CLIFFORD
CHANCE

INITIAL MARGIN IMPLEMENTATION
FOR 2019 AND 2020

APRIL 2019

INITIAL MARGIN IMPLEMENTATION FOR 2019 AND 2020

Preparing for the Challenges of 2019 and 2020 Initial Margin Implementation

In August 2018 the United Kingdom's Financial Conduct Authority (FCA) published a research note which identified a likely ten-fold increase in firms needing to comply with the initial margin requirements for uncleared derivatives (IM) following the final stage of the phased-in implementation in September 2020. Many smaller banks and investment firms (including non-EU firms) will be impacted and will need to implement for IM over the next two years and those firms need to start preparing now to avoid the inevitable bottleneck closer to the implementation deadlines.

This briefing highlights the key implementation challenges for in-scope entities and the importance of preparing early.

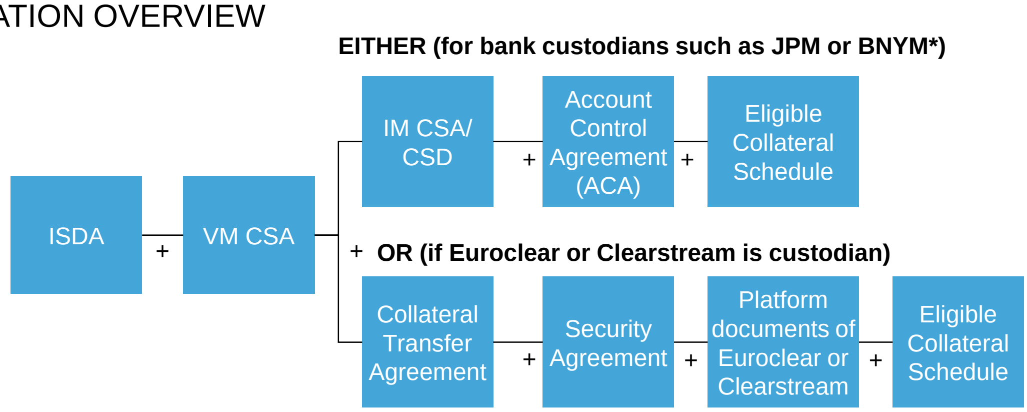
Scoping the challenge

Firms will recall variation margin (VM) repapering projects, the thousands of new credit support annexes (CSAs) which had to be agreed and the rush to meet the March 2017 deadline. The implementation challenge for IM is very different. Whilst the universe of entities within scope of IM is far narrower than for VM, for those that find themselves needing to implement for IM, the legal, operational, IT, liquidity and funding challenges far exceed those associated with VM and in-scope entities are strongly recommended to begin preparations as soon as possible. The first task is for firms to identify whether or not they are in-scope for IM (see Box 1 for eligibility criteria under EMIR). Entities not in-scope for VM will, by definition, also be out-of-scope for IM.

If in-scope for VM, a group-wide calculation of aggregate average notional amount of uncleared OTC derivatives (AANA) is necessary. This calculation will need to be done for all jurisdictions and rule sets relevant to a trading relationship. For a smaller bank or investment firm facing a major bank or dealer, for example, this will likely include both European (EMIR) and US (CFTC and/or PR) rules, each with their own exemptions and nuances, particularly when it comes to calculation of AANA and the rules around consolidation for certain entity types.

ISDA has prepared a standard form of Information Letter (published 11 July 2018) which entities can use to indicate to trading counterparties whether they are likely to be in-scope for IM in September 2019, September 2020 or not at all.

DOCUMENTATION OVERVIEW



*Note: Other custodians which maintain accounts outside New York or London may require a Collateral Transfer Agreement and Security Agreement instead of an IM CSA/CSD

BOX 1: TESTS FOR SEPTEMBER 2019 AND SEPTEMBER 2020 IM IMPLEMENTATION UNDER EUROPEAN RULES

An EU entity will be in-scope of IM under the European rules if:

- it is in-scope for VM;
- it or its "group" has an aggregate average notional amount of non-centrally cleared derivatives (AANA) that is above EUR 750 billion (September 2019) or EUR 8 billion (September 2020). This is based on the average of the total gross notional amount of all non-centrally cleared OTC derivative contracts of the entity and its group recorded as of the last business day of March, April and May of 2019 (for September 2019) or 2020 (for September 2020); and
- it trades non-centrally cleared derivatives with other entities in-scope of IM.
- Entities that are not established in the EU can be in-scope for IM if the entity would be in-scope for VM if it had been established in the EU and it trades with another entity that is directly in-scope or another entity where there is a direct, substantial and foreseeable effect in the EU.

VM VS. IM documentation		
	VM CSA	**IM documentation**
Method of collateralisation	Title transfer	Security interest
Where is the collateral held?	The counterparty	Segregated account of custodian/clearing system secured in favour of the counterparty
How is the quantum of collateral calculated?	Mark-to-market as per the “Exposure” definition in VM CSA	In accordance with regulatory requirements, ISDA SIMM or grid method
One-way or two-way collateral posting?	Two-way	One-way or two-way (While both parties will be required to post, each party may post under separate IM documentation, depending on the custodians being used)

The Legal Documentation

All jurisdictions which have implemented IM requirements require collateral posted as IM to be held on a segregated basis. This usually means that a party to a trading relationship will post IM into a segregated account held with a custodian which will then be secured under the relevant law in favour of the trading counterparty. The trading counterparty will do the same, although it may well use a different custodian for the posting of its IM. As new-in-scope entities seek to use their existing custodians and depositories for IM posting, the range of custodians offering initial margin services is increasing.

The segregation requirement complicates the legal documentation significantly. CSAs used for VM cannot be used for IM collateral posting as they do not support a segregated collateral model. ISDA has published a dedicated suite of documentation for IM (including a New York law CSA, an English law credit support deed, a Japanese law CSA and similar local law documentation if Euroclear or Clearstream are to be used as custodian).

ISDA has provided “next generation” IM documentation updated specifically for the 2019 and 2020 phases. This documentation will need to be negotiated with each in-scope trading counterparty, including bank and dealer counterparties.

In addition, custody documentation will need to be agreed. Each party will select its custodian of choice. As a result, any in-scope entity will need to review and negotiate not only the custody documentation for its own custodian, but also the documentation for each custodian used by any of its trading counterparties.

The range of documentation that any one in-scope entity will need to negotiate and agree (both as collateral taker and collateral receiver) with trading counterparties and custodians, together with the complexity of that documentation stemming from the need to meet the mandatory segregation requirements, highlights both the difference in the documentation challenge to VM implementation and the time it takes to implement for IM.

Beyond the documentation

IM implementation is more than just a legal and documentation exercise:

- **Operations** – each in-scope entity will need to on-board with the relevant custodians. KYC checks will need to be completed and accounts opened, and protocols will need to be agreed for the day-to-day operation of segregated accounts. In addition, operational functionality will need to be built to support the determination of the amount of IM which must be exchanged.
- **IT** – IT systems will need to be updated to achieve connectivity with custodians' systems and to reflect the new IM arrangements more generally, with time allowed for testing.
- **Liquidity and Funding** – in-scope entities will need to source liquid assets to post as IM collateral. Whilst an in-scope entity may wish to post cash, many custodians are reluctant to accept cash and there are regulatory restrictions on the use of cash under certain rule sets. Also, unlike collateral posted as VM, posted IM collateral cannot be reused or rehypothecated by the collateral taker.

Will the EUR/USD 50 million threshold make posting unnecessary?

Both the European and US rules allow parties not to post IM if the group-wide amount of IM which would otherwise be required does not exceed EUR/USD 50 million. This is expected to mean that a significant proportion of in-scope entities will never in practice post IM, with those close to the threshold incentivised to manage their derivatives portfolio to stay under the threshold. Under the current rules, parties under the threshold will still need to agree all the necessary documentation and systems set out above, notwithstanding the fact that no IM is exchanged.

However, in March 2019 BCBS IOSCO published a statement aimed at providing guidance to support timely and smooth implementation of the margin framework and to clarify its requirements. In particular, the statement commented on the fact that in 2019 and 2020 IM requirements will apply to a large number of entities for the first time, potentially involving documentation, custodial and operational arrangements. BCBS IOSCO noted that the margin framework does not specify documentation, custodial or operational requirements if the bilateral IM amount does not exceed the framework's EUR/USD 50 million IM threshold. Regulators in the US and EU have not yet commented formally on the statement, but it is possible that we will see guidance or amendments to rules to reflect the BCBS IOSCO statement.

Potential impact of Brexit

The timetable for the implementation of IM coincides with the implementation of Brexit projects by buy- and sell-side communities alike. Brexit-driven transfers of derivative portfolios could result in the quantum of required IM increasing and changes in the location of parties (including custodians themselves) complicates the legal and documentation analysis. The Brexit overlay is certainly an issue to keep in mind whilst planning and implementing for IM.

Given the scope of the challenges of implementing IM highlighted above, we would recommend that those which are likely in-scope of IM should commence their projects as soon as possible. In the worst case, in-scope entities which have not implemented IM by the regulatory deadline may not be able to trade non-centrally cleared OTC derivatives with their counterparties. Having acted for dealers and custodians in earlier phases of IM implementation and for asset managers, pension funds, insurance companies and funds on VM implementation, Clifford Chance are well placed to advise entities coming in to scope on their 2019 and 2020 IM projects.

CONTACTS

JAMES GEER
Senior Associate
London

T +44 207006 4295
E james.geer
@cliffordchance.com

CAROLINE DAWSON
Senior Associate
London

T +44 20 7006 4355
E caroline.dawson
@cliffordchance.com

WILLIAM WINTERTON
Partner
London

T +44 20 7006 4386
E will.winterton
@cliffordchance.com

LAURA DOUGLAS
Senior Associate
London

T +44 20 7006 1113
E laura.douglas
@cliffordchance.com

MARIA LUISA ALONSO
Counsel
Madrid

T +34 91 590 7541
E marialuisa.alonso
@cliffordchance.com

MARC BENZLER
Partner
Frankfurt

T +49 69 7199 3304
E marc.benzler
@cliffordchance.com

ANNA BIAŁA
Counsel
Warsaw

T +48 22429 9692
E anna.biala
@cliffordchance.com

LUCIO BONAVITACOLA
Partner
Milan

T +39 02 8063 4238
E lucio.bonavitacola
@cliffordchance.com

LOUNIA CZUPPER
Partner
Brussels

T +32 2 533 5987
E lounia.czupper
@cliffordchance.com

PAGET DARE BRYAN
Partner
London

T +44 20 7006 2461
E paget.darebryan
@cliffordchance.com

FRANCIS EDWARDS
Partner
Hong Kong

T +852 2826 3453
E francis.edwards
@cliffordchance.com

DAVID FELSENTHAL
Partner
New York

T +1 212 878 3452
E david.felsenthal
@cliffordchance.com

STEVE JACOBY
Partner
Luxembourg

T +352 48 50 50 219
E steve.jacoby
@cliffordchance.com

FRÉDÉRICK LACROIX
Partner
Paris

T +33 1 4405 5241
E frederick.lacroix
@cliffordchance.com

LENG-FONG LAI
Co-Managing Partner
Tokyo

T +81 3 6632 6625
E leng-fong.lai
@cliffordchance.com

SARAH LEWIS
Associate
Amsterdam

T +31 20 711 9630
E sarah.lewis
@cliffordchance.com

KIMI LIU
Senior Associate
Beijing

T +86 10 6535 2263
E kimi.liu
@cliffordchance.com

LENA NG
Partner
Singapore

T +65 6410 2215
E lena.ng
@cliffordchance.com

GARETH OLD
Partner
New York

T +1 212 878 8539
E gareth.old
@cliffordchance.com

JEREMY WALTER
Partner
London

T +44 20 7006 8892
E jeremy.walter
@cliffordchance.com

CLIFFORD CHANCE

OUR INTERNATIONAL NETWORK

32 OFFICES IN 21 COUNTRIES

Clifford Chance, 10 Upper Bank Street, London, E14 5JJ

Clifford Chance LLP is a limited liability partnership registered in England and Wales under number OC323571

Registered office: 10 Upper Bank Street, London, E14 5JJ

www.cliffordchance.com

Abu Dhabi • Amsterdam • Barcelona • Beijing • Brussels • Bucharest • Casablanca • Dubai • Düsseldorf • Frankfurt • Hong Kong • Istanbul • London • Luxembourg • Madrid • Milan • Moscow • Munich • Newcastle • New York • Paris • Perth • Prague • Rome • São Paulo • Seoul • Shanghai • Singapore • Sydney • Tokyo • Warsaw • Washington, D.C.

Clifford Chance has a best friends relationship with Redcliffe Partners in Ukraine.

Clifford Chance has a co-operation agreement with Abuhimed Alsheikh Alhagbani Law Firm in Riyadh.