

amendment to Regulation Y that would permit bank holding companies to (i) take and make delivery of title to commodities underlying commodity derivative contracts on an instantaneous, pass-through basis; and (ii) enter into certain commodity derivative contracts that do not require cash settlement or specifically provide for assignment, termination, or offset prior to delivery.

DATES: The final rule is effective August 4, 2003.

FOR FURTHER INFORMATION CONTACT:

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SUPPLEMENTARY INFORMATION:

Background

The Board's Regulation Y currently authorizes bank holding companies ("BHCs") to engage as principal in forward contracts, options, futures, options on futures, swaps, and similar contracts, whether traded on exchanges or not, based on a rate, price, financial asset, nonfinancial asset, or group of assets (other than a bank-ineligible security) ("Commodity Contracts"). A BHC's authority to enter into Commodity Contracts is subject to certain restrictions that are designed to limit the BHC's activity to trading and investing in financial instruments rather than dealing directly in commodities. In particular, Regulation Y provides that a BHC may enter into a Commodity Contract only if (i) the commodity underlying the contract is eligible for investment by a state member bank; or (ii) the contract requires cash settlement; or (iii) the contract allows for assignment, termination, or offset prior to delivery or expiration (the "Contractual Offset Requirement"), and the BHC makes every reasonable effort to avoid taking or making delivery of the underlying commodity (the "Delivery Avoidance Requirement").¹

The effect of these restrictions is to allow a BHC to engage as principal in cash-settled derivative contracts involving any type of commodity (other than certain derivative contracts involving bank-ineligible securities) but to limit the authority of a BHC to engage in physically settled derivative contracts. Under these restrictions, a BHC may take and make delivery on physically settled derivatives involving commodities that a state member bank

is permitted to own.² For all other types of physically settled derivatives,³ a BHC must make reasonable efforts to avoid delivery, and the contract must have assignment, termination, or offset provisions.

The Bank Holding Company Act ("BHC Act"), as amended by the Gramm-Leach-Bliley Act (Pub. L. 106-102, 113 Stat. 1338 (1999)) ("GLB Act"), permits a BHC to engage in activities that the Board had determined were closely related to banking, by regulation or order, prior to November 12, 1999. A BHC must conduct these activities in accordance with the terms and conditions contained in such regulations and orders, unless modified by the Board.

In response to requests by Citigroup Inc., New York, New York ("Citigroup"), and UBS AG, Zurich, Switzerland ("UBS"), the Board issued a proposal in March 2003 that would modify the restrictions in Regulation Y to allow BHCs to 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 (regardless of whether the contracts contain specific assignment, termination, or offset provisions).⁴ The Board received six public comments on the proposal: two from banking organizations, three from financial services trade associations, and one from an individual. The five financial services commenters supported the proposal and offered no general or specific criticisms of the proposal. These commenters believed that the Board's proposal would enhance the ability of banking organizations to serve as financial intermediaries and satisfy customer needs and would improve liquidity and competition in a number of commodity markets.

The individual commenter expressed opposition to the proposal. The commenter asserted that the proposal would reduce the stability of the financial system by permitting banking

organizations to engage in risky activities. The commenter also contended that permitting banking organizations to participate in a wider variety of derivatives markets would increase the scope of potential conflicts of interest for banking organizations.

Final Rule

After carefully reviewing the public comments on the proposal, the Board has determined to modify the conditions that the Board imposed in Regulation Y on the permissible derivatives activities of BHCs to permit BHCs to enter into Commodity Contracts that are settled by the BHC receiving and transferring title to the underlying commodity instantaneously, by operation of contract, and without taking physical possession of the commodity. The final rule also modifies the existing condition in Regulation Y that generally prevents BHCs from engaging as principal in a physically settled Commodity Contract unless the contract specifically provides for assignment, termination, or offset prior to delivery.

The Board adopted the restrictions in Regulation Y on the types of Commodity Contracts that a BHC may enter into as principal to reduce the potential that BHCs would become involved in and bear the risks of physical possession, transport, storage, delivery, and sale of bank-ineligible commodities. The restrictions ensure that the commodity derivatives business of a BHC is largely limited to acting as a financial intermediary that facilitates transactions for customers who use or produce commodities or are otherwise exposed to commodity price risk as part of their regular business.

The Regulation Y derivatives restrictions, however, have impeded the ability of BHCs to participate substantially in certain derivatives markets. Notably, in some over-the-counter forward markets (U.S. energy markets, for example), the physically settled derivative contracts traded by market participants do not specifically provide for assignment, termination, or offset prior to delivery and, thus, do not conform to the Contractual Offset Requirement of Regulation Y. Moreover, participants in these markets generally settle contracts by temporarily taking and making delivery of title to the underlying commodities and, thus, do not comply with the Delivery Avoidance Requirement of Regulation Y.

Financial intermediary participants in these markets generally enter into back-to-back derivative contracts with third parties that effectively offset each other.

² State member banks may own, for example, investment grade corporate debt securities, U.S. government and municipal securities, foreign exchange, and certain precious metals.

³ These would include derivative contracts based on, for example, energy-related commodities and agricultural commodities.

⁴ See 68 FR 12316, March 14, 2003. Citigroup and UBS also have asked the Board to allow financial holding companies to take and make physical delivery of a limited amount of commodities as an activity that is incidental or complementary to engaging as principal in BHC-permissible Commodity Contracts. The Board continues to review these broader requests. Several commenters on the proposed rule expressed support for Board approval of these broader requests by Citigroup and UBS.

¹ 12 CFR 225.28(b)(8)(ii)(B).