

Sharpening the tools

Preparation for UMR phase five

A forum of industry leaders discusses the suitability of the standard IM model for phase five firms, how they can optimise portfolios to minimise margin costs and how the lessons learned from previous phases can help prepare firms

Despite the delay to phase five uncleared margin rules (UMR) implementation, many firms have made little preparatory progress. What implementation priorities should they focus on as the deadline approaches?

Tom Archer and Kah Yang Chong, LCH: Firms in scope for phase five should ensure that appropriate documentation – such as credit support annexes (CSAs) – and custodial arrangements are in place with dealer counterparties. Firms should prioritise counterparty relationships likely to meet the \$50 million IM threshold. With more than 300 entities coming into scope, they need to be aware that this process creates an operational burden for their dealer counterparties and could take many months to resolve.

To reduce the impact of UMR, these firms should also consider portfolios that can be transferred to clearing. Although it is perhaps a little too late to use this strategy to reduce the average aggregate notional amount (AANA) to below \$50 billion before the end of the calculation window, a firm in scope for phase five UMR can reduce the number of impacted counterparty relationships by transferring risk between cleared and uncleared portfolios, either in totality or such that the IM exchange falls below the \$50 million threshold.

To what extent will phase five firms rely on margin monitoring services to forestall their preparations? What governance processes are required in following this strategy?

Tom Archer and Kah Yang Chong: Firms in scope need to carefully monitor their bilateral IM for each counterparty and only set up UMR arrangements with counterparties close to or above the IM threshold. On the face of it, this approach is proportionate; however, the logistics can be complex. It requires daily, active, real-time threshold management across all asset classes and making decisions at the right time to set up UMR arrangements.

As regulations do not extend a grace period to firms that breach the IM threshold, market movements and material risk position changes can quickly increase bilateral IM, while setting up UMR arrangements could take months. This could lead to loss of liquidity access and, ultimately, impact best execution.

Monitoring IM thresholds is also challenging for separately managed accounts, where multiple fund managers are executing on behalf of a single fund. The IM threshold may need to be shared or divided, which could negate any benefits by monitoring margin.

In contrast, alternative approaches, such as voluntary clearing and product substitution, deliver the benefits of counterparty choice, capital savings and operational efficiencies.



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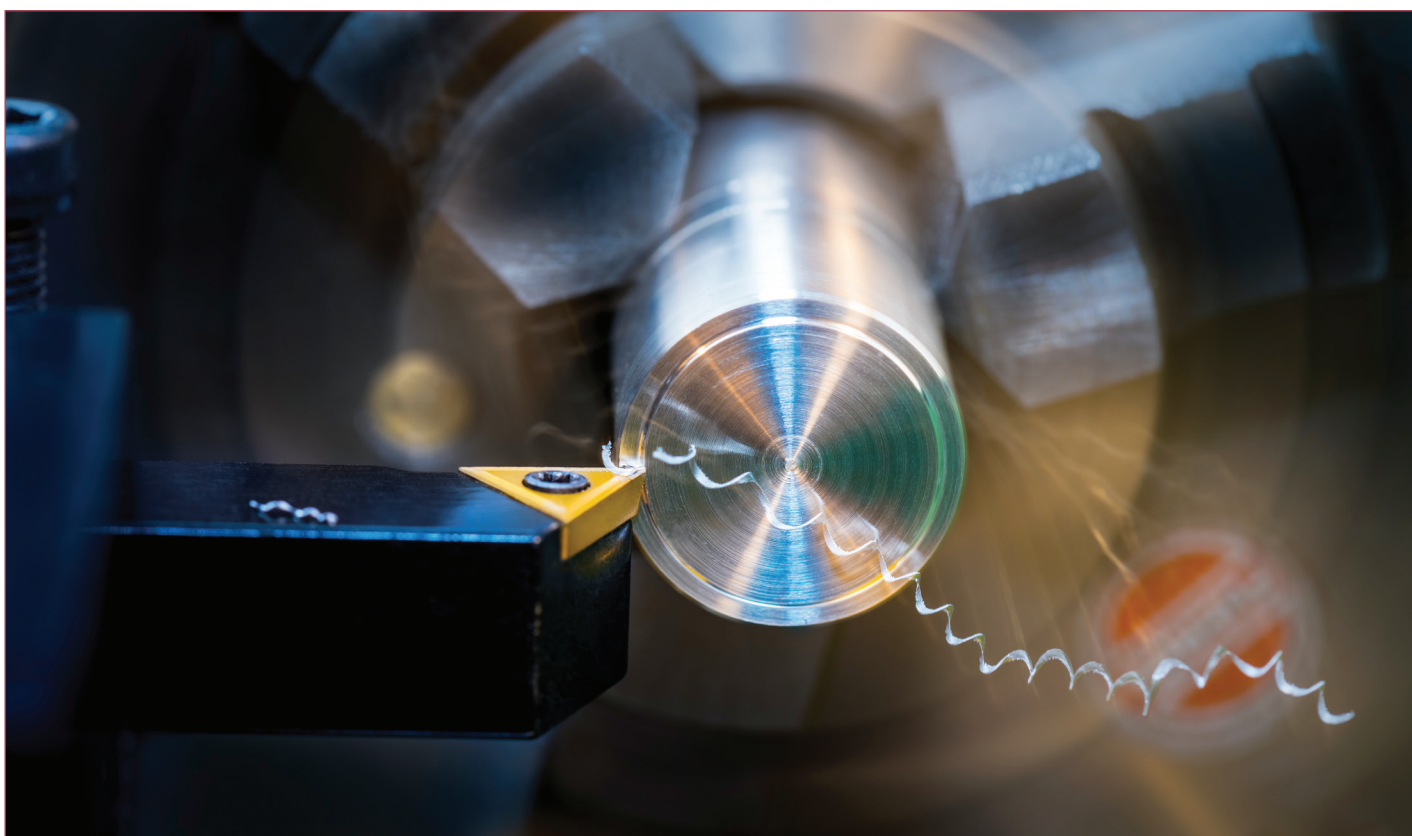
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How suitable is the standard initial margin model (Simm) for phase five clients?

Tom Archer and Kah Yang Chong: The regulations mandate two alternative methods of calculating IM: the schedule-based grid approach and an internal model-based approach, such as Simm. The former has the benefit of simplicity and ease of implementation. However, firms should be aware that the schedule approach tends to generate IM many times greater than the model-based approach. Simm has become the industry standard, and asymmetry in the calculation method is impractical. Therefore, firms should prepare for increased transactional costs if they opt for the schedule-based approach.

Although more complex than the grid method, Simm is relatively simple and predictable compared with other proprietary IM models. Furthermore, a wide range of commercial vendors offer solutions that manage the Simm calculation and reconciliation. Firms can therefore outsource much of the operational burden, although independent model validation and back-testing requirements are still in effect in Europe – and proposals for relief may not be in place before the September 2021 deadline.

Use of clearing relieves clients of the requirement to calculate IM themselves, thereby reducing the operational burden. Additionally, central counterparty (CCP) margin models provide opportunities for netting efficiencies across counterparties that cannot be achieved bilaterally. This also may cut both the amount and procyclicality of payments.



How can phase five firms optimise portfolios to minimise margin costs?

Tom Archer and Kah Yang Chong: Voluntary clearing of derivatives presents a great opportunity for clients to optimise their portfolios and achieve savings in two ways. First, the consolidation of positions across multiple counterparties to a single CCP allows for maximum netting opportunities. Second, the LCH IM model has a lower margin period of risk versus International Swaps and Derivatives Association's (Isda's) Simm, which could result in lower margin for diversified and directional positions.

LCH recently undertook a cost comparison that examined a number of portfolios across a diverse set of participants, including dealers, hedge funds and asset managers. In the foreign exchange space, analysis suggests clearing may result in large IM savings versus bilateral trading – up to 70% in some cases.

Once firms start to clear, they reap other benefits as well. For example, operational, credit risk and liquidity considerations may also tip the balance in favour of clearing. A streamlined operational model with a single counterparty – under the LCH rulebook, where there are no valuation disputes and a strong network effect – could provide a solid foundation that enables counterparties to prefer selecting clearing rather than bilateral counterparties.

What can phase five firms learn from the experience of previous phases?

Tom Archer and Kah Yang Chong: Delays in setting up custodial arrangements marred the first wave of IM implementation in 2016, with many banks reportedly unable to face a number of their counterparties on day one of the new regime. With a significantly greater number of counterparties in scope for phase five, the potential for similar disruption is as great, if not greater. Firms should therefore ensure they are pushing implementation as much as possible ahead of the September 2021 deadline, prioritising those counterparty relationships that are likely to meet the IM threshold.

Firms should also consider clearing as a way to alleviate the UMR burden as some firms in previous phases have done. There has been a general increase in the volume of cleared derivatives driven by the initial phases of UMR, with LCH's ForexClear non-deliverable forward (NDF) clearing service being a prime example of this. CCPs continue to extend their range of cleared products and are venturing into areas not traditionally associated with clearing, such as over-the-counter (OTC) equity swaps, giving the market a choice and the ability to optimise resources.

How have vendors sharpened their IM tools, tech and services in recent months in preparation for phase five?

Tom Archer and Kah Yang Chong: As costs relating to UMR compliance have become clearer over the past few years, many providers have launched new products and services to help firms navigate the ever-changing landscape. This includes services around operational and legal setup, and creating margin efficiencies through optimisation.

Voluntary clearing is a key component of clients' UMR preparation toolkits. A streamlined setup coupled with inherent margin optimisation puts firms in a great position to deal with UMR. At LCH, we are constantly enhancing our products to better serve our customers.

In FX, LCH recently launched clearing of non-deliverable options (NDOs), added seven new currency pair NDFs and extended the maximum maturity of trades to five years for certain NDF currency pairs. LCH EquityClear also plans to launch clearing of OTC equity swaps – contracts for difference – in the near future. This will allow our customers to gain further margin efficiencies and increase their clearable product netting set. ■

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