CEOs Should Take the First Steps on Financial Reform

Allan D. Grody October 25, 2011

The financial crisis that erupted in September 2008 taught us all a very hard lesson. It became apparent that no one had a line of sight on institutional and counterparty risk at Lehman or at any other major financial firm. Corporate issuers are now waking up to the fact that preventing another financial meltdown is their issue as well.

Of all the activities engendered by the Dodd-Frank Act, there's one critical piece that we cannot afford to put on hold – the implementation of a universal identification system for financial market participants. What is least understood, however, is that this effort is critical to being able to analyze systemic risk and to allow regulators to see that which they are mandated to oversee. CEOs are not yet aware of the connection between global identification of their companies and the ability to prevent, or at least judge when another financial crisis is imminent.

The proposed identification system will be a type of global tax identification number for every market participant, whether a corporate issuer of securities, a bank or other financial intermediary, a counterparty in a swap or foreign exchange transaction, a named reference entity in a credit default swap, or even a sponsor of a pension plan. These identification numbers, termed the Legal Entity Identifiers (LEIs) by the US Treasury's new Office of Financial Research (OFR), the Unique Counterparty Identifier by the Commodity Futures Trading Commission and the Unique Identifier Code by the SEC, are needed as a foundational element in aggregating data across global financial institutions to observe the contagion of systemic risk.

The financial crisis that erupted in September 2008 taught us all a very hard lesson when regulators, creditors, counterparties, forensic accountants and bankruptcy lawyers went into the basement of Lehman brothers and saw the leaking plumbing. It became apparent that no one had a line of sight on institutional and counterparty risk at Lehman or at any other major financial firm. Even corporate clients who had accounts with Lehman could not verify its positions nor even understand in what capacity they were doing business with the firm, and certainly had no way of assessing the risk of a Lehman bankruptcy.

The objective of the Dodd Frank legislated identification system is to provide regulators with the means to aggregate risk at a more granular level across multiple financial institutions and across economies, and to send up flares when risk is reaching troubling levels. Such a capability would be quite handy now as the world's central bankers and regulators debate the pros and cons of allowing defaults or bailing out sovereigns. We might all be in a better position to assess whether the collapse of parts of the world's banking system would bring the global economy to its knees or not. Actually we could have seen the risk building up before we came to this point.

US regulators have asked for a global consensus to be formed between governments and industry on this identification system. The G-20's Financial Stability Board has been given the global mandate to oversee systemic risk. It has now accepted the task of building a consensus on the LEI within the regulatory community. This is to be undertaken in parallel with the financial industry as they too bring their members closer to a consensus on this issue. What is missing however from this consensus building is the voice of the corporate users of financial markets and the clients' of financial intermediaries. All of whom will be asked to accept this yet to be developed numbering convention and use it to report its business ownership hierarchies to a government regulated, industry operated facility.

Corporate issuers are now waking up to the fact that preventing another financial meltdown is their issue as well. In this past crisis their shareholders were disenfranchised, businesses couldn't get loans from banks, public companies were neither able to raise capital nor issue commercial paper, and business users of hedging markets were asked to put up huge amounts of additional collateral or margin.

In today's globally interconnected financial system, companies are represented by dozens of different naming conventions depending on which market their financial instrument trades in or from which private database a vendor transmitted a piece of corporate information. Myriad financial institutions, regulatory bodies, data vendors, and technology suppliers now provide their own data identity schemes in the financial supply chain. What US regulators and regulators around the globe are asking for is a single uniform identification system.

The LEI should become as foundational and have as profound an effect on financial trade as the creation of the unique numbering system in the bar code had on commercial trade. The phenomenon of the Internet's order-to-ship-to-deliver process, the economic scale of Amazon and Federal Express and Walmart, and the ubiquitous smart phone scans at airline counters and checkout counters are all enabled by a simple unique computer readable numbering convention manifest in a bar code. Further technology advances were all accompanied by unique computer readable numbering conventions, for example, in an internet address, in the global positioning satellite coordinate system and in the global mobile phone network's calling scheme.

In the financial industry constructing such a numbering convention has been worked on for nearly 25 years by various financial industry standards' bodies with no satisfactory result. Divulging confidential information of the business hierarchies and their ownership relations is but one issue;

having standards bodies that compete with each other now asked to work together to come up with a new standard is another.

What had always been missing in these past attempts was corporate stakeholders' and their auditors participation, coupled with CEO's lack of awareness of the connection between global identities of their businesses and its tie to observing systemic risk. Public auditors should have a role in both the certification of their clients' legal identities and in reporting their hierarchical ownership structures. This later activity is something auditors already have knowledge of as part of their audits. It should, therefore, be left to their clients and regulators to determine the auditors' role in overseeing the confidential vs. public disclosure parts of the legislation.

Whatever the barriers were in the past, we can't leave the LEI piece of Dodd Frank to fall by the wayside. It's a foundational component of the legislation needed to monitor for systemic risk and shine a light on the financial system before it again spins out-of-control. CEOs have to do the right thing and get behind the LEI.