Implications of Final Volcker Rule
Impact of Final Volcker Rule on Bank’s Investment Portfolios

Final Rule

On December 10, 2013, the Federal Reserve (Fed), Federal Deposit Insurance Corporations (FDIC), Office of the Comptroller of the Currency (OCC), Securities & Exchange Commission (SEC) and Commodities Futures Trading Commission (CFTC) issued the final rule implementing the Volcker Rule. The Volcker Rule generally prohibits banking entities from engaging in proprietary trading, acquiring or retaining ownership interest in a hedge fund or private equity fund—covered funds—and sponsoring a hedge fund or private equity fund. The final rule becomes effective April 1, 2014, with a conformance period that extends until July 21, 2015.

The final rule has some changes from the original 2011 proposal that may have significant unforeseen implications for banks holding certain investments. While the restrictions were intended to cover hedge funds and private equity funds, many securitization vehicles closely resemble hedge funds and private equity funds structurally. The final rule does not exempt all structures considered securitizations. The final rule also defines “ownership interest” in covered funds broadly, which may include interests usually considered to be debt instruments.

This paper summarizes only the portion of the final rule related to covered funds and highlights investments that will require additional review. An overview of impairment accounting rules is included along with possible effects on a bank’s balance sheet classifications and net income.

Banking entities will need to thoroughly review their investment portfolio to determine if divestiture is required to be in compliance with the final rule. Banks will need to determine if investments in securitizations fall within the definition of covered fund. If so, it will be necessary to determine whether there is an applicable exclusion from the covered fund definition. If a securitization is a covered fund with no exclusion, it may be subject to the Volcker Rule and required to be divested by July 21, 2015. The flow chart on Page Three explains the review process.
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Is investment a “covered fund”?

Yes

Exemption available?

Yes

Document compliance with exemption

No

Is investment an “ownership interest”?

Yes

Divest before July 15, 2015 or request extension

No

Review accounting treatment

Document review process
Covered Fund

Several revisions were made to the 2011 proposal’s definition of a covered fund. While the Volcker Rule was intended to limit bank investments in hedge funds and private equity funds, the final rule broadly defines hedge funds and private equity funds to include any issuer that relies on one of the following exemptions under the Investment Company Act of 1940 (ICA):

- Funds sold to 100 or fewer investors (referred to as the Section 3(c)(1) exemption)
- Funds sold only to Qualified Purchasers (QPs) (referred to as the Section 3(c)(7) exemption)

These are the two exemptions most widely used by hedge funds and private equity funds to avoid registration with the SEC, public disclosure and compliance obligations. The Volcker Rule also defines covered funds to include commodity funds and certain foreign funds organized and operated outside the U.S. but sponsored by a U.S. bank.

However, the two ICA issuer exemptions, Sections 3(c)(1) and 3(c)(7) also were used in the origination of many collateralized loan obligation (CLO) and collateralized debt obligation (CDO) securitizations. Transactions relying on different exemptions from the ICA—such as the Section 3(c)(5) exemption for real estate investment trusts (REIT) and private label mortgage-backed security (MBS) securitizations, the Rule 3a-7 exemption for nonmanaged fixed income funds used by many asset-backed securities (ABS) issuances and Section 3(c)(3) exemption for trust funds maintained by a trustee or fiduciary—would not be subject to the Volcker Rule. As a result, the same type of collateral could be sold in a securitization with the same waterfall structure. However, if that transaction relied on a different exemption in the ICA, it would not be viewed as a covered fund and would not be subject to the Volcker Rule.

Even if a securitization relied on 3(c)(1) or 3(c)(7), it may not be a covered fund if another 1940 exemption also is available. For example, some issuers may qualify for exemption under ICA Rule 3a-7, which exempts nonmanaged fixed income funds from the definition of an investment company. If an issuer meets the requirements of Rule 3a-7, the securitization would not be subject to the Volcker Rule, even if the sponsors did not expressly rely on Rule 3a-7 for exemption from the ICA.

The exemption relied on by a securitization issuer under the 1940 ICA is usually contained in the offering documents. Be careful in your review—many prospectuses also reference exemption from registration under Rule 144a (the 1933 act exemption).

Excerpt from RAS 10-K

Taberna’s subsidiaries that hold real estate assets—Taberna Realty Holdings Trust and Taberna Loan Holdings I, LLC—and the mortgage loan securitization trusts wholly owned by Taberna Loan Holdings I, LLC rely on the exemption from registration provided by Section 3(c)(5)(c) of the ICA because each of these entities owns legal title to whole residential mortgage loans. The restrictions of Section 3(c)(5)(c) will limit the ability of these subsidiaries to invest directly in TruPS, mortgage-backed securities representing less than the entire ownership in a pool of mortgage loans, unsecured debt and preferred securities issued by REITs and real estate companies or in assets not related to real estate. Taberna Realty Holdings Trust’s assets consist exclusively of whole residential mortgage loans to which it has legal title. Taberna Loan Holdings I, LLC’s investments consist exclusively of its holdings in the securities of five wholly-owned subsidiaries. Each subsidiary’s assets consist exclusively of whole residential mortgage loans to which it has legal title and the unilateral right to foreclose.

We believe that each of these entities is exempt from registration as an investment company pursuant to Section 3(c)(5)(c) under the ICA.
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Exclusions from Definition of Covered Funds

Trust Preferred CDOs (TruPS CDO)

On January 14, 2014, the agencies approved an interim final rule allowing banks to retain interests in TruPS CDOs if the following conditions are met:

- The TruPS CDO was established, and the interest was issued, before May 19, 2010
- The bank reasonably believes the offering proceeds received by the TruPS CDO were invested primarily in qualifying TruPS collateral
- The bank’s interest in the TruPS CDO was acquired on or before December 10, 2013

Qualifying TruPS Collateral is defined as any trust-preferred security or subordinated debt instrument meeting either of these requirements:

- Issued before May 19, 2010, by a depository institution holding company with total consolidated assets of less than $15 billion
- Issued before May 19, 2010, by a mutual holding company

TruPS CDOs with a majority of collateral issued by REITs or insurance companies would not benefit from the exemption and may still be subject to divestiture by July 21, 2015. To expedite the review process, the agencies have provided a nonexclusive list of issuers that meet the requirements of the interim final rule, which includes 85 of the 108 TruPS CDOs issued. If a TruPS CDO is not on this list you will need to determine if another exemption maybe available.

Loan Securitization Exclusion

This exclusion applies to an issuer of ABS if its underlying assets are comprised solely of the following:

- Loans (defined as any loan, lease, extension of credit or secured or unsecured receivable that is not a security or derivative)
- Rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders or related or incidental to purchasing or otherwise acquiring and holding loans, subject to certain limitations
- Interest rate or foreign exchange derivatives that
  - Directly relate to the loans in the issuing entity, the related ABS or certain related contractual rights or assets
  - Reduce the interest rate and/or foreign exchange risks related to such loans, the related ABS or permitted contractual rights or assets
- Special units of beneficial interest (SUBI) and collateral certificates
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Examples

In a securitization of equipment leases, a titling trust is used to hold ownership of the equipment. The titling trust typically will own the equipment and the right to payment on the leases, and then will issue a security or other instrument, often referred to as a special unit of beneficial interest (SUBI), that represents an ownership interest in the titling trust to the securitization issuer. The use of SUBIs allows the sponsor to avoid the cost of retitling the equipment underlying the leases.

Certain securitizations use a master trust structure allowing the trust to issue more than one series of asset-backed security collectively backed by a common revolving pool of assets. A master trust may hold assets (such as loans) and issue a collateral certificate supported by those assets to an issuing trust that issues asset-backed securities to investors. The assets held by the master trust typically are a pool of revolving accounts that may be paid in full each month, e.g., credit card receivables, or a revolving pool of short-term loans replaced with new loans as they mature, e.g., floor plan loans.

- Certain securities constituting cash equivalents and securities received in lieu of debts previously contracted with respect to the loans underlying the ABS. Cash equivalents might include deposits insured by the FDIC, certificates of deposit issued by a regulated U.S. financial institution, obligations backed by the full faith and credit of the U.S., investments in registered money market funds and commercial paper.

In addition, in order to qualify for the loan securitization exclusion, the issuer may not hold any of the following:

- A security, including an ABS, or an interest in an equity or debt security other than as permitted above
- A derivative, other than as permitted above; credit default swaps are prohibited
- A commodity forward contract

A synthetic securitization in which the asset-backed securities are supported by cash flow from derivatives, such as credit default swaps and total return swaps, would not be permitted to rely on the loan securitization exclusion because such derivatives are excluded from the final rule’s definition of loan.

A securitization that owns a tranche of another loan securitization is not itself a loan securitization, even if the ownership of such tranche by a banking entity would otherwise be permissible under the final rule.

Asset-Backed Commercial Paper Conduit (ABCP) Exclusion

This exclusion applies if the underlying assets are comprised solely of the following:

- Loans or other assets that would be permissible under the loan securitization exclusion described above
- ABS supported solely by assets permissible under the loan securitization exclusion and acquired by the ABCP conduit as part of the initial issuance of the securities

To qualify for the exclusion, a “regulated liquidity provider” must provide a legally binding commitment to provide full and unconditional liquidity coverage with respect to all the outstanding ABCP issued in the event that funds are required to redeem the maturing ABCP.

Covered Bond Exclusion

This exclusion applies to an entity that owns or holds a dynamic or fixed pool of assets covering the payment obligation of covered bonds if such assets or holdings meet the requirements of the loan securitization exclusion. In addition, the covered bonds must be debt obligations that are issued directly by one of the following:
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- A foreign banking organization
- The entity that owns the permitted cover pool

Public Welfare Investment Funds

The final rule exempts investments in funds designed to promote public welfare. This includes Small Business Investment Companies (SBIC) (including companies that have received from the SBA notice to proceed to qualify for a license as an SBIC), Low-Income Housing Tax Credit (LIHTC), Renewable Energy Tax Credit (RETC), New Markets Tax Credit (NMTC) and Rural Business Investment Companies (RBIC).

Wholly Owned Subsidiary Exclusion

This exclusion applies to an entity if all of its outstanding ownership interests are owned directly or indirectly by a banking entity or an affiliate thereof, except for the following circumstances:

- Up to 5 percent of the entity’s ownership interests may be owned by directors, employees and certain former directors and employees of the banking entity or its affiliates
- Within the 5 percent ownership interest, up to 0.5 percent of the entity's outstanding ownership interests may be held by a third party if the ownership interest is held by the third party for the purpose of establishing corporate separateness or addressing bankruptcy or insolvency

Covered Funds – Areas of Focus

The definition of covered fund and the aforementioned exception exclude most asset securitizations from the Volcker Rule restrictions; however, a number of structured finance transactions commonly thought of as securitizations appear not to be covered by the above exclusions. These are structures in which the securities typically are issued in reliance on the exemptions in Section 3(c) (1) or 3(c)(7) of ICA and which are backed, in whole or in part, by securities or derivatives as opposed to loans. Unless the agencies grant further relief or the securitization sponsor agrees to restructure, it appears the securitization issuers in these types of transactions may be deemed covered funds.

Banks will need to review the structure of each securitization in its investment portfolio and the terms of each interest held. Below are some of the more common structures that will warrant a detailed review of the deal prospectus and possibly additional materials from deal sponsor.

CDOs Backed by Securities or Derivatives

CDOs typically are issued and offered in reliance on the Section 3(c) (7) exemption under ICA and thus fall within the basic covered fund definition. If the CDO’s underlying assets include any securities or derivatives, the CDO issuer will not fall within the loan securitization exclusion. The agencies only provided relief to certain TruPS CDOs.

CLOs That Hold Debt Securities

CLOs typically are backed primarily by unsecuritized bank loans. If a CLO consists entirely of unsecuritized bank loans, the issuer would qualify for the loan securitization exclusion from the covered fund definition. Frequently, the CLO asset manager is permitted to invest a small percentage of the pool in senior secured bonds. Since these bonds are considered securities, their presence in a CLO structure would disallow the loan securitization exclusion.

An exemption can be applied if the manager were to remove all nonloans from the structure prior to the end of the conformance period.
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CMOs Backed by MBS

Many collateralized mortgage obligations (CMOs) are backed by MBS rather than by unsecuritized mortgage loans. Depending on the characteristics of the underlying MBS, such CMOs may or may not qualify for the Section 3(c)(5)(C) exemption under ICA for certain mortgage-related interests. To the extent these CMOs rely on Section 3(c) (1) or (3) (c) (7) for their ICA exemption rather than Section 3(c) (5) (C), they may be considered covered funds.

Resecuritizations & Bond Repackagings

Resecuritizations of previously issued ABS and repackagings of corporate bonds frequently rely on Section 3(c) (1) or Section 3(c) (7) exemptions under ICA. Since the issuers in these structures principally hold securities rather than loans, they are likely to be considered covered funds.

Synthetic ABS

Synthetic ABS are securities structured to perform based on the performance of an underlying reference pool of financial assets, which are not themselves owned by the issuer of the securities. Synthetic ABS depend heavily on derivative instruments in their structures. Since the assets of a synthetic ABS structure consist of interests in these derivative instruments rather than the underlying financial assets, which may well be “loans” in their own right, synthetic ABS issued in reliance on Section 3(c)(1) or 3(c)(7) of ICA are likely to be considered covered funds.

Synthetic Structured Products

Often, banking entities will sponsor a trust or other pass-through vehicle that will have among its assets corporate bonds and a series of equity derivatives to replicate the economic experience of a structured product. These trusts or other pass-through vehicles are likely to be considered covered funds if they rely solely on Section 3(c) (1) or 3(c)(7) for their ICA exemptions.

Auction-Rate Preferred Securities

Auction-rate preferred securities often are issued by entities the assets of which may consist of other securities, including municipal bonds and securities issued by Fannie Mae or Freddie Mac. To the extent such auction rate preferred securities are issued in reliance on Section 3(c)(1) or 3(c)(7) of ICA, the issuers of such securities may not qualify for the loan securitization exclusion because their underlying assets consist of securities rather than loans. Such issuers may be considered covered funds.

Funding Vehicles

Some banking entities establish special purposes entities, which may not be wholly owned subsidiaries (and therefore ineligible for the wholly owned subsidiary exclusion), that they use to offer secured debt securities or other debt securities that may or may not benefit from a guarantee. To the extent these funding vehicles rely on Section 3(c) (1) or 3(c) (7) for their ICA exemption, they may be considered covered funds.

Domestic Covered Bonds

The qualifying covered bond exclusion applies only to covered bond issuances sponsored by a Foreign Bank Organization (FBO). While not commonplace, covered bonds have been issued by U.S. issuers. Such issuers may not be excluded from the definition of covered funds unless another exclusion is available.
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Pass-through Real Estate Investment Trusts (REIT)

Some issuers structure their REIT offerings by using a passive, pass-through statutory trust between the banking entity and the REIT to issue REIT-preferred securities. Because the pass-through trust holds the preferred securities of the underlying REIT (which would itself not be a covered fund) while providing administrative and ministerial functions for the REIT (including passing through dividends from the underlying REIT), the pass-through trust may not itself rely on the exclusion contained in Section 3(c) (5) or 3(c) (6) and, thus, typically relies on Section 3(c) (1) or 3(c) (7). Such issuers may be considered covered funds.

Municipal Securities Tender Option Bond Transactions

A typical tender option bond transaction consists of the deposit of a single issue of highly-rated, long-term municipal bonds in a trust and the issuance by the trust of two classes of securities: a floating rate, puttable security (the floaters) and an inverse floating rate security (the residual) with no tranching involved. The holders of the floaters have the right to put the floaters for purchase at par, generally on a daily or weekly basis. The put right is supported by a liquidity facility delivered by a highly-rated provider and allows the floaters to be treated as a short-term security. Most of these securities are issued in reliance on Section 3(c) (1) or 3(c) (7), and the final rule provided no specific exemption.

Definition of “Ownership Interest”

Assuming an investment falls under the definition of a covered fund, an entity must then determine if the investment would be considered an “ownership interest.” Ownership interest is broadly defined to include an interest, however structured, that results in a banking entity having similar exposure as an owner to the profits and losses of a fund. The final rule lists characteristics that would help in the analysis, noted below. The presence of any of the criteria would qualify that security as an ownership interest:

- The right to participate in the selection or removal of a general partner or investment advisor

Many CLOs and CDOs provide rights to a “controlling class” of senior debt security holders to participate in the designation of investment managers or investment advisors. This creates the possibility that even the most senior highly rated debt securities may be considered an “ownership interest.”

On December 24, several industry groups jointly requested clarification from the agencies on ownership interest as it related to CLOs.

“We ask for confirmation that the term ‘ownership interest’ does not include debt securities of CLO issuers that are covered funds where these CLO debt securities have a contingent right to remove a manager ‘for cause’ or to nominate or vote on a nominated replacement upon a manager’s removal for cause or resignation, but contain none of the other indicators of ownership interests listed in the definition. CLO debt securities are paid serially and any class of these debt securities can become the controlling class after the prior classes have been paid in full. Moreover, as a practical matter, it is very difficult to restructure an existing CLO or to obtain consent to amend CLO documentation to modify the rights of holders of debt securities.”

- Right to receive a share of the income of the covered fund
- Right to receive the underlying assets of the covered fund, after all other interests have been redeemed and/or paid in full (the “residual” in securitizations)
- Right to receive excess spread
- Losses arising from the underlying assets of the covered fund reduced by payments from the covered fund
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- Right to receive income on a pass-through basis from the covered fund, or a rate of return that is determined by reference to the performance of the underlying assets of the covered fund (excluding interests that are entitled to received dividend amounts calculated at a fixed or floating rate)
- Any synthetic right that provides similar rights as above

The definition of ownership interest in the final rule may include interests in a covered fund that might not usually be considered an ownership interest or an equity interest.

Accounting

Upon completion of its investment portfolio review and final determination of prohibited holdings, a bank then should consider the appropriate accounting treatment. If any covered fund securities are classified as held-to-maturity and the final maturity date for the security is after July 21, 2015, the investment would need to be reclassified to available-for-sale since the bank will no longer have the ability to hold the security to maturity. In this situation, the reclassification to available-for-sale would not taint the remainder of the held-to-maturity investment portfolio since the reclassification would result from a change in the statutory or regulatory requirements significantly modifying what constitutes a permissible investment. Available-for-sale securities, including those reclassified from held-to-maturity, should be reflected on the balance sheet at fair value with the unrealized gain or loss reflected in accumulated other comprehensive income. If amortized cost exceeds fair value, the security would be evaluated for other than temporary impairment (OTTI). Since the bank will be required to sell the security, an OTTI charge to earnings will be required for the entire unrealized loss unless there is evidence the entire unrealized loss will be recovered prior to the disposition of the security—for example, subsequent to year-end but prior to issuance of the financial statements, the security is in an unrealized gain position.

This evaluation would need to be completed at December 31, 2013, and any resulting OTTI charge would need to be reflected in the period then ended. The flow chart on the next page summarizes the OTTI evaluation process.
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1. Fair value is less than amortized cost?
   - No: No OTTI is recorded
   - Yes: Intends to sell or “more likely than not” will be required to sell before recovery of amortized cost?
     - No: No OTTI is recorded
     - Yes:
       - 100% of impairment is recorded in earnings (fair value – amortized cost)

2. Other than temporary impairment due to credit?
   - No: No OTTI is recorded
   - Yes: Credit loss portion is recorded in earnings; non-credit loss portion is recorded in Accumulated Other Comprehensive Income (AOCI)
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Next Steps

While the agencies may issue additional guidance and interpretation, financial institutions should immediately begin a review process to evaluate the potential effect on their organization. This paper is intended as guidance only and should not be substituted for analysis of specific securities in your portfolio. It is important to review the actual terms of the securities issued by the pooled investment vehicle, the underlying securities held and the terms under which the securitization was issued. You may need to reach out to custodians, trustees or sponsor of the securities to obtain all the relevant information needed. Given the complexity of many of these securities structures, it would be prudent to seek legal advice from a firm specializing in securities law in making a final determination if particular securities are subject to the Volcker rule.

BKD will continue to follow this issue. For further information, contact your BKD advisor.

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