Lessons from the Latest Phase of Initial Margin Regulation

By Vivek Agarwal

Initial margin requirements for uncleared trades were brought into effect on September 1, 2016, and started with a few large financial institutions in the scope of the regulation. Each year, these requirements have been aggressively enforced upon other financial institutions.

September 1, 2019, marked the Phase 4 of initial margin regulation, meaning that counterparties are required to calculate and exchange initial margin if they have trades with an aggregate average notional amount (AANA) over $750 billion. From the institutional perspective of those covered in this phase, this deadline is a test for its yearlong preparation.

Efforts included contract repapering, negotiating new custodian relationships and implementing infrastructure to calculate initial margin – as well as changes to margin workflow, changes to collateral movement and settlement systems, and drafting new reports.

Although the requirements are enforced, the outcome of these preparations will not be known until a few months from now. Most firms are not likely to start exchanging initial margin immediately for two reasons. The first is that only those trades that entered into or amended after the deadline are covered by the regulation. The second is that margin requirement needs to exceed $50 million, or the agreed threshold if lower than that amount, which might not happen immediately.

Here are several considerations that firms covered in phase 5 and phase 6 may find beneficial in preparation for their respective deadlines.

Calculate AANA

Calculating AANA (aggregate average notional amount) is the first step towards initial margin compliance. It is an average of total notional of in-scope trades over the specified period. It may seem simple, but complications can begin with identifying in-scope trades across all the legal entities within the firm. Separately, the definition of notional for some exotic derivatives might not be straightforward. This exercise needs to be done often to ensure the regulatory threshold is not breached as the business grows.

Self-Disclosure

Based on the AANA calculation exercise, firms are required to disclose if they expect to be in scope for the September 2020 or September 2021 deadline. The buy-side firms who audit the scope may be asked to provide information for the dealers to confirm this determination. This can be a burden when a buy-side firm is working with multiple dealers through many investment managers.
To ease this burden, the International Swaps and Derivatives Association (ISDA) has published a self-disclosure letter template to assist with this process. Additionally, ISDA frequently conducts a voluntary multilateral disclosure exercise to provide the industry transparency into the in-scope counterparties early as well as other useful information like the choice of the custodian and whether they are going to tap a third party or a tri-party model.

**Risk-based Methodology for Initial Margin Calculation**

Uncleared margin rules require a risk-based methodology to calculate the initial margin. Specifically, firms should be able to demonstrate the value of risk coverage over 10 days with 99% confidence. Another alternative is that firms can choose a grid-based method under which the initial margin is calculated as a percentage of notional where the percentage depends on the asset class and duration.

The grid-based method is simpler to calculate, however, the initial margin amount calculated based on the grid may turn out to be five to ten times the amount calculated by risk-based methods. There is also an apprehension in the market that buy-side firms choosing the grid methodology may receive unfavorable prices from their dealers further increasing the overall cost of a trade.

ISDA has published a standardized form of the risk-based model named Standard Initial Margin Model (SIMM). The model simplifies the calculation and allows firms to consistently calculate the initial margin. SIMM is the virtual standard for risk-based model and several vendors offer SIMM based initial margin calculation as a service.

Firms will need to decide whether to use the grid or the SIMM model for calculations. If they choose SIMM, they will need to decide if they want to implement the SIMM model in-house or select a third-party to perform the calculations.

**Posting Collateral in a Segregated Account**

The initial margin regulation requires firms to post collateral in a segregated account. There are two ways in which firms can segregate collateral.

The first option is by opening a segregated account with a custodian of choice and providing guidance on what to move and where into that account, similar to how firms move around assets today. This is referred to as the third-party model (3PA). Within the 3PA model, firms need to determine eligible collateral and make appropriate haircuts in order to arrive at the set of assets need to be moved.

The second option is that firms can outsource part of the responsibility to tri-party agents. Tri-party agents will need the amount that needs to be collateralized and based on that they take over the task of selecting appropriate collateral and managing the movement to and from segregated accounts. This model is the Tri-party agent model (TPA) and is considered to be the easier option of the two models.
The 3PA model is the more complex option because it requires selecting appropriate collateral and applying a correct haircut making it more prone to operational risk. However, the convenience of the TPA model comes at a price and requires building new swift messaging — for example, the MT527 message for communication of the amount to be collateralized.

**How to Move Forward**

There are several moving parts to the initial margin regulations and if not done correctly, each could lead to non-compliance and even force the firms to abruptly stop trading.

For an effective and timely compliance, firms need to make several strategic decisions about which methodology to use for calculation of initial margin, whether to calculate initial margin in-house or to outsource it, which custodian should they segregate, and whether to employ a 3PA model or a TPA model. Each of these decisions has implications on upfront cost, running cost, schedule, and risk.

Fortunately, help is available. Consulting firms who have been active in this area during the last four phases can accelerate and simplify compliance. They can help banks calculate and audit AANA, assist in the preparation of the self-disclosure letter, advise on the segregation model, help choose the right custodians, upgrade IT applications and augment firms’ operations capacity. There are an estimated three hundred firms in the scope of phase five of the regulation and firms that act now will set themselves up for compliance.

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