****

**Let Banks Be Intermediaries in the Commodities Markets**

American Banker  |  Thursday, May 1, 2003

By Isaac B. Lustgarten

Despite the post-Enron taint on energy and commodities trading, the Federal Reserve Board is considering a rule that would let bank holding companies enter into derivative contracts that typically result in taking and making delivery of title to, but not physical possession of, commodities on an instantaneous, pass-through basis.

The Office of the Comptroller of the Currency just approved a similar proposal for banks to settle and hedge electricity derivative transactions in which they accept and immediately relinquish titles to electricity - as a party in a "chain of title" transfers - without having to receive or deliver actual power.

Regulators should go further and permit banking organizations to act as financial intermediaries in the commodities markets generally by allowing them to own commodities under certain circumstances.

Currently, bank holding companies may engage as principal in forward contracts, options, futures, options on futures, swaps, and similar contracts, based on a rate, price, or assets if:

* The commodity underlying the contract is investment-grade corporate debt securities, U.S. government and municipal securities, foreign exchange, and certain precious metals.
* The contract requires cash settlement.
* The contract allows for assignment, termination, or offset before delivery or expiration and the bank holding company makes every reasonable effort to avoid taking or making delivery of the underlying commodity.

For physically settled commodity derivatives that a bank may not own - like derivative contracts on energy-related commodities - a bank holding company must make reasonable efforts to avoid delivery, and the contract must have assignment, termination, or offset provisions requirements.

Consequently, the Fed proposes that bank holding companies be allowed to take or make delivery of title to commodities underlying derivative transactions on an instantaneous basis and to participate in physically settled derivative markets where the standard industry documentation does not allow for assignment, termination, or offset.

The regulators have argued that banking organizations should be largely limited to acting as financial intermediaries that facilitate transactions for commodities users or producers, and that they should not be involved in and bear the risks of physical possession, transport, storage, delivery, and sale of bank-ineligible commodities. Hence financial intermediary participants in commodity markets generally enter into back-to-back derivative contracts with third parties that effectively offset each other.

According to the Fed, taking title to a commodity on an instantaneous basis involves no risk that is greater than, or different in kind from, the risk that it currently has as a holder of a commodity derivative contract, and involves the routine operations functions of passing notices, documents, and payments - functions that bank holding companies regularly perform in their role as financial intermediaries in other markets. Allowing banks to trade commodities - as financial intermediaries - would help them better understand the markets and use of the appropriate hedges. The risks of physical possession, transport, storage, delivery and sale of a commodity are risks banking organizations and especially financial holding companies are equipped to evaluate, accept, and minimize.

Even now, national banks can be involved in physical commodity transactions in order to manage the risk arising out of physical commodity financial derivatives transactions if they meet the following conditions:

* Any physical transactions supplement the bank's existing risk management activities, constitute a nominal percentage of a bank's risk management activities, are used only to manage risk arising from otherwise permissible (customer-driven) banking activities, and are not entered into for speculative purposes.
* A national bank may engage in physical commodity transactions in order to manage the risks arising out of physical commodity financial derivatives transactions subject to a detailed plan, which should be approved by the bank's board and OCC supervisory staff.

Moreover, the Comptroller's Office has indicated that futures contracts may be fulfilled either by delivery or offset. Though only a very minimal portion of all futures contracts are ever settled by deliveries, in the actual market delivery is expected.

Regulators should permit banks to trade commodities as a financing technique. The transactions could be structured to be on a customer-driven basis with a hedge by either derivatives or an offsetting contract for receipt or delivery of the commodity.

© 2009 American Banker and SourceMedia, Inc. All Rights Reserved.
SourceMedia is an Investcorp company. Use, duplication, or sale of this service, or data contained herein, except as described in the Subscription Agreement, is strictly prohibited.

For information regarding Reprint Services please visit: <http://www.americanbanker.com/reprint-services-rates.html>