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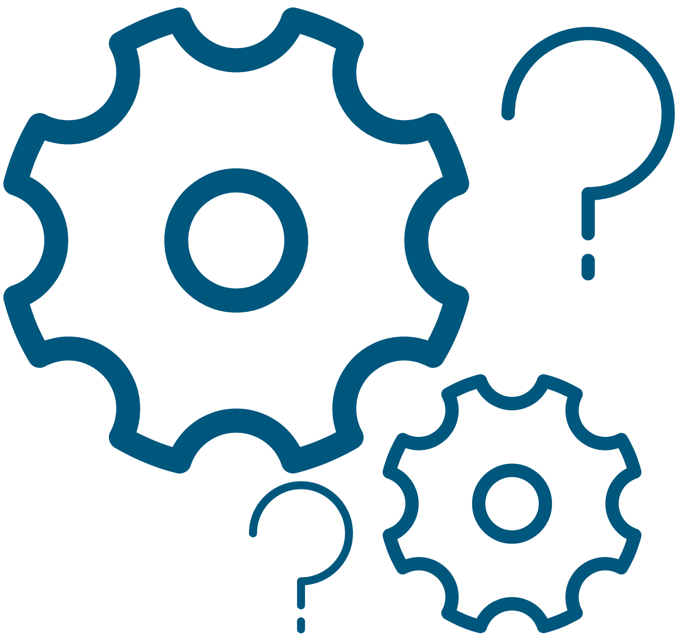
SFTR: An Operational Game Changer for the Market

Introduction: SFTR Update

Securities Financing Transactions Regulation (SFTR) requirements are expected to be adopted by the European Commission (EC) by Q1 2019. Prior to finalisation, the EC and the European Securities and Markets Authority (ESMA) must resolve some differences over the SFTR level 2 Regulatory Technical Standards (RTS), but no further material changes are expected. Reporting of securities financing transactions (SFTs) to authorised trade repositories (TRs) would then commence in Q1 2020, requiring investment firms to report all new SFT trades; amendments; corrections; life cycle events; and collateral valuations and re-use on a daily basis.

While firms may be tempted to put SFTR implementation projects on hold pending the EC's final endorsement of the RTS, the reporting obligations are well known at this point, and TRs will begin rolling out user acceptance testing in 2019 for market participants ahead of the Q1 2020 go-live reporting date. Compliance with SFTR reporting requirements will present a number of operational and data challenges, so firms should begin testing and adopting reporting solutions for SFTs as soon as possible.

Operational Challenges



Calling SFTR a massive disruptor to the SFT trading market is not an overstatement. Generally, SFTs are not traded in homogenous markets, and capturing trade data elements, such as unique transaction identifiers (UTIs), is likely to become an issue for reporting. As is the case with most previous transaction reporting regulations, the SFTR reporting process starts with trading systems and other internal data sources; however, with SFT trading happening either at third-party solutions or via bilateral trading, the required data does not reside internally at just one single point. Accurately tracking information that must be reported will be a key implementation challenge for the business side.

The lack of consistency in how SFTs are represented across the industry also leads to immediate challenges. As an example, data attributes such as "nominal amount" may seem simple, but can differ between firms if the security itself is denominated in lots of 100 or 1000. There is a need for markets to come up with a standard, and that standard may be very different from how some firms treat SFT trading today.

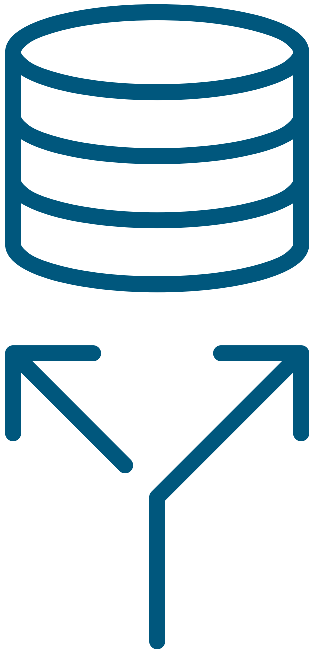
Additional SFT practices are likely to change as a result of SFTR. Currently, some firms who use third-party lending agents have no control over the SFT and are simply happy to receive a premium at month-end. This will change as firms consider whether the lending programme is financially viable considering the new SFTR requirements. Firms who continue will need to decide whether to reconcile their internal books with what is reported through delegation or to reconcile daily reporting from their agent and submit their own reports; either way, a paradigm shift is imminent and data control will be key.

Even delegation of reporting will not relieve firms from SFTR challenges because reconciliation will still be required. In today's SFT environment, third-party complexity can result in firms not knowing that they have entered into a lending contract. When settlement fails, tri-party agents will automatically (if possible) lend a security to ensure settlement. This type of securities lending transaction might then be partially reimbursed over the course of the day, but may not appear in the end-of-day books (typically, only the fully settled trade will be recorded). When this occurs, firms will need to keep track of reimbursements and report them in the correct order to meet SFTR requirements. In this scenario, reporting will likely be delegated to the third-party agent, but firms will need to gather details about the transaction flow to facilitate reporting reconciliation.

Data Sourcing Obstacles

Successfully sourcing SFTR data will require firms to overcome several obstacles. Challenges include pulling required data from multiple sources/third-party providers, reconciling information for many types of trades (such as margin lending and repo trades) directly with trading platforms, and resolving data breaks.

Sourcing data from third-party providers and various internal systems will be essential for SFTR compliance. Required data may come from front- and back-office systems, as well as customer relationship management systems, which may contain counterparty information such as legal entity identifiers (LEIs), branch LEIs, and other firm-specific details. While the concept of gathering data from multiple internal and external sources is not new, partnering with a service provider experienced in integrating multiple systems into a single reporting solution can simplify reporting for both buy- and sell-side firms. Further, service providers who support existing transaction reporting obligations – such as European Market Infrastructure Regulation (EMIR) and Markets in Financial Instruments (MiFIR) – will be able to leverage this expertise as SFTR is introduced.



As SFTR is rolled out, data matching breaks are likely to occur. Looking back, EMIR has had extremely low matching rates and there is nothing at this point to suggest SFTR reporting will see significantly higher numbers.

Currently for EMIR:

- The matching rate is 1.1% for transactions when both parties use the same TR and reporting is not delegated.
- For cross-TR reconciliation, 1.2% of transactions are matched and 0.5% are actually reconciled.

Under SFTR, there are 62 required reconcilable fields with an additional 34 reconcilable fields to be added two years after the initial reporting period. These fields will be difficult to match, so having accurate data in a timely manner is essential for increasing the chances of success. Fields such as price and notional amount may seem easy to match, but are actually highly complex when it comes to reporting. The top five break fields for OTC derivatives under EMIR are notional amount, asset class, confirmation timestamp, price notation, and price; all of these fields seem straightforward to match, but statistics indicate they are not.

Adding on to the inter/intra TR reconciliation of both parts of the trade, there is also a need to confirm that everything that should be reported is reported. Responsibility is non-transferrable, so firms that delegate reporting must ensure that the entity responsible for it does what is actually obligated. Fines have been issued by authorities under EMIR for reporting violations – the most prolific case being the FCA fining Merrill Lynch £34.5 million for failing to report transactions.[1] To safeguard against possible reporting lapses, it is critical that TR data is reconciled by the firm against internal data to ensure complete and accurate SFT reporting.

Value in an Automated Solution for Transaction Reporting

A fundamentally automated approach will be necessary to keep up with the future of transaction reporting and data automation. Automated SFTR solutions should be evaluated based on four criteria: Unified Dataset Usage, Reporting Accuracy, Submission Recipient Integration, and Reconciliation Efficiency.

1. Unified Dataset Usage

The required data elements for SFT reporting will come from a number of different upstream source systems and have yet to be fully defined. As highlighted by the International Capital Market Association, some of the potential problematic data fields regarding collateral for reporting are: jurisdiction of the issuer; collateral quality; LEI of the issuer; collateral type; event date; and collateral basket identifier. It has also been noted by other industry participants, such as the International Securities Lending Association and REGIS-TR, that data for approximately 40% of the 153 required fields is not easily available. Firms will face a significant challenge to obtain and collate these required data points in order to successfully report.

An efficient transaction reporting process starts with leveraging a single, unified dataset, to complete multiple regulatory transaction reporting obligations (e.g. EMIR, MiFIR, SFTR, etc.). When a single dataset is used, it can be consumed and analysed by a software solution that identifies which subset of transactions must be submitted to meet various reporting obligations.

As the data challenges that SFTR will bring continue to be examined, maintaining a set of homogenous incoming data from various upstream sources will allow for the rapid identification of the root cause of data issues or matching breaks, as well as the efficient resolution of mismatching and simplified data reconciliation.

An extendable reporting solution that goes beyond EMIR, MiFIR, and SFTR should use a single dataset to ensure clients can add future transaction reporting requirements at a minimum operational cost. By leveraging a unified data source infrastructure that allows for a configurable regulatory rule set to be applied dynamically to each regulation, clients will be able to add new reporting obligations with minimal effort.

When encountering a new reporting obligation, an agile reporting solution should have the ability to extend its existing universal dataset, rather than creating a new dataset that is specific to the obligation. For example, EMIR contains 129 data fields while SFTR has 153 data fields; about 50 fields from EMIR are reusable in some form for SFTR. A flexible reporting solution is capable of extending its existing EMIR data source to include any additional SFTR fields to create a new universal data source that covers both regulations.

2. Reporting Accuracy

Implementing as many validation checks as possible to ensure accurate reporting is another key component to limiting SFTR roadblocks. Solutions should support configurable pre-submission validations, including both "out-of-the-box" required regulator validations and client-defined validations that cover unique data scenarios or internal circumstances.

Pre-submission validation checks are an effective way to reduce submission errors across all transaction reporting requirements. At a minimum, an SFTR reporting solution should have data input/output validations and support pre-matching of critical data fields – such as UTI; reporting counterparty; other counterparty; and master agreement type – prior to submission.

3. Submission Recipient Integration

Transaction reporting solutions should also be flexible to allow for submission method updates and to meet the recipient party's integration requirements. An extendable reporting solution will need to be configurable so it can export submissions to a TR, Approved Reporting Mechanism, Approved Publication Arrangement, or National Competent Authority for both existing and future regulatory reporting obligations.

For SFTR, this means confirming the solution provider can submit reports to the desired TR in the required ISO 20022 standard format. This reporting standard is not currently used for any existing European transaction reporting requirements; thus, the ability to comply with various reporting standards at a low operational cost is an essential component of any effective reporting solution.

4. Reconciliation Efficiency

Firms obligated to complete SFTR reporting should expect a large volume of initial transaction matching reconciliation breaks (similar to the trend that occurred in the EMIR rollout). As was also consistent with EMIR, these breaks are expected to decrease over time as the regulation matures. However, in preparation for this, an end-to-end reporting solution should have functionality to minimise time spent on correction and resubmission. A reporting solution should assist with the reconciliation process by providing in-application flexibility and efficiency to handle and correct breaks. It should handle this without technical intervention (where possible) to allow the business operational team to fix breaks, resolve mismatching, and swiftly resubmit. A configurable rule set will allow users to handle issues initially and then add validations to ensure they do not occur again in the future.

Another aspect that will help create reconciliation efficiency in a solution is to maintain detailed data error handling and transaction history logging during the reconciliation process. This will allow users to follow a transaction through to origination and ultimately identify the root cause of the break or put a resolution in place upstream to prevent the issue in the future.

Conclusion: An intelligent approach to SFTR

SFTR promises to bring changes and challenges to the SFT trading market. To ensure preparedness and compliance, firms should begin reviewing business and operational practices now ahead of the likely Q1 2019 finalization of requirements. Resolving data sourcing and reconciliation challenges will be particularly important in successfully meeting SFTR obligations.

As transaction reporting obligations continue to increase with the rollout of SFTR, it is becoming more imperative than ever for firms to adopt automated solutions that extend across multiple regulations. A reporting solution that offers use of a unified dataset, accurate reporting, integration with submission recipients, and efficient reconciliation will help firms to simplify their compliance processes and increase operational efficiency.

1 "FCA fines Merrill Lynch £34.5 million for failing to report transactions." Financial Conduct Authority, https://www.fca.org.uk/news/press-releases/fca-fines-merrill-lynch-failing-report-transactions