

The Government's 'Canary in the Coal Mine'

The Office of Financial Research (OFR) occupies just 20 pages in the Senate Banking Committee's massive 1,336-page financial reform bill-but its importance far outstrips the brief space devoted to it.

The OFR, variously referred to as the Office of Research and Analysis (by The New York Times) and the National Institute of Finance (its name in a bill introduced by Sen. Jack Reed, D-R.I.), is a proposed new risk body designed to give financial regulators the data and analytic tools they need to prevent and contain future financial crises.

It would, in effect, be a kind of "canary in the coal mine" for the entire financial system, providing early warnings of possible collapses.

Its role, according to Reed's Feb. 4 statement upon introducing his bill, is crucial. "Any new regulatory structure will be ineffective," he said, "unless we also equip it with a strong, independent and well-funded data, research and analytic capacity to fulfill its mission."

Reed says the proposed body will support the community of financial regulatory agencies by collecting and standardizing the reporting of data on the financial market; performing applied and essential long-term research; and developing tools for measuring and monitoring systemic risk.

It is part of a two-part approach to systemic risk oversight in the Senate's reform package (also known as the Dodd bill). The second piece is the Financial Stability Oversight Council (FSOC), which is envisioned as a kind of "College of Cardinals" composed of the heads of existing regulatory agencies.

GUTS OF THE SYSTEM

The OFR is what Kurt Schacht, managing director for standards and advocacy of the Chartered Financial Analyst Institute, calls the "guts of the system" of risk oversight being proposed by Congress. It will be tasked with setting up the systems and operations to track and aggregate systemic risk, he explains.

The OFR will in turn feed information into the FSOC, which will make the decisions about what to do with it.

"The OFR ... will set up all the systems to track and aggregate systemic risk across the system," Schacht explained in an interview. "The information will be fed into the Financial Stability Oversight Council, which decides what to do with it."

Also advocating for a National Institute of Finance, or OFR, is the Committee to Establish the National Institute of Finance (NIF). "The OFR is in essence the National Institute of Finance, re-proposed," explains John C. Liechty, an associate professor of business at Penn State University and a founder of the

Committee, which is made up of researchers, economists and statisticians, including Nobel laureate Harry Markowitz.

"The OFR can look across the landscape and identify risks," Liechty said. "It retains most of the authority in the Reed bill. We are the least controversial part of the whole title.

You can't do systemic risk regulation without gathering the appropriate data."

As far as organizational specifics, both the House and Senate reform bills include a data center and a research center within the OFR.

According to both bills, the data center's mandate includes the following:

1. Maintain reference databases (legal entity and financial instruments)
2. Develop and maintain reporting standards
3. Collect, validate and maintain transaction and position data, allowing for granular, exposure level systemic risk models (optional in the Senate bill)
4. Secure and protect the data
5. Make the data available to regulators
6. Oversee the management of the data supply chain, ensuring that data regarding collateral used in financial instruments is properly tracked (in House bill only)
7. Provide summarized data to the public
8. Categorize financial instruments and entities
9. Collect data as directed by the Systemic Risk Council and coordinate sharing of data among member agencies.

The research center is tasked with the following:

1. Develop models of systemic risk and monitoring systems for systemic risk
2. Measure, monitor, investigate and report on systemic risk
3. Develop metrics and monitoring systems for the soundness of systemically relevant financial entities
4. Evaluate and report on stress tests of individual entities, markets or the entire financial system
5. Provide advice as requested
6. Benchmark and promote risk-management best practices
7. Conduct, coordinate and sponsor research
8. Investigate disruptions and failures in the financial markets
9. Report on the state of the financial system
10. Provide analysis of, and advice on, systemic risk policy and mitigation.

"This will keep track of basically everything people are doing in the [markets and sectors of the financial] system," Liechty says.

With regard to administration of the OFR, the current congressional proposals call for a director who is a presidential appointee and confirmed by the Senate for a fixed term. The director will control the budget, will be allowed to testify without peer review and will determine what data is collected.

Given these controls, "It doesn't really matter if it is [housed] in Treasury," Liechty says. "It is like the Office of the Comptroller of the Currency."

However, a close read of the Senate bill raises some red flags, the CFA Institute said in a recent statement. "What is not clear is how the Federal Reserve and U.S. Treasury will be able to control where and what the OFR looks at," said Jim Allen, head of capital markets at the CFA Institute. "Perhaps even more troubling is how the OFR is funded."

Currently, the Senate legislation says that it is at the behest of the federal assessment process and controlled by the Secretary of the Treasury. "In our view, investors should have more assurances that the OFR will have full independence and that the Federal Reserve and Treasury will not proscribe or otherwise limit its investigative and recommendation efforts," Allen says. "Renewed confidence in the integrity of capital markets requires faith in the independence of OFR."

Liechty maintains that whether or not it is housed within the Treasury Department., its independence should be assured by the management structure.

As the debate grows more urgent and more public, what are the OFR's prospects? The House passed its bill last December. Liechty thinks that the Senate reform bill, which was approved by the Senate Banking Committee on March 22, will soon be brought to the floor. "We are the least controversial part of the whole title," he says, adding that the OFR enjoys bipartisan support.

Nevertheless, its fortunes will rise and fall with those of the whole bill. On that score, "The chances are about 50 percent," he thinks. "The real question is whether [the Senate] will have time to go to a conference with the House, or negotiate with the House leadership as they go along."

Schacht thinks that if the Senate bill passes, the OFR proposal is sure to be included. "There is a lot of horse trading going on with the Dodd bill," he says. "We think this [part of it] is baked in."

Significantly, the Obama administration, particularly its Treasury Department, has yet to weigh in with strong views about the proposed agency. Still, "You really need this kind of capacity," Liechty says. "It doesn't currently exist."

The Proposed Office of Financial Research

Director

Presidential appointee, confirmed by the Senate for a fixed term. The director will control the budget, will be allowed to testify without peer review and will determine what data is collected.

Mandate

To support the community of financial regulators by collecting and standardizing the reporting of financial market data; performing applied and essential long-term research; and developing tools for measuring and monitoring systemic risk.

Objective

To provide financial regulators with the data and analytic tools needed to prevent and contain future financial crises.

Organization

Houses a data center and a -research center. May or may not be part of the Treasury Department.

Status

- Is part of the financial reform bill passed by the House, as well as the reform bill currently before the full Senate.
- The Obama administration said on March 30 that it expects financial regulatory reform to pass the Senate in late May.
- Consensus is that the OFR, which has bipartisan support, will be part of any final bill.