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Federal Reserve energy transaction requirement

The proposed rule

In late September 2016, the Federal Reserve issued a proposed rule that would require financial holding companies (FHCs) to hold more capital in reserve against investments in energy, commodity infrastructure, and operating assets. Some of the key changes in the proposed rule include:

- **Changes in Section 4(k) authority.** The rule would impose stricter conditions on commodity activities that Section 4(k) of the Bank Holding Company (BHC) Act classifies as "complementary" to financial activities.
- **Rolling back FHC latitude.** The Federal Reserve orders that allow FHCs to perform energy tolling and energy management services would have their underlying findings rescinded.
- **A super capital charge for Section 4(o) and merchant banking activities.** An approximate 1:1 requirement for capital versus energy holdings would amount to a capital charge of up to 1,250 percent on banks' energy industry "bets." This would apply to commodities and related assets held by FHCs under Section 4(o) and the Merchant Banking authority that purportedly raised environmental liability concerns.
- **Reclassification of the ownership and storage of copper.** Under the proposed changes, Regulation Y would specify that owning and storing of copper is not "an activity closely related to banking."
- **New public reporting requirements.** By creating a new Schedule HC-W (Physical Commodities and Related Activities) and adding data items to Schedule HC-R (Risk Wighted Assets), the Federal Reserve will compel disclosure of the specific types and value of covered physical commodities holdings and related activities of FHCs. The Fed can also compel those companies to disclose the risk-weighted asset amounts as they relate to the new capital requirements.

In the years following the 2010 Deepwater Horizon oil spill in the Gulf of Mexico, BP has paid out more than $60 billion. If paid out all at once, the large sum could have shocked any bank's financial position and triggered a cascade of effects throughout the financial system. While the Fed's stated intent is to safeguard the financial system and individual institutions from the effect of such a costly environmental disaster, the proposed rule may have unintended effects on the flow of capital within the energy sector.

By limiting the flexibility of certain institutions to finance energy-related transactions, and by taking more capital out of circulation, the reserve requirement has the potential to drive some players out of the market while attracting others to amplify their energy commitments, decrease liquidity, and increase price volatility. One estimate held that the total amount of new capital reserves required under the rule could total approximately $4 billion.[1]

The proposed rule would apply to equity investments in infrastructure, such as power generating plants or distribution systems, and would impose limits on the size of an FHC's holdings of energy-related commodities. One specific example is that the proposed rule would reclassify copper from an industrial metal to an energy commodity. The new rule would also impose additional reporting requirements.

The September 23 announcement marked the beginning of a three-month period during which the Federal Reserve will accept comments on the proposed rule before taking further steps toward making it final.

Driving down risk—while driving out risk-takers

The cash banks would have to hold in reserve to satisfy the new requirement would not be available to finance transactions. It is conceivable thisshrinkage of liquid capital would make financing for energy transactions—and perhaps others—more costly. The market's reduced liquidity also has the potential to make energy-related commodity prices more volatile.

While it appears the proposed rule is meant to apply to a small number of large banks, it may create a proportionately larger burden for smaller ones for whom the required carrying charges represent a greater commitment.

The effect on market participants may spread even farther than that:

- If some banks are driven out of participating as counterparties in energy transactions, other institutions not burdened by the proposed Fed rule—such as insurance companies—may assume a greater role in underwriting the risks.
- Because some banks have used physical commodity investments as hedges for speculation in their proprietary trading books, the market may become dominated by energy firms who are seeking only hedge positions, not speculative positions. This may reduce volatility and hold back the price appreciation energy firms are hoping for.

In addition, entities outside the financial services realm, including institutional energy companies themselves, may act to fill the potential vacuum and secure larger shares of the available commodities and investments.

As Commissioner J. Christopher Giancarlo of the Commodities Futures Trading Commission (CFTC) said in a December 2015 address at Harvard Law School, "Traditionally, [large banks'] balance sheets served as market 'shock absorbers' in times of market turbulence. Now, market 'shock absorbers' seem to be a thing of the past. Throughout these recent sharp volatility episodes, banks appear to have been unable to step in aggressively to provide additional trading liquidity... A major catalyst of the reduced bank trading liquidity in financial markets is the new regulatory policies of US and overseas bank prudential regulators imposed in the wake of the financial crisis... Most of the new regulations have the effect of reducing the ability of medium and large financial institutions to deploy capital in trading markets. Combined, these disparate regulations are already sapping global markets of enormous amounts of trading liquidity."[2]

Proceeding with caution

Energy companies watching this proposal unfold can consider a variety of steps to prepare for its effects, including reexamining all of their contractual counterparty relationships and assessing how much exposure each bank is likely to have to the rule's liquidity requirements. Such an analysis can serve to identify which banks might remove themselves as counterparties—or which ones might sell their existing energy contracts to third parties.

If traditional financing vehicles appear threatened by the coming change, energy companies may also wish to get a head start on identifying alternatives. Among the potential new sources of underwriting support are insurance companies, or perhaps even internal guarantees from energy companies' parent organizations.

Finally, energy companies may wish to assess their ability to become dealers in their own right—to hold their own commodity positions and make their own direct investments in energy projects. But having the financial wherewithal to do this is only one hurdle. Players also need to register as bona fide swap dealers to take on these responsibilities legally, which is both an administrative task and a new risk and compliance challenge. They also need to make sure they are able to clear transactions and perform other market functions, which can spread the challenge into areas, such as technology and talent. Part of the context for this consideration is that commodities trading desks have already been in a talent exodus that began in 2014. As banks shed assets, and some even leave the business entirely, this talent concern may intensify.

Over the long term, the proposed rule has the potential to drive shifts in financial participation that can alter an energy-related company's fundamental strategy and ways of doing business. Monitoring the development of the Federal Reserve proposal is an early step. Participating in the call for public comment is a possible short-term opportunity as well. But this is also the time for companies to start examining where a change like this may leave them down the road.

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[1] http://www.reuters.com/article/us-usa-fed-commodities-idUSKCN11T1ZB
[2] http://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-11

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