STATEMENT OF

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on

"VOLCKER RULE IMPLEMENTATION"

before the

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Chairman Hensarling, Ranking Member Waters and members of the Committee, I appreciate the opportunity to testify today on behalf of the Federal Deposit Insurance Corporation (FDIC) on the regulations to implement section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), also known as "the Volcker Rule."

On December 10, 2014, the FDIC, along with the Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (OCC), the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission (CFTC), adopted a final rule implementing the Volcker Rule requirements of the Dodd-Frank Act.[1]

My testimony today will include a brief overview of the statutory provisions and an overview of the final rule.

Overview of the Volcker Rule Statutory Provisions

Section 619 of the Dodd-Frank Act is designed to strengthen the financial system and constrain the level of risk undertaken by firms that benefit, directly or indirectly, from the federal safety net provided by federal insurance on customer deposits or access to the Federal Reserve's discount window. Section 619 added a new section 13 of the Bank Holding Company Act (BHC Act) to prohibit banking entities from engaging in proprietary trading activities and to limit the ability of banking entities to invest in, or have certain relationships with, hedge funds and private equity funds. In general terms, proprietary trading occurs when an entity places its own capital at risk to engage in the short-term buying and selling of securities primarily to profit from short-term price movements, or enters into derivative products for similar purposes.

[1] The final rule was published in the Federal Register of January 31, 2014 (79 FR 5536).

Section 619 of the Dodd-Frank Act generally places prohibitions and limitations on the ability of banking entities to:

- engage in short-term proprietary trading of securities or derivatives for their own account and
- own, sponsor, or have certain relationships with hedge funds or private equity funds, referred to as "covered funds."

The challenge to the agencies in implementing the Volcker Rule was to prohibit the types of proprietary trading and investment activity that Congress intended to limit, while allowing banking organizations to provide legitimate intermediation in the capital markets.

While section 619 broadly prohibits proprietary trading, it provides several "permitted activities" exemptions that allow banking entities to continue to provide important financial intermediation services and to promote robust and liquid capital markets. Most notably, section 619 allows banking entities to take principal risk in securities or derivatives, to the extent necessary to engage in bona fide market making and underwriting activities, risk-mitigating hedging, and trading activities on behalf of customers. Other permitted activities include trading in certain domestic government obligations; investments in small business investment companies and those that promote the public welfare; trading for the general account of insurance companies; organizing and offering a covered fund (including limited investments in such funds); foreign markets trading by non-U.S. banking entities; and foreign covered fund activities by non-U.S. banking entities.

In addition, Section 619 contains two quantitative limits on the amount a banking entity may invest in covered funds organized and offered by the banking entity or an affiliate. First, for any particular covered fund, a banking entity may not own directly, and/or indirectly, more than 3 percent of the value or ownership interests of that fund. Second, a banking entity's aggregate direct and/or indirect ownership in all covered funds may not exceed 3 percent of the banking entity's Tier 1 capital. In addition, any ownership interest in a covered fund that is held by a banking entity must be deducted from the banking entity's Tier 1 capital, including ownership amounts that fall within the limitations described above.

To prevent banking organizations from engaging in otherwise prohibited proprietary trading through one or more of the permissible activity exemptions described above, section 619 provides at least three prudential safeguards. First, section 619 requires the federal banking agencies, the SEC, and the CFTC to issue regulations that may include restrictions or limitations on the permitted activities if appropriate. Second, section 619 states that no transaction, class of transactions, or activity may be a permitted activity if it would: involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties; result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or high-risk trading strategy; or pose a threat to the safety and soundness of the banking entity or the financial stability of the United States. Third, section 619 contains anti-evasion provisions that, in part, require the Agencies to include internal controls and recordkeeping requirements as part of their implementing regulations. In addition, the appropriate federal agency has the authority to order a banking entity to terminate any activity or dispose of any investment, after due notice and opportunity for hearing, if the agency has reasonable cause to believe that a banking entity

has engaged in an activity or made an investment in a manner that functions as an evasion of the general prohibitions under section 619.

Final Rule

In October 2011, the FDIC, along with the OCC, the FRB, and the SEC, invited the public to comment on proposed rules through the issuance of a Notice of Proposed Rulemaking (NPR). In January 2012, the CFTC requested comment on a substantively identical proposal for the same common rule. Those proposals generated more than 18,000 comment letters. FDIC staff has read and carefully analyzed all of these comment letters, and has met with a number of these commenters to discuss issues related to the proposed rule. The comment letters received by the FDIC and summaries of these meetings are available on the FDIC's public website.

As part of the rulemaking process, the FDIC, along with the other agencies, sought to respond to all of the significant issues commenters raised. The final rule is consistent with the parameters of the NPR and reflects changes made in response to the substantive comments received during the rulemaking process. These changes, which reduce the compliance burden and associated costs, are discussed below. Overall, these changes result in a better balance between the prohibitions and limitations imposed by the Volcker Rule and the operational and compliance requirements placed on banking entities. The resulting final rule should preserve legitimate market making and hedging activities while maintaining market liquidity and vibrancy.

The final rule is structured around the three main elements of Section 619: 1) the proprietary trading restriction, 2) the covered funds restriction, and 3) the compliance requirements.

Proprietary Trading Prohibition

In general, the final rule prohibits proprietary trading. However, consistent with Section 619, the final rule includes exemptions for underwriting, market making, and risk-mitigating hedging, among other exemptions provided in the final rule.

The underwriting exemption requires that a banking entity act as an underwriter for a distribution of securities and that the trading desk's underwriting position be related to that distribution. However, the underwriting position must be designed not to exceed the reasonably expected near-term demands of customers.

Under the exemption for market making–related activities, a trading desk must routinely stand ready to purchase and sell one or more types of financial instruments. The trading desk's inventory in these types of financial instruments must be designed not to exceed, on an ongoing basis, the reasonably expected, near-term demands of customers. Under the final rule, determining customer demand is based on such things as historical demand and consideration of current market factors. A market-making desk may hedge the risks of its market-making activity under this exemption, provided it is acting in accordance with certain risk management procedures required under the final rule.

One of the most frequent comments with respect to proprietary trading suggested that the proposal would reduce liquidity of certain products like corporate bonds because traders would be unsure whether or not a particular trade would be in violation of the proprietary trading prohibition. Many of these commenters suggested revising the rule to allow banks to set limits in accordance with the proprietary trading restriction and allow traders to trade within these limits, thereby not impairing liquidity in these markets. The agencies largely adopted this suggestion from commenters in the final rule.

The requirements of the risk-mitigating hedging exemption are generally designed to ensure that the banking entity's hedging activity is limited to risk-mitigating hedging in purpose and effect. For instance, hedging activity must be designed to demonstrably reduce or significantly mitigate specific, identifiable risks of individual or aggregated positions of the banking entity. In addition, the banking entity must conduct an analysis (including correlation analysis) supporting its documented hedging strategy, and the effectiveness of hedges must be monitored and, as necessary, recalibrated on an ongoing basis. The final rule also requires banking entities to document, contemporaneously with the transaction, the hedging rationale for certain transactions that present heightened compliance risks.

Under the final rule, a banking entity would be allowed to hedge individual exposures or aggregate exposures—for example, a specific loan book. However, a banking entity would not be allowed to engage in so-called "macro hedging." The result is to allow cost-effective, risk-reducing hedging while preventing banking entities from entering into speculative transactions under the guise of hedging.

The final rule also includes the other exemptions to the prohibition on proprietary trading allowed under the Dodd-Frank Act. For instance, the final rule permits a banking entity to continue to engage in proprietary trading in certain government obligations. A banking entity may engage in proprietary trading in U.S. government, agency, state, and municipal obligations. The final rule also permits, in more-limited circumstances, proprietary trading in the obligations of a foreign sovereign or its political subdivisions.

The final rule generally does not prohibit certain trading activities of foreign banking entities, provided the trading decisions and principal risks of the foreign banking entity occur and are held outside of the United States. Such transactions may involve U.S. entities only under certain circumstances. Specifically, an exempt transaction may occur a) with the foreign operations of U.S. entities; b) in cleared transactions with an unaffiliated market intermediary acting as principal; or c) in cleared transactions through an unaffiliated market intermediary acting as agent, conducted anonymously on an exchange or similar trading facility.

The final rule also exempts certain other permitted activities, provided certain requirements are met. These exemptions include trading on behalf of a customer in a fiduciary capacity or in riskless principal trades and activities of an insurance company for its general or separate account.

The final rule also includes clarifying exclusions to proprietary trading. Provided that certain requirements are met, certain activities are not considered proprietary trading, including

transactions solely as an agent, broker, or custodian; transactions through a deferred compensation or similar plan; transactions to satisfy a debt previously contracted; transactions in certain repurchase and securities lending agreements; transactions for the purpose of liquidity management in accordance with a documented liquidity plan; transactions in connection with certain clearing activities; or transactions to satisfy certain existing legal obligations.

Covered Fund Prohibitions

The final rule prohibits banking entities from owning and sponsoring “hedge funds” and “private equity funds,” referred to in the final rule as “covered funds.” The final rule follows the statutory definition of covered funds and encompasses any issuer that would be an investment company under the Investment Company Act if it were not otherwise excluded by two provisions of that Act (section 3(c)(1) or 3(c)(7)). The final rule also includes in the definition of covered funds other similar funds such as certain foreign funds and commodity pools, which are defined in a more limited manner than under the proposed rule. Commenters frequently noted that including all “commodity pools” as covered funds, as originally proposed, would be overly inclusive. The agencies broadly accepted this suggestion from commenters, resulting in a final rule that narrows the proposed definition of covered funds to include only those commodity pools that have characteristics that are more closely aligned to those of a hedge fund or private equity fund.

The final rule includes exclusions from the definition of covered funds for certain entities having more general corporate purposes such as wholly owned subsidiaries, joint ventures, and acquisition vehicles. The final rule also specifically excludes registered investment companies

and business development companies that are regulated by the SEC. Other exclusions have been provided for certain foreign funds publicly offered abroad, loan securitizations, insurance company separate accounts, small business investment company investments, public welfare investments, and issuers in conjunction with the FDIC's receivership and conservatorship operations.

Consistent with the Dodd-Frank Act, the final rule designates certain activities as permissible. The final rule permits a banking entity, subject to appropriate conditions, to invest in or sponsor a covered fund in connection with organizing and offering the covered fund, underwriting or market making-related activities, certain types of risk-mitigating hedging activities, activities that occur solely outside of the United States, and insurance company activities.

The final rule places a number of limitations on permitted ownership interests in covered funds. In general, consistent with the statute, the final rule provides that a banking entity may not have any ownership in a covered fund unless it qualifies for an exemption such as organizing and offering the fund in accordance with requirements of the final rule or acting as a market maker for the fund. A banking entity that organizes and offers a covered fund must limit its total interest in each covered fund to no more than 3 percent of the ownership interests issued by the covered fund, and to no more than 3 percent of the value of the entire covered fund. However, if the covered fund is subject to risk retention requirements that must be satisfied by the banking entity, the final rule provides that the banking entity may retain additional ownership interests in the covered fund in order to satisfy any minimum risk retention requirement that may be

established by the agencies by regulation. In addition, the aggregate of all interests the banking entity has in all covered funds may not exceed 3 percent of the banking entity's tier 1 capital. Finally, the banking entity must deduct the value of all of its interests in covered funds and any retained earnings from its capital for purposes of applying regulatory capital standards.

The definition of a covered fund excludes any issuer of securities backed entirely by loans, subject to certain asset restrictions. Accordingly, covered funds do not generally include securitizations such as residential mortgage-backed securities, commercial mortgage-backed securities, auto securitizations, credit card securitizations, and commercial paper backed by conforming asset-backed commercial paper conduits.

Certain other securitizations, such as collateralized loan obligations, will also be excluded from the definition of a covered fund if they are backed exclusively by loans. However, securitizations that currently include assets other than loans can be excluded from the definition of covered funds if they divest impermissible assets during the conformance period. For securitizations that are covered funds, the conditions for a banking entity to be permitted an ownership interest in these types of securitizations are, with one exception described below, the same conditions that apply to any other covered fund—for instance, it organizes and offers the securitization or engages in underwriting or market making-related activities.

Finally, commenters frequently noted that although certain vehicles that might be exempted from the prohibition for investments in covered funds in the proposed rule, those vehicles were still subject to the prohibition on extensions of credit from a sponsoring banking

entity under section 13(f)(1) of the BHC Act, known as "Super 23A." The commenters raised the concern that this lending prohibition would limit the liquidity for certain fund structures. In response, the final rule was reorganized to ensure through exclusions from the definition of "covered fund" that such vehicles were not subject to the "Super 23A" restrictions.

Compliance Requirements

In order to ensure compliance with the final rule, institutions engaged in covered practices will be required to have compliance programs in place commensurate with their size and level of activity. The agencies will monitor compliance through the compliance programs established by the institutions they regulate. To ensure consistent application of the final rule across all banking entities, the FDIC, FRB, OCC, SEC and CFTC have formed an interagency Volcker Rule Implementation Working Group (Working Group). The Working Group will address implementation issues on an on-going basis and will provide the industry with additional guidance or clarity as necessary. The Working Group has begun meeting and will meet regularly to address reporting, guidance and interpretation issues to facilitate compliance with the rule.

The final rule generally requires banking entities to establish an internal compliance program reasonably designed to ensure and monitor compliance with the final rule. In response to concerns raised by some commenters, the final rule provides compliance requirements that vary based on the size of the banking entity and the amount of covered activities it conducts. For example, banking entities that do not engage in activities covered by the final rule will have no compliance program requirements.

Under the final rule, larger banking entities with $50 billion or more in total consolidated assets must establish a more detailed compliance program as described in Appendix B of the final rule, including requirements that:

- The banking entity adopt a written compliance program approved by the board of directors;
- The board of directors and senior management are responsible for setting and communicating an appropriate culture of compliance and ensuring that appropriate policies regarding the management of trading activities and covered fund activities or investments are adopted to comply with the requirements of the final rule; and
- The chief executive officer of the banking entity must annually attest in writing to its primary federal regulator that the banking entity has in place processes to establish, maintain, enforce, review, test, and modify the compliance program in a manner reasonably designed to achieve compliance with the final rule.

Banking entities with total consolidated assets between $10 billion and $50 billion will be subject to the minimum compliance program requirements included in section 20(b) of the final rule.

Finally, the final rule requires banking entities with significant trading operations to report certain quantitative metrics related to trading activities, in accordance with section 20(d) and Appendix A of the final rule. These metrics are designed to monitor certain trading activities and. will be phased in over a period of time based on the type and size of the firm's trading activities.

Burden Reduction

While the requirements of Section 619 apply to all banking entities regardless of size, the prohibited proprietary trading activities and investments in, and relationships with, hedge funds and private equity funds that are covered by the final rule are generally conducted by larger, more complex banking organizations. As a result, the final rule is designed to avoid placing needless requirements on banks that do not engage in these activities or have only limited exposure.

The final rule focuses compliance requirements on those institutions that are more likely to engage in prohibited proprietary trading and covered fund activities. Under the final rule, a bank is exempt from all of the compliance program requirements, and all of the associated costs, if it limits its covered activities to activities that are excluded from the definition of proprietary trading, such as trading in certain government, agency, state, and municipal obligations. In particular, the final rule provides that a banking entity is not required to implement a compliance program if it does not engage in activities or investments covered by the rule. This eliminates the compliance burden on banking entities that do not engage in covered activities or investments.

A banking entity with total consolidated assets of $10 billion or less that engages in covered activities can meet the compliance requirements of the final rule simply by including in its existing compliance policies and procedures references to the requirements of section 13 of the Bank Holding Company Act and subpart D of the final rule as appropriate given the activities, size, scope and complexity of the banking entity. This significantly reduces the

compliance burden on smaller banking entities that engage in a limited amount of covered activities or investments.

The final rule requires all other banking entities to establish a compliance program designed to ensure compliance with Section 619 and the requirements set forth in the final rule.

Even for banking entities that must establish a compliance program, the final rule makes changes from the NPR to reduce the burden of the metrics reporting requirements. For example, the final rule raised the threshold for metrics reporting from $1 billion in trading assets and liabilities threshold originally proposed to $10 billion in trading assets and liabilities, thereby capturing only firms that engage in very significant trading activity. The final rule also reduced the number of mandatory trading metrics required to be reported to the agencies from around 20 in the original proposal to 7 in the final rule. Additionally, the final rule provided for metrics reporting to be phased-in based on the size of the banking entity's trading assets and liabilities, with banks with more than $50 billion in trading assets and liabilities reporting first, following banks with more than $25 billion in trading assets and liabilities, and then banks with more than $10 billion in trading assets and liabilities.

Treatment of TruPS CDOs

Following the issuance of the final rule implementing section 619, a number of community banking organizations expressed concern that the final rule conflicts with the Congressional determination under section 171(b)(4)(C) of the Dodd-Frank Act to grandfather trust preferred securities (TruPS). On December 19 and December 27, 2013, the banking

agencies issued joint statements providing guidance to financial institutions regarding the potential impact of the final rule on the treatment of TruPS held in collateralized debt obligations (CDOs). These statements outlined some of the issues that must be resolved in order to determine whether ownership of an interest in a securitization vehicle that holds primarily TruPS would be subject to the provisions of section 619 of the Dodd-Frank Act and the final implementing rules.[2]

Following additional review, the agencies determined that it is appropriate and consistent with the provisions of the Dodd-Frank Act to exempt certain collateralized debt obligations backed primarily by trust preferred securities (TruPS CDOs) from the investment prohibitions of section 619 of the Act. Section 171 of the Dodd-Frank Act provides for the grandfathering of TruPS issued before May 19, 2010, by certain depository institution holding companies with total assets of less than $15 billion as of December 31, 2009, and by mutual holding companies established as of May 19, 2010. The TruPS CDO structure was the vehicle that gave effect to the use of TruPS as a regulatory capital instrument prior to May 19, 2010, and was part of the status quo that Congress preserved with the grandfathering provision of section 171.

The interim final rule (IFR) adopted by the agencies on January 14, 2014[3] is consistent with the relief the agencies believe Congress intended to provide community banking organizations under section 171(b)(4)(C) of the Dodd- Frank Act. Under the IFR, the agencies

[2] http://www.fdic.gov/news/news/press/2013/pr13123.html; http://www.fdic.gov/news/news/press/2013/pr13126a.pdf

[3] http://www.fdic.gov/news/news/press/2014/pr14003a.pdf The IFR was published in the Federal Register of January 31, 2014 (79 FR 5223).

have exempted TruPS CDOs from the prohibition on the acquisition or retention of any interest in or sponsorship of covered funds by banking entities if the following qualifications are met:

- the TruPS CDO was established, and the interest was issued, before May 19, 2010;
- the banking entity reasonably believes that the offering proceeds received by the TruPS CDO were invested primarily in qualifying TruPS collateral; and
- the banking entity's interest in the TruPS CDO was acquired on or before December 10, 2013, the date the agencies issued final rules implementing section 619 of the Dodd-Frank Act.

In conjunction with the issuance of the IFR, the federal banking agencies also released a non-exclusive list of issuers that meet the requirements for the exemption.[4] The IFR is clear that banking organizations can rely solely on this list for compliance purposes.

The IFR also provides clarification that the exemption relating to these TruPS CDOs extends to activities of the banking entity as a sponsor or trustee for these securitizations and that banking entities may continue to act as market makers in TruPS CDOs. The agencies will accept comment on the IFR for 30 days following the publication of the IFR in the Federal Register.

International Efforts to Limit Risky Trading Activities by Financial Institutions

The U.S. is not unique in our concern about the possible impact of proprietary trading on financial institutions. The European Commission, in addition to individual countries such as Britain, France and Germany, is already taking steps to prohibit, limit, restrict or isolate the risks associated with proprietary trading by traditional banking entities. For example, the European

[4] http://www.fdic.gov/news/news/press/2014/pr14003b.pdf

Commission's recent proposal on structural reform of the EU banking sector would ban the biggest and most complex banks in Europe from engaging in proprietary trading and from holding investments in hedge funds and other funds that engage in proprietary trading. In addition, the proposed reform would separate other non-proprietary trading activities from traditional banking activities if the non-proprietary trading activities were significant. While these proposals may differ in some respects and are still being developed, they represent important attempts by foreign jurisdiction to prevent the risks of proprietary trading from threatening the banking entity, traditional banking activities, the public safety net, and the broader financial system.

Conclusion

Few financial rulemaking proposals in recent years have generated as much interest or comments as the final rule to implement the Volcker Rule. In finalizing this rule, the agencies carefully reviewed more than 18,000 comments and made significant changes to the original proposal to address the concerns by commenters. The final rule reflects the best judgment of the agencies, as informed through the notice and comment process, regarding the appropriate way to enact the Volcker Rule in a manner that meets Congress's intent. The final rule ensures that the federal banking safety net does not subsidize the risks of proprietary trading and investments in hedge funds and private equity funds, while also preserving legitimate market making, hedging and the liquidity and vibrancy of financial markets.