Strategic preparation

The impact of the UMR phase five delay

Bruce Kellaway, global head of rates, securities and collateral at LCH, discusses the most likely instruments to be pushed into the cleared world as a result of phase five implementation, the tactics firms use to drive efficiency in exchange threshold monitoring and how firms' approaches to collateral management are likely to change in the wake of the Covid-19 pandemic

LCH The Markets' Partner

Bruce Kellaway
Global Head of Rates,
Securities and Collateral
www.lch.com

Was the delay to implementation phases five and six of the uncleared margin rules (UMR) necessary? What impact is it having on firms' preparations?

Bruce Kellaway: The delay makes sense, as there is still a great deal of preparatory work required to ensure UMR readiness, and it is important not to underestimate the complexity involved and the level of advance planning required. While phases five and six mainly capture buy-side firms, the sheer number also creates operational challenges for the sell side. Establishing custodial relationships and negotiating credit support annex documentation with every in-scope bilateral counterparty can take many months, and any legal challenges will also need to be resolved. IT, operations and risk systems must be established, and internal processes updated.

Rather than using the extension to slow down or pause plans, participants should take advantage of the additional time to evaluate and implement strategic solutions that can help lessen the financial impact and reduce the operational complexity of UMR. Voluntary clearing of products in scope for UMR, for example, may reduce the aggregate average notional amount (AANA) and lower margin costs. LCH has already seen increased clearing of products not mandated by regulation, such as foreign exchange non-deliverable forwards (NDFs), and options, single names and inflation swaps.

The AANA calculation window has also been deferred by a year, potentially creating a new bottleneck before the phase five deadline – to what extent is this a missed opportunity?

Bruce Kellaway: Deferring the AANA calculation window is consistent with the revised UMR implementation timeline, and we don't see this creating a bigger or smaller bottleneck. Although the US AANA calculation window has not yet been formally moved, this is expected in due course.

The deferral gives some firms more time to reduce their AANA for the March–May 2021 calculation by putting mitigation measures, including clearing and bilateral compression, in place. LCH's services for cleared (SwapClear) and non-cleared (SwapAgent) over-the-counter (OTC) derivatives integrate with vendors offering portfolio compression and optimisation, enabling participants to optimise their IM requirements across margin pools and potentially bring them under the UMR threshold.

Product substitution – where participants clear their emerging market NDFs and replace their uncleared Group of 10 deltas with cleared G10 NDFs is another option for managing AANA thresholds.

How is the need to post regulatory IM affecting firms' trading strategies and product choices? Which instruments are most likely to be pushed into the cleared world as a result of phase five implementation?

Bruce Kellaway: Cleared and non-cleared products require different strategies. While we are seeing a growing uptake of cleared products, less liquid, non-clearable products are also benefiting from greater standardisation and operational efficiency through services such as LCH SwapAgent.

The growing interest in clearing is, however, not entirely product-related. For many counterparties, there is simply an opportunity to reduce the operational burden, but there is also a funding cost benefit. Firms are also optimising more between counterparties to lower their IM requirements, including optimisation between cleared and uncleared to reduce the uncleared AANA scope and stay below the threshold for UMR. In addition, there are capital benefits, as two-way margin has to be posted in UMR, but with clearing, interest rate swaps- and futures-executing dealers can clear their hedge positions with the same central counterparty (CCP) to extinguish their IM liability. With OTC equity derivatives, the delta is hedged with the cash equity, but we are exploring possible future revisions to the EquityClear risk model to enable cross-margining between the derivative and the cash.

Having said this, we have experienced product-specific migration to clearing, and the added transparency and efficiency have catalysed growth in those markets. We are already seeing increased volumes in inflation swaps and EM NDFs, G10 NDFs and forex options. Cleared credit index options have also seen large increases in activity this year, and we expect UMR phase five to push these products much more quickly into the cleared world. We can also expect firms trading OTC equity derivatives products – which historically have not

been cleared – to look for strategic choices that deliver the benefits of central clearing, but retain the flexibility of the OTC market, such as through the product partnership between Turquoise NYLON™ and LCH EquityClear. Clearing may be introduced for additional instruments, but the ability to default manage new products should remain a key consideration for clearing suitability.

What tactics are firms employing to drive efficiency in exchange threshold monitoring and optimisation?

Bruce Kellaway: Where participants are unable to get below UMR notional thresholds, we are seeing risk optimisation between counterparties and into cleared products. A firm in scope for UMR can keep its IM exchange for each counterparty below the $50 million threshold, either by participating in bilateral or multilateral compression (with rebalancing) or by transferring risk between cleared and uncleared portfolios.

This can be complex, especially across different asset classes, as it requires daily, active, real-time threshold management. In contrast, alternative approaches, such as voluntary clearing and product substitution, are low-touch once implemented and deliver the benefits of counterparty choice, capital savings and operational efficiencies.

To what extent will the recent market volatility influence firms' choice of IM models?

Bruce Kellaway: Margin models need to be efficient and sufficiently reactive but also relatively controlled, with safeguards in place to ensure margin levels aren't increased dramatically during periods of market stress. LCH deploys a single margin model per clearing service, and the recent volatility has been integrated into our models and reflected in overall margin numbers, which have remained stable throughout this period.

Cleared IM is typically lower than non-cleared IM because of the lower margin period of risk (MPOR), which falls below the 10-day UMR MPOR, leading to lower IM for a given confidence model. Clearing also provides opportunities for netting efficiencies across counterparties that cannot be achieved bilaterally.

Recent market volatility may lead firms to test different UMR models and compare them to the cleared IM model. But, in the current environment, clearing dramatically cuts both the amount and procyclicality of payments and, as a result, intraday liquidity needs, as well as capital usage procyclicality.

How are firms' approaches to collateral management likely to change in light of recent events?

Bruce Kellaway: Recent events have highlighted just how relevant and important collateral velocity is to execution speed as it takes longer to price a deal where the specific eligible collateral has a bearing on execution price.

Faced with the possibility of having to hold greater liquidity buffers, some firms are using this opportunity to enhance their collateral optimisation and transformation capabilities by implementing more efficient systems and processes across a wide range of collateral services.

Participants may also consider new datasets incorporating recent Covid-19 volatility to test liquidity buffers and hold more collateral on their books. This could raise funding and capital costs further under UMR, which requires two-way margin to be posted. This is in contrast to clearing, where the execution dealer can net off client positions with the same CCP to reduce their IM liability. Through its partnership with leading vendors, LCH also extends the benefits of optimisation and compression to non-cleared OTC derivatives, providing the bilateral market with significantly cleaner, more efficient booking, valuation, reconciliation and settlement processes. ■