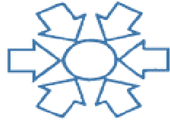

# *FedFin Client Report*

Wednesday, May 30, 2018

## FRB Charts Careful Path to Target Volcker Relief to Small, Foreign Banks

Client Report: **PROPTRADE25**

## Executive Summary

Following more forward signaling than we can remember for most consequential rulemakings, the FRB today unanimously began the five-agency process of revising Dodd-Frank's Volcker rule (see FSM Report **PROPTRADE6**). As anticipated, the proposal does not implement new statutory small-bank relief (see Client Report **SIFI25**), but addresses some of the most problematic aspects of the rule for banking organizations with small trading books, defined as those with less than $1 billion in trading assets and liabilities. These companies would come under a rebuttable compliance presumption. "Moderate" and "significant" trading organizations – about forty firms or 98 percent of industry trading – would come under tailored standards scaled up to apply most stringently to the largest companies. However, some of these standards are also eased, most notably those pertaining to the sixty-day rebuttable presumption.

Chairman Powell emphasized remaining tough standards for large traders throughout the Board meeting, with Gov. Brainard signaling that this proposal is as far as she will go and that aspects of it continue to trouble her. Former Chairman Volcker sided with the Fed as the institution best able to simplify his rule, supporting this proposal but also making it clear that more sweeping changes affecting large companies would be opposed. Sens. Merkley (D-OR) and Warren (D-MA) blasted the proposal, which was also lambasted by non-industry advocacy groups. This report assesses key provisions in the NPR, including those narrowing the scope of CEO attestations, refining key definitions, providing more flexibility for foreign banks, and reducing compliance burden for all but the largest trading banks. A subsequent report will analyze the proposal in detail.

## Analysis

### *Opening Statements*


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Chairman Powell opened the meeting by emphasizing that the proposal provides the most relief for companies that do the least amount of trading. Vice Chairman Quarles emphasized that the NPR is not the product of Trump-Administration appointees, but rather of hard work by professional staff across all five issuing agencies. As noted, implementation of Volcker changes in the new law will come in a separate rulemaking. Mr. Quarles also said that the NPR includes a range of issues on which questions are posed to guide the agencies to still more substantive rulemaking, but Gov. Brainard strenuously resisted the idea of anything more than these changes to the post-crisis framework. She took particular objection to any changes to "core" capital and liquidity rules for the largest banks. Gov. Brainard supports the proposal but argued for retaining the CEO-attestation requirement. She also called for rapid action to finalize single-counterparty credit limits (see FSM Report **CONCENTRATION9**) and the NSFR (see FSM Report **LIQUIDITY26**). At the end of the meeting, Mr. Quarles said that the FRB will be moving forward with the single-counterparty credit limit rule in the "very near term."

### *Proposal*

The staff presentation clarified that the current Volcker standards will not be enforced for banks below the $10 billion asset threshold specified in the new law but that, as noted, a formal proposal will implement it. Key proposals would:

- establish three categories of banking entities based on trading activities: those with "significant" trading assets and liabilities (i.e., more than $10 billion), "moderate" traders (between $1 billion and $10 billion), and "limited" traders (activities below $1 billion). Only limited firms would receive a rebuttable presumption of regulatory compliance;
- apply the current CEO-attestation standards only to significant and moderate traders;
- redefine "trading account" to eliminate the "intent" prong from the three prongs covering permissible accounts to replace the short-term, intent-based prong with one based on accounting treatment. The market-risk and dealer prongs are retained, but the market-risk one is redefined to cover certain FBO trades if the parent bank is subject to market-risk capital standards;
- eliminate the sixty-day rebuttable presumption. An assumption of compliance would also be accorded trading desks subject only to the accounting prong and operate within prescribed P&L criteria;
- preserve the agencies' right to deem a trade impermissible even if it nominally complies with applicable standards;
- expand the liquidity-management exclusion;

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- create a new exclusion for trades correcting erroneous ones;
- clarify the underwriting and market-making exemptions based in part on internal risk limits. Only "significant" traders would continue to have to have comprehensive compliance programs;
- ease the standards governing permissible risk-mitigation hedging. Compliance restrictions here are also relaxed for non-significant companies and "enhanced" documentation requirements are generally eliminated for low-risk hedge instruments;
- reduce the scope of impermissible activities to confine them to banking entities and their personnel engaging in the activity as principal in the U.S.;
- retain the definition of "covered fund," but seek comment on revisions to it. Comment is also sought on relationships with covered funds, including adding current exemptions in the inter-affiliate transaction rules; and
- clarify covered-fund standards to reflect FBO activities outside the U.S. The current no-enforcement policy on the barriers between banks and covered funds would stand for another year while comment on this question is solicited.

***Q&A***

Questioning today was limited to Chairman Powell, who used his time to reinforce that the proposal retained tough rules for the largest trading banks. Staff also reassured him that they would sanction any bank that set its position limits too liberally.

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