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The sweeping financial reform bill has been finalized and has provisions of significance for energy commodity markets. These provisions are sure to reduce capital flows into the oil paper markets by banks in the long term. Although uncertainty remains over the size of these reductions they will help temper price volatility in the long run. In the short term, their impact could encourage more investment as some regulatory uncertainty is removed.

Financial Reform Impacts Mixed

Early this morning a joint committee finalized a financial market reform bill that will help illuminate mysterious OTC energy commodity trading and alter bank activities in the broader energy commodity markets. The most significant impact on oil markets will be a reduction in the capital that banks devote to these markets. The size and significance of this reduction remains relatively uncertain, however, and should be limited in the short-term.

Banks Will Reduce Capital, But By How Much?

Bank participation in these markets is significant so changes to their trading activities have the ability to significantly impact these markets. Although the size of OTC bank investment in energy commodities remains a mystery, banks account for a large portion of exchange trading in the WTI contract.

The first provision that will impact bank participation in energy commodity markets will force banks to spin off swaps dealing units involved in energy markets into separately capitalized entities. This will eliminate the use of federally insured capital for these activities by requiring banks to devote their *own* funds to capitalize these entities. The question that remains will be how much capital will be devoted to these entities? It will certainly reduce overall bank capital in the market, but the size of the reduction is unclear at this point.

A similar provision to remove riskier investment activities from federally insured capital (the so-called "Volker Rule"), will also act to reduce bank capital in the energy commodity markets. It will limit bank investments in hedge fund and private equity vehicles, which will impact energy markets to the extent that banks reduce their investments in hedge funds that trade commodities. With current activities as opaque as they are, the impact of this provision is very unclear, but is likely to be minor. Further reducing its

impact is a proposed loophole that could exempt some of the largest players in these markets from these restrictions. Under the provision, firms would have two years to institute the new rules, so any impact in the short-term will be minor.

Even more uncertainty surrounds the final rules on bank proprietary trading. Its impact will remain a mystery in the short-term, with the agreed provision calling for federal financial regulators to study the measure and then implement rules based on the results of that study. Although over the long term this provision may have the most significant impact on speculative activity, it remains the least certain.

Investment May Rise in the Short Term

One provision that will have a short-term impact will be the requirement to move much of the OTC trading in these markets to cleared exchanges. With speculative investors now required to move certain trades to clearinghouses it will increase their costs slightly, eliminating some leverage and reducing overall investment levels. This provision is expected to further reduce overall speculative investment in energy commodities and it will have a more significant short-term impact than the other provisions.

Almost certainly these combined provisions will reduce overall bank capital in the energy commodity markets in the long run. Combined with positions limits, reduced swaps dealers activity and required clearing will also likely discourage some institutional investment moving forward. The overall reduction in speculative capital, although its magnitude uncertain, should help temper oil price swings in the long term.

In the short-run, however, their overall impact will be limited. If anything, now that rules are finalized, traders who were likely hesitant under the regulatory uncertainty of recent months may even increase trading activity and provide additional price volatility for oil markets in the short-term.