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# Uncleared margin rules – initial margin: It's time to commence the journey

**Chetan Joshi**

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**Chetan Joshi** is the founding partner of Margin Reform, a new boutique management and information technology (IT) consultancy that provides advice and solutions to firms that require help navigating through their challenges in the margin, collateral and legal space. Chetan has over 20 years' experience in the collateral domain, having held roles in operations, technology, and front office. Chetan is a regular speaker at industry conferences and webinars and has delivered workshops and training sessions on collateral specifically focused on the uncleared margin rules (UMR). Margin Reform believes that with an experienced focus on the design and structure of the approach to UMR, the chances of a positive transformation and implementation experience are multiplied.

## ABSTRACT

*This paper aims to provide significant evidence that suggests many of the impacted entities in Phases 4 and 5 are still going through the stages of discovery on the complexity of the uncleared margin rules (UMR) initial margin requirements. To educate themselves they must cultivate knowledge through those that have already gone through the process and the industry vendors that would have experienced the different issues that had arisen through the previous three phases of UMR. Cementing that understanding is going to be critical for institutions. They need to be able to mitigate the risks, problems and issues that present themselves as they build, develop and execute on an implementation plan. They also need to utilise the external levers*

*that are available to them and give themselves the best opportunity to end up with an efficient, robust and integrated operating model that transforms their internal collateral and margin capabilities. The reader can expect to take away a number of facts, considerations and solutions that will impact security, custody and Phases 4 and will be of especial interest to 5 firms preparing for UMR in 2019 through to 2020.*

**Keywords:** *uncleared margin rules, custodian, initial margin, third party, IM segregation, outsourcing*

## A QUICK RECAP

At the time this paper was written, there were ten jurisdictions where the UMR were live or known to be effective and at least another three that were in different stages of finalising rules and compliance dates (Figure 1).

UMR require two types of margins to be exchanged. The first is variation margin (VM); this happens on a daily basis and is to cover the mark-to-market position of the portfolio. The second is initial margin (IM), and this is to cover the market risk loss during the time it takes to hedge and close out the defaulting counterparty's trades and collateral. IM is exchanged two ways on a gross basis and reflects the potential future exposure of the portfolio, which will vary dependent on the volatility of the underlying instrument and the duration of the portfolio.



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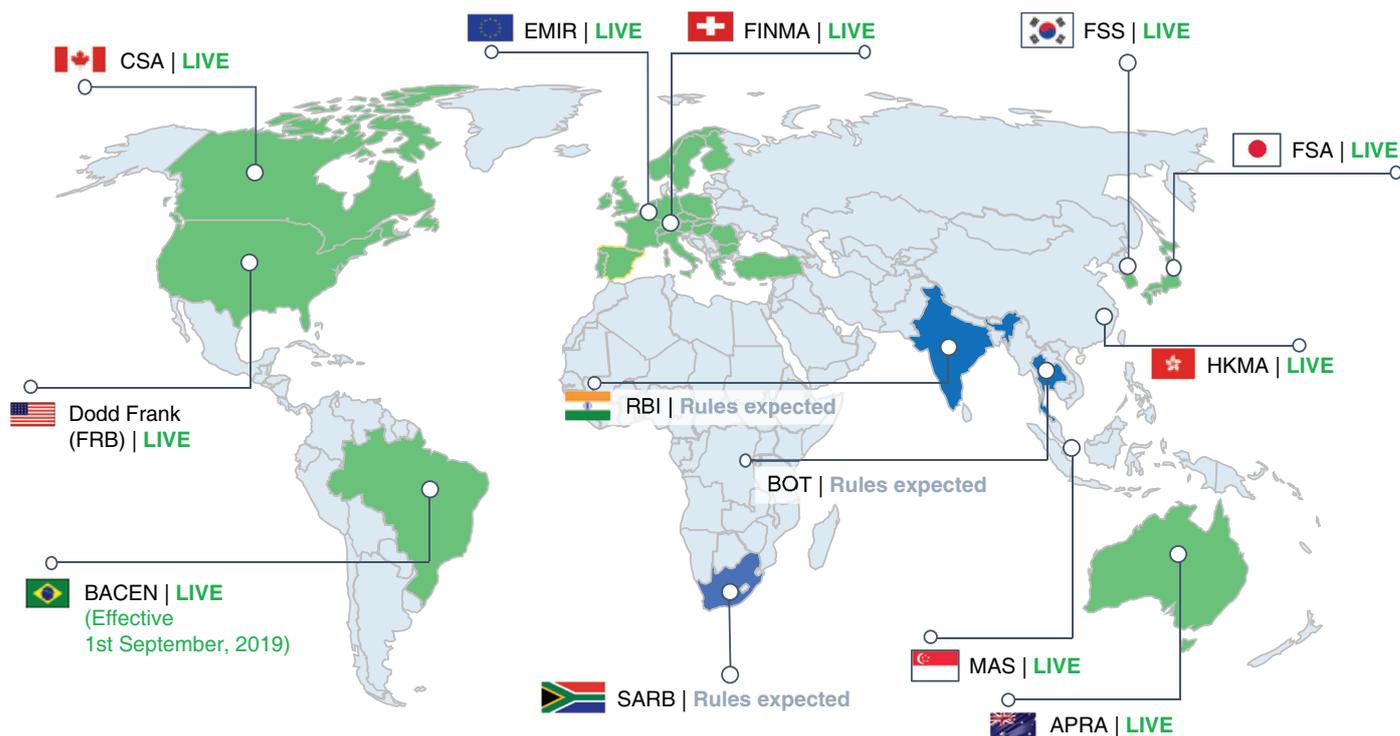


Figure 1 Jurisdictional timeline

Note: APRA, Australian Prudential Regulation Authority; BACEN, Banco Central do Brasil; BOT, Bank of Thailand; CSA, Canadian Securities Administrators; EMIR, European Market Infrastructure Regulation; FINMA, Swiss Financial Market Supervisory Authority; FRB, Federal Reserve Board; FSA, Financial Services Agency; FSS, Financial Supervisory Service; HKMA, Hong Kong Monetary Authority; MAS, Monetary Authority of Singapore; RBI, Reserve Bank of India; SARB, South African Reserve Bank.

UMR impact a wide range of clients. According to the European Market Infrastructure Regulation (EMIR) terminology, all clients who are classified as financial counterparties (FC) or nonfinancial counterparties+ (NFC+) are in scope. VM big bang went live on 1st March, 2017, following a welcome six-month delay from the global regulators. So far, the industry has gone through three phases of IM, starting on 1st September, 2016, and the same date every year thereafter, concluding with phase 5 on 1st September, 2020.

To determine whether an entity is required to exchange IM, it must self-disclose to the market that it is over the threshold (see Table 1), which is exceeded by calculating the aggregate average

notional amount (AANA) of non-cleared derivatives. In 2016-7 the only impacted entities have been the largest banks and broker dealers. In 2018, however, we saw the first buy-side institution self-disclose to the market.

### INITIAL MARGIN: WHAT IS THE IMPACT?

The collecting and posting of IM are relatively new processes for the market and have a unique and challenging set of circumstances. For those impacted, they need to consider a myriad of regulatory requirements, an industry-driven calculation methodology, a two-way posting, new and old technology providers and

**Table 1: UMR AANA thresholds from 2016 to 2020**

Region/Country	Variation Margin		Initial Margin				
	Sep 16	Mar 17 Everyone else	Phase 1 – Sep 16	Phase 2 – Sep 17	Phase 3 – Sep 18	Phase 4 – Sep 19	Phase 5 – Sep 20
US	D	E	3tn USD	2.25tn USD	1.5tn USD	0.75tn USD	8bn USD
EU	E	V	3tn EUR	2.25tn EUR	1.5tn EUR	0.75tn EUR	8bn EUR
Japan	A	E	420tn JPY	315tn JPY	210tn JPY	105tn JPY	1.1tn JPY
Switzerland	L	R	3tn CHF	2.25tn CHF	1.5tn CHF	0.75tn CHF	8bn CHF
Singapore	E	Y	4.8tn SGD	3.6tn SGD	2.4tn SGD	1.2tn SGD	13bn SGD
Canada	R	N	5tn CAD	3.75tn CAD	2.5tn CAD	1.25tn CAD	12bn CAD
	S	E					

Note: EU, European Union; US, United States.

custodial providers who will segregate their collateral.

The custody element is significant. Every impacted entity is required to have a third-party custodial agent who can legally segregate the assets that they are required to pledge, to protect the counterparty with whom they trade should they default, in which case the client would utilise those assets to make themselves whole. To support this process there is a huge three-way documentation exercise between the entity, its client and the custodial agents on both sides.

After agreeing on the documentation and trading, the business will eventually be required to exchange collateral, at which point there is the need to be able to source and optimise the required eligible collateral and to recognise the increased funding costs that the business will need to consume. Recent industry analysis has highlighted how this problem is intensified by the sheer volume of clients who are likely to be impacted in 2020 and the limited amount of time that is left in which to resolve all of the issues.

The analysis that was completed in September 2018 was undertaken as a huge data collection exercise by the International Swaps and Derivatives Association (ISDA), which received feedback from over 80 members. The full results and advocacy letter

can be obtained through the ISDA website where they highlight the following<sup>1</sup>:

- Over 1,100 newly in-scope counterparties, with over 9,500 new relationships potentially subject to UMR.
- Each of the 9,500 new relationships requires documentation that must be tested and loaded into systems.
- Up to 19,000 segregated IM custody accounts must be set up and tested (2 per relationship, for posting and collection of IM).

#### **INITIAL MARGIN: WHAT ARE THE CONSIDERATIONS?**

It's been ten years since the global financial crisis. The industry is at a reflection point as it weighs up and looks back to understand whether the rules and regulations that emanated postcrisis have indeed met their clear and stated intention to reduce systemic risk. The advocacy letter, written by the various industry bodies, is backed by the data exercise and quantitative analysis completed by ISDA, which suggests for Phase 5, IM may be a step too far and that the unintended consequences could be to increase risk in other areas.

Collateral technology innovation over the past five years has hastened the industry

to move towards a more efficient processing model. Automation has increased, and more tasks are now straight-through processed (STP) with an onus on management by exception. It is clear though that the new market environment for collateral and specifically for IM purposes has focused on the global systemically important banks (GSIBs), the next largest banks and the buy-side firms with the biggest derivative portfolios. The counterparties that have not been exposed to the new processes are less likely to have assessed the complexity of their existing operational environment or to have considered collateral as a product and are likely to still be operating in a fragmented and disjointed fashion to some degree.

Noting the significant amount of regulatory cohesion that will be required for any advocacy efforts to be effective, the considerations for the industry remain. There are a number of weighty challenges to be addressed, of which some experience and know-how to implementation will be essential.

A number of these issues have been widely discussed across the industry, and having context on the issues that need to be solved is important; understanding which are more complex and time-consuming will require a significant investment of time.

Margin Reform has gone through a number of these challenges and have categorised them as follows (Figure 2). The red-highlighted colours have presented a number of significant new challenges to the industry.

### **FOR SECURITY OPERATIONS AND CUSTODY PROFESSIONALS, WHAT CAN BE LEARNED FROM THE PREVIOUS PHASES?**

There are five main areas that have caused the most industry concern. Various

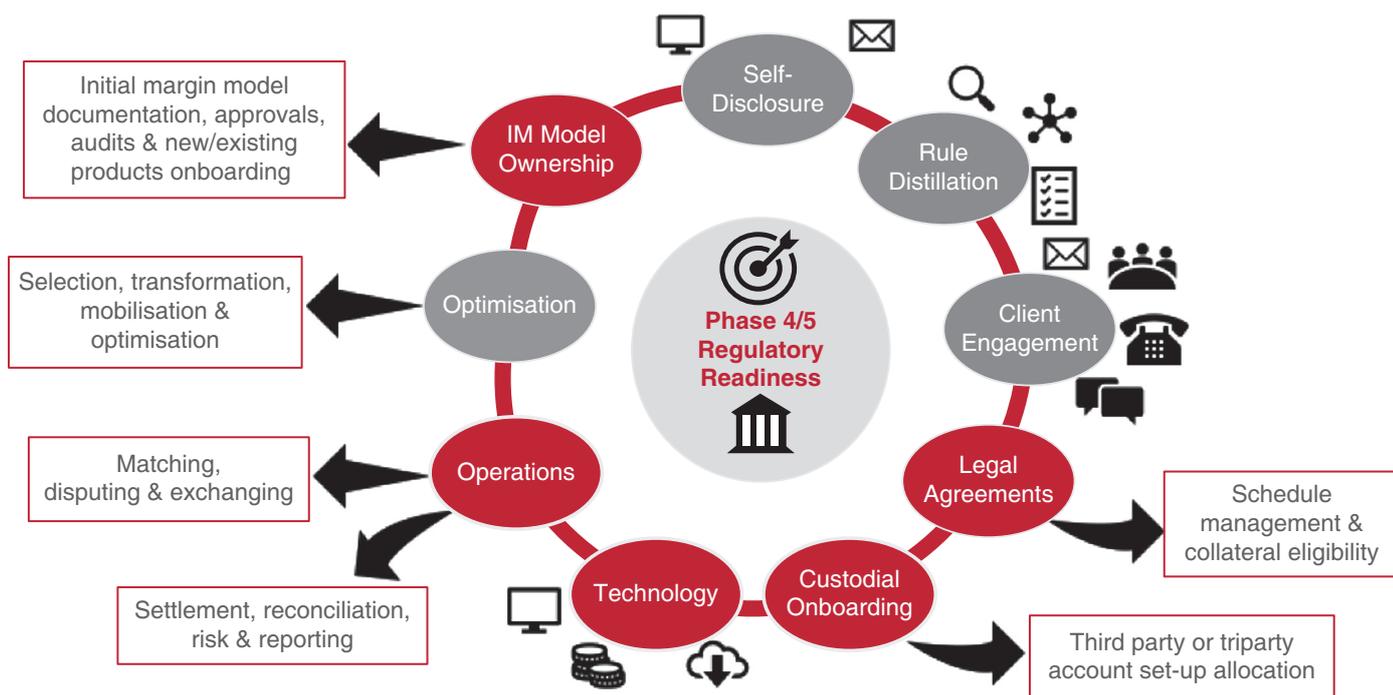
industry bodies are now working closely with the dealer and custodian community on collaborations to create beneficial solutions for all sides with the aim of increasing automation and efficiency for the upcoming burdens that the industry faces.

1. **Custodian Onboarding** — *has been slow, manual and mainly paper based.*
2. **Custodian Automation** — *replacing the use of faxes and portals to achieve higher STP.*
3. **Custodian Reporting** — *reconciliation of collateral balances is slow; reporting is poor and cumbersome.*
4. **Custodian Same Day Settlements** — *ensuring that collateral settles on a T+1 basis, as per regulations.*
5. **Custodian Market Utilities** — *improving interoperability between buy and sell side, increase STP.*

### **INITIAL MARGIN: HOW CAN ONE SOLVE THIS?**

It is clear, even with recent advocacy efforts, that counterparties who are in Phase 4 or 5 should already have started their journey to compliance internally and externally with their chosen custodians. For those that have not yet started, all is not lost; there are several levers that can be utilised to help one find the most efficient way to expedite success.

At the very least all parts of the equation should start having discussions on how they will navigate through the compliance challenges in the near future. Most of processes that will be needed to support IM will not be well known to the majority of Phase 4 and 5 firms; therefore the decision-making process is difficult when one considers challenges like SIMM calculation, IM segregation, triparty or third party or what level of collateral optimisation is relevant for the firm. There are several vendors who can help but understanding how UMR fit into the portfolio



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Figure 2 Margin Reform hottest topics

**Table 2: The road to compliance**

Security and Custody Firms	Phase 4 or 5 Firms
	<ul style="list-style-type: none"> <li>Commence the programme or project that will help/lead firms to compliance.</li> <li>Engage with experienced industry practitioners to accelerate solutions/learning.</li> <li>Secure internal and/or external legal resources to negotiate, execute and input contract data.</li> <li>Complete internal and external training and communications.</li> </ul>
<ul style="list-style-type: none"> <li>Consider the market. Which clients are likely to use the services?</li> <li>Work with the entities that will need to be onboarded and repapered.</li> <li>Consider whether one can simplify or automate the onboarding processes.</li> <li>As a custodian, will one offer triparty, third-party or both services?</li> </ul>	<ul style="list-style-type: none"> <li>Consider the requirements of IM, the model itself, SIMM or Schedule, to buy or to build?</li> <li>Decide if one will use triparty agent or third party to segregate the IM.</li> <li>Start to work with dealers and their agents to onboard as a receiver of collateral.</li> <li>Create and complete new target operating models and operational risk management reviews.</li> </ul>

is the primary consideration before any decisions should be taken.

Outsourcing is a potential growth area for collateral and margin management and is something that could be examined

for firms that do not have the resource or technology capacity to take on such a workload. There are different regulatory requirements to overcome in certain outsourcing cases that need to be appraised

along with the cost benefits that such an approach could bring. One aspect that does not go away, though, is that of control and oversight. Firms need to understand what it is they are outsourcing and why. Another issue that remains pertinent is the suitability question for SIMM and how a regulatory approval, if required, would work with regards any outsourced components.

### **WHAT ARE THE KEY NEXT STEPS?**

The task list in Table 2 is not sequential, nor is it all encompassing.

### **CONCLUSION**

In summary, there is significant evidence that suggests many of the impacted entities in Phases 4 and 5 are still going through the stages of discovery on the complexity of the UMR IM requirements. To educate themselves they must cultivate knowledge through those that have already gone through the process and the industry vendors who would have experienced the

different issues that had arisen through the previous three phases.

Cementing that understanding is going to be critical for institutions. They need to be able mitigate the risks, problems and issues that present themselves as they build, develop and execute on an implementation plan. They also need to utilise the external levers that are available to them and give themselves the best opportunity to end up with an efficient, robust and integrated operating model that transforms their internal collateral and margin capabilities.

For further reading ISDA have created a fact sheet that provides a high-level list of steps to take for IM compliances.

### **REFERENCE**

- (1) 'Margin requirements for non-centrally cleared derivatives: Final stages of initial margin phase-in', available at: <https://www.isda.org/a/5evEE/Initial-Margin-Phase-In-Implementation-Joint-Trade-Association-Comments.pdf> (12th September, 2018).



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