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UMR Implementation

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Coremont led the UMR implementation for Brevan Howard, the first buy side firm in scope for UMR phase 3, between January and September 2018. In this article we share some of the insights that we've gathered over the course of multiple implementations, focusing on the less obvious aspects of UMR.

Legal agreements – dust down your CSAs/CSDs

Amending your current agreements to be UMR-compliant is neither efficient nor acceptable to most counterparties. As such, if new agreements are to be created, why not revisit old margin methodologies at the same time?

Over the years, many funds accepted margin methodologies that were dictated by the big banks. Those methodologies include VaR or stress-based margin, which are often unique to each counterparty, updated periodically at the counterparty's discretion, and difficult to monitor or replicate. Agreeing to a new SIMM-based houseIA margin methodology would be helpful for all parties.

A SIMM-based houseIA margin methodology will improve the reconciliation of data, and enhance the monitoring of margin across multiple dimensions. The methodology is well- agreed, transparent, frequently updated and is therefore beneficial to both sides. Once agreed, houseIA is simply a factor of SIMM. As your counterparty's credit appetite is unlikely to change, it can also be factored into the methodology. For example, one could agree on a "max of" formula – e.g. the greater of houseIA, SIMM*factor (where the factor is determined on a case-by-case basis with each counterparty) or SIMM-50m threshold (outlined in more detail below).

Collateral schedule: use the same schedule for both sides

There is a built-in tension between phase 1-3 (2016-2018) and phase 5-6 (2021-2022) parties. Phase 1-3 firms were initially focused on becoming UMR-compliant by 1 September of the year of implementation, even if not in the most efficient way. When collateral schedules were discussed, they were quite narrow in scope, only including the highest quality collateral. Over time, banks have become more comfortable with posting other assets as collateral, including lower-grade and more esoteric instruments. However, with the 1 September deadline in mind, phase 5-6 firms tend to be focused on keeping their UMR implementations as simple as possible, and therefore have a strong preference for including only the highest rated collateral.

By asking counterparties for a symmetrical agreement, i.e. they can only post identical assets as you to them, you will likely receive a narrower list of eligible collateral. If planning to only post T-bills on day one, a symmetrical agreement will result in your counterparties posting the highest quality collateral in return. Moreover, a symmetrical agreement gives you the flexibility to post other types of asset in future, without having to recommence negotiation.

Risk transfers – a way to avoid hitting thresholds and reducing your risk

There are two relevant thresholds for UMR. The first one, which determines if one is in or out of scope, is the AANA (Average Aggregate Notional Amount). If the AANA of non-cleared OTC trades on the relevant dates is above 50bn (USD, EUR, or similar, based on the regulation in scope), phase 5 applies. Similarly, if it's above 8bn, it would fall under the scope of phase 6. However, if AANA is close, but not exceeding these thresholds, you may want to consider implementing trades using cleared or listed products, which are exempt from AANA. Alternatively, you could collapse trades, thereby reducing the gross notional and counterparty exposure without altering your overall risk profile. As the AANA threshold is reviewed annually, this exercise would need to be completed each year.

The second threshold is Initial Margin (IM). In March 2019, BCBS-IOSCO published a UMR clarification which was later adopted by regulators, stating that firms in scope for UMR can delay their legal documentation and custodial and operational arrangements if they don't exceed the 50 million IM threshold. There is no clear relationship between AANA and IM, due to the discrepancy between products which are included in AANA, but not in OTC IM, such as FX forwards, spot trades and equity options in certain jurisdictions. This means that in practice, even if the AANA threshold has been crossed, there is no need to panic!

Moreover, firms can reduce IM by transferring bilateral risk to a clearing house or to a product which is not subject to SIMM. E.g. you could replace a deep in-the-money FX option with a combination of an out-of-the money option and a forward (using call-put parity). In doing so, you replace a high SIMM transaction (the in-the-money option) by two others, one that attracts a lower margin (the out-of-the money option) and the other, no SIMM margin (the FX forward).

The risk will not necessarily change materially if properly hedged, but might lower IM back towards the threshold.

Monitoring IM – mini thresholds

We find it beneficial to implement and monitor additional IM flag levels below the standard 50m threshold.

At the 20-25m level, you are unlikely to need to take any action as the appetite of your counterparties to start legal negotiations is likely to be low, given the resource cost of doing so. However, at the 30-35m level, it may be wise to begin to approach your counterparties and start discussing a plan to either reduce margin or negotiate the methodology as full documentation is likely to be triggered beyond this.

Note that this is only relevant if margin is relatively stable. If there are large daily margin movements, this is likely to necessitate documentation from day one. Also, note that this means margin will need to be monitored daily to avoid any surprises.

SIMM calculations – consistency is the key

At Coremont, we have the ability to calculate SIMM internally. Whether a firm calculates SIMM themselves or outsources it to an external service provider is an individual decision. Ironically, SIMM is not that sensitive to sensitivities! Therefore, even in the absence of 100% numerical accuracy, the SIMM result is likely to be satisfactory, especially for firms in scope but not subject to this regulation. A major source of difference lies with the different buckets used for equity and credit or trade population. As a result, firms need to ensure that all trades subject to

SIMM are fully in line with the trading positions that are reconciled at their counterparties, administrators and all other service providers.

Consistency is key here - and that's where Coremont can help you with its full back-to-front offering.

SIMM, Grid, or perhaps a hybrid model?

Whilst the vast majority of agreements will follow the SIMM methodology for margining, some will follow Grid. Each firm will need to decide upon which works best, given the pros and cons of each option.

The characteristics of the SIMM model are:

- Approved by regulators, calibrated and validated yearly.
- Easy to compare the results across platforms.
- Allows for netting and reflects risk better than Grid.

The Grid model features:

- A simple and intuitive approach.
- Suitability for firms that don't want to develop and maintain quantitative models, nor rely upon third-parties to do this for them.

However, these models are not mutually exclusive; a hybrid model may be one to consider once a firm acquaints itself with the SIMM methodology. Coremont boasts experience in this area as an existing service provider.

For certain types of trade it may be cheaper to use Grid, as SIMM can be punitive at times, such as in the case of dual binary FX options. SIMM takes into account the sensitivities of each currency pair and can charge IM multiple times the MV or the notional of the trade, especially when close to expiry. Indeed, this approach, if one has a long position in the option, is counter-intuitive. A hybrid approach would be to charge 6% based on the Grid methodology for those trades, and SIMM otherwise.

Our view is that this is not considered a cherry-picking of sorts, which is forbidden by the existing regulation. Firms are allowed to use SIMM, Grid, or a combination of both. Only the choice of how to charge margin cannot change frequently and a firm will need to decide in advance what type of positions are to be excluded from SIMM and charged based upon the Grid model. As a rule of thumb, the broader the exceptions, the better, and of course this should also be justified from a market and credit risk perspective, not just with the goal of reducing margin.

There are many ways to approach UMR and a lot of ways to build, and manage an implementation plan. It is extremely important to consult with a firm, such as Coremont, that has demonstrable experience to help your firm save margin and operate in a more robust, efficient and cost effective way.

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