TO THE OFFICER IN CHARGE OF SUPERVISION
AT EACH FEDERAL RESERVE BANK

SUBJECT: Supervisory Guidance on the Capital Treatment of Certain Investments in Covered Funds under the Regulatory Capital Rule and the Volcker Rule

Applicability: This guidance applies to state member banks, bank holding companies, and savings and loan holding companies (not substantially engaged in insurance underwriting or commercial activities) supervised by the Federal Reserve, including those with $10 billion or less in consolidated assets.

The Federal Reserve, together with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, is issuing the attached Deduction Methodology for Investments in Covered Funds (guidance) to clarify the interaction between the agencies’ regulatory capital rule and the Volcker Rule with respect to the appropriate capital treatment for investments in certain private equity funds and hedge funds (“covered funds”). In particular, the guidance clarifies supervisory expectations on how a banking organization’s regulatory capital deductions of investments in covered funds made pursuant to section 13 of the Bank Holding Company Act (also referred to as the Volcker Rule) and implementing regulations relate to deductions of these investments pursuant to the regulatory capital rule.

Federal Reserve Banks are asked to distribute this letter to banking organizations supervised by the Federal Reserve, as well as to their own supervisory and examination staff.

Questions concerning the deduction mechanics described in the attached guidance should be directed to the following staff in the Board’s Capital and Regulatory Policy Section: Elizabeth

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2 “Banking organization” includes national banks, state member banks, state non-member banks, federal savings associations, state savings associations, and top-tier bank holding companies domiciled in the United States not subject to the Federal Reserve’s Small Bank Holding Company Policy Statement (12 CFR part 225, appendix C), as well as top-tier savings and loan holding companies domiciled in the United States, other than (i) savings and loan holding companies subject to the Federal Reserve’s Small Bank Holding Company Policy Statement and (ii) certain savings and loan holding companies that are substantially engaged in insurance underwriting or commercial activities.
MacDonald, Manager, at (202) 475-6316, or Kevin Tran, Supervisory Financial Analyst, at (202) 452-2309. In addition, questions may be sent via the Board’s public website.\(^3\)

Michael S. Gibson
Director

Attachment:

- *Deduction Methodology for Investments in Covered Funds*

\(^3\) [http://www.federalreserve.gov/apps/contactus/feedback.aspx](http://www.federalreserve.gov/apps/contactus/feedback.aspx)
Deduction Methodology for Investments in Volcker Rule Covered Funds

Purpose

The Office of the Comptroller of the Currency (OCC), Federal Reserve Board (FRB), and the Federal Deposit Insurance Corporation (FDIC) are issuing this guidance to clarify the interaction between the agencies’ regulatory capital rule and the Volcker Rule with respect to the appropriate capital treatment for investments in certain private equity funds and hedge funds (covered funds).

Background

In July 2013, the FRB and OCC issued a final rule (regulatory capital rule) that increased the quality and quantity of regulatory capital held by banking organizations and strengthened the framework for calculating regulatory capital to better reflect the underlying risks taken by banking organizations.1 The FDIC adopted an interim final rule that was substantively identical to the regulatory capital rule in July 2013 and later issued a final rule in April 2014 identical to the FRB’s and the OCC’s final rule.2 In December 2013, the FDIC, OCC, and FRB, along with the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission, adopted a final rule to implement section 13 of the Bank Holding Company Act, also known as the Volcker rule, which was added by section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, and which prohibits any banking entity3 from engaging in proprietary

1 “Banking organization” includes national banks, state member banks, state non-member banks, federal savings associations, state savings associations, and top-tier bank holding companies domiciled in the United States not subject to the Federal Reserve’s Small Bank Holding Company Policy Statement (12 CFR part 225, appendix C), as well as top-tier savings and loan holding companies domiciled in the United States, other than (i) savings and loan holding companies subject to the FRB’s Small Bank Holding Company Policy Statement and (ii) certain savings and loan holding companies that are substantially engaged in insurance underwriting or commercial activities.

2 78 Fed. Reg. 62018 (October 11, 2013) (FRB and OCC); 78 Fed. Reg. 20754 (April 14, 2014) (FDIC). These rules are codified at OCC - 12 CFR part 3 (national banks and federal savings associations); FRB - 12 CFR part 217 (state member banks, bank holding companies, and savings and loan holding companies); and FDIC - 12 CFR part 324 (state non-member banks and state savings associations).

3 A “banking entity” is defined by statute as any insured depository institution, any company affiliated with an insured depository institution, as well as any foreign bank that has a branch, agency, or commercial lending company in the United States, with certain limited exceptions. Any banking organization that is subject to the regulatory capital rule would be included within the definition of banking entity under the Volcker rule. 12 U.S.C. 1851(h)(1).
trading or from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with, a covered fund.  

Certain covered funds could be subject, under the regulatory capital rule and the Volcker rule, to overlapping tier 1 capital deductions. Specifically, the Volcker rule requires a banking organization to deduct the full amount of the banking organization’s investment in a covered fund from tier 1 capital. Simultaneously, under the regulatory capital rule, a covered fund that meets the definition of an “investment in the capital of an unconsolidated financial institution” (a covered fund UFI) also could be subject to a deduction from tier 1 capital. The potential overlapping capital treatment for covered funds is discussed in the preambles of both the Volcker rule and the regulatory capital rule, and the preamble to the Volcker rule explains that the federal banking agencies would review the interaction between the requirements of the Volcker rule and the requirements of the regulatory capital rule and reconcile the two rules.  

To clarify the interaction between the two rules with respect to these capital treatments, the methodology described in this guidance outlines mechanics aimed at reconciling the treatment across these rules. A banking organization should be able to demonstrate to its primary federal regulatory agency that the banking organization is in compliance with the Volcker rule and that all amounts of investments in covered funds have been deducted from tier 1 capital.

The Volcker rule, including the required capital deduction for investments in a covered fund, became effective on July 21, 2015, for investments in and relationships with a covered fund made after December 31, 2013. The FRB acted to give banking entities until July 21, 2016, to conform investments in and relationships with covered funds that were in place prior to December 31, 2013 (legacy covered funds) and announced its intention to grant banking entities an additional one-year extension of the conformance period until July 21, 2017, to conform ownership interests in and relationships with legacy covered funds. As a result, for legacy covered funds, the Volcker rule capital deduction will not become effective until July 21, 2017.

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4 See 12 U.S.C. 1851; 12 CFR part 44 (OCC); 12 CFR part 248 (FRB); 12 CFR part 351 (FDIC). For defining hedge fund and private equity fund, see 12 U.S.C. 1851(h)(2). For defining covered fund, see 12 CFR 44(10)(b)-(c) (OCC), 12 CFR 248.10(b)-(c) (FRB), and 12 CFR 351.10(b)-(c) (FDIC).

5 See 12 CFR 44.12(d) (OCC), 12 CFR 248.12(d) (FRB), and 12 CFR 351.12(d) (FDIC); see also 12 CFR 44.12(b)-(c) (OCC), 12 CFR 248 10(b)-(c) (FRB), and 12 CFR 351.10(b)-(c) (FDIC).

6 See definitions of “financial institution,” “non-significant investment in the capital of an unconsolidated financial institution,” and “significant investment in the capital of an unconsolidated financial institution” in 12 CFR 3.2 (OCC), 12 CFR 217.2 (FRB), and 12 CFR 324.2 (FDIC). For an explanation of the regulatory capital treatment that applies to investments in the capital of an unconsolidated financial institution, which includes covered fund UFIs, see 12 CFR 3.22 (OCC), 12 CFR 217.22 (FRB), and 12 CFR 324.22 (FDIC).


Deduction Methodology

1. The banking organization determines the amount of its investment in covered funds\(^9\) that is subject to a full deduction from tier 1 capital pursuant to section ___.12(d) of the Volcker rule.\(^{10}\)

2. If the amount in step 1 is greater than zero, the banking organization must determine whether any investment in a covered fund is also an investment in a covered fund UFI under the regulatory capital rule.

3. If the banking organization determines in step 2 that no covered fund is an investment in a covered fund UFI under the regulatory capital rule, the banking organization must fully deduct the amount calculated in step 1 from tier 1 capital pursuant to the Volcker rule and proceed to step 5.\(^{11}\)

4. If the banking organization determines in step 2 that an investment in a covered fund is also an investment in a covered fund UFI, such that a part or the aggregate of its covered funds is deducted from common equity tier 1 capital or additional tier 1 capital under sections ___.22(c) and (d) of the regulatory capital rule,\(^{12}\) such deducted amounts count toward the amount required to be deducted that was calculated in step 1.

5. Any remaining amount of covered funds that is not deducted from either common equity tier 1 capital or additional tier 1 capital under the regulatory capital rule in accordance with step 4 must be fully deducted from tier 1 capital pursuant to the Volcker rule. A banking organization must deduct the full amount of covered funds required to be deducted under section ___.12(d) according to the valuation methodology specified therein.

6. A banking organization may exclude from risk-weighted assets (for calculating risk-based capital ratios), average total consolidated assets (for calculating the tier 1 leverage ratio), total leverage exposure (for calculating the supplementary leverage ratio), and total assets (for calculating whether a bank is critically undercapitalized for prompt corrective action purposes), amounts that are deducted from capital (i) under paragraphs (c) and (d) of section ___.22 of the regulatory capital rule (step 4) or (ii) under paragraph (d) of section 12 of the Volcker rule (steps 3 or 5).

\(^{9}\) See 12 CFR 44.12(d) (OCC), 12 CFR 248.12(d) (FRB), and 12 CFR 351.12(d) (FDIC).

\(^{10}\) See 12 CFR 44.12(d) (OCC), 12 CFR 248.12(d) (FRB), and 12 CFR 351.12(d) (FDIC).

\(^{11}\) Id. The Volcker rule requires that deductions be made from tier 1 capital. A banking organization can comply with this rule through a deduction from additional tier 1 capital or common equity tier 1 capital. See 12 CFR 44.12(d) (OCC), 12 CFR 248.12(d) (FRB), and 12 CFR 351.12(d) (FDIC).

\(^{12}\) Certain investments in the capital of unconsolidated financial institutions must be deducted from common equity tier 1 capital while others may be deducted from additional tier 1 capital, the two elements that comprise tier 1 capital, under the regulatory capital rule. See 12 CFR 3.22(c)-(d) (OCC), 12 CFR 217.22(c)-(d) (FRB), and 12 CFR 324.22(c)-(d) (FDIC).
Reporting of Volcker Rule Deductions

A banking organization should report deductions of covered funds made pursuant to the Volcker rule under steps 3 or 5 in line items 17 (BHCAP857 and RCFA/RCOAP857) and 24 (BHCAP864 and RCFA/RCOAP864) of Schedule HC-R of the FR Y-9C *Consolidated Financial Statements for Holding Companies* report form or Schedule RC-R of the FFIEC 031 or 041 *Consolidated Reports of Condition and Income* (Call Report forms), as applicable.\(^\text{13}\) In addition, banking organizations with $50 billion or more in total consolidated assets should reflect this treatment on the applicable DFAST reporting templates as follows: (i) DFAST-14A (OCC), (ii) DFAST-14(A) (FDIC); or (iii) the FR Y-14Q and FR Y-14A, *Capital Assessment and Stress-Testing* forms, *Regulatory Capital Transitions Schedules*, line items 24 (CQCDP857) and 30 (CQCDP864) and on the FR Y-14A’s *Summary Schedule for Capital – DFAST and Capital – CCAR Worksheets* on line items 65 (CASDP857 and CPSDP857) and 72 (CASDP864 and CPSDP865) (FRB). Further, banking organizations that are required to complete the FFIEC 101 *Regulatory Capital Reporting for Institutions Subject to the Advanced Capital Adequacy Framework* should reflect this treatment in line items 27 (AAABP857) and 41 (AAABP898) of schedule A of the FFIEC 101.