INSTITUTE FOR AGRICULTURE AND TRADE POLICY

Robert V. Frierson, Secretary December 21, 2016
Board of Governors of the Federal Reserve System (Board)
20th Street and Constitution Avenue NW.,
Washington, DC 20551.

FEDERAL RESERVE SYSTEM 12 CFR Parts 217 and 225 Regulations Q and Y

Docket No. R-1547; RIN 7100 AE-58

Risk-based Capital and Other Regulatory Requirements for Activities of Financial Holding Companies Related to Physical Commodities and Risk-based Capital Requirements for Merchant Banking Investments[1]

Notice of proposed rulemaking (NPR)

Submitted electronically

Dear Mr. Frierson,

The Institute for Agriculture and Trade Policy (IATP)[2] appreciates this opportunity to comment on the Commission's above captioned proposed rulemaking on physical commodities. Our comment, like our April 15, 2014 response to the Board's Advanced Notice of Proposed Rulemaking (ANPR), concerns only the activities of financial holding companies related to physical commodities.

General comment

IATP understands that the Board's primary concern in this NPR is to ensure that the complementary commodity activities of Financial Holding Companies (FHCs) do not compromise the safety and soundness of the FHCs and the U.S. financial system overall. Additionally, the Board is required to consider whether the complementary commodity activities produce "produce benefits to the public—such as greater convenience, increased competition, or gains in efficiency—that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices" (NPR , 9) We address these two distinct statutory obligations in turn with regard to one of the permitted complementary commodity activities, "the purchase and sale of commodities in the spot market, and taking and making delivery of physical commodities to settle commodity derivatives (physical commodity trading)" (NPR, 9).

Safety and Soundness

Towards protecting the safety and soundness of the FHCs, the Board would limit "the market value of the commodities an FHC could hold under complementary authority to an aggregate of 5 percent of the FHC's consolidated tier 1 capital" (NPR, 20). However, FHCs are allowed to hold physical commodities under authorities not subject to Board oversight. Because the liabilities of such physical commodity holding and trading may imperil FHC safety and soundness, the Board proposes to limit FHC physical commodity activities, "if the market value of physical commodities owned by the FHC and its subsidiaries under any authority, other than authority to engage in merchant banking activities, similar investment authority for insurance companies, or authority to acquire assets or voting securities held in satisfaction of debts previously contracted, exceeds 5 percent of the consolidated tier 1 capital of the FHC" (NPR, 21-22). FHCs would have two years to adjust their capital holdings to comply with the new more comprehensive 5 percent requirement.

Unlike some market participant commenters, IATP does not view this capital requirement as "extreme."[3] Indeed, the expansion of the capital requirement beyond that authorized by the Banking Holding Company Act, is prudent in view of the lack of a consolidated FHC statement of physical commodities holdings and trading reported to federal authorities. IATP assumes that the 5 percent limit to the value of complementary commodities activity corresponds to the minimum capital ratios of the Board's Comprehensive Capital Analysis Review of the FHCs.[4] If so, the proposed value limit appears to meet the safety and soundness objective, since the likelihood of FHC losses and liabilities alone amounting to a scale as to exceed the tier 1 capital reserve requirement does not appear to be great. However, we support the Board's proposed limit with a caveat.

IATP believes that the Board underestimates the FHC and bank market share participation in commodities derivatives (NPR, 34), and as a result may underestimate the impact of commodity derivatives losses on the FHC trading losses in physical commodities. The NPR estimation relies on two Commodity Futures Trading Commission reports (NPR, 35, footnotes 60 and 61). These reports document only the market share participation in futures and options contracts, and not in Over the Counter commodity swaps. FHCs have resisted agreeing on standardized data elements for swaps reporting to make their swaps activities subject to computer surveillance by the CFTC. As a result, the CFTC has not reported the notional value of swaps in commodities and other asset classes since October 28, 2015.[5] In the words of one market observer, "U.S. swaps data reporting remains pretty much a disaster."[6]

Another source of Board underestimation of FHC participation in commodity derivatives are their Commodity Index Trader (CIT) operations. The CFTC does not regulate CITs specifically, among them FHCs permitted by the Board to also trade physical commodities.

A study by Better Markets estimated that CITs alone (not counting other financial speculators) controlled more than 20 percent of open interest in some commodity contracts from 2006 to 2011.[7] The promises of the incoming administration to dismantle Dodd Frank Act authorized derivatives rules and an increase in the spot price of dominant CIT commodities, particularly crude oil, likely will result in a larger CIT/FHC market share in commodity derivatives than that indicated by the CFTC futures and options reporting cited in the NPR.

Last but not least, the Board should take into consideration the impact on safety and soundness of FHC commodity derivatives trading through Automated Trading Systems and particularly High Frequency Trading, neither of which are regulated by the CFTC. For example, a 2011 study by the Tabb Group calculates that HFT proprietary firms account for about a third of the volume of OTC energy swaps.[8] Hedge funds' commodity trade advisors used automated programs to short crude oil futures and swaps, driving prices on the regulated futures markets in 2015.[9] As Dow-Jones Wire reported on January 25, "A tumbling oil price, sharp declines in global stocks and big moves in currencies this month have provided near ideal conditions for commodity trade advisors, or CTAs, which run around $260 billion globally, providing the market trends and volatility that they can latch onto and profit from."[10] To the extent that FHCs are counterparties to HFT commodity swaps or have HFT subsidiaries or affiliates, whether in the U.S. or not, the Board should consider how these unregulated commodity derivatives activities may affect the safety and soundness of parent FHCs.

Public benefits of FHC physical commodity trading

The question of whether FHC complementary commodity activities produce public benefits is more difficult to analyze than issues pertaining to what capital requirements are needed to ensure safety and soundness. The initial FHC lobbying response to the NPR repudiates it in no uncertain terms, but also imputes benefits to commodity end users that will be lost if the Board applies its proposed capital limit to FHC complementary commodity activities: "it is both inappropriate and unfortunate that [the Federal Reserve] has proposed regulatory changes that are based upon wholly theoretical and unsubstantiated concerns rather than actual facts, evidence, or historical experience… By imposing unjustifiably higher capital on this important economic activity, end-users will ultimately pay the price, burdening business and hindering job creation, the formation of new businesses and economic growth."[11] There is a tiny smidgen of truth in this statement, namely that facts and data about FHC complementary commodity activities are in very, very short supply, so data verification about the alleged benefits of FHC physical commodities trading is likewise in very, very short supply.

We cited in our 2014 letter to the Board, a study by Saule Omarova, according to whom, "It is virtually impossible to glean even a broad overall picture of Goldman's, Morgan Stanley's or JMPC's physical commodities activities from their public filings with the Securities and Exchange Commission (SEC) and federal bank regulators."[12] The success of the FHCs in failing to report any relevant granular data on the scope of their complementary commodity activities must not be rewarded with light touch regulation. Furthermore, their claims of public benefits and harm to commodity end-users must be regarded skeptically until such time as they report those data.

IATP assumes that FHCs gain an informational advantage for their commodities derivatives activities by trading physical commodities. The Board should investigate whether and when this physical commodities trading affects the exchange estimated deliverable supply, according to which spot month and non-spot month position limits for commodities derivatives are set, both by the CFTC and by the individual exchanges. In assessing FHC claimed benefits of the complementary commodity activities, the Board should investigate whether there is excessive HFC capital in contracts that exacerbates price volatility and drives end users out of derivatives markets, due to the high margin and clearing cost of managing such price volatility. The Board must verify the end user benefits of FHC complementary commodities activity not with hortatory statements from the end-user members of the International Swaps and Derivatives Association, but on the basis of comprehensive and uniformly formatted commodities trading data from the FHCs and their foreign subsidiaries and affiliates.

Response to specific questions

Question 5. Does the proposed definition of "covered physical commodity" sufficiently cover the commodities that pose the greatest legal, reputational, and financial risks to an FHC? If not, please describe those high-risk commodities that would fall outside the scope of the definition.

IATP is not aware of FHCs that trade rare earth minerals, but given the strategic importance of these minerals to the U.S. economy and indeed, to national defense, we would be surprised if there were not an FHC contemplating application to the Board to trade rare earths as part of its complementary commodity activities, merchant banking and/or derivatives strategy.[13] Rare earth minerals are highly toxic and pose great environmental and health risks and liabilities in their mining, transport and warehousing.[14] Because most known rare earth deposits lie outside the United States, the environmental, public health, reputational and indeed, diplomatic risks and associated liabilities should become a subject of Board research.

Question 6. What, if any, other criteria should the Board consider when determining whether a physical commodity poses a risk that the FHC would be liable for a catastrophe involving its physical commodity activities?

If greenhouse gas emissions and emissions offset credits become tradeable on U.S. markets as "physical" commodities and commodity derivatives, the Board will have to amplify its understanding of what comprises a "catastrophe." The Board should be aware of the extent and kinds of criminality in the carbon emissions markets,[15] and the risks posed to FHCs by trading such commodities. Far greater, however, are the opportunity costs and FHC reputational risks of investing in emissions trading schemes, rather than directly and urgently reducing emissions and adapting to climate change.[16] Climate change and the attempt to manage climate risks with emissions trading pose catastrophic risks that FHCs have yet to report,[17] much less to counter. If "catastrophe" is conventionally defined as an event in a fixed time and place, substituting emissions derivatives trading and emissions offset credit trading for emissions reduction and climate change adaptation requires the Board to broaden the insurance-based understanding of what comprises a "catastrophe" with regard to the failure of emissions trading schemes to reduce greenhouse gas emissions.[18]

Conclusion

IATP thanks the Board for this opportunity to comment on the NPR. We urge the Board to rebut industry attacks on its proposed tier one capital limit by requiring FHCs to divulge comprehensive and standardized data about their complementary commodity activities to verify their claims of harm from the Board's actions, and their claims of end user and greater social benefits from those activities.

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[1] https://www.federalreserve.gov/newsevents/press/bcreg/bcreg20160923a2.pdf

[2] IATP is a U.S. nonprofit, 501(c)(3) nongovernmental organization, headquartered in Minneapolis, Minn., with an office in Washington, D.C. Our mission states, "The Institute for Agriculture and Trade Policy works locally and globally at the intersection of policy and practice to ensure fair and sustainable food, farm and trade systems." To carry out this mission, as regards commodity market regulation, IATP has participated in the Commodity Markets Oversight Coalition (CMOC) since 2009, and the Derivatives Task Force of Americans for Financial Reform since 2010. IATP has submitted several comments on U.S. Commodity Futures Trading Commission rulemaking, and on consultation papers of the International Organization of Securities Commissions, Financial Stability Board, the European Securities and Markets Authority, and the European Commission's Directorate General for Internal Markets (now Directorate General for Financial Markets).

[3] E.g. Jesse Hamilton, "Fed Seeks Aggressive Limit on Wall Street Commodity Holdings," Bloomberg, September 23, 2016. https://www.bloomberg.com/news/articles/2016-09-23/fed-proposes-aggressive-rule-on-wall-street-commodity-holdings-itfye706

[4] https://www.federalreserve.gov/bankinforeg/stress-tests/CCAR/201503-comprehensive-capital-analysis-review-requirements-in-ccar-2015.htm

[5] http://www.cftc.gov/MarketReports/SwapsReports/index.htm

[6] George Bollenbacher, "ESMA Gets Semi-Serious About Swaps, the CFTC Not So Much," OTC Space, June 19, 2015. http://www.theotcspace.com/2015/06/19/esma-gets-semi-serious-about-swaps-reporting-cftc-not-so-much

[7] David Frenk and Wallace Turbeville, "Commodity Index Traders and Boom/Bust in Commodity Prices," Better Markets, 2012, Chart 2,

http://www.bettermarkets.com/sites/default/files/documents/Better%20Markets-%20Commodity%20Index%20Traders%20and%20Boom-Bust%20in%20Commodities%20Prices.pdf

[8] Isabella Kaminska, "Tabb: HFT makes up a third of OTC energy swap trading," Financial Times, July 18, 2011. http://ftalphaville.ft.com/2011/07/18/625701/tabb-hft-makes-up-a-third-of-otc-energy-swap-trading/

[9] E.g. Dan Murtaugh, "Speculators Shorting Crude Oil to End 'Great Year'." Bloomberg, January 4, 2016.

[10] "Automated Hedge Funds Make Millions in January's Sell-off," Dow-Jones Wire, January 25, 2016. http://www.morningstar.com/news/dow-jones/TDJNDN_201601253652/automated-hedge-funds-make-millions-in-januarys-market-selloff.print.html

[11] Cited in "Fed Proposes Tighter Limits for Physical Commodities Activities," ABA Banking Journal, September 23, 2016. http://bankingjournal.aba.com/2016/09/fed-proposes-tighter-requirements-for-physical-commodities-activities/

[12] Saule T. Omarova, "The Merchants of Wall Street: Banking, Commerce and Commodities", Minnesota Law Review, Vol. 98 (2013), 273.

[13] Johann Nylander, "China's Trump Card," Asia Times, November 24, 2016. http://www.atimes.com/article/china-holds-trump-card-rare-earths-trade/

[14] Johnathan Kaiman, "Rare earth mining in China: The bleak social and environmental costs," The Guardian, March 20, 2014. https://www.theguardian.com/sustainable-business/rare-earth-mining-china-social-environmental-costs

[15] McKenzie Funk, "The Hack that Warmed the World," Foreign Policy, January 30, 2015. http://foreignpolicy.com/2015/01/30/climate-change-hack-carbon-credit-black-dragon/

[16] Sean Sweeney, "Carbon Trading After Paris: Trading in Trouble," Trade Unions for Energy Democracy, Decmeber 2016. http://unionsforenergydemocracy.org/wp-content/uploads/2015/01/tuedworkingpaper645.pdf

[17] "Recommendations of the Task Force on Climate-Related Financial Disclosures," Financial Stability Board, December 14, 2016. https://www.fsb-tcfd.org/wp-content/uploads/2016/12/18_1216_TCFD_Report_A4.pdf

[18] Joseph Stromberg, "How the Insurance Industry Is Dealing with Climate Change," September 24, 2013, Smithsonian.com http://www.smithsonianmag.com/science-nature/how-the-insurance-industry-is-dealing-with-climate-change-52218/