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Rising to the repapering challenges of IM

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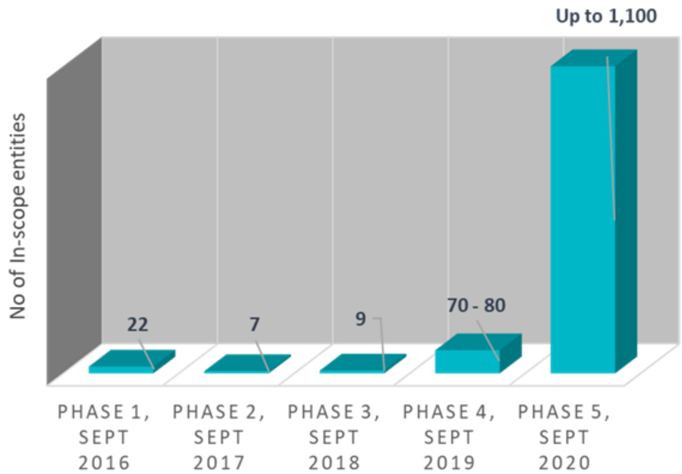
Summary

Broaching the topic of upcoming initial margin regulations, the typical response (often from a smiling lawyer) is "there aren't going to be enough lawyers". Still swamped by the ongoing regulatory tsunami and with a Brexit storm brewing, AIMA members might be forgiven for putting initial margin regulations somewhere down their "must do now" list. This article will briefly explain why this may be a costly mistake.

Introduction

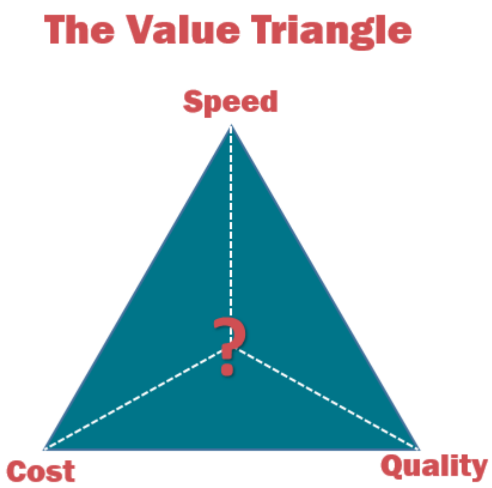
Initial margin (IM) requirements form part of post-crisis rules intended to mitigate the build-up of credit risk via bilateral swaps exposures. While variation margin (VM) accounts for daily credit risk, the exchange of initial margin provides a buffer for the time between a VM default and termination of the swap. IM is phased-in over five periods, starting and ending in September of each year, culminating in 2020. The in-scope population for each phase is determined by the notional size of an entity's derivative portfolio, calculated as an annual average of month end totals during March to May (AANA). To date, the IM obligation has been confined to the sellside, with only Brevan Howard joining phase 3.

Of the approximately 80 entities expected to be phase 4 (deadline September 2019), up to 20 may be buyside. It is anticipated that phase 4 will include at least 5 of the largest hedge funds- BlueCrest Capital Management, Capula Investment Management, Citadel, Millennium Capital Partners and Rokos Capital Management. By contrast, in phase 5 the AANA threshold gaps down disproportionately from phase 4's $750bn to include all entities with a derivatives portfolio over $8bn. As illustrated by this graph- an order of magnitude increase in affected population.



Why now?

The "magic" project management triangle mandates that there is always a compromise to be made between time, cost and quality.



Each antagonising the other, the simultaneous performance of all three is problematic. Failure to finalise the operational and legal arrangements required by the IM rules by the deadline will preclude an entity from transacting OTC derivatives. **The deadline-imposed time factor combines with an IM knowledge gap and a requirement for high-quality execution, perfectly highlighting the triple constraints**

Large in scope and complex to execute

From a documentation point of view, IM repapering represents a significant challenge in both magnitude and complexity.

In response to the challenge posed by the population increase, the industry is engaged in ongoing advocacy, ranging from increasing the AANA threshold to $100bn to exempting physically-settled FX swaps from the calculation. While the latter recommendation seems to have the tacit support of the CFTC, a reduction in phase 5 numbers will require unprecedented international adjustment to primary legislation on a short time-scale. The possibility also exists that phase 5 may itself be broken into "mini phases" by a series of threshold-dependent extensions to the deadline. Market participants should not confuse wishful thinking with a concrete solution.

While it is technically possible to amend existing credit support agreements to achieve compliance, this is far more complex and time-consuming than beginning afresh with industry-approved IM-compliant documentation. In contrast to VM's single CSA, IM repapering will usually require the negotiation of 4 documents per counterparty pairing. In addition to an eligible collateral schedule (detailing the type of collateral which counterparties can post to each other) you will also have to negotiate:

An IM CSA/CSD (or a CTA and Security Agreement):

The DNA of an IM CSA is inherently more complex than that of a VM CSA. IM CSAs calculate collateral requirements separately with respect to each "Regime" in accordance with a defined "Method" (usually, but not always, ISDA SIMM). They are also much more complex in the way they define and handle 'defaults' by the provider of collateral, the holder of collateral, and the custodian – all of which can result in the liquidation (or return) of the collateral.

Alternatively, you may prefer to negotiate a Collateral Transfer Agreement ("CTA") instead of a CSA/CSD. The CTA essentially mirrors the operational mechanics of the CSA, but does not include a security interest. It requires the execution of separate Security Agreements (one for each party when acting in the capacity of a provider of security).

Account Control Agreements

Initial margin is typically held in a segregated account by a third party custodian. This necessitates the execution of an Account Control Agreement – a document which details the circumstances in which the Custodian may release the collateral to the secured party (or return it to the provider). Usually, two Account Control Agreements are required – one for each party when acting as the provider of collateral.

It's more time-consuming

The number and interdependent complexity of IM documents mandates a markedly longer lead-time than VM. 7 days after the original VM deadline (1 March 2017) average VM CSA execution rates were reported to be 40.72% (a surprising increase from the 8% of 22 February) with only 10.45% of documents having been loaded into bank reference data systems by the deadline. The industry's failure to substantively comply by the deadline forced regulators to grant a six month extension. Regulatory forbearance is rare and any a priori reliance on this for IM would be reckless at best.

The skills are there but rare

The scarcity in sourcing experienced derivatives documentation negotiators was evident throughout VM 'big bang'. When it comes to IM, the talent pool is a puddle, a shallowness exacerbated by the fact that many of these documents are brand new or at an early stage of evolution. Scarcity translates to expense

Where to start?

Assess and monitor your AANA numbers early and use them as a guide. Taking any portfolio compression into account, if it looks likely that you will breach the phase 5 $8bn threshold- start planning now. Two basic questions- **"where will I get the resources I need?" and "how many people do I require?"**

Where will I get the resources I need?

Use in-house resource

Assess whether this is a realistic option. Can you afford to divert legal staff from 'business as usual' workstreams? If so, do you have the necessary level of experience to execute an IM repapering project properly? Many firms have already answered these questions in the negative.

Law firms

Law firms justify their relatively high cost base by the provision of legal advice. They are not set up to deliver large-scale, specialised documentation projects. As large as they are, they have limited numbers of lawyers with significant IM experience – many of whom are already effectively retained by the Phase 1 and 2 banks.

Access the temp market

The IM knowledge that does exist sits almost exclusively within Phase 1 and 2 banks. Those banks are not only taking steps to retain their existing IM knowledge, but they are actively acquiring additional IM experience in anticipation of Phases 4 and 5. If you can access the resource at all, the cost is likely to increase significantly as the Phase 4 and Phase 5 deadlines loom.

Other vendors

For many, third-party document outsourcers will represent the only real option, but vendor choice should be undertaken carefully. Practical IM experience is limited to a handful of firms. An outsourced vendor may achieve a desired price point and a tightly-controlled process, but too-frequent recourse to in-house resource will introduce inefficiencies.

How many people do I require?

The answer will specific to your own circumstances and hostage to a number of variables. It's helpful to look at two inter-related questions – "**How many negotiations can one person handle?" and "How long will a negotiation take?"**

How many negotiations can one person handle?

Estimates vary widely. Our practical experience suggests that, with full focus and the right support, one experienced negotiator can simultaneously handle between 25 and 30 negotiations.

How long will a negotiation take?

Again, phase 1-3 experience indicates that a single suite of IM documentation can be negotiated and executed within 4 months. Phases 4 and 5- market resources will be stretched by volume and a decrease in counterparty education, a delay potentially amplified by the need to familiarise with the new breed of documentation. To the contrary, a number of factors may mitigate the time required. Increased buyside participation will comprise more replications and umbrella agreements, a clear per document efficiency saving. Technology solutions are currently in development, assisting with first draft production, data extraction from executed documents and the upload to relevant systems. Time savings will result, but these solutions will not be a replacement for IM experience and their operation will require a high degree of knowledge.

Given the above, how many people might you need? **There is a Rubik's cube of variables. One year, one entity to execute with 200 counterparties would equate to approximately 3 experienced negotiators.** If you have only six months left, the number will double. If you (and your counterparties) were negotiating on behalf of multiple group entities the number will increase. This estimate assumes that all of your counterparties are as organised, motivated and well-resourced as you are. It also assumes perfect initial data and no unforeseen delays- experience does not accord. The vital process of on boarding at custodians was one of the main bottlenecks for Phases 1 and 2. The introduction for phases 4 and 5 of more (and smaller) custodians with little (or less) IM experience IM is unlikely to accelerate the process. Other considerations include: team management and supervision, location and physical resources, and provision for resource absence or failure.

Conclusion

Assess your AANA numbers early, if you might be in scope- take action now. Nobody has unlimited IM expertise. Mike Tyson was right when he said that 'everyone has a plan until they get punched in the mouth'. If your plan is to rely on possible regulatory forbearance and pick up the necessary negotiation resource nearer the event, then the punch may be coming and you do not even have a plan. The work may need to be done, but you will have little to no control over cost, timeframe or quality.