CAPCO

EMIR REFIT:
GETTING TECHNICAL

Speed Read

In this paper we provide our industry insights to the imminent changes due to impact EMIR reporting under the new technical standards, for the reporting of OTC Derivatives under Regulation (EU) 2019/834 (EMIR REFIT), as well as the key challenges and considerations for investment firms in preparation.

The benefit of mandatory delegated reporting may in the end be minimal due to the on-going need for smaller firms to report exchange-based activity and provide the required data to the reporting firm. However, it is a welcome step.

The EMIR REFIT standards are likely to require material work to implement and the response by ESMA regarding use of ISO20022 standards and Critical Data Element Methodology will be key.

Firms should start to consider their approach to implementation (across data, technology, people, and processing) from Q1 2021 given this requirement will be due in Q3 2022.

BACKGROUND

The European Securities and Markets Authority (ESMA) has an ongoing commitment in relation to the regulation of financial markets in the EU. ESMA's Regulatory Fitness and Performance (REFIT) Programme was introduced to help deliver on this commitment to improve Implementing Technical Standards (ITS) for the reporting of derivatives and the registration of Trade Repositories and improve the Regulatory Technical Standards (RTS) for the reconciliation, validation, and provision of data by Trade Repositories.

REFIT impacts financial services firms and trade repositories (TRs) that have an obligation to report OTC Derivatives, specifically the reporting of data, the reconciliation and validation of critical data elements (CDE), data access by competent authorities and the registration of TRs.

The outcome of the ESMA review determined that, although no fundamental changes were required, it did identify necessary improvements to technical standards, as well disproportionate and overly complex rules and requirements being placed on Non-Financial Counterparties (NFC), small Financial Counterparties, as well as some pension funds.

MANDATORY DELEGATED REPORTING

The first significant change under the REFIT programme was implemented on the 18th June 2020. On this date Financial Counterparties (FCs) became liable for the reporting of OTC derivatives contracts for both themselves and their Non-Financial Counterparties (NFC) under mandatory delegated reporting.

The obligation for FCs to report for Non-Financial Counterparties that do not breach the clearing threshold (€1-3 billion notional depending on asset class) was introduced with the main objective of reducing the compliance burden to be more proportionate for small financial services firms that have an obligation to report OTC Derivatives under EMIR regulations.

APPLICATION OF MANDATORY RULES

Overall, the benefit of this for NFCs can be seen to be outweighed by the additional burden placed on FCs, particularly as NFCs will still be required to report any exchange traded derivatives (ETDs) obligated under EMIR. This means that the benefit of these changes may be minimal, given these firms would have to maintain their current infrastructure to report exchange traded products.

The Futures Industry Association (FIA), the industry body for derivatives clearing, has lobbied ESMA to this effect. As currently drafted, the regulatory text is likely to lead to an inconsistent application of the rules. Applying the mandatory reporting obligations to Futures and Options executed on a non-equivalent 3rd country exchange will result in FCs being required to report a subset of their ETD business on behalf of NFC. Furthermore, inconsistent interpretation of the rules will increase the potential for misreporting and enhance the burden faced by NFC-counterparties where, depending on their reading of the text, certain FCs will take action to report some, or all ETD contracts on behalf of their NFC while others will deem this activity to be out of scope.

The NFC still has the obligation to provide the FC with all relevant data to facilitate the reporting. Where this is not forthcoming it impedes the FC from fulfilling the mandatory reporting responsibilities. Additional complexity arises where there are bilateral agreements between FCs and NFCs to agree the reporting obligations at a more granular level. For example, an FC reports OTC Credit Derivatives, but the NFC continues to report OTC Equity Derivatives, which are not universally supported by all FCs.

THRESHOLD CHALLENGES

Furthermore, the clearing threshold obligation can change for firms who trade OTCs. NFCs can move above or below this threshold depending on exposure to the market, changing the obligation to report. It is also worth noting that even though there is now a mandatory obligation for FCs to report, the NFC may choose to continue to report on their own behalf.

This also impacts the porting requirements where the NFC has the obligation to notify the FC of a change in clearing threshold and initiate the migration of all its live contracts from its nominated TR to that of the FC. Challenges have been experienced by both parties where the porting procedures are not well established at the repositories where they have adopted differing interpretations of how to implement the porting process.

EMIR TECHNICAL STANDARDS

The next significant change under the REFIT programme, the implementation of the ESMA technical standards, is currently at the final consultation stage. The Commission communicated the draft proposal via the REFIT consultation paper in March 2020. These changes are again specific to the reporting of OTC Derivatives.

That was followed by a Q&A phase, where impacted investment firms and associations were given the opportunity to respond to the draft proposals, and relay back any concerns or recommendations on the final implementation requirements of the technical standards.

ESMA are due to produce the finalized technical standard in Q1 2021. Following this firms are likely to be given a minimum period of 18 months to implement the technical specifications of these requirements. This will be dependent on reporting format and eligibility rules being fully defined, which in turn will allow firms to commence internal development of the technical build.

As REFIT now considers responses to the Q&A phase and the feedback from impacted firms, repositories and relevant trade associations, the industry – although broadly supportive – will be apprehensive to the impact on trade reporting, data quality and data access. The industry will welcome improvements to the accuracy and completeness of trade reporting. However firms will also be considering the significant cost, scalability and internal burden that come with these changes, whilst also looking to ensure compliance with further industry wide regulatory change, such as CFTC Dodd Frank rule reforms (which are likely to share implementation timelines).

KEY CONSIDERATIONS – IMPACT LEVEL HIGH/MEDIUM/LOW

Below we have listed some key considerations from the consultation on the Reporting Technical Standards, Data Quality, and the impact to in scope Financial Services firms and Trade Repositories (TRs).

KEY

Focus item: Key firm consideration for refit technical standards with high potential impact

No impact: Not expected to be a mandated change requirement of refit

Key project milestone item: Expected firm reporting impact under the new technical standard

DATA PROVISIONING	EMIR IMPACT
Critical Data Elements (CDE) The industry will welcome the recommendation and intention to adopt the Critical Data Elements (CDE) methodology across all reporting for EMIR. The recommendation from competent authorities is that this data standard must be consistently applied and should not diverge in any way from the principals of adopting this approach for all firms. REFIT has provided numerous updates to the data requirements for reportable fields. It is important that the final output fully clarifies the mandated approach of CDE in a manner that supports the reconciliation and matching of data across all counterparties and TRs. ESMA is expected to adopt the CDE approach and this is a key consideration for all reporting firms.	High
ISO 20022 reporting format To address a consistent approach to data standards and formats for all firms and trade repositories, ESMA is proposing that the industry adopt a uniform harmonised approach to trade submissions. The mandated proposal on the consultation paper is that all OTC Derivatives contracts be submitted in XML format under an ISO 20022 standardized template methodology. Creating all reporting in this structured XML format could present disproportionate costs and operational burdens across the industry. Trade associations have highlighted significant potential impact to firms if this format is adopted with significant costs to implement. ISO 20022 is a general industry standard; however, it does not immediately translate to a universal single use message across domains. Data elements can have multiple definitions across regimes depending on the firms reporting obligations globally and the user build architecture implemented by individual member firms. ISO 20022 is likely to be the standard adopted for REFIT and could add additional complexity and burden to implementing the technical standards.	High

DATA PROVISIONING	EMIR IMPACT
ISDA Common Data Model (CDM)	Low

The International Swaps and Derivatives Association (ISDA) have raised concerns over the intention of ESMA to adopt the ISO20022 technical data standards, citing the burden this will place on firms as well as inconsistencies that would arise from adopting this standard. It should be stated that the Securities Finance Transaction Reporting (SFTR) was successfully delivered under this data standard.

They have proposed the CDM as a more appropriate mechanism for the reporting under EMIR. CDM follows a standardised method for electronic reporting and is compatible with ISO 20022 as well as other ISO standards. It has the capability and functionality to report under multiple message formats and has been created by comparing best practices across trade repositories and the global reporting landscape. It also has the capability to interpret reporting rules and data points, enabling consistent interpretation of eligibility and reporting rules.

ISDA have engaged ESMA on the possibility of this being adopted as an alternative reporting solution to the technical standards. The publication of the final response from ESMA will confirm the approach for impacted firms. Either way, this will be a key requirement for EMIR reporting, with significant impact to in scope financial counterparties.

Although this would present added complexity for impacted firms. The likelihood is that the CDM will not be the standard approach from ESMA.

TRADE REPOSITORY IMPACT	EMIR IMPACT
FCA Divergence for UK reporting	High

The FCA requirement for EMIR reporting post Brexit does broadly follow the reporting requirements of all EU member firms, however expect some divergence in the validation rules, in addition to the impact to the reporting for internal company entities. The FCA have advised that their expectation is that UK reporting will follow the same timelines as ESMA, however the original technical standards are still under FCA review with their guidelines scheduled to be published in February 2021.

The recently introduced UK Financial Services Bill underlines the likelihood of some divergence in the FCA approach. This bill, introduced by the UK government in October, has an aim of promoting financial stability and enhanced reporting standards for the UK financial market, as well as a culture that promotes openness and transparency. The Bill has already stipulated that EMIR REFIT will improve data quality for all trade repositories in the UK capital market and make the switching of trade repository providers more accessible.

The divergence of reporting for the FCA post Brexit will have a significant impact to EMIR REFIT with additional complexity expected at field level.

Back Reporting	Medium

It is expected that ESMA will require the re-reporting of live trades in line with the new technical standards that REFIT will deliver. Competent authorities are likely to request a grace period of at least 6 months for the re-reporting of any live positions opened prior to go-live of REFIT and that no supervisory actions are taken by National Competent Authorities (NCAs) against firms within that grace period for any impacted trades.

Firms will have a reasonable timescale to report live trades and with appropriate readiness planning should have low impact.

INDUSTRY REPORTING CONSIDERATIONS	EMIR IMPACT
Upfront Info provided by NFC The ESMA consultation states that NFC- will be required to provide data for some fields on a trade by trade basis. This is highly likely to be onerous for both the FC and NFC- and potential unfeasible due to the operational impact. To reduce the operational cost and streamline this requirement, some trade organisations are recommending that standard values of common data are agreed up from between counterparties to the trade and any amendments to this would be advised directly by the NFC-. The impact will depend on the final ESMA response and the operational impact could be significant to firms.	High
Action type As part of REFIT ESMA have taken the opportunity to amend and increase the use of Action Type and introduce Event Types. Whilst again this is widely welcomed, further clarification is required on their practical use for trade reporting. For instance, Collateral has been introduced where the use of the existing action type of Modify would generally suffice for reporting changes to collateral portfolio indicator or code. Termination action type also required further clarification, as this has different usage across the various global reporting regimes. Revive action type has also been introduced to reopen previously terminated positions, this may provide a standard approach to this event, however ESMA need to clarify the impact to other action types such as collateral, modify or correct and what impact this would have when submitted on a terminated position. It is likely that some worked examples from ESMA on all action type scenarios will be required to fully clarify the approach impacted firms should adopt as they build out the new reporting infrastructure internally. The introduction of event type and without worked examples means this remains a risk. Incorrect Action Type logic would result in a high volume of rejections for the TRs.	High
Reconciliations There will be a significant increase to reconciliation and matching of data between counterparties. A high proportion of these fields will be transactional data, which, in theory should be agreed up front by both counterparties to the trade, making the additional level of matching somewhat negated. For some reconcilable fields there may also be no requirement to report a value for that particular asset class, instrument, or event. In some instances, the tolerance levels also need to be reviewed to allow the possibility of matching reportable fields. Some firms and competent authorities are recommending that there is flexibility on reconciliation of data within the technical standard, rather than it being mandated. Also, that the regulator considers the potential systemic risk across the industry, a main contributor to the 2008 financial crisis and subsequent implementation of stricter regulations such as EMIR, rather than broad field level reconciliation that will be onerous to implement. With appropriate collaboration across the industry and robust adherence to internal controls this should be low risk	Medium
Unique Product Identifier (UPI) The recommendation from ESMA is that this new identifier for products will be reported in addition to the current requirement to report ISIN or CFI depending on product type. However, the reporting of UPI may negate the need for the additional reporting, although ISIN is likely to remain in scope for ETD at instrument level, the UPI may provide sufficient product information to allow it to be the only source required for OTC. The CFI code would highly likely be a duplication of the information provided for the UPI. UPI is a confirmed requirement from ESMA and should be a manageable risk for impacted firms	Medium
Legal Entity Identifier (LEI) The responsibility for maintaining the LEI needs to be clarified by the final ESMA response. where the NFC- has delegated reporting of OTC Derivatives to the FC, then in instances where the LEI of the delegated counterparty has lapsed, the FC may incur reporting rejections from the TR. Without visibility of LEI status for counterparties, the FC will be exposed to reporting risk. Clarification is required on the ownership of LEI maintenance to avoid any reporting issues. Robust LEI maintenance and clarification from ESMA on minor audit points should allow firms to implement appropriate control over this requirement.	Medium

CONCLUSION

The success of EMIR REFIT technical standards will be underpinned by the quality of data. The adoption of Critical Data Element (CDE) methodology, and the decision on whether the ISO 20022 message schema will be mandated, are likely to be critical factors in its success – and the key determinant of the approach of impacted firms.

Already concerns have been raised around how these can be adopted and whether they should be the solution for EMIR standardisation. These decisions will also have a significant bearing on counterparty and repository reconciliation and matching of fields.

Regardless of the final requirements, there is likely to be a high cost to impacted firms, substantial strategic & tactical delivery work to achieve compliance, and business readiness, necessary to deliver these changes across an already congested regulatory marketplace.

The final ESMA reveal on the technical standards is scheduled to be dispersed to the market in Q1 2021, bringing clarification to impacted firms and providing full disclosure on the mandated approach.

KEY DATES

- Initial consultation paper: 26th March 2020 ✓
- Industry response to consultation: 19th June 2020 ✓
- ESMA REFIT final technical standards: expected Jan 2021
- FCA guidance on impact to UK reporting: Feb 2021
- Implementation of EMIR technical standards: anticipated q2/q3 2022

WHAT STEPS SHOULD FINANCIAL INSTITUTIONS TAKE TO PREPARE?

Given the substantial change work required to meet the new technical standards, we recommend investment firms may want to undertake some of the following in preparation:

PREPARATION RECOMMENDATIONS	EMIR IMPACT
FCA divergence Most firms will have finalized their approach to UK EMIR reporting in anticipation of Brexit on January 1st, 2021. The FCA have stated that they will provide their own guidance on the impact of the new technical standards. It is highly likely that, at least at field level, there will be some divergence on reporting requirements. What should firms do – Consider additional budget requirements and timeline to build in the additional scope of work whilst considering opportunities for data efficiency	**High**
Implementation planning Consider the resource requirements and existing internal capability to deliver this strategic project over the expected 18-month timeline. Additionally, we recommend reviewing existing data analytics and tooling available to provide a robust and efficient delivery model. What should firms do – Review lessons learned from previous implementations and consider approaches such as a managed service model. Ensure change working groups are in place and engaging with compliance teams to keep up to date with current industry updates.	**High**
Current v Future state report level analysis Review current reporting and eligibility rules for EMIR and compare to the initial draft of the new rules. Consider current internal data models across all reporting jurisdictions and assess any potential reuse of data to allow efficiency savings. What should firms do – Perform traceability analysis from current reporting model to assess any gaps, risks, or dependencies ahead of the final consultation paper.	**High**
Current v Future state report level analysis Review current reporting and eligibility rules for EMIR and compare to the initial draft of the new rules. Consider current internal data models across all reporting jurisdictions and assess any potential reuse of data to allow efficiency savings. What should firms do – Perform traceability analysis from current reporting model to assess any gaps, risks, or dependencies ahead of the final consultation paper.	**High**
Data quality Consider the implications to the firms existing data policy and quality standards with the implementations of ISO 20022 and the introduction of new EMIR reporting fields. • Does the firm currently have adequate data standards in place to meet reporting obligations? • What technical changes would be required between front office and downstream reporting systems to accommodate the increase in reportable fields or to deliver an XML encoded format? What should firms do – review current data policy internally and the accuracy of current regulatory reporting submissions.	**High**

PREPARATION RECOMMENDATIONS	EMIR IMPACT
Engaging counterparties The success in sharing of common data between counterparties is likely to be a critical step in meeting the reporting obligations, as is the ongoing responsibility to maintain the LEI. There are many critical elements that support successful pairing and matching of data. Early and ongoing engagement between counterparties on how they interpretate the technical standards and reporting fields should ultimately be beneficial to support a successful go-live. What should firms do – Engaging with counterparties across industry forums and working groups.	**Medium**
Re-reporting of open positions In line with the implementation of previous EMIR regulatory change, it is fully expected that all open positions with an obligation to report under EMIR will have to be re-submitted under the new technical standards. Historically, a six-month grace period has been granted for the re-reporting of transactions, however failure to successfully back report can have substantial impact to firms. There have many instances where regulatory bodies have taken an uncompromising approach where there has been a failure to accurately report. What should firms do – Ensuring project implementation planning considers the impact and resource requirements for this post go-live.	**Medium**
Internal Controls The increase in the number of reportable fields will impact existing internal pre-submission controls, as well as how data is reconciled between upstream systems and external counterparties. Enhancements to internal controls are likely to be in comparable in scale to the field level requirements. What should firms do - Review current internal control frameworks and perform gap analysis against new EMIR trade level requirements. Consider lessons learned from SFTR go-live.	**Medium**
Wider regulatory reform Ilt is highly likely that the delivery timeline for the EMIR technical standards will be around q2 2022. In a heavily regulated market, this will mean that other American regimes particularly, Dodd Frank, SEC and other mandatory regulations will be in scope. Global financial institutions will have to consider how this impacts discretionary projects, as well as the potential for a significant incremental increase to deliver multiple regulatory change projects. What should firms do – Review current global regulatory impact and book of work for 2021 onwards and consider where discretionary projects align to overall priorities as well as wider firm initiatives.	**Low**

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ABOUT CAPCO

Capco is a global technology and management consultancy dedicated to the financial services industry. Our professionals combine innovative thinking with unrivalled industry knowledge to offer our clients consulting expertise, complex technology and package integration, transformation delivery, and managed services, to move their organizations forward.

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