

Physical Commodities Activities of FHCs, BHCs and FBOs: New Risk-based Capital Charges and Activity Restrictions

Federal Reserve Board Proposal, September 23, 2016

Activity	Affected Institutions	Current Authority	FRB Proposal
Copper – physical trading or hedging of derivatives as <u>principal</u>	All BHCs/FBOs	Permissible – unlimited 12 CFR § 225.28(b)(8)(iii)	Impermissible unless conducted by an approved FHC as a “complementary” activity, subject to proposed capital charges and restrictions
Copper – physical trading as <u>agent</u> for customer	All BHCs/FBOs	Permissible – unlimited 12 CFR § 225.28(b)(8)(iii)	Likely no change intended; deletion of “copper” from authority in (b)(8)(iii), which includes trading for the account of others, introduces some ambiguity. Comments likely to request clarification in final rule.
Copper – cash-settled derivatives trading as <u>principal</u>	All BHCs/FBOs	Permissible – unlimited 12 CFR § 225.28(b)(8)(ii)(B)(2)	No change
Copper – physically settled derivatives trading as <u>principal</u>	All BHCs/FBOs	Permissible – unlimited 12 CFR §§ 225.28(b)(8)(ii)-(iii)	Would require: <ol style="list-style-type: none"> (1) transitory title transaction under 12 CFR § 225.28(b)(8)(ii)(B)(4)(ii); (2) reasonable efforts to avoid taking/making delivery under 12 CFR § 225.28(b)(8)(ii)(B)(4)(i); or (3) conduct by an approved FHC as a “complementary” activity, subject to proposed capital charges and restrictions
Copper – cash or physically settled derivatives trading as <u>agent</u> for customer	All BHCs/FBOs	Generally permissible 12 CFR § 225.28(b)(7)(v)	No change



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<p>Non-precious metal commodities – physical trading or hedging of derivatives as <u>principal</u></p>	<p>12 FHCs granted complementary authority (Bank of America Corp., Barclays, BNP Paribas, Citigroup, Credit Suisse, Deutsche Bank, JPM Chase, Scotiabank, SocGen, RBS, UBS, Wells Fargo)</p>	<p>Complementary authority granted to individual FHCs with following typical conditions:</p>	<p>Federal Reserve Board would tighten restrictions:</p>
		<p>(1) Aggregate market value of commodities not to exceed 5% of Tier 1 capital</p>	<p>(1) 5% limit to be calculated including commodities held under other authorities (e.g., national bank hedging authority), except DPC authority or commodities held by controlled merchant banking/insurance companies</p>
		<p>(2) Notify FRB if aggregate market value of commodities reaches or exceeds 4% of Tier 1 capital</p>	<p>(2) 4% notification threshold would apply with adjustments comparable to those for the 5% limit above</p>
		<p>(3) No ownership or operation of, or investment in, facilities or vessels for extraction, transport, storage, alteration or distribution, under complementary authority</p>	<p>(3) To be codified in Regulation Y; new and expansive definition of “operation” to include participation in day-to-day management or ordinary course decisions, or providing advice regarding leakage or disposal of physical commodities or compliance with environmental laws</p>
		<p>(4) Commodity must be approved for trading by CFTC on a national futures exchange</p>	<p>(4) No change</p>
		<p>(5) Appropriate risk management policies and procedures related to positions and to third-party service providers</p>	<p>(5) No change</p>
		<p>Capital risk weight of physical commodity positions: Market risk capital charge (whether or not held in the trading account)</p>	<p>300% for physical commodities with potential environmental liability under Federal or state law (in addition to market risk charges) (For FBOs, applies only to U.S. IHC/BHC (if any))</p>

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Non-precious metal commodities – physical trading as <u>agent</u> for customer	All BHCs/FBOs	Potentially permissible 12 CFR § 225.28(b)(7)	No change
Non-precious metal commodities – derivatives trading as <u>principal</u>	All BHCs/FBOs	Permissible – would require: (1) Cash-settlement (12 CFR § 225.28(b)(ii)(B)(2)); (2) Assignment/termination/offset provision, plus either reasonable efforts to avoid making/taking delivery or transitory title transfer (12 CFR § 225.28(b)(ii)(B)(3)); or (3) CFTC-approved futures or futures option contract, plus either reasonable efforts to avoid making/taking delivery or transitory title transfer (12 CFR § 225.28(b)(ii)(B)(4))	No change
Non-precious metal commodities – derivatives trading as <u>agent</u> for customer	All BHCs/FBOs	Generally permissible 12 CFR § 225.28(b)(7)(v)	No change

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<p>Grandfathered commodity activities</p>	<p>Two FHCs (Goldman Sachs and Morgan Stanley)</p>	<p>BHCA § 4(o), 12 USC § 1843(o), subject to the following conditions:</p>	<p>No change, although FRB has separately recommended that Congress repeal § 4(o) in Dodd-Frank § 620 study</p>
		<p>(1) Activities limited to no more than 5% of total consolidated assets</p>	
		<p>(2) Prohibition on cross-marketing services of depository institution subsidiaries and § 4(o) subsidiaries</p>	
		<p>Capital risk weights:</p> <ul style="list-style-type: none"> Commodity positions: Market risk capital charge (whether or not held in the trading account) Asset positions: 100% generally Non-fund equity positions: 100-400% 	<p>Risk weights for positions in physical commodities with potential environmental liability under Federal or state law:</p> <ul style="list-style-type: none"> 1,250% generally 300% for positions permissible under complementary authority, unless market value of commodities (when aggregated with other commodities under any authority (other than DPC authority or commodities held by controlled merchant banking/insurance companies)) exceeds 5% of Tier 1 capital, in which case excess is 1,250% Market risk charges will apply in addition to these capital charges <p>Asset positions (e.g., infrastructure assets that are not themselves physical commodities or equity): 1,250%</p> <p>Non-fund equity positions: 1,250%</p>

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Merchant banking investment activities	All FHCs with merchant banking authority	12 CFR Part 225, Subpart J	Generally no changes, but FRB (1) has outstanding Jan. 2014 ANPR on merchant banking activities; (2) has separately recommended that Congress repeal merchant banking authority altogether in Dodd-Frank § 620 study; and (3) in context of current proposal, has requested comment on whether capital risk weights for <u>all</u> investments in merchant banking portfolio companies should be increased
		Capital risk weights: Equity risk weights of 100-400%	<p>Risk weights for equity investments in unconsolidated merchant banking portfolio companies engaged in any activities related to commodities with potential environmental liability under Federal or state law:</p> <ul style="list-style-type: none"> • 1,250%, unless the company’s physical commodity activities are limited to trading in the spot market or settlement of derivatives, in which case: <ul style="list-style-type: none"> ▪ 300% for a publicly traded company, or ▪ 400% for a company that is not publicly traded, and <p>in each case with exceptions for commodity end users, in which case the risk weight would remain the currently applicable equity risk weight</p> <ul style="list-style-type: none"> • For FBOs, applies only to U.S. IHC/BHC (if any)
Energy management agreements	5 FHCs granted complementary authority	<u>RBS</u> , 94 Fed. Res. Bull. C60 (2008) <u>Fortis</u> , 94 Fed. Res. Bull. C20 (2008)	Not permissible
Energy tolling agreements	Same 5 FHCs	<u>RBS</u> , 94 Fed. Res. Bull. C60 (2008)	Not permissible

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Commodity purchase/forward sale (repo-like transactions)	All BHCs/FBOs	Board letter (May 15, 2006)	No change; compare OCC statements regarding permissibility of reverse repos in OCC's Industrial/Commercial Metals NPR (Sept. 2016)
Volumetric production payments	All BHCs/FBOs	Board letter (May 15, 2006)	No change
Holding physical commodities in satisfaction of "debt previously contracted" (DPC authority)	All BHCs/FBOs	BHCA §§ 4(c)(1)(C) and 4(c)(2), 12 USC §§ 1843(c)(1)(C) and (c)(2); 12 CFR § 225.22(d)(1).	No change
Holding physical commodities as trustee or in fiduciary capacity for customer	All BHCs/FBOs	12 CFR § 225.22(d)(3)	No change
Islamic financing, using deferred purchase price of commodities to create extension of credit (Murabaha)	All BHCs/FBOs	Board letter (Dec. 18, 1997) under Regulation K; transitory title transfer under 12 CFR § 225.28(b)(8)(ii)(B); BHCA § 4(k)(4)(G), 12 USC § 1843(k)(G) (incorporation of Regulation K precedent into FHC authority)	No change

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Investments in companies engaged in physical commodity activities, not under merchant banking authority or BHCA § 4(o) authority	All BHCs/FBOs	Passive, non-controlling investments in companies engaged in physical commodity activities, if investment is less than 5% of a class of voting securities and less than one-third of total equity. BHCA § 4(c)(6), 12 USC § 1843(c)(6); 12 CFR § 225.22(d)(5)	No change
	All BHCs/FBOs	Investments, including controlling investments, in a fund that invests in companies engaged in physical commodity activities, if the fund's investments are less than 5% of a class of voting securities and less than one-third of total equity of portfolio companies, and otherwise passive and non-controlling. BHCA § 4(c)(7), 12 USC § 1843(c)(7); 12 CFR § 225.22(d)(6)	No change
	All BHCs/FBOs	Holding shares of a company as trustee or in fiduciary capacity for a customer. BHCA § 4(c)(4), 12 USC § 1843(c)(4); 12 CFR § 225.22(d)(3)	No change
	All BHCs/FBOs	Investments in companies or projects that promote community welfare or economic rehabilitation, subject to certain limits. 12 CFR §§ 225.28(b)(12), 225.127	No change
	All BHCs/FBOs	Investments in small business investment companies (SBICs), subject to certain limits. 12 CFR §§ 225.107, 225.111	No change
	All BHCs	Regulation K portfolio investments in non-U.S. companies engaged in physical commodity activities. 12 CFR § 211.8(c)(3)	No change

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		<p>Regulation K joint venture investments in non-U.S. companies engaged in physical commodity activities, provided that not more than 10% of assets or revenues are attributable to impermissible activities under Regulation K. 12 CFR § 211.8(c)(2)</p> <p>Regulation K subsidiary investments in non-U.S. companies engaged in physical commodity activities, provided that not more than 5% of assets or revenues of the company are attributable to impermissible activities under Regulation K. 12 CFR § 211.8(c)(1)</p>	
	All QFBOs	<p>Regulation K investments in non-U.S. companies engaged in physical commodity activities, including non-U.S. companies which have more than 50% of their assets and revenues derived from activities outside the U.S. and which may have U.S. subsidiaries in the same business line. BHCA §§ 2(h)(2) and 4(c)(9), 12 USC §§ 1841(h)(2) and 1843(c)(9); 12 CFR § 211.23(f), (f)(5)</p>	No change