RECONCILIATION

DERIVATIVES TRADE REPORTING IN PRACTICE: MANAGING THE OPERATIONAL IMPACT OF EMIR
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A new era for derivatives operations

The global financial crisis of 2008 revealed an urgent need to improve the transparency and risk management practices of the over-the-counter (OTC) derivatives market, worth around $500 trillion in notional value. As a result, in 2009, the G20 summit passed a resolution stating that:

In line with this resolution, the U.S. and Europe, the two biggest markets for OTC derivatives, passed the Dodd-Frank Act and the European Markets Infrastructure Regulation (EMIR) respectively. As well as mandating the central clearing of standard OTC contracts, both regulations require derivatives counterparties to report trading activity to an approved trade repository. Singapore, Australia and Japan have now also approved similar rules.

For the global derivatives market, the new reporting obligations represent a major operational challenge. With the EMIR requirement now in effect, this paper aims to highlight the potential impact of trade repository reporting on a counterparty’s day-to-day, back- and middle-office processes, beyond the reporting requirement itself. It also provides practical advice on steps organizations can take to minimize the risk of reporting incorrect trade data, and adapt their operations to better manage regulatory change.

EMIR comes into effect

What is EMIR?

Five years on from the G20 summit of 2009, EMIR essentially translates world leaders’ high-level decisions about the derivatives market into European regulation. In general terms, it has the same intent as the U.S.’s Dodd-Frank Act: to mitigate systemic risk and increase transparency. However, the specific requirements of the two regulations vary – in particular, the individual segregation mandate is specific to EMIR only.

Who does EMIR affect?

In terms of organizations, EMIR applies to all buy-side and sell-side firms involved in derivatives trades, defined as any bilateral or exchange-traded transaction between two counterparties. These include financial institutions such as investment banks, brokers and institutional asset managers, and non-financial corporations that trade derivatives. Geographically, the regulation affects any entity that was established in the EU or is trading either with an EU entity or on a European exchange.

How will EMIR affect your organization?

Sell-side institutions

EMIR will affect sell-side financial institutions such as investment banks and brokers in a number of different ways. As well as reporting all derivatives trades to a registered repository, they must clear standard OTC contracts at a CCP. Should their customers request it, they will also need to maintain individually segregated accounts at the CCP, for both their OTC and ETD investments.

Buy-side institutions and corporations

Buy-side financial institutions, and non-financial corporations that trade derivatives, have the same obligation as the sell side to report their OTC and ETD trades to a repository. They must also make sure they keep an accurate record of the Unique Trade Identifier (UTI) that must now be attached to each trade.

In addition to reporting under EMIR, buy-side institutions, both financial and non-financial, must have formalized, robust and auditable portfolio reconciliation processes. That means matching their own data on portfolio positions against their broker’s statements. While portfolio reconciliation is itself a long-established practice, EMIR has introduced tighter guidelines on how to manage the process and, in particular, disputes between the buy side and brokers.

All standardized OTC derivatives contracts should be traded on the exchanges or via electronic trading platforms, where appropriate, and cleared through central counterparties (CCPs) by end of 2012 at the latest.
Trade reporting under EMIR

Of all the provisions set out within Dodd-Frank, EMIR and equivalent regulations around the world, the new trade reporting requirements are among the most stringent and challenging for the derivatives market to date. Failure to report trading activity, as mandated, will result in both financial and reputational penalties for the counterparties concerned.

What is the scope of EMIR trade reporting?
Like Dodd-Frank, EMIR requires derivatives counterparties to report all OTC derivatives to an approved trade repository, whether they were cleared centrally or traded on a bilateral basis. This rule applies across all OTC asset classes, including foreign exchange, rates, credit, equity and commodity contracts.

EMIR’s requirements, however, go a step further by also applying to exchange traded derivatives (ETDs) – mandating the reporting of both individual ETD trades and end-of-day ETD positions. What is more, while Dodd-Frank demands that only one counterparty reports on a bilateral derivatives trade, EMIR states that both counterparties to a trade are responsible for reporting it.

It is likely that most buy-side firms will ask a third party – i.e. their broker – to manage reporting duties on their behalf. However, it is still ultimately their responsibility to provide compliant data for the regulator, and consistently ensure the broker’s reporting data matches their own records of derivatives trades.

What must be reported?
For all the trades and counterparties concerned, the following information must now be reported under EMIR:

- Parties to the contract
- Type of contract
- Maturity
- Notional value
- Price
- Settlement date

Additionally, financial institutions, plus non-financial institutions with nominal exposure above certain thresholds, will need to report exposures no more than six months after their first report of a trade. These include:

- Mark-to-market or mark-to-model valuations
- Collateral value

The trade reporting landscape – who are EMIR’s main players?
Under EMIR, trade reporting is regulated by the European Securities and Markets Authority (ESMA), set up by the European Commission in 2011. Counterparties, however, will not report trades directly to ESMA itself but to any one of a select number of ESMA-approved trade repositories. Launched by private companies – including existing exchanges – as a commercial service, these new market entities are competing for custom not only on price but also by offering additional services (such as matching) to counterparties.

The trade repositories registered to date by ESMA are:

- DTCC Derivatives Repository Ltd. (DDRL)
- Krajowy Depozyt Papierów Wartosciowych S.A. (KDPW)
- Regis-TR S.A.
- UnaVista Ltd.
- CME Trade Repository Ltd. (CME TR)
- ICE Trade Vault Europe Ltd. (ICE TVEL)
The role of reconciliation in trade reporting

For both counterparties to a derivatives trade, ESMA-approved trade repositories will effectively correspond to a third “golden source” of data for trade records alongside their own. With the reporting obligations in place, it will be imperative to verify that the trade repository’s record of each deal is complete: showing the same trade as the counterparties concerned. The record must also be accurate: making sure the material terms of the deal are the same at the repository and in both counterparties’ records.

The key to ensuring accuracy and completeness and minimizing the risk of discrepancies is reconciliation. By reconciling their books and records against those held at the trade repository, counterparties can validate their data and guarantee they have collated and reported their trading activity correctly. This will, however, require them to make a number of further adaptations to their existing reconciliation environment.

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Reconciliation and exception management checklist

To extend their reconciliation operations to encompass trade repository reporting under EMIR, derivatives counterparties must consider and add the following new processes to their reconciliation and exception management framework.

1 Reconciliation between the source system and the trade repository

In their own books and records, counterparties must identify the trades that are reportable to the trade repository and check the positions against those held at the repository at the end of the day. The aim will be to verify that the two sets of records are complete (containing the same list of trades) – and accurate, showing the same details of the trade on both sides.

From a technical perspective, this reconciliation makes sure that the reporting process is working correctly for a firm. The journey that the reported data must make from counterparty to repository is not straightforward: along the way it will be enriched with further static and counterparty information, reformatted and then, finally, transmitted to and accepted by the repository’s own system. Each step of this complex enrichment and translation process has the potential for error or failure, making technical checks imperative.

An example of where the reporting stream may falter is with the use of a Legal Entity Identifier (LEI) to identify the counterparty. A firm’s own LEI might not actually be stored by its source system – which may use an internal account number instead – and is likely to be added further down the line. Alternatively, only one of the two counterparties to the trade might have registered for an LEI. A firm’s reconciliation tool will therefore need an intelligent means of translating and matching identifiers.

It may also be that, even when a trade is reported correctly initially, certain details change later on. So, a process must be in place to report any alterations to a reported trade and update the details on the repository side.
2 Exception processing
As part of the reporting process, the repository will need to feed back on the reporting of each trade. If no problems are identified, it will accept the report with an acknowledgement message. If there’s an issue, such as with the way a jurisdiction is defined, it may still accept the report but with a warning acknowledgement. However, the repository may also reject a report outright when, for example, it is provided in an incorrect format – by sending a negative acknowledgement (NAK).

Whatever message the repository generates for each report, the counterparty’s system requires a way to consume and manage them. While not part of the trade matching process per se, warning acknowledgements and NAKs will need to be treated as breaks. Firms must therefore plan exception management processes to efficiently deal with and resolve them as part of their day-to-day operations.

3 Matching between counterparty reports by the trade repository
In contrast to Dodd-Frank, EMIR requires both counterparties to a trade to report its details to a repository. As part of its service, a repository may offer to perform basic matching on a firm’s behalf between the two counterparty reports: checking for accuracy and completeness, and either pairing up the details successfully or identifying breaks.

As a result, the repository will not only send a list of all positions reported by the firm, but also notification of any discrepancies between the firm’s own reports and those made by its trade counterparties.

If a repository is performing this kind of service, the firm will, again, need robust processes to consume and process the output – and, above all, manage and resolve any resulting exceptions. Part of this exception management process could involve matching the repository’s exceptions with a firm’s own internal books and records, in particular records of trades for which no UTI has been allocated yet.

It is to be noted that, as multiple trade repositories exist, it is likely that some of a firm’s counterparties will report their trade activity to another repository. The operational process would therefore need to handle mismatches not only between firm and counterparty records within the same repository, but also between repositories as well.

4 UTI processing
According to the rules of EMIR, every derivatives trade must now have its own UTI. This UTI will be shared by both counterparties and also help the trade repository match counterparty reports, as previously described.

In practice, the introduction of UTIs presents a further opportunity for exceptions to occur. For example, one or both of the counterparties to a trade may have allocated the wrong UTI, or failed to assign a UTI at all.

As part of their operational checklist, firms will therefore also need to consider how to manage such scenarios. This may involve looking beyond the UTI and reconciling trades on the basis of other key material terms, such as the counterparties, the rate and the notional amount. These criteria can be used to pair trades successfully and propose potential UTIs.
Conclusion: prepare for continued operational change

As organizations strive to comply with EMIR’s trade reporting regulation, many will be yet to consider the full impact of reporting on their operational environment. However, as this paper has demonstrated, the initial reporting requirement will give rise to a number of further processing challenges, beyond reporting itself.

In a time of great regulatory change for the derivatives market, these challenges should not be underestimated. Their effective management will require a broad range of expertise in regulation, reporting, operations and the market itself – underlining the growing complexity of achieving regulatory compliance. Time is of the essence; and as new requirements continue to be enforced, derivatives investors must ask themselves if they are adequately prepared to meet them on an operational level.

FIS can help

To manage the operational impact of EMIR, and prepare for market change, turn to FIS’ IntelliMatch Operational Control. A comprehensive platform for enterprise reconciliation and exception management, FIS’ IntelliMatch Operational Control solution suite enables financial institutions to manage market change by:

- Ensuring connectivity to a fast-changing market infrastructure.
- Increasing efficiency for lower operational costs.
- Reducing risk to manage regulation and market volatility.
About FIS’ IntelliMatch Operational Control solution suite

FIS’ IntelliMatch Operational Control provides organizations with a comprehensive reconciliation solution for data collection, rules processing, automated matching, exception management and reporting, helping them manage derivatives market change. The suite of solutions enables firms to ensure connectivity to a fast-changing market infrastructure, increase efficiency for lower operational costs, and reduce risk to manage regulation and market volatility.

About FIS

FIS is a global leader in financial services technology, with a focus on retail and institutional banking, payments, asset and wealth management, risk and compliance, consulting and outsourcing solutions. Through the depth and breadth of our solutions portfolio, global capabilities and domain expertise, FIS serves more than 20,000 clients in over 130 countries. Headquartered in Jacksonville, Florida, FIS employs more than 55,000 people worldwide and holds leadership positions in payment processing, financial software and banking solutions. Providing software, services and outsourcing of the technology that empowers the financial world, FIS is a Fortune 500 company and is a member of Standard & Poor’s 500® Index. For more information about FIS, visit www.fisglobal.com