Volcker Rule NPR

ALM and the Accounting Prong

February 19, 2019

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Executive Summary

- **Volcker objective:** Final regulations implementing the prohibition on proprietary trading should be based **on clear, consistent and objective criteria** and only **cover** the activities Congress intended to curtail: **short-term trading activities**
- As **proposed, the Accounting Prong is overly broad and flawed**:
  - Restricts a bank's ability to conduct ALM risk management
  - Scopes in certain traditional lending activities as proprietary trading
  - Relies on accounting standards that can change at any time
- **While the industry expressed concerns about the lack of objectivity of the current "trading account" definition, it is still preferable to the proposal** because it more accurately captures the intent of the statute. However, the presumption should not be interpreted to pull in longer-term balance sheet risk management activities (ALM) and banks should be able to rely on any presumption consistently.
- **In view of the foregoing, BPI recommends**:
  1. For Market Risk Rule (MRR) firms, a more objective and consistent approach to focus only on the MRR Prong and to apply a modified Dealer Prong as a second prong – **this would cover more than 99% of Bank Trading Assets and Liabilities**
     - Together, the MRR and (modified) Dealer Prongs are clear, objective and collectively cover the short term trading activity that the Congress intended to capture
     - If a third prong is retained, the current rebuttable presumption should be replaced with a presumption of compliance for positions held for longer than 60 days (and a consultative process with exam teams for trades within 60 days)
  2. For non-MRR firms, continue to rely on the Short-Term Intent Prong (with a different presumption as described above) as well as a modified Dealer prong – **this would cover the remaining less than 1% of Bank Trading Assets and Liabilities**

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* Under the proposal, FBOs subject to home country market risk capital rules would be covered by the MRR Prong (i.e., for purposes of this deck, the term "MRR firms" includes these entities).

Volcker Trading Account: Recommendation

BPI Recommendation:
1. MRR Firms: MRR Prong with Modified Dealer Prong
2. Non-MRR Firms: Modified Dealer Prong and Short-Term Intent Prong with presumption of compliance for positions held >60d

Key Benefits:
- Clear and efficient, while leveraging existing controls/compliance frameworks
- Consistent with the statute with no unintended consequences
- Consistent with streamlining of compliance program requirements for non-MRR Banks under the NPR

Prong Test	Applies to...	Suggested Modifications
Market Risk Capital Rule Prong	MRR Firms	No modifications
Modified Dealer Prong	MRR Firms Non-MRR Firms	Clarify that only those instruments/activities that are required to be held or conducted by a registered dealer and held as part of, or to hedge risks associated with, its dealing inventory are included in the definition of "trading account" (e.g., dealing and underwriting positions)
Short Term Intent/Purpose Prong	Non-MRR Firms	Replace existing 60-day rebuttable presumptions with a revised presumption that positions held for > 60days will not be included in the "trading account" (additional details in BPI comment letter)

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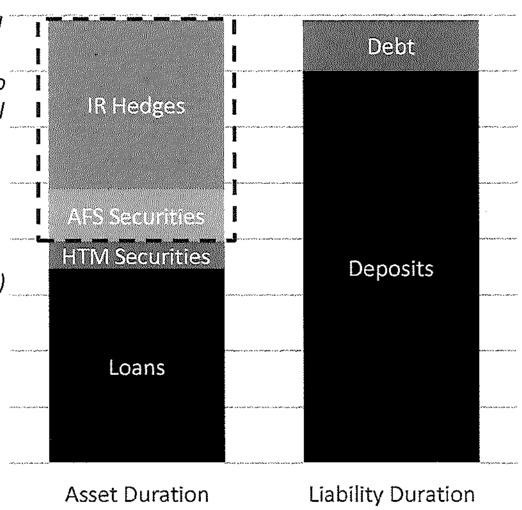
Annex 1: AFS Securities and Derivatives in ALM

- AFS securities and interest rate swaps are important tools used to manage the structural duration mismatch between loans and deposits on bank balance sheets:
  - Banks have a large base of stable deposits, which are an excellent source of funding and have a long duration
  - On average, the duration of loans - a significant portion of which are floating rate - tends to be much lower than deposits
- As seen in the interest rate risk illustrations below, **AFS securities and derivatives reduce asset sensitivity**
- AFS securities also play an important role in liquidity management as a source of HQLA and an investment for excess liquidity, representing ~13% of overall Bank Assets in 3Q '18
  - **$509bn of Non- US Govt AFS securities** would be ineligible under the Accounting Prong. These investments provide additional credit to the private lending markets, including the consumer ABS market where bank holdings are 10-15% of the overall market

Illustrative Interest Rate Risk

AFS Securities and IR Derivative Hedges are used to manage structural interest rate mismatches and reduces overall Asset sensitivity (less earnings at risk to lower rates)



Illustrative Balance Sheet without Security and Swap Hedges has more IR Risk

	Spot Bal	Unhedged Duration (yrs) *w/o Securities & Swaps*	Hedged Duration (yrs) *w/ Securities & Swaps*
Assets			
Loans and leases	59	1.18	1.18
Securities	22	0.00	3.77
Other Earning Assets	7	0.03	0.03
Nonearning Assets	12	2.46	2.46
Total Assets	**100**	**0.98**	**1.81**
Interest Rate Hedges		0.00	2.67
Liabilities			
Transactional Deposits	65	-3.39	-3.39
Time Deposits	4	-1.30	-1.30
Borrowings	16	-1.46	-1.46
Other Liabilities	2	-2.45	-2.45
Total Liabilities	**88**	**-2.87**	**-2.87**
Equity Duration *(Implied from Net IR Risk)*	12	-6.62	-1.02

85% reduction in net interest rate risk after including Securities and IR Hedges

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Source: Top 50 Banks FRY9C via SNL

Annex 2: Longer Term AFS Balance Sheet Management Positions

We estimate that the proposed Accounting Prong would bring into the trading account over $500 billion in non-US Government AFS debt securities.

Q3 2018 AFS securities composition Top 50 Largest U.S. Banks by Assets (data SNL)	$bn	% of AFS Portfolio	
AFS securities eligible for US Domestic Govt Bond Exemption:	1,470	74%	
Treasuries	372		
Agency Debt & MBS (RMBS & CMBS)	963		
Municipal Securities	134		
AFS Securities not eligible for US Domestic Govt Bond Exemption	509	26%	
Non Agency RMBS & CMBS	55		
Structured Finance	67		
ABS	81		**10-15% of the consumer ABS market**
Foreign Govts	211		
Other Corp	95		
Total AFS Securities	1,978		
Total AFS as % of Total Securities	67%		

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Annex 3: Related Recommendations

- **Liquidity Management Exclusion**:
  - Revise the exclusion to include:
    - All interest rate and FX derivatives, including non-deliverable FX forwards, and
    - Investment-grade debt securities permitted under 12 C.F.R. Part 1 and corresponding state authorities that are used for liquidity and interest rate risk management
  - Revise the exclusion to exclude the "near term" funding requirement to allow management of broader ALM interest rate, capital or liquidity risks
  - Revise the exclusion to eliminate the "limited to financial instruments the . . . risks of which the banking entity does not reasonably expect to give rise to appreciable profits or losses as a result of short-term price movements" requirement and **replace with** a requirement that financial instruments held under the exclusion are not acquired for the purpose of generating appreciable profits or losses as a result of short-term price movements.
- **Zero Percent Risk Weight Non-U.S. Government Securities:**
  - To preserve international comity and liquidity in non-U.S. sovereign bonds, permit trading in government obligations that receive a zero percent risk weight under the Federal Reserve's, OCC's and FDIC's capital rules.
- **Trading in Derivatives that Reference Government Obligations:**
  - Expand the exemptions for trading in domestic and foreign government obligations to permit trading in derivatives that reference the government obligations.