Non-Cleared Derivatives: Preparing for new Margin Requirements under BCBS/IOSCO

Julia: **Welcome to a DerivSource podcast. I'm Julia Schieffer, the Founder and Editor of DerivSource.com. With me today I have Nick Newport, Managing Director of InteDelta in London. Nick is well known in the industry as an expert in risk and collateral management, with a particular focus on regulatory-driven change.**

Welcome, Nick, to the podcast.

Nick: It's great to be here, thanks Julia.

Julia: **I'm interviewing Nick today to learn a little bit more about how industry participants, both buy-side and sell-side, are preparing for the BCBS / IOSCO margin requirement for non-cleared derivatives. I know this is a big concern for many of our DerivSource readers and some of you in fact are preparing strategies right at this minute for Q4 and beyond.**

Let's start by giving our readers the background into these margin requirements for non-cleared derivatives.

Nick: Well, firstly, as we all know there's a lot of talk about uncleared or non-cleared derivatives. Historically, most of the derivatives market outside of the listed derivatives market was literally what we're talking about as uncleared. It's only been with the regulatory developments of recent years with the move to clearing which has led to a specific focus on what we're now terming uncleared derivatives. So, historically, we would have talked about bilaterally traded derivatives and then with cleared derivatives coming on and those have been juxtaposed against the cleared market.

A lot of the market has now moved to clearing, particularly in the US where it's now mandatory. In Europe it's going to become mandatory sometime in 2015, and a lot of the market has already moved to clearing on a voluntary basis.

However, it does seem that there will be a large part of the market with significant volumes which will remain non-cleared, or uncleared, certainly in the near term, but potentially over the long term, because such products can't be standardised or there's not liquidity in those products, so there will remain a significant uncleared market in derivatives for the foreseeable future.

As a consequence of this, the G20 governments as part of the financial stability recommendations want to make sure that the uncleared markets are as safe and as well collateralised as the cleared markets.

As a consequence, various regulations are under discussion about how to govern the non-cleared markets and ensure there is sufficient collateral being placed for uncleared derivatives as there are for cleared derivatives.

Firstly, to set a level playing field for these markets the international rules were prepared by BCBS / IOSCO as you referred to, to create a set of international rules around this. These were discussed last year; following a consultation these rules were finalised in September. These now need to be implemented in each national or regional jurisdiction under European supervisory authorities who

have been the first to consult on these and that's currently nearing completion and in due course other jurisdictions are expected to follow, with particular interest on this in the US.

That's kind of the context: the uncleared markets aren't *new*, but there's regulation around how their collateralised which *is* new. The aim is that this will be as rigorous a collateralisation process as on the cleared markets.

***Julia*: I understand that you recently conducted a survey on industry planning for forthcoming uncleared margin regulations for derivatives. Nick, can you tell us what's the most significant finding of that survey?**

Nick: There are a number of things I'd like to point out.

Firstly, the key one is that everybody thinks these regulations are important to address, or everybody believes that they need to look at these regulations because nobody seems to think that the bilateral market is going away any time soon. In the survey we asked participants whether they thought in the medium term bilaterally traded uncleared derivatives would still be a significant part of their portfolio and pretty much everybody said, "*yes*", so everybody feels they need to work on them.

Secondly, most participants, whether they were buy or sell-side, seemed to think that they would be significantly impacted by all the aspects of the regulations, even interestingly initial margin. If you look at both the European regulations and the international regulations, initial margin is planned to be phased in over a number of years, initially with only the very large banks being impacted with over three trillion of notional derivatives in their portfolio. However, even smaller buy-side firms feel that they're going to be impacted by these regulations, despite the fact that the regulation seems to, from a mandatory perspective, give them at least some deferment or rule them out altogether of being impacted. That's an interesting finding: that people seem to think they will be impacted, maybe as a knock-on or maybe directly. That's a key thing.

Thirdly, one of the key findings was that the regulations are all being implemented by both the buy-side and the sell-side, but the buy-side are very much more cautious about embarking upon the implementation and the change before all the rules are agreed, whereas the sell-side are very much getting on and doing what they see as the firm and certain rules that are being put out.

Finally, an interesting difference between the buy and sell-side is around the modeling of initial margin and also of haircuts. The buy-side are leaning towards a standardised regulatory schedule which is outlined within the regulations as a preferred means of both initial margin and haircuts, whereas the sell-side are very much in favour of internal models, particularly for initial margin but also to nearly as great an extent for haircuts as well.

***Julia*: Sticking with the models a little bit longer, why do you think buy-side and sell-side have different views on the models used for initial margin?**

Nick: The buy-side seem to favour simplicity and ease of implementation. The standardised schedule outlined in the regulatory documentation will give a much higher level of margin than an internal model would require, however it's a lot easier to implement. So what that would imply is that many of the buy-side firms, certainly the ones who responded in favour of the regulatory schedule in our survey, they would prioritise the simplicity and ease of implementation, ease of understanding the model, over necessarily squeezing as much out of the margin as possible, whereas the sell-side very much the focus seems to be on having a model which will be as risk-sensitive as possible whilst covering the counterparty credit risk, giving the lowest amount of

Copyright for this document and podcast is retained by DerivSource. This document or any excerpts should not be republished or distributed without written notice of DerivSource.com. For further information please contact us at info@derivsource.com

margin possible and the greatest amounts of offsets between different transactions in the portfolio. That's the main difference.

Also, it's probably fair to say that such models being historic value at risk models, very well understood on the sell-side, have been used in many different processes over the years for market risk and other means, possibly less understood on the buy-side. So there's a different level of understanding around them and also different commercial parameters.

***Julia*: Is there anything that both the buy-side and sell-side both agree on with regards to these requirements for non-cleared derivatives?**

Nick: Sticking on the topic of models, what they both do agree on is that there needs to be an industry agreement around the models which are used. Whether it is using a regulatory standardised schedule, or whether it's using an internal model, everybody agrees that to ward off disputes, other disagreements around how much margin is placed, it is much better that everybody agrees on the models that are going to be used. So the prioritisation of the model, the confidence level, the historic data which feeds the model, and that the preferences are all agreed by the industry on an industry-wide basis in advance, so that ties into the SIMM or Standardized Initial Margin Model conversation which ISDA has been leading. That seems to be a big driver for both the buy-side and sell-side.

Secondly, the next layer above that is: over and above agreeing the model itself, most people seem to want to actually have the model run on a standard market utility so not install the model on their own software or either vendor or in-house built in their own environment, it's to leverage a common model which fits in an industry utility to make sure then everybody is really one hundred per cent up to date on market data and other inputs to the model and using the same infrastructure around that.

***Julia*: Who would be this industry utility that would host this standardised model? Would it be an existing utility or a new one?**

Nick: I won't mention any particular names because I know there are commercial sensitivities around some of the people offering these and not everybody has fully started publishing and marketing their offerings around this yet. However, there are a handful, I would say two to three potential providers in the market, some of whom are existing utilities or providers of risk capabilities who would like to extend existing offerings to actually meet this market need, and there are certainly some forthcoming new entrants to the market who have seen this as an opportunity to actually build out a proposition.

***Julia*: So it's very much possible that an industry-wide internal model that is hosted on a utility as opposed to internal systems or supplied by vendor systems is feasible then?**

Nick: Yes, very much so, it does seem like it. There's a demand for it and there's very much a real possibility that it can be delivered. I'm not ruling out, and certainly the survey findings didn't rule out, that some people will want to run their own model in-house or add their own vendor applications or in-house software, but there seems to be a big drive in the market, I would say about 65% of the market would prefer to be using standardised models on standardised bureau service or utility.

***Julia*: Great. Looking beyond the initial margin modeling, Nick what do you think is the biggest challenge the industry faces in preparing for these uncleared margin requirements?**

Copyright for this document and podcast is retained by DerivSource. This document or any excerpts should not be republished or distributed without written notice of DerivSource.com. For further information please contact us at info@derivsource.com

Nick: I think it's the breadth of requirements that are there. So, once you take away the initial margin conversation, there's a whole raft of different requirements within the rules, from daily exchange of variation margin through to eligibility and concentration rules, through to haircuts, intragroup exchange of margin, and so on, and so on. Whilst the initial margin rules phase in the exchange of initial margin by different thresholds of counterparties dependent upon their volume over time between 2015 and 2019, the way the rules are currently written is that all of the other rules come in as a big bang on 1st December 2015 which means that whilst they may not be as complicated to implement, because they're going in for the whole market and for all counterparties, the potential market impact may be more significant.

Whilst for many large banks actually all of the rest of the rules are fairly well-trodden territory and to some extent best practice, there's a lot of smaller players in the market in different segments on the buy-side for whom these will represent significant change, so they may be currently on weekly margin calls with many counterparties, they'll need to move to daily exchange of variation margin; they may not have the robust processes in place for eligibility and concentration, they'll need to do that; and so on with haircuts and the other aspects of this.

Certainly, in the European rules an interesting element is that even for counterparties which are not strictly caught within the rules, the European entities who are under the rules are required to try to ensure that all of their counterparties globally meet all of these requirements. Even if you happen to be a corporate counterparty that's in Asia, or a corporate counterparty in the US and you're dealing with a European-regulated entity, they need to attempt to ensure that you are exchanging daily variation margin etc with them on an ongoing basis. So the extent of the rules is across the market and will be significant, even if you take the initial margin element out of it.

***Julia*: Perfect, thanks Nick. Now, in terms of general advice, and Nick you deal with the buy-side and sell-side of institutions of various different types and sizes, so I'm curious what advice you would give our listeners who might be starting to create their strategies for addressing compliance with these non-cleared derivatives margin requirements. Are there any words of wisdom you'd like to leave our listeners with?**

Nick: I think the key thing to understand is that there's work to be done to meet the rules in a number of different areas: there's clearly significant technology change, there's also a lot of change around policies that are required, processes, documentation, and even to some extent there may be organisational change, particularly you may need your risk management departments or front office involved in the collateralisation process with the new rules because there's new things to be done. So, there's a whole range of different things that need to be done to get ready to comply with the new rules. You will need to line up a lot of different parties in your organisation to be involved in that process.

The first step is to really understand which of these rules are we certain enough about will be the final view of the rule to work on now, and which ones are slightly more uncertain and maybe need to be left to a later part of the process.

For firms which were to wait and not do anything with cross-technology process documentation policy organisation for another six months until everything was finalised they may find there's really too much to do to comply by 1st December. However, what I would say is that there is a lot in there which is pretty well understood now and in many ways is actually market best practice across the industry, so people can start to work on that.

Copyright for this document and podcast is retained by DerivSource. This document or any excerpts should not be republished or distributed without written notice of DerivSource.com. For further information please contact us at info@derivsource.com

Julia: **Great. So people should no longer be waiting around for absolute clarity, they should get working on it now as there's enough clarification and market practice, more importantly, that they can follow now.**

Nick: Yes, there is significant clarity around certain areas. There is clarity which still needs to come on other areas, particularly for example what might be rehypothecation rules coming out of the US regulations, because that has been completely ruled out in the European regulations, so many firms might want to leave that aside now but other things like variation margin, haircuts, eligibility, concentration, there's plenty of work which can get on and be started now.

***Julia*: Ok, great. Thank you, Nick, for sharing your industry insight with us today via our Podcast and listeners you can find the full transcript of this podcast and links to related articles on our Podcast Notes page which is available on DerivSource.com.**

Thank you for listening to this DerivSource podcast. See you next time.

DerivSource

Copyright for this document and podcast is retained by DerivSource. This document or any excerpts should not be republished or distributed without written notice of DerivSource.com. For further information please contact us at info@derivsource.com