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THRESHOLD MANAGEMENT – WHAT IS IT AND HOW WILL IT WORK?

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Introduction

It is evident from the myriad of conferences, working groups, webinars, podcasts and written prose on the many components of compliance with Uncleared Margin Rules (UMR) – and how best to ensure compliance with each facet, there is a level of ambiguity regarding the monitoring and management of UMR-related thresholds.

Note the plural use of “thresholds”, there are two specific thresholds that need to be determined and managed by every firm impacted by UMR in order to become compliant. The aim of this article is to review both thresholds and make some recommendations for how best to comply for those firms in Phase 5.

Threshold No. 1 – AANA management

Firstly, and most importantly, is the threshold that determines whether your entire group, that is, all your group of legal entities (as defined in the rules) trading non-cleared derivatives, needs to be concerned with UMR, otherwise known as “self-disclosure”.

Across your group you are required to calculate the Aggregate Average Notional Amount (AANA) over a three-month period¹. Your regulatory body expects you to calculate whether the total notional of executed non-cleared derivatives exceeds the prescribed thresholds.

With Phases 1 to 3 already live, the AANA thresholds to be concerned with are for Initial Margin (IM) Phases 4 and 5 which are specified below.

Region/Country	Phase 1 - Sep 2016	Phase 2 - Sep 2017	Phase 3 - Sep 2018	Phase 4 - Sep 2019	Phase 5 - Sep 2020
US	3tn USD	2.25tn USD	1.5tn USD	0.75tn USD	8bn USD
EU	3tn EUR	2.25tn EUR	1.5tn EUR	0.75tn EUR	8bn EUR
Japan	420tn JPY	315tn JPY	210tn JPY	105tn JPY	1.1tn JPY
Canada	5tn CAD	3.75tn CAD	2.5tn CAD	1.25tn CAD	12bn CAD
Switzerland	3tn CHF	2.25tn CHF	1.5tn CHF	0.75tn CHF	8bn CHF
Singapore	4.8tn SGD	3.6tn SGD	2.4tn SGD	1.2tn SGD	13bn SGD
Hong Kong	24tn HKD	18tn HKD	12tn HKD	6tn HKD	60bn HKD
Australia	4.5tn AUD	3.375tn AUD	2.25tn AUD	1.125tn AUD	12bn AUD
Brazil	-	-	-	-	2.25tn BRL
South Korea	-	-	-	-	10tn KRW

What should you do if you are above the threshold, and therefore subject to UMR?

Initially, we recommend that you review all avenues to understand whether there is a way to reduce your AANA below the Phase 5 threshold, some of these considerations could be as follows:

- Review your trade inventory to ensure that every product that can be cleared, is cleared. Usually, it is demonstrably cheaper to clear, than to maintain non-cleared derivatives in your portfolio.
- Work with your sell-side dealer panel to understand whether portfolio compression can be enabled to reduce your risk profile and subsequently your AANA.
- Consider novating large notional trades or a portfolio of trades.
- Bilaterally terminate transactions with individual brokers.
- Remove trading branches from IM CSD's to reduce multi-jurisdictional compliance.
- Review Intra Group (IG) trades and determine whether all are necessary for risk management purposes. (IG trades only count once as part of the AANA calculation).
- Consider utilising risk simulation strategies, offsetting tools and exchange traded derivatives, to manage portfolios more effectively.

¹. As part of self-disclosure, the calculation period of the AANA is driven by the local regulators. For example, the EU use month end notional for 3 specific months, the US look at daily average.

When you are satisfied that you have exhausted all options and remain over the AANA threshold then you need to commence the legal and operational journey to compliance with UMR.

Threshold No. 2 - Initial Margin Management

The Basics

The second threshold is similar to a Variation Margin (VM) CSA in that you need to exceed your threshold before you exchange (recall that IM is 2-way) collateral with your counterpart. Unlike a VM CSA, this calculation is not on your Mark-to-Market (MtM), but the IM sensitivity calculation of your portfolio. This means you can continue to trade until you breach the allocated IM threshold on each bilateral relationship.

On the *Margin Reform "Wheel of Pain"*² we identify 9 key components for a successful UMR programme, the second of which is client engagement. Once you have self-disclosed, you need to analyse and identify who you face when trading non-cleared derivatives, only then can you commence with the Initial Margin (IM) documentation and custody requirements.

In this article, we are focusing specifically on regulatory IM documentation, a key component of which is the Eur/\$50m threshold. You will need to take decisions at the time of the IM negotiation on how you are going to allocate that threshold. It sounds simple until you consider the threshold is allocated per group and not per legal entity, which means you need to be very specific and deliberate on the allocation.

What do Margin Reform suggest you consider as part of that deliberation?

- Which of your group entities trade non-cleared derivatives?
- Are all entities required to continue trading non-cleared derivatives, or can equivalent economic objectives be achieved utilising alternate instruments?
- How is that entity structured, are they a branch or subsidiary?
- Can all entities use the Standard Initial Margin Model³ (SIMM) for their existing portfolios?
- Who has oversight and visibility on any additional trading relationships versus that banking group?
- Define who is responsible for the increased funding costs for IM should you breach the threshold.

² https://www.marginreform.com/wp-content/uploads/2019/07/WOP_3.png

³ <https://www.isda.org/2018/08/27/isda-publishes-isda-simm-2-1/> ISDA SIMM is the calculation methodology. Optionality exists to use the 'grid'. All Phase 5 counterparts should consider how utilising either approach affects their Initial Margin management.

- Determine your critical trading relationships and decide whether non-critical relationships could be managed under the threshold to avoid the immediate necessity to document (more on that later).

Group Threshold Management Base Comparison

Variation Margin		
MR Bank LDN HO Threshold 50m	Bilateral Trading Threshold	Client 1 Threshold 50m
MR Bank Sub NY Threshold 50m	Bilateral Trading Threshold	Client 1 Threshold 50m
MR Bank Sub HK Threshold 50m	Bilateral Trading Threshold	Client 1 Threshold 50m
Threshold 50m	Initial Margin	Threshold 50m
MR Bank Group LDN HO - 25m Sub NY - 15m Sub HK - 10m	Group Threshold	Client 1

Let's assume that before the negotiation process commences you have understood where your risk lies and have constructed your preferred allocation. What happens if your dealer disagrees? What happens if they want to stop trading with you out of certain entities or jurisdictions? Does your legal documentation playbook cover these types of exceptions and the management process to solve them?⁴

Fund Management: The Not-so-Basics

- 1) You are an end client and you execute through 5 different Asset Managers. Will you be advising each manager how much of the Eur/\$50m they will be allocated to face MR Bank Group?
- 2) You are an Asset Manager are you expecting your client to tell you what threshold you will receive in the IM negotiation with MR Bank Group?

We believe these 2 unanswered questions neutralise the benefits of the BCBS-IOSCO statement and subsequent clarification from certain regulators for clients executing through multiple Asset Managers.

⁴ <https://www.marginreform.com/wp-content/uploads/2019/05/2327ten-IMPact3.pdf>

*“The **Basel Committee** and **IOSCO** note that the framework does not specify documentation, custodial or operational requirements if the bilateral initial margin amount does not exceed the framework’s €50 million initial margin threshold. It is expected, however, that covered entities will **act diligently** when their exposures approach the threshold to ensure that the relevant arrangements needed are in place if the threshold is exceeded.”⁵*

Thresholds are allocated for each Legal Group. Legal Entity Identifiers⁶ (LEIs) are the standard data codes across the industry to enable client identification. If a client executes non-cleared derivatives through multiple Asset Managers, the Eur/\$50m threshold when facing MR Bank Group must be allocated across all of these Managers, so who gets what? What does this mean in reality?

Someone, at the point of the legal negotiation across the dealer, the client and the multiple Asset Managers needs to own not exceeding the Eur/\$50m threshold. Repeating that for multi-managed relationships, it is not Eur/\$50m for each Asset Manager, it is per underlying client LEI.

At **Margin Reform**, we have not seen anyone take ownership of this problem. There is a technology provider who are developing an IM Threshold Monitoring Service (IM-TMS), but through no fault of their own, if the negotiations have taken place, this is the horse after the cart.

How will the process be managed throughout the negotiations? These will advance at different times, at a different pace and with different challenges across Asset Managers. What happens post 1st September 2020 and the IM-TMS notifies you that the allocated threshold is in excess of Eur/\$50m?

Clearly, there needs to be a re-negotiation, but who owns that process? What happens in the meantime, you are in regulatory breach? Do you stop trading? Do you report to the regulator? Do nothing and wait for someone else to raise it?

In conclusion, one must question whether the BCBS-IOSCO statement for multi-managed clients is relevant? Based on the very complex nature of everything we have highlighted, maybe, the certainty of proceeding under an assumption of a **ZERO threshold for IM exchange** is preferable to a situation that leaves much ambiguity.

It may cause more pain upfront, in the form of legal renegotiation and process change, but affords the security that one is compliant with regulatory Initial Margin requirements.

⁵ <https://www.iosco.org/news/pdf/IOSCONEWS526.pdf>. Additional statements have followed from the HKMA, OSFI and the CFTC.

⁶ <https://www.gleif.org/en/about-lei/introducing-the-legal-entity-identifier-lei>

If you are interested in a further discussion on any aspect of this document or your UMR compliance, please get in touch with me at Margin Reform on the following email:

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