Insideview

LEIs – Regulating Identity to Build Transparency

INTERVIEW WITH CHRIS PICKLES, HEAD OF INDUSTRY INITIATIVES, GLOBAL BANKING & FINANCIAL MARKETS, BT

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"Know Your Customer" (KYC) has been a part of the business process of banks and other financial institutions for many years now. Why do regulators think that a new Legal Entity Identifier (LEI) should now be a global compliance requirement?

Having processes in place is just a start for making positive changes happen. Having processes that work, that work every time and that regulators can understand is the next vital step.

Banks and brokers in financial markets have processes in place for order management, execution, clearing, and settlement, and think that they are working well – doing as well as their peers – if just 2% of their transactions fail. That is a failure rate of 2 parts per 100. As a comparison, as long as 25 years ago car manufacturers had quality standards that permitted a maximum failure rate of only 6 parts per million. Business processes within financial institutions are too often prone to failure. Not only that, but financial institutions cannot always clearly define who they were doing the transaction on behalf of or who they are doing the transaction with.

But surely banks would not do business with organizations they do not know?

Sometimes it is also a question of how well you know who you are doing business with. While the 2008 crash was happening, firms were offloading bad positions and risks onto other market participants in order to get out of the market – only to find that those market participants actually belonged to the firm itself!

It is also a question of whether the risk managers and regulators can clearly identify the party in question. Financial institutions tend to be siloed in their internal structures, with different business units using different identifiers for the same counterparty or client. That makes it difficult and expensive for an internal risk manager to identify where the firm's risks lie. And it can make it impossible for a regulator to identify those same risks.

With firms trading in multiple markets and across borders and reporting to multiple regulators – sometimes by asset class as well as by country – getting a true picture of a firm's global risk, of a national economic risk or of systemic risk is almost unthinkable today.

So how do regulators believe that a new LEI will help to fix this problem?

Though regulators can exchange information with each other, they have no practical means of reconciling that information when the same firm uses different identifiers for the same client or counterparty and where the regulators themselves have no standards for identifiers.

The industry has come together and defined a new international standard for the Legal Entity Identifier – ISO 17442 – and the regulators of the G20 economies have indicated that they intend to adopt that standard for regulatory reporting purposes. The first regulator to move in this direction is the CFTC, the US regulator of derivatives markets.

In return, the regulators see that the more widely this standard can be used for financial activities, the greater the potential economies of scale for banks are, thus making it even more worthwhile for banks to use LEIs as widely as possible across their business activities.

Will this be a major change for financial institutions?

It is likely to be an enormous change – but a change for the better. When you hear of a bank that has over 4,000 separate systems for identifying its own customers and counterparties, you start to register what an expensive and complex mess underpins market operations across the global financial community, and why transaction failure rates are so high.

And it is a change driven by regulators – a change that financial institutions will have to make, and therefore a change that will definitely happen, starting from 2013.

Thank you for this interesting conversation.