EMIR Uncleared Margin Rules: Phase 5

Background

These new uncleared margin rules are the final pieces of the EMIR risk mitigation plans for OTC derivatives and are part of the EU implementation of commitments made by the G20 group of countries.
The rules were calibrated with the explicit intention of reducing systemic risk and promoting central clearing.

Over the next two years, Uncleared Margin Rules (UMR) will capture more and more buy-side firms, as the regulatory thresholds for applicability get lower.

Product scope

The new rules apply to all newly transacted OTC derivatives contracts that are not cleared by a central counterparty (CCP) and are transacted after that individual counterparty's relevant phase-in date.

Following products are considered non-clearable by a CCP: Variance Swaps, Cross-Currency Swaps, swaps complexes, options non-standard.

Who will be affected? And when?

Post relevant phase in dates, counterparties to uncleared OTC derivatives must comply with these new rules subject to the categorisations used by EMIR – a Financial Counterparty (FC) or a Non-Financial Counterparty having non-hedging activity above certain clearing thresholds.

When the first phase of implementation began in September 2016, it applied to those firms with a notional value of non-cleared derivatives exceeding €3 trillion, effectively capturing only the largest dealers.
It has fallen each year in September to €2.25 trillion in 2017 and €1.5 trillion in 2018.
It is now set to drop to €750 billion in 2019 and just €8 billion in 2020.

During waves 1-3 of UMR, only some 34 global asset managers come under the scope of UMR. But waves 4 and 5 will see that expand to 1,200 firms, who between them will have some 9,500 counterparty relationships.

Additional actions done on industry for UMR 5 Phase

ISDA sent an industry association letter to regulators in September 2018 called for the phase five threshold to be raised from €8 billion to €100 billion, which would cut the number of new entities by 83% without materially reducing the volume of initial margin posted.

ISDA said "This will create certainty and reduce operational complexity for smaller firms, without compromising safety and soundness." One of the key policy objectives of the margin requirements was to reduce systemic risk, but analysis shows the rules are not appropriately aligned with this goal"

Challenges

The timing, the scope and the number of relationships to deal with on a bilateral basis, is a challenge for smallest entities. Operational challenges associated with the calculation and posting of IM and VM, it will inevitably be more difficult for smaller firms that do not have the same internal resources and budget to devote to the project.

According to our and industry experience in implementation of previous waves, huge amount of tech and infrastructure changes for the IT and operational teams within firms are expected.

How can i-Fihn Consulting help you?

Based on years of experiences in the implementation of regulatory requirements and with the knowledge of his experts on clearing area, i-Fihn could guide you to establish new requirements and optimizations efficiently. In addition, we support you in the integration with the operative business.
Attention points are:

- IM Implementation

Many of the newly in-scope firms will be familiar with posting variation margin, but IM presents a very different challenge that will require systems and processes to be adapted or built from scratch.

How will each firm and its counterparties calculate IM (eg, using the ISDA Standard Initial Margin Model (ISDA SIMM), regulatory tables (also known as grids) or some other method)?

Each firm needs to agree on eligible collateral and haircuts with each counterparty and with custodians.

How each firms will prepare a regulatory IM calculator? Develop calculation capacity, or set up with a vendor?

Firms have to conduct portfolio matching/ISDA SIMM test calculations with counterparties, once IM calculation methodologies will be implemented and tested.

- New Documentation

Firms have to negotiate and agree new documentation with every counterparty; third-party custodial relationships will need to be set up.

The process of negotiation of new IM documentation can be complex and laborious. It is a significant operational task to repaper contracts, set up custody accounts and move to the daily exchange of margin.

- Operational Challenges

With firms suddenly exchanging much more margin, many more disputes have arisen, which had to be monitored and managed through operations reporting and managing of the process could be intense.

Exchanging margins every day will require new operational set ups.

If you have any questions regarding this i-Fihn Consulting Memo or you would like to reach us, please contact i-Fihn Business Unit Clearing & Post Trade Activities:

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