Exploring the operational challenges facing buy-side firms coming into scope under Phases 5 and 6 of the Uncleared Margin Rules (UMR)

The first four phases of UMR have come into force in stages since 2016 and have affected banks. Many buy-side firms will now come into scope with Phases 5 and 6 of UMR, which are now delayed 12 months to September 2021 and September 2022, respectively. We asked Ankeet Dedhia, Americas Head of Product, ForexClear, LCH to comment about this.

Ankeet Dedhia

What are the main obligations and requirements associated with these additional phases?

According to ISDA, approximately 1,100 buy-side entities, 315 in Phase 5 and 775 in Phase 6, are going to be impacted by the upcoming phases of UMR. This number translates to around 9,000 separate counterparty relationships, 3,600 covered under Phase 5 and an additional 5,400 in Phase 6, for which buy-side firms need to initiate projects whose timelines might range from a couple of months to a couple of quarters. Once a market participant gets phased in for UMR, they are required to exchange two-way initial margin (IM) for all bilateral in-scope UMR products. For FX, in-scope UMR products includes non-deliverable forwards, non-deliverable options and physically settled FX Options. While physically settled FX forwards, FX swaps and currency swaps are exempted from two-way IM exchange, they still would count towards a firm's aggregate average notional amount (AANA), which determines UMR compliance timelines.

In what key ways will UMR Phases 5 and 6 affect the buy-side in particular?

As highlighted in ISDA's 2018 IM factsheet, market participants preparing for UMR face a demanding and complex process with numerous steps, and we suggest they tackle two distinct sets of work. The first set of work 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 IM methodology; exchange relevant compliance information with each counterparty; negotiate and agree new CSAs and custody relationships; and then execute these agreements, potentially with third-party assistance.

The second set of work involves making long-term strategic choices in trading and operating behaviours within the new framework. Compressing portfolios on a regular basis, voluntary clearing new trades and backloading old ones into clearing for in-scope products can significantly reduce the number of entities in scope of UMR and reduce a firm's AANA. Some buy-side firms who have made these strategic choices so far have seen many benefits, including reduction in overall costs of trading, reduction in counterparty credit risk, larger counterparty selection for trading during volatile times and streamlined operations.

What do you see as the most serious operational challenges facing buy-side firms in implementing UMR?

The biggest challenges for buy-side participants are:

Costs – UMR implementation comes with initial set-up and ongoing costs, in addition to the new margin costs. This could make maintaining OTC derivatives positions expensive, and we understand that firms are considering appropriate measures to operationally allocate these costs internally, and if needed, externally. The other challenge here for buy-side firms is these costs are likely to make bilateral derivatives expensive, hence eating into trading margins.

Documentation – Buy-side firms continue to be overwhelmed with competing priorities, and as highlighted before, UMR requires firms to thoroughly examine all existing paperwork and negotiate and execute new documentation – CSAs, custodial arrangements, etc.

Margin regimes – Historically, many buy-side firms have posted margin in the form of independent amount (IA) to dealer counterparts. In the post-UMR world, buy-side firms now need to renegotiate existing IAs vis-à-vis new UMR IM and agree on ongoing compliance and dispute resolutions processes around margin management.

Clearing helps overcome these challenges. When a firm opts to clear their OTC derivatives, they are subject to the CCP's margin models, which in most cases is cheaper than bilateral margin. This margin benefit further compounds due to CCP's multilateral netting, where a firm gets netting benefits across all their bilateral counterparties. In addition to this, CCPs follow standardized rulebooks that are publicly available and applicable to all counterparties, making the cleared processes streamlined, transparent and easy to implement for all.

Many buy-side firms will be new to these activities, with limited internal resources to deal with them. What sort of assistance are they likely to require to meet their obligations?

Industry advocacy groups continue to host forums to discuss best practices and common challenges for market participants. Firms can also get help from their dealer counterparties, who have already been phased into earlier phases of UMR. Additionally, there are many third-party vendors who are offering services to help the buy-side manage UMR obligations. Needless to mention, firms can always reach out to their preferred clearing house and their preferred clearing broker to learn more about how to make strategic clearing choices, as highlighted before.

Although post-trade processing across most asset classes has been improved with technology, much of the activity around margin calls and collateral movement remains untouched by automation. What role can it play in helping buy-side firms to overcome some of the operational burdens of UMR?

Recent market events have highlighted the importance of collateral velocity, as it takes longer to price a deal where the specific eligible collateral has a bearing on execution price in a post-UMR world. 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.Buy-side firms are generally the end customers for a lot of these firms, who have gone through the transformation, and should get overall benefits of these streamlined processes.

Many within the industry broadly welcome the deadline extension. What would you recommend buy-side firms do with the extra time that's now available to them? For example, with respect to their forward planning and also in steps they can take to improve their existing margin and portfolio reconciliation operations.

The deadline extension is needed, as there is still a great deal of preparatory work required to ensure UMR readiness. 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 like voluntary OTC clearing, compression and product substitution, where applicable, that can help lessen the financial impact and reduce the operational complexity of UMR.

How can LCH help buy-side firms with many of the challenges associated with UMR that we have been talking about, and how has the firm been working to innovate and deliver new solutions to help your clients?

Many challenges can be reduced, and in some cases eliminated, by voluntary clearing. Once a buy-side firm starts clearing at LCH, it may benefit from overall reduced margin costs compared to bilateral, streamlined operational and collateral workflows, lower counterparty credit risk and overall larger trading counterparty selection. This has already been a catalyst for buy-side clearing of products not mandated by regulation, such as NDFs, options in FX, inflation swaps in rates and single names in credit at LCH Group. At LCH we continue to engage our buy-side community to discuss UMR impacts and how clearing eases the UMR burden. We offer to run all our customers through detailed portfolio analytics, comparing cost of clearing vs bilateral IM, and provide education on the mechanics of the cleared workflows.

We also continue to innovate across product and workflow solutions to help clients manage UMR costs. In the past couple of years, we have added cash-settled products like G5 NDFs, EM and G5 non-deliverable options, as well as physically settled products like FX Options to ForexClear's product list, making a wider set of products eligible for clearing.

We have also offered many workflow solutions which include integration with a major buy-side FX venue in 2019, and solutions to enable buy-side FX clearing to facilitate a richer customer experience. Our workflow offerings for FX clearing in LCH ForexClear parallel LCH Group's other services in rates and credit clearing, where the Group has the experience of processing trillions of dollars in OTC derivatives daily.