The initial margin regime and the false economy trap

In the scramble to meet incoming initial margin requirements, installing a very basic collateral management system might prove tempting to many firms. But beware of false economies, warns *Trevor Negus*, product manager and principal business analyst for SmartStream – sophisticated technology offers a more cost-effective answer in the long term.

Deadlines for compliance with the initial margin (IM) rules for uncleared derivatives implemented by the Basel Committee on Banking Supervision and the International Organisation of Securities Committees (BCBS/IOSCO) are on the near horizon. They take effect for phase 4 firms this September and for phase 5 organisations in September 2020. Phase 5 is likely to have a significant impact on the buy-side, with as many as 1,000 entities brought within the IM regime.

Compliance with the new standards creates several hurdles: both parties to a deal must exchange initial margin, with IM being calculated on a daily basis, at a netting set level, and then posted to a segregated account.

Trade associations representing phase 5 firms have petitioned global regulators to raise the aggregate average notional amount (AANA) threshold at which counterparties must comply. Regulators' response is still pending but companies should not assume that exemption will automatically be granted.

If phase 5 firms are unable to claim exemption, how should they best meet IM requirements? Some may opt for a basic collateral management solution, considering it the quickest and cheapest route to compliance. However, a mature system could, in the long term, provide a more cost-effective answer, one that better equips firms to deal with future change.

Coping with further regulatory change is an essential consideration. To date, regulators have worked in unison on the creation of the new IM rules. Divisions have arisen, however – for example, in relation to Brexit and the UK's departure from the European Union – and these could see regulators distancing themselves from each other. Typically, basic collateral management systems have been designed to answer the needs of a harmonised regulatory world, whereas a sophisticated solution can handle both the complexities and the opportunities that a diverging regulatory landscape presents.

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> **Trevor Negus, SmartStream**

COPING WITH COMPLEXITY

A system that is proven to cope with the complexity inherent in IM compliance is SmartStream's TLM Collateral Management. The solution allows a high degree of automation, reducing the effort associated with moving collateral between counterparties. It takes an exception-based approach, enabling financial institutions to better accommodate the growth in margin calls that IM rules are expected to stimulate.

SmartStream's TLM Collateral Management system has been installed by Tier 1 and 2 institutions. Mutualised knowledge from these projects has been incorporated into the design of the solution and firms preparing for IM regulation can take advantage of this shared experience.

Adding to its ubiquity, TLM Collateral Management can be deployed in the cloud. This is a major plus for firms, as it means they are able to benefit from its "Tier 1 DNA" without the need for either a lengthy installation phase or for heavy investment in infrastructure. Regular software updates also ensure that maintenance costs are minimised.

A further advantage offered by TLM Collateral Management is the fact that it does not commingle data. This is an important security consideration, for where a firm's proprietary data is commingled it could – in the event of a breach – become apparent to competitors, leaving the firm then exposed to potential financial or reputational risks.

Underpinning the quality of TLM Collateral Management is the high level of investment that SmartStream makes in its solutions. About 25% of the company's revenue is ploughed back into research and development. This focus on R&D is reflected in the partnerships that SmartStream has created with various industry specialists. They include an agreement with Cassini Systems, that will see the integration of Cassini's analytics platform with TLM Collateral Management to provide SIMM (ISDA Standard Initial Margin Model) calculation and risk sensitivity generation. A similar collaboration with Numerix will provide sensitivity and SIMM calculation.

In conclusion, the pressing need to fulfil IM obligations, coupled with concerns over cost, could lead some institutions to opt for very basic collateral management solutions. Yet once the initial rush to comply has passed, other considerations such as cost-effectiveness, efficiency, consolidation, risk, business and regulatory change will take on greater importance. The limitations of less sophisticated systems are then likely to be fully exposed. **bt**