Uncovering systemic risk

Regulators push for global Legal Entity Identifiers

by Paul Janssens

The recent financial crisis has underscored the need for additional transparency and regulation in financial markets. Globally, regulators are conducting systemic risk analyses aimed at understanding the aggregate risks of entities and their counterparties across asset classes and regions. Precise and accurate identification of legal entities engaged in financial transactions is important to private markets and government regulators alike.

An essential component of enabling regulators to conduct such risk analysis is the creation and maintenance of a global, standard Legal Entity Identifier (LEI), the core record attributes which comprise it, and a utility to support it. In other words, the adoption of a reliable, internationally accepted LEI solution. ISO technical committee ISO/TC 68, *Financial services*, has formed a dedicated group to develop a strategy for identification standards, including legal entity identifiers.

LEIs are not new to the financial services industry. They are used by financial institutions to identify customers and trading partners. This enables them to trade, know their customers and conduct internal risk analysis and stress-testing. Commercial LEI vendors exist, but there is no widely accepted LEI standard in the marketplace. In the absence of a universal system for identifying the legal entities that participate in financial markets, private firms and regulators have created a variety of identifiers.

Most financial firms have developed their own LEI solutions in-house, an approach that creates inefficiencies. Tracking counterparties and calculating exposures across multiple data systems is complicated and expensive, and it can result in costly errors.

LEI creation should adhere to industry best practices.

Maintaining internal identifier databases and reconciling entity identification with counterparties is expensive. Complete automation of back-office activities remains elusive, in part because of the lack of a universal identifier for legal entities. On occasion, the straight-through processing chain is broken and transactions fail to settle because counterparties have not been properly identified.

Regulatory concerns

Regulators too have taken a specific interest in LEIs. In the USA, the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA) created the Office of Financial Research (OFR) with the specific task of collecting large quantities of pricing, position and trading information and analysing it to uncover systemic risks. Other US regulators will need to perform similar tasks.

In Europe, meanwhile, the European Securities Market Authority (ESMA) and the European Systemic Risk Board (ESRB), which held its inaugural meeting in January 2011, have been set up to collect transactions reporting and analyse global systemic risks.

Precise identification of financial firms is necessary to evaluate whether a firm poses a systemic risk. This involves assessment of the relationships among firms operating across a range of markets and financial instruments. In addition, securities regulators must often identify parents and affiliates of broker-dealers manually and by name. Multiple identifiers for participants in securities trading make it difficult to create a consolidated order audit trail.

This means that regulators cannot adequately analyse systemic risk unless a common, widely adopted LEI is established containing basic information that uniquely identifies all the entities involved in reported transactions. Jean-Claude Trichet, President of the ECB and newly appointed Chairman

of the ESRB, recently announced, "The CSDB [Centralized Securities Database of the European System of Central Banks] would be best complemented by a public reference data utility providing standardized information on instruments and entities that would be operated on the basis of an international agreement."

Initiatives in the USA

In late 2010, the Commodities Futures Trading Commission (CFTC), Securities and Exchange Commission (SEC), Office of Financial Research (OFR) and a consortium of US regulators known as the Linchpin group (the US Treasury Department, the Federal Reserve Board of Governors, the Federal Reserve Bank of New York, the Federal Deposit Insurance Corporation, the Financial Industry Regulatory Authority, and the Securities and Exchange Commission) all issued proposals for public comment that included the LEI concept.

The Office of Financial Research, for example, issued a statement of LEI policy with a request for comment at the end of November 2010, where it declared its preference, through rule-making, to adopt "a universal standard for identifying parties to financial contracts that is established and implemented by private industry and other relevant stakeholders through a consensus process."

The Office also believes that participation of International Standard-setting bodies would be beneficial in developing the standard. If an LEI is established to the satisfaction of the Office by 15 July 2011, it plans to issue a regulation mandating its use for data reported to the Office.

A consistent overview of systemic risk will require engagement from the industry.

The Office has also set out what it sees as the main characteristics of an appropriate LEI. It should:

- Be based on a standard developed and maintained via an international "voluntary consensus standards body". The Office cited ISO in this regard
- Be unique for each legally distinct entity, where each legal entity is assigned only one LEI which cannot be reassigned
- Persist over the life of an entity, regardless of corporate actions or other business or structural changes
- Include minimal information about the entity in the identifier itself
- Accommodate growth in the number of legal entities that need to be identified in the full range of reporting systems, and to potential industry and regulatory innovations
- Be available for all eligible market participants, including, but not limited to, all financial intermediaries, all companies that issue stock or debt listed on an exchange, all companies that trade stock or debt, infrastructure providers, all entities subject to financial regulation, and firms affiliated with such entities
- Not be contractually restricted in use
- Where possible, be compatible with existing systems, work across various platforms, and not conflict with other numbering or identification schemes
- Be readily accessible using secure and open standards
- Be reliable and secure against corruption or misuse

- Be capable of becoming the single International Standard for unique identification of legal entities in the financial sector.

The Office notes that LEIs should be issued by an entity with expertise in implementing standards for the financial sector "organized and operated as a not-for-profit body and have a formally documented governance structure with balanced representation for relevant stakeholders".

A recent discussion paper issued by the Divisions of Research and Statistics and Monetary Affairs of the Federal Reserve Board, "Creating a linchpin for financial data : toward a universal legal entity identifier", argues that a universal LEI would likely provide a "public good" in that it could allow cheaper and more efficient analysis for all interested parties.

The paper identifies a number of standards used in industry today to ensure quality and accuracy in identification assignment. Regardless of the methodology selected, it argues, LEI creation should adhere to industry best practices in identification assignment to ensure high quality and accuracy.

Several organizations have expressed an interest in providing a global LEI service for the financial industry. These include Depository Trust & Clearing Corporation (DTCC) and SWIFT, organizations that have cooperated to study and develop an optimal solution to the LEI challenge.

The two industry utilities have proposed to work jointly in creating a LEI service to assign, maintain and distribute new LEI codes. Initially, the focus would be on the US requirements since these regulators appear to be making their decisions first. The partnership could involve additional players as regulatory requirements emerge around the globe.

The wealth of experience that SWIFT has gained in its capacity as Registration Authority for ISO 9362:2009, *Banking – Banking telecommunication messages – Business identifier code (BIC)*, provides it with a highly informed perspective on the adoption of a universal LEI standard. SWIFT is also the Registration Authority for ISO 10383:2003 *Securities and related financial instruments – Codes for exchanges and market identification (MIC)*, Part 1 and 2 of ISO 13616:2007, *Financial services –International bank account number (IBAN)*, Part 1 and 2 of ISO 15022:1999, *Securities – Scheme for messages (Data Field Dictionary)*, and the six-parts of ISO 20022, *Financial services – UNIversal Financial Industry message scheme.* ■

About the author

Paul Janssens joined SWIFT, the member-owned cooperative supporting standardized financial information, in 1988. He has held the positions of Group Treasurer and Euro Programme Manager, and is now heading the Legal Entity Identifier initiative.