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REGULATORY PERSPECTIVES

June 27th, 2017

Volume - 9

Series - 1

NEW MARGIN REQUIREMENTS SWEEP THE OTC WORLD

By **Adam Litke – Head of Enterprise Risk Services, Bloomberg**

On March 1, 2017, the second wave of margin regulation for OTC derivative products swept over the world as the European rules for the mandatory posting of collateral for non-cleared derivatives began to take effect. This delayed implementation followed on the heels of the initial implementations in the US and Asia in September 2016 and ended the first phase of a global roll-out that will last until 2020. While the aim of these regulations was to eliminate the domino effect of a large bankruptcy rolling through the derivatives markets, is a good one, it is going to have a profound impact on the way firms manage risk and on the way they manage their technological infrastructure.

We will start by looking at the most important provisions of the rule.

- Both initial margin and variation margin must be posted.
- Initial margin cannot be taken into account when computing daily variation margin.
- Bilateral margining including the posting of two-way initial margin required to be held in safekeeping by a third party.
- Initial margin must be posted whether a trade is cleared or is purely bilateral.

To some extent this levels the playing field between the OTC and cleared markets, but upon further inspection things are subtler.

- Centrally cleared trades have the advantage of a shorter margin period of risk.
- The central counterparties (CCPs) are also advantaged in the standardized calculation because gross initial margin is included as part of what must be posted.
- Finally, netting is perfect with the clearinghouse, but is far from perfect with OTC counterparties because OTC initial margin cannot be rehypothecated.

This last piece is particularly important because it will inevitably lead to increased concentration amongst an already tiny group of very large counterparties. This is because the best price for a trade will often be with the firm you already traded with for other instruments.

In addition to unintended consequences of the rules, there is also the issue of jurisdictional interpretation. As is usual with the local implementations of standardized rules, the inability of regulators to actually agree on just what those standards are will lead to some interesting market dislocations. Here are some examples.

The strange case of the simplest product: Foreign Exchange

Deliverables

Deliverable foreign exchange trades have been explicitly excluded from margining in the US, but are not completely exempt in Europe. This exemption makes a certain amount of sense in that a huge piece of this market is composed of individuals and firms simply moving assets from one

market to another. Whether this is repatriation of profits or to pay bills, margining would act as a huge drag on international trade.

On the other hand, European regulators have, at least partially, taken the attitude that risk is risk and should be mitigated in a consistent way. Many FX forward trades are entered into as hedges and not to explicitly transfer assets, so, in this instance, US regulators have taken the side of the hedgers. Of course, this means there is no level playing field. US institutions have a huge incentive to trade with US banks, which bifurcates the market and hurts liquidity.

Regulatory Conflict

Compounding the jurisdictional difference is the way it interacts with other regulations. In the US, mutual funds are required to use the entire notional of a physically settled trade when computing leverage rather than just the value of the transaction, but this is also what they use when computing leverage for non-deliverable forwards. That means that US mutual funds now have two competing incentives: i) keep forwards non-deliverable to lower their leverage statistics, or ii) move towards deliverable forwards and avoid margining.

We also have the sticky question of intent. Let us look at the example of a foreign exchange swap. This is economically the same as executing two FX forwards or a spot trade and an FX forward. In fact, when one trades an FX swap it is usually confirmed as two completely separate trades. Here's the rub. Even though the two separate trades are exempt from margining, if the trade was executed as a single trade it would be marginable. In the European regulations, the whole question seems to have been left to intent. That is, if one intends to trade an FX swap, then it is an FX swap. If one intends to trade the two pieces, then it is not. Of course, it is not at all clear how a booking system can discern intent. In order to manage this distinction in any reasonable way, firms will have to set up a whole system of qualifying and non-qualifying portfolios.

Differences in timing

Jurisdictional differences in the timing of margin enforcement creates global challenges unlike other rule enforcement. It is quite clear at this point that some regulators feel they are ready to implement margin rules while others are worried about operational risk. When the first wave of rules, applicable only to the largest banks, hit in September of 2016, the US and most Asian regulators decided to enforce margining while European regulators decided to allow for a 6-month delay. Now margin rules are not like capital rules. Capital applies to an institution on a standalone basis while margin applies to bilateral transactions. Even if a European bank was exempt from the rules when trading with another European bank, it still needed to have full margining systems in place for trading with banks outside of the EU. The dealing arms of these banks were able to comply without too much trouble, but many of their branch operations and private banks, operating on different systems, got caught out by the rules. These operations had to rush to implement collateral management systems and margining calculations simultaneously.

The March 1 deadline was no different. This time, many more entities are covered by the rules. Across the industry, thousands of CSAs that are not compliant with the new regulations need to be renegotiated. Some firms, which in the past had chosen to operate on an uncollateralized basis, now have to negotiate new CSAs from scratch. This time, the Japanese regulators are moving full steam ahead while the EU regulators have indicated no delay. The US regulators have stated that the rule is in effect, but the CFTC has issued a 6-month enforcement stay, effectively the same as delaying the rule by 6 months. This means that banks supervised by the Federal Reserve are subject to the rules, but non-bank derivatives dealers get to wait. This guidance is continually evolving. On Feb 23, both US and European regulators indicated publically that they would be enforcing the rules selectively under the assumption that banks are making a good faith effort to get new documents in place. The smaller the exposure, the more likely you are do get a reprieve. Once again, who you trade with determines the margin you have to post, at least for the near term.

Legacy trades

Both the US and Europe allow legacy trades that are entered into before the rules take effect to be exempted from margining. Of course, in the interest of complexity, regulators in the two

jurisdictions have decided that they will have different rules for novation and amendments. In the US there is simply no exception. That is, once anything about a trade is altered post-implementation, the trade automatically becomes part of the margining set. In the EU, legacy trades stay legacy trades unless they are amended in such a way as to avoid the rules. Once again, we have the thorny issue of intent here. It is not at all clear if changing the size of a trade triggers margining or not. There will also be trades which are treated as legacy by a counterparty is Europe and marginable by the other counterparty in the US.

Equity Derivative Phase In

In the US, equity derivative trades are covered by the margining rules. There are no exemptions. In the EU they will be covered. The key word here is will. Single stock options and options on equity index futures are delayed until 3 years after the implementation of the rest of the rule in the EU. This means that even for firms that must margin everything else, equity derivatives trades will be delayed until 2020.

ISDA SIMM

On top of the fact that the rules and their implementation differ by jurisdiction, there is also the issue of standard vs. internal model approaches used asynchronously between counterparties. Some counterparties will employ the standard rules for margining while others will have been approved for internal model margining. Like its counterparts for market risk capital, internal margining rules will give numbers that are both lower and more realistic than the standard paradigm. If a firm is a prime broker, then it may already have such a model and it has probably imposed this on its customers. Reconciliation between two dealers requires a good deal more transparency. After all, even if both dealers use value at risk models to compute margin, they will not have the same parameters.

The International Swaps and Derivatives Association (ISDA) has tried to step into this breach by developing a standardized model for computing initial margin (SIMM). This model is based on the sensitivities of the position values to standardized inputs, grouped together in a consensus bucketing scheme. For the big banks, this is a godsend. They already have automated systems in place to reconcile trade values with their counterparties which simply need to be extended to the sensitivities. This is far from trivial because two banks may use different models for the same type of trade, but it is at least a well-defined problem and fits into existing system architectures.

What About Everyone Else?

For smaller banks and other market participants, even implementing something as seemingly simple as standardized greeks is a huge undertaking. Let's examine a typical private bank. Historically these banks traded with their own derivatives desks, or with the desks of other firms, and were pure price-takers. They simply stood in between their customers and the other firms and thought of themselves as credit intermediaries. Now, even if their customers are end users and are exempt from margining, the private bank must post and collect margin with dealers. They must move from a role as price-takers—where they receive marks from dealers and check them with an independent third party on a monthly basis—to having daily marks, daily greeks and a complete reconciliation system. This is upgrading to a fully-fledged, mark-to-market and collateral system from what has been, at best, a spreadsheet driven operations function.

New Documentation

In addition to all of the systems issues, there is one more, not-so-little problem facing the industry. This is the fact that the vast majority of existing credit support agreements (CSAs) must be modified to comply with the new regulations. On top of this, many firms that never had to post margin before are suddenly caught in the net and must sign new agreements and set up collateral posting arrangements at the same time. Some players have already decided that the extra cost of all of these processes is not worth it and they will simply stop hedging.

Conclusion

The new margin regulations represent a valiant attempt to reduce systemic risks, but they fall short in significant ways. The intent was to ensure that in the next financial crisis, there may be a run on the bank, but there won't

be a run on the market by simplifying the connections between financial firms, making resolution of failing banks easier, and setting up firewalls between firms.

The continuing implementation of these regulations over the next 3 years is going to be far from consequence free. Many firms will have to create new operational processes and implement their corresponding systems from ground zero. Jurisdictional differences will fragment the trading markets, at least temporarily, and in some cases permanently. In the end, the world will be somewhat safer from financial melt-down, but getting there is going to be a difficult process.