

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

---

Date: September 12, 2016

To: Board of Governors

From: Staff<sup>1</sup>

Re: Proposed Rule Implementing Strengthened Prudential Requirements, including Risk-based Capital Requirements, for Physical Commodity Activities and Investments of Financial Holding Companies

---

**ACTIONS REQUESTED:** Approval of: (1) the attached draft proposed rule that would adopt strengthened prudential requirements and limitations on the physical commodity activities of financial holding companies (“FHCs”) to better address the potential legal, reputational, and financial risks posed by such activities, particularly those that can result from an environmental catastrophe; and (2) proposed amendments to the FR Y-9C reporting form to collect more detailed information on the physical commodity activities of FHCs. Among other requirements, the proposal would amend the risk-based capital requirements applicable to physical commodity activities, revise the cap on physical commodity holdings of FHCs to include commodities held in the consolidated organization, and rescind the findings underlying the Board’s orders authorizing five FHCs to engage in energy tolling and energy management activities. Staff also requests authority to make technical and minor changes to the proposal to prepare it for publication in the *Federal Register*.

**EXECUTIVE SUMMARY:**

- **Overview:** In January 2014, the Board issued an advance notice of proposed rulemaking that invited public comment on the potential environmental catastrophe and other risks associated with physical commodity activities of FHCs, whether the current prudential limitations were adequate and what, if any, additional prudential restrictions on physical commodity activities may be warranted. Based on the comments received and further staff analysis, this

---

<sup>1</sup> Messrs. Gibson, Van Der Weide, Campbell, Finger, Brooks, Carpenter, and Tran, and Mmes. Hewko, Horsley, MacDonald, Snyder, and Davis (Division of Banking Supervision and Regulation) and Mr. Alvarez, Ms. Schaffer, Mr. Giles and Ms. Watkins (Legal Division).

rulemaking would propose additional prudential standards to more effectively address those risks and rescind the authority to conduct certain activities that do not appear to be sufficiently connected to financial activities.

- Risk-based capital requirements for covered physical commodity activities: For activities involving commodities for which Federal or state laws impose liability if released into the environment, the proposed rule would apply:
  - A 1,250 percent risk weight to physical commodities and related assets (e.g., infrastructure assets) permitted to be owned solely under a statutory grandfather provision. The same risk weight would be applied to merchant banking investments in companies that engage in physical commodity activities other than complementary physical commodity trading activities (as described below); and
  - A 300 percent risk weight to physical commodity holdings permissible under complementary physical commodity trading activities. A 300 percent risk weight floor also would be applied to activities and investments that are permissible under complementary authority but conducted under the grandfather provision or through merchant banking authority.
- Strengthened limitations on permissible physical commodity trading: The proposed rule would:
  - Tighten the limit (5 percent of tier 1 capital) placed on physical commodity holdings of FHCs under complementary authority by taking account of the physical commodities held anywhere within the FHC under most other authorities; and
  - Clarify that the existing prohibition on operating storage facilities or transportation vessels for physical commodities includes a prohibition on *directing* the operations of third-party storage or transportation providers.
- Rescission of the Board’s energy management and energy tolling authorizations: The proposed rule would rescind the findings underlying the Board’s orders authorizing certain FHCs to engage in energy management and tolling activities.
- Reclassification of copper: The proposed rule would delete copper from the list of precious metals that bank holding companies (“BHCs”) are permitted to own and store.
- Proposed reporting modifications: The proposed rule would establish new public reporting requirements for commodities holdings and activities of FHCs to increase transparency, allow better monitoring by the regulatory community, and improve firm management of these activities.

## **DISCUSSION:**

### A. Background

The proposal addresses physical commodity activities conducted by FHCs under three authorities. First, pursuant to the authority in the Bank Holding Company Act (“BHC Act”) to determine that certain activities are complementary to a financial activity, the Board has

authorized certain FHCs to engage in physical commodity trading, energy management and energy tolling activities (“complementary activities”).<sup>2</sup> Second, section 4(o) of the BHC Act grandfather a broad range of physical commodity activities if these companies subsequently become FHCs. Two FHCs, Goldman Sachs and Morgan Stanley, use this grandfather authority to engage in physical commodity activities, such as extraction, transportation, storage, and alteration of a physical commodity, that have not been authorized by the Board for other FHCs. Third, the BHC Act allows FHCs to make merchant banking investments in any type of nonfinancial company, including a company engaged in activities involving physical commodities.

#### B. Risks Associated with Physical Commodity Activities

There are a number of legal, reputational and financial risks associated with the conduct of physical commodity trading activities. Over the past decade, monetary damages associated with an environmental catastrophe involving physical commodities have ranged from hundreds of millions to tens of billions of dollars. These damages can exceed the market value of the physical commodity involved in the catastrophic event, and can exceed the committed capital and insurance policies of the organization.

Federal and state environmental laws can impose liability for the damages associated with unauthorized release of many physical commodities from a storage facility or transportation vessel (“covered substance”). A company that directly owns or operates the facility or vessel from which a covered substance is released could be held liable for the release of the substance in the absence of fault.

---

<sup>2</sup> Twelve FHCs currently have authority to engage in one or more complementary activities. The FHCs are Bank of America Corporation, Barclays Bank PLC, BNP Paribas, Citigroup Inc., Credit Suisse Group, Deutsche Bank AG, JPMorgan Chase & Co., Scotiabank, Société Générale, The Royal Bank of Scotland Group plc, UBS AG, and Wells Fargo & Company.

State laws separately impose liability for the unauthorized release of an environmentally sensitive commodity, including some that impose liability based solely on owning the commodity.<sup>3</sup> State law also provides for a parent company to be held liable for the acts of its subsidiaries in certain situations. Even if a parent company is not held liable under Federal or state law, the parent company may provide support to affiliated entities involved in an environmental catastrophe to limit reputational damage or as a condition to a settlement agreement.<sup>4</sup>

C. Advance Notice of Proposed Rulemaking

As FHCs have engaged in physical commodity activities under the various authorities described above, the Board has gained experience with the supervision of these activities as well as with the adequacy of the restrictions imposed on them in the orders authorizing complementary activities. This experience raised concerns as to whether the prudential limits were adequate with regard to the potential risks posed by physical commodity trading activities, whether additional capital requirements should be imposed on physical commodities activities, and whether certain activities, as conducted, were sufficiently connected to financial activities. In 2014, the Board issued an advance notice of proposed rulemaking (“ANPR”) inviting comment on the risks posed to FHCs by physical commodity activities and whether additional prudential restrictions or limitations were appropriate to further mitigate the risks of these activities. The ANPR came out of a review of physical commodity activities that the Board

---

<sup>3</sup> States that impose strict liability based on ownership of the hazardous substance include Alaska, California, Florida, Maryland, Oregon, and Washington. See Alaska Stat. § 46.03.822; Cal. Gov’t Code §§ 8670.3, 8670.56.5; Fla. Stat. § 376.12 (imposing liability for cleanup costs on the owner of the covered substance but only under certain circumstances); Md. Envir. Code Ann. § 4-401; Or. Rev. Stat. § 468B.310; Wash. Rev. Code Ann. § 90.56.370.

<sup>4</sup> For example, BP p.l.c. guaranteed the payment of more than \$20 billion as part of a consent decree resolving claims against its subsidiaries resulting from the Deepwater Horizon oil spill.

undertook in response to growth in the involvement of FHCs in physical commodity activities and concerns regarding environmental disasters associated with certain physical commodities and the potential legal liability that firms engaged in those activities could face.

The Board received more than 180 unique comments and more than 16,900 form letters in response to the ANPR. The form letters and a little over two-thirds of the unique comment letters opposed the involvement of FHCs in physical commodity activities. These commenters argued that these activities pose catastrophic risks and compliance risks to the firms individually and the financial system generally. Many commenters expressed concern regarding the ability of FHCs to monitor or protect themselves against these risks. Some commenters also expressed concern that FHC involvement in these activities could enable FHCs to manipulate commodities markets or encourage FHCs to reduce banking services to customers that compete in commodities markets.

Other commenters supported allowing FHCs to engage in physical commodity activities. Many of these commenters were end users that believe FHCs are reliable providers of commodity services that enhance the liquidity of commodities markets and often set more stable and reasonable terms than other providers of these services. These commenters asserted that FHCs could adequately protect against the risks associated with conducting physical commodity activities by obtaining insurance, taking steps to limit corporate liability, and using other mitigants.

#### D. Summary of Proposal

Based on the review of comments and additional analysis, the proposal would (i) amend the Board's risk-based capital requirements to increase the risk weights associated with physical commodity and merchant banking activities to better reflect the risks associated with the physical commodity activities of FHCs, (ii) revise the cap on physical commodity holdings of FHCs to

include commodities held in the consolidated organization and clarify certain existing limitations on those activities to reduce potential risks these activities may pose to the safety and soundness of FHCs and their depository institutions, (iii) rescind the findings underlying the Board's orders authorizing five FHCs to engage in energy management and energy tolling activities and provide those firms a transition period to unwind or divest these activities, (iv) remove copper from the list of precious metals that BHCs are permitted to own and store, and (v) increase public transparency regarding physical commodity activities of FHCs through more regulatory reporting.

*1. Proposed Capital Requirements*

*a. Risk-based Capital Requirements for Covered Physical Commodities*

To help address the legal liability and reputational risks of physical commodity activities as well as the inherent uncertainty in valuing the potential damages associated with a catastrophe, the proposal would impose new risk-based capital requirements for activities involving physical commodities for which Federal or state environmental law impose liability if released into the environment ("covered physical commodities"). Specifically, the capital requirements would require FHCs to risk weight at 300 percent the value of covered physical commodities held by an FHC pursuant to complementary authority.<sup>5</sup> The proposed 300 percent risk weight is designed to help ensure that FHCs engaged in commodity trading have a level of capitalization for such activities that is roughly comparable to that of nonbank commodities trading firms.

---

<sup>5</sup> The proposed capital requirement would be in addition to any counterparty credit risk, market risk or operational risk capital requirements already applicable to the assets involved in physical commodity activities.

The proposal also would assign a 1,250 percent risk weight—the highest risk weight currently specified under the standardized approach of the Board’s risk-based capital rules—to covered physical commodities and related on-balance-sheet assets held by an FHC under section 4(o) grandfather authority if not permitted under complementary authority, such as storage facilities, refineries and transportation vessels. The proposed risk weight is not intended to require capital against the full amount of legal liability and reputational harm that might result from a catastrophic event, which can vary significantly depending on the nature and extent of an environmental disaster and could be extremely large. Rather, the risk weight is intended to reflect the higher risks of physical commodities activities permissible only under section 4(o) grandfather authority without also making the activities prohibitively costly by capturing the largest environmental catastrophes. The 300 percent risk weight would be available to FHCs engaging in activities under section 4(o) grandfather authority so long as the activity comports with the relevant limitations the Board has prescribed for physical commodity trading under complementary authority. The limitations to be incorporated into the capital requirements for companies operating under section 4(o) grandfather authority would include the proposed tightening of the 5 percent of tier 1 capital limit (discussed below). The proposed rule would provide that the amount of section 4(k) permissible commodities of those companies, when aggregated with the market value of the company’s physical commodities not already subject to a 1,250 percent risk weight, would receive the 300 percent risk weight to the extent that the amount does not exceed 5 percent of the consolidated tier 1 capital of the FHC. If it exceeded the 5 percent limit, the excess amount would be subject to the 1,250 percent risk weight. (*See Attachment pp 23-28.*)

*b. Risk-based Capital Requirements for Merchant Banking Activities*

FHCs may use merchant banking authority to invest in companies engaged in physical commodity activities. Consequently, the proposal would amend the risk-based capital requirements applicable to these investments. Specifically, the proposal generally would assign a 1,250 percent risk weight to a merchant banking investment in a company engaged in physical commodity activities unless all of the physical commodity activities of the portfolio company are permissible under complementary authority. If all of the physical commodity activities of the portfolio company are permissible under complementary authority (i.e., physical commodity trading), the proposal would assign a 300 percent risk weight to the investment if the company is publicly traded and a 400 percent risk weight if the company is not publicly traded.

To ensure the proposal would not apply to all merchant banking investments that own physical commodities but that are not engaged in a physical commodity business, the proposal would not subject a portfolio company to these additional capital requirements solely because the portfolio company owns or operates a facility or vessel that purchases, stores, or transports a covered physical commodity only as necessary to power or support the facility or vessel (e.g., grocery stores). (*See Attachment pp 28-31.*)

*c. Impact of Proposed Capital Requirements*

Staff does not believe that the proposed additional capital requirements described above would have a significant impact on the broader commodities markets. In addition, while FHCs would need to individually consider the impact of the proposed risk weights on their overall business strategies, staff believes the additional capital requirements would not have a material impact on capital ratios of FHCs. If, in response to the proposal, FHCs were to reduce their physical commodity activity, staff believes that the effect on the broader commodities markets and participants in those markets would not be significant. Information available to staff

supports the view that FHCs' market shares in physical commodity markets are quite low and typically represent less than 1 percent of the market. Similarly, based on the aggregate level of merchant banking investments among FHCs of approximately \$29 billion and the fact that only a portion of this amount are equity investments in portfolio companies that engage in physical commodity activities, staff does not expect the proposed increase in risk weights for FHCs' merchant banking investment activity to have a material impact on the firms' capital ratios. (*See Attachment pp 32-36.*)

## *2. Additional Limits on Complementary Commodity Activities*

The Board has authorized FHCs as a complementary activity to engage in physical commodity trading involving the purchase and sale of physical commodities in the spot market and taking and making delivery of physical commodities to settle commodity derivatives. The Board orders authorizing physical commodity trading prohibit FHCs from operating facilities that extract, transport, store, or alter commodities and limit the total value of commodities held by an FHC under complementary authority to an aggregate of 5 percent of the consolidated tier 1 capital of the FHC. This limit does not take account of physical commodity activities that the FHC may conduct under other authorities. For example, the current limit does not account for the fact that a national bank owned by the FHC may be holding physical commodities to hedge bank-permissible derivatives transactions within the bank.<sup>6</sup>

To address the potential that the Board's 5 percent limit may be of limited value in addressing the level and risks of physical commodity activities of FHCs because FHCs also rely on other authorities to conduct these activities, the proposal would revise the calculation of the 5 percent limit to include physical commodities held by the consolidated organization with

---

<sup>6</sup> 12 U.S.C. § 24(7). See, e.g., OCC Interpretive Letter No. 935 (May 14, 2002).

certain exceptions, such as assets acquired in satisfaction of debts previously contracted.<sup>7</sup> This would not restrict the ability of a subsidiary to engage in physical commodity activities pursuant to any authority other than complementary authority (for example, a national bank could engage in any amount of physical commodity activities in accordance with the rules of the Office of the Comptroller of the Currency (“OCC”). It would limit the ability of the FHC to conduct additional physical commodity trading activities within the FHC or a nonbanking subsidiary based on complementary authority if the FHC already engages in a substantial amount of physical commodity activities under other authorities. Firms would generally have two years from the effective date of the rule to conform to the revised 5 percent cap.

The Board’s orders permitting FHCs to engage in physical commodity trading prohibit FHCs from owning, operating, or investing in facilities for the extraction, transportation, storage, or distribution of commodities. The proposal would codify this limitation in Regulation Y and strengthen restrictions designed to ensure that FHCs are not found to “operate” an entity engaged in physical commodity activities under Federal and state environmental laws. In particular, these restrictions would prohibit participating in management or operational decisions related to a facility or vessel or directly providing advice regarding decisions related to the facility’s or vessel’s compliance with environmental laws. (*See Attachment pp 20-23.*)

### *3. Reconsideration of Energy Management and Energy Tolling*

In addition to considering whether conduct of the activities by an FHC poses a substantial risk to the safety and soundness of depository institution subsidiaries of the FHC or the financial

---

<sup>7</sup> The proposal excludes from the calculation of the 5 percent cap physical commodities (i) that are held by companies that the FHC controls under merchant banking authority or under similar authority for insurance company investments; or (ii) that an FHC holds in satisfaction of debts previously contracted.

system generally, in approving a complementary activity, the Board considers whether the non-financial activity is meaningfully connected to a financial activity such that it complements the financial activity.<sup>8</sup> A number of FHCs that engage in physical commodity activities have discontinued or decreased these activities. Of the five FHCs that currently have the authority to engage in either energy management services or energy tolling, at least four have discontinued these activities in the United States.

In seeking approval to conduct energy management services, FHCs argued that energy management and energy tolling activities were complementary activities because both activities would allow an FHC to obtain information to help the FHC manage commodity risk and would help place FHCs on a more level competitive playing field with non-bank competitors in the derivatives markets.<sup>9</sup> Under an energy management agreement, an FHC provides transactional and advisory services (e.g., coordinating fuel deliveries and negotiating contracts) to a power plant owner. Under an energy tolling agreement, the FHC pays the plant owner a fixed periodic payment and a marginal payment based on energy produced.<sup>10</sup>

The proposal would rescind the Board's prior authorizations regarding energy management services and energy tolling because these activities do not appear over time to have been as directly or meaningfully connected to a financial activity so as to complement the financial activity and the expected benefits of these activities do not appear to have been realized over time. Under the proposal, FHCs may still provide services that are financial in nature to

---

<sup>8</sup> See, e.g., Citigroup Inc., 89 Fed. Res. Bull. 508 (2003).

<sup>9</sup> The Board also noted that energy management services would allow an FHC to provide an integrated approach to managing the commodity-related aspects of power plant owners' business and that energy tolling would allow an FHC to hedge its or its clients' positions in energy.

<sup>10</sup> In its role in energy tolling, the FHC may act as principal for its own account, rather than for the benefit of the plant owner, and direct the owner to operate the plant under an agreement.

power plants, such as financing physical commodities inventory and financially- and physically-settled derivatives to hedge fuel costs and energy prices. The proposal would prohibit firms from entering into any new energy management or energy tolling agreements as of the effective date of the final rule and would provide a two-year conformance period for termination of any existing agreements. (*See Attachment pp 37-45.*)

#### *4. Reclassification of Copper as an Industrial Metal*

The proposal would delete copper from the list of precious metals that BHCs are permitted to buy, sell, and store without limit. Over time, copper has become most commonly used as an industrial metal and not as a store of value. The list of precious metals was expanded to include copper, a metal used in minting coins, after it became permissible for national banks to trade copper as a precious metal. The OCC has recently proposed a similar reclassification of copper under the National Bank Act. BHCs would still be able to trade in derivatives and similar financial contracts that have copper as a reference asset. (*See Attachment pp 45-47.*)

#### *5. New Financial Reporting of Commodity Activities*

Staff recommends that the Board modify the BHC reporting requirements to collect more information on the nature and extent of, and risk-based capital requirements related to, an FHC's physical commodity holdings and activities. The proposal would make the additional reported information available to the public. (*See Attachment pp 48-52. Proposed reporting form and instructions available upon request.*)

### **RECOMMENDATIONS:**

Staff recommends that the Board approve the proposal for a 90-day comment period and requests authority to make minor and technical changes to the draft proposed rule and related reporting modifications in preparation for publication in the *Federal Register*.

Attachments