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Volcker Rule: The day of reckoning is near

Overview

The latest buzz surrounding the Volcker Rule has centered on when the "final" rule will be issued and how different it will be from the proposal. Among the five agencies that must agree on the rule's next iteration,[1] it is our view that the CFTC has been the last piece of the puzzle for several months. That the latest round of chatter largely stems from this agency suggests the pieces are finally coming together.

Chairman Gensler recently indicated that the CFTC will vote on the rule in December. With his departure by the end of this year, and news that Commissioner Chilton will soon be stepping down (leaving the CFTC with only two of five commissioners come January), he has more incentive than ever to vote the rule out. Combine this motivation with Treasury Secretary Lew's push to complete the rule, and it is fair to expect it by the end of the year (likely in the form of an *interim* final rule, discussed below).

However, we believe that the timing of the rule's completion is less important than its content and whether banks are ready to meet the rule's requirements. Our view is that the rule will end up longer and tougher than the proposal, but less complicated. The rule will be tougher, for example, by limiting the use of macro and portfolio hedging to meet the hedging exemption. It will be less complicated by requiring banks to review and report fewer metrics to prove they are not proprietary trading.

With a final rule nearing, banks must re-assess where they are on Volcker and ensure that they have a strategy – and the resources – to meet its requirements. We have already seen at least one bank undergo a formal examination by a US regulator regarding its Volcker "good faith" conformance to date, so more examinations are coming.

The other topic of debate has been whether the conformance period will be extended beyond the current July 21, 2014 deadline. We see a blanket extension of the conformance period as less likely than the Federal Reserve ("Fed") granting extensions on an individual basis. The Fed is the only agency with authority over the conformance period and has issued a final rule allowing for up to

[1] Dodd-Frank requires the three federal banking agencies – the Federal Reserve, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation – to issue a joint rule for insured depository institutions. Separately, the Federal Reserve, the Securities and Exchange Commission, and the Commodity Futures Trading Commission ("CFTC") are also to issue rules for those entities for which each is the primary regulator. These agencies must consult with each other so that their rules are consistent "to the extent possible."

three one-year extensions on a case by case basis, upon a bank's request and the Fed's approval.[2] The challenge is that this extension request must be filed by January 2014 (i.e., 180 days before July 21, 2014), so time will be short to make the case based on a Volcker Rule that comes out next month. Accordingly, some institutions have already begun drafting their request based on the existing proposal.[3]

This **Financial Services Regulatory Brief** provides our view of (a) changes to expect in the Volcker Rule, (b) where banks are now with respect to their "good faith" conformance, and (c) the key challenges ahead.

How will the Volcker Rule change?

After more than two years of interagency discussion and thousands of public comments, the real surprise would be if the rule did not change. As stated in our prior brief on the Volcker Rule,[4] we believe that the rule will ease in certain respects. For example, the rule's current exemption for US debt will likely be expanded to include other sovereign debt.

However, rather than relaxation of the rule, it is our view that the following two themes will be evident when the rule emerges:

- ***Longer, but less complex:*** The market is bracing for a Volcker Rule that will exceed 1,000 pages. While the sheer length suggests more complexity, in our view it likely signals an improved roadmap. The rule's preamble will be longer in an effort to provide better explanation and respond to received comments. If written well, the preamble should provide the industry with needed clarity around the rule's unique definitional issues (e.g., "market making," "hedging," and "solely outside the US"), its regulatory policy objectives, and – most importantly – how compliance will be monitored and supervised.
- ***Less complex, but tougher:*** One of the primary complaints about the proposed rule (from both industry and regulators) is that it is overly complex and difficult to implement and supervise. In response, we expect fewer reporting metrics than the 17 included in the proposed rule (i.e., as few as seven or eight) with the elimination of those metrics that are less useful for identifying proprietary trading or are more particular to specific classes (e.g., spread P&L, P&L attribution, and inventory aging). The trade-off, however, is that the rule's exemptions will likely be narrowed, especially the ability to utilize macro and portfolio hedging to meet the requirements of the hedging exemption.

Because of such modifications, the agencies are likely to issue the rule as an interim final rule. In other words, the rule will be largely complete, but new public comments will be allowed without having to go through a re-proposal. Due to the rule's complexity, we would expect a new comment period of at least 60 days.

Are banks ready?

With the specter of a final rule – and the end of the conformance period – looming, many banks are taking a fresh look at where they stand with their Volcker planning. At this point, most banks have implemented some type of a "good faith" conformance period compliance program – although we still see quite a bit of variation across the industry as to what and how much has been done.

We see large global banks falling into one of three general camps with regards to their "good faith" compliance:[5]

- ***Waiting for a sign:*** A few banks continue waiting for the clarity that will come from a final rule before doing any more than an initial impact assessment. The number of banks in this category has dropped significantly as these banks began to realize that a final rule may not come much before the end of the conformance period.
- ***Finding faith:*** Many banks still fall into this category and have started to take a more formal approach to addressing the requirements of the rule. These banks have, for example, estimated Volcker's impact to their P&L at the desk level (at least in the US), are actively collecting and reviewing some of required metrics, and have identified an inventory of their covered funds.

[2] See also PwC's *Financial Services Regulatory Brief, Volcker Rule: Are banks keeping the [good] faith? – Changes and more delays expected* (March 2013), where we reported the possibility that the threshold for having to meet the rule's enhanced compliance requirements would be raised from $1 billion to $10 billion (average gross sum of global trading assets and liabilities). Although we have heard nothing more about this possibility, a higher threshold would make granting such extensions on an individual basis more feasible as the number of covered banks would be reduced from over 60 to under 30.

[3] Were the Fed to determine that not enough time exists for institutions to prepare the type of detailed request required under its extension rule, it could grant a blanket one-year extension for all affected firms or otherwise make the request process less burdensome. We recommend preparing now to submit a request under the existing rule since there is no guarantee that the Fed will ultimately adopt a less burdensome alternative.

[4] See note 2.

[5] We first described these categories in our prior brief (see note 2).

- ***The converted:*** As we close in on a final rule, more and more banks are moving into the ranks of the converted. These banks have assessed trading activities both in the US and overseas, started to implement formal programs to monitor and review many or all of the metrics (many through an automated approach), have identified their inventory of covered funds and have started to identify transactions or business (such as some asset servicing businesses) that will be impacted by the rule's Super 23A restriction on extensions of credit to covered funds, and started to implement changes to their trading strategies to conform those activities to the rule's requirements.

The progress that major global banks have made during this year is depicted in the following table, which demonstrates that more institutions are now among the "the converted":

	March 2013		Today
Waiting for a sign	**30%**	→	**10%**
Finding faith	40%		40%
The converted	**30%**	→	**50%**

The key remaining challenges

Those banks that have done the most so far will be best prepared to meet the heavy business implications and compliance challenges that the (interim) final rule will bring. The main challenges will be around the following three areas:

- ***Prohibited proprietary trading:*** While most banks have preliminarily assessed which of their activities are likely to be deemed impermissible, the final rule will provide more clarity around the definition of proprietary trading and its exemptions (e.g., hedging and market making). Reassessment upon the final rule will likely result in the need for more changes to existing trading activities. Moreover, how the final rule defines (or redefines) the "solely outside the US" exemption will have a significant impact on bank activities outside of the US.
- ***Covered fund limitation:*** The rule's limit on private equity or hedge funds within the bank holding company will impact liquidity and lending, but the triggered Super 23A issues will present the largest operational and conformance challenges. The final rule will require reconsideration of these challenges, along with bringing the need to develop an appropriate business strategy.
- ***Compliance program:*** The proposed rule requires a comprehensive compliance program that includes new policies and procedures, internal controls, training, record-keeping, and third-party validation. In the absence of a final rule, most banks have held off on building new dedicated compliance programs. The upcoming requisite investment will be significant.

While there is much concern about the arrival of the final rule, it will at least bring much needed clarity regarding the restrictions and requirements that banks will have to meet. Many banks realize they have work to do and have already set aside significant 2014 budget to address technology and compliance costs associated with Volcker implementation. While 2013 was the year of derivatives reform (which will likely continue), 2014 is shaping up to be the year of the Volcker Rule.

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