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A price to pay for change and progress

Jonathan Adams of Delta Capita questions whether SFTR will ultimately deliver more efficiency and transparency to the securities finance market

When the first Securities Financing Transactions Regulation regulatory technical standard (RTS) was released to market participants for consultation, it was met with dubious distain. Of the 153 fields, few could imagine how it would be possible to report more than 30 fields. Settlement matching had been on dates, security identifiers, counterparty information and economic terms.

The reporting complexity for the securities finance industry is set to trump other transaction reporting regimes despite the fact that those already live regimes had suffered poor matching statistics, resulting in multiple participants being burdened with significant remediation programmes.

From a processing perspective, a stock loan with the participation of multiple principals, currently treated as a single transaction, will have to be treated as multiple transactions with each of those principal's participation to the trade treated as individual transactions with separate trade identifiers. This essentially mandates point-of-trade disclosure. This will disrupt the existing post-trade Agent Lender Disclosure of Principal (ALDOP) regime with its deadline of one day after settlement.

It begs the question, how can a reporting regime of this complexity, fraught with the risk of matching failure, serve the regulator in determining the potential for systemic failure? Moreover, how can it benefit market participants?

The penny drops

With the finalisation of the RTS market participants in discussion with the industry's trade associations, vendors and consultancies quickly came to the realisation that the immense challenges were not going to be solved by the individual efforts of firms working in isolation; it would require the collaboration of all participants irrespective of their role in the securities finance 'food chain'. And so, a journey of discovery was embarked upon.

The fallout is significant. Within seemingly identical businesses, firms' varying approaches to lifecycle event processing will be a showstopper in a transaction reporting context.

Even when two firms employ the same technology vendor solution, there is sufficient flexibility to approach lifecycle events differently. For example, one firm may treat a lifecycle event as an amendment to a transaction (retaining the original trade identifier) whereas another may close the transaction and create a new transaction (creating a new trade identifier). In a reporting context, trades that matched on day one will no longer match after a lifecycle event.

Solving for this challenge requires an industry-wide consistent approach.

Today's world

The roles of the types of institution in the securities finance 'food chain' to a large extent have remained unchanged irrespective of jurisdiction. The bulk of the supply is provided by the beneficial owners many of which lend via their global custodian. There are significant exceptions, some beneficial owners with their own lending programmes and some beneficial owners participating in third-party lending programmes, either via another custodian lender or via a dedicating third-party lending provider. Whether directly or via a lending programme, stock is lent to broker dealers and prime brokers. Prime brokers on-lend to hedge funds. Lending platforms and other intermediaries (voice broking still exists) serve the prime brokers and broker dealers; there is no disintermediation.

There are two reasons why this is the case. Credit disintermediation by prime brokers serves to protect the beneficial owners. Secondly, it has usually not made economic sense for beneficial owners to invest in the technology and expertise required to run their own programmes. Income from securities lending is still considered as discretionary, non-core and more effective when pooled in custodian lending programmes with flexible product and collateral options.

Prior to the financial crisis of 2008, the function of a highly effective settlement was a source of competitive advantage over a less efficient counterparty. For example, knowing that there was a good chance that a counterparty would fail to deliver provided the borrower with the use of the cash collateral, punitive charges for failing and the arrangement of a temporary borrow.

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However, the overall impact was chaotic with settlement bottlenecks impacting heavily on market liquidity, so eventually tools such as contract comparison became available to reduce settlement failures. It reinforced that the direction of travel for the securities finance market (as with markets in general) had to be innovation to reduce friction. This had been achieved where markets are on-exchange and clear via central counterparties because clearing processes require process standardisation driven by the central counterparty.

However, bilateral over-the-counter (OTC) activity, such as securities lending, remains largely unchanged despite the availability of lending platforms and clearing solutions. The technology that supports the industry has evolved to support new products and new jurisdictions, but industry participants adopt the changes with varying levels of sophistication. Over time, each firm has addressed the evolutionary changes individually, hence a variety of approaches to solve for the same change.

To sum up, despite the emergence of trading platforms the bilateral securities finance 'food chain', business process and technology have remained largely unchanged for decades and the absence of industry-wide standardisation has held back the uptake, development and investment in the next generation technology and cost reducing innovation. Until the SFTR regulation, with competition for resources, cost controls and the burden of other regulation, industry participants have had to focus on 'keeping the lights on'. Where firms have invested in newer enterprise technology, implementations have sometimes been lengthy and costly, making it difficult to realise the cost benefits of the investment, reducing the incentive for other firms to invest in wholesale change, giving tactical improvements to the front office experience.

Unintended—but highly desirable—consequences of SFTR?

The unintended consequence of SFTR insistence on so much more data being matched is that the industry has no option but to improve data quality and adopt a far greater level of standardisation through industry collaboration.

SFTR indirectly forces the digitisation of data that in some cases remains undigitised (for example, legal agreements) and elimination of manual task and processes. It also forces the standardisation of data in order for it to match at the trade repository. Therefore, every element of transaction data has to be available digitally.

More generally, even when budgets and resources are constrained, it forces investment in streamlining industry processes.

Unlike other traded products represented by a single trade association, the securities finance industry is served by multiple trade associations—the International Securities Lending Association, the European Repo and Collateral Council and the Association for Financial Markets in Europe, not forgetting the Risk Management Association, Pan Asia Securities Lending Association, South African Securities Lending Association and Canadian Securities Lending Association. In solving for the common challenges that have emerged as a result of SFTR regulation, these associations have consulted one another and collaborated.

It has precipitated the emergence of the first securities finance industry consortium where banks have collaborated to agree approaches to common issues and an industry-wide SFTR test strategy, with test packs and expected results.

Perhaps a little late for the SFTR compliance deadline, the industry (at the association level) is collectively investigating a common domain model for securities finance. This will form the foundations of next-generation technology, eventually setting the course for the adoption of distributed ledger technology. It will reduce the time, cost and risk of developing, integrating and implementing new technology, paving the way for rapid innovation.

The industry is on a journey to solve challenges collectively, collaborating on common complex process challenges to reduce cost (individually and collectively), which will improve efficiency of the marketplace overall.

This journey will over time disrupt the securities finance ecosystem enabling sophisticated beneficial owners to lend low margined supply directly to large end-user firms. Prime brokers will perform a facilitation or agency role, disintermediating themselves from a credit perspective, reducing expensive balance sheet usage. The industry landscape will change and may bring greater success to emerging platforms and trading venues.

While the SFTR regulation may appear to be a business burden, it will be the catalyst for change across the securities finance industry as whole. The full digitisation of all elements of the data and resulting improved data quality will smooth the path for greater innovation, automation and cost reduction and precipitate fresh approaches to a business that in places has come dangerously close to being unprofitable.

Call to action

It appears, that however positive, there is always a price to pay for change and progress. The securities finance industry has traditionally been a very relationship-based industry and its eventual streamlining will diminish that benefit. Moreover, it will change the business model for the supply side of the business and transparency will cause some beneficial owners to lend securities in jurisdictions that have not yet been impacted by SFTR or retreat altogether.

The industry is on a journey to solve challenges collectively

The industry as a whole needs to develop metrics on the impact to asset liquidity if certain types of beneficial withdraw from lending. More generally, firms that operate pooled lending programmes will need to develop strategies and infrastructure to re-incentivise beneficial owners to participate in lending. Those firms that are essentially conduits for end users will also need to develop strategies to deliver and capture business value in the medium to long term ecosystem. After all, infrastructure plumbing services may prove to be temporary if distributed ledger technology is the direction of travel.