UNCLEARED MARGIN RULES

PHASE V AND VI FIELD MEMO

UNCLEARED MARGIN RULES BACKGROUND

In response to the global financial crisis of 2008, the G20 agreed to a financial regulatory framework for non-centrally cleared derivatives, the Uncleared Margin Rules (UMR). In September 2013, the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) jointly published a margin requirement framework to establish global standards for the exchange of Variation Margin (VM) and Initial Margin (IM) between market participants (see Table I below).

Margin collected under UMR is known as 'regulatory margin' and began to be phased in September 2016, covering the largest market participants. In 2017, all market participants became compliant with Variation Margin (VM) requirements. Additionally, 23 of the largest swap dealers are currently in compliance with IM rules, and an estimated 20 firms became compliant in Phase IV on September 1, 2019.

In-Scope Market Participants:

- Swap Dealers (SDs)
- Major Swap Participants (MSPs)
- Financial End Users (FEUs)[1]

In-Scope Products:

- Majority of uncleared OTC derivatives with minor exclusions defined by a regional regulatory authority

Key Requirements:

- Gross daily Initial Margin (IM) calculation
- Initial Margin segregation at a third-party custodian
- Collateral eligibility
- Account Control Agreement (ACA) and Credit Support Annex (CSA) renegotiations

[1]Examples of Financial End Users (FEUs) include banks, investment funds, insurance companies, and GSEs. Applicability of rules for FEUs depends on the materiality of the swaps exposure (MSE) of the firm.

Recent Regulatory Announcements

In July 2019, BCBS and IOSCO agreed to extend the final implementation of the margin requirements by one year for firms with an AANA (Aggregate Average Notional Amount of non-centrally cleared derivatives) between €8 billion and €50 billion; the application date is now September 1, 2021. For firms with an AANA between €50 billion and €750 billion, the application date remains September 1, 2020 (announcements from regional regulators on local currency thresholds and timeline alignment is pending at time of publication of this document). In addition, BCBS, IOSCO, and regional regulators (e.g. CFTC) have clarified that the posting, collection, and custody of Initial Margin is not required until the Initial Margin threshold exceeds a certain amount.

IMPLEMENTATION PHASE-IN SCHEDULE A firm is in-scope for a particular phase if their ANNA is above the specified threshold for that phase								
Jurisdiction	**Phase I** IM **Sep 2016**	**Phase II** VM **Mar 2017**	**Phase II** IM **Sep 2017**	**Phase III** IM **Sep 2018**	**Phase IV** IM **Sep 2019**	**Phase V** IM **Sep 2020**	**Phase Vi** IM **Sep 2021**
US	$3 trillion	All covered entities	$2.25 trillion	$1.5 trillion	$.75 trillion	€50 billion[2]	€8 billion[2]
EU	€3 trillion		€2.25 trillion	€1.5 trillion	€.75 trillion		
Japan	¥ 420 trillion		¥ 315 trillion	¥210 trillion	¥105 trillion		
Canada	$ 5 trillion		$3.75 trillion	$2.5 trillion	$1.25 trillion		

Table 1

[2] Announcements from regional regulators on local currency thresholds and timeline alignment is pending at the time of publication of this memo.

IMPLEMENTATION OF UMR: PREPARING AND BECOMING COMPLIANT

The journey to IM compliance is lengthy and requires coordination across multiple divisions for newly in-scope counterparties. For phases I-IV, the typical implementation took 18-24 months. Phase V and VI implementations are expected to take 12-18 months for newly in-scope firms. With many market participants expected to come into scope, there will be increased demand on market resources.

SELF ASSESSMENT

Market participants are required to calculate the average aggregate notional amount (AANA) daily for three months at a group level to determine in-scope vs. out-of-scope

SELF DISCLOSURE

At the end of the calculation period, if AANA is greater than the AANA threshold, all derivatives counterparties that are Swap Dealers should be notified

IM CALCULATION

Market participants must select a methodology and calculation agent. Regulatory approval is required

CUSTODIAL RELATIONSHIPS

Triparty and/or third-party custodial relationships must be established to satisfy segregation requirements. Comprehensive onboarding (inclusive of AML, KYC, legal negotiations, account & platform set up) along with infrastructure and connectivity buildout is required

CSA AND LEGAL DOCUMENTS

CSAs must be executed in advance of regulatory go-live to be eligible for activity. Legal negotiations with counterparties will require participation with associated custodians

COLLATERAL ELIGIBILITY

Collateral must be segregated for regulatory IM. In certain regions concentration limits on certain collateral exist (e.g. high-quality government bonds and central bank securities)

TECHNOLOGY INFRASTRUCTURE

Technology enhancements across platforms are required to support IM calculation, collateral processing, and custodian segregation

PROCEDURES & CONTROLS

Clients and their brokers need to determine how the rules apply, any edge cases, collateral eligibility, and how calls are met, disputed and reconciled

INTER-AFFILIATE TRADES

Special rules apply for the treatment of inter-affiliates swaps under PR and CFTC rules where participants may need to calculate and post IM with financial end-user inter-affiliate entities

MONITORING

Following the regulatory deadline, market participants are required to proactively monitor their IM and be prepared to post if they breach defined thresholds

KEY CHALLENGES:
NEWLY IN-SCOPE PHASE V AND VI FIRMS

New Custodial Relationships and Setups

Triparty and/or third-party custodial relationships need to be established to allow for the segregation of regulatory IM. Know Your Client (KYC), negotiations, technology and operational setup and testing can take up to several months for a new relationship to be established. Large swap dealers have generally elected to utilize triparty custodial relationships to maximize processing efficiency; a third-party model should also be considered by phase V & VI market participants as they are usually more cost effective.

Complex IM Technology Functionality

A multi-layered set of functionality is required to meet the IM requirements, including items such as: calculating regulatory IM per counterparty agreement, sending/receiving collateral calls, and posting IM at a custodian.

Changes to Legal Documentation

All agreements may need to be repapered in preparation for go-live. This is required at the counterparty pairing level, which can require many negotiations to happen concurrently. Agreement on eligible collateral, including haircuts, and termination currency will also need to be established.

Determining the Impact of IM Obligations

Given the varying compliance scenarios between counterparty pairs and the existing relief thresholds that may or may not apply in each case (e.g. if Reg IM is less than $50 million with a particular counterparty then updated documentation is not required on go-live date), market participants are grappling with how substantial their Day 1 compliance obligation is.

Understanding the Cost-Benefit of Their Uncleared OTC Derivatives Activity

One of the stated objectives of BCBS and IOSCO regarding margin requirements for non-centrally cleared derivatives is the promotion of central clearing. Applying margin requirements to uncleared swaps activity increases capital costs and generally reduces the attractiveness of these products. Market participants are challenged to understand whether the increased cost of uncleared OTC trading, as well as the cost of IM compliance, is worth their current benefits.

KEY CHALLENGES:
PHASE I THROUGH IV FIRMS FACING OFF WITH NEWLY IN-SCOPE COUNTERPARTIES

Handling of Prime Brokerage (PB) Vs. Non-Prime Brokerage Activity

- Many buy-side firms are coming into scope under UMR Phases V and VI, which will in many cases impact sell-side Prime Brokerage divisions for uncleared OTC derivatives activity.
- Historically, separate teams, processes, and systems handle Prime Brokerage derivatives trading activity and corresponding margin calculations. Applying the regulatory IM calculation across PB and non-PB business areas is disruptive and complex.

Dealing with Bespoke Client Scenarios

- Given that more nuanced buy-side clients are coming into scope, at times, tailored calculations and operational processes are utilized.
- Additionally, clients and their swap dealers need to determine how the rules apply, any edge cases, collateral eligibility, and how calls are met, disputed, and reconciled.

Client Communication Constraints Risking Delay of Setups

- Client communications have been limited and hampered by clients moving too slowly and/or not recognizing the urgency of the upcoming regulations. There will be an influx of clients requiring setup. Lengthy setup processes (e.g. new third-party/triparty custodial account setup) place risk on go-live readiness.

Lengthy Client CSA Negotiations

- Negotiations can be lengthy, and the documentation process is often manual and bespoke. There can be time constraints, data quality issues, and system integration constraints.

Handling of Regulatory IM vs. House IA

Many of the counterparties coming into scope currently meet House IA and will need to account for regulatory IM as well, resulting in three potential calculations:

- Greater of approach, where House IA is already segregated at a third-party
- Allocated approach, for clients where the House IA is held bilaterally
- Distinct approach, where independent regulatory IM and House IA margin calls are called separately without any netting of collateral

CAPCO AND UMR

Capco has deep experience and expertise in delivering UMR IM solutions from phases I-V. We have a successful track record of executing UMR compliance solutions for our clients in phases I-IV and are currently supporting our clients in phase V.

We offer robust end-to-end UMR assessments and execution services. Our solutions act as accelerators to expedite your IM compliance readiness. We tailor these solutions further to fit your bespoke OTC derivatives business situation and needs.

For further details on our offering, please reach out to us at CapcoCapitalMarkets_NA@capco.com.