

SmartStream: Preparing firms as initial margin segregation becomes the new status quo

Financial institutions are in for a transformation as regulatory changes come in the next two years.

When examining the regulations about to come into force over the next two years, it might seem like only the biggest financial institutions will need to brace for the impact of stricter requirements surrounding initial margin. But even smaller firms would need to prepare for the regulatory changes, such as having third-party segregation for initial margin, as the targeting becomes more granular over the phase-in period. "In the past, initial margin segregation used to be something that some parties would decide to do. Now everybody has to do it if you are doing OTC derivatives," Jason Ang, programme manager for TLM Collateral Management at SmartStream, a global software and managed services provider, noting that it is more prudent to prepare early and avoid the crush of compliance demand expected in 2019 and 2020.

Initial margin concerns

Ang said that some clients that choose to do their own calculation of initial margins might be drawn to using the standard initial margin model proposed by industry body ISDA in order to reduce disputes. But to be able to do such a calculation, clients would need to generate sensitivities, which is where they could start engaging a provider like SmartStream who can help coordinate creating the sensitivities or running the calculation for them.

The whole process, which involves different parties, can become quite complicated and firms should not underestimate the time and resource requirements, said Ang. Delays can quickly add up given that parties often have to wait for another party's action to move forward, so starting early provides the necessary buffers to ensure on-time compliance.

If companies that will be in scope in 2020 only begin working on compliance that year, Ang warns they run the risk of competing with other firms who might be doing it last minute. "There might only be a certain number of resources to serve that kind of volume. If you're in scope in 2020, you should be starting the preparations sometime in 2019."

More clients are also finding out that

the responsibility of checking whether the tri-party custodian is doing the right thing still falls on the two parties. Ang reckoned that there were some clients who thought that long as those assets are allocated appropriately, it is the custodians who bore the bulk of responsibility for making sure the process is done smoothly and correctly.

"This is not immediately the case, which is why we felt we needed to build a module to be able to take the information from those custodians and use that and compare that with what we think is correct in our systems," said Ang.

Automated compliance monitoring

SmartStream also provides increased convenience, speed and efficiency by automating client monitoring the proper fulfillment of collateral calls. Ang said most clients have shifted towards using an automated tri-party arrangement with the broker, who is given authority to figure out different assets on how to fulfill a collateral call. "However what we're seeing now in the marketplace is that does not absolve clients of checking whether they did a good job or not" in selecting assets, he said.

If custodians make a mistake and choose an asset that is ineligible for the contract, it still falls on clients to flag the mistake so it

could be corrected, which can be a tedious process. Ang said more clients have started to realise that it is still their responsibility to check that the custodian has correctly chosen eligible assets and have taken it upon themselves to raise concerns when ineligible collateral had been selected.

Given the increased workload for clients, SmartStream's system eases the compliance burden by providing tools for automating the initial margin call process. The system also automates the custodian review and should there be a lapse, the client will be able to clearly communicate the regulatory or eligibility violation so the appropriate fix can be implemented. "What we're doing with our system is to make sure that after we dealt with regulatory concerns, we now help deal with operational concerns," Ang added.

For clients, Ang said the advantage is clear: leveraging on a well-built, proven system that has been further bolstered by the perspective of serving both buy-side and sell-side clients.

"We marry that perspective with our expertise as former practitioners, and then we come up with solutions so our clients do not have to go out there all individually themselves and get all this information and then figure things out."

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