



DODD-FRANK ACT: ASSESSING THE REGULATIONS

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Patrick Amon describes the likely impact of the new rules for the US banking sector

The Dodd-Frank Wall Street Reform and Consumer Protection Act is commonly viewed as the most important piece of legislation in the US banking sector since the Great Depression of the 1930s. The act creates a number of institutional frameworks and reorganizes the federal regulatory system, but most of its impact will lie in the rules that stem from this federal reorganization.

The Act is also philosophically significant in that it goes some way in reversing a principle enshrined by the Gramm-Leach-Bliley Act of 1999, which holds at its core the ability for financial markets, especially on the wholesale side, to self-regulate and to function relatively unencumbered.

A representative measure of this philosophical bent is the appointment of a Financial Supervisory Oversight Council, FSOC, headed by the Secretary of the Treasury, which will be responsible for identifying potential systemic risks to the U.S. economy, partially on the basis of information it can obtain from the Office of Financial Research, which is discussed below, and to take whatever action is mandated, including lowering capital requirements in times of stress. This is directly at odds with prevailing philosophy prior to the crisis, which would have viewed such an interventionist mandate as unnecessary and burdensome.

Beyond the creation of FSOC, which a priori is a relatively technical measure, the institutional and philosophical changes resulting from Dodd-Frank are likely to take some time to fully take effect, yet the reach of the law is certain to start being felt in the short term.

A case in point is the implementation of the Volcker Rule (named after former Fed chairman Paul Volcker), which aims to proscribe banks from proprietary trading, with its inherent moral hazards and risks, and limit its practice to dedicated actors such as hedge funds.

The proprietary trading model has created certain conflicts of interest for banks in that they hold information on clients' flow that could be used to influence their own trading decisions – known as front-running. If the Volcker Rule is properly implemented, which will be a challenge in itself, it will be a positive development for the industry because it will bring banks back to the principle of serving their clients' interests before their own.

The second major implication of Dodd-Frank is the movement of over-the-counter (OTC) securities trading to central counterparties (CCPs). Prior to Dodd-Frank, OTC instruments such as swaps were traded on a bilateral, one-off basis. In this context, the onus was on the client to seek optimal pricing from multiple liquidity providers and to take into account counterparty solvency, often through the use of credit valuation adjustment (CVA) or debt valuation adjustment (DVA). This process could be onerous and time-consuming, especially as swaps tended to include confidential clauses, which made comparisons a significant practical challenge.

A greater concern arising from the OTC trading model was that the failure of a significant trading 'hub' could cause untold damage to the market in general. These fears were realized to a devastating extent with the collapse of Lehman Brothers in 2008. The considerable losses of one firm created huge issues in netting, collateralization and rehypothecation for every other firm as all Lehman Brothers trades were unwound and the challenges in ascertaining the ownership and location of collateral among a multitude of participants became evident.

By ensuring that sufficient collateral is available to offset this default risk, the migration of a substantial portion of OTC trades to CCPs should minimize the risk of these events happening again. However, CCPs are not silver bullets; solvency risk is not obviated but simply moved further into the tail of the risk distribution as a multitude of individual counterparties are replaced by a theoretically smaller number of central counterparties. The failure of a CCP may therefore prove catastrophic, even more so than that of a "typical" bankruptcy in the pre-Dodd-Frank world. This puts a significant onus on the regulator to ensure that all CCPs are properly capitalized.

Another risk is that more and more CCPs may set up as private entities to take advantage of the mandatory migration to these models. This may create further market fragmentation and inefficiency in the allocation of collateral. This risk could be mitigated by agreements that allow cross-margining and cross-collateralization between CCPs. However, this would create potential liquidity risk in times of market stress should collateral not be readily available when and where it is required.

A little-noted but essential feature of Dodd-Frank is set to take place in July 2011, when banks will be required to offer their clients the ability to segregate their assets from those of the banks'. This rule is designed to make it simpler to disentangle clients' assets from the banks in the case of a default, something that proved particularly troublesome in the case of the Lehman's default. However, such a move is likely to raise the cost of trading derivatives because collateral will probably become less liquid.

Dodd-Frank also tackles a number of other issues, including the Orderly Liquidation Authority, which decrees that systemically important financial firms may supersede the bankruptcy code. This is again an attempt to respond to issues unearthed in the liquidation of Lehman Brothers.

Beyond clarifying the process of liquidating a financial firm, Dodd-Frank aims to lessen the probability of such a failure by raising overall capital requirements and, most importantly, lessening such capital requirements in times of market stress. This approach is starkly at odds with Basel II-vintage regulation, which mechanically raised capital requirements pro-cyclically because these were steadfastly tied to Value at Risk (VaR).

Dodd-Frank's capital requirements are established as minima for US-based institutions as well as US subsidiaries of foreign entities. Any superseding law has to comply with those minima.

Further measures to lessen the risk of a significant financial firm (referred to as SIFIs or Systemically Important Financial Institutions) failing are to be subject to tighter regulation, and to Federal Reserve supervision, in addition to oversight by their "primary" regulators. Further constraints may include further trading restrictions or higher capital requirements. All bank holding companies with assets exceeding \$50 billion dollars automatically qualify, but it is expected that additional financial firms, such as insurance companies or hedge funds will join the ranks of the thusly-designated institutions. Firms will be designated by the Federal Reserve and the FSOC. Expect fierce lobbying from financial firms outside of the bank holding companies to escape the designation.

A measure starkly at odds with prevailing wisdom prior to the crisis of 2008/2009 is the creation of a potentially important institution, the Office of Financial Research (OFR). The OFR is a largely independent institution, hosted within the U.S. Treasury and mandated with monitoring firms' financial exposures. Not only will the OFR disseminate this exposure information within the regulatory apparatus, it will also have the power to amend existing rules to reinforce its monitoring where warranted.

In effect, all designated financial institutions must develop adequate technology to transfer trade-level holdings information to the OFR. The OFR is then responsible for monitoring counterparty relationships within the firm and performing whichever risk calculations it deems relevant to inform policy making and enforcement.

How the OFR uses the information remains one of many open questions around the Dodd-Frank Act. Primarily it is meant to serve as a statistical office to the Financial Supervisory

Oversight Council, as an aid in decision-making. The agency may beyond this become a rich source of information for academic work, particularly in financial economics. It is not known, however, how this data will be generated, transmitted, secured, anonymized, and treated, and made available, and to whom. It may remain captive to Treasury or may become a significant driver of risk and trading technology globally and thus may have consequential impact beyond pure risk technology. The OFR should thus be considered a powerful tool.

Current commercially available technology cannot comply with the breadth of the OFR mandate. Therefore this single part of Dodd-Frank is potentially far-reaching as it is likely to lead to the development of new technology to represent trades and monitor risk internally at a time when much of the financial sector takes a siloed approach. The OFR is thus likely to have a substantial impact on both future risk technology and more a-propos, on risk governance at large, since the two often seem to evolve in lockstep. The impact of the OFR at both a micro and macro prudential level, beyond its role within FSOC and government should not be underestimated.

The mandate of Dodd-Frank is arguably a worthy one. However, in some ways it is a framework rather than a complete body of law. Much of the implementation is not made explicit but left up to subsequent rule-making by the SEC, FDIC, Federal Reserve and CFTC, muddying the field and putting much of the efficacy of the law in the political realm, even if the law itself clarifies the purview of each of the regulators dramatically over the status-quo ante. Rule-making, as opposed to just enforcement, is crucial in this process and is therefore a substantial onus on these agencies. However, because these agencies rely on congressional appropriations, much of their efficacy can be hampered by poor oversight or cuts in their funding. Recent attempts at delaying the nomination of a chair to the Consumer Financial Protection Bureau (CFPB) is a case in point.

Even assuming that the law is fully funded, which is difficult to conceive in the current budgetary climate, deadlines are likely to be missed. The CFTC, for instance, has announced that the July 2011 deadline for rules affecting the regulation of swaps dealers will not be respected.

A further threat to Dodd-Frank's integrity comes from the possibility that it will be diluted to allow for regulatory arbitrage. Such arbitrage was a key enabler in the failure of AIG, as the firm was structured to fall within the purview of the Office of Thrift Supervision, an agency generally mandated with overseeing small enterprises and not large, leveraged institutions.

Proposed exemptions to the Dodd-Frank Act also create a risk of regulatory arbitrage. For example, the U.S. Treasury recently submitted a formal proposal to exempt a large class of FX swaps from central clearing. Arguments have been put forward to justify this exemption, including the existence of well-established payment systems in the FX world, the relatively short average maturity of such trades, and the great liquidity of FX exchange mechanisms globally. However, the existence of such a large loophole in the regulation of swaps creates an opportunity for regulatory arbitrage and thus a situation potentially worse than the current status quo. One can easily conceive of mechanisms to transform ordinary interest rate swaps into FX swaps by hedging away currency exposure, creating a parallel market outside of the purview of the CCP. This issue was most recently pointed out by Darrell Duffie, a noted financial economist and derivatives expert.

A further exemption to central clearing affects so-called end users of derivatives: i.e. non-financial firms. This exemption primarily relieves such firms from having to post collateral in derivatives trades because they are most often entered into not on a speculative basis but to hedge an underlying exposure. Such exemptions are problematic because the definition of an end user is unclear and therefore once again we see opportunities for regulatory arbitrage. For example, it is not clear what can prevent an ostensibly non-financial company from creating a trading arm that is not recognized as a bona-fide financial company, thus benefitting from regulatory relief.

The Volcker rule, perhaps the centrepiece of Dodd-Frank, is also subject to regulatory uncertainty because in practice, proprietary and non-proprietary trading can be difficult to distinguish. Providing liquidity to its clients may require a bank maintain exposures on its own books for long periods of time. When does such a book become proprietary? Arguably, in a one-off case a regulator could make a determination, but it is difficult to establish a hard-and-fast rule for these situations.

Although the Dodd-Frank Act is complex, imperfect and subject to the same law of unexpected and unintended consequences that all human endeavors are, it is nonetheless likely to result in a financial sector that is less prone to systematic crises. Let us not forget that no serious financial crisis occurred between the 1930s and 1987, and thereafter such crises have had the habit of rearing their ugly heads every three to four years, in different guises. The key is to regulate the financial sector consistently without depriving the economy of the capital that it requires to function effectively.

Disclaimer: This document is not meant as an exhaustive summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act. It parses out some features of the Act and leaves much undiscussed. It is not meant as an endorsement or rejection of particular parts of the law, but is rather meant as a collection of thoughts of the author's on the potential reach of a complex piece of legislation.

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