Margins are too low….

Or too high…

Or Just Right?

Costas Mourselas writes a good article in Risk.net https://www.risk.net/risk-management/7506216/coronavirus-rout-revives-attacks-on-futures-margining

It appears that bank FCMs believe that the margins charged by CCPs are too low, as margin breaches have been particularly troublesome in the last few weeks of volatile markets. A trading firm, itself a CCP member went under last week and its positions were auctioned off.

Several bank FCMs feel that margin should be permanently hiked to reduce 'cheapness' after extended periods of calm in markets.

So let's see, CCPs are too expensive – so let's trade OTC? Or now CCPs are too cheap and we have to accept the 'cheap initial margins' they levy on us, and blindly pass them on to clients?

This is a flawed and self contradicting set of arguments. Everyone is at liberty to adjust initial margins beyond the exchange minimum rates. The reason they don't is because they are stuck with outdated back office systems that have no optionality in adjusting margins based on different criteria. Is the CCP model the right one? Usually, when things are normal (11 years of bull market normal?), they are. Well young risk managers and heads of business have little if any ***bear*** *market experience. This is 'black swan month'.*

With the unrest in China (Hong Kong protests) the news of a strange virus outbreak in the world's manufacturing base (China is now key in just about every supply chain as well as a key consumer of global raw materials), a long, long bull market in stocks, a weakening (not suddenly weak) oil price, the risk managers should have all been on 'orange' alert.

Risk profiles for all accounts should have been under review, additional collateral called, accounts closed, moved out and position limits decreased. Yes, this would present some serious commission revenue hits (but rather that than unrecoverable losses?), but the exposure could then be better assessed, managed and mitigated.

But – markets move after the close (settlement last night and trading prices today can always be vastly different) – and positions change overnight (particularly options positions) – and Initial Margins that were charged last night are already irrelevant, as are the portfolios that existed yesterday that have changed, altering stress test outcomes….

So Initial Margins are front office and real time in managing risk.

In systems like ours, easily modified (increased) in times of stress, which, when changing their base values, trigger early margin calls, bringing overexposure to the attention of risk managers and clients earlier, encouraging action.

As markets move so does liquidity – ability to liquidate efficiently requires a good view of all the elements:

- *real time exposure knowledge (certainty), which near real time FIX drop copy delivery assures, so estimating the account's current delta, the overall size of a pool of liquidity as a good directional hedge if not actual position close,*
- *its likelihood of approaching need for action (percentage of collateral used up),*
- *the relationship of that account's size of exposure to the firm's overall exposure in that set of instruments (if every account is long index futures and the biggest account is in trouble, then the action will impact all accounts),*
- *the regulatory consequences of massive liquidation impacting the market's behaviour.*

An exchange official quoted in the article believes holding enough margin for a 24% plunge in oil futures as not practical. Why not – if you are long oil and it collapses, you should be in a position to take delivery of that oil at the price you bought it – or cover the move without an additional margin call when you liquidate your position – right? Otherwise the CCP and its members is on the hook.

The CCP is obliged to manage the risk between its members adequately, and one large one is in the process of modifying its margin models into a proprietary one, with no sharing of the detail with the markets. So clearing members should be OK with that? At the time of writing, it seems that even with a fully disclosed margin model clearing members aren't satisfied, so why would a secret and unmodifiable model be acceptable?

When markets are volatile, adequate funding takes priority over encouraging trading and generating fees (many members at the large US markets pay capped fees – so the clients are the real contributors), and if limiting positions (both long and short with higher margins) reduces turnover, and some liquidity in the process the price is lower, it is a necessary evil. As it is the exchange CCP needs to also have more skin in the game, and be responsive as markets evolve, not just simply charging a toll and throw up their hands when things go wrong.

Have we forgotten Nasdaq Nordics already?