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Regulatory Forces Driving the Behaviour of Financial Firms in Asia

Beyond Margin Reform

Whitepaper

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Executive Summary

Today's financial markets are still being shaped by the repercussions of the 2008-09 global financial crisis (GFC), as regulatory bodies around the world reform the standards under which many transactions are conducted, with the aim of standardising processes and removing systemic risk.

Beginning this year and rolling on through the end of the decade, OTC derivatives markets will fall under new collateral and risk management standards with the adoption of central clearing practices. These requirements have been developed by the International Organisation of Securities Commissions (IOSCO), and while only the United States and the European Union have mandated them for OTC trades, any counterparty that wishes to execute trades with entities in the US or EU will have to comply with these new standards.

The standards come into force beginning September 2016, and industry professionals have outlined the challenges ahead:

- The impact of variations between regional regulators' standards and the IOSCO standards;
- The operational processes and a variety of systems, encompassing front, middle and back office, that will have to be readied to handle impacts on trading activities, risk calculations, reconciliation requirements, transaction lifecycle management and reporting;
- The varying levels of preparedness of market participants for looming deadlines.

Experts say these challenges present work for both the buy-side and the sell-side. On the sell-side, banks and collateral management service providers are readying their internal systems to comply with the various tasks that come with running these operations, as well as implementing IT systems that can provide support and full coverage over the lifecycle of an OTC derivative trade.

On the buy-side, entities will have to ensure they have the documents in place to conduct trades, as well as think about policies and process management needs – internal and/or external – to support the new requirements for day to day operations management and complying with the new regulations.

"Markets in Asia Pacific will have to implement margin reforms if participants wish to trade with counterparties in the US or EU."

Regulatory Concerns

Beginning in September 2016, there will be compulsory two-way margin requirements for exchange of variation margin (VM) for firms that are above volume thresholds defined by IOSCO. Further requirements covering initial margin (IM) exchange commence 1 September 2016 and scale up in terms of reducing covered entity thresholds until 1 September 2020. On 1 March 2017, exchange of VM commences for all covered entities. This is possibly the single largest shake-up seen in derivatives markets for decades.

As deadlines loom and market participants in Asia Pacific turn their hands to integrating these standards, banks and providers of collateral management services are concentrating on developing their internal operations to calculate margin, risk and capital liquidity needed to adequately manage their impacted operations. On the buy-side, entities will have to ensure they have credit support annexes (CSAs) in place, have considered the impact on their daily operations and have communicated with their brokers, custodians and service providers.

For their part, banks report that they are focusing on refining their internal operations to allow compliance and at the same time keeping an eye on efficiencies that can be extracted, such as issues of straight-through processing (STP).

These new margining requirements are intended to address some of the systemic risks that were thrown into sharp relief during the GFC.

"Currently, 2016 is a big year and many of the major reforms are due to be implemented in many of the jurisdictions during this time," said Shane Worner, chief economist at IOSCO. "In terms of the intended consequences, it's pretty clear from the previous crisis that collateralised transactions acted as one of the conduits of risk, almost like an amplification mechanism.

"The reforms are there to mitigate against some of the adverse problems of that and to help, obviously, alleviate concerns with counterparty risk as well. As for its intended consequences, they're the sorts of areas IOSCO is looking to see have the greatest impact under the umbrella of overall financial stability."

But while IOSCO promulgates the standards through its consultative process, it is up to individual jurisdictions to implement those standards as legislation or regulation.

Industry professionals report that there is variation in local application of IOSCO standards across jurisdictions in Asia Pacific, and there is no unified understanding of what needs to be done before standards kick in.

"We're going to end up in a situation where arbitrage is likely to occur as the lack of cross-border equivalence is unlikely to get resolved before September 2016," noted Shaun Murray, managing director, head, strategic collateral management, Standard Chartered Bank. "It will lead us into a situation where, as part of the G20, there are multiple regulators following the IOSCO framework and all are adding their own touches which will somewhat determine how the industry evolves and what the future of the market looks like."

"Collateralised transactions acted as one of the conduits of risk"

Operational Concerns

There are concerns these variations in local regulation could lead to system arbitrage. From an information technology and back office operations perspective, banks are focusing on increasing operational efficiency to handle the volumes of information they will need to manage, which feeds into front-office decisions on hedging and pricing.

Banks that manage the lifecycle of a trade are faced with multi-jurisdictional challenges and the implications of regulatory differences. One head of an APAC collateral management programme said his bank will align its technology to regulation and adhere to the most stringent standards, rather than taking a least common denominator approach.

"I can give you an example – not all jurisdictions are applying concentration limits, for example," said Karim Chabane, director Futures, Clearing and Collateral and APAC head, Collateral Management at Citi. "If you want to run a reasonably sophisticated collateral management operation, and to make sure you diversify your risk portfolio, you would, however, develop the management of concentration limits. People will probably align to the most stringent standards. If they're not mandatory in a market, or if a jurisdiction doesn't apply them, or they're applied more loosely, that's something else, but from a technology perspective, they will probably have one system that applies to all needs."

In addition to managing internal systems, collateral management service providers are also educating clients on what they will need to be compliant to trade with counterparties in the US and the EU. There can be wide variations in the understanding and the preparedness of clients. Standard Chartered's Murray noted that his bank is now applying technology solutions to manage upstream and downstream feeds, documentation systems to on-board clients' CSA and develop margin (SIMM) calculators. He estimated that more than 100 people at the bank were involved in the preparations for September and beyond.

"There are clients that haven't needed to comply with EMIR or Dodd-Frank, but they will have to care if they trade with the US or an EU bank," Murray said. "On the other side of the coin, it's not just the buy-side impacted, but banks as well. They need to understand what IOSCO is trying to do and what the impact is, and it's not as simple as, derivative prices are higher."

Worner of IOSCO said that while the legal agreements in existence can accommodate the need for market participants to set and agree on what counterparty risks exist, the new standards are prompting more due diligence on the buy-side.

"Outside of periods of stress, like the previous crisis, markets in general have been pretty good at assessing counterparty risk and having bilateral flexibility to adjust these on a counterparty by counterparty basis. Maybe in some respects, these new reforms are essentially formalising previous industry practices or standards that had been going on between market participants for some time. But particularly on the buy-side they're caring about how they do due diligence more. Pension funds are now doing in depth due diligence on potential hedge funds that could be managing the money, and so all around, there is a lot more homework."

Buy-side clients are moving from consideration to implementation when it comes to providing the documentation that will enable collateral managers to manage their OTC derivative margining come the compliance deadlines.

CSAs must be negotiated – and this can take between three to six months for each counterparty. The operational changes that stem from the terms of CSAs must be implemented, and a collateral agent must have these agreements from the client before 1 September, as well as systems in place to deal with contingencies such as not having the required documentation in place.

For some on the buy-side, the challenge around these reforms isn't collateral optimisation – it is managing this operational process.

"Some of the buy-side are not only new to the IM process but are also new to the tri-party arrangement and how it works," said O'Delle Burke, Head of Product for Agency Clearing, Collateral Management and Execution at JP Morgan. "What goes along with that is, from an operational perspective, what level of interaction and what do they need to do from their side on the securities that are involved or cash that is going to be involved, and also getting in the reporting."

For those on the buy-side with lower volumes of OTC trades, it is possible to handle all of this process in-house with a small staff, but significant volumes can require out-sourcing to an external agent.

If choosing an external agent, industry professionals warn that getting this documentation in place and establishing the operational arrangements requires a substantial block of time – and the room to achieve before September is narrowing. One market professional noted that while it's one process with clients who have already established collateral management processes and will be providing additional documentation by September, it is a longer process to on-board new clients.

"As we get through the coming months, there may be a limit, where in terms of on-boarding new clients, we're going to reach maximum capacity," Citi's Chabane said. "Clients need to do their homework early so that they can secure the fact that they have chosen to be ahead of the regulatory deadline."

As agents build up their collateral management programmes, they emphasise their internal IT processes and how they have responded to the new margining requirements. Most professionals note the need for systems that calculate valuations, haircuts, concentration limits and other factors for clients to provide support for decision making.

"We have been following all the changes that have taken place in the broader OTC derivative reforms, whether it's the migration of most of the non-cleared into central clearing, or this recent bit around the collateralisation of initial and variation margins," said Burke. "Over the last three years, we have spent significant amounts on updating our infrastructure, adjusting things like reporting, and creating online portals so that the client can have a near real-time view of what's going on from an operational perspective. They have a real sort of real transparency."

Future Concerns

The regulation and concomitant costs will – as intended – impact the way in which banks trade OTC derivatives.

"Larger banks and firms are embarking on programmes to calculate the cost of collateral before executing the deal," said Greg Ballesty, SME for Collateral Management APAC at SmartStream. "They're now looking more closely at factors that are key drivers of deal execution such as the possible clearing venue, the cost implications of uncleared trades, the regulatory costs impacting the trade and the likely revenue that they're expecting to make from the trade for its duration."

"Of course this is all balanced against the collateralisation costs of the trade and this is invoking a mindset change and bringing collateral into the front office. It's requiring a clinical approach to executing OTC derivatives and the subsequent management of the trades. Beyond execution, firms need to have a well-considered strategy to manage operational burden and balance this with their operational culture. Under the buy, build or outsource paradigm, firms need to consider carefully but quickly their preferences."

These considerations will substantially change the trade lifecycle management behaviour for banks and buy-side firms alike, Ballesty said, conclusions supported by other market professionals.

Global banks are developing one-stop-shops for buy-side clients to manage the lifecycle of an asset and trade. This raises another concern – the settlement cycle of collateral versus the settlement of an asset transaction, and how to manage the risk in the predicted case that one settles before the other. If margin needs to be settled on a T+1 cycle, but the collateral settles on a T+2 basis, it creates huge potential risk.

"Not only do you have different time zones, you have differences in the settlement cycle for certain types of securities," said Burke of JP Morgan. "In the non-cash space, government bonds settle on a T+2 basis. If you cover your margin on T+1, that's more than a challenge, that's impossible."

"There's a balance that is being discussed, wherein the IM is calculated from a VM perspective, the amount is calculated, and the entire industry is in full agreement that this needs to be collateralised as soon as practically possible, hence the T+1 process. Because of the time zone difference and the difference in the settlement cycle around non-cash types of collateral, I think there's an open discussion in the balance of expediency and also what is practical in terms of making sure that the APAC counterparties have time to settle."

The timing of settlement is another risk management concern for the clearing houses that will handle collateral flow in certain markets. Hong Kong Exchanges and Clearing (HKEx) operates multiple clearing houses covering equities, OTC derivatives and commodities, and is considering the timing of settlement as part of its risk management process.

"The clearing house should be able to liquidate the posted collateral within a reasonable time. If the posted collateral has a long settlement cycle, the clearing house has to rely on its own resources to meet the immediate liquidity need in managing a clearing member's default," said Wallace Chan, Managing Director, Clearing Division, HKEx. "So we have to factor that in alongside other risk management considerations. We have policies and procedures that take that into account, and adjust the level of acceptable collateral accordingly. Besides, the collateral accepted has to be high quality; the related market risk has to be within our risk appetite after applying an appropriate haircut, and there has to be enough liquidity. It boils down to how fast and how much you can liquidate, and how much risk you'll face in the process."

The reforms are also driving up demand for high quality liquid collateral, and clearing houses expect to see more business opportunities as a result of increased collateralisation.

"With the implementation of bilateral margining, you'll probably see an overall increase in demand for high quality collateral," Chan said. "As a clearing house, we will find solutions to help market participants optimize their collateral management. We will explore possibilities to broaden the types of acceptable collateral within our risk management framework. "

"More importantly, we will develop more clearable products so that the market can have wider access to central clearing. One key feature of central clearing is multilateral netting. Through this process, a clearing member's exposures, and hence collateral requirements, can be significantly reduced."

"The timing of settlement is another risk management concern."

This is another factor that collateral agents touch on – how to use systems that can implement cost efficiencies, minimise margining requirements and provide the reporting on calculations to manage margin requirements before considering issues such as collateral transformation.

"I think it's really like the very end," Chabane of Citi noted. "You get everything else like operational issues and then minimise the costs and liquidity, and then when you've optimised all this, you get to the point where you add transformation on top of it. If you put transformation in too early, it probably won't provide you all that much benefit."

Acknowledgements

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