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Alacra Reference Data Alert

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Accelerating LEI Adoption – An Idea from the Edge

None of the benefits that could be gleaned from the establishment of the Legal Entity Identifier have been realized and there is no evidence that the status quo will change anytime soon. To jumpstart the adoption and usefulness of the LEI, regulators must mandate the world's largest financial institutions register or pay them to comply.

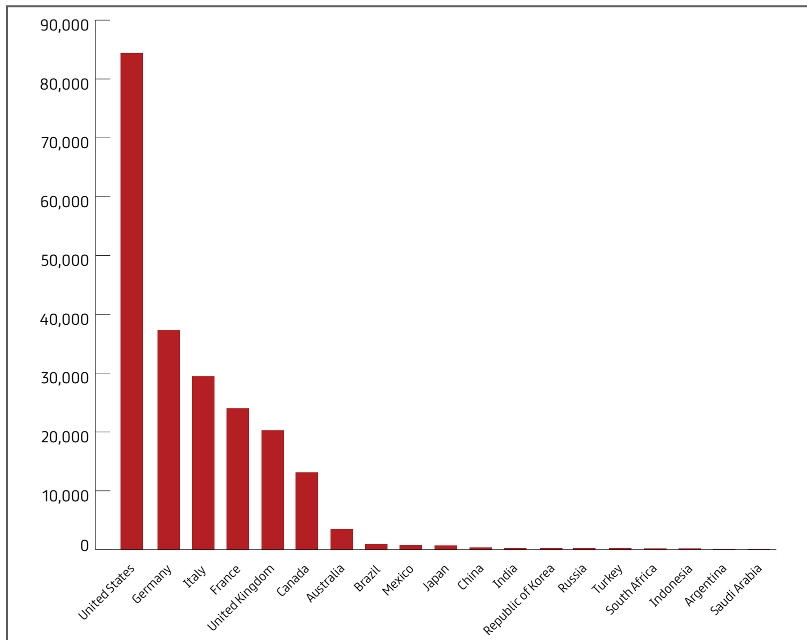
Recently, the Global Legal Entity Identification Foundation (GLEIF) began a roadshow to update market participants on the progress being made on LEI adoption. There was a "Meet the Market" event in London in late January, a webinar in early February, and a series of other meetings have been scheduled. The message is encouraging—it seems as if GLEIF executives have a plan and a new focus on transparency.

All of this is welcomed, since up until now there has been plenty of cheerleading by a handful of regulators and industry players but little tangible progress of late. Just because there are more than 300,000 entities that have been assigned an LEI does not equate to progress being made. And much of the data does not meet the minimum quality standards one would expect from a global commercial database system with such a limited number of attributes. Only a small fraction of the value and utility that could be gleaned from the establishment of the Legal Entity Identifier (LEI) has been realized. None of the benefits that were carefully and thoroughly outlined by the global financial community, including various regulatory bodies, over three years ago have been achieved.

One must remember that the global LEI system was designed as a "common good" to help prevent another market collapse. But a data collection methodology and business model has been instituted that does not provide incentives or a requirement to produce accurate, high quality and useful data. If the data in the Universal Product Code system (the bar code system, on which the LEI is loosely based) had been this weakly monitored for accuracy, it would have failed long ago. This is not primarily the fault of the Local Operating Units (LOUs) that are collecting the data. A federated approach has been deployed with no central oversight to ensure data standards and consistency.

The challenges, while enormous, are not insurmountable.

So what's the idea from the edge? What can jumpstart the adoption and usefulness of the LEI? The challenge with the current model is that it is bottom up. Yes, a small number of regulators are mandating the use of LEIs. Other regulatory bodies have made recommendations. But mandates apply to very few entities, and the



LEI Registrations in the G20

structure of the existing mandate(s) does not do anything to help measure systemic risk or roll-up counterparty exposure, nor do they demand the data be of sufficiently high quality to promote use across multiple use cases. And new regulatory mandates, as we have seen, tend to be slow to arrive. So I recommend the following:

Regulators should impose a top-down structure. They must either:

1. Mandate that the world's largest financial institutions register all their legal entities and demand a high level of data quality; or
2. Pay them to comply, using funds from recently assessed regulatory penalties.

Before I get into the details, some history…

WHAT'S AN LEI?

The idea for a "bar code" for financial market participants dates back more than 20 years.

> …the LEI concept is quite simple: every financial firm should be required to have one consistent identification code (the LEI)—similar to a social security number—that is used anytime the firm enters into a financial transaction or trade. Similarly, any entity that engages in a transaction with a financial firm should also be required to have an LEI.[1]

The acute need for a legal entity identification system and LEIs was spurred by the financial crisis, when financial institutions and regulators could not determine counterparty exposure to Lehman Brothers, which at the time of its bankruptcy had more than 8,000 legal entities in 40 countries. The belief was that the "counterparty interconnectedness" problem could be solved by a global entity identification system.

The Dodd-Frank Act was the first global regulation to address the counterparty risk issue and initially focused on swaps, which Warren Buffett at one time called "financial weapons of mass destruction." Transparency, standardization and reduction of risk were acknowledged to be the critical benefits of swap data repositories, for which the establishment of a legal entity identification system was deemed imperative:

> To enhance transparency, promote standardization, and reduce systemic risk, Section 727 of the Dodd-Frank Act added to the CEA new section 2(a)(13)(g) which requires all swaps, whether cleared or uncleared, to be reported to swap data repositories ("SDRs"), which are registered entities created by section 728 of the Dodd-Frack Act to collect and maintain data related to swap transactions as prescribed by the Commission and to make such data electronically available to regulators.
>
> LEIs will be a crucial tool for enabling the Commission and other regulators to search, aggregate and use the swap data reported to the SDRs for fulfill the purposes of the Dodd-Frank Act.[2]

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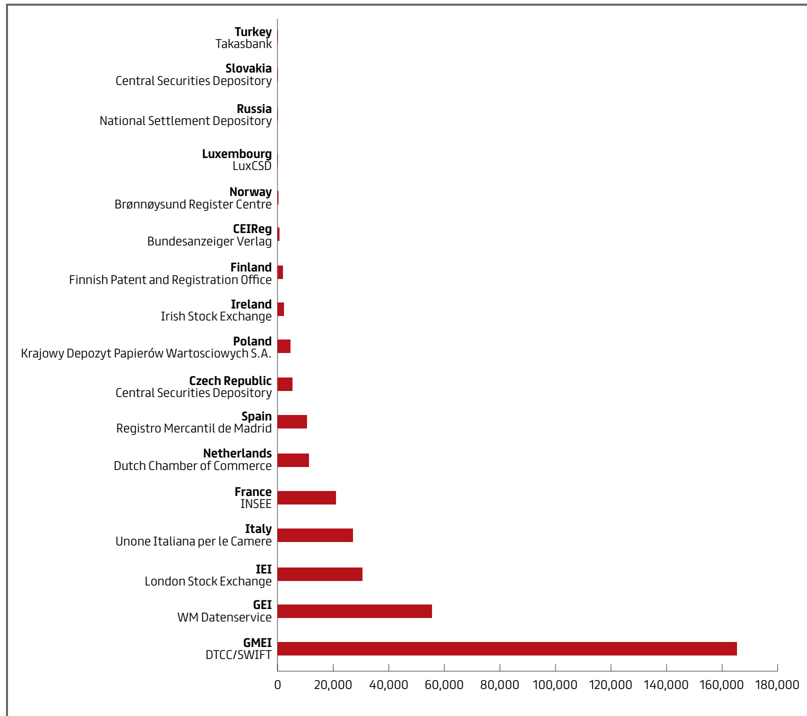
1 Tom Price and David Strongin, *Why the Industry Wants Better Financial Data,* May 13, 2013

2 *Swap Data Recordkeeping and Reporting Requirements*, Dec. 20, 2011, CFTC



Number of LEIs assigned by LOU

PROPOSED BENEFITS

A GFMA (Global Financial Markets Association) presentation dated Nov. 10, 2011, called for the creation of a global legal entity identifier standard. The need for such a standard had existed for years; there was never a strong enough regulatory or commercial impetus to get the project off the ground. Two sets of benefits were highlighted in the GFMA presentation:

Benefits to Regulators—a common LEI will be a powerful tool for regulators in monitoring and managing systemic risks.

- More efficient data aggregation
  - Makes it much easier to aggregate and analyze data, eliminating the need for cross-referencing and mapping when combining multiple data sets
  - Allows for much more powerful modeling and timely risk analysis
- Information sharing and reconciliation
  - Common identifiers will make it easier to share information on legal entities between regulators across borders
  - Allows for better supervision of cross-border firms and firms whose business lines are overseen by multiple regulators
- Identification of Affiliates and Parent Companies
  - Easier to make connections between parents and affiliates, especially when combined with basic hierarchy data

Benefits to Industry—a global LEI standard will be a powerful tool for firms' risk management and operations improvements.

Advantages for Risk Management:

- Improve response times for crisis reporting and potential for same with sanctions monitoring
- Holistic view of counterparty and issuer risks
- Easier data aggregation, modeling, and analysis
- Component for developing "Living Wills"

Other operational benefits to the industry include:

- Integrated view of entities across divisions & subsidiaries
- Supports development of hierarchy information
- Processing & settlement efficiency
- Improved vendor feed and corporate actions management
- Supports new client on-boarding
- Post-merger integrations

None of these potential benefits have yet been realized, and looking out over the next 6 months to 12 months, there is no event or series of events that will change the status quo. Yes, more entities will register for and be assigned LEIs by one of the 17 (and soon to be 30) LOUs. Yes, a common format is in place so the data

can be more readily consumed by those that need to consume it. Yes, a funding model will be more firmly established, and yes, there may be additional regulatory mandates that will drive registrations. But the foundation is flawed and by adding more weight to a faulty foundation, the risk of collapse increases.

WHAT ARE THE PROBLEMS?

- **There are insufficient and inconsistent quality controls.** While the federated model ensures competition among LOUs and ease of registration, unless there are common methods and measures of data quality, the usefulness of the data will be severely limited.
- **Entities that don't need LEIs have them.** Numerous churches, badminton clubs, windfarms, storage facilities and country clubs, as well as many other non-financial legal entities, are all represented in the LEI database. Given the number of extraneous entities with LEIs, it's difficult to imagine a financial institution using this data for anything other than mandated transaction reporting.
- **Entities that should have LEIs don't.** Most of the entities regulated by key global financial regulators have not been assigned an LEI. For example, only about 20% of NFA (National Futures Association) and FCA (Financial Conduct Authority) entities have registered. A tremendous number of entities that should have an LEI do not.
- **There are no hierarchies.** There's no way to relate one entity to another, which is critical for individual risk rollup between counterparties and understanding systemic risk across the financial supply chain. The only way to decide if one entity is related to another is by the name of the entity as submitted upon registration—little better than guessing. Assuming you've guessed correctly, there is no way to determine which entity is higher (a parent) in the hierarchy and which entity might be lower (a child) in the hierarchy. [The GLEIF will be looking into hierarchies this year but given the complexity of financial institutions' corporate structures, the frequency at which these structures change and the fact that the LEI is a random number, it will be an extremely difficult if not impossible puzzle to solve.]
- **The updating cycle is annual.** Data on financial institutions changes every day. There are corporate name changes, domicile changes, M&A transactions that affect ultimate parents—none of these events are captured as they happen. They are only captured when an entity updates its information on the annual update cycle.
- **There are no requirements for consistency and completeness.** Various data attributes are handled differently from one LOU to another; different character sets are used in different geographies and some registrations are validated using local business registries and some are not.

All these factors make it extremely difficult to consume the data. And although the GLEIF is committed to providing a "golden copy," many of these data issues will likely be incorporated in this copy. Given that the number of entities with LEIs is ultimately expected to grow to more than 1,000,000, it is imperative that the quality issues plaguing the current dataset be resolved quickly.

HOW CAN WE CHANGE IT?

Currently the system is bottom up:

- Anyone *can* register, but very few entities *must* register.
- While most entities have registered in the geography in which they're domiciled, that is not required. Any entity can register anywhere.
- The Local Operating Units (LOUs) are supposed to be cooperating, but in fact they are competing.

While the "federated model" may have its advantages, without a strong GLEIF (formerly the COU) enforcing system-wide standards, there is variability in data collection and data validation methodologies, leading to poor data quality and data inconsistencies that limit the value of the database.

So, as mentioned above, regulators should impose a top-down structure. They must either:

1. Mandate that the world's largest financial institutions register all of their legal entities or
2. Pay them to comply, using funds from recently assessed regulatory penalties

It is not unreasonable to assume that 80% of the world's systemic financial risk can be attributed to, not 20% of the world's financial institutions, but to perhaps 2% of the world's financial institutions. We recommend that regulators allocate $100 million per year so that the world's 100 largest financial institutions can publish, on a monthly basis, their entire corporate legal hierarchies in a standard, easy-to-consume format. For $1MM a year these 100 financial institutions can each hire and house four people who would be responsible for collecting, understanding and publishing their firms' corporate hierarchies with a defined set of data attributes, including the LEI.

If this funding model was in place for two years, practically all the benefits to the regulators and the industry outlined above would be already achieved for the financial institutions that matter. These financial institutions could then be weaned off the regulatory subsidy and pay for the ongoing maintenance themselves and could, in turn, cooperate with the LOUs to get the long tail of the financial community registered for LEIs. This could be accomplished at the time of onboarding or during the periodic KYC review.

While having the regulatory authorities bear the start-up costs for the GLEIS may seem like a radical suggestion:

1. The current system is in slow motion, and a strong plan to accelerate it does not exist.
2. The money is available from recently levied fines.
3. By paying the financial institutions to comply, the regulatory authorities can theoretically wield a stick they currently do not have.

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