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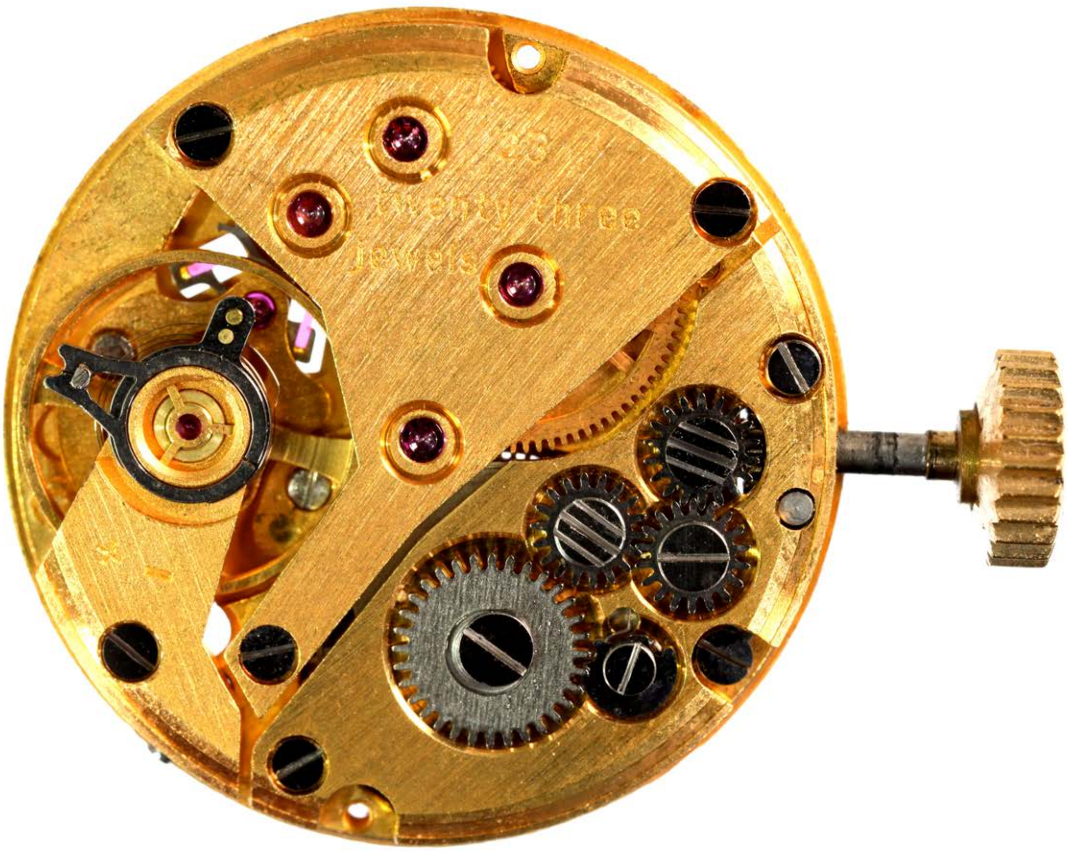
The Volcker Rule compliance monitoring program



Deloitte Center
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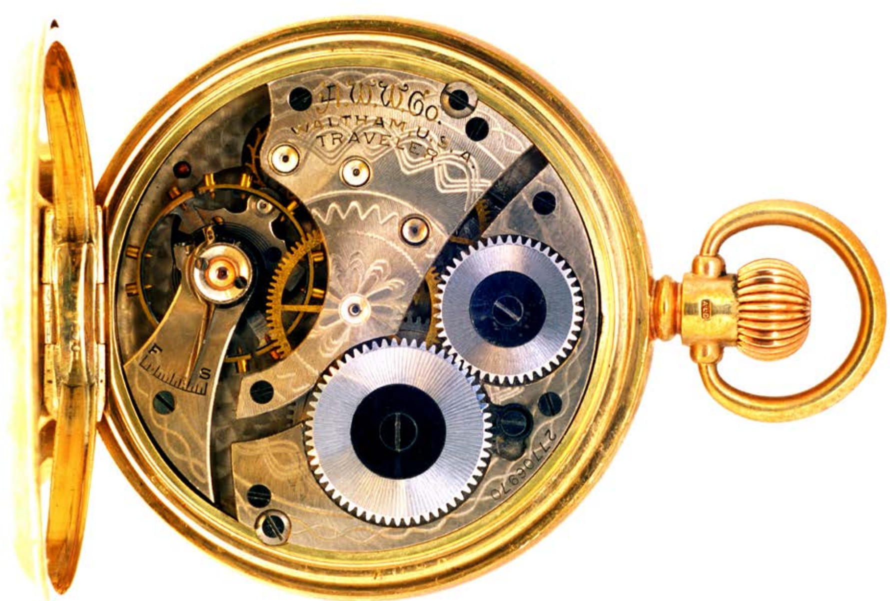
Contents

Introduction	**1**
Three types of compliance programs	**2**
Standard vs. enhanced compliance programs	**3**
Timing considerations	**5**
Roles and responsibilities	**6**
Technology considerations	**8**

Introduction

The final "Volcker Rule"[1] issued December 10, 2013, requires banking entities to demonstrate that prohibited proprietary trading is not taking place at their firms. While smaller, less complex banks obtain much relief in the final rule, medium-sized and larger banks must implement a rigorous compliance program. This paper explores the compliance program requirements for the proprietary trading restriction component of the Volcker Rule, in particular for these medium-sized and larger banks where much work is required with not much time to do it.

For most medium-sized banks, the so-called "standard" compliance program must be implemented by July 21, 2015. For larger banks or those with more active trading, an "enhanced" program is required, though the deadlines for implementation vary depending on the size of the bank's trading book (see Figure 1 for a summary timetable). For the very largest banks,[2] the enhanced program is required by the July 2015 date, in addition to the June 2014 deadline for reporting of quantitative metrics.[3] Because the regulation has specific requirements spelled out for underwriting, market-making, and hedging activities, the standard program is still quite demanding of banks with these activities.



Larger banks that already have policies and procedures (including automated workflows) regarding trading mandates and position/risk limits will be able to focus more on enhancing policies and procedures to cover the additional requirements and harmonizing the different business lines for a consistent operating model. They will also likely have to document much more rigorously their policies on hedging and justifying the classification of their inventories related to market-making.

Many medium-sized banks will have to create this infrastructure from the ground up, with monitoring tools and workflows related to breach management and remediation. Some of these firms may need to enhance their "three lines of defense" in delineating roles and responsibilities between business line managers, risk management and compliance, and internal audit, and applying this structure to the Volcker Rule compliance requirements.

With conformance dates soon approaching, firms need to quickly ramp up assessments of their current environment, build remediation plans, and marshal resources to implement them. With the lead time required to build or enhance a technology infrastructure to support a robust compliance program, firms will likely need to work in parallel with developing and documenting policies, procedures, and the limits that will drive the monitoring process.

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

[2] Banks with more than $50 billion in total consolidated assets (for foreign banking organizations, U.S. domiciled assets and liabilities only).

[3] If you would like to receive a copy of Deloitte's paper, "The Volcker Rule: 13 considerations for calculating and reporting quantitative measures," contact Seth Raskin at sraskin@deloitte.com.

Three types of compliance programs

The U.S. regulatory bodies that have approved the Volcker Rule (the "agencies")[4] received numerous comments on the proposed rules regarding the burden being placed on smaller U.S. banks that conduct little or no proprietary trading. The final rule relieves this burden by stating that those smaller (under $10B in assets) banks with no covered activities do not need to implement a compliance program unless they begin covered activities. And those smaller banks with moderate covered activity can implement a "simplified" compliance program satisfying the regulatory compliance requirements by adding references to the regulation in their existing policies and procedures.

However, banks with greater than $10B in total consolidated assets (nearly 100 U.S. banks and 50 foreign banks) must implement the "standard" compliance program, outlined in Subpart D of the regulation, by July 2015. This program has six required components for banks with covered activities and is accordingly sometimes also called the six-point compliance program:

1) **Policies and procedures** – These must be established at the desk-level to reflect authorized products and trading limits, and hedging strategies permitted by the rule.
2) **Controls** – A system of internal controls must be established to monitor compliance with the rule.
3) **Governance** – A management framework must be established with clear accountability for compliance, including periodic review of the limits laid out in the policies and incentive compensation arrangements.
4) **Independent testing** – Periodic independent testing and audit of the effectiveness of the compliance program must be performed by qualified independent personnel or an outside party.
5) **Training** – Banks must provide training to trading personnel, management, and others as appropriate to effectively implement and enforce the compliance program.
6) **Recordkeeping** – Documentation demonstrating compliance with the rule must be kept for five years and be readily available to regulators upon request.

[4] The regulatory bodies consist of the Board of Governors of the Federal Reserve System, Office of Comptroller of the Currency, Federal Deposit Insurance Corporation, Securities and Exchange Commission, and Commodity Futures Trading Commission.

The "enhanced" program described in Appendix B of the final rule provides more detail regarding the types of analyses the agencies require for large/complex banks. Those firms required to report quantitative metrics will need to implement the enhanced program by the time they are required to report these metrics (except those that begin reporting in June 2014 must have the enhanced program in place by July 2015).

Appendix B of the final rule reiterates many of the requirements laid out in Subpart B regarding the permitted activities of underwriting, market-making, and risk-mitigating hedging. In it, the regulators provide further detail on what large and/or complex banks should do in terms of quantitative analysis to demonstrate compliance with the rule and documentation of the suitability of the limits and hedging strategies. For example, Appendix B calls for detailed descriptions of the process for developing, documenting, testing, approving, and reviewing all models used for valuing, identifying, and monitoring the risks of trading activity and related positions. Beyond the more detailed description of a compliance program "appropriate" to complex banks, there are a few significant requirements that go beyond this; most notably that the enhanced program requires the CEO (or the senior officer in the U.S. for foreign banks) to attest in writing annually that a reasonably designed compliance program is in place.

Figure 1 below depicts the differing compliance program types and implementation deadlines required based upon the thresholds established for banking entity size and size of trading assets and liabilities.

Figure 1: Volcker Rule compliance program implementation deadlines

GTAL→ TCA↓	<$10B	$10B-$25B	$25B-$50B	>$50B
> $50B	July 21, 2015	July 21, 2015	July 21, 2015	July 21, 2015
$10B-$50B	July 21, 2015	July 21, 2015 Dec. 31, 2016	July 21, 2015 April 30, 2016	July 21, 2015
<$10B	July 21, 2015	July 21, 2015 Dec. 31, 2016	July 21, 2015 April 30, 2016	July 21, 2015

Legend: Enhanced Standard Simplified

Notes:
- The shaded cells represent firms that must implement the standard program by the earlier date, and the enhanced by the later date.
- TCA = Total consolidated assets
- GTAL = Gross trading assets and liabilities
- For foreign banks, TCA and GTAL refer to assets and liabilities domiciled in the U.S.

Standard vs. enhanced compliance programs

The standard compliance program laid out in Subpart D of the regulation may appear, on the surface, to be far less burdensome than the enhanced program described in Appendix B. But upon closer examination, the standard program references specific requirements in the sections on permitted activities, many of which are the same as the requirements laid out in Appendix B of the rule.

For example, the enhanced program mandates documented trading desk authorization for products, instruments, strategies, holding periods, and risk limits. For the standard program, similar requirements are spelled out in the relevant subparts for underwriting, market-making, and risk-mitigating hedging. While the enhanced program mandates that this documentation also indicate why such limits are appropriate, the standard program does not state this explicitly. However, it is likely that despite this difference, banks will be asked why the chosen limits are appropriate, so it behooves them to follow the enhanced guidelines in this regard.

The standard program also stipulates that the bank's compliance program must be "appropriate for the types, size, scope, and complexity of activities and business structure of the banking entity," so even mid-sized firms should consider whether or not they have any activities that might require specialized controls.

In short, whether or not explicitly subject to the enhanced program, banks would be wise to look carefully at all of the requirements and determine what is appropriate to their unique activities. The enhanced program could be considered as the agencies' view of leading practices, and therefore something to aspire to even if not a mandatory requirement.

Compliance program details

Below is a summary of the requirements of the compliance program, including the requirements indicated in the subparts related to permitted activities. Where there are substantial additional requirements in Appendix B, these are highlighted as well.

Compliance program details

Policies and procedures	Standard	• Establish written procedures "reasonably" designed to document, describe, monitor, and limit prohibited activities. • Establish written policies for each trading desk (usually referred to as "trader mandates") covering its mission, permitted financial instruments, limits (more specifically, authorized risk types and levels, holding period, and authorized hedging strategies), techniques, and instruments. • Establish written procedures "reasonably" designed to document, describe, monitor, and limit prohibited activities. • Design limits so as not to exceed the reasonably expected near-term demands of clients, customers, or counterparties.
	Enhanced adds	• Outline authorized types of clients, customers, and counterparties. • Map each trading desk to the division, business line, or other organizational structure responsible for managing the trading desk's activities. • Illustrate where permitted activity occurs in the organization, which exemption is relied on, and why. • Establish risk management documentation describing the supervisory and risk management structure governing all trading activity and new product approval; the process for developing, documenting, testing, approving, and reviewing all models used for valuing, identifying, and monitoring the risks of trading activity and related positions. • Outline a description of the process by which a security may be purchased or sold pursuant to the liquidity management plan and subsequent monitoring. • Establish policies for monitoring and prohibiting potential or actual material conflicts of interest between the banking entity and its clients, customers, or counterparties.

Compliance program details...continued

Controls	Standard	• Establish a system of controls "reasonably designed" to monitor compliance. • Create escalation procedures that require review and approval of any trade that would exceed a trading desk's limits. • Perform demonstrable analysis that any temporary increase to limits is consistent with relevant policy. • Perform ex-ante correlation analysis for hedge positions, techniques, and strategies that can be expected to mitigate the specific, identifiable risks (e.g., market risk, counterparty or other credit risk, foreign exchange risk, interest rate risk, commodity price risk, basis risk, etc.) being hedged; similar ex-post analysis demonstrating effectiveness.
	Enhanced adds	• Provide more detailed description of the types of analysis expected, including back-testing of quantitative measures. • Establish any additional quantitative measurements specifically tailored to the risks, practices, and strategies of the trading desk to ensure compliance. • Carry out ongoing and timely monitoring of quantitative measurements. • Review and escalate issues to senior management when quantitative measurements or other information (including findings of internal audit, independent testing or other review, considering facts and circumstances) suggest a reasonable likelihood of violation; provide timely notification to the relevant agency and documentation of the investigation and remedial action. • Monitor potential or actual material exposure to high-risk assets or strategies including Level-2 or -3 priced assets, hard-to-hedge products, new products, products with embedded leverage, significant historical volatility, etc.
Governance/ Management	Standard	• Outline a management framework that clearly delineates responsibility and accountability for compliance with the Volcker Rule and includes appropriate management review of trading limits, strategies, hedging activities, investments, incentive compensation, etc. • Provide demonstrable analysis to justify any permanent change to limits. • Design the compensation arrangements of persons performing the activities described in the rule so as not to reward or incentivize prohibited proprietary trading.
	Enhanced adds	• The CEO (or the senior U.S. management officer at a foreign banking organization) must annually review and attest in writing to the regulator that the bank has in place processes to establish, maintain, enforce, review, test, and modify the compliance program that are "reasonably" designed to comply with the rule. • The board of directors, an appropriate committee of the board, or equivalent governance body and senior management must approve the compliance program and ensure that senior management is capable, qualified, and motivated to manage compliance. • Senior management is responsible for implementing and enforcing the compliance program and ensuring corrective action is taken when failures are identified; senior management must report to the board at least annually on the effectiveness of the program. • Business line managers are accountable for the effective implementation and enforcement of the compliance program for their desk(s).
Independent testing	Standard	• Conduct independent testing and audit of the effectiveness of the compliance program periodically using qualified personnel of the banking entity or a qualified outside party.
	Enhanced adds	• Document the process for periodic independent testing of the reliability and accuracy of risk models. • Document the role of the audit, compliance, risk management, and other relevant units for conducting independent testing of trading and hedging activities, techniques, and strategies.
Training	Standard	• Conduct training for trading personnel and managers, as well as other appropriate personnel, to effectively implement and enforce the compliance program.
	Enhanced adds	• N/A
Record-keeping	Standard	• Keep records sufficient to demonstrate compliance with the rule and promptly provide to the regulators upon request. • Retain records for a period of no less than five years.
	Enhanced adds	• N/A

Timing considerations

While reporting of quantitative metrics to the agencies has specific requirements for timing, the final rule is not specific regarding internal reporting and monitoring. It is up to the individual firm to determine what is "appropriate to the size and complexity" of the organization. For those firms required to report quantitative metrics, given that the rule specifies daily measurement, it would seem the regulators expect daily monitoring of these as well. The requirement for "ongoing monitoring and analysis" of each trading desk's compliance with the limits related to underwriting, market-making, and risk-mitigating hedging, and to remediate breaches "promptly" would further suggest daily monitoring, regardless of the metrics reporting requirement.

Another question on timing is whether or not all trading activity can be monitored on a post-trade basis. For risk limits, a daily review of risk limit compliance or profit and loss (P&L) attribution would seem to align with current practices in large trading organizations. However, the underwriting and market making exclusions require "escalation procedures that require review and approval of any trade that would exceed a trading desk's limit(s)." This would seem to suggest pre-trade compliance in at least some instances.

For simpler instruments, this may be fairly straightforward, but given the complexity of calculating the risk of certain instruments and the dynamic nature of many trading books, this will present technical challenges. The most sophisticated firms may have the capability to automate this process; however, many banks may have to rely on traders' awareness of their proximity to the limits and the risk profile of new trades being contemplated.

Another case where pre-trade compliance is required is when one desk is establishing a hedge for another desk or desks or when a hedging instrument or strategy is applied that is not established in the policy for that desk. In those cases, the desk must "contemporaneously" document the specific risks the hedge is designed to reduce, the strategy being deployed, and who is responsible for the hedge.

In calculating metrics, banks will need to consider the timing of these calculations. Most firms calculate risk metrics on T+0 or T+1 basis, but calculate P&L on T+1 or T+2. With requirements to calculate metrics on both measures, firms will need to consider the potential impact that this timing difference might have.

Actions to consider taking now

- Understand what level of Volcker Rule compliance program requirements apply to your firm: simplified, standard, enhanced.
- Conduct a high-level assessment of your current compliance program vs. the high-level requirements of the rule to prioritize areas where more work is required.
- Assess the bank's book structure and hierarchy to determine if changes are required (significant effort and lead-time required) to facilitate metrics reporting and monitoring.
- Consider how to build the Volcker Rule governance structure leveraging a three-lines-of-defense framework; establish agreed-upon roles and responsibilities before building automation around violations/breach reporting.
- Review current written policies and procedures for trading desks against the Volcker Rule Appendix B requirements (even if compliance with the enhanced program is not mandatory for your firm).
- Develop processes for how Volcker Rule violations will be reported and remediated; determine what in-use workflow solutions might be suitable for case management or seek external solutions.
- Develop and implement controls around opening new books in the context of underwriting, market-making, and hedging.

Roles and responsibilities

The standard compliance program requires a management framework that clearly delineates responsibility and accountability for compliance with the Volcker Rule. Again, Appendix B of the rule provides more detail for banks that are required to implement the enhanced program. Figure 2 summarizes these requirements at different levels of the organization.

The requirement for CEO attestation is likely to lead firms toward a certification and subcertification process, similar to the Sarbanes-Oxley certification programs put in place during the last decade. In this process, the traders would certify (at least annually, but with a frequency "appropriate to the size, scope, and risk profile" of the covered activities) that they are not engaging in prohibited activities. The business line managers would then certify that they have monitored compliance of their desks, and so on up the chain of command to the CEO. As with breach escalation management, a workflow tool would help track this process and any exceptions.

The Volcker Rule requirements for monitoring compliance lend themselves to a "three lines of defense" model. In the first line, the business line managers must create a culture of compliance for the desks, including implementing a compensation structure that rewards risk reduction and not risk-taking. They must monitor the trading activities and challenge traders when breaches occur. They must implement limits that are appropriate for the institution's business and consistent with the prescriptions of the regulation.

The second line of defense focuses on the compliance function, which must monitor any breaches, ensure that false positives are clearly explained and documented, and that any true violations are promptly remediated and senior management is made aware. Other independent control functions such as risk management and finance could also be considered part of the second line of defense activities.

The third line of defense is the independent testing and audit required by the regulation. The agencies have given banks some flexibility in who performs this function. Appendix B requires that the review be performed by "a qualified independent party, such as the banking entity's internal audit department, compliance personnel or risk managers independent of the organizational unit being tested, outside auditors, consultants, or other qualified independent parties."

Figure 2. Volcker Rule compliance program roles and responsibilities

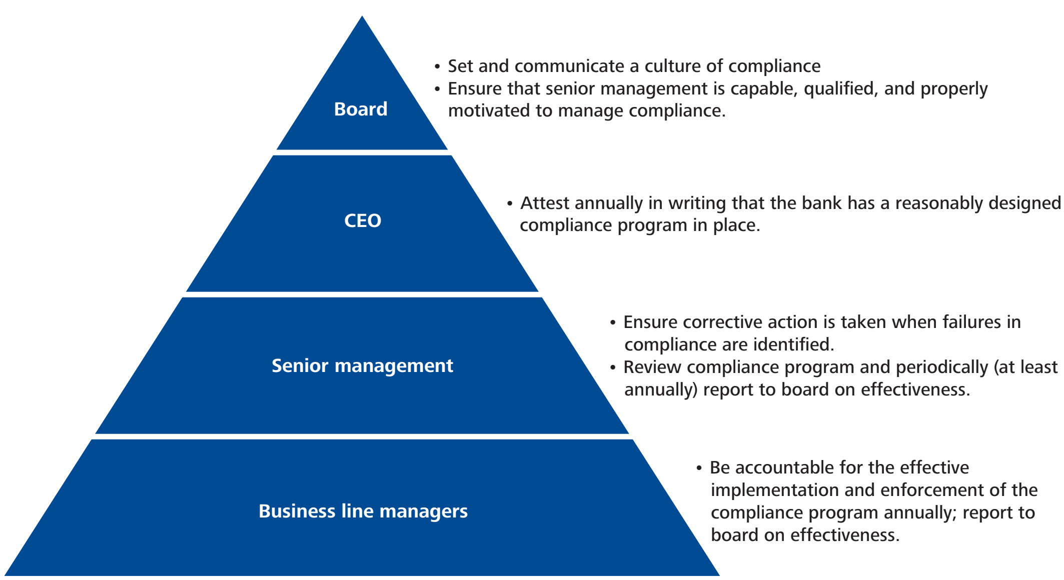


Figure 3: Examples of responsibilities aligned to the three lines of defense

	First line of defense	Second line of defense	Third line of defense
	Business unit	Compliance	Independent audit
Example responsibilities	• Conduct business in accordance with stated "trader mandate" policy. • Promote a strong risk management culture. • Establish and operate business unit risk and control structure able to ensure operation within agreed policies and risk limits. • Conduct rigorous self-testing against established policies, procedures, and limits. • Perform thoughtful, periodic risk self-assessments. • Report and escalate limit breaches. • Provide subcertification for Volcker Rule compliance.	• Implement tools to effectively track limit breaches. • Supply adequate resources to follow all cases through to resolution. • Compile metrics to provide senior management and the board of directors with the information needed to certify compliance. • Monitor compensation structures to avoid rewarding of risk-taking. • Implement training programs for all personnel involved in permitted trading activities and monitor completion. • Manage certification and subcertification program and provide subcertifications for Volcker Rule compliance.	• Perform independent testing and assess whether the compliance framework, policies, procedures, and related controls are functioning as intended. • Perform independent testing and validation of escalation and approval processes. • Provide assurance to management and the board related to the quality and effectiveness of the Volcker Rule compliance program.

In order to adequately communicate roles and responsibilities and the parameters surrounding permitted activities, banks will need to implement Volcker Rule training programs. Both the standard and enhanced compliance programs mandate training for traders, desk managers, and any other personnel involved in the compliance program. The importance of this should not be overlooked. Firms should consider implementing training programs along the same lines as anti-money laundering and know-your-customer training.

Technology considerations

The largest firms that must report quantitative metrics beginning in June 2014 are understandably focusing their technology resources on this effort. Regardless of size, firms should not lose sight of the infrastructure required to support the monitoring of these metrics and other limits that they may implement in policy.

It is worth considering this as a separate task from the calculation of the metrics because it relies on quite different toolsets. Perhaps the most important technology component of the monitoring platform is the workflow tool. The industry has matured significantly since the days of risk managers and controllers bringing paper reports to the trading desk for signoff; today, regulators are driving more and more for electronic delivery and approval. Even email-based procedures, though providing some level of traceability, may now be viewed as substandard because of the difficulty in maintaining an audit trail and the lack of management metrics.

Rather, leading practice suggests the use of workflow tools that facilitate creation of automated processes for delivering risk and P&L numbers and tracking acceptance or challenge at a more granular level and with time-stamped status updates to the records. Firms that have these tools already should consider adapting these to the broader requirements of Volcker Rule compliance monitoring such as certification and subcertification process. A case-management approach to resolving potential or actual violations of the Volcker Rule will help ensure completeness of review and resolution. These tools also typically feature queue management and aging, allowing managers to monitor bottlenecks or repeat issues. Firms with manual or email-based procedures should strongly consider a more robust solution.

Whatever tools are selected to manage breaches, firms should allow plenty of time for testing. In lessons learned from similar risk and P&L processes, data issues can create false positives. One missing price or risk factor can impact thousands of positions. Parallel testing is the ideal way to identify the real-world problems that occur with the complex linkages and timings of aggregating data from disparate sources.

The Volcker Rule mandates maintaining records for a minimum of five years in a readily accessible format. The primary challenge in this regard is determining what level of detail is appropriate. It is clear in the regulation that exception approvals for out-of-policy hedging strategies and temporary breach approvals need to be documented and that this documentation falls under the recordkeeping requirement. However, it is less clear how much of the risk/position data driving these exceptions must be maintained and at what level of detail. Larger firms will have millions of data points on a daily basis, and managing this on an ongoing basis (i.e., keeping it usable) would require significant resources.

Final thoughts

Medium-size and large banks have significant work to do to implement a robust Volcker Rule compliance program. With a looming deadline for conformance of July 21, 2015, these firms should begin to assess the current-state gaps and assemble resources to execute remediation plans now in earnest. As a starting point, they may use the “three lines of defense” model to define the target operating model and at the same time organize a change program with clear accountability for implementation.

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