Data Management Review

Opinion: Regulators Blink on Derivatives Reform – Industry Leadership Required

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While the complications of Obama Care reform in the US has reached all Americans directly, the complications of the implementation of the swaps risk regime are similarly 'problematic.' But they are not yet well enough understood to touch the lives of everyday people, although indirectly they will impact everyone through higher interest rates and a higher cost of capital.

Both the Affordable Health Care Act (better known as Obama Care) and the Dodd-Frank legislation were passed during a 4½ month period in 2010 when both houses of congress and the White House were controlled by one party. Back then, when we roamed the halls of congress with our 'Fix the Plumbing' amendment the clarion call of the reformers was: 'Just let's pass the damn thing – we'll fix it later!'

Well, now is later and at the detail level, where the regulation hits the data and technology road, things are failing. The regulators have now blinked.

The regulation of the shadow banking system, populated in one instance by unregulated derivatives contracts – primarily swaps and their variations – is the first and most significant stage of reengineering the financial system. It is the first instance of implementation of a global data standardization and identification system.

In the US, the CFTC had been given responsibility to oversee this market and has now, after nearly four years of hearing from the industry on market practices and then writing rules, basically asked for a rethink. The CFTC's Request for Comment on its Swap Data Reporting Rule was released after the commission was deluged with industry data its computers could neither ingest nor aggregate. The consultative document suggests that the commission's technology and data requirements are in need of a carefully considered redesign, taking into account market practices that regulators are still not well informed on.

Taken together with the G20's Financial Stability Board's recent consultative paper on Aggregation of Data in OTC Derivatives Markets, it suggests a need for a global industry response by an informed constituency of industry practitioners and academics. They should be setting goals for the collective interests of regulators, users of these markets and intermediaries alike. Cooperating on re-architecting the data and technology infrastructure should come before competing on business fundamentals, which is the case today. Industry leadership is needed.

Today's diverse capital markets cannot work without equivalent risk-shifting markets. There are many tradable financial instruments and contracts used for hedging and risk management. Some are firmly established like exchange-traded options and futures contracts. Others are not. A whole new set of contracts, swaps and over-the counter derivative contracts, formally traded as dealer-to-dealer and customer-to-dealer contracts, are moving onto an exchange-traded infrastructure in a massive experiment to regulate these contracts globally.

To understand the implementation burden, recall that the financial system is a 'system', an almost indescribable interconnected web of computers and networks. Financial institutions are huge technology factories. They have survived within a crumbling underfunded infrastructure and a Rube Goldberg (or Heath Robinson) legacy of technology and data that each financial institution lives with day to day. Each describes its data and technology separate from industry considerations that they must interface with. They, and the data vendors and technology companies that service them, accommodate this problem by creating vast arrays of mapping tables, each subject to the risk of timing differences and improper updates that cause transaction payment mismatches and data aggregation issues … and additional cost and risk.

It is obvious to many that the financial industry has exceeded the capacity of the evolved, interconnected but asymmetrically joined financial system to absorb more incremental change. We see this dysfunction every day: in market shutdowns; stolen credit card portfolios; failed IPOs; swaps trades that overwhelm regulators' computer capacity; inability to aggregate data for systemic risk analysis across multiple financial institutions; inability to aggregate risk data for each financial institution across business silos; and on. And let us not forget the frauds and collusions that went undetected because industry members, their gate keepers and their regulators alike had manual check list devices to oversee an interconnected financial system that creates undetectable risk exposures in real time.

The swaps risk regime is but the first step in implementing a far-reaching data standardization regime. A barcode-like unique set of identifiers and a set of standard data tags for all financial market participants and the instruments and contracts they trade in, and the financial transactions they generate has been requested by regulators.

We should not waste a financial crisis, and now a redo offer from regulators, to get on with fixing the plumbing. We need industry leadership now.