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FFI'S EXPERIENCES FROM THE INITIAL STEPS OF DERIVATIVES REPORTING

Background

On 12 February 2014, the reporting obligation of derivative contracts entered into force as dictated by the European Market Infrastructure Regulation (EMIR, EU 648/2012). Derivative contracts will now be reported into specific trade repositories. The obligation is unusually wide in scope, as it concerns all companies using derivatives, regardless of their size, field of business, types of derivatives, or the sizes of contracts.

Start-up problems are clearly evident

The Federation of Finnish Financial Services (FFI) has collected feedback from its members regarding the initial month of the reporting process. FFI proposes that this feedback is taken into account when the reported data is examined, and that the start-up issues are tolerated as understandable and human, instead of systemic, as long as is required.

FFI supports increased market transparency

Throughout the process, FFI has supported the reporting obligation of derivatives, which would improve market transparency. However, certain details and tight schedules have increased burden for companies and made interpretation of legislation more difficult without good reason. We hope that this is used as a learning opportunity when new reporting obligations are drafted (such as the SFTR-proposal for example) and when EMIR is eventually reviewed.

Interpreting EU regulation is not easy

When it comes to comprehensive, large-scale pieces of EU regulation, EMIR is one of the first that will not only be directly implemented in the member states, but also involves extensive regulation on lower levels. Handling it requires exceptionally high judicial competence and resources that may not be readily available, especially in smaller companies.

Due to the regulatory nature of EMIR, government proposals and other law drafting material do not have their usual standing as interpretation guidelines in the implementation process. Regulatory authority is now with the EU and the instructions come mainly from EU supervisors rather than the national supervisory authorities. FFI is aware that the FSAs cannot give guidelines on the interpretation of EMIR and lower-level EU regulation, but all assistance has been received with gratitude.

We can nevertheless state that all in all, Finland and the other Nordic countries are well prepared for the reporting and strive to comply with it as well as possible.

First month of reporting did not yield convincing experiences

Eye must be kept on the trade repositories

FFI member companies report to the two largest trade repositories: DTCC and Regis-TR. Some report to one of the two while some report to both. Regardless of the company's size and main field of business, the reporting of all contracts or some specific contracts has been outsourced to the counterparty, which in this case is usually a large international bank.

There have been reported difficulties in joining a trade repository. Occasionally, for instance, the repository has alleged that no joining application had been made. In some of the worst cases the connection was only established on the previous night before the obligation entered into force.

FFI has previously discussed the equality of access to the repositories. Applications should not be treated with unreasonable inequality, but it seems that companies have unfortunately still experienced prioritisation.

Hiccups in acknowledgement of receipt and matching

FFI members and Finnish companies are well prepared for the reporting, and will carry out their part of the process. However, in many cases the trade repositories have not sent an acknowledgement of a received report. Some outsourced reporting service providers cannot provide their customers with lists of reported trades and their details.

Matching between contracting parties in different trade repositories barely functions at all. According to some estimates, repositories are unable to match up to 60% of the contracts reported to them. One cause for these problems are different practices in different repositories, such as the use of upper and lower case letters, or the way these get mixed in the repositories' own reporting practices.

The matching requirement stems from the fact that EMIR requires both parties of the contract to report. In the name of free competition, each party can choose which repository to use, and therefore the two legs of the transaction have to be matched. This two-way reporting obligation is one of the largest challenges in the reporting process. Even outsourced reporting basically has to be done twice. This results in matching problems, and we therefore think it is worth considering if just one joint report would be enough to satisfy the reporting obligation.

Different identifiers carry problems, but PRH worked efficiently

An international Legal Entity Identifier (LEI) is required in the reporting of derivatives. Finland decided to establish a distributor for LEIs, and the task was well-suited for the Finnish Patent and Registration Office (PRH). Initiation of the distribution took time due to reasons innately related to the legislative process, but once the distribution began, PRH was quick and efficient in giving out LEIs.

The day before the reporting, European Securities and Markets Authority (ESMA) gave instructions for example on how a unique trade identifier (UTI) should be made. Unfortunately, these instructions deviated from the logic originally developed by ISDA, which is widely used in the market. The lateness of the instructions was also unreasonable. This should be avoided in the future; when interpretation notes are given to participants, they must come well in advance so that they can be taken into account in the development of IT systems.

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The way trade data and details of a single product are registered can vary between registers. A swap contract can be pointed out as an example; in DTCC the trade data and trade details are reported separately on their own lines, whereas in Regis-TR, one combined line suffices. These kinds of differences are likely the main reason why matching between different registers does not work as expected.

The definition of derivatives continues to cause interpretation difficulties. Many companies are still pondering which of their contracts need to be reported. With this in mind, when the time comes to examine the definition of derivatives during the revision of MiFID, we encourage the Commission to be as precise as possible in its analysis and regulation. When new regulation is drafted in the future, such questions that closely pertain to its scope of application should not remain open after its entry into force.

Backloading and reporting of exchange-traded derivatives add unnecessary burden

The requirement to backload trades has raised many questions. Backloading will cause expenses from the collection of data as well as from e.g. the acquisition of a LEI. The timeline from the regulation’s entry into force to the beginning of the reporting obligation is so long that the volume of contracts is huge. Reporting has proceeded fairly well in practice, but because of the cost effect, we nevertheless suggest that similar undertakings are avoided in the future, or at least that the backloading requirements would only apply to contracts that are in force at the time. Such specification would not increase systemic risk. FFI believes that the reporting of intragroup derivative contracts does not have effect in terms of systemic risk, either, and that it would be sensible to remove the obligation to restrain the growing reporting costs.

The reporting of exchange-traded derivatives has been subject of much discussion throughout the legislative process. The requirement is difficult to find in the relevant regulation (which concerns OTC derivatives) and differs from the objective set at G20 level. In practice the reporting of exchange-traded derivatives has proceeded fairly well, and is usually outsourced. However, data must be collected from several separate sources, which causes additional administrative burden – and therefore costs – for the companies. Because many non-financial and small-in-size financial companies only use exchange-traded derivatives, removing the requirement would have spared them from the reporting and the acquisition of the LEI. Expansions such as this, which place European companies at an unfair disadvantage, should be avoided in the future.

The reporting process is incomplete while the markets are not

Based on the above, the total reporting process can be considered incomplete. What came somewhat as a surprise is that the largest reporting challenges are linked to the contracts made with large investment banks, whereas reporting with corporate and smaller counterparties goes without problems. Yet these easily reported contracts involve disproportionate reporting costs and an administrative burden, due to which many companies operate on very small resources entirely against regulatory requirements. It would therefore be extremely important to follow the principle of proportionality in the reporting obligations.

FFI will keep a close eye on the information published based on the reports, and the subsequent conclusions. It should be noted that the information may be disorganized due to the incompleteness of the reporting process. Majority of the issues are related only to the reporting techniques, and therefore the information should not be taken to reflect the market situation. Similarly, successful reporting of small transactions should not be treated as a signal of a well-directed wide reporting obligation, but rather as a sign that information on these contracts will not have a significant impact on the big picture.