

Whither the Office of Financial Research?

The new US Office of Financial Research can make a real contribution to financial stability, but only if it develops goals that are both ambitious and realistic, argues David Rowe

The Dodd-Frank

Wall Street Reform and

Consumer Protection Act creates a powerful new Office of Financial Research (OFR). It has considerable potential to contribute to improved financial stability, but realisation of this potential is far from assured. Success of the OFR will depend on whether it develops a mandate and set of goals that are both ambitious and realistic. Its promise will remain unfulfilled if its targets are set too low, but overreaching holds equally serious dangers.

Some highly regarded figures have argued the OFR can meet its mission to assess systemic risk by collecting only well-defined sensitivities or appropriately filtered summaries of reporting institutions' positions. It is argued this would allow the OFR to avoid the mammoth task of assembling detailed transaction data in a standardised format. I totally disagree with this proposition. My experience tells me that assembling data on the structure of transactions in sufficient detail to evaluate and simulate their value under various market conditions is essential. I hold this view for a number of related reasons.

First, any pre-defined filter or vector of sensitivities would necessarily be focused on a preconceived idea of the types of contingencies that need to be analysed. This is almost bound to lead to fighting the last war. As new potential threats arise, the reporting set would need to be revised – and this would be both time-consuming and costly for all concerned, especially the reporting institutions. It would also send signals to the market that could have their own volatile feedback effects.

With transaction level data, you can always reaggregate as needed and drill down to the actual details of a specific institution when required. (Think in terms of the one-way structure of the

American International Group credit default swap portfolio or Bernie Madoff's hedging transactions.)

Pre-defined aggregations/filters inevitably introduce rigidity into a system that must have flexibility to be effective. Transaction level details represent a stable data set that does not need to be revised to be suitable for analysing new threats as they emerge. From a cost standpoint, reporting institutions would be spared the need for continuous overhauls of their reporting as the inevitable shortcomings of any

aggregation/filtration rules arise and need to be addressed.

Second, there is a significant advantage in having reporting requirements that are well defined and easily audited. Descriptive details of transactions meet this requirement perfectly – there is no room for slippage or interpretation. Aggregate data files conforming to a pre-defined filter necessarily introduce judgement and interpretation into their preparation. There is no way to ensure all institutions are making these interpretations in the same way or with the same rigour. The opportunities for gaming the system are greatly increased in this environment and you can be sure that large, systemically important institutions will take full advantage of such opportunities (*Risk* July 2009, page 76').

Third, insisting on transaction level details would slow the process of quants creating a new structure in a spreadsheet in the morning and dealers actually booking such trades in the afternoon. I detest the idea of a financial market equivalent to the US Food and Drug Administration, where bureaucrats would have to sign off on any new trade structure before it could be booked. Nevertheless, demanding that firms be able to represent the structure of any new trades in a standardised electronic form before booking them hardly seems like an outrageous requirement or an unacceptable burden on financial innovation.

Finally – and perhaps most important – imposition of a standardised electronic trade description protocol would have significant beneficial side-effects for reporting institutions themselves. It would produce long-term cost savings by enabling electronic reconciliation and confirmation, thereby making T+0 trade settlement a realistic process. This would, in turn, make it harder for rogue traders to hide fake positions in the ever-fluctuating backlog of unconfirmed trades. Such a standard protocol would also allow all institutions to build their own firm-wide trade databases with minimal additional effort, greatly enhancing internal risk management analysis and reporting. By contrast, preparation of a specialised series of reports at various levels of detail based on pre-defined filters would offer limited secondary value to the reporting institutions. In effect, such reports would be just another regulatory reporting burden to be completed at the minimum cost necessary to pass muster with the supervisors.

In short, I believe comprehensive and detailed electronic reporting of derivatives and structured security transactions is a win-win proposition, despite the inevitable industry resistance and complaints. Such detailed reporting is also essential if we are to have any chance of detecting and mitigating the impact of future forms of systemic risk. ■

¹ www.risk.net/1497537

David Rowe is president of David M Rowe Risk Advisory, a risk management consulting firm. Email: davidmrowe@dmrra.com

