April 29, 2020

The Honorable Jerome Powell
Chair
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue N.W.
Washington, DC 20551

Dear Chair Powell:

We are writing on behalf of Americans for Financial Reform Education Fund[1] because we are gravely concerned about a *Reuters* report from April 9 that JPMorgan Chase & Co, Wells Fargo & Co, Bank of America Corp and Citigroup Inc are considering taking possession of and possibly operating oil and gas properties to avoid losses on loans to insolvent energy industry debtors.[2] Banks have been permitted to make hundreds of billions of loans to oil and gas companies on the security of assets that have now plunged to record lows in value, with no recovery in sight.

The Board has itself laid out the manifold physical, economic, reputational and financial system risks of bank commodity holdings, which are also supported by other research and investigations.[3] These risks are particularly large in the case of oil and gas holdings, they have only grown over time, and they are extremely severe under present circumstances. That is why we believe it is of the utmost importance in dealing with this situation for the Board to avoid any actions which would permit the banking and financial system to be entangled with operation, management, or ownership of the energy industry.

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[1] Americans for Financial Reform Education Fund is a coalition of consumer, civil rights, investor, and retiree, community, labor, faith based, and business groups. A list of coalition members is available at: https://ourfinancialsecurity.org/about/our-coalition/.

[2] David French and Imani Moise, Exclusive: U.S. banks prepare to seize energy assets as shale boom goes bust (April 9, 2020), https://www.reuters.com/article/us-usa-banks-energy-assets-exclusive/exclusive-u-s-banks-prepare-to-seize-energy-assets-as-shale-boom-goes-bust-idUSKCN21R3JI.

[3] Saule T. Omarova, *The Merchants of Wall Street: Banking, Commerce, and Commodities*, Minnesota Law Review, Vol. 98 (2013), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2180647; and *Wall Street Bank Involvement with Physical Commodities*, United States Senate Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs (November 2014), https://www.hsgac.senate.gov/imo/media/doc/REPORT-Wall%20Street%20Bank%20Involvement%20With%20Physical%20Commodities%20(12-5-14).pdf.

While banks may take possession of property in satisfaction of a debt previously contracted (DPC), such acquisitions are intended to be purely temporary pursuant to quickly selling the assets. The Fed must ensure that any oil and gas acquisitions by banks are disposed of quickly, and must under no circumstances allow FHCs or any of their subsidiaries to directly or indirectly operate oil or gas companies.

There is no legal authority under which it would be permissible or reasonable for the Fed to allow this to happen, and it would create potentially significant risks to safety and soundness of the institutions and of the U.S. banking sector to do so. It could also result in decreased market competition, as consolidation and bankruptcies in the oil sector could lead to FHCs accumulating control over a larger portion of operating companies in the energy sector.

The Board has no legal authority to permit FHC operation of oil or gas companies

The Board's interpretation of DPC acquisition authority in 12 CFR 225.140, makes it clear that any DPC acquisitions of oil and gas must not be an entry point into sustained ownership of such assets. Instead, such assets must be disposed of as quickly as possible. This section states that if "a bank holding company were permitted, either directly or through a subsidiary, to hold DPC assets of substantial amount over an extended period of time, the holding of such property could result in an unsafe or unsound banking practice or in the holding company engaging in an impermissible activity in connection with the assets, rather than liquidating them." Thus, if banks come into possession of oil and gas assets through seizure of collateral for defaulted debts, they must be required to sell these assets as quickly as possible.

The *Reuters* story indicates that the BHCs are actually seeking to operate the energy companies themselves in order to avoid selling the assets of bankrupt firms at depressed prices. Claims that DPC acquisitions should be held for long periods or that banks should become involved with their operation in the hope that the oil market will recover must be rejected. First, DPC acquisitions are not a license for speculation, nor do they permit banks to engage in non-financial activities. Second, It is likely that these markets will be disrupted for an extended period. Over 200 fracking companies have gone bankrupt since 2015, with thirty-two declaring bankruptcy in 2019 alone.[4] Data compiled by Rystad Energy shows even the major producers operating in the Permian Basin—Exxon Mobil Corp., Occidental Petroleum Corp., Chevron Corp., and Crownquest Operating LLC—can only turn profits at $31 a barrel.[5] Permitting extended holding will create a lasting cloud of uncertainty as to the condition of bank balance sheets and the size of any write downs that should be taken. This will undermine economic recovery and financial stability.

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[4] *Pandemic Crisis, Systemic Decline: Why Exploiting the COVID-19 Crisis Will Not Save the Oil, Gas, and Plastic Industries*, The Center for International Environmental Law (April 2020), https://www.ciel.org/reports/pandemic-crisis-systemic-decline/.

[5] Rachel Adams-Heard and Kevin Crowley, *Shale's New Reality: Almost All Wells Drilled Now Lose Money*, Bloomberg (March 9, 2020), https://www.bloomberg.com/news/articles/2020-03-09/shale-s-new-reality-almost-all-wells-drilled-now-lose-money.

The Board's November 2019 Financial Stability Report warned of corporate debt risks, excessive leverage, proliferation of issuance in the high-yield space.[6] The Board noted in this report that there were concerns "a U.S. recession would expose highly leveraged sectors of the economy," and this has been precisely what has happened in the U.S. energy sector.[7] 91 percent of defaulted U.S. corporate debt in Q3 2019 was due to oil and gas companies.[8] The energy industry has been the largest issuers of high yield corporate debt for a decade, and accounts for 13 percent of the bottom tier, CCC rated corporate bonds.[9][10]

Energy companies owe an estimated $200 billion through loans backed by oil and gas reserves.[11] JPMorgan, Wells Fargo, Bank of America, and Citigroup are the largest of these lenders, but only about 1 to 3 percent of their portfolios are exposed to the industry.[12] If FHCs were allowed to retain the assets of bankrupt energy companies rather than disposing of them, however, it could extend and possibly increase their exposure to a troubled sector.

The Board itself noted many risks to FHCs conducting these types of physical commodity activities in its 2016 Proposed Rule, including that companies may face liability from state and federal environmental laws following oil spills or other disasters stemming from physical commodity release.[13] The Board also noted that "over the past decade, monetary damages associated with an environmental catastrophe involving physical commodities have ranged from hundreds of millions to tens of billions of dollars."

In addition, there is a growing international consensus by financial regulators that climate change poses serious financial risks, including risks to physical assets and due to the transition risk, when economies shift away from fossil fuels and to renewables.[14] Former Deputy Treasury Secretary Sarah Bloom Raskin, when asked about the Fed's Primary and Secondary Market Corporate Credit Facilities, noted the risk of future losses in the energy industry's corporate debt

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[6] Board of Governors of the Federal Reserve System, *Leverage in the financial sector*, Financial Stability Report (November 2019), https://www.federalreserve.gov/publications/2019-november-financial-stability-report-leverage.htm.
[7] Board of Governors of the Federal Reserve System, *Near-term risks to the financial system*, Financial Stability Report (November 2019), https://www.federalreserve.gov/publications/2019-november-financial-stability-report-near-term-risks.htm
[8] https://www.nytimes.com/2020/04/10/opinion/sunday/coronavirus-texas-fracking-layoffs.html.
[9] Bethany McLean, *Coronavirus May Kill Our Fracking Fever Dream*, NYTimes (April 10, 2020), https://www.nytimes.com/2020/03/20/business/energy-environment/coronavirus-oil-companies-debt.html.
[10] Joe Rennison in London and Jennifer Ablan, *US energy 'junk' bonds hammered by oil plunge*, FT (January 29, 2020), https://www.ft.com/content/55f74150-4225-11ea-a047-eae9bd51ceba.
[11] French and Moise, *supra* note 2.
[12] Megan Greene, *Bailing out the oil industry brings a fate worse than death*, FT (April 19, 2020), https://www.ft.com/content/4a6494e2-7fbe-11ea-b0fb-13524ae1056b.
[13] Board of Governors of the Federal Reserve System, Proposed Rule Implementing Strengthened Prudential Requirements, including Riskbased Capital Requirements, for Physical Commodity Activities and Investments of Financial Holding Companies (September 12, 2016), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20160923a1.pdf.
[14] Graham Steele, *Confronting the 'Climate Lehman Moment': The Case for Macroprudential Climate Regulation*, Cornell Journal of Law and Public Policy (March 2020) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3542840.

because there may be increasing recognition of climate risk.[15] These same risks apply to the banks should they become fossil fuel operators themselves.

FHCs may also face a reputational cost for engaging further with oil and gas. Some financial institutions such as BlackRock have, for example, divested from some types of coal, and asked companies it invests in to give a clear analysis of their preparedness to transition their business model to address risks associated with climate change. But BlackRock still faced criticism as they failed to meaningfully divest from oil and gas.[16] Bank financing of fossil fuel companies is also thoroughly tracked by climate groups, such as the “Banking on Climate Change: Fossil Fuel Finance Report 2020” from Rainforest Action Network, which notes that banks have spent $2.7 trillion on fossil fuel financing since 2016.[17]

Complementary activities

Banks may also seek to use other authorities to use these assets. Under the Gramm-Leach-Bliley Act of 1999, U.S. FHCs are allowed to engage in a variety of non-financial, commercial activities. For example, Section 4(k) of the Bank Holding Company Act permits banks to engage in activities complementary to finance that do not pose significant risk. However, operating and managing oil and gas producers cannot reasonably be considered complementary to financial activities and, as the Board itself has previously stated, would pose significant prudential and financial system risks. Therefore it does not satisfy statutory requirements under Section 4(k). It is important to note that previous Board actions permitting physical commodity ownership under this authority, even actions we would otherwise consider too permissive, have explicitly banned bank ownership or investment in facilities for the extraction, transportation, storage, or distribution of commodities.[18]

The statute provides that, in order to approve any request for a “complementary power,” the Board must find that the FHC’s proposed commercial activity does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally. The Board must also consider whether the complementary activity is reasonably expected to produce public benefits that outweigh possible adverse effects like undue concentration of resources, decreased or unfair competition, conflicts of interests, unsound banking practices, or risk to the stability of the United States banking or financial system.[19]

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[15] Avery Ellfeldt, *Fed faces climate test as it tries to rescue economy*, E&E News (April 16, 2020), https://www.eenews.net/stories/1062883505 ("If it turns out that the corporate debt of Exxon Mobil is worth less in three years because there's a greater recognition of climate risk, then the debt of Exxon Mobil when the Fed unwinds it is going to be worth less," Raskin said. "And that's going to be a loss the Fed takes on their balance sheet — and the American people.")
[16] BlackRock’s Big Problem, *Our in-depth analysis of BlackRock’s climate announcement* (January 14, 2020), https://www.blackrocksbigproblem.com/post/our-in-depth-analysis-of-blackrock-s-climate-announcement.
[17] Rainforest Action Network, *Banking on Climate Change: Fossil Fuel Finance Report 2020* (March 18, 2020) https://www.ran.org/bankingonclimatechange2020/.
[18] https://www.federalreserve.gov/newsevents/pressreleases/files/orders20080327b1.pdf
[19] 12 U.S.C. 1843(j).

FHCs owning and operating oil and gas assets, especially on a potentially significant scale, would elevate potential risks to banking entities and the safety of the financial system overall. Legal scholarship[20] and Senate investigations[21] alike have highlighted how the "too-big-to-fail" banking institutions had already grown even bigger by expanding their operations into the physical commodity markets, potentially also making their institutions riskier and less manageable. The recent historic turmoil in oil markets dramatically exacerbates existing risks. In the course of the last month, U.S. and global oil markets have been experiencing severe dislocation. On April 20, futures for light sweet crude oil (WTI) dropped to record lows before hitting zero and then turning negative, as contract owners became increasingly desperate to avoid taking physical delivery at a time when storage capacity is already overloaded.[22] There is no recent precedent for these levels of volatility in the oil and gas markets, and it will dramatically increase the cost of future hedging for oil and gas operators.[23] With the price of the September contract for WTI currently below $25 a barrel,[24] it appears low prices may continue for years to come.

Oil market fundamentals were broken long before COVID-19. For the last decade, oil and gas companies have been the single largest junk bond borrowers.[25] The sector is plagued with bankruptcies, steadily decreasing oil prices, and is directly exposed to potentially catastrophic climate-related risks. Oil companies are also facing transition risks, as the world's economies continue to shift to renewables. If a small number of systemically important FHCs were permitted to take over failing oil and gas producers, they would be (a) taking all of these risks and uncertainties directly onto their own balance sheets, and (b) if it happened at scale, it would be raising the specter of increased and extreme consolidation and concentration of market power in the energy sector.

"Grandfather" authority and merchant banking activities

The "grandfather" authority for commodity activities under Section 4(o) of the Bank Holding Company Act permits the continuation of pre-1997 commodity related activities, not the

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[20] Saule T. Omarova, *The Merchants of Wall Street: Banking, Commerce, and Commodities*, Minnesota Law Review, Vol. 98 (2013), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2180647.

[21] *Wall Street Bank Involvement with Physical Commodities*, United States Senate Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs (November 2014), https://www.hsgac.senate.gov/imo/media/doc/REPORT-Wall%20Street%20Bank%20Involvement%20With%20Physical%20Commodities%20(12-5-14).pdf.

[22] *US oil prices turn negative as demand dries up*, BBC News (April 21, 2020), https://www.bbc.com/news/business-52350082.

[23] Bill Holland, Allison Good, and Everett Wheeler, *For oil and gas, the key to survival may be an old foe: government*, S&P Global (April 21, 2020), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/for-oil-and-gas-the-key-to-survival-may-be-an-old-foe-government-58117358.

[24] The Last Price for the NYMEX Light Sweet Crude Oil September 2020 futures contract was $24.48 as of 8:45am ET on April 29, 2020.

[25] Matt Phillips and Clifford Krauss, *American Oil Drillers Were Hanging On by a Thread. Then Came the Virus*, NYTimes (March 2020), https://www.nytimes.com/2020/03/20/business/energy-environment/coronavirus-oil-companies-debt.html.

acquisition of oil and gas companies in 2020. In addition, in its 2016 report pursuant to Section 620 of the Dodd Frank Act, the Board urged Congress to repeal the ability of certain banks to invest in physical commodities pursuant to the "grandfather" authority. The Board stated that physical commodity activities "may expose such firms to liability arising from environmental catastrophes, which can create material financial and legal harm for these firms or could harm public confidence in and access to funding markets for the firm or its subsidiary insured depository institution". The Board further stated that commodity activity "also undercuts the general separation of banking and commerce. That separation is important to ensuring a sound, efficient, and objective banking system that allocates credit and provides services on a fair and equitable basis".[26] At the same time, the Board proposed to substantially increase capital requirements for commodity holdings to address the financial and reputational risk of catastrophic environmental disasters and put banks on an equal competitive playing field with other commercial firms holding these assets.[27]

The merchant banking authority in Section 4(k)(4)(H) does not apply because no bona fide investment banking or underwriting activity was involved here. In its 2016 Section 620 report, the Board also suggested the repeal of merchant banking authority, stating that such a repeal would " address potential safety and soundness concerns and maintain the basic tenet of separation of banking and commerce".[28] The Board should certainly not allow banks to bend the law by attempting to claim that oil and gas collateral assets seized for non-payment of debt were somehow obtained through merchant banking.

Conclusion

The Board must not take any actions which allow the entanglement of the banking and financial system with operation, management, or ownership of the energy industry. In particular, we make the following recommendations:

- The Board should require that any DPC acquisitions of oil and gas be disposed of as quickly as possible, as required in the Board's interpretation of DPC acquisition authority.[29]
- The Board should reject any requests by FHCs for expanded "complementary" powers that allow FHCs to own and operate oil and gas assets at this time of extreme market dislocation.

[26] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency, *Report to the Congress and the Financial Stability Oversight Council Pursuant to Section 620 of the Dodd-Frank Act* (September 2016), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20160908a1.pdf.
[27] Board of Governors of the Federal Reserve System, *Notice of Proposed Rulemaking: Regulations Q and Y; Risk-Based Capital and Other Regulatory Requirements for Activities of Financial Holding Companies Related to Physical Commodities and RiskBased Capital Requirements for Merchant Banking Investments* (September 30, 2016), https://www.govinfo.gov/content/pkg/FR-2016-09-30/pdf/2016-23349.pdf.
[28] Board of Governors, *supra* note 26.
[29] 12 CFR 225.140

- The Board should reject any request for extension of the DPC period[30] and any claims that DPC acquisitions should be held for long periods in the hope that the oil market will recover. DPC acquisitions are not a license for speculation.
- The Board should scrutinize any new oil or gas assets FHCs place in their merchant banking subsidiaries, to ensure that they are a bona fide merchant banking investment, and if they are not, to force divestment. The Board has taken such action before, such as when it required JPMorgan Chase to divest from its metals warehouse with Henry Bath & Sons Ltd, as it was found not to be a bona fide merchant banking investment.[31]

In sum, the Board must firmly reject any effort by banks to use the situation with respect to defaulting loans in the energy industry to increase bank involvement in the oil and gas industry. There is no legitimate legal path to such involvement, and as the Board has repeatedly acknowledged in the past, the financial, transition, and reputational risks to banking entities engaging in the management of oil and gas assets are extremely high even in normal times, let alone under the current circumstances. Instead, any collateral assets from oil and gas companies that are seized due to loan defaults must be rapidly sold. Bank involvement with the oil and gas industry must be reduced, not increased.

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[30] 12 USC 1843(c)(2) provides that the DPC period can be extended up to a decade. In the case of oil and gas assets, the larger FHCs may try to keep them as they already have commodities businesses. The Fed must take into account this structural context, and the incentives it creates. A DPC in this case could be used as an excuse for circumventing the Bank Holding Company Act, and the Board must reject that.

[31] Examining Nonfinancial Activities Currently Being Permitted Under the Bank Holding Company Act and the Economic Impact of Such Activities on the Physical Commodity and Energy Markets as Well as the Safety and Soundness of the Nation's Banking System: Hearing Before the Subcomm. on Financial Institutions And Consumer Protection, S. Hrg. 113-375, (2014), https://www.govinfo.gov/content/pkg/CHRG-113shrg89605/html/CHRG-113shrg89605.htm. (Responses to Written Question 4 for the Record of Senator Brown by Michael S. Gibson, Director, Division Of Banking Supervision And Regulation, Board Of Governors Of The Federal Reserve System. “In cases where Federal Reserve examiners identified risk management or other weaknesses as part of the horizontal examination of the firms involved in physical commodities activities, this information was communicated to each of the firms, and examiners monitored the firms to ensure that the firms were taking appropriate steps to remediate these weaknesses. For example, Federal Reserve examiners have required: modification of value-at-risk calculations pertaining to commodities positions,more granular risk limits for commodities positions, consistent valuations of physical and derivative positions in the same commodity, divestiture of impermissible commodity assets, and a more robust compliance function for commodities activities. In the case of JPMorgan Chase & Co., Federal Reserve staff notified the firm that Henry Bath & Sons Ltd (Henry Bath) was not a bona fide merchant banking investment and consequently, JPMorgan Chase & Co. is required to divest its investment in Henry Bath.”)