

Sponsored repo goes mainstream

Evolving trends in SR market entrants and ops support





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OVERVIEW



While the birth of the Fixed Income Clearing Corporation's (FICC) Sponsored Repo (SR) Program began in 2005 with State Street as its inaugural sponsor, it has only recently taken off with strong market interest when FICC expanded sponsored member eligibility, moving from just Registered Investment Company (RICs) to Qualified Institutional Buyers (QIBs). This not only expanded the number of cash providers eligible for the program but opened the door for collateral providers as well.

In January 2019, recognizing the milestone SR represented between sell-side and buy-side marketplace roles, Broadridge issued thought leadership on what this type of deal represented for capital markets. Sell-side firms are looking for ways to keep buy-side clients 'sticky' as well as new and creative ways to generate more revenue with competitive costs and acceptable business risk and the buy-side is looking for additional alpha. SR checks many financing goal objectives for both sides of the street.

The influx of firms moving to open their doors for SR business (or are in the process of ramping up to offer SR) inside two years is substantial at the time of writing. Volumes are anticipated to climb steadily throughout 2020 as newly approved SR FICC members enter the marketplace.

Like any other trading methodology that grows from immaterial to material in relation to the size of the overall industry book of business, there is a natural progression from early adopters to mainstream participants. There are also trends inside firms for technology and operations initiatives to support these trading methodologies.

This paper delves into the trends Broadridge has witnessed for early adopters of SR and the upstream/downstream departmental impacts on operations and technology. It also looks at the next SR waves anticipated as this trend of sell-side and custodians facilitating access into new deal structures to the buy-side and others continue to evolve.

BACKGROUND

If the birth of SR was in 2005 with the inaugural member State Street, it has started to jump in a growth spurt with JP Morgan Bank and BNY Bank as catalysts entering the marketplace under Category 1 SR. Category 1 SR allows U.S. based banks to apply to FICC for permission to trade in SR. Sponsored members are only permitted to trade with their sponsor in clearing delivery-versus-payment (DVP) services with securities eligible for comparison. All netting is at FICC and FICC acts as the central counterparty (CCP) for all transactions by Category 1 Sponsoring Members. Securities eligible for SR include T-Bills, Bonds, Notes, US TIPS, STRIPS, FRNs and Non-Mortgage Backed Agency Securities.

In April 2019, the SR growth spurt continued as the gates opened wider for SR with the approval by FICC for Category 2 Sponsoring Members. This facilitates expanded application submission eligibility to FICC for SR to include prime brokerage, broker dealers and non-U.S. based banks. In addition, Category 2 SR expansion allows sponsors under a sponsored member to trade with counterparties other than themselves. This feature is anticipated to provide sponsored members with the same execution flexibility as they have in the bilateral market.

The introduction of Category 2 SR has seen many non-U.S.-based banks stepping into the arena. Many of the larger U.S. and now non-U.S. banks are also looking to adopt SR in multiple silos of their business. The bank is typically the first entrant for a firm. The broker dealer or the prime brokerage arm then typically follows, depending on how bullish each firm is for the

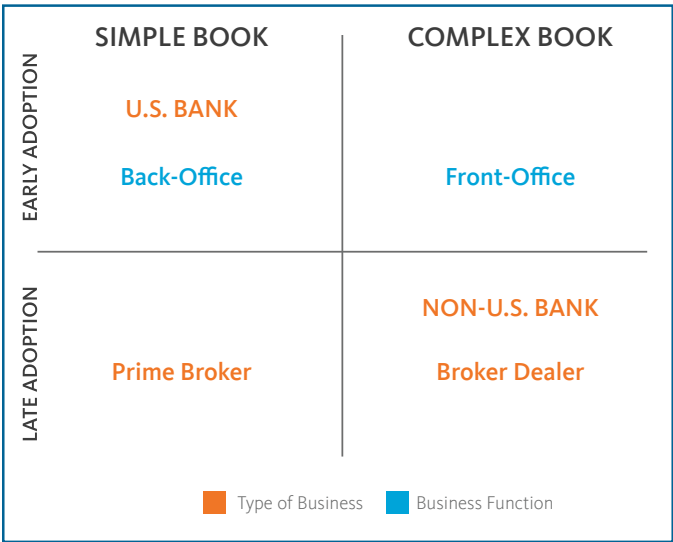
indications of interest (IOIs) they have from each of their clients in the different lines of business. The trend is that these lines of business are being setup and run independently from each other much in the way it has been done previously for other trading methodologies.

In April 2019, JP Morgan Securities was the first firm to be approved under Category 2. JP Morgan was also the first firm to adopt a second line of business for SR services. JP Morgan worked with FICC for the development of Category 2, so they knew it was in the pipeline. This explains why they were able to execute the first Category 2 SR trade shortly after FICC announced the launch of Category 2 expansion for FICC, as JP Morgan worked concurrently on their systems, operations and IOIs in preparation of potential Category 2 approvals for the broker dealer side of the business.

Broadridge has been in conversations with over 30 firms interested in SR adoption and more than 20 that are in various stages of evaluation, FICC application approvals, systems adoption and/or are live. As non-U.S. banks explore the opportunities for SR in their books of business combined with U.S. banks exploring additional groups that should be members, Broadridge expects entrants to the SR marketplace to continue at a steady pace well into 2020.

EARLY SR PATTERNS ARE STARTING TO PAINT A PICTURE

With any new industry trend, there are early and late adopters and they fall into streams driven by activity and focus. Under Category 1, the early adopters were U.S.-banks only and the entrance of Category 2 facilitates discussions across non-U.S. banks, broker dealers and prime brokers. As SR has grown in size and complexity, technology adoption is starting to take shape as well.



WHY THE QUICK RISE IN POPULARITY FOR SR?

For a methodology type that smoldered for over a decade before it caught fire, it raises the question of why now? SR has seen a significant rise in appetite amongst both buy-side and sell-side firms in 2019. With the introduction of Category 2 SR by FICC, growth is now global with the entrance of non-U.S. banks - but what is the attraction creating both the supply and the apparent demand? Examining other factors in the marketplace helps explain the appeal and growth.

SR ATTRACTION: BUY-SIDE

The buy-side has started to become a more significant player in the securities lending and collateral management space in recent years. Historically, securities lending has been a secondary focus for their long-only portfolios and handled largely by their custodial providers. As rates of return on portfolios for pension, insurance and other asset management firms have struggled, buy-side firms are looking for additional alpha to bolster returns.



There are two main roles the buy-side is playing in financing and liquidity:

1. **Cash providers** – they want to invest their excess cash into the repo markets as part of their investment strategies. SR provides an efficient outlet that has more capacity and counterparty benefits when dealing via a CCP (FICC) than bi-laterally in repo markets.
2. **Collateral providers** – for the buy-side, gaining access to liquidity is an attractive play.

SR represents an interesting route to market for the buy-side:

- There is potential growth of their on-loan balances and income, as borrowers shift their demand to CCP channels to take advantage of capital savings.
- It allows them to explore better working relationships with custodial players as part of their longer-term strategy to optimize their financing opportunities;
- The introduction of Category 2 SR via FICC further enhances this last scenario. Sponsoring members can facilitate sponsored members (i.e. the buy-side) to access other counterparties via the sponsored member's FICC membership.

Regardless of individual firm motives in the short or long term, FICC members offering SR are seeing appetite from the buy-side. This growth does not appear to be slowing any time soon, either in the U.S. or cross-border activity.

SR ATTRACTION: SELL-SIDE

For the sell-side, SR helps provide opportunities for enhanced customer relationships through the provision of agent services and to solidify working relationships. First and foremost, SR facilitates balance sheet neutrality and is an attrition play by the street to keep clients 'sticky'. There are opportunities for their books of business and interesting plays for securities lending, but keeping clients engaged and tethered to them is a very high priority.

As commissions for trades are quickly evaporating in a competitive execution market for broker dealers and others, eyes are turning to other revenue generating opportunities in collateral management, securities lending and SR as sources of revenue and trade activity.

SR OPERATIONAL SUPPORT AND MATURITY ON THE RISE

As with any trading methodology that begins to grow as part of the book of business pie chart, other non-trading departments at a firm start to sit up and take notice. Most notably the functions that start to raise their voice about business and operational risk concern are accounting, compliance and risk (both credit and market risk). Understanding repo in general as a starting point helps various departments get up-to-speed quickly when learning of the impacts of SR to their functions.

GRID OUTLINING REPO VS. SPONSORED REPO DIFFERENCES

Transaction Type	GSD FICC Sponsoring Member Submission	Start Leg Clears vs Counterparty	Submission to FICC for Close Leg Clears vs Counterparty	Close Leg Novates and Settles as Net Obligation vs FICC	GSD FICC Sponsored Member Submission (done by Sponsor for SM)	* FICC Same Date Settlement Open Leg Settles 1-1 as an Obligation vs FICC
Bilateral Repo	N	Y	Y	N	N	N
Bilateral Repo-FICC DVP	Y	Y	N	Y	N	Y
Sponsored Repo-FICC DVP vs Custody Client	Y	Y	N	Y	Y	N
Sponsored Repo-FICC DVP vs. Non-Custody Client	Y	Y	Y	Y	Y	N

*Future FICC initiative

Other firm functions impacted by sponsored repo include tax and client billing. The go to initial tool for trading desks and most other emerging functions for new trading methodologies in a firm is often Excel. The most typical scenario is the desks start managing their deals in Excel. They then share details with accounting and settlement functions who struggle to account, price, settle and track in their corporately supported platforms.

Accounting and settlement teams are usually the first ones to put up their hands and ask for new technology to support new deal types. Traditionally, as a footprint in a trading methodology grows, firms invest in accounting/back office technology and operational procedures. As the book of business grows, investment in front office trading and risk analytics tools becomes necessary to ensure business and operational risk oversight grows in parallel to the size of the exposure and opportunity.

While there are many advantages of engaging in SR trades for sponsoring members such as increased balance sheet optimization, capital efficiencies and reduced liquidity risks, SR establishes a new type of exposure and risk which requires examination by risk tolerance functions as the book of business grows. Most notably for SR trades:

- Firms that are FICC members are liable to FICC for securities and funds-only settlement obligations.
- Sponsoring members are also responsible to FICC for posting all clearing funds associated with the activity of the associated omnibus account.
- Regarding the obligations of its clients under FICC activity, the sponsoring member guarantees to FICC all trades and activity by its clients under SR it introduces.

Given the obligations to FICC for its clients, sponsored members are picking the best quality clients to help minimize obligation risk. In addition, risk teams are assessing the risks of exposure, handling of failed SR trades and other scenarios that may occur as firms partake in SR and open their FICC membership to selected clients.

ARE PRIME BROKERS THE NEXT WAVE FOR SR?

Since the inception of Category 2 in April of this year, a stream of non-U.S. banks have been steadily lining up to take part in the next wave. Prime brokerage looks like a probable candidate engaging with FICC on sponsored repo. A primer on sponsored repo for prime brokers is therefore provided below.

PRIMER ON SR FOR PRIME BROKERS

Core concepts:

- Clients who currently support their prime brokerage business within a single entity can support their sponsored repo activity in the same entity.
- Two FICC participant ID's will be needed to support the sponsored repo business, one for the sponsoring member and a new FICC OMNI participant ID for all the sponsored members.

Pre-requisites (impact focus):

- Multiple FICC participant ID's in a single entity processing.
- Sponsored repo for multi FICC participant ID's processing.
- Activity is captured as a two-sided transaction. The first trade is versus the street and second trade is versus a segregated customer representing the prime broker.
- Individual wash trader per sponsored member is required.

The devil is in the details:

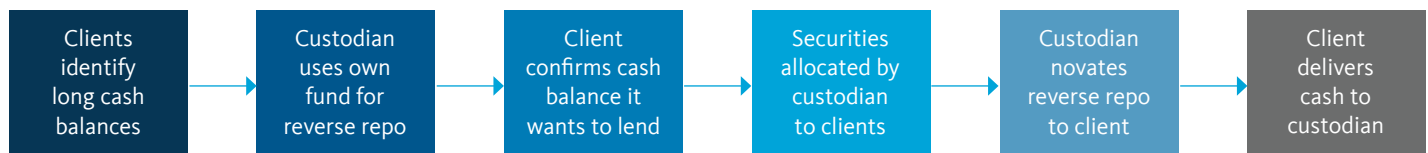
To support the sponsored repo trade submission on behalf of the sponsored member (aka prime broker customer), when a sponsored member trades against the firm ('done with' transaction):

- The street side transaction will be submitted to FICC using the FICC OMNI participant ID along with the broker/correspondent symbol assigned to the sponsored member by FICC.
- This broker/correspondent symbol will be housed on the customer deliver instruction setup.
- When a sponsored member executes a trade away from the firm ('done away' transaction) with a netting dealer, a street side transaction must be booked to reflect the sponsored member trade with the netting dealer.
- In order to capture the sponsored member broker/correspondent symbol it requires the sponsored member trades to be booked against a unique wash trader for every sponsored member.
- The unique wash trader is required to house the sponsored member broker/correspondent symbol required for the FICC OMNI submission.
- Each wash trader will also require a trade depository pointer set up against the FICC OMNI participant ID account.
- When a 'done away' trade is executed the broker/correspondent broker symbol will be referenced from the wash trader account.
- The following trade flow illustration (next page) depicts two sponsored members trading with an FICC member firm and away from the same FICC member firm with a netting dealer.

WHAT ARE THE FUNCTIONS FIRMS NEED FOR SR HANDLING AND/OR OPTIMIZATION?

The creation of the SR deal and surrounding process flows to execute are straight forward but involve several steps and can be challenging for organizations to wrap their heads around. Introduction of technology to support these workflows is gaining traction to help ramp up volume without creating undue business, operational or deal risk.

SELL SIDE VIEW: HIGH-LEVEL PROCESS FLOWS FOR PROVIDING SR TO CLIENTS



Outlined below are emerging support areas for SR in both back office and front office functionality. These examples outline common practices to support SR provided by Broadridge platforms, but these features and the handling of SR do not represent an exhaustive list of SR trade support used by the industry at present.

BACK OFFICE SR SUPPORT

The most common methodology firms are using to handle SR trades in their settlement process is flip trades.

- **Flip trade rules** - flip trade rules drive the creation of flip repo/reverse trade and novation instructions in the SR entity against the sponsored member trading accounts.
- **Flip trade creation** - this allows for the sponsoring member to submit sponsored member repo and reverse overnight and term DVP repo in U.S. Treasury and agency securities to FICC. The submission facilitates comparison, netting and subsequent creation of a FICC obligation. Flip trade rules also facilitate reporting of sponsored member trades to FICC via the FICC sanctioned sponsored member Omnibus account.
- **Sponsored repo correspondent code/counterparty symbol** - this is a FICC specific code unique to each sponsored member. FICC identifies a transaction as a SR transaction using this code and calculates SR specific margin.
- **Messaging changes for ficc submission** - to flag and reflect/report the counterparty symbol of the sponsored member on the trade for submission to FICC for comparison and netting purposes, messaging changes for FICC submission have been setup.
- **Omni depository account** - this is required to facilitate settlements for Sponsored Members from the new SR entity.
- **Security/cash settlement instruction and confirmation interfaces** - a system supporting SR needs the ability to generate security movement instructions on behalf of the bank and bank's clients. These instructions may be on a DVP or FOP basis dependent on client type. In return, the supporting system also needs the ability to accept settlement confirmations confirming the securities have been paid or received. In addition, the supporting system needs the ability to generate cash instructions on behalf of the bank and bank's clients. Furthermore, it needs to be able to accept settlement confirmations confirming the cash has been paid or received.
- **End of day/leg netting process** - a system supporting SR needs the ability to consume the netting obligation file produced by FICC and display this to the user. The user should then be able to reconcile this information against the system bookings to ensure cash and security moves are valid and correct.

FRONT OFFICE SR SUPPORT

Beyond settlement, as SR interest grows, firms are seeking additional functionality to optimize their books of business and are looking for functionality to help them with SR methodologies, deal management and execution.

- **ECN connectivity** - an ECN connector allows firms to consume the post trade feeds with IDB and voice brokers. Traders interact with the broker screens and place orders for relevant collateral based on cash demands. These feeds will contain the trade flow of reverse repo trades which is then used to match SR clients' cash placement demands.
- **Repo/reverse repo booking capability** - a SR system needs to have the ability to accept, enter and maintain trade information during the lifetime of the transaction. This includes booking and substitution.
- **Shell trade booking and conversion** - SR trading needs the ability to book cash shell trades to store a record of cash being placed out for reverse repo prior to collateral being known. A SR system then needs to allow for easy conversion into the underlying collateral shapes.
- **Cash monitoring** - a system supporting SR should make it easy for the trading team to view the expected and actual cash available for the program. Information should also be shown surrounding the value of reverse repo agreed and the value to agree.
- **Rate setting** - a system supporting SR needs the ability for traders to set and send quoted rates to each of the cash providers within the SR program.
- **Rate and order management connectivity** - a component needs to be made available which will display quoted rates to the cash providers, preferably on a real-time basis. The cash provider should then be able to place orders and see the subsequent acceptance of the order and linked collateral and status of that request.
- **Novation request/response interface** - SR trade support needs the ability to generate novation request messages for both reverse repo and repo trades on a flip basis. The SR system support needs the ability to receive confirmation update flows for DTC which will confirm when the novation request has been matched and novated.
- **Static data feeds** - a system supporting SR trading needs the ability to accept static data from multiple sources daily via automated interfaces. This data (i.e. prices, FX, factors, etc.) is used in a variety of places and functions within the trade execution and trade lifecycle processes.



TOP 10 QUESTIONS BROADRIDGE IS ASKED ON SR

- 1. Do I have to set up SR in a separate trading entity/instance?** For clarity on trade workflows, settlement and ease of traceability, the answer is yes. There may also be some requirement from FICC and clearing bank partners for separate instances for SR trade support.
- 2. If I am looking to setup SR in my bank, prime brokerage and dealer, which which do I rollout first?** Most firms looking to do multiple roll outs of SR in various lines of business start with the bank book of business, but this is driven by the existing books of business in the various units, client demand and individual business goals on a firm-by-firm basis.
- 3. How long will it take our firm to setup SR?** For integration of an SR module to an existing system, three to four months. For end-to-end adoption of robust platforms with a base new system, over six months.
- 4. What catches firms off-guard setting up SR?** The approval window timeframe expiry from FICC to commence SR deals is six months after approvals. To achieve this, firms bullish on their prospects for the SR business should concurrently prepare their operations, systems environment and seek client interest in conjunction with the FICC application. This will allow firms to dovetail anticipated FICC approvals with business/operations readiness to jump start the six month window to go live with activity.
- 5. Is there anything out of scope for FICC's Sponsoring Service?** SR is limited to overnight and term repurchase agreement. Buy/sell trades, General Collateral Financing (GCF), tri-party and Central-Cleared Institutional Tri-party (CCIT) are out of scope for SR.
- 6. Does SR look, feel and run the same for a bank vs. broker dealer or prime broker?** The short answer is no. There are many factors that influence how SR will run in each business unit that is setup. This includes technology flows, current operating processes, the type of business a client represents on the other side of the SR (i.e. custodied vs. non-custodied or the tax/accounting implementations for cross-border activity are examples). An example of how SR might look for a prime broker is reviewed earlier in this document. Broadridge has walked many firms through how specific 'flavors' of SR might look as part of each firm's business and technology planning.
- 7. What are the main accounting issues that firms adopting SR are grappling with?** Since firms are facilitating FICC interaction via a sponsored repo entity, accounting teams are faced with a decision to post/not post these transactions. In case they choose to post these transactions, the issue of account gross ups needs to be addressed.
- 8. Do I need to generate confirms for SR transactions?** Most of the participants have chosen not to generate any confirms for these transactions.
- 9. Is there a method to streamline receive/deliveries from an OMNI depot account?** Since SR uses OMNI accounts, settlements teams have requested binding functionality to impose a settlement discipline.
- 10. Is there an FICC onboarding check list for SR?** Broadridge has an evolving list of common practices for SR adoption and FICC SR onboarding. Below is the high-level checklist for SR at the time of writing.

FICC SR SPONSORING MEMBER ONBOARDING HIGH-LEVEL CHECKLIST

The checklist below is not an exhaustive view of tasks to be completed by firms FICC for legal, credit, accounting, tax, technology, interfaces and administrative setup but will give readers an idea of the tasks and complexity involved if planning for their own SR adoption.

Task	Responsibility
Connectivity which can run parallel with the stage 2 and credit/market risk review	
FICC RM to reserve the sponsoring Omnibus GSD account number	FICC RM
Testing which can run parallel with the stage 2 and credit/market risk review	
Applications testing	FICC integration
Sponsoring Omnibus account pre go-live	
Access coordinator form(s)	FICC integration
Receive countersign approval letter from client via email	Applicant/FICC RM
Applicant to submit and ficc to confirm receipt of required clearing fund deposit for the sponsoring Omnibus account	FICC treasury
Applicant to submit completed and signed activation letter	Applicant/FICC RM
Distribute important notice announcing new sponsoring member	Account admin
Confirm firm access to RTTM, portal, CFM, FIR (risk reporting tool)	FICC integration/ RSG
Countersign all FICC legal documents on go-live	Account admin
Update GSD member list on website	Account admin

Task	Responsibility
Sponsored member application	
Sponsored membership questionnaire	Account admin
Letter of representation	Account admin
Tax form or email confirmation as detailed in comments (as applicable)	Account admin
Sponsored member's agreement (U.S. or non-U.S. as applicable)	Account admin
Sponsored COI (agent COI or sponsored entity COI as applicable)	Account admin
Sponsored member pre go-live	
Sponsored activation letter	Account admin
Distribute important notice announcing new sponsored member(s) (if applicable)	Account admin
Update sponsored member list on website (if applicable)	Account admin
Ongoing quarterly requirement for sponsoring members	
Quarterly letter of representation	Account admin

CONCLUSION

As the popularity of sponsored repo rises, the industry will see more types of entrants to the marketplace. Firms will invest in technology for front and back office platforms to support these trade methodologies. Firms will also look to optimize workflows and tweak upstream/downstream functions such as risk, tax, client billing, reporting and processes to support SR for both client reporting needs and internal business operations.

The industry has already seen strong adoption of technology to support the back office for SR. As these SR books of business grow, firms are investing in planning/strategy to optimize growth and invest in platforms such as front office decision making and trading to optimize SR books of business and reduce operational and exposure risk.

Broadridge Consulting Services can help you expedite your time to market with a gap analysis, business case preparation, our knowledge of proven solutions for SR support, industry/peer activity for common practices in this space and assistance we have provided other firms to ramp up these types of methodologies/programs.



As a managing director and practice lead for Consulting Services at Broadridge, Carol brings three decades of experience to financial services mandates and helping firms achieve business goals and remain competitive. Carol has spearheaded many end-to-end transformational mandates by optimizing technology stacks, addressing data governance and migrating to more effective processes and work flows to service disruptive business impacts and demands.

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