

# CAPCO

## VOLCKER 2.0

### SUMMARY OF AMENDMENTS AND IMPACT

## THE JOURNEY TO VOLCKER 2.0

On October 8, 2019, the five federal financial regulatory agencies finalized the revisions to Section 13 of the Bank Holding Company Act, referred to as the 'Volcker Rule.' The newly amended rule, aptly referred to as Volcker 2.0, has an effective date of January 1, 2020, and the mandatory compliance date of January 1, 2021. In response to the 2008 financial crisis, the original rule aimed to reduce risk in the US financial markets by prohibiting banks from the following:

- Engaging in short term proprietary trading of securities, derivatives, commodity futures and options. The rule allowed some proprietary trading activity under certain conditions. (Subpart B – Proprietary Trading Prohibitions and Exemptions)
- Owning, sponsoring, or having certain relationships with hedge funds or private equity funds referred as 'covered funds' (Subpart C – Covered funds)

The Volcker Rule primarily targeted the 'Big 9' banks who have \$50 billion-plus in total consolidated assets. Most financial institutions impacted responded by making significant investments in enhancing IT infrastructures and building their Volcker compliance programs accordingly. As illustrated in the below timeline, the Volcker Rule has gone through various, sometimes significant changes since inception. Nonetheless, the original intention of the rule has remained the same.

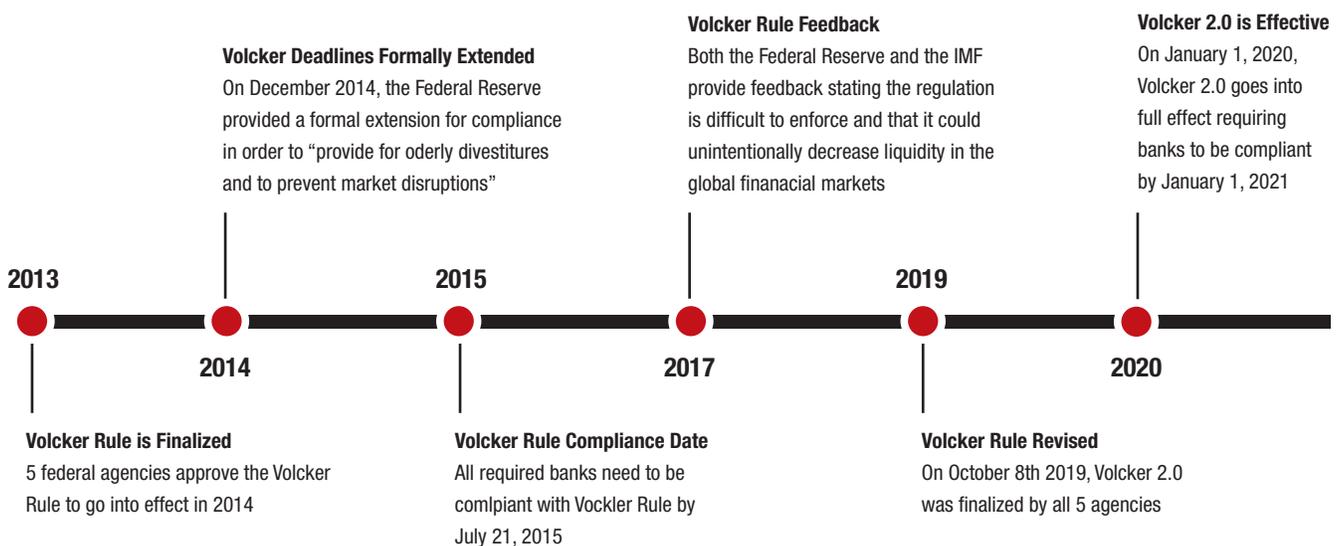


Figure 1: Evolution of Volcker Rule Over Time

# IMPACT AND SUMMARY OF RULE AMENDMENTS

## THREE-TIERED CLASSIFICATION OF BANKS

Volcker 2.0 redefines how the size of banking entities are measured and subsequently, the extent of the Volcker requirements on respective financial institutions. In line with the industry's opinion, it changed the measurement used for tiering the banks from total consolidated assets to trading assets and liabilities (TAL). Additionally, the agencies are putting the focus on what would put the US financial system most at risk, which is TAL in banking entities' Combined US Operations (CUSO). Lastly, financial instruments that are obligations or insured by the US government or agency of the US government are excluded from TAL.

● = High    ● = Medium    ● = Low

	<i>Trading Desk Activities/Hierarchy</i>	<i>Proprietary Trading Adjustments</i>	<i>Metrics Reporting</i>	<i>Covered Funds</i>	<i>% of Trading Assets in US Banking System<sup>1</sup></i>	<b>Compliance Requirements Summary</b>
<b>Significant</b> (TAL > \$20B)	●	●	●	●	93%	CEO attestation required, most stringent compliance requirements
<b>Moderate</b> \$1B < TAL < \$20B	●	●	●	●	6%	No CEO attestation required, less stringent compliance requirements (maintain policies and procedures only)
<b>Limited</b> (TAL < \$1B)	●	●	●	●	< 1%	No CEO attestation required, a rebuttable presumption of compliance to Subpart B and C. No obligation to demonstrate compliance on an ongoing basis

Figure 2: Preliminary impact assessment on financial institutions

In response, banks, especially foreign banking organizations (FBOs), should consider the implications of how their trading organization structure determines their position within the Volcker 2.0 three-tiered classification framework. For example, FBOs with small trading operations in the US may benefit from the decreased compliance burden associated with classification as 'Moderate' or 'Limited.'

<sup>1</sup> Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds

## TRADING ORGANIZATION (HIERARCHY) AND PERMITTED TRADING ACTIVITIES

Volcker 2.0 amends the 2013 definition of a trading desk from “the smallest discrete unit of an organization of a banking entity that purchases or sells financial instruments for the trading account of the banking entity or an affiliate thereof” to align with a more standard definition used by other regulatory regimes (e.g., Basel). This change will allow banking entities that also define trading desks for purposes unrelated to the 2013 rule to avoid duplicative compliance and reporting efforts. Examples include market risk capital regimes such as Fundamental Review of the Trading Book (FRTB).

Further, Volcker 2.0 allows for some additional permitted trading activities via additions to proprietary trading exclusions that will impact desks’ business strategies. This gives banks more freedom to manage their risks effectively.

- **Liquidity Risk Management Exclusion:** The exclusion is expanded to cover the purchase or sale of foreign exchange forwards, foreign exchange swaps, and cross-currency swaps (including non-deliverable cross-currency swaps) entered into by a banking entity for the purpose of liquidity management in accordance with a documented liquidity management plan.
- **Matched Derivatives Transactions:** Customer-driven swaps and security-based swaps and contemporaneous matching trades are excluded if: (i) the banking entity retains no more than minimal price risk; and (ii) the banking entity is not a registered dealer.
- **Hedges of Mortgage Servicing Rights:** Purchases and sales of financial instruments to hedge mortgage servicing rights or mortgage servicing assets in accordance with a documented hedging strategy are excluded.
- **Error Trades:** A new exclusion added for trades made in error by the banking entity engaging in a permitted or excluded activity.

## PROPRIETARY TRADING ADJUSTMENTS TO EXEMPTIONS

The amendments within Volcker 2.0 provide banks with several opportunities to realize operational efficiencies, particularly in its changes to the proprietary trading (Subpart B) definitions, exclusions, and exemptions. However, Volcker 2.0 relies heavily on a robust framework of internal risk limits and controls in lieu of ongoing monitoring and reporting.

The below changes to Proprietary Trading Exemptions will result in reduced operational impact for banks:

- **60-Day Rebuttable Presumption:** Volcker 2.0 reverses the 60-day rebuttable presumption. Under the changes, financial instruments held for 60 days or longer are now presumed not to be used for short-term trading.
- **Underwriting and Market Making-related Activities:** There is a new presumption of compliance for trading within risk limits set by the banking entity (including RENTD). Breaches and limit increases do not require reporting; instead, banking entities are required to maintain records that need to be available to regulators upon request.
- **Risk Mitigating Hedging:** The requirements for correlation analysis and that a banking entity show a hedge ‘demonstrably reduces’ risk was removed. For banking entities with significant TAL, commonly used hedges would not be subject to documentation requirements that otherwise apply to cross-desk hedges and aggregated hedges.
- **Trading Outside the United States (TOTUS):** US personnel would be permitted to help arrange and negotiate transactions, and trading would be permitted with US counterparties. There will be no prohibition on financing from US offices or affiliates. Decisions to trade would originate from outside the US and principal risks and actions of transactions would need to reside outside of the United States.

## METRICS REPORTING

The agencies endeavored to simplify the metrics reporting requirements without compromising insight into how the banks manage their risk. Banks spent significant amounts of money to build the IT infrastructure and processes to adhere to the original Volcker metrics reporting requirements. Volcker 2.0 does not change the requirement that banking entities with ‘Significant’ TAL must record and report the quantitative measurements. However, per the table below, there have been changes to which metrics need to be reported. Banks’ existing infrastructures and processes should be leverageable.

Metrics no longer required	Metrics remaining in scope from original 2015 rule	New Metrics/Schedules under Volcker 2.0
<ul style="list-style-type: none"> <li>• Customer Facing Trade Ratio (CFTR)</li> <li>• Inventory Turnover</li> <li>• Risk Factor Sensitivities</li> <li>• Inventory Aging</li> <li>• Stress Value-at-Risk (SVaR)</li> </ul>	<ul style="list-style-type: none"> <li>• Risk and Positions Limits and Usage</li> <li>• Value-at-Risk (VaR)</li> <li>• Comprehensive P&amp;L</li> </ul>	<ul style="list-style-type: none"> <li>• EOD Positions of ‘Securities’ and ‘Derivatives’ as measured by long/short market value</li> <li>• Daily Transaction Volumes of ‘Securities’ and ‘Derivatives’ with Customer, Non-Customer and Internal counterparties</li> <li>• Descriptive information and narrative statements for trading desks engaging in covered trading activity</li> <li>• Internal limits information schedule (supplement to Internal Limits and Usage)</li> <li>• Risk factor attribution information schedule (supplement to Comprehensive P&amp;L)</li> </ul>

Table 1. Metrics summary

In addition, the metrics reporting requirement has been lessened for all the ‘Significant’ banks. The reporting frequency changed from monthly to quarterly which aligns with other regulatory regimes.

Compared to the 2013 rule, the revised metrics result in:

- 67 percent decrease in the number of data points and
- 94 percent decrease in the total volume of information submitted to regulators<sup>2</sup>

The agencies identified that the original Volcker Rule metrics requirements closely align with other regulatory expectations (e.g., Basel Committee’s Market Risk Capital Calculations) and will continue to efficiently harmonize these requirements as additional Basel requirements are adopted in the US.

<sup>2</sup> Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds

## COVERED FUNDS

The amendments to Covered Funds (Subpart C) of the rule in Volcker 2.0 are less substantial than those pertaining to proprietary trading. Key changes to Covered Funds are summarized below:

	Applicable Limits and Deductions Under Final Rule (2015)	Applicable Limits and Deductions Under Volcker 2.0
<b>Related Covered Funds</b>	<ul style="list-style-type: none"> <li>• 3 percent per fund limit</li> <li>• Aggregate covered fund limit</li> <li>• Tier 1 capital deduction</li> </ul>	<ul style="list-style-type: none"> <li>• 3 percent per fund limit</li> <li>• Aggregate covered fund limit</li> <li>• Tier 1 capital deduction</li> </ul>
<b>Third-Party Covered Funds</b>	<ul style="list-style-type: none"> <li>• Aggregate covered fund limit</li> <li>• Tier 1 capital deduction</li> </ul>	<ul style="list-style-type: none"> <li>• None</li> </ul>

Table 2. Limits and Deductions

- **Underwriting and Market-Making:** Banking entities no longer need to include the value of ownership interests of third-party covered funds held as underwriting or market-making positions for the three percent aggregate covered fund ownership limit and capital deduction.
- **Risk Mitigating Hedging Exemption:** Under Volcker 2.0, banks would be permitted to hold covered fund interests to hedge fund-linked products. The agencies believe this type of hedging activity is not 'High Risk' and doesn't threaten the safety and soundness of the respective bank.
- **Solely outside the United States ('SOTUS') fund exemption:** The amendments eliminate the restriction on a foreign banking entity receiving financing from a US branch or US affiliate of the banking entity for the purchase or sale of a covered fund ownership interest or covered fund sponsorship under the exemption (similar to TOTUS changes).

## NEXT STEPS

With the compliance date of January 1, 2021, banks have just over a year to be compliant, and immediate steps should be taken to assess the impact of the rule amendments. The intent of Volcker 2.0 is to retain the essence of the initial rule while leveraging existing processes and infrastructures. While Volcker 2.0 permits new trading activities, it puts increased reliance on internal controls and limits to mitigate risk. Banks should ensure continued compliance with the Volcker Rule, realize operational efficiencies and adjust their business strategy accordingly.

For further details on our offering, please reach out to us at [CapcoCapitalMarkets\\_NA@capco.com](mailto:CapcoCapitalMarkets_NA@capco.com).

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## ABOUT CAPCO

Capco is a global technology and management consultancy dedicated to the financial services industry. Our professionals combine innovative thinking with unrivalled industry knowledge to offer our clients consulting expertise, complex technology and package integration, transformation delivery, and managed services, to move their organizations forward.

Through our collaborative and efficient approach, we help our clients successfully innovate, increase revenue, manage risk and regulatory change, reduce costs, and enhance controls. We specialize primarily in banking, capital markets, wealth and investment management, finance, risk & compliance and insurance. We also have an energy consulting practice in the US. We serve our clients from offices in leading financial centers across the Americas, Europe, and Asia Pacific.

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