FinOps Report

Swaps Margin: The Final Sweep of Document and Ops Morass

APRIL 5, 2019 BY CHRIS KENTOURIS — LEAVE A COMMENT

For collateral management operations and IT managers at hundreds of small to mid-sized broker -dealers and fund managment shops the nightmare of handling the new regulatory-imposed initial margin requirements for uncleared derivative contracts has just begun.

Phase four of the US and non-US regulations, effective September 2019, and the ultimate phase five version, effective September 2020, are expected to capture far smaller-sized financial firms than the first three phases starting in 2016. Fund management shops falling within the Phase five timeframe are expected to face the most challenges as they might have either never posted initial margin (IM) or done so with broker-dealer and bank counterparties voluntarily outside the scope of any regulatory mandate.

The global trade group International Swaps and Derivatives Association (ISDA) anticipates that 1,100 firms will be in scope for phase five– a ten-fold increase from those in 2019. A large broker-dealer could have about 100 counterparties to deal with from phases one through three and more than 1,000 in phase five. If a recent polling done by buy-side technology provider SimCorp is any indication of how well fund managers are coping, the results aren't promising. Only seven percent of the 200 asset management firms attending SimCorp's recent webinar on IM say they are fully prepared.

Unlike variation margin (VM) which is meant to address fluctuations in the daily value of an uncleared swap contract, IM is intended to protect against a counterparty's bankruptcy. Although calculating regulatory-required IM might sound like a simple one-time event, preparing the documentation will take up forty percent of the total workload, predicts Boston-based research firm Celent. Doing the math will take up to 30 percent.

Each financial firm may need to create at least four separate contracts for each counterparty relationship reflecting initial margin requirements and account control rules for custodians. Drafting the contracts necessary to confirm the rules of engagement for IM won't be as easy as adding language about IM to existing VM contracts. "Counterparties will generally have to enter into and negotiate IM credit support annexes (CSAs) and credit support deeds (CSDs) and one or two account control agreements," says Ilene Froom, a partner with the law firm of Reed Smith in New York. "Counterparties have to decide which regulatory regime (s) to apply, how to treat negotiated independent amounts, which methodology to apply for calculating IM, who will be the calculation agent and who will be the custodian."

ISDA has tweaked its CSAs and their European version– CSDs– to accommodate firms falling under phases four and five. Still, compliance managers at US fund management firms tell FinOps Report that the negotiation process remains a bit cumbersome because there are so many elements to sort out. Not everything can be accomplished by simply checking off a box.

Applying Right Math

Before even calculating regulatory IM, fund managers, banks and broker-dealers will need to determine which phase they belong to, if any. To do so they must measure the daily aggregate average notional amount (ANNA) over three months– March, April and May. If the figure falls to over US$750 billion or E750 billion under either US or European regulations, the firm will fall under phase four. If the figure considered a "material exposure" for US regulations or falls to over US$8 billion or E8 billion for European regulations, the firm can wait until phase five.

"Calculating AANA isn't as easy as it sounds," explains Darren Thomas, a New York-based managing director of IHS Markit, which offers swaps processing, pricing and documentation services. "For most regulatory regimes, the calculation must be at the consolidated group level aggregated over all subsidiaries and include transactions such as forward currency swaps that don't require posting initial margin."

When crunching numbers, counterparties must also take into account subtle differences between US and foreign regulatory regimes as to what should be included in their math. Case in point: US regulations on Phase four require the counterparty to rely on figures for March, April and May of 2019 on a daily business basis. By contrast, European regulations call for a calculation to be made on the last business day of March, April and May of 2019. In the case of Phase five, US regulations on "material swaps exposure" also call for using daily figures from June, July and August of 2019 while European regulations on the E8 million threshold call for using the average daily aggregate notional amount as of the last business day of March, April and May of 2019. About forty of the 200 asset management representatives attending SimCorp's recent webinar claim they are having trouble calculating their ANNA and more than 100 say they aren't certain which phase of the IM regulations apply.

There are also important regulatory distinctions as to whom is allowed to do the IM calculations. European regulations require that the fund manager and broker-dealer calculate their IM separately on their own. US regulations permit the fund manager to delegate the calculation of IM to their broker-dealer or bank counterparties. Compliance managers at some US fund management shops tell FinOps Report they will still do their own work to avoid potential disputes.

Although fund managers and their sell-side counterparties have several IM methodologies to choose from the sensitivity-based Standard Initial Margin Model (SIMM) devised by ISDA has proven the most popular despite the challenging calculations required. Because broker-dealers favoring SIMM appear to be calling the shots, fund managers might have no alternative but to embrace SIMM, albeit begrudgingly. Alternative methodologies aren't receiving as much traction, because they might result in a higher initial margin. Broker-dealers also don't want to have to ask regulators for permission to use proprietary models. Proving the validity of their models can end up being far more costly and time-consuming than relying on the already-blessed SIMM.

Calculating IM is just the beginning of the operational work involved. "Fund managers and broker-dealers separately have to continually monitor whether they have to post initial margin at all based on whether they exceed the US$50 million or E50 million threshold," says Mathew Keshav Lewis, senior vice president at Axiom, a New York firm focused on technology-based legal services. Just one transaction could place the firm over the threshold.

Tough Choices

Fund managers and broker-dealers will also separately have to decide how they will handle independent negotiated IM for legacy transactions out of scope with the regulations. That analysis will require them to evaluate one of three options; either deal with separate calculations and payment flows for independent margin and regulatory initial margin; rely on the allocated margin method; or use the greater of margin method. "One would expect that parties posting independent collateral would prefer to use the allocated margin flow or greater of margin flow approach as they will result in a lower amount to be posted than the distinct margin flow approach," says Froom.

Here is a simple example of how each method would work: say a fund manager has to post US$40 million in initial margin for trades in scope for regulatory IM and US$100 million for independent IM.Under the distinct method, the fund manager would send the broker-dealer two payments for a combined US$140 million. In the case of the allocated margin flow, the total payment made in two separate flows would come to only US$100 million which represents US$40 million for regulatory IM and US$60 million for independent IM. That is because the allocated method reduces the amount of independent IM by the amount of regulatory IM. In the case of the greater of margin flow, the total payment would also come to only US$100 million. However, in that instance the US$100 million represents the greater of US$100 million and US$40 million and there is only one payment flow.

As the allocated margin and greater of margin methodologies require posting the same total amount of margin the decision on which one to use then comes down to at least two critical factors, explains Lewis. "The first factor relates to whether a firm's operational infrastructure and collateral management systems can accommodate multiple margin calculations and cash movements," he says. "The second will be which calculation methods are agreed with counterparties." The amount of leeway fund managers will have likely enjoy likely depends on the size of their book for business with their broker-dealer counterparties.

Custody Agreements

Sending over regulatory-required IM isn't as simple as posting the right securities directly to a counterparty account. Fund managers and broker-dealers will be required to use a custodian as an intermediary and sign either a third party or a tri-party account control agreement which defines the responsibilities of the custodian. In either case, the IM posted by the fund manager or broker-dealer to be segregated or separated from the custodian bank's own assets.

"The third party account agreement will only require the custodian to move collateral at the behest of either the fund manager or broker-dealer," explains Andrew Cross, a partner with the law firm of Perkins Coie in Washington, D.C. "The tri-party agreement puts the custodian in more of an agency role and gives the custodian discretion to carry out what have historically been described as collateral management functions."

Of the two custodial agreements, the triparty agreement is the obviously the more costly to implement but from what fund managers tell FinOps Report it is the one most broker-dealers prefer and could even demand fund managers implement. Regardless of which one is used, it is critical for any conditions involving collateral use to match whatever is stated in the initial margin agreements, says Cross.

Like any custody arrangement, the third-party and tri-party models raise concerns for fund managers and broker-dealers should their custodian go out of business or decide to no longer offer services. If the custodian doesn't want to do the work anymore, the answer is simple: find another one quickly. There are a handful of brand-name custodians willing to step in.

Resolving matters in the event of a custodian bank's bankruptcy becomes a bit messier. "The insolvency of a large custodian bank would be unprecedented and require the intervention of market regulators in the manner prescribed by insolvency regulations that apply to financial institutions," says Cross. "Initial margin at the insolvent custodian would post to a successor custodian." However, for certain buy-side firms, such as mutual funds, there are additional regulatory hurdles to overcome, such as a fund board needing to approve a new custodian. "That [scenario] adds another layer of regulatory complexity to an already complex insolvency proceeding," says Cross.

Broker-dealers and banks relying on either international securities depository Euroclear Bank in Brussels of Clearstream in Luxembourg as their custodians for IM services will need to sign separate specialized agreements with either depository. Because neither securities depository accepts fund managers as members, a fund manager may also be required to select an iintermediary agent member of either Euroclear or Clearstream to perfect its security interests. Belgian law applies in the case of margin held by Euroclear and Luxembourg law in the case of margin held by Clearstream.

It is unclear how far the intermediary agent will want to go to help out and just how high the fee will be. Compliance managers at US fund management firms tell FinOps Report that given a choice they will always opt to use US global custodians to eliminate any legal misunderstandings. However, US fund management shops falling under the fourth and fifth phases of the IM regulations acknowledge that they might be pressured by European broker-dealers and banks accustomed to using Euroclear and/or Clearstream during the first three phases to also rely on one of the international securities depositories. The ultimate decision will come down to which side can outmaneuver the other.

Tech Options

Technology can go a long way to easing the documentation process. The ISDA Create platform, which relies on technology developed by law firm Linklaters, and the IHS Markit-operated Margin Xchange platform allow fund managers, broker-dealers and banks to work out the terms of initial margin agreements. "ISDA Create's on-line platform for preparing, delivering and executing agreements also lets parties locate and store data in a technologically feasible way," says Froom, praising the platform as "useful." IHS Markit says that its Margin Xchange platform, which also relies on the law firm of Allen & Overy and technology provider SmartDX, goes a step further in allowing for the creation of documentation for variation margin, as well as third-party and tri-party account control agreements.

A host of software vendors have also stepped up to address the operational aspects of initial margin. Case in point: TriOptima's centralized web-based service triCalculate can calculate trade sensitivities for each trade relying on ISDA's SIMM and feed those calculations into AcadiaSoft's IM Exposure Manager to make IM calculations. TriOptima predicts that each trade could require firms to calculate at least twenty sensitivities. In addition to document management, IHS Markit offers a host of platforms to handle trade capture, validate positions, calculate IM sensitivities, make IM calculations and handle the mechanics of collateral management.

For those wanting to take collateral management to the next level and evaluate the impact of initial margin on their trade strategy, margin analytics software provider Cassini Systems provides a platform which will do pre-trade calculations. "Fund managers and other financial firms can determine whether they will even want to engage in certain transactions depending on the amount of IM they have to post," says Liam Huxley, chief executive of the London-headquartered Cassini."They could decide to also change the terms of the transactions to fall below the threshold needed to post initial margin."

Cassini's platform also links with Charles River's order management platform and SimCorp's IBOR platform to allow pre-trade and executed orders to flow into Cassini's calculation engine. A separate connection to SmartStream's collateral management platform allows mutual users of Cassini and SmartStream's platforms to make initial margin calculations and forward the margin to the right counterparties.

Ultimately, the reliability of any system used is based on the accuracy of the data. Disparate data might need to be reconciled from multiple systems depending on the asset class involved, says Thomas. Hence, it might be a good time for fund managers, broker-dealers and banks to get their data management programs underway to ensure the best data quality.

Handling the IM process will also require some good teamwork between front-office trading desks, back office collateral management operations managers and counterparty managers. Arranging the right paperwork, knowing which trades fall into which phase, making the right IM calculations before and after trades are completed can help ensure the best trading strategies and most effective counterpart relationships. relationships. with the lwith trading strategies and counterparty relationships.

Unfortunately, as is typically the case with any regulatory requirements preparing early will achieve the best results only if one's counterparties are also willing to do so. It pays for fund managers to be proactive, but broker-dealers may be unwilling to negotiate with fund managers falling under phase five. From what US fund managers tell FinOps Report broker-dealers are telling them to take a number and wait their turn.

Still, having a lot of patience and determination to start earlier rather than later will pay off in the long run. "It could take several months to get onboarded from a know-your-customer perspective and to establish account control agreements." says Thomas.

Fund managers predict that custodian banks, rather than broker-dealers, might end up being the slowest link in the documentation process for regulatory IM. Fund managers could leverage existing VM and independent margin relationships with broker-dealers. By contrast, fund managers may need to negotiate from scratch with custodian banks about the terms of third-party or triparty account control agreements. Axiom says it offers on-demand attorneys to help resource-strapped buy and sell-side firms negotiate IM and account control agreements.