk prevention, and conflict-of-interest standards);
- variations in commodity risk and appropriate controls;

- negative impact on an IDI if the parent were not engaged in complementary commodity activities;
- the extent to which physical activities remain "meaningfully connected" to financial ones and thus are still permissible complementary ones;
- the costs and burdens of changing the complementary rules and, conversely, the public benefit of additional constraints;
- whether any of the actions noted above for merchant-banking activities is needed or if others – e.g., higher capital – should also be imposed; and
- the fairness of the differences between FHCs engaging in these activities under grandfathered rights versus all others and the value of additional prudential restrictions in alleviating any undue difference and in improving safety and soundness at grandfathered firms.