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Uncleared derivatives - initial margin (IM) and variation margin (VM) credit support documentation

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Banking & Finance analysis: The International Swaps and Derivatives Association (ISDA) recently published a series of credit support documents in relation to margin requirements. Antony Bryceson, managing partner and Jelena Novakova, senior associate at AB Trading Advisors, explain the new documentation and connected issues…

Why have ISDA published a series of credit support documents in relation to margin requirements?

The financial crisis of 2008 revealed that large banks and financial institutions as well as other market participants might be particularly vulnerable to systematic and other risks caused by over-the-counter (OTC) derivatives, which are privatelynegotiated derivative contracts between two counterparties. To limit such risks, and to mitigate potentially catastrophic consequences of a default by a large bank under its OTC derivative transactions, the Group of Twenty (G20) initiated reform efforts in relation to OTC derivative transactions, markets and practices. The reform agenda comprised such measures as:

- central clearing of standardised OTC derivative transactions
- reporting of OTC derivative transactions
- higher capital requirements for market participants, and
- mandatory margin requirements for non-centrally cleared (or ‘uncleared’) OTC derivative transactions

Central clearing refers to replacing your original counterparty with a (supposedly more robust) clearing house, which takes over as the ‘central’ counterparty.

As part of this reform agenda, the Basel Committee on Banking Supervision (BCBS) and the International Organisation of Securities Commissions (IOSCO) developed and finalised an international framework and global standards for margin requirements for OTC derivative transactions that are not required to be centrally cleared. Similar to traditional contractual margin arrangements between counterparties to OTC derivative transactions, these new regulatory margin requirements for uncleared OTC derivatives encompass two specific margin types—initial margin (IM) and variation margin (VM).

Existing template credit support documentation published by ISDA is already used by the vast majority of market participants to document their IM and VM requirements. The new ISDA regulatory compliant credit support documentation is designed as a template to allow market participants to comply with each type of regulatory margin (ie, regulatory IM and regulatory VM) under multiple relevant regulatory regimes. Market participants will have the traditional choice of English law, New York law or Japanese law to govern their regulatory IM and VM credit support documentation.

The application of the regulatory margin requirements (and hence the need for market participants to implement new compliant credit support documentation) will primarily depend on:

- the regulatory categorisation of the market participant and the categorisation of the market participant's counterparty
- the aggregate average notional amount of uncleared derivatives which the market participant engages in over a given period, and
- the types of OTC derivatives transacted by the market participant

What is the implementation time frame for IM and VM requirements and what types of entities are considered to be 'Phase One' Entities?

Regulatory IM and VM requirements are intended to be implemented across various jurisdictions consistently pursuant to the key dates set out below in order to achieve the objectives envisaged by BCBS/IOSCO under the international framework of margin requirements for uncleared derivatives. However, while some jurisdictions including the US and Japan have adhered to the proposed international schedule, the EU has postponed implementation of the IM requirements.

The implementation timetable began as of 1 September 2016, with the largest derivatives users (based on volume of uncleared OTC derivative transactions) being first subject to the new rules. VM requirements for other covered entities will become effective as of 1 March 2017, while IM requirements for other covered entities will be phased in over a four-year period.

Only transactions with a trade date falling on or after the relevant implementation date will be subject to the new margin requirements/

Phase One—1 September 2016

The term 'Phase One Entity' is used to denote entities subject to a compliance start date of 1 September 2016, and generally encompasses entities which are designated as covered swap entities by national regulators under the relevant national regulations, if the covered swap entity (and its affiliates) and the relevant counterparty (and its affiliates) have an average daily aggregate notional amount of covered swaps outstanding for March, April, and May of 2016 of more than $3trn. In other words, 'Phase One Entities' would generally comprise large systemically important financial institutions with significant OTC derivatives portfolios and exposures.

Phase One entities are expected to start posting/exchanging IM and VM on their in-scope uncleared OTC derivative transactions, beginning 1 September 2016.

1 March 2017

Requirements to post/exchange VM on in-scope uncleared OTC derivatives transactions start to apply to other covered swap entities, financial firms, non-financial firms and systemically important non-financial firms, irrespective of the size of their OTC derivative transactions portfolios and exposures, from 1 March 2017. Precise definitions of entities which fall under the requirement to post VM starting 1 March 2017 are determined under relevant national regulations.

1 September 2017

IM requirements start to apply to covered swap entities and their counterparties from 1 September 2017 if the covered swap entity (and its affiliates) and the relevant counterparty (and its affiliates) have the average daily aggregate notional amount of covered swaps outstanding for March, April, and May of 2017 in excess of $2.25trn.

1 September 2018

IM requirements start to apply to covered swap entities and their counterparties from 1 September 2018 if the covered swap entity (and its affiliates) and the relevant counterparty (and its affiliates) have the average daily aggregate notional amount of covered swaps outstanding for March, April, and May of 2018 in excess of $1.5trn.

1 September 2019

IM requirements start to apply to covered swap entities and their counterparties from 1 September 2019 if the covered swap entity (and its affiliates) and the relevant counterparty (and its affiliates) have the average daily aggregate notional amount of covered swaps outstanding for March, April, and May of 2019 in excess of $0.75trn.

1 September 2020

IM requirements start to apply to covered swap entities and their counterparties from 1 September 2020 if the covered swap entity (and its affiliates) and the relevant counterparty (and its affiliates) have the average daily aggregate notional amount of covered swaps outstanding for March, April, and May of 2020 in excess of $8bn.

How do the initial margin credit support documents differ from the standard credit support annexes (CSAs)?

On 1 August 2016 ISDA published the following IM credit support documents:

- the ISDA 2016 Phase One Credit Support Annex for Initial Margin (Security Interest—New York Law)
- the ISDA 2016 Phase One IM Credit Support Deed (Security Interest—English Law), and
- the ISDA 2016 Phase One Credit Support Annex for Initial Margin (IM) (Loan—Japanese Law)

Each IM credit support document has been developed by ISDA to ensure that market participants who are or will be subject to IM requirements under relevant regulatory regimes starting 1 September 2016 are able to document their IM margining terms and conditions in a regulatory compliant manner.

The overall form and structure of each IM credit support document look and feel familiar, as each IM credit support document is built on the foundations of the traditional CSA (in case of New York law and Japanese Law) and credit support deed (CSD) (in case of English Law) respectively. Under the CSD, collateral is held by the collateral receiver subject to an English law charge instead of title transfer. Consequently, each IM credit support document contains a number of the same or similar provisions, and has a similar structure and functionality to the existing credit support document from which it is derived (and to this extent may be seen to be an updated version). For example, the new IM credit support documents all contain terms dealing with the delivery and return of IM, the IM transfer deadline (whereby if a demand for collateral is delivered before a specified time, collateral must be delivered prior to another specified time), any applicable threshold amount (representing an amount by which a party is prepared to take unsecured exposure to the other party), the minimum transfer amount, the dispute resolution procedures, and so on. The new IM credit support documents include a broadly similar pre-printed standard form annex, allowing for the parties to tailor the documents in the 'elections and variables' section.

A key feature of the new IM credit support documents is that, seeing as their purpose is to provide for compliance with regulatory IM obligations, they are designed to cover only certain designated transactions ('IM Covered Transactions'). An ISDA master agreement may now have multiple credit support documents, each defined under the new architecture as an 'Other CSA'. The new architecture specifically excludes IM covered transactions from the operation of any other CSA with the result that exposure calculated under any other CSA does not include IM covered transactions.

The new IM credit support documents do not include VM within their ambit, with the result that they cover only calculation, and transfer and return obligations, in respect of minimum regulatory IM for IM covered transactions as required under the relevant regulations. In other words, unlike the existing ISDA credit support documents which deal with posting both IM and VM (with both IM and VM included for purposes of calculating exposure), the new IM credit support documents contain provisions dealing exclusively with the IM required to be posted by the parties under the relevant regulations.

Other significant features which distinguish the new IM credit support documents from the traditional existing ISDA credit support documents include:

- a choice of IM calculation methodology which can be specified as either the required IM as set forth in the applicable regulation or an alternate model approved for use by a regulated party, such as the ISDA Standard Initial Margin Model (SIMM)
- the requirement to segregate IM from the collateral receiver's proprietary assets
- the requirement to hold IM at permitted custodians in a segregated account pursuant to a legally binding custody agreement, and
- a prohibition on the re-use/rehypothecation of the IM (where 're-use/rehypothecation' refers to a process whereby the collateral receiver takes beneficial title to the collateral assets)

How do the variation margin credit support documents differ from the standard CSAs?

As from 14 April 2016, in an effort to assist market participants in implementing the new VM margin requirements for uncleared derivatives transactions, ISDA published new VM credit support documentation comprising:

- the ISDA 2016 Credit Support Annex for Variation Margin (VM) (Security Interest—New York Law)
- the ISDA 2016 Credit Support Annex for Variation Margin (Title Transfer—English Law), and
- the ISDA 2016 Credit Support Annex for Variation Margin (Loan—Japanese Law)

Similar to the IM credit support documents, the VM credit support documents are based on the existing credit support documentation published by ISDA and widely used in the market, but amended to include regulatory compliant provisions relating to VM.

The VM credit support documents also cover only specifically designated transactions (VM covered transactions) to comply with regulatory VM requirements in relation to those transactions, and may be used alongside other credit support documents which attach to the same ISDA master agreement (which are defined in the VM credit support documents as 'Other CSAs'). Similar to the IM credit support documents, the parties' obligations under the VM credit support documents concern only VM, as IM will be dealt with under the relevant IM credit support document, or under another CSA. Thus, a delivery amount due to be made by one party to the other under a VM credit support document is based solely on a calculation of exposure under the VM credit support document, and does not include any IM or any amounts due under other CSAs

Other significant features which distinguish VM credit support documents from traditional credit support documentation include: