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BCBS/IOSCO ANNOUNCE PHASE 5 INITIAL MARGIN SPLIT

Global standard setters have announced that the fifth implementation phase for initial margin (IM) rules for uncleared OTC derivatives will now be split into two phases, with smaller buy-side firms granted an extra year to implement these requirements. This briefing provides an overview of this change to the international IM implementation timetable and considers the practical implications for firms.

Summary

- BCBS and IOSCO have announced an extension of the final initial margin implementation phase
- The IM application date for Phase 5 firms with less than €50bn AANA of uncleared derivatives is extended by one year to 1 September 2021
- The existing 1 September 2020 deadline will continue to apply to Phase 5 firms over the new €50bn AANA threshold
- We expect national and regional policy makers and regulators will reflect this change in their implementation of the internationally agreed rules for OTC derivatives in the coming months

EXTENDING THE INTERNATIONAL TIMETABLE FOR PHASE 5 INITIAL MARGIN

On 23 July 2019, the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) issued a statement advising that they have agreed a one-year extension of the final IM implementation phase for uncleared OTC derivatives. This follows an earlier statement from March 2019, in which BCBS and IOSCO indicated that firms in scope of Phase 5 IM requirements may nevertheless be able to continue trading without new documentation in place, provided that the amount of IM they owe to an individual counterparty is below the €50 million IM transfer threshold.

Under the revised international timeline, firms with an average aggregate notional amount (AANA) of uncleared derivatives of more than €50bn will need to comply with IM requirements from the existing Phase 5 implementation deadline of 1 September 2020. However, firms with an AANA of uncleared derivatives between €8bn and €50bn will have an extra year to implement IM requirements, until 1 September 2021.

The statement explains that BCBS and IOSCO have agreed to extend the timetable in this way to support the smooth and orderly implementation of IM requirements. Industry associations, such as ISDA, had previously raised concerns that the original Phase 5 timeline and threshold would sharply increase the number of firms subject to IM requirements on 1 September 2020 in an IM 'big bang', presenting the industry with significant logistical challenges. For UK firms, the FCA estimated that this would be close to a tenfold increase.

The agreed extension is expected to smooth the implementation of Phase 5 IM requirements both by reducing the number of firms that will become subject to IM requirements for the first time on each of the September 2020 and

September 2021 deadlines and by granting smaller firms more time to prepare.

NEXT STEPS: AMENDMENTS TO REGIONAL AND NATIONAL IMPLEMENTATION OF IM RULES

This change to the international IM implementation timetable does not automatically apply to firms. Instead, policy makers and regulators would need to reflect this change in their existing implementation of IM rules, as illustrated in the following examples.

United States

In the United States, multiple regulators have issued IM rules. To implement the new BCBS/IOSCO guidelines fully, each of the Commodity Futures Trading Commission and the prudential regulators (the Federal Reserve, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation and others) would need to propose and approve revisions to their existing IM rules. The regulators have not yet responded publicly to the revised guidelines and, largely for procedural reasons, any amendments to the U.S. rules are likely to take several months to finalize.

Singapore

In Singapore, the Monetary Authority of Singapore (MAS) has already published its revised guidelines on margin requirements for non-centrally cleared OTC derivatives contracts, on 26 July 2019. The revised guidelines have amended the phase-in schedule for the exchange of IM by including a threshold of SGD80 billion for the revised Phase 5 commencing 1 September 2020 and revising the final phase with a threshold of SGD13 billion to commence from 1 September 2021.

The revised guidelines also provide that the margins requirements will not apply to a securities-based derivatives contract until 29 February 2020. Previously, the exemption from the application of the margins requirements to such contracts was granted until 31 August 2019. The revised guidelines also clarify that an "MAS Covered Entity" (i.e. the entity that is subject to the margin requirements) is not required to put in place documentation, custodial or operational requirements if the bilateral IM amount does not cross the IM threshold of SGD 80,000,000. However, an MAS Covered Entity is expected to act diligently when their exposures approach the IM threshold to ensure that the relevant arrangements needed are in place if the IM threshold is exceeded.

EU and UK

In the EU, we expect that the European Supervisory Authorities (ESAs) may seek to implement this change via amendments to the existing regulatory technical standards (RTS) setting out initial margin requirements under EMIR.

In terms of process, the ESAs would first need to consult on proposed changes to the margin RTS before submitting them to the European Commission for adoption. This could, for example, be included as part of the ESAs' upcoming consultation on proposed extensions to existing derogations under the margin RTS for intragroup transactions and equity options, which is expected to be published shortly.

In the context of Brexit, it seems unlikely that this change to the margin RTS under EMIR would be agreed and effective by 31 October 2019. In any case,

Phase 5 and new Phase 6 IM rules would not yet apply on 31 October 2019. Therefore, if the UK were to leave the EU without a withdrawal agreement including an implementation period on that date, the UK onshored version of the margin RTS under the European Union (Withdrawal) Act 2018 would not include this change. However, in this situation, the UK regulators would have powers to make binding technical standards to amend the onshored version of the margin RTS accordingly.

In its latest consultation paper CP18/19 published on 25 July 2019, the Prudential Regulation Authority (PRA) proposed making amendments to binding technical standards relating to the onshored margin RTS in respect of Phase 4 IM (the implementation date for which is 1 September 2019, i.e. before the UK is due to leave the EU) but did not include any provisions implementing Phase 5 IM requirements or the new Phase 6. We therefore expect the UK regulators to deal with Phase 5 and 6 IM implementation separately, at a later date.

As a general policy matter, the UK government and regulators have not proposed changing thresholds expressed in euro to Sterling on exit day, as this would cause significant cliff-edge risks and operational challenges for firms. However, it remains to be seen whether the they might seek to make such a change at some point in the future.

PRACTICAL IMPLICATIONS FOR FIRMS

The announcement from BCBS and IOSCO is likely to be welcome news for many firms, particularly smaller buy-side firms which will now have an extra year to prepare for implementation of IM requirements. Sell side counterparties and custodians may also welcome the splitting of the original Phase 5 in two, reducing the number of clients that they may need to onboard with IM related documentation and arrangements in advance of the original September 2020 deadlines.

In their July statement, BCBS and IOSCO also referred back to their earlier statement from March 2019, indicating that in-scope firms may be able to continue trading without new documentation in place, provided that the amount of IM they owe to an individual counterparty is below the €50 million IM transfer threshold and that they act diligently when their exposures approach this threshold to ensure that the necessary arrangements are in place if the threshold is exceeded.

Whilst many Phase 5 firms would not expect to exceed this €50 million threshold, putting in place the necessary documentation, custodial and operational arrangements for the exchange of IM is a significant exercise, as discussed in our recent briefing on practical IM implementation challenges. Therefore, firms will need to consider carefully how they would seek to monitor and ensure that they do not exceed the IM transfer threshold and/or at what point they may need to start putting these arrangements for the transfer of IM in place.

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