# FS Regulatory Brief

## Collateral damage: Impact of margin for uncleared swaps will not be marginal

April 2013

### Overview

The drumbeat for global mandatory margin requirements on uncleared swap transactions is quickening. The G20's agreement in 2011 to require margin for these transactions reached an important point in February 2013 when the Basel Committee on Banking Supervision and the International Organization of Securities Commissions announced "near-final" principles for requiring uncleared swap margin ("Basel/IOSCO Margin Principles" or "Principles").[1]

Although these Principles left open some important questions for further public consultation, they represent a significant step toward global regulatory clarity and indicate that a more pragmatic approach to uncleared margin is likely. The Principles improve upon last July's initial Basel/IOSCO proposal by establishing minimum thresholds under which initial margin would not be required, and under which certain entities would be entirely exempt from uncleared margin rules based on their notional derivatives outstanding. The Principles also provide for phased implementation through 2019. These developments respond to market participants' concerns – confirmed by a Quantitative Impact Study completed in late 2012 – that margin rules will constrain global market liquidity.

The Basel/IOSCO process also solidifies the expectation that US regulators will adapt their final rules to the new Principles.[2] The US has been heavily involved in crafting this global framework – the Federal Reserve is co-chair of the working group that produced the Principles, and the OCC, FDIC, CFTC, and SEC serve on the working group. With these regulators' concurrence, a comprehensive global solution is more likely, and at a minimum the Principles are likely to form the framework for US regulators' final rules.[3]

Despite the improvements in these emerging global Principles, the guidelines do not resolve the significant liquidity constraints that will accompany the new uncleared margin framework. More onerous than mandatory central counterparty clearing and reporting to data repositories, margin rules for uncleared swaps will have a profound impact on the global swaps market. The Principles' requirements for margin posting and collateralization with only cash or high-quality liquid securities further squeezes supply and introduces new costs and operational complexity for all covered counterparties. Whatever the outcome, the requirement of initial margin effectively shifts the uncleared derivatives market from a "survivor pays" model to a "defaulter pays" model by reducing the reliance on capital during periods of financial stress.

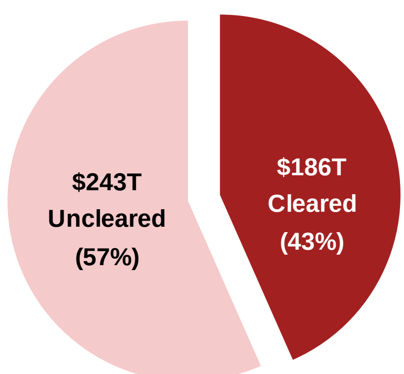
Furthermore, uncertainty remains in those areas where the Basel/IOSCO working group has not yet reached agreement. The working group requested public comment in four areas where consensus remains outstanding, including whether physically-settled FX swaps and forwards should be subject to margin requirements, whether collateral may be re-hypothecated (i.e., used for more than one collateral obligation), and whether the phase-in arrangements are appropriate. It is also not certain when Basel/IOSCO will issue its final uncleared margin principles and when individual G20 nations will adopt them.

This **FS Reg Brief** (a) analyzes the key areas where Basel/IOSCO has reached consensus and where global agreement remains outstanding; (b) provides our perspective on when final global principles are likely to be reached, and ultimately implemented in the US; and (c) points out important areas of market and institutional impact, suggesting what firms should be doing now.

## *Near-final Basel/IOSCO Margin Principles: Global consensus close?*

In 2011, the G20 added margin requirements for uncleared swaps to its list of agreed upon reforms in response to the financial crisis. The G20 was addressing the concern that uncollateralized swaps left the buy side free to gamble and the sell side uninhibited from taking the bet, thereby leaving systemic risk unmitigated. As indicated in the below pie chart, this uncleared market remains substantial, representing over half of the $429 trillion[4] in OTC global derivatives net notional outstanding.

**OTC Derivatives Market**
(Net notional outstanding)




*Source: ISDA OTC Derivatives Market Analysis*

Since differing margin rules across national jurisdictions would undermine the G20 effort and create arbitrage opportunities, Basel and IOSCO were jointly tasked with developing "consistent global standards" that each nation could eventually implement. The Basel/IOSCO margin working group issued an initial consultation paper on July 6, 2012 outlining a global policy framework for calculating, calling, and collecting initial margin ("IM") and variation margin ("VM") for uncleared swaps.

Given that IM and VM seriously implicate market liquidity, the Basel/IOSCO working group also conducted a Quantitative Impact Study ("QIS") in 2012 to estimate the financial impact of these proposed margin requirements. Thirty-nine entities from 10 different jurisdictions responded to the QIS including 19 institutions classified by Basel/IOSCO as "large, internationally active derivative dealers or globally systemically-important banks."

Based on the QIS and numerous public comments, the near-final Basel/IOSCO Margin Principles were issued on February 15, 2013. Virtually every major global derivatives regulator was involved, including the five US regulators, suggesting that these Principles set the core baseline for national regulators to eventually implement in their home countries. Achieving this consensus required an evolution from the initial US proposal (please see the **Appendix** for a comparison of the Basel/IOSCO Margin Principles to the US proposal).

The three key elements that are new in the Basel/IOSCO Margin Principles are the following:

- Applicability only to entities or affiliate groups with over €8b gross notional uncleared derivatives outstanding, and a complete exemption for sovereigns, central banks, and certain international agencies.
- An IM minimum threshold amount of €50m gross between counterparties, applied at the consolidated group level, under which IM is not required.
- Phase-in from January 2015 through 2019.

These topics are analyzed below, along with two additional ones which remain unresolved: physically-settled FX swaps/forwards and re-hypothecating collateral.

## Who is impacted? Fewer entities in scope

The Basel/IOSCO Margin Principles establish that most financial and systemically important nonfinancial firms[5] would be subject to the margin rules, but only if their total gross notional uncleared swaps outstanding exceed €8 billion for the entity or affiliate group – an important change from last year's Basel/ IOSCO proposal. The Principles largely do not distinguish among these institutions, other than to definitively exempt sovereigns, central banks, and certain international agencies.

**Entities Subject to Basel/IOSCO Margin Principals**

| *In scope* | *Out of scope* |
|---|---|
| • Financial firms<br>• Systemically important non-financial firms | • Non-financial firms that are not systemically important<br>• Sovereigns<br>• Central banks<br>• Multilateral development banks<br>• Bank of international settlements |

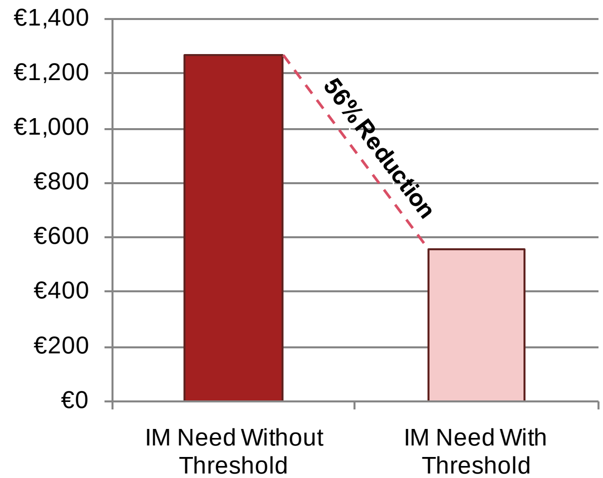
The Principles represent important progress toward settling the long debated issue of which entities should be subject to uncleared margin requirements. The US proposal reached more broadly by imposing requirements for any entity (even if non-financial and not systemically important) that traded uncleared swaps with a swap dealer or major swap participant (with an exception for commercial firms using swaps to hedge). The US proposal was also more complicated than the Principles, as the US called for a risk assessment of an entity in order to determine its appropriate margin requirements.

The progress made in the Basel/IOSCO Margin Principles is particularly important for pension and hedge funds that would have faced margin calls under the US proposal and under Basel/IOSCO's initial proposal. Under the Principles, only the largest pension and hedge funds are now in scope given the €8 billion threshold (regardless of their perceived risk under the US proposal). The Principles are also a significant improvement for sell-side financial firms with uncleared swaps books below the threshold.

## €50m IM threshold: Some relief

The Basel/IOSCO Margin Principles allow for up to a €50 million (consolidated across the affiliate group) IM exposure per counterparty before two-way margin is required.[6] The introduction of this threshold is a second example of a more pragmatic approach since the US proposal and the initial Basel/IOSCO proposal.

**Projected Initial Margin Reduction from Threshold (€ billions)**



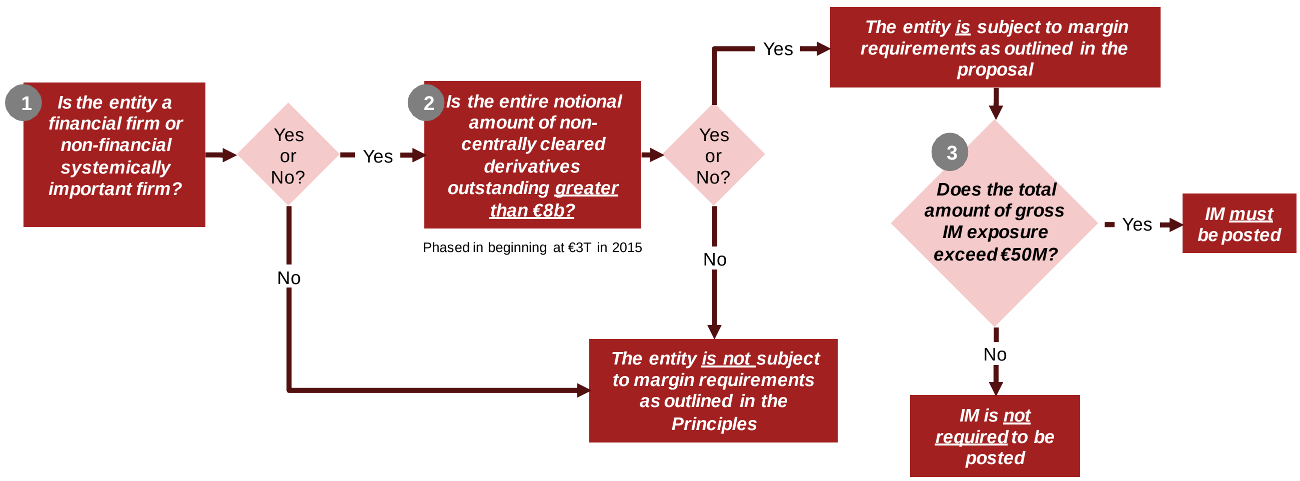

*Source: Basel/IOSCO*

The 2012 QIS estimated that the Principles' inclusion of this €50 million threshold would reduce total IM needs in the market by 56% (approximately €558 billion) from the initial Basel/IOSCO proposal. This significant reduction in needed collateral could ease the strain on prime liquid securities and the potential for a market wide collateral squeeze (further discussed below).

With this €50 million threshold and other features of the Principles described above, three questions now effectively govern whether or not IM must be posted, described below and depicted on the following page.

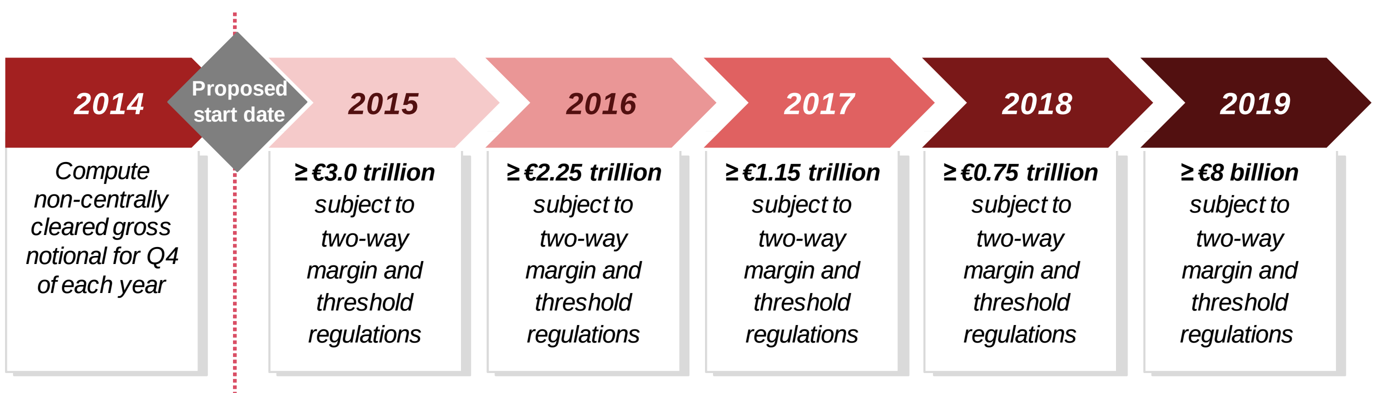
1. Is the entity a financial firm or a non-financial systemically important firm?
2. Is the entire notional amount of non-centrally cleared derivatives outstanding for the entity (or affiliate group) greater than €8B?
3. Does the total amount of gross IM exposure for the entity (or affiliate group) exceed €50M?

**Is Initial Margin Required?: Three key questions**




## *Implementation Schedule: Global phase-in likely*

The Basel/IOSCO Margin Principles would gradually phase-in uncleared margin requirements beginning in 2015, starting with those institutions with the largest derivatives trading books. Those with over $3 trillion in outstanding gross notional will be subject to two-way IM requirements in 2015. Financial and non-financial systemically important entities must calculate their outstanding gross notional uncleared derivatives for Q4 of each year beginning in 2014. These amounts will be used to determine which institutions are subject to the regulations as indicated in the following phase-in schedule.




Beginning on January 1, 2015, covered entities (excluding affiliates) also would be required to exchange VM for all new contracts. The calculation and collection of VM will be required on a timely basis (e.g., daily) to ensure that any fluctuation in the value of a trade is realized and additional collateral is posted.

Although this phase-in schedule is an open issue that is out for public comment, it is our view that a phase-in schedule is necessary to avoid unintended collateral consequences and, therefore, likely to be part of the final Basel/IOSCO principles. Home country regulators will feel pressure to implement the Principles in line with the global consensus schedule; regulators that are too aggressive risk driving liquidity offshore, and those that delay implementation will be accused of undermining global agreement.

The Basel/IOSCO start date is broadly consistent with time frames suggested by US regulators. In the US, the CFTC's implementation schedule to date has been the most aggressive, and its Chairman has estimated adoption of final rules by the end of 2013. CFTC rules will cover swap dealers and major swap participants that are not subject to regulation by a US prudential regulator. The CFTC's proposed margin rules provided for phased implementation over 270 days depending on the type of counterparty; the prudential regulators provided for a six month delay from issuance of final rules. On those schedules, full implementation likely would occur well into 2014, which would end up being close to the proposed commencement date of the Basel/IOSCO phase-in schedule.

## *What products are impacted? No global consensus yet on FX*

The question of which products should be covered under the Basel/IOSCO Margin Principles remains one of the most significant areas where global consensus has been elusive. The document requests public comment on the question of whether physically-settled foreign exchange FX forwards and swaps should be included.

This open issue is where significant divergence between jurisdictions is most possible. The US has already suggested these FX instruments would be exempt from uncleared margin rules – the initial US proposal exempted them, and last November the US Treasury excluded them due to their typically high liquidity and short tenor from central counterparty clearing and from the de minimis threshold calculation for swap dealer registration. That the question was put out for comment by Basel/IOSCO indicates that at least some other key national regulators are not yet persuaded by the US approach.

It is our view that the US will maintain its position on this issue. In order to avoid arbitrage opportunities in this important market, at least the major jurisdictions will ultimately have to adopt the US approach even if Basel/IOSCO cannot reach consensus.

## *Eligible collateral: Re-hypothecation needed to minimize liquidity squeeze*

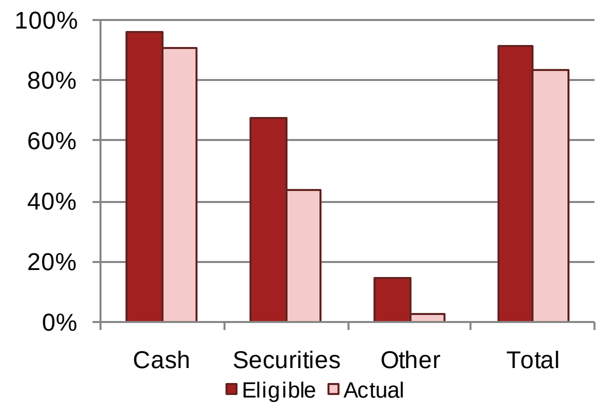
The other very important question put out for comment is whether collateral that has been pledged to satisfy IM requirements can be used for other purposes (i.e., re-hypothecate). The Principles demonstrate that collateral requirements are evolving to become more practical by expanding the types of collateral that are eligible beyond what was proposed by US regulators, as shown in the following chart.

**Eligible Collateral**

| *Basel/IOSCO Margin Principles* | *US Proposal* |
|---|---|
| • Cash<br>• High-quality government bonds<br>• Central bank securities<br>• High-quality corporate bonds<br>• High-quality covered bonds<br>• Equities in major stock indexes<br>• Gold | • Cash<br>• US Treasury, Agency, and GSE bonds<br>• Insured debt of Farm Credit System banks |

However, despite this broadening of eligible collateral, competition for high-quality liquid collateral will necessarily increase under the Principles. The resulting shortage will drive up prices and increase costs, as many have stated, as market participants are forced to find additional prime liquid securities to satisfy multiple collateral needs. This concern is very real, as suggested by the below graph showing that the vast majority of liquid collateral (cash, securities, other) currently eligible for re-hypothecation is in fact used to support multiple financial arrangements, according to an ISDA survey of large dealers.

**Percent of Collateral Re-Used Posted in Connection with OTC Trades**




*Source: 2012 ISDA Margin Survey (Large Dealers Only)*

These survey results, which are concerning enough on their own, likely understate the problem by only including large dealers. It is therefore our view that at least some re-hypothecation of collateral will ultimately be permitted in order to minimize a liquidity squeeze and avoid any market disruption.

## *When will final global principles be agreed on, and when will they be implemented in US?*

Nearly two years after the US proposal and the G20's agreement to address uncleared swaps, it is likely that Basel/IOSCO will reach agreement on final principles this year. The US and the rest of the G20 nations have been waiting for these final principles before acting individually. In the event that global consensus on the unresolved principles does not occur this year, US regulators may feel compelled to act first to advance two other key G20 and Dodd-Frank goals – central counterparty clearing and systemic risk reduction. Margin for uncleared swaps fosters these goals by making uncleared swaps less attractive alternatives.

However, several hang-ups exist that could delay the process or at least create challenges. First, the SEC has signaled that it has a different view from its US counterparts on the Basel/IOSCO Margin Proposal for SEC-regulated firms that are not subject to regulation by US prudential regulators. Chairman Walter recently addressed the issue publicly stating that the "fundamental differences between banks and non-bank institutions mean that the SEC's approach to the financial responsibilities of non-bank institutions — to capital, margin, liquidity and segregation requirements, among others — will necessarily differ from the approach taken with regard to banks."

A second key area of potential disagreement relates to physically-settled FX swaps and forwards which, as discussed earlier, are not exempt under the Principles but are likely to be in the US. If the Basel/IOSCO working group cannot achieve consensus on this issue soon, they will have to decide whether to delay the entire framework or leave the FX issue to home country regulators. In our view, US regulators are unlikely to wait too long to achieve consensus on this point before going out on their own guided by the rest of the Principles.

Third, US regulators may need more time to finalize their rules if they conclude that they have to re-propose uncleared margin rules before issuing final rules. This will depend on how far the final Basel/IOSCO margin principles diverge from US regulators' original proposed rules. A two-step process will add at least 4 months to allow time for a public comment period, consideration of comments, and to perform cost/benefit analyses. Regulators could opt to issue an interim final rule, instead, to accelerate the effective date, depending on how they assess the risk of a legal challenge to such a rule.

## *Impact on the market and institutions: What should you be doing now?*

The uncleared swaps market has provided a necessary and useful mechanism for the bilateral transfer of risk in the global economy. Mandating margin requirements is expected to lead to two basic results: higher cost and reduced liquidity. The impact is projected to be significant. The QIS results estimate IM requirements could reach up to €558 billion if implemented as currently proposed. Not only will cost go up and liquidity down, but risk may also increase in two ways:

- The expense of customizing risk management solutions will increase, potentially causing market participants to use less effective risk management tools that force a mismatch between actual and hedged risks (known as basis risk).
- Risk will concentrate at central clearing utilities, even more so than anticipated under the mandatory clearing requirements for standard swap contracts, as trades move away from the increasingly expensive uncleared market. This aggregation of risk will require improved risk management and heightened precaution in order to avoid greater consequences than in prior crisis situations, which will in turn make the cleared market more expensive, while intensifying systemic risk concerns.

In addition to these broad effects, institutions will be most individually impacted by the following provisions of the Principles. They should take certain preparatory actions now.

***IM threshold:*** Significantly less IM will be required at some institutions due to the Principles' new €50 IM threshold. Firms that have performed an impact analysis of IM based on previous proposals should update those estimates to consider the threshold. Those that have not yet taken this step should do so, as global IM requirements now seem inevitable.

***Eligible collateral requirements:*** The Principles limit the re-hypothecation of collateral that has been pledged to satisfy IM requirements. This presents a very serious challenge, especially given the rules governing the use of eligible collateral. Dealers need a consistent supply of quality collateral to satisfy other daily fiduciary requirements and overall business operations (e.g., repo markets); however, the upcoming squeeze on eligible collateral will reduce the leverage dealers can employ in their business. To remain competitive in this new environment, dealers will need to deploy collateral and capital efficiently and in the cheapest manner. Given the significant change that will be required across the trade lifecycle, market participants should begin planning now for the enhancement of collateral management operational and technological capabilities.

***IM calculation and VM exchange operational requirements:*** Since proposed IM calculation exchange methodologies have remained similar since the US proposal, market participants have substantial visibility into what they need to do to overhaul their existing IM infrastructures. The daily call-and-collect requirement would require major technology and process enhancements to reduce IM calculation time, improve call issuance speed, and ensure timely processing of margin submissions. In addition, the Principles require counterparties to agree on margin calculation methodologies and on "robust dispute resolution procedures" prior to executing transactions. These mandates will certainly result in additional pre-deal negotiations and increased legal costs associated with enhancing the detail of Credit Support Annexes to netting agreements. Although the Principles indicate that margin should not be used as a competitive tool, dealers with limited IM calculation capabilities will find it difficult to compete against those firms with more sophisticated engines.

***Client documentation needs:*** Swap dealers will have to enter into or modify existing agreements with clients. These agreements may require variations based on asset-class, especially if the FX exemption is not applied consistently across national jurisdictions. Swap dealers may want to perform documentation inventories now to determine which client relationships need amending and which would need new documentation.

***Global implementation:*** It is our view that the Principles will be fairly consistently adopted across jurisdictions; however, even minor home country differences regarding margin may require different operational approaches. For global dealers, managing the application of the right rules, to the right trades, to the right counterparties will be an ongoing challenge as national implementation occurs during 2014. Swap dealers may want to include readiness to create customized solutions on a per-country basis as they assess their operational and systems abilities for managing collateral.

Although the Basel/IOSCO Margin Principles are not a final call to action for swap dealers, they should serve as a catalyst to assess the impact of uncleared margin rules and to begin needed infrastructure enhancements. Most market participants have much to do to ensure that their business lines and their operational support structures are fit for the purpose. Once the final rules shake out, capital and funding efficiency will become the new competitive advantage in the uncleared swaps game.

# Appendix: Comparison of Basel/IOSCO Margin Principals to US Proposal

| | Basel/IOSCO Principals | US Proposal | Similar or Different? |
|---|---|---|---|
| **Entities in scope** | • All financial firms and systemically important non-financial firms<br>• Central banks, sovereigns, multilateral development banks, BIS, and non-systemic firms are exempt | • All swap dealers/MSPs and financial entities<br>• Exempts commercial end-users if credit limits or CSA is in place | ***Different*** |
| **Notional minimum for in scope entities** | • Applies to entities or consolidated groups with >€8 billion uncleared derivatives notional outstanding | • None | ***Different*** |
| **Minimum IM and VM thresholds** | • €50 million IM threshold between consolidated groups<br>• No threshold for VM | • No threshold for swaps between dealer/MSPs or high-risk financial end user<br>• Threshold for swap dealer/MSP to low-risk financial | ***Different*** |
| **Implementation timeline** | • Phase-in between 2015 and 2019, based on total gross notional | • CFTC phase-in is 90-270 days by counterparty type; bank regulators give 6 months to effective date of rule | ***Different*** |
| **Products in scope** | • Applies to all uncleared derivatives; comment sought on coverage of physically-settled FX swaps and forwards | • Swaps and security-based swaps only; physically-settled FX swaps and forwards exempt | ***Different*** |
| **Eligible collateral** | • Highly liquid including cash, high quality government bonds, and central bank securities<br>• Haircuts apply | • Depends on counterparty type; includes cash, US government obligations, senior GSE debt, and (for commercial end users) other assets<br>• Haircuts apply | ***Different*** |
| **Calculation of IM amounts** | • 99% Confidence Interval over 10-day horizon<br>• Internal approved models or vendor models<br>• Models subject to valuation by regulator | • Approved model (min. 99% of price change over 10 days) or standardized schedule | ***Different*** |
| **Exchange of collateral** | • Gross two-way IM exchange between covered firms | • Gross two-way IM between swap dealers/MSPs; one-way from non-dealer counterparty to dealer/MSP | ***Similar*** |

# Endnotes

1. See *Second Consultative Document: Margin Requirements for Non-centrally Cleared Derivatives* (February 2013), Working Group on Margining Requirements of the Basel Committee on Banking Supervision ("Basel") and the International Organization of Securities Commissions ("IOSCO"), http://www.bis.org/publ/bcbs242.pdf.

2. The US prudential regulators (i.e., Federal Reserve, Office of Comptroller of the Currency ("OCC"), and Federal Deposit Insurance Corporation ("FDIC")), Commodity Futures Trading Commission ("CFTC"), and Securities and Exchange Commission ("SEC") each proposed rules regarding margin for uncleared swaps pertaining to the institutions they regulate (collectively "US proposal", even though some differences exist between the individual proposed rules).

3. The European Securities and Markets Authority (ESMA) also proposed uncleared margin rules under the 2012 European Market Infrastructure Regulation (EMIR). Like the US's proposed rules, ESMA's proposal will also likely be harmonized with the Basel/IOSCO Margin Principles.

4. OTC derivatives market figures account for portfolio compression and netting.

5. The Principles do not provide a precise definition for these institutions; rather, they leave the definition up to national regulators upon implementation.

6. Furthermore, if the amount of IM calculated on a netted basis is below €1 million, regardless of how high above €50 million the gross IM calculation is, IM is still not owed.

# Additional information

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