Flying blind

Despite including some useful proposals, the Obama administration's regulatory reform initiative ignores a crucial issue, argues David Rowe

Crises always provide both the impetus and rationale for government action. Certainly, the Great Recession, as our current painful experience is frequently being called, is no exception. Right on cue, the Obama administration has released its Financial Regulatory Reform proposal. Subtitled *A new foundation: rebuilding financial supervision and regulation*, its substance fails to live up to its title.

The one very constructive proposal it advances is to eliminate legal form as the conclusive basis for determining who will regulate large, systemically important financial institution. The proposed legislation would empower the Federal Reserve, in co-operation with a new Financial Services Oversight Council, to designate entities as Tier I financial holding companies (Tier I FHCs). The Federal Reserve Board would have the authority for consolidated supervision and regulation of all Tier I FHCs. The document also calls for establishment of a badly needed resolution regime for insolvent Tier I FHCs, which would allow them to continue operating under government control while a financial restructuring is established.

Beyond these proposals, there is a great deal of 'bureaucratese': 'raise regulatory standards', 'improve international co-operation', 'promote robust supervision', 'strengthen the capital framework' and 'impose rigorous liquidity risk requirements'. Despite these many good intentions, the proposal fails to address a critical issue – namely, the appalling lack of detailed, transaction level information to inform regulatory decisions.

As pointed out last month[1], no global financial institution can claim to possess such consolidated detailed information in its own right. In addition to the rather cynical motivation of avoiding regulatory transparency, there are other structural and motivational obstacles at work here. Development of a uniform and broadly implemented messaging framework for detailed business information has huge internal and external network effects. The internal benefits for one institution are distinctly limited until a critical number of departments are fully operational on the system. Even then, however, the external benefits to any one institution are constrained if its peers and regulatory agencies are not operating in the same framework. This has discouraged individual firms from spending the considerable time and resources to move ahead with this type of system, since doing so in isolation offers questionable return on investment.

Mandating this type of detailed reporting in a centrally defined standard format would assure individual institutions of a significant return on the necessary investment. They could proceed knowing the regulatory mandate guarantees their efforts would reap substantial network benefits (notably, cost reduction and increased reliability) that flow from being compatible with widespread information exchange and reporting procedures.

In August 2008, the Counterparty Risk Management Policy Group III recommended the industry move swiftly to implementing a system for T+0 trade reconciliation and confirmation. Implementation of a uniform trade messaging protocol would take such a system from the realm of fantasy into a practical and cost-efficient reality. Among other things, eliminating the floating backlog of unconfirmed transactions would make it easier to detect the manipulations of rogue traders. It also would provide the essential information for regulators to monitor and assess future accumulations of systemic risk. For example, if such a system had been in place across both the trading and banking books of regulated financial institutions in 2005 and 2006, it would have been quite easy to track the extent of subprime mortgage exposures in the system. It is not clear if this would have averted the current crisis, but lack of ready access to the necessary information, even to the senior management of these institutions, made timely corrective action far less likely.

Unfortunately, the Obama administration's regulatory reform proposal has no provision for a neutral government agency with both the resources and the authority to assemble trade level data on systemically relevant institutions and the detailed portfolio content of all structured securities. There is, however, an initiative to promote formation of such an agency, tentatively known as the National Institute of Finance.[2] I support the initiative and fervently hope it is successful. Lacking a change of this type, internal risk management will continue to be hampered by partial summary data that fail to support structural analysis and effective stress testing.[3] Furthermore, regardless of how they are (re)organised, financial supervisors will continue to fly in the dark – or, at best, in the twilight. ■

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[1] *Rowe D,* Fostering opacity, *Risk July 2009, page 76 (www.risk.net/public/showPage.html?page=864663)*
[2] *See www.ce-nif.org/ for further information*
[3] *See Rowe D,* From VAR to stress testing, *Risk December 2006, page 67 (www.risk.net/public/showPage.html?page=356556)*

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