



Americans for Financial Reform
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December 18, 2015

The Honorable Thomas J. Curry,
Comptroller
Office of the Comptroller of the Currency
250 E Street SW
Washington, DC 20219

The Honorable Timothy Massad, Chairman
Commodities Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington DC, 20581

The Honorable Martin Gruenberg, Chairman
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

The Honorable Mary Jo White, Chair
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

The Honorable Jacob Lew, Secretary
U.S. Department of the Treasury
1500 Pennsylvania Avenue NW
Washington, DC 20220

The Honorable Janet L. Yellen, Chair
Board of Governors of the Federal Reserve
System
20th Street and Constitution Ave., NW
Washington DC, 20551

Dear Comptroller Curry, Chair Gruenberg, Secretary Lew, Chair Massad, Chair White, and Chair Yellen:

On behalf of Americans for Financial Reform, we are writing to urge you to provide far more extensive transparency into the implementation of the Volcker Rule's prohibitions on proprietary trading by banking organizations.¹ In the absence of such transparency, the public cannot have confidence that the law has been effectively implemented. In the following we recommend specific measures for improving the public's understanding of the Volcker Rule's implementation and its effects on bank behavior.

Background

In July of this year, five years after it passed into law, the Volcker Rule (Section 619 of the Wall Street Reform and Consumer Protection Act, also known as Dodd-Frank) finally went into legal

¹ Americans for Financial Reform is a coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups. A list of coalition members is available at <http://ourfinancialsecurity.org/about/our-coalition/>

effect.² The public received considerable information about the Volcker Rule during the passage of Dodd-Frank and prior to the approval of the final rule in December 2013. But since the passage of the final rule, regulators have failed to clearly inform the public, or even lay out a plan for clearly informing the public, as to the parameters for enforcement of the rule, the standards for compliance, the penalties for non-compliance, and the success or failure of major banking organizations in achieving compliance.

This lack of transparency is especially significant since the Final Rule approved in 2013 left major uncertainties as to the actual, on-the-ground limits on trading and investment activities that would result from the Volcker Rule. The Final Rule described a number of metrics of trading activity that would be tracked by regulators in order to determine whether banks had exceeded the bounds of market-making and were engaging in proprietary trading. However, the Final Rule did not specify exactly how the metrics would be used, the quantitative thresholds that would determine whether regulators judged proprietary trading to be taking place, or the procedure for penalizing non-compliance. Many other key areas of Volcker Rule implementation – including the level of additional risk that could be incurred in hedging activities, the amount of inventory holdings permitted after an underwriting, the specific types of high risk assets and trading strategies that would not be permitted under the rule, and the specific protections against material conflicts of interest that institutions would be required to have in place in order to comply with the statutory ban on such conflicts – were also left to supervisory discretion under the Final Rule.

We understand that enforcing the statutory prohibitions of the Volcker Rule while still allowing the range of activities permitted under the law does require some degree of supervisory discretion. We also understand that some information gathered in Volcker Rule enforcement can reasonably be seen as confidential business information. But both of these circumstances could be respected while providing much more information about implementation and compliance. The current lack of transparency is likely to create public doubts concerning the efficacy of the rule. It will also lead to confusion among market participants, including business competitors of major banks, as to the level and kind of trading permitted within bank holding companies.

This is especially true since overall levels of trading activity at bank holding companies do not appear to have materially declined over the initial Volcker Rule implementation period (the period since the passage of the Final Rule in December 2013). As discussed in the attached Appendix to this letter, public data shows little evidence of a significant impact of Volcker Rule implementation so far. For example, overall bank trading revenues appear to be at roughly similar levels to what they were prior to the beginning of Volcker Rule implementation.

The Volcker Rule of course continues to permit trading for market-making and underwriting purposes, and so is compatible with significant continued trading activity. In addition, there are

² Regulators have begun audits to determine compliance with the proprietary trading portion of the Volcker Rule. However, the enforcement of the crucial ‘covered funds’ portion of the rule, which covers bank investments in hedge funds and private equity funds, has been delayed by two years, until July 2017.

many influences on the level of trading activity beyond Volcker Rule implementation. But the lack of any clear pattern of change still raises legitimate questions for the public about what exactly has been accomplished in the course of Volcker Rule implementation. If bank trading activity and revenues is not a good metric of the rule's success, then regulators should provide alternative outcome metrics demonstrating the effect of the rule on bank activities or risks.

The two-year delay by regulators in the implementation of Volcker Rule prohibitions on bank investment in hedge and private equity funds also leads to concerns regarding the effectiveness of the rule's implementation. Since proprietary trading can take place indirectly through these types of funds, the Volcker Rule prohibition on proprietary trading will not be fully effective until regulators implement the covered funds provision of the rule as well. There has been no transparency provided to the public concerning the extent and nature of bank's remaining investments in covered funds and the plans for unwinding these investments by 2017.

These questions about the Volcker Rule's effectiveness and implementation should be addressed through much greater and more detailed reporting by regulators, including making more data available on bank trading practices. Beyond creating public accountability for successful Volcker Rule implementation, broader transparency for bank trading practices under the Volcker Rule would have additional benefits. Such transparency would inform the market – including bank investors, counterparties, and non-bank competitors – as to the specific nature of market-making activities permitted under the law. In addition, the release of detailed information on the Volcker Rule's implementation would allow outside experts and academics to conduct research and provide commentary on the effectiveness of the Volcker Rule in reducing systemic risk.

Recommendations

Below, we give four specific recommendations for providing regulatory transparency.

I. Give a qualitative overview of Volcker Rule enforcement, including progress, violations, penalties, exceptions, escalations, and areas in which compliance must be improved

Regulators should provide the public a summary overview of their progress in implementing and enforcing the Volcker Rule on at least an annual basis. As the Volcker Rule's final regulations do not make clear the specific trading behaviors that will count as a violation, or the penalties for such violations, such a summary will be useful in helping the public understand the emerging boundaries of permissible trading behavior and how such boundaries are enforced. A progress overview should also include discussion of key decisions being made that will shape rule enforcement (e.g. the exact parameters of the "customer" definition, any important decisions made regarding ownership interest in covered funds, etc.).

Such a report should also include counts and descriptions of Volcker Rule violations and any penalties resulting from such violations. Descriptions should include the nature of the violation

and the area of the Volcker Rule involved (e.g. proprietary trading, permitted investments, or conflicts of interest), as well as the institution committing the violation and the reason why it was found to have violated the Volcker Rule. The Volcker Rule's regulations also state that bank compliance procedures should include a mechanism for making and approving requests for exceptions to trading risk limits set under the rule. To give a sense of the enforcement of Volcker rule limits, regulatory reporting should also include aggregate figures for the number and size of exceptions to pre-set risk limits that were permitted over a given time period, along with the number of requests for exemptions, and the percent granted and denied.

II. Release certain summary quantitative metrics governing market-making and underwriting activities at the trading desk level

According to the Basel Committee's recent Comprehensive Review of the Trading Book, the consensus of the international community of banking regulators is that banks should make public a broad set of quantitative and qualitative data regarding activities for each individual bank trading desk.³ The recommended data releases include a wide variety of desk-level risk measurements as well as a qualitative description of the desk structure of the firm and the types of instruments traded at each desk. AFR strongly supports the Basel Committee's recommendation to release this data at the trading desk level.

In implementing the Volcker Rule, regulators are relying on tracking aggregate quantitative metrics of trading activity at the trading desk level. These metrics are tabulated on a daily basis and are used to determine whether proprietary trading activity is taking place. We believe that the U.S. implementation of Basel recommendations on trading desk transparency should also include the release of certain key desk-level Volcker Rule metrics. These metrics can be released on a delayed basis (e.g. after several months) to address any concerns about the potentially sensitive nature of contemporary information. The metrics to be released should include reasonably expected near-term customer demand (RENTD), profit and loss attribution, inventory turnover, inventory aging, and the volume and proportion of trades that are customer-facing. To render metrics such as customer-facing trades easier to understand, information on the nature and type of counterparties who are counted as "customers" should be released as well.

These aggregated metrics should not raise confidentiality concerns, particularly when released on a delayed basis.⁴ It would be effectively impossible for a counterparty to profitably make specific

³ See Tables 10 and 11 (pp. 114-115) in Basel Committee on Banking Supervision, "[Fundamental Review of the Trading Book: A Revised Market Risk Framework](http://www.bis.org/publ/bcbs265.pdf)", Bank for International Settlements, October, 2013, available at <http://www.bis.org/publ/bcbs265.pdf>

⁴ Indeed, we believe that the release of even much more extensive trading data would not create a true business confidentiality concern, so long as a delay period was sufficient that the bank was generally no longer holding positions related to the trade. Reverse engineering a bank's trading strategy based on stale information would be both enormously difficult and extremely risky for a counterparty who intended to actually trade on such information. See <http://ourfinancialsecurity.org/blogs/wp-content/ourfinancialsecurity.org/uploads/2013/10/KYLE-PPT.pdf>

trades based on such aggregated and general information, particularly when it is released after a substantial delay.

In addition, trading desks should be required to release similar information on trading and inventory linked to their underwriting activities. Underwriting activities for illiquid securities have been a significant contributor to financial risk in the past, and today in the market for leveraged loans. As we understand that regulators are using similar desk-level trading metrics to track underwriting activity, these should be released at an aggregated level to the public as well.

III. Provide a more general overview discussion, including quantitative ranges, of trading desk risk limits and how they are determined, as well as the methodologies for estimating near term customer demand

As part of Volcker Rule compliance, banks are expected to set market making risk limits at the trading desk level. Unlike the inventory and profit metrics listed above, the specific details of trading desk risk limits could raise real confidentiality concerns, as they represent bank policies concerning the specific level and type of trades that are permitted at a desk. However, these risk limits are also at the core of Volcker Rule enforcement. We suggest that regulators provide the broad parameters of risk limits permitted in different markets, including some quantitative ranges for such limits. Such an overview discussion could usefully focus on different markets and types of securities, rather than individual banks.

We also believe that regulators should provide an overview discussion of the principles that guide oversight of bank modeling of risk limits and reasonably expected near term customer demand (“RENTD”). The RENTD concept and its relation to risk limits is at the core of the market making restrictions in the Volcker Rule, and these restrictions will simply not be effective unless these parameters are calculated in a consistent and realistic manner.

We believe regulators should provide particularly extensive detail and discussion concerning the use of the RENTD concept and applicable risk limits in thin, illiquid, and exotic markets. AFR and other commenters have raised concerns as to whether the concept of “market-making” can be effectively operationalized when the external market is limited or the instrument is exotic, and we do not feel that regulators have made the response to this question clear. Markets in which a small set of banks both create the securities and support demand for these securities could create a deceptive picture of external customer demand.

IV. Report information on exposure to private equity and hedge funds permitted under the Volcker Rule, as well as required divestments under the rule

The Volcker Rule generally bans bank investments in private equity and hedge funds. This is a critical element of the rule. Without this limitation on bank investments banks could gain proprietary trading exposures. However, there are also a significant number of exemptions to this

ban, including various *de minimis* exemptions, and exemptions added by regulators to accommodate securitization vehicles. In addition, news reports have made it clear that some banking entities have pursued investments that appear designed to test the boundaries of the ownership interest definition.⁵

We recommend that regulators report on all bank interests in funds that qualify as hedge or private equity funds under the Section 619 statutory definition, and exactly which exemption or exception permits any retention of ownership in such funds. Regulators have delayed full implementation of the investment ban until 2017. The reasons for this delay are unclear, but in the period before the investment ban goes into full effect we believe that regulators should provide information on the size and nature of bank holdings that they expect banks will be required to divest when the Volcker Rule is fully implemented.

Conclusion

The four recommendations above would provide the public and market participants with a solid evidence base for understanding the implementation of the Volcker Rule and its impact on bank trading practices. In the absence of this kind of transparency, the extremely opaque nature of the supervisory process and the complexity of the regulatory implementation of the rule mean that it will not be well understood outside of a relatively small circle of insiders at the largest banks and within the regulatory agencies. Given the significance of this rule and its importance to the financial system, this is not an acceptable outcome. We therefore urge you to release detailed information to the public regarding the implementation and impact of the Volcker Rule.

We understand that there could be complexities in implementing the recommendations above, particularly as providing the accessible and unified overview of enforcement recommended in this letter would require close coordination between the five different agencies involved with Volcker Rule implementation. However, such coordination would be a worthwhile investment. In addition to making it possible to give the public a clear overview of Volcker Rule implementation, coordination would be beneficial to regulators and regulated entities in ensuring clarity and consistency in the implementation of the rule.

We hope that this letter is helpful to you in improving the transparency of the Volcker Rule to the public. We would also like to request the opportunity for a follow-up discussion with you concerning the recommendations in this letter.

Sincerely,

Americans for Financial Reform

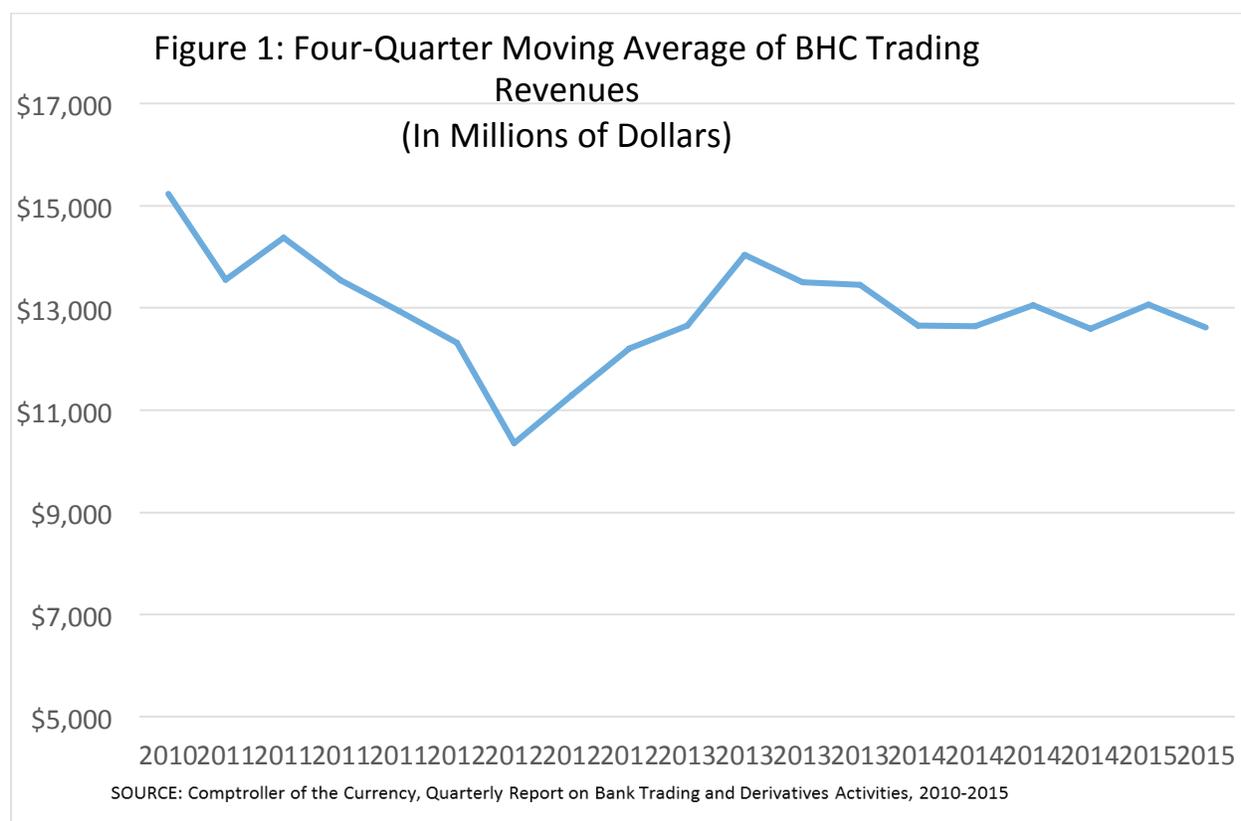
⁵ Nathaniel Popper, "Goldman Sachs Investments Test the Volcker Rule," THE NEW YORK TIMES, (Jan. 21, 2015), http://dealbook.nytimes.com/2015/01/21/goldman-investments-are-testing-volcker-rule/?_r=0.

APPENDIX: Bank Trading Revenues Since the Passage of the Volcker Rule

Since the passage of the Dodd-Frank Act, there have been many reports in the popular press of banks divesting proprietary trading operations. More recently, declines in fixed income, commodity, and currency (FICC) trading revenues for a number of major banks in Q3 2015 led to a wave of press stories on the decline of trading as a profit center for major Wall Street banks.

However, a closer examination of the data shows that it is difficult to find a clear impact of the Volcker Rule on overall bank trading revenues. Q3 2015 trading revenues did decline at a number of major banks, but levels were much higher over the first half of the year. While Volcker Rule enforcement only began in summer 2015, meaning that Q3 revenues could indicate the impact of the rule, banks have been aware of the Volcker Rule since 2010 and formal implementation of the rule began with the passage of the final implementing regulation at the end of 2013.

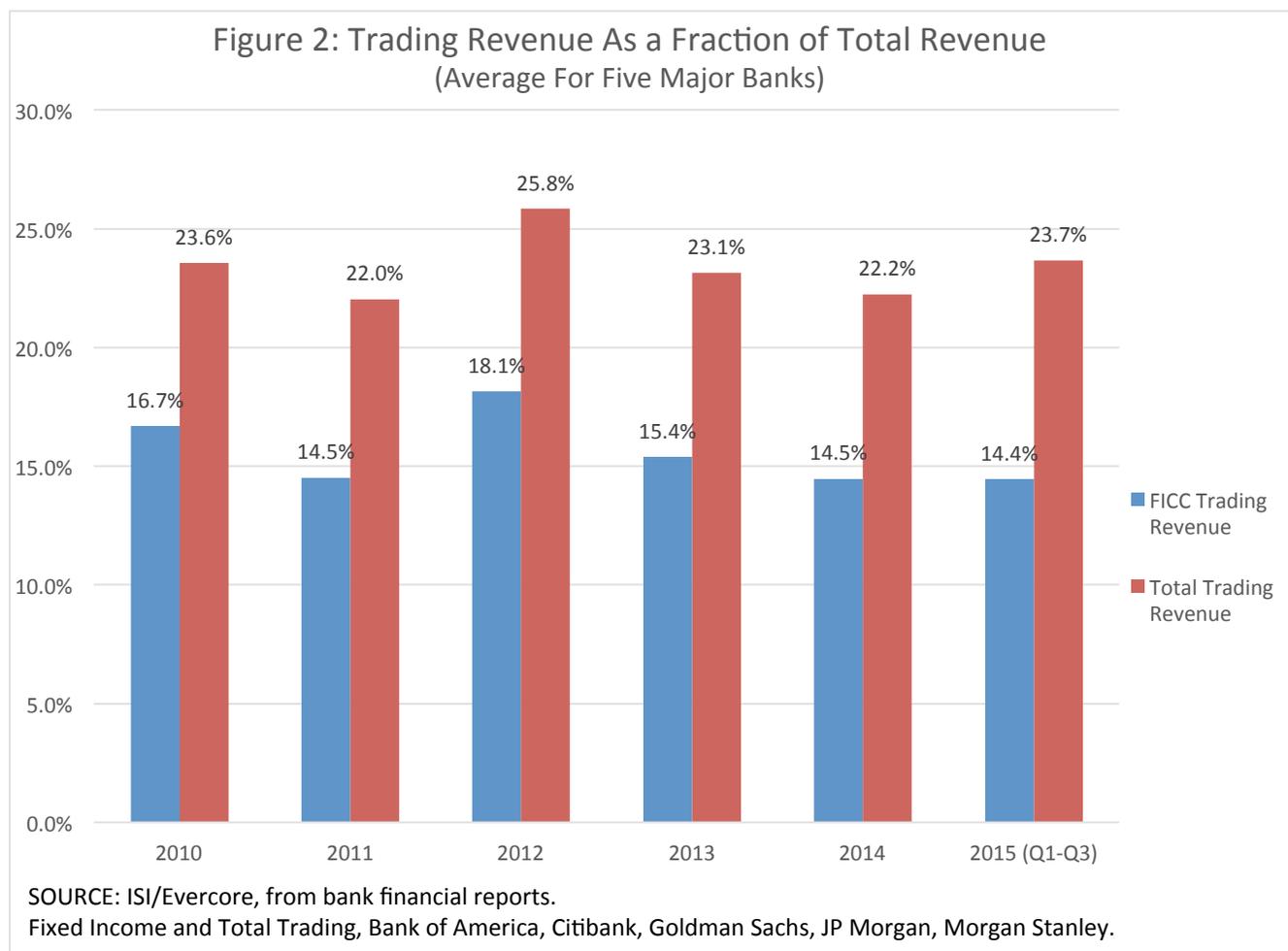
Bank trading revenues over this longer period of time do not show a clear pattern. Figure 1 below is drawn from call report data, and shows the four-quarter moving average of overall trading revenues at all U.S. bank holding companies.⁶



⁶ The data is collected in trading reports, available at <http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/derivatives-quarterly-report.html>. As call report data did not yet include Q3 2015 at the time this Appendix was released, the chart is current only through mid-year 2015.

These revenues declined from unusually high levels in 2010 but have been steady at an average of around \$13 billion per quarter since the Volcker Rule was finalized at the close of 2013.

The second chart below is drawn from financial reports to the SEC by five major banks.⁷ The chart shows trading revenues as a fraction of overall bank revenues, both for total trading revenues and Fixed Income, Commodity, and Currency (FICC) revenues.



The chart shows that trading revenues in the first three quarters of 2015 are little under 24% of total bank revenues, about the same as they were in 2010 when Dodd-Frank was passed. FICC revenues, which some see as the most important area of bank trading, have declined somewhat as a share of overall bank revenues since the Dodd-Frank was passed and the Volcker Rule was finalized at the close of 2013, but not by a very significant amount.

⁷ The data is drawn from the ISI/Evercore database of financial reporting data, current as of Q3 2015. The spreadsheet containing the revenue data used can be downloaded at <http://ourfinancialsecurity.org/wp-content/uploads/2015/12/ISI-Evercore-Investment-Banking-Revenue-Data-Through-2015-YTD.xlsx>

Other evidence also tends to indicate that the Volcker Rule has had a limited effect so far. For example, the Office of Financial Research in their recent Financial Stability Report concludes that there has been ‘limited aggregate effect’ from the Volcker Rule. The OFR’s research finds that while bank trading books overall have become smaller, likely due to stricter capital rules, banks have reduced their holdings of those securities exempt from Volcker Rule limits (such as government securities) by more than they have reduced their holdings of trading assets covered by the Volcker Rule.⁸

Of course, none of this data is dispositive concerning the impact (or lack of impact) of the Volcker Rule on trading practices. Many activities permitted under the Volcker Rule, notably market-making, underwriting, and various forms of agency trading, will generate trading revenues. The Volcker Rule also affects a number of activities, such as investments in hedge and private equity funds that affect bank revenues in areas other than trading. In addition, since Volcker Rule enforcement only began in July, 2015, the complete impact of implementing the rule may not yet be evident. Finally, completely separately from Volcker Rule implementation, changes in market conditions and customer demands have a significant impact on trading revenues and trading assets.

Nevertheless, the implementation of a historic new mandate such as the Volcker Rule, which bans a significant range of previously permitted bank trading activities, could be expected to have a significant and visible impact on even crude top-line metrics such as bank trading revenues and their significance as a revenue source for major banking institutions. Based on public data, such an impact is not apparent. Especially in the absence of additional transparency provided by regulators on the effects of the Volcker Rule, this is a disturbing indicator.

⁸ See pp. 59-60, Office of Financial Research, “[2015 OFR Financial Stability Report](https://financialresearch.gov/financial-stability-reports/files/OFR_2015-Financial-Stability-Report_12-15-2015.pdf)”, Office of Financial Research, December 15, 2015. Available at https://financialresearch.gov/financial-stability-reports/files/OFR_2015-Financial-Stability-Report_12-15-2015.pdf

