FRTB, MiFID II & BCBS239 - Effects on Contributed Data

Introduction

The purpose of this report is to look at three regulations: FRTB, MiFID 2 / MiFIR and BCBS239, to see where contributed data is most affected, and how Financial Machineries (FM) can help to survive the workload.

Regulatory challenges highlight the need to set standardised definitions, thereby enabling firms and impacted parties to achieve data regulation compliance, efficiently and cost effectively. Creating a clearly defined contributed data strategy framework will ensure clients have a clear understanding of the data they are contributing and the venues/firms that they are contributing to, as well as the efficiency of contributed data throughput and the reduction in cost.

Financial Machineries (FM) has launched a new suite of methodologies to help financial institutions improve transparency and reporting around financial pre-trade contributions and other price sensitive data, ensuring effective monitoring of activity and guiding firms to a stronger position to satisfy evolving global regulations.

Background

Banks are under increasing pressure to focus on regulatory demands and much effort needs to be invested to identify which regulations affect which areas of a bank's business, thereby prioritising effectively. First we define the three regulations that FM believes affect contributed data the most:

FRTB - fundamental review of the trading book

FRTB is loosely defined as a set of proposals by BCBS forming a framework for the next generation of market risk regulatory capital rules for large, internationally active banks: it will require banks to gather data for trading desks, and use that data to support and analyse risk factors to be input into risk models for the requisite trading desks and financial instruments. The quality of data (completeness, integrity and accuracy) will determine if the risk factors are modellable and, if so, the firm can adopt an internal model which will result in lower calculations of risk and, therefore, the requirement for less capital to safeguard against losses. If there is not sufficient data, the risk factors shall be determined as non-modellable and firms will have to use standard models developed by BCBS (Basle Committee on Banking Supervision) in higher levels of capital being put aside.

In particular, trading firms face increasing scrutiny surrounding their monitoring processes for contributed data, most notably for benchmark contributions, following recent benchmark-fixing investigations. Global regulators and associations such as IOSCO are looking into firms' controls and compliance measures in this area, with discussions continuing around how to effectively ensure increased transparency and control. This will push firms to ask questions about their current data governance frameworks, aggregation and validation capabilities.

Under FRTB, banks will have to retrieve, aggregate, cleanse and consolidate data going back to 2007. The data will enable banks to establish extreme events, such as the sovereign debt crisis, which will then be entered into risk models and calculations. Challenges in contributed data could arise due to legacy systems, business issues resulting from past mergers and acquisitions and the sheer level of data that will be required to be reconciled and validated.

MiFID II / MiFIR

MiFID II and MiFIR extend the scope of transparency regulation of markets in financial instruments to equity instruments other than shares, as well as to non-equity instruments. Objectives include the improvement of oversight and transparency, with regard to commodity derivative markets, ensuring that they function for hedging and price discovery; banks must also tackle loopholes in less regulated, more opaque parts of the financial system, in line with G20 commitments.

MiFID II/MiFIR addresses insufficiencies in key areas:

a. Transparency: they extend transparency requirements to equity-like and non-equity instruments and to market players that had not previously or to a lesser extent been regulated;

b. Market integration: they strive to extend these transparency requirements in a level fashion across trading venues and between trading venues and bilateral trading systems, while taking into account their respective specificities.

c. Extension of the Systematic Internaliser regime

BCBS239

New data aggregation standards were introduced under BCBS239, which require banks to put in place strategies to meet principles on data governance, data aggregation and reporting. BCBS239 sets a high bar for data standards, with several areas potentially requiring considerable change. The standards adopt a principles-based approach which leaves firms frustrated by the lack of guidance on acceptability of compliance. In particular, BCBS239 lacks guidance on how the competent authority would assess standards and firms are struggling to understand what is good practice , which must be resolved before the regulator decides to undertake an investigation. It may be argued that, by getting the governance structure in place, and ensuring appropriate policies, procedures, systems and controls exist, other challenges, such as aggregation and reporting, may decrease accordingly, as that oversight will already be in place.

Future Utilities

There are opportunities to establish utilities that implement these standards on an open, non-discriminatory basis. Such utilities would enable users to capture the value of any network effect and associated economies of scale in non-competitive functions, whilst allowing vendors to provide value-added services to market participants, on top of the basic utility infrastructure.

a. Data is one area that may be suitable for the creation of utilities. Given the continued and seemingly inexorable rise in the cost of market data in equities, there is an opportunity for OTC markets to leapfrog the equities model by establishing open-source data utilities with industry governance and cost-priced models. Such utilities are already being discussed, for example, for the supply of ISINs and the associated instrument reference data for OTC derivatives, based on the relevant ISO standards.

b. Another potentially suitable area is standardised connectivity to allow easy data transmission from content producer to consumer. Given the sensitivity of data in the OTC space, such utilities will also need appropriate data governance for content providers, as exemplified by Neptune in the bond markets.

c. Additionally it is important to focus on the products that may be classified as illiquid under FRTB observability rules. If the utility can help firms to demonstrate observability in less liquid instruments, there is the opportunity for significant savings in RWA capital charges.

Summary

It is clear that there is increased industry appetite in OTC markets to establish market infrastructures in areas of common concern, through open standards and industry utilities operating under balanced governance. Having been an opaque backwater in terms of automation and standardisation, it now seems possible that FRTB, MiFID II and BCBS239 might prove to be the catalyst for OTC markets to create a modern, low-cost, standards-based infrastructure, to allow the industry to service client needs, efficiently and electronically.

Because of the stringent standards for data under FRTB and a lack of guidance on quality under BCBS239, a cost benefit approach could be adopted to determine which regulation to focus on. In this case, the concept being that, if the firm focuses on FRTB in order to establish data standards, they could roll these standards to other regulatory programmes throughout the firm. But there could be danger that, with the specificity of FRTB focusing on market risk, other areas of BCBS239, and therefore other areas of the firm, may be ignored. Nevertheless, Financial Machineries believes that FRTB will act as a guide for the less-prescriptive BCBS239 and recommends that firms start with addressing FRTB for data contributions as an advisable approach to meeting the oncoming regulatory requirements.

The Financial Machineries Proposition

FM can help clients discover which data is impacted by which regulations, investigate opportunities for clients to create an independent market data utility and can also carry out an independent contributions discovery audit of all data impacted by regulations, with a particular focus on systematic internalisers.

FM's methodologies will allow firms to better manage their data governance requirements of controlling who in their firm is publishing contributed data. They will also provide oversight and transparency of data usage for regulatory purposes, facilitate price formation and assist firms in proving/providing best execution to their clients. If the OTC markets want to see better days, all participants (including contributing bank sources) must challenge themselves to think outside the box.

FM's approach would be to follow the stringency of FRTB, which would give banks a greater acceptance of the other regulations.