This issue contains detailed information on the following:

- **Federal Regulators Issue Final Rules Implementing the Volcker Rule**, including:
  - Prohibition on Proprietary Trading
  - Prohibited Relationships with Hedge Funds and Private Equity Funds
  - Compliance Requirements
  - Conformance Period

- **Federal Regulators Approve Interim Final Rule Allowing Banks to Retain Interests in Certain TruPS CDOs**

- **Fed, FDIC, and OCC Propose New Liquidity Coverage Ratio Requirement for Large Financial Institutions**, including:
  - Tighter Restrictions on HQLA and Total Net Cash Outflows
  - Modified LCR for Certain Bank and Savings and Loan Holding Companies
  - Quicker Implementation Time of the LCR

In addition, it summarizes other notable legislative, regulatory, and judicial developments that occurred during the fourth quarter of 2013.

**Federal Regulators Issue Final Rules Implementing the Volcker Rule**

On December 10, 2013, the Board of Governors of the Federal Reserve (the Federal Reserve Board), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission (CFTC) published final rules developed jointly to implement Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). Also known as the Volcker Rule, the final rules implementing the Volcker Rule were first proposed by the Federal Reserve Board, the FDIC, the OCC, and the SEC in October 2011 and by the CFTC in January 2012.¹

The Volcker Rule prohibits insured depository institutions, bank holding companies, and their affiliates (known collectively as banking entities) from engaging in proprietary trading for their own account and from issuing or investing in covered funds.

¹ For more information on the original proposals regarding implementation of the Volcker Rule, see *Banking Legislation & Policy, Volume 30, Number 3* and *Banking Legislation & Policy, Volume 31, Number 1*.
from engaging in short-term proprietary trading of certain securities, derivatives, and other financial instruments for their own account, subject to certain exemptions. Section 619 also prohibits banking entities from owning, sponsoring, or having certain relationships with hedge funds or private equity funds.

**Prohibition on Proprietary Trading**
The Volcker Rule restricts banking entities from proprietary trading. Broadly, a firm engages in proprietary trading when it trades financial instruments on its own account in an attempt to make a short-term profit.

Under the final rules, proprietary trading is defined as a banking entity acquiring principal positions in the purchase or sale of one or more financial instruments on its trading account.2 The trading account would use these principal positions for short-term resale, benefiting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging one or more of these positions. Under the rebuttable presumption of the Volcker Rule, a banking entity has to hold on to these financial positions for at least 60 days without substantially transferring the risk of those positions within that time period.

Banking entities that are registered securities, swap dealers, or security-based swap dealers may not take certain financial positions on their trading account if these positions relate to their dealer activities. Certain proprietary trading restrictions also remain on banking entities or affiliates of banking entities that are insured depository institutions, bank holding companies, or savings and loan holding companies and calculate risk-based capital ratios under the market risk capital rule.3

**Proprietary Trading Exemptions**
The final rules permit a banking entity to engage in certain underwriting and market making-related activities. In addition, the amount and type of securities in the trading desk’s underwriting position cannot exceed the reasonably expected near-term demands of customers.

A banking entity may be allowed to perform some risk-mitigating hedging activities. A banking entity is permitted to engage in hedging activity that is designed to demonstrably reduce and mitigate specific risks of individual or aggregate positions of a banking entity.

The final rules allow a banking entity to continue proprietary trading in U.S. government, agency, state, and municipal obligations. The final rules generally do not prohibit proprietary trading of non-U.S. banking entities that are organized outside the U.S. and that are not directly or indirectly controlled by a U.S. banking entity so long as the trading decisions and principal risks of the foreign banking entity occur and are held outside the U.S. Other exemptions from the final rules include exemptions for trading on behalf of customers in a fiduciary capacity and exemptions for certain trading by a regulated insurance company.

However, like the proposed rules, even trading activities that would otherwise be exempt will still be prohibited if the activities present a conflict of interest between a banking entity and its clients, create a significant exposure to high-risk assets or

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2 Financial instruments would include securities, options on securities, derivatives, options on derivatives, contracts of sale of a commodity for future delivery, and options on contracts of sales of a commodity for future delivery.

3 The market risk capital rule is used by banking entities to determine capital requirements for trading assets based on general and specific market risks associated with those assets.
trading strategies, or threaten the stability of the U.S. financial system.

**Prohibited Relationships with Hedge Funds and Private Equity Funds**
The final rules prohibit a banking entity from owning or sponsoring hedge funds and private equity funds (referred to as covered funds). An ownership interest would include any equity, partnership, or other similar interest with a covered fund. Broadly, sponsoring a fund is defined as including activities such as serving as a general partner, controlling the fund, or sharing the same name as the fund.

**Covered Funds Exemptions**
The final rules allow a banking entity to be involved with foreign funds organized and established outside the U.S. that sell ownership interests mainly through one or more public offerings abroad.

A banking entity may continue to sponsor and invest in covered funds under certain circumstances. It can be involved in organizing and providing the covered fund with seed capital as long as the banking entity retains no more than 3 percent ownership interest in the covered fund by the end of one year. A banking entity may be involved with covered funds in relation to underwriting or market making-related activities or in relation to certain types of reasonable risk-mitigating strategies. In addition, covered funds with activities outside the U.S., as well as covered funds involving regulated insurance companies, would be exempted.

Certain relationships between a banking entity and a covered fund that would otherwise be exempt under the final rules will still be prohibited if the activities present a conflict of interest between a banking entity and its clients, create a significant exposure to high-risk assets or trading strategies, or threaten the stability of the U.S. financial system.

**Compliance Requirements**
The final rules detail compliance requirements that vary based on the size of a banking entity and the scope of the trading activities conducted. Under the final rules, banking entities have to establish an internal compliance program reasonably designed to ensure and monitor that a banking entity is complying with the Volcker Rule’s requirements. Such a compliance program would include controls such as maintaining appropriate documentation of trading activities, as well as independent testing and auditing of the compliance program’s effectiveness.

In addition, banking entities with at least $50 billion in total consolidated assets (or with at least $50 billion in total U.S. assets if the banking entity is foreign) are required to report certain quantitative trading metrics, such as their trading desk’s risk-factor sensitivity, on a monthly basis starting June 30, 2014. The threshold for reporting these quantitative trading metrics will drop to include banking entities with at least $25 billion in total consolidated assets starting April 30, 2016, and to banking entities with at least $10 billion in total consolidated assets starting December 31, 2016.

Banking entities with at least $50 billion in total consolidated assets are also required to have their CEO annually verify the integrity of their internal compliance program. For foreign banking entities with at least $50 billion in total U.S. assets, the verification will come from the senior management officer of the foreign banking entity in the U.S.

Under the final rules, any banking entity that does not engage in covered trading activities (besides exempt government and municipal obligations) and any banking entity with less than $10 billion in
total consolidated assets that engages in proprietary trading will not have to create any formal compliance program.

**Conformance Period**
The Volcker Rule is effective April 1, 2014. However, the Federal Reserve Board extended the time period for banking entities to conform their activities and investments to the final rules. As a result, all banking entities will now be required to satisfy the Volcker Rule’s requirements by July 21, 2015.

**Federal Regulators Approve Interim Final Rule Allowing Banks to Retain Interests in Certain TruPS CDOs**
On January 14, 2014, five federal regulators approved an interim final rule that would permit banking entities to retain interests in certain collateralized debt obligations backed by trust preferred securities (TruPS CDOs), protecting such investments from the provisions of the new Volcker Rule. The five federal regulators are the same federal regulators that approved the final version of the Volcker Rule: the Federal Reserve Board, the FDIC, the OCC, the SEC, and the CFTC.

According to the interim final rule, banking entities may retain an interest in, or sponsorship of, covered funds if the TruPS CDO was established, and interest was issued, before May 19, 2010, if the banking entity reasonably believes that the offering proceeds received by the TruPS CDO were invested primarily in Qualifying TruPS Collateral, and if the banking entity’s interest in the TruPS CDO was acquired no later than December 10, 2013.

Qualifying TruPS Collateral is any trust preferred security or subordinated debt instrument that was issued before May 19, 2010, by a depository institution holding company that had total consolidated assets of less than $15 billion at that time. Qualifying TruPS Collateral is also any trust-preferred security or subordinated debt instrument that was issued before May 19, 2010, by a mutual holding company.4

The five federal agencies also released a non-exclusive list of issuers that meet the requirements of the interim final rule. They will accept comments on the interim final rule for 30 days following publication of the rule in the Federal Register.

**Fed, FDIC, and OCC Propose New Liquidity Coverage Ratio Requirement for Large Financial Institutions**
On October 24, 2013, the Federal Reserve Board proposed a rule that would implement a quantitative liquidity requirement designed to strengthen the liquidity positions of large financial institutions. The rule, which would establish a minimum liquidity coverage ratio (LCR) requirement for large financial institutions, is largely based on the Basel Committee on Banking Supervision’s LCR requirement published on January 7, 2013.5 Six days later, the FDIC and the OCC subsequently released their own versions of the LCR rule that were substantively the same as the Federal Reserve Board’s LCR rule. Comments on the three agencies’ LCR rule were due January 31, 2014.

The three agencies’ LCR requirement would apply to all internationally active banking organizations, which would include banking organizations with at least $250 billion in total assets or at least $10 billion in on-balance sheet foreign exposure as well

4 A mutual holding company is a type of corporate structure that lets a mutual company sell shares of stock to investors while allowing its original depositors and policyholders to retain ownership of the mutual company.
5 For more information on the Basel Committee on Banking Supervision’s LCR rule, see Banking Legislation and Policy, Volume 32, Number 1.
as consolidated subsidiary depository institutions of these banking organizations with at least $10 billion in total consolidated assets. In addition, the LCR rule would apply to all nonbank financial institutions designated as systemically important by the Financial Stability Oversight Council that do not have significant insurance operations, as well as any of their consolidated subsidiaries that are depository institutions with at least $10 billion in total consolidated assets. On its own, the Federal Reserve Board also proposed a modified, less strict LCR requirement for bank holding companies and savings and loan holding companies without significant insurance or commercial operations that have at least $50 billion in total consolidated assets but would not have been impacted by the three agencies’ LCR rule.

Tighter Restrictions on HQLA and Total Net Cash Outflows
The ratio of a firm’s high-quality liquid assets (HQLA) to its projected net cash outflow is its LCR requirement. Under the three agencies’ proposal, just as with the Basel Committee’s LCR requirement, any impacted financial institutions would have to maintain enough HQLA to match at least 100 percent of its projected total cash outflows minus its projected cash inflows over a prospective 30 calendar-day period.

The proposed LCR rule is broadly similar to the Basel Committee’s LCR rule, but it is more stringent in certain areas. The agencies have narrowed the definition of what qualifies as HQLA to exclude certain assets from counting toward a financial institution’s LCR requirement. As a result, the proposed LCR requirement would not permit firms to include covered bonds and securities issued by public sector entities, such as a state, local authority, or other government subdivision below the level of a sovereign as Level 2A HQLA. Unlike the Basel Committee’s LCR rule, the proposed LCR rule would exclude firms from including private label residential mortgage-backed securities as Level 2B HQLA.

The proposal would require qualifying banking organizations to withhold HQLA to meet the largest net cumulative cash outflow day within a 30 calendar-day liquidity stress period. In contrast, firms would only have to hold HQLA against the net cumulative cash outflow over a 30 calendar-day liquidity stress period under the Basel Committee’s LCR requirement.

Modified LCR for Certain Bank and Savings and Loan Holding Companies
The Federal Reserve Board has shortened the liquidity stress period that certain bank holding companies and savings and loan holding companies without significant insurance or commercial operations with between $50 billion and $250 billion in total consolidated assets have to consider. Instead of a 30 calendar-day stress period, these firms only have to consider a 21 calendar-day stress period to determine their largest net cumulative cash outflow day.

Quicker Implementation Time of the LCR
Under the Basel Committee’s LCR requirement, impacted banking organizations have to reach an LCR requirement of 60 percent by January 1, 2015. For each subsequent year, the LCR requirement would increase by 10 percent until the LCR requirement reaches 100 percent on January 1, 2019. However, under the three agencies’ LCR rule,
impacted banking organizations have to reach an LCR requirement of 80 percent by January 1, 2015. The agencies’ LCR requirement would rise to 90 percent by January 1, 2016, and to 100 percent by January 1, 2017, two years before the Basel Committee’s rule.

**Federal Regulation**

**Federal Reserve System**

*Fed Proposes Rule Limiting Its Powers to Extend Credit for Emergency Lending*

On December 23, 2013, the Federal Reserve issued a proposal that would restrict its ability to bail out individual failing financial institutions. As required by Section 1101 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the proposal would amend the Federal Reserve’s emergency lending authority in Section 13(3) of the Federal Reserve Act by guaranteeing that any emergency lending program or facility is solely for the purpose of providing liquidity to the financial system and not to benefit any one specific company. The Federal Reserve proposed the rule in consultation with the Treasury Department, and the Federal Reserve will accept comments on the proposed rule until March 7, 2014.

Before passage of the Dodd-Frank Act, the Federal Reserve had the authority to extend credit to any individual, partnership, or corporation in times of unusual and exigent circumstances and when such entities were unable to secure adequate accommodations from other banking institutions. Under the new proposal, as stipulated by the Dodd-Frank Act, the Federal Reserve must obtain approval from the Treasury Department before it can establish a program or facility extending emergency credit. The Federal Reserve can still extend credit through any program or facility of its choosing as long as the program or facility has broad-based eligibility. Any emergency credit program or facility could not be structured to remove assets from the balance sheet of a specific company, and any such program or facility could not be created to simply help a specific company to avoid bankruptcy or other federal or state insolvency proceeding.

*Fed Issues Final Rule Aligning Current Market Risk Capital Rule with U.S. Basel III Standards*

On December 6, 2013, the Federal Reserve released a rule that makes technical changes to the Federal Reserve’s current market risk capital rule to align it with the market risk capital rule from the new U.S. Basel III capital framework adopted on July 2, 2013. The market risk capital rule is used by banking organizations to determine capital requirements for trading assets based on general and specific market risks associated with those assets.

Under the U.S. Basel III capital framework, the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency updated the market risk capital rule to address issues ranging from clarifying the treatment of certain traded securitization positions to clearing up the timing of required market risk disclosures. The new market risk capital rule is effective January 1, 2015.

*Fed Finalizes Rules on Treatment of Uninsured U.S. Branches of Foreign Banks*

On December 24, 2013, the Federal Reserve approved a final rule clarifying the treatment of uninsured U.S. branches and agencies of foreign banks under Section 716 of the Dodd-Frank Act. The final rule is exactly the same as the interim final rule issued by the Federal Reserve on June 5, 2013, so the final rule will generally

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7 For more information on the U.S. Basel III capital standards, see *Banking Legislation & Policy, Volume 32, Number 2.*
prohibit the provision of certain types of federal assistance to swaps entities. The final rule took effect January 31, 2014.


On November 15, 2013, the Federal Reserve announced that it would not object to a resubmitted 2013 capital plan from Ally Financial Inc. On March 14, 2013, the Federal Reserve objected to Ally Financial’s original 2013 capital plan based on both qualitative and quantitative assessments during the Federal Reserve’s annual Comprehensive Capital Analysis and Review (CCAR). Therefore, Ally Financial had to submit a new capital plan for approval.

On December 2, 2013, the Federal Reserve also stated that it would not oppose resubmitted 2013 capital plans from both JPMorgan Chase & Co. and The Goldman Sachs Group, Inc. While the Federal Reserve did not oppose the capital plans of these two banking organizations as it did in the case of Ally Financial, the Federal Reserve did require both firms to submit new capital plans addressing weaknesses in their capital proposals identified during the Federal Reserve’s annual CCAR.

Basel Committee on Banking Supervision

Basel Committee Revised Proposed Changes to Basel Securitization Framework

On December 19, 2013, the Basel Committee updated its proposed changes to its securitization framework. First created in December 2012, the new proposal would alter the Basel Committee’s treatment of securitization within the risk-based capital framework. The Basel Committee will accept comments on the revised proposal until March 21, 2014.

The main changes from the original proposal stem from the hierarchy of approaches for addressing securitization exposures. Under the revised proposal, banks should use an internal ratings-based approach to determine the capital requirement based on the risk of underlying pool of exposures, including expected losses. The original proposal had banks use a modified version of the Basel II supervisory formula approach instead of an internal ratings-based approach. Should banks not be able to use an internal ratings-based approach for a particular securitization exposure, banks would have to use an external ratings-based approach in jurisdictions that permit the use of external ratings. Should banks not be able to use either the internal or external ratings-based approaches, banks would have to apply the standardized approach. Under the new proposal, the standardized approach would be slightly altered to be based on the underlying capital charge from the Basel Committee framework’s standardized approach for credit risk and other risk drivers.

Lastly, another important deviation between the new and old proposals stems from changes to the calibration of capital requirements. The revised proposal would set a 15 percent risk-weight floor for the treatment of securitization exposures under any approach used by banks. Originally, the Basel Committee proposed a 20 percent risk-weight floor for the treatment of securitization exposures.

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8 To see the complete version of the interim final rule, see Banking Legislation & Policy, Volume 32, Number 2.
9 For more information on the Federal Reserve’s 2013 CCAR results, see Banking Legislation & Policy, Volume 32, Number 1.
Basel Committee Publishes Revised Capital Framework for Banks’ Equity Investments in Funds

On December 13, 2013, the Basel Committee on Banking Supervision released final standards that would change the way banks calculate their capital requirements for equity investments in funds that are held in their banking book. The new standards finalize the Basel Committee’s proposed capital framework issued in July 2013, and will be effective starting January 1, 2017.\(^\text{10}\)

The new framework will apply to all banks whether they apply the standardized approach or internal ratings-based approaches from Basel II for credit risk. It will also be applicable to banks’ equity investments in all types of funds, including any off-balance sheet exposures. The final rule incorporates almost the entire capital framework from the original proposal, only making a few clarifications. These include allowing banks to use third-party calculations for determining relevant risk weights if they are unable to perform such calculations themselves.

Basel Committee Revises Proposed Changes in Banks’ Capital Requirements for Trading Book

On October 31, 2013, the Basel Committee issued a revised proposal that would heighten banks’ trading book capital requirements. First proposed in May 2012, the revised proposal would continue to tighten existing rules on capital set-aside requirements for a bank’s trading book exposures by imposing a less permeable boundary between a bank’s trading book and its banking book.

The revised proposal would shift the measure of risk from value-at-risk to expected shortfall to better capture tail risk and would also incorporate the risk of market illiquidity through the introduction of liquidity horizons in the market risk metric.\(^\text{11}\) The revised proposal also modifies the way banks determine risk management by making changes to the standardized approach and the internal models-based approach. The changes to the standardized approach include further developing the partial risk factor approach to be sufficiently risk-sensitive to act as a credible alternative to internal models without being too complex, while the changes to the internal models-based approach revolves around detailing a more rigorous model approval process and more consistent capitalization of material risk factors. Comments on the revised proposal were due January 31, 2014.

Consumer Finance Protection Bureau

CFPB Releases Rule Overseeing Nonbank Student Loan Servicers

On December 3, 2013, the Consumer Finance Protection Bureau (CFPB) issued a rule allowing the CFPB to supervise the largest nonbank servicers of student loans in the nation. Originally proposed in March 2013, the new rule allows the CFPB to supervise any nonbank student loan servicer it considers to be a larger participant in the student loan servicing market, which would be any nonbank student loan servicer that handles more than 1 million borrower accounts.

The rule covers the servicing of both federal and private student loans. The CFPB will gather reports from, and conduct examinations of, nonbank student loan servicers that are deemed larger participants. In addition, the

\(^{10}\) For more information on the Basel Committee’s proposed capital framework for banks’ equity investments in funds, see Banking Legislation & Policy, Volume 32, Number 2.

\(^{11}\) Value-at-risk is used to place limits on the probability of large losses, for example, imposing a 1 percent limit on the probability of large losses. Expected shortfall (also known as conditional value-at-risk) is used to place limits on the size of the losses when tail events occur.
agency will require servicers to take appropriate action to address any harm done to student loan borrowers during the life of a student loan.

Justice Department
JP Morgan and U.S. Reach $13 Billion Settlement Regarding Securities Containing Toxic Mortgages
On November 19, 2013, JPMorgan Chase & Co. agreed to a record $13 billion settlement with the Justice Department and various other federal and state partners to resolve federal and state civil claims regarding securities containing toxic mortgages. These claims involve the packing, marketing, sale, and issuance of residential mortgage-backed securities (RMBS) by JPMorgan, Bear Stearns, and Washington Mutual before January 1, 2009. This settlement is the largest among a number of other settlements made by banking institutions during the past quarter, including the Royal Bank of Scotland’s $153.7 million settlement with the Securities and Exchange Commission regarding the offering of a subprime residential mortgage-backed security, Bank of America’s $404 million settlement to resolve outstanding mortgage issues with Freddie Mac, and PNC Bank’s $89 million settlement to also resolve outstanding mortgage issues with Freddie Mac.

As part of the settlement, JPMorgan acknowledged that it seriously misrepresented numerous RMBS transactions to the public. Of the $13 billion settlement, $9 billion will be paid to settle federal and state civil claims by various entities related to RMBS. Of the $9 billion, $2 billion will go to the Justice Department, $1.4 billion to settle federal and state securities claims by the National Credit Union Administration, $515.4 million to settle federal and state securities claims by the Federal Deposit Insurance Corporation, $4 billion to settle federal and state securities claims by the Federal Housing Finance Agency, and the rest to various state governments. JPMorgan also paid the Federal Housing Finance Agency an additional $1.1 billion to resolve repurchase claims by Fannie Mae and Freddie Mac, which was not part of this $13 billion settlement. The remaining $4 billion of the settlement will take the form of relief to consumers harmed by the bank’s conduct as determined by the Justice Department. The settlement also does not absolve JPMorgan or its employees from facing possible criminal charges.

This record settlement comes on the heels of a November 18, 2013, settlement where JPMorgan agreed to pay $4.5 billion to 21 institutional investors to resolve claims regarding representations, warranties, and servicing of 330 RMBS trusts issued by J.P. Morgan, Chase, and Bear Stearns.

Financial Stability Board
FSB Announces 2013 Update of G-SIBs
On November 11, 2013, the Financial Stability Board (FSB) published its annual list of global systemically important banks (G-SIB) using end of 2012 data and an updated assessment methodology issued by the Basel Committee in July 2013. The FSB added Industrial and Commercial Bank of China Limited to its list of G-SIBs, raising its total designated G-SIBs from 28 to 29.

For more information on the Basel Committee’s updated assessment methodology, see Banking Legislation & Policy, Volume 32, Number 2.
Federal Housing Finance Agency
FHFA Orders Fannie Mae and Freddie Mac to Not Reimburse for Force-Placed Insurance
On November 5, 2013, the Federal Housing Finance Agency (FHFA) announced that it has directed Fannie Mae and Freddie Mac to prohibit mortgage servicers from being reimbursed for expenses associated with force-placed insurance. Force-placed insurance is insurance taken out by mortgage servicers when a mortgage borrower does not maintain the property insurance required by the terms of mortgage. The announcement comes in response to the FHFA’s earlier proposal from March 2013 that bans insurance companies from paying sales commissions and other fees on force-placed insurance to mortgage servicers for mortgages owned or guaranteed by Fannie Mae and Freddie Mac.13

13 To see the FHFA’s earlier proposal aiming to control the costs of force-placed insurance, see Banking Legislation & Policy, Volume 32, Number 1.

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