Panelists

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HOW EFFICIENT IS YOUR CROSS ASSET MARGINING?

Competition, ease of market access and client demand has pushed the sell-side to deliver more asset classes to a wider array of customers. With these higher costs and diverse geographies efficient margin is a must for any firm offering multi-asset trading. The decoupling of business silos and the rise of regional brokers to the international stage coupled with the historically low interest rate environment have been the catalyst for a careful assessment of efficient cross asset margining.

SunGard and Asia Etrading brought together a panel of specialists for a webcast to examine the complexities and challenges of cross-asset margining in Asia. Interesting ideas and conclusions were shared to achieve the required results and improve margin efficiency, including mobile collateral, centrally managed positions, de-siloing of business lines, and regulatory will all be driven by a robust and scalable technology platform.

Here we share what the panelists said on cross-asset margining.

***Steve Edge:* What does true cross-asset margining require?**

Chris Rojek: Let us take it from an end users perspective. In my account I can trade not only indices, commodities and bond futures but also leveraged FX and single stocks on margin. Margin calculations are updated in real time and there is a single number for available equity and margin requirements across all my positions. I have a single pool of collateral so I didn't have to worry that I had to move collateral from a different account by the end of the day. The end user when they choose which broker they want to trade with it, comes down to three things. First, the range of products offered. Second, the leverage. The higher the better. And third, ease of use. From the liquidity provider perspective there is a lot of processes in the background that make it easy for the user moving collateral between accounts calculating margin for unlisted products like leveraged FX they have to understand what risks the users are taking.

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Matthew Png: I agree with Chris. As a futures broker there is a lot of demand to not only offer futures products but other types of products like leveraged FX and securities in one portfolio. True cross-asset margining does require efficient trade management across all asset classes. This includes portfolio variation as well as client margin calculation. The important issue is to allow the market participant to reduce total risk across all asset classes.

TK Yap: Clients just want a single account. What prevents that is regulations of different jurisdictions around the world. In many markets, you need multiple accounts to trade multiple asset classes. This is a risk challenge trying to manage multiple assets classes. When we look at the risk management model it's also a challenge when you want to mix margin trading with cash products. Cash and margin trading work on different principles and putting that together with a single pool of collateral there is not a global set of rules everyone can rely on. There is a difference between managing risk and observing risk. Many risk engines allow you to watch where your exposure is but as you get into the cutting edge managing risk, you want to actively anticipate the downside. You don't want to be reactive because by then your recovery of collateral has shrunk. You really want to see where trades are going to head and where your collateral pool is going to shrink to and this impact will be different from the beginning of the day to the end of the day. This is a huge challenge. Really what matters is how you end up at the end of the day. The other challenge is different business units. They tend to use different systems. These have to be integrated into a common infrastructure. To be able have all the systems talk to each other. The vendors haven't reached that stage where they can easily interact with each other.

Sam Ahmed: The problem with the bank is that it is so large and as such everything is in a silo. Each desk has separate Commission Sharing Agreements (CSA) with their counterparties and they also have separate pools of collateral. The first step is to break down the silos so that you see all your exposure under one platform. From a technology perspective you should have a single trade capture system that captures all the executions from each desk. The middle office will enrich the data and ensure each trade is captured across all desks at the end of the day. This will allow for netting of exposure. If different desks are trading the same underlying netting exposure will minimize margin. On the inventory side, there should be a platform where you can see all of your custodians and other accounts. So at any point in time you can have a full view of your total inventory. If the market falls by 5% you will be able to see across your entire inventory whether you have enough collateral to cover the margin. It's too cumbersome to break down silos. You have involved all the departments not just the front office. Secondly, you need to renegotiate you master ISDA and CSA agreements to incorporate all of your entities and portfolios if you want to have cross margining. CSAs are designed to support one entity and one portfolio only.

SE: Won't the cost of technology be too high to manage all the different types of assets, risk, margin, etc?

CR: There is a big demand for a cross asset offering from the end client, and if there is a demand there has to be a solution. The question is that it's not too costly but how to make it cost efficient. When it comes to these different silos they typically use different solutions and this causes multiple mid- and back office solutions. For the back office every broker must be able to provide a statement at the end of the day with all the calculations for margin. I see a great opportunity in the mid-office for a technology revamp as it seems that risk is being managed in the mid-office but It tends to be siloed. There is a lot of redundancy first off and there is a need for organizations to consolidate risk at the end of the day. If it's not done properly it presents an operational risk. Replacing the mid-office silos with a single solution that can calculate risk margin across all asset classes tends to lower the overall cost of the solution.

TK: What we need from technology are an optimal trading architecture, robust reliability, fast time to market and a very scalable cost structure. Scalability is very important because that allows you to reduce your cost as your business grows. The architecture is important because if it's outdated it's difficult to grow and customize. You need to find consolidated risk engines and they would be standalone in an outdated architecture. As you go forward and regulations change outsourcing will be a big problem. We are seeing more consolidation of financial institutions which raises the bar of operating standards required by regulators. This will affect the way you need to design your vendor solution where potentially vendors may have to become vendor-agnostic. Lastly, cost. It is easier to approve spending if it increases revenue. Its much harder to approve spending on infrastructure where you

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cannot see an incremental increase in revenue. But that is what you need to do to improve your risk management and operational efficiency. However, the pay back isn't immediate. When you look at KPI and ROI the focus is on the short term return rather than invest for the longer term.

SE: How should one price risk?

SA: I am not sure what the question means. From the trading desk perspective you have various risks such as market, credit and counterparty risk. How many of those counterparties are actually collateralized. Even if you are collateralized what kind of CSA do you have, are there thresholds? What kind of collateral are you using? The regulators having been focusing on counterparty risk particularly with respect to OTC. Of course there is operational risk too such as Dodd-Frank. Are you trading a SEF (Swap Execution Facility) on an approved platform. Also, with your downstream systems where you have full connectivity and STP you are able to swiftly review your net exposure and resolve disputes and meet margin calls when the market goes against you.

TK: This eludes to an earlier point of managing risk. From the brokers perspective it comes down to recovery risk. Can I get my money back when it goes wrong. In traditional securities brokerage, margin financing would be based on the break up value of a stock. So if I sell it out I can get money back. The market has recently moved to volume driven where a share may not have great fundamentals but you are prepared to finance it because of the large volume traded. I can sell it without moving the market much. It doesn't help me if I have a very good stock that has no liquidity because I can't recover the money. The next level will be to look at the hidden liquidity. Print volume and bid and ask on exchanges excludes hidden liquidity. When you move into a darkpool you can actually work a block and trade a large amount of shares that is many times the average daily volume. It makes it difficult to price in that liquidity to provide the correct type of collateral to a customer. We see a movement from a quantitative base to a much more qualitative judgment which depends on your risk tolerance.

MP: From purely a margin business, variation risk is big concern to make sure customers don't run the risk of having bigger losses than necessary. Our risk parameters are focused on that. That is how we run the business.

SE: What are your client's preferences with regards to pledged collateral?

SA: What you are talking about is the difference between pledged collateral and title transfer. What we are seeing in Asia, particularly on the Australian buyside who don't feel comfortable with large amounts of collateral moving outside their control, is pledged collateral. If we look at the regulation around posting initial margin for non-cleared trades, this is very tricky and comes into affect December 2015. This is the first time where bilateral counterparties will have to post initial margin. It's fine in the same jurisdiction but what about cross border trades. If DBS is trading with Standard bank in South Africa, would DBS really feel comfortable posting collateral in a jurisdiction where they have no legal claim? In this case it is better to appoint one custodian in the middle which will actually have a branch in South Africa and in Singapore. That way DBS and Standard bank can post collateral to their respective pledge accounts. The collateral doesn't have to move off shore unless one party defaults.

MP: I can see the desire for clients to use collateral instead of cash. This is the trend going forward. Any firm that can provide collateral management services is ahead of its peers.

TK: On the securities side, particularly for small brokers who want to trade cross border. They don't have a strong balance sheet but they have a lot of clients. How do we decide what trade limits to offer them? Some of these brokers will use a larger financial institution that will stand behind the trades. We can then offer to them a higher limit than if they were not guaranteed. There are two levels then, the assets of the broker and the financial standing of a much larger guarantor.

SE: What are some of the regulatory changes the industry should be aware of? Will these present challenges or opportunities for their business?

MP: Looking at the collateral on the bilateral basis there is no need to post initial margin but that is changing by 2015 as was previously mentioned. Collateral is a means to address credit risk which affects haircuts and segregation of client assets and these are issues both the buy side and sell side should be aware of.

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SA: The three key regulations in the OTC space are Dodd-Frank, EMIR and Basel. Interestingly, both Dodd-Frank and EMIR don't specifically have punitive regulations that require you to have an approved collateral platform. For Dodd-Frank you have to trade on an approved platform in this case SEFs (Swap Exchange Facility) but for collateral most of the market seems confused as there are no regulations that you must use a provider. Basel III on the other hand advocates that you have an appropriate system and staffing to ensuring that none of the KPIs around collateral such as margin calls, settlements and substitutions are missed. Basel wants margin requirements to be done in a timely and efficient manner. Failure to do so means you need more to put up more capital as a buffer for your operational risk. In Asia, most of the big banks are adopting to develop in-house or buy from vendors collateral systems. The buyside is not moving too fast on this. They are relying on the sell side to provide to them a service around margining.

CR: When I think about brokers what springs to mind is the curbing of contra trading on the Singapore Exchange. For example, the rule to have 5% collateral on all unsettled trades. That is going to require reorganizing of infrastructure in several places. Another example is the lowering of pre-margin financing. This will only be available to those firms who can prove they can calculate margin intraday.

TK: Every time there is a challenge there is an opportunity. On SGX and Bursa Malaysia for the longest time clients could trade on contra which means no cash up front. This introduces systemic risk but it also introduces liquidity to the market. This is going to change with the 5% minimum collateral you need to post before trading. There will be a change in operational processes as this will impact the back office, the front office to ensure they have the correct information and pose a lot of unanswered questions. With all regulations there is an interpretation of that regulation. What do you mean by cash? Is a check sufficient or does it have to clear? What is the cut off time? End of day varies around the world. This is an area where brokers will struggle. The Monetary Authority in Singapore has a consultation paper out on outsourcing. When you are using a hosted model there is going to be a lot of obligation placed upon the financial institution that contracts out to third parties. That will also be open to interpretation. This could be a game changer as it goes to the debate of having an enterprise model versus an ASP model. With an ASP model it increasingly appears you will need to do as much work as you would for an enterprise model. At the end of the day the regulator will hold the financial institution responsible. Standards will take a step up. In terms of cost, upgrades will require a lot of testing and be highly secure. IT security is going to be a key area. It's possible that the testing will exceed to cost of an upgrade.

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SE: Where should the cross margining occur at the clearer, CCP or with the broker?

SA: From an OTC perspective, the executing broker, no. Why? Because they may not clear and may not know how much the CCP is getting. Clearing broker, perhaps yes, because they will have an idea of how many trades are going through to the exchanges. However, they cannot see what trades are done bilaterally. The CCP definitely not because they will only see the trades that are cleared through them. That leaves only in-house. Cross margining should only really be done in one's own firm and for that you need to have process reengineering, appropriate technology and break down the silos.

TK: I would add what technology the clearing house has. In the case of SGX, they are currently revamping the entire backend processes. Currently, brokers can't see what portfolio retail customers have. This will change with the new process and a decentralized approach, brokers will own their own backend instead of a single exchange provided system. This will allow for the brokers to see their customer portfolios. This is a game changer. You can offer more products. You can get them to write options because you know what their holdings are. This is possible when you have a clearinghouse providing a system that the brokers can leverage on.

CR: I would like to add leveraged FX into this. I agree with Sam that it should be done in house as its about the recovery risk as TK said. My favorite example asks should it be six percent or should it be based on more information? If we compare Dollar / Ruble which should be around 10percent margin to Dollar / Hong Kong Dollar which should be around 1 percent as it is pegged. I think it's about knowing the risk which the customers take. The broker takes the risk not the exchange.

> "There is a difference between managing risk and observing risk"