A closer look A publication of PwC's financial services regulatory practice

May 2014

Volcker rule clarity: Waiting for Godot

Overview

Five months after regulators released the final Volcker rule, banks are pressing ahead with their implementation efforts, but are still waiting for promised guidance to clarify the rule's many ambiguities.

Reminiscent of last year when banks were expecting the final rule, industry commentators have already sounded false alarms regarding this guidance's imminence.[1] Also, despite establishing an interagency taskforce this year to reconcile supervisory views, the five regulators are again having difficulty coordinating. The only regulatory guidance issued so far has come from the OCC acting alone (through the unusual approach of a "Dear CEO" letter),[2] which merely confirmed the rumored September 2, 2014 metrics reporting due date for the largest firms.

Behind the scenes, regulators have offered more instruction to the banks, but not much more. They have reached out individually to meet with those banks required to report their metrics in September and have provided them with baseline reporting templates. But rather than addressing banks' specific questions about certain metrics, trading desk definitions, or compliance program expectations, the regulators are in an information gathering mode. They are trying to understand the Volcker rule's implementation challenges, but are not providing many answers.

The reality is that Volcker is going to hit banks' bottom lines and many are facing key business decisions in the coming year. We believe the regulators will ultimately provide some formal guidance in the form of FAQs before September 2nd, but are skeptical that this initial guidance will give banks the clarity they need. We see the next year as a learning curve for both the banks and the regulators, as both begin to understand the impact of the Volcker rule, and regulators begin to provide guidance that reconciles their policy ambitions with their hope of avoiding unintended market impact.

With or without regulatory guidance, banks have to press ahead with implementing the rule and the onus will ultimately be on them to prove that they are not engaging in prohibited activities (as we detailed in our prior brief on this topic, *Volcker Shrugged*). At this point, banks need to answer their own questions and establish their "Volcker compliance risk appetite" based on their understanding of the rule and its impact on their business. While not a perfect method, it is the only course to take as deadlines approach and regulatory clarity remains elusive.

This **A closer look** focuses on the Volcker rule's proprietary trading elements, providing our view of (a) where banks are (and where they should be) with respect to their Volcker implementation efforts, (b) five key compliance issues banks are facing, and (c) what to expect down the road from the regulators and the industry.

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[1] Last year, we correctly suggested that the final Volcker rule would be released in December 2013 in our *Regulatory Brief, Volcker Rule: The day of reckoning is near* (November 2013).

Where banks are and where they should be

We see banks falling into three general categories as they move toward the July 21, 2015 Volcker compliance deadline:

1. **2014 reporting banks** – the nine largest trading banks, with $50 billion or more in trading assets and liabilities ("trading A&L")[3] have been in a hard push to ensure that they have the technology to generate and report metrics daily (or as required) by September.

2. **2016 reporting banks** – the banks with between $10 billion and $50 billion in trading A&L have more time to strategically define their trading desks and Volcker compliance strategy.

3. **Under $10 billion/over $5o billion banks** – these banks have under $10 billion in trading A&L (so do not report metrics), but have over $50 billion in *consolidated* assets[4] so must have an enhanced compliance program in place by July 21, 2015.

The following chart provides a more detailed Volcker compliance timetable:

Size (in trading A&L)	Volcker compliance deadline
$50B or more	**September 2, 2014** • Metrics reporting **July 21, 2015** • Enhanced compliance program*
$25B – $50B	**July 21, 2015** • Standard compliance program** **April 30, 2016** • Metrics reporting • Enhanced compliance program
$10B – $25B	**July 21, 2015** • Standard compliance program** **December 31, 2016** • Metrics reporting • Enhanced compliance program

* Also applies to banking entities with $50 billion or more in consolidated assets.

** Also applies to banking entities with $10 billion or more in consolidated assets.

2014 reporting banks – Scrambling to meet the deadline

The nine largest trading banks have focused their efforts on meeting the September 2nd metrics reporting deadline, and most are nearly prepared. They quickly completed their desk-level assessments to classify activities as permissible or impermissible, and they continue to refine the level of specificity in defining their trading desks for reporting purposes (i.e., establishing their "reporting hierarchy"). The importance of getting this virtual organizational chart right goes far beyond reporting – banks will have to live with this hierarchy into the future as they use the metrics as a key component of their overall Volcker compliance program. We are seeing the number of reporting desks range from about 50 to 125.

An important question that these banks are asking is, beyond metrics, how far toward completion of the enhanced compliance program should they be on September 2nd? In our view, banks will need to have progressed on certain components of their compliance programs in order to credibly submit their metrics reports to regulators (i.e., with adequate processes and controls in place). By September 2nd, these banks should:

- Establish responsibilities and processes to manage the review of metrics against limits or thresholds
- Define escalation channels for potential breaches of these limits or thresholds
- Progress in closing gaps between desk practices and trading mandates and dealing authorities
- Draft initial Volcker policies and procedures, and
- Have a basic governance structure in place

Banks will then have between September 2nd and July 21, 2015 to refine these elements and address the rest of their enhanced compliance program, including the important process for CEO attestation to the program's reasonable design.

2016 reporting banks – Have a bit more time

Banks with under $50 billion in trading A&L have a bit more time to consider and implement their Volcker compliance strategy. These banks are developing their

[2] The regulators have taken other actions with respect to collateralized debt and loan obligations (CDOs and CLOs); however, this document focuses on the rule's restrictions on proprietary trading.

[3] Trading A&L is measured globally for US banks, but are limited to US trading A&L for foreign banks.

[4] Like trading A&L, consolidated assets are measured globally for US banks but are limited to US assets for foreign banks.

metrics and compliance programs together (rather than first focusing on metrics), while benefiting from slowly emerging industry and regulatory viewpoints regarding the rule. These banks are also spending more time conducting detailed trading desk level assessments and determining the optimal "Volcker compliant" global infrastructure to support metrics reporting.

A special consideration for banks with under $50 billion in trading A&L is that the regulators could request metrics reporting from them at any time after September 2nd. As a result, by September 2nd, these banks should have a well-defined approach in place with a detailed plan for implementing their compliance programs. The plan would support any requests from the regulators with respect to metrics or overall compliance program progress.

Under $10 billion/over $50 billion banks

The relatively few banks that are below the thresholds for mandated metrics reporting (i.e., under $10 billion in trading A&L), but are over the $50 billion consolidated assets threshold for having to have an enhanced compliance program in place, are in a bit of bind. These banks are working to find the appropriate metrics to support their compliance program, without having to track all the metrics that the larger trading firms must report.

Five key Volcker questions

While the regulators are not providing answers, the industry continues to have questions about how the Volcker rule will be applied. The following five Volcker questions routinely arise in our conversations with banks.

1. Trading desk definitions: How should we define our reporting hierarchy?

Defining trading desks is the foundation of metrics reporting and compliance program implementation. Banks have taken different approaches to this task based on the bank's structure, size (e.g., over or under $50 billion), and core business activities. Some banks are defining desks based on their approach to their business (e.g., by P&L), while others are doing so based on the rule's prescribed definitions (e.g., market-making, risk-mitigating hedging).

Although each bank's reporting hierarchy will be specific to the complexity of its trading activities, the common trend is to develop reporting or compliance structures on top of existing desks (i.e., the physical arrangement of traders does not drive the reporting hierarchy). The challenge here is determining how "low" to go in defining desks for reporting and compliance purposes – i.e., should desks be defined at the product level, sub-product level, trade level, or at a combination of product types together with classes of counterparties?

The reality is that defining desks at a "lower level" provides greater compliance transparency, but also increases the number of desks to manage overall. This increase can pose a challenge to a bank's technological infrastructure and resources, as metrics and limits must be set for each trading desk separately and be monitored on a daily basis. In short, banks face a trade-off between transparency and manageability.

The table below provides the number of desks defined by each bank (by business line) based on our market observations:

Business line	Number of desks	Desk details
Equities	10 – 25	Consist primarily of cash, derivatives, and prime services in some instances (e.g., cash equities, equity derivatives, and prime brokerage)
Fixed income	30 – 65	Consist primarily of cash and derivatives (e.g., rates, credit, and FX)
Commodities	5 – 10	Consist primarily of listed derivatives (e.g., gas, energy, and metals)
Other	5 – 25	Consist of shared/specialized trading desks (e.g., treasury, corporate banking, and credit value adjustment ("CVA") management)

2. Metrics: How should we quantify Volcker compliance?

Although certain metrics that must be reported exist in current risk management reports (e.g., VaR, stress VaR, and risk limits), collecting others metrics (e.g., customer-facing trade ratio, P&L attribution, and inventory aging/turnover) is a significant change to business-as-usual processes that has required a great deal of time and resources.

The industry is also grappling with the applicability and usefulness of the metrics to certain asset classes. For example, while the customer-facing trade ratio and inventory aging/turnover metrics may be applicable to a trading desk engaged in market making activity, they are not as useful for a desk engaged in macro hedging that does not manage risk through the duration of a position. Yet regulators have indicated they still want to see all seven metrics for each desk.

The bigger challenge does not arise until after the metrics are collected and deemed applicable. The truly hard part is understanding what the metrics are telling you – and your regulators. The rule does not prescribe metrics thresholds or limits that inform the bank that they are compliant. Rather, the banks themselves must determine the acceptable levels for each metric. For example, banks need to decide how risk limits should correlate with the VaR and stress VaR metrics when they are managed at varying levels, and how the customer-facing trade ratio should correlate with inventory aging or turnover. It is also up to banks to determine, e.g., how much fluctuation in VaR would evidence impermissible activity, or how long to hold positions to remain within acceptable values for inventory aging or turnover.

3. Permitted activity ambiguity: Is our hedge a prop trade?

Banks face difficulty in determining whether or not their hedging activities are permissible due to the rule's ambiguous definition of risk-mitigating hedging. For example, banks must continue to hedge their CVA risk, though the rule does not explicitly address how to do that. Similarly, hedging activity is not perfectly correlated to its underlying exposure, which requires banks to determine what constitutes a proper hedge under the rule.

In addition, hedging against the exposure of products that the rule does not apply to (such as FX spot, loans, and repos) requires accounting for both the underlying risk and the hedging activity to prevent the hedge from appearing as a proprietary trade. To resolve this issue, some banks have opted for defining activities narrowly at the trade level, which enables them to segregate the hedging of products to which Volcker does not apply. However, as discussed earlier, this trade level approach requires significant process and technological enhancements.

4. Governance: How can we efficiently create a governance program for Volcker's prop trading restrictions?

Efforts to implement various Dodd-Frank provisions beyond the Volcker rule are competing for limited resources at banks (e.g., derivatives reform, enhanced prudential standards[5]), so banks are trying to strike the right balance between efficiency and prudent Volcker governance. On one hand, a stand-alone Volcker compliance program allows for dedicated stakeholders with a clear Volcker compliance focus (which we saw a few banks establish immediately after the final rule was released). On the other hand, this "Volcker silo" imposes significant additional costs, and makes it harder to recognize cross-dependencies with other compliance programs, and to assess the overall business impact of compliance.

Considering these implications, the prevailing view is to embed Volcker governance within existing compliance structures, and to leverage existing desk governance and reporting lines with an emphasis on the "three lines of defense" (i.e., business, compliance, and internal audit). While some banks have consolidated governance structures on a smaller scale (e.g., by merging the governance of derivatives and Volcker), others are focused on building a far more holistic compliance program covering derivatives, Volcker, enhanced prudential standards, Basel III implementation,[6] and other requirements.

A key consideration pertains to the difference between US and foreign banks. For US banks, all operations are in-scope for Volcker. For foreign banks, the scope of application is limited by the *solely outside the United States* ("SOTUS") exemption. In addition, most foreign banks are likely to designate authority to the US CEO to provide the CEO attestation and manage Volcker compliance regionally. Therefore, Volcker governance for foreign banks may not fit as neatly into other compliance structures.

5. CEO attestation: When is the CEO Attestation required and what must be attested to?

The rule does not specify when the first CEO attestation is required (nor the independent testing that would support the attestation). Some of the largest banks are operationalizing toward the view that their CEO will need to attest in July 2015, while others believe the attestation will be required one year after implementation of the enhanced compliance program (yet other banks believe attestation can only be required at year-end, and not mid-year).

It is our view that although the compliance program needs to be up and running by July 2015, the regulators are unlikely to expect a CEO attestation on that date. Late 2015 or 2016 is far more likely.

Not only is the CEO certification date murky, but so is the requirement itself. The attestation is supposed to support the reasonable design of the bank's "processes to establish, maintain, enforce, review, test and modify the compliance program," but little further guidance is provided by the rule.

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[5] See PwC's *First Take: Enhanced Prudential Standards* (February 19th, 2014).

[6] See PwC's *Regulatory Brief, Basel III capital rules finalized by Federal Reserve: But much more to come for the big banks* (July 2013).

The mainstream approach is to develop a framework that accounts for multiple levels of monitoring and testing to support the certification. Some banks are taking the next step by developing sub-certification processes that use the "three lines of defense" approach to support each sub-certification. Such a process might start at the desk level, move to the head of the business unit, and ultimately reach the CEO.

What's next?

As firms ponder the next 14 months, the only things known for certain are that the biggest banks will begin reporting metrics on September 2nd and that the rule will go into effect on July 21, 2015.

We see the year ahead as one of increasing interaction between the regulators and the banks. The beginning of metrics reporting will provide a logical starting point as regulators begin to get a better picture of the value of metrics to identify problematic behavior and as a supervisory tool. With this information, regulators will be in a better position to advise banks on some of their more technical questions and on issues such as trading desk definition and compliance program structure.

As the July 21, 2015 Volcker compliance deadline approaches, we expect to see examinations of banks' progress towards Volcker compliance. Since the rule is not yet "effective," we believe regulators will take more of a collaborative prudential approach, rather than an enforcement-oriented one.

While the regulators develop their supervisory approach, banks will continue to develop their "Volcker compliance risk appetite" for addressing some of the rule's more difficult questions, making their own individual judgment calls as to what will be deemed a "reasonably designed" Volcker compliance program.

Volcker compliance teams have essentially graduated from one limbo into another. They join their colleagues who have been writing bank resolution plans (or implementing certain other rules) and know the drill well: the involvement of multiple regulatory agencies means a lot of promised regulatory advice but little meaningful instruction. The largest resolution plan filers are still waiting for plan feedback nearly a full year after their last submissions – and years since the resolution planning final rule was issued.[7]

The final Volcker rule, therefore, was only a first step down a long foggy road. The only thing to do – instead of lingering like Vladimir and Estragon in Samuel Beckett's *Waiting for Godot* – is to keep walking.

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[7] See PwC's *Regulatory Brief, 2014 Resolution Plans: The guidance you won't receive* (April 2014).

Additional information

For additional information about this **A closer look** or
PwC's Financial Services Regulatory Practice, please contact:

Dan Ryan
Financial Services Regulatory Practice Chairman
646 471 8488
daniel.ryan@us.pwc.com

Shyam Venkat
Partner, Financial Services Risk Advisory
646 471 8296
shyam.venkat@us.pwc.com

David Sapin
Partner, Financial Services Regulatory Advisory
646 471 8481
david.sapin@us.pwc.com

Armen Meyer
Director of Regulatory Strategy
646 531 4519
armen.meyer@us.pwc.com

Contributors: Christopher Scarpati, Gary Welsh, Shweta Jain, Christopher McGee, and Jacob Kindberg.

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