

# DODD FRANK AND THE OPPORTUNITIES FOR CONSULTING FIRMS

## ARE HARD TIMES FOR BUSINESSES AND REGULATORS GOOD TIMES FOR CONSULTANTS?

Not since the Great Depression have we seen such sweeping regulatory reforms in the aftermath of a market crisis. These changes stand to influence every segment of the financial services industry with reverberations to be felt throughout corporate America. The general consensus is that other regulatory reforms affected key business areas of banks, like risk and technology, while Dodd-Frank, the US government's answer to avoiding a repeat of the 2008 debt crisis, is much more strategic, broader and far-reaching.

Implementing Dodd-Frank will be difficult for the financial community. Banks are taking a very dedicated, methodical approach to adopting the vast requirements mandated by the new regulatory environment, but just what approach to take is not always clear. Enter the role of the consultant. As experts in project management and process design and implementation, regulators and business leaders alike recognize the benefits that arm's length professionals can bring to large internal change projects and are engaging consultants to fulfill these interim needs. As such we are seeing an up-turn in consulting business and engagements. How will regulatory obligations continue to shape the future of the consulting industry?

First let's take a look at Dodd-Frank. A recent WSJ article pointed out that the Dodd-Frank law is 849 pages long, as compared with the 64 page Sarbanes-Oxley Act initiated after the Enron Crisis or the slim 34 page Glass-Steagall Act which was passed after the 1929 stock market crash. Recent reports suggest that the Commodities Futures Trade Commission (CFTC) will be responsible for regulating 83% of the over-the-counter (OTC) derivatives markets. OTC contracts are bilateral contracts in which two parties agree on how a particular trade is to be settled in the future. Forwards, futures and swaps are prime examples of these types of contracts, which are traded in a de-centralized market place where participants trade over the phone or electronically as opposed to through a central exchange. The OTC marketplace is instead facilitated by middlemen, called dealers or brokers who provide a matchmaking service between buy and sell orders. OTC's are a \$277 trillion business in the US, dwarfing the regulated exchanges like NYSE-Euronext which is \$20 trillion. In 2008, the international OTC marketplace peaked at roughly \$680 trillion, more than 10 times the gross national product of all the countries in the world.

The problems that emerged within the OTC markets began with the absence of sufficient oversight or regulation. The OTC market is sometimes referred to as the 'dark market' because of its lack of transparency, which means there were few record-keeping or reporting requirements imposed upon its participants. Additionally, leveraging and borrowing was permitted without serious requirements for capital secured as collateral, or margin. Furthermore, all the players in the marketplace were participants and counterparties to one another's contracts. Without government oversight to control abuses like fraud and manipulation, without a limit to speculation and without the controls necessary to ensure that a major default wouldn't cause a domino effect throughout the economy, the public interest was exposed to the danger that grew into the 2008 financial crisis. Dodd-Frank is the US government's answer to solving these deep and far-reaching challenges and the bulk of that implementation falls under the jurisdiction of the CFTC.

The CFTC's overriding mandate, then, is to reduce risk by increasing the transparency of the unstructured and unregulated OTC markets through regulation. In particular, the swaps markets, including sub-prime credit default swaps, interest rate swaps, oil and gas/commodities swaps and foreign exchange swaps, are just some of the complex derivatives markets that the CFTC has been asked to regulate. Furthermore, under Title VII of Dodd-Frank, the CFTC will also have to enforce transparency regulations in all dealings where US companies are trading with overseas investors, which opens up an even bigger responsibility in the global swaps markets.

The CFTC has broken down the legislation into 31 topic areas, three of which are still under discussion due to their complexity and the sheer volume of public comments and debates being fielded concerning them. These topics include the idea of clearinghouses, business conduct rules around reporting and data repositories, as well as trading platforms, including the subject of position limits and capital margins.

So what is the role for consultants supporting the regulators? Obviously, consultancies are well suited to provide these agencies with the project management and process skills necessary to deliver their demanding mandates. Consultants are presently working in Washington and elsewhere, aiding the government in articulating, expressing and communicating the legislation's rules and regulations so that they can be first understood, and secondly implemented, by their targeted audiences. With expanding agency budgets in 2012, we could expect to see more of these consulting engagements over the next 18 months,

How are the banks faring under the onerous task of re-formatting their businesses to comply with Dodd-Frank and similar regulations? There seems to be full agreement that responsibility for key implementation tasks span entire organizations, but where the tasks and responsibilities begin and end is not yet clear. Boards must be fully aware of regulatory demands, and of the current state of the bank's readiness to fulfill them, but what are the best processes with which to communicate about the plethora of mandates, how often and to what level of detail? Senior Managers must be kept abreast of the far-reaching changes falling under the responsibilities of their business units to make them compliant, but what is the best way to implement full scale change programs while still running profitable P&L's in a volatile, shifting market place?

No one is under the mistaken belief that adopting, and adapting to, such wide sweeping regulatory reforms can be done on an ad hoc or part-time basis. This understanding has given birth to scores of internal Program Management Offices (PMOs) throughout the financial industry, specifically responsible for the task of implementing these new mandates. How to design and staff the PMO's, however, is an area of much debate. The best practice approach by many banks presently is anchored upon the organized dissemination of information throughout the firm with key responsibilities and tasks clearly articulated. The process usually begins in the legal department. The firm's legal team has the initial responsibility for receiving the new piece of regulation and interpreting its significance to the firm. Second, the compliance team or perhaps the PMO is responsible for bringing information and knowledge of the latest regulation to the firm's affected business units. Together with the business heads, the PMO will discuss how that new regulation will change present processes as well as how the new regulation may play out in different areas of a bank (e.g. Capital Markets vs. Consumer Businesses). Next it is the responsibility of the business unit with the help of the compliance team, or PMO, to answer key questions; what exactly do we need to do to comply with this regulation? What are the new policies and procedures that need to be put into practice and how are those changes best and most quickly adopted? What affect will these new regulations have on the way I do my business and on the people who run it?

The next consideration is risk. The new control obligations associated with these business changes must be operationalized through existing risk management functions (compliance, regulatory affairs, operational risk, market risk, credit risk, business continuity, and internal audit) and reach down into the most minute details of the workings of business departments. The regulatory changes are putting tremendous strains on reporting procedures as well as the technology needed to implement practices that are much more onerous than ever demanded before. How will banks need to change the way they are collecting information and expressing positions and portfolios? If all of these challenges weren't enough, each change needs to be followed by strict validation testing and an on-going monitoring process. What is the best way to assure that the changes a firm put in place to become compliant actually had the intended outcome and that those outcomes will remain consistent?

How does one assess the impact of the new requirements on the risk of individual products, overall positions or even total business units? What are the changes, if any, to margin or capital requirements and given the new regulatory environment, is the business still attractive to the firm? How should these determinations be made? A great example of just this type of decision tree are the effects the Volcker Rule, which takes effect on July 21, 2012, are having on banks proprietary trading groups.

In recent months, Goldman Sachs, Morgan Stanley and JPMorgan Chase announced plans to shut down or spin off their proprietary trading units. According to guidelines set under Dodd-Frank, any position without a hedge could be considered proprietary. For many banks, that regulation makes proprietary trading too risky, regardless of its profit potential. Experts predict proprietary trading operations at banks will largely disappear in one to two years. Most are expected either be folded into hedge funds, of which banks own a sliver, or parceled off into other departments. This is an obvious example of regulation changing banking.

The impact of implementation of the new Dodd-Frank regulations does not stop at US borders. Momentum is building across the European Union to replicate the corporate transparency enforcements contained in Dodd-Frank, with draft proposals expected by November, according to EU officials. Klaus Rudischhauser, a senior European Commission official, was quoted recently in the Financial Times as stating, "We will make a proposal to include mandatory country-by-country disclosure by November, with Dodd-Frank as a minimum (standard).

There is no over-estimating the influence of these new regulations upon the future of the global financial markets. A recently released JP Morgan study of Dodd-Frank claims that the opportunities arising from its provisions forcing banks to spin off some derivatives business, halt proprietary trading and wind down their investments in hedge funds could encourage big European banks to steal business from their United States rivals. "Thanks to elements of the Dodd-Frank financial regulatory law, big banks in Britain, Germany and France could benefit from regulatory arbitrage opportunities and gain market shares," the report states.

It's no wonder that the financial community needs help with their exhaustive mandates and, let's face it, consultants can be great at this type of thing, but many banks are struggling with the right model to include consultants in this process. Most acknowledge the benefits of outside, professional help but many are concerned about the best way to leverage internal talent and make sure that the projects take into consideration the internal practices and culture of the firm. Although incredible tactical challenges exist, it is commonly acknowledged that the successful firm will not look at Dodd-Frank, or any of the new regulatory reforms simply as a series of restrictions being mandated, but rather will treat these changes as opportunities to help businesses manage risk while growing and creating value.

Satori Consulting is one firm giving a lot of careful attention to the opportunities the new regulatory environment is providing for its clients. "Given their systemic nature, careful structuring of these change projects is required to manage the impact they will have on ongoing operations and is also essential if an organization is to capitalize on the opportunity to implement changes that bring lasting value", states Satori partner, Justin Ockenden. It is for this reason that financial institutions are looking for assistance from consulting firms that can demonstrate a track record of establishing and operating the program structures that are required. Satori is a boutique consulting firm whose business model concentrates on bringing highly experienced professionals to support a firm's mission-critical initiatives by delivering high-level strategic thinking, exceptional process and change skills together with a sensitivity to the client's unique culture. "With this approach, the change agenda is well adapted to the organization's dynamics, is strategically directed and is not merely a series of modifications to processes", says Mr. Ockenden, "The way in which these implementation projects are managed becomes of significant strategic importance to the firm itself and to its ability to compete in the new global market place."