

For Release Upon Delivery  
10am February 5, 2014

**TESTIMONY OF**  
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**before the**

**HOUSE COMMITTEE ON FINANCIAL SERVICES**  
**U.S. HOUSE OF REPRESENTATIVES**

Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Chairman Hensarling, Ranking Member Waters, and members of the Committee, thank you for the opportunity to discuss the Volcker Rule. As the Committee has requested, my testimony first describes the interagency process that the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission (CFTC) (together, the “Agencies”) used to consider and agree to the final regulations. It then highlights some of the key issues addressed in the final regulations and the changes that were made to the proposed rule<sup>1</sup> to address commenters’ concerns. This testimony also discusses the final regulations’ impact on community banks, market liquidity, job creation, and the prospects for similar reforms to be adopted internationally. It concludes with a description of the OCC’s plans to examine compliance with and enforce the final regulations.

### **Implementing the Volcker Rule**

The statutory provision referred to as the Volcker Rule is set forth in section 619 of the Dodd-Frank Act. Section 619 prohibits a banking entity from engaging in short-term proprietary trading of financial instruments and from owning, sponsoring, or having certain relationships with hedge funds or private equity funds (referred to here, and in the final regulations, as covered funds).<sup>2</sup> Notwithstanding these prohibitions, section 619 permits certain financial activities, including market making, underwriting, risk-mitigating hedging, trading in government obligations, and organizing and offering a covered fund.

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<sup>1</sup> See 76 FR 68846 (Nov. 7, 2011).

<sup>2</sup> The statute defines the term “banking entity” to cover generally any insured depository institution (other than a limited purpose trust bank), any affiliate or subsidiary of an insured depository institution, and any company that controls an insured depository institution. See 12 U.S.C. 1851(h)(1).

On December 10, 2013, the OCC and the other rulewriting Agencies adopted final regulations implementing the requirements of section 619.<sup>3</sup> In accordance with the statute, the final regulations prohibit banking entities from engaging in impermissible proprietary trading and strictly limit their ability to invest in covered funds. At the same time, the regulations are designed to preserve market liquidity and allow banks to continue to provide important client-oriented services.

In developing the final regulations, the Agencies carefully considered the more than 18,000 comments received on the proposed regulations from a diverse group of interests—including banks, securities firms, consumer and public interest groups, Members of Congress, foreign governments, and the general public.<sup>4</sup> Commenters raised numerous significant and complex issues with respect to the proposed regulations, and provided many—sometimes conflicting—recommendations. For example, the Agencies heard from various commenters regarding the distinction between impermissible proprietary trading and permitted market making, and with respect to the definition of a covered fund. These comments often highlighted key differences in the markets and asset classes subject to regulation by the respective Agencies under the Volcker Rule. In contrast, other commenters urged the Agencies to construe the statutory mandate narrowly to avoid the potential for evasion of the proprietary trading and covered fund prohibitions.

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<sup>3</sup> See 79 FR 5536 (Jan. 31, 2014). The OCC, FRB, FDIC, and SEC issued a joint regulation, and the CFTC issued a separate regulation adopting the same common rule text and a substantially similar preamble.

<sup>4</sup> Of the 18,000 comment letters, more than 600 were unique comment letters, and the remaining letters were from individuals who used a form letter. The Agencies each also met with a number of the commenters to discuss issues raised by the proposed regulations and have published summaries of these meetings.

To meet these challenges, the Agencies worked closely with each other in developing the final regulations, from the principal level down to staff at all the Agencies who worked long days, nights, and weekends, to grapple with extraordinarily complex and important policy issues. Though the final regulations have been published, the OCC is continuing to work closely and cooperatively with the other Agencies as we work on our supervisory implementation of the final regulations during the conformance period, which runs through July 21, 2015.<sup>5</sup>

### **Key Issues Addressed in the Final Regulations**

The Agencies improved the proposed regulations in several key ways to address concerns raised by commenters. These concerns included requests for final regulations that: ensure banking entities can continue to manage their risks effectively, but without engaging in prohibited proprietary trading under the guise of permitted hedging; avoid a transaction-by-transaction based approach to defining market making and underwriting that could impact market liquidity; do not bifurcate the municipal securities market; avoid unintended consequences in defining covered funds; and minimize compliance burdens for smaller banking entities that do not engage in covered activities or do so only to a minimal extent. These issues are next briefly described.

Limits on Hedging General Risks. The statute permits banking entities to engage in risk-mitigating hedging activities in connection with, and related to, individual or aggregated positions, contracts, or other holdings of the banking entity. The final regulations modify the

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<sup>5</sup> Section 619 authorized a two-year conformance period, until July 21, 2014, for banking entities to conform their activities and investments to the requirement of the statute. The statute also permits the FRB to extend this conformance period, one year at a time, for a total of no more than three additional years. In a separate action, the FRB has extended the conformance period for an additional year until July 21, 2015, and has indicated that it plans to monitor developments to determine whether additional extensions of the conformance period are in the public interest.

proposal to more effectively implement these provisions of the statute. First, by focusing on “risk-mitigating hedging activity” instead of individual purchases and sales of financial instruments, as the proposal did, the final regulations address criticism that the trade-by-trade approach in the proposed regulations would impair the ability of banking entities to hedge their positions and manage risks effectively. Second, the proposed regulations, among other things, required that hedging transactions be reasonably correlated to the risk or risks the transaction is intended to hedge or otherwise mitigate. The final regulations enhance this requirement to ensure proper oversight of hedging activities. While banking entities must consider correlation as one factor to determine whether hedging activities are risk-mitigating, the final regulations now specifically require hedging activities to be significantly and demonstrably risk-reducing and related to specific, identifiable risks. This means that activities relying on the hedging exemption may not be designed to hedge more generalized risks, such as market movements, or to allow a banking entity to profit in the event of a general economic downturn. Finally, the robust metrics that large banks will be required to report will help the Agencies identify and police trading activity that may be cast as risk-mitigating hedging but actually implicates the proprietary trading prohibition as implemented in the final regulations.

Limits on Market Making and Underwriting. The proposed regulations were criticized for regulating banking entities’ market-making and underwriting activities on a transaction-by-transaction basis, raising concerns about the effects of this approach on the liquidity and efficiency of markets. The final regulations address these concerns by adopting a risk-based approach that focuses on the aggregate risks of businesses across legal entities, while tightening particular provisions to avoid creating opportunities for evasion. So, for example, while the proposed regulations focused on whether individual purchases and sales of financial instruments

satisfied the market-making exemption, the final regulations look at market making-related activities as a whole, consistent with the way the trading business is actually conducted, recognizing that certain characteristics of a market-making business may differ across markets and asset classes. The final regulations also permit a banking entity to aggregate positions from a single distribution of securities in an underwriting in a manner that reflects the range of public and private securities offerings an underwriter may facilitate.

Liquidity in Municipal Securities Markets. The proposed regulations treated obligations issued by agencies and instrumentalities of states and municipalities differently than direct obligations of states and municipalities, which could have resulted in decreased liquidity in municipal securities markets. The final regulations permit proprietary trading in obligations issued by agencies and instrumentalities acting on behalf of states and municipalities to the same extent as direct obligations of states and municipalities.

Definition of Covered Fund. The proposed definition of covered fund—which, consistent with the statute, relied on two widely used exclusions from the definition of “investment company” under federal securities laws—would have subjected to the covered fund prohibitions under section 619 a number of entities that are not traditionally considered hedge funds or private equity funds, such as wholly-owned subsidiaries, joint ventures, and acquisition vehicles. The final regulations adopt a more narrowly tailored definition of a covered fund that applies to funds that are similar to hedge funds and private equity funds, in accordance with the language, purpose, and intent of the statute.

Compliance. The proposed regulations included compliance program requirements tailored to the size and complexity of the banking entity. The final regulations modify the

proposal in a few key ways to reduce costs to banking entities and to provide for effective supervision of the largest banking entities.

First, the final regulations require a banking entity to adopt a Volcker compliance program before engaging in a covered activity, other than trading in exempt government and municipal obligations. The proposed regulations would have required a banking entity to adopt measures designed to prevent the entity from becoming engaged in such activities.

Second, the final regulations reduce burdens on banking entities with total consolidated assets of \$10 billion or less that are engaged in a more limited amount of covered activities. These banking entities are only required to update their existing policies and procedures to include references to the requirements in the final regulations, as may be appropriate given their activities and complexity. Under the proposal, some of these entities would have been required to adopt: a compliance program focusing on written policies and procedures; internal controls; a management framework with clear accountability and responsibility; independent testing and audits; training; and recordkeeping requirements.

Third, the final regulations require banking entities that have \$50 billion or more in total consolidated assets or that report metrics to adopt an enhanced compliance program requiring more detailed policies, procedures, and governance processes. In addition, the Chief Executive Officer (CEO) of every banking entity subject to enhanced compliance must personally attest annually to the relevant supervisory agency that the entity's program is designed to achieve compliance with the final regulations. By contrast, the proposed regulations would have imposed enhanced compliance obligations on banking entities that exceeded a \$1 billion asset

threshold (based generally on consolidated trading assets and liabilities or covered fund assets under management) and would not have required a CEO attestation.

Metrics Reporting. The final regulations reduce the number of proposed metrics from seventeen to seven, and raise the minimum threshold for metrics reporting for banking entities from the proposed \$1 billion asset threshold to \$10 billion (based on aggregate trading assets and liabilities). This threshold will be phased in over time, and requires the largest banking entities (over the \$50 billion asset threshold) to begin reporting metrics this summer. The Agencies will review the adequacy of the metrics data collected and revise the collection requirement, as appropriate, prior to September 30, 2015.

### **Evaluating the Volcker Rule's Effects on Community Banks, Market Liquidity, and Job Creation**

The statute applies to all banking entities, regardless of size; however, not all banking entities engage in activities presenting the risks the statute sought to curb. One of my priorities in the Volcker rulemaking was to make sure that the final regulations imposed compliance obligations on banking entities in proportion to their involvement in covered activities and investments. The final regulations appropriately recognize that not all banking entities pose the same risk and impose compliance obligations accordingly. So, a community bank that only trades in "plain vanilla" government obligations has no compliance obligations whatsoever under the final regulations. Community banks that engage in other low-risk covered activities will be subject to only minimal requirements.

All banking entities, including community banks, will need to divest impermissible covered fund investments under the final regulations. Recently, however, the Agencies heard,



and promptly responded to, a concern raised by community institutions that the final regulations treated certain investments in a way that was inconsistent with another important provision of the Dodd-Frank Act. Banking entities of all sizes hold collateralized debt obligations backed primarily by trust preferred securities (TruPS CDOs). These TruPS CDOs, originally issued some years ago as a means to facilitate capital raising efforts of small banks and mutual holding companies, would have been subject to eventual divestiture and immediate write-downs under the applicable accounting treatment under generally accepted accounting principles. As a number of community institutions pointed out to the Agencies, this result was inconsistent with the Collins Amendment to the Dodd-Frank Act,<sup>6</sup> where Congress expressly protected existing TruPS as a component of regulatory capital for the issuing institution so long as the securities were issued by bank holding companies with less than \$15 billion in consolidated assets or by mutual holding companies. To mitigate the unintended consequences of the final regulations and harmonize them with the Collins amendment, the Agencies, on January 14, 2014, adopted an interim final rule to permit banking entities to retain an interest in or sponsor a TruPS CDO acquired before the final regulations were approved, provided certain requirements are met.<sup>7</sup> Among others, the banking entity must reasonably believe that the offering proceeds from the TruPS CDO were invested primarily in trust preferred securities issued prior to May 19, 2010, by a depository institution holding company below a \$15 billion threshold or by a mutual holding company. To help community institutions identify which CDO issuances remain permissible, the OCC, FDIC, and FRB have also issued a non-exclusive list of TruPS CDOs that meet the requirements of the interim final rule.

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<sup>6</sup> See 12 U.S.C. 5371(b)(4)(C).

<sup>7</sup> See 79 FR 5223 (Jan. 31, 2014).

For banking entities that engage in a high volume of trading and covered fund activities, namely, the largest banks, the final regulations will impose some significant changes. These large firms have been preparing for these changes since the statute became effective in July 2012, and have been shutting down impermissible proprietary trading operations. Now that the final regulations have been released, these institutions will need to take steps during the conformance period to bring their permitted trading and covered fund activities, such as market making, underwriting, hedging, and organizing and offering covered funds, into compliance with the requirements of the final regulations. Large banking entities must develop robust compliance programs, and they will be required to compile and report quantitative metrics on their trading activities that may serve as an indicator of potential impermissible proprietary trading or a high-risk trading strategy. Banking entities will not be able to use covered funds to circumvent the proprietary trading restrictions, and they will not be able to bail out covered funds they sponsor or invest in.

It is not possible to predict with precision the impact of the final regulations on aspects of the broader economy such as market liquidity and job creation. What we do know is that the Agencies have designed the final regulations to achieve the purposes of section 619—which include implementing the statutory prohibitions on proprietary trading and investing in and sponsoring covered funds—while at the same time permitting banking entities to continue to provide, and to manage and limit the risks associated with providing client-oriented financial services that are critical to capital formation for businesses of all sizes, households and individuals, and that facilitate liquid markets. These client-oriented financial services, which include underwriting, market making, and asset management services, are important to U.S. financial markets and the participants in those markets. Moreover, by taking into account

commenters' suggestions with regard to the activities permitted by statute, in particular in the area of market making and underwriting, the final regulations reduce the likelihood that there will be a negative impact on the ability of banking entities to provide these currently-available services across markets and asset classes.

The ultimate impact of the final regulations on certain asset classes that are not exempt from the definition of covered fund will not become clear until banking entities start to bring covered fund investments into conformance with the final regulations. As I have indicated, this must be done by July 21, 2015, either by divesting non-permitted investments in covered funds or by bringing these investments into conformance with the exclusions or requirements under the final regulations, including applicable statutory investment limitations and capital deduction requirements. Banking entities will have to discontinue some activities and investments, but the impact of those changes on the overall market will depend in large measure on factors that neither banking entities nor the Agencies control; for example, the extent to which new firms enter these businesses and the extent to which covered funds can be restructured as permissible investments.

### **International Activities**

A number of European countries have enacted, or are considering, reforms that limit bank trading activities. Last week, the European Commission, under the leadership of Commissioner Michel Barnier, published a proposed rule that would prohibit proprietary trading in about 30 of the largest European banks. The proposed rule would also give discretion to national authorities on whether certain trading activities posing systemic risks, such as market making and trading in derivatives, should be "ring-fenced," that is, moved away from the banks' retail operations into

separately capitalized entities. Last year, France, Germany, and the United Kingdom (UK) adopted legislation requiring the ring-fencing of certain trading activities. We understand that the UK government has committed to enact secondary legislation by May 2015 that may impose additional activity restrictions on large ring-fenced banks, including restrictions on certain types of transactions, and on the holding and voting of shares in certain companies.

### **Implementation**

Of course, issuing a final regulation is only the beginning of the Agencies' implementation process. Equally important is how the Agencies will enforce it. The OCC is committed to developing a robust examination and enforcement program that ensures the banking entities we supervise come into compliance and remain compliant with the Volcker Rule. In the near term, our priority is implementing examination procedures and training to help our examiners assess whether banks are taking the necessary steps to come into compliance with the final regulations by the end of the conformance period, and we are actively engaged in these efforts. Using these procedures, examiners will direct banks they examine to identify the range and size of activities and investments covered by the final regulations, and will assess banks' processes and systems for metrics reporting and their project plans for bringing their trading activities and investments into conformance with the final regulations. Moreover, key OCC subject matter experts across our policy and supervision divisions are developing training for our examiners to be held later in 2014. We will build upon these initial procedures and training through the course of the conformance period as we further assess the progress and needs of our examiners.

The Agencies also are working to ensure consistency in application of the final regulations. I am pleased to report that the OCC has led the formation of an interagency working group to address and collaborate on developing responses to key supervisory issues that arise under the final regulations. That interagency group held its first meeting in late January and will continue to meet on a regular basis going forward. The OCC is also participating in interagency training on the final regulations this spring and summer under the auspices of the Federal Financial Institutions Examination Council.

### **Conclusion**

When fully implemented, I believe the final regulations will achieve the legislative purpose for which the Volcker Rule was enacted. The final regulations will limit the risks the prohibited activities pose to the safety and soundness of banking entities and the U.S. financial system in a way that will permit banking entities to continue to engage in activities that are critical to capital generation for businesses of all sizes, households and individuals, and that facilitate liquid markets.