REGULATION

UMR efficiency: optimising systems and processes for IM compliance

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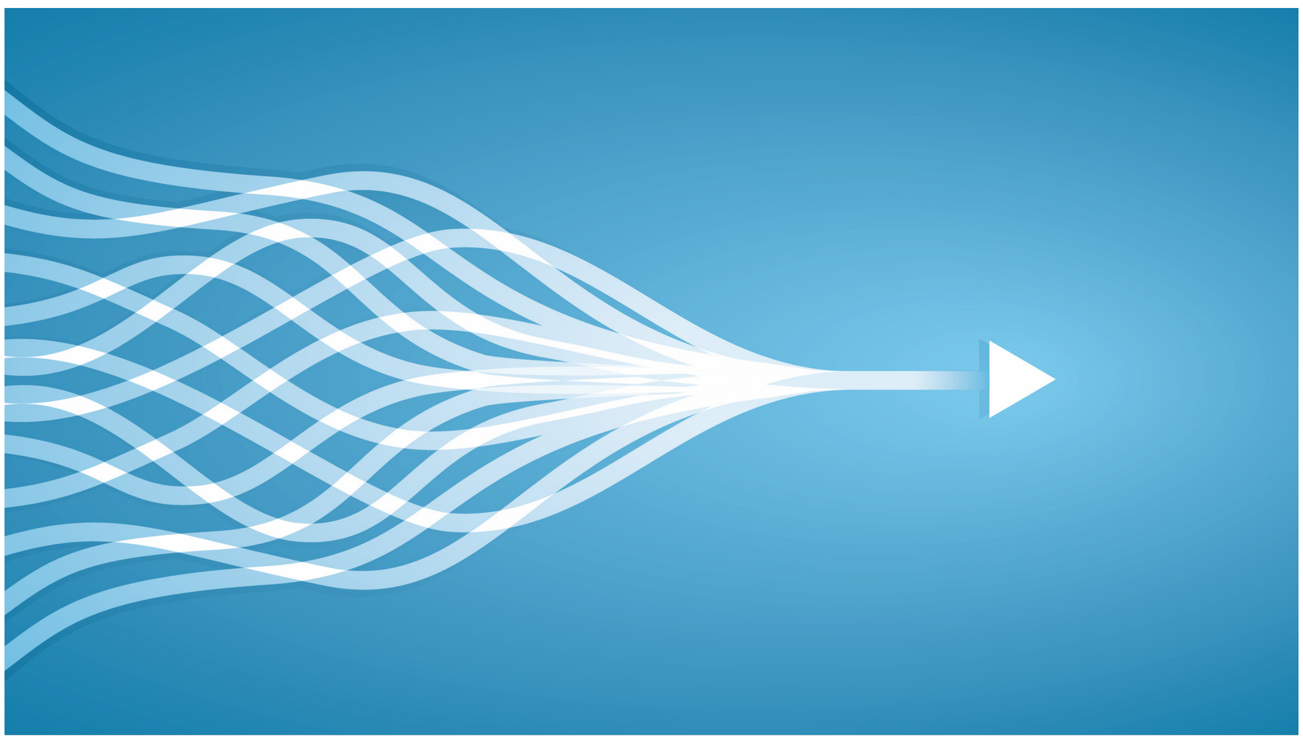

Uncleared margin rules (UMR) are among the biggest collateral management issues faced by investors in over-the-counter (OTC) derivatives. At a specially convened session sponsored by IHS Markit at *Risk.net*'s Buy-Side Risk Global event, panellists discussed the latest phases of UMR, their impact on buy-side operations and the role technology can play in compliance

The panel

- **Mark Higgins**, Senior Product Manager, Liquidity and Margin Services, BNY Mellon
- **Chetan Joshi**, Founder and Chief Operating Officer, Margin Reform
- **Hiroshi Tanase**, Senior Product Manager, IHS Markit
- **Moderator: Stephen Bruel**, Head of Derivatives and Foreign Exchange, Market Structure and Technology, Coalition Greenwich

Wider net

Since they came into force in 2016, the post-financial crisis UMR have aimed to reduce risks associated with non-centrally cleared OTC derivatives, and have captured a wide range of parties – from dealers to investment firms and pension schemes – within their scope.

Hundreds more market participants are adjusting to the new rules for UMR after the Covid-19 pandemic delayed implementation by a year.

Phase one in 2016 focused on the biggest firms – those with an average aggregate notional amount of non-centrally cleared derivatives valued at $3 trillion in the US and €3 trillion in Europe. This average lowered to $50 billion in phase five, which was introduced in September this year, and reduces to $8 billion in phase six in September 2022.

With market participants getting to grips with phase five rules focusing on the buy side – and with phase six on its way – those affected will need to consider the various factors involved in deciding a suitable strategy, a framework Margin Reform's Chetan Joshi refers to as the "wheel of pain".

The process comprises nine steps, the first four of which are the actions firms must take regardless of whether they will breach the initial margin (IM) exchange threshold of $50 million (or relevant currency equivalent), for compliance.

However, the ambiguity around the $50 million and what that means in 'relevant currency' is a reason for caution.

"You will have to agree with your counterparty, if you are in America and they are in Europe, what the number is and how it will work," said BNY Mellon's Mark Higgins.

The wheel of pain

The first step on Joshi's framework concerns self-disclosure and understanding if a firm is caught within the scope of the rules.

Producing accurate and reliable calculations to determine a firm's status can be laborious and complex – and getting it wrong could result in rising operational costs following IM disputes.

Market intelligence firms such as IHS Markit provide an IM calculator to help firms avoid falling foul of mistakes.

The second step covers client engagement and using the self-disclosure process to define the onboarding scope. Firms may consider clearing, novations, compressions or even stop trading in certain product types to avoid UMR altogether.

The third step focuses on rule distillation – understanding the regulatory regimes a firm falls under. The UMR directive covers 13 jurisdictions based on a Group of 20 mandate, with each regulator defining its own set of rules.

The fourth step centres on legal agreements – which Joshi describes as "one of the biggest pain points in the UMR world".

"There are different types of agreements depending on what custodial model you are going to support," he says. "And you need to understand what type of collateral you are going to post. When we looked at the first four phases of UMR, the collateral was very narrow. But when we moved into phase five ... we [saw] money market funds and equities and diverse collateral coming into UMR, and [for phase six] we will start to see that broadening as well."

Onboarding and tech

Once firms have used the first four steps to determine whether they must comply – and exceed the $50 million threshold – they enter step five: custodial onboarding.

This potentially lengthy process can mean varied documentation requirements depending on the chosen custodian. Firms should also establish a relationship with their counterpart's custodian.

Participants can then turn their attention to processes that may make UMR compliance more efficient. For step six, Joshi said improvements in vendor technology had been transformational.

For example, the IHS Markit Collateral Manager enables firms to meet regulatory deadlines by bringing collateral management in-house, and centralising and standardising workflows. The system also allows participants to benefit from an automated and scalable system that will help save costs in the long term.

Operations

Step seven – operations – is the biggest area impacted by UMR, according to Joshi, leading to increased margin calls, and new dispute management procedures and escalation to risk teams. Firms will also face daily monitoring reports and IM threshold calculations.

“You need to segregate that collateral. I might decide to segregate that with BNY Mellon, for example, and my counterpart might be looking to put it with Euroclear. So now I need to get on board with Euroclear and my counterpart needs to onboard with BNY Mellon.”

At the last count, there were about a dozen custodians offering UMR services, said Joshi. “Depending on the regimes, you need to move collateral the same day, so this is another game-changer ... It is a real big impact to the operations team.”

Optimisation

Step eight involves optimisation, which can have a significant effect on the front office because it has the potential to drag down a fund’s performance depending on the cost of collateral.

Hiroshi Tanase, IHS Markit

Tri-party agents can provide an optimisation service, but third-party firms will need to do this themselves. “So it is important to be efficient with the collateral you are going to post to your counterpart,” said Joshi.

“This collateral is going to be segregated, it is going to be off balance sheet, it is going to be unencumbered. So you want to make sure that you are posting the right assets into your third-party or tri-party accounts.”

Moving trades judiciously across netting sets is one way phase five and six firms can think about reducing and optimising margin, added IHS Markit’s Hiroshi Tanase.

“The margin is, largely speaking, proportionate to the amount of risk that you have in each netting set,” he said. “If you have certain long positions in one netting set facing a counterparty, and then certain short positions in another netting set facing another counterparty, you could, potentially, move a few trades across these two netting sets – such that more risk offsets are achieved and you reduce the risk amount in each of these netting sets. And, by doing so, you can reduce the margin amount.”

Model

The ninth and final step in Joshi’s wheel of pain framework centres on the choice of IM model.

Regulators provide two: the standard initial margin model (Simm), which participants caught in phases one to four have all used, and Grid – known as the schedule.

"Grid is the standard approach, a methodology where the margin is calculated as a percentage of the notional, say, 10% of the notional with a certain netting benefit," said Tanase. "Risk offset benefits are taken into account – but only to an extent."

"On the other hand, Simm is fully risk-based. It is a methodology that is created and designed by the International Swaps and Derivatives Association and a group of investment banks for use by the industry, with all the nice properties including flexibility, ease of implementation and transparency."

Simm is the preferred choice for most firms, including those in phases five and six, because it can be used for a variety of portfolios across the industry.

"Even if Grid is seen as a reasonable choice, the choice to go with it should be made with the utmost care," Tanase warned. "Because it is not a risk-based approach, it may not work well under all possible scenarios."

Lessons learned: a ticking time bomb?

With phase six set to begin in September 2022, there are lessons the industry can take from the roll-out of previous phases.

For instance, firms have tended to be overreliant on threshold monitoring, which should be used as a tactic to delay getting pulled into UMR – not as a long-term strategy.

"Everyone thought it was going to be a 'big bang' and there [would] be lots of clients moving collateral – that hasn't been the case," said Joshi. "Everyone has gone for this threshold monitoring ... You don't have $50 million. And when we negotiate with the dealers, they like to put a haircut on that from an FX [foreign exchange] point of view. So now you are getting down to your $30 million number. You put a couple of big trades on over $500 million notional and you have blown that IM straight away."

Firms that have delayed compliance through threshold monitoring will soon find themselves appointing custodians. "Because you are going to breach that threshold in the middle of phase six, that is going to be ... a ticking time bomb," said Joshi.

Meanwhile, large bank broker-dealers that have already experienced UMR have geared up their practices to cope with compliance, said BNY Mellon's Higgins.

"We have rolled out standard account control agreements – you elect your terms, and you don't negotiate any more," he said. "A key lesson we have learned from earlier phases is that we like to be flexible and work with our clients but, ultimately, it can't be to the detriment of the overall project.

"In phases one through four, most parties would look after themselves when it came to calculating the IM and making the margin calls, and so on ... For ourselves, as a custodian providing middle-office services, we have done similar capacity but also, operationally, we are doing the calculating, calling and instruction of the margin calls – and I think our clients have been pleased with that," added Higgins.

IHS Markit's Tanase stresses the need for timely and thorough preparation to ensure success. "Getting ready for setting up a Simm calculation itself isn't straightforward," he said.

“Setting up an IM calculation solution ... [is about] getting the workflow done, it is about reconciling IM and, in certain cases, firms need to go through a formal model validation to meet the requirements set by their regulators.

“This exercise was a lot more laborious and time-consuming than initially anticipated ... [You] need to start early and also plan ahead with the thoroughness for a smooth go-live,” Tanase added.

[Download the IHS Markit initial margin calculation white paper]

The panel members were speaking in a personal capacity, and the views expressed do not necessarily reflect or represent the views of their employing institutions.