OTC derivatives margining regulation wave 1 **lessons learned**

Did the firms find it easy or difficult?

Last September's introduction of Initial Margin (IM) rules for major swap dealers served as a warning to the wider market of the considerable efforts required to comply with non-cleared OTC derivatives market reforms; but it also demonstrated the power of industry cooperation and collaboration to adapt to new rules with minimal disruption.

These were among the key observations made in a panel discussion on preparing for non-cleared OTC derivatives margin rules during the Euroclear Asia Collateral Conference 2016, held in Hong Kong in late November.

One of the panellists acknowledged that compliance with the deadline of 1 September for new IM exchange rules by swap dealers executing non-cleared OTC derivatives transactions was not the smooth ride reported in the financial press in the early weeks of that month.

Sticking points

Whilst the 20+ banks and brokers included in this first wave of compliance with the new margining regime were among the world's largest and most highly experienced OTC derivatives market participants, their preparations were contingent on clarifications from regulators over acceptable methods and techniques for meeting their new obligations.

A key sticking point was regulatory approval of the Standard Initial Margin Model (SIMM) developed under the auspices of ISDA to ensure agreement between counterparties on IM calculations on individual transactions.

The US Federal Reserve approved the model in the first week of August, whilst the US Office of the Comptroller of the Currency took a further week to confirm approval, giving major swap dealers barely two weeks to complete final testing before going live.

According to a panellist from a major investment bank, the regulatory delays had a knock-on effect on other aspects of swap dealers' preparations.

The late approvals meant the firms had very little time to finalise new Credit Support Annexes (CSAs) with counterparties incorporating use of the SIMM, while also attempting to open a large number of new custody accounts, which entailed the negotiation and signing of multiple new custody agreements to confirm security over assets for collateral purposes.

Was everyone ready on time?

Unsurprisingly, it was not the case that all of the world's 20 swap dealers' entities could trade non-cleared OTC derivatives with each other come 1 September.

Naveen Khanna, Chief Operating Officer, rates and currencies trading, Asia Pacific, highlighted the coordinated efforts made by Bank of America Merrill Lynch to handle the fact that documentation had not been completed on schedule for a number of the bank's regular counterparties by 1 September 2016.

"We nominated 'champions' to train colleagues about the new rules and established processes to intercept any 'not good to trade' activity and unwind positions to avoid accidents," he explained, adding that a dearth of market-sensitive economic data releases in the first two weeks of September helped to keep trading volumes low as the final documentation was completed with counterparts.

A particular requirement of the new regime for Asia Pacific was addressed by Hiroaki Tanaka, Deputy Head of GMTS Group, GM Operations, at Nomura Securities. The move to T+1 settlement of IM/VM (Initial Margin/Variation Margin) non-cleared OTC derivatives transactions under the new regulatory framework has required the whole industry to step up efforts to automate, standardise and reengineer post-trade processes, but it poses some challenges when you are positioned at the very start of the Asia day, which is still the previous day on the other side of the globe.

Greater coordination between counterparties across time-zones has been a priority, according to Tanaka, as has coordination with and explanation to regulators.

Historically, US-based counterparts have conducted the calculations underpinning margin calls starting at the end of the New York trading day, and even though this – for obvious reasons – cannot be changed, even to meet the new T+1 requirements, has prompted new efforts to accelerate the various end-of-day processes in order to facilitate making margin calls earlier in the following Asian business day. "Due to the combination of their efforts and our shortening of cycles, we have been able to make it work," he said.

" September served as an awareness-building exercise or even a rude awakening for the rest of the market "

Karim Chabane, Head of Collateral Management for Asia Pacific at Citi

What we really learned

Noting the sheer volume and complexity of preparations required for IM exchange by a small, well-resourced and relatively homogenous set of OTC derivatives counterparties, panellists were asked to consider the possible lessons for the wider market.

Although regulators have provided market participants with some wriggle room on VM rules – March's 'big bang' launch of new rules is now the start of a six-month transition process – there are still many challenges ahead, both for this new requirement and the staggered roll-out of IM rules over the next three years for non-swap dealers.

"September served as an awareness-building exercise or even a rude awakening for the rest of the market," said Karim Chabane, Head of Collateral Management for Asia Pacific at Citi. "The buy-side saw for the first time that firms would be prevented from trading [if they didn't have the requirement documentation arrangements in place]. This increased their focus on preparing for the next waves of IM and VM reforms."

As well as trying to ensure documentation is completed in good time, Chabane said many buy-side firms were concentrating their efforts on streamlining margin resources, with particular emphasis on mobility of collateral to ensure that assets can be delivered within the timelines demanded by the new regulations.

While cash and AAA-rated government bonds have been the predominant medium for VM collateral in the OTC derivatives markets to date, the new regulatory framework widens the scope, enabling a broader range of high-quality liquid assets to be used.

This potentially offers the buy-side an opportunity to leverage assets already held in their portfolios, rather than maintaining a cash cushion for collateral which could drag on performance, especially when many major currencies are yielding low or negative rates.

In response to a question from the audience, Purtini Joshi, Head of Collateral Sales for Asia Pacific at the DTCC, said use of securities for collateral to support non-cleared OTC derivatives transactions was far from a straightforward matter. "There are a number of operational challenges in posting securities as collateral on a T+1 basis, for example getting securities back in time to respond to a corporate action, which could limit use of securities, at least in the short term, if firms do not deploy the necessary technology," she said.

Citi's Chabane agreed that low-yielding cash holdings maintained for collateral purposes could serve to reduce overall portfolio returns. "If firms don't have the right mix of securities in their portfolios to use for VM they could enter into collateral swap transactions to get the collateral they need," he added.

" Getting securities back in time to respond to a corporate action, which could limit use of securities, at least in the short term, if firms do not deploy the necessary technology "

Purtini Joshi, Head of Collateral Sales for Asia Pacific at the DTCC

euroclear

Post-trade made easy