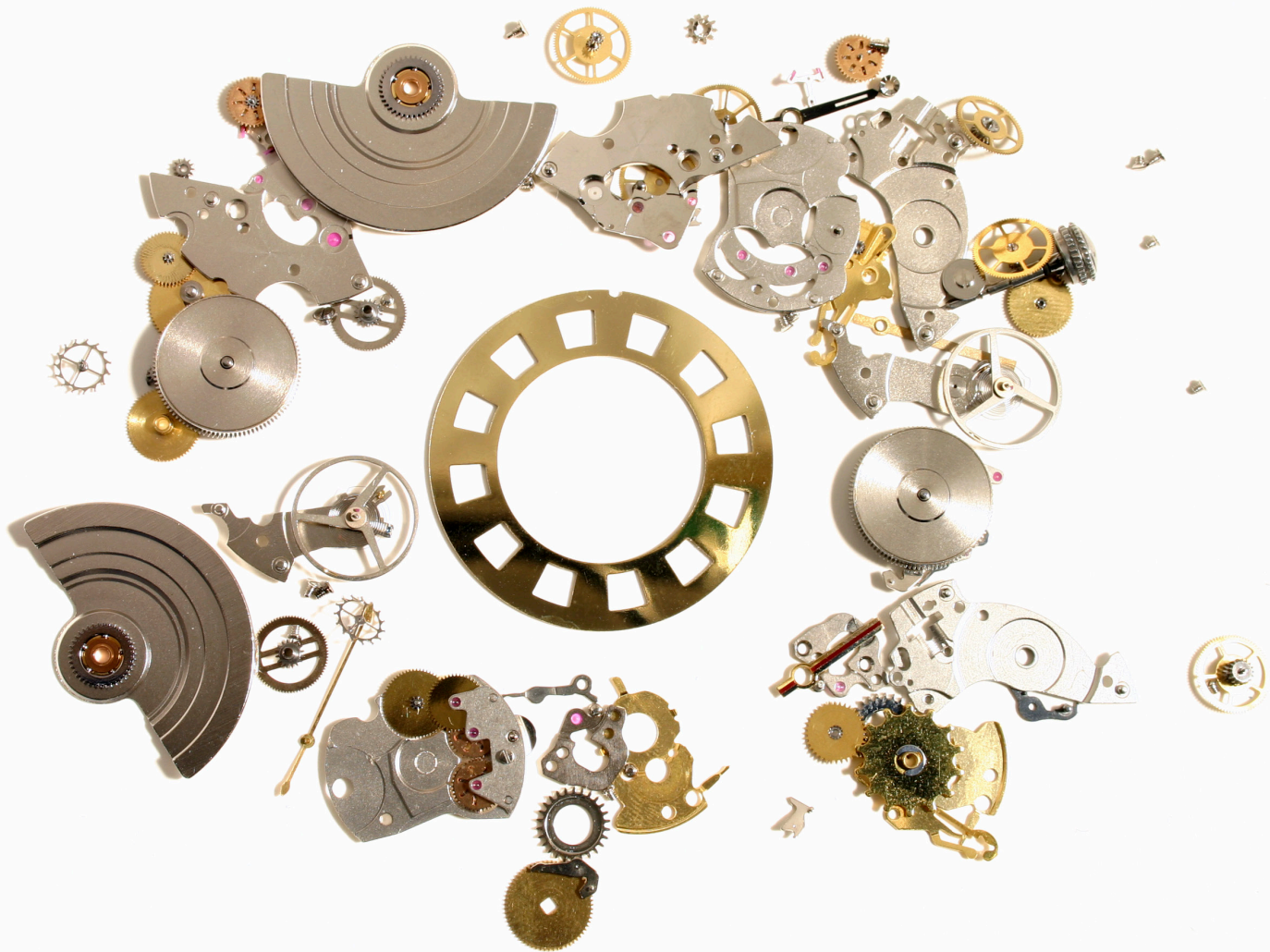


The final Volcker Rule  
What does it mean for banking  
institutions?

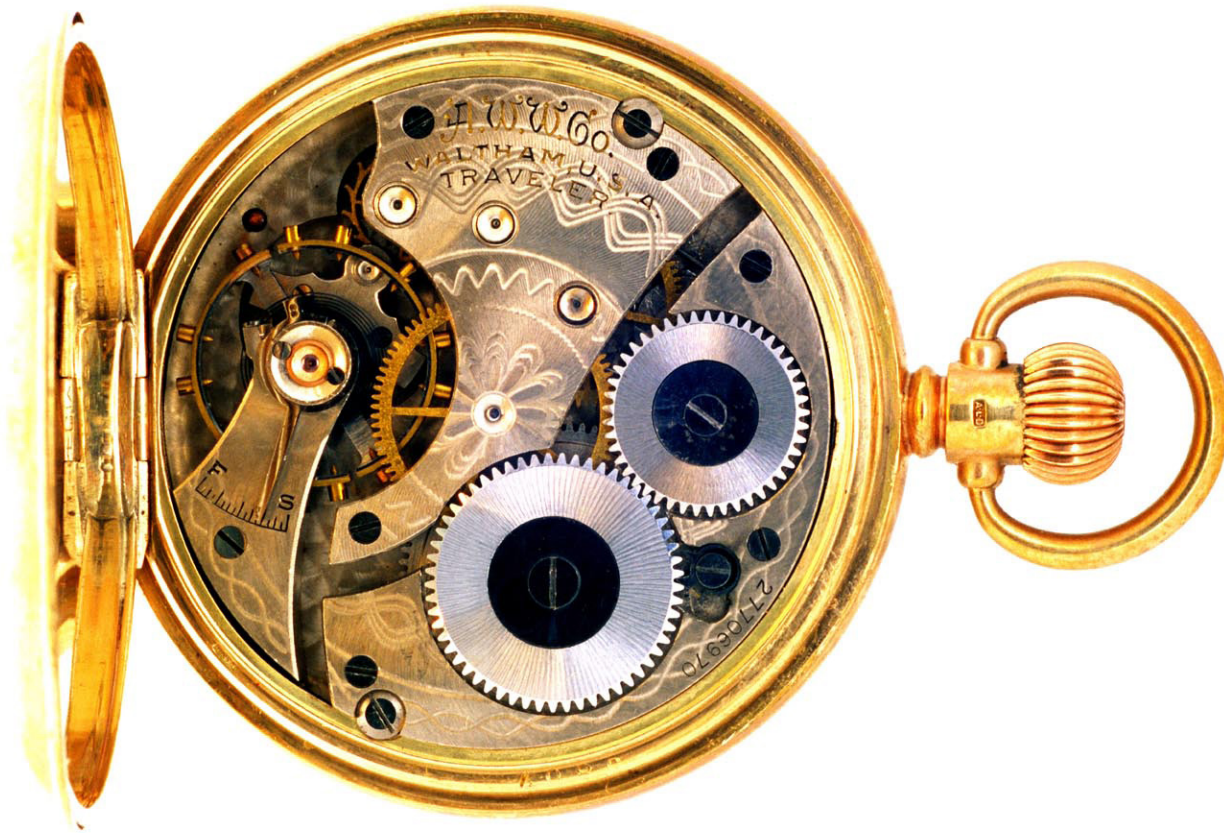




# Introduction

In the spirit of the holidays, there are some hoped-for elements of relief in the final<sup>1</sup> Volcker Rule, which was approved and released by the U.S. regulators on December 10, 2013. The scope of the market making exemption is broader than in the notice of proposed rulemaking<sup>2</sup> (NPR), the minimum threshold for metrics reporting has increased, the number of required metrics is reduced, and the regulators have provided an extension of the conformance period by one year to July 21, 2015. Foreign banks (and foreign governments) may also be heartened, as the final rule is less restrictive in several ways, including the scope of permissible foreign banks' non-U.S. activities, and the permissibility (albeit with limitations) of trading in foreign sovereign debt.

But make no mistake – the impact of the rule will be significant. Some requirements have become more stringent, the compliance bar overall has been set high, and there is much work to do. This document highlights some key operational considerations for banking organizations' compliance with the rule requirements.



<sup>1</sup> "Agencies Issue Final Rules Implementing the Volcker Rule," Federal Reserve news release, Dec. 10, 2013, <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210a1.pdf>.

<sup>2</sup> "Federal Reserve seeks comment on proposal to implement 'Volcker Rule' requirements of the Dodd-Frank Act," Federal Reserve news release, October 11, 2011, <http://www.federalreserve.gov/newsevents/press/bcreg/20111011a.htm>.

# 10 key considerations for banking entities

**1 Broader interpretation and judgment.** The final rule allows for – and requires – greater judgment in an institution’s interpretation of what is permissible vs. impermissible in certain areas (i.e., market making, hedging, etc.). On its face, one might believe this is a pure plus. However, such judgment may also serve to introduce greater compliance risk. We know that after bad things happen, hindsight vision is 20-20. Banking organization personnel may find the application of judgment to be more complex. Additionally, operationalizing judgment to preclude unintended inconsistency is a challenge in large organizations where information and decision making is typically somewhat compartmentalized.

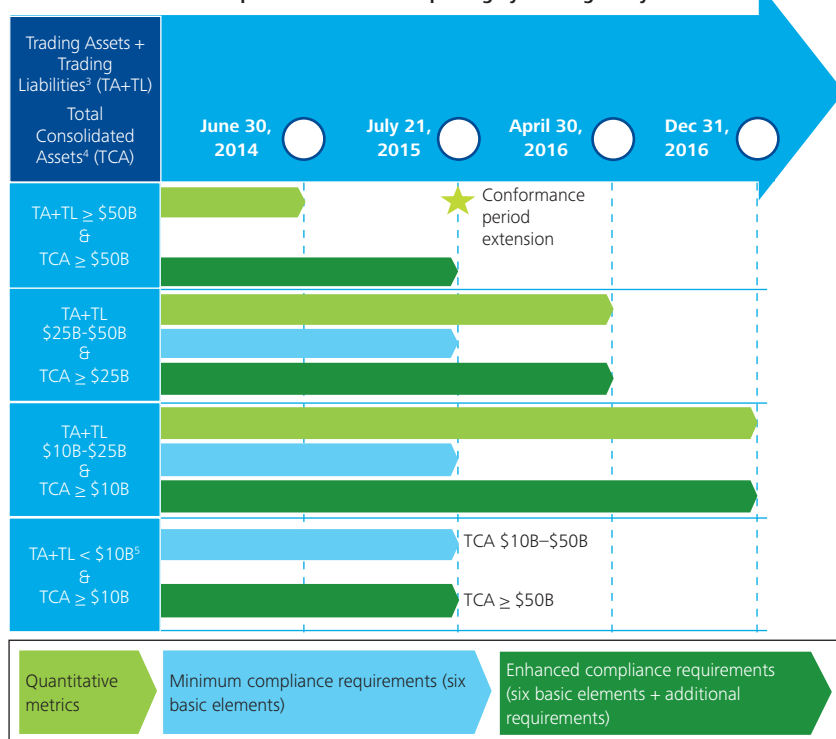
**2 Risk-mitigating hedging.** The good news is that the risk-mitigating hedging exemption permits the hedging of not only individual but also aggregate risk. The bad news is that complying with this exemption will be complex. The requirements include identification of the risks being hedged, demonstrable reduction or mitigation of the identified risk, contemporaneous documentation, and demonstrating correlation both prior to execution and on an ongoing basis. These requirements are somewhat analogous to certain requirements present in U.S. GAAP and IFRS accounting standards. Individuals that have experience in applying the accounting standards well understand that it is difficult to industrialize and sustain executing these types of requirements. The breadth and scope of hedging/risk mitigation at large organizations – including treasury activities that are included within the scope of the Volcker Rule – will necessitate that such capabilities for complying with the exemption be robust.

**3 Reporting metrics.** The number of metrics required to be reported have in fact been reduced from 17 in the NPR to seven. Most notably, the final rule does not require the calculation of “spread P&L.” Additionally, the “inventory risk turnover” has been replaced by a requirement to calculate a simpler “inventory turnover” metric. Nevertheless, the calculation of metrics at institutions is – in some cases – inconsistent across desks and inconsistent across metrics (e.g., risk sensitivity vs. comprehensive P&L attribution). However, the rule specifies that a larger banking organization “may need to develop other quantitative measurements...to have an effective compliance program.” Additionally, institutions with greater than or equal to \$50B of trading assets and trading liabilities will need to start reporting their metrics in six months. Alternatively, institutions with less than \$10B of trading assets and trading liabilities will not have to report metrics at all; however, many of these smaller institutions will nevertheless be required to calculate and monitor them, or calculate and monitor metrics of their own design.

**4 Book structure and control processes.** For the largest banking organizations, a foundational internal control will be the integrity and robustness of trading book structure and related control processes. The book structure aligns with the trading desk concept and underlies the operational basis for applying metrics, distinguishing between risk positions and hedges, and effecting compliance monitoring. An appropriately designed book structure and robust related book control processes will be critical to efficient and effective compliance especially at larger banking organizations.

**5 Compliance requirements.** Generally, banking entities exceeding \$10 billion in consolidated assets will be required to implement a program of compliance. The compliance program would need to be “appropriate for the types, size, scope, and complexity of activities” for the banking organization. At a minimum, the program is required to include policies; limit setting, monitoring, and management; internal controls designed to monitor compliance; independent testing and audit of the

**Exhibit 1. Timeline for compliance and metrics reporting by banking entity size**



<sup>3</sup> For U.S. banking organizations, the trading assets + liabilities will be based on the worldwide consolidated trading assets and liabilities (excluding U.S. government obligations); for foreign banking organizations (FBOs) the trading assets and liabilities will be based on the trading assets and liabilities across all U.S. operations (excluding U.S. government obligations).

<sup>4</sup> For U.S. banking organizations, the total consolidated assets will be based on the worldwide consolidated total assets as of the previous calendar year end; for FBOs, the total consolidated assets will be based on total assets across all U.S. operations.

<sup>5</sup> While banking organizations within this tier are not subject to the quantitative metrics reporting requirements, they would be subject to the recordkeeping requirements (including the requirement to promptly produce such records to the relevant agency upon request) by virtue of the compliance requirements.

effectiveness of the compliance program; and retention of records sufficient to demonstrate five years of compliance. The enhanced minimum standards for programmatic compliance apply to larger banking entities based on varying thresholds including U.S. institutions with greater than or equal to \$50 billion in total consolidated assets. These requirements are more stringent – and are too detailed to list. The final rule clarifies that institutions will need “ongoing, timely monitoring and review of calculated quantitative metrics” and the establishment of “numerical thresholds” for each trading desk, and undertake “immediate review and compliance investigation when quantitative measurements or other information suggest a reasonable likelihood” of a trading desk violation. Some large institutions may have hoped to implement compliance monitoring on more or less a monthly basis. In this regard, a monthly review or monitoring cycle does not appear to be sufficient.

**6 Responsibility and accountability.** Responsibility and accountability under the rule are significant. The enhanced minimum standards for programmatic compliance impose significant responsibility on the board of directors. Senior management is responsible for “implementing and enforcing the compliance program,” and is “responsible for reviewing the compliance program and periodically reporting to the board (or committee thereof) on compliance matters and program effectiveness.” Business line managers are “accountable for the effective implementation and enforcement of the compliance program” for applicable trading desks. Lastly, the chief executive officer (CEO) of the banking organization must annually attest in writing to its regulator that the banking organization has in place processes to establish, maintain, enforce, review, test, and modify the compliance program. While the standard of CEO certification is less than what many discussed, the responsibility and accountability provisions of the rule are collectively stringent. It is likely that many institutions will implement a regime of sub-certifications to support the CEO certification, as well as board and business line manager accountabilities.

**7 Functional responsibilities and interaction model.** All organizational units will be involved in compliance. Based on the foregoing, the accountability of front office and/or business unit personnel is clear. Risk and revenue related metrics, including “correlation” and “back-testing” requirements make significant finance and risk function responsibilities also certain. Interpreting rule requirements, the rigor of ongoing compliance monitoring, and the need

for evaluation and investigation suggest a prominent role for legal and compliance functions. Additionally human resources (personnel evaluation and compensation), treasury (ALM, investing, liquidity management, etc.), internal audit (testing and “independent assessment”) as well as technology and operations (enabling infrastructure and processes) all have important roles. We believe the configuration of roles and responsibilities, and the interaction model of functions, will be complex.

**8 Covered funds.** All banking organizations are subject to the final rule’s covered-fund provisions regardless of the size of their funds’ activity. The final rule provisions preserve the three percent per fund and tier 1 capital de minimus limits, as well as the Super 23A and Section 23B provisions. The final rule, similar to the proposed rule, does not exclude or grandfather pre-existing investments in covered funds or restricted relationships and transactions. In respect of such restricted relationships and transactions, the identification and conformance could be operationally challenging for large institutions with significant activity in this regard.

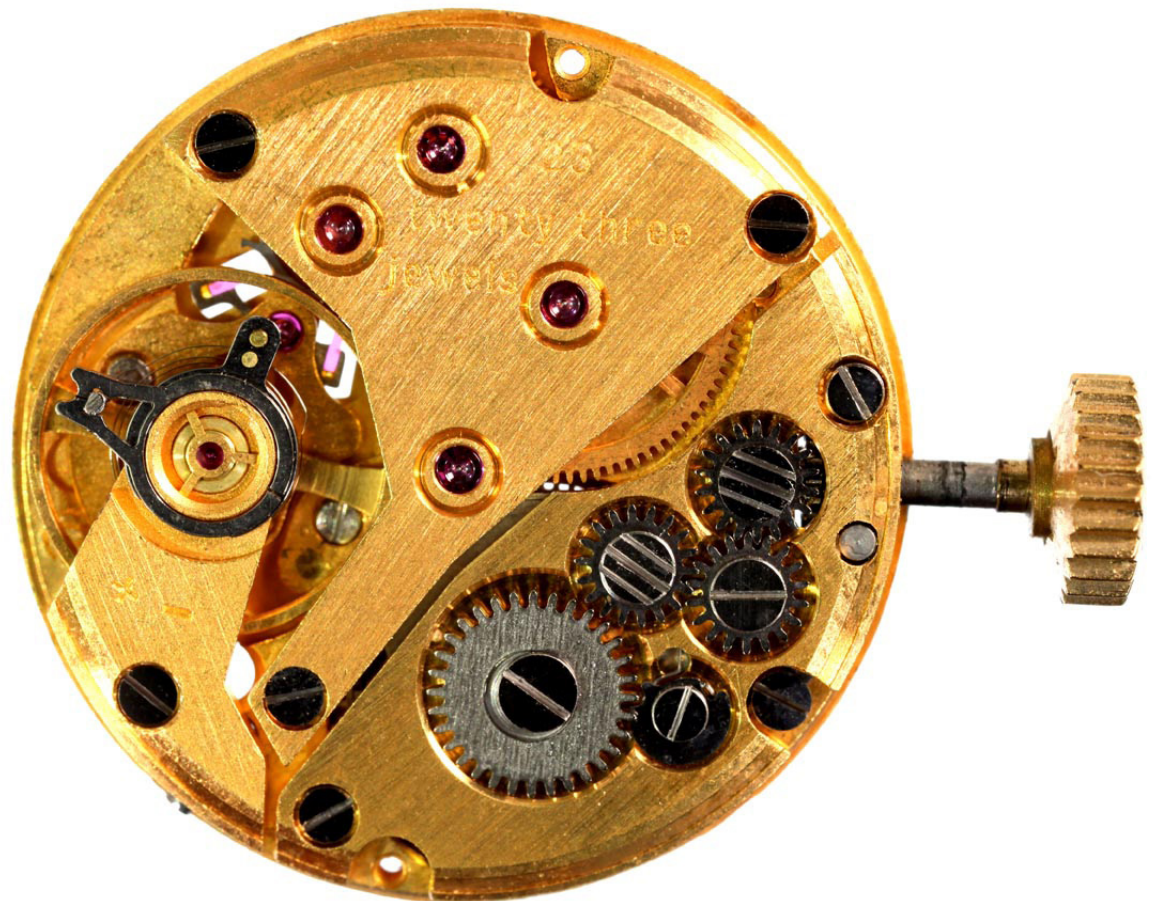
**9 Other than temporary impairments (OTTI).** The issuance of the final rule potentially triggers the recognition of OTTI, if there are instances in which underwater investments would now need to be disposed. Collateralized loan obligations and possibly other instruments may be ineligible for the covered fund exclusion. In such circumstances, even if disposition would be required at a later date, the impairment may need to be recognized earlier. Institutions should evaluate this issue.

**10 Interactions with other regulations.** There are interactions between the Volcker Rule and other regulations, including potential impacts related to Basel capital and nexus to the Basel III liquidity coverage ratio standards, Regulation W, proposed enhanced prudential standards (and proposed enhanced prudential standards for foreign banking organizations), and Dodd-Frank Title VII. The roughly coincident timing of implementation for complying with these other requirements, and leveraging – in certain instances – common methodologies, processes, and systems suggest that disciplined program management is likely to be key.



# Conclusion

July 21, 2015 may seem distant. However, except for the smallest banking organizations, a significant amount of work will need to be planned and executed in 2014. Unfortunately, 2014 is a year in which many other Dodd-Frank requirements will also need to be implemented. Financial institution personnel should understand the Volcker Rule requirements broadly in order to evaluate the distance between where they are now and where they will need to be, as well as to understand the interaction of these requirements with other in-flight initiatives. This understanding will assist institutions as to the proper sequencing and prioritization of their 2014 focus.



## Exhibit 2. Volcker Rule key highlights compared to the NPR

### Key highlights

#### Scope of application: Proprietary trading

**Market making:** Consistent with the NPR, the trading desk's inventory will need to be designed not to exceed, on an ongoing basis, the reasonably expected near-term demands of customers. However, banks will now additionally be required to provide demonstrable analysis of historical customer demand.

**Market making-related hedging:** The final rule has removed the requirement that hedges of market making-related activities meet the criteria of the risk-mitigating hedging exemption. Rather, such hedges are permissible trading activities if they are executed by the trading desk with the exposure, are consistent with the bank's documented risk management strategies for the market making desk, and demonstrably reduce or mitigate specific market making risks. However, hedges of market making exposures not executed by the trading desk with the exposure must meet the risk-mitigating hedging exemption criteria.

**Risk-mitigating hedging exemption:** While the final rule permits hedging of individual or aggregate positions, largely consistent with the NPR, it imposes the following additional requirements, which are expected to create significant operational burdens for banks claiming the exception:

- Portfolio hedging: Continues to permit hedging of aggregated positions, but imposes additional contemporaneous documentation requirements upon trade execution intended to ensure such hedges are demonstrably risk mitigating in the following situations:
  - Trading desk hedges positions established by other trading desks or business units
  - Hedge is not an existing documented and approved strategy
  - Hedges of positions of more than one trading or business unit
- Correlation requirement: Prior to execution, and on an ongoing basis as hedges are recalibrated, an entity must demonstrate that the hedge demonstrably reduces or mitigates the risk it is intending to hedge and the final rule reinforces that simply demonstrating mathematical correlation to risk is not sufficient if the hedge is not demonstrably risk reducing.

**Foreign bank non-U.S. trading:** The final rule allows foreign banking organizations to transact with the foreign operations of U.S. entities and enter into transactions cleared with U.S. market intermediaries under certain circumstances.

**Trading in foreign government obligations:** The final rule allows trading in obligations of a foreign sovereign or its political subdivisions under certain circumstances.

#### Scope of application: Covered funds

**Covered funds:** The covered funds rules are complex and will require a significant level of assessment to understand the impact and response required to comply. The rules:

- Join the definition of hedge fund and private equity fund into a single definition of covered fund
- Modify and/or clarify the list of permissible activity exemptions and increases the scope of those activities to include:
  - Qualifying asset-backed commercial paper conduits
  - Qualifying covered bonds
  - Registered investment companies and excluded entities
- Enhance the definition of loan to explicitly exclude securities and derivatives
- Emphasize that agencies will monitor banking entities for potential evasion of the rule
- Adopt documentation requirements for covered fund activities

#### Quantitative metrics

**Thresholds:** The final rule raises the threshold for reporting quantitative metrics whereby banks under \$10B of gross trading assets and liabilities are not required to report, so fewer institutions will be required to report metrics. The NPR had called for a threshold of \$1B.

**Required scope of metrics:** The number of metrics required to be reported is reduced to seven from the original proposed set of 17. Additionally, the same seven metrics are required for all trading desks, regardless of the type of permitted activity. The NPR varied the number of metrics based on the activity type.

**Computational level:** The final rule requires metrics to be calculated at only one level ("trading desk") of the organization. The NPR required the calculation at multiple "trading unit" levels.

**Reporting timeline for organizations with trading assets and liabilities > \$50B:** The largest banking institutions have a compressed timeline. Beginning June 30, 2014, they will be required to report quantitative metrics on a monthly basis to the regulators. This timeline is earlier than the original two-year conformance period ending on July 21, 2014.

**Reporting timeline for organizations with trading assets and liabilities < \$50B:** Compared to the largest banking institutions, the reporting timeline for banking entities in this category has been phased (varies by size of trading assets and liabilities) and extended into 2016, which is beyond the revised conformance date of July 21, 2015. Additionally, the reporting requirement is on a quarterly basis, compared to a monthly reporting requirement in the NPR

#### Compliance program

**Thresholds:** Banks with less than \$50B in total assets and with moderate covered activity now need only comply with the six basic elements of the compliance program, while banks with less than \$10B in total assets and with moderate covered activity can adapt their existing compliance program to the rule. The largest and most active banks still fall under the "enhanced" compliance program requirements.

**Enhanced compliance program:** While the enhanced compliance program should now apply to fewer banks due to the modified thresholds, the requirements are now more detailed about what is required of banks that meet the criteria (e.g., requiring detailed documentation at the desk level, ongoing review of quantitative metrics including periodic and independent back-testing, etc.). Hence, even where banks have existing compliance programs, they will have to ensure they are in compliance with these more detailed requirements.

**CEO certification:** CEOs need to annually attest in writing that their organization has the procedures to establish, maintain, enforce, review, test, and modify the compliance program. Note that the scope of this attestation is to the compliance program, not the company's compliance with the provisions of the Volcker Rule. This requirement was not included in the NPR although the Financial Stability Oversight Council had recommended it as part of its January 2011 study.

**Independent testing:** Periodic independent effectiveness testing can be conducted internally (e.g., by personnel considered independent such as internal audit, compliance or risk managers from another business unit). While testing by internal audit was specified in the NPR, other internal functions such as compliance or risk were not.

**Foreign banks:** The scope of assets included in the above thresholds has been clarified to be only those of U.S. subsidiaries, affiliates, branches, and agencies.

#### Conformance period

**Compliance deadline:** Banking institutions have an additional year to comply with the new rule – until July 21, 2015. The conformance period guidance released in April 2012 allowed for a two-year conformance period ending July 21, 2014.

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