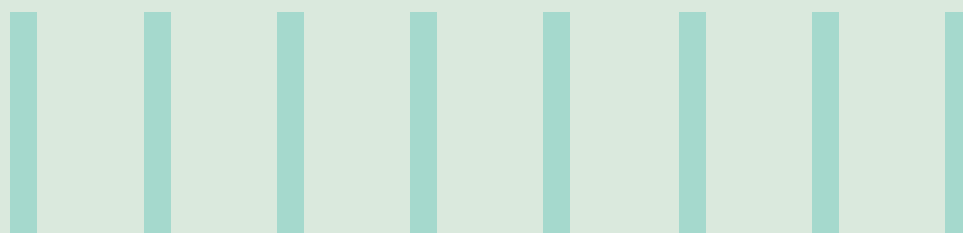




SECURITIES FINANCING TRANSACTIONS REGULATION (SFTR)



Abstract

Regulatory reporting for OTC derivative transactions is currently in place and firms dealing with such transactions are reporting in scope transactions to the concerned regulators. The EU regulators have also realized the importance of reporting for the Security Financing Transactions (SFTs) and hence introduced “Security Financing Transactions Regulation” (SFTR) with the estimated phased go live date planned from Q3 2019. The paper explains high level requirements of the regulation and how firms are preparing for the SFTR reporting. It also focuses on how the regulation can leverage other existing regulations and how firms can speed up their implementation amidst challenges around data sourcing and requirement interpretation.

Introduction

Transactions in which securities are used to borrow or lend the money are known as Securities Financing Transactions (SFT). Security can be a share or a bond.

Such transactions mainly include -

- Repurchase transaction (REPOs)
- Security lending transaction
- Buy and sell back or sell and buy back transaction

All the above transactions are similar in nature where a security is sold with an agreement to buy it back on a future date with the price agreed at the time of transactions.

Investors enter into such transactions to earn extra return on their security lying idle in the account.



Rationale behind SFTR

Due to lack of data, regulators earlier failed to anticipate the risk in the securities financing transactions during financial crisis and thereafter. Regulators have repeatedly demanded transparency in such transactions to avoid risk and further prevent their negative impact on markets. Hence SFTR was introduced in January 2016 by the European Commission to avoid the risk in SFT for banks and to bring transparency.

After the SFTR goes live in 2019, banks will need to report their SFTs to the ESMA (European Securities and Markets Authority) registered repositories.

Firms in scope of SFTR reporting:

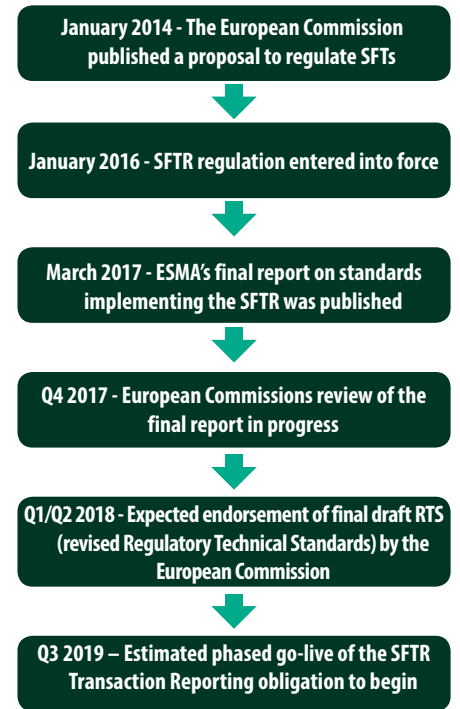
- SFTs conducted by any counterparty which is established in the European Union (EU), irrespective of location of

their individual branch.

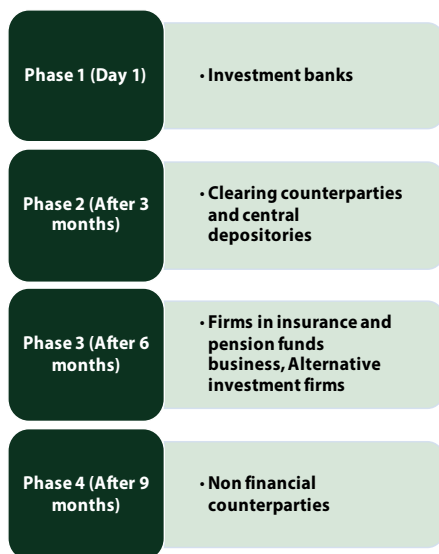
- SFTs conducted by EU branches of non-EU entities.
- SFTs where the securities used are issued by an EU counterparties or by an EU branch of an entity
- SFTs reused by EU counterparties including their branches, irrespective of their location.
- SFTs reused by non EU counterparties operated from EU location.
- Types of firms affected include Banks, Investment Firms, Central Counterparties (CCPs), Central Securities Depository (CSDs), Insurance, Reinsurance Undertakings, Pension Funds, Undertakings for the collective investment of transferable securities (UCITs) which issues mutual fund in EU region, Alternative Investment Funds

(AIFs) and Non-financial counterparties.

Timeline for SFTR



Phase wise implementation of SFTR by type of entities



Key requirements covered by SFTR:

1. Transaction Reporting:

- Dual sided reporting of lifecycle events on T+1 basis (similar to EMIR – European Market Infrastructure Regulation)
- Record keeping of the transactions for minimum 5 years following the trade termination
- Unique SFT can be identified by the repository by the combination of LEI (Legal Entity Identifiers) and UTI (Unique Trade Identifier), hence both parties involved in the transaction must report it

2. Collateral Reuse:

- Counterparties which have received the security can reuse it, only if it complies with the terms mentioned in the SFTR. Counterparty needs to inform duly in writing if it is reusing it and need to express the consent.

3. Information disclosure:

UCITS needs to highlight below details in the documents shared with their clients -

- Details of the SFTs with their justification.

- Details of the SFT counterparty and various criteria considered to select it.
- Details of the security used in the SFT like type of the security, issuer of the security, maturity date, etc.
- Description of risks for the SFTs and collateral management.
- Collateral valuation methodology.
- Details of any restrictions.
- Overall detailed information for each SFT.

The regulation requires total 153 fields to be reported in total. Out of the total 96 fields to be matched, in the beginning, total 62 fields need to be matched, with rest 34 to be matched 33 months later. All data needs to be reported to a repository in the standard ISO 20022 format. All trade data need to be reported on T+1 with collateral required to be reported on S+1.

Expected challenges of implementing SFTR:

1. The collateral reuse practices can result into complexity

If the buyer counterparty fails to return the security back to its seller on the agreed date as per the SFT, then it will result into default if the same seller counterparty has the obligation to deliver the security further to its buyer if there is an another SFT.

Hence, default by one counterparty can result into several defaults by other counterparties if same security is being used in all the SFTs. This scenario will have impact on the reporting tools and trade booking systems to further report the trade to the repository when buyer and seller counterparties agreed to partially amend the trade in case of default.

2. Reconciliation:

The regulation requires both the counterparties of the SFT to submit a UTI (Unique Trade Identifier). If the SFT is booked in which clearing counterparty

(CCP) is involved, then it is not confirmed who will be the UTI generating party for the clear trades as clearing counterparties are in SFTR phase 2 reporting scope.

For such trades, counterparties should have tactical solution to generate the UTI and also to report the trade to the repository.

In addition to the above, parties need to match large number of data, which will be a challenge. These reconciliations are needed to enable ESMA to interpret data. The matching is also critical for the aggregation of data across Europe. After the regulation go-live, the matching process is expected to be operationally too cumbersome and create breaks.

3. Counterparties in scope:

As SFTR has Non EU entities which are based in EU in scope of reporting, these counterparties may face challenges to report the SFT as they will need to have the details of the counterparty LEIs and also the confirmed UTI.

4. Manual Nature of the Market

The markets and infrastructure related to Security Financing are largely manual and fragmented. SFTR is likely to bring a lot of changes to this. While the changes are good for the market, lot of work is needed to bring changes in the existing trade booking systems and contractual and lifecycle aspects.

5. Data Sourcing

SFTR requires large number of fields to be reported including key ones like ISINs, LEIs, UTIs, MIC Code and CFI codes. Majority of these fields, among others are not well understood in the market, and many participants will find it difficult to source.

While firms need to look beyond their internal systems to source this data, providing the same for all their legal entities could be challenging.

EMIR and SFTR – Similarities and Differences:

Although fundamental scope is different for both the regulations, they have similar requirements in terms of classification of the counterparty, reporting eligibility logic of counterparty entities, the granularity level for reporting requirements and the reference data collection for instruments in scope of reporting.

Similar to EMIR, SFTR requirement is to report new and subsequent lifecycle events to the repository by T+1. Counterparties need to keep the record of the SFT for 5 years from its termination.

Differences between the two are in terms of transaction reporting scope - the counterparty needs to report OTC derivative transactions under EMIR and scope for SFTR reporting is SFT. There will be differences in the structure of the reports and in the logic for UTI generation under the two regulations.

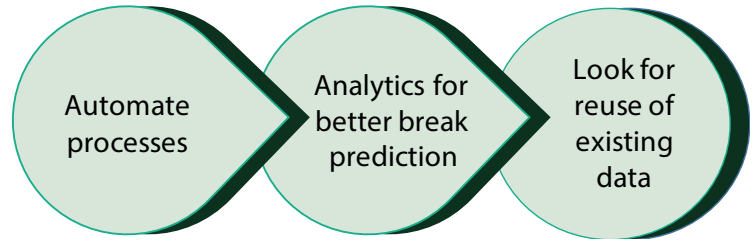
Both these regulations also vary in terms of LEI referred for identification of the counterparty. While EMIR requirement is to report only head office level LEI, counterparty needs to report both the head office level and branch level LEI for SFTR reporting.



Recommendations:

Firms can leverage some of their existing regulatory knowledge and infrastructure to build SFTR reporting requirements. These include EMIR and MIFID II.

Firms can also leverage vendor solutions to speed up their implementation. Vendor solutions in the market have invested significant amount of time and resources in understanding the reporting requirement and can deliver standardized data to the repositories. Key benefits from this approach can be around interpretation of requirements, validation and enrichment of data, reconciliation process and UIs to manage breaks.



Firms should seize the opportunity to improve automation in their processes, which can help them reduce cost, be agile in the longer run and reduce data quality errors in reporting. As matching requirement becomes large and more data is being exchanged between parties, better processes and automation will help

compliance levels improve overall.

Establishing data lineage will also be critical for data accuracy under SFTR. As tolerance limits are low, firms must ensure that data reported is sourced back to an appropriate system before being enriched and reported to the regulator.



Analyzing exceptions and errors effectively is a critical step. Firms must ensure that they use a sound system that identifies breaks, analyses them and addresses discrepancies.



Conclusion

As SFTR requirement is an evolving area, firms should stay focused regarding its confirmed/evolving scope.

To utilize the existing EMIR infrastructure for SFTR reporting, firms can start their analysis to find the similarity and the differences in scope of reporting in both the regulations by referring to SFTR latest requirement reports.

Firms need to identify SFT instruments in scope of SFTR reporting. They can also start looking into requirements of reports and structure of the reports along with its field details to decide its source for reporting.

Significant work will be required sourcing of data and reconciliation of data especially in the backdrop of manual nature of the processes in the industry and large number of reporting requirements.

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Anubhav Kondawar is a Senior Associate Consultant with the Domain Consulting Group (DCG) at Infosys Limited. Anubhav holds an MBA Degree in Finance and has about 8.8 years of post-qualification experience in the areas of Trade Settlement Process, SWAPs Regulatory Reporting and TLM reconciliation process of SWAPS regulatory reporting. He can be reached at anubhav_kondawar@infosys.com



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