

# Regulatory brief

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## ***Physical commodity activities: Too risky for banking organizations?***

### **Overview**

On January 14, 2014 the Federal Reserve Board ("FRB") issued an advance notice of proposed rulemaking ("ANPR") seeking public comment on physical commodities activities conducted by Financial Holding Companies ("FHCs").<sup>1</sup> The FRB will conduct a review following the comment period to determine whether any further action, including rulemaking, is necessary. Comments on the ANPR must be received by March 15, 2014.

Historically, US policy has separated banking and commerce on the theory that separation is necessary to prevent undue concentration of resources, conflicts of interest, or unsound banking practices. Among the few exceptions to this policy are those available to FHCs that (a) with FRB approval, are allowed to engage in physical commodity trading and other activities considered to be "complementary to authorized financial activities,"<sup>2</sup> (b) without FRB approval, are permitted to make merchant banking investments in nonfinancial companies, including those engaged in physical commodity activities,<sup>3</sup> and (c) qualify for the statutory grandfathering of certain physical commodities activities lawfully engaged in by a company that became a FHC after the enactment of the Gramm-Leach-Bliley Act ("GLBA").<sup>4</sup>

These relatively obscure exempted activities recently became the subject of congressional hearings at which several private witnesses expressed concerns about the role of financial institutions in commodity markets, and witnesses for the FRB, Commodity Futures Trading Commission ("CFTC") and the Federal Energy Regulatory Commission ("FERC") explained their roles in overseeing commodities activities. Following these hearings, the FRB's ANPR sets forth concerns largely around FHCs' potential exposure to liability for environmentally catastrophic events due to their physical commodities activities (which the ANPR reviews in grim detail under an assumption of massive lawsuits).

Beyond catastrophic events, the FRB also questions the rationale behind its own exemptive orders allowing FHC's to expand into "complementary" physical commodities activities to be more competitive and to better serve their clients in the commodity markets. Only a dozen firms have applied for this exemption since it was first provided in 2003, and some of these firms have recently announced their intentions to withdraw from or reduce their presence in the physical commodity markets.<sup>5</sup>

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<sup>1</sup> See the FRB's Press Release of January 14, 2014 on *Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies related to Physical Commodities*; and the ANPR at 79 Fed. Reg. 3329 (Jan. 21, 2014).

<sup>2</sup> Section 4(k)(1)(B) of the Bank Holding Company Act ("BHCA"). Note also that this ANPR is the first action by the FRB since its announcement on July 19, 2013 that it would be reviewing its post Gramm-Leach-Bliley Act determination that certain commercial commodity activities are "complementary" to financial activities and thus permissible for FHCs.

In our view the ANPR will likely lead to proposed regulations that include additional restrictions on physical commodity activities, with stricter limitations when the underlying physical commodities are more likely to cause catastrophic events. Less clear is whether additional restrictions will be proposed for merchant banking portfolio investments in physical commodities or other activities. We believe there could be a Notice of Proposed Rulemaking within six to nine months, if Congress remains interested in the subject.

This **Financial Services Regulatory Brief** provides the current status of FHCs' role in physical commodity activities and analyzes the released ANPR.

## Physical commodity activities by FHCs

Before the enactment of GLBA in 1999, bank holding companies ("BHCs") were authorized to engage in a very limited set of physical commodity activities that were related to banking closely enough to be considered incidental to it. These activities included (a) buying, selling, and storing copper and certain precious metals (e.g., gold, silver, platinum, and palladium), (b) engaging as principal in cash-settled derivative contracts based on commodities, and (c) engaging in commodity derivatives that allowed for physical settlement if the BHC made reasonable efforts to avoid delivery of the commodity.

GLBA created the FHC framework which allowed BHCs with well-capitalized and well-managed bank subsidiaries to elect FHC status in order to engage in expanded financial activities.<sup>3</sup> This expansion of scope was made possible by three GLBA provisions.

The first GLBA provision authorizes an FHC to engage in any activity that the FRB finds to be "complementary to a financial activity," so long as the activity does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally. Under this authority, the FRB has approved requests by FHCs to engage in three types of complementary activities:

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<sup>3</sup> Section 4(k)(4)(H) of the BHCA.

<sup>4</sup> Section 4(o) of the BHCA.

<sup>5</sup> The ANPR lists Deutsche Bank, JPMorgan Chase, and Morgan Stanley as such firms.

<sup>6</sup> In addition to capital and management requirements, the subsidiary depository institutions of FHCs must have at least a "satisfactory" rating under the Community Reinvestment Act, and the FHCs themselves must also be well capitalized and well managed. These additional requirements are imposed by the GLBA and the Dodd-Frank Act, respectively.

- **Physical commodity trading** – the purchase and sale of commodities in the spot market, and taking and making of physical commodities to settle commodities derivatives.
- **Energy tolling** – paying a power plant owner fixed periodic payments that compensate the owner for its fixed costs in exchange for the right to all or part of the plant's power output.
- **Energy management services** – providing transaction and advisory services to power plant owners.

In each case of authorizing these activities, the FRB generally has found that the approved activities (a) flowed from the financial activities already authorized under the BHCA, (b) would enable FHCs to be more competitive in commodity markets, and (c) would allow FHCs to provide a full range of services to their customers.

To mitigate the risks posed by these activities to the FHC, its bank subsidiary, or the US financial system, the FRB placed certain restrictions on the activities. Perhaps most importantly, an FHC's aggregate market value of commodities is limited to no more than 5 percent of the FHC's consolidated Tier 1 capital. Furthermore, physical commodity trading is generally limited to physical commodities approved by the CFTC for trading on a US futures exchange or otherwise approved by the FRB.

Other restrictions the FRB places on FHCs that engage in commodity activities include requiring FHCs to:

- Hold regulatory capital against the counterparty credit risk from commodity derivatives (and other types of over-the-counter derivatives), and against the market risk of all commodity positions.<sup>7</sup>
- Hold capital against the operational risk of their activities, including their commodities activities (under the Basel III advanced approaches capital rules).
- Not own, operate, or invest in facilities for the extraction, transportation, storage or distribution of commodities, or facilities that process, refine or otherwise alter commodities.
- Obtain insurance and establish policies and procedures that are intended to prevent and respond to oil spills and similar incidents of catastrophic events that involve environmentally sensitive products (such as oil or natural gas).

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<sup>7</sup> Following the financial crisis, the FRB has strengthened its capital requirements for the credit risk and market risk of these transactions.

Under the second GLBA provision, FHCs are permitted to make merchant banking investments, without prior approval, in companies engaged in nonfinancial activities not otherwise permitted for FHCs, including in companies engaged in physical commodities activities.<sup>8</sup> This exemption is subject to a number of conditions, including restrictions on the ability of an FHC to routinely manage or operate a merchant banking portfolio company, and the requirement that merchant banking investments be disposed of within 10 years after purchase (or within 15 years for investments made through a private equity fund).

The third GLBA provision allows FHCs to engage in grandfathered physical commodity activities pursuant to Section 4(o) of the BHCA. Under this Grandfather Authority an FHC that was not a BHC and becomes an FHC after November 12, 1999, may continue to engage in the activities related to the trading, sale, or investment in commodities that were not permissible for BHCs as of September 30, 1997, if the company engaged in such activities as of September 30, 1997 in the US. Only Goldman Sachs and Morgan Stanley currently engage in physical commodity activities under this grandfathering provision.

Unlike the FHCs trading physical commodities under complementary authority, the grandfathered firms are able to engage in the transportation, storage, extraction, and refining of commodities. Moreover, the cap on commodity activities under grandfathered rights is 5 percent of the FHC's aggregate assets, rather than 5 percent of Tier 1 capital for FHCs relying on complementary authority. The activities that grandfathered firms are allowed to conduct are limited to those done before the GLBA; however, the specific parameters of what activities were conducted and the parallel to another activity are fact-specific for each firm.

## FRB concerns with physical commodity activities

The ANPR requests information and comments in response to 24 specific questions, 18 of which focus on complementary physical commodities trading activities engaged in by a dozen large FHCs. An additional four questions raise the broader issue of whether merchant banking investments in portfolio companies that are engaged in activities that pose significantly greater risks should be subject to greater prudential restrictions, or whether all merchant banking investments should be subject to additional prudential safeguards. A final two questions concern whether FHCs with grandfathered activities have any competitive advantages in conducting

their physical commodity activities and should be subject to additional prudential measures.

As evident by the FRB's 18 questions on the topic, a major FRB concern is around the effect that an environmental catastrophe or similar activity with "tail risk" could have on a FHC that is engaged in physical commodity activities, and on the financial system. The ANPR specifically details the potential risks to FHCs posed by such activities involving environmentally sensitive commodities such as oil and gas. Examples of the risks included in the ANPR are the Deepwater Horizon oil spill that has resulted in over \$42 billion in cumulative losses recognized by BP to date, and the 2010 natural gas transmission pipeline rupture (owned and operated by Pacific Gas and Electric Company) that resulted in over a billion dollars in losses.

Currently, 11 of the 12 FHCs that are authorized to engage in complementary commodity activities are also designated as global systemically important banks ("G-SIBs") by the Financial Stability Board,<sup>9</sup> and two additional G-SIBs conduct grandfathered activities. In the view of the FRB, ownership of physical commodities that are part of a catastrophic event could undermine public confidence in the FHC and could impact its access to funding markets, which for G-SIBs could raise financial stability concerns. Furthermore, the FRB notes that current management risk mitigation techniques, such as frequent monitoring of risks, could (paradoxically) increase the FHC's risk of liability in case of a catastrophe. FHCs may be exposed to liability under environmental laws (notwithstanding corporate separateness), which could have a market impact regardless of whether the FHC is ultimately found liable.

The FRB is thus using the ANPR to review the adequacy of its current safeguards with respect to physical commodities activities, and is also considering whether to impose additional safeguards. Among the questions posed in the ANPR concerning complementary physical commodity activities are several in which the FRB requests comments on specific additional limitations, including (a) enhanced capital requirements, (b) increased insurance requirements, and (c) reductions in the amount of assets and revenues attributable to the activities, including absolute dollar limits and caps based on a percentage of the FHC's capital or revenue. The ANPR also asks whether the scope of limitations should differ for underlying physical commodities that may be associated with catastrophic events.

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<sup>9</sup> The FHCs currently authorized by the FRB to engage in complementary physical commodities activities are Bank of America, Barclays Bank, BNP Paribas, Citigroup, Credit Suisse, Deutsche Bank, JPMorgan Chase, Scotiabank, Société General, Royal Bank of Scotland, UBS, and Wells Fargo.

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<sup>8</sup> The ANPR does not identify any FHCs that have made merchant banking investments in any such companies.

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The four questions raised with respect to merchant banking activities go beyond physical commodities to address risks associated in general with merchant banking investments. Among the actions being considered by the FRB are (a) more restrictive holding periods, (b) additional restrictions on management, (c) additional capital requirements on some or all merchant banking investments, and (d) enhanced regulatory reporting and public disclosure of merchant banking investments. Also raised as a specific question is whether there should be more restrictions for investments in portfolio companies that pose significantly greater risks to FHCs or their bank subsidiaries. This is the first indication since adoption of the merchant banking rules in 2001 that the FRB is considering restrictions or limitations on the types of companies in which FHCs may invest under merchant banking authority.

Finally, with respect to the grandfathering, FHCs with such authority may engage in a broader set of physical commodities activities than FHCs may conduct under the complementary authority, and without the limitations on duration and control for merchant banking investments. The ANPR thus seeks comment on whether additional prudential requirements could help ensure competitive equity and that grandfathered activities do not pose undue risks to the FHC, its bank subsidiaries, or US financial stability.

## *Additional information*

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