

FS Regulatory Brief

The Volcker Rule – How much faith is good faith?

On Thursday, April 19th, the Board of Governors of the Federal Reserve (BoG) released a formal policy statement intending to clarify expectations for covered banking entities at the July 21, 2012, statutory effective date of the Volcker Rule and in the two-year conformance period (See PwC's *FS Regulatory Brief*, "Volcker, For Now, Just Good Faith," April 2012). The BoG stated that during the two-year conformance period, banking entities should engage in "good-faith" planning efforts to enable them to conform their activities and investments by no later than July 21, 2014.

Since the release of the policy statement, there has been a surprising amount of discussion in the press as to what constitutes "good faith" efforts toward compliance with the Volcker Rule. In our view, the largest banks have been undertaking a "good faith" approach to Volcker since the passage of Dodd-Frank, with several firms spinning off or otherwise eliminating their bright-line proprietary trading activities well in advance of the release of the rule.

So what is "good faith"?

It is our view that the Federal Reserve and other regulators will expect banks to use the conformance period to identify which aspects of a firm's trading and covered funds activities and covered fund investments will be impacted by the Volcker Rule and to develop "good faith" plans to bring a firm's activities and investments into compliance. Regulators will tell you that they will know "good faith" when they see it. Most firms also know what "good faith" means and most have already been taking that approach with the Volcker Rule.

When we think about "good faith" preparations for the Volcker Rule, we think about it in three stages (see Chart 1 below):

- **Stage 1**—Now until the next version of the rule is issued—The institution-specific "blind faith" stage
- **Stage 2**—From the next rule until the end of the conformance period—The final rule "we have faith" stage
- **Stage 3**—Once full compliance with the rule is required—The business as usual stage

Implementing a "good faith" effort

It is our view that in each stage there are certain activities that banks should be engaging in to move towards compliance with Volcker in "good faith." While the Stage 1 activities will vary by institution and will be dependent on that institution's view on Volcker, there are certain **Assess** and **Design** activities that every firm should be considering. The primary objective during this period is to evaluate current activities and investments in light of the proposed rule and document the firm's current understanding of how and where the firm is vulnerable. This will allow for discussions with regulators, but more importantly will be a critical starting point for a Volcker conformance plan which can be refined when the final rule is published.

In developing an action plan, we believe that firms should prioritize action plan points by the extent of that activity's /investment's vulnerability to the rule. For those activities and investments which clearly will not be permissible under any refinement of the rule, we believe it is appropriate to develop concrete plans and potentially start to move towards implementation of those elements of the plan. It is likely that this subset of action points will be limited and largely fall into covered funds' illiquid investments, which will require protracted liquidation. Alternatively, there are many activities and investments which will need additional clarification (e.g., market making or covered funds relying on the exemptions from the Investment Company Act specifically section 3(c)(1) and 3(c)(7)) for fully detailed action steps to be developed or implemented. In those cases, firms may consider a range of outcomes (e.g., a stringent final rule and a benign final rule) to determine the potential action steps which could be pursued to bring the firm into compliance with the final rule by the end of the conformance period.

While firms should use this period to evaluate the usefulness of existing metrics, we do not believe that firms should be making any significant investments in developing any of the 17 prescribed metrics that they do not currently use to manage their business. Moreover, we do not believe that firms should

be making any significant changes to their business until further clarity is provided by the final rule. Firms should, however, ensure that they have created or augmented their oversight structure to prevent them from initiating new activities which would clearly run afoul of the spirit of the rule.

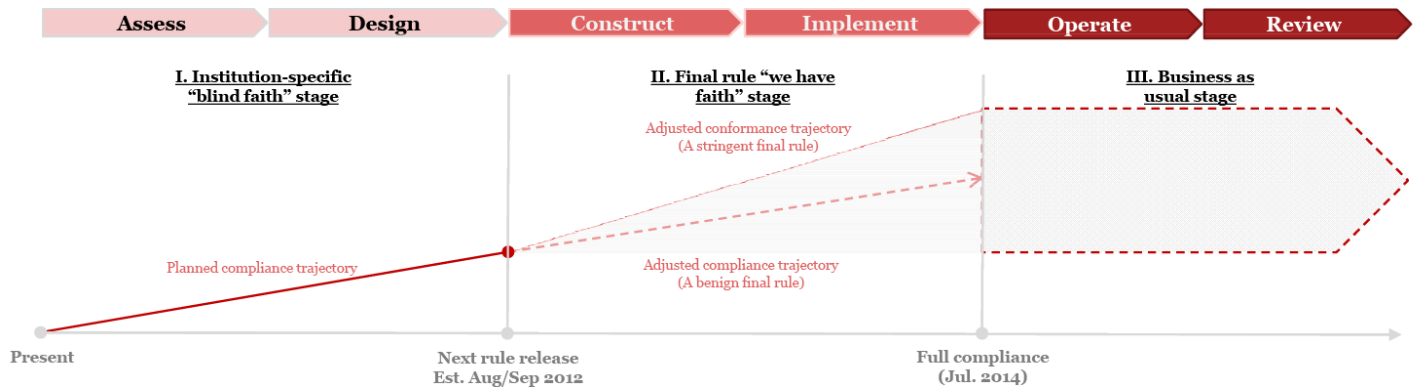
After the final rule

We may have a final rule as early as this summer, but it is also possible that there will be a re-proposal which might push a final rule to the fourth quarter. The final rule, whenever we have it—and we do think we will have one—will provide firms with the clarity that they need to finalize their Volcker impact analysis, to formalize their plans to conform their activities and to **Construct** and **Implement** their Volcker compliance and reporting program (see chart).

The BoG guidance was clear that covered banking entities will not need to conform their activities until the conformance date, which is currently July 21, 2014, but which could be extended if the final rule is delayed. During the conformance period firms will begin to transition their business activities—as necessary—and will begin to implement their business as usual compliance and reporting regime mandated by the final rule.

Moving towards full compliance—with good faith

We believe that covered banking entities should develop a phased-in conformance trajectory, supported by tangible actions, to demonstrate their good faith efforts until a final rule is published.



Examples of tangible actions to demonstrate “good faith”

	Assess	Design	Construct	Implement	Operate	Review
Strategy	<ul style="list-style-type: none"> Vulnerability (e.g., market making/prop, underwriting, hedging, US trades) 	<ul style="list-style-type: none"> Planned compliance trajectory External/internal comm. 	<ul style="list-style-type: none"> Adjust compliance trajectory (gap anlys.) Identify legacy prop positions 	<ul style="list-style-type: none"> Actions to unwind legacy prop positions/prop businesses 	<ul style="list-style-type: none"> Business changes 	<ul style="list-style-type: none"> Managing regulatory expectations and requirements
Structure	<ul style="list-style-type: none"> Trading unit def. Risk governance Global hierarchy (extraterritoriality) 	<ul style="list-style-type: none"> Volcker governance framework Independent testing 	<ul style="list-style-type: none"> Formalized Volcker governance /oversight Volcker compliant risk/trading limits 	<ul style="list-style-type: none"> Volcker risk control environment go live US nexus solution for identified entities 	<ul style="list-style-type: none"> BAU Volcker governance Poss. redefined trading units 	<ul style="list-style-type: none"> Volcker risk control environment and propose required adjustments
Process	<ul style="list-style-type: none"> Risk monitoring Risk mitigating Existing reporting Policies/procedures 	<ul style="list-style-type: none"> Data collection and metrics reporting Progress reporting Internal education 	<ul style="list-style-type: none"> Pilot data collection and metrics reporting Trading unit compliance monitoring 	<ul style="list-style-type: none"> Self-review based on supervisory metrics Volcker specific policies/procedures 	<ul style="list-style-type: none"> BAU self-review Reg. reporting (if applicable) Data maintenance 	<ul style="list-style-type: none"> Internal audit
People	<ul style="list-style-type: none"> Roles/responsibilities 	<ul style="list-style-type: none"> PMO function Ownership/accountability 	<ul style="list-style-type: none"> Refined compensation structure 	<ul style="list-style-type: none"> Organizational changes 	<ul style="list-style-type: none"> Culture development (top-down) 	<ul style="list-style-type: none"> Continuing education
Technology	<ul style="list-style-type: none"> Existing data and metrics producing capabilities 	<ul style="list-style-type: none"> None 	<ul style="list-style-type: none"> Data requirements for data collection and metrics reporting 	<ul style="list-style-type: none"> Data collection and metrics reporting solutions 	<ul style="list-style-type: none"> Fully-automated data collection and metrics reporting solution 	<ul style="list-style-type: none"> On-going data integrity and system capability check

Additional information

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