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Grody: The new world of risk mitigating technology tools

Segregated customer balance reporting and swaps counterparty risk aggregation coming soon to your local regulator, says Allan Grody

The view from the thirty thousand foot level provided by the popular media and national dailies paints a bleak picture of dysfunctional politicians, uncooperative financial institutions, underfunded regulators, and unintended consequences of hastily litigated rules for financial reform.

But below the surface are two simple solutions, pillars of all risk management to come that are poised to see the light of day. Both are transformational, a harbinger of what technology is allowing in oversight of financial institutions. One is the near real time view of customer segregated balances in the futures markets and the other is counterparty risk aggregation in the swaps markets.

The foresight of the Chicago Mercantile Exchange (CME) and the National Futures Association (NFA), and the unprecedented global initiatives of the G20 through their Financial Stability Board (FSB) have set these pillars of financial reform and oversight in place.

Implementation has begun to bring a near real time view of FCM required customer segregated fund balances held at banks into regulatory view. It has been given the force of regulation through the CME's ability as a self-regulatory organization to set rules for its member FCMs in the US and with the NFAs oversight responsibilities of US registered futures entities.

In collaboration both are sponsoring a system for the acquisition, analysis and reconciliation of bank balances maintained and FCM balances reported, with the intent to prevent such failures as occurred at MF Global and Peregrine Financial. The intent is to move this system into the global arena within similar regulatory regimes in established listed contract markets.

At the same time the G20, through the FSB has been working toward establishing a global identification system for all financial market participants. Known as the Global Legal Entity Identifier (LEI) initiative, its aim initially is to assign a unique, unambiguous and universal identifier to each swap's counterparty. The LEI code will be required in order to enter into a swaps transaction in any trading or clearing system sponsored initially by a G20 country but eventually anywhere in the world.

What also gives this initiative the force of regulatory compulsion is the makeup of the FSB - regulators, finance ministers and central bankers from their respective G20 countries. The LEI initiative is poised to stand up the governing body of this initiative, the Regulatory Oversight Council, its Board of Directors, its Central Operating Units, and participating Local Operating Units upon approval by the G20 at their meeting in Mexico this coming March. Already the construction of the LEI code itself has passed initial mile stones on its journey to be approved when the first Board of the ROC is convened.

Taken together these events portend a future of unprecedented oversight for regulators, and limitless opportunities for financial institutions. FCMs, banks and all who participate in contract markets will have the opportunity to use the tools of technology for better risk management, to move toward near-real time straight through processing, and to leverage the rebuilding of contract market infrastructure to reengineer their own internal processes and systems.

We are comfortable that the benefits will be achieved in the short term. Given that already existing technologies are to be leveraged with systems that are operational today, the implementation is expected to occur in short order. First implementation of both initiatives within the US, perhaps shortly thereafter followed with other G20 countries, then the expected global rollout.

What was thought as "boiling the ocean", the naysayers retort to progress, has been made doable by already in place private sector initiatives.

The segregated funds project was initiated in early November and will start reporting daily data in early December. In addition there are several discussions going on with other global exchanges and regulatory bodies to provide similar aggregation and monitoring services.

Global financial institutions have long ago breached the territorial jurisdictions of sovereign countries, the reality of serving its global clients. Systems and oversight regimes too must follow this path.

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