

POINT OF VIEW OCTOBER 2011

THE VOLCKER RULE BAN ON PROP TRADING: A STEP CLOSER TO REALITY

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INTRODUCTION

The Volcker Rule is one of the more controversial pieces of legislation to emerge from the financial crisis. Attached to the Dodd-Frank Act, the rule was intended to limit banks' ability to make speculative investments that do not benefit their customers. Translating this concept into functional regulation has turned out to be extremely difficult.

As enacted into law, Section 619 of the Dodd-Frank Act (what is termed "the Volcker Rule") has three major effects on banking entities:

- Prohibits meaningful investment in hedge funds, private equity funds, and similar vehicles
- 2. Prohibits separately organized "prop trading" desks in most asset classes
- 3. Allows market making, underwriting, and related hedging but only if such activity does not involve prohibited proprietary trading

The first two effects are relatively easy to understand and, importantly, to police. It is the third that has proved so challenging. The core idea is that one could keep the "good" activities of capital markets dealers, such as providing market making and hedging services, while stamping out the "bad" practice of speculation by firms with access to the bank safety net. However, both sets of activities necessitate taking and managing market risks, with the possibility of gain or loss on market moves. Telling the two apart promised to be difficult from the outset.

US regulators, having spent over a year wrestling with this, have finally released proposed rules implementing the Volcker Rule. The regulatory agencies¹ have realized that the prop trading ban will be nearly impossible to police from outside and, accordingly, have placed the onus on each banking entity to police itself through a complex compliance regime, monitored by regulators.

Critically, the proposed rule does not:

- Make market making impossible to pursue for banks;
- Make it impossible for banks to manage liquidity and firm-level interest rate risks;
- Make it impossible for banks to hedge risk dynamically at the portfolio level;
- Require trade-by-trade reporting and analysis to demonstrate compliance; or
- Mandate the same compliance regime for firms of all sizes and scope.

It does, however, have very far-reaching implications for banks. Complying with the Volcker Rule as proposed will require a major effort by nearly all bank-owned trading businesses worldwide, and will involve potentially profound changes to business activities and ultimately market structure.

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¹ The Fed, SEC, OCC and FDIC all collaborated on the proposed rule; the CFTC is reportedly waiting before considering its own implementation of the Volcker Rule.

WHO WILL BE AFFECTED

As proposed, the rule will effectively cover every bank with a meaningful trading business, regardless of domicile. This is a surprise – most had expected global operations of US-headquartered banks to be covered, but concluded that the non-US operations of foreign banks would not be affected. Instead, the proposed rule is notable for its extraterritorial reach. Foreign Banking Organizations are eligible for exemption from the prop trading ban and associated compliance regime, but only if trading activity occurs completely outside the US and does not involve a US counterparty.²

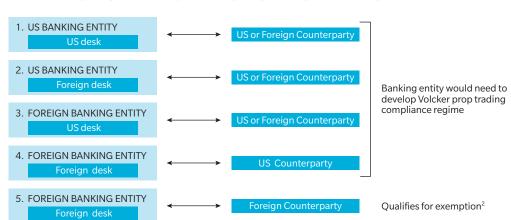


EXHIBIT 1: FOREIGN BANKING ENTITIES ELIGIBLE FOR EXEMPTION1

- $1. \ For eign \ banking \ entities \ with \ some \ presence \ in \ the \ US \ today$
- $2. \ Provided \ no \ personnel \ directly involved \ in \ the \ transaction \ is \ physically \ located \ in \ the \ US \ and \ the \ transaction \ is \ wholly \ executed \ outside \ the \ US$

In practice, nearly all foreign trading desks at least occasionally trade with US counterparties (such as US dealers) and will therefore be subject to the full compliance regime envisioned by the proposed rules implementing the prop trading ban.

The proposed rule also establishes a tiered compliance regime for the prop trading ban, with the full set of requirements falling on banks with "worldwide consolidated trading assets and liabilities" of \$5BN or more, and less onerous requirements for those with \$1-5 BN in such assets.³ According to the latest Federal Reserve data, 9 US bank holding companies would meet the higher threshold and 9 others would be subject to less stringent compliance requirements, based on US trading assets and liabilities alone.⁴ More than 200 foreign banks with a US branch, agency, or commercial lending subsidiary also report to the Federal Reserve under Section 8 of the International Banking Act.⁵ Given the expansive definition of

² To qualify for the exemption, no party to the trade may be a US resident, no personnel directly involved in the trade may be physically located in the US, and the trade must be wholly executed outside US borders (risk management and booking outside the US is insufficient).

The release does not define "trading assets and liabilities"

⁴ Bank Holding Company Performance Report, National Information Center (Dec 2010)

⁵ Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks, Federal Reserve Board (Dec 2010)

worldwide trading assets and liabilities and the relatively low threshold for application, the total number of banks subject to the Volcker Rule could exceed 50.

WHAT COMPLIANCE WILL INVOLVE

The proposed rule describes a broad range of activities that affected banks will need to undertake in order to comply with the prop trading ban. An overall compliance regime will need to be developed at the firm level that includes policies, procedures, and senior management accountability for the effectiveness of the program. (The requirement that CEOs publicly certify compliance is mentioned in a question, but not directly proposed.) Existing liquidity management and hedging policies will need to be certified to ensure prohibited activity is not "concealed" within safe harbors.

Furthermore, a wide range of policies and processes will need to be developed at the trading desk level, customized to the business dynamics of that organization. The criteria the proposed rule sets out for activities to qualify as "permitted market making" are indicative of what many trading desks will need to be able to demonstrate:

- · Bona fide market maker (e.g. regularly provides quotes or liquidity to the market)
- Trading activities designed not to exceed the reasonably expected near-term demands of clients, customers, and counterparties
- Registration under relevant securities or commodities laws
- Trading activities designed to primarily generate revenue from fees, commissions, and spreads, rather than from market price changes
- Compensation incentives that primarily reward customer-related services, rather than revenue from market price changes

In addition, banks will need to develop processes for the daily capture and monthly reporting of an extensive set of metrics on risk exposure, revenue volatility, risk-adjusted performance, customer-facing activity, and composition of revenue at the desk level. Some traditional metrics – such as how often profit or loss exceeds VaR – are being asked for in new ways, such as net of bid-ask spread. Other metrics, such as those measuring how much activity is "customer facing," will be new to most organizations.

EXHIBIT 2: SCOPE OF REQUIRED REPORTING

REPORTING CATEGORY	REPORTING METRICS ¹	UTILIZATION	
Risk Management	VaR and Stress VaR	•	
	VaR Exceedance	0	
	Risk Factor Sensitivities	•	
	Risk and Position Limits	•	
Source of Revenue	Comprehensive P&L	•	
	Portfolio P&L	•	
	Fee Income and Expense	•	
	Spread P&L	0	
	Comprehensive P&L Attribution	•	
Revenue Relative to Risk	Volatility of Comprehensive and Portfolio P&L		
	Comprehensive and Portfolio P&L to Volatility Ratio		In wide use to Possible with existing data but rarely tracked toda New metrics significant costs/challe to implemen
	Unprofitable Trading Days ²		
	Skewness and Kurtosis of Portfolio P&L		
Customer-Facing Activity	Inventory Risk Turnover		
	Inventory Aging		
	Customer-Facing Trade Ratio	0	
Payment of Fees, Commissions, Spreads	Pay-to-Receive Spread Ratio	0	

^{1.} See appendix for metric definitions

The compliance and reporting regime proposed will impose significant costs on all institutions covered by the rule. New policies and procedures, internal controls, and reporting systems will need to be introduced across the organization and tested independently. One major initial cost could be tied to the systems changes needed to track data relevant to required metrics (e.g. whether trades are with a customer, and trade spread P&L excluding price impacts). Reminiscent of Sarbanes-Oxley, compliance activities would need to be independently tested on a regular basis, which will significantly raise the level of documentation and overall cost of the entire effort.

TIMELINE

The proposed rule sets a deadline of July 2012 for establishment of the full compliance program. Given the 90-day comment period and some time for the agencies to finalize a rule, this will leave affected firms a very short window between publication of the final rule and the deadline for having a compliance program in place. The agencies intend to use the two-year conformance period (during which compliance processes must be followed but before the ban comes into full force) to road-test many of the requirements, recognizing that this will be a learning process for all involved.

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^{2.} For Comprehensive P&L and Portfolio P&L exclusive of Spread P&L

IMPLEMENTATION CHALLENGES

Given the wide net cast by the proposed rule, a key challenge will be the sheer size and complexity of the undertaking. Assembling and monitoring this level of detail on this many entities will be a vast operation that will require significant additional resources and operational capacity. It will be important for regulators to avoid the trap of gathering so much information there turns out to be little they can do with it.

In particular the way that the data is used and interpreted will require detailed expertise on the part of the regulators. Ensuring comparability will be critical for example; the metrics will look completely different for different desks within any firm. The requirements of a market maker in FX forwards versus one in commodity derivatives are totally different, and as a result many of the metrics outlined above will look nothing alike across these businesses. It will be important that the regulators recognize this where appropriate, rather than applying a one-size-fits all solution across individual trading units and firms.

Finding the right level of granularity will be important so that the compliance regime focuses on monitoring proprietary activity rather than getting overly focused on how trading desks are operationally set up. For example:

- Most cash desks hedge their positions via desks in "Delta one" markets such as futures or forwards, generating significant internal flows and inter-dealer flows in some desks;
- In some businesses, desks have been functionally split between sales-trading desks which liaise with clients and pure trading desks which make markets;
- All desks have to manage FX exposure through internal and inter-dealer FX hedging in spot or derivative markets;
- In most banks there are significant internal flows where trades are booked "back-to-back" between legal entities, whether for the clients' benefit or the bank's;
- While repurchase agreements and securities lending transactions are exempted, standalone equity, rates, and credit repo desks serve multiple functions, including (for example) covering shorts for customer-facing desks that may otherwise appear to be taking proprietary positions;
- Banks manage correlation across VaR types using a wide range of approaches, which can result in trades being executed in particular desks which are not necessarily related to client activity in that desk.

In these and other cases, banks may need to make operational changes to simplify the way their trading businesses are set up to ensure compliance with the prop trading ban. Judging where change is appropriate or necessary will be non-trivial.

STRATEGIC IMPACT ON THE INDUSTRY

We expect that the proposed rule will change before it is finalized, potentially in significant ways. However, the core idea of requiring a serious internal compliance regime is likely to remain. As proposed, there is little doubt the rule would have significant implications for banking organizations in the US and abroad:

- Reduced revenues and profitability Proprietary trading and investment has historically been a volatile but significant source of revenues and profitability for banking organizations worldwide. Revenues generated by ring-fenced proprietary trading desks alone contributed approximately 10% of industry revenues in 2009 at substantially higher margins than most other trading activities. US banks (and subsidiaries) will need to shut these desks and many have already done so. Other desks that take directional positions in markets as well as servicing customer needs will be limited to the latter, changing the return profile of the business. These effects will have downstream impacts on cost and capital management, and on the way client services are priced.
- Longer-term changes to operating models Eventually, the compliance regime and its oversight by regulators will highlight current trading practices and business processes that are not sustainable under the prop trading ban. These effects may take some time to become clear, given that regulators have offered a minimum two-year conformance period before the ban comes into true force, and will use that time to work with banks to refine the compliance programs in place. But the ultimate impact could be substantial, as hedging and risk management practices are re-designed, trading units re-organized, and business models re-tuned. The impact may be sharply different depending on the nature of the desk, with asset classes that have proportionally more inter-dealer trading and more complex retained basis risks more profoundly affected.
- Reshaping the business, including pullback from marginal trading businesses The
 rule raises the overall costs for a bank to have any trading businesses. Institutions with
 relatively low trading profits may choose to retrench to avoid falling subject to the rule –
 shutting down US trading desks or exiting the business entirely.
- Shifting activity away from bank trading books Ultimately, the balance of activity that takes place in banks vs. in non-bank entities such as funds and non-bank broker-dealers is likely to change significantly as a result of the Volcker prop trading ban. Dealers unrelated to banks will have a new competitive advantage in terms of choice of trading strategies and opportunities for trading talent. While regulators have the option to apply Volcker provisions to systemically important non-banks, today's non-bank trading businesses have room to grow by orders of magnitude before such an outcome is a real threat. Additionally, the prop trading ban will contribute to the incentives from Basel 3 capital charges to move bank risk-taking from trading books into the banking book.

As proposed, the Volcker Rule is likely to have profound impacts on the structure of capital markets businesses in every market. These effects will play out in very different ways (and require very different responses) depending on the size and domicile of the bank. The largest US institutions have been actively engaged in the rulemaking process from day one and were largely prepared for the outcome. Smaller US firms and foreign banks were caught

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somewhat by surprise – they will need to come up to speed quickly to fully understand the implications of the rule for their business and respond accordingly. For many foreign banks, this will involve significant restructuring to avoid trading with US counterparties or broader strategic decisions on the regional footprint of the business.

WHAT AFFECTED INSTITUTIONS NEED TO DO NOW

In the coming months, US and foreign-based banks with trading businesses should focus on:

- Actively participating in the 90-day comment period. All banks should work to ensure
 the agencies fully understand the impact of the proposed rule. Many aspects of the
 proposed rule (such as the extraterritorial application) seem unworkable in practice, and
 the number and range of questions posed in the notice make clear that there is scope
 for refinement.
- 2. Evaluating readiness and developing a plan to comply. While some uncertainty remains, the broad outlines of the compliance and reporting regime are now clear. Firms will need to start now to (i) assess the firm's readiness to comply with the new rules (e.g. which metrics will require significant changes to existing systems) and (ii) identify "high impact zones" across the trading business where significant restructuring may need to take place. This will involve a comprehensive review of existing trade reporting data/systems.
- 3. Launching a compliance development program. The Volcker Rule will have a profound impact on the trading businesses of banks in the US and abroad. This is much more than a compliance exercise senior engagement needs to set the strategy, agree resource commitments, and launch a program that will ultimately be led by Market Risk and the middle office. Given the substantial demands already being placed on these parts of trading organizations, prioritization and smart resourcing will be critical.
- 4. Developing operational solutions for compliance. The Volcker Rule will lead to significant restructuring for trading businesses to ensure trading activity does not violate (or even appear to violate) the provisions of the final rule. Some desks will be more affected than others, but legacy structures that consolidate internal trade flows, trade exclusively with other dealers, etc. may need to be revisited. This will require extensive preparation in the coming months to review (by 2012) and optimize (by 2014) desk structure.

CONCLUSION

Considerable challenges lie ahead for regulators and affected institutions in the US and abroad. Given the amount of attention and effort the Volcker Rule will require, the biggest challenge of all may be ensuring that other pressing issues are not starved for the regulatory and industry resources they need. There is a risk that the shared goals of reducing systemic risk, improving risk governance, effectively controlling operational risks, and ensuring that bank capital and liquidity are adequate and well-managed could be given short shrift as regulators and the industry focus on the complexities of Volcker Rule implementation. Financial regulation, like business itself, is a matter of prioritization.

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APPENDIX - REPORTING METRICS DEFINED

RISK-MANAGEMENT MEASUREMENTS

- 1. Value-at-Risk and Stress Value-at-Risk: Value-at-Risk ("VaR") is the commonly used percentile measurement of the risk of future financial loss in the value of a given portfolio over a specified period of time, based on current market conditions. For purposes of this appendix, Stress Value-at-Risk ("Stress VaR") is the percentile measurement of the risk of future financial loss in the value of a given portfolio over a specified period of time, based on market conditions during a period of significant financial stress
- 2. VaR Exceedance: VaR Exceedance is the difference between VaR and Portfolio Profit and Loss, exclusive of Spread Profit and Loss, for a trading unit for any given calculation period
- 3. Risk Factor Sensitivities: Risk Factor Sensitivities are changes in a trading unit's Portfolio Profit and Loss, exclusive of Spread Profit and Loss, that are expected to occur in the event of a change in a trading unit's "risk factors" (i.e., one or more underlying market variables that are significant sources of the trading unit's profitability and risk)
- 4. Risk and Position Limits: Risk and Position Limits are the constraints that define the amount of risk that a trading unit is permitted to take at a point in time, as defined by the covered banking entity for a specific trading unit

SOURCE-OF-REVENUE MEASUREMENTS

- 5. Comprehensive Profit and Loss: Comprehensive Profit and Loss is the net profit or loss of a trading unit's material sources of trading revenue, including, for example, dividend and interest income and expense, over a specific period of time. A trading unit's Comprehensive Profit and Loss for any given calculation period should generally equal the sum of the trading unit's (i) Portfolio Profit and Loss and (ii) Fee Income
- 6. Portfolio Profit and Loss: Portfolio Profit and Loss is a trading unit's net profit or loss on its underlying holdings over a specific period of time, whether realized or unrealized. Portfolio Profit and Loss should generally include any increase or decrease in the market value of a trading unit's holdings, including, for example, any dividend, interest income, or expense of a trading unit's holdings. Portfolio Profit and Loss should not include direct fees, commissions, sales credits, or other sources of trading revenue that are not directly related to the market value of the trading unit's holdings
- 7. Fee Income and Expense: Fee Income and Expense generally includes direct fees, commissions and other distinct income for services provided by or to a trading unit over a specific period of time
- 8. Spread Profit and Loss: Spread Profit and Loss is the portion of Portfolio Profit and Loss that generally includes revenue generated by a trading unit from charging higher prices to buyers than the trading unit pays to sellers of comparable instruments over the same period of time (i.e., charging a "spread," such as the bid-ask spread)
- 9. Comprehensive Profit and Loss Attribution: Comprehensive Profit and Loss Attribution is an attribution analysis that divides the trading unit's Comprehensive Profit and Loss

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into the separate sources of risk and revenue that have caused any observed variation in Comprehensive Profit and Loss. This attribution analysis should attribute Comprehensive Profit and Loss to specific market and risk factors that can be accurately and consistently measured over time. Any component of Comprehensive Profit and Loss that cannot be specifically identified in the attribution analysis should be identified as an unexplained portion of the Comprehensive Profit and Loss

REVENUE-RELATIVE-TO-RISK MEASUREMENTS

- 10. Volatility of Comprehensive and Portfolio Profit and Loss: Volatility of Comprehensive Profit and Loss generally is the standard deviation of the trading unit's Comprehensive Profit and Loss estimated over a given calculation period. For purposes of this appendix, Volatility of Portfolio Profit and Loss generally is the standard deviation of the trading unit's Portfolio Profit and Loss, exclusive of Spread Profit and Loss, estimated over a given calculation period
- 11. Comprehensive and Portfolio Profit and Loss to Volatility Ratio: Comprehensive Profit and Loss to Volatility Ratio is a ratio of Comprehensive Profit and Loss to the Volatility of Comprehensive Profit and Loss for a trading unit over a given calculation period. For purposes of this appendix, Portfolio Profit and Loss to Volatility Ratio is a ratio of Portfolio Profit and Loss, exclusive of Spread Profit and Loss, to the Volatility of Portfolio Profit and Loss, exclusive of Spread Profit and Loss, for a trading unit over a given calculation period
- 12. Unprofitable Trading Days: Unprofitable Trading Days Based on Comprehensive Profit and Loss is the number or proportion of trading days on which a trading unit's Comprehensive Profit and Loss is less than zero over a given calculation period. For purposes of this appendix, Unprofitable Trading Days Based on Portfolio Profit and Loss, exclusive of Spread Profit and Loss, is the number or proportion of trading days on which a trading unit's Portfolio Profit and Loss, exclusive of Spread Profit and Loss, is less than zero over a given calculation period
- 13. Skewness and Kurtosis of Portfolio Profit and Loss: Skewness of Portfolio Profit and Loss and Kurtosis of Portfolio Profit and Loss should be calculated using standard statistical methods with respect to Portfolio Profit and Loss, exclusive of Spread Profit and Loss

CUSTOMER-FACING ACTIVITY MEASUREMENTS

14. Inventory Risk Turnover: Inventory Risk Turnover is a ratio that measures the amount of risk associated with a trading unit's inventory, as measured by Risk Factor Sensitivities, that is turned over by the trading unit over a specific period of time. For each Risk Factor Sensitivity, the numerator of the Inventory Risk Turnover ratio generally should be the absolute value of the Risk Factor Sensitivity associated with each transaction over the calculation period. The denominator of the Inventory Risk Turnover ratio generally should be the value of each Risk Factor Sensitivity for all of the trading unit's holdings at the beginning of the calculation period

- 15. Inventory Aging: Inventory Aging generally describes the trading unit's aggregate assets and liabilities and the amount of time that those assets and liabilities have been held for the following periods: (i) 0-30 days; (ii) 30-60 days; (iii) 60-90 days; (iv) 90-180 days; (v) 180-360 days; and (vi) greater than 360 days. Inventory Aging should measure the age profile of the trading unit's assets and liabilities
- 16. Customer-Facing Trade Ratio: The Customer-Facing Trade Ratio is a ratio comparing (i) the number of transactions involving a counterparty that is a customer of the trading unit to (ii) the number of transactions involving a counterparty that is not a customer of the trading unit. For purposes of calculating the Customer-Facing Trade Ratio, a counterparty is considered to be a customer of the trading unit if the counterparty is neither (i) a counterparty to a transaction executed on a designated contract market registered under the Commodity Exchange Act or national securities exchange registered under the Exchange Act, nor (ii) a broker-dealer, swap dealer, security-based swap dealer, any other entity engaged in market making-related activities, or any affiliate thereof. A broker-dealer, swap dealer, or security based swap dealer, any other entity engaged in market making-related activities, or any affiliate thereof may be considered a customer of the trading unit for these purposes if the covered 263 banking entity treats that entity as a customer and has documented how and why the entity is treated as such

PAYMENT OF FEES, COMMISSIONS, AND SPREADS MEASUREMENT

17. Pay-to-Receive Spread Ratio: The Pay-to-Receive Spread Ratio is a ratio comparing the amount of Spread Profit and Loss and Fee Income that is earned by a trading unit to the amount of Spread Profit and Loss and Fee Income that is paid by the trading unit

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