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Carrie R. Hunt
Executive Vice President of Government Affairs
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National Association of Federally-Insured Credit Unions

October 5, 2018

Ann E. Misback
Secretary
Board of Governors of the Federal Reserve
System
20th Street and Constitution Avenue NW
Washington, DC 20551

Christopher Kirkpatrick
Secretary
Commodity Futures Trading Commission
1155 21st Street NW.
Washington, DC 20581

Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Legislative and Regulatory Activities
Division
Office of the Comptroller of the Currency
400 7th Street, SW, Suite 3E-218
Washington, DC 20219

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NW
Washington, DC 20549

RE: Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and
Certain Interests in, and Relationships With, Hedge Funds and Private Equity
Funds

Dear Sirs/Madams:

On behalf of the National Association of Federally-Insured Credit Unions (NAFCU), the only trade association exclusively representing the federal interests of our nation's federally-insured credit unions, I write today to urge your reconsideration of planned deregulatory action under section 13 of the Bank Holding Company Act (BHC Act)—also known as the Volcker Rule—as described in the Agencies' joint notice of proposed rulemaking.

The Volcker Rule is a critical reform that emerged from the financial crisis which restricts proprietary trading by bank entities. It is the logical and essential response to the mantra of "too big to fail." The restrictions contained in section 13 of the BHC Act represent common sense: banks should not be able to gamble with consumer deposits on speculative investments that could imperil the safety and soundness of the financial system. The Volcker Rule addresses, among other things, the riskiest of all investment behaviors—investing in private equity or hedge funds using a bank's own accounts for the bank's own benefit. The infamy of individual traders like the "London

"Whale" demonstrates the destabilizing effect of proprietary trading; when banks maintain large, illiquid positions in opaque derivatives contracts, the risk of substantial loss is greatly magnified. While banks may claim that the Volcker Rule is unreasonably limiting—or that trading losses are merely the result of modeling errors—there is ample research that links proprietary trading to significant losses incurred by banks during the financial crisis.

General Comments

Eroding critical protections of the Volcker Rule will likely undermine financial stability and exacerbate the risks posed by speculative trading. Although Congress recently enacted legislation to provide relief from the Volcker Rule, it specifically limited this relief to community banks. By contrast, the proposed rule goes much further and relaxes compliance requirements for all banking entities, including those with significant trading assets. Certain proposed changes go even further, and are designed to relax safety and soundness safeguards related to the financing of restricted trades outside the United States by a U.S. affiliate or branch of a foreign bank.¹ The proposal provides only minimal justification for these dramatic changes and fails to adequately consider the potential destabilizing effects that would follow from a regulatory scheme that practically invites proprietary trading through the guise of market-making or hedging activities.

The proposal would permit liberal use of an existing exemption in the Volcker Rule by making it much easier for banks to claim that transactions are part of underwriting or market-making activities rather than prohibited trades. The proposal merely requires that banks adopt internal risk limits in order to benefit from a presumption of compliance. Specifically, the proposal states that "all banking entities, regardless of their volume of trading assets and liabilities, would be able to voluntarily avail themselves of the presumption of compliance with the statutory [reasonably expected near term demand of clients, customers, or counterparties] requirement in section 13(d)(1)(B) of the BHC Act by establishing and complying with these internal risk limits."² The presumption of compliance for underwriting activity that meets a bank's internal risk tolerances would undermine well-established principles of safety and soundness, particularly given the general lack of scrutiny over bank developed risk limits. As the proposal makes clear, this approach "would not require that a banking entity's risk limits be based on any specific or mandated analysis, as required under the 2013 final rule."³ However, history suggests that placing such a high degree of trust in banks can prove disastrous.

In the aftermath of the financial crisis, a report prepared by the Senate Permanent Subcommittee on Investigations Report, titled "JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses," revealed the extent to which large banks continued to take risks in order to maximize profitability.⁴ The report found that JPMorgan Chase's Chief Investment Officer used bank deposits, including some that were federally insured, to construct a \$157 billion portfolio of

¹ 83 Fed. Reg. 33432, 33468 (July 17, 2018).

² Id. at 33456.

³ Id.

⁴ S. Rep. No. 113-96, Vol. 1, (2013), available at <https://assets.documentcloud.org/documents/623882/jpmorgan-chase-whale-trades-a-case-history-of.pdf>.

synthetic credit derivatives, engaged in high-risk, complex, short term trading strategies, and disclosed the extent and high-risk nature of the portfolio to its regulators only after it attracted media attention. The losses JPMorgan Chase incurred in 2012 as a result of its poorly supervised proprietary trading strategies revealed the extent to which a weak ban on proprietary trading could drive risk and cause severe losses.⁵

The Agencies' proposal would also eliminate safeguards in the Volcker Rule related to the statutory exemption for certain risk-mitigating hedging activities that are designed to prevent improper, speculative trading. For banks with significant trading assets and liabilities, the proposal would eliminate the current requirement to show that hedging activity "demonstrably reduces" or otherwise "significantly mitigates" risk.⁶ In addition, the proposal would reduce current documentation requirements associated with hedging transactions and eliminate the correlation analysis requirement.⁷ Taken together, the removal of these key requirements from the Volcker Rule would invite risk-taking and undermine financial stability. Furthermore, the correlation analysis requirement, by itself, represents a minimum standard by which a bank can show that its hedges are actually reducing risk. Absent such a requirement, a bank could easily evade the spirit of the Volcker Rule by disguising speculative trades as risk-mitigating hedges.

The proposal also widens the liquidity management loophole in the Volcker Rule, which excludes from the definition of proprietary trading the purchase or sale of securities for the purpose of liquidity management in accordance with a documented liquidity management plan. The proposal would add foreign exchange forwards, swaps and cross-currency swaps to the list of financial instruments that can be used as part of a liquidity management plan. Yet the liquidity management exclusion already provides banks with too much leeway to classify trades as providing liquidity. Even under the existing rule, certain derivatives that meet the definition of a security may be eligible for liquidity management purposes, which makes it difficult to distinguish between legitimate use of the exclusion and speculative trading. Instead of widening the liquidity management exclusion, the Agencies should seek to narrow its scope.

In sum, NAFCU believes that the Agencies should withdraw the current proposal. The Volcker Rule maintains the depth and liquidity of U.S. capital markets, promotes stability, and has not impaired the profitability of large banks. As demonstrated in the following chart, large bank holding companies, which have consistently sought to weaken the Volcker Rule's protections, have already captured the vast majority of total banking assets, and the Volcker Rule has had no demonstrable impact on this trend. Recent earnings reports from large banks also suggest that the Volcker Rule is not holding back growth. In fact, in April 2018, JPMorgan Chase reported that its trading revenue increased 13 percent to \$6.57 billion from \$5.82 billion in the previous year.⁸ The

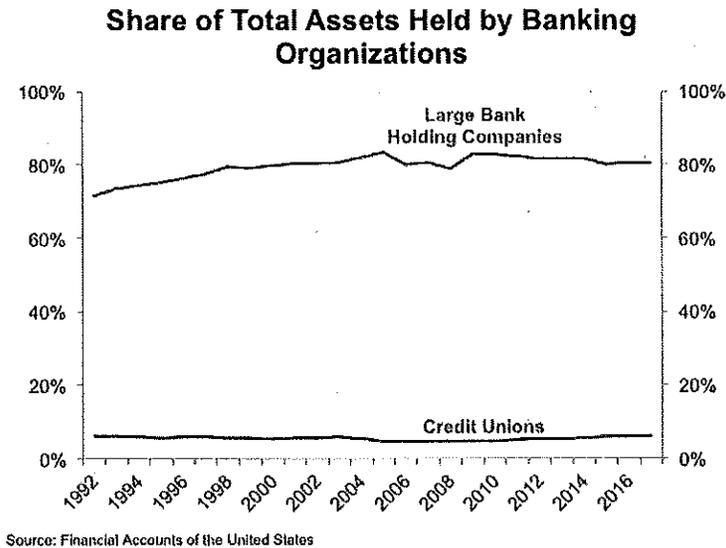
⁵ Id. at 9.

⁶ 83 Fed. Reg. 33439.

⁷ Id.

⁸ Peter Rudegair and Emily Glazer, "JPMorgan Reports Record Earnings, Boosted by Tax Law," *The Wall Street Journal* (April 13, 2018), available at <https://www.wsj.com/articles/jpmorgans-reports-higher-earnings-1523616848>.

fact that large banks continue to outperform earnings expectations should be a signal that the Volcker Rule is not as burdensome as its critics would like the Agencies to believe.⁹



The Volcker Rule already affords a high degree of flexibility; it explicitly permits banks to engage in market-making, underwriting, hedging to mitigate risk, and trading in certain U.S. and foreign government obligations. In addition, the current rule exempts smaller banks that do not engage in a significant amount of proprietary trading or investments in covered funds from unnecessary compliance and reporting requirements. Compliance with the rule is also based on a tiered regime that prioritizes flexibility by adjusting requirements based on the nature and size of a banking entity's activities.

Conclusion

Loosening requirements under section 13 of the BHC Act would revive the risky trading practices that contributed to the financial crisis and fundamentally degrade the stability and liquidity of capital markets. Accordingly, NAFCU asks that the Agencies put Main Street financial principles ahead of the speculative and potentially destabilizing priorities of large banks.

⁹ See The Wall Street Journal, "The Big Banks' Quarterly Earnings" (July 18, 2018), <https://www.wsj.com/graphics/bank-earnings/>.

NAFCU appreciates the opportunity to provide comments on the Agencies' joint notice of proposed rulemaking. If you have any questions or would like us to provide you with further information, please do not hesitate to contact me or Andrew Morris, Regulatory Affairs Counsel, at [REDACTED] or [REDACTED].

Sincerely,

A handwritten signature in black ink, appearing to read "Carrie R. Hunt". The signature is fluid and cursive, with a large, stylized initial "C".

Carrie R. Hunt

Executive Vice President of Government Affairs and General Counsel