



BNY MELLON

Regulatory reform

The shape of things to come

The Bank of New York Mellon (BNY Mellon) is currently the only financial institution in the US with a triple A rating from Moody's. With the firm's representatives actively engaged in industry and public policy forums, as well as advising regulators, its derivatives and risk expertise is exemplary. Patrick Tadie, Executive Vice President, shares some insights on best practices

What do you see as the key trends in the derivatives arena at this time?

While trading in most fixed-income securities – especially collateralised debt obligations – remains lower than pre-crisis levels, there are some strong signs of stabilisation, and even some upswings. We're starting to see interest rate and foreign exchange derivatives reverse course with outstanding values rising again, which speaks to their effectiveness as a hedging strategy.

We're also seeing the growing globalisation of derivatives. Volumes are increasing in emerging economies such as Asia-Pacific and Latin America, and even in more established regions such as Canada and Mexico. A growing number of first-time users in these regions are looking to derivatives to help manage commercial risk. So, far from being avoided as risky, these two trends show firms are viewing derivatives as a value proposition for risk reduction.

Concerns about counterparty exposure continue to preoccupy buy-side and sell-side institutions. Many institutions continue to renegotiate the terms of their credit support annex (CSA) agreements to strengthen protection against counterparty default, and they're investigating ways to improve their middle-office and technology solutions to minimise counterparty and operational risk. We're seeing a lot of attention being paid to the automation of such key functions as valuation, reconciliation and collateral management.

Not surprisingly, however, the most important trend is an ongoing focus on the regulatory environment, especially transparency and reporting. There's a strong awareness of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*, but companies are still trying to determine its impact.

How is regulatory reform likely to change the derivatives landscape?

It is all but certain that regulatory reform will lead to greater standardisation in the way that some over-the-counter (OTC) derivatives are traded and cleared. Bilateral trading of core vanilla products like interest rate swaps between the buy and sell sides will be migrating from OTC to the exchange-traded arena and will be cleared by central counterparties. We're already seeing a trickle of activity in this direction for the simplest rate products. So, the primary goal of regulatory reform, increased transparency of pricing, volumes and counterparty exposure is likely to be achieved.

At the same time, speculative use of derivatives is down substantially and the all-in cost of derivatives trading is rising for end-users. The latest quarterly review from The Bank for International Settlements shows credit default swaps down 47% since the financial crisis began in 2008. Overall volumes are likely to remain suppressed, with capital requirements increasing and initial margin requirements becoming mandatory for derivatives trading as a result of regulatory reform.

It is understandable why some market participants feel OTC derivatives will cease to exist over time. However, we believe OTC activity will continue accounting for at least 30–40% of the overall derivatives market, down from an estimated 90% of notional and trade volume at its peak.

There is still a significant unknown with foreign exchange derivatives as the Dodd-Frank legislation didn't mandate how this asset class should trade or be cleared.

No matter how regulatory reform unfolds, increased oversight is here to stay and financial institutions face quite a few challenges gearing up for it.



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What are the major challenges that financial institutions face under the new regulatory environment?

The first challenge is trying to anticipate the changes that will be enacted. There is a high degree of uncertainty right now with the Dodd-Frank legislation having outlined broad initiatives and setting strict deadlines for compliance, but leaving the rule-setting process to the regulatory authorities. So, institutions have no choice but to evaluate the potential impact on their trading strategies using assumptions about the scope of the rules that will be enacted.

We're seeing many firms taking a conservative approach, anticipating significantly greater reporting requirements and assuming an incremental investment will be required to their infrastructure. They are also evaluating the expertise needed to comply with new regulations. Some of the best firms in the industry are even looking at the cost-effectiveness of outsourcing non-core functions to a specialist provider. Outsourcing alternatives have been around for some time, but the cost-benefit analysis has been difficult to pin down until now.

We have found the decision process for outsourcing isn't just a review of time and cost. Firms have to assess their bench strength to tackle complicated challenges like risk analysis of counterparty exposure that may not have been a high priority in the past. Now that they're faced with having to measure credit risk, market risk and operational risk on an ongoing basis – at least daily – they need a firm grasp of industry best practices.

Financial institutions are facing rising costs due to mandatory collateral posting requirements. Collateral management is a mature and highly effective risk-mitigation strategy, but its use has been optional until now. Each futures clearing merchant and exchange is likely to impose its own collateral and initial margin requirements so firms could easily be faced with inefficiency and higher cost. Plus, collateral requirements are likely to be even greater for OTC markets and it is unclear if standardisation and the move to exchange-traded markets will offer any offsetting relief.

How should institutions prepare for these challenges?

Firms are much more aware of the risk of counterparty default, and many are already taking steps to mitigate that risk. For those that haven't, consideration should be given to having a broad range of trading partners rather than highly concentrated positions with just a few, and adopting collateral management and initial margin best practices regardless of how well they know their counterparties.

We recommend that firms be very proactive with implementing new collateral management programmes, requiring independent third-party valuations and initiating more frequent reconciliation to improve transparency and reduce risk. All institutions continue to move towards a daily reconciliation process to protect their trading portfolios as they realise the cost far outweighs the risk of over/under-collateralisation. And it has become much more common for firms to leverage industry vendors or proprietary pricing models to value their portfolio, rather than simply take the word of their counterparty. If a firm isn't proactive yet, it may be worth considering partnering with a specialist as opposed to undertaking the challenge itself.

What derivatives solutions does BNY Mellon provide?

Our goal is to help clients optimise their use of derivatives by enabling them to concentrate on derivatives trading and strategy. We're focused on the OTC market and, at the same time, we're expanding our services to provide even better tools for operational and counterparty risk mitigation. BNY Mellon's Derivatives360 business covers the full trading life cycle and provides an

integrated solution that helps clients through all stages of derivatives transactions, from front to middle to back office.

For example, we can be counterparty to a derivatives transaction, which currently is very appealing to trading partners as we're the only financial institution in the US that is triple A rated by Moody's. And, in addition to a very strong balance sheet, we have expertise in middle-office derivatives processing, especially collateral management. We've been managing the posting of collateral for quite some time at the request of early adopters of this risk mitigation strategy. We also provide confirmation, three-way reconciliation, independent valuation and event management for institutions that have chosen to outsource these middle-office functions, and we extend into the back office with a comprehensive suite of custody, accounting and reporting services for derivatives. Our services are modular, so clients can select and customise the approach depending on their individual outsourcing needs.

How should a firm go about evaluating its current derivatives model to determine whether services like Derivatives360 can help them?

Firms should look at their current portfolio and ask:

- Are our trades collateralised or not?
- Is our existing collateral process efficient? Is it automated with scalable solutions?
- What is our current experience level in managing the complete life cycle of a derivative transaction?
- How well do we evaluate the creditworthiness of our counterparties?
- How capable are we of handling the current and expected changes in regulatory requirements?

We recommend that they consider current and future costs for personnel, technology and the flexibility to adapt continuously to changes in the market place. Risk mitigation should be at the front and centre of any 'build' versus 'buy' evaluation, with a focus on whether or not the required experience levels exist internally for key roles and the ability to secure additional experts quickly for this advanced asset class if needed. That's the only way a firm can determine if it is more cost-effective to invest internally or to consider third-party specialists who are tackling these challenges now. For some firms, it may make more sense to hand off the operational, technological and regulatory headaches.

But not before a firm considers how comfortable it is with outsourcing. This is a tough business decision that goes well beyond dollars and cents to the very heart of a company's corporate culture. One of our pension fund clients made the jump from internal processing to outsourcing all post-execution duties after deciding to self-trade its liability-driven investment strategy. Another client outsourced its collateral management function – which was being run off a spreadsheet – after doubling the number of counterparties to accommodate its credit department's policy to spread risk through smaller trades and more trading partners. Both were significant changes and it was BNY Mellon's responsibility to make the transition go as smoothly as possible.



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