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Volcker Anniversary: a quest for answers or a taboo?

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July 21, 2016 marks the one year anniversary since the Volcker Rule became effective. However, there seems to be a taboo bounding both the regulators and the industry to openly talk about what still left undone for the compliance. The only rumbling we've heard so far is from the Washington amid the upcoming Presidential election. On one side of the camp, Senator Merkley sent out a letter to all five regulatory agencies in quest for answers regarding the billion dollar loss at Credit Suisse. On the other side, Rep. Hensarling's Financial CHOICE Act aims to repeal the Volcker Rule's restrictions on proprietary trading. In any case, there is no celebration of accomplishments after one year, nor enforcement action to pin point compliance weaknesses. So, where are we exactly in the journey to address issues identified in the 2008 crisis?

Allow me to recap on what happened in 2007 to 2008. Toxic mortgage back securities were trading at ridiculously unreasonable level driven by speculation. Banks, including Lehman and others, were participants to seek proprietary trading gains from these volatile markets. Trading used to be easy money for banks as compared to transaction banking. Unfortunately, easy money became huge losses when market adversely turned in split second. Some proprietary traders were doubling down in hope to hedge or recover their losses. Sadly, market collapsed and liquidity evaporated take no more than one day on Aug 9, 2007. Things crumbled when Lehman was allowed to go bankrupt on September 15, 2008.

Although the Volcker proposal is a 'last minute' slip-in bill included in the 2010 Dodd-Frank Act, Volcker's intent is inarguably right that pin point problems of any crises, i.e.:

- Trading beyond "reasonable" level needs to be stopped;
- "Financial engineering" have created toxic products that add significant risks to the players and the market;
- (FDIC Insured) banks as financial intermediates should not be engaged in proprietary trading because of moral hazard concern (speculative risk is not insurable) and the contagion effect on the economy.

For those who follow my series of Volcker stories would know that:

1) "Reasonable" inventory (RENTD) means right amount of trades at the right time.
2) Timing is crucial and RENTD is not the same as "risk appetite statement" (RAS) – the "X" percent chance of "Y" dollar amount of losses that the bank is willing to take in pursuing their business objective.
3) Risk and compliance need surveillance capability in "real-time" to match-up against the front-office traders whom

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use artificial intelligence and high frequency trading algorithms.

4) "Instrument-approach" to Volcker inventory uses engineering method to solve "financial engineering" problems. It prevents the rogues from bypassing controls, while all other approaches (e.g. "risk-based") are sinking sand.
5) Proprietary trading ban's ripple effect on market liquidity is like the "dihydrogen monoxide (H2O) ban" – a Hoax!

Below table summarized our observations of where the industry is at in complying with the Volcker Rule:

Require	Status
Metrics Reporting	Many suggest using Expected Shortfall to replace the Value-at-Risk (VaR) measurements. VaR is flaw because of its impending problem of not able to tell when, not situational, and VaR is often too normalized that over-fit the model. In the meanwhile, banks should compute and report VaR and Stress VaR consistently with Fed Reg Capital requirements (12 CFR Part 208 and 225). Yet, banks face computation challenges, including the determination of stressed period/ dynamic re-calibration, and additional complications for foreign banks (e.g. "EU institution may have an exception, where a different stressed period at a subsidiary's level may be determined if the stressed period defined for the group is not considered relevant to the subsidiary's portfolio…"). In short, the above proves that Volcker compliance cannot be effectively deal with using metrics.
Covered Funds ($66 billion of impermissible assets per OCC analysis of 12 CFR Part 44)	Banks are supposed to identify and divest all covered funds held after 12/31/2013 by 7/21/2015 (a year ago). In fact, the industry in large are waiting for Bloomberg to launch a tool called CFID to help identify if they may have any impermissible assets. Unfortunately, a briefing note by SIA partner already pointed out "the tool itself has not yet proven to provide significant added value, especially for certain American banking entities and Foreign Banking Organizations with significant covered funds activities outside of the United States." FAQ#17 also states that, "the Agencies staffs do not believe it would be reasonable for a trading desk to rely on … would not convey sufficient information … to determine whether a security is issued by a covered fund". Regulatory relief/ extension (2017 deadline) is only for covered fund prior to 12/31/2013, and the 2022 transition period (for a stable run-off) exemption has to be obtained on a fund-by-fund basis. Therefore, the extension and exemption aren't applicable to fund after 12/31/2013. Without an effective tool to identify covered funds, it is doubtful that banks can assure they have no new acquiring or reacquiring of covered funds since 7/21 last year per the rule requirements.

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Proprietary trading ban compliance program	Most banks have RENTD determined every 3 to 6 months, rather than considering the right amount of trade at the right time daily. It's a problem for banks to regurgitate Risk Appetite Statement (RAS) as RENTD. "Credit Suisse CEO blindsided about added risky position" could be a potential violation for exceed of "reasonable" inventory. Per OCC interim exam procedures, banks should have "a system of internal controls reasonably designed to monitor compliance with and to prevent the occurrence of activities or investments prohibited by the regulations". In fact, most system enhancements are related to overhaul of the legacy, BCBS239 data aggregation, and/or pulling data for metrics reports (i.e. major in the minors). Trading desk control may have added an army of staffs to invade the operations, but we don't see any "real-time" preventive risk control automations. Risk, compliance, and legal counsels are hesitated whenever they hear the term "real-time". They claimed not enough resources to monitor queue of warning signals for possible misconducts. At a result, risk practices remain passive and manual for after-the-fact investigations, rather than proactive to prevent violations.
Independent Testing & CEO Attestation	The 3rd line of defense's assessment is largely based on a review of bank's governance policies and procedures. Like an art collector appreciating an art piece, the document may be well articulated but not necessarily enforceable. Compliance program lacks sufficient emphasis on how various exemptions may be "qualified". Sample testing can't effectively identify if proprietary trades may have slipped through a compliance program. Banks may only want to stuff their trades into "market making exemption" in good times, but not willing to bear market makers' responsibilities to regularly provide liquidity in bad times. "Selective timing" to get in-and-out of market are suspicious activities that needs closer attention. Given the "guilty until proven otherwise" clause under the Volcker Rule, banks can't be sure that they have used the correct exemption for each transaction, despite large banks' CEO have already attested their compliance on or before 3/31/2016. False attestation can be criminally prosecuted, and we have suggested how different degrees of violations may be determined.

Doing the bear minimum to meet the compliance necessities may simply be out of a profitability concern. Perfunctory responses (digress to point at other priorities), backburner mentality (see/ hear no evil about compliance weaknesses), and 'revolving doors' (leave problems to someone else or the next generation) aren't helpful to heighten the industry's defense against future crises. The quest towards risk management excellence should continue, while no one should be naïve to think any crisis can be totally exterminated by Volcker. Before seeing the lights in winning the race over rogue traders through Volcker compliance, let's turn our attention to another worthy and related Reg reform – CAT NMS Plan. I remain faithful that we'll get closer to the financial safety and soundness goals if we are tenacious to work on stackable improvements!

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