Standardization of financial contracts

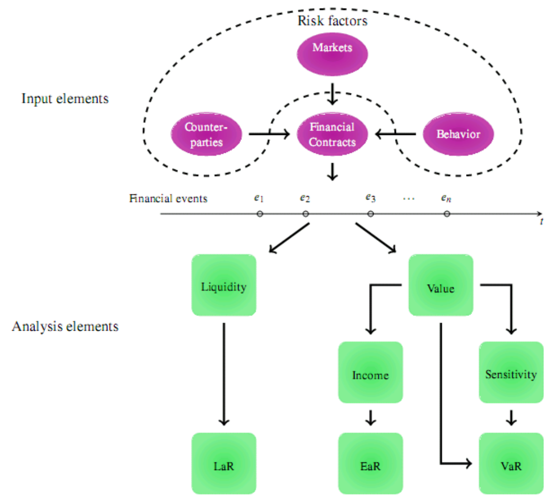
Letter soup contracts (CDS, ABM, CDO etc.) have been singled out among the prime culprits of the financial crisis. The complexity of these products even defied their inventors which calls for simplification by standardization. While such standardization can only be greeted as a step into the right direction it must however be seen, that the planned moves can at best be deemed half hearted and a further patch to the existing patch-work financial system. It will not solve the entire problem and the value added will be low compared to the cost.

What we need

Standardization however has to go across all financial contracts stretching from saving accounts via all types of loans and deposits to derivatives and structured products. Moreover, this standardization should not be strictly bound to specific platforms as proposed in the current legislation moves surrounding for example CDS' contracts. The target must be to get an easy insight into any financial positions independent of who originated the contract, on which platform it resides or who is the current holder. Information about book or market value, income, cash flow or sensitivity and risk figures must be easily obtainable. No technical limitation can be accepted as excuse except legal constraints.

How to get there

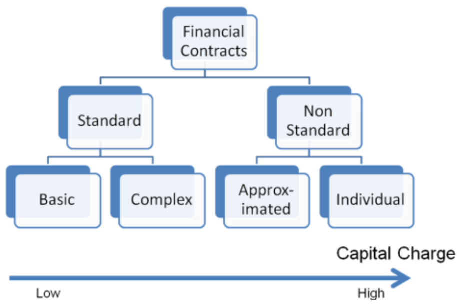
Behind the bewildering names of financial products and letter soups there is a surprising homogeneity and lower than expected variance between financial products. It can be shown that two and a half dozen patterns suffice to cover 98+% of the number of all financial contracts. The remaining 2-% percent can be covered by special non-standard patterns. The resulting system would look like the next figure:



Once the contract is the central focus point, it is possible to link it to external factors such as "market", "counterparty" and "behavior", from where all typical risk information (green lower part) can be derived. This concept applies to any single financial contract or a portfolio thereof, but also to that of an institution and even to the entire contract based financial banking world as a whole. The difference between the levels is mere computing power.

Advantages

The advantages of such a standardization of this system would be manifold. It could form the analytical basis of systemic risk regulation, since contracts could be made comparable independent of origination. It would allow improved stress testing since any of the risk factors could be uniquely stressed and the contracts be recalculated. It would allow capturing model complexity risk, since they could be ordered by complexity following the next figure.



Not only CDS, but every financial contract could be judged by its complexity and ordered within a scale that could be communicated not only to regulators but also the much spoken about "consumers" who, instead of being patronized, would be better informed. Regulators could charge capital according to the complexity scale thereby providing incentives to reduce model risk, which would greatly stabilize the financial system.

What next?

So how can standardization of contract types best be achieved? The development of Solvency rules such as Basel II or Solvency II has demonstrated that industry working groups can be a powerful instrument helping to put vaguely formulated regulatory ideas into practice. A working group comprising a dozen global investment banks to identify the basic set of "standard contract types" could be the first step to solve the problem. The second step would additionally require some technical know-how to formulate a global "contract type language" that maps the newly defined standards into a real-world trading environment.

About the authors

Jörg Behrens has spent many years in Investment Banking and Financial Consulting and is now managing partner with Fintegral Consulting. He has served in IIF & ISDA industry working groups prior to the release of the Basel II rules and was a member of the Swiss Standard Setting Board helping to define the Swiss Solvency rules for insurance companies.

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