IMPLEMENTING VOLCKER: who sets the standards for compliance and reporting?

After a lengthy development period, the Volcker rule (section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act) finally hit the regulatory statute books on December 10, 2013. Prior to finalization, many banks had already started work to meet the anticipated requirements for compliance. In this article, Chris Collins, Ted Harvey and Alpa Rajai discuss the real-world challenges associated with Volker’s conformance and reporting requirements and propose some immediate actions that firms can consider as they work to comply with this long-anticipated regulation.

Volcker, like many recent regulatory initiatives, is aimed as much at driving changes to culture as it is at compliance and risk mitigation. It outlines three areas that firms must address for compliance:

- Structure, strategies and products
- Compliance monitoring and reporting
- Compensation and culture

For most firms, the initial focus has been on restructuring legal entities, booking models and trading books which extended to the disposal of their proprietary trading (prop trading) businesses. The restructuring exercise involved evaluating all trading practices to support a liquidity plan and setting the wheels in motion for strategic changes to booking models (separation of “books”) and trading and hedging strategies. In some cases, this has involved major wind-downs and sell-offs in an effort to reduce or eliminate positions in entities that fall under the Volcker compliance purview, such as a private equity or hedge fund (covered funds).

With the decisions required for streamlining close to completion for many, financial institutions have started taking the more challenging next steps towards implementation and conformance, which include the reporting of metrics and the implementation of compliance programs as shown in Figure 1. With the onus on the larger firm to prove that they are not undertaking any prop trading, these measures are required even in the absence of restricted activity or ownership. This is to help to ensure that any future changes to the business model, products or strategies do not prejudice a firm’s position under Volcker.

DATA MANAGEMENT AND REPORTING CHALLENGES

Although the final Volcker rules reduced the possible list of metrics reporting to just seven, daily data aggregation and consistency will pose problems for many firms. The seven metrics now required by Volcker include:

- Risk and Position Limits and Usage
- Risk Factor Sensitivities
- Value-at-Risk and Stress Value-at-Risk
- Comprehensive Profit and Loss Attribution
- Inventory Turnover
- Inventory Aging
- Customer Facing Trade Ratio

Figure 1: Volcker Requirements and Associated Timelines

METRICS REPORTING

Reporting of all metrics required
- Changes to Trading Unit Processes
  - Additional data/calculations - Comprehensive profit and loss attribution, inventory aging and customer-facing trade ratio
  - Business and technology assessment for reporting consistency across trading units
- Calculation Systems and Aggregation
  - Additional data/calculations – Inventory aging, customer-facing trade ratio
  - Processes needed to collect, store, format and report these metrics
- Enhancements to Risk Systems
  - Additional data/calculations - VaR exceedance, inventory turnover

COMPLIANCE

Compliance program required for gate keeping, monitoring and auditing
- Monitoring and Investigative Capabilities
  - Ability to calculate, store, view and report supporting detail for required metrics
  - Centralized investigative support and monitoring
- Data Sourcing and Storage
  - Ability to identify and recall trade sources and attributes for investigative analysis
  - Data identification and standardization across trading desks
  - Capability to drill down and research
The final rule retains seven of the proposed seventeen metrics, with some simplification of calculations. They include:

1. Risk and Position Limits and Usage
2. Risk Factor Sensitivities
3. Value-at-Risk and Stress Value-at-Risk
4. Comprehensive Profit and Loss Attribution
5. Inventory Turnover
6. Inventory Aging
7. Customer-Facing Trade Ratio

For some firms, the majority of these metrics may already be calculated under existing processes either at the desk level or as part of current market risk management functions. However, as part of conformance, the calculations must be cross checked with the detail in the rules because there are still some areas where the granularity of Volcker metrics may need additional calculations at the trading book level or enhancements to calculations performed elsewhere in the firm.

Additionally, there could be gaps in the calculation of comprehensive profit and loss, inventory turnover metrics and customer trade ratios. For example, comprehensive profit and loss may be currently calculated at a trading desk level and not calculated per individual trading book. Derivatives desks may not calculate inventory turnover since it is not as relevant a metric and some desks may not differentiate interdealer trades from customer trades. For most firms, some additional work will be required to discover and submit this data.

The agencies responsible for the rule intend to compare this data collected across banks during a review period. They will then evaluate whether the metrics and the various limits on them provide a way to assess approved activities [such as market making and hedging] and, in turn, whether proprietary trading is taking place. Following this assessment, they may adjust their requirements for metrics reporting. As such, firms will want to build flexibility into any technical solutions since they may be tweaked later as regulatory requirements change.

While most metrics are requested at the desk level, the final report submitted to regulators will likely be aggregated at a consolidated level. Therefore, it is important to combine the metrics produced by each desk into a firm-wide report that is subject to the appropriate control and assurance reviews before submission.

To make this happen, firms must first normalize the output and aggregate the metric reports (assuming that most of the metrics are being produced by desks already). This alone can be an extensive exercise subject to a number of risks.

### METRICS REPORTING REQUIREMENTS

| 1. Risk and Position Limits and Usage | These first three metrics related to risk are intended to "characterize the overall risk profile of trading activities" (Volcker preamble, p. 834) and determine if this activity is permissible. The agencies will be looking for changes in this behavior or inconsistencies across trading desks or banks. |
| 2. Risk Factor Sensitivities | |
| 3. Value-at-Risk and Stress Value-at-Risk | |
| 4. Comprehensive Profit and Loss Attribution | Desks are required to break out profit and loss attributable to i) Existing positions (close of business prior day), ii) New positions (day’s trading activity) and iii) Residual, non-attributable. The intent is to “capture the extent, scope, and type of profits and losses generated by trading activities” (Volcker preamble, p. 841). |
| 5. Inventory Turnover | These remaining customer-facing activity measures are aimed at characterizing trading activities and distinguishing customer transaction volumes as a fraction of the overall business. |
| 6. Inventory Aging | |
| 7. Customer-Facing Trade Ratio | |

Reporting dates are based on a bank’s gross sum of trading assets and liabilities over the previous year (excluding some approved trading activity and also differing for US banks and foreign subsidiaries located in the US).

- Greater than $50 billion—June 30, 2014
- Between $25 billion and $50 billion—April 30, 2016
- Between $10 billion and $25 billion—December 31, 2016

All metrics must be calculated daily, submitted monthly for banks larger than $50 billion and quarterly for other banks. The agencies will review data collected prior to September 30, 2015 and may revise the required metrics.
and requiring a complex control environment depending on the number of desks involved. A more strategic approach, however, would be to conduct a complete and in-depth evaluation of the underlying data and calculation models used to produce the results. It is possible that a firm has desks trading similar products across different business lines and it would be negligent if the desks are making different—and possibly contradictory—assumptions in their calculations. Doing a complete review produces results that are actually useful to the bank’s understanding of its financial performance rather than just marking off a regulatory checkbox. And, it will ensure that an accurate (apples-to-apples) comparison is made across desks.

The record-keeping requirements of Volcker require firms to maintain reported data and the data used to calculate those metrics for a period of five years. A consolidation and review of trading systems will help to eliminate inconsistencies across this data. Additionally, this data may currently reside in front-office systems, market-risk systems and any additional systems designed to calculate enhanced Volcker metrics. Without the consolidation of systems, auditing and monitoring for Volcker compliance will be fraught with risk.

All of the above suggests that this data-intensive regulatory requirement provides a catalyst to review and possibly re-engineer another area of a firm’s data architecture. Such an effort should be undertaken by any firm that has the additional year for metrics reporting and would provide management with an increased comfort level in the final consolidated metrics reporting.

**COMPLIANCE PROGRAM CHALLENGES**
Conformance and compliance covers both specific rules within Volcker and those areas that fall under the responsibility of senior management and will support the CEO’s annual attestation. The annual attestation is the Volcker requirement that the CEO must indicate on a yearly basis that he or she has reviewed the effectiveness of a bank’s Volcker policies and procedures and they represent the firm’s good faith effort to ensure compliance.

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**Figure 2: Challenges and Opportunities**

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<th>CHALLENGES &amp; OPPORTUNITIES</th>
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<td><strong>Data Aggregation</strong>—Metrics reporting capabilities generally exist but may not be centrally coordinated. This will require metrics consolidation into a firm-wide report that is subject to the appropriate control and assurance reviews before submission.</td>
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<td><strong>Auditing &amp; Testing</strong>—Early stages of testing and assurance regime. There is a need for independent processes for validating business logic to include/exclude certain activity from metrics reporting. Auditing and compliance empowerment will include knowing current state, hedge tracking and trade evolution.</td>
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<td><strong>Architecture Review</strong>—Opportunity to conduct a complete and in-depth evaluation of underlying data and calculation models used to produce the results. The cost of complying with Volcker, along with the raft of other recent and future regulations, can only be reduced through the effective use of compliance technologies.</td>
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<td><strong>Monitoring Tools</strong>—Tools should enable compliance groups to deeply analyze trade data and calculations for approved trading activities. Compliance groups will need the appropriate tools to perform this analysis as they will be required to quantitatively measure compliance on an ongoing basis.</td>
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<td><strong>Data Enrichment</strong>—Filling gaps in current systems (recording inventory accumulation, client trades, formatting, etc.). Metrics may necessitate additional calculations at the trading book level or elsewhere.</td>
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Larger banks face an additional layer of compliance and monitoring requirements under Volcker. Banks with large trading books will need to meet an enhanced compliance program encompassing six elements covering such areas as documentation, controls, auditing and record retention. This compliance regime will encompass the full trade life cycle from documenting approved trading activities and gate keeping trades to auditing trade books for compliance.

The cost of complying with Volcker, as with the number of other recent and future regulations, can only be reduced through the effective use of compliance technologies. Metrics and data are only part of the problem. Before they can create the rules behind a successful technology-enabled Volcker compliance program, a firm must clearly document allowed activities [trading strategies, market making limits, hedging strategies], be able to monitor and identify prohibited trading against defined normal hedging and market making activities and be able to perform analysis on this activity. Compliance groups will need the appropriate tools to perform this analysis since they will be required to quantitatively measure compliance on an ongoing basis.

These enhanced compliance programs and conformance plans are a fundamental part of the Volcker regulation and will likely be reviewed by regulators during 2014 as the large banks approach the July 2015 deadline. Although smaller banks will have more time to develop metrics reporting systems and design compliance programs, they will also benefit from building metrics reporting systems that take into account the compliance requirements. Data management systems will enable compliance groups to analyze trade data and calculations for approved trading activities. This data will need to be readily available and in a form that is easily digested and analyzed to highlight any potential Volcker breaches for remediation. As the analytic metrics proposed by regulators are based upon common risk metrics, these Volcker compliance systems should be able to leverage, at least initially, systems currently used by risk management groups. User experience features that risk groups utilize today will be beneficial to compliance monitoring groups (with the addition of metrics such as client trade ratios and inventory turnover). These tools will need to be integrated into Volcker data management systems to receive timely data, and at the same time allow compliance groups to dig down into trade details and history. This transition may be more difficult if banks have not taken a holistic view of their trading systems and Volcker tie-ins.
FUTURE CONCERNS

While Volcker-driven structural reforms have mostly taken place, the cost of compliance is continuing to rise. Further back- and middle-office cost cuts will not deliver the improved return on equity (ROE) banks are looking to achieve. Longer-term, front-to-back initiatives around culture change and industrialization that introduce innovative and compliant processes, including those around Volcker, can help to grow the business. In today’s evolving regulatory-driven business environment, financial institutions must continue to be flexible and have adaptable architectures to take advantage of emerging business opportunities within the new regulatory framework. Internationally, regulators are also increasingly focusing on the liability of individual managers as a method of enforcement. Therefore, without a robust control framework and clear management information, the CEO’s annual attestation could become a dangerous admission of liability. This is such a concern that the final signatory is still open to debate within many international firms.

However, alongside this emphasis on personal liability, regulators have shown an initial degree of flexibility and have noted that the currently required Volcker metrics, although appropriate for monitoring trading risk, may not be suitable to distinguish proprietary trading from approved activities. As such, these metrics may change following a review of the data from the reporting banks and a comparison across trading desks. This presents an opportunity for firms and regulators to work together to achieve their respective goals and outcomes.

Volcker has an extra-territorial dimension that requires foreign banks and especially those with US branches or affiliates to comply with many of the Volcker requirements, including attestation. Additionally, with both the UK government and the European Commission recently releasing their proposals on banking structural reform, it is evident that there will be further regulatory requirements surrounding the structures and monitoring of proprietary trading. There is still a considerable amount of work to be done to harmonize Volcker, the UK government (Vickers) and the EU proposals (Liikanen). While Volcker is leading the way today, firms—and especially those with international connections—should continue to build flexibility into their approach.

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