Commercial Feature

Preparing for next stage in derivatives reporting

Sandy Broderick, chief executive of DTCC's global trade repository business, explores the key steps to achieving regulatory compliance with European Market Infrastructure Regulation and warns of imminent deadlines ahead

Sandy Broderick's responsibilities at the Depository Trust & Clearing Corporation (DTCC) include leading overall derivatives global post-trade processing and trade reporting services

Three months after derivatives reporting became mandatory in Europe, corporates have made significant strides in meeting their reporting requirements. However, notwithstanding the progress made around the "big bang" of February 2014, a large part of the corporate market is yet to attain compliance with European Market Infrastructure Regulation (EMIR).

Reporting of derivatives trades to European trade repositories, a key requirement under EMIR, began in February 2014.

The implementation of derivatives reporting was an unprecedented undertaking for a number of reasons, which can be grouped into two categories. First, European regulation mandated that reporting for all five derivatives asset classes, both for over-the-counter as well as exchange-traded derivatives, began on a single day. Second, unlike regulations promoted in other derivatives markets, EMIR captured the widest numbers of entities – brokers, fund managers and corporates.

This meant corporates, which had previously been largely exempted from reporting regulations developed in response to the global financial crisis, found themselves for the first time with an obligation to report their derivatives trades.

Many large corporates started making provisions for compliance with derivatives reporting under EMIR immediately after the European Securities and Markets Authority authorised the first trade repositories on November 7, 2013, among them the Depository Trust & Clearing Corporation's Derivatives Repository Limited (DDRL). From the date the trade repository authorisations came into effect, corporates had 90 days to comply with the initial EMIR reporting deadline of February 12, 2014, which required reporting of derivatives transactions entered into on or after August 16, 2012.

A number of corporates managed to successfully start reporting their derivatives to trade repositories. Others assumed their dealer counterparties would report on their behalf and, when this did not materialise, found themselves with an ever-tighter deadline for compliance. However, a significant portion of the market, in the main consisting of smaller non-financial corporates, is still unaware of the reporting obligations.

UP TO A MILLION EUROPEAN CORPORATES

Estimates of the number of European corporates that use derivatives and therefore have a reporting obligation, range from 500,000 to a million. However, the number of legal entity identifiers – a key requirement for regulatory compliance – issued to date is still relatively small compared to the size of the market, which would imply that a large part of the market is still not compliant.

In the majority of cases, lack of compliance is unintentional. While larger corporates have sophisticated corporate treasury functions which keep abreast of regulations, at the smaller end of the scale, many corporates may enter into derivatives transactions (for example, when they buy a currency forward) without knowing that these transactions fall within the scope of the regulation.

For corporates that have not yet made any provisions for complying with derivatives reporting, there are a number of steps which they need to undertake. First, identify whether their banks will report their trades on their behalf. If this is not the case, they need to identify the trade repository they will report to directly. Second, they need to determine with their bank counterparty who will ultimately be responsible for generating the unique transaction identifier required for trade reporting reconciliation. Third, they need to decide their reporting method and lastly, they need to identify the information which falls within the scope of regulation.

FUTURE DEADLINES: BACKLOADING, COLLATERAL AND VALUATION

For corporates that have already complied with the initial February 12 deadline, there are a number of additional deadlines which they need to prepare for.

First is the backloading of historic derivatives trades. EMIR mandates that derivative transactions, which are outstanding on the reporting start-date and were also outstanding on August 16, 2012, must be reported on or before May 13, 2014. While the majority of large corporates have completed this process ahead of the deadline, smaller corporates are in the early stages of, or are yet to even begin, backloading this data. Given the historic reach of the regulation, a key challenge for these corporates will be to locate the data that needs to be reported.

Valuation of derivatives trades will begin on August 11, 2014 for financial companies and those non-financial users of derivatives whose unhedged positions exceed the clearing threshold. Given the multitude of valuation methods that exist today, as a trade repository we are actively consulting with the industry to establish which valuation methods they intend to use. DTCC will be accepting valuation given by banks, the firms themselves or a valuation given by a central counterparty. The issue of valuation is increasingly important as any discrepancy in valuation above a certain threshold may become subject to regulatory fines, so for corporates, agreeing valuation parameters with their counterparties will be key to ensuring future compliance.

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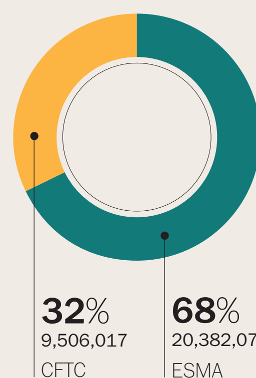
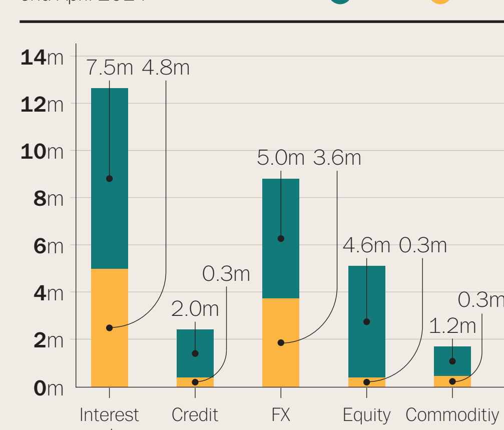
DERIVATIVES OPEN POSITIONS REPORTED TO DTCC'S GLOBAL TRADE REPOSITORY





Information about collateral associated with derivatives trades will also need to be reported to trade repositories, as well as collateral changes on an ongoing basis thereafter by those firms reporting valuations. Pending definition of regulatory standards regarding collateral reporting, from August 11, 2014, compliance will for now consist of reporting the underlying collateral for each trade.

DATA QUALITY AND ENFORCEMENT

While national regulators have shown some sympathy about the challenge of compliance with EMIR, corporates need to be prepared for an imminent roll-out of enforcement rules. The German Federal Financial Supervisory Authority has warned German firms that the auditors would not be permitted to sign off their accounts if they did not comply with derivatives reporting. Other regulators may follow suit, so preparation is key, not only in meeting reporting requirements, but also in ensuring that the information submitted is accurate. Last but not least, compliance has a direct impact on corporate risk management, given that compliance with derivatives regulation is key to ensuring corporates can continue to use derivatives to hedge currency risk.

Corporates have made significant strides in meeting EMIR reporting requirements under a compressed timeframe. The path ahead won't be without challenges and, as the regulatory roadmap becomes clearer, we see the compliance window is getting narrower. Swift action is required to achieve long-term compliance.

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