

Daniel K Tarullo: Volcker Rule

Testimony by Mr Daniel K Tarullo, Member of the Board of Governors of the Federal Reserve System, before the Committee on Financial Services, U.S. House of Representatives, Washington DC, 5 February 2014.

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Chairman Hensarling, Ranking Member Waters, and other members of the committee, thank you for the opportunity to testify on the interagency final rule implementing the requirements of section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), commonly known as the Volcker Rule. Section 619 of the Dodd-Frank Act generally prohibits any banking entity from engaging in proprietary trading. It also generally prohibits a banking entity from investing in, or having certain relationships with, a hedge fund or private equity fund (a covered fund). My remarks today will focus on the recent actions taken by the Federal Reserve Board and other agencies responsible for issuing implementing rules under section 619. As I have previously noted in congressional testimony, the goal of the Federal Reserve with respect to this and all other provisions of the Dodd-Frank Act is to implement the statute in a manner that is faithful to the language of the statute and that maximizes financial stability and other social benefits at the least cost to credit availability and economic growth.

As you know, on December 10, 2013, the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the Commodity Futures Trading Commission (collectively, the agencies) approved a common final rule that was developed jointly to implement section 619 of the Dodd-Frank Act.¹ This final rule applies the statutory provisions to insured depository institutions; companies that control an insured depository institution; and foreign banks with a branch, agency, or subsidiary bank in the United States, as well as to affiliates of these entities, such as broker-dealers and commodity pool operators.

The final rule is not a regulation that would have been written by any one agency, much less by any one principal at any of those agencies. But I think the text is an improvement, both normatively and technically, on the proposed rule issued in October 2011. The basic approach of the final rule is generally consistent with that adopted in the proposed rule, but the many comments we received from a variety of perspectives, including from members of Congress, helped us make useful changes and clarifications throughout the final rule. Also, of course, the “London Whale” episode allowed staff to test the procedural and substantive requirements of the proposed rule against a real-world example of what should not happen in a banking organization.

The final rule has been modestly simplified from the 2011 proposal, but the agencies found that a good bit of the complexity in the proposal was hard to avoid in the final rule. Much of the remaining complexity lies in the part of the rule dealing with covered funds. The part of the rule dealing with proprietary trading has been streamlined somewhat, particularly by reducing the number of metrics that will be used in the reporting and analysis of trading data.

Of course, as I have noted in previous testimony, a fundamental challenge of the Volcker Rule is to distinguish between proprietary trading, on the one hand, and either market-making or hedging, on the other hand. The difficulty in making this distinction inheres in the statutory provision that makes trades either permissible or impermissible depending on the intent of the trader and the context and circumstances within which the trades are made. While the final rule issued by the agencies articulates standards for making those distinctions, those standards will be given meaning as they are applied by banking entities and supervisors in the field. Thus, implementation will be particularly important in continuing to shape the Volcker Rule. The

¹ See the agencies’ joint press release, www.federalreserve.gov/newsevents/press/bcreg/20131210a.htm.

extended conformance period, during which relevant data will be collected from large banking organizations, will allow for the development of additional guidance. More generally, one would expect that a good many of the uncertainties will be reduced over time, as both banking entities and regulators gain experience with this new regulatory framework.

The final rule requires banking entities with significant trading operations to report to the appropriate regulatory agency a variety of metrics. These data will be an important tool to help firms and regulators monitor and identify prohibited proprietary trading and high-risk trading strategies. In order to minimize burden and give full effect to the conformance period provisions of section 619, the reporting requirements are applied in a graduated manner, with only the firms with the largest trading books required to report metrics. These metrics will be used to trigger further scrutiny by banking entities and examiners in their evaluation of whether a banking entity is engaged in permitted or prohibited trading activities. As part of implementation, we expect that a horizontal comparison of these metrics across firms and over appropriate time periods will help improve our understanding of the trading activities of banking entities. The agencies will continue to review and revise these metrics, as appropriate, as we learn what metrics are most useful.

The covered funds provisions of the interagency final rule are mainly driven by the specific requirements of the statute, which sets limits on the amount of investments that banking entities may make in covered funds as well as the types of relationships that banking entities may have with covered funds. These provisions are largely designed to limit exposures by banking entities to covered funds, ensure that banking entities do not attempt to bail out other investors in covered funds, and prevent banking entities from using covered funds to evade the prohibition on proprietary trading. The agencies recently addressed an issue raised by the confluence of the covered fund restrictions of the Volcker Rule, accounting requirements, and the grandfathering provisions of section 171 of the Dodd-Frank Act (commonly known as the Collins Amendment) as they applied to investments in collateralized debt obligations backed by trust-preferred securities issued by community banking organizations. This is an early example of the constructive interagency cooperation that the agencies plan to bring to resolving issues raised by the regulations implementing the Volcker Rule.

Both the proprietary trading and the covered fund restrictions and prohibitions of section 619 of the Dodd-Frank Act became effective on July 21, 2012. The statute provides banking entities a period of two years to conform their activities and investments to the requirements of the statute. Section 619 also permits the Board to extend this conformance period, one year at a time, for a total of no more than three additional years. Many commenters requested that, prior to or in connection with issuing a final rule, the Board extend the conformance period by an additional year. After consultation with the other four agencies and in connection with issuing the final rule in December, the Federal Reserve granted a one-year extension of the conformance period until July 21, 2015. This extension provides banking entities with additional time to develop appropriate compliance programs as well as to identify and conform activities and investments to the requirements of the final rule. Providing banking entities with sufficient time for these actions is consistent with protecting the safety and soundness of banking entities because it allows for the termination of activities and the divestiture of prohibited investments in an orderly manner.

Because the bulk of the activities encompassed by the statute takes place in U.S. broker-dealers and national banks, entities for which the Federal Reserve is not the primary supervisor, we will have a somewhat lesser role in the Volcker Rule implementation process. But as the primary supervisor for state member banks, foreign broker-dealer subsidiaries of U.S. bank holding companies, and state-chartered branches of foreign banking organizations, we will still have a role to play. Staff of the Federal Reserve will continue to engage with staff of the other agencies and work together, to the extent appropriate and practicable, to help ensure consistency in application of the final rule to banking entities within their respective jurisdictions. Indeed, shortly after adopting the Volcker Rule, the five agencies agreed to create an interagency working group in pursuit of this goal, and the group has already begun to meet.

It remains to be seen whether other jurisdictions will adopt banking reforms similar to the Volcker Rule. While reforms dealing with the trading activities of banking firms have been recommended by the Vickers Commission in the United Kingdom and by the Liikanen Group in the European Union, neither of these approaches expressly prohibits a consolidated banking firm from engaging in proprietary trading. Rather, these reforms bear closer resemblance to the traditional U.S. banking structure concept of ring-fencing depository institution subsidiaries of bank holding companies. Most notably, under both Vickers and Liikanen, banking firms would be able to continue to engage in proprietary trading, but would simply be required to do it outside of the retail deposit-taking unit of the organization. Some individual countries – France and Germany, for example – have developed banking structure reforms that specifically address proprietary trading, but it appears that these proposals as well would require only a push-out of certain proprietary trading activities to non-bank affiliates. And just last week, the European Commission proposed bank structural reform that would prohibit certain large European banking firms from operating standalone proprietary trading desks, though this proposal appears to differ from the Volcker Rule in a number of significant respects.

It is also important to keep in mind that the Volcker Rule has limitations, and it is critical that the Federal Reserve and other agencies take a comprehensive and appropriately tough approach to monitoring and constraining the risks in all the trading operations of our largest financial institutions. Capital regulation is at the core of that comprehensive approach. To that end, the Basel 2.5 and Basel 3 capital reforms that the federal banking agencies have developed and adopted in final form in the past several years are crucial. Bank liquidity regulations, such as the Basel 3 liquidity coverage ratio and net stable funding ratio, are also significant elements of the program. And at the Federal Reserve, this focus on monitoring and constraining the risks in the trading operations of our largest banking firms may also be seen in our supervisory assessment process – through the trading book market shock conducted as part of the comprehensive capital analysis and review, or CCAR, and the stronger overall supervision of trading operations conducted by our large institution supervision coordinating committee, or LISCC. These approaches to strengthening the risk management, capital, and liquidity positions of our largest banking firms augment and enhance the steps taken under the Dodd-Frank Act to strengthen the financial health and resiliency of our banking system.

Thank you for your attention. I would be pleased to answer any questions you might have.