

RECOVERY & RESOLUTION PREPAREDNESS

Choosing the Right Approach for SR 14-1 Compliance

01 - INTRODUCTION

The global financial crisis of 2008 rocked the world. It erased trillions of dollars from the market, shook the financial services industry to its core, and brought financial institutions like Bear Stearns and Lehman Brothers to their breaking point. Not surprisingly, when institutions like these — long deemed too big to fail — suddenly did, it sparked fear, panic, and widespread calls for new safeguards and security.

That's why nearly eight years later, large financial institutions face a growing web of increasingly onerous and complex regulatory requirements. Designed to address moral hazard within the financial system, regulations such as SR 14-1 are aimed at ensuring that the country's banking institutions, from the largest "systemically important financial institutions" (SIFIs), through to other smaller financial services organizations have "adequate and credible" recovery and resolution plans in place.

Like other recent regulations, SR 14-1 sets a variety of new hurdles that banks need to overcome to prove their operational resilience and demonstrate the viability of contingency plans. Specifically, it calls for adding an array of capabilities in areas such as collateral management, payment, clearing, and settlement (PCS), management information systems, and shared and outsourced services.

Practically speaking, the guidance that SR 14-1 sets forth boils down to one thing: They need to set up a reporting capability in the areas mentioned above for presentation to the Fed, and fast, easy, and reliable access to critical information to feed the reporting. Much of that information resides in the tens, to hundreds of thousands of contracts that represent an organization's transactions, relationships, obligations, opportunities, and liabilities.

To comply with Fed regulation, these banks must be able to report on, and answer questions about the details contained within those contracts. They also have to be able to do so at the aggregate level, across the different types of agreements that exist, as well as on an individual, contract-by-contract basis. Among the questions they have to answer include how many clients they have, what different types of agreements exist in their organization and how they're structured, as well as what the inherent risks within any given agreement may be.

Being able to answer these questions quickly, accurately, and on demand is critical. The Fed has real time, quarterly and annual reporting requirements that are stipulated in the regulation.

Although many have internal systems in place to capture various bits of the information they need, those systems are often siloed, spread across different parts of the business, and incomplete. As they begin to unravel the full implications of what SR 14-1 actually entails, their recovery and resolution teams soon discover that they don't have a single, consolidated way to meet all of the regulation's requirements. Nor are they in a position to be able to pivot to comply with any new regulations, or changes in existing regulations that may be implemented by the Fed.

The reality is that complying with SR 14-1 is a very real challenge and one that could easily consume a huge amount of time, money, and other resources. With its July 2017 deadline rapidly approaching, and the implications of non-compliance severe, the stakes couldn't be higher. For these reasons, finding the path to achieve compliance with the least cost, time, resources, and business disruption is an extremely high priority for banking institutions right now.

02 – UNDERSTANDING SR 14-1 AND ITS IMPLICATIONS FOR YOUR BUSINESS

On January 24, 2014, the Federal Reserve issued SR 14-1. As a supplement to SR letter 12-17/CA letter 12-14 “Consolidated Supervision Framework for Large Financial Institutions,” the new regulation provides specific guidance about the capabilities that financial institutions will need to maintain by July 2017 to ensure effective recovery and resolution preparedness.

Fundamentally, that guidance falls into a number of high-level categories, which among other things, mean that you need to be able to:

- Manage, identify, and value collateral
- Understand the obligations and exposures that occur as a result of payment, clearing, and settlement (PCS) activities
- Produce specific data about the legal entities they engage with and have the right controls in place to ensure the integrity and reliability of that data
- Maintain critical operations by having the necessary arrangements to engage with and manage the risks associated with vendors

These requirements have a vast number of implications. For example, in July 2017, SIFI banks will need to be able to identify the legal entity and geographic jurisdiction where counterparty collateral is held, and track their customers and counterparties for all PCS activities.

They will also need to be able to document all netting and rehypothecation arrangements with clients and counterparties. Plus, they will need to produce various types of information pertaining to legal and service level agreements, as well as guarantees, cross holdings, financial commitments, and other transactions with material entities. Other requirements include being able to identify exposures to financial market utilities, Nostro agents, and custodians.

And that’s just the tip of the iceberg.

It’s also important to note that although the list of requirements built into the SR 14-1 mandate is quite long, the guidance it provides isn’t exhaustive and has intentionally left the door open to updates and changes over time.

The Fed has also made it clear that non-compliance would likely mean millions of dollars in fees, possibly loss of operational control, increased Federal oversight, and damage to public perception of a bank’s brand. This ensures failure to comply simply isn’t an option.

03 – MEETING THE CHALLENGES OF SR 14-1 HEAD ON

Compliance with SR 14-1 boils down to the following:

- Knowing where all relevant contracts and legal agreements are located
- Extracting the relevant terms, provisions, clauses and data needed by SR 14-1
- Implementing the appropriate analytics and reporting systems to design and build the needed submissions by the deadline

When it comes to deciding how to comply with SR 14-1, banks have three options to choose from: Manual contract reviews, building a solution in house, or implementing a solution from an experienced software vendor.

04 – MANUAL REVIEW

When contract data is needed from a large set of contract documents, one option is to call in a legal services firm to manually review all contracts, and record the key terms, provisions, and data into spreadsheets. Manual reviews have been used for years to extract content out of contracts.

Unfortunately, there are mostly negatives associated with manual contract reviews, including the following:

- Process assumes all contracts are already collected and triaged to the relevant agreements
- Manual reviews take months to years to go through large portfolios of contracts
- The costs of manual reviews are high, as reviewers often must have legal background and training
- Manual reviews are subjective, meaning one reviewer may interpret a clause a certain way, while another may perceive it differently
- Reviewers are looking for a predetermined set of data. You can not “future proof” a manual review effort.
- Once the data is extracted, it must be analyzed and imported into a reporting tool for presentation

It is clear that manual reviews, once the only option for this function, are no longer viable for large portfolios, and technology is now available to take much of the burden from data extraction, in a more reliable, timely and cost effective manner.

With a manual review, the human reviewers are looking for a predetermined set of data. If new requirements or mandates mean different data must be extracted, then you must start the process over.

05 – DEVELOPING A SOLUTION IN-HOUSE

Some large banks will consider building their own solutions to extract contract data, particularly if they already have internal systems in place, such as databases or contract repositories that will help meet some of the requirements, or have investments in large IT organizations.

What we find with this approach is that to match the speed and accuracy of specialized systems, it takes significant skills and experience in machine learning and natural language processing technologies that are very expensive. It also tends to consume resources at a higher rate than planned and distract from other core applications that share IT resources.

Finally, homegrown tools lack the flexibility needed to accommodate new requirements as they emerge and often fail to meet the original objectives. If there are new terms or provisions to be extracted or searched and reported on, then extensive work must be done to train the system to accurately find this data. The tuning and training is extensive, and we find organizations moving away home grown systems onto packaged systems over time.

When it comes to SR 14-1 there just is not enough time to build a solution before the deadline for compliance.

06 – IMPLEMENTING A PACKAGED SOLUTION

As mentioned, there are solutions available that will discover contract documents across the network and extract a set of data that can be used for SR 14-1 compliance. In most cases these solutions have been trained, with the processing of multiple contracts, to identify and extract certain sets of data from contract documents. They also contain the latest evolutions of analytics and reporting technologies to ensure banks fully leverage the speed and accuracy of automation for this application.

A packaged contract review solution reduces the need for full manual contract reviews across all contracts, and can speed up the process and reduce the cost to extract the data needed for SR 14-1 reporting. It will also cost less to purchase, tune and support over time than an in-house developed solution. In addition, a contract platform allows the organization to evolve as the SR 14-1 regulation changes or new regulations require contract assessments.

07 – SELECTING THE RIGHT CONTRACT DISCOVERY AND ANALYTICS SOLUTION

In the process of implementing a system for SR 14-1, banks must look for certain things needed from a contract review solution to maximize the benefit, including:

1. A system that automates the identification and discovery of existing contracts across the various repositories, file shares, network drives, and systems across the organization. To do this, a system must have an integrated OCR (optical character recognition) system to convert various contract formats including non-searchable PDF documents into documents that can be understood to determine if a particular document is a contract or not.

The majority of contract review systems do not include contract discovery functionality.

2. The consolidate and copy all contract documents into a centralized and secure repository. At this point all documents are now categorized by type of contract document and in a searchable format, and there is already significant value for users in just knowing where all the contract documents are, and that the data can be searched and extracted.

3. A system must provide the ability to quickly triage down to the relevant contracts based on auto classification. Filtering down to the critical agreements is time consuming so this process is key to introduce automation.

4. The right system now automates the extraction and indexing of key terms, using a set of pre-defined extraction policies that are specific for the industry so it's easy to search for, sort through, and analyze relevant data. For SR 14-1, this includes specific terms such as party names, termination terms, default terms, conditional support, bankruptcy, and netting just to name a few. Users can now search and sort all contracts containing certain types of data, and review subsets of documents from within the platform.

Most review tools have limited sets of extraction terms, and require the building of additional extraction policies and training of the system to achieve SR 14-1 compliance.

5. A strong contract discovery and analytics system must then provide a customized search and term extraction capability, allowing business users to easily review individual clauses across thousands of contracts for real-time analysis. This is the functionality that provides the flexibility to adapt to new requirements and mandates, and to extract data specific to other business functions that need contractual data. Many contract review tools require highly trained analysts or users with legal backgrounds to extract specific provisions or clauses from portfolios of contracts.

6. The right platform for SR 14-1 also requires a robust reporting and data visualization tool to find the contract opportunities and areas of concern, and extract the full set of contract intelligence to better manage the business. It is then needed to develop the reporting packets to develop the SR 14-1 submission, and automate the data feeds to ensure the submission is timely and accurate.

Most contract analytics solutions have limited reporting functionality.

7. Finally, the right contract discovery and analytics solution must be an efficient and effective platform for ongoing analysis, not only for SR 14-1 but for many regulations and business functions. This includes the processing of various types of contracts across all departments, including client contracts, ISDAs and CSAs, and supplier agreements, and the ability to go as far as comparing standard and non- standard language within specific clauses, from deep within the portfolio of contracts.

08 - THE SEAL SOLUTION

At Seal, we have invested heavily in the seven areas above, ensuring we provide all the needed functionality to help organizations get through their SR 14-1 planning, data capture and analytics, and reporting tasks. Most importantly, Seal is working on SR 14-1 projects with SIFI banks right now. The proven process that we are conducting around SR 14-1 has been successful, and allows Seal to provide critical insight to quickly move forward to compliance.

Seal also can bring to bear deep relationships with the top consulting firms to augment a bank's current resources and ensure all of the regulatory requirement are satisfied.

Our discovery capability is unique, and ensures our customers find all their relevant contracts from wherever they are being stored. We also have robust APIs sets and are very extensible across the enterprise so we can work with the systems that banks have invested in, and are currently using - not displace them.

We extract over 100 terms and provisions that have been built into the Seal system over time with high degrees of refinement and system training, including many directly relevant with SR 14-1 reporting.

Our combination of machine learning and natural language processing technologies mean that we can process large numbers of contracts, in the 100s of thousands, with the highest speed and accuracy. We also have capabilities built into the platform, including the ability to compare standard and non-standard clauses, which are patented, and unique in the market.

We have integrated the industry-leading Sisense reporting and data visualization platform into Seal, so our customers have a robust system to facilitate their SR 14-1 submissions.

A sample of terms that can be extracted by Seal for SR 14-1:

- Party name
- Legal Entity
- Agreement type
- Governing Law
- Key Dates
- Term
- Product/Services
- Intermediaries
- Party/Counterparty
- Amendment Reference
- Signed
- Default Terms
- Termination Terms
- Netting
- Conditional scenarios
- Credit Support
- Bankruptcy
- Disputes
- Etc., etc.

Finally, we have designed our platform for a rapid time to value. Our system can be up and running in a matter of weeks, and will shorten the discovery and review of an organization's portfolio of contracts from months and years to just weeks, to give them the ability to meet SR 14-1 reporting mandates in plenty of time.

Last, but certainly not least, a bank wants to find a solution that can leverage the work that has already done to manage contracts. A good solution will build upon whatever systems and insights in place, rather than discarding them and forcing them to start over.

09 – THE WAY FORWARD

SR 14-1 is a complex regulation that requires immediate attention. By far one of the biggest obstacles that needs to be overcome to meet the regulation's requirements is being able to quickly and easily access highly specific information that currently resides in the contracts that live across the organization, and create comprehensive reports on that data to achieve compliance.

The initial step of finding contracts, triaging to the relevant documents and getting access to the key required terms is a considerable challenge for organizations. When they take into account the cost and time of manual reviews and reporting, or the complexity of building an in-house solution, finding the right strategy to plan for these challenges becomes a critical choice.

To meet the range of contractual obligations set forth in SR 14-1, banks need to select the right technology partner. One who has a powerful solution, experience and expertise in contract reviews, and who can also leverage deep relationships with a wide range of tier I consulting companies who can bring deep domain, project management, and guidance to help guide organizations through the process.

When it comes to navigating your way through SR 14-1, your best option is to find a solution that helps you achieve compliance, and one that also improves your business operations and decision making in many other ways. Seal Software is here to solve the challenges related to SR 14-1 and many of your other regulatory requirements. Let Seal Software be your contract regulatory platform to drive high value across your organization. Compliance is required by July 1, 2017, and banks are now taking the steps to achieving their goals.

ABOUT SEAL SOFTWARE

Seal Software, the leading provider of discovery, extraction and analytics solutions, enables companies around the world to effectively manage their contract portfolio by understanding exactly where their contracts are when needed and, more importantly, what is buried within them, in order to maximize revenue opportunities, mitigate risk and reduce expenses. It's also the only total solution capable of helping banks address their contractual obligations as part of SR 14-1.

To Learn More, visit: www.seal-software.com/regulatory-sr-14-1

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