Looking beyond regulation

Whilst firms will continue to keep an eye on UMR post-phase six, there is now an opportunity to focus on issues such as cost reduction, consolidation, and automation says **Trevor Negus,** senior product manager at SmartStream.

UMR may not be completely done and dusted in that there will be some legacy considerations around the regulation, but now that phase six has been implemented there is an opportunity to look beyond OTC and consolidate across business lines.

One of the big consolidation issues is getting data from all the different clearing houses across Europe and the US into the collateral management system. Being able to normalise the different data structures from each of the clearing houses and brokers will enable firms to monitor margin calls, funding, and inventory more effectively.

This is important for global management reporting, but also fundamental for managing inventory. Firms must look at inventory on a global basis, rather than by region or business line to facilitate an efficient optimisation process.

The peripheral inventory systems feed in data enabling firms to determine what is available. These connections are through APIs and allow firms to connect the collateral system to the inventory management system - as well as connecting to analytical tools for optimisation and initial margin calculations. APIs also permit interfaces to new technologies like micro services and distributed ledger technology.

We have been working very hard on our API suite. We understand that we are just one part of the ecosystem within the back or middle office and have to receive data from upstream trading, inventory management and credit risk management systems, whilst at the same time feed data like collateral movements downstream into settlement systems, general ledgers, and custodians.

Having access to that data in real time is very important, particularly when it comes to settlement - firms need to know whether something settled or failed immediately rather than at the end of the day or the following day.

Cost reduction

From a technology perspective we see a shift towards micro services. One of the big expenses with any software solution is upgrading it, so being able to take different components of the application independently without upgrading the whole system will obviously help in terms of overall cost of ownership.

Collateral management was a little slow to embrace software-as-a-service on the basis that it was seen as a critical function. But concerns around security have been addressed, particularly through our use of private cloud. Cloud technology, of course, offers lower install costs combined with services such as auditing, archiving, and service level agreement reporting as part of the package.

Firms have been benefiting from automation through messaging for a long time and this has become the norm for margin call processing, but we also need to be looking at processes such as interest and substitution events. Monthly interest processing can be onerous and allowing for automatic reconciliation and messaging should reduce the staffing required.

Pre- and post-trade optimisation

Optimisation comes in a lot of different forms, from straightforward collateral optimisation where you are looking at what is the most cost-effective collateral to deliver based on eligibility rules and the inventory

position, to margin optimisation where the focus is on transparency around the cost of a trade. So optimising where best to trade and which clearing house to use - based on the likely IM impact - is paramount.

If firms are optimising their collateral portfolios, not only will they be optimising at the point of the original margin call – they will also be rebalancing retrospectively, looking at whether the collateral held or posted on particular agreements is optimal.

Regular rebalancing will require firms to automate the substitution process. Having adaptors to connect to messaging platforms is fundamental because collateral will have to physically move back and forth as it is switched from one agreement to another. Automating this is likely to be the next big thing.

Treasury optimisation is also key through forecasting future margin calls and aligning that with cash or collateral ladders. By understanding what they have got to cover in future margin calls, firms can minimise their collateral buffer, avoid scenarios where they are left short of collateral, and make better term lending decisions.

Intelligent approach

There has been much discussion about the impact of artificial intelligence on collateral management over the last few years. A lot of the decisions that are made in the margin call process tend to be done by humans or by rules-based approaches – AI systems can learn the processes that users go through in terms of deciding whether a call is good to send out or not.

There is also a need for natural language reading to automate the reading of emails and call notices. In our industry there are lots of reconciliations beyond standard portfolio reconciliation and AI tools can manage these ad hoc reconciliations very efficiently.

These systems do not require configuration but read in the files, carry out the matching and understand the correlations through machine learning.

Best practice processing

We are all looking to streamline processes, but there are many instances where people are just following a process rather than understanding why that process exists. This underlines the importance of training and skills retention.

Understanding the market is fundamental. There has been a trend in the industry for moving manual processes to cheaper locations, which obviously makes sense to reduce costs. But are we losing and not replacing people who understand the collateral market and know why the processes are there? This is important for continuity, but also to ensure new business is integrated correctly. For example, the introduction of crypto derivatives or taking crypto collateral may not fit into the current paradigm, so having people that are familiar with the whole collateral market, the regulations and the history is critical.

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