

Backstopping Risk: Capital vs. Transparency

by

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Lead Editorial in the Spring, 2017 edition (Vol. 10, 2) Journal of Risk Management in Financial Institutions at
<http://www.ingentaconnect.com/content/hsp/jrmfi/2017/00000010/00000002/art00001;jsessionid=2mdj212wo080i.x-ic-live-03>

For a very long time capital and more of it has been the clarion call of regulators to financial institutions for safeguarding our financial system. CEOs and their risk managers dutifully acceded to this notion, whether we agreed or not, and applied elaborate models to calculate regulatory capital. But as we learned from the last financial crisis, after the fact in most cases, no amount of capital would have prevented the withdrawal of business from those thought to be 'weak' institutions in what was a classic 'run on the bank' panic.

Regulators, who supposedly knew of the deteriorating condition of these potentially failing institutions did not, in fact, know their condition. Neither did accountants, lawyers, consultants, investment bankers, credit agencies and others who were entrusted with due diligence. Nor did external auditors who signed off on these firms' books and records.

Sadly, as we learned, capital was then and is still now a measure with which to count down to failure. Even with more capital, higher quality capital and more liquid capital, capital will disappear as before, only it will take a bit more time, slightly more time. We will not have the luxury of the time needed to successfully unwind a 'Too-big-to fail' enterprise nor even a modestly sized globally interconnected one when fear of a weak institution again causes a run-on-the bank.

So what could give us the time to see the deterioration in the condition of a financial institution? It's transparency. Not the type that is practiced today as in 'disclosure statements' or regulatory reports, or even quarterly statements of financial condition or annual stress tests. It is the kind of granular transaction-by-transaction and open position transparency made available by advanced technologies such as Cloud computing and distributed ledger technologies (DLTs), technologies that are already here today but under deployed in the reporting of risk.

Along with global financial data standards currently being worked on by joint industry/regulatory committees, common data sets represented in all manner of financial transactions can be realized. Commonly defined transactions, in turn, can be maintained on a ledger at each financial institution, perhaps starting with SIFIs, as a node on a distributed network. Thereafter, these financial transactions can be monitored in real time with triggers of risk developed through Artificially Intelligent (AI) learning algorithms as this data accumulates. Both

transactional data and position data can be analyzed for accumulating risk exposures, both within an enterprise and across multiple ones, allowing for the contagion of systemic risk to be observed.

Simple narrative, though hard to think that this is all possible within one's lifetime....unless we act now to

- standardize the disparate DLT projects that are proliferating across the globe, mostly in finance, into one focused on a universal financial industry DLT network, and
- embrace, accelerate and internalize the global standards initiatives now underway by global regulators.

Risk managers appreciate that without good data management risk management is flawed. This is clearly understood by regulators, whether it be as stated in the BCBS's 239 Risk and Data Aggregation mandate, or ESMA's MiFid II transaction rules or EMIR's trade reporting rules. It is clearly embedded in the FSB's mandate from the G-20 to create global standards for unique identification of financial products and financial market participants. It is part of IOSCO/CPMI's charge to harmonize data elements for derivatives and other financial product reporting.

The potential of a real-time global network for financial transactions and a distributed database to house these immutable transactions is the means to a transparent financial system. Right now the proof-of-concepts of distributed ledger technologies are being carried out through competitive self-interest rather than a cooperative common interest. There are many such activities underway, in multiple collaborations and in stand-alone efforts. However, with a single standard for a common use DLT network the financial industry could implement a closed and secure infrastructure to house and distribute risk data. Like the Internet's virtual private networks used in finance, all manner of competitive and innovative forces would arise from sharing the common good.

Why should risk managers get involved? Because they are the front line in protecting their financial institutions from risk. They use data and understand how faulty, untimely and low quality data impacts risk analysis. They wonder what uses and decisions are being made by regulators when they send their 'best effort' reports to regulators. Even external auditors, taking an after-the-fact six months or longer, can only sign off on no material weaknesses, not that the data is correct.

Capital does not fix anything. It only provides a cushion, like foam on a runway, to land an in-trouble airplane. Like the result of capital depletion, we count down to the stopping point of the plane until it either stops skidding or blows up.

The reporting line of the CRO to the CEO is the mechanism to get the top of the pyramid interested in the bottom of the pyramid, the back office where risk hits the technology road. Transparency through timely, high quality, transactional and aggregated data available in real-time to all who monitor risk is a better leading metric than counting down capital depletion toward a financial institution's failure.

"Automatic and real-time filings to regulators

Many DLT proponents note that one of the benefits of DLT is that regulators can participate as one of the nodes in the DLT, thereby having automated access to all the data. This in turn would allow regulators to have more complete and more traceable, real time records."

IOSCO Research Report on Financial Technologies (Fintech),
February, 2017

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