Meeting Between Staff of the Federal Reserve Board and the Bank Policy Institute
August 8, 2018

Participants: Laurie Schaffer, Flora Ahn, Greg Frischmann, Kirin Walsh, Kevin Tran, Amy Lorenc, David McArthur, Lara Lylozian, Cecily Boggs, Emily Yang, David Imhoff, Amy Petersen, and Ryan Rossner (Federal Reserve Board)

Jahad Atieh and Jill Funk (JPMorgan); Andrew Auten (Key Bank); Joseph Barry (State Street); Timothy Becker, Mario Mastrantoni, and Daniel Nelson (Wells Fargo); Linda Bergen and Curtis Tao (Citi); Sean Flanagan (Capital One); Ravi Ivaturi (Deutsche Bank); Adam Kezsbom (Barclays); Eric Kriftcher and Ileana Stone (Bank of America); Esther Mills (Accounting Policy Plus); Lawrence Nesbitt (Huntington National Bank); Ursula Pfeil (PNC); Ian Shaw (HSBC); Rodgin Cohen and Camille Orme (Sullivan & Cromwell); Gregg Rozansky and David Wagner (Bank Policy Institute)

Summary: Staff of the Federal Reserve Board met with representatives of the Bank Policy Institute (BPI) and its members to discuss the proposal to amend the regulations implementing section 13 of the Bank Holding Company Act of 1956 (commonly referred to as the "Volcker Rule"). Representatives of BPI expressed concern with the proposed amendments to the Volcker Rule's definition of "trading account." In particular, the representatives encouraged the Board not to amend the definition of trading account to include financial instruments that are recorded at fair value on a recurring basis under applicable accounting standards.

Attachment

Volcker Rule NPR

The Proposed Rule's Accounting Prong

August 8, 2018

BANK POLICY INSTITUTE

Overview

- **BPI continues to focus its efforts relating to the Volcker Rule on issues of concern for commercial banks, including asset-liability management and the conduct of traditional commercial banking activities.**
- **BPI plans to file a comment letter on a number of aspects of the interagency Volcker Rule NPR and, among other things, the letter will address the proposed "Accounting Prong" of the "trading account" definition.**
  - **Although we appreciate the Agencies' efforts to create a test that is simple and objective, there is a significant disconnect between the results the Accounting Prong would have and the objectives of the Volcker Rule.**
    - **Of particular concern to BPI members, the Accounting Prong would impact certain asset-liability and liquidity management activities and long-term investing activities not contemplated by the existing exclusions and exemptions (even if modified as proposed).**
  - **Contrary to Congress's focus on short-term principal trading in the Volcker Rule's proprietary trading prohibition, the Accounting Prong would expand the reach of the Volcker Rule in a manner that is inconsistent with the statute and the underlying policy objectives of the Final Rule.**
  - **Importing accounting concepts that have no relation to the Volcker Rule's statutory focus will have multiple negative consequences.**
  - **We therefore urge the Agencies not to adopt the Accounting Prong. We also recommend modifications to the current definition of the "trading account."**

The Proposed Rule's Accounting Prong

- **The Accounting Prong expands the scope of the Volcker Rule "trading account"**
  - It would capture debt securities recorded as AFS under U.S. GAAP, equity instruments, derivatives and positions that a company has elected to account for at fair value under the Fair Value Option.
  - This accounting-based standard covers a wide range of assets and liabilities that have no relation to the type of principal trading that the Volcker Rule was intended by Congress to prohibit. Those assets and liabilities include positions acquired or retained in connection with normal course commercial banking activities or for risk management purposes and not principally for the purpose of selling in the near-term (or otherwise with the intent to resell in order to profit from short-term price movements).
    - Positions that may be fair valued, depending on a variety of circumstances, include a number of investment-grade corporate bonds held by banking entities as investment securities in their banking books, long-term equity and debt investments, seed capital investments in RICs and FPFs, etc.
    - In many cases, these positions were not previously within the definition of "trading account" under the Short-Term Intent Prong and the 60-day rebuttable presumption (or otherwise captured by the MRC Prong or the Dealer Prong).
      - The proposed P&L Presumption would not provide any practical relief from the Accounting Prong's overbroad scope.
- **Congressional Policy Objectives of the Volcker Rule**
  - The proprietary trading prohibition is intended to capture short-term principal trading.
  - The statutory definition of "trading account" leaves no doubt of this intent.
  - The existing exclusions and exemptions appropriately focus on short-term principal trading and may not accommodate longer-term investment and traditional commercial banking, risk management and ALM activities.

The Proposed Rule's Accounting Prong

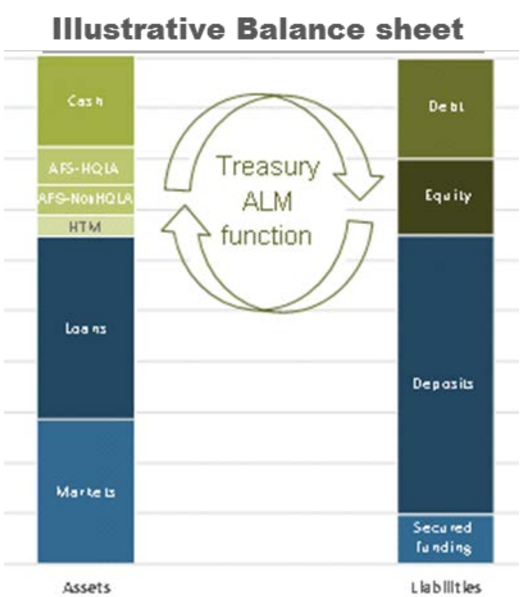
- **Consequences:**
  - Impact on Asset-Liability Management (Treasury Function)
  - Impact on Traditional Commercial Banking Activity
  - Impact on Accounting-Related Decisions
  - Increased Compliance Burdens
- **BPI Proposal:**
  - Not adopt the Accounting Prong
  - Amend the current definition of the "trading account"

Appendix 1

- **Impact on Asset-Liability Management ("ALM") (Treasury Function)**
  - The Treasury ALM function manages a variety of liquidity, capital and interest rate risks and seeks to efficiently allocate resources (*e.g.*, balance sheet, liquidity, capital, etc.) to businesses while planning for future growth or stress scenarios.
  - A mix of fair value AFS securities and derivatives are critical components of ALM that are used to hedge interest rate risk or potential credit losses, invest excess liquidity and satisfy LCR requirements.
  - The Accounting Prong would bring into the trading account liquidity and ALM activities as proprietary trading activity, while the existing liquidity management exclusion and risk mitigating hedging exemption do not accommodate the multiple risk dimensions covered by a robust ALM process.

ALM Related:

- Cash
- AFS
- HTM
- Hedges
- Debt
- Equity



- Derivatives are used to manage mismatches in interest rate risk between assets and liabilities (e.g., between floating rate loans and fixed rate debt[1]).
- Excess liquidity can be invested in non-HQLA AFS securities (e.g., if deposit growth exceeds loan growth), which can be sold to generate liquidity needed to fund business growth or LCR requirements.
- HQLA AFS securities satisfy LCR requirements and can be used to manage structural interest rate risk and hedge potential credit losses.
- HTM holdings are restricted to positions where the banking entity has the intent and ability to hold the security to maturity, providing less flexibility to adapt to changes in a Bank's risk profile.

[1] 90% of USD IG corporate bonds are fixed rate, source: Dealogic

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