

**OPENING STATEMENT OF SENATOR CARL LEVIN
BEFORE
U.S. SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
ON
WALL STREET BANK INVOLVEMENT WITH PHYSICAL COMMODITIES**

November 20, 2014

Today, the Subcommittee meets to discuss the product of a two-year investigation into Wall Street bank involvement with physical commodities. Our 396-page bipartisan report with nearly 800 pages of exhibits provide facts and details that, for too long, have been missing from the public debate about the growing role of large Wall Street banks in sectors of the economy outside of banking – in this case, activities involving physical commodities such as oil, metal, coal and electricity – as well as trading in financial instruments whose value could be affected by a bank’s involvement with those physical commodities.

For more than a century, the United States has, by law and practice, worked to maintain the separation of banking from commerce, directing banks to concentrate on taking deposits, transferring funds, and providing credit, and to avoid commercial activities like supplying oil, producing electricity, or storing aluminum. The principle of separating banking from commerce wisely seeks to reduce risk to the economy and to the integrity of commodity markets.

Our investigation found that this principal has eroded and, predictably, that erosion has increased risk for the economy, markets, industry, and consumers. We found that banks – and for clarity’s sake, I’ll use that term generically to refer to federally insured banks and their holding companies registered with the Federal Reserve – we found that banks have vastly accelerated their physical commodity activities, and are competing directly with commercial businesses that lack the big banks’ easy access to government-subsidized capital. At the same time, these banks have taken on dramatic new risks – risks that, because of the size of these banks, fall not just on them, but on the larger financial system and therefore our entire economy. In addition, their activities raise significant questions about whether banks are profiting at the expense of end-users who must wait longer and pay more for critical raw materials. And they give Wall Street the opportunity to use valuable nonpublic information to gain unfair trading advantages or to profit from the manipulation of prices.

Today’s hearing will focus on the activities of three major banks – Goldman Sachs, JPMorgan Chase and Morgan Stanley – that over the last ten years have become very active in physical commodity markets.

If you like what Wall Street did for the housing market, you’ll love what Wall Street is doing for commodities. Some of the same people who brought us the synthetic mortgage-backed security – and with it, the term “toxic asset” and the recent financial crisis – now dominate the commodities futures markets. Producers and end-users once held about 70 percent of commodities futures; by 2011, that had fallen to about 30 percent, with the majority of futures held by speculators looking to profit from price volatility. That means commodities markets are increasingly unable to fulfill their purpose – which is to allow end users, from shipbuilders to beverage companies and automakers to airlines, to manage their risks.

These Wall Street banks have stored and sold uranium, operated coal mines and metal warehouses, stockpiled aluminum and copper, operated oil and gas storage facilities and pipelines, planned a compressed natural gas facility, supplied oil refineries, sold jet fuel to airlines, and operated power plants. They have acquired staggeringly large positions and executed massive trades in oil, metal, and other physical commodities. While Wall Street's growing role in physical commodities has been discussed and debated, the scope of this involvement, and the potential for abuse, has not been widely known.

Those physical commodity activities bring with them many risks. Goldman Sachs' involvement with uranium and coal exposed it to the kinds of environmental and catastrophic-event risks that traditional banks don't usually face. Morgan Stanley used shell companies in its plans to build a compressed natural gas plant, exposing itself to direct liability should disaster strike. The Federal Reserve recently reported: "[C]atastrophes involving environmentally sensitive commodities may cause fatalities and economic damages well in excess of the market value of the commodities involved or the committed capital and insurance policies of market participants." Should a catastrophe occur, it could undermine a bank or spur fears that it might fail, sparking a bank run, a shut-down of lending, and turmoil in the U.S. economy.

Wall Street has made legal arguments contending that its liability risk is limited and manageable. But at times even the banks acknowledge that they could be held liable if they, for example, are negligent in managing these activities. And even if courts eventually upheld a bank's legal defense, even the possibility of liability judgments on the scale of a Deepwater Horizon or Exxon Valdez could freeze a bank's access to capital and risk a Lehman Brothers-style crisis.

There is much more. Bank involvement with physical commodities also raises concerns about unfair trading. In some cases, banks have been implicated in outright market manipulation. JPMorgan recently paid \$410 million to settle charges by the Federal Energy Regulatory Commission that it used manipulative bidding schemes at its power plants to elicit \$124 million in excessive electricity payments in California and Michigan.

Activities involving physical commodities also give Wall Street banks access to valuable nonpublic information with which they can profit in physical and financial commodity markets at the expense of other market participants. The banks and their regulator, the Federal Reserve, acknowledge as much. JPMorgan, in a 2005 application for authority to make physical commodities investments, said its plan would "provide access to information regarding the full array of actual [production] and end-user activity in those markets. The information gathered through this increased market participation will help improve projections of forward and financial activity and supply vital price and risk management information that JPM Chase can use to improve its financial commodities derivative offerings." Similarly, a Morgan Stanley executive publicly spoke of the advantage of its involvement in oil storage and pipelines: "We're right there seeing terminals filling up and emptying." And a Federal Reserve analysis of Morgan Stanley and Goldman Sachs said the banks' physical commodities activities provided "important asymmetrical information ... which a market participant without physical infrastructure would not necessarily be privy to."

Our bipartisan report contains nine case studies illustrating the risks and unfair trading concerns raised by bank involvement with physical commodities. Each is worthy of its own hearing. Today we will examine activities at three banks, and we will highlight one case study in particular, to demonstrate how actions taken by a single financial institution – Goldman Sachs – in a single commodity – aluminum – has given that Wall Street giant the ability to affect prices and supplies of that commodity while trading in financial instruments related to that commodity.

In 2010, Goldman Sachs bought a company called Metro International Trade Services LLC, which owns a global network of warehouses certified by the London Metal Exchange, or LME, the world's largest market for trading metals. LME certification means Metro can store metal that has been warranted as meeting LME standards for quality and quantity and is approved for use in settling LME aluminum trades. Under Goldman's ownership, Metro mounted an unprecedented effort to dominate the North American market for storing aluminum. By early this year, Goldman's warehouses in the Detroit area held nearly 1.6 million metric tons of aluminum – roughly 25 percent of annual aluminum consumption in North America – and 85 percent of the LME-warranted aluminum in the United States.

Why is this important? Because aluminum warehouses owned by Goldman, and overseen by a board consisting entirely of Goldman employees, manipulated their operations in a way that impacted the price of aluminum for consumers, while at the same time Goldman was trading in aluminum-related financial products.

Goldman's subsidiary achieved this dominant position through aggressive incentives for metal owners to store aluminum in its warehouses – incentives that appear to be inconsistent with the LME's prohibition on "exceptional inducements." One set of incentives involved a series of "merry-go-round" transactions that bottled up millions of tons of aluminum and appears to have affected prices for businesses and consumers.

Those merry-go-round transactions first came to the public's attention through a 2013 New York Times article. We dug into the facts behind the story and uncovered a troubling set of practices that included six merry-go-round trades involving more than 600,000 metric tons of aluminum.

To remove LME-warranted metal from an LME warehouse, the metal's owner must cancel its warrants and pay any rent or storage bills. Then the metal is placed in line for load-out. That line is the "queue" you'll hear a lot about today.

Until Goldman bought Metro, aluminum in the load-out line was shipped from a warehouse in a matter of days or weeks. But as you can see in the attached chart [Exhibit 1(f)], since Goldman's acquisition of Metro, the queue to exit the Detroit warehouses has gotten longer and longer. In January 2010, it was about 40 days; by September of this year, it had grown to an unprecedented 600 days. Why? Because of actions taken by Metro, the Goldman-owned warehouse operator. And what difference does it make? A big difference. The price consumers must pay for aluminum is made up of the benchmark price set on the LME's exchange, plus a regional premium based on regional storage and logistics costs. The longer the queue, the higher the storage costs, and the higher the storage costs, the higher the premium consumers must pay.

Statistical analysis shows an extremely high correlation between the length of the queue and the U.S. premium level.

LME rules require that warehouses each day load out a minimum quantity of metal. That minimum was 1,500 metric tons a day for large warehouses such as Metro's, until April 2012, when it was increased to 3,000 metric tons. Goldman's warehouses have treated the daily LME minimum as a maximum, shipping no more than the minimum. In addition, Metro formed a single exit line for all 28 of its Detroit-area warehouses combined, and decreed that the daily minimum applied to that single exit line.

The merry-go-round deals increased the length of the queue and clogged the exit line. In most of the merry-go-round deals, the metal owner agreed to cancel warrants on a large amount of aluminum and put that metal in the exit queue. When the owner got to the front of the line, it loaded out its metal onto trucks, but the metal didn't leave the Metro system. Instead, the trucks moved the aluminum to a nearby Metro warehouse and the metal owner eventually re-warranted the metal. In exchange, Metro paid millions of dollars to the metal owners – once when they cancelled the warrants, and again when they re-warranted the metal in another Metro warehouse.

It's important to understand that the first of these deals, reached with Deutsche Bank just seven months after Goldman bought Metro, came after Deutsche Bank simply asked for a discount on rent for its aluminum. Nothing prevented Metro from simply giving such a discount. Instead, the warehouse proposed the convoluted merry-go-round, which effectively gave Deutsche Bank the discount it wanted, but with the added benefit to Metro and Goldman of adding 100,000 tons of aluminum to the exit queue.

Metro used this same model in several subsequent deals. In some deals, metal was loaded onto a truck and shipped a mere 200 yards to a different warehouse. Most of the deals involved shuffling virtually identical loads of aluminum among multiple warehouses, which is why a forklift operator called it a "merry-go-round of metal." Because each deal involved between 100,000 and 190,000 metric tons of aluminum, loaded out at 1,500 or 3,000 metric tons a day, the net effect was that each deal added weeks or months to the queue.

The lengthening queue had a number of effects. First, it boosted revenue at Goldman's warehouses – the more metal stored in the warehouses, the more rent and fees.

The longer queue also affected aluminum prices. The "all-in" price that consumers pay for aluminum has several components, but the two major components are the LME Official Price, set on LME's exchange, and a regional premium that reflects local variations in storage and delivery costs. The regional premium in the United States is known as the Midwest Aluminum Premium. As this chart shows, as the queue in Metro's Detroit-area warehouses increased, so did the Midwest Premium. [Exhibit 1(f)]

Most market participants believe a higher Midwest Premium means higher all-in prices, which means Goldman's warehouses are using a tactic that earns the bank higher rents at the expense of a wide range of businesses that use aluminum. Those businesses include Austal, a company that builds combat ships for our Navy and which told the Subcommittee that the effects

of rising Midwest Premiums have forced it to take costly steps that damage not just the company, but cost U.S. taxpayers.

Goldman argues that these market participants are incorrect, and the total price of aluminum was unchanged by the merry-go-round deals and the longer queue. It argues that as the Midwest premium rises, the LME price falls, so that the all-in price remains unchanged. Again, that is not what other market participants say. But even if it were true, Goldman's warehouses are still engaged in unacceptable manipulation. As the queue-inflated Midwest Premium has risen, it has taken up an increasing share of the all-in price for aluminum – from just 6 percent of the all-in price in 2010 to over 20 percent this year. That increase means the LME price has fallen as a percentage of the all-in price, making LME futures a less effective tool to hedge price risk. Now, in addition to assessing supply and demand, aluminum users must try to hedge just how long a load-out queue Goldman's warehouses can engineer. What's more, if Goldman's theory is correct and the LME price goes down as the premium goes up, Goldman has the ability to manipulate the LME price by manipulating the Midwest premium, and then to make trades taking advantage of that manipulation. Goldman's ability to influence any portion of the price for a key component of the industrial economy is simply unacceptable.

While the LME has rules designed to prevent a situation where a warehouse could share valuable confidential information with traders, those rules are porous. Under LME rules, Metro shares confidential information with about 50 Goldman employees, including top executives who manage Goldman's commodities trading while also sitting on Metro's Board of Directors. The Metro Board, which has consisted exclusively of Goldman employees, reviewed and approved all significant business decisions at Metro, including the merry-go-round deals. In other words, a warehouse strategy that materially affected the aluminum market was approved by executives of a bank uniquely positioned to trade profitably on the effects of that strategy. Think about the opportunity for Goldman to affect the premium and price at the same time it was trading in that metal.

In fact, the information to which Goldman's top commodities executives have access through Metro is so sensitive and valuable that LME won't publish it. In a 2013 report, LME said it does not publish detailed information on warehouse stock and queues because "the danger is that those merchants and trading houses with the most well-staffed analytical capabilities will take advantage of the availability of data to derive a trading advantage." It's hard to think of a trading house that better fits that description than Goldman Sachs.

There is little doubt that if we were talking about the stock market, rather than commodities transactions, the use of inside information that affects prices would be strictly prohibited. But until passage of Dodd-Frank, there were no legal prohibitions on using valuable nonpublic information to trade commodities, and even now, regulators' authority to stop such abuse is untested.

So, the potential for abuse is great, and the only protections against abuse are company policies against sharing information. Given the recent history of banks improperly sharing information to manipulate electricity, LIBOR, and foreign exchange rates, the reliance on voluntary policies at companies that have an economic interest in the opposite direction is not enough protection for consumers.

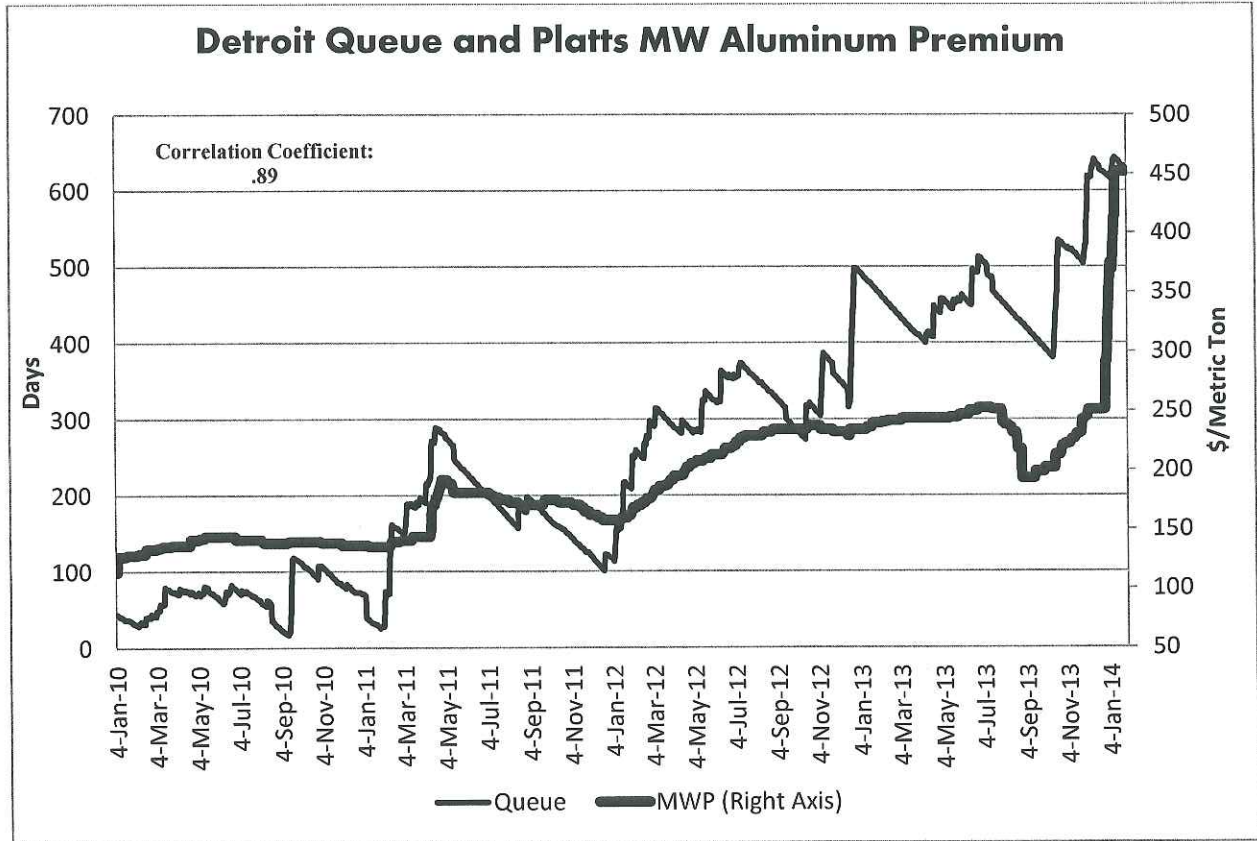
This concern is especially relevant given Goldman's rapid increase in aluminum trading after it acquired Metro. After buying Metro in 2010, Goldman's physical aluminum stockpile grew from less than \$100 million to, at one point, more than \$3 billion, a 30-fold increase. This stockpile also allowed Goldman itself to add to the queue at its Metro warehouses, where in 2012, it cancelled warrants on about 300,000 metric tons of its own aluminum, adding months to the queue. Goldman made a series of massive aluminum trades at the same time its warehouses' dealings were pushing the Midwest Premium higher, including 2012 trades involving more than 1 million metric tons of metal.

Goldman contends that it adheres to rules preventing the sharing of useful information between its warehouses and its traders. That contention is hard to square with the bank's stated justification for its involvement in physical commodities. In a 2011 presentation to Goldman's board, executives wrote that Goldman's commodities division would achieve higher value "if the business was able to grow physical activities, unconstrained by regulation and integrated with the financial activities." Goldman's goal, in the words of its own executives, is to profit in its financial activities using the information it gains in the physical commodities business.

All of these issues and concerns come back to the principle of separating banking and commerce. Banks are not supposed to be running commercial businesses like warehouses, natural gas facilities, or power plants. Those activities open the door to higher prices and greater uncertainty for businesses and consumers, and to price manipulation and trading based on information not available to other market participants. To restore confidence in commodity markets as well as reduce risk in the banking system, it's time to reduce bank involvement with physical commodities and to prohibit the use of nonpublic information in transactions involving commodities the banks themselves control.

Our report offers a number of ways to address the issue, and the Federal Reserve's possible rulemaking provides a needed opportunity to address the problems. Today, we will explore banks' physical commodity activities and the dangers that result. Tomorrow we will hear from additional experts and regulators. But first, I turn to my partner in this bipartisan investigation, and my partner in so many other efforts over the years, Senator McCain.

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Source: Prepared by the Permanent Subcommittee on Investigations using information provided by Harbor Aluminum. See undated "HARBOR's estimated aluminum load-out waiting time in LME Detroit Warehouses vs HARBOR's MW Transactional Premium," prepared by Harbor Aluminum, PSI-HarborAluminum-03-000004.