The Banker

How to run a bank 2012

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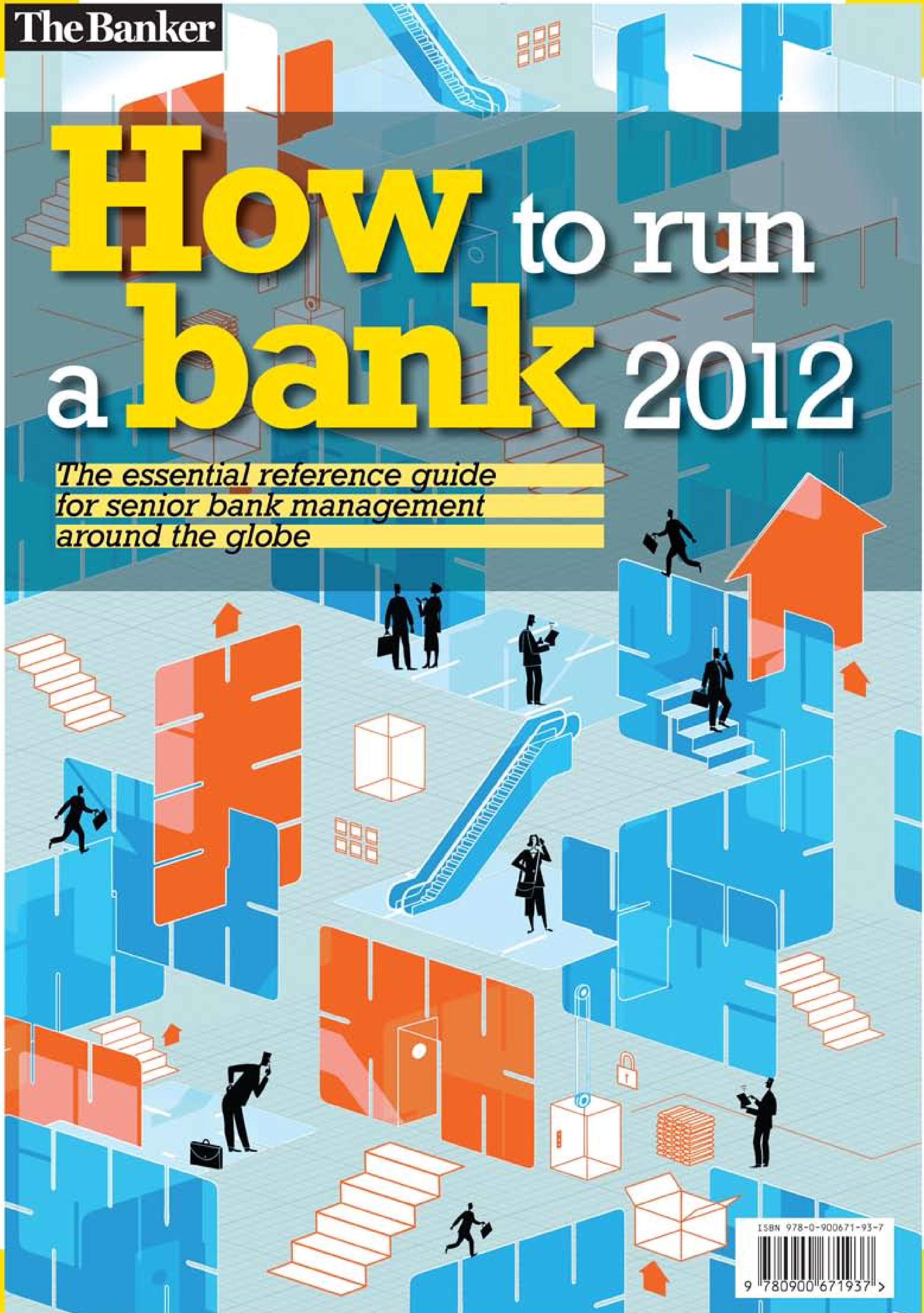

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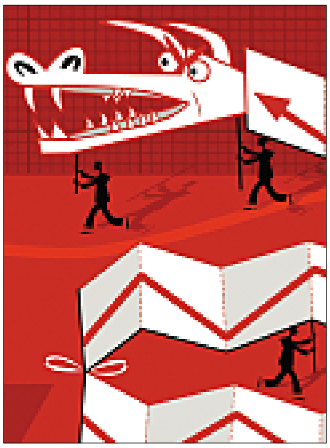

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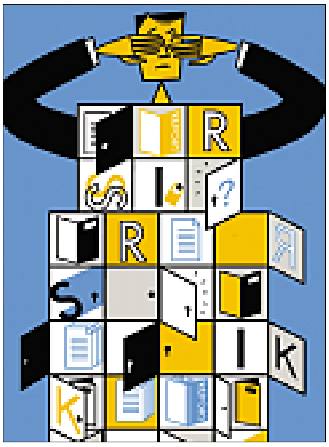

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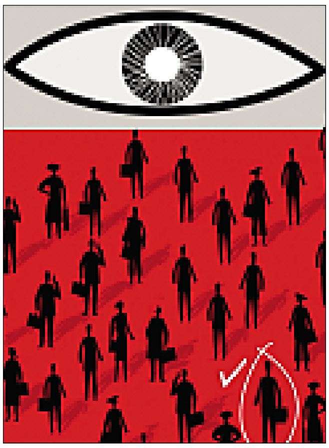

Resolution planning and the Volcker Rule

Derek Bush
Partner
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BY WORKING WITH REGULATORS, AND NOT AGAINST THEM, BANKS CAN ESTABLISH AN EARLY CREDIBILITY WITH RULE-MAKERS, CREATING A MORE CONSTRUCTIVE ENVIRONMENT IN WHICH THE TWO CAN WORK TOGETHER. HOWEVER, THE POLITICAL NATURE OF THE US'S VOLCKER RULE PRESENTS A WHOLE NEW SET OF CHALLENGES.

Two of the more novel aspects of the Dodd-Frank Act – resolution planning and the Volcker Rule – represent an important lesson for US and international banks adjusting to the new regulatory landscape. The two reforms could not be more different in many respects, but they both point to a common, if basic, strategic conclusion for banks: establishing early credibility with regulatory authorities is of paramount importance. Establishing credibility will not only minimise obvious downside risks but also maximise opportunities.

Bank supervisory authorities across the globe have quickly embraced the concept of resolution planning, even if some may view the potential benefits differently. This international consensus means that it will likely become a permanent fixture of bank supervision, surviving even after institutional memories of the most recent financial crisis fade.

Regulatory engagement

Large, complex banking organisations in the US faced the prospect of resolution planning with considerable unease, especially after the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) issued proposed regulations that raised numerous concerns for the industry. The concerns centred around the proposed timetable, confidentiality issues and a lack of clarity regarding specific requirements.

The Federal Reserve and the FDIC took into account and addressed many of the industry's concerns, in a positive sign for the future in this area. The agencies adjusted the timetable, prioritised larger and more complex institutions and affirmed that they would follow an iterative process of reviewing initial plans and providing feedback to institutions.

In public statements and private meetings since finalising the regulations, the agencies have continued to demonstrate a willingness to work with institutions to develop viable resolution plans. Although many larger institutions remain concerned that resolution planning could become a 'trap' that will force them to change their structure, scope or activities, there is reason to hope that resolution planning could evolve into a constructive exercise.

This, in turn, has created incentives for institutions to approach resolution planning as an opportunity, even offering a potential competitive edge for institutions that succeed. They are discovering ways to leverage existing risk management resources to develop resolution plans while, at the same time, looking for opportunities to leverage the outcomes of resolution planning back into their risk management approaches. Some institutions will struggle with budgetary concerns as substantial internal and external resources will be required, but early experience suggests that the largest institutions are taking resolution planning extremely seriously.

By establishing credibility early in the process, banks will be positioned to reap rewards later and mitigate potentially costly outcomes. Disagreements between institutions and their supervisors over the details of a resolution plan are inevitable as institutions confront what may appear to be unrealistic expectations of their management information systems. But those institutions that are viewed by their supervisors to be dedicated to adhering to the rules will have more leeway to define their plan proactively. In contrast, institutions that communicate – even unintentionally – to their supervisors that they view the exercise as a waste of time risk losing opportunities to control their future.

Volcker dilemma

Owing to the Volcker Rule being largely politically motivated, its implementation is likely to be different to the implementation of resolution planning. Legislative hearings failed to show that proprietary trading or sponsoring and investing in private equity and hedge funds contributed meaningfully to the financial crisis, and the Volcker Rule is an outlier among international approaches to financial stability regulation.

Attempting to prohibit banks and their affiliates from engaging in speculative trading, while permitting them to continue legitimate market-making, hedging and other activities, begs huge numbers of questions about line-drawing and compliance. Trying to restrict banks' ability to sponsor and invest in private equity and hedge funds also creates complex problems, not least the problem of defining a private equity or hedge fund.

These problems are compounded by ambiguities, contradictions and mysteries in the text of the Volcker Rule. As a result, the agencies charged with deciphering and implementing the Volcker Rule in regulations face a fairly hopeless task, especially when there is no coherent policy framework that the agencies can turn to for ultimate guidance on key questions.

Whatever the outcome of the agencies' attempt to write regulations implementing the Volcker Rule, the many US and international banks subject to the Volcker Rule will eventually be left

early experience suggests the largest institutions are taking resolution planning extremely seriously

to confront the most important phase of the process.

Open to interpretation

Banks will need to make judgements as best they can about what the Volcker Rule does and does not prohibit, adopting reasonable positions on issues left unaddressed by the agencies' regulations. In the coming years, banks could experience a highly compressed version of the decades that followed the Glass-Steagall Act and the Bank Holding Company Act, when banks' interpretations of permissible activities ultimately fed into regulatory change and rationalisation of laws that came to be viewed over time as unnecessarily blunt instruments.

In this phase, an institution's credibility with its supervisors will be vital. Banks will need to reach good faith conclusions about how to give the Volcker Rule real-world meaning. Some of these judgements will be second-guessed by examiners, especially in today's environment of more intrusive on-site supervision and ever-increasing expectations of banks' risk management, including management of legal and compliance risk. By establishing a proactive approach and demonstrating a commitment to compliance, banks will avoid perceptions of evasion, and be better placed to convince examiners of the reasonableness of their positions.

The importance of credibility in regulatory relationships may seem obvious. And yet institutions sometimes find themselves in shorter supply than they need. In the evolving landscape of Dodd-Frank reforms, credibility will be critical as institutions grapple with new regulatory requirements. Whether it is to take advantage of opportunities presented by new resolution planning requirements, or to preserve flexibility for legitimate business practices under the Volcker Rule, there is much to be gained from credibility, and much to be lost without it.

biography

Derek Bush is a Washington, DC-based partner at law firm Cleary Gottlieb Steen & Hamilton.

Key ideas

Credible judgement

- **The largest institutions** are taking resolution planning extremely seriously.
- **Prohibiting banks** from engaging in speculative trading while permitting them to continue legitimate market-making, hedging and other activities, begs huge numbers of questions about line-drawing and compliance.
- Banks will need to make **judgements** on what the **Volcker Rule does and does not prohibit.**
- Banks will need to reach **good faith conclusions** about how to give the Volcker Rule real-world meaning. Some judgements will be second-guessed by examiners in today's environment of more intrusive on-site supervision.
- **By establishing a proactive approach** and demonstrating a commitment to compliance, banks will avoid perceptions of evasion.