ESMA, EBA, EIOPA Consultation Paper on Initial and Variation Margin rules for Uncleared OTC Derivatives

Greg Stevens
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Summary

ESMA* have updated their proposal for the margining of uncleared OTC derivatives. They continue to follow the BIS/ IOSCO proposals closely particularly over standardised calculations and the timing of implementation. Their previous proposal included a significant restriction on collateral from a single issuer which has now been relaxed. It now applies only to G-SIIs, O-SIIs or where the collateral exceeds €1 billion, in which cases assets from a single issuer cannot exceed 50% of the collateral supplied. Medium sized institutions will benefit significantly from this as many will have significant portfolios of bonds issued by their own government which they will naturally seek to use. The other useful change is that where variation margin is supplied in a currency which differs from the settlement currency of the derivative there is no need to apply the 8% haircut to the cash which makes sense given the nature of the daily mark to market operation of the variation margin. Although this is a consultation paper ESMA make it clear that they are only looking for feedback on a limited set of issues. Firms need to exchange initial margin on a T+1 basis but can exchange variation margin up to C+3 which is a little odd as variation margin is likely to be much easier to compute and agree than initial margin.

Cross border Implications

ESMA are clear that an EU entity covered by the regulations needs to apply them consistently regardless of whether their counterparty is inside or outside the EU. Where the transactions would be subject to third country legal systems that do not support netting and rights of offset EU persons are not required to place collateral that could be at risk under such jurisdictions but should rely on alternative arrangements such as using international custodians who operate outside the third country legal system.

Intergroup Transactions

Will be exempt provided certain risk management processes are in place and there are no legal impediments to fund transfer and settlement of liabilities. Firms which wish to take account of this must notify and supply the relevant information to their regulators who may then give full or partial exemption from the margin requirement. Regulators may modify these permissions (for example as a result of the imposition of capital controls).

Covered Bond Issuers

The exemption from initial margin is still there for the issuers and cover pool operators subject to

* In this document references to ESMA mean ESMA, EBA and EIOPA

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some specific conditions basically giving the OTC counterparty to the contract that hedges the bond the same legal rights to the pool assets as the bond holders.

Treatment of physical FX forwards and FX swaps

ESMA expect variation margin to be exchanged but do not require initial margin. The notionals of these contract have to be included in the counts to determine when a party exceeds the thresholds for the commencement of margin exchanges (The BIS/IOSCO proposal did not clarify how they should be treated merely that they were out of scope).

€500k minimum transfer threshold applies to the net change in initial and variation margin.

Variation Margin

Must be calculated at least daily but collection can occur up to three business days later. Where margin is collected more than one business day later the initial margin model must be extended to compensate. I.e. if the parties agree C+3 collection then the initial margin will be twelve days instead of ten. This seems a reasonable compromise for the firms complaining that next day settlement was onerous particularly for certain timezones. Where initial margin is not required variation margin must be settled on a C+1 basis.

Initial Margin

Parties are only required to call initial margin amounts above a €50 million threshold. This threshold operates at a group wide level.

The two parties must agree how the margin will be calculated but they do not need to use the same method, they can be on different models or they could use the standardised method. Margin must be calculated at least every ten days or whenever there is a change to the composition of the portfolio (new, amend, maturity, cancellation) or a time bucket shift for a contract. In the event of a dispute the undisputed amount must be collected. Margin must be calculated and collected on a T+1 basis.

Models provided by the counterparty or a third party may be used. Where a party uses a model it must be able to provide sufficient information such that an independent third party can reproduce its calculation results.

One change that ESMA has made in response to the feedback they have received is over positions that represent no credit risk to one party such as short option positions where the premium has been settled. In these cases no initial margin is required and the positions can be excluded from any margin calculation.

ESMA is using the BIS/IOSCO standardised rules table for initial margin when an internal model is not used and the same standardised net to gross adjustment to incorporate a degree of netting offset in the standardised rules calculation.

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Internal Models

Initial margin may be calculated through the use of internal models. The same 10 day 99% one sided methodology but only three years history is required but 25% of that must be from a period of stress (BIS/ IOSCO recommend the same but with five year's history). Firms may use up to five years if they wish. The difference is likely to be academic as the "tail" of the distribution is going to be dominated by the moves during the period of significant stress. The time series should have an equal weighting (some methods use exponential factors to increase the significance of more recent data). If three years data are not available credible techniques for scaling shorter periods may be used. The model must be recalibrated every twelve months or more frequently if market conditions or other circumstances justify this. These rules must be documented. Where recalibration or market changes result in a change to the margin requirement the two parties need to agree and document a recalibration implementation over a period of between one and thirty business days. There must be processes to ensure the model data is of an acceptable quality. Proxies may be used provided they are demonstrably conservative.

Certain of the model's mechanics are defined in detail. FX risk factors for both the currencies in the netting sets as well as the currencies in which the contracts are denominated must be incorporated. The yield curve must have a minimum of six maturity buckets and must capture any real non 100% correlations between different yield curves or risk factors or maturity buckets. Every significant equity or commodity or index risk factor must be included and the model must also incorporate conservative adjustments to reflect the limited price transparency for less liquid instruments. Where the model covers credit risk it must include idiosyncratic risk from the credit underlying.

The model must capture non-linear dependencies and be subject to back testing every three months which must be documented and included in the firm's policies and procedures. The model must be monitored on a continuous basis to ensure it is performing correctly. The governance and validation of the model must be carried out by persons who are suitably qualified and independent. As well as performing model reviews (at least annually) there needs to be an audit process over the accuracy and suitability of both the market data and the assumption sets used by the model. The documentation needs to be detailed and comprehensive including the key assumptions and limitations of the model and circumstances under which the model should not be considered valid.

Asset classes

ESMA is keeping the same asset class segregation that the BIS/ IOSCO propose to only permit internal model netting within the following asset class families;

Interest rates, currencies and inflation
Equities
Credit
Commodities and gold

Eligible Collateral

In 2013 the EU finalised its Capital Requirements Regulation 2013/575 in which it specifies the credit risk capital computations. ESMA is proposing to use exactly the same requirements which is efficient as many firms should already have means of identifying assets that meet these rules for the CRR compliance. The method assigns assets to one of a series of credit quality steps, only assets that are in step 3 or higher may be accepted.

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Derivatives Regulation and Control

Where a party has approval to use the Internal Ratings Based approach to calculate their credit capital adequacy they may use the same ratings and models to determine that the collateral is of a high enough quality to be accepted. This is still permitted if the IRB model is outside the EU but approved under an equivalent regime.

When eligible collateral becomes ineligible parties have up to two months to replace it with qualifying assets. Parties need to define credit qualities which require immediate replacement as well as schedules of haircuts for assets that do not qualify, to use during the replacement period.

Where a party wants to use shares or UCITS they must have a daily public price or quote and the UCITS must only invest in assets which are eligible as collateral (or other UCITS which invest in eligible assets). Equities must also belong to the indices defined in CRR, convertible bonds must have a qualifying equity as their underlying.

Almost all standard debt securities issued by governments, central banks, supra-nationals, regional government bodies, public utilities, corporates inside or outside the EU may be used. Only the most senior tranche of a securitisation may be used and the securitisation must not be a re-securitisation.

Cash is accepted as well as accredited claims for cash such as a money market deposit.

Gold is accepted provided it comes with a mechanism for recognised good delivery.

Collateral must be revalued daily

Collateral Concentration

Any collateral pledged must not have any correlation with either the creditworthiness of the collateral provider nor the value of the assets being collateralised to avoid any build up of wrong way risk.

ESMA are setting a couple of asset quality and concentration limits that will apply to all parties and a third which only applies to major institutions or on very large margin exchanges;

No more than 10% of the collateral must come from a combination of;

- Gold
- Regional authority or local government or utility bonds who may not be permitted to be treated as national government exposures

Not more than 40% of the collateral may come from a combination of;

- Securitisations
- Convertible bonds
- Equities
- UCITS that are primarily invested in the above three securities

Where the firm is a G-SII or a O-SII or where the initial margin to be collected exceeds €1 billion no more than 50% of the collateral must be from a single issuer of;

- Central governments, regional and local governments, central banks, public utilities
- International organisations and development banks

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Haircuts may be determined for all collateral through the use of internal models. Such models must use the same volatilities as the firm uses for its day to day risk management. If the firm believes the OTC will take more than ten days to liquidate then it should use a square root of time adjustment to increase the haircut. The entire process must be subject to an annual review by internal audit.

Generally ESMA is following the standardised haircut tables provided by the BIS/ IOSCO although it has incorporated the credit quality step process from CRR and also given securitisations specific haircuts. Convertible bonds get the same haircuts as equities (15%).

FX Haircut

The BIS/IOSCO propose a flat 8% haircut when the asset delivered is denominated in a different currency to the exposure. ESMA have introduced a couple of modifications.

Cash for variation margin will not be subject to an FX haircut.

If the parties' agreement documents either a cash transfer currency or a termination currency then the currency mismatch should be measured against these currencies for variation margin and initial margin respectively. If these terms are not defined then the calculation reverts to the BIS/ IOSCO position. So for example if the parties have a USD swap portfolio with an agreement that any termination will happen in EUR and a party supplies Bunds as collateral there will be no FX haircut on the initial margin but there will be on the part treated as variation margin.

Collateral Exchange procedures

Must be robust and documented. There must clear escalation procedures for non-receipt or delivery or any other breach of operation. Terms must be clearly pre-agreed and documented with counterparties including portfolio identification, segregation, notification, collection methods and dispute resolution. Firms should also have all the necessary legal agreements in place by the point of execution if not before to ensure that legal offset and netting is in place. There must be an independent review at least annually to confirm that the legal enforceability is still valid.

Segregation

Initial margin must be segregated from the firm's own assets and must be clearly visible as such in any third party or custodian's books. Collateral segregation arrangements must ensure that either party can gain prompt access to it in the event of a default by the other party. The EU is not taking up the BIS/ IOSCO's concession to allow one step of re-hypothecation of collateral under certain strict conditions but it will allow cash collateral to be invested in suitable investments.

Firms must be able to provide individual segregation arrangements. Cash must be individually segregated unless the receiver has legally binding arrangements which segregate it from house assets. Again the effectiveness of these arrangements must have an independent legal review at least annually.

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Phase in

ESMA matches the revised BIS/ IOSCO timetable with the first wave of variation margin starting on 1 September 2016 and the final tranche of initial margin commencing on 1 September 2020. Both firms have to be above the current threshold for the margining obligation to be mandatory. There is no back loading requirement, these rules will only apply to new contracts or existing contracts which have been subject to renegotiation. The final base level of €8 billion notional is to be checked annually with reference to the group wide aggregate month-end average notional for the months of June, July and August of the preceding year. Whilst the EU has struggled to achieve some reform timetables it looks highly likely that this one will be met given the advanced state of the document and its status as a regulation (not a directive) means that there is no national action required for it to become law.

The timetable is as follows;

Variation Margin	Date
Aggregate notional[1] > €3 trillion	1 September 2016
Everyone covered by the rule	1 March 2017

Initial Margin	Date
Aggregate notional > €3 trillion	1 September 2016
Aggregate notional > €2.25 trillion	1 September 2017
Aggregate notional > €1.5 trillion	1 September 2018
Aggregate notional > €0.75 trillion	1 September 2019
Aggregate notional > €8 billion	1 September 2020

The major differences from the BIS/ IOSCO proposal

ESMA is not proposing that firms need to apply and gain regulators' approval to use internal models. This is a major win as there is a strong chance that some generic industry models are adopted and the process of supplying all the documentation and testing to support an application is a significant exercise. One can easily see the inefficiency of several hundred buy-side firms all applying to the same regulator (whose model approval teams are quite finite in size) for approval of the same model. Requiring significant control, governance and review seems an effective compromise as it is augmented by the power of the regulator to request all the information it might want.

The removal of FX haircuts for cash variation margin is sensible as effectively variation margin ensures that the net spot exposure of the parties to each other is reset to zero.

Allowing inter-affiliate trades to be un-margined also seems sensible although some firms already prefer to margin these contracts as it can act to bring down the Large Exposure calculation for exposures to affiliates.

The BIS/ IOSCO are somewhat vague on concentration risk whereas ESMA have softened the single issuer rule in their previous consultation to only apply it where the initial margin exceeds €1 billion or the party is a G-SII or O-SII, as well as the 10% and 40% restrictions.

[1] The aggregate notional is determined by taking the average of the month end notionals for March, April and May of that year.

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Market Impact

I think any doubts firms may have had about this actually happening should now disappear. Most firms now trade under bilateral variation margin arrangements but these will have to be modified to be daily and to fit the minimum transfer thresholds. Existing contracts are not affected so firms will be operating a dual set of rules with dual CSAs. The administration of setting this up will be considerable, even if much of it is handled through electronic legal agreements. The major banks will move in the first wave as their notionals are almost certainly above the €3 trillion level but I think the biggest change will come when the threshold drops from €750 billion to €8billion for initial margin on 1 September 2020 as this is likely to catch many firms that are regular users of derivatives with portfolios of more modest size. Firms will continue to work hard at minimising their notionals through novations and unwinds particularly if it keeps them under a threshold.

Similarly, firms are likely to trade selectively to keep their margin below the €50 million level too. For example if a firm had an initial margin rate of say 1% then this would mean that they would need to restrict their bilateral trading to below €5 billion. One method to manage this will be for firms to clear OTCs voluntarily and take advantage of the lower initial margin regime although they will also need to look at where they can get risk offsets which will require careful tracking of the portfolios they have in the CCPs and also bilaterally with their major counterparties. The market already factors the nature of collateral agreements when contracts are priced. This will become yet more complicated. Firm's whose assets are not suitable for delivery as collateral will need to resort to credit enhancing techniques and this may increase the amount of low quality assets on term financing arrangements.

Overall the imposition of initial margin will decrease the effectiveness of OTC contracts but I do not think it is likely to make them uneconomic for most users.

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