December 21, 2016

Mr. Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Via Agency Website

Re: Docket No. R-1547; RIN7100 AE58: Regulations Q and Y; Risk-Based Capital and Other Regulatory Requirements for Activities of Financial Holding Companies Related to Physical Commodities and Risk-Based Capital Requirements for Merchant Banking Investments

Novelis Inc. appreciates the opportunity to respond to the Board of Governors of the Federal Reserve System's (the "Fed") Notice of Proposed Rulemaking regarding the activities of Financial Holding Companies ("FHCs") related to physical commodities (the "NOPR"). We are submitting these comments to provide our thoughts on how the restrictions on FHCs' ability to trade in physical commodities set forth in the NOPR will have a detrimental impact on end-users that manage their businesses and risk through transactions involving physical commodities and financial instruments derived from commodities.

Background on Novelis

Novelis is the world's leading aluminum rolled products producer. We produce aluminum sheet and light gauge products primarily for use in the beverage can, automotive, specialties (including transportation, consumer electronics, and architecture) and foil markets. During the twelve months ended March 31, 2016, we shipped approximately 3,123 kilotonnes of flat rolled products and had net sales of approximately $10 billion. We are also the global leader in the recycling of aluminum. We have recycling operations in many of our plants to recycle aluminum, such as used-beverage cans ("UBCs"). As of March 31, 2016, we had manufacturing operations in 11 countries on four continents - North America, South America, Asia and Europe - through 25 operating facilities, including recycling operations in 11 of these plants. In addition to aluminum rolled products plants, our South American businesses include primary aluminum smelting and power generation facilities.

Novelis' Hedging Transactions

There are three sources of input material for manufacturing aluminum rolled products: (1) primary aluminum in sheet ingot from primary smelters, (2) primary aluminum in P1020 form to control the final chemical composition of products in our casthouses and (3) recycled aluminum, such as recyclable material from fabrication processes and UBCs. Primary aluminum and sheet ingot can generally be purchased at prices set on the London Metal Exchange ("LME"), plus a premium that varies by geographic region of delivery, alloying material, form (ingot or molten metal) and purity. Because Novelis operates as a standalone aluminum company without an upstream business to supply inputs, we are exposed to fluctuating metal prices between the time the price is set for the raw materials that we buy from our suppliers and the time the price is set for the products that we sell to our customers. Novelis attempts to preserve its conversion margins (that is, its charges for converting primary or recycled metal into rolled aluminum sheet) and remove the resulting price volatility from earnings by engaging in hedging transactions. To hedge, Novelis buys and sells futures contracts (or other suitable derivative products) equal and opposite to its underlying physical position. In particular, we sell short-term LME aluminum forward contracts to reduce our exposure to fluctuating metal prices associated with the time period between the pricing of our metal purchases and the pricing of the sale of the products produced from that metal to our customers. We also purchase forward contracts when we enter into transactions that contain fixed metal prices with our customers. These LME aluminum forward contracts directly hedge the economic risk of future metal price fluctuations to ensure we sell metal as close as possible to the price at which we purchase metal. It is critical for our business to be able to access the derivatives market in a timely manner to engage in these hedging transactions so that we may eliminate or mitigate metal price risk, maintain stable cash flows and serve our customers.

How Novelis Interacts with FHCs in Hedging Transactions

FHCs act as the hedging counterparty in nearly all of our hedging transactions. By acting as a counterparty in the aluminum futures market, FHCs allow Novelis and other aluminum market participants to shift the metal price risk associated with aluminum to creditworthy third parties. Having multiple FHCs that participate in the aluminum futures market available to us has helped keep hedging transactions costs relatively low and stable and given manufacturers in the aluminum industry improved liquidity. FHCs provide Novelis with well-regulated counterparties/market-makers with which Novelis can efficiently transact at the appropriate points in time to best manage our risk. In our experience, FHCs are some of the most creditworthy counterparties available, with the market experience and the means to handle market volatility. In addition, FHCs offer local market premium hedging (that is, hedging the premium over the LME index price for delivery to a particular market) through OTC transactions, which is a space with growing importance and relatively few participants.

If FHCs were prohibited (or highly restricted) from engaging in hedging transactions with Novelis and we were unable to engage in hedging transactions with other creditworthy, properly-regulated counterparties in a similar manner to manage risk, our results of operations, cash flows and liquidity could be adversely affected. For example, losing FHCs as counterparties would significantly reduce the credit available to us to engage in all of the hedging activity necessary to operate our business as we currently do.

Impact of the NOPR on Novelis

Novelis is very concerned that the NOPR would remove a critical source of institutional knowledge within the market by imposing costly funding requirements and restricting the overall volume in which FHCs may engage in physical commodities activities. In particular, we would point to two aspects of the NOPR that are of concern: (1) increased risk weighting for Section 4(o) FHCs and (2) the restriction of Section 4(k) complementary authority.

The risk weighting assigned by the Fed to physical commodities held by FHCs under Section 4(o) authority appears to be overly burdensome. Applying 1,250% risk-weighting should be expected to drive key participants from the market, reducing choice and liquidity, and increasing costs and burdens to end-user companies, like Novelis.

FHCs will likely find little relief under complementary authority provided under Section 4(k) to continue holding physical commodities. Under the National Bank Act, an FHC's national bank subsidiary can hold physical commodities in amount equal to 5% of its total notional value of its derivatives in that particular commodity. The NOPR would further restrict our access to sophisticated counterparties by limiting FHCs' derivatives activities by now counting them towards the 5% of Tier 1 Capital that the Fed has imposed under Section 4(k).

The Fed itself has noted that FHC involvement in physical commodities has declined since the Financial Crisis. The NOPR could exacerbate this problem by making physical commodities activities under both Section 4(o) and Section 4(k) commercially unviable for FHCs. As we outline below in further detail, this would effectively push FHCs out of the market and increase market concentration in a handful of less-sophisticated, less-resilient, and less-supervised institutions. Novelis relies on large institutions, such as FHCs, to efficiently manage costs and commercial risks. However, market concentration in less-sophisticated institutions has the potential to restrict competition and increase prices for our consumers.

The NOPR's Impact on End-Users and Consumers

As an end-user of physical commodities and commodity-derivatives, we wish to emphasize that the commodities markets, like markets generally, benefit from robust competition. As previously noted in the Advanced Notice of Proposed Rulemaking, 14 FHCs are currently authorized to engage in physical commodities activities, either under Section 4(k) or Section 4(o) of the Bank Holding Company Act.[1] These FHCs are sophisticated participants in the commodities markets, have substantial market knowledge, and use their expertise to tailor commodity products efficiently to customer needs, including our specific needs. FHC market expertise is particularly important in the case of physically settled OTC derivative contracts, which are essential to our hedging strategy.

Restrictions imposed by the NOPR and their resulting impact to end-users like Novelis have the potential to (1) reduce market liquidity, (2) increase costs (and ultimately the costs to consumers), (3) increase price divergence, and (4) increase counterparty risks.

1. *Reduced Market Liquidity.*

We rely on sophisticated counterparties that understand our unique commercial risks. The size and stability of FHCs, coupled with their ability to deal in physical commodities, offer economies of scale that allow for highly tailored and affordable derivatives products. Over the last few years, demand for these FHC commodity activities has increased not only for Novelis but also throughout the global aluminum market, primarily driven by increased focus on working capital and cash flow objectives. The NOPR could undermine such synergies and add additional challenges due to liquidity scarcity.

Market liquidity could suffer because FHC affiliates are frequently the most knowledgeable participants and the most willing to enter into customized trades, and there are few potential new market entrants who can replace them. In particular, non-bank counterparties may be unable or unwilling to enter into long-term transactions or to offer a range of financial solutions, as certain products essential to our operations are generally only available from banks. Also, non-bank counterparties will likely be able to service only niche areas within the commodities market, unable to adequately craft products to match the tenor and scope needed for our operations.

We are concerned that, especially in the markets for customized commodity products, a retreat by FHC affiliates will lead to reduced market liquidity and higher prices. To our detriment, these FHCs would not be able to maintain the critical intermediary role they serve for both our domestic and international operations.

2. *Increased Costs.*

FHCs are able to offer physical commodities services that are attractive to the market (e.g., carry trades, consignment stock and intermediation) due in part to their market experience and expertise at managing the risks associated with physical exposure and trading among various market participants.

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[1] Advance Notice of Proposed Rulemaking, *Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies related to Physical Commodities*, 79 Fed. Reg. 3329 (Jan. 21, 2014).

Restricting FHCs' ability to engage in these activities could burden global manufacturing with a sharp increase in costs and working capital requirements.

The NOPR could serve to increase costs for our physical commodities transactions three-fold. First, increased funding requirements for FHCs may force us to liquidate our physical commodities to satisfy potential requests for cash-based, rather than commodities-based, collateral. For example, FHCs' ability to offer working capital improvements to Novelis at attractive costs is facilitated by their involvement in both physical and financial markets—FHCs' appetite for extending payable financing on physical metal supply has improved Novelis' cash flow position. Second, costs would likely increase in the form of additional transaction fees. And third, costs are likely to increase due to reduced pricing competition. As FHCs exit the market, Novelis will no longer be able to address its needs in an economic and consolidated fashion. A fractured non-bank market would likely require multiple derivatives contracts when an FHC may have been able to leverage its economies of scale to provide a comprehensive risk mitigation plan. These extra transactional layers and additional capital commitments would hinder Novelis' ability to effectively manage risk.

3. *Increased Price Divergence and Arbitrage.*

As market liquidity decreases, we could experience additional risks posed by the increase in price divergence between physical aluminum and aluminum-based commodity products. The increased spread will (1) provide arbitrage opportunities for our competitors and (2) increase pricing volatility. These added risks may lead to the need for separate hedges, further increasing burdens on our operations.

4. *Increased Counterparty Risks.*

In the event of the exit of FHCs from the commodity-based derivatives market, we may find ourselves transacting with less-sophisticated, less-regulated non-bank counterparties, often located outside the United States.

In our view, the current overall regulatory scheme affecting the largest FHCs provides far better protection than anything that exists in the unregulated space. Not only are the FHC affiliates that engage in commodities activities subject to comprehensive consolidated supervision, but the FHCs themselves are among the most highly regulated FHCs in the world. The supervision and regulation of globally systemically significant financial institutions has increased markedly both in the United States and abroad since the Financial Crisis.

However, if FHCs and their affiliates are not available, the most obvious alternative providers of physical commodities services, the largest commodity firms, are undiversified businesses. Unlike diversified financial institutions where commodities activities are only one of many business lines, it is far more likely that a "tail risk" event affecting the commodities industry would call into question the stability of firms highly concentrated in that industry. As a result, restricting FHC legal authority could result in less well-capitalized, less well-rated and less financially transparent commodities market participants.

<u>Novelis' Working Capital Management and FHCs</u>

FHCs play an important and irreplaceable role in aiding Novelis' working capital goals by holding metal until it is delivered to us or until we need it and offering Novelis extended payment terms on certain transactions. Without these services from FHCs, all of which could be impacted under the NOPR, our results of operations, cash flows and liquidity could be adversely affected.

FHCs are able to provide these services at a relatively low cost because they are able to benefit from the contango in the market (i.e., the price of metal in the future being higher than the spot price). If FHCs were restricted from transacting in the physical or derivative aluminum markets, they would lose the benefits derived from contango and likely no longer be incentivized to provide these services to companies like Novelis. Specifically, Novelis benefits from FHC services as follows:

1. *Carry Trades and Repos*

At times, metal may be available from suppliers to Novelis at favorable prices and quantities. It we do not have an immediate need for the metal but anticipate making use of such metal in the near future, we may ask an FHC to purchase the metal and then sell it to us based on an agreed formula when we need it. This practice, sometimes referred to as carry trades, allows Novelis to more effectively manage inventory levels and working capital. For example, Novelis could capture supplier capacity when it is available at favorable prices even when it does not align with our demand timing (e.g., differences caused by seasonality).

Another similar scenario, sometimes referred to as a "Repo," is when Novelis is holding excess inventories of metal that we are unable to use at that time or in the near future. In these situations, we may ask FHCs to purchase the excess inventory and then sell it to us when we need it. Again, this allows us to more effectively manage our inventory levels and working capital.

2. *FHC as Intermediary*

Another important way that Novelis transacts with FHCs is by having them act as an intermediary between Novelis and geographically distant smelters. For example, shipments from remote suppliers often travel several thousand miles before arriving at our plants. The approximate in-transit time for such shipments can average five to six weeks. Without an FHC as an intermediary to take ownership of and move this inventory, either Novelis or the supplier would tie up working capital that could be put to better use managing the needs of its business. On the other hand, if the supplier sells this inventory to the FHC and is paid immediately. The FHC carries the inventory on its books while it is in-transit to our plants, at which point Novelis may also get extended payment terms after delivery. It has been our experience that both the supplier and Novelis gain a working capital advantage through this intermediation compared to a traditional direct sales model. This is an important service from FHCs that we view as integral to our entire industry's business practices.

3. *Consignment Stock*

An additional important service FHCs provide is carrying our prime aluminum inventory, on a consignment basis, at our numerous locations. If we experience an unplanned surge in prime aluminum usage (which occurs with some regularity), we would be able to pull from the FHCs' consignment stock instead of carrying an excess buffer of such inventory on our books during these times. This allows us to reduce our book inventory and manage working capital.

FHCs have also aided Novelis in dealing with our suppliers' maintenance planning. For example, a supplier will pre-produce sheet ingot as capacity is available, usually months before a planned outage. An FHC purchases this metal and carries the inventory on its books while it is in-transit to a Novelis plant, and the FHC holds the material on consignment until we need the units during the supplier's outage. This allows us to reduce our book inventory and manage working capital.

Conclusion

For the foregoing reasons, we believe that the NOPR goes too far to place overly burdensome restrictions on FHCs engaging in physical commodities activities. We and other end-users rely on FHCs as reliable, regulated counterparties for physical commodity activities, and restrictions that could drive FHCs out of this space or increase costs for end-users would negatively affect our ability to manage our risk and businesses. We respectfully request that the Fed take negative impacts on end-users into account when further considering the NOPR, or, alternatively, returning regulation of FHCs to the current regulatory framework.

Again, we appreciate the opportunity to comment and offer our time to answer any questions the Fed may have as it considers the NOPR.

Sincerely,

NOVELIS INC.

Nick Madden
Senior Vice President, Manufacturing Excellence