A crisis of identity

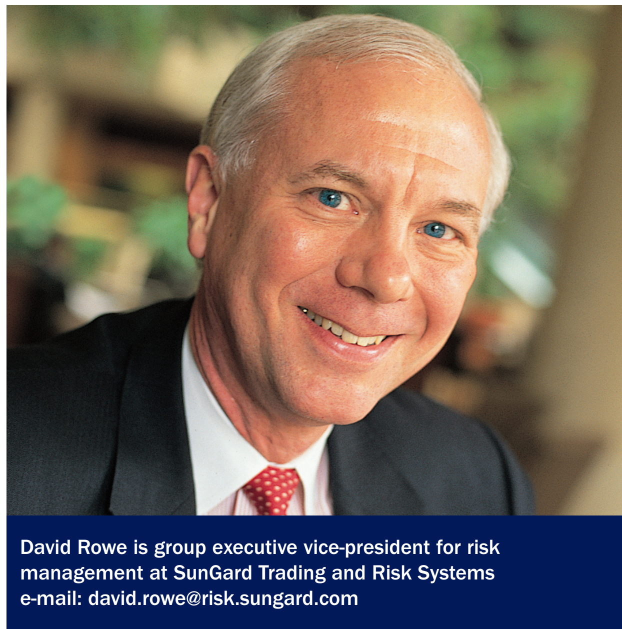
Recent news stories have highlighted a controversy over identification of the specific reference entity in certain credit derivatives contracts. Troubling as this is, it reflects a more pervasive lack of discipline among financial institutions. In this second of four related columns, David Rowe argues that improved quality control of legal information is vital for the success of integrated credit risk management

Recent news stories have described two disputes surrounding credit derivatives written on Armstrong World Industries, a company that declared bankruptcy in December 2000 over rising asbestos-related claims (see, for example, *The Economist*, May 23, 2002). Writers of the protection argued that the contracts actually related to Armstrong Holdings, which had not filed for bankruptcy, and of which Armstrong World Industries is the biggest subsidiary. Fearing that outdated or confusing names may be all too common, some major dealers were reported to have begun a thorough review of the reference entities in outstanding credit derivatives.

This controversy is especially striking given that the reference credit is the single most important element defining a credit derivative. As such, purchasers of these contracts have a material interest in assuring that such reference credits are clear and unambiguous. If financial institutions are this casual about defining legal entities at the heart of bilateral contracts, it is not surprising that even worse problems exist elsewhere.

Financial institutions have been slow to embrace the lessons of quality control that most basic manufacturing industries learned from the Japanese as much as 20 years ago. Too often, operations staff have been viewed as second-class citizens in banks and brokerage firms. This has made it hard to marshal the resources and senior management support for process quality improvements. I believe recognition of this is partly why the Basel Committee on Banking Supervision has proposed an operational risk component in its regulatory capital requirements.

One area where substantial improvement is needed is in the reliability of, and electronic access to, contractual and other legal data. Corporate legal names, unlike the names of individuals, are unique. This has led to the practice of using only those names to identify an entity. Unfortunately, related entities often have very similar names based on a common root such as 'Armstrong'. This means these names must be entered in their full and exact legal form to be reliable identifiers. Maintaining this degree of precision in all locations demands a virtually unachievable degree of discipline. The obvious answer is to use a uniform supplemental identification number for every business entity. Unfortunately, no such identifier exists on a global basis. In the US, the Internal Revenue Service employer identification number (EIN), also known as the federal taxpayer identification number (TIN), is a good starting point, although it may have to be supplemented for certain non-taxable entities. The UK Company Registration Number is also a possible identification scheme, albeit confined to limited liability companies. Such schemes do not offer a universal solution to the unique obligor identification problem. Utilising them where available, however, would eliminate needless ambiguity and associated risk in many situations.



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Transactions, agreements and netting

A closely related issue is reliable association of capital market transactions with their corresponding trading agreements. A sensible approach would be to store a centrally assigned agreement number with each trade booked under its provisions. This would greatly simplify the process of defining enforceable netting when simulating counterparty exposure. Currently, most systems attempt to impute transactions to trading agreements based on the terms of the agreements and the characteristics of each deal (primarily the deal type and the internal and external counterparties). Unfortunately, this process is far from foolproof. It is probably 95–99% accurate, but if the erroneous imputation of netting causes serious understatement of exposure to a dicey counterparty, this will be cold comfort. Improved precision in the identification of counterparty legal entities, as described above, would enhance the accuracy of these imputed assignments. The ultimate answer, however, is to record the trading agreement in the systems of record as a characteristic of each deal, and to subject these assignments to regular audits.

An important concept that risk managers ignore at their peril is the law of conservation of information. This is the principle that a set of data contains only so much information. Sophisticated analytical techniques can maximise how much of this information can be extracted from the data, but they cannot create information that isn't implicit in the data in the first place. In effect, like water, information cannot rise higher than its source.

The evolving practice of integrated credit portfolio management involves the application of increasingly sophisticated analytical tools. This is all as it should be. I fear, however, that many institutions will over-invest in advanced analysis at the expense of improving the reliability of the source data. Reducing, and even distorting, the information content of the raw inputs cannot be made good at a later stage. Only the hard and unglamorous task of better quality control at the source will permit enterprise-wide credit risk management to achieve its full potential. ■