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Uncleared Margin Rules: Initial Margin

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What You Need To Know

- Smaller, less systematically important, in-scope firms have (subject to confirmation by the relevant regulators) been given additional time – until 1 September 2021 – to comply with the mandatory exchange and segregation of initial margin under global uncleared margin rule regimes.

- This expected delay in implementation does not mean that market participants should relax. In order to prepare properly, a significant amount of legal documentation must be put in place, and operational and IT work must be completed, against a backdrop of squeezed resources at third party custodians and dealer counterparties.

- The implementation process for initial margin compliance is more documentation-heavy and complex (and hence time-consuming) than the variation margin repapering process from 2017.

- At a minimum, firms should be:
  - checking whether they are, or are likely to be, in-scope (and whether action could be taken to ensure that they are out of scope);
  - deciding which custodian(s) they will use to hold initial margin;
  - opening up discussions with counterparties to start the documentation process;
  - considering which initial margin model to use, as well as the pricing, liquidity and regulatory issues that will arise; and
  - familiarising themselves with the new complex legal documentation and internal processes and procedures, operational and on-boarding requirements and necessary ongoing compliance monitoring.

Please read on below, for more information.

The Full Read

A shortened version of this Briefs for the Buy side will appear in HFMWeek next month.

Briefly, what are the Initial Margin requirements in the European Union ("EU")?

Initial margin is a 'buffer' amount of collateral collected to cover a party's current and future exposure during the 'margin period of risk', being the interval between the (i) last collection of margin by that party and (ii) liquidation of positions or hedging of market risk following a default of the counterparty.

The initial margin requirements under the European Market Infrastructure Regulation[1] ("EMIR") and accompanying regulatory technical standards[2] (the "Margin RTS") provide that in-scope counterparties must exchange initial margin on a two-way gross basis in respect of non-centrally cleared derivatives ("Uncleared OTC Derivatives").

Which counterparties are in-scope?

The Margin RTS apply directly to a: (i) 'financial counterparty' ("FC") (whether it exceeds any EMIR clearing threshold applicable to any asset class or not – i.e. whether it is a 'large' or 'small' FC); and (ii) non-financial counterparty which has exceeded the EMIR clearing threshold for any asset class ("NFC+"). The rules also apply indirectly to a third country (i.e. non-EU) entity that would be categorised as an FC or NFC+ if it were established in the EU, which is facing an FC or an NFC+. Two third country entities facing each other may also be in-scope in certain circumstances (not considered further here).

With respect to initial margin requirements, the Margin RTS apply on a phased-in basis according to an in-scope counterparty's or its group's aggregate average notional amount of Uncleared OTC Derivatives ("AANA") for March, April and May of a given year. The AANA is calculated on a gross basis and is determined on the last business day of each relevant month.

Phase 4 of the phase-in process came into effect on 1 September 2019 for those in-scope entities with an AANA of over €750 billion. It was expected that there would be a 'Big Bang' Phase 5 from 1 September 2020 for those in-scope entities with an AANA of over €8 billion (calculated for March, April and May 2020) – so called due to the significant increase in numbers of counterparties that would be caught under Phase 5 (including many buy side firms) compared to Phases 1 to 4. For those entities with an AANA of under €8 billion on the relevant dates, the initial margin requirements of the Margin RTS do not apply.

The key requirements

The Margin RTS impose detailed rules relating to the calculation, holding and type of initial margin, including that initial margin must: (i) be both posted and collected by each in-scope entity with no netting or offset; (ii) meet certain eligibility criteria and concentration limits; (iii) be protected from the default or insolvency of the collecting counterparty by being segregated on the books and records of a custodian or under other legally binding arrangements; and (iv) be calculated (x) in accordance with certain prescribed methodologies ("IM Model") and (y) at least every 10 business days or upon the occurrence of certain events. The IM Model must be either an initial margin model developed by counterparties or by a third party agent complying with the Margin RTS criteria ("Non-Standardised IM Model") such as the ISDA Standard Initial Margin Model (SIMM), or a standardised 'grid' approach set out in the Margin RTS[3].

Use of a Non-Standardised IM Model will present its own challenges since a directly in-scope entity will need to establish internal governance processes to assess its appropriateness on a continuous basis, including initial and ongoing validation and regular audits. Risk management procedures will also need to be developed to ensure that performance of the Non-Standardised IM Model is continuously monitored and back-testing occurs at least every three months.

Other regimes

It should be borne in mind that whilst the Uncleared OTC Derivatives margin rules in other jurisdictions are similar to the Margin RTS, the United States ("US") uncleared margin rules contain a number of substantial differences. For example, under the US rules the AANA calculation period is June to August in the previous year, and is determined on each business day across the relevant three month period.

What about that September 2020 "Big Bang"?

On 23 July 2019, the Basel Committee on Banking Supervision ("BCBS") and the Board of the International Organization of Securities Commissions ("IOSCO") published an updated version of their Framework on Margin Requirements for Non-Centrally Cleared Derivatives[4] ("BCBS–IOSCO Framework"). In relation to the requirement to exchange and segregate initial margin in respect of

Uncleared OTC Derivatives, the updated BCBS–IOSCO Framework sets out requirements for: (i) a one year extension to the phase-in implementation deadline, creating a new Phase 6; and (ii) an increase in the Phase 5 threshold. As a result, the compliance date for a large number of in-scope entities will be postponed from September 2020 to September 2021, with the adjusted Phase 5 and the new Phase 6 criteria now being as follows:

Phase 5: from 1 September 2020, a covered entity belonging to a group with an AANA for March, April and May of 2020 exceeding €50 billion will be in scope; and
Phase 6 from 1 September 2021, a covered entity belonging to a group with an AANA for March, April and May of 2021 exceeding €8 billion will be in scope.

Why the delay?

For some time, the industry has been warning of the challenge to ensure that all Phase 5 entities (estimated by the International Swaps and Derivatives Association ("ISDA") to be over 1,100 entities representing over 9,500 counterparty relationships[5]) would be ready by 1 September 2020 to collect, post and appropriately segregate initial margin given that this would require: (i) the creation of up to 19,000 segregated initial margin accounts[6]; (ii) a significant volume of new and complicated contractual documentation and custodial onboarding requirements; and (iii) extensive operational and technological build-outs.

Whilst calls had been made for the €8 billion threshold to be raised to €100 billion to better reflect those entities that pose a systemic risk, this latest approach from BCBS-IOSCO serves to kick the compliance can further down the road (and, of course, many 'old' Phase 5 entities will still be caught by the 'new' higher Phase 5 threshold, so there will be no change for them) instead of offering permanent relief for smaller market participants.

Can Phase 6 entities now pause their compliance efforts?

No, those market participants likely to be caught in the new Phase 6 should not cease preparations – and if they have not begun preparations, they should start now. We think it unlikely that any further delays or material concessions will be forthcoming, in which case in-scope entities should use the additional time wisely.

Firms should be actively assessing whether they may be in scope – if they are, they should approach their counterparties as soon as possible. Early consideration should also be given to fundamental issues such as:

1. which IM Model to adopt – this will have a significant impact on the amount of required initial margin – and, where applicable, how to develop the operational, connectivity and technological capabilities and capacity required to comply with the monitoring, testing, verification and other criteria relating to use of the chosen IM Model;
2. if, aside from EMIR, another Uncleared OTC Derivatives initial margin regime will apply; and
3. how existing independent amounts (i.e. non-regulatory initial margin) already posted should be treated.

Relationships with custodians should be established as early as possible to avoid the bottleneck that will occur as the Phase 6 compliance date draws closer, and to allow for time to put in place and test connectivity infrastructure.

Wider funding and liquidity issues arising from the Margin RTS will also need to be considered, insofar as firms will need to ensure that they can obtain sufficient eligible initial margin which can settle within the required same day margin delivery cycle.

From a documentation, operational and compliance perspective, the efforts and resources required for Phase 6 compliance should not be underestimated. Phase 6 entities should note that the new Phase 6 compliance date will conflict with another significant project that will consume a large amount of dealer and custodian resources and bandwidth: namely, the expected transition away from LIBOR by the end of 2021.

ISDA has published a document entitled "Getting Ready for Initial Margin (IM) Regulatory Requirements"[7], which is a good place to start.

Why is the documentation piece so challenging?

Anyone hoping for a light repapering process similar to the 2017 variation margin documentation exercise will be in for a shock: the initial margin contractual documentation is far more voluminous and far more complex. Considering that the segregation requirement applies to both posted and collected initial margin, appropriate documentation and accounts are needed for both: (i) initial margin posted by a counterparty to its dealer; and (ii) initial margin posted by a dealer to its counterparty. Although it is possible to have one set of documentation dealing with initial margin accounts for both parties, in reality each party can be expected to have its own custodial arrangements and hence its own 'set' of documentation for posting collateral in favour of the other party.

A buy side entity is likely to post initial margin to a segregated account opened in its name with a bank custodian (such account being secured in favour of the dealer) whereas a dealer is likely to post initial margin to a collateral / pledged account opened in the Clearstream or Euroclear systems (such account being pledged in favour of the counterparty). Each party will need to review both its own, and the other's, documentation.

The required documentation for each trading relationship is likely to include: (1) where using a bank custodian, a next generation (i) ISDA 2018 Credit Support Deed for Initial Margin (IM) (Security Interest – English Law) or (ii) ISDA 2018 Credit Support Annex for Initial Margin (IM) (Security Interest – New York Law); or (2) where using Euroclear or Clearstream, or in certain circumstances using bank custodians, a form of collateral transfer agreement and related security agreements (typically, to be governed by the laws of the location of the account).

Under those documents, the parties will need to agree: (i) the IM Model to be used; and (ii) how to deal with the interaction between non-regulatory independent amount already posted ("Independent Amount") and the new regulatory initial margin requirements by electing one of the following: (x) Distinct Margin Flow (IM) Approach – which treats initial margin and Independent Amount completely separately (with no offsets between the two) and is likely to result in more initial margin being posted than under the other two approaches; (y) Allocated Margin Flow (IM/IA) Approach – which reduces any posting obligation in respect of Independent Amount under 'other' credit support arrangements by the amount of the regulatory initial margin requirement (with the result that the 'excess' Independent Amount remains under the 'other' credit support arrangements) but still retains two margin posting flows; and (z) Greater of Margin Flow (IM/IA) Approach – which 'allocates' all existing Independent Amount as regulatory initial margin (with the result that nothing is posted under the 'other' credit support arrangements, so there is just one margin posting flow).

In addition, depending on the custodian used, a triparty account control agreement (or similar agreement), an eligible collateral schedule in respect of each segregated account, as well as membership documents of Euroclear or Clearstream, may also be required. To the extent that such documentation does not itself establish the collateral accounts, or the accounts have not already been opened under existing custodial relationships, then further custodial (and KYC / AML) documentation may be needed. Also, again depending on the custodian used, it may also be necessary to agree upon the segregation structure (the so-called 'Triparty' or 'Third party' offerings). If a party wants to

use ISDA SIMM as its IM Model, then an ISDA SIMM licence agreement will be required, and the party may also choose to enter into an ISDA SIMM Crowdsourcing Utility participation agreement.

The manner of the documentation negotiation may also be unfamiliar. ISDA has launched ISDA Create – IM, an online tool which allows the negotiation of initial margin documentation to be automated across multiple counterparties. Although the buy side may be unaccustomed to using online tools for negotiations, the objective is to make the overall negotiation process more efficient and less time consuming.

Entities directly in-scope of the Margin RTS must also remember to perform a legal review to verify that the segregation arrangements meet the Margin RTS requirements and that the collateral agreements are enforceable.

Under the Margin RTS, counterparties using a Non-Standardised IM Model will need to provide to the relevant national competent authority ("NCA") relevant documentation upon request. As a further potential complication, EMIR REFIT introduced a requirement for the relevant NCA to validate IM Models on an initial and ongoing basis and for regulatory technical standards to be developed for this purpose by 17 June 2020 (although the recitals to EMIR REFIT suggest that this may apply to internal IM Models only (i.e. a Non-Standardised IM Model)).

Is the delay now effective?

The BCBS–IOSCO Framework is not binding and, as such, the changes to the phase-in periods are recommendations only. However, a number of regulators around the world have confirmed adoption or intended adoption of the revised BCBS-IOSCO implementation schedule. Whilst the EU has yet to issue any view on the revised framework, it is surely inconceivable that it will not follow in the footsteps of those regulators.

Is there any other mitigation in relation to the initial margin requirements?

The Margin RTS provides for a €50 million initial margin exchange threshold[8]. It was, however, unclear whether counterparties that were in-scope but would not exceed the threshold would nevertheless be required to open custodial accounts, negotiate and execute relevant documentation and ensure operational capability to exchange and segregate initial margin even though they would not be required to actually exchange and segregate. On 5 March 2019, BCBS-IOSCO released a statement[9] confirming that such documentation and capability may not be required until the threshold is breached ("BCBS-IOSCO Guidance").

However, BCBS-IOSCO have also stated (in that same BCBS-IOSCO Guidance) that they expect that counterparties will "act diligently when their exposures approach the threshold to ensure that the relevant arrangements needed are in place if the threshold is exceeded". Quite what that means is uncertain – but it would seem that counterparties must be fully ready in advance from a documentation and operational perspective to be compliant once the threshold is breached. At the least, this would suggest that counterparties should have internal policies and procedures in place to monitor the initial margin threshold and to set a point at which efforts would be made to achieve compliance.

As with BCBS-IOSCO's recommendation for the adjusted Phase 5 and the new Phase 6 requirements, the guidance from BCBS-IOSCO is not binding and we await national regulators' responses, noting that some have already endorsed that interpretation.

Will Brexit impact the initial margin phase-in timings?

Assuming that the United Kingdom ("UK") exits the EU on the "do or die" date of 31 October 2019, then one of two outcomes are possible:

(1) If the UK leaves without a Withdrawal Agreement (i.e. a 'hard' Brexit): the Margin RTS will be onshored into UK domestic law on the exit day pursuant to the European Union (Withdrawal) Act 2018 (as amended by the Technical Standards (European Market Infrastructure) (EU Exit) (No. 3) Instrument 2019) to the extent that they are "operative immediately before the effective day". Seeing as Phases 5 and 6 will not be operative at that time, they will not automatically form part of UK law (whereas Phases 1 to 4 will). Consequently, it is expected that, at a later date, UK regulators will separately provide for the application of Phases 5 and 6 respecting the current phase-in timings; or

(2) If the UK leaves with a Withdrawal Agreement: the terms of the Withdrawal Agreement and the (currently envisaged two year) implementation period should mean that Phases 5 and 6 will apply in the UK.

The above material is provided in brief, summary form. It is provided for information purposes only and should not be taken to constitute legal advice. Professional legal advice should be obtained before taking or refraining from any action in relation to the contents of this email.

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[1] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories. Available at: https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ%3AL%3A2012%3A201%3A0001%3A0059%3AEN%3APDF (as amended by (amongst others) Regulation (EU) 2019/834 of the European Parliament and of the Council of 20 May 2019 amending EMIR as regards the clearing obligation, the suspension of the clearing obligation, the reporting requirements, the risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty, the registration and supervision of trade repositories and the requirements for trade repositories ("EMIR REFIT") which is available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R0834&from=EN). See also the May 2019 edition of Briefs for the Buy side, available at: may-2019-emir-refit-how-it-will-affect-you/

[2] Commission Delegated Regulation (EU) 2016/2251 supplementing EMIR with regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty. Available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R2251&from=EN

[3] At Annex IV thereof.

[4] Available at: https://www.bis.org/bcbs/publ/d475.htm

[5] See: https://www.isda.org/2019/03/11/tackling-the-im-challenge/ and also fn. 5 below.

[6] See: https://www.isda.org/a/5evEE/Initial-Margin-Phase-In-Implementation-Joint-Trade-Association-Comments.pdf at page 3.

[7] Available at: https://www.isda.org/a/iVmEE/ISDA-Initial-Margin-Fact-sheet.pdf

[8] See Article 29 of the Margin RTS.

[9] Available at: https://www.bis.org/press/p190305a.htm