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Statement of  
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Member  
Board of Governors of the Federal Reserve System  
before the  
Permanent Subcommittee on Investigations  
U.S. Senate  
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Chairman Levin, Ranking Member McCain, and other members of the subcommittee, thank you for the opportunity to testify at today's hearing. Let me begin by also thanking the subcommittee for its work on issues raised by the physical commodities activities of financial holding companies. Based on my quick perusal of the report you issued Wednesday, I am sure it will be an important input into our deliberations at the Federal Reserve on how we might adjust our regulatory and supervisory programs to address the risks that can be associated with these activities.

My testimony today first reviews briefly the history of bank and bank holding company engagement in physical commodities activities. I will then address the Federal Reserve's approach to supervising financial institutions engaged in physical commodities activities. I will close my remarks by discussing the Federal Reserve's ongoing review of the physical commodities activities of the institutions we supervise, including a summary of the responses we received on our Advance Notice of Proposed Rulemaking (ANPR) inviting public comment on physical commodities activities.

### **History of Physical Commodities Authority of Banks and Bank Holding Companies**

Before the enactment of the Gramm-Leach-Bliley Act in 1999 (GLB Act), bank holding companies were authorized to engage in a limited set of commodities activities that were considered to be "so closely related to banking as to be a proper incident thereto."<sup>1</sup> These activities included the authority to buy, sell, and store certain precious metals (for example, gold, silver, platinum, and palladium) and copper, which are activities that national banks were generally permitted to conduct at the time. Bank holding companies were also authorized to engage as principal in cash-settled derivative contracts based on commodities, and in commodity

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<sup>1</sup> Section 4(c)(8) of the Bank Holding Company Act, 12 USC 1843(c)(8).

derivatives that allowed for physical settlement if the bank holding company made reasonable efforts to avoid delivery of the commodity.<sup>2</sup>

Additionally, under the National Bank Act, the Office of the Comptroller of the Currency (OCC) has authority to approve national banks to engage in commodity-related activities under national banks' authority to "exercise . . . all such incidental powers as shall be necessary to carry on the business of banking."<sup>3</sup> The OCC has approved some national banks to engage in customer-driven, perfectly matched, cash-settled derivative transactions referencing commodities; certain types of commodity derivatives transactions settled by transitory title transfer; the purchase and sale of coin and bullion, precious metals, and copper; and the holding of physical commodities to hedge customer-driven, bank-permissible derivative transactions.

Under the GLB Act, Congress created the financial holding company framework, which allowed bank holding companies with bank subsidiaries that are well capitalized and well managed<sup>4</sup> to engage in expanded financial activities.<sup>5</sup> Three provisions in the GLB Act have enabled certain financial holding companies to engage in commodities activities. The first provision--section 4(k)(1)(B) of the Bank Holding Company Act--authorizes a financial holding company to engage in any activity that the Board finds to be "complementary to a financial activity." This provision in the GLB Act enables financial holding companies to engage in commercial activities that complement their financial activities, so long as the activities do not pose a substantial risk to the safety and soundness of depository institutions or the financial

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<sup>2</sup> 12 CFR 225.28 (b)(8).

<sup>3</sup> 12 USC 24 (seventh).

<sup>4</sup> In addition to the capital and management requirements, the GLB Act also requires the subsidiary depository institutions of financial holding companies to have at least a "Satisfactory" rating under the Community Reinvestment Act. The Dodd-Frank Wall Street Reform and Consumer Protection Act added a requirement that the financial holding companies themselves must be well capitalized and well managed.

<sup>5</sup> Many bank holding companies of various sizes are financial holding companies. The Board maintains a list of financial holding companies on its website at [www.federalreserve.gov/bankinfo/fhc.htm](http://www.federalreserve.gov/bankinfo/fhc.htm).

system generally.<sup>6</sup> In reviewing requests for complementary authority, the Board is required to consider whether performance of the activity can reasonably be expected to 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.<sup>7</sup>

Beginning in 2003, the Board issued a limited number of orders permitting individual financial holding companies to engage in specified commodities-related activities as complementary activities under this statutory authority. These activities included physical settlement of derivative contracts involving certain approved commodities and spot trading of those commodities.<sup>8</sup> A dozen financial holding companies currently have this 4(k) authority.<sup>9</sup>

In addition, a subset of these companies has been granted additional authority to engage in energy tolling and energy-management activities. Energy tolling involves making fixed, periodic payments to power plant owners that compensate the owners for their fixed costs in exchange for the right to all or part of their plants' power output. Energy-management activities are transactional and advisory services, which are provided to power plant owners.

The Board's orders placed prudential limits on financial holding companies that engage in commodities activities under complementary authority. The Board limited the total market value of all commodities held under this authority, including periodic payments under tolling

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<sup>6</sup> Section 4(k)(1)(B) of the Bank Holding Company Act, 12 USC 1843(k)(1)(B).

<sup>7</sup> 12 USC 1843(j)(2).

<sup>8</sup> This authority is generally limited to commodities for which derivatives contracts have been approved by the Commodity Futures Trading Commission for trading on a U.S. exchange. In a few cases, other commodities with comparable fungibility, liquidity, and other relevant characteristics have been approved.

<sup>9</sup> The financial holdings companies currently authorized by the Board to engage in complementary physical commodities activities 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. The Board's approvals regarding section 4(k) are publicly available.

agreements, to 5 percent of the financial holding company's tier 1 capital. In addition, the Board prohibited financial holding companies from owning commodity transportation, storage, extraction, or refining facilities under complementary authority. Moreover, companies are required to demonstrate risk-management processes sufficient to support their activities and to put in place additional risk mitigants, such as insurance.

A second provision that Congress included in the GLB Act permits financial holding companies, without prior Board approval, to make merchant banking investments in companies engaged in activities not otherwise permitted for financial holding companies.<sup>10</sup> There are several statutory conditions on merchant banking investments, including restrictions on the authority of a financial holding company to routinely manage or operate a merchant banking portfolio company and a requirement that merchant banking investments be held only for a limited period. To implement these restrictions, the Board adopted regulations in 2001 that require merchant banking investments to be disposed of within 10 years after purchase (or 15 years for investments made through a qualifying private equity fund), and that limit the officer and employee interlocks between financial holding companies and portfolio companies. These restrictions were designed to help ensure that merchant banking investments generally are passive investments and limited in duration.

A third provision in the GLB Act permits certain companies to engage in a broad range of physical commodities activities. Section 4(o) of the Bank Holding Company Act authorizes a company that was not a bank holding company and becomes a financial holding company after

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<sup>10</sup> 12 USC 1843(k)(4)(H). The merchant banking authority permits a financial holding company to acquire or control any amount of shares, assets, or ownership interests of any company or other entity that is engaged in an activity not otherwise authorized for the financial holding company under section 4 of the Bank Holding Company Act.

November 12, 1999, to continue to engage in activities related to the trading, sale, or investment in commodities that were not permissible activities for bank holding companies if the company was engaged in the United States in any of such activities as of September 30, 1997.<sup>11</sup> In contrast to section 4(k) complementary authority, this authority is automatic--meaning no approval by or notice to the Board is required for a company to rely on this authority for its commodities activities. Also, unlike the firms conducting limited commodities activities found to be complementary to financial activities under section 4(k), the section 4(o) grandfathered firms are authorized to engage in the transportation, storage, extraction, and refining of commodities. Moreover, while the cap on complementary activities under section 4(k) is 5 percent of tier 1 *capital*, commodities activities permitted under the section 4(o) grandfather provision may represent up to 5 percent of the company's total consolidated *assets*. Only two financial holding companies currently qualify for these grandfather rights--Goldman Sachs and Morgan Stanley.

During 2008, both Goldman Sachs and Morgan Stanley became bank holding companies and elected financial holding company status. They each claim the right to conduct commodities activities under the grandfather provision found in section 4(o). In addition, during this same period, J.P. Morgan Chase & Co. acquired Bear Stearns and Bank of America Corporation acquired Merrill Lynch; both Bear Stearns and Merrill Lynch engaged in a substantial amount of commodities trading activities. However, the range of permissible physical commodities activities of these latter two financial holding companies is limited because they are not grandfathered under section 4(o).

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<sup>11</sup> 12 USC 1843(o).

## **Federal Reserve Supervision of Commodities Activities**

The prudential supervision of the largest, most complex banking companies is a cooperative effort in which the Federal Reserve acts as the prudential regulator and supervisor of the consolidated holding companies, with some of the principal business activities of such companies supervised by other functional regulators. The Federal Reserve's supervisory program focuses on the enterprise-wide risk profile and risk management of those companies, with particular focus on financial strength, corporate governance, and risk-management practices and competencies of the company as a whole. To this end, we monitor the largest of these institutions on a continuous basis and routinely conduct inspections and examinations of all of these firms to encourage their safe and sound operation.

The Federal Reserve has no direct role in the supervision of the commodities markets generally. The Commodity Futures Trading Commission (CFTC) was created by Congress in 1974 as an independent agency with the mandate to regulate commodity futures and option markets. Congress significantly expanded the authority of the CFTC to regulate the over-the-counter commodity derivative markets in the Dodd-Frank Wall Street Reform and Consumer Protection Act. Additionally, the Securities and Exchange Commission (SEC) oversees our nation's securities exchanges and markets and disclosures by public companies, among other things. Other independent agencies, such as the Federal Energy Regulatory Commission (FERC), also regulate segments of the physical commodities market.

Over the last five years, the Federal Reserve has taken several steps to strengthen its ongoing supervision of the largest, most complex banking companies. Most importantly, we established the Large Institution Supervision Coordinating Committee (LISCC) to ensure that oversight and supervision of the largest firms incorporates a broader range of internal

perspectives and expertise; involves regular, simultaneous, horizontal (cross-firm) supervisory exercises; and is overseen in a centralized process to facilitate consistent supervision, a well-considered response to risks or problems that may be present in more than one firm, and a perspective on the financial system as a whole. The committee includes senior bank supervisors from the Board and relevant Reserve Banks as well as senior Federal Reserve staff from the research, legal, and other divisions at the Board and from the markets and payment systems groups at the Federal Reserve Bank of New York. To date, the LISCC has developed and administered several horizontal supervisory exercises, notably the capital stress tests and related comprehensive capital reviews of the nation's largest bank holding companies.

Bank holding companies that conduct commodities activities pursuant to either section 4(k) complementary, merchant banking, or section 4(o) grandfather authority are typically subject to continuous supervision by the Federal Reserve. That supervisory oversight, for example, includes review of internal management reports, periodic meetings with the personnel responsible for managing and controlling the risks of the firm's commodities activities, and targeted examinations of those activities. The primary goals of our supervision of commodities activities are to monitor the management of risks of those activities to the financial holding companies and assess the adequacy of the firms' control environments relating to physical commodities activities.

The Federal Reserve expanded the scope of its examination and review of the firms engaged in physical commodities activities as the events of 2008 and 2009 alluded to earlier brought more firms engaged in commodities activities under the supervisory purview of the Federal Reserve. In 2009, the Federal Reserve formed an examination team to conduct



horizontal examinations of firms across the LISCC portfolio that are engaged in commodities activities.

Among the supervisory activities taken were additional reviews by examination staff specializing in commodities risk-management practices. During these reviews, the teams examined the ways firms managed risks from commodities activities. In addition, the teams reviewed the firms' processes for assessing capital needs associated with these activities. On an ongoing basis, supervisory experts monitored the firms' exposures and assessed the strength of the corresponding risk-management and control processes. This work led us to explore possible additional actions in our ANPR.

The Board requires financial holding companies that engage in commodities activities to hold regulatory capital to absorb potential losses from those activities. Financial holding companies have long been required to hold 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. Following the financial crisis, the Board has strengthened its capital requirements for the credit risk and market risk of these transactions.

Still, physical commodities activities can pose unique risks to the safety and soundness of financial holding companies. While firms engaged in physical commodities activities employ measures to limit liability--including using a variety of legal structures that attempt to limit liability for catastrophic and environmental events, purchasing insurance, and allocating capital aimed at mitigating operational risk--there are considerable difficulties in estimating the possible damages related to environmental or catastrophic incidents, as evidenced by some well-publicized events in recent years. Moreover, just the uncertainty that can come about after a

catastrophic event as observers wait to see the ultimate damages could put extraordinary pressure on a financial institution engaged in these activities that could threaten its safety and soundness.

### **Federal Reserve Review of Physical Commodities Activities**

This past January, the Federal Reserve invited public comment through an ANPR on a range of issues related to the commodities activities of financial holding companies. The scope of our ongoing review covers commodities activities and investments under section 4(k) complementary authority, merchant banking authority, and section 4(o) grandfather authority. Recently, some of the financial holding companies engaged in physical commodities activities have publicly indicated that they are reducing or terminating some of these activities.

As the ANPR explains, we are exploring what further prudential restrictions or limitations on the ability of financial holding companies to engage in commodities-related activities as a complementary activity are warranted to mitigate the risks associated with these activities. Such additional restrictions on complementary commodities activities could include reductions in the maximum amount of assets or revenue attributable to such activities, increased capital or insurance requirements on such activities, and prohibitions on holding specific types of physical commodities that pose undue risk to the company. We also are exploring what restrictions or limitations on investments made through the merchant banking authority would appropriately address those or similar risks.

In response to the notice, the Board received 184 unique comments and more than 16,900 form letters. Commenters included members of Congress, individuals, public interest groups, academics, end users, banks, and trade associations. The comments present a range of views and perspectives. Those opposed to financial holding company involvement in physical commodities activities argued that the different roles of financial holding companies in the commodities

markets (such as trading and credit) allow these firms an unfair competitive advantage and present conflicts of interest in dealing with customers. They also contend that physical commodities activities pose a wide range of risks (including compliance with environmental laws and potential market conduct issues) to financial holding companies that are difficult for companies to measure and mitigate, and for regulators to monitor.

On the other hand, a number of commodities end-users, including corporate treasurers and municipalities, as well as several trade associations and others, argued that financial holding companies provide valuable and hard-to-replace services to end-users. They also argued that financial holding companies are reliable and low-risk counterparties that enhance the efficiency of the commodities markets and provide additional liquidity to those markets. These commenters contended that financial holding companies can successfully mitigate the risks of commodities activities with robust risk management, insurance, and maintenance of appropriate corporate separateness.

As would be expected from this range of views, commenters also suggested a range of potential Board actions--from no action to prohibiting trading or ownership of commodities associated with catastrophic risk, strengthening prudential safeguards (such as reducing caps on the amount of permitted activities), strengthening risk-management practices, enhancing public disclosure, requiring additional capital, increasing regulatory coordination, and developing risk-management best practices. The Federal Reserve has been reviewing the comments and considering what steps would be appropriate to address the risks posed by physical commodities activities.

The Board has discretion with regard to the complementary activities approved under section 4(k). We are also considering whether additional restrictions are appropriate on

merchant banking investments to ensure that the investments are truly passive. Moreover, we are exploring measures such as additional capital requirements, enhanced risk-management requirements, and additional data collection and reporting requirements on physical commodities activities to help ensure that such activities do not pose undue risks to the safety and soundness of financial holding companies and their subsidiary depository institutions, or to financial stability.

### **Conclusion**

Our review of the commodity-related activities of the firms we supervise is ongoing. We are assessing the potential risk of physical commodities activities to the safety and soundness of the financial holding companies engaged in these activities. In doing so, we are focusing on the risk to safety and soundness presented by specific activities and on whether those risks can be appropriately and adequately mitigated. In addition, we are conducting a careful and thorough assessment of the costs and benefits of financial holding company engagement in these activities. Our work includes a complete assessment of the comments we received in response to the ANPR. We expect to issue a formal notice of public rulemaking regarding these matters in the first quarter of next year.

Thank you for your attention. I would be pleased to answer any questions you might have.