THE RISING COST OF TRADE REPORTING:
can firms afford to stay compliant?

Now that most G20 member states have mandated trade reporting of derivatives, market participants have an opportunity to evaluate the agility and sustainability of their current approach. In this article, ***Randall Orbon, Arun Karur*** *and* ***Cian Ó Braonáin*** *discuss the state of trade reporting and show how growing costs, complexity and regulatory scrutiny are fueling a compelling business case for third-party managed solutions.*

To address the trade reporting requirements outlined in Dodd-Frank and EMIR, many organizations made significant investments in internal systems. Now additional regulations and further enhancements—including MiFID II/MiFIR and requirements in other regions—are poised to effect more change. In addition, it is likely that regulators will begin to scrutinize data and organizations will need ways to create assurance and paths to remediation for trades that are self-reported or reported on their behalf. With many of the systems currently implemented there is no clear path to efficient tracking, reconciliation and remediation of trade data. The time is right for firms to reevaluate the ongoing business-as-usual outlay for trade reporting and determine whether or not the cost for compliance will be sustainable into the future. More specifically, firms may benefit from exploring how to:

- cost-effectively maintain their reporting system(s)
- improve their ability to remain 100% compliant
- ensure their current system(s) are enhancing overall reporting capabilities
- afford the expansion or adaptation of their system(s) to meet emerging requirements
- track what has been reported and provide assurance and remediation capabilities

TODAY'S TRADE REPORTING SYSTEMS: HOW COMPLEX AND COSTLY?

Driven by requirements, existing systems and available budgets, market participants have tackled regulatory compliance in a variety of ways.

Investment Banks

With an average spend of almost $25 million to achieve compliance for both Dodd-Frank and EMIR, many banks have implemented basic compliance, often with more than one reporting system servicing different silos of the bank. Most firms quickly discovered it was too difficult and time consuming to build a single, enterprise-wide solution to comply with regulations.

Despite sizable investments, many banks are still grappling with data management challenges and inefficient trade reporting processes and governance. Tight timelines have resulted in many shortcuts and reduced features, particularly related to data mapping, data ingestion and operational management information reports. In addressing these challenges, banks face tight budgets and a persistent belief that once compliance dates are achieved, additional funds will be unnecessary.

In reality, many banks will spend almost as much to meet forthcoming regulations as they did to get to where they are now. In all likelihood, they will realize little to no savings due to the lack of extensibility and flexibility in their current reporting solutions.

For most banks, the bigger concern is that delegated reporting is becoming a risky proposition, with hard-won clients facing difficult questions from regulators. Initially rolled out as a free service to clients to retain business, trade reporting is quickly becoming a high-risk offering; reporting confidently for clients will require a sizable investment.

Buy-Side Firms

Until EMIR took effect in August 2014, buy-side firms felt confident that their executing broker or clearing member was fulfilling their basic transparency requirements. Unlike Dodd-Frank's single-sided reporting obligation, which placed responsibility for reporting to a trade repository on the executing broker or clearing member, EMIR requires that both the buy-side firm and the sell-side broker or clearing member report their transactions. Although firms have the option of continuing to delegate their reporting obligation, they cannot delegate liability for the collateral and valuation information provided to the broker.

Thus, even with a third party handling reporting, buy-side firms must be able to demonstrate to regulators that they are validating the delegated reporting against their own records. Further, they must provide assurance to regulators and their own management teams that reporting data is accurate, timely and complete. Doing so can be challenging for buy-side firms if they lack a detailed understanding of regulations.

Third-Party Service Providers

Many buy-side firms have turned to service providers for solutions to reporting commitments. While service providers are frequently the only data source for reporting buy-side trading activity, many have been reluctant to assume the added responsibility of ensuring regulatory compliance for their customers. Reconciliation and control challenges, as well as the risk of duplication and fragmentation, are among the potential downsides to providers. Reporting flow is further complicated by the buy side's use of delegated reporting by their banking counterparties—who select data repository locations convenient to them, not to buy-side firms. This fragmented approach complicates reconciliation and puts pressure on service providers to maintain connectivity to all relevant trade repositories.

Given firms' small appetite to pay for reporting services, third-party service providers are realizing that the risks may outweigh the profit potential.

In reality, many banks will spend almost as much to meet forthcoming regulations as they did to get to where they are now. In all likelihood, they will realize little to no savings due to the lack of extensibility and flexibility in their current reporting solutions.

Evaluating Current Systems: Is the Status Quo Sustainable?

Now that several major deadlines have passed, market participants can expect active regulatory scrutiny. What regulators find will likely be fraught with issues, and the cost of non-compliance can be steep. Deutsche Bank recently was fined £4.7 million for failing to properly report transactions.[1] Previously, Barclays was fined £2.45 million for failing to provide accurate transaction reports under MiFID 1 to the Financial Conduct Authority and for serious weaknesses in its transaction reporting systems and controls.[2]

Regulatory audits aside, organizations face other potential threats—including confidential data breaches, technology failures or client transaction errors. Such threats have significant reputational, regulatory or legal ramifications, and very likely expose the organization to financial loss.

A number of triggers may prompt market participants to reevaluate their current trade reporting infrastructure. Among them:

1. **Achieving compliance across jurisdictions proves challenging.**
   Depending on entity classification, reporting requirements for the same trade can differ across jurisdictions. Institutions delegating their trade reporting or offering reporting services need to be ready for potential conflicts if they are operating within the EU or within countries where local law differs from ESMA or Dodd-Frank. To ensure full compliance, institutions need sophisticated rules engines, systems and data management—features which most current in-house systems lack.

2. **Poor data quality inhibits the ability to meet requirements.**
   Siloed infrastructures persist throughout the financial services industry, presenting tremendous challenges for cross-border trade reporting. Trades with counterparties in different jurisdictions often involve two or more incompatible data stores and trade processing systems. Such structural issues create poor data quality and significantly hinder a reporting party's ability to achieve 100 percent match rates. Compounding the data quality issues is the introduction of several new fields that trade capture systems need to accommodate—including LEI (Legal Entity Identifier), Product Taxonomy (UPI) and UTI / USI (Universal Trade / Swap Identifier).

3. **Managing governance with siloed systems proves risky and costly.**
   Many organizations are managing their governance, risk and compliance initiatives with dozens of disparate, often disjointed systems. The approach fuels duplicative and contradictory processes and documentation. With such complexity, it becomes easy for suppression logic to become stale. That, in turns, results in over- or under-reporting, which puts organizations at risk of censure and fines. Add the expense of maintaining multiple point software solutions, and the cost of compliance can quickly spiral out of control.

4. **Using multiple, inter-trade repositories results in poor pairing and matching rates.**
   Inconsistent interpretation of reporting requirements has led to varied reporting formats and standards within the industry. With multiple inter-trade repositories accepting these different standards and formats, the result has been poor trade pairing and low matching rates.[3]

With so many challenges, participants face a fundamental question: Can they afford to continue with their current solutions? Those that have invested in internal solutions need to determine whether or not they can scale to accommodate change as the regulatory environment continues to evolve. What will happen when leadership with accountability for regulatory reporting starts asking for real management information reporting? How long will it take until the business initiates or accelerates strategies to unwind trading because business-as-usual costs for regulatory reporting make trading unprofitable?

Some banks and large buy-side firms that have already spent millions developing an internal reporting infrastructure may opt to continue with what they have built. However, with CIOs focused on improving efficiency and reducing costs, a growing number of organizations are weighing the options—and concluding that it no longer makes sense to maintain expensive, proprietary systems or to support third-party solutions in house.

Those that have invested in internal solutions need to determine whether or not they can scale to accommodate change as the regulatory environment continues to evolve.

LOOKING "OUTSIDE THE BOX" FOR A TRADE REPORTING SOLUTION

Why are so many companies reexamining their original decision to build in-house solutions? Based on conversations with our clients, it comes down to the following reasons:

1. First, companies underestimate the total cost of ownership. Companies often estimate only the cost of an initial build or implementation and don't typically account for the following:

    - **Cost of understanding regulatory requirements** and creating traceability to the reporting functionality upfront but also on an ongoing basis as regulations change or new ones are rolled out.
    - The likelihood that **technology builds and implementations do not go as planned** creating either additional technology costs or compromised solutions that often create additional operational overhead on an ongoing basis.
    - **The ongoing cost of supporting and adapting the technology platform** as regulations change.
    - **Infrastructure and connectivity cost** to support their platforms and negotiate the onboarding and ongoing relationship management with trade repositories like DTCC, CME, ICE, REGIS or UnaVista.
    - The emerging cost of **reconciliation and assurance** as firms will need to have teams and technology that can work across trade repositories to reconcile what has been submitted, remediate errors and provide assurance to key stakeholders or clients. Many firms only account for the cost of submitting trades.

2. Second, building in-house systems was the accepted practice, especially for large banks and custodians. This is no longer true. Banks are now looking for alternatives to building their own systems for all of their needs, not just trade reporting.

3. Finally, there were few alternatives when companies were initially trying to understand how to respond.

THE BENEFITS OF MANAGED SERVICES

Today's growing availability of managed services and cloud computing has driven many industries to shift away from developing software and maintaining hardware—functions deemed too expensive and complex to keep in house. For example, long ago most major airlines have done away with their proprietary ticketing systems in favor of outsourcing through systems such as Sabre or Amadeus.

When financial regulations were coming into effect in 2012, there were no managed solutions available to help market participants handle trade reporting. Today, robust, third-party managed services are available, offering organizations a number of benefits:

1. **Lower Total Cost of Ownership (TCO):** A managed solution helps organizations minimize capital outlay and staffing requirements. With operating costs syndicated across multiple subscribers, ongoing cost of ownership is also significantly reduced.

2. **Improved Reconciliation:** Trade reporting service providers maintain a reconciliation engine that takes reports from trade repositories, TriOptima and other sources, and then reconciles them to a client's internal database. This approach addresses regulatory rules for portfolio reconciliation, discrepancy identification and dispute resolution, as well as reporting.

3. **Reduced Compliance Risk:** In addition to offering out-of-the-box support for reporting to all global trade repositories for all asset classes and message types, best-in-class trade reporting solutions include regular, timely updates reflecting reporting rule changes. Additionally, such providers maintain close relationships with regulators to stay informed about new requirements.

4. **Improved Data Usability:** Access to a comprehensive solution that aggregates data from multiple sources creates an opportunity to expand data analytics and utilize the trade reporting solution as a decision support system.

5. **Rapid Deployment:** With pre-configured reporting rules and message types, trade reporting service providers seamlessly integrate with any source system. Designed to work in conjunction with other reconciliation applications, they also enable easy integration with all trade repositories, counterparties and vendors.

6. **Better Reliability and Security:** Despite continued concerns about the reliability and security of managed solutions, remotely hosted services can offer a higher and more reliable standard for data protection than onsite software.

WEIGHING THE OPTIONS: IN-HOUSE VS. OUTSOURCE

As with any business decision, a financial analysis is a critical input to deciding whether to upgrade/build a trade reporting solution or outsource to a third-party provider. In building or upgrading a solution, firms typically incur the following major costs:

- ✔ Cost of interpreting regulations and defining business requirements
- ✔ Cost of design/engineering and project implementation
- ✔ Cost of physical infrastructures
- ✔ Cost of ongoing operations and support staff
- ✔ Trade repository fees

Finally, opportunity costs—the consumption of resources that could support other business initiatives—should be factored into the total cost of ownership.

What follows are two scenarios that demonstrate the total cost of ownership of building an in-house reporting system versus using a managed solution. Costs and calculations reflect Sapient's firsthand experience working with banks and buy-side firms worldwide.

Scenario 1: Managed Trade Reporting Solution for Tier 2 Bank

Large banks with 500,000 trades per month can expect to spend close to $30 million to build an initial reporting approach plus another $18 million per year to maintain it (including operations, testing, technical, remediation and business analysis resource costs).* Additional system build-out costs for Tier 2 banks to address EMIR and other G20 rules are estimated at $45 million.

In comparison, a fully managed solution—in which infrastructure, software and operational processes are managed by a third party—removes the costly upfront build and many of the ongoing internal resource expenses. With an estimated yearly managed services fee of $3.5 million, a Tier 2 bank's total business-as-usual expenses are reduced from $18 million to $8 million per year—a savings of $70 million over seven years.

Scenario 2: Managed Trade Reporting Solution for Buy-Side Firm

Buy-side firms are likely only partially down the path of implementing robust trading capabilities. For Dodd-Frank, they relied on their counterparties to report. For EMIR they are still figuring whether to delegate or self-report. Most have not yet begun to consider what capability they will need in order to assure management and investors that they are compliant.

Depending on volumes, a fully managed solution, which removes costly upfront build and many ongoing internal resource expenses, would cost in the range of $50,000-$2,000,000 per year. Variability of cost to volumes is a significant benefit of managed services as opposed to the fixed one-time and ongoing costs of an owned solution.

* Source: Sapient Global Markets (modeling scenarios used $150,000 avg. annual resource salary and 3 reporting systems)

CONCLUSION

After making considerable investments, firms now face another wave of trade reporting regulations. As a result, market participants are re-examining their current strategies and, in many cases, are questioning whether or not it makes financial sense to continue to adjust internal infrastructures—particularly with the availability of new alternatives, such as outsourced trade reporting services.

For some firms, cost savings will be a key driver. Others will be seeking ways to mitigate risk as regulatory scrutiny intensifies. Either way, outsourcing offers what in-house systems cannot: a more adaptable, cost-effective approach to meeting today's trade reporting requirements—and those that are bound to emerge in the future.

Resources

1. "Deutsche Bank fined £4.7m for failing to properly report transactions". Financial Conduct Authority. 28 Aug 2014. See http://www.fca.org.uk/news/press-releases/deutsche-bank-fined-transaction-reporting-failures

2. "FSA fines Barclays £2.45m for failures in transaction reporting". Financial Conduct Authority. 8 Sep 2009. See http://www.fsa.gov.uk/pages/library/communication/pr/2009/117.shtml

3. "Pairing/Matching – the last hurdle in the race to reporting transparently? Part 1". Sapient. 14 August 2014. Retrieved from http://gmblog.sapient.com/?p=2764

THE AUTHORS

Randall Orbon

As part of the Sapient Global Market leadership team, Randall Orbon defines strategy, drives business development and executes key components of the strategy. Randall joined the company in 1996 and has built a breadth and depth of experience that spans Sapient's capabilities. He has worked with numerous capital and commodity market participants to develop and execute transformative strategies. Randall holds a BSE in Computer Science from the University of Pennsylvania and an MBA from Columbia and London Business Schools.

rorbon@sapient.com

Arun Karur

is Vice President and Head of Commodities and Regulatory Solutions at Sapient Global Markets. Within this role, Arun helps drive the company's go-to-market strategy for downstream oil and gas companies, utilities and commodities divisions of investment banks globally. He works with clients to develop strategic initiatives around areas such as business intelligence and data governance, reporting and analysis, achieving transparency into physical and financial aspects of portfolios and capture of trading and asset data for strategic planning.

akarur@sapient.com

Cian Ó Braonáin

is the global lead of Sapient Global Markets' Regulatory Reporting practice providing guidance, insight, leadership and innovative solutions to the company's regulatory reporting and response project portfolio. Cian has over 14 years of experience as a lead business analyst, project manager and business strategist, developing methodologies and tools for solving the risks of regulatory impact and change. He has been involved in numerous regulatory reporting projects, many of which focus on pre-compliance date readiness activities, such as analysis, implementation and post-compliance assurance activities.

cobraonain@sapient.com