February 13, 2012

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, N.W.
Washington, D.C. 20551
**Docket No. R-1432**
**RIN 7100 AD 82**

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220
**RIN 3235-AL07**
**File No. S7-41-11**

Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429
**Attention: Comments**
**RIN 3064-AD85**

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 2-3
Washington, D.C. 20219
**Docket No. OCC-2011-0014**
**RIN 1557-AD44**

David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, D.C. 20581
**RIN 3038-AD05**

Re: Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds

Ladies and Gentlemen:

The Clearing House Association L.L.C. ("**The Clearing House**") and the ABA Securities Association (the "**ABASA**" and, together with The Clearing House, the "**Associations**")[1] are writing to comment on the joint notice of proposed rulemaking (the "**NPR**" and, the proposed rule set forth therein, the "**Proposed Rule**")[2] issued by the Board of Governors of the Federal Reserve System (the

[1] See *Annex A* for a description of the Associations.

[2] 76 F.R. 68846 (Nov. 9, 2011).

"**Board**"), the Federal Deposit Insurance Corporation (the "**FDIC**"), the Office of the Comptroller of the Currency (the "**OCC**") and the Securities and Exchange Commission (the "**SEC**") to implement Section 619 (the "**Volcker Rule**") of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act"**) and the notice of proposed rulemaking issued by the Commodity Futures Trading Commission (the "**CFTC**," and, together with the Board, FDIC, OCC and SEC, the "**Agencies**").[3] The Volcker Rule generally places prohibitions and restrictions on the ability of banking organizations[4] and Board-supervised nonbank financial companies to engage in proprietary trading and have interests in, and certain relationships with, hedge funds and private equity funds.

The Associations strongly support many aspects of the ongoing national and international regulatory reforms to make financial systems safer and more robust. However, we have substantial concerns that the Proposed Rule will, in certain crucial respects, adversely affect safety and soundness and financial stability and, in other respects, will jeopardize the economic recovery. In this letter, we are addressing one major concern[5] – namely, that the Proposed Rule, contrary to the general aim of the Dodd-Frank Act to promote the stability of the financial system, may significantly inhibit the ability of banking organizations to engage in *bona fide* asset-liability management ("**ALM**") activities that are essential to the safe and sound management of the risks that arise from the core business of banking. It is critically important that the Agencies' implementation of the Volcker Rule preserve, and not inhibit, the ability of banking organizations to engage in *bona fide* ALM activities.

Part I of this letter summarizes our concerns and recommendation with respect to the Proposed Rule as applied to ALM activities (with parenthetical references to the more detailed discussion of certain key items later in this letter). Parts II and III address our concerns and describe our recommendation, respectively, in substantially more detail.

## I. Executive Summary

ALM is at the heart of bank safety and soundness and is essential to the stability of the U.S. and global financial systems. Banking organizations engage in ALM in order to manage a variety of risks that arise from the business of banking, including risks posed to the value of their assets (such as

---

[3] CFTC, *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Covered Funds* (Jan 11, 2012) (the "**CFTC NPR**"). The CFTC NPR is substantially similar to the NPR. Accordingly, references to the Proposed Rule in this letter also refer to the proposed rule set forth in the CFTC NPR.

[4] "**Banking organizations**" as used in this letter refers to insured depository institutions, bank holding companies (and their nonbank affiliates) and foreign banks that are treated as bank holding companies for purposes of section 8(a) of the International Banking Act of 1978.

[5] The Volcker Rule has broad implications for the financial services industry, financial markets and U.S. competitiveness. Many of our members and industry associations (including on certain issues, the Associations) will comment separately on other aspects of the Proposed Rule.

loans) and liabilities (such as deposits) and to net interest income as well as liquidity, market, credit, foreign exchange and interest rate risks. ALM activities, therefore, advance rather than detract from Congress's objective of reducing risk and enhancing bank safety and soundness.[6] ALM transactions are not entered into "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)"[7] and therefore should not be made subject to the Volcker Rule's statutory prohibition on proprietary trading.

However, the Proposed Rule's broad definition of trading account would cause important ALM activities to fall within the prohibition on proprietary trading to the detriment of both banking organizations and financial markets. In particular, under the Proposed Rule, any account used to make trades not held for at least 60 days will be presumed to be a trading account; further, accounts used to take "covered positions" as defined under the proposed market risk capital rules (the "**MRC rules**") of the Board, OCC and FDIC[8] (with limited exceptions) will also be trading accounts. In order to manage effectively the risks that arise in the ordinary course of a bank's business of serving its customers (for example, asset and liability mismatches), ALM activities may involve entering and exiting a position within 60 days or taking "covered positions" under the MRC rules. As a result, many *bona fide* ALM activities would fall within the prohibition on proprietary trading, unless there is an exemption for these activities or the account used to conduct these activities falls under an exclusion from the Proposed Rule's definition of trading account.[9]

---

6 *See* 12 U.S.C. § 1851(b)(1)(A) (requiring the Financial Stability Oversight Council to make recommendations on implementing the Volcker Rule so as to "promote and enhance the safety and soundness of banking entities", among other things).

7 *See* 12 U.S.C. § 1851(h)(6). As discussed in this letter, at the time an ALM transaction is entered into, it may be the case that the position is expected to be resold in the near-term. However, the *purpose* of an ALM transaction is not short term resale; rather the purpose is to prudently manage the banking organization's risks, as described in this letter.

8 The Board's, FDIC's and OCC's respective market risk capital rules are at 12 C.F.R., part 3, Appendix B (OCC); 12 C.F.R., part 208, Appendix E and 12 C.F.R. part 225, Appendix E (Board); and 12 C.F.R., part 325, Appendix C (FDIC). In January 2011, the Board, the FDIC and the OCC proposed substantial amendments to the MRC rules that would largely implement Basel II.5 in the United States. *See* Board, FDIC and OCC, Risk-Based Capital Guidelines: Market Risk, 76 F.R. 1890 (Jan. 11, 2011). Except where otherwise indicated, each reference in this letter to the "**MRC rules**" means the banking Agencies' market risk rules as proposed to be revised. The Agencies indicated, in the NPR, that the prong of the trading account definition relying on the MRC rules is premised on the MRC rules as proposed to be revised and that, if those revisions are not adopted, "the Agencies would expect to take that into account in determining whether or how to include the proposed second prong of the trading account definition . . . ." 76 F.R. 68846, 68859.

9 The Associations also have serious concerns with the definition of "resident of the United States" that are being addressed in separate letters to the Agencies. Because of their importance, however, we wish to briefly highlight them here as well. Under the Proposed Rule, the exemption for foreign banking

In the Proposed Rule, the only exemption that touches upon ALM activities in general (and not just transactions involving specific types of instruments, such as U.S. Treasury or agency securities) is the exemption for risk-mitigating hedging transactions, and the only exclusion that touches upon ALM activities in general (and not just specific types of transactions, such as repurchase/reverse repurchase agreements and securities lending/borrowing transactions) is the exclusion for *bona fide* liquidity management. We are concerned, however, that neither of these will be sufficient for a wide variety of ALM activities.

The exemption provided in the Proposed Rule for risk-mitigating hedging activities would not be available for many *bona fide* hedging transactions undertaken in connection with ALM activities because of the following requirements of that exemption:

- the requirement that risk-mitigating hedges relate to risks to which a banking organization is "already exposed" (Part II.b.i);
- the requirement that hedges not earn "appreciably more profits" than a banking organization stood to lose on the related hedged position (Part II.b.ii);
- the requirement that hedges be "reasonably correlated" to the risk being hedged (Part II.b.ii);
- the requirement that hedges not give rise to "over-hedging" or "significant exposures that were not already present" in the underlying position (Part II.b.iii); and
- the requirement that risk-mitigating hedging transactions satisfy the Proposed Rule's documentation requirements "at the time" the hedging transaction is executed (Part II.b.iv).

---

organizations' ("**FBOs**") trading "solely outside the United States" is not available if the FBO is trading with a "resident of the United States." Because the Proposed Rule defines "resident of the United States" to include entities organized under U.S. law and does not contemplate branches as separate entities, foreign banking organizations subject to the Volcker Rule may decide as a matter of policy that entering into transactions with the overseas branches of U.S. banking organizations is not cost-effective because evaluating whether such transactions fit within an exemption (for example, market making-related activities) or are prudent as a risk management matter is simply too onerous. If FBO counterparties subject to the Volcker Rule are unwilling to transact with the foreign branches of U.S. banking organizations, U.S. banking organizations' counterparties may be limited to other U.S. institutions or institutions without a U.S. presence, which could hamper their ability to execute *bona fide* ALM transactions, restrict their business outside the United States and lead to an unacceptable concentration of counterparty risk in some jurisdictions, thereby diminishing the safety and soundness of U.S. banking organizations, weakening financial stability in the United States and making U.S. banking organizations less competitive.

More importantly, regardless of whether a particular ALM transaction in fact ultimately qualifies for the risk-mitigating hedging exemption in the Proposed Rule, it will often be impossible for risk managers to know at the outset of a transaction whether the transaction falls within the exemption because of the uncertainty created by the foregoing requirements and the fact that a risk manager's judgment in applying these requirements to a particular transaction will always be subject to after-the-fact review by one or more of the Agencies. This uncertainty will have a chilling effect on the exercise of a crucial safety and soundness function.

In addition, the application of VaR-based metrics to ALM portfolios would not provide meaningful information and would likely generate numerous false positives (Part II.b.iv).

Similarly, the *bona fide* liquidity management exclusion from the definition of trading account also is too restrictive to accommodate many *bona fide* ALM activities that pertain even to the narrow goal of liquidity risk management (Part II.c). Especially problematic are the exclusion's requirements that: (i) liquidity positions be limited to an amount consistent with the banking organization's "near-term" funding needs (Part II.c.i.1), be "highly liquid" (Part II.c.i.2) and not give rise to "appreciable profits or losses" (Part II.c.i.3); and (ii) the liquidity management plan specifically authorize the circumstances in which a particular instrument may or must be used (Part II.c.i.4).

In view of the foregoing limitations of the risk-mitigating hedging exemption and the liquidity management exclusion as applied to *bona fide* ALM activities, the Associations urge the Agencies to replace the exclusion provided for *bona fide* liquidity management activities with an exclusion that would cover transactions in covered financial positions that are in furtherance of a banking organization's *bona fide* ALM activities (which include, but are not limited to, transactions in furtherance of *bona fide* liquidity management activities). The Associations' proposed exclusion, among other requirements, would require, in furtherance of the *bona fide* criterion, that (i) any such transactions be conducted pursuant to a documented ALM policy, (ii) compensation arrangements of persons performing the ALM function be designed so as not to reward prohibited proprietary trading, (iii) a compliance and audit regime designed to ensure compliance with the Volcker Rule is established and (iv) the day-to-day line management of the ALM function is separate from the day-to-day line management of non-ALM trading functions (for example, permissible market making and underwriting activities).

## II. Concerns

ALM is at the heart of bank safety and soundness and is integral to the stability of the U.S. and global financial systems.[10] The Financial Stability Oversight Council ("**FSOC**"), in its study

[10] *See, e.g.*, OCC Bulletin 2004-29 (July 1, 2004) ("It is critical that bank managers fully understand their institution's interest rate risk exposures and ensure that their risk management framework incorporates the controls and tools necessary to conduct asset/liability management activities in a safe and sound manner."). As illustrated in footnote 13 of this letter, banking authorities have issued a substantial amount of regulatory guidance regarding ALM.

regarding the Volcker Rule,[11] recognized that the appropriate treatment of ALM activities is "one of the more significant scope issues" under the Volcker Rule and concluded that the Volcker Rule should not prohibit ALM activities:

> All commercial banks, regardless of size, conduct [ALM] that help[s] the institution manage to a desired interest rate and liquidity risk profile. This study recognizes that ALM activities are clearly intended to be permitted activities, and are an important risk mitigation tool. . . . A finding that these are impermissible under the Volcker Rule would adversely impact liquidity and interest rate risk management capabilities as well as exacerbat[e] excess liquidity conditions. These activities also serve important safety and soundness objectives.[12]

Banking organizations engage in ALM in order to manage liquidity risk, as an important component of ALM, but also to (i) manage the risks that changing economic circumstances pose to changes in the value of the banking organization's assets and liabilities; (ii) manage the risks that changing yield curves pose to the banking organization's net interest income; (iii) manage foreign exchange ("**FX**") risk that arises from investment in overseas subsidiaries and branches; and (iv) hedge the balance sheet risks to which a banking organization is exposed, including market, credit, foreign exchange and interest rate risks that arise from assets and liabilities on the banking organization's balance sheet.[13] The purpose of these core risk management activities is not speculative in nature, and

---

11 *See* Financial Stability Oversight Council, *Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds* (Jan. 2011) (the "**FSOC Study**"), at 47.

12 *Id.*, at 47. We recognize that the FSOC went on to state that the Agencies "should consider whether to verify as part of their ordinary supervisory activity that there is no prohibited proprietary trading occurring in ALM portfolios." *Id.* One element of our proposal, described below, is a compliance and audit regime designed to ensure compliance with the Volcker Rule.

13 *See, e.g.*, Board, *Commercial Bank Examination Manual*, § 4020.1 (discussing liquidity risk management in the context of ALM and noting that the price of liquidity is a function of market conditions and market perception of the risks, both interest rate and credit risks, reflected in a balance sheet and off-balance sheet activities); OCC, *Risks Associated with Lease Financing* (Jan. 1, 1998) ("When the bank funds a lease, management should consider the potential impact on earnings arising from interest rate risk and, through asset-liability management, should attempt to mitigate the risks associated with fixed rate lease financing."); OCC, Board, FDIC, National Credit Union Administration and State Liaison Committee, *Interagency Advisory on Interest Rate Risk Management: Frequently Asked Questions* (Jan. 12, 2012), at 3 (stating that, as part of interest rate risk management, financial institutions are expected to measure the potential impact of changes in market interest rates on earnings and economic value of capital using methodologies that generally focus on changes to net interest income/net income or changes to the economic value of capital over various time horizons); Board, OCC, National Credit Union Administration, the Office of Thrift Supervision and the Financial Institutions Examination Council State Liaison Committee, *Advisory on Interest Rate Risk Management* (Jan. 6, 2010), at 1, 5 (discussing the identification of yield curve risk as part of interest rate risk management and the importance of interest rate risk management processes for institutions experiencing downward pressure on earnings and capital because of lower credit quality and market illiquidity); OCC, *Comptroller's Handbook: Bank Supervision*

ALM transactions are not entered into "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)."[14] ALM activities therefore should not fall within the Volcker Rule's prohibition on proprietary trading. As currently drafted, however, the Proposed Rule would inhibit, and in many cases prohibit, *bona fide* ALM activities, largely because of the Proposed Rule's expansive definition of "trading account", including, most importantly, the 60-Day Rebuttable Presumption (as defined below) discussed in Part II.a.i. Moreover, the exemption for risk-mitigating hedging activities and the exclusion for liquidity management are not sufficient to allow the normal range of *bona fide* ALM activities.

The importance to both banking organizations and the broader financial system of preserving the ability of banking organizations to engage in *bona fide* ALM activities cannot be questioned. Accordingly, the Associations urge the Agencies to replace the Proposed Rule's exclusion for *bona fide* liquidity management activities with an exclusion that would encompass transactions in covered financial positions that are in furtherance of a banking organization's *bona fide* ALM activities (which include, but are not limited to, transactions in furtherance of *bona fide* liquidity management activities).

We discuss, in Parts II.a, II.b and II.c, features of the Proposed Rule that could inhibit ALM activities and, in Part III, our proposal to modify the Proposed Rule to exempt *bona fide* ALM activities from the scope of the final rule.

**a. Several aspects of the Proposed Rule would cause important ALM activities to be within the definition of prohibited proprietary trading to the detriment of both banking organization and financial markets.**

*i. The Proposed Rule's expansive definition of trading account would*

---

*and Examination Process: Community Bank Supervision*, Appendix A, at 162 (stating that credit risk arises in conjunction with, among other activities, selecting foreign exchange counterparties); OCC, *Comptroller's Handbook: Foreign Exchange (Section 813)* (Mar. 1990), at 1-5 (noting that, in contracting to meet a customer's foreign currency needs by granting loans, accepting deposits or providing spot or forward exchange, a bank bears a risk that exchange rates might change subsequent to the time the contract is made, and discussing the importance of managing that risk); OCC Bulletin 98-20 (May 22, 2002) (providing supervisory expectations for risk processes that financial institutions should establish and maintain to manage the market, credit, liquidity, legal, operational and other risks of investment securities); OCC, *Risk Management and Lessons Learned* (May 2009) (noting that "[c]oncentrations of [securities such as private label mortgage securities, resecuritizations and pools of trust-preferred securities] heighten the level of risk to earnings and capital and are receiving additional scrutiny from examiners"). Several examples of transactions in connection with ALM activities are provided in Part II.a.

14 *See* 12 U.S.C. § 1851(h)(6). As noted above, at the time an ALM transaction is entered into, it may be the case that the position is expected to be resold in the near-term. Nevertheless, the *purpose* of an ALM transaction is not short term resale, but rather to prudently manage risks that arise from the business of banking.

*cause certain bona fide ALM activities to fall within the definition of proprietary trading.*

The Dodd-Frank Act defines "proprietary trading" as "engaging as a principal for the trading account" of the banking organization "in any transaction to purchase or sell, or otherwise acquire or dispose of" a broad range of financial products.[15] In turn, it defines "trading account" as "any account used for acquiring or taking positions in [these financial products] 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)" and other accounts determined by rule to be "trading accounts" by the Agencies.[16]

The Proposed Rule defines a trading account by reference to three separate tests: (i) a purpose test, which generally tracks the statute (the "**Purpose Test**"),[17] (ii) a market risk capital test (the "**Market Risk Capital Test**"),[18] which generally captures accounts used to take covered financial positions[19] that are "covered positions" under the MRC rules (which include a purpose test), and (iii) a status test, which generally applies to accounts used to take covered financial positions in connection with activities that require registration as a dealer (the "**Status Test**").[20] The Proposed Rule also contains a rebuttable presumption that an account will be presumed to be a trading account if it is used to take covered financial positions (other than market risk capital positions or dealing positions) that the banking organization holds for less than sixty days (the "**60-Day Rebuttable Presumption**").[21] If any one of the tests is satisfied, the particular account will be a trading account for purposes of the Proposed Rule unless an exclusion is available.

An account used to take "covered financial positions" for ALM purposes would not appear to satisfy the Status Test because ALM activities are never conducted in a dealer capacity. However, as illustrated in the below examples of ALM activities, a variety of *bona fide* ALM activities (and accordingly, any related accounts used for ALM purposes) likely would fall within the 60-Day

---

15 12 U.S.C. § 1851(h)(4).

16 12 U.S.C. § 1851(h)(6). The Agencies have termed these types of instruments "covered financial positions" in the Proposed Rule. *See* Proposed Rule, § _.3(b)(3).

17 Proposed Rule, § _.3(b)(2)(i)(A).

18 Proposed Rule, § _.3(b)(2)(i)(B).

19 "**Covered financial positions**" as used in this letter has the meaning ascribed to that term in Section _.3(b)(3) of the Proposed Rule.

20 Proposed Rule, § _.3(b)(2)(i)(C).

21 To overcome this presumption, the banking organization must demonstrate, "based on all the facts and circumstances, that the covered financial position, either individually or as a category, was not acquired or taken principally for any of the purposes described in [the Purpose Test]". Proposed Rule, § _.3(b)(2)(ii).

Rebuttable Presumption or satisfy the Market Risk Capital Test, and thus accounts used to take these ALM positions would be trading accounts under the Proposed Rule, but not under the statute. For banks subject to the MRC rules, ALM activities may now (or, even more so in the future, upon operation of Basel III[22] requirements)[23] occur in accounts that acquire or take "covered positions" under the MRC rules. As a result, these accounts may be within the definition of trading account for purposes of the Market Risk Capital Test. In addition, to manage effectively applicable risks, ALM activities may involve entering and exiting a "covered financial position" (as defined in the Proposed Rule)[24] within 60 days. In this regard, it is important to recognize that the risks sought to be managed through ALM activities (for example, interest rate risk) may change daily – or even more frequently – as a result of movements in rates, spreads and other factors. By operation of the 60-Day Rebuttable Presumption, an account used for ALM purposes would therefore be "presumed" to be a trading account, and it is unclear how a banking organization would overcome that presumption under the standard provided in the Proposed Rule.[25]

Provided below are several examples of traditional, well-established ALM activities. Although none of the transactions described below would be entered into principally for the purpose of selling in the near-term or with the intent to resell in order to profit from short-term price movements, the accounts in which these transactions are executed could nevertheless satisfy the literal terms of the 60-Day Rebuttable Presumption or Market Risk Capital Test:

- *Residential Mortgage Pipeline*. From the time a banking organization agrees to make a residential mortgage to a customer, it assumes interest rate risk, regardless of whether the mortgage loan is ultimately closed. The mortgage loans that a banking organization anticipates making are referred to as its "mortgage pipeline". Banking organizations with a substantial mortgage business generally manage the interest rate risk arising from the mortgage pipeline using various strategies, such as agency (that is, Ginnie Mae, Fannie Mae or Freddie Mac) to-be-announced transactions, options on U.S. Treasuries, Treasury futures, short-term interest rate swaps and similar instruments. Although the purchase and sale of Treasury and agency securities are exempt from the proprietary trading prohibitions of the Volcker Rule under the Proposed Rule,[26] the use of options, futures and other derivatives with respect to such securities

---

22 "Basel III" as used in this letter refers to the risk-based capital framework set forth in two documents initially published by the Basel Committee on Banking Supervision on December 16, 2010: *Basel III: A global regulatory framework for more resilient banks and banking systems* (revised June 2011) and *Basel III: International framework for liquidity risk measurement, standards and monitoring*.

23 See the discussion of AOCI on page 10.

24 *See* Proposed Rule, § _.3(b)(3).

25 See footnote 21 for a discussion of this standard.

26 *See* Proposed Rule, § _.6(a).

to manage interest rate exposure arising from the mortgage pipeline is not (unless it fits within the terms of one of the exemptions). In addition, given the timings and closings of residential mortgages within pipelines, the settlement dates for these derivative instruments are often within 60 days of the trade date.

- *Mortgage Servicing Rights*. Once a mortgage loan is made, it must be serviced. When the selling institution retains the right to service the mortgage, this right gives rise to a mortgage servicing right (an "**MSR**"). The MSR, which is booked on a banking organization's balance sheet, will fluctuate in value based on the level of interest rates. In order to protect the value of the MSR asset on its balance sheet, the banking organization must manage this interest rate risk. Again, although agency securities currently are one tool used to manage the interest rate risk associated with MSRs, interest rate swaps are another important tool. The MSR asset tends to exhibit significant volatility, as the size of the asset is sensitive to economic factors, as well as interest rates. This volatility can be managed by using interest rate swaps, many of which are settled within 60 days. This is fully consistent with sound risk management practices. Indeed, given the volatility of MSRs, hedges effected through the use of agency securities also may have to be entered into and exited well within the 60-day presumptive proprietary trading period established by the Proposed Rule.

- *Managing Credit Risk*. Investments in the AFS securities portfolio are generally executed with a long-term horizon and in high quality debt instruments. Efficient hedges to manage credit risk can include "short" positions in cash bonds, or buying protection in the credit default swap markets. In both cases, the credit risk mitigant may be a "covered position" under the MRC rules. Moreover, because of the volatility in the underlying credit, these positions (for example, the credit default swaps) may be settled within 60 days.

- *Managing Earnings at Risk*. A banking organization's balance sheet gives rise to many forms of interest rate risk because a substantial portion of a banking organization's liabilities and assets are interest rate sensitive (for example, its deposits and loan portfolio). One focus of ALM activities is to manage the interest rate risks resulting from (i) the differences in the timing of the re-pricing of assets and liabilities, (ii) the level of assets and liabilities on the balance sheet at a given point in time, (iii) the changing maturity profile of assets, liabilities and off-balance-sheet instruments and (iv) the extent to which changes in the slope of the yield curve (that is, the extent to which short-term interest rates change in different amounts from long-term interest rates) affect the pricing and value of assets and liabilities. Interest rate derivatives (primarily swap and collars) are an important tool that is extensively used to manage these risks. However, these derivatives are at present, and would be as the MRC rules are proposed to be amended, held in the trading book under the MRC rules, and therefore likely would be included in the definition of a trading account under the Proposed Rule (because they likely would satisfy the Market Risk Capital Test). Furthermore, because these derivatives are used to hedge the interest rate volatility arising from forecasted balance sheet changes, they often settle within 60 days.

- *Managing Capital*. Having a strong capital position is essential to all banking organizations. One component of stockholders' equity is Accumulated Other Comprehensive Income ("**AOCI**"), which includes the after-tax changes in gains and losses on AFS securities, foreign currency translation adjustments (including the impact of related derivatives) and cash flow hedging activity, among other items. Under current regulatory reporting practice, unrealized gains and losses attributable to changes in AOCI are "filtered out" from the calculation of Tier 1 Capital. Basel III eliminates this filter, which will introduce a new type of volatility into a banking organization's capital position. In order to protect its capital position from excessive volatility that could arise in other comprehensive income, a banking organization may choose to use options, swaps or other non-AFS instruments. For example, to hedge against severe and possible (although not necessarily probable) losses indicated by the banking organization's stress scenarios, it would be prudent for the banking organization to protect its capital by the use of "fat tail" hedging strategies. These strategies utilize derivatives that will be marked-to-market because they will not qualify for SFAS 133 hedge accounting and, because of the type of volatility they are hedging, may settle within 60 days.[27]

- *Managing Asset and Liability Mismatches*. Banking organizations manage asset-liability mismatches through use of their investment securities portfolios. For example, in the current economic environment, many U.S. banking organizations have seen increased deposit inflows and diminished demand for loans; this combination of increasing deposit inflows and corporate and consumer deleveraging has resulted in an asset-liability "mismatch" and put pressure on these banking organizations' net interest margins. To manage these risks, banking organizations purchase, in addition to U.S. Treasury and agency securities, high quality corporate bonds, non-U.S. sovereign debt securities and other assets for their investment securities portfolios; although this incorporates some credit risk, it is recognized as a prudent asset allocation strategy. Certain of these positions may be "covered positions" under the MRC rules (for example, bonds that include an embedded derivative may be "covered positions"), and thus an account used for ALM purposes that takes such positions could be a trading account under the Proposed Rule because it satisfies the Market Risk Capital Test.

- *Managing FX Risks.* Banking organizations manage FX risk arising across the banking organization, for example, by entering into currency options, FX forwards and FX swaps, some of which may be settled within 60 days.

In the above examples, trades that may be held for 60 days or less are being used for *bona fide* ALM purposes, but because of their short-term nature, an account that is used for

---

[27] An alternative to addressing capital volatility arising from AFS securities with hedges would be to move as many securities as possible to a held-to-maturity account, thereby eliminating capital volatility because held-to-maturity securities are not marked-to-market. However, that approach would reduce flexibility for the banking organization (because by definition these securities must be purchased with an intent to hold them to maturity) and generally would be a lesser risk mitigant and a less safe and sound option.

transactions in such positions is presumed under the Proposed Rule to be a trading account. Further, as illustrated in the above examples, derivatives and other securities that are being used for *bona fide* ALM purposes may nevertheless be required to be held in the banking organization's trading book for purposes of the MRC rules. As a result, an account that transacts in such derivatives or other securities could fall within the Proposed Rule's definition of trading account, regardless of the purpose of such transactions.

Because, in many cases as illustrated above, an ALM account will likely fall under the Proposed Rule's definition of trading account if the Proposed Rule is adopted as proposed, banking organizations will need to determine that there is an exemption for these ALM activities or that the relevant account falls under an exclusion from the definition of trading account.

As to the Proposed Rule's exemptions, the only exemption that touches upon ALM activities generally is the exemption for risk-mitigating hedging transactions. Although that exemption would encompass some *bona fide* ALM activities (and in any event should be incorporated into the final rule in order to permit proper hedging transactions, irrespective of whether they relate to *bona fide* ALM activities, perhaps in a revised form reflecting some of the comments below), there are many *bona fide* ALM activities that it would not encompass.

As to the Proposed Rule's exclusions, the only exclusion that touches upon ALM activities generally is the exclusion for *bona fide* liquidity management.[28] However, liquidity management is only one aspect of ALM. Moreover, the exclusion for *bona fide* liquidity management in the Proposed Rule is so restrictive as to not encompass even the full scope of *bona fide* liquidity management activities, let alone the broader scope of *bona fide* ALM activities.

We have analyzed in more detail below the application to *bona fide* ALM activities of the exemption for risk-mitigating hedging transactions (in Part II.b) and the exclusion for *bona fide* liquidity management activities (in Part II.c).

**b. The exemption provided in the Proposed Rule for risk-mitigating hedging activities may not be available for many *bona fide* ALM hedging transactions undertaken in connection with ALM activities.**

The exemption for risk-mitigating hedging provided in Section _.5 of the Proposed Rule is so narrowly drafted that it would fail to protect – or, at least, leave in doubt the protection of – numerous *bona fide* and desirable hedging transactions undertaken in connection with ALM activities.

*i. The requirement that risk-mitigating hedges relate to risks to which a banking organization is "already exposed" would render the exemption for risk-mitigating hedging activities unavailable for*

[28] Proposed Rule, §§_.3(b)(2)(iii)(A), (B).

*many bona fide ALM activities.*

The NPR indicates that the exemption from the proprietary trading restriction for risk-mitigating hedging is only available to mitigate risks to which the banking organization is "already exposed."[29] Although the NPR recognizes that anticipatory hedges may be permissible, the NPR implies that such a hedge would only be permissible if, among other things, the hedge is "established slightly before the banking [organization] becomes exposed to the underlying risk."[30] Appropriate ALM risk mitigation activities, however, often require that hedges be placed when it is likely that the banking organization will be exposed to the risk, which may not be "slightly before" the risk is actually realized. Indeed, the purpose of stress tests is to inform the banking organization about risks to which it *may become* exposed. Based upon that and other information, it is prudent for the banking organization to take risk-mitigating actions ahead of the actual incurrence of the risk. If a stress test indicates that the risk is one that may arise from the current positions held by the banking organization, that should *de facto* establish that the banking organization is "already exposed" to such risks. For example, if a banking organization is projecting changes in economic or market conditions (for example, instability in European markets, a collapse in real estate prices or volatility in funding markets) it should be able to take positions for purposes of ALM based on that analysis, even if it is not certain that the banking organization will be exposed to the risks in the manner projected. Along similar lines, if a banking organization believes that, as a result of declining interest rates, mortgage repayment rates will become accelerated, adjustments to both its MSR portfolio as well as to its investment securities portfolio used to manage its net interest income is prudent and should be excluded from the prohibition on proprietary trading. Taking appropriate actions to manage forecasted balance sheet changes is in the best interests of safety and soundness.

As a general matter, it is impossible for any banking organization to anticipate with certainty the market moves that may adversely affect its assets and liabilities. Thus, no matter how sophisticated the stress tests or ALM analysis, flexibility as to the timing of hedges is required for effective ALM. If a banking organization's risk projections change so that the likelihood or extent of a projected risk declines, sound ALM practices dictate that its related hedges be adjusted in accordance with these updated projections. The purpose of the adjustment is prudential as part of a *bona fide* ALM function; the purpose is not to profit from short-term price movements.

---

[29] *See* 76 F.R. 68846, 68875.

[30] *See Id.*

*ii. Because of accounting and timing differences in the recognition of gains and losses, it is possible that hedges executed for bona fide ALM purposes would earn "appreciably" more than the underlying hedged position. In addition, such hedges would likely have significant difficulty satisfying the "reasonably correlated" requirement of the risk-mitigating hedging exemption.*

The Proposed Rule requires that a hedging transaction be "reasonably correlated" to the risk being hedged. The Proposed Rule also provides that, if the hedge and related position "would result in a banking [organization's] earning appreciably more profits on the hedge than it stood to lose on the related position", the hedge would likely fall within the prohibition on proprietary trading.[31] These requirements disqualify numerous *bona fide* ALM hedging activities, and are generally inappropriate as applied to ALM.

There are at least two reasons why a banking organization, in connection with its ALM activities, may earn "appreciably" more on a hedge position than it stands "to lose on the related position", but should not be viewed as engaging in prohibited proprietary trading.[32] First, differences in accounting treatment may cause ALM positions to create profits that would not be offset by losses in the underlying risk position. For example, a derivative hedge position may be marked-to-market (giving rise to an immediate profit-and-loss ("**P&L**") effect) whereas the underlying position, such as a loan, is booked using accrual accounting (and thus would not give rise to a contemporaneously off-setting P&L effect). Second, there may be timing differences in the recognition of the gains and losses between the ALM position and the underlying risk it is hedging. For example, as noted above, investment securities and derivatives are often purchased to help a banking organization offset the structural liability created on its balance sheet from customer deposits. The gains and losses on these instruments will be reflected immediately, either through other comprehensive income or because they are marked-to-market. In contrast, the value of the deposits being hedged is measured over a longer time horizon, and

---

[31] *See Id.*

[32] In general, even in cases where the hedging exemption is appropriately relied on, we disagree with the notion that a proper hedge may be viewed as impermissible proprietary trading solely because the hedge may result in appreciable profits. The statutory text of the exception for risk-mitigating hedges does not suggest that hedges are impermissible if they are profitable and, in fact, does not refer to profits at all. Rather, the proper focus should be on the effectiveness of the hedge in mitigating the risks for which it was obtained. If a banking organization is able to hedge its risks in a manner that is effective and reasonably correlated with the underlying risks, the fact that it managed to do so in a manner that also provides a profit to the banking organization promotes – rather than jeopardizes – the safety and soundness of the organization. Certainly, it cannot be the Agencies' suggestion that hedging is "more" permissible if the positions lose money. Unless revisions to the Proposed Rule are made to address the foregoing concerns, uncertainty over how profitable hedges can be or how "cost effective" or "highly correlated" the hedge must be will chill hedging activities, undermine this crucial risk management activity and destabilize the safety and soundness of banking institutions.

the decline in value of these deposits – that is, the spread compression that will be impacting these deposits – will only be recognized over time.

Further, precise correlations amongst and across different asset classes used in ALM are difficult to determine. Because many ALM positions are not used to hedge a particular transaction in a particular trading book, but, rather are generally intended to take a more macro and holistic view of the structural risks inherent in a banking organization's balance sheet, it is impossible to maintain "extremely high or near-perfect"[33] correlations at all times, and it is often impossible to find instruments that precisely correlate to the underlying risk. For example, a banking organization intending to hedge losses it anticipates arising in its credit portfolio may not be able to find a credit default swap that specifically and perfectly correlates to the credit risk being hedged, and instead may need to use market-based indices or other instruments that generally, but less precisely, correlate to that risk. In addition, the best hedge for a particular structural liability may be instruments or securities that have characteristics different from the securities and instruments giving rise to the liability, and market conditions affecting the structural liability may not affect the hedging instruments in a correlated manner. For example, as noted above, the structural liability arising from customer deposits is often hedged by purchasing investment securities; however, deposit inflows and outflows may occur at speeds different from changes in the interest rates on the investment securities. Finally, maintenance of correlations at both the initiation and close of a hedging strategy for purposes of ALM may not be possible. As discussed above, prudent ALM requires the judicious use of anticipatory hedging, which makes maintaining correlations difficult. Likewise, when the underlying risk is reduced, and the hedge is being "unwound", precise correlations may not be possible. Further, depending on the size, scale and complexity of the positions being unwound, flexibility in timing is needed so the unwind does not adversely affect the safety and soundness of the banking organization. During these periods, therefore, extremely high correlations will be even more difficult to maintain.

*iii. The requirement that a hedging transaction not give rise to "over-hedging" or "significant exposures that were not already present" in the underlying position will present significant burdens to effecting bona fide ALM activity.*

The NPR mentions "over-hedging" as being indicative of prohibited proprietary trading.[34] However, because outcomes cannot be forecast with certainty, there must be adequate flexibility for the estimation of – and hedging in respect of – estimated future structural risks to engage in adequate ALM activities. As the probability of certain market and economic outcomes changes over time, the "over" or "under" hedging measurement also will change relative to the underlying risk

---

[33] *See* 76 F.R. 68846, 68875 (stating that "risks that can be easily and cost-effectively hedged with extremely high or near-perfect correlation would typically be expected to be so hedged").

[34] *See* 76 F.R. 68846, 68876.

position. Further, as discussed, some likely risks need to be hedged well ahead of incurrence, in which case the potential of "over-hedging" is always present.

In addition, the Proposed Rule requires that permissible hedging transactions not give rise to "significant exposures that were not already present" in the underlying position.[35] As noted above, ALM strategies often use a wide variety of instruments, and they may cause the banking organization to be exposed to a risk that is itself not present in the underlying position. Such instruments therefore give rise to an exposure that was not "already present". For example, the use of an investment securities portfolio to manage the structural risk arising from customer deposits gives rise to basis, roll and liquidity risks. As a result, this exemption for risk-mitigating hedging is not sufficient for ALM activities.

*iv. The documentation requirements for risk mitigating hedging activities are unworkable as applied to ALM.*

The Proposed Rule requires that, for any risk mitigating hedging transactions "established at a level of organization that is different than the level of organization" establishing the positions, contracts and holdings whose risks are being mitigated, the banking organization must document "at the time" of the transaction (i) the purpose of that hedge transaction; (ii) the risks the hedge is designed to reduce; and (iii) the level of the banking organization that is establishing the hedge.[36] ALM risk management and mitigation is inherently a "top of the house" function; in the normal course of its operations the banking organization continuously executes risk mitigating transactions at a level or function of the organization that is different from the level or function of the organization that creates the loans or assets, takes the deposit or establishes the other liabilities the risks of which are being managed.

The Associations strongly believe that these documentation requirements, as applied to ALM, are unworkable. They would mean that virtually every transaction entered into by an ALM function would have to be individually documented by the ALM personnel executing the trade "at the time of the transaction" – an unreasonable and impractical requirement not likely to advance supervisory goals.

To illustrate: as noted earlier, whenever a banking organizations sells a mortgage loan but retains the servicing rights, an MSR asset is created on the banking organization's balance sheet. The combined portfolio of these MSRs is quite large for some banking organizations. Banking regulators recognize that the interest rate risk of the MSR asset must be appropriately hedged, that the MSR asset is volatile and that its value is sensitive to, and will fluctuate significantly as a result of, changes in

---

[35] *See* Proposed Rule, § _.5(b)(2)(iv).

[36] *See* Proposed Rule, § _.5(c).

interest rates.[37] But, because the management of the interest rate risk of the MSR asset is managed by the banking organization's ALM function, risk-mitigating hedging transactions addressing this risk, *de facto*, are established by an area within the organization that is different from the consumer lending and mortgage banking areas of the banking organization that originate the mortgages giving rise to the risk being managed. Accordingly, every ALM transaction in respect of a banking organization's MSR portfolio will be at a "different level of the organization" and every individual transaction would have to be documented "at the time" of the transaction. The impracticality of these documentation requirements could be particularly significant in times of stress; in those situations, when appropriate ALM management requires prompt action, managers could be hindered by the burdensome "at the time" documentation requirements, delaying ALM risk managers from establishing the very hedges required to operate the banking organization in a safe and sound manner.

The ALM activities of a banking organization are currently subject to the overall oversight of its board of directors, and the strategies employed and instruments permitted to execute them are subject to policies, procedures and limits that are managed by senior management, whether it be via the banking organization's asset and liability senior management committee, Treasury or Risk-Treasury functions or a specially formed "investment committee" consisting of senior management. We submit that these policies, procedures and limits, when combined with the other requirements we are proposing in connection with the establishment of an exception for *bona fide* ALM activities, as discussed further below, are a more than adequate, and more appropriate, manner to assure the proper conduct of ALM activities.

---

[37] Among other things, the Federal banking agencies note:

> "[Mortgage-servicing assets] possess interest rate-related option characteristics that may weaken an institution's earnings and capital strength when interest rates change. Accordingly, institutions engaged in mortgage-banking activities should fully comply with all aspects of their primary federal regulator's policy on interest rate risk. In addition, institutions with significant mortgage-banking operations or mortgage-servicing assets should incorporate these activities into their critical planning processes and risk management oversight. The planning process should include careful consideration of how the mortgage-banking activities affect the institution's overall strategic, business, and asset/liability plans. Risk management considerations include the potential exposure of both earnings and capital to changes in the value and performance of mortgage-banking assets under expected and stressed market conditions." *See* Board, FDIC, OCC, Office of Thrift Supervision, *Interagency Advisory on Mortgage Banking* (Feb. 25, 2003) (footnotes omitted), *available at* http://www.occ.treas.gov/news-issuances/bulletins/2003/bulletin-2003-9a.pdf.

*v. The application of VaR-based metrics to ALM activities would not provide meaningful information and likely generate numerous false positives.*

The Proposed Rule requires banking organizations that are engaged in permitted trading activities pursuant to the risk-mitigating hedging exemption and that have aggregate trading assets and liabilities above a specified threshold to provide data regarding several metrics, including VaR and Stress VaR.[38] According to the Proposed Rule, this data would assist the Agencies in, among other things, evaluating whether the covered trading activities of trading units engaged in risk-mitigating hedging are consistent with the requirement that this activity not result in a material exposure to high-risk assets or high-risk trading strategies.[39] Although these metrics have legitimate uses in risk management, they are not useful in distinguishing valid risk-mitigating hedging activities executed for ALM purposes from proprietary trading. In particular, the application of VaR-based metrics to assets acquired or positions established in connection with *bona fide* ALM activities would not provide meaningful information about ALM portfolios and likely would generate innumerable false positives, for several reasons:

First, VaR-based metrics at present are applied to only a small portion of the assets and positions in ALM portfolios that are marked-to-market. As result of the limited scope of these metrics as applied to ALM portfolios, using a VaR-based metric to evaluate an ALM portfolio would provide an at best incomplete and misleading picture of the risk of loss of that portfolio.[40]

Second, and most importantly, even if a banking organization calculated VaR for all positions in an ALM portfolio to which such application is possible, many of the assets and liabilities as a result of which the ALM positions are being taken, such as deposits, are not marked-to-market but rather are accounted for on an accrual basis. Because a VaR-based metric typically does not apply to positions accounted for on a held-to-maturity or AFS basis, calculating VaR on the ALM portfolios of which the ALM positions are a part will result in a skewed and meaningless value. VaR, when applied to the ALM portfolio, is in many cases only measuring one side of the equation, not both. Accordingly, its application to ALM portfolios would not provide meaningful information about a banking organization's trading activities in these portfolios.

---

38 *See Id.*, Appendix A to Part _, § III.A(i)(b). Reporting of VaR and Stress VaR for risk-mitigating hedging activities would be required of banking organizations with aggregate trading assets and liabilities of $5 billion or more.

39 *Id.*, § I(v).

40 VaR is typically only applied to marked-to-market portfolios, not only because VaR is an appropriate measure of loss from the perspective of a trading position's investment horizon, but because the regulatory capital required to be held against these marked-to-market positions is calculated based on VaR.

Third, determining the effectiveness of ALM activities requires evaluating a longer investment horizon than is incorporated into VaR tests. The periods used in VaR tests are appropriate given a trading position's investment horizon. However, ALM is focused on a longer-term values and scenario analysis. As a result, "earnings at risk", basis point value and various asset/liability gap analyses, including metrics such as "duration of equity",[41] tend to be more relevant measures of ALM activity, because these metrics focus, more appropriately, on how the value of a banking organization's assets and liabilities will be affected under various changing economic conditions and risk scenarios. Even these tests, however, are not adaptable for use as a quantitative way of distinguishing proper ALM activities from proprietary trading, because there is no practical way to quantify the risk being hedged in the same manner as the hedging instrument.

Fourth, under both current and forthcoming (that is, Basel III) general risk-based capital rules, regulatory capital to be held against AFS positions in the ALM portfolio – which account for the preponderance of the positions in the ALM portfolio – are not generally calculated using VaR because these positions generally are not in the trading account under the MRC rules. That VaR-based metrics are generally not applied to ALM portfolios in calculating regulatory capital – either by banks or in the regulatory capital regime – supports the view that they would not be informative in identifying proprietary trading in the ALM context.

Thus, although the Associations acknowledge the potential utility of VaR-based metrics in the market making context in distinguishing permissible market making from prohibited proprietary trading, these metrics are not useful or informative—indeed, they appear to be meaningless—in the context of ALM activities.

**c. The liquidity management exclusion from the Proposed Rule's definition of trading account is too narrow to accommodate many *bona fide* ALM activities.**

We commend the Agencies for recognizing the importance of liquidity management and excluding liquidity management activities from the Proposed Rule's definition of trading account. However, we are concerned that this exclusion is so narrowly circumscribed that only a fraction of a banking organization's ALM activities may qualify for this treatment and, thus, the remainder could be prohibited by the Proposed Rule as proprietary trading. Even liquidity management activities – a subset of ALM activities – could be severely curtailed by the liquidity management exclusion.

*i. Several of the requirements of the liquidity management exclusion are so restrictive that they would prohibit otherwise bona fide and beneficial ALM activities.*

[41] "Duration of equity" metrics generally measures differences in the durations of assets and liabilities.

The Proposed Rule defines *bona fide* liquidity management as activities undertaken pursuant to a documented liquidity management plan that, among other things, limits the size of any liquidity position to one that is consistent with the banking organization's "near-term funding needs", which must be estimated and documented under the plan, and requires that any position taken be highly liquid and not give rise to appreciable profits.[42] In addition, the liquidity management plan must specifically authorize the circumstances in which the particular instrument may or must be used. Each of these requirements is too restrictive to accommodate many beneficial and *bona fide* ALM activities (including *bona fide* ALM activities related to liquidity management) to the detriment of not only banking organizations, but also financial markets.

1. Near-Term Funding Requirement

Under the Proposed Rule's liquidity management exclusion, liquidity positions must be consistent with the banking organization's "near-term" funding needs.[43] The consequence – which we believe is unintended – of the exclusion's near-term requirement is to label any "cushion" of liquid securities held by the banking organization in excess of its "near-term" funding needs as "prohibited proprietary trading" to the extent these securities are not otherwise exempted from the prohibition on proprietary trading.

The "near-term" funding requirement is inconsistent with sensible and currently existing liquidity management practices and regulatory guidance, which require sufficient liquidity for long-, medium- and short-term needs and for normal and stress environments. Liquidity management is executed with a view to ensuring that a banking organization is capable of meeting its on- and off-balance-sheet obligations during both normal and stress periods, and over not just "short-term" horizons, but medium-term and longer-term horizons as well. Indeed, the 2010 *Interagency Policy Statement on Funding and Liquidity Risk Management* (the "**Liquidity Risk Policy**")[44] requires banking organizations to "ensure that their vulnerabilities to changing liquidity needs and liquidity capacities are appropriately assessed within meaningful time horizons, including . . . medium-term horizons of up to one year and longer-term liquidity needs of one year or more".[45] Similarly, one of the Basel III liquidity framework's two proposed ratios – the net stable funding ratio, or "**NSFR**" – uses a one-year time horizon. And the Board's recently proposed Regulation YY, implementing the required provisions of Sections 165 and 166 of the Dodd-Frank Act, requires that covered institutions' liquidity stress scenarios

---

42 *See* Proposed Rule, § _.3(b)(iii)(C).

43 *See Id.*, § _.3(b)(iii)(C)(4).

44 *See* Office of the Comptroller of the Currency, Board, Federal Deposit Insurance Corporation, Office of Thrift Supervision and National Credit Union Administration, *Interagency Policy Statement on Funding and Liquidity Risk Management*, 75 F.R. 13656 (Mar. 22, 2010) (the "**Interagency Policy Statement**").

45 *Id.* at 13663.

"[a]t a minimum" include, in addition to overnight and 30-day time horizons, a 90-day and a one-year time horizon.[46]

The "near-term" funding limitation thus appears to have the unintended consequence of limiting prudent liquidity management practices, perhaps significantly, thereby undermining the safety and soundness of banking organizations and making the U.S. and global financial systems more vulnerable to liquidity stresses.

2. Highly Liquid Requirement

The Proposed Rule requires liquidity positions to be "highly liquid" in order for the *bona fide* liquidity management exclusion to be available.[47] During periods of excess liquidity – for example, when natural asset growth (that is, lending) is not sufficient to utilize the all the liquidity available to the banking organization from a faster-growing deposit base – banking organizations often invest the surplus funds in commercial paper, certificates of deposit, short-term loans, interbank deposits, Fed Funds and other similar instruments of creditworthy issuers. These instruments, while liquid, may not necessarily be "highly" liquid, but are effective and beneficial investments that provide liquidity managers with the necessary flexibility to address the changing liquidity profile of the banking organization. Not allowing their use in connection with ALM activities – including liquidity management activities – would be inappropriate on numerous levels:

- Liquidity is not indicative of whether the purpose of a trade is short-term profit. High-quality liquid assets also can be traded for short-term profit. The liquidity of instruments also changes from time to time in response to market conditions.

- Limiting liquidity management to a prescribed set of instruments by regulation would prevent liquidity from being re-deployed to private credit markets. Bank investment in commercial paper, short-term loans, interbank deposits and other similar products is an important way to re-circulate available liquidity to help provide funding to others. Use of these somewhat less-liquid instruments is a cornerstone of the entire liquidity of the U.S. markets, and prohibiting their use would be detrimental to the safety and soundness of the entire banking system.

- Banks themselves are issuers of commercial paper and other securities, and constraining the ability of other banking organizations to purchase these instruments as part of their ALM or liquidity management will impair banking organizations' own funding management strategies.

---

46 Board, *Prudential Standards and Early Remediation Requirements for Covered Companies*, Regulation YY; Docket No. 1438.

47 *See Id.*, § _.3(b)(iii)(C)(3).

- Overseas subsidiaries and branches of banking organizations are subject to their local regulators' liquidity requirements and must observe these requirements, which often include requirements to buy local sovereign debt securities and which may not be tailored to meet the Proposed Rule's limitations.

- Prudent ALM and liquidity management require investing in a variety of instruments—both because prudence requires asset allocation and diversification and because prudent ALM and liquidity management require obtaining more income than could be obtained by merely investing in U.S. Treasuries. Any investment of cash carries risk and reward, and a higher return does not, and should not for purposes of the final rule, cause valid ALM and liquidity management activities to fall outside the exclusion for *bona fide* liquidity management activities.

Thus, being required to meet the requirements as proposed for the liquidity management exclusion in connection with ALM activities, too, would have the unintended consequence of limiting *bona fide* ALM practices (including practices that are part of the liquidity management component of ALM) and would likely result in making banking organizations less safe and less sound and have negative consequences for financial markets.

3. Appreciable Profits Limitation

Liquidity management involves managing a variety of assets, which are subject to different accounting treatments and different treatments for regulatory capital purposes. Accordingly, trying to evaluate in advance whether any particular liquidity management transaction may give rise to "appreciable" profits or losses as a result of short-term price movements[48] is extraordinarily difficult. Although the Proposed Rule itself addresses the expectations of the banking organization regarding the likely profitability of a position, the commentary in the NPR raises a significant concern about how this criterion would be implemented.[49] The uncertainty surrounding whether a particular transaction qualifies under the liquidity management exclusion will inhibit the proper functioning of ALM. Moreover, as noted above, whether a particular investment is profitable or the return it bears should not cause an otherwise permissible ALM-related liquidity management activity to fall outside the exclusion for *bona fide* liquidity management activities.

---

[48] *See Id.*, § _.3(b)(iii)(C)(3) (requiring that any position taken for "liquidity management purposes be . . . limited to financial instruments the market, credit and other risks of which the covered banking entity does not expect to give rise to appreciable profits or losses as a result of short-term price movements").

[49] *See* 76 F.R. 68862, fn. 114 (stating, "Any instance in which positions characterized as taken for liquidity purposes do give rise to appreciable profits or losses as a result of short-term price movements will be subject to significant Agency scrutiny and, absent compelling explanatory facts and circumstances, would be viewed as prohibited proprietary trading under the proposal.").

4. Specific Authorization Requirement

As it is proposed and described in the NPR, the requirement that the liquidity management plan specifically authorize the circumstances in which a particular instrument may or must be used is too restrictive.[50] ALM-related liquidity management activities are responsible for ensuring that any funding gaps (that is, gaps between the timing of liquidity sources and liquidity uses), both under normal and stress conditions, are appropriately measured, monitored and addressed. The ALM function is a dynamic process, one requiring continual review and monitoring of the full panoply of instruments on the banking organization's balance sheet. Because of the dynamic nature of these reviews and the breadth of the instruments taken into consideration, the requirements that a liquidity management plan specifically detail the circumstances in which a particular instrument is to be used is too narrow in view of the broad holistic nature of the ALM function as it relates to liquidity management. We note that even the "enhanced" liquidity standards proposed by the Board under section 165 of the Dodd-Frank Act for banking organizations with $50 billion or more in total assets do not include such a specific authorization requirement.[51]

* * *

Many *bona fide* ALM activities would not be permitted under the Proposed Rule's exemption for risk-mitigating hedging or its exclusion for liquidity management activities. More importantly, it will be impossible for risk managers to know at the outset which hedges, investments and transactions will be permitted pursuant to this exemption and exclusion and which will not, thereby chilling the exercise of a crucial safety and soundness function. In addition, evaluating ALM activities using VaR-based metrics is inappropriate. Use of such metrics would generate numerous false positives, potentially causing *bona fide* ALM activities to be within the definition of proprietary trading. Finally, the exclusion for *bona fide* liquidity management activities is far too restrictive to accommodate many *bona fide* ALM activities. For all of the foregoing reasons, we believe that a separate exclusion for ALM activities, as detailed in Part III, is necessary.

---

50 *See Id.*, § _.3(b)(iii)(C)(1).

51 *See* Proposed Regulation YY, Subpart C (Liquidity Requirements), 77 F.R. 594.

**III. The Proposed Rule should replace the exclusion from the trading account for *bona fide* liquidity management activities with an exclusion for *bona fide* ALM activities, provided that these activities are conducted pursuant to a documented ALM policy, compensation arrangements are designed so as not to reward prohibited proprietary trading, a compliance and audit regime designed to ensure compliance with the Volcker Rule is established and the day-to-day line management of the ALM function is separate from the trading function.**

We strongly recommend that the Agencies, in the final rule, establish an exclusion from the Proposed Rule's definition of trading account for *bona fide* ALM activities that is conditioned on meeting appropriate criteria. Such an exemption would be fully consistent with both the letter and spirit of the Volcker Rule, and would eliminate considerable uncertainties and potential adverse consequences created by the Proposed Rule's broad definition of trading account, the limited exemption for risk-mitigating hedging and the limited exclusion for liquidity management activities, as discussed above. Because *bona fide* liquidity management activities are a subset of *bona fide* ALM activities, we urge the Agencies to address this issue by replacing the Proposed Rule's exclusion for *bona fide* liquidity management activities with an exclusion for *bona fide* ALM activities.

The FSOC, in the FSOC Study, recognized that ALM constitutes more than just liquidity risk management.[52] The FSOC Study treats ALM and liquidity management together under the rubric of "ALM" and expressly recognizes, as noted above, that "ALM activities are clearly intended to be permitted activities, and are an important risk mitigation tool".[53] Moreover, such an exclusion would be fully consistent with the letter of the statute. *Bona fide* ALM transactions (including ALM transactions that pertain to liquidity management) fall outside the statutory definition of trading account because they are not entered into principally for the purpose of resale in the near-term or otherwise with the intent to profit from short-term price movements.[54]

We urge the Agencies to provide an exclusion in the final rule for ALM activities that are undertaken in accordance with a documented ALM plan of the banking organization that:

- Authorizes the particular instruments (by types or categories) to be used for ALM purposes, addressing the types of circumstances in which such instruments (by types or categories) would generally be expected to be used;
- Authorizes strategies for use of instruments for the purpose of hedging or tailoring the ALM risk profile as the macroeconomic and market environments change;

---

52 *See* FSOC Study, at 47 (noting that "[a]ll commercial banks, regardless of size, conduct [ALM] that help[s] the institution manage to a desired interest rate risk *and* liquidity risk profile") (emphasis added).

53 *See Id.*

54 *See* 12 U.S.C. § 1851(h)(6).

- Requires that any transaction contemplated and authorized by the ALM plan be principally for the purpose of managing the balance sheet exposures and liquidity risks of the banking organization, and not principally for the purpose of short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging a position taken for such short-term purposes;

- Requires that the ALM portfolios be managed within appropriate investment profiles documented in the ALM plan;

- Limits any position taken for ALM purposes, together with any other positions taken for such purposes, to amounts that are consistent with the banking organization's balance sheet management and liquidity needs as defined in the ALM plan;

- Is consistent with the banking Agencies' supervisory requirements, guidance and expectations regarding ALM;

- Requires that the compensation arrangements of persons performing the ALM activities be designed so as not to reward prohibited proprietary trading;

- Provides for a compliance and audit regime designed to ensure compliance with the Volcker Rule; and

- Requires that the day-to-day line management of the ALM function (including its employees and officers) be separate from the day-to-day line management of non-ALM trading functions.

Under this construct, the Agencies would have considerable assurance that ALM functions were being properly conducted, but banking organizations would retain the necessary flexibility to manage their risks in prudent ways. Because ALM procedures are audited, ALM results are required to be reported to the independent risk function of the banking organization. Further, because ALM activities are subject to regulatory examination and review, managerial and supervisory structures and processes necessary to ensure that the ALM function is being properly performed and appropriately controlled are in place.

* * *

The Associations appreciate your consideration of the views expressed in this letter. If you have any questions, or need further information, please contact Alex Radetsky (212-612-9285), Vice President and Assistant General Counsel of The Clearing House, or Cecelia A. Calaby (202-663-5325), Senior Vice President and Executive Director of the ABASA.

Respectfully Submitted,

Alex Radetsky
Vice President and Assistant General Counsel
The Clearing House Association L.L.C.

Cecelia A. Calaby
Senior Vice President and Executive Director
ABA Securities Association

cc: Hon. Timothy F. Geithner
*Department of the Treasury*

Hon. Mary Miller
*Department of the Treasury*

Hon. Cyrus Amir-Mokri
*Department of the Treasury*

Hon. Ben Bernanke
*Board of Governors of the Federal Reserve System*

Hon. Daniel Tarullo
*Board of Governors of the Federal Reserve System*

Mr. Michael Gibson

*Board of Governors of the Federal Reserve System*

Hon. Martin Gruenberg
*Federal Deposit Insurance Corporation*

Hon. Gary Gensler
*Commodity Futures Trading Commission*

Hon. Mary Schapiro
*Securities and Exchange Commission*

Mr. John Walsh
*Office of the Comptroller of the Currency*

Mr. Gene Sperling
*National Economic Council*

Paul Saltzman, Esq.
*The Clearing House Association, L.L.C.*

Eli K. Peterson, Esq.
*The Clearing House Association, L.L.C.*

Daniel McCardell
*The Clearing House Association, L.L.C.*

H. Rodgin Cohen, Esq.
*Sullivan & Cromwell LLP*

Mark Welshimer, Esq.
*Sullivan & Cromwell LLP*

Camille Orme, Esq.
*Sullivan & Cromwell LLP*

Joel Alfonso, Esq.
*Sullivan & Cromwell LLP*

*Annex A*

## The Associations

### The Clearing House

Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. It is owned by the world's largest commercial banks, which collectively employ over 2 million people and hold more than half of all U.S. deposits. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing—through regulatory comment letters, amicus briefs and white papers—the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the United States. *See* The Clearing House web page at www.theclearinghouse.org.

### ABA Securities Association

The ABA Securities Association is a separately chartered affiliate of American Bankers Association, representing those holding company members of ABA that are actively engaged in capital markets, investment banking, and broker-dealer activities.