FS Regulatory Brief

Volcker Rule – Are banks keeping the [good] faith?

Changes and more delays expected

March 2013

Overview

The delay in finalizing the Volcker Rule has been characterized as a "gift" to the banking industry by some critics. The many banks that are currently working diligently to meet the proposed rule's requirements would no doubt disagree. Banks know they are expected to demonstrate "good faith" conformance efforts, as the rule statutorily went into effect in July 2012, and we know that regulators are gearing up (and staffing up in certain cases) to evaluate these efforts in upcoming examinations.

Since delay is not in the regulators' interests, why is a final Volcker Rule taking so long? Simply, the final rule will greatly impact not just the banks, but the broader capital markets and global economy, and regulators are working to get it right – or maybe better said "not get it wrong."

Banks are at the core of our still recovering economy, and the rule's murky proprietary trading prohibition affects activities that are core to modern day banking and the efficient functioning of our financial system. The danger that the rule may adversely impact market making and other forms of principal risk taking is a real concern for overall market liquidity that we hear time and time again from the major buy-side investors. In addition, corporations, which rely on banks for raising financing in the capital markets, will at a minimum see an increase in the cost and a decrease in the size of new issuances and at the extremes could be unable to raise new capital to finance operations and new investment. The macroeconomic downside of "getting it wrong," will far outweigh the financial stability benefits of "getting it right," so caution is clearly warranted.

Such issues have caused disagreements and turf battles among the five US regulators writing the rules, especially with respect to the definition of market making. While the banking supervisors – Federal Reserve, OCC, and FDIC – seem to have come to some agreement, the SEC, which views itself as the primary market regulator, has differing views about both the rule and its role in the process. Chairman Bernanke recently stated that reconciling these differences is the last hurdle to finalizing the rule so that Volcker can be applied consistently across institutions.

As US regulators struggle to write the final rule, overseas regulators are addressing trading activities differently. Rather than taking the US's approach of forcing the cessation or spin-out of certain activities, foreign regulators are proposing allowing proprietary trading to continue within their banking groups but keeping it structurally separate from core retail banking. Their approach also imposes large financial and capital burdens on banks that will force them to voluntarily limit their trading and related activities. Despite starting almost two years later than Volcker, these proposals, at least for the moment, are moving faster since they are more straightforward – for instance, the Liikanen proposal refuses to draw the impossible line between proprietary trading and market making.

This **FS Regulatory Brief** provides our view of (a) where banks stand right now in preparing for Volcker, (b) the timing of the final rule and what it may look like, (c) the response of foreign regulators, and most important (d) what banks should be doing now.

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Where do banks stand in preparing for the Volcker Rule?

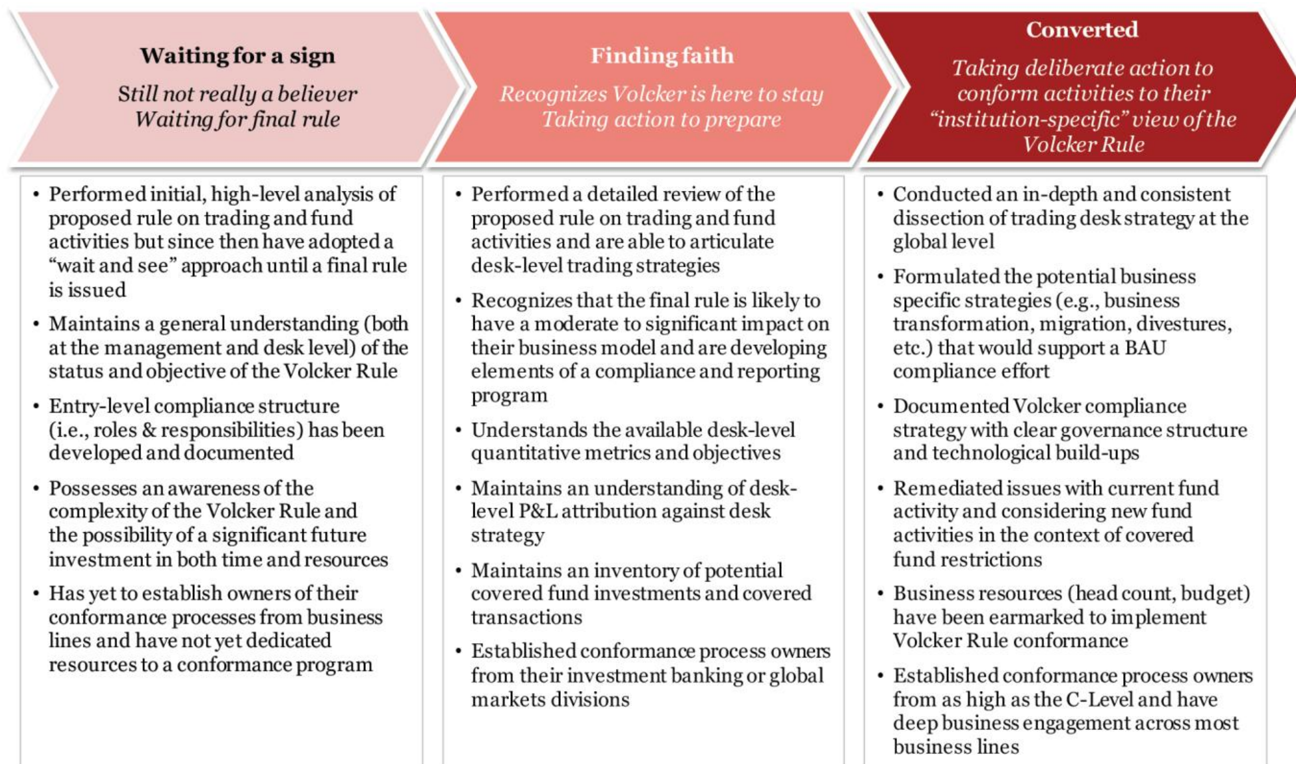
As discussed in our *FS Regulatory Brief: Volcker – For Now Just Good Faith,* Federal Reserve guidance requires banks to engage in "good faith planning efforts" to conform their activities to the requirements of the Volcker Rule by July 21, 2014. Ten months later we are seeing that good faith means different things to different banks. We generally see banks falling into one of three categories:

- **"Waiting for a sign":** Banks in this category have raised a general awareness of the proposed Volcker Rule across their key business lines, but are awaiting further clarity before they undertake any detailed assessment of the rule's impact, take actions to change their business activities, or implement a conformance program.
- **"Finding faith":** These banks have engaged in a comprehensive analysis of their desk-level trading strategies and fund investments against the proposed rule's requirements. They know what they will have to do to conform and have a good sense of the business impact, but they are not taking specific remedial actions or planning steps at this stage.
- **"Converted":** These banks have taken additional specific business actions to eliminate or adjust trading and fund activities that they believe would be violations of Volcker, and have been implementing conformance governance structures (e.g., dedicated work streams, earmarked business resources, etc.) to prove they are quickly moving towards conformance with the rule.

The good news is that we believe the majority of large global banks are somewhere between "finding faith" or being "converted" and are therefore reasonably well prepared for the final Volcker Rule.

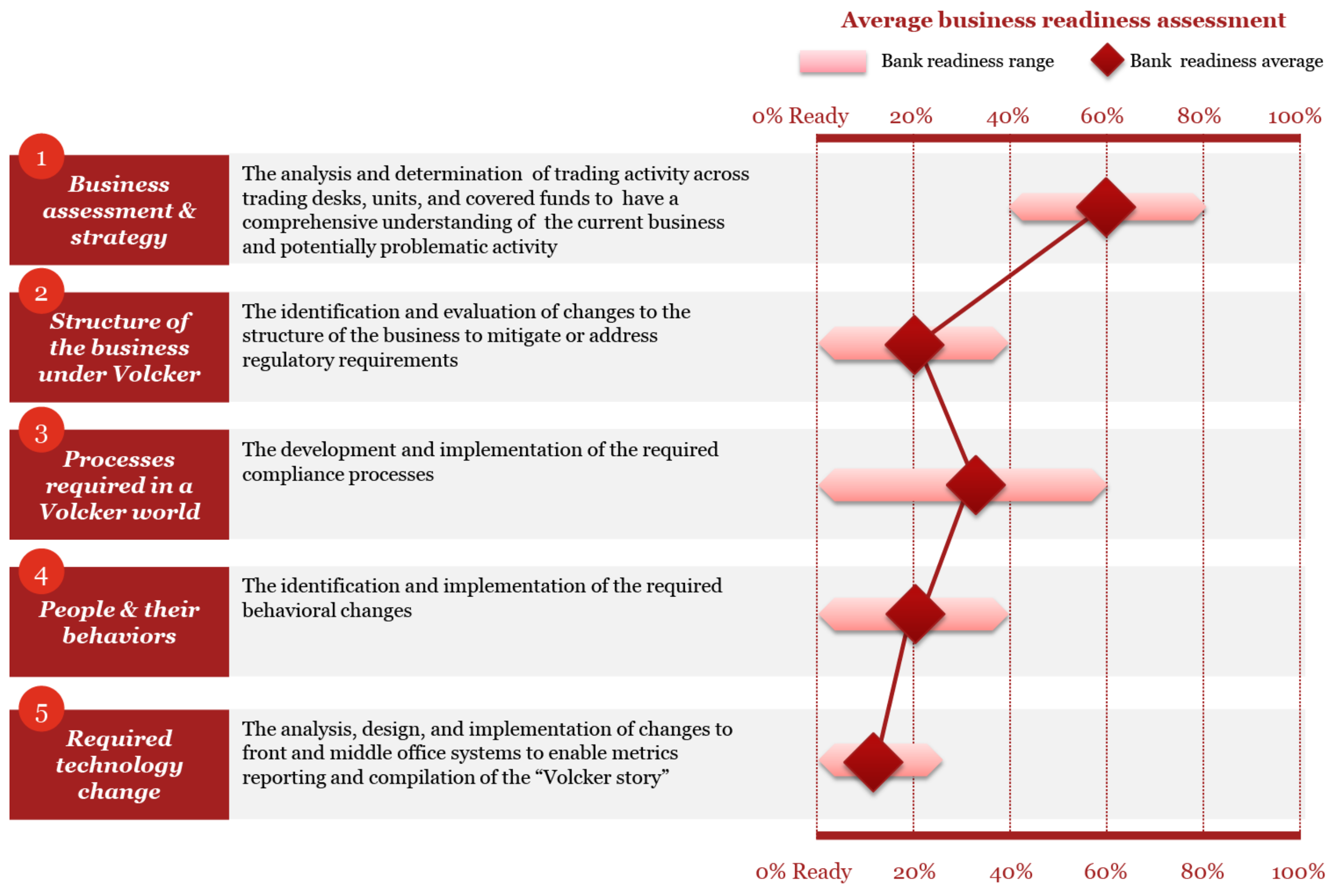
That said, a fair number of large global banks are still "waiting for a sign" as they cannot justify the costs of moving faster given all the uncertainty and the lack of progress on the rule-writing front. Our primary concern for these banks is that in almost all cases we have found, after conducting a detailed impact analysis, that the business impact – meaning the revenues at risk – was substantially greater than had been assumed by bank management in any "back of the envelope" or informal assessment. Generally, we have found that banks who have not performed a thorough analysis don't know what they don't know. As important, in almost all cases the historical trade data did not fully support management's view of the articulated trading strategy – meaning even if intentions were good, the underlying data did not support the story.

The chart below highlights the specific characteristics we have observed for each category:



While most banks have performed some preliminary assessment of the rule's impact, most have not yet taken major actions to restructure their businesses or activities, implement new compliance processes, train people, or make the technology changes necessary to prove compliance with Volcker.

We have assessed the current readiness of the major global banks by focusing on five factors:



No matter where they are on the conformance spectrum, banks will have to adjust their conformance plans (and possibly their business strategies) with respect to these implementation actions and governance structures once the final rule's requirements are released. Particularly because the definitions of "market making," "covered funds" and other key exemptions are still unclear, banks are unable to complete major changes to their operations.

This said, banks in the "converted" camp rightfully view the Volcker Rule as inevitable and view conformance as a competitive necessity for effectively managing their global strategy. The others either believe that Volcker will have a minimal impact on their business or understand that they will have a significant amount of work to do when a final rule is issued. However, they may not understand just how much work is outstanding – we have found that the devil is in the details, and the detailed answer is generally not a good one.

When will we get the final Volcker Rule and how may it change?

There seems to be little urgency to complete the final rule. The delay is a result of the rule's importance to the market, as described earlier, and of the difficulty in delivering a workable solution in light of the limited flexibility of the legislative language. The global competitiveness of US banks – who will bear the rule's brunt more than their global counterparts – is also no doubt a consideration.

With five regulators (Federal Reserve, OCC, FDIC, SEC and CFTC) involved in this process – and the SEC without a confirmed Chairman and a political split of Commissioners – it is unlikely that we will have a final rule before the middle of 2013. Politics is also a factor in timing. If regulators make politically unpopular changes to the rule, which they likely will given the party split here, a late summer release would be more realistic when Congress is in recess and news cycles are quiet.

Pragmatism will drive the rule towards a simpler, less stringent approach, while reaction to recent market news will cause the rule to be tighter in specific areas.

1. **Tightening the liquidity management and hedging exemptions:** Ensuring that critical functions for managing bank liquidity and interest rate risk do not take outsized bets will result in a much more restrictive exemption for these activities. In the original proposal, treasury activities were largely permitted under the liquidity management exemption, while macro-hedging did not have to meet any strict criteria. The new rule will be more specific in these areas and it will likely be more restrictive with:

    - New documentation requirements to prove the effectiveness of hedges and a requirement to delineate between various types of hedges; and
    - Limits on the use of macro hedging and clear delineations between macro and portfolio hedging.

2. **Equal treatment of sovereign debt:** The Federal Reserve's recently proposed prudential standards for foreign banks provide for similar treatment of foreign banks' home country debt and US government debt. This equal treatment signals a possible relaxation of Volcker's prohibition on proprietary trading in foreign sovereign debt, given that Volcker currently allows for proprietary trading of US debt only. This will eliminate some of the extraterritorial noise from abroad.

3. **Elevated compliance threshold:** Regulators are considering increasing the threshold for the enhanced compliance requirements (which includes reporting and recordkeeping of metrics) from $1 billion average gross sum of trading assets and liabilities (on a global basis) to up to $10 billion. This proposed change would reduce the number of banks subject to the enhanced requirements by more than half – from over 60 to under 30, with most being large foreign banks.

4. **More prudential approach to the use of metrics:** While the final rule would still require banks to use (and report) metrics to monitor compliance, it will likely not specify the number or type of metrics. We believe it will left up to the banks to determine their own metrics, using supervisory guidance provided by regulators. Such an approach would be consistent with the legal requirement to produce and monitor metrics while allowing regulators flexibility in tailoring their supervisory approach to each institution.

5. **Conformance period extension:** Given the delay in releasing the final rule and the related time needed to adjust conformance activities, regulators will likely extend the conformance period beyond July 2014 for at least six months and possibly as long as a year.

We understand that regulators are debating whether to re-propose the rule or issue a final rule. As a result of the significance of the expected changes, they must consider the legal risk of changing the proposed rule without public comment against the political risk of opening public comment and debate (again) by re-proposing the rule.

We believe it is likely that regulators will seek the middle road of issuing an "interim final rule," which allows for a shortened comment period, but can simply be deemed final by the regulators, at a later date without any adjustment.

How are foreign regulators responding?

The UK, France, and Germany, all have emerging legislation restricting certain higher risk activities, such as proprietary trading, in order to reduce interconnectedness and improve resolvability. Also, an EU Commission panel issued the Liikanen Report in October 2012, a fourth similar proposal. These proposals, while different from each other, are similar in that, unlike Volcker, they would not eliminate proprietary trading. Rather, they would push proprietary trading outside of the retail bank while allowing it to remain within the banking group (similar to the swaps push-out provision in Dodd-Frank). The plans do, however, propose certain additional separations of trading activity from the retail bank, which begins to bring the UK, EU, and France in line with long established US law that already prohibits certain trading activities from the insured banking entity.

Of the UK, French, German and Liikanen proposals, it appears that the UK will most limit trading activities from the retail bank. The UK bill itself provides little detail, but prior government reports indicate that market making and securities underwriting will be ring-fenced from retail banking – somewhat like Glass-Steagall. The Liikanen Report, French bill, and German bill are less restrictive. The Liikanen Report expressly allows securities underwriting to continue within the retail bank while calling for market making to take place outside the retail entity. The French and German bills, the least restrictive, appear to allow both securities underwriting and market making to remain within the retail bank, subject to restrictions.

Should any of these proposals become law, European or UK banks would be subject to at least two different sets of rules, and definitions, affecting their proprietary trading. To the extent these foreign institutions trade with US counterparties or in US markets, some of their proprietary trading would have to be eliminated under Volcker while proprietary trading falling under their own jurisdiction's definition would need to be pushed out of the retail bank. Even those jurisdictions that adopt the Liikanen philosophy against drawing a line between proprietary trading and market making will nonetheless have to separate the activities if they want to trade with US counterparties or in US markets.

If US regulators included the broad extraterritorial provisions in the Volcker Rule to cause the rest of the world to pass similar proprietary trading bans, it now seems apparent that the effort has not been successful. Rather, other jurisdictions have examined the risks associated with trading activities in banking organizations and have concluded that separation rather than prohibition is the answer. US regulators must therefore act against a different international backdrop and decide if they will maintain the aggressive extraterritorial reach in the final Volcker Rule or respect international comity by limiting its reach. We believe that the strong extraterritorial provisions will remain, regardless of the international lobbying.

What now for banks?

1. Conduct a business impact analysis

Banks need to know which of their businesses, products, and regions are at risk under Volcker. They need to determine how the rule will impact their revenues and costs across all of their businesses globally, and prepare a strategic response. Leading banks have already:

- Identified their most impacted trading units, such as desks that trade in illiquid markets and therefore buy and hold in anticipation of an event (e.g., distressed debt, emerging markets, or options); some banks have estimated a risk of decline in trading revenues of up to 20%.
- Performed risk assessments across these units globally, and have determined that common practices such as pre-positioning in anticipation of client flow will likely prove problematic.
- Conducted analyses regarding investments in or transactions with covered funds, and have considered actions to mitigate potential issues (e.g., divest, or maintain within allowable thresholds).

2. Prepare to prove your good faith

Banks must be able to demonstrate their good faith during the conformance period and regulators have already begun to assess their actions or lack thereof. At a minimum, banks will need to produce the following information:

- An overview of the Volcker program approach, including governance structure and status reporting on its assessment efforts to date.
- A description of how management has defined key Volcker terms, such as prohibited and permitted trading, in order to develop their institution-specific view of Volcker and how that information has been disseminated to impacted business units.
- An analysis of the expected impact of the rule on the bank's business, including the impact on revenues, customer relationships, impact on the bank's risk profile and ability to manage risk and the additional costs of compliance.
- An inventory of existing funds and investments and an analysis of the impact on those funds and investments under the rule's covered funds provisions.
- A description of anticipated upgrades to technology or management information systems necessary to meet the rule's reporting and recordkeeping requirements.

3. Develop a reporting strategy

Banks should be prepared to demonstrate their ability (or inability) to produce the proposed rule's 17 required metrics and to describe why any proxy metrics would be more suitable for monitoring rule conformance. This includes:

- Decomposing/recomposing business units into reporting clusters (i.e., grouping of like desks/trading units into reporting groups based on business activity).
- Developing the required reporting data dictionary including identification of proxy metrics.
- Conducting a gap analysis to understand gaps in current data capture and management reporting systems.
- Working with business leads, desk heads, and business managers to develop future state data requirements/attribute definitions and calculation methodologies (e.g., spread P&L).
- Reviewing current business management metrics and reports to understand current capability that could be leveraged.
- Developing an IT strategy, budget, and implementation plan.

4. *Design and begin implementing a compliance program*

Banks must also consider how to organize their Volcker compliance program, which will be unlike a typical compliance program in that it will likely not be owned by the compliance function. Rather, we believe it will require the most heavy involvement from the front and middle offices, risk management, finance, and operations. This includes:

- Developing a Target Operating Model (TOM) describing the controls, surveillance, monitoring, testing, strategy, people, processes, and technology needs including achieving consensus and buy-in on the governance model globally.
- Conducting a gap analysis between current control capabilities and future state requirements including inventorying of current desk manuals, dealing authorities, reporting structures, etc.
- Developing a detailed implementation plan.

Volcker is clearly one of the most important pieces of the global regulatory reform puzzle. Although most banks know the rule is here to stay, it is still not certain how it will be applied and how it will impact bank business models going forward. All that is certain now – banks need to have (good) faith!

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