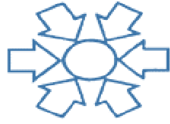

FedFin Client Report

Tuesday, August 20, 2019

Volcker 2.0 Rewrite: Significant Big-Bank/FBO Relief, Considerable Political Controversy

Client Report: **PROPTRADE26**

Executive Summary

As anticipated, the FDIC today approved what is ultimately expected to be an interagency final rule revising the Volcker Rule that has come to be known as Volcker 2.0 because it is such a significant rewrite of the initial, 2013 standard (see Client Report **PROPTRADE18**). Reflecting the controversial nature of the changes, the final rule was approved by the FDIC on a 3-1 vote, with Director Gruenberg dissenting. Mr. Gruenberg's concerns reflect those already voiced by Senate Banking Ranking Member Brown (D-OH) and HFSC Chairwoman Waters (D-CA), with Ranking Member McHenry (R-NC) making it clear that Republicans will largely support the revision through what is sure to be a contentious process at the FRB, SEC, and CFTC. The rule could also figure on the campaign trail if Sen. Warren (D-MA) or Sen. Sanders (I-VT) uses it to argue that big banks are winning undue advantage from the Trump Administration, reviving proposals for a new Glass-Steagall Act (see FSM **FHC21**) or other big-bank restructuring proposals.

The Volcker 2.0 rule retracts the earlier proposal (see Client Report **PROPTRADE25**) to include accounting "prongs" as the criterion for impermissible trading. Now, this will be judged by a straightforward time period for trades inside or beyond the window for potential proprietary trading, with a rebuttable presumption allowed for longer term positions. Size thresholds for covered institutions and those subject to CEO attestation have been increased and securities issued or guaranteed by the GSEs are now exempted in concert with sovereign obligations. FBO coverage under Volcker 2.0 limits will be judged only by combined U.S. operations, not worldwide assets and liabilities as proposed for "limited" institutions. A future rulemaking will address restrictions on the association with covered funds. Director Gruenberg argued that the changes will exempt a quarter of financial instruments at BHCs and almost half of financial instruments at banks currently subject to Volcker restrictions. He was particularly perturbed that the final rule defines trading account as only financial instruments recorded on the balance sheet as trading assets/liabilities, arguing that proprietary trading occurs in instruments denoted as available for sale, held at fair value, and derivatives not held for trading.

Federal Financial Analytics, Inc.
1255 23rd Street, NW – Suite 500, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com

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The FDIC today also approved a proposed interagency policy statement on allowances for credit losses that revised governance standards and a proposal based on ANPR issued late last year (see FSM Report **DEPOSITINSURANCE108**) dealing with brokered deposits. It revises the methodology by which the FDIC sets the interest-rate cap for institutions not meeting the well-capitalized threshold; FDIC Chairman McWilliams said her agency will issue a second NPR on the other aspect of the ANPR, brokered deposits, later this year.

Analysis

Statements

Chairman McWilliams argued that the Volcker Rule needs revision due to its high level of complexity. Distinguishing what is and is not proprietary trading under the rule has proved difficult, as evidenced by the 21 sets of FAQs that have been issued on it. Ms. McWilliams contends that today's final rule will inject more certainty and objectivity into the rule and tailor its application to focus on the banks doing the bulk of this activity, with firms engaging in lower levels of activity subjected to tiered compliance programs. She said about 93 percent of the activity resides in institutions that will be subject to the significant trading activity threshold. Chairman McWilliams also said the final rule implements fixes needed in light of experience operating under the rule – e.g., easier application of the rebuttable presumption, particularly as it relates to transactions made to correct or undo an erroneous trade. The exclusion of common banking activities, such as the hedging of mortgage servicing rights, also eases compliance.

As noted Director Gruenberg strongly opposes the final rule. Comptroller Otting noted that in his capacity as Comptroller of the Currency, he signed the final rule earlier this morning. He said the final rule makes common sense changes and eliminates unintended consequences.

Volcker 2.0

Key provisions in the final rule will:

- implement a three-tiered approach to tailoring the compliance program requirements. Firms with consolidated trading assets and liabilities equal to or exceeding $20 billion are designated as "significant;" firms between $1 billion and $20 billion will be considered "moderate," and those with less than $1 billion considered "limited";
- amend the methodology for calculating trading assets and liabilities, for example by excluding securities that are issued or guaranteed by a GSE and basing FBOs' calculations only on their combined U.S. operations;

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- revise restrictions on proprietary trading. The proposed accounting prong in the trading account definition is being dropped in favor of a modified version of the short-term intent prong. The current rebuttable presumption is being replaced with one that presumes that financial instruments held for 60 days or longer are not within the short-term intent prong. Banking entities subject to the market risk capital rule prong will not be subject to the short-term intent prong. Entities not subject to the market risk capital prong can elect to apply the market risk capital rule prong as an alternative to the short-term intent prong under certain conditions (e.g., consistent application among the entity and all of its wholly owned subsidiaries). The trading desk definition is also being revised to better align it with other trading desk definitions used in operational, management, and compliance functions. As noted, this revision will exclude fair-value and other financial instruments not reported as on-balance sheet trading assets and liabilities;
- implement new and revise proprietary trading exclusions. The liquidity management exclusion is modified to permit banking entities to use a broader range of financial instruments to manage liquidity (e.g., foreign exchange forwards, foreign exchange swaps, cross-currency swaps), and new exclusions have been added for error trades, certain customer-driven swaps, hedges of mortgage servicing rights, and purchases or sales of financial instruments that do not meet the definition of trading assets and liabilities;
- revise exemptions for permitted proprietary trading. Exemptions for underwriting and market making-related activities, risk-mitigation hedging, and trading by foreign bank entities solely outside the U.S. are being adopted largely as proposed. With respect to the exemptions for underwriting and market making-related activities, banks will no longer have to promptly report limit breaches or increases to maintain their presumption of compliance. Instead, they will need to maintain and make available upon request records of any such breaches or increases and follow certain internal escalation and approval procedures; and
- Eliminate the enhanced compliance requirements and tailor compliance program requirements. CEO attestation requirements apply only to firms with significant trading assets and liabilities.

The final rule will be effective January 1, 2020, and compliance will be required January 1, 2021. Banks may voluntarily comply at any time following the effective date and prior to the compliance date.

Interagency Policy Statement on Allowances for Credit Losses

The new policy statement as noted will replace previous interagency policy statements on allowances for loan and lease losses, with the proposed statement – if finalized – applying to institutions when CECL (see FSM Report **ALLL5**) becomes applicable. The statement in several places simply revises previously applied duties and obligations to

Federal Financial Analytics, Inc.
1255 23rd Street, NW – Suite 500, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com

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reflect the accounting standard change. However, new obligations and duties are also included. For boards of directors, these include:

- reviewing management's assessment of the effectiveness of processes and controls for monitoring the credit quality of the investment portfolio;
- approving the internal and external audit plans for the allowances for credit losses (ACLs), as applicable; and
- reviewing any identified audit findings and monitoring resolution of those items.

Responsibilities revised to reflect the shift from incurred-loss to expected-loss accounting include:

- retaining experience and qualified management to oversee all ACL and provisions for credit loss (PCL) activities;
- reviewing and approving the institution's written loss estimation policies, including any revisions thereto, at least annually;
- reviewing management's assessment of the loan review system and management's conclusion and support for whether the system is sound and appropriate for the institution's size and complexity;
- reviewing management's assessments of and justifications for the estimated amounts reported each period for the ACLs and PCLs; and
- requiring management to periodically validate and, when appropriate, revise loss estimation methods.

Comments on this NPR will be due 60 days after publication in the *Federal Register*.

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1255 23rd Street, NW – Suite 500, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com

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