Approaching new terrain

OTC derivatives readiness assessment
A new landscape is emerging
The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank or the Act), signed into law in July 2010, launched a series of reforms aimed at regulating the financial markets generally and specifically included numerous new requirements to regulate activities in the over-the-counter (OTC) derivatives market. The Act mandated significant changes to the OTC market but left many of the specific details to rulemaking by the two key OTC regulators: the Commodity Futures Trading Commission (CFTC) for swaps and the Securities and Exchange Commission (SEC) for security-based swaps (swaps and security-based swaps collectively referred to as swaps or derivatives). Regulatory initiatives in other regions (notably, the EU’s Markets in Financial Instruments Directive [MiFID] and European Markets Infrastructure Regulation [EMIR]) will also affect OTC derivatives market activity.

The effective date in the Act was originally 16 July 2011, but both the SEC and CFTC have delayed finalizing their rulemaking. The CFTC has indicated it will finalize rules in Q4 2011 and Q1 2012, with effective dates at least 90 days after that, although these are target dates and may change again. Despite the delays and uncertainty, many institutions are forging ahead with implementation and execution plans based on proposed rules because of the magnitude and complexity of the changes, as well as the long lead time needed to implement them. In some instances (notably, client-clearing capabilities), the industry is driving change ahead of the regulatory requirements.

Preparation for the new regulations includes examining the entire business model and defining fundamental changes to business and transaction-booking strategies. Firms are also reassessing their business processes and infrastructure, systems connectivity and reporting and compliance capabilities to identify gaps that must be addressed to meet the wide-ranging demands for compliance with the Act. Resource and budget constraints are also forcing firms to prioritize their implementation efforts based on the expected timing of the finalized rules and their potential impact on the business. All of these issues have raised many questions regarding the status and readiness of firms to execute, settle and report derivatives effectively in the new environment.
Defining readiness

In the summer of 2011, Ernst & Young LLP conducted a survey of financial institutions to assess their readiness to comply with OTC regulatory reform initiatives. The objective of the survey was to better understand how organizations are preparing for and responding to changes mandated by the Act, particularly given the aggressive timelines set forth by regulators. The survey consisted of 23 questions focused on the following areas:

- OTC program and overall readiness
- Business model and legal-entity (LE) rationalization
- Data and reporting requirements
- Swap-execution facilities (SEFs) and clearing
- Business conduct and compliance

Survey responses were gathered between 1 June and 28 June 2011. Participants represented 11 large global and US-domiciled banks. The survey was performed on an anonymous basis; therefore, comments and observations herein have not been attributed. The survey data was compiled from quantitative responses and through subjective categorization of responses to certain questions that allowed for free-form answers. Once compiled, Ernst & Young analyzed the data to identify emerging trends and practices.

Ernst & Young also hosted a roundtable in late June 2011 with representatives from 23 large financial institutions where preliminary survey results were discussed. Information and observations shared during this roundtable were used to enhance the analysis performed on the survey data. This report thus reflects the analysis of the survey data, discussions held during the roundtable and Ernst & Young’s perspectives.
Survey highlights

The key message from the survey responses and roundtable discussions is that there is wide diversity in the readiness of institutions to comply with the changes to their OTC derivatives activities and operations in response to the Act. Recognizing the fundamental client and business risks of noncompliance, institutions are moving forward with their implementations, despite the costs and the uncertainty in timing of final rules. Considerable resources (both people and dollars) are needed for the implementations, and the current business environment is further challenging the efforts. Business leadership is therefore forced to prioritize requirements and place bets on what is really needed to be competitive and comply versus what is merely “nice to have.” All of these factors are leading to a fragmented landscape where institutions are implementing different parts of the puzzle. As greater clarity is provided by more final rules, the next stage of implementation efforts will be defined.

Overall readiness timeline

Despite regulatory delays, the majority of our survey respondents indicated that they were still targeting operational dates within 2011 for many of their key tactical initiatives.

The spend will continue

Most institutions expect to spend even more on modifications to OTC derivatives infrastructure in 2012 than they did in 2011. Most respondents indicated a 2012 spend of between US$15 million and US$25 million on OTC derivatives reform implementation. One respondent was expecting to spend over US$75 million.

Evolving rules

While OTC derivatives reform cuts across the entire organization, approximately 45% of survey respondents indicated that the front office is most likely to be leading the change initiatives in their institutions. There has been a shift from the legal and compliance leadership employed in the earlier advocacy processes toward business leadership in the implementation efforts.

At the same time, legal and compliance functions must continue to play a leading role in advocacy, interpretation and downstream monitoring, as well as facilitating the implementation work streams with definitions of rule requirements. As implementation efforts progress, these functions will also have to support the implementation work streams to demonstrate compliance with and controls around the regulatory changes.

Business model and legal-entity rationalization

Many firms have spent a significant amount of time on analysis related to the LE registration decision and related extraterritorial aspects of CFTC and SEC regulation. Forty-five percent of respondents were planning to register
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Date back to the second or third quarter of 2012. Roundtable discussions and recent Ernst & Young client activity indicate an increasing focus on defining an effective framework for identifying rule requirements, assigning them to work stream/business owners and then monitoring implementation to confirm effectiveness. Other key priorities included clarifying the role of the compliance function in the definition and management process, along with validating the implementation requirements and the changes within the business. We are also seeing a focus on establishing a quality assurance structure within the implementation framework to facilitate communication with internal management, external auditors and regulators regarding the completeness of implementation.

Swap-execution facilities and clearing

Despite the delays in rulemaking, the institutions surveyed expected a significant scale increase in clearing capabilities during 2011 and continuing through 2012. The responses indicated that only 18% of participants were able to clear more than 300 trades a day for rates or credit on the Chicago Mercantile Exchange (CME) and London Clearing House (LCH) US platforms at the time of the survey. In contrast, 55% expected to handle this volume by July 2012. Not surprisingly, clearing capabilities for commodities and equity derivatives are less developed, given the lack of central clearing counterparties (CCPs) for these products. There is still insufficient clarity about the introduction of SEFs, but many institutions are operating under the assumption that execution on SEFs will become effective after clearing becomes mandatory and is likely to increase rapidly as SEFs are approved by the regulators.

Business conduct and compliance

Approximately 70% of respondents anticipated that most business conduct requirements would be enforced in the first quarter of 2012, although the delays in finalizing rules since the survey was performed may push this date back to the second or third quarter of 2012. Roundtable discussions and recent Ernst & Young client activity indicate an increasing focus on defining an effective framework for identifying rule requirements, assigning them to work stream/business owners and then monitoring implementation to confirm effectiveness. Other key priorities included clarifying the role of the compliance function in the definition and management process, along with validating the implementation requirements and the changes within the business. We are also seeing a focus on establishing a quality assurance structure within the implementation framework to facilitate communication with internal management, external auditors and regulators regarding the completeness of implementation.
Key findings and observations

OTC program and overall readiness

The requirements resulting from derivatives reform will fundamentally change the OTC derivatives business. It is therefore surprising that only approximately 45% of all survey respondents indicated that the front office is leading the change initiatives in their institutions. Legal and compliance groups continue to play a leading role in advocacy, interpretation and downstream monitoring. Discussion at the Ernst & Young roundtable supported the view that legal and compliance groups had played a more active role in early efforts when there was greater focus on advocacy to influence rules or press for changes to proposed rules. As firms are now concentrating on implementation, it is critical that business lines take a more active leadership role given the profound impacts the Act will have on their businesses. Front-office businesses must define their activities, volumes and requirements, as well as the implementation priorities that operations, IT and other functions must meet.

The affected areas the business will need to focus on include, but are not limited to:

- Increase in margin and capital requirements with related liquidity constraints
- Lower profitability across products due to reduced margins and increased costs
- Changes in execution trade flows
- Reporting requirements

- Client and counterparty classification and related compliance requirements
- Position limits on trading (particularly commodities)

A large majority of the survey participants indicated that they are moving forward with planned changes for OTC derivatives during 2011. Survey participants are continuing to push ahead as a result of the anticipated length of implementation time frames. At the roundtable, institutions reported that they expected client demand for clearing to grow in the lead-up to mandatory clearing and that having the capabilities represented a competitive advantage.

In an already difficult economic environment, the industry is faced with large budget needs driven by Dodd-Frank OTC changes. As indicated in the following charts, spend in 2012 is expected to increase as implementation moves into high gear. The roundtable discussion suggested that current business conditions and regulatory delays are forcing a reassessment of implementation priorities and related budgets. While this appears to be more focused on shifting the timing of spend from 2011 to 2012, some institutions indicated that they are exploring limits in client-service offerings. Figure 1 details the respondents’ OTC derivatives budget allocations. More than half of respondents indicated that they will spend up to US$15 million on their OTC derivatives efforts in 2011. Spends in 2012 are expected to increase, with more than 70% of respondents expecting to spend over US $15 million, and almost 40% of those (28% total) were anticipating spending at least US$25 million. As requirements are more clearly defined, firms recognize that reform changes may call for significantly greater spend than currently allocated.

Figure 1

Overall OTC derivatives budget allocation

- US$0m to US$15m
- US$15m to US$25m
- Greater than US$25m to US$75m
- Greater than US$75m

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One of the benefits of the electronic trading, clearing and real-time reporting mandated by Dodd-Frank will likely be the reduced number of resources required to support the middle and back offices and derivatives operations. Most firms said that they expect an increase in resources in 2012 to support implementation and transition activities, but that this will diminish during the following two years as straight-through processing for certain asset classes makes derivatives trade processing more efficient. Over half of the participants expect at least a 25% reduction in resources by 2014. The charts in Figures 3A and 3B depict this trend for rates and credit instruments, respectively.

Figure 2

Full-time employee allocations
US — Q2 through Q4 2011

Non-US — Q2 through Q4 2011

Figure 3A

Impact of automation on the middle-office and back-office needs for rates

Figure 3B

Impact of automation on the middle-office and back-office needs for credit

The increased efforts are driving increased resource needs for readiness, including ensuring compliance with rulemaking and implementing the changes across the business, operations and technology. Figure 2 provides a summary of the survey respondents’ expectations for full-time employee allocations.
Business model and legal-entity rationalization

The earliest key decisions for most institutions relate to which legal entities to register and how to register them under the new regulations. Many institutions carefully review these considerations as the final decision may affect how the new regulations change business processes. Despite uncertainties with respect to several key drivers, across all products, 45% of respondents were planning to register their parent banks as primary swap dealers. Twenty-seven percent of respondents also indicated they would register non-bank separately capitalized affiliates (SCAs) or foreign branches. Forty-five percent of respondents indicated their intention to register more than one entity, despite the potential capital and margin issues. While many global institutions indicated that they would register the parent bank, at the roundtable, participants expressed their concerns about the reach of US regulators into non-US activities. Therefore, these decisions could be reconsidered as rules are finalized.

Figure 4

Legal-entity decision by institution type across all products

<table>
<thead>
<tr>
<th>Institution Type</th>
<th>Percentage</th>
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</thead>
<tbody>
<tr>
<td>Parent</td>
<td>45%</td>
</tr>
<tr>
<td>Other non-bank separately capitalized affiliate</td>
<td>27%</td>
</tr>
<tr>
<td>Foreign bank branch</td>
<td>27%</td>
</tr>
<tr>
<td>SEC broker-dealer</td>
<td>18%</td>
</tr>
<tr>
<td>US bank branch</td>
<td>9%</td>
</tr>
<tr>
<td>Bank subsidiary</td>
<td>9%</td>
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The total responses will be greater than 100% as participants provided multiple responses among the different product types.
A number of considerations influence the decision about which legal entities to register as swap dealers. These include, but are not limited to:

- Extraterritoriality – specifically, the extent of US regulators’ reach into non-US activities
- Capital impact (e.g., country regulator versus CFTC/SEC capital calculations)
- Client and counterparty considerations, including willingness to face certain entities if current booking structure changes
- Potential infrastructure and operational technology changes needed to be compliant
- Competitive positioning (US versus global institutions)

Overall, approximately 56% of the survey respondents ranked extraterritoriality as the most significant consideration. More specifically, approximately 80% of non-US respondents ranked it as their most important consideration, while US respondents indicated that capital requirements were their greatest consideration. Overall, approximately 81% of respondents ranked capital as one of the top three drivers for the decision.

Data and reporting requirements

The CFTC and SEC each proposed rules under Dodd-Frank with regard to reporting swap and security-based swap data to regulated swap data repositories (SDRs). The CFTC’s rules on SDR reporting were expected to be completed during the fall of 2011, potentially triggering reporting requirements by the first quarter of 2012.

Front-office processes and systems, mainly order management and trade capture systems, are being reviewed as the “near real-time” reporting requirements will result in major behavioral changes to ensure trade capture, affirmation and confirmation and subsequent reporting in the mandated time. The proposed rules will also require the use of uniform legal-entity identifiers for each counterparty, product and swap transaction. The identifiers are being addressed by industry groups. Trade data enrichment through the life cycle, internal data standardization, messaging and connectivity are being considered to facilitate these aggregation capabilities and requirements.

At the time of the survey, an average of 55% of respondents had not yet identified the majority of data elements and source systems to comply with the real-time reporting requirements, as indicated in Figure 5. Not surprisingly, development of real-time reporting capabilities trailed end-of-day and client reporting. Given the likely early adoption of reporting requirements, these institutions will have to deploy considerable resources to support implementation.

Swap-execution facilities and clearing

Most institutions in the industry have made more progress in the area of clearing when compared to other areas of Dodd-Frank, primarily because it is viewed as a market-facing or client-service capability that businesses are eager to offer. From a strategy perspective, certain institutions are operating under the expectation that they will be clearing as of day one, while other institutions are opting not to clear.

Approximately 67% of survey participants plan to use their prime brokerage platform as their primary client clearing-service offering, as the service models are consistent with the anticipated services to be offered for cleared swaps. Of the remaining third, less than 10% of the survey participants have a solution for clearing capabilities in place.

To date, the primary focus of most participants has been on the baseline...
factors, such as identification and connectivity to the appropriate CCPs for the various asset classes. Their attention is now shifting to volume, scale and efficiency. Most of the effort related to clearing capability has addressed rates and credit, with foreign exchange a distant third.

Among the respondents, current client clearing capabilities are low. Focusing on CME and LCH clearing for rates and credit, between 25% and 35% of survey participants could not clear client transactions as of the second quarter of 2011, as seen in Figure 6A. Similarly, more than 300 trades per day could be cleared by only 17% of participants for LCH rates, 9% for CME credit and no respondents for CME rates. By July 2012, 55% of survey participants expect to be able to clear more than 300 trades daily for those participating CCPs, as shown in Figure 6B. This demonstrates that institutions anticipate volumes will increase significantly into 2012, and they will prioritize the enhancement of their clearing capabilities in CME and LCH for both rates and credit. Firms also indicated that they expect to be able to clear their higher volumes on other clearing platforms, notably Intercontinental Exchange, by July 2012.
Business conduct and compliance

Dodd-Frank OTC derivatives reform will bring about significant new business conduct and compliance requirements. These include new trade execution and due diligence requirements, supervisory requirements and specific limitations on activities with “special entities” (municipalities, endowments, foundations and so forth). Compliance with these requirements will have an impact on client onboarding processes, pre-trade analysis and documentation, transaction execution and greater reporting and surveillance processes.

Approximately 70% of respondents anticipated that the first quarter of 2012 will be when most requirements will be enforced. According to the CFTC’s preliminary schedule of final rules, internal and external business conduct rules should be finalized by the end of 2011. However, given the recent delay in the expected finalization of other rules since the survey was conducted, complete compliance may also be held up until the second or third quarter of 2012.

Decisions on how to register entities could trigger further business conduct and compliance provisions, such as enhancements to the institution’s compliance framework around derivatives, the designation of a chief compliance officer and updates to existing policies and procedures. Given the additional business conduct requirements for special entities, institutions are also increasingly focused on enhancements to their client classification capabilities in order to identify these specific customers.

The CFTC and SEC are concurrently writing rules related to business conduct and compliance, which are similar but may vary. The focus of most survey respondents was on the definition of requirements rather than implementation. However, discussions during the roundtable indicated that many are shifting their focus toward implementation.

Figure 7 shows our survey participants’ responses on what areas they expect to have responsibilities for the business conduct and compliance requirements between the definition and implementation phases. Surprisingly, respondents were fairly evenly split between the front office and compliance functions as those responsible for defining business conduct requirements. However, the survey indicated agreement among a large majority of participants that implementation of the requirements resided with the front office.
Please note: since respondents were allowed to choose multiple answers, the results may not add up to 100%.
Conclusion

Firms have become increasingly engaged in preparing for fundamental changes to their global OTC derivatives trading operations to meet Dodd-Frank and global regulatory requirements. Institutions are at different stages of their implementation efforts. However, the survey results indicate that many key decisions and assumptions have been made to support the development of solutions. The survey also shows that institutions recognize the significant cost and resources required to comply with the Act and are shifting their focus to driving implementation forward.

Anticipating the profound changes imposed by this legislation, institutions must examine their entire business model and make essential changes regarding business strategies. Critical areas of focus also include developing approaches to manage the impacts to business processes and operations, along with creating strategic and tactical strategies to implement impending regulations. Further, heightened budgetary concerns may challenge the ability of firms to spend to implement required changes, despite the risks of non-compliance. The degree to which regulators define rules, requirements and expectations will determine the extent to which firms can create value from the changing landscape. The key to this value will be the ability of firms to achieve efficiencies and operational effectiveness in their OTC derivatives operations. The likely winners in this process will be those firms that can provide a full-service, low-cost OTC derivatives solution consistent with the requirements of the Act.

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