

Opinion: Using Brains Not Brawn to Control Risk

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THE UK AND Europe's determination to right the wrongs of the financial markets is understandable given the events of sub-prime mortgage collapse in 2008 and beyond. But the focus must be to ensure right-size regulation rather than out-size it.

The answer lies in smarter – not simply more – regulation. A strongly worded public statement from UK Chancellor of the Exchequer George Osborne, published as a comment letter in the Financial Times on January 5, demonstrates the government's determination to place the UK at the heart of European policy making. It also makes clear that European banks have a long way to go before they are strong enough to withstand future market storms. Chancellor Osborne points to the need for more stringent stress tests and stronger liquidity requirements, such as those under Basel III.

The UK is determined to remain a global financial powerhouse in the belief that the financial services industry has a vital role to play in facilitating a period of strong, sustainable economic growth. At the same time, it has warned against badly thought through regulation, saying it must not be allowed to undermine European competitiveness in financial services.

While the City accepts, in fact welcomes, measures designed to bring greater stability to UK financial markets and reduce excessive risk taking, there is a danger of

over-regulation. Confronting market issues requires a coordinated effort between financial services firms, exchanges and other trading facilities, and regulators.

Chancellor Osborne said that we must not allow "unnecessary distractions in other areas to get in the way of agreement. For example, restrictions on short-selling in sovereign debt



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markets have no basis in evidence and if agreed in their current form will only hamper market liquidity and force interest rates even higher. Nor should we allow badly thought through regulation to needlessly undermine European competitiveness in financial services.”


Lawmakers are right to be concerned with issues such as short selling, algorithmic, high frequency trading and dark pools. However, they must not let that concern lead to banning these effective, liquidity-providing activities. If the regulators focus on their roles as market policemen, they will stand a better chance of sensing and responding to fraud, market manipulation, fat

finger and insider trading.

But to keep up requires a different kind of regulation – a mandate for technology, which can help to spot and manage these issues. In an ideal scenario, buy-side and sell-side firms and brokers would deploy pre-trade risk management tools to catch fat fingers and fraudsters. Exchanges and MTFs would employ better central monitoring and surveillance capabilities using technology that allows them to see major price and volume spikes, how often they happen and maybe even why, and whether a pattern in market behaviour caused them.

The same technology would enable them to flag liquidity concerns

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by monitoring how liquidity moves across venues. This is a huge issue for regulators as the markets become increasingly fragmented. They have also fallen behind in supervising the markets that they are responsible for, partly due to budgetary constraints and partly due to an atmosphere of complacency.

Moderating risk was not a top priority for regulators when times were good. After all, why interfere with a booming financial services industry? However, when things took a turn for the worse in 2008, they realized that they lacked the technological tools and – to an extent – the authority to fix things.

On the other hand, banks and hedge funds can afford to buy and use the latest technology to design

and execute high-speed market strategies. The UK's Financial Services Authority likened the authorities' struggle to "chasing a Ferrari whilst riding a bicycle".

Until recently, most regulators were unaware that it was even possible to monitor the markets in real time. The traditional forms of detection such as mandatory recording of phone calls, emails and messaging conversations are all useful. But, to truly address the problem and regain trust and credibility, real-time market surveillance technology must be adopted to monitor and detect patterns that indicate potential market abuse, with support for replaying OTC alongside exchange-traded instrument data as soon as it becomes available.

With the adoption of algorithmic trading the market moves a lot faster than it used to. What has not kept pace is monitoring this high-speed trading. Detection of abusive patterns has to occur in real-time, before any suspicious behaviour has a chance to move the market – i.e. before trades are settled. This approach should be taken on board not just by the regulators, but by the industry as a whole.

Technology can't solve all of these problems, but it can help to give far more market transparency. To restore confidence in capital markets, organisations involved in trading need to have an accurate, real-time view of what's going on. Mandating the use of this technology is smarter regulation.

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