US Financial Regulation Dodd Frank: Volker Rule

New developments

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Agenda

The Federal Reserve Board ("FRB") issued the final rules for Enhanced Prudential Standards for both domestic and foreign banks.

In this presentation, we refer to the foreign bank rules as ("FBEPS"). This final rule was issued on 2/18/2014 as part of the Dodd-Frank reforms (Section 165/166) and introduces proposed changes for U.S. operations of Foreign Banking Organisations ("FBOs").

Key highlights

- One size does not fit all FBOs – depending on FBOs asset size and current legal entity structure, the application of the requirements and impacts are different
- Significant operating model impact to the large FBOs including changes to strategy, infrastructure, governance and talent
- The 17 largest FBOs were required to submit to the FRB an implementation plan by January 2015

US foreign banking organisation enhanced Prudential standards

Leading up to foreign bank enhanced Prudential standards finalisation

- The Foreign Bank Enhanced Prudential Standards, issued by the FRB, are part of the Dodd-Frank reforms (Section 165/166) and introduces proposed changes for U.S. operations of FBOs.
- The FRB initially proposed the rules in December of 2013, representing a significant change to the FRB's supervision approach to FBOs operating in the U.S.
- Rules were finalised on February 18th, 2014, with some changes from what was initially proposed in December 2013.

The FRB view on the need for the final rule

Leading into the FRB meeting held on February 18th, 2014, Governor David Tarullo delivered an opening statement (highlighted below) to set the stage of what has led to the proposal and finalisation of the FBO EPS ruling.

- The mix of foreign bank activities in the U.S. has shifted decidedly toward capital markets, to the point that in recent years, the top ten broker dealers in the U.S. have included either four or five foreign-owned firms.
- The consequences of these changes in foreign bank activities were seen dramatically during the crisis, when the funding vulnerabilities of numerous FBOs and the absence of adequate support from their parents made them disproportionate users of the emergency facilities established by the Federal Reserve.
- The Final Rule would mitigate these risks in an appropriately modulated fashion.

Key highlights of finalised FBO EPS

The FRB adopted final rules (on February 18, 2014) implementing the enhanced Prudential Standards for large FBOs under Section 165 of the Dodd-Frank Act. The final rule establishes enhanced capital, liquidity and risk management requirements for foreign banks.

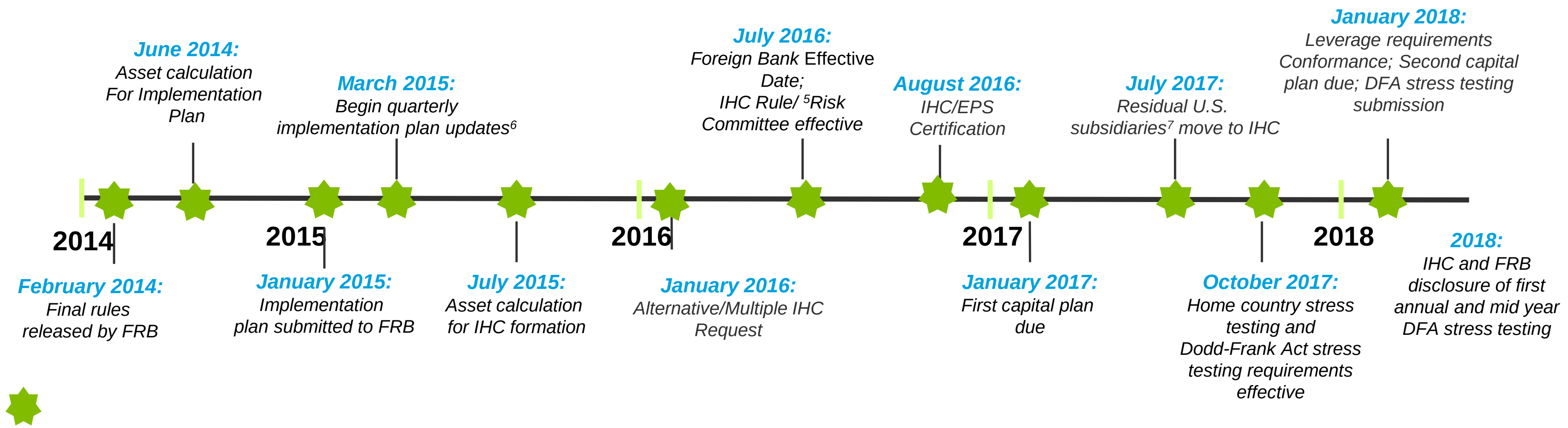
- Implementation date postponed a year to July 1, 2016
- The threshold of formation of an intermediate holding company (IHC) increased from $10bn in U.S. non branch assets to $50bn. Reduced requirements for less than $50bn.
- Branches continue to be excluded from IHC structure, however remain a critical focus area and regulators continue to monitor any movements closely
- Additional clarity provided on formation of an IHC (e.g., full ownership of subsidiaries)
- Implementation plan delivered to FRB as of January 2015 – which will increase scrutiny of program
- Single Counterparty and Early Remediation are deferred for future releases
- Leverage capital requirements conformance not required until to January 1, 2018
- FBOs not subject to advanced approach capital rules
- Comprehensive Capital Analysis and Review (CCAR) requirements will also include a transition period commencing October, 2016
- Relief on liquidity buffer requirements in Branch (reduced from 30 days to 14 days). No limit on intercompany funding
- Risk aggregation and reporting capabilities will need to extend across U.S. Operations, including branches and IHC with flexibility in creating the U.S. Risk Committee under the Group Board or the IHC Board

There are numerous other Prudential Standards on the Federal Reserve's 2014 regulatory agenda that are relevant for foreign banks (depending upon size and scale)

Timeline for FBO EPS implementation

The implementation date is postponed a year to July 1, 2016 (and transition dates for leverage ratio and capital stress testing). An implementation plan is required by January 2015.

Ten key highlights of finalised rules



[5]Applicable to foreign banking organisations that have U.S. non-branch assets of $50 billion or more as of 6/30/14 . 90% of non branch assets transferred to IHC. US non-branch assets are defined as equal to the sum of the consolidated assets of each top-tier U.S. subsidiary of the foreign banking organisation (excluding any section 2(h)(2) company and DPC branch subsidiary, if applicable).

[6]Quarterly implementation plan updates beginning January 2015 through January 2018 for IHC formation and risk and liquidity compliance implementation.

[7]The term “subsidiary” would be defined using the Bank Holding Company Act definition of control, such that an FBO would be required to transfer its interest in any U.S. subsidiary for which it: (i) directly or indirectly or acting through one or more other persons owned, controlled, or has power to vote 25 percent or more of any class of voting securities of the company; (ii) controlled in any manner the election of a majority of the directors or trustees of the company; or (iii) directly or indirectly exercised a controlling influence over the management or policies of the company.

Key areas of focus and compliance timeline for FBO

Foreign Banking Organisation (FBO)

U.S. Operations

Focus Area	Due Date
Entities with U.S. operations TA+TL between USD 10B and USD 25B are required to routinely report quantitative measurements	Dec 31, 2016
Entities with U.S. operations TA+TL between USD 25B and USD 50B are required to routinely report quantitative measurements	April 30, 2016
Re-evaluate and conform all covered activities (covered trading and covered funds) based on final Volcker Rule	July 21, 2015
Establish minimum compliance program (Timeline for enhanced compliance same as metrics)	July 21, 2015
Potential accounting impact of Other than temporary impairments (OTTI) on existing investments in covered funds	Immediate

Non-U.S. Operations

Focus Area	Due Date
Quantitative measures need to be reported for non-U.S. activities that do not meet the SOTUS exemption, if U.S. operations TA+TL is between USD 10B and USD 25B	Dec 31, 2016
Quantitative measures need to be reported for non-U.S. activities that do not meet the SOTUS exemption, if U.S. operations TA+TL is between USD 25B and USD 50B	April 30, 2016
Evaluate and conform all foreign covered activities (covered trading and covered funds) • Permitted foreign activities of foreign banking entities • Other permitted activities	July 21, 2015
Establish minimum compliance program (This would be part of the overall compliance program requirement indicated under the U.S. Operations)	July 21, 2015

Develop Conformance Plan: One year extensions, if required, should be filed by January 2015

Comply with

- ✓ **Reporting and recordkeeping requirements by April 30, 2016 / December 31, 2016**
- ✓ **Volcker prohibitions and minimum compliance standards by July 21, 2015**

What is Dodd Frank Act?

Dodd-Frank is intended to reduce risks to the financial system by imposing new requirements to:

- Prohibit or curtail activities
- Improve transparency
- Extend regulation to previously unregulated activities
- Provide regulators with new powers

Dodd-Frank requires various US regulatory agencies to propose and adopt specific rules to implement it.

Overview of Dodd Frank Act

- On 21 July 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act) into law.
- The Act is considered the most significant overhaul of financial rules and regulations in the US since the 1930s; it includes hundreds of new rules and numerous studies and reports.
- Companies must consider the impact of the new law within the context of reforms already being pursued under existing authorities. Given the range of studies and reports mandated by Congress and the extensive regulatory rulemaking process, financial reform will remain an ongoing process for the next few years.
- Reforms are broad, but there are five key themes:
  - Focus on market stability and systemic risk
  - Enhanced Prudential regulation and supervision
  - Greater transparency and disclosure
  - Restriction on activity for banks
  - Consumer and investor protection measures

Key regulations stemming from Dodd-Frank

Strategy and operating model

- Continuing strategic consolidation based on U.S.
  Regulatory challenges
- Optimising product, pricing, and distribution in the U.S.

Capital and liquidity

- Mitigating impact on U.S. operations from recent European bank stress tests
- Determining interplay between Dodd-Frank and other regulatory mandates (e.g., Basel III)

Enterprise architecture and data strategy

- Understanding new and future cross-border
  reporting requirements
- Gathering and delivering the required information to regulators efficiently

Compensation

- Understanding impact of U.S. regulations on employee compensation
- Determining likely changes in compensation and disclosure practices

Core U.S. Businesses

Corporate and Investment Banking

- Capital Markets, including Broker/Dealers
- Structured Finance
- Commercial Banking

Investment Solutions

- Asset Management
- Private Equity

Financial Investments

- Investments

Living wills

- Determining Fed/FDIC expectations to comply with recovery and resolution plan completion
- Assess jurisdictional requirements in other countries requiring a RRP response

Derivatives

- Understand both strategic and tactical implications of “push-out” provision
- Determining strategy in registering as a swap dealer
- Determine rules for compliance as a registered swap dealer

Systemic risk

- Understanding the roles of various regulatory bodies (e.g., FSOC, OFR) in oversight of legal entity identification and SIFI capital add on charge
- Dealing with necessary requirements if designated a SIFI

Proprietary trading

- Demonstrating to regulators that it is not engaging in proprietary trading
- Implementing on-going compliance, monitoring and metrics
- Ensuring that investments in hedge funds and private equity are contained within prescribed conditions and limits

Assessing legislative impacts on a sector by sector basis demonstrates the law's reach

	Key sectors				
Titles	**Banking**	**Securities**	**Insurance**	**Asset management**	**Payments**
1. Financial stability	●	●	●	●	●
2. Orderly Liquidation Authority	●		●		●
3. Transfer of powers	●				
4. Regulation of advisers to private funds	●			●	
5. Insurance			●		
6. Improvements to regulation of banking institutions	●				●
7. Wall street transparency and accountability	●	●	●	●	
8. Payment, clearing, and settlement supervision	●				●
9. Investor protections and improvements to securities regulation	●	●	●	●	
10. Bureau of Consumer Financial Protection	●				●
11. Federal Reserve System provisions	●				●
12. Access to mainstream financial institutions	●				
13. Pay It Back Act	●		●		●
14. Mortgage Reform and Anti-Predatory Lending Act	●				
15. Miscellaneous provisions	●				
16. Section 1256 contracts	●	●	●	●	

Peer institutions are acting albeit at a different pace

Capital and liquidity

- Enhancing stress testing regime and data infrastructure
- Developing prototypes of countercyclical capital instruments
- Focused on capital and liquidity implications of Basel III including considering modifications to internal capital allocation and pricing
- Analysts already measuring liquidity ratios based on public data (and assumptions)

Bureau of Consumer Financial Protection

- Analysing new fee and cost structures
- Reviewing disclosures
- Shoring up their overall compliance programs and increasing consumer protection compliance testing activities in anticipation of increased oversight

Analytics and data initiatives

Initiatives vary from “spot” solutions to enterprise wide:

- Building a roadmap to develop integrated compliance, risk and finance and the identified data related issues
- Spot technology solutions

Compensation

- Responding to Fed’s horizontal review – covered employees, claw backs factor into the process
- Looking into other forms of compensation beyond cash
- “Stress testing” compensation programs

Resolution plan

- Five banks required to submit plans
- UK banks developing living wills (and some major U.S. banks)
- Governance and data are critical component of this process

Volcker Rule

- Some institutions winding down proprietary trading businesses (e.g., JPMC, Goldman)
- Defining “prop trading” (and measuring)
- Divestitures (Citi sale of PE Fund)
- Strategic review to understand the implications of possible divestitures

Volcker Rule overview

Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 has added Section 13 to the Bank Holding Company Act (BHC Act) of 1956, which is commonly called "Volcker Rule1". Broadly, it prohibits banking entities (see definition below) from engaging in certain trading and investment activities as described below.

Proprietary trading	A banking entity is prohibited from trading any financial instruments as principal for its trading account subject to certain exclusions and exemptions
Covered funds	A banking entity as a principal is prohibited or restricted from the following (subject to certain exclusions and exemptions) • Directly/indirectly acquiring or retaining any ownership interest in the fund • Sponsoring the fund or • Engaging in covered transactions with the fund if the banking entity or any affiliate is an investment adviser or sponsor to the fund

Banking entity definition

- Any insured depository institution, i.e., any bank or savings association the deposits of which are insured by the FDIC as per section 3(c) of Federal Deposit Insurance Act (FDIA)
- Any company that controls an insured depository institution (such as bank holding company or a savings and loan holding co.)
- Any company that is treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978
  - This prong of the definition will generally capture a foreign bank that has a U.S. branch or agency
- Any affiliate or subsidiary of any entity described in points 1, 2 or 3 above

Volker Rule – Prohibited / permitted activities

Section 619 of the Dodd-Frank Act, also known as the Volcker Rule11, prohibits banking entities (i.e., an insured depository institution, a U.S. BHC, a foreign bank with a U.S. branch or agency, and any affiliate or subsidiary of the foregoing) that benefit from federal guarantees from certain trading and investing activities, subject to certain exceptions.

Key prohibited activities

Prohibited trading activities include:

- Engaging in proprietary trading where it uses its own capital to assume "principal" risk in order to benefit from near term price movements

Prohibited covered fund activities include:

- Investing in or sponsoring hedge funds and private equity funds subject to certain qualifying exclusions (e.g., qualifying asset-backed commercial paper conduits, qualifying covered bonds, etc.)
- Entering into a "covered transaction" with a related covered fund or a covered fund controlled by such related fund (Super 23A)

Limitations on permitted activities:

- Permitted proprietary trading and covered fund activities that create a material conflict of interest between the banking entity and its clients, or result in material exposure to high-risk assets or high-risk trading strategies, or pose a threat to the safety and soundness of the banking entity or to the U.S. financial stability may be deemed impermissible

Key permitted activities / exemptions / exclusions

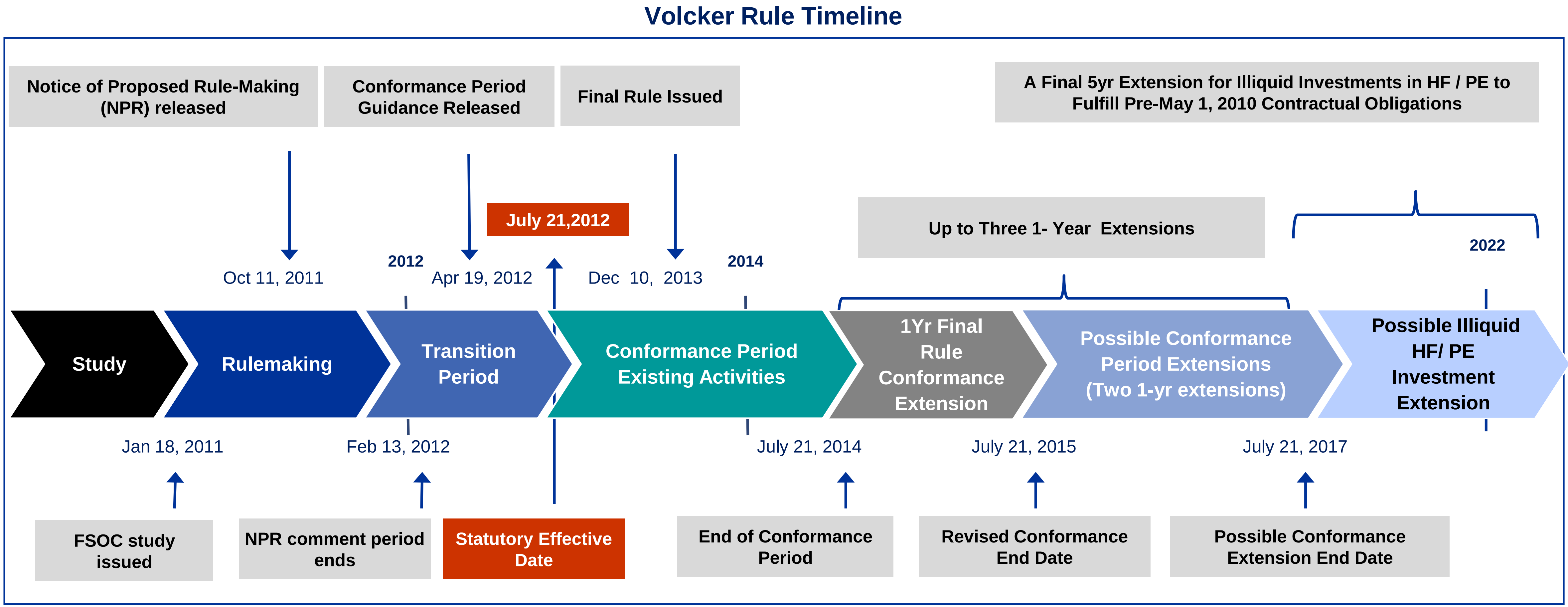
Permitted trading activities and product exemptions include:

- Trading in U.S. government obligations and foreign sovereign debt
- Underwriting, market making and risk-mitigating hedging activities
- Trading on behalf of customers
- Permitted trading activities of foreign banking entities
- Product exemptions (e.g., trading in loans, spot commodities & FX)
- Trading account exclusions (e.g., repo / reverse repo arrangement, securities lending, liquidity management activities, etc.)

Permitted Fund Investments include:

- Providing bona fide trust, fiduciary, commodity trading advisory or investment advisory services as part of its business
- Investments by foreign banking entity in / sponsoring a foreign fund
- Permissible investments are de minimis (per fund and aggregate limitations)
- Underwriting & market making in ownership interests of a covered fund

Volker Rule timeline



Proprietary trading: Exclusions and exemptions

The Volcker Rule specifies distinct treatment for transaction activities that are based on type of financial instrument, transacting objective, asset types, and geography.

Out of scope activities (‘Scope Exclusions’)	Rule exclusions	Permitted activities / exemptions
• Positions passing the three prong test. This may potentially include: – HTM portfolio – AFS portfolio’s that meet the qualifying criteria – Investments in subsidiaries – Other long-term investments • Cash • Receivables • Certain liabilities and debt	• Activities excluded from the definition of proprietary trading – Loans – Repurchase/ reverse repurchase transactions – Securities lending – Liquidity management • Excluded from the definition of a financial instrument – Currencies – Spot commodities	• Underwriting • Market making • Risk mitigating hedging • U.S. government trading • Trading in foreign sovereign bonds • Solely outside the United States (SOTUS) (for FBOs only) • Trading on behalf of customers • Permitted insurance company transactions

Considerations

Each of these exclusions and exemptions are subject to related qualifying criteria, supervisory oversight, ongoing compliance monitoring, measurement, testing and – for larger banking organisations – reporting of quantitative measures. Accordingly, all transactions, positions and customers need to be classified and categorised to facilitate executing these requirements.

Covered funds overview

While the Volcker Rule prohibits acquiring or retaining an ownership interest in and having certain relationships with a covered fund, it provides certain exclusions (both fund specific and ownership interest) and also allows for certain permitted activities in covered funds (subject to certain limitations).

Covered fund definition

Section 3(c)(1) or 3(c)(7) issuer

An issuer that would be an investment company, as defined in the Investment Company Act, but for section 3(c)(1) (i.e., not owned by more than 100 persons) or 3(c)(7) (i.e., owned by qualified purchasers) of that act

Covered commodity pools

A commodity pool where the Commodity Pool Operator (CPO) has claimed exemption under CFTC Regulation 4.7 or CPO is registered with CFTC and substantially all participation units are owned by “qualified eligible persons”

Covered foreign funds (for US banks only)

Any issuer that is organised and offered outside of the US that would be a covered fund if it is organised and offered under the laws or offered to one or more residents of the US.

Exclusions

Covered fund exclusions

- Foreign public funds
- Wholly-owned subsidiaries
- Foreign pension/ retirement funds
- Insurance company separate accounts
- Bank owned life insurance
- Loan securitisations
- Qualifying asset-backed commercial
- Qualifying covered bonds
- Federal Deposit Insurance
- Corporation (FDIC) receivership/conservatorship operations

Ownership interest exclusions

- Acquired by banking entity acting solely as agent, broker or custodian
- Activity on behalf of customers as trustee or in fiduciary capacity with no beneficial ownership
- Acquired or retained in the ordinary course of collecting a previously contracted debt

Permitted activities

Organising and offering, underwriting and market-making a covered fund

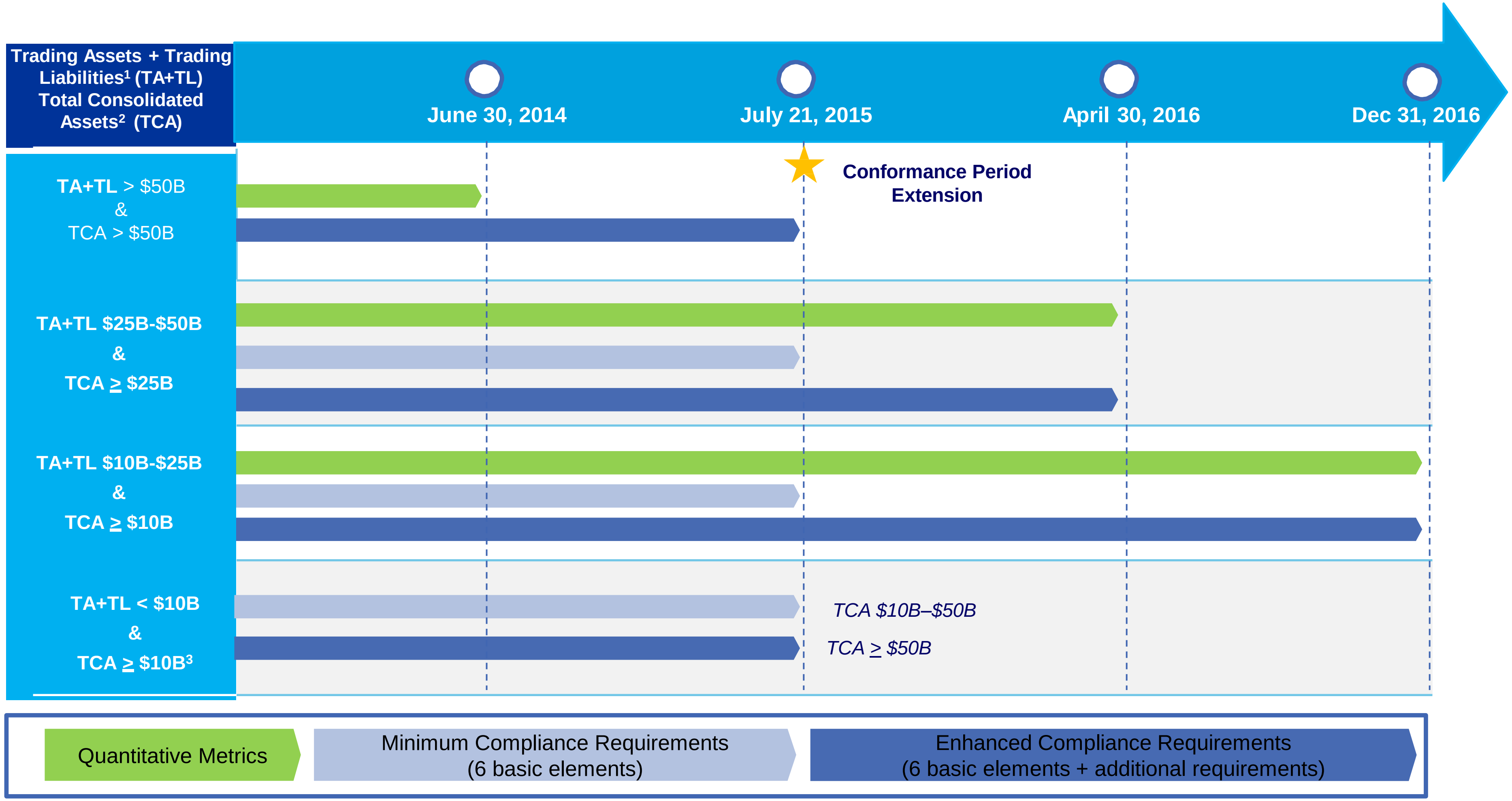
- Organising and offering a covered fund in general, subject to:
  - Per fund and aggregate level limitations
  - Section 23A/23B limitations
  - Other: e.g., providing bona fide trust, fiduciary, investment advisory services
- Organising and offering an issuing entity of asset-backed securities, subject to:
  - Per fund and aggregate level limitations
  - Section 23A/23B limitations
- Underwriting and market-making in ownership interest of a covered fund, subject to:
  - Underwriting and market-making requirements of covered trading activities
  - Per fund and aggregate level limitations

Other permitted covered fund activities & investments

- Risk mitigating hedging in connection with a compensation arrangement
- Activities conducted solely outside the U.S.
- Activities by a regulated insurance company

Timeline for compliance and metrics reporting by size

As part of the final Volcker Rule, regulators have adopted a tiered approach requiring banking entities to comply with the quantitative metrics and compliance program requirements based on their size of Trading Assets and Liabilities and Total Consolidated Assets.



Banking organisations with trading assets and liabilities and total consolidated assets less than USD 10 Billion may satisfy the compliance requirements by rolling them up in their existing compliance policies and procedures.

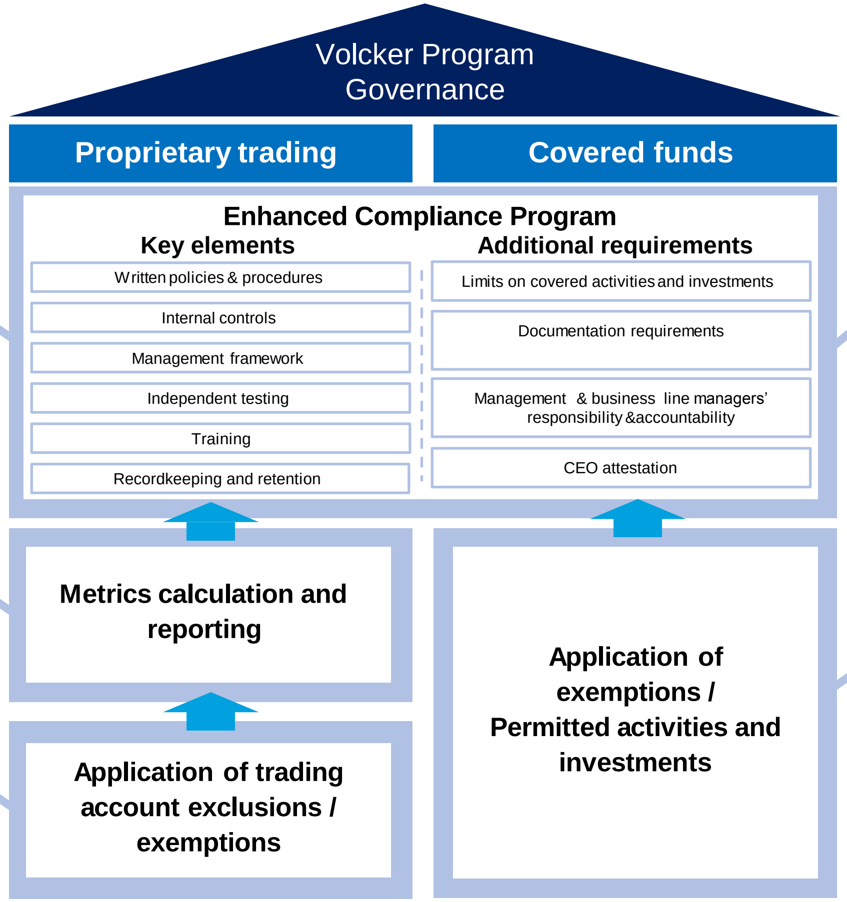
Key components for compliance with the Volcker Rule

Compliance with the Volcker Rule proprietary trading and covered funds restrictions will require banking entities to undertake a detailed inventory and analysis of their trading and covered funds universe along with designing and building the infrastructure capabilities to meet the on-going monitoring and compliance program requirements.

- Governance and operating model for compliance program
- Implement six elements of the compliance program
- Solutions for on-going monitoring and surveillance, and remediation framework

- Define governance and operating model for data sourcing, computation, validation and reporting of metrics
- Requirements analysis & documentation (business, functional , technical)
- Metrics calculation solution and reporting infrastructure design

- Mapping and logical grouping of trading desks against Volcker product exemptions and exclusions, & permitted activities
- Systematic approach / framework for analysing and classifying trading activity to Volcker exclusions and exemptions (“on-going”)



- Governance and operating model for compliance program
- Documentation of organisational unit’s authority to engage in covered fund activities
- Solutions for on-going covered fund monitoring and surveillance, and remediation framework

- Evaluate covered funds against permitted activities and investments provisions, including: meeting the ‘per fund’ and ‘aggregate’ limits, Super 23A and 23B requirements, SOTUS, etc.
- Systematic approach / framework for analysing and classifying covered fund investments and transactions (“on-going”)

Key challenges in implementing Volker Rule

		Challenges
Governance	*Managing organisational and structural change*	• Fundamental shift in organisational structures • Establishing a governance framework (i.e., appropriate committees)
	Embedding Volcker in the organisation	• Change in the organisation culture, especially front-office and risk management
	Meeting attestation and reporting requirements	• Meeting the CEO attestation and certification requirements in a tight timeframe • Establishing a compliance framework and right level of controls
Scope	*Determining Volcker reach and impact*	• Assessing rule reach • Assessing applicability and implications to the organisation and its overall activities
	Managing global coordination	• Determining impact on “non-covered” entities (i.e., entities outside US jurisdiction /affiliates) • Developing a global compliance program structure
	Maximising exemptions	• Reorganising booking models and investments
Compliance	*Monitoring and controlling trading activity*	• Defining certain trading activities for some asset classes as permissible (i.e., hedging and market-making)
	Mobilising metrics and quantitative controls	• Embedding metrics into existing supervision function • Calculating, reporting and setting thresholds
	Managing investments and covered funds	• Validating rule impact and making strategic decisions • Implementing front line controls that limit and/or block investments and sponsorships • Determining the level of data capture and IT infrastructure necessary to support implementation

Speaker’s profile

Speaker’s profile

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Hansel is a Director with the enterprise risk services practice in Singapore and Southeast Asia. He has more than 10 years of corporate experience in Asia and the Middle East, overseeing and managing regulatory risk management in the financial services and capital markets industry. Prior to joining Deloitte, Hansel was the head of the financial services risk management practice in one of the largest Southeast Asia economies as its Technical Advisor. In his advisory capacity, he had oversight of key engagement activities with global financial institutions from U.S., Europe, U.K. and Asia.

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