

HFMGlobal: Initial margin requirements in the EU

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What are the initial margin requirements in the EU?

Antony Bryceson and Richard Chapman of AB Trading Advisors lay out the margin requirements and their incoming phases.

“the initial margin (IM) contractual documentation is more voluminous and more complex”

The initial margin requirements under the European Market Infrastructure Regulation (EMIR) and accompanying regulatory technical standards (the “Margin RTS”) provide that an in-scope counterparty must exchange initial margin on a two-way gross basis in respect of non-centrally cleared derivatives (“OTC Derivatives”), on a phased-in basis according to that in-scope counterparty or its group’s aggregate average notional amount (AANA) of OTC Derivatives 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 came into effect on 1 September 2019 for those in-scope entities with an AANA of over €750bn and 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 €8bn (calculated for March, April and May 2020); so-called due to the significant increase of counterparties that would be caught under Phase 5 (including many buy-side firms) compared to Phases 1 to 4.

The Margin RTS imposes detailed rules relating to the amount and type of initial margin, including that initial margin must: (i) be both posted and collected by each in-scope entity; (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 (the “IM Model”, being either an initial margin model complying with the Margin RTS criteria, such as the ISDA Standard Initial Margin Model (SIMM), or a standardised ‘grid’ approach set out in the Margin RTS) and (y) at least every 10 business days or upon the occurrence of certain events.

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

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, being their “final policy framework”. The substantive changes are that, with respect to the requirement to exchange and segregate initial margin in respect of OTC Derivatives: (i) a one year extension to the phase-in implementation deadline has been proposed, creating a new

Phase 6; and (ii) the existing Phase 5 threshold has been raised. The result is that the compliance date for a large number of in-scope entities has been postponed from September 2020 to September 2021:

from 1 September 2020, a covered entity belonging to a group with an AANA for March, April and May of 2020 exceeding €50bn will be in scope (namely, the adjusted Phase 5); and

from 1 September 2021, a covered entity belonging to a group with an AANA for March, April and May of 2021 exceeding €8bn will be in scope (the new Phase 6).

Why the delay?

For some time, the industry has been warning of the challenge to ensure that all Phase 5 entities 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; (ii) a significant volume of new and complicated contractual documentation and custodial onboarding requirements; and (iii) extensive operational and technological build-outs.

While there had been calls for the €8bn threshold to be raised to €100bn, 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 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. It is unlikely that any further delays or material concessions will be forthcoming.

Firms should be actively assessing whether they may be in scope. Early consideration should also be given to fundamental issues such as: (i) 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; (ii) if, aside from EMIR, another OTC Derivatives initial margin regime will apply; and (iii) 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.

ISDA's document entitled "Getting Ready for Initial Margin (IM) Regulatory Requirements" is a good place to start.

Why is the documentation piece so challenging?

Anyone hoping a light repapering process similar to the 2017 variation margin (VM) documentation exercise will be in for a shock: the initial margin (IM) contractual documentation is more voluminous and more complex. Seeing as 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. Each party is likely to post initial margin under different initial margin documentation.

We believe that a buy-side entity is most likely to post initial margin to a segregated account opened in its name with a bank custodian

(which will be secured in favour of the dealer) whereas dealers will most likely post initial margin to a collateral or pledged account opened in the Clearstream or Euroclear system (which will be pledged in favour of the counterparty). Each party will need to review the other's custodial documentation.

The required documentation for each trading relationship will likely consist of either: (1) where using a bank custodian, a next generation ISDA 2018 Credit Support Deed for Initial Margin (IM) (Security Interest – English Law) or a 2018 Credit Support Annex for Initial Margin (IM) (Security Interest –New York Law); or (2) where using Euroclear or Clearstream or in certain circumstances with bank custodians, a form of collateral transfer agreement and related security agreements (governed by an appropriate law).

Depending on the custodian used, a triparty account control agreement (or similar agreement), an eligible collateral schedule in respect of each segregated account and membership documents of Euroclear or Clearstream will also be required.

Is the delay now effective?

The BCBS–IOSCO framework is not binding and, as such, the changes to the phase-in periods is, at this time, only a recommendation. While a number of regulators around the world have confirmed adoption of the revised BCBS–IOSCO framework, the EU has yet to issue a view on the revised framework. However, it is surely inconceivable that the EU will not follow in the footsteps of those regulators.

Will Brexit impact the initial margin phase-in timings?

Assuming that the United Kingdom (UK) exits the European Union 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, the 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.

BIO

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