CRE Finance Council
The Voice of Commercial Real Estate Finance

Volcker Rule

Agencies Issue Sweeping Proposal for Volcker Revisions

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Executive Summary

- **The Volcker Rule:** The Rule went into effect on July 21, 2015, and prohibits banking institutions from engaging in proprietary trading activities for their own accounts. The Rule is meant to protect taxpayers from volatile earnings related to proprietary trading and principal investing. Five agencies, including the Fed, FDIC, OCC, SEC and CFTC, are responsible for rulemaking and oversight of the Rule.

- **The Rule and Securitization:** Securitization underwriting and market-making activities are specifically exempt from the scope of the Rule under the statute, though restrictions on inventory levels have practically caused a contraction in market making.

- **Difficulty in Defining Market-Making vs. Proprietary Trading:** The definitions within the final Rule are vague, overly broad, and complicated, largely because there is no clear delineation between market making activity and proprietary trading. Therefore, it is difficult for banks to prove a "negative," or to prove conclusively that they are not making a proprietary trade, and are in compliance with the Rule.

- **General Agreement that the Rule is Inefficient:** The 2017 Treasury reports on regulatory reform (see below under "CREFC Resources") highlighted a broadly-held criticism that the Rule goes too far, affecting institutions and markets that should be excluded.

Volcker Quick Facts

- The Rule has gone beyond Congressional intent, as its broad definition of 'covered fund' has made normal 'course-of-business' CMBS market-making challenging.

- Banks have had to establish compliance groups to specifically monitor Volcker compliance, a sign that the Rule's requirements were not aligned with broader prudential standards.

- The Rule is widely believed to be a significant factor in banks' decision to pull back from market-making in CMBS and other products.

- Results of an informal survey suggests that average balance sheet allocations to CMBS secondary market trading have declined by 40% since the Rule was implemented.

- Paul Volcker is on record supporting the proposed regulatory revisions, acknowledging that they uphold the intent of the statute.

- **Agencies Issue Proposal:** In early June 2018, the five agencies that administer the Rule published proposed revisions focusing on all aspects of the proprietary trading prohibitions. The agencies were less specific about revisions on the covered funds aspect of the Rule, yet they did invite broad recommendations on the subject. Overall, the proposal may allow some operational and compliance relief for medium and smaller banks, though the net effects for the banks with the largest trading platforms could be immaterial in terms of how they allocate their balance sheets.

Key Definitions

- Market Making: A market maker or liquidity provider is an institution that quotes both a buy and a sell price in a financial instrument or commodity on behalf of its clients, and makes a profit on the bid-offer spread.

- Proprietary Trading: Occurs when an institution invests for its own direct gain instead of earning commission dollars by trading on behalf of its clients. This type of trading occurs when a firm decides to profit from the market rather than from the thin-margin commissions it makes from processing trades.

Potential Solutions

- On June 12, 2017, in compliance with Executive Order #13772, the Treasury department released a report on regulation of U.S. banking system, and recommended revisions be made to the Volcker Rule. The Administration and the majority party in Congress have also called for, at minimum, revisions to the Volcker Rule, if not the statute.

- The Senate's regulatory reform bill, S. 2155, included a limitation on the Rule's coverage universe, extending a blanket exemption to all banks with less than $10 billion in total assets. Given that CMBS and CMBX dealers exceed the $10 billion threshold, the statutory change would do little to improve liquidity in the secondary markets.

- **On August 1, 2017, the OCC issued a notice seeking public input on the Volcker Rule, indicating the potential for regulatory reform.**

- In June 2018, the five agencies with Volcker authority issued a Proposed Rule intended to simplify Volcker compliance:

  - The proposal reframes compliance on a tiered basis based on trading assets and liabilities. The top tier is composed of banks that have large broker dealers (trading assets and liabilities of ≥$10 billion) that would still mostly have to comply with the main tenants of the Final Rule going forward. The medium tier (with trading assets and liabilities of $1 billion to $10 billion) is allowed some relief. The lowest tier of small banks (with trading assets and liabilities of <$1 billion) are provided an exemption from the duty to provide ongoing compliance.

  - The initial feedback from the industry on the proposal has centered on a provision that defines the scope of trades subject to Volcker review. In the Final Rule, there is a safe harbor defined by the so-called "rebuttable presumption", which allows that trades remaining on the books for longer than 60 days are presumed not to be proprietary. In the proposal, the rebuttable presumption is replaced by a simple accounting test, which may expand the universe of trades subject to compliance. While some institutions may view the repeal of the 60-day threshold as a green light to engage in more short-term trading (for the purposes of market making), the new accounting prong is inclusive enough that, practically, it would still trigger Volcker compliance and reporting for most broker dealer, hedging and asset and liability management (treasury) activities.

- Trades that are booked at fair value, whether in the Available for Sale or the Trading Books, would be subject to the proposed definition, covering a wide range of instruments, including most securities, derivatives, and some loans.

- The accounting test is accompanied by what is widely viewed as a narrow safe harbor whereby banks do not have to apply Volcker analysis as long as the 90-day net profit and loss is <$25 million.

- For the largest banks, internally-set desk limits (which historically have been the lynchpins in risk management for trading platforms) will satisfy compliance with the "reasonably expected near-term demand" (RENTD) analysis of inventories required under the statute for market-making activities. Under the proposal, trading activities within the internal risk limits will have a rebuttable presumption of compliance. The change should allow the banks to return to a risk-based approach that is generally agreed to be the better approach to prudential supervision than current, prescriptive RENTD provisions, which could have arguably damaged market liquidity without reducing systemic risk.

- For banks with medium-sized trading platforms, compliance requirements are significantly reduced, but for banks with larger trading portfolios, only the requirement that the hedging activity "demonstrably reduces" risk is eliminated.

- The proposal includes 342 questions for the industry and comments are due by October 17, 2018.

Resources

- Volcker Rule
- Agencies' Proposed Revisions (June 2018)
- U.S. Treasury Report on Capital Markets Regulation
- OCC RFI on the Volcker Rule
- CREFC Comment Letter to the OCC's RFI on the Volcker Rule
- National Real Estate Organizations' Comment Letter to the OCC's RFI on the Volcker Rule

For further Information, visit CREFC's Resource Center at: https://www.crefc.org/library

Additional Background & History

- Former Federal Reserve chairman Paul Volcker is credited with the design of the Volcker Rule. In effect, the Rule is intended to act as a modern day Glass-Steagall Act, which was the bill that separated commercial banking from investment banking. Whereas Glass-Steagall legally and functionally divided financial conglomerates, the Volcker Rule recognizes the complexity of modern markets, and instead seeks to prevent banks' ability to blur the lines between market-making and prohibited proprietary trading activities. In particular, legislators and regulators sought to prevent banks from benefitting by trading against products they sponsored or underwrote.

- **Negative Effects:** Due to the difficulty in defining proprietary trading, banks, who typically act as CMBS market makers and liquidity providers for institutional investors (including pension funds, insurance companies, banks and money managers) have chosen to cease nearly all market-making and to simply play the role of agent, matching buyers and sellers. The contraction in CMBS liquidity not only negatively affects the ability for investors to trade in and out of positions in the secondary market, but also quells the appetite for new-issue CMBS in the primary market.

CREFC Policy & Strategy

Based on a survey of all members conducted in May 2017, 91% of CREFC members strongly support, at minimum, changes to the Volcker Rule. CREFC's Investment Grade Bondholders Forum members have long held that secondary liquidity is a critical feature of the CMBS market. Many investors have said publically that they consider secondary market liquidity for each bond when making their investment decisions.

CREFC, and the greater real estate industry, recommend that the Volcker Rule be modified in the following ways to allow for "normal course of business market making and trading," while maintaining a strict ban on the ability for an issuer to bet against its own CMBS transaction:

1. Revise definition of proprietary trading to focus on short-term, standalone proprietary trading;
2. Streamline list of proprietary trading activities and conform data capture (RENTD) accordingly;
3. Streamline definition of covered funds with a goal of aligning with short-term proprietary trading mandates;
4. Eliminate extra limitations related to market making, underwriting and hedging activities;
5. Simplify the compliance regime;
6. Align compliance regime with existing regulatory and supervisory processes and requirements;
7. Designation of a single lead agency; and
8. Elimination of metrics requirements.

Given that there are no viable legislative vehicles that directly benefit the CMBS sector, CREFC is concentrating on regulatory, instead of statutory, reforms.