

# Margin for non-cleared OTC derivatives

Navigating an uncertain regulatory  
landscape



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# Overview

As part of the Group of 20 (G20)'s commitment to stabilize and protect the financial system following the crisis in 2008, the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) created the Working Group on Margining Requirements (WGMR) to establish global requirements for margining of non-cleared OTC derivatives.

In September 2013, the WGMR published a final policy framework for non-centrally-cleared derivatives. The final framework imposes wide-ranging changes such as the universal exchange of variation margin (VM) and two-way initial margin (IM), restriction of eligible forms of collateral to highly liquid assets, segregation for initial margin and documentation requirements to govern collateral relationships. These requirements will impact various financial institutions and require front-to-back infrastructure changes.

Since the release of the final margin policy framework, regulators in the United States, European Union (EU) and Japan have proposed rules principally consistent with the WGMR final policy framework yet still divergent in key areas, further complicating an already substantial implementation effort for impacted organizations.

While many impacted organizations have mobilized internal and industry-wide programs to address these regulations, much uncertainty remains as to whether market participants can be adequately prepared for the economic and operational impacts of the new margin regulations.

## Global fragmentation

Compliance with VM requirements across all regions will be required starting December 1, 2015. IM requirements will be phased in based on aggregate gross notional amounts. The following differences in the proposed regulations will add to the implementation burden of global institutions.

VM and IM compliance schedule																									
	<p>Exceeds</p> <ul style="list-style-type: none"> <li>USA \$0 (zero)</li> <li>EU €0 (zero)</li> <li>Japan ¥300b</li> </ul> <table border="1"> <thead> <tr> <th>Date</th> <th>USA</th> <th>EU</th> <th>Japan</th> </tr> </thead> <tbody> <tr> <td>Dec.1, 2015</td> <td>\$4t</td> <td>€3t</td> <td>¥420t</td> </tr> <tr> <td>Dec.1, 2016</td> <td>\$3t</td> <td>€2.25t</td> <td>¥315t</td> </tr> <tr> <td>Dec.1, 2017</td> <td>\$2t</td> <td>€1.5t</td> <td>¥210t</td> </tr> <tr> <td>Dec.1, 2018</td> <td>\$1t</td> <td>€0.75t</td> <td>¥105t</td> </tr> <tr> <td>Dec.1, 2019</td> <td>\$3b</td> <td>€8b</td> <td>¥1.1t</td> </tr> </tbody> </table>	Date	USA	EU	Japan	Dec.1, 2015	\$4t	€3t	¥420t	Dec.1, 2016	\$3t	€2.25t	¥315t	Dec.1, 2017	\$2t	€1.5t	¥210t	Dec.1, 2018	\$1t	€0.75t	¥105t	Dec.1, 2019	\$3b	€8b	¥1.1t
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Covered entities	<ul style="list-style-type: none"> <li>Financial and systemically important nonfinancial entities are covered.</li> <li>EU requires collection of margin from third-country NFC minus<sup>1</sup> equivalents.</li> <li>US and Japan exempt all nonfinancial entities.</li> </ul>																								
Covered transactions	<ul style="list-style-type: none"> <li>IM and VM are required for all non-cleared OTC derivatives.</li> <li>Physically settled FX forwards and swaps are exempt.</li> <li>US exempts options on securities (e.g., equity options).</li> <li>EU and Japan exempt interaffiliate transactions.</li> </ul>																								
Eligible collateral	<ul style="list-style-type: none"> <li>Cash and highly liquid securities are eligible collateral for IM and VM.</li> <li>US requires VM to be cash in US\$ or currency of swap obligation.</li> <li>EU and Japan impose an 8% haircut for VM when the currencies of the derivatives transaction and collateral differ.</li> <li>EU imposes explicit concentration limits on types of collateral.</li> </ul>																								
IM models	<ul style="list-style-type: none"> <li>IM models should cover potential future exposure at the 99% confidence level over a 10-day liquidation period.</li> <li>Netting is permitted within broad risk categories (four in the EU and seven in the US).</li> </ul>																								
IM segregation	<ul style="list-style-type: none"> <li>IM collateral is required to be segregated from proprietary assets.</li> <li>US requires segregation at third-party custodians.</li> <li>EU and Japan permit other legally effective arrangements.</li> </ul>																								
Documentation	<ul style="list-style-type: none"> <li>EU and US define explicit requirements for netting agreements and other documentation.</li> <li>US requires margin for legacy transactions if under the same master netting agreement as post-compliance-date transactions.</li> </ul>																								

<sup>1</sup> Nonfinancial counterparties below the clearing threshold.

# Industry constraints

Proposed reforms to margining of non-cleared OTC derivatives will impose significant challenges across all functions of the collateral management life cycle.

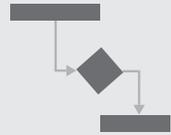
- ▶ Suppressed implementation timing given the delay in issuance of final rules
- ▶ Significant technology, documentation and operational investments to meet the “big bang” variation margin requirements on December 1, 2015
- ▶ Development of criteria to filter and flag in-scope entities and instruments for phasing in requirements
- ▶ Complex front-to-back changes to collateral systems to support multiple agreement processing (e.g. legacy and post-compliance agreements) with varying margining mechanics and elections across jurisdictions
- ▶ Uncertain process for obtaining regulatory approval of risk-based initial margin methodologies
- ▶ Significant technology changes to implement reconciliation of initial margin attributes and dispute resolution protocols
- ▶ Burdensome documentation requirements and procedural setup due to mandatory segregation of collateral posted as initial margin

## Planning for success

Plans for implementation should include the following key activities in each of the four following areas:

### Program management

- ▶ Define governance structure and key stakeholders
- ▶ Develop implementation plans with key projects, milestones and checkpoints based on known compliance dates
- ▶ Assess timing and resource constraints and define mitigation
- ▶ Mobilize global cross-functional task forces



### Client onboarding and information flow

- ▶ Analyze existing relationships and identify expected phase-in dates
- ▶ Initiate design of target state data and information flow across systems
- ▶ Develop internal and external communication strategy and approach for client outreach



### Margin methodologies and analytics

- ▶ Select an initial margin calculation approach and begin implementation efforts
- ▶ Document an initial margin calculation methodology, assumptions, valuation of conceptual soundness and testing procedures
- ▶ Assess integration points with impacted calculations (e.g., capital, liquidity, funding, pricing, stress testing)
- ▶ Identify necessary attributes to support the dispute resolution process



### Collateral management processing

- ▶ Conduct an in-house review of key systems and processes; document target state business and functional requirements
- ▶ Design high-level collateral management target state workflow (including new data fields to be consumed by the system)
- ▶ Assist in developing processes to compute gross notional calculations to determine expected phase-in year for IM
- ▶ Assess the costs of third-party custodian accounts and determine processing changes required to support third-party segregation



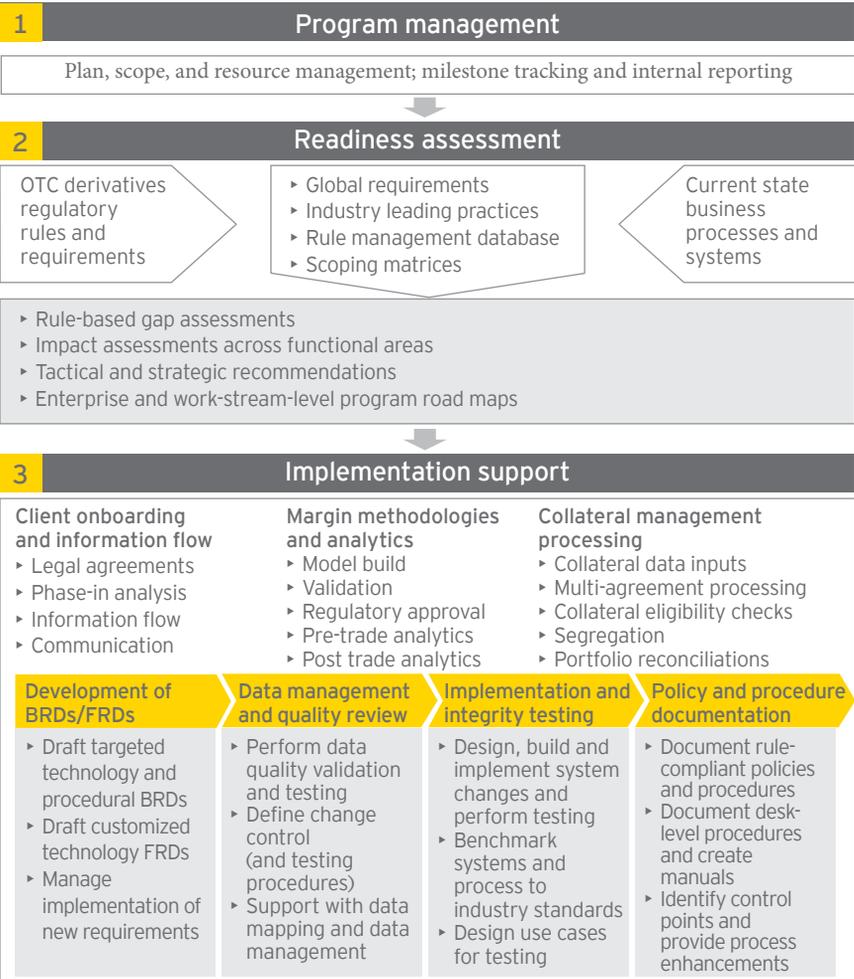
# Getting started

Given the complexity of the changes imposed by the global margin regulations, organizations should begin to mobilize in-house implementation efforts to meet the rapidly approaching compliance timelines and be responsive to the expectations of the regulators.

<b>Rules</b>	<ul style="list-style-type: none"> <li>▶ Monitor issuance of rules as they become final and prepare for change based on the proposed rules across jurisdictions</li> </ul>
<b>Regulatory advocacy</b>	<ul style="list-style-type: none"> <li>▶ Maintain active dialogue with regulators via industry forums and bilateral discussions</li> </ul>
<b>Industry initiatives</b>	<ul style="list-style-type: none"> <li>▶ Actively engage in industry initiatives to leverage collective compliance and standardization efforts</li> </ul>
<b>Implementation plan</b>	<ul style="list-style-type: none"> <li>▶ Establish contingency implementation plans and identify timeline dependencies to final regulations</li> </ul>
<b>Allocate budget and resources</b>	<ul style="list-style-type: none"> <li>▶ Assess current budget and resource alignment to plan for upcoming change</li> </ul>
<b>Prepare and mobilize cross-functional team</b>	<ul style="list-style-type: none"> <li>▶ Develop an in-house program and define the governance structure focusing on implementation efforts across regions</li> </ul>

## How EY can help

Our approach highlights three progressive phases designed to prepare for global planning and implementation of the margin requirements. Our methodology takes into account the nuances of each regulatory jurisdiction to assist institutions in moving to a globally consistent target operating model.



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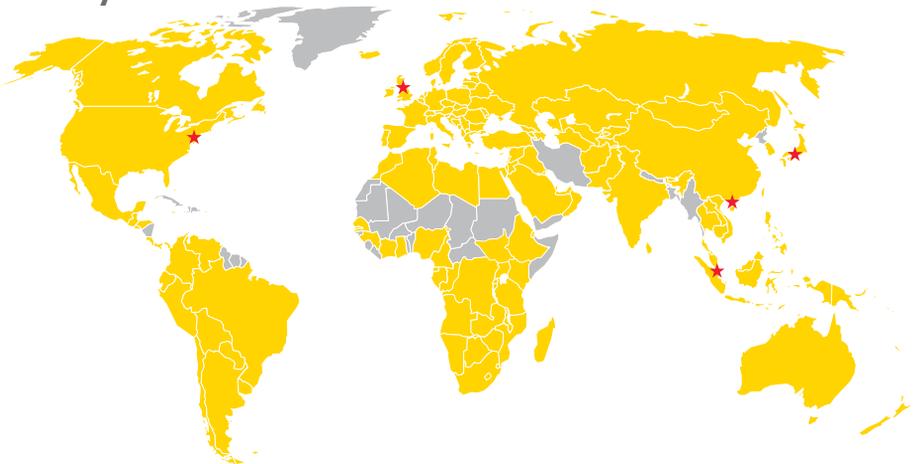
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## Why EY



■ Countries with EY offices

★ Major financial centers EY has performed G20 derivatives reform projects

- ▶ Dedicated global team with capabilities in the Americas, Europe and Far East focused on G20 derivatives reform including uncleared OTC margin/collateral reform
- ▶ Cross-functional experience implementing collateral management and OTC derivatives reform across various functional areas including risk, operations and technology
- ▶ Market leader with respect to implementation and program management for client onboarding, margin analytics and collateral management

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