Initial margin

Special report 2019

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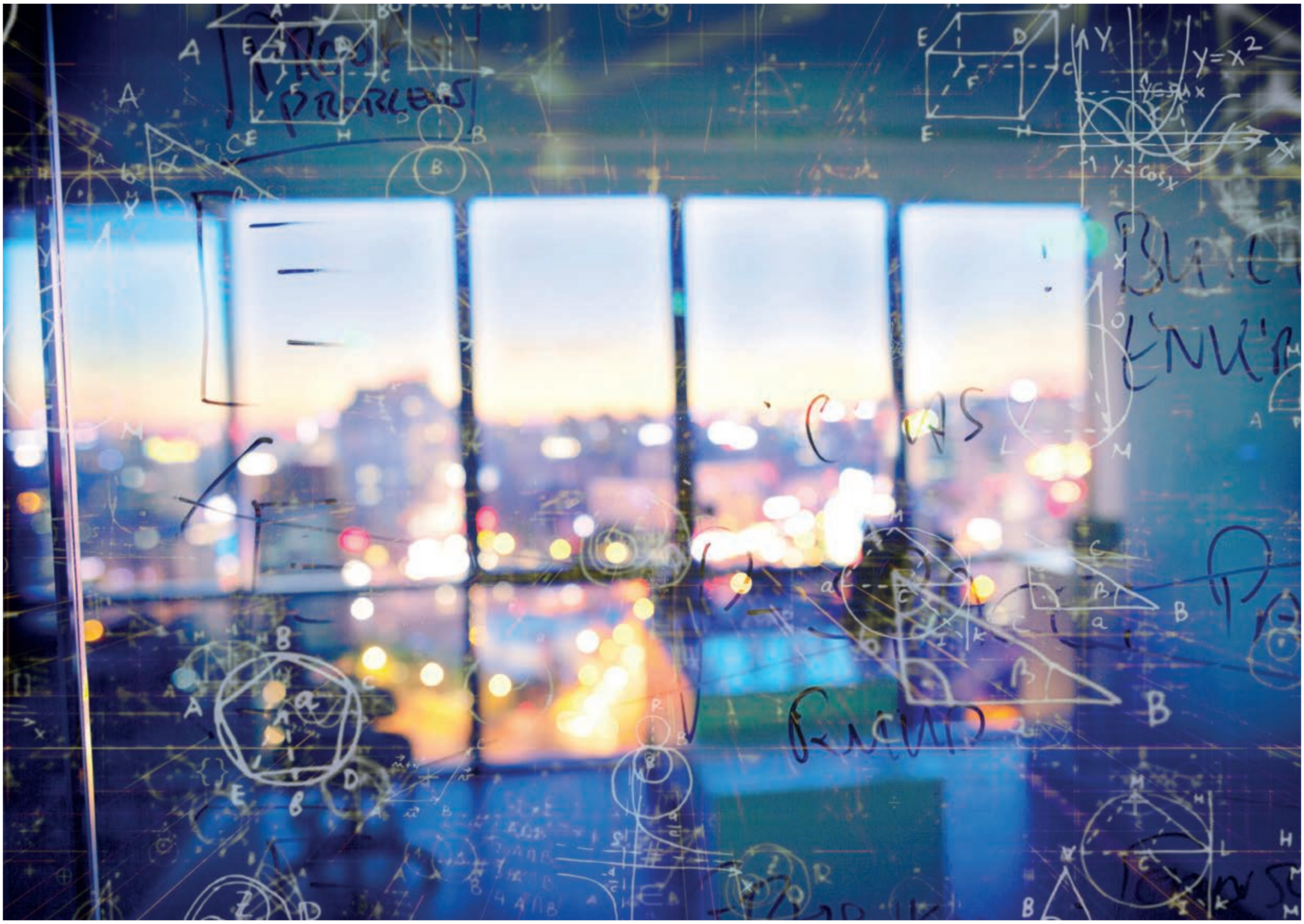

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A regulatory bottleneck

With the recent announcement of an extended preparation period for those smaller entities needing to post IM under the uncleared margin rules, the new timetable could cause a bottleneck for firms busy repapering derivatives contracts linked to the discredited Libor benchmark at the tail end of 2021. As the threshold for compliance reduces and more buy-side firms are caught, a panel of experts examines the key preparatory steps required, including documentation, custody account setup, margin calculation and the backtesting of IM models to smooth the process and ensure compliance

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How will the extension of the implementation phase affect firms' preparations?

Mohit Gupta, Cassini Systems: The extension has helped firms of between $/€50 billion and $8 billion average aggregate notional amount (AANA)[1] get an additional year to prepare for the roll-out of uncleared margin rules (UMR). This extension gives firms more time to operationally prepare and seek solutions that are holistic and can provide consistent margin calculation and controls across bilateral trading and the cleared world. This extension is not a reason to postpone projects for a year. Even the regulators have emphasised that the extension is intended to give firms enough time to act diligently to comply with the regulations. The delay also offers opportunities to firms slightly above but close to the threshold to look at solutions and alter trading styles to delay their roll-outs by another year.

Neil Murphy, TriOptima: For firms not impacted by the increase in the phase-five AANA threshold, nor by the introduction of the new phase-six timeline of September 2021, it's very much a case of business as usual. With less than one year to go, they should be in the throes of implementation. In fact, for some phase-five firms it may have given extra momentum to their preparations by removing any lingering questions with regard to possible change or further delays.

Firms falling into the new extended phase-six timeline are faced with the choice of mothballing their projects – and dusting their plans off in mid-2020 – or ploughing on. Delaying the project risks firms losing valuable momentum and knowledge – and potentially finding themselves at the back of the queue with custodians, vendors and even counterparties when they resume. Instead, most firms I work with have adopted a more pragmatic approach to their preparations – albeit working towards a later go-live date. This way, they leverage the analysis and planning completed to date, give themselves more lead time to better understand the full impact of IM on each of their portfolios and have a longer window to evaluate and test the new systems they will likely need to implement. The sentiment for many firms is: 'Let's just get on with it – get UMR finished and move on to the next thing.' With the number of firms in phase six expected to be significantly greater than prior phases – and amid concerns about being at the back of the queue – this argument makes very good sense.

Firms' perspectives on whether recent regulatory guidance – which confirms that firms are only required to have legal and custody documentation in place if their IM exposure is above the regulatory $50 million threshold – is a case of either 'glass half full' (by reducing the overall operational burden) or 'glass half empty' (by potentially complicating matters and creating bifurcated processes), which will vary for each client.

Hiroshi Tanase, IHS Markit: The extension benefits the firms whose AANA is between $8 billion and $50 billion, or the equivalent in other currencies. These are the new phase-six firms to come into scope in September 2021. The International Swaps and Derivatives Association (Isda) estimates 775 counterparties and 5,443 relationships in this phase. These counterparties now have the opportunity to observe and learn from the experience of phase-six firms to implement an optimal solution. Having said that, they are advised to make the most of the extended implementation period without halting the UMR project within their organisations. For the new phase-five firms, there is no time to waste to achieve compliance in time for the September 2020 deadline.

Paddy Boyle, LCH: Splitting the original phase five across two years extends the time available for market participants to prepare for and implement their compliance plans for UMR. While this provides all parties with enough time, market participants subject to the final phase in 2021 should not slow down their internal UMR preparations, which require a great deal of work – including managing straight-through processing (STP) and workflows upstream, as well as engaging all relevant counterparties. Despite the extra time, it is essential to stick closely to an implementation plan, given the challenges of including legal, structural – order management systems, for example – and back-office implementation modules. An extension also gives participants time to consider and implement strategic alternatives, such as voluntary clearing of in-scope products, which reduces the scope of eligible sub-accounts.

Tobias Bergholdt, Nykredit: It will give phase-six firms more time but, since everybody was preparing for 2020, I think most will try to keep to the timeline rather than put the project on hold. This will mean more time to analyse the flow and some phase-six companies will view it as a chance to learn from phase five.

Everyone agrees that the sooner you start, the better. But there are very few tri-party agents, and the buy-side firms will hit the same counterparties at the same time so you will have this bottleneck of legal work and system preparations.

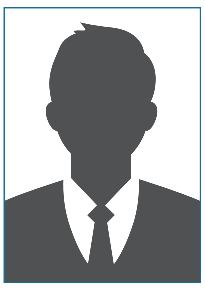
Nykredit's exposure is just under the €50 billion notional mark, so we are tracking it right now and have discussed what we would do if we're edging closer to the threshold.

[1] *Or equivalent currency based on jurisdiction.*

Chetan Joshi, Margin Reform: In July 2019, the Basel Committee on Banking Supervision and the International Organization of Securities Commissions proposed guidance for a one-year extension of the final implementation phase of UMR. Global regulators have agreed with the guidance and have started to change their regulatory technical standards.

On December 5, 2019, the European Supervisory Authorities published their final report and public statement on bilateral margin amendments and statement on introduction of fallbacks in over-the-counter (OTC) derivatives contracts. The revised margin regulatory technical standard addressed the following topics:
- Variation margin (VM)
- IM phase-in
- Intra-group derogation
- Equity options derogation
- Amendments to legacy contracts.

The challenge has always been the the number of firms in phases five and six – around 1,100 newly in-scope counterparties (NISCs). This will create a squeeze on the resources that negotiate the legal documentation and on custodians who may be required to set up new accounts. Regulatory IM is a new process for all phase-five and phase-six firms, and implementation is complex.



IHS Markit

Hiroshi Tanase, Executive Director,
Product Management
www.ihsmarkit.com

What are the key challenges for firms approaching UMR?

Hiroshi Tanase: The key challenges are mainly in three areas:

1. Determining AANA and communicating that back to counterparties in a timely manner
2. Negotiating new IM credit support annexes (CSAs)
3. Putting a mechanism in place to calculate IM.

Compared with, for example, one year ago, NISCs are in a better position as there is much more clarity about the requirements and there are more solutions on offer for all the aforementioned key elements. However, a firm still needs to make an objective assessment of its specific situation and needs, so that the implementation project can be driven with the right objectives.

Neil Murphy: The multitude of compliance challenges can be consolidated into two broad types: calculation-related and collateral-related – each of which create their own set of associated technology challenges. Calculation challenges centre on the choice of IM model – which you might expect to be an easy decision for firms not yet in scope, given the near-universal use of the standard initial margin model (Simm) in earlier phases – the associated calculation of Simm's inputs (trade sensitivities) and potential IM validation requirements.

Collateral challenges haven't been in the spotlight as much as calculation challenges, but firms must be certain not to overlook them. These challenges encompass legal documentation, margin call communications, IM reconciliation and a choice of collateral segregation options.

Mohit Gupta: The challenges UMR presents for buy-side firms fall into two buckets. On the operational front, firms need to understand if they will be affected by UMR. This depends on whether they are above or below the AANA threshold at each phase: phase five ($/€50 billion AANA) on September 1, 2020, and phase six ($/€8 billion AANA) on September 1, 2021. Once a firm knows it is in scope, it needs to speak with its respective dealers and repaper agreements along with accord on the margin calculation model to be used. This model also must be approved by the firm's respective regulators. Additionally, if firms believe they will exceed the margin posting threshold – up to $/€50 million per group relationship – they need to set up custodians who will manage the collateral on their behalf. Based on the experience from previous phases, this can be a lengthy process.

Equally important is the challenge UMR presents to firms in capital consumption and collateral liquidity. Firms must understand how to manage and reduce the amount of new collateral required to reduce the impact of carry cost on firms' profit and loss.

Paddy Boyle: Market participants preparing for UMR face a demanding and highly complex process with numerous steps – as Isda has highlighted[2] – and must tackle two distinct sets of work. The first involves setting and running compliance with the new rules. Uncleared derivatives users must calculate their AANA; determine when they are in scope in each jurisdiction, and for which entities; agree new credit service agreements and custody relationships; and then run those credit service agreements, potentially with third-party assistance. In the second, changes to behaviour can minimise the burden of operating within the new framework. Compressing more portfolios, clearing new trades and backloading old ones into clearing can significantly reduce the number of entities in scope. Clearing more flows will also reduce the amount of margin that needs to be paid.

Tobias Bergholdt: A lot of legal work is needed. The first obstacle, especially with the additional step in the timeline, is to decide whether you want to do the full legal onboarding so you are 100% prepared, or if you want to stay in the slipstream where you only calculate the IM and wait to see what happens.

This project affects the whole business. Some buy-side firms see it as a collateral issue and pass it down to the back office, yet they will be surprised how much the front office needs to be involved and how much legal work is required. Some of the legal templates have been standardised from phases one to four, but it's still a huge challenge.

Even if you choose monitoring, it is important to contact all your counterparties to confirm whether they are using the schedule approach or Simm to calculate IM – as those numbers can differ a lot – as well as agreeing the threshold on the IM. It's worth going into depth to get the right resources and technology in place. Nordea Asset Management, where I worked previously, was caught in phase two – having the IM monitoring task down to almost five minutes a day. We only checked that the IM was calculated correctly and the bonds for the IM were moved.

Chetan Joshi: As well as the squeeze on documentation and custodian relationships, the other main challenge is that of the new IM model. In the EU particularly, model development, implementation, governance, and ongoing monitoring and performance measurement are critical. The IM models will be scrutinised by your counterparties and the regulator, so you need to constantly upgrade, maintain and ensure proper controls around your model validation, backtesting and benchmarking environment.

Another potential challenge will be around the upcoming European Market Infrastructure Regulation refit and model validation, as we wait to see the requirements of the forthcoming technical standards in Europe.

[2] *Isda (2018),* Getting ready for IM regulatory requirements – What steps do I need to take?, *https://bit.ly/2JrPiPr*

TriOptima

Neil Murphy
Business Manager, triResolve
www.trioptima.com

What impact will the rules have on firms' trading strategies?

Neil Murphy: A key thread that links calculation and collateral challenges is technology. These varied challenges may mean multiple systems – but it's not enough to think about each system in isolation. Firms should view their IM solution as a single entity, ensuring seamless connectivity between each component. Implement new technology without this and your daily IM process risks being a costly operational headache. Get the connectivity right and you will be well placed to navigate the new path ahead.

Tobias Bergholdt: Everyone will do all they can to avoid posting IM. The implications in terms of the volume and cost are huge. Firms that are close to the threshold might clear some of the products or expand the range of counterparties.

The portfolio managers I speak to don't even hold many of the eligible securities. So a change of strategy is needed, including looking into clearing and even asking why you are trading a certain product. Is there a cleared or exchange-traded substitute available? Or can you go to a prime broker with another product? As I understand it, the level of IM required can be two or three times more for uncleared, so it will take a lot from the portfolio.

We may also see pressure from the buy side for regulators to expand the range of eligible securities to include, say, mid-range bonds and mortgage bonds.

Paddy Boyle: Prior to UMR, firms took a relatively simple approach to execution, with the view that the best price delivered the best execution. However, participants trading bilaterally under UMR face the daunting challenge of who to trade with to optimise IM, as not all equal prices have equivalent collateral implications. Post-trade, there is the secondary economic impact of needing to pay for optimisation vendors, third-party custodians and other consultants – costs not captured in 'price' but linked to execution decisions.

Where it is more efficient to do so, prepared firms will now switch from an uncleared to a cleared strategy, which removes the need to think about who to trade with. But LCH does not anticipate that firms will change what they trade, except in very limited circumstances.

Chetan Joshi: The sell side is working towards margin valuation adjustment and where it is negatively impacted you can expect the costs of funding to be passed back to the end-client through their derivatives pricing.

This will impact a few areas. Firstly, for derivatives users wanting to explore pre-trade analytics options, would it be cheaper to hedge using a cleared derivative or an exchange-traded instrument? The business may not be 100% hedged but this could be an acceptable risk versus the cost.

Then there is the issue of collateral drag. IM exposure needs to be covered by eligible collateral assets and these will be locked up in a segregated account and therefore not available for re-hypothecation, which means collateral costs will go up. Will organisations choose to allocate those costs back to the trading desk or centralise them as a cost of business?

Hiroshi Tanase: Understandably, the current focus for most firms coming into scope in phases five and six is to have a solution in place to avoid forced and unwelcome disruption to the execution of their trading strategies. Recently, more attention has been paid to the issue of incorporating the impact of IM cost in the trading decision-making process. That is the task of pre-trade analysis, which is often coupled with complementary effort of post-trade optimisation. While it may take some time and the evolution may not follow a straight line across different types of institutions in the industry, it is conceivable in the long term that the impact of IM will be considered in some fashion even by relatively small firms. Importantly, UMR have further spurred the interest in increasing the use of cleared and exchange-trade derivatives.

How will the need to post IM affect firms' choice of products?

Chetan Joshi: There are certain product exemptions depending on which regimes you and your counterpart fall under. In Europe, for example, the exemption on equity single stock options has just been extended until January 4, 2021. Additionally, you may want to consider the cost of a trade before you execute it and, therefore, pre-trade analytics may also be something to consider.

Mohit Gupta: Simply put, it is beneficial to find ways to trade required risk exposure that have lower IM requirements. One way is to trade using cleared products – OTC or exchange-traded derivatives (ETDs) – that offer the required risk exposure. This can help some firms avoid being in scope or delay until phase six by reducing their AANA. It also helps in-scope firms reduce overall IM and may keep them under the $/€50 million posting thresholds. A second approach is broadening the number of counterparties firms trade with. This extends the total IM exposure firms can have before having to post – $/€50 million per counterpart. The biggest impact of the rules, however, will be firms' awareness of margin and amending trading styles to consider margin requirements and collateral drag *ex ante*.

Tobias Bergholdt: In my experience, firms that are hit by IM mainly trade vanilla, with some cross-currency derivatives that are outside the scope of clearing. If your firm is big enough to be hit by IM, then you'll have to clear your derivatives either way.

Firms need to understand that it only applies to trades going forward. You've probably already been caught by mandatory clearing, so a lot of products you have in your AANA will not go into the uncleared world going forward. Where you'll be hit is more likely the exotics, such as cross-currency.

Paddy Boyle: For firms taking longer-dated or large positions in in-scope products, LCH expects a significant move to clearing, which is even more efficient once bilateral trades are also subject to uncleared bilateral IM. This efficiency accrues not only to the end-client, but their bank trading counterparties will also derive benefits, both in the form of reduced IM via clearing and from the superior balance sheet treatment of cleared versus bilateral risk exposures; risk-weighted assets and leverage ratio calculations attribute lower capital obligations for cleared trades, making dealers even more inclined to see clients clear trades.

Hiroshi Tanase: Once a fully fledged IM solution is in place, the in-scope firm can, in theory, continue to trade any type of uncleared derivatives. But the cost of IM may influence the preference for different products. The standard Simm offers a general solution across the entire spectrum of instrument types – together with schedule IM for certain esoteric types – and therefore no products would be off limits. The relative attractiveness of cleared derivatives and ETDs may increase for firms for which the IM funding cost is a material factor.

LCH The Markets' Partner

Paddy Boyle
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What tactics are firms using to reduce IM exposure?

Paddy Boyle: There are two approaches for firms looking to reduce margin exposure. First, they can reduce their OTC derivatives notional below the $50 billion or $8 billion threshold, as applicable. Where this can be achieved through more compression of bilaterally held portfolios and more voluntary clearing, entities can be kept out of scope entirely. Alternatively, for in-scope entities, more voluntary clearing will significantly increase the margin efficiency of most portfolios.

Mohit Gupta: Firms can reduce margin exposure, either by altering their trading style or investing in technology systems. Altering trading style includes trading products that require less margin to be posted or trading them on exchanges, which have lower margin requirements. This is not always possible and is dependent on availability of such products and comparable liquidity.

UMR provides a threshold per relationship where only margin exceeding the threshold has to be posted. Some firms are adding dealers to achieve a higher aggregate threshold. However, this approach is not without its own constraints.

When using technology to help reduce IM exposure, firms are looking for systems that:

- Monitor IM exposure at their respective dealers
- Explain the margin requirements at CSA and trading book level
- Provide pre-trade decisions on the best dealer to trade with, depending on the marginal cost of collateral.

Neil Murphy: For firms already in scope, the volume of IM being exchanged is sizeable – $140 billion or more. It should be no surprise to learn then that firms are actively prioritising steps to reduce the cost – and both portfolio compression and optimisation are hot topics among dealer banks.

TriOptima's triBalance service can allow in-scope firms to minimise IM costs through multilateral IM optimisation cycles. Specific sets of risk-reducing trades rebalance counterparty exposures while keeping the overall portfolio market risk-neutral. Capital costs are minimised by using the minimum possible amount of notional.

Firms have also leveraged triReduce's compression cycles to reduce overall gross notional, with the goal of minimising overall IM exposure.

Not solely linked to a goal of reducing IM exposure, but combined with a wider desire to potentially remain out of scope for as long as possible, some firms are looking to pre-trade optimisation to ensure they efficiently manage their IM and exposure across a broad set of counterparties. In doing so, they seek to take advantage of the maximum $50 million regulatory threshold per relationship, hence delaying or even avoiding having to post IM.

Tobias Bergholdt: Firms will look to compress and net as much as possible to reduce notional. It's a relatively easy calculation and there's a lot of technology available to help.

Some compression trades are easily executed with your counterparty OTC. Then there are vendors such as TriOptima – they have most derivatives trades already in their ecosystem, so they will take a portfolio of trades such as interest rate swaps with different counterparties, and recommend which can be offset against others via novation, and then compressed.

Hiroshi Tanase: Large sell-side firms in early phases have largely completed IM reduction and optimisation exercises. Techniques include risk transfer across IM netting sets – such as counterparties – and between bilateral, cleared and exchange-traded (where applicable) positions. IM is reduced if more risk offsets are achieved within a netting set. IM can be reduced – within limits – for both pre- and post-trade. For large broker-dealers, the emphasis is on post-trade optimisation/reduction. As with derviatives valuation adjustment – known as XVA –a decade ago, optimising IM requires not only the establishment of tools and processes but also developing understanding within an organisation, which is often a challenging and slowly evolving process – even at tier one banks with highly skilled staff. For phase-five and phase-six firms, reducing overall exposure by clearing more trades is currently the main tactic. The next step will be to maintain an optimally low level of IM through active use of IM optimisation tools pre- or post-trade. Pre-trade, firms will look to identify counterparties with the lowest incremental IM. Post-trade, firms will look to put additional risk-reducing trades or novate trades, for example, to optimise IM. IHS Markit anticipates that to be a gradually evolving process.

Chetan Joshi: Beyond clearing, they'll look at portfolio compression to reduce their risk profile and to bring down the notional outstanding of derivatives – via novations – which drives the AANA calculation. Another option could be ETDs, while some firms are ceasing trading in certain products altogether. There are also tactical ways firms can split their $/€50 million threshold – across subsidiaries for example – to reduce overall IM exposure.

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How will the rules affect relationships with bilateral counterparties and prime brokers?

Tobias Bergholdt: If we are moving to a cleared world, we will need more counterparties to be eligible clearing brokers. But I don't think you will see a huge shift because a lot of firms will figure out how not to be hit by IM and will keep their trades non-cleared. We'll see similar numbers of counterparties, but probably fewer and smaller portfolios.

Hiroshi Tanase: The impact depends on the current arrangement in place. Most hedge funds have historically posted independent amounts (IAs) to their counterparties. It follows that, for those firms that are currently posting an IA, the margin arrangement after the introduction of UMR will be a dual-margin regime where both the non-regulatory IA and the regulatory IM will be posted under a bilaterally agreed complex protocol.

The introduction of UMR will also have some notable implications for the relationship between buy-side firms and prime brokers. Since the regulatory IM under UMR will be exchanged on a gross basis, the funding cost for prime brokers will increase because they must post IM for the benefit of clients and the executing brokers. The increased funding cost may be passed on to the prime brokers' clients.

Second, certain buy-side firms, such as real-money firms that traditionally did not use prime brokers, may consider using them instead of trading directly with executing brokers – bilateral counterparties, for example – because of the benefit of having a centralised counterparty to net positions and minimise IM amounts.

Chetan Joshi: Clients might find their liquidity providers have a prioritisation list; equally, they might want to consider reducing the number of liquidity providers they execute through to make compliance more manageable – in particular the documentation and monitoring requirements, especially in the European Union, where the regulator wants you to be able to validate Simm numbers.

Prime brokers already have a critical role in a functioning market, and UMR does not change that. The collateral upgrade trade will likely become more prevalent alongside front-to-back solutions for calculation, documentation, settlement, dispute management and ongoing monitoring. Naturally, this will come at a cost.

Mohit Gupta: Under UMR, firms are required to repaper their agreements with bilateral counterparties and prime brokers. Previously these counterparties would generally only request margin or an initial amount for bilateral trades from clients, but both sides of the transactions now need to post margin independently in segregated accounts. This not only increases the operational overhead on the dealer side but also the additional burden to have collateral inventory for margin requirements. Furthermore, dealers can offer clients the threshold – up to $50 million at the top level – which can differ depending on the client and factors such as their trading styles.

Post go-live, counterparties and clients need to keep a process in place for dispute resolution to tackle scenarios when margin requirements are widely different. An inability to post the required margin can lead to disruption of trading with the counterparty and, in extreme cases, termination of the relationship.

Paddy Boyle: For bilateral counterparties, maintaining some positions may become very expensive. We expect these to move to clearing and, if foreign exchange follows the pattern of other asset classes, we'll see a significant increase in accompanying market volume too.

Over the past three years, LCH has seen huge growth in the voluntary clearing of in-scope products – mostly non-deliverable forwards – among the groups caught in the early waves of UMR. We expect to see the same behaviour from most entities coming into scope next year and are working with many of them on clearing projects. Most – but far from all – forex prime brokers (FXPBs) are part of business units that include clearing brokers. Some of these FXPBs expect and intend to move a large amount of their client business from FXPB to cleared forex, as there are significant cost savings for FXPBs, clients and also executing brokers.

Furthermore, given that clearing creates a new phase in the evolution of the forex market, this creates a new chance for early adopters on both the dealer and clearing side to become market leaders and thought leaders in the space. In short, the transition to clearing will likely open an opportunity for new leadership and a revamped league table, which will in turn change the dynamics among counterparties, dealers and their clearing brokers.

Chetan Joshi
Founder and Chief Operating Officer
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What pressures are UMR placing on firms' resources and technology?

Chetan Joshi: There are a number of pain points created because of margin rules. New resources and technology are required to implement and process new legal documentation, custodian connectivity, risk models, collateral management workflows and treasury management. A number of firms will need to utilise new technology providers and, if these firms have not previously been through the UMR process, this creates a level of delivery risk that you must be comfortable with.

Timeframes are also shrinking – due to the larger volumes, the custodial deadlines for guaranteed onboarding are likely to be at the end of the first quarter of 2020. There's a lot of planning and testing involved for legal data, custody, Simm calculation, IM processing and then ensuring your business-as-usual playbooks are all complete and everyone knows what they are doing when you go live. You do not want any major surprises.

Neil Murphy: A recognition that calculation and exchange of IM is largely a new requirement for firms coming into scope has meant a technology gap for many firms. Universal adoption of the new Isda Simm methodology has increased the market's requirement for new technology – not simply in terms of IM calculation but, crucially, to facilitate IM reconciliation. Phase-one to phase-four firms prioritised this technology gap – adopting the same market infrastructure to solve the problem. Rather than shoehorning IM calculation into old platforms, they've looked to adopt new systems built specificically with UMR capability.

Unfortunately, a small number of in-scope firms have faced a wider technology gap, requiring new tools to calculate underlying risk sensitivities in the necessary common risk interchange format, and to exchange IM margin calls. While this – for only the smallest firms – has been the exception to date, I expect this to become more the norm in phase five and, in particular, phase six. On the point of sensitivity calculation, firms have a wide number of vendor options to choose from, but a more restricted choice in terms of margin call exchange. Firms need to choose well, ensuring not only that the underlying technology has the capability to support their required calculation models, but that it can also be plugged seamlessly into the overall IM architecture.

Firms coming into scope need to view technology as a key UMR enabler, critical to meeting IM calculation requirements, call negotiation and dispute resolution. Underpinning this new technology approach, firms must ensure they implement an efficient STP approach to manage the uptick in volumes.

A recurring theme is firms taking advantage of UMR not only to implement a new IM-compliant approach but, where possible, to review and upgrade current VM processes. This is more pertinent to phase-five and phase-six firms that may not traditionally have had the same margin capabilities as larger firms. Given the bilateral nature of the margin process, any improvement to legacy VM processes by NISCs will surely be welcomed by the broader market.

Mohit Gupta: The new rules have created a need for firms to implement operational and system changes to move two-way collateral and be able to calculate IM. This requires changes to systems infrastructure, new operational processes and potentially selecting new operations or technology partners.

However, this challenge is also being used as an opportunity by many firms to implement a front-to-back margin transparency and optimisation solution. The regulatory mandate and budget/resource assigned to that project can deliver a lot more 'bang for the buck' across the firm. The changes required can provide additional benefits such as consistent workflows across asset classes, net margin reduction and front-office cost transparency.

Tobias Bergholdt: The technology is out there and it works well. My hope is that firms will use this process positively – to present the business case to management that the investment is needed, but the technology can also be used for day-to-day activity around VM. Since you have to agree IM on an electronic platform – Marginsphere or AcadiaSoft – you may as well manage VM on that platform rather than via email, which a lot of smaller buy-side firms do. This can save time on collateral management. The IM process is very similar to that of VM so you may as well pull those two together and make it efficient.

It will take time to oversee the project and implement the systems but the benefits on the other side are really positive, so it's money well spent.

Hiroshi Tanase: It is true that firms need to invest capital to achieve UMR compliance. However, the competitive market pressure has resulted in the availability of cost-effective solutions that address key elements such as IM calculation. Phase-five and phase-six firms should take a long-term view and obtain a solution that will prove future-proof. Different solutions have different overall impacts on in-scope firms' resources and the cost to run the daily process.

Key considerations include not only the salient service features, but other important features that may be overlooked at first. For example, the reliability and accuracy of calculation is not an academic concept, but something that would directly affect the operational costs as IM disputes would directly translate into operational burden.

Adequate and timely customer support is another important consideration as many phase-five and phase-six firms will be relying on the service provider to augment their internal staff to manage the complexity of the IM calculation process. Last but not least, the service provider's awareness of and readiness to provide adequate support for implementing model risk management, or model governance, is another key point to consider when assessing the overall viability of the solution and impact on the firm's resources. ■

>> The panellists' responses to our questionnaire are in a personal capacity, and the views expressed herein do not necessarily reflect or represent the views of their employing institutions

Morgan Stanley's swaps clearing unit boosts client margin by $4.8bn

Futures commission merchants see required client margin increase 18% quarter on quarter. By Alessandro Aimone

Required client margin held by Morgan Stanley's swaps clearing unit jumped by $4.8 billion (28%) in the third quarter of 2019 – the most of the 17 reporting US futures commission merchants (FCMs).

Data from the Commodity Futures Trading Commission (CFTC) shows Morgan Stanley held $21.9 billion from clients to cover their swap trades, the highest level since Q2 2018.

Citi posted the second-largest quarterly increase, with required margin up $3.6 billion (13%) to $31.9 billion.

Of the remaining top eight FCMs, Wells Fargo saw required margin surge $2.6 billion (30%) to $11.2 billion; JP Morgan's increased $1.8 billion (13%) to $16.1 billion; BofA Securities' $1.7 billion (23%) to $9.1 billion; Credit Suisse's $1.5 billion (14%) to $12.6 billion; Barclays' $1.1 billion (17%) to $7.6 billion; and Goldman Sachs' $532 million (7%) to $7.8 billion.

Citi remains the largest FCM, with a 26.1% share of total required client margin, down from 27.1% quarter on quarter. Morgan Stanley consolidated second place, with a share of 17.8%, up from 16.3%. JP Morgan follows with a 13.1% share, down from 13.7%.

Combined, the top eight FCMs account for 96.3% of total required client margin, flat on the previous quarter and barely changed from 96.2% the same quarter a year ago. Total required client margin stood at $122.7 billion at end-September, up $18.3 billion (18%) quarter on quarter, and $34.2 billion (39%) year on year.

In total, 17 FCMs reported client cleared swaps margin for September 2019, the same number as a year ago.

What is it?

The CFTC requires FCMs to file monthly financial reports with the Division of Swap Dealer and Intermediary Oversight.[1] Selected data from these reports is made available publicly, including information on FCMs' net capital, customer segregated funds and required margin.

Figures 1 and 2 use data extracted from the 'customer amount cleared swap segregated – required' field in the monthly reports. This data denotes the amount of funds an FCM is required to segregate for customers who trade cleared swaps.

Why it matters

The top eight clearing brokers continue to hog the client clearing wallet. The concentration of required margin among this elite climbed from 88.8% in 2014 to around 96% by mid-2017 and has stayed roughly at this level ever since.

Although mandatory margin requirements are an imperfect indicator of client activity – since movements in risk levels and netting agreements also have an impact on their level – an aggregate 18% jump in total required margin over the past three months would suggest FCMs are taking onboard more client trades and therefore risk.

The CFTC is keeping a close eye on the risks inherent in the system. In May, it published the findings of its reverse stress test of LCH Ltd and CME Clearing, two key central counterparties, which found that both would survive even if all their clearing members with losses defaulted on a day of extreme market chaos.[2] This implies that the concentration of client clearing activity among a small cadre of firms does not, by itself, imperil clearing houses. ■

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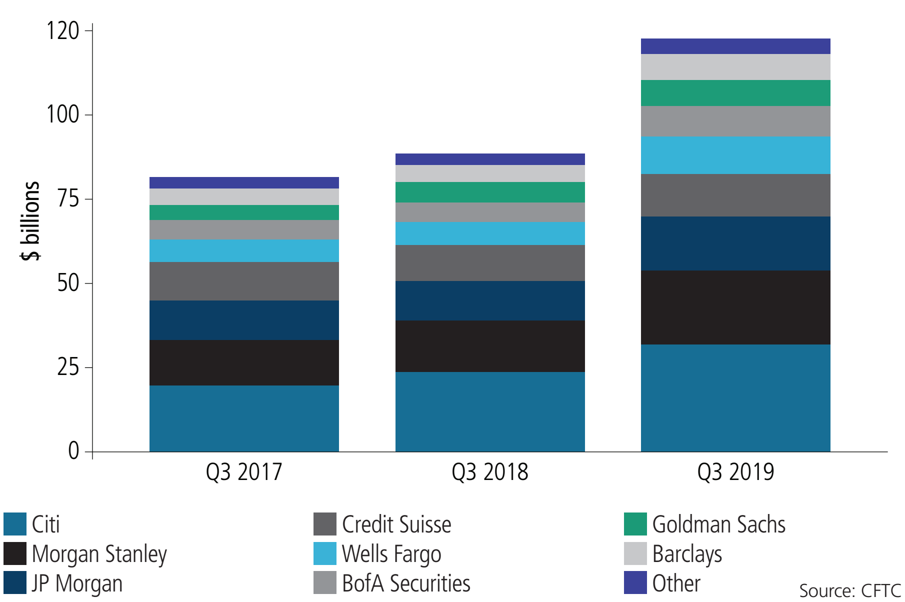
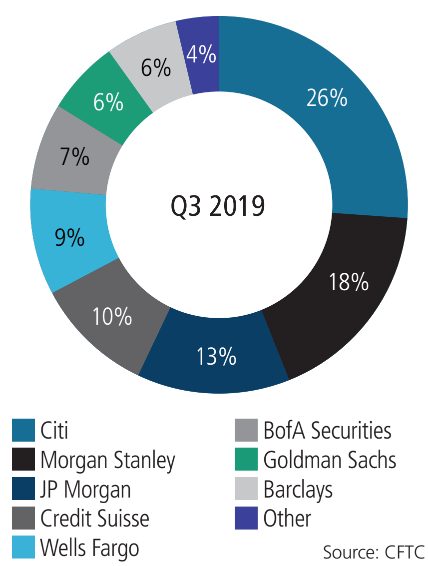
1 Total required client margin for cleared swaps across all FCMs



Source: CFTC

2 FCMs' share of total required client margin for cleared swaps



Source: CFTC

[1] CFTC, *Financial Data for FCMs*, *https://bit.ly/37vOnZs*
[2] CFTC (May 2019), *CFTC Staff Issues Clearinghouse Supervisory Stress Test Report*, *https://bit.ly/2XBbltX*