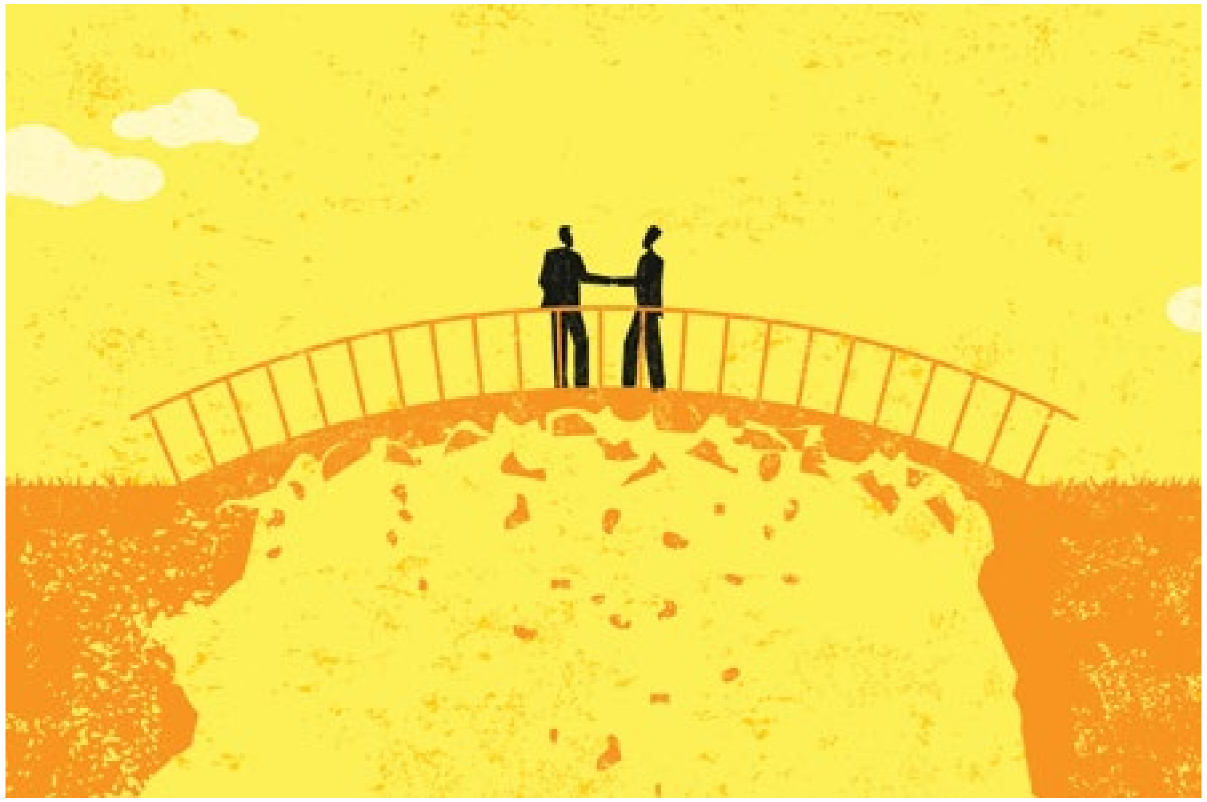
A Bridge Over Troubled Waters? Bringing derivatives under effective control

Hugh Daly, CEO of Message Automation, outlines his company's philosophy for helping clients achieve harmonisation and control of Post Trade derivatives operations in a pragmatic, efficient and effective manner.

by HUGH **DALY**



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The infrastructure required to support the full breadth of the post-trade lifecycle for derivatives, both internally and externally, is increasingly complex and fragmented. It continues to be very difficult for senior management to gain a holistic view of trade flows, breaks, root causes and the general health of the organisation's derivatives operations. The potentially enormous regulatory spend and the need to invest to address these internal control issues is making derivatives trading unprofitable and bordering on the impossible for some.

Regulation with limited harmonisation- a recipe for disaster?

Whatever the intent of the recommendations from the Pittsburgh G20 summit in 2009, the outcome has often been described as a 'Tsunami' of regulatory and market practice changes which continue to flood participants with information flows in, out and across the organisation. Many people (including Message Automation in our 2014 'Hell freezes Over' paper) have been arguing for some time that the fragmentation caused by these changes, and the way they have been implemented is actually increasing operational risk, which clearly was not the G20's intent. However, there is no sign of the pace of change abating anytime soon, and with very little evidence of the market coming together to jointly simplify or harmonise the impact of these changes, it is now clear that any serious market participant must adopt a truly strategic and flexible operational and technology approach, to have any chance of efficiently managing their derivatives processes. Living with ever-changing controls has to become 'business as usual'

Re-defining the 'Regulatory Tsunami'

The "regulatory tsunami" analogy has been around for some time. In reality the true definition of a tsunami is a catastrophic one-time event which undoubtedly leaves a trail of destruction in its wake, and then is gone, rarely ever to return. Perhaps, now it is time to challenge the accuracy of that comparison. Back when the proposed regulatory changes to support the Pittsburgh G20 were initially defined they appeared to share some of the characteristics of a one-time tidal wave – the sheer scale of the disruption followed by the seemingly unstoppable nature of the legislative forces flooding in behind. However, with 20/20 hindsight it is now clear that was simply not the case. The regularity of new regulations related to Derivatives trading and processing is actually much more akin to the series of hurricanes which hit the U.S Eastern Seaboard every year, rather than a one off Tsunami and firms need to plan accordingly

Hurricanes occur a number of times each year, with varying degrees of severity, and the harsh reality for all financial firms is that the volume of regulatory directives being unleashed is unlikely to subside for some time. You may get lucky and dodge a few of them, but sooner or later, you will suffer the full force. Being ahead of the game in building appropriate solutions for this environment will give market participants a real edge in both management information and cost-control.

The names of some of these regulatory "hurricanes" are very well known, and each needs a big budget: Dodd Frank, Volcker, EMIR, MiFID II, and Basel III each have multiple aspects; and the buy side will know and love UCITS V, UCITS VI, and AIFMD

Don't be fooled by periods of quiet, or seemingly little or no activity, in this current climate, it should always be viewed as the calm before the next storm. So for anyone who thinks the worst is over, think again. And just like the perennial hurricane, there is still plenty more to come before the G20 principles have been turned into established and accepted market behaviour.

Table 1: Known, major changes over the next two years addressing G20 principles

Market Visibility	Trade Reporting	• EMIR L2 • MiFID2 Reporting • SEC • Switzerland, South Africa Trade Reporting • Resulting changes from European Commission Industry Consultation on EMIR • ECB Money Market reporting • Securities Financing Trade Reporting (SFTR)
Price Transparency	Platform Trading	• Made Available to Trade (mandatory SEF trading) • OTF approvals
	Market Abuse	MiFID II / Market Abuse Directive
Counterparty Risk	OTC Clearing	• ESMA mandatory clearing (available to clear) • Buy-side mandatory clearing • CPMI-IOSCO Public Quantitative Disclosure by CCPs
	Collateral	• IOSCO-BCBS exchange of collateral on bi-lateral trades • FSB reporting requirements on CCP Risk

So where have we got to? - G20 Principles mid-term report card

Subject: Trade Reporting

Having overcome some of the onerous initial hurdles, a few more mountains still remain to be climbed. For example, further G20 jurisdictions such as Switzerland and South Africa are coming, and the tightening of existing requirements such as EMIR Level 2 validation, and CFTC expiry of no-action-reliefs.

With regard to the jurisdictions that already have a "tick in the box", especially EMIR, anecdotal evidence suggests that data quality of existing submissions is still mediocre at best. I single out EMIR for two key reasons: The dual reporting obligation and the fragmen-

Table 2: Post Trade Control - Objectives

Operational cost reduction	Increased confidence in regulatory compliance
Increased automation of post trade processing	Early warning through holistic lifecycle event monitoring
Efficiency in exception management	Root cause analysis and KPIs
Improvement in internal data quality	Operational risk reduction

tation of the trade population across repositories. The first high profile fines levied by regulators under the original MiFID transaction reporting regime only became public early in 2015, many years after the original implementation (or transgression?). Reputational damage aside, the dollar value of the fine is typically dwarfed by the cost of the data remediation. Sometimes this can mean that several years of historical data has to be re-analysed and re-reported, a major undertaking - with zero revenue benefit.

We strongly believe that unless radical action is taken to clean up data sent to the trade repositories, there will be more hefty fines coming down the line. It will be the regulators minimum expectation that an organisation reconcile its books and records to the reported population. A full audit trail is needed for what has been reported, and equally what has deliberately not been reported and why.

Subject: OTC Clearing

Take up of OTC derivatives clearing has been patchy to say the least, but there is some success to report.

Inter-dealer clearing of interest rate swaps has allowed over USD 300 trillion of compression to be successfully processed by Tri-optima and LCH Swapclear. This is exactly the sort of result those derivatives 'experts' in the G20 were hoping for.

In credit derivatives, for index swaps (CDX) ISDA statistics show 78% of total notional was cleared during 2015. Back in 2009, given the choice, the G20 might have elected to ban credit derivatives altogether, citing them as the worst of the financial weapons of mass destruction. But they didn't, and interestingly trade volumes are holding up, and have even shown a small increase over 2014.

A consequence of this increase, however, is the number of different reports from the CCP's and/or their brokers that have to be consumed by banks and buy-side. A typical global bank has over 300 such reports, all in different formats delivered in a variety of protocols which need to be distributed and acted upon by a large and varied population of internal users. Achieving control and harmony in such an environment is challenging to say the least, and will of course be exacerbated by the forthcoming mandatory clearing and collateral velocity initiatives.

Subject: Client Clearing

In its end of term report to the regulators, the industry will be marked down on client clearing. In part this is due to the interminable delays in the deadline for the introduction of mandatory client clearing. Without a mandatory imperative the buy side and smaller players are reluctant to devote much energy to on-boarding and adopting a cleared model. Unless of course it is free, and yet again therein lies the problem.

Even though un-cleared pricing will become considerably worse than for equivalent cleared instruments, for those participants with low volumes, they are likely to simply "suck it up". The cost (actual, legal and operational) of on-boarding with a clearing broker may not be worth it. From the clearing broker side, it is almost certainly not worth it. Allocating guaranteed credit availability against sporadic requirements is poor use of capital. The universe of brokers offering client clearing services has not grown as anticipated and in fact there have been some high profile withdrawals from the business. This has led to talk of "self-clearing" with all the unresolved issues and further fragmentation this gives rise to.

Subject: Platform Trading

The move to electronic execution on multi-dealer platforms is happening, but some 2,200 days on, this has not gone as quickly as was envisaged by our aforementioned friends in Pittsburgh. Again the U.S. has lead the way, and the CFTC is now finally publishing the Made Available to Trade characteristics. This has had an impact on single dealer platforms. It also has a substantial regulatory overhead for the traditional inter-dealer broker model if they wish to register as a SEF. The changes will certainly have an impact on the operations model of many organisations creating still more control and harmonisation challenges.

And what's still to come? - G20 principles – seven years on, a way still to go.

It is clear that a combination of these 'new' initiatives and the many other areas that are far from complete as noted in the mid-term report above means that we are faced with years of uncertainty, shifting timelines, unclear regulations and budgetary pressure. Pretty much the same as the last year five years.

So it's all doom and gloom, what's the solution? – Post Trade Control

Considering all of the above, Message Automation's philosophy is based upon the premise that financial organisations need to take ownership of post-trade derivatives control. They must expect more regulation without any accompanying industry harmonisation as business as usual. This means building an infrastructure capable of withstanding the 'hurricanes' without making the business financially unsustainable.

Post Trade Control-Principles

- Single extensible harmonised data model covering cross asset class trade economics, lifecycle events, and regulatory requirements.
- Independence from rigid technical infrastructures, operational methodologies, and legacy solutions.
- Source system agnostic; Market middleware agnostic
- Industry role agnostic (CCP, clearing broker, service provider, administrator, client)
- Support diverse business models / participant roles to co-exist in a single solution
- Common solution across as wide a range of products as possible: OTC, Listed, Cash
- Common solution across cleared / un-cleared, direct / indirect clearing etc.
- Incremental adoption enabling quick wins and rapid ROI without a big bang approach.
- Ability to integrate with new internal source systems or external parties (CCPs; GTRs etc) in weeks.
- Ability to add internal and external data sources, parts of the lifecycle, and further products, over time without upgrades or regression

- Act as a facilitator, not a hurdle, for future on-boarding to best-of-breed processes delivered by external providers as a service
- Provide and maintain industry standard solutions wherever possible
- Provide a consistent holistic view of status from inside and outside the organisation

Delivering on these Objectives and Principles

Harmonise the Data

Implement a consolidated derivatives lifecycle data model to provide a harmonised representation across multiple workflows, from affirmation connectivity to trade reporting to inbound clearing data. The model will need to describe the full trade economics, across asset classes, and complex post trade events.

Use industry standard solutions wherever possible

Using the data model as a base, build single connectivity to each of the relevant market utilities across all key aspects of post trade flows: affirmation, clearing, trade and transaction reporting, plus inbound collateral and margin information. Removing connectivity to and from each silo within the organisation and replacing it with a single consolidated solution is key. Where possible use standard vendor solutions effectively 'sharing the cost' of these standard solutions and importantly, sharing the burden of change whenever the regulators update the rules.

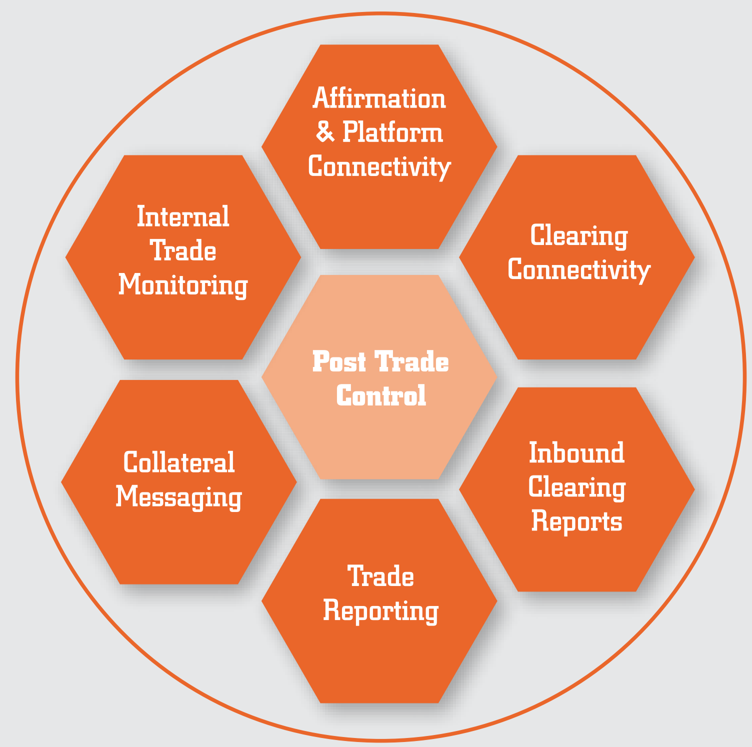
Make the results visible and highlight the exceptions

By persisting the harmonised data model in a database it is possible to achieve a trade-centric view of post trade flows across the entire lifecycle down to detailed message flow level. Issues from around the organisation that are aggregated into the Post Trade Control solution can include trade reporting failures, clearing rejections or limit breaks, margin differences, confirmation mismatches, settlement breaks, affirmation differences and many more.

Taking this further it becomes feasible to reconcile against external trade populations such as trade repositories and clearing houses. In addition reconciliation results from existing platforms (internal or external) can be included to provide the broadest view of the trade. The ability to see trade processing breaks across multiple parts of the organisation naturally leads to significant savings in operational break resolution effort.

Sounds Ambitious?

Message Automations philosophy has been proven at Tier 1 and 2 banks and buy-side organisations. Please contact us if you would like to know more.



Control Framework:
- Strategic messaging layer
- Trade lifecycle tracked
- Harmonised internal data standard
- Operations human workflow
- Rigorous data integrity
- Matching inside world to outside

Delivers:
- Control
- Efficiency
- Agility
- Transparency