Volcker Rule Compliance: Preparing for the Long Haul

With the final version of the rule set to arrive on July 21, financial institutions must devise and implement dynamic structures that can ensure ongoing compliance with key provisions.

Executive Summary

The nebulous nature of key provisions of the Volcker Rule has banking and financial services organizations in the U.S. devoting an enormous amount of time and resources to determine the best way to comply with this new regulation of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The challenge is to balance the cost of compliance with the ability to drive revenue growth.

This white paper provides guidelines for organizations seeking to plan for and achieve conformance efficiently and effectively. Determining the potential impact on various business functions through a detailed analysis is key for any affected organization. A detailed roadmap towards compliance and empowering end-users with tools to detect and preempt noncompliance are among other important components of an effective strategy.

Paradigm Shift

The Volcker Rule as proposed under the Dodd-Frank Act seeks to reduce systemic risks, while allowing trading and other security-related activities that support liquidity in the U.S. financial markets. It aims to prevent a conflict of interest between financial entities and their clients by separating traditional banking functions from activities such as proprietary trading, which are prohibited or severely restricted.

Not surprisingly, the banking industry has frequently sought clarifications about the interpretation of the rule and challenged many of its provisions. The final version of the rule is due on July 21, 2012.

Most financial entities in the U.S. are affected by this rule to varying degrees. These institutions need to reorganize their businesses to balance compliance with revenue streams.

Importantly, the regulation will affect various trading functions of financial services enterprises. The affected companies will need to assess and redefine their strategies, especially for:

- **Market making**: Although allowed under the rule, a banking entity must monitor this activity to ensure that it is indeed market making and not disguised proprietary trading.

- **Hedging**: Prohibition of certain risk-taking activities under hedging may prompt banks and dealers to evaluate their strategies and
do away with any methods that may generate profit beyond the prescribed thresholds. Prevention of hedging losses arising out of directional trades will have to be considered as well.

- **Covered funds:** The rule will limit financial entities’ sponsorship of covered funds. A covered fund is essentially a hedge fund or a private equity fund that does not offer its services to retail clients. The extent to which a banking entity can sponsor a covered fund will be determined based on its Tier-1 capitalization, the potential loss it will need to take on and the total size of the covered fund.

- **Other activities:** Some other activities related to lending and underwriting may also be affected to varying degrees. Internal controls must be put in place to ensure such activities do not cross over into proprietary trading.

The rule will affect the way risk management and compliance functions are carried out. The existing risk management and compliance infrastructure will need to be modified to accommodate increased monitoring and tracking of trading activities:

- **Risk management:** For the most part, the industry's existing risk management frameworks help financial entities predict and mitigate losses. Following the new regulation, the risk management methods will also have to predict and restrict proprietary trading. Firms will need to formulate policies and procedures to prevent noncompliance. This will require identifying areas of potential noncompliance and devising internal controls for regular audits to identify loopholes in the compliance process. The Volcker Rule also imposes new reporting requirements – both internal and external.

- **Compliance:** Banking entities will be mandated to implement both pre- and post-trade compliance measures to ensure conformance to the provisions of the rule. Pre-trade compliance relates to the account from which the trade is placed, identifying the counterparty, etc.

Post-trade compliance relates to measuring the retained risk, recognizing the breakup of the revenue earned, etc.

**Achieving Compliance**

As organizations prepare to assess the true impact of the rule in light of the reshaped regulation set to emerge on July 21, 2012, it is imperative that they:

- Identify and analyze all trading activities that come under the purview of the regulation.
- Identify and analyze exposure to covered funds and the criteria for investment decisions.
- Assess the financial impact on the top line and bottom line after considering all proprietary trading activities.

Organizations should devise an assessment framework leveraging statistical methods and analytics to map the impact (P&L, business processes and technology) from key provisions of the rule on various functions and business units. They should:

- **Analyze the nuances of permitted trading activities** that need to be tracked and monitored to ensure compliance, focusing on:
  - Revenue generation sources and patterns in trading activities.
  - Sources of trades and strategies from various trading desks and traders.
  - Financial instruments traded by the trading desks and the associated revenue risks.
  - Hedging strategies and positions.

- **Assess gaps in risk management and compliance tests** and define all the metrics that will be needed to monitor trading activities.

A multiphase project-oriented roadmap towards Volcker Rule compliance should be drafted by organizations that may want to continue with the permitted trading and sponsorship activities. Establishing a project governance model, before an organization starts identifying gaps, will ensure clear ownership of responsibilities and establish
efficient channels of communication. Mapping the needs for compliance to existing business models of trading, risk management and compliance can help identify gaps quickly. A detailed analysis of the identified gaps can be undertaken based on the organization’s priorities. Once the gaps are identified, the next step will be to develop efficient and accurate solutions that reflect the data needs and the existing business-IT landscape. The volume of business and the associated risk of noncompliance will be important factors driving the choice of solution.

Finally, a detailed implementation plan will need to be drawn up. It should not only target the gaps identified but also conform with the target operating model for the planned new business processes in the organization. Figure 1 presents a sample roadmap for achieving compliance.

**Speeding Up Conformance**

Given the wave of regulatory changes as well as the increasingly sophisticated nature of frauds being committed, compliance and risk management processes are graduating from being detection-based to becoming prevention-oriented.

An important component of this strategy is to provide responsible end-users with tools that can help them preempt and prevent noncompliance. Such an approach can go a long way toward ensuring compliance with the Volcker Rule. The designated business process and technology capabilities must develop and track the various metrics and measures that the Volcker Rule suggests. Some of these requirements are:

1. **Distinguish customer-initiated trades.**

   This distinction may not be currently made and/or tracked in the absence of regulation prohibiting proprietary trading.

   Workflows in the order-capture-to-settlement process may be required. These workflows must tie the order origination (it may be as simple as recording the phone call the client makes asking for a trade to be executed) to the settlement of the trade in the customer’s account.

   This will also create audit trails to support the audit program mandated by the Volcker Rule.

**Mapping the needs for compliance to existing business models of trading, risk management and compliance can help identify gaps quickly.**

---

**Compliance with Volcker Rule: Roadmap**

![Volcker Rule-Compliant Banking Entity](image)

- **Implement & Operationalize**
  - Define detailed specs and system requirements.
  - Develop high-level & low-level designs.
  - Data mapping and dependency identification.
  - Design, develop, test and implement.
  - Operationalize proposed recommendations based on target operating model.

- **Detailed Analysis and Process Definition (24-30 weeks)**
  - Define target state business processes.
  - Develop detailed business requirements for metrics to serve as early warning system for noncompliance.
  - Develop detailed guidelines for future policies and procedures related to risk management and compliance.
  - Define target operating model.
  - Product evaluation (if required).

- **Identify Gaps (6-8 weeks)**
  - Concentrate on market making, underwriting, hedging, investments in covered funds, lending.
  - Understand revenue-risk appetite for the affected LOBs.
  - Identify risk measures.
  - Identify gaps in risk management framework and policies and procedures.
  - Identify business process changes.
  - Understand IT landscape supporting relevant risk & compliance functions.
  - Define a high-level data model to support any solution for gaps identified.

- **Get Prepared (1-2 weeks)**
  - Understand the changes and how these impact business functions.
  - Identify impacted business and relevant stakeholders.
  - Identify SMEs from relevant LOBs.
  - Define project governance framework.
2. Determine counterparties distinctly in a trade.

Currently, generic identification processes may be in place to determine counterparties at a parent company or issuer level.

The new regulation requires establishing and tracking additional attributes that can help determine the true nature of the counterparty (or issuing entity) to decide if the trade can be placed. Derivative instruments with underlying securities and counterparties need to be examined and tracked appropriately. This will also support audits and reporting on traded counterparties.

3. Compute metrics under revenue relative to risk at the trading desk level.

Currently, it is easy to measure and attribute revenue and risk at the trade/book level. The challenge is to implement these metrics at the trading desk level in the pre-trade placement stage.

Risk attribution at the trading desk level prior to trade placement will require software that can model payoff scenarios for the trade and a risk engine that can integrate the risk and return of the trade with the risk and return of the portfolio that it is a part of.

Modeling the risk of the trade along with its risk attribution to the portfolio in the pre-trade stage will allow the trading entity to ascertain the capital required to cover the risk. It can therefore determine whether the trade would add to the profitability of the desk without increasing its uncovered risk.

4. Establish early warning systems to detect noncompliance.

Existing risk management practices and systems at trading desks come into the picture post-trade. Such systems and processes will not be able to detect “disguised” proprietary trades (directional trades disguised as market-making or hedging).

Rules-based analytics models fed with data points to detect proprietary trades, risk exposure, etc. can ensure that noncompliant trades and trading desks are detected in the pre-trade stage. Data points that need to be tracked and modeled include financial instrument type, various risk measures, asset size, revenue, fees, bid-ask spread and so on.

Such a capability will ensure conformance with the Volcker Rule provision mandating identification of potential nonconformance.

5. Enhance data management and reporting infrastructure.

The current risk and compliance reporting infrastructure at various organizations may not be geared toward collecting data and reporting for the several new metrics that may need to be developed (e.g. VaR exceedence, Skewness and Kurtosis of portfolio P&L, etc.) and tracked post-Volcker.

The data management infrastructure will need to be enhanced to ensure that appropriate systems consume the data that is required to generate all the metrics and associated metadata needed for risk and compliance processes to adhere to Volcker provisions (see Figure 2, next page). The extent of the augmentation will depend on the organization’s business volume, future growth plans, etc.

Conclusion

The evolving regulatory environment calls for augmenting and implementing capabilities that can orient risk and compliance functions from detection to prevention. To achieve this, exceptional business intelligence and/or visual analytics tools are necessary. This, in turn, requires data creation and aggregation for effective reporting on various risk metrics and other statistical measures for monitoring of trading noncompliance.

Noncompliance was never an option. Now even the intent to conform to regulations must be clearly demonstrated.
activities. Considering the continuing economic turbulence that has roiled the financial services industry worldwide, the cost of noncompliance is clearly sky-rocketing.\(^2\) Noncompliance was never an option. Now even the intent to conform to regulations must be clearly demonstrated.

Footnotes

2. Litigation involving major banking and financial services organizations such as JPMC, Peregrine Financial and Barclays are some recent examples.

References
- Volcker Rule Resource Center. [www.sifma.org](http://www.sifma.org)
About the Authors

Jaydeep Chakraborty is a Senior Consultant with Cognizant Business Consulting's Banking and Financial Services Practice. He has nine years of experience in implementing IT solutions for financial services clients in the U.S. and Europe. Jaydeep has been focusing on the regulatory changes affecting financial institutions in the U.S. and has developed and implemented solutions to help such institutions stay compliant with changing regulations. He can be reached at Jaydeep.Chakraborty@cognizant.com.

Jayanta Das is a Consulting Manager with Cognizant Business Consulting's Banking and Financial Services Practice. He has 11 years of experience in sectors such as oil and gas, BPO, retail banking, asset and wealth management and risk management and compliance in financial services in both emerging markets and the U.S. In financial services, Jayanta has worked on several consulting engagements at diversified asset and wealth management organizations in the U.S. He can be reached at Jayanta.Das2@cognizant.com.

Cognizant Business Consulting Contacts

Balaji Subramanian is a Consulting Director with Cognizant Business Consulting's Banking and Financial Services Practice. He has more than 14 years of experience in consulting in the area of asset and wealth management in financial services. Balaji can be reached at Sbalaji@cognizant.com.

Anshuman Choudhary is a Consulting Senior Manager with Cognizant Business Consulting's Banking and Financial Services Practice. He has 14 years of experience in asset and wealth management and risk management and compliance in financial services. Anshuman has been instrumental in implementing several programs on anti-money-laundering, counterparty credit risk and clearing and settlement for clients across the globe. He can be reached at Anshuman.Choudhury@cognizant.com.

Raghvendra Kushwah is a Consulting Manager with Cognizant Business Consulting's Banking and Financial Services Practice. He has nine years of experience in implementing IT solutions for financial services clients in the U.S. Raghvendra focuses on risk and compliance projects in the financial services space and has modeled innovative solutions that lowered clients' turnaround time to be compliant with regulations. Raghvendra can be reached at Raghvendra.Kushwah@cognizant.com.

The team would like to acknowledge the research contribution of Souvik Kumar Biswas from Cognizant Research Center to this report.

About Cognizant

Cognizant (NASDAQ: CTSH) is a leading provider of information technology, consulting, and business process outsourcing services, dedicated to helping the world's leading companies build stronger businesses. Headquartered in Teaneck, New Jersey (U.S.), Cognizant combines a passion for client satisfaction, technology innovation, deep industry and business process expertise, and a global, collaborative workforce that embodies the future of work. With over 50 delivery centers worldwide and approximately 140,500 employees as of March 31, 2012, Cognizant is a member of the NASDAQ-100, the S&P 500, the Forbes Global 2000, and the Fortune 500 and is ranked among the top performing and fastest growing companies in the world.

Visit us online at www.cognizant.com for more information.