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The Future: Margining uncleared derivatives

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In September, the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) released the final framework ("Framework") for margin requirements for non-centrally cleared derivatives. The Framework is designed to provide guidance to regulators in implementing G-20 commitments for uncleared derivatives margin requirements.

The future: margining uncleared derivatives

This article considers, as against existing market practice, key principles of the final framework for margin requirements for non-centrally cleared derivatives recently released by BCBS and IOSCO.

INTRODUCTION

In September, the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) released the final framework ("Framework") for margin requirements for non-centrally cleared derivatives. The Framework is designed to provide guidance to regulators in implementing G-20 commitments for uncleared derivatives margin requirements.

The Framework is intended to apply to all OTC (over-the-counter) derivatives which are not centrally cleared, but excluding physically settled FX forwards and swaps. Unlike centrally cleared OTC derivatives whereby the original trade between the two original contracting parties becomes a series of matching trades with the clearing house (also known as a CCP) and its clearing members as parties, uncleared contracts remain bilateral ie, between the two original contracting parties alone.

This article seeks to examine certain key principles of the Framework and to contrast existing market practice with how such principles can be expected to play out in practice. This article does not seek to explore the Framework in detail or to examine the nature of the "covered entities" to whom the requirements are expected to apply (or indeed applicable thresholds, minimum transfer amounts and other such criteria).

To date, a large proportion of trades in the OTC derivatives and foreign exchange world has been collateralised using credit support documentation published by the International Swaps and Derivatives Association (ISDA), in particular, so far as English law is concerned, the Credit Support Annex ("Bilateral Form – Transfer") which dates back to 1995. One major change brought about by the Framework is that title transfer, being inconsistent with the principles of segregation, will no longer be the dominant method of posting collateral.

This change, as well as others, will mean that new documentation arrangements will be necessary to implement the Framework's requirements.

MANDATORY EXCHANGE OF COLLATERAL

The Framework requires that collateral must be exchanged between the relevant parties.

This is a key divergence from existing market practice, as existing documentation (for example the ISDA Credit Support Annex) provides that a party with exposure has the right but not the obligation to require that a delivery of collateral be made by the other party. Under the Framework, the parties must be appropriately collateralised.

The terms "initial margin" and "variation margin" refer to the different components of posted collateral. Different criteria apply to initial and variation margin under the Framework, in contrast to existing market practice whereby, generally-speaking, initial margin and variation margin are treated as part of the same collateral pool and are not treated differently.

Variation margin is designed to cover present exposure between the parties according to the current mark-to-market value (ie, profit or loss) of the contract. It is designed to reflect what is actually owing to the "in-the-money" party at any one time.

Initial margin is a buffer amount to cover the time delay between the determination of the value of the contract and the actual delivery of collateral – in other words it is intended, within certain expectations, to reflect the potential future exposure under the contract. The higher the expected contract volatility, the higher the required initial margin.

<u>POSTING INITIAL MARGIN</u>

In the "end-user" portion of the derivatives market it has been typical for the end-user (for example, a hedge fund) to post initial margin to the dealer, for the primary reason that the dealer is providing a service to the end-user and should not have to take credit risk on its customer (the hedge fund).

(Whether or not the dealer is in fact a better credit risk than its customer is another matter.) It would be extremely unusual for a dealer to post initial margin in favour of its customer.

Under the Framework, initial margin is required to be exchanged by both parties, without netting of amounts collected by each party (ie, on a gross basis). The requirement for the exchange of two-way initial margin in bilateral trades is a major change for the OTC derivatives world. This is designed to be a protective measure for both parties to a trade, on the basis that the exchange of initial margin on a net basis may not result in sufficient collateral being available to cope with a default situation.

The Framework requires that initial margin must be held in such a way as to ensure that: (i) the margin collected is immediately available to the collecting party in the event of the counterparty's default; and (ii) the collected margin must be subject to arrangements that fully protect the posting party to the extent possible under applicable law in the event that the collecting party enters bankruptcy.

These requirements may be consistent both with the collecting party itself holding securities collateral and with a third party holding cash or securities collateral on behalf of the parties. It is questionable whether cash held under the UK client money rules in their current form would be "*immediately available … in the event of the counterparty's default*" (this topic on its own could merit a page of discussion), although in principle a third party holding collateral on the parties' behalf should be able to make it "immediately available" to the secured party.

<u>DETERMINING THE AMOUNT OF INITIAL MARGIN</u>

Under existing market practice, parties to a transaction generally agree upfront the amount of initial margin pertaining to a particular trade, with the dealer (which will initially be the collecting party) stipulating an amount in accordance with its own risk models.

In the new world under the Framework, initial margin must be calculated along prescriptive lines. Initial margin must be calculated based on a 99% confidence level over a 10 day horizon (or longer, if variation margin is not collected on a daily basis) based on historical data that incorporates a period of significant financial stress. Counterparties may choose to base initial margin calculations on either internal models approved by a covered entity's national regulator or on a standardised schedule (a recommended version of which is set out in the Framework, with percentage amounts ranging between 2% and 15% of notional exposure), but may not "cherry pick" between the two for derivatives in the same asset class. Whilst the recommended percentages may not be out of line with amounts typically specified nowadays, a more standardised approach can be expected in the future.

<u>ACCEPTABLE COLLATERAL</u>

Under existing market practice, cash in mainstream currencies such as US dollars or euro is typically accepted as collateral by most market participants, as well as very liquid debt securities such as US treasury bills and equivalent debt instruments issued by certain

European countries.

The Framework dictates that securities collected as collateral must be capable of being liquidated in a reasonable amount of time to generate proceeds to protect the collateralised party from losses in the event of a default by its counterparty. Crucially, the collateral should hold its value in a time of financial stress. This suggests very highly-rated, very liquid securities only.

The Framework requires national supervisors to specify eligible collateral types, at the same time suggesting that collateral types such as cash, gold, high quality government securities and certain equities forming part of a major stock index, would all be suitable. The Framework indicates that model-based haircuts for collateral should be permissible but also proposes a list of standardised haircuts that may be applied. (A “haircut” in this context refers to the amount by which the value of non-cash collateral is written down for the purposes of determining its value for covering a party’s exposure.)

Save perhaps under a prime brokerage-type arrangement whereby a prime broker takes security over a portfolio of assets which may include or consist of equities, counterparties in the OTC derivatives world do not typically accept equities or gold as collateral. Currently, there is no market standard for haircuts and, as such, the new arrangements are likely to become market benchmarks, and not just for collateralising OTC derivatives.

TREATMENT OF COLLATERAL

In theory a counterparty does not take credit risk in respect of variation margin because variation margin reflects the present mark-to-market value (ie, profit or loss) in the trade at the relevant time. The provision of variation margin can also be described as a “settlement” of gains and losses, throughout the duration of the contract. Again, in theory, initial margin is provided as a buffer within which prices/values may move before collateral is delivered to cover the new exposure. In practice, movements in mark-to-market values often mean that initial margin is needed to cover exposure, especially in respect of an extended period of delay, for example between default and close-out.

Under the Framework, variation margin is not subject to any restrictions on rehypothecation, whilst various conditions govern how initial margin must be held. “Rehypothecation” refers to the process by which a party takes full ownership of assets in its possession, whence they become its own proprietary assets, with the result that it can do whatever it likes with them.

Rehypothecation became very topical following the demise of Lehman Brothers and the consequent heightened awareness of credit risk. In short, rehypothecation is good for the collecting party insofar as it permits the collecting party to put the collateral to use and to earn fees in doing so (and hence it is good for the liquidity of the relevant asset in the wider market) but it is bad for the posting party insofar as the posting party agrees to forego its ownership rights in the asset and instead becomes unsecured, with merely a right to redelivery of equivalent assets.

Under the Framework, rehypothecation of initial margin is permitted, but only for the purpose of hedging customer positions and only subject to restrictive conditions. Since, for this purpose, “customers” include only “buy-side” financial firms and non-financial entities, but not dealers or market makers in derivatives, margin collected in the interdealer market may not be rehypothecated.

Customer collateral collected as initial margin must be segregated from the collecting party’s proprietary assets and the collecting party must give its counterparty the option to have its initial margin individually segregated.

This again rules out use of the ISDA Credit Support Annex in its current form because it does not provide for segregation of collateral from the collecting party’s proprietary assets.

CATEGORIES OF COLLATERAL ACCOUNT

As with the new arrangements under the European Market Infrastructure Regulation (EMIR) for cleared transactions, the Framework seems to be laying the groundwork for a system whereby initial margin collateral is held on a segregated basis in either an individually segregated account or in a general pooled (or “omnibus”) client account. Similar to the concept of individual client segregation under EMIR for cleared transactions whereby excess collateral must be posted to the CCP and distinguished from the collateral of other clients or clearing members, in the case of uncleared transactions the Framework requires that the posting party is given the option to have its own individually-segregated account in which the posted collateral attributable to it is held (thereby providing the means by which that specific collateral can be identified and limiting the possibility that other parties may have claims on it).

Analysing areas of credit risk between the collateral regimes under EMIR for cleared and uncleared collateral would reveal significant differences, but similar concepts nevertheless apply to both.

SEGREGATION

The concept of segregation is generally thought to refer to assets being kept separate from the holder's own assets and/or being protected against the holder's insolvency by virtue of being held in that way. In this sense segregation may be achieved by either the collecting party holding the collateral as custodian subject to a charge in its favour (meaning that the posting party retains ownership of the collateral until the charge is enforced to satisfy the outstanding debt) or by the collateral being held with a third party, again subject to a security interest in favour of the collecting party (or rather, in this context, the secured party). The former generally works where securities are posted as collateral, whilst the latter generally works where either cash or securities are posted.

INITIAL MARGIN REMAINS A CUSTOMER ASSET

The Framework requires that the collected collateral must be treated as a customer asset (ie, the ownership rights of the posting party must be respected) and segregated from the collecting party's proprietary assets until rehypothecated to a third party.

Once rehypothecated, the third party recipient must segregate the collateral from its own proprietary assets. This suggests that securities collateral must be held in custody both by the collecting party prior to being rehypothecated and by the third party recipient of the collateral, and that cash collateral must be held subject to the UK client money rules (or equivalent) or otherwise segregated with a third party.

This condition is itself protective of the posting party's collateral as compared with title transfer, whereby the posting party becomes unsecured immediately when the collateral is posted. The fact that a right of rehypothecation is granted and may be used immediately sounds similar in principle to title transfer, yet it is nonetheless more protective for the posting party since it forms the "backdrop" as to how the collateral must be held.

LIMITS ON REHYPOTHECATION

The Framework provides for restrictions on rehypothecation as follows. The customer's written consent to rehypothecation is required for the collecting party to be able to rehypothecate at all (or, to be more precise, the collecting party must inform the posting party of its right not to permit rehypothecation, as well as informing it of the risks associated with consenting to rehypothecation, namely that it may lose any excess collateral).

Where initial margin is provided on an individually segregated basis, it may be rehypothecated only to support hedging positions arising out of transactions with that particular customer. Where initial margin has been provided on a non-segregated basis, it must be used for hedging positions arising out of transactions for customers generally (ie, the "pool" of customer collateral may be used in respect of the "pool" of customer transactions).

This makes sense insofar as one can choose between one's own account risk and the risk of the customer pool more generally. It is conceptually similar to the principle under EMIR that, for cleared transactions, customers must be offered individually segregated accounts at the CCP. However, in the case of uncleared transactions, the posting party takes credit risk against the collecting party (or other third party) instead of against the CCP.

The Framework provides that initial margin may be rehypothecated only once.

In other words, the collateral may be rehypothecated by the collecting party and passed to a third party, but the third party may not pass it on to anybody else. The effect of this is that, although the posting party still takes unsecured risk on the collecting party, the risk that the collecting party will not be able to redeliver collateral to the posting party is reduced because it has assurance that the third party will be holding the assets and therefore will be able to redeliver them to the collecting party.

("Assurance" in this context means merely that contractual restrictions will be in place between the collecting party and the third party in relation to the assets.)

Finally, in the hands of the collecting party, the collateral of customers who have consented to rehypothecation must be segregated from customers who have not so consented and collateral must only be rehypothecated to, and held by, an entity that is regulated in a jurisdiction that meets all of the specific conditions under the Framework, and in which the specific conditions can be enforced by the collecting party. The Framework requires that the collecting party and the third party (to whom the collateral has been rehypothecated) keep records to show that the relevant conditions under the Framework have been complied with, and the level and volume of rehypothecation should be disclosed to authorities so that they can monitor any resulting risk.

CONCLUSION

The Framework suggests that the new collateral arrangements for uncleared OTC derivatives may be structured and documented in several different ways, for which we can expect "solutions" to emerge in due course.

Overall, the Framework is well constructed and impressively coherent, and can be expected to deliver significant improvements in the way in which collateral is handled. This should in turn promote greater confidence in the wider system. The right of rehypothecation (even a limited right with safeguards) is a little anomalous perhaps in that it dilutes to some extent the robustness of the system. No doubt this grand compromise in favour of liquidity and commercial interests was inevitable as part of the overall package.