Core Concept #4: Prudential Regulation

Prudential Regulation: Overview

- "Prudential regulation":
  - Primarily focused on the safety and soundness of the institution
  - Applies at both the BHC and IDI level – though underlying legal regimes differ, and often more stringent at the IDI level
  - Distinguish from "market regulation" done by the U.S. Securities and Exchange Commission ("SEC") and Commodity Futures Trading Commission ("CFTC")
- Rationales for prudential regulation in banking:
  - Protect depositors;
  - Protect FDIC;
  - Protect banking system; and
  - Limit moral hazard
- Consequences: Prudential regulation of banks has a substantial impact on the economics, design and management of activities in which the bank engages – and therefore both the business model of individual banks and of the banking industry as a whole

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Prudential Regulation: Safety & Soundness Framework at a Glance

- Activity restrictions (as described above)
- Capital and liquidity rules (to be addressed in detail later)
- Supervision, examination and enforcement (to be addressed in detail later)
- Governance standards
- Risk management standards
- Special regimes for loans to one borrower, insider lending and affiliate transactions

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Prudential Regulation: Affiliate Transactions

- **Overview**: Sections 23A and 23B of the Federal Reserve Act and Regulation W place substantial limits on transactions between an IDI and any “affiliate” thereof
- **Quantitative limits**: Any “covered transactions” between an IDI and an affiliate are limited as to amount (23A)
  - Covered transactions with a single “affiliate” limited to 10% of IDI’s capital/surplus, and covered transaction with all affiliates combined to 20% thereof
  - “Covered transactions” include extension of credit to an affiliate, asset purchases from an affiliate, holding securities issued by an affiliate, acceptance affiliate securities as collateral, issuing a guarantee on behalf of an affiliate and credit exposure from derivatives and securities financing transactions
- **Collateral requirements**: Extensions of credit and other credit exposures to an affiliate must be fully collateralized at specified levels at all times (23A)
- **Low-quality asset prohibition:** An IDI may not purchase low-quality assets from an affiliate (23A)

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Prudential Regulation: Affiliate Transactions (cont.)

- **Attribution rule:** Transactions by an IDI with a third party, the proceeds of which are transferred to an affiliate or that benefit an affiliate are considered made to the affiliate (23A)
- **Market terms:** Almost all transactions by an IDI with affiliates must be on market terms or better from the perspective of the IDI (23B)
- **Safety and soundness:** All covered transactions by an IDI with affiliates must be consistent with safe and sound banking practices (23A)

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Prudential Regulation: Volcker Rule

- **Overview**: Added by § 619 of the Dodd-Frank Act (§ 13 of the BHCA), the Volcker Rule statute prohibits “proprietary trading” and sponsorship of, or investment in, private equity and hedge funds (so-called “covered funds”), and also places restrictions on certain transactions with advised, sponsored and managed covered funds
    - Key exemptions apply to the proprietary trading prohibition, and permit certain underwriting and market making-related activities, hedging activities, trading in certain government obligations and trading on behalf of customers
    - Key exemptions apply to the covered fund restrictions, and permit investment in/sponsorship of a covered fund in connection with organizing and offering the covered fund, as well as certain underwriting, market making-related activities and hedging activities
- **Scope of application:** Applies to IDIs and any affiliate thereof (regardless of whether part of a BHC or not)
    - Also applies to non-U.S. banking groups with U.S. banking operations on a group-wide basis (subject to certain “exemptions” for activities conducted “solely” outside of the U.S.)
    - The Economic Growth, Regulatory Relief and Consumer Protection Act (S. 2155) exempts banks with less than $10 billion in total assets from the Volcker Rule, as long as the banks have less than 5% total trading assets and liabilities.

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Prudential Regulation: Volcker Rule (cont.)

- **Volcker 1.0:** The original regulations adopted in 2013 by the five Volcker Rule agencies [the Federal Reserve, FDIC, OCC, SEC and CFTC (Agencies)] posed a number of challenges and were widely perceived as complicated and burdensome:
  - Distinguishing prohibited "proprietary trading" (speculating) from "market-making" and other permissible trading activities;
  - Appropriately defining terms associated with the restrictions on hedge fund and private equity fund sponsorship/investment; and
  - Defining the extraterritorial reach and the "solely" outside of the U.S. standard.
- **Volcker 2.0**: The Agencies amended these regulations relating to the proprietary trading and covered funds portions of the Volcker Rule in 2019 and 2020, respectively:
  - Under Volcker 2.0, balance sheet risk management positions (cash flow hedges, investment securities, etc.) are no longer subject to the proprietary trading prohibition even if the position is sold or unwound within 60 days
  - Stringency of compliance requirements is now generally based on a banking organization's volume of trading assets/liabilities
  - Credit funds, venture capital funds and certain family wealth management and customer facilitation vehicles are now excluded from the covered funds restrictions (subject of range of key conditions)