Interactive Data’s Anthony Belcher explores the emerging best practices among margin analytics, liquidity risk analysis and collateral valuation as needed to support new demands on collateral management processes for both exchange-traded and over-the-counter (OTC) derivatives.

Q: How can firms improve the way they manage margin eligibility and margin analytics?

The first things that firms need to look at is make sure that they take a step back and plan rather than migrating what they already have or have used previously.

Both Dodd Frank and EMIR introduce significant changes into the market which requires firms to re-think how they approach and look at margin eligibility. Specifically, firms need to know what data they have available for use in undertaking their analysis to better control the margin they have and to ensure the firm has the correct collateral available to meet its obligations. For example, when firms calculate variants, such as initial margins or multi-variants, they will need to make sure that the data is timely and accurate. They also will need to know where it came from, when it arrived and how it is related to those calculations.

It also is important that financial institutions have agreements in place with bilateral counterparties and central counterparties (CCPs) that state the basis on which they will take on margin processing and understand those agreements, especially how the dispute mechanism will operate. With dispute management, firms need to put in place a number of best practices and ensure that these are well understood before they enter into agreements or positions with counterparties.

Q: What are the new best practices for conducting liquidity risk analysis?

Liquidity risk has become increasingly important in this new market environment as it is a part of a number of new regulations, such as Basel III. However, liquidity can mean different things to different people.

Liquidity risk analysis is about trying to understand relative liquidity as well as absolute liquidity across the asset classes used and the instruments held by the firm. Interactive Data recently surveyed its clients and the industry at large on how they determine liquidity and by far and away the largest response demonstrated that most determine liquidity based on their ability to exit a position at or near its current value.

Obviously, there is a requirement on where and how quickly a firm can exit its positions. To do that, the firm needs to understand the assets it holds and the correlation of those assets.

There has been a lot of concern recently about the rush to exit out of positions, especially from moves to increase areas like index tracking and thus the tightening of collateral availability rules. This means certain clients, and industry participants generally, will be holding the same instruments and might want to exit the market very quickly given price moves. So, for conducting liquidity risk analysis, firms need to understand the correlation of those assets and the groups they fit into.

Clients will also need to understand what are the indications of liquidity, such as the types of information that would give them an advanced warning of where a market or a security or sector is becoming more or less liquid. The top indicators mentioned in our survey by clients were the number of trades or quotes that have taken place for those securities, how wide the bid-ask spread was, and the volume of participants that were in the market for that security. This is the kind of information which clients should be using as part of their liquidity-risk assessments.

Q: What are some of the tools needed to support collateral funding via securities lending or repo activities?

The first step is to understand the eligibility, which securities are you able to use and make eligible and can be used for collateral repo purposes.

As an acceptor and a user of collateral, firms will have rules and guidelines that they will want to use, but the question is: How do you apply that in practice?

Firms should be thinking about, or creating, tools that allow them to segregate their securities into groups based on the different eligibilities of different haircut levels so that they can manage this process quickly and efficiently.

They also need to understand collateral transformations and the tools and services are available to undertake transformations.

If a firm is undertaking collateral funding, it needs to understand what the fair value of its securities is and the timing of those valuations. It goes back to asset pricing.

We are seeing larger firms increasingly creating cross-firm views by removing some of their silos that were managing collateral in four or five different locations. It makes the use of collateral much more efficient when there is no “silos-ization.” Firms are bringing all of those silos together to create a more centralised unit, which is increasingly important in these days of tightening collateral availability and capital requirements.

Q: How can firms better manage the valuation and risk of underlying collateral data consistently?

The first thing here is to understand the source of the valuation that the firms are going to be using for this purpose. Where has the valuation come from? What is its data lineage? From where is it derived? Which inputs and sources were used to arrive at the valuation?

It is also important to understand the firm that created the valuation, its history of controls, and its process and methodology used. Not only should information be uncovered by due-diligence visit when a firm first interacts with a data provider, but also throughout the life of that relationship.
Firms need to understand the relevance of the price to the point-in-time. They increasingly are looking to undertake or utilise valuations when the decision to exit is about to take place rather than the last end-of-day price, or even end-of-month price for less liquid securities. It is essential to get the valuation as close as possible to the time when a firm wants to use the security and understand what that valuation is based on.

Finally, firms need to understand, especially in the case of CCP-cleared collateral, the relevant rules such as how a CCP arrives at its valuation and how it might differ or play into a firm’s understanding of its valuation. What is the risk of that divergence between how a firm manages its collateral and how the CCP looks at it also needs to be well understood by financial institutions.

Q: How can firms improve market and reference data to aid collateral operations?

It certainly is important for financial institutions to put structure and management in place around how they manage market and reference data so they can understand the level of quality of the data and processes, which is needed to demonstrate robust controls are in place. Manual processing, such as the reliance on spreadsheets, is no longer good enough for conducting basic price comparisons. Firms have to have a structure in place to manage its data to ensure that there are no data errors or data problems as they are using it in their collateral operations.

Q: How can firms better manage CCP clearing and non-cleared margin requirements including fair value rules?

Firms need to utilise the tools available to assess that availability of information and therefore fair market values. There are clear rules that set out how firms can segregate and allocate securities into the various fair value rules so firms need to work and understand what information they have available. To some degree, it comes back down to understanding where the valuation, or price, originated and where firms can use it.

It is important for firms to gain acceptance and agreement from their auditors, or some internal audit and control mechanism, to ensure what they are putting in place is appropriate and relevant.

Coming back to what I said earlier about CCP clearing, it is important to gain upfront agreement from the CCP what exactly and how often firms will be taking margin adjustments when they enter into a position, the speed that margin needs to be presented, the level at which the margin is being applied, and also the frequencies and bandings (or tolerances) that would a firm would need to apply when those margin variances would need to be examined.

Firms also have to have a good understanding about the transfer of information, how much information needs to be passed between the parties so that both parties have good understandings of the basis of the information. In doing so, financial institutions will have a good way to reduce the amount of disputes and errors that will occur through this process. It is those disputes and errors that create the greatest problems in the process and the timing and the cost of collateral and capital.

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Anthony joined the company in 2007 from the former Thomson Financial where, as commercial business manager, he was responsible for European acquisitions and other strategic projects. Prior to this he was a management consultant with Accenture and worked in many different change projects across Europe.

Anthony’s work with both providers and users of financial information has given him a wide understanding of the financial markets and their participants. Anthony has a Bachelors degree in Chemistry from Sheffield University and a Masters degree in Business Administration from London Business School.

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