A view on the future landscape of European Regulatory Reporting

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A view on the future landscape of European regulatory reporting requires an understanding of the current state of financial services regulations. As a next step, one should ask oneself how the markets will react to the new regulatory constraints and what the future goals of regulators might be. A market infrastructure provider with global reach will not only need to adapt to changing circumstances, but should also endeavor to support the progress towards more stable and well-functioning markets. In this, both challenges and opportunities will abound. Regulation forms one of the three central pillars of tomorrow's markets, together with technological advances and new global markets.

Market infrastructure operators must be ready to fulfil the strong regulatory reporting role assigned to them by European governments, parliaments and regulators

MiFID II, MiFIR, REMIT, CSDR, SFTR, MAD/R—the volume of new regulation due in the near future will have a large impact on the infrastructure, resources and budgets of market infrastructure providers and their subsidiaries. The ubiquity of acronyms adds complexity and difficulty to seeing the synergies between regulations and any potential savings. From the regulators' perspective, the task at hand, namely that of policing all financial markets to fulfil the G20 mandate of preventing the world from sliding into a new financial crisis, appears even more herculean.

Current regulation can be viewed from various perspectives, encompassing compliance with the rules and the design of new markets, challenges and opportunities. A market infrastructure provider needs to look at market regulation from all angles and adjust to new regulation itself, carrying the burden of changing systems, interfaces and workflows like every other participant in the market. Some regulations are squarely directed at exchanges. In particular, the role of high-frequency and algorithmic trading has come under the spotlight of regulators. The fear is that "flash crashes", which have been observed several times and whose origins are not well understood, might foreshadow the emergence of systemic problems. Although preventing such problems on the trading platforms is quite challenging, the motives behind current regulatory drive are highly respected.

Regulatory efforts have focused on two interrelated topics for quite some time now, namely the opaque OTC business and the credit risk lying dormant under the veil of derivatives. For more than twenty years, OTC markets have been a breeding ground of new products and innovation in the financial markets. On the other hand, LIBOR-fixing and other scandals have amply demonstrated that left to their own devices, the markets are not able to keep risks from spinning out of control or create a level playing field for all participants. It was mostly investment banks that profited from this in the beginning, but many of these were then swallowed up by the financial crisis that their own actions had helped to instigate.

For now and the foreseeable future, it is time to clean up and restore the confidence of citizens and states in the workings of the financial markets. Authorities want to know, through regulatory reporting, which risks reside in the financial system. They expect publication mechanisms to provide investors with real-time information on market transactions across all execution venues, covering all asset classes. For this purpose, regulators have invented new entities, such as the "Trade Repository" (TR), "Authorized Reporting Mechanism" (ARM) and "Approved Publication Mechanism" (APM). Lastly, (at least) one "Consolidated Tape Provider" (CTP) is to be created, whose purpose is to provide the markets with one tape of all transactions, whatever the execution channel.

Market infrastructure operators must focus on the strong regulatory reporting role assigned to them by European governments, parliaments and regulators.

Three trends driving financial market changes are intertwined: continuing digitalization and automation, globalization, and all-encompassing regulation

Taking a long view, one might be tempted to interpret the current regulatory focus on the financial markets as a flash in the pan. However, we believe that there will be no turning back, as the focus on regulating the financial markets will not recede for many years to come.
First of all, regulation is going to shape the new markets. It is expected that in time, most old-style (OTC) derivative trading will be transformed or even vanish. Standard derivatives must be settled via a Central Counterparty (CCP) based on the clearing obligation declared by the regulator ESMA. If liquidity is sufficient, these must not be traded OTC anymore, due to ESMA's declaration of a "Trading Obligation". Instead, trading will take place at a new type of venue, the Organized Trading Facility (OTF). Traditional roles are shifting in the bond markets as well, with the banks squeezed by capital requirements and the buy-side necessarily playing a larger role.
Furthermore, new regulations mean that investment firms dealing in securities or derivatives and holding sizable positions for their own account must register as "Systematic Internalizers" (SI). SIs are obliged to comply with comparable pre-trade and post-trade requirements as the trading venues. Established trading venues need to help new partners like emerging OTFs and SIs fulfil their regulatory reporting obligations.
Furthermore, new-style regulations aim to be forward-looking and risk-reducing. In order to mitigate credit risk, all-encompassing trade collateralization is the regulatory answer to the financial crisis of 2007-08. The next wave of regulation covers security financing transactions (SFTR) to make sure that collateralization works in practice. The European parliament is about to confirm the existing drafts of the MiFIR RTA and ITS by ESMA. Clearstream serves its customers via a Global Liquidity Hub to deal with the regulatory constraints on collateral management and optimization. Customers should expect market infrastructure operators to help them with the forthcoming regulatory reporting obligations for SFTR as well.

Of course, market observers have commented with glee that much of the derivative data collected as part of existing EMIR regulation are contradictory. There are several reasons for this, such as lack of standardization, gaps in rules or conflicting rules and so on, which will take years to resolve, but none of these will be a permanent road block. Interestingly, regulatory initiatives drive standardization, which is a rather important condition for the digitalization of trades; examples include the unique transaction identifier (UTI), legal entity identifier (LEI), and unique product identifier (UPI).

The financial markets and globalization are natural partners. Some friction has emerged, because (supra-) national sovereignty over regional rule-setting collides with the realities of global trading: one party in one block, the counterparty in another. However, US regulations (Dodd-Frank), European regulations (MiFID II, etc.), and emerging regulations in the other countries seem sufficiently aligned, so that no fragmentation along national borders should be feared. Some intermediate hiccups notwithstanding, there are and will be opportunities for regulatory arbitrage, but these will disappear in time, like all real arbitrage opportunities. Technology is a game changer. Adding it to regulation has given rise to the breath-taking process of digitalization and automation which is still in its adolescent stages. Just a few years ago, it would have seemed impossible to master the sheer amount of data that millions of daily transactions create. But now in the era of Big Data, computers and data storages comfortably handle terabytes of data. Despite problems created by the current regulatory waves, real progress is to be made on the path to the oversight of markets by regulators and investors—even in real time. One can assume that for every trade in the market, there will be a shadow trade in the books of the regulators.
Market infrastructure providers must strive to offer a complete service to their clients. Important information, such as liquidity in benchmark products of key markets, should be provided on trading platforms. Trading, clearing, settlement—offering every step of the value chain for financial security transactions as part of a single service has been maligned in the past. However, reliability and robustness, speed and connectivity are of paramount importance to clients so that they can focus on their own core business. Integrating regulatory services is a logical consequence of a business model aimed at providing a complete service offering to customers.

A regulated market is required to comply with transparency and reporting obligations for transactions executed on its trading platforms. With the regulator having obligations aligned between different execution venues, Deutsche Börse, like other market infrastructure operators, must open its regulatory platform to other market participants. One advantage for infrastructure providers when they make their products more widely available is that the build costs are spread over a customer base that is potentially much larger. For clients, this means they can outsource the challenges and share the expenditures related to building and operating the regulatory reporting hub.

Clients expect to be supported in meeting their MiFID II related requirements. Market infrastructure operators are uniquely positioned to serve their customers by providing a central European regulatory reporting hub and to act as trusted partners in helping clients meet their regulatory obligations in an efficient and cost-effective manner, whether this involves providing a MiFID II transaction reporting or OTC trade reporting service.
A MiFID II transaction reporting service enables clients to submit the relevant data to the national competent authorities via an ARM.
A MiFID II OTC trade reporting service is an efficient and straightforward option for clients to meet the transparency requirements for OTC transactions under the new regulations via an APA.
A central regulatory reporting hub offers a strategic answer to the multitude of required reporting dimensions.

Data, data, and data—we are in the middle of the regulatory data collection stage. Every day, customers send seven million derivative trades to Regis-TR.
Much has been written about the difficulties of regulators sifting through this data and making sense of it. Admirably, regulators frankly admit when data quality is too poor to draw conclusions from, e.g. FX derivative parametrizations in recent regulatory technical specifications for MiFIR implementation of the European regulator ESMA have been left out for this reason.
Data consolidation is very much of the moment; thus, regulators envision a regime of regulatory data service providers acting as an intermediate layer of consolidation between market participants and trade repositories, or respectively regulators' databases.

The creation of a central regulatory reporting hub by market operators will enable their customers to alleviate their regulatory burden

The regulators need high-quality data not just for keeping an eye on risk positions. At the center of market regulation is the idea that transparency levels need to be balanced against the legitimate interests of trading parties not to reveal trading interests in thin, illiquid markets or to be caught with positions that are too large in size before being able to close them. An elaborate scheme of parametrizations at sub-asset, sub-class or even instrument level has been designed. It requires constant re-tuning based on checking its effects on market liquidity. A regulatory reporting hub familiar with market practices, but otherwise neutral, may deliver sound data and help regulators and market participants to get unbiased views on the trade-off between transparency and liquidity.
Post-trade data from trading venues and APAs (for OTC) are to be made available to the "European Consolidated Tape" (ECT) in real time and provided free of charge after 15 minutes. This is the most important tenet to achieve post-trade transparency in the European markets as requested mainly by the buy-side. A regulatory reporting hub carries the onus of translating all client data into a normalized format. As an APA, it will be regulated to provide high-quality OTC data.

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The success of current market regulation is not ensured in itself, but the creation of strong regulatory reporting hubs may help to alleviate many challenges, in particular during the first couple of years, i.e. the transition period between old and new regulatory reporting regimes. Liquidity may even dry up if regulatory burdens overwhelm too many market participants. Sky-rocketing regulatory costs may even force market participants to retreat from some markets.

While the costs of regulatory obligations are a major concern for clients, there are qualitative aspects to be considered as well. Unfortunately, regulators fail to provide a "golden source" of covered instruments. Correct reference data provisioning has been an area of client concern for a long time. OTC trade reporting of derivatives is not free of ambiguities concerning the instrument scope either. Ambiguities in interpreting legally binding texts should not exist, but they frequently do. They may lead to interpretation and consequently legal risks. After a long history of bad data-quality delivery by banks, regulators tend not to look kindly on misreporting, over-reporting, or underreporting.

Another area in which a central regulatory reporting hub offers help to clients is delegated reporting. Transaction reporting identifies those persons (or algorithms) responsible for each side of a transaction. This may run counter the interests of buy-side clients who have taken some bank into service, but would like to protect confidential information on their client. In such cases, a bank can publish transaction reports generated on the regulatory reporting platform. Separately, their clients can fill out confidential information through direct access on the platform.

The hub service architecture provides clients with more than a tactical solution to solve their MIFID II related reporting obligations. The hub supports the capture of data for multiple regulations, with the relevant data being routed to the correct end point per regulation, be that an ARM, RRM or trade repository. In this way, the hub can cater for current regulations, while laying the ground work for future regulations, such as SFTR, and regulation in other geographical domains.