The Effects of Trans-Atlantic Reform on Margin for Uncleared Swaps: Balancing the Risks and Benefits of Uncleared Swaps

Barney Reynolds[*]
Shearman & Sterling (London) LLP

Donna Parisi
Shearman & Sterling LLP

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Abstract

New rules on margin requirements for uncleared swaps sharply tighten counterparty risk management in the uncleared space whilst serving further to mitigate system-wide risk. The new regime, however, is not without a number of significant issues for market participants.

Introduction

To ensure that systemic concerns arising from counterparty risks associated with uncleared derivatives are sufficiently managed through collateral, the G20 added margin requirements for such derivatives to the list of post-credit crunch reforms in July 2011.

The rules are designed to reduce counterparty credit risk, limit contagion, and incentivise the central clearing of derivatives trades. The uncleared over-the-counter space, however, will continue to be very sizeable given that many derivatives are ineligible for central clearing due to insufficient standardisation or liquidity, or because of valuation challenges.

The rules, focusing on the bilateral exchange of margin, could potentially fuel negative outcomes such as regulatory arbitrage and put yet more pressure on sourcing good quality collateral, which could, in turn, create space for less regulated entities to occupy. The reliance on collateral rather than capital charges to achieve these goals ensures that the defaulting party bears the loss, rather than the performing counterparty. Further, the rules threaten to introduce new forms of legal uncertainty into the cross-border transactional environment—some of which are very significant indeed and not easy to mitigate.

International initiatives

In September 2013, the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) released their final framework for margin requirements for non-centrally cleared derivatives transactions. Due to the operational and legal complexities presented by the final framework, BCBS and IOSCO updated the framework in March 2015 to delay the start of implementation until late 2016. The framework sets out eight key principles and aims to ensure the harmonisation of their implementation across multiple jurisdictions. While the final framework is not binding on any regulatory authorities, it informs the approach of national regulators as they adopt their respective margin regimes.

In Europe, draft regulatory technical standards, closely following the final framework and implementing the relevant provisions of the European Market Infrastructure Regulation (EMIR),[1] were published by the European Supervisory Authorities for comment in April 2014. After responses were received, updated draft regulatory technical standards were published in June 2015, and are expected to be finalised in early 2016.

In September 2014, the US banking regulators and the Commodity Futures Trading Commission (CFTC) issued revised rule proposals, in each case modelled closely after the BCBS–IOSCO framework. The Securities and Exchange Commission (SEC) issued proposed rules on capital, margin and margin segregation for security-based swap registrants in October 2012, before the BCBS–IOSCO framework was finalised.[2] On 22 October 2015, the US banking regulators adopted final rules which set minimum margin requirements on swap registrants under any of their supervision in respect of all such registrants' non-centrally cleared swap activity[3] (i.e. swaps and security-based swaps), without reference to whether a registrant's status relates to transactions in one or both swap product categories.[4] The CFTC's final rules on margin requirements are expected to be broadly similar to the rules finalised by the banking regulators.

[*] Barney Reynolds is General Editor of J.I.B.L.R.
[1] Regulation 648/2012 on OTC derivatives, central counterparties and trade repositories [2012] OJ L201/1.
[2] The SEC has yet to issue a revised rulemaking proposal following the finalisation of the BCBS–IOSCO framework, and as such it is unclear the extent to which the final framework might bear on the SEC's rules.
[3] In the final rules, the US banking regulators revised the definitions of "non-centrally cleared swap" and "non-centrally cleared security-based swap" to make clear that a swap cleared by a clearing organisation exempt from registration with the CFTC and a security-based swap cleared by a clearing agency exempt from registration with the SEC is a cleared swap or security-based swap. Commenters on the rule proposal expressed concern that absent such clarification, an entity covered by the US banking regulators' margin rules would be required to comply with the uncleared swap and security-based swap margin requirements in the case of swaps and security-based swaps cleared by foreign, non-registered clearing organisations.
[4] As used in this article, the term "swap" hereinafter refers to both swaps and security-based swaps.

The BCBS–IOSCO rules require the bilateral exchange of initial margin (IM) and the delivery by one party to the other of variation margin (VM), and apply to financial firms and systemically important non-financial entities (Covered Entities), the definitions for which are left to national regulation.

Key aspects of the margin requirements

	BCBS–IOSCO	United States[5]	European Union
Parties subject to the obligation	Financial firms. Systemically important non-financial entities. IM obligations apply when a covered entity's gross notional outstanding group exposure exceeds €8 billion.	Swap registrants, which include swap dealers, security-based swap dealers, major swap participants and major security-based swap participants. Financial end-users.	Financial counterparties. Non-financial counterparties that exceed the EMIR clearing thresholds. The clearing thresholds, in gross notional value, are €1 billion for credit and equity derivatives and €3 billion for interest rate swaps, foreign exchange, commodity and other OTC derivatives.
		IM and VM requirements apply to transactions between swap registrants as well as between a swap registrant and a financial end-user where the financial end-user has material swaps exposure, i.e. an aggregate gross notional exposure under all its uncleared swaps (including foreign exchange swaps and forwards) in excess of US $8 billion. VM obligations apply even where the financial end-user's exposure does not exceed the US $8 billion threshold.[6]	IM requirements only apply if the €8 billion threshold is reached.
Transactions within scope	Non-centrally cleared derivative transactions between two Covered Entities, except for physically settled foreign exchange swaps and forwards.	Same as the BCBS–IOSCO framework.[7]	Same as the BCBS–IOSCO framework, except that the exemption for physically settled foreign exchange swaps and forwards only applies to IM requirements.
Bilateral exchange of margin	IM to be posted gross on a counterparty portfolio basis and on a bankruptcy-remote basis. VM may be posted net, and must be posted with sufficient frequency (e.g. daily).	Same as the BCBS–IOSCO framework. IM must be held by a third-party custodian.	Same as the BCBS–IOSCO framework. Requirement for bankruptcy-remote posting of IM prevents continuation of EU market practice for title transfer, introducing significant new legal uncertainties surrounding the less-developed classes of security interest (including "pledge").
Deadline for implementation	IM requirements phased in from 1 September 2016 to 1 September 2020. From 1 September 2020, IM required where gross notional outstanding group exposure exceeds €8 billion.	Same as the BCBS–IOSCO framework.	Same as the BCBS–IOSCO framework.
	Compliance with VM requirements phased in from 1 September 2016 for some entities where gross notional outstanding group exposure exceeds €3 trillion, and 1 March 2017 for all other entities. Only applies to contracts entered into after the applicable date.	While the rules adopted by the US banking regulators are not to be applied retroactively, contracts within a swap portfolio entered into before and after the relevant compliance date must be divided into separate netting portfolios, provided that the portfolio swaps are governed by an eligible master netting agreement. Absent this sub-division within the portfolio, pre-compliance date swaps held in the same portfolio with post-compliance date swaps will be subject to the margin requirements.	

[5] This column describes the final rules adopted by the US banking regulators.
[6] The rules adopted by the banking regulators include the same threshold for the calculation of initial margin provided under the BCBS–IOSCO final framework, except that the thresholds are denominated in USD not Euros, and as such reflects the one-for-one exchange rate between the USD and the Euro applied by the regulators at the time of adoption for purposes of establishing the thresholds in the final rules. The US banking regulators may over time adjust the numerical values under the thresholds as they deem appropriate.
[7] Note that foreign exchange swaps and foreign exchange forwards count towards the $8 billion material swaps exposure threshold even though such transactions are not subject to the uncleared swap margin rules.

	BCBS–IOSCO	**United States**[5]	**European Union**
Re-hypothecation of margin	Cash and non-cash VM may be re-hypothecated. IM should not be re-hypothecated except in limited circumstances and may only be re-hypothecated once.	Same as the BCBS–IOSCO framework save that re-hypothecation of IM is prohibited. Cash IM can be used to purchase other eligible assets.	Same as BCBS–IOSCO save that the re-hypothecation of IM will be prohibited (although cash deposited as IM can be re-invested in eligible securities in order to protect the collateral taker).
De minimis thresholds	De minimis threshold for IM of €50 million on a group consolidated basis for all uncleared derivatives between two consolidated groups. No threshold for VM. De minimis minimum transfer amount not to exceed €500,000. The feasibility of allocating the IM threshold across entities within a corporate group remains uncertain.	Same as the BCBS–IOSCO framework. The final rules also provide for a minimum transfer amount of US $500,000 applicable to transfers of IM and VM on a combined basis.	Same as the BCBS–IOSCO framework.
Calibration of margin	IM calculated using either a quantitative portfolio or a standardised margin schedule. Exposures within designated risk categories can be netted prior to calculating the required margin. The calibration of IM is based on what is required, at 99% confidence levels, for liquidation of a position over a 10-day horizon using historical data. The data must incorporate a five-year stress period. Dispute mechanisms required for differences between models.	Same as the BCBS–IOSCO framework but the US banking rules specify a one to five-year historical observation period. IM models are subject to quantitative and qualitative requirements. The US banking regulators propose articulated standards similar to those required for proprietary models used for internal regulatory capital monitoring purposes.	Same as the BCBS–IOSCO framework except that those using internal models must input data covering a minimum period of three years and not exceeding five years.
Inter-affiliate transactions	Defers to local rule-makers to determine application.	Inter-affiliate transactions are subject to the US banking regulators' margin requirements save that covered swap registrants are not required to post IM to an affiliate that is not a swap registrant. Such swap registrant must, however, document and notify the affiliate of the amount it would otherwise have to post on a daily basis. A swap registrant may apply an IM threshold of US $20 million per affiliate. The requirement that a custodian holding IM collateral be an unaffiliated third-party applies only to IM collateral in the form of cash. IM models used to calibrate IM requirements under inter-affiliate swaps may use a holding period equal to the shorter of five business days or the maturity of the uncleared swap. Inter-affiliate transactions will only be counted once for purposes of calculating material swaps exposure.	Intra-group transactions in a financial or non-financial group are exempt provided certain conditions are met. Financial groups need approval of regulator.
Exempt entities	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 are exempt.	Same as the BCBS–IOSCO framework. Also, commercial end-users using non-cleared swaps to mitigate commercial risk are exempt from the rules.	Same as the BCBS–IOSCO framework but includes an exemption for covered bond issuers, recognising that they are not set up to post margin.

[5] This column describes the final rules adopted by the US banking regulators.

	BCBS–IOSCO	United States[5]	European Union
Eligible collateral for margin	National regulators to develop list of eligible assets. Examples include cash, government and central bank securities, corporate bonds, covered bonds, equities, and gold. Assets to be highly liquid and, after appropriate haircuts are applied, able to hold their value in a time of financial stress. Collateral should not include securities issued by the counterparty or its related entities.	Generally the same as the BCBS–IOSCO framework. Permits assets that are eligible as IM to also be eligible as VM for swap transactions between a swap registrant and a financial end-user, subject to applicable haircuts. Securities issued by financial institutions not eligible. Additional haircut of 8% for currency mismatch.	Generally the same as the BCBS–IOSCO framework, except that the use of senior securitisation tranches and units in retail funds known as Undertakings for the Collective Investment in Transferable Securities is permitted, which will likely require larger haircuts (as the haircut will be the average of the haircuts that would apply to the assets in which the fund is invested). This will reduce pressure on government bonds. Securities issued by financial institutions not eligible. Additional haircut of 8% for currency mismatch.

Impact

The introduction of the requirements presents significant commercial, operational, and legal challenges.

Availability of collateral

There are concerns that stricter margin requirements may have a significant impact on market liquidity and the availability of collateral, particularly as IM must be posted gross and cannot be netted or offset between counterparties. Several quantitative impact studies have been conducted. An analysis conducted by the International Swaps and Derivatives Association (ISDA) estimates that the earlier versions of the BCBS–IOSCO framework could see IM requirements reach a peak of US $10.2 trillion (approximately €8.04 trillion) if internal models were not used to make IM calculations and no counterparty threshold was applied. On the other hand, a study referenced by BCBS–IOSCO projects that model-based IM calculations could result in requirements of approximately €1.3 trillion where no counterparty threshold applies and nearly €600 billion if a counterparty threshold of €50 million applies. These estimations rise dramatically to €7.5 trillion and €6.2 trillion, respectively, where calculations are entirely based on a standardised margin schedule.

Rise in shadow banking activity

Given the demand for eligible collateral, the cost of such collateral is likely to rise. Market participants will look to exchange non-qualifying securities for eligible collateral. This collateral transformation activity will increase repo and securities lending activity, which will partly be absorbed within the shadow banking sector. The CFTC has acknowledged that collateral transformation services might proliferate, but does not mention the potential risks that this might give rise to.

Moreover, the traditional repo market is under pressure from Basel III reforms (notably the Leverage Ratio and the Net Stable Funding Ratio).

Regulators are taking steps to curb risk in the shadow banking arena. The Financial Stability Board has published its final framework for haircuts on collateral in uncleared securities financing transactions as a measure to thwart the rapid onset of margin calls. The framework is made up of qualitative standards for methodologies to calculate haircuts on collateral received and proposed numerical haircut floors in which financing against collateral other than certain government securities is provided to non-banks. The proposed implementation date by national authorities is the end of 2017. There will be significant challenges in implementation, given that in the US regulation is split among various regulatory agencies and is more entity-based (i.e. on account of its status as a bank, broker-dealer, systemically important financial institution, or asset manager) as opposed to being activity-based as it is in Europe.

Infrastructure needs

Robust systems for the calculation and notification of margin amounts will be required. Despite the consensus view articulated in comments to the proposed rules that requiring the posting of IM on a T+1 basis would represent an extraordinary demand on the market, US banking regulators preserved this timeframe for the delivery of IM in the final rules. Consequently, market participants are likely to seek out resources to facilitate swift and efficient deployment of funds. Moreover, market participants captured by the rules (whether as a swap registrant or a counterparty to a swap registrant) will need to re-evaluate their liquidity and collateral management systems and procedures to enhance preparedness for the new margin requirements whilst balancing the need for efficient use of liquid resources.

[5] This column describes the final rules adopted by the US banking regulators.

In addition, new infrastructure and technology will need to be developed to facilitate the allocation and monitoring of the €/$50 million threshold across legal entities.

Likewise, it is imperative that the industry adopts and receives necessary regulatory approval of a common methodology for the calculation of IM requirements to promote consistency and minimise the risk of disputes.

In the absence of a consistent model, the bespoke calculation of margin amounts by each counterparty to a trade could result in different amounts being paid, by counterparties, due to legitimate variations between models. To this end, ISDA is leading an initiative to develop a standard IM model (SIMM) for widespread use by the market, and has recently published draft documents setting out its proposed methodology. The advantages of this would include greater predictability in margin requirements.

Commercial concerns

There have been a number of commercial concerns raised by market participants. Financial end-users with directional portfolios such as pension plans will not benefit from the limited permitted exposure netting within risk categories (see "Calibration of margin" row in the table), resulting in higher IM for those end-users.

For pension plans, this may significantly affect fund performance and the funding of pension obligations.

Predictability of margin requirements is critical to the consistent pricing of transactions and the discouragement of the use of aggressive models to win business. There are also different views regarding margin funding costs, with some institutions pricing on the basis of the term of the transaction and others on an expected or average life assumption. Another potential area of inconsistency is the placement of transactions into risk categories, which has netting implications as described above. Under the US proposals, each covered entity selects the risk category for netting purposes. This may lead to disparate results where two swap registrants are party to a trade.

The scope of the rules is wide and extends margin requirements to securitisation vehicles—an arguably unnecessary reach of the rules given the priority swap counterparties have in securitisation payment waterfalls over and above bond investors—but it is likely that many securitisations will remain below the US $8 billion material swaps exposure threshold.

This is yet another cost constraint on securitisation structures and does not serve to encourage the asset backed security market, which is an essential pillar for the full-scale rehabilitation and normalisation of the commercial and retail banking market globally. Under the EU proposals, securitisation issuers would also fall outside scope if the swap exposure of the issuer is less than the €8 billion threshold. There is also a specific exemption for covered bond issuers.

After publication of the revised proposed rules by the US banking regulators, legislation was enacted in the US providing that specified transactions of certain counterparties that are exempt from mandatory clearing are equally exempt from the margin requirements for uncleared swaps. Consistent with this legislative directive, the final rules of the US banking regulators exempt those transactions that are eligible for an exception or exemption from mandatory clearing under either the Commodity Exchange Act or the Securities Exchange Act 1934, as applicable, or rules adopted by the CFTC or SEC.

While the US banking regulators declined requests from commenters to adopt an exemption for inter-affiliate swaps, the final rules provide some relief for such intra-group transactions. Notably, swap registrants covered by the final rules are required only to collect, not post, initial margin to their affiliates that are not swap registrants. In place of the posting requirement, swap registrants are required to document and notify their affiliate counterparty of the amount they would have been required to post on a daily basis. The final rules also permit a covered swap registrant to apply an IM threshold of US $20 million in the case of each affiliate. Moreover, IM models used to calibrate IM requirements under inter-affiliate swaps may use a holding period equal to the shorter of five business days or the maturity of the uncleared swap.

Increased legal risk and additional documentation requirements

There are certain legal risk issues that have not been sufficiently acknowledged or addressed in either of the proposed US or EU rules. As mentioned, IM will have to be exchanged two-way and gross on a bankruptcy remote basis, and be immediately available to the collateral taker. The US proposals require the use of third-party custodial accounts for cash and securities, buttressed by a security interest or pledge in favour of the collateral taker. In the EU, title transfer arrangements, which currently predominate in the market, will not meet the requirement that margin be held on a bankruptcy-remote basis. The margin will have to be held on a security interest basis either with the collateral provider or with a custodian. EU laws on security interest arrangements are not well developed and are inadequately harmonised across the EU.

The EU requires collateral to be in the "possession or control" of the collateral taker to get full protection from normal insolvency law. The English courts interpret this as potentially prohibiting the collateral provider from automatically withdrawing collateral deemed no longer necessary. So US arrangements where the collateral provider periodically takes back from the collateral account excess collateral can present issues in the EU, which seeks to protect the collateral taker to a greater degree. The market will no doubt use the US style

arrangements globally if at all possible to avoid paying in IM for longer than required and to avoid having to wait for a collateral taker to release reimbursement.

To guard against the risk that their security may become void or unenforceable, counterparties will need to undertake an analysis of relevant local laws on security interests, and manage the arrangements carefully. This of course is likely to involve some uncertainties, difficult judgement calls (and the running of risk) as well as considerable expense. The EU proposals also require an annual legal review verifying that IM is adequately segregated and insulated from the bankruptcy risk of the collateral taker. Where IM is in the form of cash, the cash amount will need to be individually segregated per each collateral provider with a third-party bank (to whose credit risk the provider is then exposed).

With respect to third-party custodial arrangements, custody agreements and account control agreements will need to be negotiated and put in place with a large contingent of counterparties. Existing documentation will need to be modified to contemplate these third-party arrangements. Documentation may also need to be amended to comply with the final rules of the US banking regulators as well as CFTC rules requiring that swap trading relationship documentation includes a process for determining the value of each swap in compliance with the margin requirements. It remains to be seen what this disclosure requirement will mean in practice, especially with respect to proprietary risk-based margin models. This rule, as is the case elsewhere, also requires that each swap registrant establish and maintain policies and procedures to resolve a valuation discrepancy, including how VM will be handled pending resolution of a dispute.

Additionally, an institution may wish, consistent with the final rules, to put in place separate netting portfolios (e.g. separate credit support annexes under a single ISDA Master Agreement) under an eligible master netting agreement meeting the requirements of the final rules to avoid having the margin requirements apply to pre-effective or compliance date transactions.

From a risk perspective, while holding collateral with a custodian mitigates the risk associated with the collateral receiver's bankruptcy, it does not eliminate all risk. In the event of an insolvency of a counterparty (or other trigger for the release of collateral) it may well be that a custodian will not release the collateral to either party until directed to do so by a court with competent jurisdiction. It is also critical to keep in mind that in times of systemic stress, liquidity may be severely impaired. Additionally, upon any custodian insolvency, excluding cash collateral from the bankruptcy estate is very difficult. This requires the reinvestment of cash into securities on a daily sweep basis generally. In the EU, or at least in the UK, banks holding cash collateral could recognise the beneficial interest of the custodian's client in the cash (strictly the custodian's rights as depositor to the cash account). More broadly, as greater amounts of collateral are held in a limited number of custodian banks, this will concentrate risk in the financial system further.

The final rules of the US banking regulators require a covered swap entity posting IM to direct the custodian to re-invest cash IM in some form of eligible non-cash collateral. Accordingly, the final rules acknowledge the impracticality of eliminating IM in the form of cash to avoid the risks discussed above. To address these concerns the rules require the swap registrant to monitor the investment of cash IM into eligible securities as part of routine counterparty credit risk exposure management practices.

Extraterritorial application

Another chief concern is the extraterritorial application of the regime for cross-border transactions, potentially leading to conflicts in the detailed application of the regime at a local level. A key principle included in the BCBS–IOSCO framework is that national regulatory regimes separately 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. In certain circumstances, both the EU and the US proposed and final rules allow for substituted compliance, or compliance with home country requirements through compliance with local rules, provided that the relevant margin regime is found to be equivalent to their respective rules. Both sets of rules have extraterritorial reach, although the EU proposed rules are not as wide-reaching as those being finalised in the US. It remains to be seen how many equivalence or comparability determinations will be issued for the uncleared margin requirements. In the US, consensus has not been reached and much uncertainty remains as to the extraterritorial application of Title VII of Dodd Frank generally. For example, the CFTC's approach when it adopts its rules may diverge from the approach of the US banking regulators under their final rules. This, combined with a lack of resources on the part of CFTC staff to conduct comparability assessments, does not give the market confidence that cross-border reconciliation of the uncleared margin requirements will be achieved. This is of immediate concern, especially given the fast-approaching implementation date for the largest institutions—which generally have global businesses.

As with many of the reforms in response to the recent financial crisis, there are unintended consequences to the introduction of the uncleared margin rules, some of which are immediately apparent and some of which will only become evident as the industry begins its implementation. Unfortunately, these reforms may be pushed through too quickly without resolving the interpretative issues and legal uncertainties they create.