Initial Margin
Ready for the final wave

Uncleared Margin rules

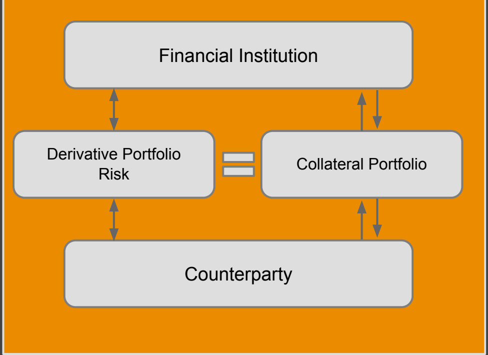
Initial margin introduction

The journey of initial margin requirements have been long and initially encompassed large global banks. But we've now reached the final wave of the rollout and with phase 5 (2021) and phase 6 (2022) we will expect to see a significant part of Danish Financial Institutions being in-scope for initial margin under the uncleared margin rules (UMR)

Initial Margin background

Uncleared margin rules were put in place to ensure similar mechanism covering the non-centrally cleared derivatives as seen from central clearing

Collateral regime pre-initial margin

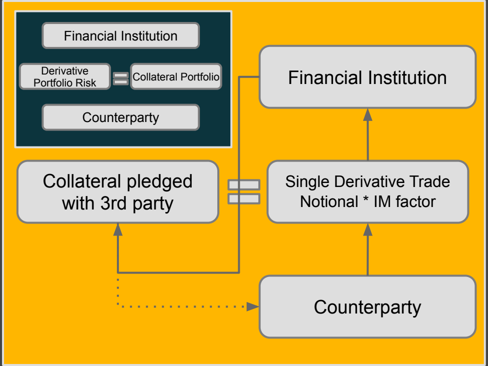


Collateral is only exchanged for the margin (risk) that is reflected in the market changes of the value of the entire nettet derivative portfolio with all counterparties subject to an ISDA CSA agreement. Under UMR known as variation margin.

ISDA comments on the final wave

"...over 1,000 NISCs* and 9,000 new relationships in this final phase…"
"...self-disclosures should be provided at least 24 months before the relevant IM go-live date…"

Collateral regime with initial margin



For every new uncleared derivative trade there should now be pledged collateral as initial margin for the specific trade. This will be posted to a 3rd party custodian on a specific initial margin account where the collateral will be locked and cannot be reused. Variation margin continues unaffected.

Are there any risks?

Yes!

1) **Deadline:** especially for institutions in scope for phase 5, i.e. models and infrastructure pipelines with custodians that communicate collateral exchange and status must be built and tested months in advance.
2) **Legal risk:** highly complicated process to implement initial margin, on an operation scale, but even more so on the comprehensive legal work required.
3) **Stakeholder**: A large number of stakeholders internally, i.e. front office, legal, compliance, operations and external counterparties to be coordinated and negotiated with.
4) **Bottlenecks**:A rush of due diligence checks,negotiations, implementation, and testing in the months approaching go-live dates is likely to create bottlenecks for custodians and swap dealer firms with large numbers of NISCs*.

Evolution of initial Margin thresholds under the Margin requirements for non-centrally cleared derivatives. Calculated as average aggregate notional amount (AANA)

2016	EUR 3,000 bn
2017	EUR 2,250 bn
2018	EUR 1,500 bn
2019	EUR 750bn
PHASE 5 - 2021	EUR 50bn
PHASE 6 - 2022	EUR 8bn

*newly in-scope counterparties

Initial margin requirements overview

There's many steps involved in getting ready for initial margin when trading non-centrally cleared derivatives. Below is a high-level overview of some of the most challenging steps we've seen in the market. Firms potentially in scope for phase 5 or 6 should be implementing the steps below now!

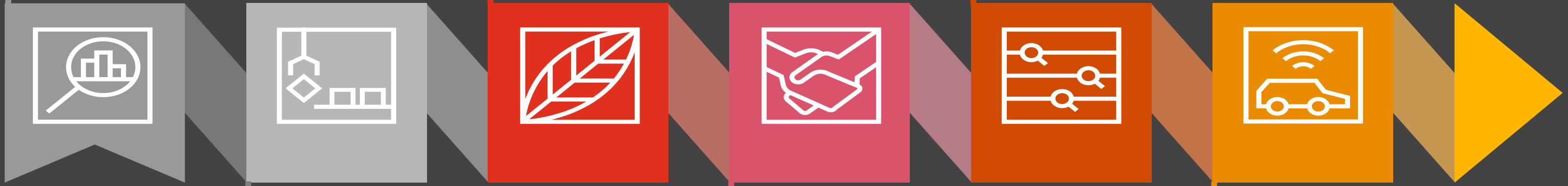
Notional Threshold

Initial margin only required to be collected if gross notional amount of uncleared OTC derivatives above €50Bn (2021),€8Bn (2022) Aggregate average notional amount (AANA) for preceding year either for counterparty or counterparty's group.

IM Threshold

No initial margin required from counterparty where amount due does not exceed €50Mn. The initial margin thresholds specified are the maximum amounts permitted. Parties may agree to a lower, or zero, IM threshold.

Firms possibly in scope for phase 5 or 6 of the initial margin under the uncleared margin rules should be doing this now!



Analysis & Calculations

- AANA calculation & analysis
- Jurisdictions
- Compression
- Novations & clearing options

Tech & Software solution

- Selection of possible software vendors
- Outsourcing partner

Modelling

- Analyse margin model options
- Identify appropriate initial margin model (e.g. schedule, SIMM, other)

Initial Margin agreements

- Negotiation of regulatory initial margin agreement with counterparties

Segregated Custodial Accounts

- IM specific custodial accounts
- Setting up segregated custodial accounts

Backtesting

- Backtesting of initial margin
- Reconciliation with counterparties
- Back-testing is a requirement for initial margin models

Critical challenges and opportunities

Not a single point that is more problematic than others, it's all a very difficult process! How do I become compliant with the uncleared margin rules

Implement margin target operating model

- Margin rules impact operation and IT capabilities front-to-back, from trade capture, exposure calculations, call management, dispute management, asset sourcing and collateral settlement
- TOM implementation will cover impact assessment, TOM design, business requirements design, IT specification, IT build and testing

Legal repapering

- Counterparties need to amend or replace existing margin agreements with in-scope counterparties or stop trading un-cleared derivatives post regulatory
- Go-live dates:

  Initial margin (IM) agreements phase 5 september 2021 and phase 6 september 2022

IM model build

- Despite the relatively simple nature of the ISDA Standard Initial Margin Model (SIMM), its implementation and incorporation into existing IT systems has posed substantial challenges to earlier phases
- Significant work involved in creating model documentation, completing validation, applying for regulatory model approval, and establishing governance frameworks

Timing of calculations & collateral

- Calculations of initial margin obligations are required within 1BD
- Collateral must be provided on the BD of the calculations with same day settlement

Costs & limits

- There are numerous initial margin specific concentration limits
- Cost of OTC trading will go up due to the additional financing and operational costs.
- Potential for using high quality liquid assets from variation margin collateral flows to raise cheap cash

Collateral optimisation

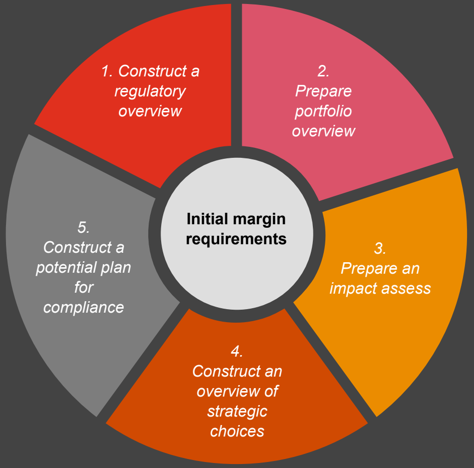
- Collateral becomes a treasury function monitoring collateral flows, investment department portfolio managers and treasury users might want to block positions for optimization which has a potential Profit & Loss effect.
- For pledged and received physical collateral we'll see an increased oversight, and an increase in substitutions. With IM the collateral could become a pre-trade decision.

PwC can assist in the implementation of the initial margin requirements

PwC recommends an assessment as first step in the preparation for initial margin:

1) Construction of a regulatory overview containing detailed information on initial margins requirements
2) Preparation of a portfolio review (based on current notional and strategic direction)
3) Preparation of an impact assessment on the requirements (with current derivative portfolio) describing how the organization will be affected
4) Construction of an overview of strategic choices (i.e. offset/close down contracts to minimize notional, prepare for initial margin regime, FSA dialogue to achievement postponements)
5) Formation of a potential action plan with defined tasks, roles, regulatory deadlines, requirement specifications and resource requirements

When completing this assessment the organization and PwC will be able to determine next steps in order to be compliant with the uncleared margin rules.
We can carry out this assessment as a short one month strategic assignment!



Examples of possible strategic solutions and related impact

Aim to avoid breaching the €50Mn IM threshold

Establish multiple new counterparties to spread out trading

Document to the FSA that the IM threshold will no be breached in a foreseeable future

Positive Effect
- Possible postponement of IM rules (3-4 years), otherwise required in all non-cleared trading of derivatives

Consequences
- Not all Financial institutions necessarily have operations departments ready to cope with sharp increases in number of counterparties
- Substantial legal work and onboarding to be carried out
- A need for thorough analysis, documentation and planning ahead

Avoid being in scope for phase 5 of IM rules

Comprehensive analysis of AANA calculations and portfolio composition to conduct targeted compressions and novations

AANA calculation below the notional threshold

Positive Effect
- Firm is below the notional threshold and thus not in scope for IM rules

Consequences
- Short term strategy unless AANA can aim for the lasting threshold of €8bn in phase 6
- Interrupts trading strategies, possibly impacting client returns and costs
- Puts a long term cap on the trading volumes of the firm

For more information

Contact Financial Markets & Risk

www.pwc.dk

Succes skaber vi sammen …