

# New margin regulations for non-cleared derivatives

Capital Market Risk Advisors (CMRA) has surveyed market participants about the new variation and initial margin requirements. Leslie Rahl and Peter Niculescu, partners at CMRA and members of the P.R.I.M.E. Finance Panel of Experts outline the responses on this topic and highlight the potential benefits and costs of implementing the new regulations and explain that while the new regulations seek to reduce both systemic risk and counterparty risk, they likely will not significantly curtail future legal disputes surrounding derivatives closeout.

New margin regulations for non-cleared derivatives are being rolled out. Each jurisdiction builds upon the framework published by the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) in September 2013. **Capital Market Risk Advisors** surveyed market participants about the new variation and initial margin requirements. Leslie Rahl and Peter Niculescu—partners at CMRA who have advised clients in over 15 Lehman-related derivatives disputes and are regularly called upon for their expertise in the trading, risk management, and valuation of derivatives—outline responses on the topic. Ms. Rahl and Mr. Niculescu are both members of the P.R.I.M.E. Finance Panel of Experts. They highlight the potential benefits and costs of implementing the new regulations and explain that while the new regulations seek to reduce both systemic risk and counterparty risk, they likely won't significantly curtail future legal disputes surrounding derivatives closeout.

## How far have market participants gotten in implementing new variation margin requirements?

Variation margin requirements have been standardised, requiring new or amended CSAs (Credit Support Annexes). Collateral is not fungible across old and new CSAs. While there have been a number of complaints about the cost of executing the updated CSAs, the process appears to be well on its way to completion. Most market participants have already implemented compliance with variation margin regulations, with regulatory relief for those not in compliance scheduled to expire by September 2017 in most cases.

In a **study** published on 30 June 2017, the UK's Financial Conduct Authority (FCA) has found that the implementation of the variation margin requirements does not appear to have caused a significant decline in the amount of trading or the number of firms active in the market. While this is a comforting data point, it will be interesting to see if this finding holds up both as the market spends more time in the new variation

margin regime and as the number of counterparties required to implement initial margin regulations increases (initial margin requirements are expected to carry more significant funding cost considerations discussed later in this regulatory update).

## What does the standardisation of variation margin accomplish and what are some of the accompanying costs for market participants?

The most significant change for market participants reported to us is the standardisation of collateral and haircuts. The intention that swap valuations not be sensitive to collateral valuation appears largely to have been satisfied. Furthermore, standardised collateral could in theory facilitate novation, especially at a time of distress or potential counterparty default.

The costs to standardisation are the increased funding costs, especially if cash has to be posted as collateral. The vast majority of our survey participants have expressed concern over requirements for some counterparties (mainly the larger institutions) to post and collect variation margin in cash. Slightly less than half of survey respondents were worried that limitations on eligible collateral and mandated collateral haircut schedules might impact their own funding considerations.

Multinational market participants face a greater burden as they seek to comply with slightly different local margin regulations in each of the jurisdictions that they may fall under. For example, the US has moved to T+1 settlement for variation margin while many other jurisdictions will remain at T+2. This difference across jurisdictions was cited by US-based derivatives dealers as an operational concern, as they reported that some clients were still struggling to implement T+1 settlement because of time zone differences and other logistical obstacles. Moreover, certain market participants subject to T+1 settlement requirements described the mandated shift from T+2 as a de facto limitation on collateral rehypothecation that would increase their overall funding costs.

## To what extent will new variation margin regulations be helpful in the event of future counterparty defaults?

Notably, the new regulations require the posting of variation margin for most financial counterparties, and thus would have likely precluded the viability of some pre-crisis liquidity providers that relied on AAA ratings and one-way CSAs, such as AIG, monoline insurers, and credit derivative product companies (CDPCs). However, the market had already moved toward two-way CSAs even before the new margin regulations, and thus the required posting of variation margin likely codifies market practice rather than promoting new best practices.

Overall, market participants thought that the standards embodied in the new variation margin requirements would be minimally helpful in settling uncleared swaps in the event of counterparty default. They noted that in some cases, high initial margin requirements would likely disincentivise the additional effort required to novate positions away from defaulting counterparties. The response from market participants is consistent with CMRA's experience in over 15 Lehman-related derivatives settlement claims, where we have observed that most disputes arise because of differences between mid-market variation margin posted and replacement cost (especially in light of elevated bid/offer spreads that manifested most significantly in more esoteric products with few or no market makers).

## Where are market participants currently in terms of understanding and implementing new initial margin requirements?

The implementation schedule for initial margin regulations pushes further into the future than for variation margin, with market participants in different stages of compliance through 2020 depending on the size of their positions. Yet, many have already begun to think about the impact of two-way initial margin posting.

## What aspects of initial margin regulations are market participants looking forward to?

Larger buy-side participants, who were often required by their dealer counterparties to post initial margin even before the financial crisis, were enthusiastic about independently custodied initial margin. They noted that in the event of counterparty default, recoveries are often uncertain, but that possession could be nine-tenths of the law.

## What aspects of initial margin regulations are market participants most concerned about?

The majority of survey respondents reported that the direct and secondary funding costs of implementing two-way initial margin posting, with segregated custody of collateral

in some instances, was something that highly concerned them. In particular, a few major derivatives dealers noted that they anticipated the potential reduction in counterparty credit risk capital would be minimal compared to the cost of funding initial margin, particularly given the fact that regulators have been trying to move market participants away from advanced internal model approaches for capital.

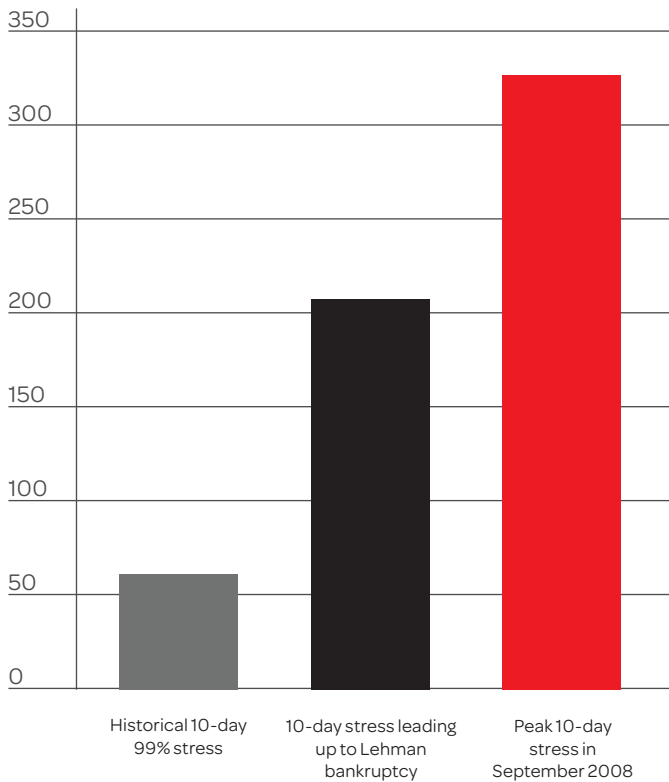
In particular, market participants were concerned that some products (e.g., total return swaps, liquid credit, certain pay-as-you-go CDS) had initial margin requirements that appear to be punitively high whereas initial margin for large size positions and less liquid products might be insufficient in the event of counterparty default. They commented that a ten-day default window seemed unrealistic for more liquid products but potentially insufficient for more esoteric products, and were unsure of specific counterparty outcomes despite the cost frictions to the system that the initial margin regulations impose.

While the new initial margin regulations may reduce systemic risk to some extent through increased collateralisation, it is not clear that it will forestall future derivatives closeout disputes. Depending on their actual exposures, non-defaulting counterparties may still find that the collateral pledged to them is insufficient to cover replacement cost.

## What are some examples of products where initial margin based on a ten-day liquidation window may be insufficient to cover replacement cost?

While for more liquid uncleared swap products, a ten-day liquidation window may be too long, the risks of certain product types can be overlooked by an approach that relies upon available historical data. Market participants should be cognisant of the risk that stress losses set via a historical, VaR-like process may not be indicative of future stresses, and that the calculation of initial margin based on historical data is necessarily vulnerable to the market regime changes that may occur just as initial margin is most needed by non-defaulting counterparties. For example, the preferred securities market experienced spread widening in September 2008 that greatly surpassed the historical ten-day 99% stress as the result of a paradigm shift in the market for preferred securities in the wake of GSE conservatorship and Lehman's bankruptcy filing. The Bank of America Merrill Lynch US Preferred, Bank Capital, and Capital Trust Securities (COPS) Index, had a ten-day 99% stress spread widening that was at most 63 bp over any 5 year period from 1996 (the inception of the index) through August 2008. Yet, in September 2008, when Lehman defaulted spreads had widened by 212 bp over the previous ten days and would go on to widen by as much as 333 bp within the week—the impact of which would have dwarfed an initial margin requirement based on the previous ten-day 99% stress of 63 bp.

bp



## How will new initial and variation margin regulations impact the landscape of the over-the-counter derivatives market?

Despite the increased protections embodied by the new initial and variation margin regulations, market participants should nonetheless be prepared to face future Lehman-style derivatives closeout disputes for their non-cleared derivatives. It is likely that for certain derivatives portfolios, there will be gaps between the replacement cost and the value of collateral (variation margin + initial margin) held against that exposure. The difference may be particularly significant for large-sized positions and more illiquid/esoteric products as a result of the standardised approach to initial margin modelling.

Moreover, as the market moves increasingly towards central clearing as the result of increased costs in non-cleared products, the resilience of central counterparties becomes increasingly relevant while also becoming more challenging because of their growing market share. Market participants will be best served by a thorough understanding of central counterparty default resolution processes as well as by diligently monitoring the interconnectivity of the central counterparties with whom they transact.

*Interviewed by Emma Millington*

*The views expressed by our Legal Analysis interviewees are not necessarily those of the proprietor.*