The EMIR compliance game

Reducing risk in the
OTC derivatives market

1. The rules of the game

In the wake of the financial crisis, regulators around the world set out to reduce risk, improve transparency and to standardise products and processes in the often risky OTC derivatives market. In Europe, the culmination of these efforts is the European Market Infrastructure Regulation (EMIR). The practical implementation of EMIR can be viewed as akin to a game of 'Snakes and Ladders'. There are quite possibly one hundred steps along the road to compliance and with each new looming deadline there are new ladders to climb to get ahead of the pack. However, there are also hidden snakes waiting to strike underprepared participants. Whilst falling foul of a snake or two will not be uncommon, all firms will need to avoid those with venom that could impact their reputation and bottom line.

On 12 February 2014 the EMIR trade reporting mandate came into effect. Most large sellside organisations invested much time and many resources in ensuring that they had a robust reporting mechanism in place ahead of the deadline. However, the level of preparation and investment has been somewhat mixed on the buyside. Some firms have lacked clarity on the exact impacts of the legislation on their business, or have focused their attention on implementing temporary tactical solutions and waiting to see how the service providers develop. For many buyside organisations the hope is that the number of delegated reporting venues will increase and the legislation will become clearer as the European Securities and Markets Authority (ESMA) releases more detail on the technical standards.

Whilst the larger sellside organisations have tended to tackle the trade reporting challenge head on, they too have faced a number of issues. Having surmounted the initial challenge of working out which products are classed as derivatives under EMIR and knowing the unique product identifier (UPI), there are now two contentious issues outstanding.

- The creation of the legal entity identifier (LEI) which every legal entity that needs to report under EMIR should have set up
- The generation and exchange of unique trade identifier (UTI) which is made up from a combination of the LEI and other references

Once the LEI has been obtained and the UTI generated by either party to a transaction, the information then has to be delivered to and consumed by the receiving party before finally being added to their own trade report. In order for trade reports to be deemed fully compliant, both parties must report the transaction and the details of each report must then be matched at the trade repository. Achieving this has not been as straight forward as it was expected to be.

Although trade reporting under EMIR is currently the primary cause for concern amongst most market participants, it's important to note that this is just the first roll of the dice in the EMIR compliance game. Over the next 12 to 18 months firms will need to negotiate many more deadlines, obstacles and challenges on their long road to compliance.
All institutions seem to have a good foothold on the ladder rungs to compliance, or at least none will knowingly and publicly admit that they don't. There are five main areas of the legislation that are now actively being monitored by ESMA and the local financial authorities. With most having successfully completed their first turn in the EMIR game, firms now need to objectively review their market position and plan for the next phases of EMIR implementation.

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2. The current state of play

2.1 Trade reporting

Firms that have implemented a robust reporting solution are still grappling with issues around data population and exchange. All firms need to be able to confirm that they have successfully reported on T+1 but many are over reliant on the acknowledgement / no acknowledgement (“Ack / Nack”) processes of the trade repositories (TRs), which are used to communicate the acceptance or rejection of trades. In order to ease the nightmarish reconciliation process, some institutions are using a central warehousing solution for their trade reporting data. However, others are individually reporting from their various trading systems, which makes it extremely difficult for them to demonstrate that the full suite of reports has been sent.

By 13 May 2014 all firms should have also completed their back loading of trade reports for contracts that were executed after 11 August 2012 and were still outstanding on the 12 February 2014. Again, the challenge here has been the retrospective production and exchange of a UTI for those contracts.

A practical step any firm can take to remove some of the confusion around the UTI generation and exchange would be to implement a firm-wide policy on UTI generation, usage and consummation. This should then be shared with the firm’s clients and counterparties and used as a basis to ensure the correct level of dialogue when agreeing who should generate, deliver and consume what, with whom and when.

Institutions that have not yet started their reporting, either because the products traded are not reportable under EMIR or they are unsure of which products are reportable, a regular review of existing agreements and product sets should be put in place to ensure that reporting will not become a problem if there is a change in business strategy. The signing of new legal International Swaps and Derivatives Association (ISDA) agreements could trigger such a change as in most instances firms trading under an ISDA are usually executing derivatives.

From a new product onboarding perspective, static reference data systems should be updated so that a reportable ‘yes’ / ‘no’ flag can be added for any relevant pieces of legislation, for example Dodd-Frank or EMIR.

2.2 Delegated reporting

Firms that have chosen to delegate their reporting will likely have chosen more than one service provider, usually a custodian, broker and / or clearer. Although this removes the headache of connecting directly to a trade repository (TR), the need to know and track which contracts are being reported by which delegated party will require internal systems enhancements from a routing perspective.
For example, if you have multiple derivatives trading with various brokers / venues you may be faced with the following scenario in which one or more of the following is occurring;

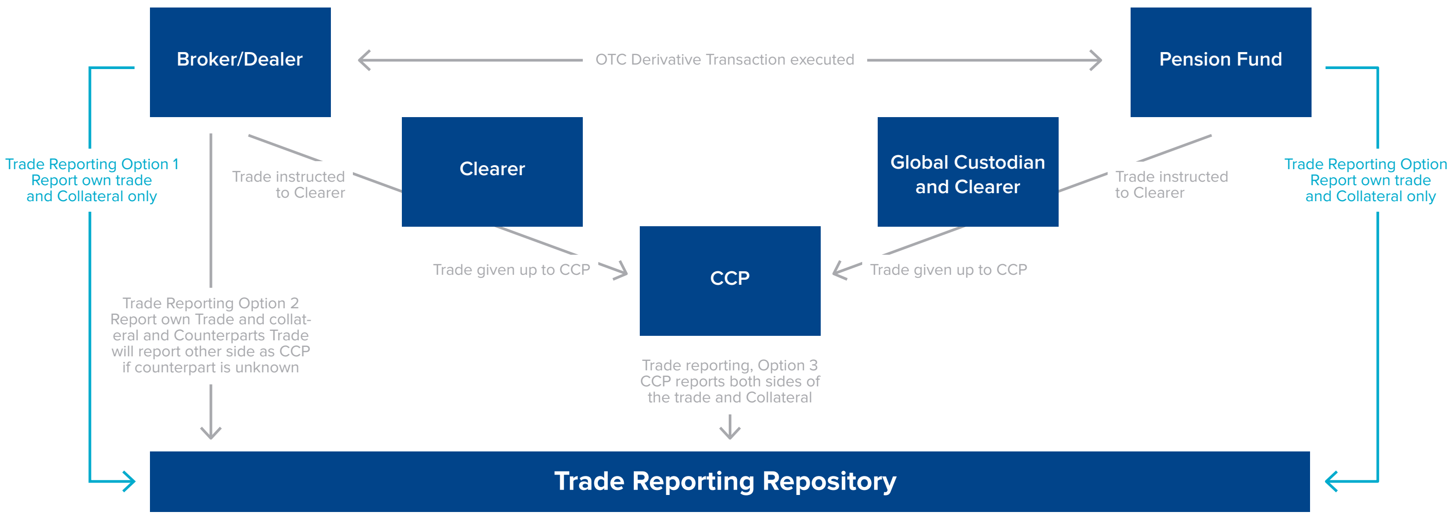
- Exchange traded derivative (ETD) trades are executed directly on exchange and cleared via a central counterparty (CCP) offering delegated reporting

- Foreign exchange (FX) forwards are executed via a broker and the broker is also your clearing agent and offers delegated reporting

- Over the counter (OTC) bilateral trades are exchanged directly with your counterparty, but you have outsourced the management of the collateral to a custodian and signed up to delegated reporting for those contracts

This diagram details the three ways in which you can trade report, although it is highly likely that firms will be utilising all three simultaneously, in varying proportions depending on their requirements.

Diagram 1: The options for reporting centrally cleared trades



In the above scenario (which will not be uncommon for many institutions) there are three reporting service providers; the CCP reports the ETD trades; the executing broker reports the FX Forwards and; the custodian reports the OTC derivatives. Each of these mechanisms for reporting will need to be tracked and monitored internally. To add to this mix, each of the delegated service providers may also use different TRs, so there will be no single place where all of the firm's trade data will be held. This could lead to some reconciliation and auditing challenges.

There have been fewer service providers willing to enter into delegated reporting provision than ESMA had initially hoped for. The legal ramifications on the delegated reporting provider have been the main barrier to this, as they have been working with their legal teams to draft indemnity clauses. However, it has become clear that most buyside firms will eventually seek to delegate their reporting function, so it is anticipated that more players will enter the delegation game in the coming months. There are clearly a number of not insurmountable challenges associated with delegated reporting that impact both the client and the service provider. Most of these issues relate to the transfer and population of data (be it counterparty data, collateral data, or intercompany data) and it is likely that the prevalence of these concerns is fuelling service providers' reluctance to formalise their offerings in this space.

From a practical perspective, it is important that firms understand exactly who is reporting on their behalf and what they are reporting, as they are ultimately accountable for the reports submitted In order to avoid contravening regulation, firms must ensure that any existing gaps in their reporting capability are plugged, perhaps with a manual reporting mechanism, until they have either established their own reporting capability directly or have resolved any delegated responsibility issues.

2.3 Portfolio reconciliation and escalation

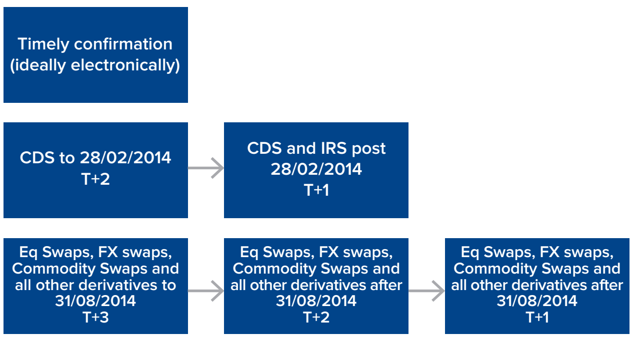
By now any portfolio reconciliation and discrepancy escalation procedures should be well established, as the EMIR business conduct rules come into effect on 13 September 2013. However, institutions with only a small number of open contracts i.e. below the thresholds for daily, weekly or quarterly reconciliation, and these are reconciled annually, then the first reconciliation would have been completed on or before 15 March 2014.

If any financial or non-financial EU institution has not yet completed a full cycle of portfolio reconciliation and / or compression and has not escalated items over five days old, then they need to formulate a plan to complete the process as soon as possible.

2.4 Trade confirmations

Interest rate swaps (IRSs) and credit default swaps (CDSs) confirmation deadlines moved to T+1 from T+2 on 28 February 2014. For all other derivatives the confirmation deadlines are currently T+2, but move to T+1 on 31 August 2014, as outlined in diagram 2. However, there are some C6i energy derivatives that fall outside of these confirmation deadlines.

Diagram 2: New confirmation deadlines overview



> "Trade and collateral linkage will be the biggest hurdle to compliance as most collateral is pledged on a portfolio basis rather than an individual trade or basket level."

Institutions should now be well on their way to implementing electronic solutions for trade confirmation where possible and clearing any backlogs. They should also have in place clear escalation procedures for any confirmations that are not agreed within five business days of the contract confirmation date.

2.5 Margin models

As with portfolio reconciliation, the valuation also needs to be reconciled, therefore there must be an agreed and demonstrated margining model in place for each contract.

Margin models will be an area that will come into focus over the coming months as the collateral reporting mandate comes into effect and central counterparties (CCPs) start to onboard OTC products that meet the clearing obligation.

3. The next big ladders to climb

The three main challenges facing firms in the coming months are collateral reporting, clearing, and product standardisation. These are formidable ladders to climb and they continue to create problems for all market participants including trade repositories, service providers and CCPs.

3.1 Collateral reporting

On 11 August 2014 the requirement to add collateral valuations to trade reports will come into effect. This poses many challenges for institutions as the valuation and collateral systems are often separate from the trading systems that the derivatives have been executed on. This means that compiling a compliant trade report will involve gathering and collating information form a number of separate systems; the trading systems and a suite of collateral valuation systems.

Trade and collateral linkage will be the biggest hurdle to compliance as most collateral is pledged on a portfolio basis rather than an individual trade or basket level, which means that the counterparty to a contract could be applying a different collateral mix or haircut to the portfolio.

Luckily the collateral valuation will not be a required matching field. However, there is much discussion around whether firms should use the pricing and haircut valuations provided by third party reporting providers, collateral custodians or their own internal valuation processes for reporting purposes.

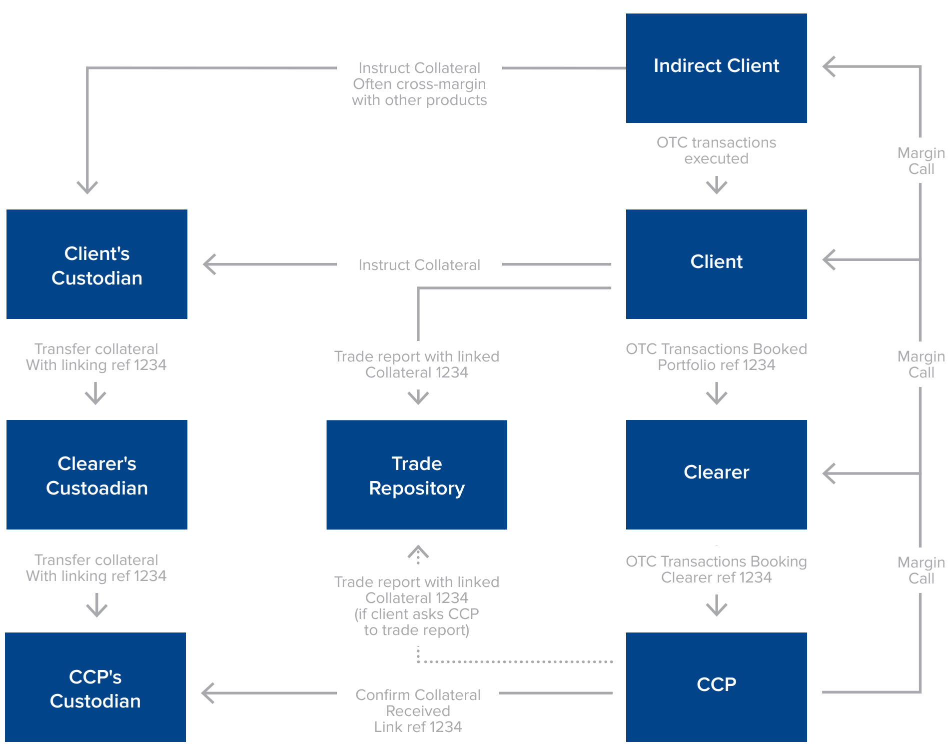
If a contract or portfolio is only collateralised with cash then it will be relatively straight forward to use a third party's valuation. If, however, there are non-cash collateral pledges then it becomes much harder for third parties to know how firms' internal risk departments would value that collateral based on internal haircuts, concentration limits and thresholds. Users of triparty collateral facilities will need to take this into account when reporting.

If a contract is centrally cleared then there is no choice to make; the valuation used is always that supplied by the CCPs, whom have very sophisticated margin models and collateral valuation models that are publicly available.

Ultimately, regardless of who is doing the collateral reporting, a process of linking the collateral to the portfolio will need to take place. The diagram below demonstrates the likely links in the chain that may be required to fulfil the collateral reporting requirement.

Diagram 3 below demonstrates the different collateral valuations provided to the trade repository from either the self-reporting client or a central counterparty.

Diagram 3: Collateral call and subsequent reporting requirements

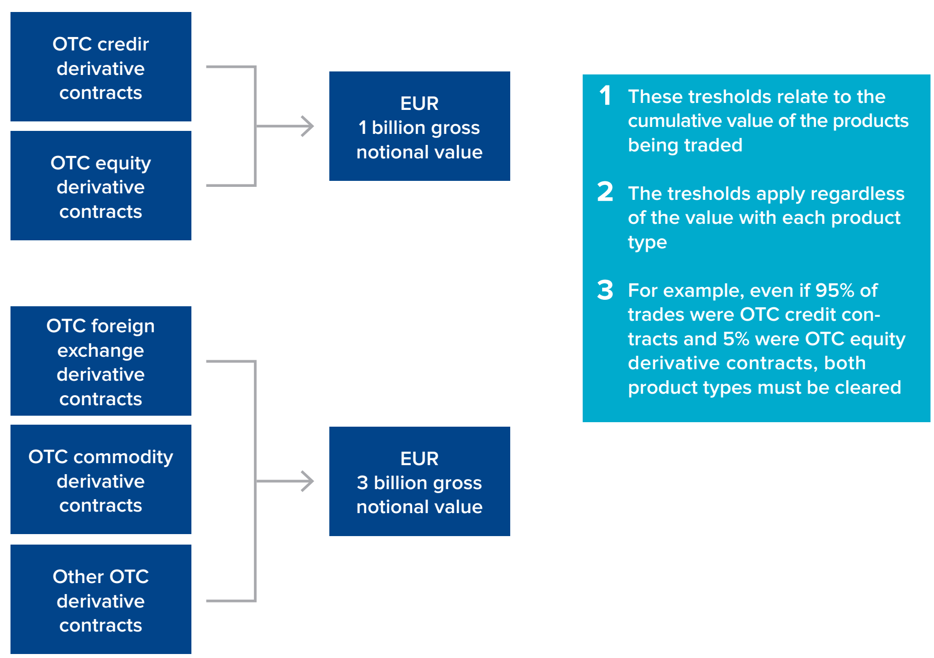


3.2 Clearing obligations

Calculating, monitoring and managing whether or not your trading volumes in a particular derivative product will push you over the mandatory clearing obligation threshold will come to the fore. However, all these mandatory thresholds will only come into effect for OTC derivatives once clearing houses have been approved for those products to clear through them.

Currently this is forecast to take place in Q1 2015 at the earliest, or at the latest Q2 2016. There are also many questions around how open contracts that were bilaterally agreed will be ‘migrated’ into the clearing model and there are two main options for doing this (see diagram 4). If a firm is trading in the products listed in the following diagram and they exceed the thresholds outlined in Euros, they will be legally obliged to clear at the CCP. For the first three years following the enactment of the EMIR legislation pension funds will remain exempt from such clearing obligations, whilst non-financial institutions will enjoy immunity for the foreseeable future.

Diagram 4: Thresholds for CCP clearing



(i) Re-paper existing contracts, placing the CCP as the counterparty to the transaction from both sides and agree new economic terms with the CCP that maintain the economic viability of the original contract. The benefits of doing this are that it would enable firms to maintain the history of contracts, be able to negotiate the terms between all parties and to keep consistency within systems.

(ii) Terminate existing contracts early and then re-execute the trade on the exchange for that newly cleared product. The benefit of this approach is that it eradicates the need to link old and new systems / contracts and generates a new ‘clean’ P&L process. The risk is that the new process becomes more ‘loss’ than ’profit’ if the price differential between the old OTC contract and the new exchange pricing is too great.

Clearing thresholds will take into account whether the OTC derivatives are concluded for hedging purposes. Those that are deemed to be reducing risks will be excluded from the clearing threshold. Clearing thresholds will be reviewed periodically.

The clearing obligation has not yet come into effect, however the ESMA RTS for Central Clearing Mandate is due September 2014 and firms could commence the Clearing Calculation game. These changes could eventually force firms to make some large and fundamental decisions around their execution behaviour.

3.3 Product standardisation

All new trade reporting mandates require that the trade is reported with a unique product identifier (UPI). There is a general desire to see the Financial products Markup Language (FpML) format used across the board for derivative products. Currently FpML supports many centrally cleared contract types and there are many more that will be developed over the next two years as the CCPs start to onboard new products for clearing.

When a new OTC derivative product is to be centrally cleared, the CCP must submit a notice to ESMA, who will then perform the necessary checks to register the CCP as a clearer of that OTC derivative product. Diagram 5 below is an in-depth flowchart which stands as a testament to the lengthy process that a CCP will have to go through in order to get ESMA to approve a product. Understandably then, products will be onboarded more slowly than anticipated.

Diagram 5: New clearing obligation notification process for CCPs to ESMA

The launching of a new OTC derivative contract for a CCP will involve extensive liaison with the trading venue; typically historical price models will be provided by the trading venue and the CCP will provide the standard portfolio analysis of risk (SPAN) or value at risk (VAR) parameters back to the venue for the calculation of liability aggregation.

Firms should be ready for an influx of new product static data either to standardise their current derivatives product codes or when new products are on-boarded for central clearing.

4. The changing rules of the game

All of the changes to how firms execute, clear, and report trades as well as how they manage their collateral will change with the full implementation of EMIR. This in turn will force change on how derivatives are traded and settled in the future, ultimately achieving the overarching goal of the European regulators; to create a more stable and transparent marketplace. We have already seen a marked change in trading behaviour since the implementation of the Dodd-Frank legislation in the US with energy swaps moving to futures. In the same way, there will be unintended consequences as well as deliberate moves by market players to position themselves in this new derivatives game.

4.1 Execution behaviour

Some market participants may decide to exit whole product groups where the economic challenges of providing increased margin may make trading strategies unviable. Firms may decide to cap the volume of trades in a particular product to keep themselves below the clearing thresholds. Creative inter group and intercompany trading may increase as they attract a degree of exception under certain circumstances, but ultimately the OTC derivative market that we see today will be more standardised and streamlined.

4.2 Service provider landscape

Service providers, such as DTCC or Unavista, have everything to play for in terms of interoperability, cost, and volume. It’s rapidly becoming clear that there is a need for increased interoperability between trade repositories. If this is not established then most participants will naturally gravitate towards the small number of providers who service the bulk of the big players. Without increased interoperability, firms choosing alternative providers would simply exacerbate the audit, data aggregation and reconciliation issues that already plague the trade reporting process.

4.3 Political impacts

Many industry forums and bodies have been pushing back on ESMA, especially on issues concerning the generation and tracking of UTIs and the cross-regional issues that come about when one party is from the EU and obligated under EMIR and the other counterparty is non-EU and can choose not to confirm or report a trade. This inability to enforce regulations on non-EU counterparties could simultaneously give them an unfair advantage and put EU participants at risk. One of the key goals of EMIR is to increase interoperability and prevent what it labels liquidity fragmentation.

5. The end game

Will this legislation become a slippery snake or the ladder to success for the OTC marketplace?

After the financial crisis of 2008, the volumes traded in derivatives reduced significantly and they have never really recovered. With the transparency, standardisation and ease of access that these reforms will bring to trading, regulators and market participants, OTC derivatives as we now know them will cease to exist and will merge into the ETD market. There will always be innovation for new OTC trading structures, but rather than them being seen as the snake of the investment banking industry, perhaps in the future they will come to be the ladder to success in enabling firms to hedge their risk and optimise their collateral without the spectre of a pricing apocalypse hanging over their heads.

i MiFID II – Annexe I Section C.6 – Definition of Financial Instruments

Featured specialists

Emily Cates

Specialist in Operational Processing

Emily joined GFT Technologies AG in June 2012, bringing with her over 18 years of experience across Securities Financing, Prime Brokerage, Equities, Fixed Income and Structured Trades. She joined from Knight Capital Europe, where she worked for 18 months as Head of London Operations. Prior to her role at Knight Capital Europe, Cates spent eight years at Dresdner Kleinwort, most recently holding the position of Global Head of Client and Cross-Products Services. She also spent six years at Credit Suisse, where she held the post of Vice President Strategic Change Management and Prime Banking.

Francis Cook

Specialist in Regulatory Compliance

Francis brings more than a decade's experience of delivering complex business and IT solutions within large corporations. Francis is a specialist in the financial regulatory space, having an in-depth knowledge of current EMIR trade reporting requirements (in Europe) and experience of solving similar regulatory challenges under Dodd-Frank (in North America). In his capacity as a technical consultant he has worked closely with GFT colleagues in application management and has also developed an ETF trading platform using Java, Oracle, and jBoss. Prior to GFT AG Technologies, Francis was a senior software engineer with BBC New Media before joining ITV as a systems architect. He is a graduate of the University of Manchester with a BSc in Computer Science.

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