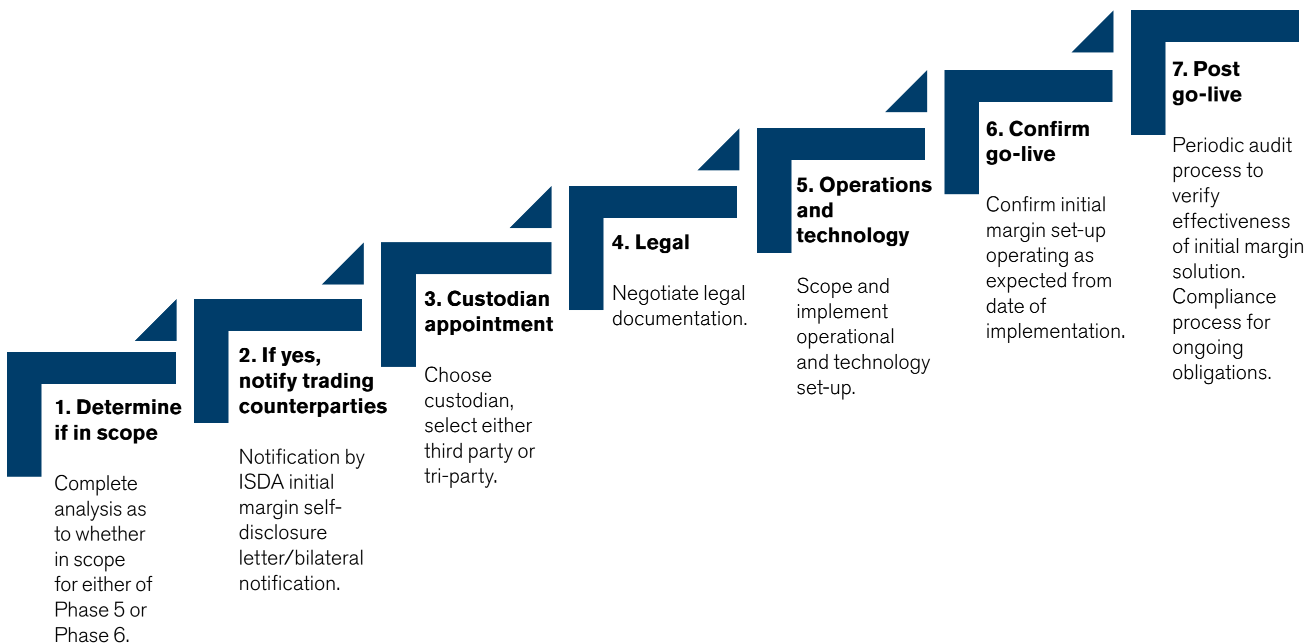
Regulatory initial margin
The obligations on the buy-side

To date, the firms subject to the regulatory obligation to exchange initial margin on uncleared over-the-counter (OTC) derivatives have been the heaviest users, predominantly on the sell-side. However, over the next two years a large number of buy-side firms will be caught as the threshold for compliance drops to include entities with uncleared OTC derivatives portfolios of €50bn or greater in 2020 and of €8bn or greater in 2021.[1]

In this note we set out the steps that affected buy-side firms should be taking to prepare for the exchange of initial margin.[2] For a summary of the wider requirements under EMIR[3] relevant to the exchange of margin on uncleared derivatives, our earlier publication is linked here.[4]

The steps to compliance with the initial margin obligation



[1] This timing is subject to confirmation by local regulators of an extension recommended by The Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) issued by them in a statement dated 23 July 2019, as detailed in our publication available here.

[2] This note primarily focuses on the EU implementation of the uncleared margin rules. Please contact us directly for analysis on the implementation of the uncleared margin rules in other jurisdictions.

[3] The European Market Infrastructure Regulation (EU) No 648/2012, as implemented by Commission Delegated Regulation (EU) 2016/2251.

[4] “Implementation of the EMIR Margin Rules for Uncleared OTC Derivatives”, published January 2017.

Who is affected?

Coverage is effectively global
Initial margin regimes exist under the laws of the European Union (and will apply in the United Kingdom irrespective of what occurs upon Brexit due to the substantive replication of the relevant provisions of EMIR into UK domestic legislation on withdrawal), the United States, Canada, Brazil, Switzerland, Japan, Hong Kong, South Korea, Singapore and Australia, with requirements due to be implemented in South Africa.

However, as with regulatory variation margin requirements, the scope of the initial margin requirements is effectively global. This is because an entity incorporated in a country that has legislation imposing initial margin obligations is typically obliged to exchange initial margin with its derivative counterparties wherever they are. As a consequence, a buy-side entity with a wide geographical spread of counterparties may find itself having to exchange initial margin in accordance with each regime that applies to its regulated counterparties, even if that buy-side entity is not itself directly subject to margin regulation.

The various margin regimes for uncleared OTC derivatives typically only indirectly impact buy-side firms, as the regimes predominantly apply directly to only the sell-side. However, the EU is an exception, in that the EMIR rules apply directly to a wide range of buy-side firms.[5] This note focuses on the position under EMIR while noting the rules of other jurisdictions that may indirectly impact buy-side firms.

The threshold to be caught is dropping significantly over the next two years
When first introduced three years ago, the obligation to exchange initial margin only applied to parties that had an average aggregate notional amount (AANA) of uncleared OTC derivatives of over €3trn ($3trn in the US, and broadly equivalent figures in the other countries that imposed the requirements). These AANA thresholds have steadily dropped over the intervening years, and in September 2019 reduced to €750bn in the EU and $750bn in the US (Phase 4).

It is the final stages of threshold levels for the implementation of initial margin at which large numbers of buy-side firms will be substantially affected. Reflecting the recommendation by BCBS/IOSCO for a delay in the implementation of the rules for those with an AANA of uncleared OTC derivatives of between €8bn and €50bn, these thresholds for particular countries are:[6]

Implementation date	Europe	US	Switzerland	Canada	Japan	Hong Kong	Singapore	Australia
Phase 4 - 1 September 2019	€750bn	USD 750bn	CHF 750bn	CAD 1.25trn	JPY 105trn	HKD 6trn	SGD 1.2trn	AUD 1.25trn
Phase 5 - 1 September 2020	€50bn	USD 50bn	CHF 50bn	CAD 75bn	JPY 7trn	HKD 400bn	SGD 80bn	AUD 75bn
Phase 6 - 1 September 2021	€8bn	USD 8bn	CHF 8bn	CAD 12bn	JPY 1.1trn	HKD 60bn	SGD 13bn	AUD 12bn

With the exception of the US, the AANA for the jurisdictions above is calculated as the average aggregate notional amount of uncleared OTC derivatives across the last business day in each of the March, April and May immediately preceding the relevant implementation date, so that the period for measurement for Phase 5 is March to May 2020. Under proposed rule changes published by the US federal banking regulators and by the Commodity Futures Trading Commission (CFTC)[7], the period for measurement of the revised Phase 5 with the new threshold of $50bn is intended to be each business day in March, April and May 2020. The period for measurement for the $8bn threshold for Phase 6 is to be each business day in June, July and August 2020.

[5] European Economic Area entities are directly subject to margin requirements if they are “financial counterparties” or “non-financial counterparties above the derivative clearing threshold”, as more fully described in our note set out in footnote 4 above.

[6] The splitting into Phases 5 and 6 suggested in the BCBS/IOSCO guidance still requires implementation into local law, or at least into local regulatory practice, but, given that IOSCO’s membership includes the European Securities and Markets Authority (ESMA) and all of the 28 EU national securities regulators, we do not anticipate there to be any difficulties in this.

[7] The proposed rules of the federal banking regulators are here, and the proposed rules of the CFTC are here.

Which transactions are subject to the initial margin obligation?
Initial margin must be exchanged on every uncleared derivative that has a trade date on or after the relevant 1 September date that both parties to the derivative are above an AANA threshold at which the obligation to exchange initial margin applies. This means that parties caught in Phase 5 will need to exchange regulatory initial margin on derivatives entered into on or after 1 September 2020, and those caught in Phase 6 will need to do so on transactions with a trade date on or after 1 September 2021.

The table below summarises which of the more significant categories of non-cleared derivatives are subject to the initial margin obligation.[8]

Instrument type	Europe	US[9]	Switzerland	Canada	Japan	Hong Kong	Singapore	Australia
Credit derivatives	√	√	√	√	√	√	√	√
Interest rate derivatives	√	√	√	√	√	√	√	√
Foreign exchange (FX), except:	√	√	√	√	√	√	√	√
-FX spot ***-Physically settled FX forwards and FX swaps*** ***-Principal payments on currency swaps***	X	X	X	X	X	X	X	X
Equity derivatives, except:	√	√	√	√	√	√	√* But only from 29 February 2020 if securities-based	√
-Equity options	√* From 4 January 2020	X	√* From 4 January 2020	X	√	√	√* From 29 February 2020	√
-Physically settled equity forwards	√	X	√	√	√	√	√* From 29 February 2020	√
Commodity derivatives, except:	√	√	√	√	√	√	√* Exempt if for "commercial purposes"	√
-Physically settled forwards	√* Subject to conditions[10]	X	√* Subject to conditions[11]	X	X	X	√* Exempt if for "commercial purposes"	√
-Physically settled options	√* Subject to conditions	√	√* Subject to conditions	√	X	√	√* Exempt if for "commercial purposes"	√

[8] Source: "Derivatives subject to non-cleared margin rules", 8 August 2019, ISDA. Available here.
[9] Different regulatory regimes apply to US entities, and not all regimes cover each of the products above. Irrespective of this, a US entity subject to the margin rules that entered into the products marked with a tick in the chart above would be subject to initial margin requirements on that product.
[10] The margin obligation only applies to a physically-settled commodity contract if an additional condition is met, including that it is traded on a "multilateral trading venue" (MTF) or non-EU trading venue, or has the "characteristics of other derivative financial instruments" such as being stated to be equivalent to a contract traded on a regulated market, MTF or non-EU trading venue. Physically-settled contracts on wholesale energy products such as gas and power traded on an OTF are exempt, and physically-settled contracts on coal and oil traded on an OTF are exempt if traded prior to 3 July 2020.
[11] Physically-settled commodities are only subject to the Swiss law obligation to exchange margin if further conditions are met.

Whether amendments create an obligation to exchange margin on legacy trades

If a legacy derivative that was in existence when the initial margin obligation commenced (and so was not subject to the obligation to exchange initial margin) is later amended, it is possible that the amended transaction is so materially changed that it should be considered a new transaction to which initial margin obligations apply.

In particular, many derivatives will require amendment with the cessation of LIBOR and other IBOR interest rates in the coming years. To avoid uncertainty on whether these amendments would create new transactions to which initial margin requirements apply, BCBS/IOSCO has stated[12] that amendments to derivatives contracts pursued solely for the purpose of addressing interest rate benchmark reforms do not require the application of the margin requirements for the purposes of the BCBS/IOSCO framework, an approach that we understand the UK Financial Conduct Authority follows. Also reflecting this approach, the US federal banking regulators have proposed a rule change that derivatives' legacy status under the non-cleared margin rules should not be affected by amendments to replace interest rates that are expected to be discontinued.[13]

Undue impact on firms that breach thresholds due to foreign exchange trading

FX swaps and forwards are anomalous, in that they are included in AANA calculations but no initial margin needs to be exchanged on them. Entities that are heavy users of FX but which do not enter into high volumes of other OTC derivatives may have an AANA largely composed of FX that exceeds one of the implementation thresholds. Such an entity would need to go to the expense of monitoring whether the €50m initial margin threshold discussed below is exceeded on which an exchange of initial margin is required, despite having a relatively small volume of OTC derivatives and so having few, and possibly no, relationships that will generate initial margin numbers greater than €50m.

Unfortunately, BCBS/IOSCO has not acted on requests from industry bodies that FX swaps and forwards be excluded from AANA calculations.

The significance of the €50m initial margin threshold

The threshold before initial margin exchange is required lengthens the implementation period

Under EMIR, the parties to a derivative relationship may agree that initial margin need only be exchanged between them to the extent that the amount of initial margin required under their uncleared trading relationship exceeds €50m (and equivalent thresholds apply under other regimes). Only the excess over €50m needs to be exchanged so, for example, if the calculation of initial margin results in a figure of €52m, only €2m needs to be exchanged.

This means that from the relevant phase-in date parties that agree such a threshold will have a ramp-up period as they will only need to exchange regulatory initial margin once the initial margin required by the other party on transactions entered into on or after the relevant 1 September exceeds the agreed threshold.

In response to concerns that every derivatives relationship between in-scope parties would require full documentation for initial margin irrespective of the size of the bilateral relationship, BCBS/IOSCO provided guidance that the G-20 framework for initial margin does not require putting in place documentation for initial margin if the bilateral initial margin amount does not exceed €50m[14] (while noting that it expected 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")*.

[12] BCBS/IOSCO statement on the final implementation phases of the Margin requirements for non-centrally cleared derivatives, 5 March 2019, https://www.bis.org/press/p190305a.htm.

[13] "Margin and Capital Requirements for Covered Swap Entities", The Federal Deposit Insurance Corporation, the Department of the Treasury, the Board of Governors of the Federal Reserve System, the Farm Credit Administration and the Federal Housing Finance Agency, published 17 September 2019.

[14] See footnote 12.

Combined with the lifting of the AANA threshold in 2020 to €50bn, this guidance reduces some of the most immediate pressure, as ISDA estimates that, for at least the first two years following the Phase 5 implementation date, 72% of the approximately 3,600 bilateral relationships that are subject to the requirements in Phase 5 would not need to exchange initial margin. Of the approximately 5,400 relationships caught in the new Phase 6, ISDA estimates that 85% would not be subject to the need to exchange initial margin for the first two years.

While the clarification that full documentation is not needed immediately is welcome, in-scope parties will still need to put in place arrangements for the calculation of initial margin to determine whether the €50m threshold is close to being breached.

Complexity caused by allocations to multiple managers

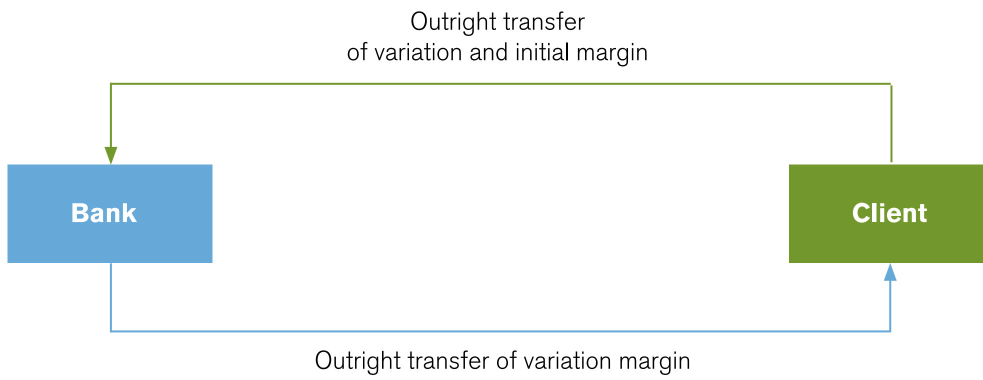
The €50m initial margin threshold comes with significant complexity for fund managers that allocate assets of a single fund to multiple separately managed accounts with independent advisors. An investment advisor appointed to manage part of the assets of a fund with a relatively small derivative book may face a demand for initial margin due to the fund exceeding the €50m threshold when aggregated across the positions of all of the fund's managers. One of the many unwanted demands of the initial margin regime is the need for fund managers to develop a centralised process across each fund to deal with margin calls and apply thresholds across accounts.

Segregation of initial margin

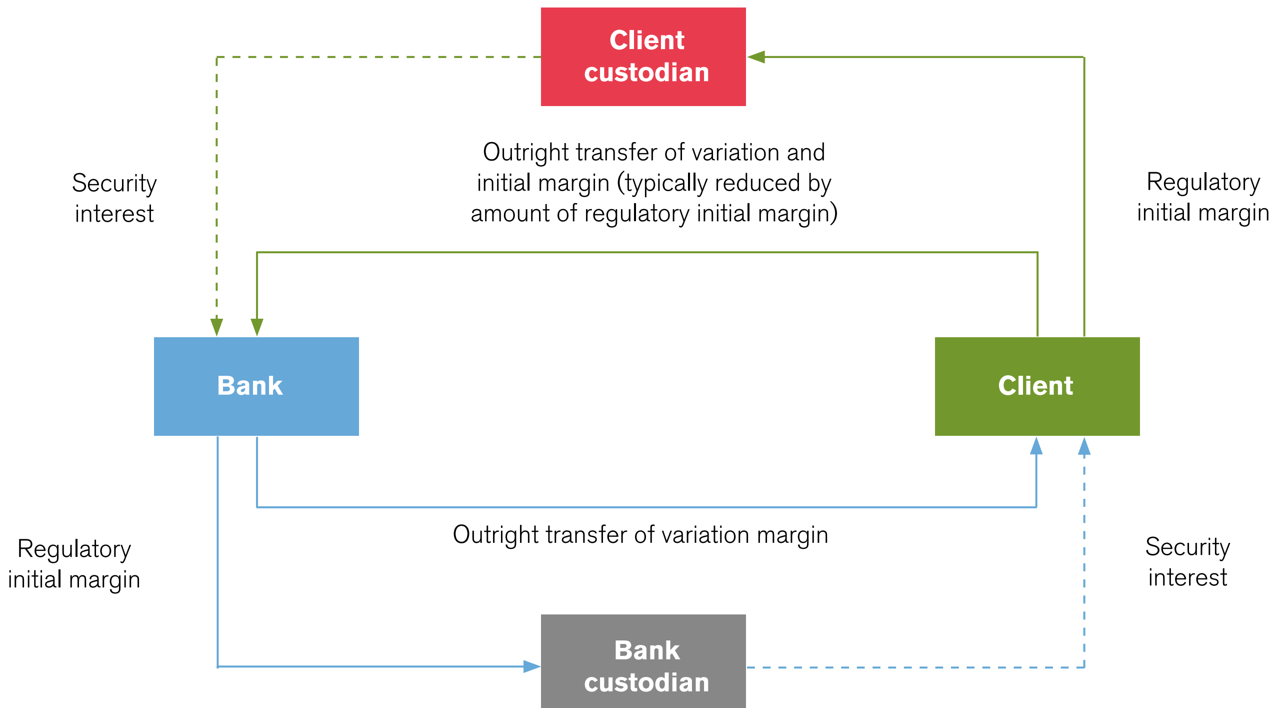
Regulatory initial margin must be segregated from the collecting party's own assets, and the collecting party cannot reuse that initial margin. This is a change to the normal practice of transferring initial margin on derivatives outright to the counterparty, which is free to re-use that collateral.

The following diagrams show simplified structures under an English law collateral arrangement for: (1) the current structure that a buy-side firm that is obliged to post initial margin will commonly have, involving the transfer of non-regulatory initial margin on an outright basis; and (2) the structure for the segregation of regulatory initial margin where each party has appointed its own third-party custodian.

Current structure – outright transfer of non-regulatory initial margin



New structure – segregation of regulatory initial margin



The two trading counterparties post their respective initial margin amounts to third party custodians, where the initial margin is held in separate segregated accounts, and a security interest is granted over each account in favour of the collateral receiver.

Triparty or third party custody?

The custodians active in offering initial margin segregation are a mix of the traditional global custodians such as Bank of New York Mellon and State Street as well as central securities depositories such as Clearstream and Euroclear. Two similarly-named alternatives are commonly available from custodians for the custody of regulatory initial margin: triparty and third party custody.

— **Triparty custody**: A collateral provider appoints the custodian as collateral agent. Once the counterparties agree on the amounts of initial margin to be provided, the custodian determines which assets of the collateral provider would best meet the margin call, and transfers those assets automatically from the collateral provider's general custody account to the segregated initial margin account.

— **Third party custody**: Once the counterparties agree on the amounts of initial margin to be provided, the collateral provider instructs the third party custodian to transfer the collateral as determined by the collateral provider. The third party custodian plays no part in determining the appropriate collateral to transfer.

Triparty custody is the process most commonly used to date by the largely sell-side firms that have been made subject to the initial margin requirements. Buy-side firms had been anticipated to largely use third party custody, but a number of buy-side firms have shown willingness to pay the higher fees involved in triparty custody.

The documentation requirements

The complexity of meeting the requirements of different regulatory initial margin regimes has meant that a significant increase in the number and complexity of documents is required compared to those for the regulatory variation margin obligations. Typically in addition to existing documents for exchange of variation margin, each party that posts collateral via a bank custodian requires a document to cover non-regulatory initial margin, a custody agreement, a security interest document, an account control agreement and an eligible collateral schedule; with a different set of documents required if a central securities depository such as Clearstream or Euroclear is acting as custodian.

To assist with this, ISDA has developed and is continuing to develop a range of documents to deal with the provision of initial margin, including documents individually tailored to major custodians active in providing regulatory initial margin services, and will source and regularly update opinions confirming the effectiveness of these documents in the relevant legal jurisdictions.

The calculation of initial margin under EMIR

The differences between ISDA SIMM™ and the grid method

A notable requirement for buy-side firms subject to EMIR is that they will be directly required to calculate the initial margin requirement to be posted to them by their counterparties. The amount of initial margin exchanged between counterparties subject to the EU requirements must be calculated using either the "grid method" in the EMIR margin rules or a regulatory-approved internal model.

The grid method applies percentages to the notional of derivatives by product type and tenor as a simplistic means of determining the initial margin required.

The alternative to the grid method that has been near-universally adopted[15] by those already subject to the need to exchange initial margin is ISDA's Standard Initial Margin Model (SIMM). SIMM generates a significantly lower initial margin requirement than that generated using the grid method, particularly for non-directional portfolios. ISDA estimates that, for parties applying a €50m margin threshold, the amount of collateral required under the grid method will on average be 2.8 times greater than the amount calculated using SIMM.[16]

[15] A few firms have used the grid method rather than SIMM for transactions that are not well-covered by SIMM, typically for a narrow range of commodity derivatives.

[16] ISDA and others in a letter to ESMA titled "Margin Requirements for Non-Centrally Cleared Derivatives – Initial Margin Models", 7 May 2019.

Buy-side likely to be obliged to adopt SIMM

Some buy-side firms have expressed a preference for the use of the simple grid method over the complexity of SIMM. However, we expect that in practice sell-side firms will insist on their buy-side counterparties using SIMM to avoid having to post collateral based on the larger numbers that the grid method produces.

Problematically, firms directly subject to EMIR are obliged to put in place governance processes for the use of an internal model such as SIMM, including onerous obligations such as back-testing the model at least quarterly to confirm that the calculations of initial margin are accurate. For many buy-side firms the only realistic means of addressing these requirements would be to engage a third party collateral service provider that can assist in the firm meeting its regulatory requirements regarding the use of SIMM.

Regulatory initial margin vs. title transfer initial margin

Most buy-side firms not yet subject to regulatory initial margin are used to sell-side firms insisting as a necessary condition to be able to trade that the buy-side firm post initial margin on a "title transfer" basis, meaning that ownership of the collateral passes to the recipient. Initial margin posted on a title transfer basis is able to be re-used by the sell-side recipient, so serving a dual use for the recipient of providing credit protection and providing assets that can be reused for funding and other purposes.

For parties using SIMM, the amount of regulatory initial margin that a buy-side firm will need to post is likely to be lower than the amount of bilaterally agreed initial margin, perhaps materially so. A bank counterparty that took the approach of reducing its title transfer initial margin requirement by the amount of the regulatory initial margin would maintain the same level of credit risk on its client, but with an impact on its funding, as discussed below.

Compared to existing initial margin practices, regulatory initial margin imposes an increased funding cost…

By contrast with title transfer initial margin, regulatory initial margin cannot be reused by the recipient and instead must be held in custody with the collateral provider remaining the owner. This amounts to a dead weight in the relationship, involving an additional funding cost for the sell-side party, both for the initial margin that the sell-side party must provide and for the inability of the sell-side to reuse the regulatory initial margin that it receives. This funding cost is likely to then be reflected in pricing given to the buy-side.

…while materially decreasing buy-side entities' credit risk on counterparties

The current practice of the buy-side being obliged to pass non-regulatory initial margin on a title transfer basis increases a buy-side entity's credit exposure to its counterparty, as on a bankruptcy of the counterparty the value of the margin provided is no more than a debt owed by that counterparty.

By contrast, regulatory initial margin offers a two-fold reduction in credit risk – the buy-side entity takes initial margin, and an equivalent amount of the initial margin posted by the buy-side entity is protected from the insolvency of the sell-side counterparty by being placed in custody.

Because of the funding cost of regulatory initial margin, counterparties that want to keep these additional overheads to a minimum are incentivised to minimise the amount of regulatory initial margin. But buy-side firms will need to bear in mind that minimising the amount of regulatory margin in this way limits the reduction in credit risk on their sell-side counterparties that buy-side entities would otherwise benefit from.

Eligible collateral

One of the most contentious matters in the negotiation of terms for the provision of collateral to date has been reaching agreement on the range of collateral that may be passed.

EMIR permits a broad range of collateral to be passed to satisfy the margin requirements. Our earlier publication contains a full summary of the types of collateral which can be posted as initial margin and details the credit quality, wrong-way risk and concentration requirements relevant to the posting of initial margin. Acceptable collateral under regimes other than EMIR varies, which can add to the complexity of agreeing an acceptable range of collateral.

To assist counterparties in the process of documenting acceptable collateral, ISDA has published template collateral schedules with pre-selected lists of eligible collateral types and minimum regulatory haircuts, which can be used as a starting point for negotiation between parties in scope for regulatory initial margin.

Some types of permitted margin under EMIR – such as senior tranches of securitisations – go beyond that which commonly would be accepted as collateral by derivative counterparties. Those subject to initial margin requirements will need to balance the benefit in reduction of credit

risk achieved by insisting on high-quality liquid collateral against the greater cost imposed on its counterparty that the relationship must then bear if only a limited range of collateral is acceptable.

What do firms caught in the final phases need to do?
With the recent splitting of the final Phase into Phases 5 and 6, ISDA has produced a revised "ISDA Initial Margin Self-Disclosure Letter". Parties can electronically deliver the ISDA Initial Margin Self-Disclosure Letter to other ISDA Amend participants via the ISDA Amend platform, disclosing in which Phase they expect to be subject to the obligation to exchange initial margin, so allowing parties to identify each potentially affected relationship.

With the delay in implementation for Phase 6 firms, there may be a temptation to pause work on implementation. However, despite the staggering of implementation with the introduction of Phase 6, the sheer volume of relationships that will be brought in scope in 2020 and 2021 is likely to result in capacity problems for brokers, custodians and service providers in putting in place compliant relationships in good time, with the potential that firms that leave matters too late may be unable to trade. Firms should therefore take steps to agree custodial and other service provider relationships, determine suitable eligible collateral to give and receive and negotiate compliant documentation well in advance of the relevant deadline.

Contact details

If you would like further information or specific advice please contact any member of the derivatives & trading team.

Will Sykes
Partner
Derivatives and trading
DD +44 (0)20 7849 2294
william.sykes@macfarlanes.com

Robert Daniell
Senior counsel
Derivatives and trading
DD +44 (0)20 7849 2807
robert.daniell@macfarlanes.com

Tom Mortlock
Senior solicitor
Derivatives and trading
DD +44 (0)20 7849 2403
tom.mortlock@macfarlanes.com

October 2019

Macfarlanes LLP
20 Cursitor Street London EC4A 1LT
T +44 (0)20 7831 9222 | F +44 (0)20 7831 9607 | DX 138 Chancery Lane | macfarlanes.com

This note is intended to provide general information about some recent and anticipated developments which may be of interest. It is not intended to be comprehensive nor to provide any specific legal advice and should not be acted or relied upon as doing so. Professional advice appropriate to the specific situation should always be obtained.

Macfarlanes LLP is a limited liability partnership registered in England with number OC334406. Its registered office and principal place of business are at 20 Cursitor Street, London EC4A 1LT. The firm is not authorised under the Financial Services and Markets Act 2000, but is able in certain circumstances to offer a limited range of investment services to clients because it is authorised and regulated by the Solicitors Regulation Authority. It can provide these investment services if they are an incidental part of the professional services it has been engaged to provide.
©Macfarlanes 2019 (1019)