

ESMA publishes feedback on SFTR reporting: is the industry ready?

HOT TOPIC

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Highlight

ESMA published the responses to its consultation on SFTR reporting draft guidelines.

Final guidelines are expected by the end of 2019. Firms will only have a few months to finalise their reporting architecture.

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Summary

To support firms' implementation of the Securities Financing Transaction Regulation (SFTR) reporting, the European Securities Markets Authority (ESMA) published a [consultation on guidelines for SFTR reporting](#) on 23 May 2019. On 31 July 2019, ESMA published the [responses](#). Most firms agreed with ESMA's approach, but highlighted that the implementation timeline will be challenging. This will be the first time many of these transactions need to be reported to regulators.

The guidelines included detailed guidance on how to complete the SFTR reporting fields and reporting scenarios for each type of Securities Financing Transaction (SFT).

ESMA's requirement to report Legal Entity Identifiers (LEIs) will be difficult to fulfill. Many non-EU jurisdictions have still not mandated the use of LEIs.

In this Hot Topic, we recap the main elements of SFTR and highlight the key features of the reporting regime.

Background

After an initial focus on banking regulation following the financial crisis, policy-makers sought to ensure that risk would not move towards unregulated areas of the market. In 2013, the Financial Stability Board (FSB) released a [comprehensive roadmap](#) to address the risks of 'shadow banking'. Shadow banking is generally defined as credit intermediation taking place outside the banking sector.

SFTR is part of the EU response to these recommendations. Finalised in November 2015, it provides the EU with the most detailed regulatory framework across FSB jurisdictions to address the risks arising from SFTs. The regulation defines SFTs as encompassing four types of transactions: a) repurchase transactions ('repo'), b) securities or commodities lending and borrowing, c) buy-sell or sell-buy back transactions and d) margin lending transactions. (In margin lending, loans are secured against a pool of securities as opposed to a single piece of collateral).

The regulation is a response to regulatory concerns about collateral chains, whereby counterparties to an SFT may re-use collateral in multiple other transactions. Regulators were concerned about the same collateral being used in too many transactions.

To address these risks, SFTR proposed a threefold response. First, counterparties to an SFT are required to secure consent from other counterparties to re-use their collateral. Second, management companies of Alternative Investment Funds (AIFs) and Undertaking for Collective Investment in Transferable Securities (UCITS) have to disclose their use of SFTs and total return swaps in their annual reports to investors. Third, SFTs shall be reported to trade repositories.

While the first two requirements have been implemented, reporting requirements have yet to enter into force. Investment and credit institutions will be the first to start reporting, on 1 April 2020. To support this exercise, ESMA published draft guidelines in May 2019.

EMIR-style reporting tailored to SFTs

To minimise the compliance burden for the industry, ESMA was asked to achieve consistency with the reporting already required under the European Markets Infrastructure Regulation (EMIR) for derivatives.

Ultimately all market participants, whether they are financial and non-financial counterparties, will be required to report the details of their SFTs to trade repositories.

The reports shall contain the composition of the collateral used in a SFT, whether that collateral is available for re-use and has been re-used, or whether any haircuts have been applied to it.

The rules will be deployed in four phases, with banks and broker-dealers leading the way (11 April 2020). They will be followed by financial markets infrastructures (11 July 2020), insurers and asset managers (11 October 2020). Finally, non-financial entities will need to comply with the requirements (11 January 2021).

ESMA guidelines to harmonise reports

The RTS which mandate the contents of the reporting fields were [published](#) on 22 March 2019. To support firms' implementation, ESMA produced draft guidelines, setting out guidance on how to fill the main field and including base scenarios.

They cover seven aspects of the reporting requirements, including the number of reportable SFTs, how to link SFT collateral with SFT loans, or how to reconcile breaks or rejections between counterparties.

ESMA seeks to clarify the different definitions of SFTs, provide more details on the transactions excluded and explain how to allocate the different reporting responsibilities between FCs and NFCs.

The guidelines also give ESMA an opportunity to clarify supervisory expectations for different categories of SFTs. ESMA explains for example how to report transactions linked to margin lending.

Reporting historic transactions ('backloading')

Like EMIR, SFTR contains a backloading requirement. The reporting obligation applies to some SFTs concluded before the application date, if they remain outstanding on that date and if their remaining maturity exceeded 180 days.

While there is a requirement for this specific population of trades to be covered in SFTR reporting, firms may decide to go beyond. They may wish to report their entire population of live trades on the reporting start date.

The responses received by ESMA show there is no industry consensus on this point. The effort to prepare the core reporting mandated by the SFTR is already significant and firms may limit their reporting to this population.

The adoption of different approaches to backloading by firms would lead to more reconciliation breaks, where the two legs of the same transaction are reported differently. Firms will need to discuss how to best reconcile their approaches in this instance.

LEI compliance continues to be a challenge

ESMA notes that counterparties should report the LEI of the issuers of the securities that are lent or borrowed, or of the securities used as collateral. This will present the same compliance problem that occurred when MiFID II reporting went live.

The International Capital Markets Association (ICMA) highlighted there are gaps in LEI coverage across jurisdictions. The FSB's [Thematic Review on implementation of the LEI](#) in May 2019 contained an overview of LEI coverage for securities issuers across 25 jurisdictions, Only 55% of the financial instruments in scope have an LEI code.

While LEI is mandatory in the EU, it remains optional in many non-EU jurisdictions, which would make it difficult to fill this field in an SFTR report when trading with non-EU counterparties. Failure to report the LEI would result in a significant number of rejections.

One solution which has been suggested by some respondents is to make the LEI field optional. ESMA's response to this suggestion is difficult to predict, as the text of the regulation does specify an LEI shall be included. ESMA may choose a temporary flexible approach, but past experience does not suggest this would be likely.

FC and NFC reporting

Because the regime is phased-in, Financial Counterparties (FCs) will start reporting before the requirement applies to Non-Financial Counterparties (NFCs). In the context of SFTs involving FCs and NFCs, ESMA acknowledged that reporting for these transactions will not be reconciled until the obligation applies to NFCs.

The draft guidelines specify however that ESMA expects counterparties for which the reporting obligation has not started to provide all the relevant information necessary to submit the reports. Asset managers raised concerns about this provision in their responses. They noted that it goes against the spirit of the regulation, creating de facto an obligation to report before the requirement enters into force for asset managers.

Like EMIR, SFTR also provides an option for delegated reporting. For example, two NFCs not equipped with the required infrastructure to report may decide to delegate this reporting to a third party. Delegated reporting remains optional and would not discharge delegating counterparties of their legal obligations to report accurately.

Application to third country branches

SFTR has extraterritorial implications. The regulation applies to any counterparty established in the EU, including all its branches. It also applies to a non-EU counterparty if the SFT is concluded "in the course of the operations of a branch in the Union of that counterparty".

To help interpret this provision, ESMA included guidance on how a transaction would be deemed "concluded". An EU branch of a non-EU entity would need to meet one of four criteria to determine that it has concluded an SFT in scope of the SFTR reporting requirement.

This would depend on whether the branch i) received an order from a client, ii) has responsibility for the person responsible for the investment decision, iii) has supervisory responsibility for the person responsible for the execution of the transaction or if iv) the transaction was executed on a trading venue using the branch's membership.

ICMA noted that this proposal differs from the reporting logic under EMIR and places more focus on the activity of individuals rather than the risk held in the EU.

A challenging implementation timeline

ESMA published these draft guidelines to facilitate compliance and give firms additional details on their expectations. A workshop was organised in Paris on 16 July to discuss them further.

Despite these efforts, firms are concerned that the final guidelines are only expected in Q4 2019. With reporting requirements going live on 1 April 2020, this would leave only a few months between the publication of the final guidelines and the go-live date.

Respondents highlighted that building the required infrastructure is an extensive exercise, likely to take more than a few months. To meet the reporting deadline, firms would probably need to have concluded most of this work by Q4 2019. This means they will have to build their systems on assumptions and change them later if ESMA makes material amendments to the guidelines.

ESMA may be unable to produce the guidelines before Q4, given the amount of implementing standards the organisation has to deliver before the end of the year.

What does this mean for firms?

If they have not already started, firms should start working on their reporting infrastructure, assess the budget required to comply with the requirement and plan the deployment of the relevant IT solutions.

They should review the data to be reported under SFTR, determine how much of that data the firm has within its own systems, and explore how they can seek efficiency in reporting across different regulations (e.g. EMIR, MiFID II, SFTR).

Firms will need to liaise with trade repositories to determine who they will report their transactions to. ESMA will allow trade repositories already registered under EMIR to extend their offering to support SFTR reporting.

It is expected that many existing providers will use this option and provide integrated services but SFTR reporting authorisations have not been completed to date.

Work is underway to develop new master reporting agreements to support SFTR reporting. Trade associations representing the main markets impacted have partnered to develop a common industry standard. They will use this document to define in more detail all parties' responsibilities and the interaction with existing EMIR reporting requirements.

To support implementation, firms should review the draft guidelines published in May 2019, as they already contain multiple examples of how to report each type of SFT and give a clear idea of ESMA's expectations.

Banks should think about the commercial opportunity of offering delegated reporting to small financial firms or corporates. These counterparties will need to consider the investments required to support reporting and whether or not they prefer to delegate this responsibility.

Corporates have more time to prepare but not much. Reporting for NFCs will start only eight months after credit institutions, leaving them limited time to benefit from the experience of other actors in the market.

How can PwC help?

While SFTR reporting seeks to be consistent with EMIR reporting, a number of new fields have been added to cater for SFTs. SFTR will also require the reporting of transactions that have never been reported before to regulators.

PwC can use its extensive experience of MiFID II and EMIR reporting to help you mobilise a program, establish the required infrastructure and test the data ahead of the go-live date.

Post-implementation, PwC also offers a full suite of tools to identify and correct errors. From diagnostic testing of submissions to full front-to-back testing, we can help you identify completeness and accuracy issues and build out a robust control framework to prevent and detect these going forward.

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