

CAPCO

SFTR:

UNPRECEDENTED TIMES



INTRODUCTION

With COVID-19 causing unprecedented disruption around the world, ESMA released a welcome statement urging competent authorities to deprioritise supervisory activities around the Securities Financing Transaction Regulation (SFTR) until 13th July 2020.

For phase one firms (Investment Firms and Credit Institutions) who had expected to commence reporting on 13th April 2020 this news will have come as the industry focuses on stabilizing markets, continuing to provide liquidity and adapting to a new remote way of working.

That said, there are still key SFTR implementation challenges which firms will need to address. In this article Capco examines challenges and proposes recommendations in the following areas:

- Level 3 Guidelines
- UTI Solutioning and Contingency Planning
- Reportable Fields
- Pairing and Matching Fields

CHALLENGES AND RECOMMENDATIONS

1

L3 Guidelines – January Release Date

Challenge

ESMA published the final L3 guidelines on 06th January 2020, which was only 4 months before the original go live. These guidelines were a lengthy 200+ pages so it would have taken firms quite a long time to review final changes. The European Repo and Collateral Council (ERCC) SFTR Task Force did not reconvene until the end of January, which highlights the length of time it took to review the guideline document.

Recommendation

Despite the final guidelines being published in early January the consultation paper has been available a lot longer and many firms used this to start build whilst documenting all their assumptions.

Capco strongly recommends all firms should have a full regulatory decomposition for the levels 1, 2 and 3 text. This should include a 'plain English' interpretation of the rule and what the associated action is for firms. Firms should then look at the applicability of that rule in relation to their business. This is something Capco carries out for all regulations, which allows us to accelerate firms' efforts on implementing regulation. If firms had executed this level of planning the L3 guidelines (with track changes) and industry forums (ERCC Task Force) should have left firms well placed to assess what requirements they still have remaining so they can plan their implementation accordingly.

For firms not in the above position, Capco advises collating a full traceability that shows what has and has not been implemented. Firms should be transparent by outlining why something has not been implemented and having a clear day two timeline for when it will. This will leave firms better placed for conversations with audit and the regulators.

The Financial Conduct Authority (FCA) has set up a new website and a dedicated SFTR email address, where firms can get the recent updates and contact the FCA directly in relation to any specific SFTR queries.

CHALLENGES AND RECOMMENDATIONS CONTINUED

2

L3 Guidelines – Stock Loan / Borrow Contractual vs. Actual Reporting

Challenge

The final guidelines provided helpful clarifications on certain topics like reportable fields and report types. However, in other areas the guidelines were less helpful. In Stock Loan / Borrow (SLB) transaction types firms are still tackling surprising decisions in the final L3 guidelines. After responses from the consultation paper firms thought they would be reporting SLB lifecycle events on an actual settlement basis. However, when the final guidelines were released, firms quickly learned they would need to report partial settlements on a contractual basis and full returns on an actual basis. For many firms this was a big setback as it would require large implementation changes. Firms would need to be able to differentiate between partial returns and full returns and report the settlement date accordingly. For many firms this was a big setback as it would require large implementation changes where firms may have to differentiate between partial and full returns in order to report them accordingly. It has also been highlighted to the regulator that the market risk and exposure is calculated based on actual settlement under Global Master Securities Lending Arrangements (GMSLA) making it impossible for trade repositories to reconcile the collateral with individual SFTs. A final point to note is many banks use Agent Lenders for SLB and many Agent Lenders have already confirmed this is not something they expect to be able to do for go-live.

Recommendation

The extent of this challenge will vary from firm to firm. If firms had made an incorrect assumption, they would first need to scope out the size of the change. Firms that assumed they would be reporting SLB as per actual settlement would be linked into their settlement systems in order to determine the actual settlement date. Firms should run the analysis to uncover whether their settlement systems can differentiate between full returns and partial returns. They should assess whether they can access contractual settlement dates directly from their settlement systems. Once these kind of questions have been answered firms will have a view on whether they can make the relevant changes before go-live. Capco observe that for many firms the answer to this question is no and, in that case, we advise following the guidance we set out under point one around being open with the regulator and having a clear day two plan. Even for those firms that do believe this is a change they could make before go-live it still could be a topic they need to raise to the regulator if they have a dependency on Agent Lenders who are not able to comply.

3

L3 Guidelines – Repo Collateral Reporting

Challenge

The final guidelines around the reporting of collateral associated with uncleared bilateral repos caused widespread confusion for a lot of firms. When a set of repos are executed under the same contractual agreement you will have the individual trades that will have a piece of collateral associated with each of them. Throughout the life of these trades you will see the market value of collateral fluctuate, which means contractual agreements governing these transactions are prone to increases and decreases in risk. Variation Margin (VM) is exchanged between counterparties at an agreement level to reduce the exposure created by the underlying transactions. In the final guidelines ESMA suggested that a firm will report both the trade level collateral and VM in one report. For many firms this was very confusing as the sample tables suggested you would need to allocate components of the VM to individual trades so the collateral amount could be reported as one figure. Firms pushed back on this because the reporting did not reflect how the product worked and implementing such a process would prove almost impossible for many firms. Finally, the sample tables of the guidelines showed the UTI field being reported in COLU reports at an agreement level, which was something not permitted by both ESMA in the field validation rules and trade repositories. This was a theme all firms needed further clarification on.

Recommendation

International Capital Markets Association (ICMA) Recommendations for Reporting under SFTR (February 2020) clarify this topic under section 9.10.2. ICMA starts by describing how uncleared bilateral repos work and goes on to recommend how the reporting should work. ICMA state that once a new transaction has been executed a firm should report a NEWT report type. For so long as the trade is live firms should report a daily COLU report type at trade level that will show the market value of the collateral fluctuating. In addition to reporting a COLU at trade level firms should report a daily COLU report type for the VM. This report will cover the VM being exchanged on an agreement governing a set of transactions.

To implement the above, firms should be able to source the daily trade level collateral updates from its trade booking systems. The trade booking systems should already be providing transaction details for new in scope trades, so for the daily collateral updates firms should simply be updating an existing feed to include daily dirty prices, haircuts and market values for all live repos.

For the VM report a firm will need to go to its collateral management system. This data should be available because it is simply the VM that a firm is posting to counterparties daily.

CHALLENGES AND RECOMMENDATIONS CONTINUED

4

UTI Generation & Sharing – Solutioning

Challenge

Regardless of whether a firm is going live in July or October Capco observe that firms are still having issues with UTIs. For those firms going live in October it is the more common challenges like:

- Deciding whether to use a vendor for UTI generation and sharing
- Determining the party responsible for UTI generation

Recommendation

Many firms seem to be favoring a vendor for UTI generation and sharing. This makes it particularly easy if counterparties are using the same vendor, which is quite common. However, a firm cannot expect to have all its counterparties signed up to one vendor so it will need to establish a counterparty outreach workstream. This workstream should be reaching out to counterparties to solicit information on UTI generation and sharing. At a minimum the workstream should establish who is generating / receiving the UTI and what the counterparty solution is.

Capco advise starting communications early on as many firms will take a long time to reply.

UTI Generation & Sharing – Contingency Planning

Challenge

For firms going live in July who already have a UTI solution the challenges exist in contingency planning. For example:

- What is the process if the UTI is unavailable at the time of reporting?
- How do incorrect UTI's get resolved?

Recommendation

Many firms are still unclear on their process should something go wrong with the UTI. Based on the recent ESMA guidelines, our view is that regulators want counterparties to provide timely reports (T+1). A missing UTI will not be a credible response to the regulators, because they classify the generation of UTI as a contractual issue between the counterparties. The regulators expectation is that counterparties should resolve any UTI related issues prior to T+1 so they can report on time. ESMA have confirmed, if the UTI itself is incorrect, the trade should be cancelled and reported as new with the correct UTI. We have observed that this was the approach being taken by several clients – for example:

- Set aside the report and look to agree a UTI with the counterparty by T+1
- If the UTI is not received by T+1, generate own UTI and send the report
- Once the UTI is generated, cancel the report and report the transaction with the correct UTI

Until a global UTI system is finalised and considered suitable for reporting SFTs, a UTI agreed between counterparties, such as the above, must be used. The impact of this on organisations may cause pairing and matching challenges which could ultimately impact the transparency which regulators are seeking to achieve through this regulation.

CHALLENGES AND RECOMMENDATIONS CONTINUED

6

Reportable Fields – Duplicate Fields Across Different Report Types

Challenge

When the SFTR reportable field tables were published, (Level 2 RTS / ITS), firms quickly noticed a gap between the data they stored internally and the data they needed to report. Many firms were quick to plug the data gaps without giving too much thought to the different report types and their overall architecture.

The reports must be detailed into action types. There are 9 different action types applicable to the 4 different reporting tables. For many transaction types (Repos, Stock Loan activity and Buy / Sell Backs), reporting requires you to report the same fields in different action types and these action types originate in different sources. For example, under a NEWT (New Trade) action type you need to report the products; Collateral Quality, Collateral Type, LEI of Issuer, Jurisdiction of Issuer and much more. Firms need to report these same fields as part of their Collateral Update action type at position level, which is a report covering the VM (securities and cash) at an agreement level.

Certain firms addressed the above fields by signing up to a vendor's enriched trade execution services, which enriches the fields at point of execution. This would address the above fields for a NEWT action type but would fail to address the fields for the Collateral Update action type that would arguably originate in a firm's collateral management system.

Recommendation

Capco's advice to firms would be to have a work in progress solution design with the SFTR field analysis overlaid. This will give firms a holistic view of a potential solution whilst also highlighting where all action types originate and what fields are required, available and not available. Taking this approach avoids looking at problems in isolation and later uncovering issues like we observe in the NEWT and Collateral Update example.

In response to the problem around the reportable fields for the NEWT and Collateral Update action type, Capco advise the following: Most firms should already have a product database that will tell you about a product at an ISIN level. It may not contain all SFTR reportable fields but Capco advise enriching this database with the additional reportable fields from a data provider (Bloomberg, Reuters etc.). A firm's SFTR reporting solution can then look up this database and extract the relevant reportable fields regardless of the action type. Taking this approach will ensure you are taking duplicate fields across different action types from one consistent data provider. As well as working for product related data this advice should also be followed for counterparty data.

7

Matching Fields

Challenge

SFTR requires Trade Repositories (TRs) to pair and match report submissions by counterparties. Not all fields are required to match but the vast majority are. This will include fields relating to the transaction and counterparty, collateral and / or security. For certain fields matching will commence on the go-live whilst other fields will be phased in over a two-year period.

This is an issue that is worrying a lot of firms for two reasons. The first is the sheer number of fields that need to match. The second is the low-level match rates we witnessed in EMIR reporting, which were at 40% in 2019.¹

Recommendation

There are several vendors that offer a pre-matching service. This means a vendor will take your transaction and match it with the counterparties. This is great news for firms using the same vendor, which is more common than you would think. In the Repo space we see a lot of clients all signed up to one vendor. And the same in the SLB space. However, there will always be nuances where counterparties are not using the same vendor.

For those firms that are not using the same matching vendor, Capco advise breaking the matching fields into three different categories.

1. Transaction and counterparty
2. Security
3. Collateral

The majority of fields for point one will originate when the trader executes a trade and for most banks this is a completely automated process in that the trader accepts or sends a trade ticket and this will automatically flow into the trade booking system and through the rest of a firms SFTR architecture. It is important a firm puts in place reconciliation controls from a completeness and accuracy perspective to ensure there has

1. Risk.Net (2019) <https://www.risk.net/regulation/6575661/data-reveals-emir-swaps-report-matching-rates-at-40>

CHALLENGES AND RECOMMENDATIONS CONTINUED

7

Matching Fields (continued)

Challenge

Data from both sides of the trade are required to pair and match. The high number of data fields will inevitably lead to implementation complexities, there are a total of 96 pairing and matching fields in this category consisting of:

- 4 pairing fields – UTI, Counterparty LEI's and Master Agreement
- 92 matching fields must match with no or very limited tolerances such as 0.0005% for several transaction data fields such as market value and principal amount on maturity date.

Recommendation

not been any erroneous transformation of data from point of execution to reporting. A firm will then need to have some luck that the counterparty has equally strong data quality controls in place to ensure high match rates.

For points two and three the matching fields remain largely static. When a firm looks up a security / collateral ISIN most supplementary fields are static and as a result should match the counterparties. Examples include LEI of Issuer, Jurisdiction of Issuer, Security / Collateral Type, Security / Collateral Quality etc.

The above recommendations will not cover 100% of a firm's scenarios, action types and reportable fields but it should provide fundamental advice that a firm can further build on to ensure it has covered all eventualities.

CONCLUSION

As many firms have now had employees working remotely for several weeks, Capco are observing less environment issues meaning firms can resume with their efforts on SFTR. Firms who were worried about meeting the original go-live date should now be hard at work to ensure compliance for 13th July 2020. For firms who were on track to meet the original go-live date, Capco's advice is to start work on the day two list whilst continuing to test and work towards higher ACK rates. It is hoped that the extended timeline will result in a smooth go-live with firms well prepared to pick up any remediation once reporting commences.

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ABOUT CAPCO

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