The changing landscape

With the securities finance industry about to go through possibly the largest round of regulatory driven change, David Field of The Field Effect discusses how it will affect the market

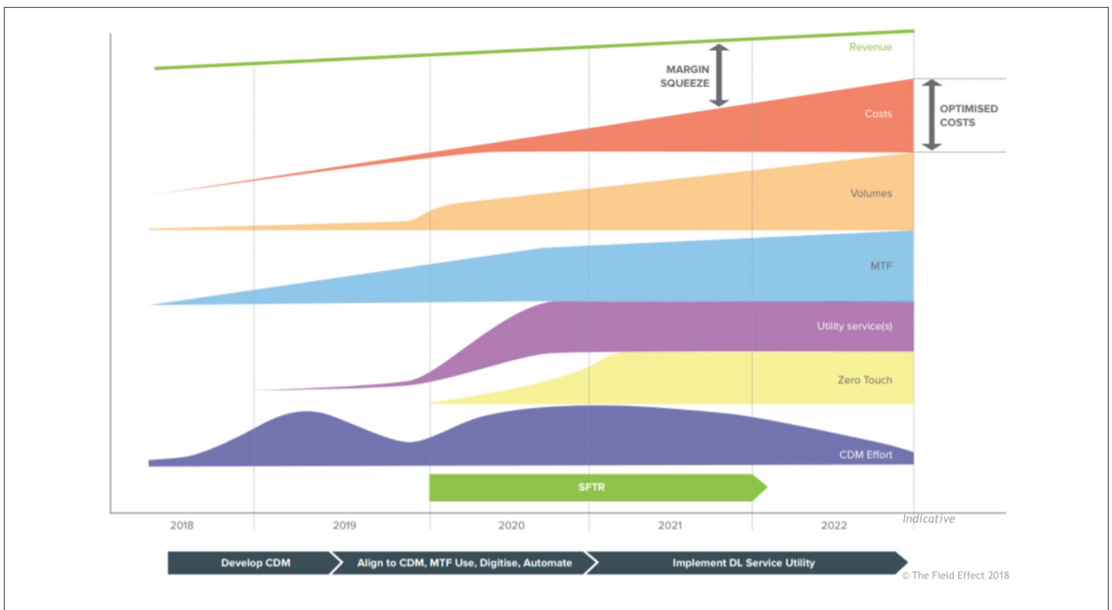
Securities finance is not immune to the changing forces seen within financial services, particularly those around regulation, technology, competition and shifting demands.

The industry is about to go through its latest, and arguably the largest round of regulatory driven change in the shape of the European Union's Securities Financing Transactions Regulation (SFTR) reporting requirements—the EU's implementation of the Financial Stability Boards (FSBs) transparency requirements in securities finance. With other jurisdictions starting to consult on implementing the FSB requirements, this is expected to, in some form, rollout to the G20 over time.

At The Field Effect, we've looked at some of the challenges ahead, and how the industry will evolve to deal with these. Are you ready for them?

The margin squeeze

Although margin erosion isn't a new phenomenon, we expect this to accelerate as firms absorb the costs of regulatory compliance, and struggle to deal with the increasing costs of servicing legacy technology. SFTR, along with Brexit, brings new pressures on a firm's business model. Aside from significant compliance implementation costs, firms are facing increasing running costs through



additional trade repository and vendor charges, and new regulatory reporting processes and controls. These, alongside an explosion in reporting volumes (versus booking volumes)—firstly to deal with beneficial owner disclosure and multiple reportable events on trades, and secondly to counter the margin squeeze by increasing volumes to deal with lower margins—will produce a perfect storm. Factor in Brexit bringing in new teams to support local EU activity and back-to-back trading with existing entities—it will all add to the cost pressure.

In our opinion, the industry simply isn't efficient enough to support everyone in the future. Currently, there are too many participants in the value chain, and this is likely to be exacerbated with SFTR, increased clearing activity, new trading platforms and technology providers.

This will lead to firms assessing the viability of their securities financing business and increased competition amongst industry players to capture flow—itself feeding back into the margin pressure. Of course, firms will look to pass on some, if not all of this cost to their clients—and the impacts on clients will be similar. They are also likely to look for alternative lower cost solutions or reduce/stop their securities finance activity.

Dealing with the squeeze

Firms should be adapting their business models now in anticipation of the introduction of SFTR, but most are not. Inevitably, inertia, resistance to change and the desire to maintain the status quo prevail. Firms that adapt and change their business models early will help delay the onset of any pain that is experienced in the industry. However, many firms aren't adapting quickly enough, and the changes being made may help buy time, but delay the inevitable.

So, what should firms be doing to deal with these future challenges and how will technology play a part in the industry?

There are still too many manual touch points in securities finance, often exacerbated by legacy technology platforms—some of which date from the early 1990's. However, the cost of replacing that technology is often prohibitive. The budgetary hurdle will only increase as time goes by, making it harder for firms to justify the cost of replacing systems when profits themselves are reducing and competition increasing.

Forward-thinking firms are looking at the use of zero-touch processing. This goes beyond straight-through processing (STP) and includes the pre and post-trade client engagement—with fully automated order management, trading, life-cycle events processing and exception handling. Clearly, this will have benefits in an SFTR and CSDR world but will take time to implement and is not supported by current systems functionally and industry best practices. Robotics will help with some of the strain in automating processes in current platforms, but while this is relatively quick it's not a sustainable fix to the problem.

The start of zero-touch is in the use of multilateral trading facilities (MTFs) and/or exchanges to automate trade processing. Firms, driven by the second Markets in Financial Instruments Directive (MiFID II) best execution have already made headway with this, and its expected to increase further in the build-up to SFTR going live. While this is increasing, there has often been slow uptake - driven by two factors. Firstly, incentivisation within the front office and secondly, opportunity. The first can be tackled by the individual firm's incentive models. Ask yourself—where an MTF is available, why isn't 100 percent of the relevant trading activity done on it? This is often because of behaviour within the front office and firms should look at how they structure teams and incentivise them to change this. The second will be driven by the relevant platforms that clients demand—is it a liquidity issue or functionality, and can this be tackled bilaterally or at an industry level to support the development and use of platforms? We've seen regulators push for more exchange trading of products in the derivatives world, and securities finance won't be an exception to this and will likely be a focus post-SFTR go live.

As firms grapple with zero touch and MTF use, reporting volumes will be huge compared to current trade booking volumes—we estimate that this will be at least 500 percent greater—driven by beneficial owner bookings of agent lending trades, and life-cycle events creating multiple reports per trade. Firms currently struggle to deal with the volumes that they have, and contract

comparison focused on risk and economic fields—unlike transaction-based reconciliation with very low tolerances as prescribed by SFTR. Reviewing these volumes and the expected breaks against your current processes will help you identify where issues are likely to occur and remediation to these processes should be prioritised, including any necessary automation and additional controls needed to deal with them.

Firms will also need to be more closely aligned with industry best practices. Alignment to industry best practices across the industry is at best, inconsistent. Ideally, firms will adapt their processes to the industry best practices, but again driven by current operating limitations and technology, they are often looking to report to these standards rather than fix the problem at source. For example, some firms book repo rolls by amending the maturity date, others by terminating and booking a new trade.

The industry standard is clear, and the reportable events required for SFTR purposes will be defined. Where booking processes differ, there will be a break at the TR and the firm with the incorrect process will either need to align to the industry best practice or create the correct reportable event and manage that going forward. Delaying process alignment is likely to cause process reworking and reporting enhancements post-SFTR go-live.

The definition of industry best practices differs greatly between the industry bodies and isn't always reflected in legal documentation, so firms often see it as a 'nice to have' rather than being legally defined and enforceable. This coupled with the use of legacy technology makes change very difficult at a firm level, and this is going to manifest itself in challenges around transaction reporting process automation. As an added incentive, the Bank of England requires firms to, voluntarily, sign up for the Money Market Code of best practices—these are reasonable prescriptive and refer to industry best practices too.

They have just published a list of firms that have signed up to the code—although it is telling who has not—a significant proportion of the volume passing through the market each day has currently not signed up.

Aligning the best practices to legal documentation would be beneficial, although this creates less flexibility. We advocate the use of a common domain model (CDM) across the securities finance industry incorporating securities borrowing and lending (SBL), repo, margin lending and collateral in a consolidated CDM model.

This has two benefits, a clear definition across the industry of best practices that firms can work towards implementing and a standard on which to build on and take advantage of new technology platforms—such as cloud and distributed ledgers, which will in turn help with the adoption of zero-touch processing and deliver significantly lower costs.

This will take a coordinated effort across the industry and we believe should be done across the product. Clearly there is a great deal that firms should be doing themselves, however, much of the industry would benefit from sharing technology and building towards a utility model, which in turn should help manage the costs associated with implementing new platforms and technologies.

In our opinion, the industry should be preparing for these changes now, with a view to firms developing transition plans towards 2020 and beyond.

This planning should include scenario analysis, a target operating model and a roadmap to achieve the future state with the aim of achieving the optimised costs available to help maintain profitability. **SLT**

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