

On the role of the global legal entity indicators (LEI)

O úlohe globálnych indikátorov právnych entít (LEI)

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Abstract

Reducing the risks in the financial markets and supporting financial stability are the main priorities of financial markets' regulation. To increase the security of transactions when trading with financial assets, it is essential to reliably identify the market participants. Following the initiative of the G-20 summit in 2012, there has been an unprecedented attempt to design a universal tool – a global legal entity identifier within the LEI system. The article deals with theoretical resources of the “legal entities” concept, obstacles preventing the identification of the financial market participants and the characteristic of the project of the universal identifier of entities entering financial markets' system. The article also contains an evaluation of the current state of the LEI system construction and an analysis of conditions for its completion.

Key words

Legal entity, identity and identification, global legal entity identifier, financial transactions' safety.

JEL Classification

G 21, G 23

Anotace

Omezení rizik na finančních trzích a podpora finanční stability patří mezi priority regulace finančních trhů. Pro zvýšení bezpečnosti transakcí při obchodování s finančními aktivy je nezbytné spolehlivě identifikovat účastníky trhu. Z podnětu summitu skupiny G-20 probíhá od r. 2012 bezprecedentní pokus o vybudování universálního nástroje – globálního identifikátoru právních entit v rámci systému LEI. Stať se zabývá teoretickými východisky koncepce „právních entit“, překážkami, které brání identifikaci účastníků finančního trhu a charakteristikou projektu systému universálního identifikátoru entit vstupujících na finanční trhy. V článku je rovněž hodnocen současný stav vytváření systému LEI a rozbor podmínek pro jeho dobudování.

Klíčová slova

Právní entita, identita a identifikace, globální identifikátor právních entit, systém LEI, bezpečnost finančních transakcí

Introduction

The aim of this article is to analyze the concept of the so called global legal entity identifier and to provide a characteristic of the project for constructing a legal entity identification system on a global scale. The bases of these ideas are potential approaches to reducing the lack of transparency of legal entities operating on financial markets and analyses of obstacles preventing their identification. Following from the example of the so called Wolfsberg group, some of the large international banks made attempts to reduce the risk of the financial market participants' lack of transparency. But only the Global financial and economic crisis, which burst in USA in 2007 made the authoritative G-20 to use new tools and methods of international regulation to reduce financial risks, to promote the quest for financial stability and thus to contribute to increase in transactions' security in the financial markets. Furthermore, the paper contains a characteristic of the global identifier system and a description of the current state of its functioning with the expected prospect of its implementation. The paper is based mainly on the documents of the Financial Stability Board (FSB).

1. The issue of identity and identification of subjects entering the financial markets

It is well known in practice that some subjects participating in the financial markets are not transparent enough (non-transparent). These subjects may be divided into groups with respect to the role they can play in utilizing their lack of transparency. Among the best known "invisibles" are persons labeled as white horses, whose task is to cover, to mask the real identity of their upholders, godfathers, bosses and various controlling officers in the crime hierarchy. This category of people represents only the "laborers": they are always in the first line for doing dirty jobs and they are also usually the first to be swept away. In the hierarchy of the "invisibles", they are accompanied by the category of "accomplices", playmates or even partners. Trading decisions are therefore usually made by other persons, whose real identity is even more difficult to reveal than the identity of the white horses.

Unfortunately, even on the side of the financial services, there are many relatively non-transparent subjects operating in the "grey" or even illegal economy when trading financial assets.

In practice, there are several possible approaches how to deal with the issue of identity and the way of financial market participants' identification. The state cares about the security of the financial sector by issuing regulations with definitions of activities considered as illegal, which enables to sanction their perpetrators. Thus, the state aims to create a favorable environment in the financial markets and at the same time, it also deals with the protection of the financial services' consumer: On banks, it imposes obligations, which the banks have to fulfill towards consumers. Banks and other providers of financial services are obliged to act in accordance with the relevant regulations and to protect the consumers, their customers; (b)

banks and other providers of financial services protect themselves against thefts and frauds to avoid damage on property and loss caused by insufficient protection of their clients as they shoulder not only the risk of the counterparty but also the regulatory risk, reputational risk or other risks - according to the current state of a given bank; (c) the bank clients and other consumers of financial services should protect themselves; however, due to lack of interest, indifference and financial illiteracy they are not always able to do so.

The success rate of banks' efforts to protect their security against attacks of the "invisible" clients is based - among other things - also on the results of new researches on the customer behavior and on a scientific analysis. More recent researches on how to increase the security of financial services' consumers are based on the fact that it is effective to divide the protection of these services' security into several parts.

For an effective system of the financial services' consumers, mainly the following components are essential: (a) Physical prevention measures, (b) Account monitoring, (c) Agency monitoring, (d) Password security, (e) Risky behavior avoidance.¹

In their own interest, the consumers of financial services should realize that for protecting their identity against its theft and against frauds, they have to learn to use the above mentioned ways of behavior and thus to minimize potential risks and losses. By analogy, this also applies for the providers of financial services – because if they do not observe the principles of safe financial assets' trading, there is a threat of financial (and other) loss.

1.1 Nature of financial markets and obstacles associated with the identification of participants

Financial markets are made of a complicated and internally richly structured totality of relationships. In addition to common features, the individual market segments have also a variety of specific features by which they differ from each other. These specific features are based on the fact that the individual segments differ with respect to products (investment tools), type and number of participants, different level of transparency, their way of functioning and last but not least also with respect to their meaning. The contemporary financial markets are dynamic; current high volatility of some of their segments (especially of the financial derivatives market) is higher than in the past, which leads to higher risk levels. The financial markets are exposed to various kinds of failures, which may be caused both by different objective reasons and by subjective reasons in the form of undesirable behavior of market subjects.

The "invisible" clients of banks and other financial market institutions usually know well the specific conditions taking place in the individual market segments and they are able to take advantage of these specifics. Given the fact that the regulation degree of the individual market segments of the financial markets is still not the same as well as the transparency level

¹ PAVLÁT, V. Some Reflections on Internal Regulatory and Control Mechanisms in Banking as a Tool of Prevention. In: Police Academy of the Czech Republic. Security and Safety Management and Public Administration. Proceedings of Conference. Praha, 2008. ISBN 978-80-7251-289-8.

of the individual segments, it may be presupposed that the market failure probability (caused either by an objective situation or illegal activity of the market subject) is on some markets higher than on others. Currently, the least secure market is still the market of financial derivatives.

Knowledge of the individual market segments' specific features is very important for the possibility of the gradual reduction of illegal activity of the financial markets' participants, who may be put in the category of the so called invisibles. From the perspective of the topic we deal with, it is effective to distinguish between legal markets, markets on the verge of legality and apparently illegal markets. The issue of the "invisible" subjects concerns mainly the legal markets. Owners of financial assets (especially cash) obtained from activities in various financial markets, who cannot prove the origin of these assets as it may be on the edge of the law, are trying to enter the legal markets.

Some types of markets may also be labeled according to their "color" – such as black (black markets), gray (gray markets) or white (white markets). The "black" market is being associated with the so called underground economics, which flourishes especially in times of economic failures, wars etc. Labeling the markets with different colors manifests the effort to distinguish the various nature of different markets. In the financial markets, distinguishing the market "color" – and the associated "color-blindness" (both intentionally faked and unintentional) is usually connected with the area of "money laundering", i.e. money coming from the grey or black markets.

The problems associated with insufficient identification of clients are present mainly in the shadow economy and associated shadow finances and shadow banking, which currently exists in parallel with the "official" banking.

The framework of the shadow banking currently involves the so called hedge funds, money market funds and structured investment vehicles - SIV. The share of the shadow banking operating worldwide on the volume of the world's banking system is currently estimated to be ca. 25-30%. The three risks of the shadow banking lay firstly in its procyclicality, secondly in the nontransparent transformation of loans maturity in long complicated chains and thirdly in the unclear relationship between financing and market liquidity.²

The quasi-banks (non-banks) operating in the contemporary banking, either do not have a full banking license or they are not controlled neither by national nor international regulator. These banks focus on providing various financial services. Among these institutions are for instance providers of non-bank loans, some currency exchanges, pawnshops, issuers of some kind of checks etc. Also for these kinds of businesses, a certain regulation which will be instrumental in reducing the amount of controversial transactions on the edge of the law is being prepared.

² LORD TURNER. Shadow Banking Agenda Should have „Bias Against Complex Interconnectivity“. Accessed from: <http://www.icffr.org/Resources/News/Shadow-Banking-Agenda-Should-Have--Bias-Against-Co.aspx> (Downloaded on 5.4.2012)

In some kinds of financial markets with operating of both banks and quasi-banks, the problem is if the client identification transforms to a different kind of issue: if the bank truly wants to identify the client or not, i.e. the issue of compliance with regulations and rules. Regarding this, between licensed banks and quasi-banks, there is a difference in the stringency of requirements on identification. In the category of non-banks, these requirements are less rigorous, the discipline of non-banks is usually looser and the possibility of illegally obtained money entering the banks and subsequently its legalization is easier and the possibility of sanctioning the nonbanks is lower, if not zero.

The issues associated with the difficulties during the bank and other financial institutions' client identification follow, among other things, from the differences of national legislations and from the limited possibility of applying international agreements aiming to tighten the obligations of financial institutions with a careful identification of clients. An important role for dealing with the issue of "invisible" clients may also be played by large, systemically important financial institutions with a great economic power in the given economy.

1.2 From a recent history

In 2000, some of the large international banks, which are currently on the list of the so called global, systemically significant banks (so called G-SIFIs) created the so called Wolfsberg group. These banks joined together to form certain safety standards and associated products for the entire "financial industry". These standards and products concern the following areas: 1. Standards concerning banks' obligation to know their customers (Know Your Customer), 2. Standards against the so called money laundering (Anti-Money Laundering), 3. Standards aiming against terrorist financing (Counter Terrorist Financing policies).

Aims of the Wolfsberg group, which represented the at that time international bank elites, were an effort to influence the further development of existing regulations in the way which should better correspond to the interest of the participating banks especially in the field of private banking. The banks united in this group were already at the time of its origin among the most influential global banks, i.e. they were banks of a considerable importance for the development of the banking sector worldwide and their activity had a considerable influence on the security of financial assets of the wealthiest group of people in the world.

The Wolfsberg group was founded by these 12 large international banks: ABN AMRO, Banco Santander, Bank of Tokyo-Mitsubishi UFJ, Barclays, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan Chase, Société Générale and USB.³

Upon founding this group (in 2000 in the Swiss chateau Wolfsberg), the Wolfsberg principles were developed and accepted with the participation of leading experts (including representatives of the company Transparency International). The result of the first stage of

³ ADOLFI, Gemma, BAUER, Hans-Peter. *The Wolfsberg Group*. In 'Collective Action: Innovative Strategies to Prevent Corruption', Mark Pieth (ed.), 2012, Dike Zurich/St. Gallen. Accessed from: http://www.dike.ch/Collective_Action_Pieth. (Downloaded on 25.5.2015)

works were directives against money laundering designed for private banks which had been published in October 2000 and reviewed in May 2002.⁴

In 2004, the global banks belonging to the Wolfsberg group along with the Bankers' Almanac created a central repository for storing initial information, which are required by the member banks during monitoring the transactions with the counterparties (so called due diligence). This center enables banks to run a business in compliance with legislation on banking regulation by securing services of experts, who deal with combating illegal transactions (money laundering) and who have an access to centralized information. In the center, there are about 36 thousand documents containing information about nearly 11 thousand financial institutions in the world. There are also information concerning banks' ownerships, structure of various bank groups, data on regulators of the banking sector and on banking products and services stored in the center.

Following from the brief overview of the activities of the Wolfsberg group, it is apparent that even before the financial crisis in burst out in 2007, there had been a need of a thorough solution of financial markets security. The world financial crisis was an impulse for taking necessary measures, which could no longer be postponed.

2. Finding new ways to reduce the systemic risk and to increase financial stability

A significant role for finding new ways to reduce systemic risks and to increase financial stability is played mainly by the state summits of the G-20. The initiative of this group also gave rise to the intention to strengthen the transparency of financial transactions and to form the system of the so called global economic subject identifier (LEI).

2.1.G-20 summits and their significance for the LEI system construction

The crucial role for the LEI system agenda was played by the seventh summit of the G-20 in 2012 (Los Cabos in Mexico), the eight summit of the G-20 in 2013 in Saint Petersburg and the ninth summit, which took place on 15th to 16th November 2014 in Brisbane, Australia.⁵

From the topic of finances, a wide range of issues was discussed on these summits, the most relevant of which for the theme of international financial stability and protection against illegal activities and financial crime were the areas described below.

In the resolution from the last year's summit in Brisbane, positively evaluated were (in the articles 12.-14.) some steps in the field of financial reforms: Appreciated was the initiative of the Financial Stability Board (FSB) concerning increasing of G-SIFIS financial reserves for

⁴ The Wolfsberg Group. Accessed from: <http://www.wolfsberg-principles.com/> (Downloaded on 17.5.2015)

⁵ Telegraph.G20 Leaders Declaration-Los_Cabos_Summit. Accessed from: <http://www.telegraph.co.uk/finance/g20-summit/9343250/G20-Summit-communicue-full-text.html>

the case of failure which is a significant feature of the taxpayers protection; (b) there was a certain development in the field of grey banking reduction; (c) the aim to take a measure, which would reduce the risks arising from transactional channels between banks and non-bank financial institutions (non-banks) was stressed; (d) in the international system, emphasis was put on the need to apply the principle of taxing revenues to places where they are made and where the value is being made, i.e. reduction of revenue transfer, which undermines the income side of state budgets; (e) it was decided that international tax rules should be modernized and in 2015, rules of transparency for taxpayers should be implemented; (f) together with the tax reforms, a system of automatic exchange of tax information between countries should be implemented on the basis of reciprocity (by 2017-2018) which will call for legislative changes; (g) the summit accepted an action plan to combat corruption at the end of 2015-2016.

On the meeting of finance ministers and central banks governors in September 2015 which served as a preparation for the November summit of the G-20 in Brisbane, previous achievements of the financial reforms were evaluated. Particularly these issues were emphasized: Setting out stringent capital requirements for the SIFI-banks; (2) Measures concerning increase of bank reserves for the case of bank failure; (c) Preparation of measures aiming at grey banking reduction; (d) Improvement of monitoring potential systemic risks; (e) Measures concerning over-the-counter trading of financial derivatives.

2.2 Key role of the FSB in implementing the project of constructing the global identifier

Along with the decision to construct the *global legal entity identifier*, which was taken at the G-20 summit in 2012 in Los Cabos, Mexico (in articles 42 and 44 of the final resolution)⁶, it was also decided that the implementation of this task will be entrusted to the Financial Stability Board (FSB).⁷ The reason was that the LEI system construction is closely related to the regulation of national and international financial stability, particularly to the reduction of systemic risks associated with the existence of large globally systemically significant banks, and to other significant risks especially in the field of trading financial derivatives.⁸

The Financial Stability Board was assigned to construct and put into operation a new system in cooperation with other international organizations without the collaboration of

⁶ Cannes Summit Final Declaration – *Building Our Common Future: Renewed Collective Action for the Benefit of All*. Draft of November 4. Cannes, November 4, 2011. Accessed from:

<http://www.g20.utoronto.ca/summits/2011cannes.html>. (Downloaded on 31.3.2013.)

⁷ FSB. *A Global Legal Entity Identifier for Financial Markets*. June 2012. Accessed from: http://www.financialstabilityboard.org/publications/r_120608.pdf

⁸ BOTTEGA, J., POWELL, L. *Creating a Linchpin for Financial Data: The need for a Legal Entity Identifier*, p. 4. SSRN-id1723298.

which this task would practically not be achievable. In their actions, none of these organizations can work without identification and classification of organizations and institutions operating in the member states, the activity of which it unifies and directs internationally.

Currently, the activity of the Financial Stability Board goes in several main directions, which may be characterized by these brief titles of relevant agendas: 1. Banking regulations; 2. State debt; 3. Derivatives; 4. Administration and management; 5. Taxes; 6. Trade and finances.

Although the LEI agenda is not directly stated in the above mentioned list, it is a *cross-section agenda*, which penetrates (in different degree) practically all above stated sections. The LEI agenda is strongly connected mainly to the topic of systemically significant banks (SIFIs), which is primarily dealt with by the Basel Committee on Banking Supervision (BSBS) which is one of the bodies whose responsibility is to process the necessary principles, rules and standards. Analogically, in the field of financial markets infrastructures (FMIs), the crucial role is played by the International Organization of Securities Commissions (IOSCO) along with the Committee on Payments and Market Infrastructures (CPMI).

The issue of a clear identification of financial and other organizations and institutions is currently one of the keys for the qualitative leap in the international regulation of financial stability as it should ensure – among other things – the comparability of data on financial (and later also other) operating units. At present, bases for more efficient identification of insurance companies and non-bank financial subjects are being created.

3. Characteristic of the project for the construction of a universal identifier of entities entering financial markets

Within the system of the global identifier, each “entity” gets its unique identification code, which should contain specific information about this entity. This code may be metaphorically compared to the given entity's “DNA” which contains all the features by which this entity differs from other entities. As another simile, we may use the example of a personal identification number of individuals or a corporate ID of legal entities; this simile, however, is not very precise as these numbers do not provide information enabling to estimate for instance the interconnection between different persons or organizations and thus to estimate risks following from these connections. The LEI identifier, however, solves this problem.

*The identifier is a system for recognizing the contracting parties of financial transactions labeled as “legal entities” and for registration of performed financial transactions.*⁹ The legal “entity” is a legal person or structure organized in compliance with

⁹ CHOUEIRI, H., JOHNSON, C. The Global Legal Entity Identifier System: what firms should be doing to prepare. Accessed from: <http://www.hsbcnet.com/gbm/global-insights/insights/2013/global-legal-entity-identifier-system-what-firms-should-be-doing-to-prepare.html> (Downloaded on 11.11.2013)

laws of any legislation. Legal entities also include subjects which are responsible for performing financial transactions or which have the right (according to the given legislature) to independently enter into a legal agreement. The term “legal entity” is defined very broadly: “entity” is understood to be a business, company, owning, partnership or corporation.

From the technical perspective, the LEI identifier is a twenty-digit code issued by local operating units (LOU, see below). By the 31th December 2014, 20 operating LOU issuers (approved by ROC) issued these codes for 330.000 “entities” from 189 countries.

The main objective of the LEI identifier implementation is: 1. to ensure greater transparency of legal units; 2. to enable regulators to monitor and reduce systemic risks.¹⁰

Transparency is the opposite of opacity during the identification of legal entities; opacity creates a wider area for illegal financial flows, illegal money transfers, money laundering and incorrect allocation of income from natural resources. A practical importance and impact of implementing the LEI identification system may be illustrated for instance by the fact that developing countries lose nearly 2 trillion of USD every year (!) because legal entities and financial transactions are defined vaguely.

The LEI identifier system is based on continual collecting of any data considered as relevant and necessary for the identification of legal units. An absolute prerequisite for a practical applicability of the identifier is the comparability of obtained data both in national and international dimension.

At the state of hardly comparable or completely incomparable legislation of the national evidence of legal units, it is impossible to even construct an applicable identifier. The implementation of the idea of the clear financial entities' identification is therefore entirely dependent on securing comparable data. Therefore, it is necessary that the states aiming to implement the identifier would come to a mutual agreement about providing clearly defined and quality data and also about the fact whether they will be able to supply these data to the LEI system bodies.

The implementation of GLEIS in practice assumes a construction of a relatively complicated organization structure which is necessarily multilevel because it is crucial to connect the “national” level (i.e. national economies of the individual countries) with the “international level” (i.e. terminology of international organizations' documents labels it as the “global” level in contrast to the “local” level).

The system (GLEIS) is constructed on three levels:

The Regulatory Oversight Committee (ROC) sets global LEI principles and supervises the entire system. This independent committee consists of more than 70 global regulation bodies.

(2) The Central Operating Unit (COU) – is the executive body of ROC; it is a non-profit organization (founded in June 2016) which deals with unifying and implementing of the global standards; it is expected that it will supervise national operating units (LOU).

¹⁰ FSB. Getting the data to regulate global banks. Accessed from: <http://fsbwatch.org/derivatives-articles/getting-the-data-to-regulate-global-banks.html> (14. 2. 2015)

(3) Local Operating Units (LOU) – register and confirm applications for codes' issuance, they issue LEI codes and store data connected with LEI.

In the Czech Republic, this local level is secured by the Central Securities Depository (Centrální depozitář cenných papírů, a.s., hereinafter referred to as "CSD"). The ROC Commission approved it as a local operative unit on 6th February 2014.

The GLEIS system implementation is somewhat lagging. According to the plans adopted in 2012, the identification system should have been constructed during one year and therefore should have been functional in 2014. This task, however, was not completely fulfilled before the deadline.

During 2014, the FSB secretariat managed to successfully transfer from the first - political - stage of the GLEIS construction to the stage of operative readiness. In June 2014, the construction of the institutional GLEIS structure was completed. The ownership and supervision of the system was passed to the Regulatory Oversight Committee (ROC). The FSB remains to be a full ROC member but it will no longer fulfill the function of its secretariat. Institutions responsible for supervising GLEIS agendas' operations were founded. Within ROC, the Committee on Evaluations and Standards was founded. More than 60 countries participate in activities of ROC and COU.

Although the process of LEI construction was very fast, some areas were still not sufficiently functional in 2014; even though their mastering is necessary for the system functioning. The main issues concerned a variety of serious facts. For instance, testing of the reliability and the accuracy of collected data was not performed and securing the possibility of public use of data was not achieved either. Nevertheless, these two important facts are necessary for the future proper functioning of the system. Some countries still have not been gotten to cooperate and in some countries, legal issues related to ensuring security and discretion in handling financial data still has not been solved. If the system should work properly worldwide, it should cover the majority of the trustworthy states. As the most serious issue should be indisputably considered the fact that there was no successful enough analysis of the relationships between the identified entities, that the systemic risk was not monitored, that there was no overview of beneficiaries and that the aggregated data were not tested. Thus the conclusion that the LEI construction process may be endangered if these problems will not be discussed.

In the overall evaluation of the results from the perspective of risks for the financial stability, it was found out that the impact of measures implemented within the LEI construction was "slightly positive" but that the LEI system is currently not ready or able to face these risks.¹¹

Since the activity in the field of securitization, shadow banking and over-the-counter trades with derivatives after 2010 were increasing again, the real economy was to a significant degree exposed to opacity and systemic risks in the financial sector. These risks are similar to

¹¹ BEEKARRY, N. Global LEI System Impact Assessment. Accessed from: <http://fsbwatch.org/2014-governance-and-impact-report/global-lei-system-impact-assessment.html> (Downloaded on 14.2.2015)

risks which culminated in 2008 and have resulted in significant economic losses and which have affected many people in both developed and developing countries.

The overall evaluation of the LEI system potential in 2014 was overall positive but only after emphasizing the condition that the constructed system will be able to deal with the above stated shortcomings. The elimination of the shortcomings discovered in 2014 was performed continually on different levels, mainly by changes of regulations, monitoring, by the ongoing evaluation of implementation and also by peer-reviews. Among the very significant measures has been the implementation of the international standards of cooperation and information exchange and unification of information. These works are performed continuously since 1999. After 2012, legislatures of 60 countries (including 24 FSB member states) were evaluated. Jurisdictions of the individual countries were divided to three groups depending on to what extent they meet the FSB requirements (compatibility with the declared principles). The Czech Republic was placed to the first group. An important step was also releasing of a new version of the directive concerned with ways and procedures for cancelling and eliminating collapsing institutions intended for non-bank financial institutions. The directive is based on the principle that the foreign creditors will not take priority over the local creditors in satisfying the claims. Among other things, the directive includes measures in the field of information sharing at the elimination of these institutions.

Conclusion

It is expected that the contribution of the successful LEI implementation will be significant. The possibility of the identification of the so far insufficiently transparent or entirely non-transparent subjects will be a considerable step forward not only because the reporting framework will be strengthened but also because it will be possible to considerably increase the chance of applying sanctions for non-compliance of the regulatory requirements. Increasing the security of financial transactions may also increase the possibility of predicting the development of financial markets, which is currently rather limited due to their volatility.

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