The securities financing transaction regulation: Practical implications for the securities lending industry

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Abstract

Securities financing transaction regulation (SFTR) is a huge data gathering exercise for those participating in securities lending. Who is required to report and when? Who will actually be responsible for reconciliation and reporting? What are the areas that concern participants? What will regulators do with the data they receive? This paper will address these issues and discuss what buy-side participants should be thinking about in terms of preparation for SFTR.

Keywords: SFTR, securities lending, repo, ALD, UTI, delegated reporting, reconciliation, trade repositories, regulators

INTRODUCTION

The author was asked to moderate a panel recently, which aimed to address the practical implications of Article 4 of the securities financing transaction regulation (SFTR).[1] Aside from the thought that a 45-minute panel discussion would only scratch the surface of the subject, our panel was struggling to get some positive thoughts to share with the audience.

Why was this?

THE REPORTING BURDEN

First, the burden of reporting securities finance transactions fall on the principals to the transaction, which in may cases, include buy-side participants despite the fact that they have appointed an agent to manage the activity for them.

Who is required to report?

European Union (EU) based entities and non-EU-based branches of an EU entity are required to report securities finance transactions. For example:

- A Luxembourg undertakings for collective investment in transferable securities (UCITS) lending a security to a German borrower — both parties will need to report the transaction.
- A UK pension fund lending a security to a NY branch of a French entity — both parties will need to report the transaction.
- A US pension fund lending to a UK borrower — only the UK borrower will be required to report.
- A US 40 Act Fund lending to an EU branch of a US entity — only the EU

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branch of the US entity will be required to report.

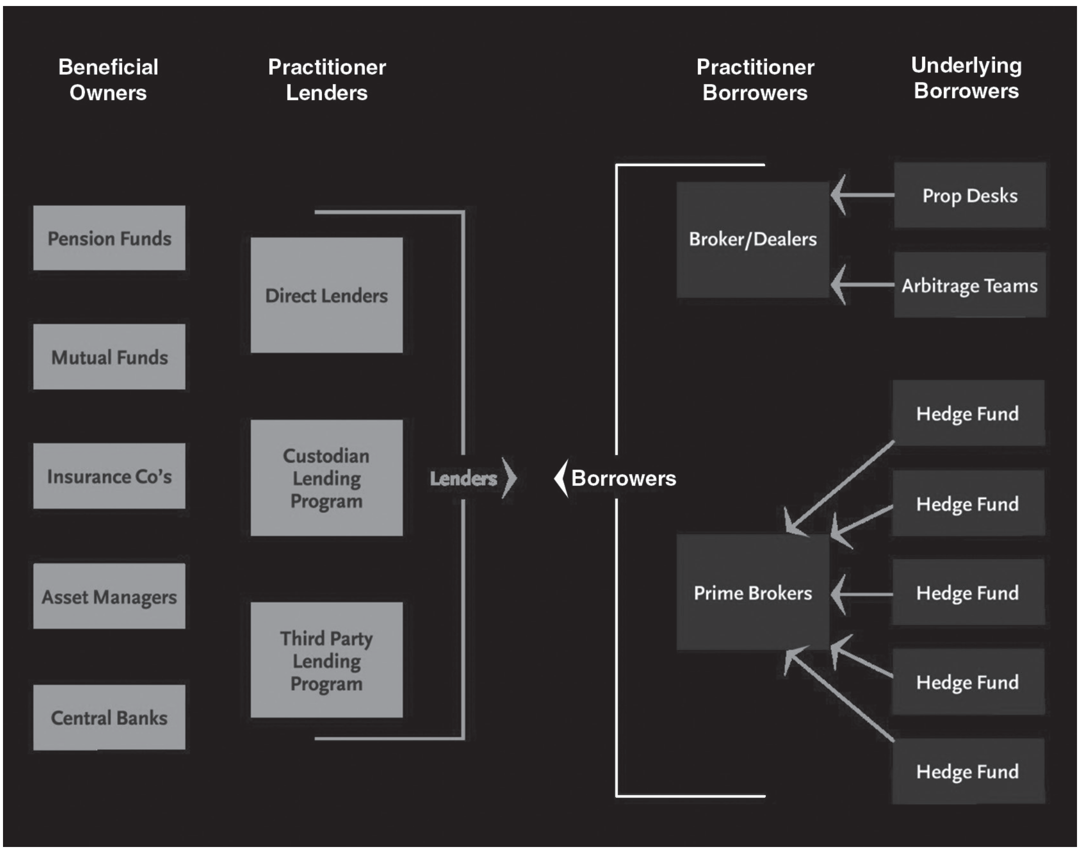
- A Japanese pension fund lending to an Australian borrower — neither party will be required to report.

Note: The issuance/settlement market of the security in the transaction is irrelevant for this reporting.

EU pension funds, UCITS, insurance companies, etc will likely delegate their reporting requirements to their appointed agent whom is usually a custodian or third-party lending agent (practitioner lenders in Figure 1). If they are a direct lender and have their own lending desk, they will need to establish their own solution. Importantly, buy-side participants will need to be satisfied that the reporting is being done accurately, as it is their responsibility. Therefore, there is an additional element of oversight that will be required for those firms.

Given that most beneficial owners will delegate reporting responsibilities to their agents, the 'burden' of reporting the transactions will be with the agents. For securities lending transactions (see Figure 1), agents have become accustomed to providing significant datasets to the data vendors that service the industry — the likes of IHS Markit, DataLend and FIS Astec Analytics take daily data from the agents detailing available inventory for lending and actual

Figure 1 The Securities Lending Landscape



Source: Bassler, Peter and Oliver, Ed (2018) 'Securities lending best practices', available at: http://www.eseclending.com/resources/eSecLending-Best%20Practices-US-2018.pdf (accessed 3rd May, 2018).

loan information. They anonymise and aggregate the data and provide it back to market participants in the form of web and Excel tools that assist in trading and performance benchmarking.

The current datasets provided to these data vendors, however, are much smaller in scale — approximately 25 data fields. SFTR requires 153 data fields, and the collation of these additional datasets is a challenge for the industry. The International Securities Lending Association (ISLA) has pulled together a small Data Interpretation Working Group to help provide clarification on some of the data requirements, which are open to interpretation. The output from this group is expected in May 2018.

At the time of writing (early May 2018), the final regulatory technical standards (RTS) had still not been published, but most observers do not expect a reduction in the number of data fields. This is despite the fact that the Financial Stability Board (FSB), the catalyst to guiding regulators to obtain more transparency on securities financing transactions (SFTs),[2] suggested on 5th March, 2018, that they felt 30 data points were sufficient.[3] Separately, an independent survey of market professionals conducted by the consultant firm Finadium in February 2018 determined that 75 per cent of respondents thought that between 15 and 50 data points is the ideal number to gain sufficient insight into SFT activity.[4]

For other transactions caught by SFTR — repurchase agreements (repo), margin lending and buy-sell backs — there is currently not a broad exchange of data that exists in securities lending, so the reporting of these transactions may be even more challenging.

RECONCILIATIONS

One other area that securities lending has an advantage over the other SFTs is in the area of reconciliation. Under SFTR, there is a requirement for matched entries to be submitted to the regulators by both sides of the transaction (assuming both are in-scope EU entities), so reconciliation is absolutely key. Currently, securities lending participants utilise reconciliation tools provided by Pirum or EquiLend to ensure post-trade efficiencies.

There will still need to be additional focus on the timeliness of reconciliation and clearing breaks to ensure that all items are matched ideally before reporting is delivered by midnight on trade date plus one. This will ensure that corrections are not required subsequent to the first reporting of a transaction. It is to be expected that significant resources will need to be applied to focus on reporting breaks in the initial stages of live reporting, but over time, the breaks for securities lending should be manageable. It should be expected that there will be better matching rates than seen in the early stages of the European market infrastructure regulation (EMIR) reporting of over-the-counter (OTC) derivatives.

Again, industry standard reconciliation tools do not generally exist for the other SFTs, so this is an area that will require significant focus. There are already vendor solutions, such as Trax Match Repo, emerging to fill this gap.

WHAT IS NEW?

We have discussed the reporting requirement and data elements. We have also mentioned that data vendor solutions are now in place. The most relevant of these solutions in the securities lending and repo markets are provided by an IHS Markit/Pirum offering and by EquiLend/Trax. Both service partnerships will offer services that include reconciliation, provision of unique trade identifiers (UTIs), time stamps and onwards reporting to trade repositories (TRs). The latter three elements are all new requirements to satisfy SFTR.

For UTIs and time stamps, ISLA and the industry have already worked on developing a 'waterfall' that addresses how a UTI or timestamp is generated depending on the circumstances of the trade and the relationship between the principals to the transaction.[5]

The provision of legal entity identifiers (LEIs) is new for SFTs, but most buy-side participants have likely obtained these to support EMIR reporting, and increasingly, LEIs are becoming common in other reporting areas too. Although it will be a task to gather and store LEIs, it should be one of the easier components of the new requirements.

The TRs are also new for SFTs — they are authorised by the European regulator, European Securities and Markets Authority (ESMA), to collect and report the SFT data. Some buy-side participants will already be reporting their derivatives activity to a TR as required by EMIR and may choose to use the same one for SFTR (although not all TRs may apply to do both). Some participants may choose to use the TR that is linked to a data vendor solution. Others could potentially provide internally generated transactions, such as in-house repo activity, to one TR and have their securities lending activity distributed to another TR via an agent.

Another significant change for the securities lending community is the requirement to provide loan life cycle updates. At present, the standard data reported to data vendors is end-of-day positions — what is available for lending and what is on loan. SFTR requires reporting of corporate actions and margin updates, for example.

ESMA is also keen to understand the level of reuse of collateral that occurs. For most buy-side participants, collateral reuse is likely to be minimal, if it happens at all. Although, ironically, the move of OTC derivatives activity to central clearing has increased the likelihood of the buy-side utilising securities lending and repo to obtain appropriate collateral to pledge as initial and variation margin. Thus, any reuse growth in recent years has been driven by ESMA's own regulation.

The majority of lending agents that operate a traditional lending programme have a further complication as well. In the current market, in order to allocate lenders fairly into loans where a number of lenders hold the same security, the lending agent operates an algorithm (sometimes referred to as the queue) to determine which lender should be allocated the loan. As a result, it is not possible for the borrower to know the identity of the lender at the point of trade negotiation. The details of the allocated lenders on each loan are shared at the end of the business day (during overnight processes) with the compliance team at each borrower using a process known as agency lender disclosure (ALD). The lenders on each loan can change intraday as lenders sell securities and other lenders get 'reallocated' into the loan. Thus the actual lenders on an individual loan are dynamic. ISLA has developed an ALD Working Group that is aiming to improve the ALD process so that lender details can be provided in a timelier manner. This will be a significant exercise for all participants.

It can be concluded, accurately, that this regulatory reporting initiative requires a very considerable production to provide a huge reconciled dataset to the regulator within tight deadlines. This 'production' inherently will cost money and resources. The TR and data vendors will not be providing their services free of charge. There is not going to be additional revenue to help compensate the buy-side for these costs, or indeed the agents who are required to produce the data on their clients' behalf. The typical portfolio in a securities lending programme earns approximately four basis points per year.[6] That is not a massive revenue number, but it helps to offset costs in some cases or improve portfolio performance in others. A small percentage of the revenue is shared with the lending agent (perhaps 10–20 per cent), and ultimately, in most cases it will be the agent expected to pay for the additional costs, as the buy-side participant will argue that an increase in their costs may lead them to examine if the activity is worth it.

IS THE REPORTED DATA HELPFUL FOR REGULATORS?

The question for the industry is: Will all of this additional data be helpful to regulators? We have already mentioned that the data being provided will be more detailed than ever before. Part of the TR costs are incurred due to their need to build a system that can take the data, store it and share it with the regulator(s) such that they can review it as necessary. The SFT activity is significantly more voluminous than that provided for derivatives activity today, so it will be interesting to see what regulators do with the information and on which pieces they choose to focus.

The data is also further complicated by the one-sided nature of much of it. Many of the biggest lenders in securities lending are based outside the EU, such as US Pension and US Mutual Funds or Sovereign Wealth Funds. There is currently no requirement for these entities to report, but if they are transacting with an EU bank, the bank will be required to report. It is anticipated that in excess of 60 per cent of loans involve a non-EU lender, so there will be a significant amount of one-sided reporting. Although this is the case, it will not be possible for the EU bank to report without receiving some information about the lender so, in reality, even non-EU lenders will be required to have some method for sharing relevant information with their EU counterparties. Of course, one alternative for the non-EU lenders will be to only trade with non-EU Banks, thus removing this requirement entirely. It is unlikely that this will happen, but it is a possibility.

The EU has gone first with their regulation to satisfy the FSB directive to obtain more transparency in SFTs. As described previously, SFTR is comprehensive. During a recent conference, an ESMA representative advised that both Japanese and US regulators were likely to initiate a less comprehensive approach to SFT reporting. This raises the risk that market participants are going to have to build multiple reporting solutions to satisfy multiple regulatory reporting requirements, which is less than ideal. It could be the case, however, that other regulators will seek a smaller subset of data that is similar to the dataset already provided and perhaps closer to the 30–40 data points the FSB has suggested will be sufficient. Will ESMA's regulatory leading approach ultimately be scaled back? Some industry participants are already talking optimistically about SFTR 2.0!

Let's not get ahead of ourselves though; we have yet to see the final RTS. Once this is available, we will be waiting for it to be published by the European Commission before the one-year clock begins ticking to the first reporting requirement. Although the reporting requirement is being phased in with only the banks having to be ready for day one, as mentioned above, the lenders (and their agents) will need to be ready so that the banks have sufficient information to be able to report on day one. At the time of writing, the best guess for day one is during the second half of 2019.

It is worth noting here that the industry is going to have to think carefully about how to report the first day's activity. The requirement is to only report new loans, but practically, it may be easier to report the whole set of outstanding loans and collateral held for each lender.

When will reporting be required?

The first reporting obligation will occur one year after the EU ratification of the final RTS and publication in the *Official Journal*. The reporting is then phased in:

- Twelve months after ratification — investment firms (including borrowers) and credit institutions.
- Fifteen months after ratification — central securities depositories and central counterparties.
- Eighteen months after ratification — all other financial counterparties, including UCITS, alternative investment funds, pension funds and insurance companies.
- Twenty-one months after ratification — all non-financial counterparties.

So, back to our panel preparation — did we find any positives?

Actually, we concluded that post SFTR implementation, the SFT marketplace could be in a much better place primarily because of the increased rigour around reconciliation processes that will lead to increased efficiencies. The question has to be whether this increased efficiency will compensate for the increased costs that will result from SFTR

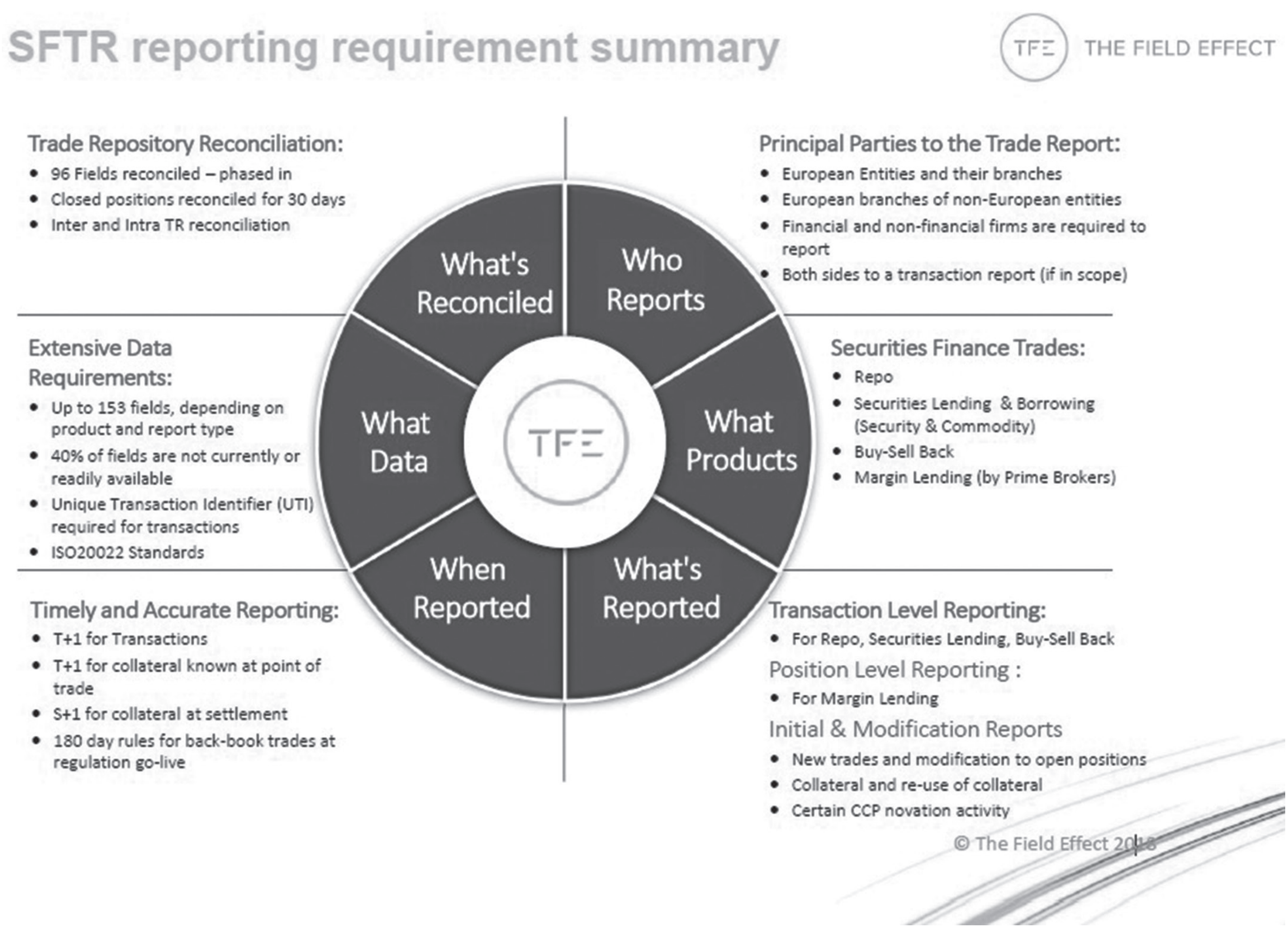


Figure 2 Securities financing transaction regulation reporting requirement summary
Notes: SFTR, securities financing transaction regulation; CCP, central counterparties.
Source: The Field Effect.

reporting and, indeed, start to repay the resources used in the project (see Figure 2).

A viable long-term solution to ALD will also be a big win if it can be achieved. This should help borrowers too, as the enhanced capability to share details of the lenders allocated to a loan may allow borrowers to gain additional capital relief if managed well.

Whatever happens though, it is up to the industry to do the heavy lifting. In discussions with the buy-side participants, it is clear that they are going to rely on their agents to provide the data and get this right. Any suggestion that the reporting will not work or will be inaccurate could lead to EU lenders pulling back from participation in securities lending. They have a requirement to report accurately and could be subject to regulatory fines if they fail to do so.

The good news is that the industry is actively working on the SFTR project — led by industry associations and supported by commercially opportunistic technology companies, participants in the marketplace are getting their solutions lined up so that they can demonstrate and reassure their clients that they will be ready for day one. Many agents, including eSecLending, are starting to produce test files to see if the additional data points can be easily produced. Others are still wrestling with the build vs. buy question, and vendors are being inundated with requests for information.

BUY-SIDE PARTICIPANTS: WHAT CAN BE DONE NOW?

- Obtain LEIs if not already available.
- Ask lending agents what their SFTR plans are, and obtain regular updates on progress.
- If processing internal SFTs, eg repo, start to consider how to report.
- Consider which TR solution is appropriate.
- Compliance and oversight teams should start to familiarise themselves with SFTR and potential reporting solutions (sharing of delegated reported transactions).

The industry will be ready, but industry participants will be interested to see what regulators do with the data. Perhaps another potential positive will be that the transparency provided to regulators will reinforce the message that SFTs are low risk transactions that help to provide liquidity to capital markets. Will this ultimately be beneficial to the industry as regulators become more comfortable with SFTs and actually start to roll back existing regulation or reduce impact of future regulation? Only time will tell.

References and Notes

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