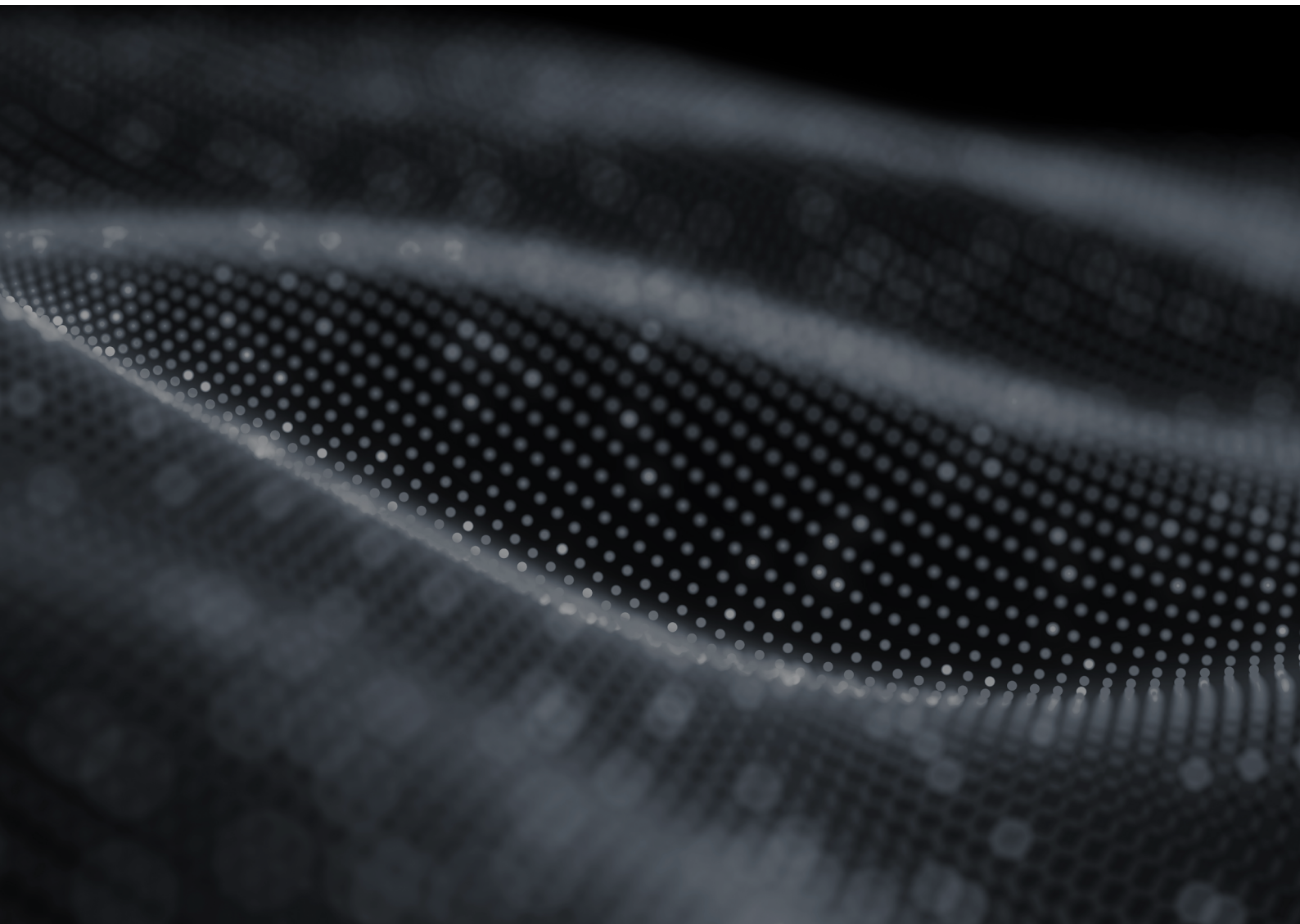


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SFTR ... THE IMPORTANCE OF A POST GO-LIVE HEALTH CHECK



SFTR ... THE IMPORTANCE OF A POST GO-LIVE HEALTH CHECK

- Securities Financing Transactions Regulation (SFTR) has now gone live, but confusion around certain rules persists as evidenced by ESMA's November 2020 Q&A paper.
- COVID and the late release of the Level 3 (L3) guidance meant many firms did not have time to carry out interpretation and traceability on that L3 guidance.
- A comprehensive post-implementation health check is recommended to ensure firms' compliance is future proof.

SFTR has now gone live for both the sell-side and buy-side and many market commentators have deemed it to be a success,

pointing to the high acceptance rates by Trade Repositories (TR) in respect of report submissions. However, relying solely on report acceptance rates will not give a firm a full picture of how successful their implementation has been; nor will give assurance that a firm is reporting every field completely and accurately or is compliant with all aspects of the regulation, including the L3 guidance text.

In this paper we explore the importance of a post go-live health check that will review the End-to-End (E2E) solution put in place for SFTR, and highlight any areas of the regulation which could give rise to issues for a firm now or in the future.

TRANSACTION REPORTING

SFTR requires firms to submit a range of different reports, and each comes with its own unique complexities. For many market participants, the New Trade (NEWT) and Standard Collateral Update (COLU) report types are the most straightforward as they entail fundamental transaction / position reporting. That said, these report types still have their intricacies. Below we examine some issues (Branch of Other Counterparty, Haircut, Collateralization of Net Exposure) that firms have encountered with these report types.

Branch of Other Counterparty Problem

Requirement: to report the country code of the branch being traded with in the 'Branch of Other Counterparty' field.

Problem: due to information shortcomings, some firms are not able to detect whether they are trading with a Parent or Branch.

Quality Assurance (QA) Health Check Focus: testing will examine whether the Branch of Other Counterparty field is being correctly reported.

The Haircut Problem

Requirement: to report the haircut of a value between 0 and 100. Positive and negative arithmetical signs should be used to illustrate whether the transaction is under or over-collateralized.

Problem: market convention for reporting Haircuts would not follow the above system, as traders would report over-collateralized trades via a value greater than 100. Firms need to ensure they correctly convert Haircuts into SFTR format. The below conversion table illustrates this further.

Client A enters into the various transaction types...

Transaction Type	Principal Amount on Value Date	Collateral Market Value	Market Convention Haircut	SFTR Reportable Haircut
Reverse Repo	\$1,020,000	\$1,000,000	102%	2%
Reverse Repo	\$1,000,000	\$1,020,000	98%	-2%
Repo	\$970,000	\$1,000,000	97%	-3%
Repo	\$1,030,000	\$1,000,000	103%	3%

Quality Assurance (QA) Health Check Focus: testing and a full review of live production data will validate that a firm is correctly reporting the Haircut field. This includes confirming the correct number and the arithmetical sign.

Collateralization of Net Exposure Problem

Requirement: for Repos collateralized initially on a transaction basis and then again on a VM level, field 2.73 (Collateralization of Net Exposure) should be populated as 'TRUE' from the onset. This requirement was confirmed by ESMA in the recent 5th November 2020 Q&A paper.

Problem: many firms were not in compliance with this requirement and were populating field 2.73 as 'FALSE'. This was causing pairing and matching breaks.

Quality Assurance (QA) Health Check Focus: testing and a sample review of live production data will assess how trades are collateralized and uncover whether Field 2.73 (Collateralization of Net Exposure) is being populated correctly.

COLLATERAL REUSE

Another concept that sets SFTR aside from other transaction reporting regulations is the need to report collateral reuse. This required many banks to pull the relevant data from a variety of sources (trading systems, collateral management system) and perform a calculation that had never been carried out before in this manner.

The Collateral Reuse Problem

Requirement: calculate an actual or estimated value of reused collateral per counterparty, per ISIN.

Problems: firms ran into several problems with this requirement:

- Many firms had to take the data inputs from various sources, and then could not decide from which source to run the calculation.
- Certain firms failed to include all the in-scope components into the calculation i.e. Variation Margin.

- One firm in error did not scale back prices that were expressed in percentages.

Quality Assurance (QA) Health Check Focus: testing will include validation of the scoping exercise, validation of the inputs that are being used, validation of the calculation, and validation that the output is aggregated at the correct level.

LIFECYCLE EVENTS

Lifecycle events are another area of SFTR that has required significant time and investment. The money has been spent on aligning reports between counterparties rather than the ability to report itself. The below illustration provides further detail.

Lifecycle Events Problem

Requirement: All in-scope trades that undergo lifecycle events must be reported in the same way by both counterparties to ensure the reports can pair and match. Examples of lifecycle events include refixing rates, substitutions, partials, partial substitutions, and corporate action events.

Problem: counterparties reporting lifecycle events differently resulted in reports not pairing and matching. For example, if a substitution event occurs, then counterparties can both choose to send a collateral update or modify / terminate the existing trade and create a new one. When counterparties are not communicating in an aligned fashion, lifecycle events can be reported in different ways – meaning the transactions will not pair and match when trade repositories carry out their reconciliations.

Quality Assurance (QA) Health Check Focus: testing would include validation of the scoping exercise and that the lifecycle events are being reported correctly by reviewing pairing and matching results. Any issues would be remediated through counterparty outreach to ensure future lifecycle events are mirrored in the way they are booked and reported.

L3 GUIDANCE

The late release of the L3 guidance left many firms with insufficient time to go through every element of the guidance to ensure full compliance. It is important firms fully review the L3 guidance as it highlights 'how to report', whereas the L2 text simply illustrates 'what to report'.

L3 Guidance Problem

Requirement: implement SFTR requirements in line with the L3 guidance.

Problem: guidance was released late, meaning firms did not have time to implement all elements.

Quality Assurance (QA) Health Check Focus: a health check on the L3 guidance would take the form of a traceability matrix. All L3 guidance would be marked as applicable or not applicable based on a firm's trading activities. Next, those items marked as applicable would be designated as either delivered or not delivered. Those items not delivered would be put forward into the book of work, while those items delivered would be validated through identifying the requirements that were implemented.

CONCLUSION

As illustrated in this article, the inconsistent implementation of SFTR across the industry has resulted with many issues that are not immediately apparent from simply referring to the trade repositories submission responses and pairing and matching results.

A comprehensive health check is recommended that includes a review of a firm's approach to implementation, data sourcing traceability and end-to-end testing (including a sample review of production data).

This comprehensive health check would entail a full review of the E2E solution as follows:

- Validating the scope of reporting (trading scenarios, report types, reporting fields) for a firm.

- Once the scoping has been validated, reporting accuracy, timeliness and completeness will be reviewed in line with the regulatory requirements (L1, L2 & L3 text) to ensure correct reporting.
- Whilst this exercise is carried out, trade repository submission responses and pairing and matching responses will be reviewed to uncover any additional reporting issues.
- Finally, a full traceability step will be carried out on the L3 guidance to ensure compliance with all applicable items.

Undergoing this health check will give firms the assurance they need to demonstrate full compliance with SFTR.

AUTHORS

George Phillips, Principal Consultant
George.Phillips@capco.com

Kajal Patel, Principal Consultant
Kajal.Patel@capco.com

CONTACT

Tej Patel, Partner
Tej.Patel@Capco.com

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