RFA RICH FEUER ANDERSON

Quick Hit: Volcker Rule Analysis

Top Line Analysis

Yesterday's FDIC vote to finalize the Volcker Rule was perhaps the most significant regulatory reform action by Trump-appointed financial regulators.

Reforming the Volcker Rule has been a top priority of the Treasury Department, and something Republicans on Capital Hill have focused on since President Trump was elected. Senate Banking Committee Chairman Mike Crapo (R-ID) in particular has pressed the regulators very hard to not only move quickly, but take an expansive reform posture. Behind the scenes, senior political staff at the agencies ramped up their engagement over the last few months and were able to push through the complexity of the interagency rulemaking process and neutralize difficult career staff who may have had different reform views. This was the ultimate tool to break the logjam that had prevented the rule from being finalized for more than a year.

In addition to providing substantive relief for a number of financial institutions, the ability to finalize the rule at this time ensures the reforms are protected from a Congressional Review Act (CRA) challenge by Democrats next Congress. Republicans have been laser focused on telling regulators to finalize rules before May 2020 to ensure they aren't eligible to be challenged under the CRA.

We anticipate Chairman Crapo and other Republicans will continue be engaged and to press the agencies to finalize additional reforms to the covered funds section. Both depository institutions and private equity firms have been very engaged with members of Congress to let them know a rewrite is not complete without additional relief for covered funds investment.

Key Takeaways

- The FDIC voted 3-1 to approve the final rule amending the Volcker Rule. OCC Director Joseph Otting also approved the final rule prior to the FDIC vote, while the Federal Reserve, SEC, and CFTC must still approve it.
- The final rule will be effective January 1, 2020 and have a compliance date of January 1, 2021.
- FDIC Director Martin Gruenberg was the sole dissenting vote on Tuesday. The rest of the board is made up of FDIC Chair Jelena McWilliams, OCC Director Joseph Otting, and CFPB Director Kathy Kraninger.
- In the coming months, the regulatory agencies plan to introduce a separate interagency Notice of Proposed Rulemaking that would propose specific changes to the restrictions on the covered fund investments and activities.
- With most of Volcker now done, the federal regulatory agencies will have more bandwidth and are likely to more aggressively implement the regulatory provisions of S. 2155 and the long list of pending regulations like on FBO tailoring, inter-affiliate initial margin, and the stress capital buffer.

The proposal

- Accounting and short-term intent prongs – The final rule does not include the proposed accounting prong in its trading definition, and instead retains the short-term intent prong. It also replaces the 2013 rule's rebuttable presumption (that financial instruments held for fewer than 60 days are within the short-term intent prong) with a presumption that investments held for 60 days or longer are not captured by this prong.
    - The short-term prong will only apply to banks that are not subject to the market risk capital rule or that don't elect to apply the market risk capital standard.
    - The new rebuttable presumption shifts the burden of the rebuttal process from the banking entity to the primary supervisor.

- Three-tiered compliance approach – The final rule implements a sliding scale of compliance requirements based on the bank's consolidated trading assets and liabilities:
    - "Significant" (over $20 billion) – six-pillar compliance program and metrics, including a requirement for bank CEOs to attest to their firm's compliance
    - "Moderate" (between $1 and $20 billion) – simplified compliance program
    - "Limited" (under $1 billion) – presumption of compliance

- Calculation of trading assets and liabilities – The final rule amends the methodology for calculating trading assets and liabilities.

- Proprietary trading definition exclusions – New exclusions were added to the final rule, such as for error trades, certain customer-driven swaps, and hedges of MSRs. The final rule also modifies the liquidity management exclusion to permit banking entities to use a broader range of financial instruments to manage liquidity.

- Exemptions for permitted proprietary trading – The final rule includes the Notice of Proposed Rulemaking's proposed changes to the exemptions for underwriting and market making-related activities, risk-mitigating hedging, and trading by foreign banking entities outside the U.S. It also adopts a presumption of compliance for trading within certain internal limits, and a requirement that banks maintain and make available on request records of any breaches or increases.

Reactions from the Hill

- **Senate Banking Committee Chairman Mike Crapo (R-ID)** praised the rule for "reducing unnecessary compliance burden" but noted that further revisions, such as the covered funds provision, are necessary "to improve market liquidity and preserve access to diverse sources of capital for businesses."

- **Senate Banking Committee Ranking Member Sherrod Brown (D-OH)** blasted the final rule as a gift to Wall Street, saying that it continues to "open a Pandora's box of risky trading and speculation at the expense of American taxpayers."

- **House Financial Services Committee Chairwoman Maxine Waters (D-CA)** criticized the rewrite, saying that it "will not only put the U.S. economy at risk of another devastating financial crisis, but it could potentially leave taxpayers at risk of having to once again foot the bill for unnecessary and burdensome bank bailouts." She added that the final rule "would curtail prohibitions in a manner that Congress never intended."