KPMG

Regulatory Alert

Financial Services Regulatory Insight Center

September 2019

Final rule amendments to Volcker Rule

Revisions to impact compliance and metrics, proprietary trading, and covered funds; a second round of revisions is anticipated.

Key points

— Final rules amending the Volcker Rule are being adopted; the revisions address compliance and metrics, proprietary trading, and covered funds.

— An additional proposed rulemaking on a broader set of covered funds issues is forthcoming.

— The current final rules tailor application of the Volcker Rule to the size of a banking entity's trading assets and liabilities, with the most stringent requirements applied to those banking entities with the most trading activity.

Five federal agencies (FRB, OCC, FDIC, SEC, and CFTC)* are finalizing amendments to the interagency regulations implementing section 619 of the Dodd-Frank Act, commonly known as the Volcker Rule. The Volcker Rule generally prohibits banking entities from engaging in proprietary trading and from owning or controlling hedge funds or private equity funds.

The final rule follows a proposal published by the agencies in July 2018, but with some modifications. Highlights of key new provisions follow.

Compliance program requirements

Tailored approach: Compliance program requirements will be based on a three-tiered tailoring approach:

1. Banking entities with total consolidated trading assets and liabilities of at least $20 billion (the proposed rule would have set this threshold at $10 billion) will be considered to have "significant" trading assets and liabilities and will be subject to a six-pillar compliance program, annual CEO attestation, and metrics requirements.
2. For purposes of the final rule, "total consolidated trading assets and liabilities" excludes obligations of or guaranteed by the United States, its agencies, or a government-sponsored enterprise. For U.S. banking entities it is measured on a worldwide basis and for foreign banking organizations it is measured using the entity's combined U.S. operations.
3. Banking entities with total consolidated trading assets and liabilities between $1 billion and $20 billion will be considered to have "moderate" trading assets and liabilities and will be subject to a simplified compliance program.

   Banking entities with total consolidated trading assets and liabilities of less than $1 billion would be considered to have "limited" trading assets and liabilities; these entities will be subject to a presumption of compliance and will not be required to demonstrate compliance.

   Banking entities with total consolidated assets of $10 billion or less and trading assets and liabilities equal to 5 percent of less of their total consolidated assets are exempt from the Volcker Rule and the final rule.

Effective date: The final rule has an effective date of January 1, 2020 though compliance is not required until January 1, 2021.

Banking entities may voluntarily comply, in whole or in part, with the rule changes prior to the compliance date. A banking entity seeking to switch to the revised metrics prior to January 1, 2021, must first successfully test submission of the revised metrics.

Quantitative metrics: For banking entities with significant trading assets and liabilities:

- The metrics for "Risk Factor Sensitivities," "Inventory Aging," and "Stress Value-at-Risk" will no longer be required. Other metrics generally will be retained, renamed, and/or replaced with alternate measures.
- New quantitative and qualitative information will be required to be reported, including descriptive information for each trading desk engaged in covered trading activity.
- Metrics reporting will be required on a quarterly basis.

Proprietary trading

Trading account:

- For all banking entities, the trading account definition will consist of the Dealer Prong and either the Short-Term Intent Prong or the Market Risk Capital Prong. The proposed Account Prong was not adopted.
- Banking entities subject to the Market Risk Capital Rule Prong will not be subject to the Short-Term Intent Prong.
- Banking entities that are not subject to the Market Risk Capital Rule Prong may elect to apply the Market Risk Capital Rule Prong as an alternative to the Short-Term Intent Prong under certain conditions.
- Financial instruments held for 60 days or longer will be presumed to not be covered by the Short-Term Intent Prong. As such, the 60-day rebuttable presumption, where instruments held for fewer than 60 days are presumed to be covered by the Short-Term Intent Prong, will be reversed.
- The definition of "trading desks" will be required to be based on the criteria used to establish trading desks for other operational and compliance purposes, including the market risk capital rule.

Exclusions from the proprietary trading restrictions:

- The liquidity management exclusion will be expanded to permit banking entities to use a broader range of financial instruments to manage liquidity, including the purchase or sale of foreign exchange forwards, foreign exchange swaps, and cross-currency swaps entered into by a banking entity for the purpose of liquidity management in accordance with a documented liquidity management plan.
- New exclusions will be added for error trades and correcting transactions, certain customer-driven swaps, hedges of mortgage servicing rights, and purchases or sales of instruments that do not meet the definition of trading assets or liabilities.

Exemptions from the proprietary trading restrictions:

- A new presumption of compliance will apply to the reasonably expected near term demand ("RENTD") requirement for both the underwriting and market making-related activities exemptions. The presumption will be available to each trading desk that establishes, implements, maintains, and enforces internal limits that are designed not to exceed the RENTD.
- Banking entities will no longer be required to conduct a correlation analysis or to show that a hedging activity demonstrably reduces risk.
- Revisions to the "trading outside of the United States" exemption will permit U.S. personnel to help arrange and negotiate transactions, though the decision to purchase or sell as principal must still be made outside of the U.S. by non-U.S. personnel. In addition, financing from U.S. offices or affiliates will be permitted.

Covered funds

The final rule adopts, as proposed, covered fund changes for which the agencies had proposed specific rule text. Accordingly:

- Banking entities will no longer be required to include the value of ownership interests of third-party covered funds held as underwriting or market making positions for purposes of the aggregate covered fund ownership limit and capital deduction.
- Banking entities will be permitted to hold covered fund interests to hedge fund-linked products.
- The Financing Prong will be removed from the "solely outside of the United States" fund exemption.

The agencies state they intend to issue a notice of proposed rulemaking that would propose additional, specific changes to the restrictions on covered fund investments and activities and other issues related to the treatment of investment funds, including revisions to limitations on relationships between a banking entity and a covered fund for purposes of section 23A of the Federal Reserve Act.

KPMG perspective

The agencies state that experience with the Volcker Rule since its implementation in 2013 has highlighted certain areas that "may have resulted in ambiguity, overbroad application, or unduly complex compliance routines or may otherwise not have been as effective or efficient in achieving its purposes as intended or expected." The final rule attempts to add clarity and certainty to the implementing regulations.

Consistent with recent efforts to tailor the application of certain Dodd-Frank Act regulations, the final rule also tailors application of the Volcker Rule to the size of a banking entity's trading activity, with the most stringent requirements applied to those banking entities with the most trading activity. Notably, the agencies finalized a rule in July that excluded certain firms that have total consolidated assets equal to $10 billion or less and total trading assets and liabilities equal to five percent or less of total consolidated assets from compliance with the Volcker Rule.

The agencies further intend to issue an additional proposed rulemaking to address other revisions related to covered funds.

For additional information please contact Bill Meehan.

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* *As of September 5, FDIC and OCC have approved the final rule.*

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