Financial markets are inherently risky. And they are risky because of their complexity and interdependencies. In order to construct and price some of the instruments that are traded today, financial institutions perform macroeconomic alchemy, gaze at their crystal ball and run sophisticated models frequently based on past experience rather than current business reality. But this is nothing new. Financial institutions are used to analysing credit, market and liquidity risk. That’s the nature of the game. Analyse it right and you make money. Analyse it wrong and you lose money.

What is new is the recent focus on how to incorporate operational risk – meaning the risk of loss from inadequate or failed internal processes, people and systems – into the mix. In fact, the recent stress in the financial markets continues to open a lot of eyes about fundamental infrastructure systems and the management of the factors of input that are used to mitigate risks.

Everything from the Giovannini reports to the G-30 study on global clearing and settlement to the Department of Treasury’s Blueprint for Modernising the Regulatory Structure to the recommendations of the BIS Committee on Payment Systems to the Securities & Exchange Commission’s advocacy of interactive data – all basically say the same thing. And that is that financial processes are interconnected in ways that we haven’t experienced before and that they can be undermined by lapses on data, operational processes, people and systems.

To make matters worse, we don’t really do that good a job in measuring the risks associated with these operational processes and incorporating them into our oversight approach, accounting practices, risk reporting systems or capital reserve requirements. But let’s not belabour the point. Underneath it all is the maxim that these risk models are dependent on accurate correlations, links and relationships among entities, the securities they issue, the debt they assume, the ownership of the obligations and the viability of the counterparties they do business with – all in the context of economic and business conditions. If the correlations and connections are not complete or wrong, then the models will generate flawed or skewed results and the risks will mount.

BUSINESS ENTITY IDENTIFICATION

And one of those very important connectors is the business entity identification scheme. It’s one of the foundational data elements that are used to link and relate. And if the foundation isn’t correct or consistent, the beautiful model-based house firms have built can come crashing down.

Just for the record, I have been an observer and participant in industry-wide discussions about business entity identification since 2001. And I won’t bore you with all the details of its evolution, but our research was clear then and it’s unchanged today. The identifier is missing. It is needed. And it continues to grow in importance. The problem is simply stated. We have some of the identifiers, but particularly those related to payment processing (i.e. clearing/settlement organisations, custodian and agent banks, broker/dealers and fund managers) but a few critical ones such as those for funds, issuers, corporate clients and supply chain participants are missing on an industry-wide basis. And without those identifiers in place, it is hard to link things – hard to automate post trade and accounting processes – hard to extract information for reporting – hard to mine business intelligence – hard to initiate business relationships – hard to group things to evaluate credit worthiness or understand exposure tolerances – hard to keep up with corporate actions maintenance – hard to manage legal agreement guidelines and hard to do client segmentation or profitability analysis.

RESEARCH FINDINGS

With that as the backdrop, the EDM Council (a non-profit trade association of financial institutions, data vendors, software companies and system integrators) was engaged to conduct primary research to determine whether there was a sufficient business justification case for the assignment, maintenance and implementation of an industry standard business entity identifier.

The findings were not earth shaking and are known to everyone. The ability of a financial institution to uniquely and precisely identify business entities and track all the relationships that exist between entities, the securities they issue and the counterparties they do business with is an essential requirements of business operations. Basel II, AML, MiFID and audit control were the primary drivers – on par with gaining accurate and consistent views...
OPERATIONS & IT
OPERATIONAL RISK AND THE IMPORTANCE OF ACCURATE BUSINESS ENTITY IDENTIFICATION
by Michael Atkin, Managing Director, EDM Council

Our current regulatory regime is almost solely focused above ground, at the tree level. The real threat to market stability is below ground, at the root level, where the health of financial firms is intertwined.

The bottom line is that both the business and regulatory obligations are mandatory and will not wait for an industry-wide solution to be developed and implemented. Many of the firms we interview are well down the pathway of normalising the plethora of internal identification schemes that exist and are creating proprietary identifier keys (i.e. an internal Dewey Decimal system) to facilitate essential business objectives. Most of these internal solutions are being implemented on a departmental or functional basis in response to pressing requirements. And even though suppliers and trade matching facilities are basically point solutions, they are viewed as viable in the short run. Basically, we’re putting a band-aid on the problem. In general, many firms don’t have a centralised process for entity reconciliation. There is not often a single instance of the counterparty. There is not usually an organisational wide view of the definition of ‘entity’ or the attributes required for uniqueness given the variety of functional views. As a result, firms are still stuck constantly mapping to external views.

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BEI: BEYOND THE BUZZ WORD
And when you step back from short term operational reality, you realise that the world is only going to get more complex, regulators are only going to get more worried - and with it will be the need to create consistent linkages and relationships throughout all the processes and entities involved in the transactions chain.

Soviews tactical approaches to entity identification do work in the short run, the lack of a consistent entity identifier creates problems in keeping up with changes in corporate structures, holdings, name changes, retired, merged funds, and ownership. Without a BEI firms must cross reference corporate action feeds to all the internal files that exist – making it easier to miss or misinterpret actions, and harder to unravel the multiple issuer-issue-issuer relationships, and harder to reconcile inventory at the issuer level and hard to get a clear and consolidated view of exposures. From a regulatory perspective, enterprise-wide and industry-wide BEI is needed in order to respond to non-standard regulatory requests about an activity or a position for a specific counterparty, or about insider trading or about groups of trades or about relationships between investment activities. Not only that, but the reports must match the regulatory view across a host of jurisdictions – all looking different views of firms, positions and exposures.

Now, imagine the challenge of reconciling all your internal systems and entity repositories. As a result, firms are still stuck constantly mapping to external views. And when you step back from short term operational reality, you realise that the world is only going to get more complex, regulators are only going to get more worried - and with it will be the need to create consistent linkages and relationships throughout all the processes and entities involved in the transactions chain.

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BEI is needed to help with transactions enrichment and the ability of the firm to link SSIs to business entities to reduce trade repair, to ensure that trades and payments are routed to the correct place of settlement and to automate post-trade clearing, settlement and allocation processes. That’s why we’re all still focused on BEI. We’re stuck in a quagmire. We know it’s critical, but we can’t seem to get our act together to do it right.

OBSTACLES AND CHALLENGES
The underlying problem is the industry’s fixation on tactical solutions and point-to-point workarounds as the methods of redress for these types of data-related challenges. Functional myopia and the inability of firms to operate in a cohesive manner is probably the top obstacle. Most of the people that own this problem within financial institutions are practitioners and deal with “domain specific” objects.

And to make matters worse, many of those holding the strategic reins still don’t think in composite terms. Executive management is still driven by immediate ROI and the cost savings just aren’t there given all the other stuff on the plate.

The second is to help mitigate the cross-referencing and reconciliation challenges related to processing corporate actions.

Third is to improve STP rates particularly for high volume processes where margins are low and manual processing is costly. Inaccurate counterparty data and standing settlement instructions are a primary cause of trade processing errors. The existence of an industry-standard entity identifier would significantly help with transactions enrichment, improve the ability of the financial institution to link SSIs to business entities, reduce trade repair/failure, help ensure that trades and payments are correctly routed, and help promote automation of post-trade allocation, enrichment and confirm/affirm processes.

CONCLUSION
Consistent and accurate identification of business entities is clearly essential. So essential, that many firms are now and have been working on the normalisation and alignment of their internal proprietary identifiers. These tactical internal solutions are viable for many of the immediate business requirements of the financial institution. Combine that with the fact that many data management groups are functionally focused, with near term orientations, overwhelmed by multiple data-related production tasks and without sufficient internal clout to address broader and more strategic goals even if they agree with the logic of the argument. As a result, the internal business justification case for an industry-wide standard business entity identifier is hard to articulate. The exceptions to the “we’ve solved the problem and have to move on” argument associated with ad-hoc regulatory reporting, external cross-referencing.

Henry M. Paulson, Jr., Blueprint for a Modernized Financial Regulatory Structure, 2008

Michael Atkin was recently appointed Managing Director of the EDM Council, a business forum for financial institutions designed to enable senior officers responsible for content management to share information on the business strategies and practical implementation realities associated with achieving enterprise-wide control over data content.

Prior to the EDM Council he managed the SSIA’s Financial Information Services Division (FISD) and established it as a neutral business forum for exchanges, data vendors and financial institutions to address the strategic and commercial issues associated with market and reference data management.

He was a member of both ISO TC68 and ISO TC138 and is currently a member of the ISO TC307. He is a member of both SIBOS and the SEC’s Advisory Committee on Market Data and a member of both ISOTCAR and ANSI X9. Please see BIOGRAPHY for full details.

[NOTE: For those interested in a copy of the report, it’s available on the EDM Website.]

Michael Atkin