SPEECHES & TESTIMONY

Dissenting Statement of Commissioner Dan M. Berkovitz on Volcker Rule Amendments – Final Rule

September 16, 2019

Congress adopted the statute commonly known as the "Volcker Rule" in the wake of the 2008 financial crisis to prevent banks that benefit from federal depository insurance or other government support from taking excessive risks that could lead to future taxpayer bailouts. The Volcker Rule prohibits proprietary trading and the owning of hedge funds and private equity funds by banks and their subsidiaries ("banking entities"), with certain exceptions and exemptions. In 2013 the Commission and other financial regulators adopted regulations to implement the Volcker Rule. The final rule before the Commission today ("revised Volcker Rule") substantially weakens these implementing regulations.

The revised Volcker Rule eliminates or reduces a variety of substantive standards in the current rule. The revised Volcker Rule will render enforcement of the rule difficult if not impossible by leaving implementation of significant requirements to the discretion of the banking entities, creating presumptions of compliance that would be nearly impossible to overcome, and eliminating numerous reporting requirements. The revised Volcker Rule also substantially reduces the bank trading activity covered by the rule. Finally, the revised Volcker Rule includes a number of changes and additions not contemplated or adequately discussed in the notice of proposed rulemaking (NPRM) in violation of the Administrative Procedure Act ("APA") requirements for public notice and comment for rulemakings.

For these reasons, I dissent.

Weak Regulation and Enforceability Concerns

Nearly every amending provision of the revised Volcker Rule adopts the weakened provisions from the NPRM, further weakens the proposed changes, or makes new changes that weaken or eliminate existing requirements and standards. New presumptions of compliance favoring the banking entities, regulatory determinations left to the banking entities, and reductions in reporting requirements by the banking entities will make the revised Volcker Rule more difficult to enforce. The cumulative effect of this myriad of changes is a set of regulations that is ineffective and unenforceable. Although a single chip off a sculpture, by itself, may not create a noticeable blemish, widespread chiseling will disfigure the object. Such is the result here.

The "trading account" definition and related regulatory exclusions in the 2013 rule determine which financial transactions are subject to the restrictions on proprietary trading. Financial transactions of banking entities are subject to the Volcker regulations if they fall within certain "prongs" established in the trading account provision. The revised Volcker Rule rejects the "accounting prong" proposed in the NPRM and effectively jettisons the existing "short-term intent prong" for most entities.[1] In addition, there are a number of newly created outright exclusions of whole types of transactions and broadening of existing exclusions under the revised Volcker Rule.

FDIC Commissioner Martin Gruenberg provided an analysis of how these changes will significantly reduce the banking activity subject to Volcker oversight. "By excluding these financial instruments from the Volcker Rule, the final rule . . . opens up vast new opportunity –hundreds of billions of dollars of financial instruments – at both the bank and bank holding company level, for speculative proprietary trading funded by the public safety net."[2]

The 2013 Volcker rules define the "trading desk" as the "smallest discrete unit of organization" that purchases and sells financial instruments. The revised Volcker Rule removes the quoted text, and instead provides four broad criteria for designating a trading desk. The rule then allows the banking entities to designate the trading desks for purposes of Volcker.

The new trading desk designation criteria appear to be broad enough that a “trading desk” could include whole business lines, divisions, or an entire swap dealer. The opportunities for undertaking greater amounts of proprietary trading expand significantly when the limits (which are set by the banking entities themselves), the desk-specific positions being hedged, and reporting requirements are applied to much larger trading portfolios. Because the revised Volcker Rule effectively presumes that these trading desk designations by the banking entities are valid, it will be more difficult for the applicable regulator to reign in proprietary trading undertaken by more expansively designated trading desks.

How much proprietary trading can occur under the market making exemption in the revised Volcker Rule will be determined by the risk limits set for each trading desk. The risk limits are to be established at the discretion of each banking entity and, as noted above, the scope of a trading desk also will be determined by the banking entity within broad criteria. “Reasonably expected near-term demand” (“RENTD”) of customers is included in the Volcker statute to establish the level of market making permissible. While the RENTD concept is still in the revised Volcker Rule, a presumption has been added that the RENTD levels set by each banking entity are correct.

Because these determinations will be established by the banking entity and presumed to be compliant, it will be difficult for any regulator to challenge them or take any enforcement action – even if a banking entity experiences large losses from proprietary trading – so long as the trading is found to be within the set limits.

These concerns about enforcement and oversight are exacerbated by the reduced metrics and other reporting, documentation, and compliance requirements. Numerous changes are made both as proposed and added on in this final rule. To name a few, stressed value at risk, daily risk factor sensitivities, and risk limit breaches need not be reported. In some cases, changes to reporting requirements make sense if experience shows a metric has little or no regulatory value. But most of these changes in the revised Volcker Rule are purportedly justified because they reduce the burden on banking entities and the cumulative effect on the ability of a regulator to monitor for compliance and potential significant issues is not addressed.

Logical Outgrowth Concerns

The revised Volcker Rule includes a number of new rules and amendments that were not mentioned or adequately described in the NPRM. The APA requires that a proposed rulemaking be published in the Federal Register and that interested persons be given an opportunity to comment.[3] A “notice of proposed rulemaking must provide sufficient factual detail and rationale for the rule to permit interested parties to comment meaningfully.”[4]

In comparing the revised Volcker Rule to the NPRM, there are a number of changes that were either not addressed in the NPRM or at best are based on comments received in response to general questions. For example, the NPRM included a proposal to replace the short-term intent prong with what is commonly referred to as the “accounting prong.” In the revised Volcker Rule, the accounting prong was rejected, but the short-term interest prong also is eliminated for most banking entities.[5] While replacing the short-term intent prong was discussed in the proposal, effectively eliminating the prong without a replacement was not proposed. Similarly the option for certain banking entities to now elect to comply with the market risk capital rule prong rather than the short-term intent prong was not discussed as an alternative. Nor was the replacement of the rebuttable presumption of proprietary trading for positions held shorter than 60 days with the opposite presumption that positions held longer than 60 days are not proprietary trading for purposes of the Volcker Rule. Agencies cannot “pull a surprise switcheroo” in the rulemaking process.[6]

Furthermore, the NPRM appears to not even contemplate excluding government bond assets and liabilities, mortgage servicing rights hedges, or financial instruments that are not trading assets or trading liabilities from counting as proprietary trading. Other changes, such as the elimination of incentive compensation limits, the matched derivatives transaction exclusion, and elimination of risk factor sensitivity metrics reporting appear to be based on general questions in the NPRM. In each case, no draft rule text or adequate discussion of such amendments was provided that would allow the public to have anticipated those amendments. Rather, many of these changes appear to be based on de novo comments made by banks or their trade organizations. "[I]f the final rule 'substantially departs from the terms or substance of the proposed rule,' the notice is inadequate."[7]

Conclusion

Self-regulation failed us in the early part of this century. Dodd-Frank, including the Volcker Rule, has helped this country rebuild a strong and better managed financial sector. To maintain a robust financial sector that benefits the American people, we must maintain strong standards and vigorous oversight. Otherwise, it is only a matter of time before the memory of the huge losses and resulting pressures for a taxpayer bailout fades and excessive risk taking comes home to roost. While the Dodd-Frank regulations may not be perfect and modest adjustments may be appropriate, the wholesale revision of regulations that greatly weaken the enforceability of those regulations such as we have before us today will, in the long run, weaken the financial sector and pose risks to the American public.

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[1] While the short-term intent prong remains for a limited number of banks not subject to the market risk capital rules in banking regulations, compliance with the short-term intent prong is now optional if those banking entities instead elect to comply with the market risk capital rules for Volcker compliance.

[2] Statement by Martin J. Gruenberg, Member, FDIC Board of Directors, *The Volcker Rule* (Aug. 20, 2019) at 3, available at https://www.fdic.gov/news/news/speeches/spaug2019b.pdf.

[3] 5 U.S.C. 553(b) and (c).

[4] *Honeywell Int'l, Inc. v. EPA*, 372 F.3d 441, 445 (D.C. Cir. 2004) (internal quotation marks omitted).

[5] Firms subject to, or which elect to be subject to, the market risk capital rule prong are no longer subject to the short-term intent prong.

[6] *Environmental Integrity Project v. EPA*, 425 F.3d 992, 996 (D.C. Cir. 2005).

[7] *Chocolate Manufacturers Assoc. of the United States v. Block*, 755 F.2d 1098, 1105 (4th Cir. 1985) (*quoting Rowell v. Andrus*, 631 F.2d 699, 702 n.2 (10th Cir. 1980).