Mass margin calls spark operational headache for buy-side and brokers

Market volatility sparked by the COVID-19 pandemic has resulted in a significant increase in prime brokers asking for more collateral from hedge funds.

Sharp rises and falls in global financial markets caused by the COVID-19 outbreak has resulted in firms facing huge margin calls, putting additional operational pressure at a crucial time where many are struggling to stay afloat.

Private and institutional investors, as well as corporates, have seen increased collateral demands from their banks and prime brokers for being on the wrong side of their OTC derivatives trades.

"There has been a significant increase in volume of margin movements for our clients, both posting and receiving collateral. Our teams have been working unbelievably hard helping clients manage their liquidity in a volatile market," said David Nable, managing director, Arcesium.

According to technology vendor Hazeltree, margin calls increased by more than 20% over the months of February and March 2020, in comparison to historic average margin calls, across institutional clients trading collateralised derivatives.

If firms are unable to meet their collateral demands, it could lead to the close-out of all outstanding derivatives transactions.

Highly leveraged hedge funds that have found themselves on the wrong side are witnessing devastating effects of these huge margin calls. Last week, ABN Amro said it would incur a $200 million loss after a single US hedge fund client trading futures and options failed to meet margin calls.

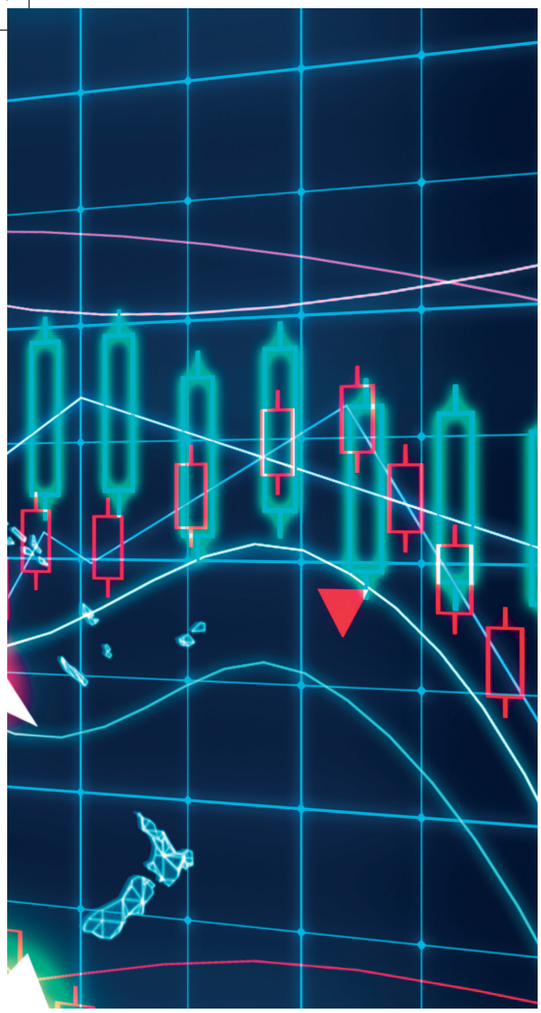
According to Bloomberg opinion article published at the end of March, the author described the situation as a 'system-wide margin call.' With record outflows from bond funds and billions more from stock funds, many firms are seeing the value of their collateral falling, further exasperating the dilemma they face.

"For those investors that have locked in at certain price levels, they are being hit twice and are losing money on both the hedging side and on the market side. This is a perfect margin squeeze," said Marcus Cree, risk management specialist, OpenGamma.

"Hedge funds that are highly leveraged, they have to have at least 60% of their liquidity to cover redemptions and volatility. To cover these redemptions and margin calls, they would need to liquidate positions to fund them. However, if the underlying value of the collateral is going down at the same time that the need to cover margins is going up, this means firms will be bleeding real capital, and if they go below their minimum liquidity requirement, it will be very difficult for them to bounce back."

More often than not, prime brokers have the last word in deciding what a position is worth, and therefore how much collateral to demand.

Yet many systems prime brokers use to



calculate how much collateral to ask for cannot factor in the extraordinary market conditions firms are are facing, and as a result, it has led to a rise in disputes with their clients.

"Brokers have been inconsistent in applying some of their more complex, portfolio based margin methodologies. These agreements typically involve sophisticated calculations that don't get triggered other than in times of significant market volatility," added Nable.

"Perhaps because these clauses are so rarely triggered, the brokers haven't tested them in practice as fully as other terms. As a result, we have seen a notable uptick in the number of margin disputes due to incorrectly applied methodologies."

Some firms are also finding it increasingly difficult to liquidate certain assets, particularly real estate assets, to fund their margin calls.. For these illiquid assets, their valuation is further determined by the banks and brokers, and therefore causing further disputes.

According to Bloomberg news, Royal Bank of Canada (RBC) has recently been sued by New York-based AG Mortgage Investment Trust, where the firm claimed the bank used the coronavirus pandemic to seize a large portfolio of its assets when it could not meet margin calls.

According to the compliant filed by the real estate investment trust (REIT), RBC said its commercial mortgage-backed securities had "drastically declined in value due to the crisis, allowing the bank to demand additional cash or securities to meet requirements. But the trust said the calls are entirely subjective and don't accurately reflect the true value of its portfolio.

The case with RBC may not be the only one as the fallout of the virus continues to unravel.

"As financial institutions seek to make margin calls for additional collateral, this has brought force majeure, market disruption and dispute resolution clauses into play; we can expect an increase in the number of legal claims from investors for recovering their losses from disputed margin calls during this market shock," explained Sakti Narayan, senior consultant in securities financing, Margin Reform.

According to Dave Grace, managing principal at consultancy firm Capco, there is a possibility that buy-side firms will make claims against banks as their positions are being closed out due to delays in covering margin shortfalls.

"Usually the client has until the end of the day to cover positions – but where assets have been rehypothecated, for the purposes of leverage and financing and effectively immobilised, accessing collateral quickly will be a challenge for some," said Grace.

"Some banks will have taken prudent risk management decisions to protect themselves against any potential client default and liquidate positions. The result may be that clients sustain realised losses on their books, and some have started legal proceedings against their banks."

Elsewhere, some firms may have to turn to overnight funding markets to gain access to that collateral to cover their positions.

"I would expect an impact on repo markets as it's likely higher grade collateral will not be considered 'spare', and therefore firms will look to overnight or short term repos to ensure they can access collateral as and when they need it. Posting cash margin would not be preferable," added Grace. "A falling market should see a spike in stock lending activity as short-selling increases and these shorts need to be covered."

The current operating environment for firms means that the need for fully automated workflows that can value the collateral correctly and then transfer it efficiently has become even more important. Yet with many functions still heavily reliant on paper-based methods, this is adding extra strain for operations teams.

"While our clients operate with fully automated workflows, the ecosystem as a whole still has a tremendous amount of cash and collateral processing done by email or even fax. It doesn't matter how automated a buy-side firm is if their counterparties are drowning in paper requests from their other clients," said Nable.

"Banks who have not moved their clients to automated methods of processing cash and securities transfers are experiencing bottlenecks, placing added strain on their operations teams to get payments and transfers out."

Many banks and brokers are urging their clients that are working remotely to leverage digital tools. Jim Crowley, CEO of BNY Mellon's Pershing, said in a letter on the firm's website that digitally transforming the way the industry works has become a business imperative. "To truly operate effectively, it's now more important than ever that your firm adopt and utilise digital services and processes," he said.

To help free up resources, regulators have pushed back a number of upcoming legislations, including the Securities Financing Transaction Regulation (SFTR) and the last two phases of the Uncleared Margin Rules (UMR), to allow firms to focus on keeping their business up and running.

However, this could delay firms on implementing automated processes in their collateral operations.

"While the delay of SFTR and UMR have helped firms free up resources and avoid regulatory costs, the pressure to have a end-to-end automation in the collateral management process also gets pushed down the line. When there are such large volumes of margin calls and little automation, the manual input of so many SWIFT messages means settlement failures will most likely occur," added Chetan Joshi, founder and COO of Margin Reform.