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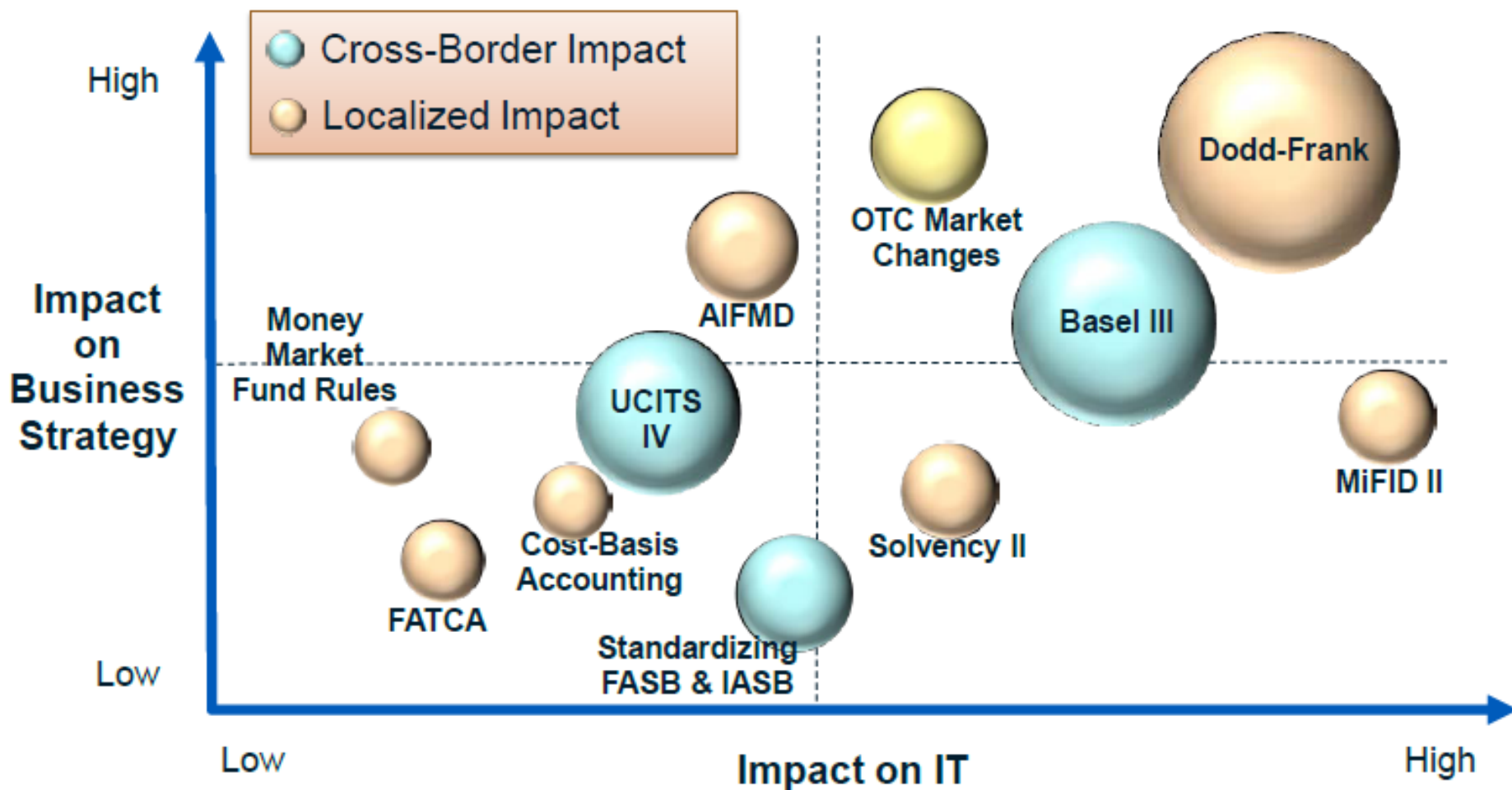


# Systemic Risk, Regulation and Corporate Actions

A tale of Sticks, Herring, and Carrots

**Gert Raeves**  
Research Director  
Capital Markets

# Assessing the Multiple Dimensions of Regulations

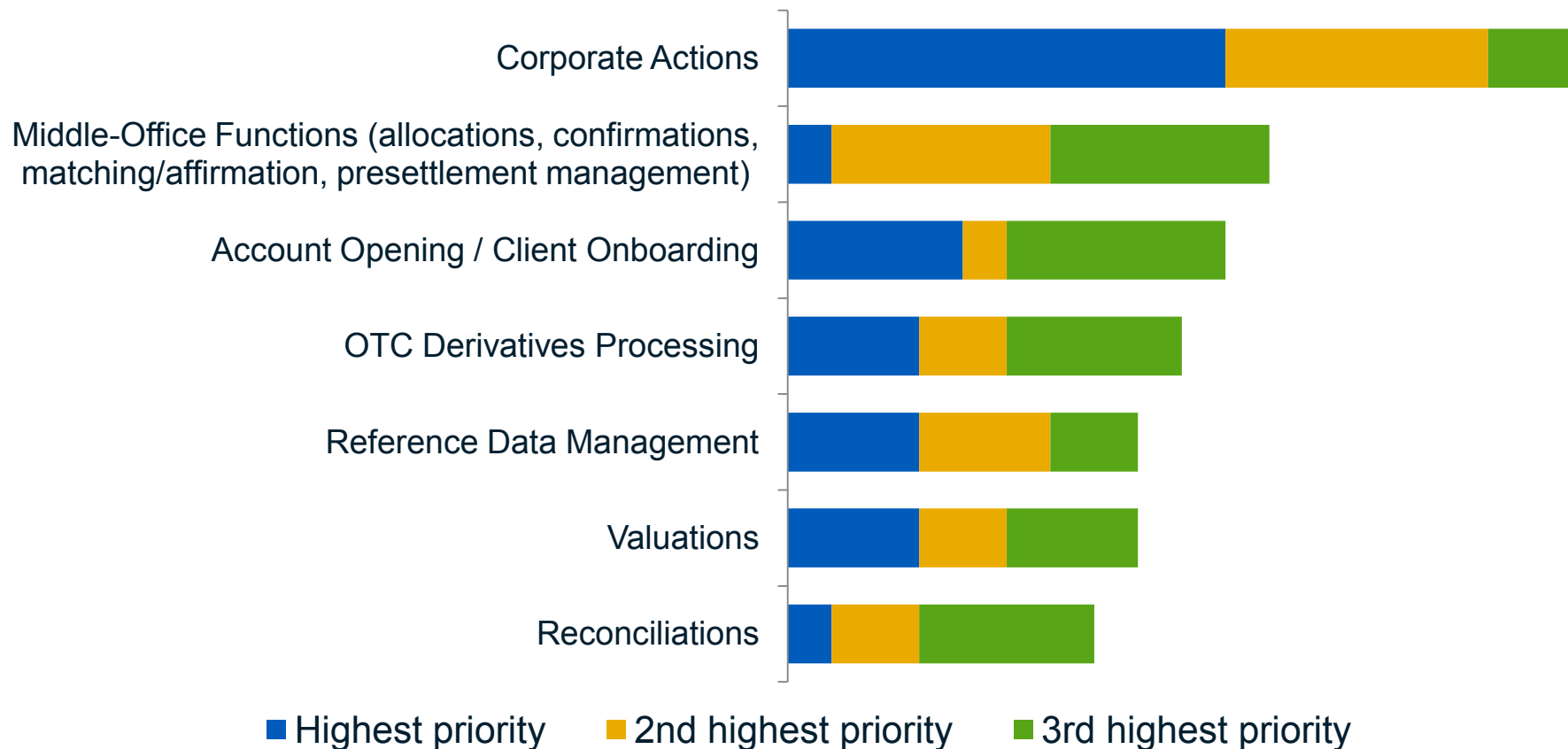


# Challenges Facing Each Type of Firm in the New OTC Market Structure?

	Buy Side	Sell Side	Service Providers
<b>Pre-Trade</b>	<ul style="list-style-type: none"> <li>Identify total cost of trade (capital, clearing, pricing)</li> <li>Decide execution venue and execution method</li> <li>Reconcile CCP, broker, and internal valuations</li> </ul>	<ul style="list-style-type: none"> <li>Assess counterparty risk</li> <li>Provide pricing details</li> <li>Develop transaction cost analysis as a service</li> <li>Develop innovative financing solutions</li> </ul>	<ul style="list-style-type: none"> <li>Valuations and Analytics</li> </ul>
<b>Trade</b>	<ul style="list-style-type: none"> <li>Trade on SEFs</li> <li>Explore use of e-trading tools (e.g., algos, HFT)</li> <li>Reduce dependence on voice communications</li> </ul>	<ul style="list-style-type: none"> <li>Build OTC derivatives clearing broker capability</li> <li>Differentiate execution capabilities</li> <li>Connect to SEFs</li> <li>Develop e-trading tools</li> </ul>	<ul style="list-style-type: none"> <li>Trade capture</li> </ul>
<b>Post-Trade</b>	<ul style="list-style-type: none"> <li>Manage margin with CCPs</li> <li>Manage relationships with clearing brokers</li> <li>Develop intraday margin calculation process</li> </ul>	<ul style="list-style-type: none"> <li>Build margin solutions (e.g., "de-link" client from CCP)</li> <li>Analyze CCP's daily margin and mark-to-market requirements</li> </ul>	<ul style="list-style-type: none"> <li>Improve valuations services</li> <li>Build capability to service complex securities</li> <li>Manage collateral and margin tracking and movement</li> </ul>

Source: TowerGroup analysis

# 7 Functions Top the List for Operational Risk



Source: TowerGroup Assessing Operational Risk in the Securities and Investments Industry Survey

# Dodd Frank Buzzword Bingo

■ SYSTEMIC RISK	39
■ TRANSPARENCY	69
■ DATA	387
■ GOVERNANCE	31
■ CLEARING	492
■ DERIVATIVES	207

■ CORPORATE ACTIONS	0
- CORPORATE EVENTS	0
- REORGANIZATIONS	0
- MERGER	0
- STOCK SPLIT	0
- RIGHTS ISSUE	0
- PROXY	23

Source: TowerGroup analysis

# Big Game Hunting – DFA targeting systemic risk

- (A) explicit or implicit limits on the maximum size of banks, bank holding companies, and other large financial institutions;
- (B) limits on the organizational complexity and diversification of large financial institutions;
- (C) requirements for operational separation between business units of large financial institutions in order to expedite resolution in case of failure;
- (D) limits on risk transfer between business units of large financial institutions;
- (E) requirements to carry contingent capital or similar mechanisms;
- (F) limits on commingling of commercial and financial activities by large financial institutions;
- (G) segregation requirements between traditional financial activities and trading or other high-risk operations in large financial institutions; and
- (H) other limitations on the activities or structure of large financial institutions that may be useful to limit systemic risk.



Source: Dodd Frank Act, TowerGroup

# If not Systemic, then what?

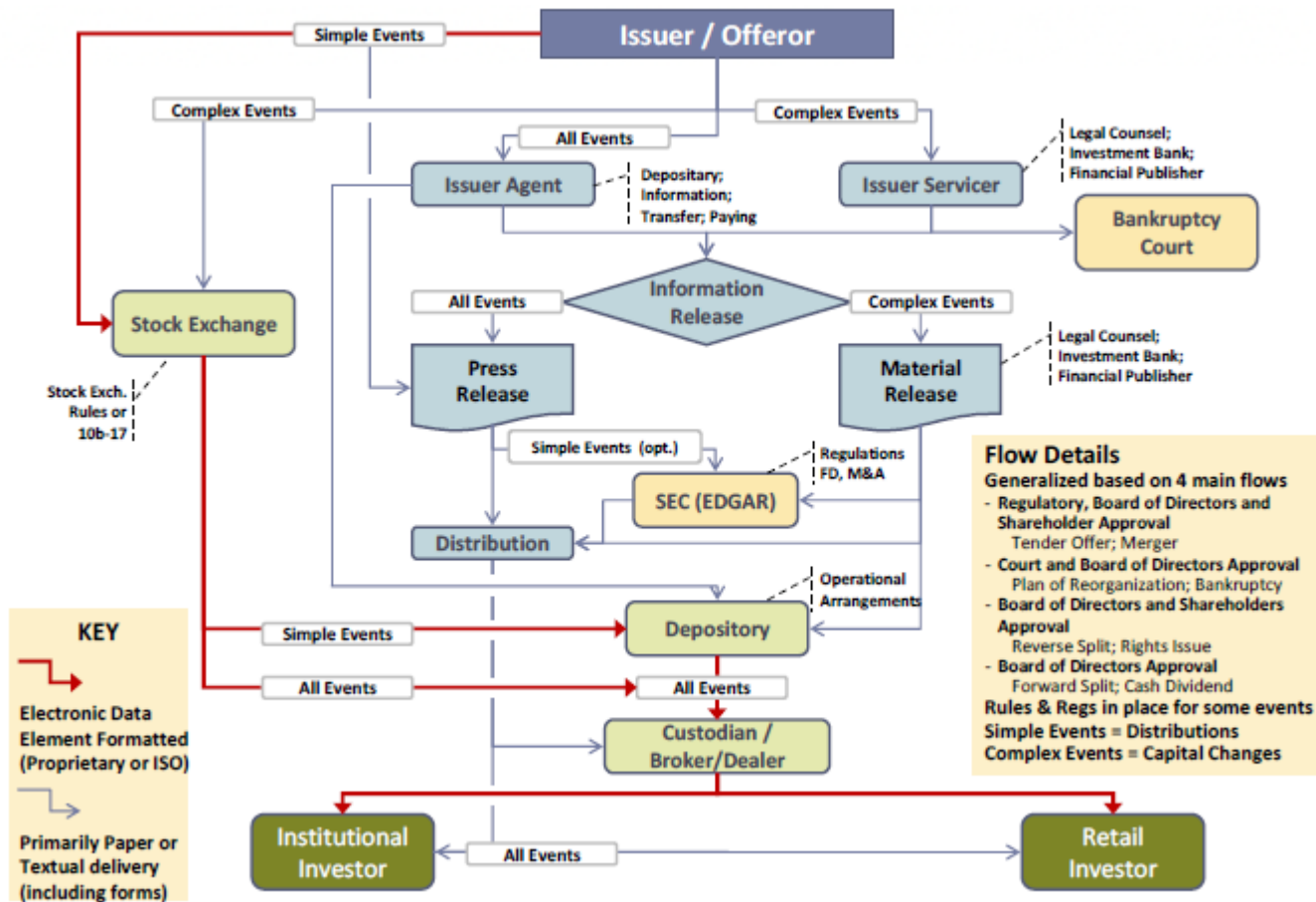
Type of cost	Type of corporate action involved	Who bears the cost?	Zero-sum or net cost to the financial system?
Direct risk of processing failures	Mandatory with options; voluntary	Can be anybody in the corporate action chain (eg, custodian, fund manager, or broker)  Liability depends on which market participant causes the failure	In part zero-sum (offsetting trading positions), but gains and losses are unevenly distributed; and extra transaction costs to unwind failures represent a cost to the system
Direct cost of late payments	Mainly mandatory (mostly dividend and interest payments)	Investors (interest forgone)	Mostly zero-sum (interest forgone is gained by others)
Risk of sub-optimal trading decisions	All	Brokers or fund managers involved in trade (if proprietary) or investors (if cost passed on)	Mostly zero-sum (offsetting trading positions), but gains and losses unevenly distributed, and 'deadweight' loss to investors
Indirect cost of ineffective corporate governance	Voluntary (mainly proxy voting)	Issuers (in the long run), investors, the system at large	Net cost to the system

Source: Oxera

# Root Cause 1: Domain Complexity

*“The Interest Amount payable on each Interest Payment Date shall be calculated by reference to the Interest Accrual Period ending on (and including) the first Interest Period Date falling prior to such Interest Payment Date (or, in respect of the Interest Payment Date that is the Equity Trigger Event Redemption Date, by reference to the Interest Accrual Period ending on (but excluding) the first Interest Period Date falling prior to the Equity Trigger Event Redemption Date (provided that if the Equity Trigger Event Date falls after an Interest Period Date but the Equity Trigger Event Redemption Date falls on or prior to the day that would have been (in the absence of an Equity Trigger Event) the Interest Payment Date falling immediately after the Interest Accrual Period ending on such Interest Period Date, then the Interest Amount payable on the Interest Payment Date that is the Equity Trigger Event Redemption Date shall be calculated by reference to an Interest Period comprising the Interest Accrual Period ending on (but excluding) the first Interest Period Date falling prior to the Equity Trigger Event Redemption Date and the Interest Accrual Period ending on (and including) the second Interest Period Date falling prior to the Equity Trigger Event Redemption Date)).”*

# Root Cause 2: Process complexity



Source: DTCC

# Isn't everything just operational risk?

Risk Domains
Underwriting
Actuarial
Claims
Counterparty
Investment
Credit
Reputation
Regulation
Sovereign
Market
Systemic

Managing operational risk requires an enterprise approach with an industry view

## Operational Risks Cross Domains

### Risks of Omission:

- Inadequate review
- Mere mistakes
- Miscommunication
- Lack of communication
- The unanticipated
- The underestimated
- The unknown
- Unseen change
- Security breakdown

### Risks of Commission:

- Unchecked aggressiveness
- The ignored
- Financial crimes
- Process breakdown
- Fragmented risk management
- A failure of culture

Source: TowerGroup

# Recommended Next Steps for FSIs

- Avoid the regulatory hype cycle
- Adopt grassroots initiatives
  - ISMAG Market Practice
  - EIG Event Interpretation Grid
  - SWIFT STaQS testing service
- Evaluate providers of applications AND content



# Questions?

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[graeves@towergroup.com](mailto:graeves@towergroup.com)

## *Q3 research:*

- Transformation of Data Management
  - Originators, supply chain, standards
  - Platform vendor profiles
  - Risk and analytics
- Corporate Actions – Vendor profiles