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Via regs.comments@federalreserve.gov

Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Advance Notice of Proposed Rulemaking Relating to Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies Related to Physical Commodities: Docket No. 1479 and RIN 7100 AE-10

Ladies and Gentlemen:

The Institute of International Bankers ("IIB") appreciates the opportunity to comment on the Advance Notice of Proposed Rulemaking[1] (the "Notice") of the Board of Governors of the Federal Reserve System (the "Board") regarding complementary activities, merchant banking activities, and other activities of financial holding companies related to physical commodities. This letter addresses principally the Board's request for comments on the risks and benefits associated with allowing financial holding companies to participate in physical commodities activities and whether such risks warrant additional rulemaking by the Board in order to further limit such activities. In addition, we address whether additional or different capital requirements would be appropriate for certain physical commodities and/or merchant banking activities.

The IIB strongly supports continuing the Board's policy of allowing financial holding companies—well capitalized and well managed bank holding companies and foreign banking organizations—to conduct physical commodities and merchant banking activities in a manner consistent with safety and soundness of banking institutions and with the efficient functioning and stability of the international economy. The IIB's member banks are active

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1 79 Fed. Reg. 3329 (Jan. 21, 2014).

participants in both the physical commodities markets and merchant banking financing; indeed, 8 of the 12 banks that have been granted complementary authority by the Board to participate in physical commodities activities are members of the IIB.

In our view, as discussed more fully below, the benefits that result from permitting financial holding companies to participate in physical commodities and merchant banking activities outweigh the associated risks. Furthermore, the IIB has not observed an increase in the risks associated with financial holding companies' participation in physical commodities or merchant banking activities, and, therefore, does not take the view that further limitations or additional rulemaking in this area are necessary or warranted. On the contrary, additional rulemaking would likely diminish the benefits provided by bank participation in physical commodities markets and in merchant banking financing.

The IIB is a signatory to the comment letter on the Notice also signed by the Securities Industry and Financial Markets Association ("SIFMA"), the American Bankers Association, the Financial Services Forum and the Financial Services Roundtable, as well as to the comment letter also signed by The Clearing House Association L.L.C., the American Bankers Association, the Financial Services Forum and the Financial Services Roundtable (together, the "Joint Trade Associations Letters"). We are submitting this separate letter in order to highlight certain aspects of the issues raised by the Notice of particular relevance to foreign banking organizations. As explained below, further limitations on physical commodities activities would disproportionately affect foreign banking organizations' ability to participate in these activities, in particular as related to capital requirements, customer expectations and organizational inefficiencies within foreign banking organizations.

BENEFITS ASSOCIATED WITH PHYSICAL COMMODITIES ACTIVITIES

Historical Benefits Associated with Physical Commodities Activities

Commodities markets are global in nature, and foreign banks have long facilitated the efficient functioning of these global markets through activities authorized by their home country regulators. It is true that such authorizations may be conditioned on the safe and sound operation of the business, but it has been generally understood that, if a banking institution can apply appropriate risk mitigants, as it would in other banking, lending, derivatives and trust activities, the benefits of engaging in physical commodities activities can be achieved for the global economy.

International banks are uniquely positioned to facilitate the markets for physical commodities. Unlike commodity-intensive business corporations that may be focused primarily on their own inputs and outputs of physical commodities, international banks operate for customer facilitation purposes across a range of products and commodities. In addition to being able to help move commodities (through trading) from their sources (e.g., a bauxite mine in Australia) to the areas of demand (e.g., an aluminum processing plant in China), banking institutions combine other necessary financial services, such as hedging, financing, credit intermediation and financial guarantees. In particular, hedging and risk management products require knowledge of not only the synthetic or futures markets, but also of the physical markets and the pricing and availability of various analogs to different commodities. Such risk management products, as well as physical trading, also require creditworthy counterparties to both transact as principal and to intermediate trades between other, perhaps less creditworthy, counterparties. For this reason, global banking institutions are often the counterparty of choice for derivative trades as well as physical offtake and supply contracts.

Foreign bank participation in physical commodities activities is generally considered (including by third parties) to provide significant benefits to the market. In making determinations to grant complementary authority to financial institutions, the Board is required to consider whether the benefits to the public of conducting such activities outweigh possible adverse effects;[2] and indeed when issuing orders granting such authority, the Board has noted such benefits are reasonably expected to result.[3] A recent report (the "IHS Report") described the benefits banks provide, noting banks "play an essential, if poorly understood, role in assuring the smooth functioning of the commodity markets . . . on which consumers ultimately rely."[4] They do so by, among other things, "providing capital, enabling companies of all kinds to manage risk, and by bringing disparate buyers and sellers together."[5] The "ability to physically settle commodity positions . . . is crucial to" the ability to provide these benefits.[6]

Increased liquidity is among the specific benefits global banks provide to the physical commodities market. For example, since not all participants in the commodities markets would otherwise have equal and offsetting positions, banks are in a position to, and do, step in as intermediaries and counterparties. As noted above, banks, which typically have strong credit ratings, are a natural fit to play this role as counterparty. Typically, non-bank entities are willing to step in and play this role only "when there is a strong enough arbitrage to do so."[7] A related effect of the liquidity provided by bank participation is a more efficient allocation of commodities.[8]

Foreign banks have long participated globally in the physical commodities markets. Foreign banks, as additional participants in the U.S. physical commodities market, add to the market's capacity to serve customers and bring liquidity to the U.S. market from their

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2 12 U.S.C. § 1843(j).

3 See, e.g., Board Letter to Cleary Gottlieb Steen & Hamilton LLP, Sept. 21, 2010 re BNP Paribas (under Section 4 of the Bank Holding Company Act to engage in physically settled tolling agreements with power plant owners); Board Letter to Cleary Gottlieb Steen & Hamilton LLP, Mar. 27, 2007 re Credit Suisse (under Section 4 of the Bank Holding Company Act to engage in a limited basis in physical commodity trading activities).

4 IHS Global Inc., The Role of Banks in Physical Commodities (2013), p. 7 available at http://ihs.newshq.businesswire.com/sites/ihs.newshq.businesswire.com/files/press_release/additional/IHS_Role_of_Banks_in_Physical_Commodities_Final.pdf.

5 Id.

6 Id. at 5.

7 Id. at 9.

8 Id.

trading operations outside of the United States. Participation by foreign banks, to the extent they facilitate access to, and expertise in, other geographic markets, broadens this effect over a wider geographic range. Foreign bank participation also enhances competition in the physical commodities market. Banks promote enhanced competition both as direct market participants and by supporting other market participants via financing and risk management activities.[9] Thus, through the complementary authority that has been granted to them to participate in physical commodities activities in the United States, foreign banks serve an essential role facilitating a larger number of potential counterparties and increasing competition among market participants, with the end result being a more effective global market for serving clients.

Foreign banks have conducted physical commodities activities in the United States in a manner consistent with safety and soundness. Although the Notice recounts several significant disasters related to physical commodities, including the Deepwater Horizon oil spill and the nuclear incident at the Fukushima Daiichi nuclear power plant, as described in the Notice, none of these incidents was caused by or involved the collapse of a financial institution as a result of its physical commodities activities.[10] In fact, to our knowledge, no foreign or domestic financial institution has experienced any material risk to its financial stability as a result of its participation in physical commodities activities in the United States. On the contrary, there is a record of benefits and success in this area.

Forward-Looking Effects of Regulation of Physical Commodities Activities

We and our members agree that physical commodities activities, including those related to merchant banking investments, must be conducted by financial holding companies ("FHCs") in a safe and sound manner. As discussed in the Joint Trade Associations Letters, there are certain practices which, if implemented when appropriate, should be effective to avoid or substantially mitigate the risk of potential legal liabilities arising out of such activities to a level consistent with an FHC's risk tolerance and risk management framework (see the list of practices provided in Appendix C to the Joint Trade Associations Letter to which SIFMA is a co-signatory).

Indeed, the key to preserving efficient global markets and the traditional intermediary function of banks is judicious use of appropriate safeguards and risk mitigation techniques, rather than increased prohibitions or additional limitations on physical commodities activities. International banks that conduct such activities globally would be particularly affected by a proscriptive approach. As noted in the IHS Report, the "consequences of impairing [banks' role in the commodity markets] could be far-reaching and negative."[11] Bank customers have come to expect transactions to seamlessly span borders in order to connect global supply and demand. A prohibition or additional limitations on banks' ability to conduct these activities in the United States would risk hampering banks' ability to provide this service to customers. Such a disruption to customers' activities would have unpredictable effects on the customers and

9 Id. at 19.

10 79 Fed. Reg. at 3331.

11 IHS Report, *supra* note 4, at 7.

global markets that rely on access to commodities. The U.S. market serves as both a significant source of commodities, as well as perhaps the most significant demand for commodities. International banks play an intermediary role between sources and demand for commodities, as they do in other financial markets. Hindering this intermediary role between the U.S. market and the international market will undoubtedly make the global market less efficient and more costly. Furthermore, as discussed above, participation by banks in the commodities markets enhances competition in the market, promoting liquidity and efficiency in the market. A prohibition or additional limitations on physical commodities activities could result in reduced liquidity and efficiency in the commodities markets in the United States.

In addition, further restrictions on banks' ability to conduct physical commodities activities, beyond appropriate safeguards discussed above, would be unduly restrictive and may cause unpredictable and potentially significant inefficiencies in how these operations are conducted within international banks. Specifically, organizational complications may follow if the commodities division of an international bank cannot participate in physical commodities activities in the same manner across geographies and operations. Such complications may result in disjointed operations between the domestic and foreign commodities divisions of a bank by, for example, dividing personnel and expertise within the bank. Customers look to banks, in their role as commodities market participants, to provide expertise in the field, including an understanding of local markets.[12] Along the same lines, bank customers look to banks to provide an integrated set of potentially diverse solutions in the physical commodities space.[13] Dividing operations, personnel and expertise within banks runs the risk of diminishing banks' effectiveness in carrying out these services. Because it is not clear what entities could step in to replace banks' unique, multifaceted role as physical commodities market participants integrated with providers of financial services, bank customers' ability to operate efficiently and effectively would also be put at risk.[14]

CAPITAL REQUIREMENTS FOR PHYSICAL COMMODITIES AND MERCHANT BANKING ACTIVITIES

The Notice asks whether additional or different capital requirements for certain physical commodities and/or merchant banking activities would be appropriate.[15] With respect to potential additional capital charges, we note that, under implementation of the Basel capital framework both in the United States and internationally, new higher risk weights have been imposed on various types of equity investments, particularly if they are not publicly traded equities (as is the case with many start-up or emerging businesses in which banking institutions make merchant banking investments). Furthermore, commodities derivatives and physical positions are subject to the market risk capital rules, which have been recently enhanced. We also note that, internationally, the market risk capital rules are coming under some scrutiny, with

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12 Id. at 13.

13 Id.

14 Id. at 7.

15 79 Fed. Reg. at 3333-35.

the prospect of the insertion of additional minimum (or floor) capital charges. Thus, with respect to both physical commodities activities and merchant banking activities, additional or different capital requirements for these businesses would seem disproportionate to their risks, given the benefits described above, and the adverse impact of such action would be magnified if it included a capital deduction. Moreover, any such action would seem to evidence a conclusion that the new capital charges described above, which are only in their nascent stages of implementation, have already been determined not to be sufficient without any quantitative evidence supporting such conclusion.

We also note that the current complementary authority already includes limits on physical commodities activities based on a percentage of Tier 1 capital of the organization, and in the case of foreign banks, these requirements are based on the Tier 1 capital of the top-tier foreign banking organization. For foreign banks, both physical commodities activities and merchant banking investments are likely to be integrated with global investment and trading strategies. Physical commodities businesses are undoubtedly global in reach, as the nature and purpose of trading in this market is to span borders. Similarly, merchant banking investments in physical commodities activities and related activities are likely to be part of global investment strategies that are not solely U.S.-focused. Therefore, any limitation on these activities based on capital (such as further limits related to a percentage of Tier 1 capital or the like) should continue to be based on the capital of the top-tier foreign banking organization.[16] Anything different would severely hamper foreign banks' ability to compete with U.S.-headquartered banks that would be able to utilize the capital base of their top-tier organization. Given the global nature of the commodities markets, increasing competition in the domestic U.S. market is by far preferable to concentrating it in U.S. banks.

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We appreciate your consideration of our comments above. If we can answer any questions or provide any further information, please contact the undersigned (646-213-1147, smiller@iib.org) or Richard Coffman, our General Counsel (646-213-1149, rcoffman@iib.org).

Very truly yours,

Sarah A. Miller
Chief Executive Officer

16 Foreign banks operating in the United States that may be required to create intermediate holding companies ("IHC") pursuant to the Board's recently finalized rules under Section 165 of the Dodd-Frank Act may suffer an especially severe adverse impact in relation to their U.S. merchant banking or physical commodities activities if the Board were to impose either higher capital charges on physical commodities or merchant banking activities or a limitation based on the capital levels of the IHC rather than those at the parent level.