27 MARCH 2014 12:00AM

Derivatives reform hits a technology roadblock

Industry needs to implications of derivatives reform, says Allan Grody, president, Financial InterGroup

Industry standards bodies and regulators including the CFTC, the EU and the Financial Stability Board were given responsibility to oversee the over-the-counter derivatives markets. Now, after nearly four years of consultation with the industry and writing new regulations, and after being deluged with industry data their computers could not ingest, it has basically asked the industry to help them rethink the data and technology implications of derivatives reform.

The CFTC has just released a Request for Public Comment on its Swap Data Reporting Rules [i] suggesting that issues that surfaced around technology and data requirements are in need of a carefully considered review, taking into account market practices that regulators are still not well informed on. This comes after the G20's Financial Stability Board's similar request in its recent consultative paper on Aggregation of OTC Derivatives Data [ii]. Both consultative documents suggest an opportunity for a coordinated global industry response.

The industry should put forward an informed constituency of industry practitioners, technologists and academics to set realistic goals for re-architecting the data and technology infrastructure of the industry. They then need to stay the course through implementation. Right now there is a race by financial firms, SDRs, SEFs, data vendors and financial market utilities to gain competitive advantage by stepping ahead of an incomplete and, at this moment, dysfunctional regulatory regime trying to design such industry infrastructure. The objective should be to serve the collective interests of users, intermediaries and regulators by cooperating on global infrastructure design before industry members compete on business fundamentals. Industry leadership is needed.

The regulation of derivatives contracts, primarily swaps and its variations is the first and most significant stage of reengineering the financial system. It is also the first instance of the global effort to standardize on a common identification system for financial market participants and the contracts and instruments they trade in.

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 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 legacy of technology each financial institution lives with day to day. Each firm defines their identification coding systems and data differently, separate from industry considerations that they must interface with. Huge mapping tables are used to conform (the technical term is to 'normalize') data between interconnected intermediaries. Industry infrastructure run by financial market utilities (exchanges, clearing houses, central counterparties, netting and novation systems, et al) spend a large part of their budgets on reconciling disparate data sets that purport to be identical but are not.

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, etc. And let us not forget the frauds and collusion 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 derivatives industry had its share of these issues – the great salad oil scandal of the early sixties that saw the largest commodity broker at the time, Ira Haupt & Co. go under; the clearing houses of the Paris Sugar Market, the Kula Lumpur Palm Oil Market and the Hong Kong Futures markets that had extinction events but recovered, albeit in different forms; and futures and energy trading firms Refco, Enron, MF Global and Peregrine that had underlying mischief at its core in their failings.

Without fixing the infrastructure at the fundamental level regulator's computers will never be able to monitor the global financial system. Regulators and industry participants alike would not be able to understand the daisy chain implications of multiple firms interacting within the financial supply chain. The already after-the-fact observations from the financial crisis of 2007-2008 and its aftermath i.e. over-extended credit to the same counterparty; over leveraging; shifting balance sheet items dynamically between sovereign jurisdictions; obfuscating and falsifying financial transactions; etc. will forever go undetected.

There were many times when the financial industry stood up and accepted the challenge of re-engineering the financial system. When the Paper Crisis of Wall Street nearly collapsed the financial system in the 1960's Herman Bevis, the retired head of Price Waterhouse stood up and led the initiative. When the first National Market System was implemented in the early 1970's the Chairman of Paine Webber at the time, James Devant led that initiative. When the Inter-market Trading System was stood up in the late 1970s the Chairman of the NYSE, John Phelan oversaw that initiative. And during the Market Crash of 1987, Nicholas Brady, the Chairman of investment bank Dillon Read led an investigation on the fundamental market mechanisms that caused the crash. John Reed, the then Chairman of Citibank stood up, thereafter, to oversee what became a twenty year global project to re-engineer the fundamentals of the global infrastructure of finance from the lessons learned from the 87 crash. It was in 2006 that the final report of that effort was issued, applauding significant achievements but one significant failing, the fundamental weakness in the disparate data and identification systems of the industry. It is now the derivatives industry that is the test bed for accomplishing this.

The derivatives industry has proven itself more than up for this latest challenge. It has morphed from trading basic agricultural products, animal parts and produce, to trading index, currency, energy, metals and interest rate products; evolved from humans waving hands in trading pits to electronic trading; went from barter as an exchange of value to central counterparty clearing and payment. It invented the tradable risk management product and now has committed itself to trade swaps and other former OTC derivatives on its trading, clearing and payment platforms.

We should not waste a financial crisis, and now an offer of a redo from derivatives regulators. We need to get on with fixing the plumbing as a global industry. We need industry leadership as demonstrated by those leaders of the derivatives industry who stood up in the past to step up now. Brooksley Born, John Conheeney, Gerald Corrigan, Philip Jonhnson and Leo Melamed come to mind. We need a person of such stature, or a group of such individuals, to lead us into our destiny as an information age industry, following in the footsteps of these and those other leaders of the financial industry that stood up in their industry's time of need.

The Author

Allan D. Grody is President of Financial Intergroup Holdings Ltd.

Mr. Grody is a founding editorial board member of the Journal of Risk Management in Financial Institutions; a member of the Blue Ribbon panel of the Professional Risk Managers International Association; the Chairman of the Advisory Board of the Financial Industry Ontology, Risk and Data consortium; an advisor to the Regulatory Oversight Committee of the FSB and to the FSB; a retired partner and founder of Coopers& Lybrand's (now PWC's) Financial Service Consulting Practice; a former adjunct professor at NYU's Stern Graduate School of Business where he organized and taught the first university level risk management systems course; and a former founding Board member of the Technology Committee of the Futures Industry Association. He was a practitioner in various segments of the financial industry and has been involved in advising the financial industry and its regulators for nearly five decades. He speaks, writes and consults on issues at the crossroads of risk management, data management and technology.