



# Regulators can bear gifts

Martin Walker, head of product management for securities finance and collateral management Broadridge, discusses the benefits of embracing the opportunities created by using LEIs and UTIs

The key challenge for regulators, central banks and governments attempting to manage systematic risk in the financial system, is simply knowing what is going on. During the financial crisis, transparency was lacking in most areas of derivatives. It was also lacking in securities finance where repo transactions by money market funds were identified as a major source of instability, little understood by regulators.

The one area where regulators had a good view of what was going on was the credit derivatives market, where the vast majority of trades were already being reported to DTCC's Trade Information Warehouse (TIW). Following the 2009 G20 Summit, compulsory reporting of derivative transactions was introduced in the US by Dodd-Frank Act and in Europe by the European Market Infrastructure Regulation (EMIR). However, that desired transparency has been obscured by poor quality data.

In October last year, the Bank for International Settlements (BIS), said: "These exercises have provided evidence of systematic misreporting. This can cause significant quality problems that hamper data aggregation and analysis. In particular, despite the requirement to include a UTI agreed in advance by the two counterparties, for a substantial fraction of the trades the opposite trading position (leg) cannot be found in the reported data. As a result, the two legs of a trade cannot be paired or reconciled...the reasons include counterparties' failure to report or to agree on the common UTI, counterparties' misreporting of their own legal entity identifier (LEI)—or their counterparties' one—and the failure to properly report the closing of transactions."

Compulsory reporting of derivative transactions has been a painful process for everyone involved, not just the regulators and central banks who have put great efforts into cleaning up data, and in the process having to discard a large proportion of it. Major banks are reputed to have spent \$100 million each on implementation of new infrastructure. Not to mention the ongoing costs of supporting that infrastructure, teams dealing with ongoing operational issues and control teams providing monitoring the reporting process. These costs have placed a heavy burden on many capital markets businesses. In Europe, the securities finance market is racing to comply with the Securities Financing

Transactions Regulation (SFTR), which extends EMIR to securities finance. However, it faces some fundamental choices in both the short- and long-term regarding how it deals with the challenge. For derivatives reporting it was common to throw resources at building new systems and processes, on top of already complex operating models. Any changes not related to trade reporting were cancelled or deferred.

Generally, firms were distracted from investing in improvements to overall front-to-back infrastructure. Improvements that ironically are needed to achieve fundamental improvements in the quality of data reported. Unsurprisingly, there was little bandwidth to consider internal benefits to firms from trade reporting. After all the financial crisis revealed that at the firm level, many managers had little transparency about their own overall risks.

Two of the aspects of derivatives trade reporting under EMIR, that have created the most pain for both reporting firms and regulators are unique transaction identifiers (UTIs) and LEIs. Both are simple and rather obvious concepts. A UTI is a unique trade reference shared by both parties to a trade. This allows regulators to avoid double counting trades in the common scenario where both parties are obliged to report. It also allows regulators to check that both parties to a trade are reporting it consistently. LEIs were designed to introduce a standard worldwide code for consistently identifying legal entities involved in financial transactions.

The need to populate UTIs and LEIs have been treated by firms as, at best, an annoyance and at worst as a nightmare. As identified by the BIS, the failure to report UTIs and LEIs correctly has been a major source of trade repository reconciliation breaks and their subsequent costs. These types of problems do not just create costs in the reference data or regulatory reporting teams. When there is a break due to LEI or UTI issues, the query can bounce around the organisation, including the front and middle office until a conclusion is reached about what are really very fundamental questions. Who have we traded with and which trade are we all talking about?

The time pressures to meet derivatives, regulatory reporting deadlines made pragmatic responses

understandable. These include measures such as only enriching reporting data with LEIs at the end of the reporting process (for example, not storing them in core systems). With the deadline for SFTR rapidly approaching, the securities finance industry seems in danger of repeating many of the mistakes around UTIs and LEIs that made EMIR compliance such a painful process (pain that continues to this day).

The reality is that UTIs and LEIs are extremely good ideas. Not only are they essential to support effective regulatory reporting but they could also provide a great value for market participants. The absence of a standard global identifier for counterparties, clients and issuers of securities has been a major obstacle to the adoption of standardised counterparty reference data systems. Many firms have struggled for years to implement centralised counterparty reference data systems.

The failure to consolidate and rationalise means many firms have a multiplicity of systems. Even some of those firms that build very effective systems had to support multiple different codes for identifying clients, specific to different business functions or legal entities. Lacking a market standard, such as those defined by the International Standards Organisation for securities currencies has led to both higher costs and risks. Identification of the correct master agreement to apply to trade, the right settlement instructions and correct risk aggregation are all dependent on getting the counterparty's legal entity identified. Embracing the LEI as a standard way to identify counterparties across both internal systems/departments and the market will ultimately lead to reduced costs and risks.

Even more underappreciated than the LEI is the UTI. In the typical trade processing infrastructure, a trade may feed through multiple processing layers, some external, the others internal. At each stage including trade execution, capture, confirmation and settlement, an additional trade ID may be generated. Similarly, the counterparty will be generating their own set of trade IDs. The lack of a standard trade identifier can cause major costs in both the inter-system reconciliations between internal systems and the external matching and contract compare processes carried out between counterparties.

The inevitable breaks, which can persist for days in some scenarios are a major source of operational risk.

The establishment of a UTI, either through execution on an electronic platform or automated post-trade processes, could ultimately revolutionise many aspects of the processing of securities finance transactions. The risks and costs from breaks between counterparties rise geometrically rather than arithmetically. The older the break, typically the longer and more complicated the process to identify the cause and resolve it. If breaks are in core trade economics, it means the front office are making trading decisions based on an incorrect view of risk and profit and loss. Embracing the UTI concept in both systems and processes creates some fascinating possibilities.

If trades are "paired" rather than "matched" at the very beginning of the trade lifecycle it means any subsequent divergence between trades can be identified quickly if there is an efficient messaging layer in place between firms. This would make it possible to have a continuous real-time matching of trades. If breaks are found and resolved in near real-time it would considerably reduce costs and operational risks.

Paired trades, where there is a near real-time view of the degree of consensus between the parties' views of the trade, also create more potential for mutualised post-trade processing. If both parties are confident they share the same real-time view of trades, it is far more plausible for them to use a common system for common life-cycle activities such as marks, returns and crystallisation.

These are just some of the benefits of embracing the opportunities created by using LEIs and UTIs. The overall lesson from the EMIR is to think ahead. In the short-term take a fresh look at operating models and working out how to integrate reporting with existing post-trade processes to avoid drowning under breaks and additional manual processes. For the longer term think about how changes and innovations such as LEIs and UTIs could drive the overall improvement of infrastructure, processes and data quality.