Alternative.
Legal.
Solutions.

Threshold Monitoring - IM Panacea?

DRS™
Alternative.
Legal.
Solutions.

12/12/2019

Threshold monitoring – IM panacea?

As the number of newly in-scope IM entities is set to explode, the possibility of threshold monitoring has the potential to ease what will be a huge effort across all in-scope market participants to meet the new Phase 5 and 6 deadlines. Properly implemented, threshold monitoring imposes its own significant legal and operational challenges. The potential upside is that, if newly in-scope participants estimate that their IM exposure will not approach the EUR 50 million threshold, threshold monitoring could avoid, or postpone, the need to open custodial accounts and put in place IM documentation.

ISDA estimates that around 70 – 80% of IM accounts opened across Phases 5 and 6, will be - essentially - dormant, dedicated to relationships that would - at least initially, and perhaps permanently - fall below the IM exposure threshold, thereby precluding the obligation to exchange IM. The ability to monitor IM exposure amounts, in lieu of entering into regulatory compliant documentation and opening segregated custodian accounts, stems from the March 2019 BCBS/IOSCO "clarification".

To date, this announcement has been somewhat overshadowed by the Phase 5 bifurcation into the new 50 billion AANA (from September 2020), and a final 8 billion AANA (being Phase 6, from September 2021) . However, as the market continues to make strides into Phase 5 and begins Phase 6 preparations, the potential advantages of threshold monitoring are moving to the centre of IM-related discussions.

BCBS/IOSCO clarified that, the "framework does not specify documentation, custodial or operational requirements if the bilateral initial margin amount does not exceed the framework's EUR 50 million initial margin threshold."

As market participants brace for a projected influx of 300 new in-scope entities for Phase 5, and around 700 for Phase 6, threshold monitoring may present a less onerous alternative to full repapering and the activation of custody accounts. However, it is far from being a "silver bullet". Threshold monitoring presents a significant and ongoing operational challenge and its use is subject to a number of vital caveats.

Before determining whether any of its in-scope relationships would exceed the relevant IM regulatory threshold, a market participant must still complete the same initial steps as it would if it were intending to adopt full compliance with rules. It must ensure timely completion of the self-disclosure process with their counterparties. It is important to note, that any regulatory threshold is applied to the aggregate IM amount across the parties' corporate groups, and is not allocated on a per-trading relationship basis. Further guidance as to completion of these two stages can be found within the "Compliant with Initial Margin (IM) Regulatory Requirements Following BCBS/IOSCO Guidance Statement" issued by ISDA on 21 May 2019.

Any market participant intending to rely on threshold monitoring, must determine that they are permitted to do so by their own regulatory bodies and it would be prudent to ensure that their counterparty has done the

same. To date announcements have been made by the Australian, Canadian, EU, Hong Kong, Singaporean, US CFTC and US Prudential regulatory bodies, indicating that they intend to follow the guidance issued by BCBS/IOSCO in March 2019. Japan is yet to make such a statement, although it is anticipated that they will align their positions accordingly.

BCBS/IOSCO act as the highest level of G20 oversight. Their statement is accordingly both imperious and vague. Regulators have so far been disinclined to add detail, preferring to echo the BCBS/IOSCO announcement. The second limb of the BCBS/IOSCO statement complicates what would have otherwise been an overly simplistic alternative, contrary to the spirit and intention of the margin regulation framework. Less than explicitly, it states that there is an expectation on covered entities seeking to utilise a threshold monitoring arrangement in order to defer their IM preparations to "act diligently when their exposures approach the threshold and to ensure that the relevant arrangements are in place if the threshold is exceeded".

This requirement to act "diligently" raises its own hydra-headed questions. A joint Staff Advisory issued by the CFTC and DSIO highlighted an expectation that CFTC-regulated swap dealers have "appropriate risk management systems in place to calculate and monitor initial margin amounts" and "act diligently".

The Prudential Regulator's proposed amendments to Swap Margin Rules similarly affirmed that "covered entities will act diligently when their exposures approach the threshold to ensure that the relevant arrangements needed are in place if the threshold is exceeded." Neither deign to specify what "acting diligently" means in this context.

All of this, at the very minimum, indicates that parties looking to defer their IM preparations in this manner, must have established the ability to monitor IM exposure levels and an agreed set of steps that would need to be taken should such IM exposure encroach on the regulatory threshold.

Following the 14 August 2019 release for consultation of APRA's proposed amendments to the Australian margin regulations, somewhat unsurprisingly, one respondent requested further guidance as to the requirements surrounding a compliant threshold monitoring arrangement - specifically "the level of exposures at which entities should begin this process."

APRA's response did little to quell the questions arising from market participants looking to employ such a model, stating that "as the circumstances and complexity of each APRA covered entity is different, APRA does not consider it appropriate to include specific guidance on when an entity should begin its preparation."

What is clear, however, is that a simplistic one-size fits all approach is unlikely to be a sufficient alternative to fully compliant regulatory documentation, custodial and operational requirements.

Each regulator that has so far indicated that it will allow market-participants to defer their IM preparations by way of threshold monitoring, has also made it clear that all regulatory required arrangements must be complete by the time the relevant threshold is exceeded.

It would be prudent therefore, to ensure that market-participants have obtained as much potential relevant information as possible from their counterparty in order to agree upfront what steps would need to be taken to prevent the regulatory threshold from ever being breached before the necessary formal arrangements have been fully cemented.

Market participants must still consider a myriad of other critical factors. For example,

should a counterparty indicate they wish to use a custodian with which the market participant has no existing relationship, timelines will need to be adjusted significantly. Our evaluations suggest that, without taking into account potential (possibly inevitable) bottlenecks, and including required KYC/AML checks, it can take around 3 months to complete the necessary on-boarding procedures. Such procedures are in addition to more complex tasks, such as agreeing collateral schedules.

Consideration should be given to the calculation methodology (i.e. ISDA SIMM or grid), how frequently such IM amounts will be calculated, and – if, as may be likely, one party takes responsibility for calculating IM exposure - the frequency for sharing calculations with the other party – certainly at the very least how quickly they would be notified in the case where exposure levels go beyond anticipated levels or a pre-agreed maximum.

In our experience across all IM Phases, the negotiation of IM documentation may take between 3-5 months to complete. This assumes a relatively sophisticated counterparty; the increased numbers and limited experience of Phase 6 counterparties will likely lengthen negotiating times. Already strained Phase 6 legal resources will be further impacted by the coincidence of Benchmark Reform and the enterprise-wise transition to risk-free rates.

Whilst these considerations are by no means exhaustive, they strongly suggest that in any threshold monitoring agreement the parties should set an indicative threshold well below the regulatory limit, designed so that, once breached, it would afford sufficient time to put in place all necessary arrangements. Such “sub-threshold” levels will be determined on a case-by-case basis. Careful thought should be given to the setting of the sub-threshold and projected exposure and volatility levels.

A secondary sub-threshold, higher than the first, but still below any regulatory IM threshold, may well be a useful mechanism to act as a form of backstop. It would be prudent to pre-agree both the exact figure and the consequences of any such breach (e.g. cessation of additional trading and/or unwinding of current trades) before such an event occurs. An inadvertent breach of the regulatory IM threshold, even if subsequently rectified by tools such as portfolio compression, will still result in a regulatory breach if the set-up of IM documentation and custodial arrangements is still pending.

Remember that, if multiple regimes apply, “strictest of” prevails. Each regime will have its own regulatory threshold and it is the lowest of all applicable regimes to the group relationship that must be applied. Previous phases have frequently seen market participants elect to include a buffer amount below such regulatory threshold, in order to account for potential foreign exchange rate fluctuation

With whispers circulating of market participants receiving informal notifications, barely informing them that their counterparty relationship is subject to threshold monitoring, you would be wise to question whether such a simplistic and somewhat opaque arrangement would be sufficient to fulfil the diligence requirement imposed by the framework and meet regulators’ expectations.

Certainly, in-scope entities wishing to take advantage of any threshold monitoring would be prudent to carefully consider their approach, and how they wish to formally document their agreement, before entering into any such arrangement.

DRS is an alternative legal services provider to the financial services sector. Trusted by banks, asset managers, funds and trading firms across the globe, we provide solutions that deliver rapid and efficient negotiation and remediation of document portfolios.

We achieve this by channelling deep industry knowledge and experience through hiring outstanding people, implementing a rigorous process and applying state-of-the-art technology. Our clients achieve these results without any capital expenditure or infrastructure costs.

Our team is led by industry practitioners with extensive legal and financial services expertise. We negotiate, amend and analyse contracts, in large scale or in low volumes – delivering high quality, high-value solutions on a 'business as usual' or project basis.

Please visit drs-als.com for more information about our services or contact knowledgehub@drs-als.com.

This communication is private and confidential. It is for your information only, and is not for publication elsewhere. It has been prepared solely for informational purposes and is prepared from generally available information believed to be reliable, but we do not guarantee the accuracy of the information, which should not be relied upon, and may be incomplete or condensed. Document Risk Solutions Ltd. accepts no liability for any loss or damage occurring from the use of this information. *Copyright © Document Risk Solutions Ltd. 2019*