Meeting The Challenges of UMR Compliance – Impact To Margin & Collateral Management

NRI White Paper
March 2019

NRI

Summary

- Uncleared Margin Rules (UMR) have been put in place globally to mitigate credit exposures and reduce systemic risk in derivative markets
- Firms are required to calculate initial and variation margin requirements on a daily basis
- Daily initial margin requirements must be supported by both the posting AND receiving of collateral which must be held in segregated bankruptcy remote custodial arrangements
- Costs associated with UMR compliance may affect the business models and investment strategies of newly in scope firms
- Phases 4 and 5 of UMR scheduled for September 2019 and September 2020 could bring into scope over 1,000 firms trading under nearly 10,000 legal agreements, requiring the establishment of up to 20,000 custodial arrangements
- Smaller firms may not have the experience, processes and technology to implement and manage daily margin and collateral processes
- Larger firms may not have the scale and efficiency to cope with the increased numbers of clients caught by phases 4 and 5

Background

Introduction

As a result of the financial crisis, in September 2009 the G20 agreed to introduce a range of regulations to make financial markets safer, fairer, more efficient and more transparent[1].

In 2011 the BCBS and IOSCO were called upon to develop consistent global standards for the margining of non-centrally cleared derivatives[2] with the dual intentions of reducing systemic risk and promoting central clearing.

The resulting policy framework published in 2015[3] has been enacted into global legislation requiring derivative trading to be supported by the exchange of variation and initial margin[4]. The legislation has been phased in based upon firms' aggregate average notional amount (AANA) of non-centrally cleared derivatives.

The first three phases up to September 2018 have affected a relatively small number of dealers and large, well-resourced financial firms. The introduction into force of Phases 4 and 5 in September 2019 and September 2020 respectively is on a different scale. ISDA estimates that up to 1,000 firms trading under around 9,400 legal agreements, requiring 18,800 segregated initial margin accounts may be caught in these final phases[5].

Furthermore, industry estimates suggest that the renegotiation of existing ISDA Master Agreements

and Credit Support Annexes might take up to 3 months, and that the KYC due diligence and onboarding requirements of custodians potentially taking up to a year. Given the numbers of market participants looking for similar solutions in the same short time period, these estimates are not unreasonable.

The sheer scale of the numbers of firms caught by the final phases is likely to have an impact on the capabilities of dealers, custodians, vendors and service providers to assist firms in meeting their obligations in a timely and efficient manner.

Without the ability to both call and receive collateral to support initial margin calculations, parties will no longer be able to trade uncleared OTC derivatives beyond their relevant deadlines.

So What Should Organisations Be Doing?

Preparing for the implementation of waves 4 and 5 will create a significant project management requirement for impacted firms. Leading the compliance obligations will require project management expertise to bring together the impacted stakeholders across trading, resource management and the core support functions such as operations and legal. Once enabled, the project organisation will then need to drive forward bilateral compliance with their trading counterparties to ensure readiness for the new regime.

---

[1] G20, *Pittsburgh summit declaration*, http://www.g20.utoronto.ca/2009/2009communique0925.html
[2] G20, *Cannes summit final declaration*, http://www.g20.utoronto.ca/2011/2011-cannes-declaration-111104-en.html
[3] BIS/ISOCO, *final policy framework*, https://www.bis.org/bcbs/publ/d317.pdf
[4] European Commission, https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R2251&from=EN US Prudential Regulators, https://www.govinfo.gov/content/pkg/FR-2015-11-30/pdf/2015-28671.pdf CFTC, https://www.cftc.gov/sites/default/files/idc/groups/public/@lrfederalregister/documents/file/2015-32320a.pdf NB The SEC reopened its comment period on margin rules for Security Based Swap Dealers in Oct 2018: https://www.sec.gov/rules/proposed/2018/34-84409.pdf
[5] ISDA / SIFMA, *July 2018 white paper*, https://www.isda.org/a/D6fEE/ISDA-SIFMA-Initial-Margin-Phase-in-White-Paper-July-2018.pdf

Alongside this requirement, impacted organisations will also need to consider the robustness of their infrastructure to support the daily oversight and control of the new IM regime. Given the sheer volume and scale of the change, process automation and STP must be the foundation upon which scalability and cost-effective compliance is built. This is true for both existing organisations who are already exchanging IM – who need to consider how their process will scale to deal with the volume of new counterparts – as well as new organisations preparing to exchange IM for the first time.

Key focus areas for assessment are:

- Portfolio reconciliation, to ensure timely flagging and resolution of portfolio differences
- Margin call generation and agreement, both through industry platforms such as MarginSphere as well as via bilateral email exchange with counterparties
- Inventory management, to determine availability of collateral to satisfy the IM requirement and to ensure visibility over 'what' is 'where', 'when'
- Custodial structures, to support collateral posting and oversight within standalone custody or tri-party models
- Settlement capability, to provide intraday oversight for deliveries and receipts of collateral
- Reporting requirements, to support the daily oversight of the collateral management obligations and provide transparency to relevant stakeholders

Organisations should be assessing their infrastructure to ensure sufficient levels of automation and capacity are embedded within their end to end process. Where gaps exist, they should be exploring solutions that can fulfil their processing requirements

The GX-Margin Solution

Through development of the GX-Margin product, NRI has delivered a functionally rich platform that supports the margin and collateral management requirements across the OTC, secured financing, prime brokerage and MBS asset classes. This comprehensive platform facilitates consolidation of all collateral management requirements into a single solution, enabling all activities to be managed in one place. Current users of the product have leveraged these consolidation benefits to enhance their operating model by bringing together different collateral management users into a centralised function, where process standardisation and economies of scale delivers a robust, scalable solution.

As organisations assess the robustness of their in-house processes and the levels of automation and STP that support it, the GX-Margin solution is well positioned to provide a solution to the challenges of UMR. Some of the key functionality within the platform includes:

- automated margin calculation and call generation per agreement type
- interfaces with industry utilities – Acadiasoft, Tri-resolve – to drive automation and efficiency
- automated email capture and call creation, eliminating manual effort and providing enhanced control to the call management process

- workflow based dispute tracking and resolution
- support for both triparty and bilateral custody models
- collateral booking and management
- consolidated inventory management view, providing real time transparency on location and status of collateral
- MI and reporting capability to support regulatory and risk management objectives

Developed upon modern, componentised architecture the GX-Margin solution is simple to integrate into existing infrastructure, making deployment practical and straightforward. This integration ease avoids large scale disruption through providing a modular add-on to existing infrastructure.

Contact us at gx-info@nri.co.jp to see how the GX-Margins solution can support your automation and compliance goals with UMR

gx-info@nri.co.jp

company/nri-nomura-research-institute

About NRI

NRI is a global top 10 Fintech company with annual sales exceeding $5 billion. Leveraging our consulting expertise, NRI provides state-of-the-art managed service and financial system solutions to transform financial institutions into digital companies equipped to thrive in the new digital era. With a 50-year track record of success and a team of 13,000 skilled professionals in more than 50 offices globally, NRI caters to a wide range of post-trade operational needs by mitigating cost and risk, and improving efficiency.
To learn more, please visit:
https://www.nri.com/en/service/fis