VM as “Settlement to Market” on cleared OTC markets

Background

Today, an increasing number of banks are now recording variation margin on cleared derivatives as settlement payments rather than as transfer of collateral. These contracts are called “settled to market”. It is a recent innovation in derivatives trading (introduced in 2015 by CME and LCH and validated by ISDA in 2017). It has helped banks reduce regulatory capital and derivatives exposures.

Settle to Market (STM) treats Variation Margin at CCPs as settlement instead of collateral. This has the possibility of reducing Leverage Ratio costs and hence lowering regulatory capital charges.

The overall cash flows under a CTM and STM arrangement for a derivative contract with the same terms would be the same in amount and timing. The prominent difference is that the CTM contract would have a cumulative MTM with an equal amount of collateral posted by the counterparty holding the loss position, while the STM contract would reflect a MTM of zero and no collateral posted.

This practice, which occurs particularly for cleared swaps, allows these banks to take ownership of the collateral they receive.

Variation Margin on an OTC derivative may now be treated as cash settling an outright exposure to zero every day, rather than collateralising a contract. Two new acronyms are introduced – CTM (collateralised to market) and STM (settle to market).

What is the rational for banks?

- Saving scarce resources mainly on Single Fund Resolution (FRU) and on expected Net Stable Funding Ratio (NSFR) costs

The Basel Committee replied to frequently asked questions related to the treatment of settled-to-market (STM) derivatives under Net Stable Funding Ratio (NSFR) that:

Derivatives structured as “settled-to-market” should be included in the calculation of the 20% of derivative liabilities (with a national discretion for jurisdictions to lower the value of this factor, with a floor of 5%)
The replacement cost amount of these derivatives should be calculated as if no settlement payments and receipts had been made to account for the changes in the value of a derivative transaction or a portfolio of derivative transactions.

- Reduce balance sheet size for bank and the branches

Rather than recording an asset (mark-to-market) versus a liability (pledged collateral), this means that a derivative can show a single value on the balance sheet. STM removes the large balance sheet consumption of OTC derivatives.

In other words, STM derivatives contracts cleared through CCPs should be considered as a “single unit-of-account” (instead of two units-of-account: the derivative unit-of-account and the collateral unit-of-account), with the variation margin transfers being cash flows of the derivative itself. Under the STM approach, variation margin does not constitute collateral, and so, there is no “financial asset” for the pledger’s right to reclaim collateral or “financial liability” for the secured party’s obligation to return collateral or liabilities being recognized.

The cash flows serve to settle and reduce the recognized asset or liability arising from the derivatives' MTM, and not to result in additional financial assets. Bank of America Merrill Lynch (BAML), Morgan Stanley, JPMorgan, Goldman Sachs, Wells Fargo, and Citigroup all started treating the variation margin on their cleared swaps as settlement instead of collateral in 2017. The shift allowed the banks to cut billions off of their gross derivative values.

Challenges

Still a big number of banks and financial entities are in CTM model for VM payment. To switch to STM model in front to back and finance infrastructure means a complete review of technical and functional architecture.

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:

- Operational Challenges

For collateral management, portfolio analysis on existing OTC contracts will determine the strategy of switch. Impacts on existing settlement and custodian SSIs impacts should be analysed and cash flow management should be adapted.

- Accounting Chain Challenges

Existing and new OTC products will be integrated into new settlement and accounting process chain.
In order to profit from advantages linked to STM, finance systems should be adapted to reflect figures in balance sheet.

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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