Margin requirements for uncleared swaps

Contributed by Shearman & Sterling LLP

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Background

In July 2011 the G20 added margin requirements for uncleared derivatives to its regulatory reform agenda. The setting of margin standards was entrusted to the Basel Committee on Banking Supervision (BCBS) and the International Organisation of Securities Commissions (IOSCO), and final standards were issued in September 2013. In March 2015 BCBS-IOSCO issued a revised framework and extended the timeline for the implementation of final standards.

The framework consists of key principles aimed at ensuring harmonisation across jurisdictions. The requirements apply to financial firms and systemically important non-financial entities, the definitions of which are left to national regulation. Although BCBS-IOSCO has no power to impose mandatory requirements on regulatory authorities, the standards serve as a reference for national regulators as they implement them in their respective jurisdictions.

In the United States, prudential regulators re-proposed rules regarding margin requirements for uncleared swaps in September 2014. These rules would apply to swap dealers, security-based swap dealers, major swap participants and major security-based swap participants. The Commodity Futures Trading Commission (CFTC) followed with its own re-proposed rules, which would apply to swap dealers and major swap participants that are not subject to the jurisdiction of the prudential regulators. Both sets of rules are substantially similar and reflect the September 2013 BCBS-IOSCO framework. The rules are expected to be finalised in mid-2015.

The proposed rules call for initial margin requirements to be phased in from December 1 2015 to December 1 2019 and variation margin requirements to be introduced as of December 1 2015, in line with BCBS-IOSCO's September 2013 release.

The timeline has been subject to substantial concern and comments from market participants, including an August 2014 comment letter from the International Swaps and Derivatives Association (ISDA) requesting a two-year delay to the deadline. The March 2015 revision extended the timeline for both initial margin and variation margin by approximately nine months and added a phase-in period for variation margin. Initial margin is now required to be phased in from September 1 2016 to September 1 2020, while variation margin is required to be phased in from September 1 2016 to March 1 2017.

Key requirements

Key requirements of the framework include the following:

- Initial margin will be posted gross on a counterparty portfolio basis and will need to be held in a bankruptcy-remote manner.
- Variation margin will be posted net, and will generally be required to be posted daily, which could prove to be operationally challenging for smaller entities and trades across time zones.
- The proposals will prohibit the re-hypothecation of initial margin required to be collected and posted under the rules.
- The initial phase-in of the initial margin rules will capture trades between the largest counterparties. The proposals set the materiality threshold triggering the application of initial margin requirements at a much lower figure of $3 billion in gross notional outstanding group exposures.
- The *de minimis* exemption from posting initial margin will be where the exposure to the counterparty is less than $65 million (€50 million) on a group consolidated basis. The feasibility of allocating the initial margin threshold across entities within a corporate group remains uncertain.

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There is no proposed threshold for variation margin.

- The calibration of initial margin will be based on what is required, at 99% confidence levels, for liquidation of a position over a 10-day horizon using historical data. Initial margin models will also be subject to quantitative and qualitative requirements; the proposal of the US banking regulators is similar to those required for proprietary models used for determining capital to be held against derivative counterparty exposures.
- The BCBS-IOSCO framework defers to national regulators on the question of whether intra-group transactions should be subject to the margin requirements. Under the US proposals there will be no exemption for such swaps, which clearly raises concerns for the ability of corporate groups to optimise internal risk management strategies.
- Exemptions will be available for sovereigns, central banks, multilateral development banks, the Bank for International Settlements and non-systemic non-financial firms. Transactions between a covered entity and an exempt entity will be exempt. Although industry groups have been lobbying for an exemption for securitisation vehicles, the proposals do not contain any such exemption.
- Physically settled foreign exchange swaps and forwards will be exempt from both initial margin and variation margin.

Materiality threshold

The introduction of margin requirements for non-centrally cleared derivatives presents significant commercial, operational and legal challenges. A guiding principle of the BCBS-IOSCO framework is that national regulatory regimes implementing the framework should not lead to conflicting, duplicative or inconsistent requirements for participants; should limit regulatory arbitrage; and should maintain a level playing field.

The US proposals set the materiality threshold triggering application of initial margin requirements at $3 billion in gross notional outstanding group exposure. The proposed rules are stringent and could result in entities attempting to avoid transacting with US counterparties. In response to such concerns, the CFTC has been considering increasing the margin threshold.

Comment

The regulators have been charged with the incredibly complex task of applying margin requirements to uncleared swaps, and this endeavour is further complicated by the challenges inherent in harmonising rules between jurisdictions. The underlying intent of these proposals is to create a safer structure for one of the key marketplaces that played a significant role in the financial crisis. However, there remains a narrow window for striking the proper balance between sound regulation and compliance which does not impose undue burden on market participants. Disparity between regulatory mandates could ultimately disadvantage US market participants and harm swaps trading activity as a whole.

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