Fed unlikely to require U.S. banks to exit commodity trade

NEW YORK (Reuters, July 26, 2013) - When it comes to commodity trading, the U.S. Federal Reserve has a habit of lengthy deliberation, deep enquiry and saying yes.

The Fed granted its first authorization to trade physical commodities to Citigroup Inc (NYS:C) in 2003 after nearly five years of study; the letter allowing it to keep its Phibro unit arrived just six days before a grace period ended.

It spent another nine months scrutinizing one of its last such permits, given to the Royal Bank of Scotland (RBS.L) in 2008 when it bought half of Sempra Commodities; the Fed's deliberations delayed plans to close the deal by months, but it ultimately approved a vastly expanded array of activities.

So even after a week of unprecedented public and political scrutiny on the multibillion-dollar commodity trading desks at Goldman Sachs Group Inc (GS), Morgan Stanley (MS) and JPMorgan Chase & Co (JPM), a dozen legal experts and industry sources say the Fed is unlikely to turn back the clock to an era when banks were barred from touching gasoline cargoes or aluminum coils.

"I would be quite surprised if the Fed were to reverse 10 years of practice for a dozen financial institutions," said Robert Tortoriello, a partner at law firm Cleary Gottlieb who has worked with banking organizations.

He said he had "not heard anything at the Fed staff level" to suggest that the regulator would backtrack.

But in sticking to its long-held position that trading raw materials can be "complimentary" to a bank's core financial activities, the Fed may also decide to maintain an equally long-held view that owning warehouses, pipelines and tankers does not fit with banks' missions - meaning they could be ordered, or pressured, to divest those infrastructure assets.

Whatever the outcome, the Fed is coming under intensifying pressure over an issue that has lurked just below the radar since

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the 2008 financial crisis.

Over the past week alone, brewers complained before Congress that metals warehousing units owned by banks were driving up prices of aluminum they use for cans. Lawmakers likened banks that own oil tankers or pipelines to the collapsed energy giant Enron, saying they added "more and more risk" to the financial system. And federal energy regulators were reportedly close to a $400 million settlement over alleged market manipulation.

But most unnerving of all was an abrupt Federal Reserve statement last Friday saying it was "reviewing" the landmark 2003 Citigroup decision that first allowed deposit-taking banks to play in the murky markets of power, pipelines and pallets.

Despite speculation of a worst-case outcome, experts agreed that incremental measures were far more likely.

"My instinct is there will be new limits on certain types of activities and then significantly more explicit and stringent safety and soundness, particularly firewall-type requirements," said Karen Petrou, a co-founder of Financial Analytics, a Washington firm that consults clients on regulation.

'SOUND AND FURY' BUT LITTLE CHANGE

New legislation to force the issue was also seen as long odds, despite a renewed enthusiasm among some lawmakers to reinstate the Glass-Steagall Act that separated investment and commercial banking. The law that overturned that rule 15 years ago initially opened the door to wider commodity dealing.

"There will be a lot of sound and fury, signifying nothing -that is, no legislation," said Craig Pirrong, a professor at the University of Houston and expert in commodity markets.

Senator Sherrod Brown, the Ohio Democrat who this week presided over the first hearing questioning whether commercial banks should own commodity infrastructure, launched a bill earlier this year that would force banks to raise far more capital than they currently hold.

While the bill is unlikely to make it through Congress given Republican opposition and reluctance among many Democrats for further rules, it does increase pressure on regulators.

Public pressure may have also played a role in the Fed's abrupt, brief one-sentence statement last week announcing its "review", several of the sources said.

It was the Fed's first public comment on commodity trading since a Reuters report in March 2012 put a spotlight on the lingering issue, and arrived one day before a front-page New York Times investigative story on metals warehouses and four days before Brown's Senate bank committee hearing.

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YEARS OF SCRUTINY

The Fed has already spent years scrutinizing the question of banks trading in the physical commodity markets, at times leaving key decisions to the 11th hour.

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Citigroup asked for permission to trade commodities after inheriting the famed Phibro trading house in its merger with Travelers Group in 1998. It was finally approved by the Fed on October 2, 2003 - exactly six days before Citi's five-year grandfathering period would have run out.

The Fed has continued to scrutinize each new request, even for banks who were simply seeking "me too" approval to trade in the same way as Citi, say sources familiar with the process.

It is not known to have rejected any requests outright, but after 2008 has grown more deliberate in granting some petitions. Bank of America Corp (BAC) submitted a request to expand its physical trading activities after buying Merrill Lynch in 2008, but as of last March it was still awaiting a response from the Fed, Reuters reported last year. A bank spokesman declined to comment on the current status of the request.

With a decade of commodity market experience, the Fed may also be sensitive to the concerns of commercial firms and counterparties who trade regularly with the banks - and who fear their expulsion could diminish liquidity.

Randall Guynn, a partner law firm Davis Polk & Wardwell who appeared at this week's hearing, said some hedge funds and trading firms told him that banning the banks would be a worry.

"Having more counterparties, not less, is better for liquidity and competition," he said.

PHYSICAL SPLIT

The Fed's decision on the subject of physical assets is less clear-cut, the experts said.

From 2003 onward, the Fed has placed a number of clear conditions on banks seeking to trade physical commodities: the activity must be "complimentary" to the banks derivatives business and in the public good; the value of the commodities must be under 5 percent of the Tier 1 capital; the commodities must be related to ones that trade on U.S. futures exchanges.
And it has said repeatedly that the ownership or investment in any "extraction, transportation, storage, or distribution" businesses was off limits in the context of commodity trading.

But two issues complicate that simple determination.

One is a "grandfathering" clause inserted into the 1999 amendment to the Bank Holding Company Act that allowed any investment banks that converted to "holding company" status after the fact to continue their activity in commodities. Goldman Sachs and Morgan Stanley both converted to bank holding companies during the 2008 financial crisis. The Fed gave them five years to divest any off-limits business but the banks, especially Morgan Stanley with its vast oil trading and logistics business, have sought a broad interpretation of that clause in a bid to keep its operations.

And while some experts said the recent publicity may have tilted the scales against them, one lawyer who works with financial institutions said they had a good case to argue.

Compared to other similar grandfathering exemptions in banking regulations, some of which limit growth or include cut-off dates, the 1998 clause was written intentionally broadly, said one lawyer who declined to be named.

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"This particular 'grandfather' was designed so that you could organically evolve in the commodities business, and that your activities could change with the markets," he said.

The other complicating issue is merchant banking, under which regulated banks are allowed to invest freely in any kind of commercial enterprise so long as the bank is not involved in day-to-day operations and it is divested within 10 years.

JP Morgan and Goldman Sachs bought their now controversial warehouse units in 2010, by which point the Fed had already made clear that such holdings were impermissible. Goldman Sachs now holds its Metro division as merchant investment, according to a source familiar with the matter. JP Morgan declined to comment on the status of its Henry Bath warehouses.

While experts say the conditions required to own an asset as a "merchant" investment are clear and relatively simple, the Fed has ongoing discretion to determine whether those conditions are being met - and could, in theory, require so much separation between the trading divisions and the warehouses that the bank decides the investment isn't worth keeping.

Both banks are said to have floated the idea of selling the warehousing businesses. They have declined to say why they are considering selling.

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