October 17, 2018

Office of the Comptroller of the Currency
Legislative and Regulatory Activities Division
400 7th Street, SW., Suite 3E-218
Washington, DC 20219
Docket ID OCC-2018-0010

Board of Governors of the Federal Reserve System
Ann E. Misback, Secretary
20th Street and Constitution Avenue NW
Washington, DC 20551
Docket No. R-1608; RIN 7100-AF 06

Federal Deposit Insurance Corporation
Robert E. Feldman, Executive Secretary
Attn: Comments/Legal ESS
550 17th Street NW
Washington, DC 20429
RIN 3064-AE67

Securities and Exchange Commission
Brent J. Fields, Secretary
100 F Street NE
Washington, DC 20549
File No. S7-14-18

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

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

To Whom It May Concern:

We, the 27 undersigned banks, along with Chatham Financial Corp.,[1] appreciate the opportunity to comment on the Agencies' proposed revisions to the regulations implementing section 13 of the Bank Holding Company Act ("Volcker Rule"). Collectively, the banking institutions representing views in this letter serve consumers and small businesses in 35 states across the U.S.

The undersigned are small[2] and mid-sized banks who utilize derivatives in two primary ways:

- **Satisfy Demand from Commercial Customers**: We provide derivatives to our commercial customers in connection with loans we make to them.
- **Manage Balance Sheet Risk**: We enter into derivatives to mitigate or eliminate risk that arises from mismatches between interest-sensitive assets and liabilities.

<u>Satisfying Demand from Commercial Customers</u>: Small and mid-sized banks, including the undersigned, offer derivatives in connection with loans they make to their commercial customers. These derivatives

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[1] Chatham is the largest independent adviser and technology provider to derivatives end users, advising and providing services to more than 1,900 clients annually on interest rate, currency and commodity hedging. In addition to assisting end users with designing, implementing and managing risk management programs, Chatham provides services to approximately 150 small and mid-size banks ("bank clients") that provide risk management products to their commercial customers and that use derivatives to manage their own balance sheet risk.

[2] Several of the undersigned banks currently do not have, and are not controlled by a company that has, more than $10 billion in total assets, and therefore recently became exempt from the Volcker Rule by virtue of the Economic Growth, Regulatory Relief and Consumer Protection Act. We are joining this letter in the event that we subsequently become subject to the Volcker Rule through growth, acquisition, or further regulatory changes.

assist the banks' customers in managing their financial risks and help banks manage their own balance sheet risk. They also allow small and mid-sized banks to compete with larger banks who offer such products in their markets.

We do not take on market risk when entering into these transactions, because the risk that such transactions create is eliminated by simultaneously entering into offsetting derivatives transactions with swap dealer counterparties. The combination of the swap that the smaller bank enters into with its customer and the offsetting swap with a swap dealer – a so called "back-to-back" transaction – is the cornerstone of what are often called "loan level hedging" (LLH) programs.

LLH programs provide us with a competitive alternative for helping our clients hedge financial risks associated with floating rate debt service payments, interest rate changes, and other costs. When fixed-rate loans were prevalent for commercial debt, they provided more predictability for interest expense and payments to commercial customers. However, such loans often shift financial risks to banks – especially those that substantially fund such loans with floating-rate funding such as deposits. This is because rising short-term interest rates increase funding costs, even while customer loan payments on fixed-rate loans remain unchanged.

To address this, LLH programs allow banks to match the interest rate risk of floating-rate assets (*i.e.*, floating-rate commercial loans) with floating-rate funding. The swap provides payment predictability and thus eliminates interest rate risk for commercial borrowers – typically small and mid-sized businesses. The swap executed by the smaller bank with a swap dealer relieves the smaller bank of the market risk it takes on from its customer by taking on the customer's interest rate risk. Thus, the swap provided to our customer and the swap offset with a dealer are not intended to create profits off of short-term movements in interest rates.

In addition to the risk-reducing benefits of these transactions, LLH programs have become essential for enabling us to compete in the commercial lending space. Larger banks offer such products to their customers, and the undersigned must do so as well in order to remain competitive in meeting customers' needs.[3]

<u>Managing Balance Sheet Risk</u>: Banks also rely on derivatives to minimize or eliminate risks that arise in the ordinary course of providing banking services. Banks hold both fixed- and floating-rate assets on their balance sheets, including commercial and residential loans, and securities. They also hold both fixed- and floating-rate liabilities, including retail deposits and wholesale funding, such as FHLB advances. If there are mismatches in the frequency by which fixed- and floating-rate assets and liabilities reprice, this could adversely affect banks' profitability or even viability. Derivatives are among the key tools banks use to manage such mismatches. Indeed, derivatives are often essential tools for banks in their capacities as prudent balance sheet stewards.

Consider an example in which a bank's balance sheet is comprised of floating-rate assets and fixed-rate liabilities. Such a bank would be at risk when rates fall, because its income would decline when short-term rates decrease, but its costs would remain unchanged due to the fixed-rate character of its liabilities. Such a bank could reduce or eliminate this risk with interest rate swaps, which can be used to synthetically

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[3] In addition to interest rate derivatives, some of the undersigned also offer foreign currency and commodity derivatives to meet customer demand for products that afford predictability with respect to financial risk.

convert floating-rate assets to fixed to match the fixed-rate liabilities, or by synthetically converting fixed-rate liabilities to floating to match the floating-rate assets.

Importantly, all derivatives entered into as part of the undersigned's LLH programs or balance sheet risk management strategies are recorded at fair value under applicable accounting standards and would therefore become subject to the Volcker Rule under the Agencies' proposed accounting prong.

In response to the Agencies' proposed changes to the Volcker Rule, we offer the following comments.

> **Question 3:** *Would the general approach of the proposal to establish different requirements for banking entities based on thresholds of trading assets and liabilities be appropriate?*

We support the Agencies' proposal to correlate a banking entity's obligations under the Volcker Rule to the size of its trading assets and liabilities, and believe the tiers proposed by the Agencies are generally appropriate. We believe this approach will more effectively ensure that only entities that engage in the type of trading activities that contribute to systemic risk are subject to the most stringent requirements under the Rule.

> **Question 6:** *The proposal contains a presumption of compliance for banking entities with limited trading assets and liabilities. Should the Agencies presume compliance for any other levels of activity? Why or why not? Are the proposed requirements for a banking entity with limited trading assets and liabilities appropriate? Should any requirements be added? If so, please explain which requirements should be added and why. Do commenters believe this approach would work in practice? Would it reduce costs and increase certainty for small firms? If not, what approach would work better or be more appropriate and why? Is the proposed scope of banking entities that would be eligible for the presumption of compliance appropriately defined? Why or why not? Please explain. If not, what scope would be more appropriate?*

We broadly support the Agencies' proposal to presume that entities with limited trading assets and liabilities are in compliance with the Volcker Rule. While the undersigned would generally qualify for this presumption, we are concerned that this approach would not provide us with the level of certainty and cost reduction the Agencies intend.

Specifically, the proposed rule permits the Agencies to rebut the presumption of compliance and require a bank with limited trading assets and liabilities to comply with any requirements of the compliance program that would otherwise apply if the entity had significant or moderate trading assets or liabilities. The standard for such a determination, however, is unclear. Without additional specific guidance concerning what types of activities might trigger a reversal of the presumption, banking entities with limited trading assets and liabilities will be left with considerable uncertainty concerning the status of their trading activities and the likelihood of potential of future compliance requirements imposed by the Agencies. As a result, the undersigned anticipate that they may incur costs preparing a compliance plan to implement in case the Agencies exercise their authority to require a compliance program notwithstanding the entity's limited trading assets and liabilities.

This concern is more than theoretical. Under the current Volcker Rule, the subjective nature of the "purpose test" has required many of us to expend considerable resources determining whether the proprietary trading ban will apply to our trading activities, including our LLH programs. We have conducted internal analyses, and many of us have hired consultants and external counsel, and had to considerably invest in conducting and documenting our assessments. While we have collectively concluded that LLH programs and balance sheet hedging do not constitute proprietary trading, we are concerned that such costs will again be required to prepare for a scenario in which one of the Agencies rebuts a presumption of compliance, particularly given that the standards for such a rebuttal by the Agencies are undefined.

> **Question 23**: *Should the Agencies adopt the proposed new accounting prong and remove the short-term intent prong? Why or why not?*
> **Question 27:** *The proposed accounting prong would include all derivatives in the proposed accounting prong since derivatives are required to be recorded at fair value. Is this appropriate? Why or why not?*
> **Question 33:** *For purposes of determining whether certain trading activity is within the definition of proprietary trading, is the proposed accounting prong over- or underinclusive?*

We strongly encourage the Agencies not to adopt the accounting prong as proposed, as it would be enormously overinclusive with respect to derivatives which, as the Agencies note, are required to be recorded at fair value.

If the accounting prong were enacted as proposed, it would place the hedging activity of the undersigned squarely into the ambit of the Volcker Rule, which we believe is inappropriate. The undersigned's LLH and balance sheet hedging programs do not fit within the existing definition of proprietary trading because we are not registered swap dealers nor are our transactions subject to the market risk capital rule. Nor is this hedging activity captured by the parameters of the existing "purpose test" because the swaps involved are not entered into principally for the purpose of (1) short-term resale, (2) benefitting from short-term price movements, (3) realizing short-term arbitrage profits, or (4) hedging positions relating to any of the above.

As noted above, the swaps serve risk-mitigating and commercial – rather than trading or investment – purposes, both for the bank and its customers. It is inapposite to the purpose of the Volcker Rule to sweep these swaps in through the proposed accounting prong, thereby requiring our banks to qualify for – and maintain – a presumption of compliance, or establish a compliance program.

If the Agencies proceed with the accounting prong, the undersigned urge the Agencies to exclude from its scope: (1) all derivatives entered into as part of an LLH program, and (2) all derivatives entered into for hedging purposes, in each case by banks that are not captured by either the market risk capital rule or swap dealer prongs of the existing definition.

> **Question 30:** *Would the short-term intent prong in the 2013 final rule be preferable to the proposed accounting prong? Why or why not?*

The ambiguity inherent in the Volcker Rule's existing short-term intent prong has caused considerable uncertainty as to whether LLH programs constitute proprietary trading, rendering compliance difficult and resource intensive. Several of our bank supervisors have advised us that they would treat transactions executed as part of a LLH program as proprietary trading, and have thus required that we implement compliance programs[4] necessary to enable us to continue providing such swaps to our customers. These supervisors have frequently indicated that, because we immediately[5] offset the swap we provide to our customer with a dealer counterparty, we are subject to the sixty-day rebuttable presumption of proprietary trading.[6] We do not believe this provision was intended to capture LLH programs. Indeed, the Agencies have noted that the sixty-day rebuttable presumption has led to overinclusion of financial instruments that were held for fewer than sixty days but were not principally for the purpose of short-term resale and thus did not constitute proprietary trading.[7]

In light of the guidance we have received under the short-term intent prong, many of the undersigned have expended resources setting up and operating compliance programs at our regulators' request. These compliance programs are costly and burdensome for banks of our size, especially given the relatively small volumes of swaps that we provide to our customers. Indeed, each of us transact in quantities sufficiently small that we are not required to register as swap dealers under rules promulgated by the Commodity Futures Trading Commission (CFTC).

While the undersigned have had difficulties ascertaining our compliance obligations under the existing short-term intent test and its sixty-day rebuttable presumption, we believe this approach is preferable to the proposed accounting test as the latter would automatically capture all derivatives associated with LLH and balance sheet hedging programs, regardless of whether such derivatives implicate the statutory prohibition against proprietary trading. Indeed, the undersigned believe that introducing the accounting test – and specifically its coverage of all derivatives – would be inconsistent with the Agencies' goal of better tailoring the scope of the Volcker Rule by removing the overly-broad sixty-day rebuttable presumption.

As noted above, regardless of whether the Agencies retain the short-term intent test or implement the accounting test,[8] we urge the Agencies to explicitly scope out of the Volcker Rule for banks that are not captured by either the market risk capital rule or swap dealer prongs: (1) all derivatives entered into as part of an LLH program, and (2) all derivatives entered into for balance sheet hedging purposes.

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[4] While guidance has evolved over time, since July 2105 some of us have been advised by our supervisors that we should apply the market making exemption and implement compliance programs necessary to avail ourselves of that exemption.

[5] With respect to foreign currency derivatives, because foreign currency derivatives are often for small amounts, banks offering such derivatives may wait before entering into an offsetting position. However, this is done only for efficiency reasons until sufficient volume has accumulated to justify entering into an offsetting position. Where delays in hedging occur for efficiency reasons, such delays are managed within prescribed risk limits.

[6] Although many of us have documented a rebuttal of the presumption of proprietary trading as permitted by the Volcker Rule, we have largely been told to instead implement a market-making compliance program.

[7] 83 F.R. 33432, 33446-47.

[8] We believe it is appropriate to rely on the market risk capital rule and swap dealer tests exclusively. Both tests provide much-needed objectivity and certainty, while capturing the banking entities that are responsible for creating the types of risk that we understand the Volcker Rule is intended to address. Moreover, banks are already determining their trading assets and liabilities for purposes of the market risk capital rule and know whether or not they are required to register as swap dealers.

Question 45. *Is the process by which the Agencies may rebut the presumption of compliance sufficiently clear? If not, how should the process be changed?*

We believe that the process by which the Agencies may rebut the presumption of compliance is sufficiently clear. The standard the Agencies intend to use for such a rebuttal, however, is not. Without concrete guidance concerning the types of activities that might trigger a reversal of the presumption, banking entities availing themselves of the presumption of compliance will be left with considerable uncertainty of the Volcker Rule's ongoing applicability to their program.

We are also concerned that this lack of clarity may result in inconsistent guidance and rebuttals provided to similarly-situated market participants. Indeed, under the existing short-term intent test, the undersigned have received varying advice from their regulators concerning their LLH programs – including that such programs are not subject to the Volcker Rule, that they should rebut the sixty-day presumption of proprietary trading, or that a market-making compliance program is required. We believe that without clear, consistent direction as to the treatment of LLH programs and balance sheet risk management strategies, we will face similar inconsistencies in the implementation of the revised Volcker Rule.

Question 104. *Should the Agencies exclude loan-related swaps from the definition of proprietary trading under §__3? Would including loan-related swaps within the definition of "trading account" or "proprietary trading" be consistent with the statutory definition of trading account? Why or why not?*

We strongly urge the Agencies to exclude loan-related swaps from the definition of proprietary trading under either §_3 or §_6. Such an exclusion would be consistent with the treatment of loan-related swaps for purposes of other rules; specifically, banks are not required by the CFTC to include such swaps in their swap dealer *de minimis* calculations to determine whether they are required to register as swap dealers.

Further, as noted above, LLH programs serve commercial – rather than trading or investment – purposes, both for the bank and its customers. Because of the purposes of LLH programs and the limited risks such programs create, we believe that clarifying the status of such programs with respect to the Volcker Rule would reduce adverse consequences of the Rule without undermining its intent. We further recommend that the Agencies make the exclusion available only to entities that are not subject to the market risk capital rule or swap dealer test in order to ensure the Volcker Rule continues to capture the banking entities and activities that contribute to systemic risk.

Question 106. *How should loan-related swaps be defined? What parameters should be used to assess which swaps meet this definition?*

As noted above, under the CFTC's regulations, an insured depository institution is not required to include in its swap dealer calculation any swap entered into in connection with originating a loan to its customer.[9] Generally speaking, loans are exempt from swap dealer calculations if the rate, asset, liability or other term underlying such swap is related to a financial term of a loan originated by the bank, or if such swap is required as a condition of the loan. We urge the Agencies to adopt a definition of loan-related swaps that is substantially similar to the definition adopted by the CFTC for swaps executed in connection with

[9] 17 C.F.R. 1.3. This definition is currently subject to further proposed rulemaking by the CFTC. *See* 83 F.R. 27444.

originating loans to customers, and to include in the definition the derivatives transaction entered into with a dealer to offset the risk of the customer-facing swap.

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We thank you for considering this matter. If you would like to discuss these issues further, please contact Carla Bennett at (720) 746-6525 or cbennett@chathamfinancial.com.

Sincerely,

ATLANTIC CAPITAL BANK
Atlanta, Georgia

BANK RHODE ISLAND
Providence, Rhode Island

BROOKLINE BANK
Boston, Massachusetts

CAMBRIDGE TRUST COMPANY
Cambridge, Massachusetts

CARTER BANK & TRUST
Martinsville, Virginia

CHATHAM FINANCIAL CORP
Kennett Square, Pennsylvania

CHEMICAL BANK
Midland, Michigan

COLUMBIA BANK
Fair Lawn, New Jersey

CUSTOMERS BANK
Phoenixville, Pennsylvania

EAGLEBANK
Bethesda, Maryland

EASTERN BANK CORPORATION
Lynn, Massachusetts

FIRST FINANCIAL BANCORP
Cincinnati, Ohio

FIRST IPSWICH BANK
Ipswich, Massachusetts

FIRST MERCHANTS BANK
Muncie, Indiana

GERMAN AMERICAN BANK
Jasper, Indiana

GREAT SOUTHERN BANK
Springfield, Missouri

HOME SAVINGS BANK
Youngstown, Ohio

HOMESTREET BANK
Seattle, Washington

INTER NATIONAL BANK
McAllen, Texas

INVESTORS BANK
Short Hills, New Jersey

LAKE CITY BANK
Warsaw, Indiana

LAKESIDE BANK
Chicago, Illinois

NBT BANK, N.A.
Norwich, New York

OLD NATIONAL BANK
Evansville, Indiana

OLD SECOND NATIONAL BANK
Aurora, Illinois

ROCKLAND TRUST COMPANY
Rockland, Massachusetts

UMB BANK, N.A.
Kansas City, Missouri

WESBANCO BANK, INC.
Wheeling, West Virginia