Journal of Financial Regulation
2016 Annual Conference
Hong Kong
24 June 2016

Toward Global Regulatory Harmonization: Mandatory Margining for Non-cleared Swaps

Keith Noyes
Regional Director, Asia Pacific
ISDA

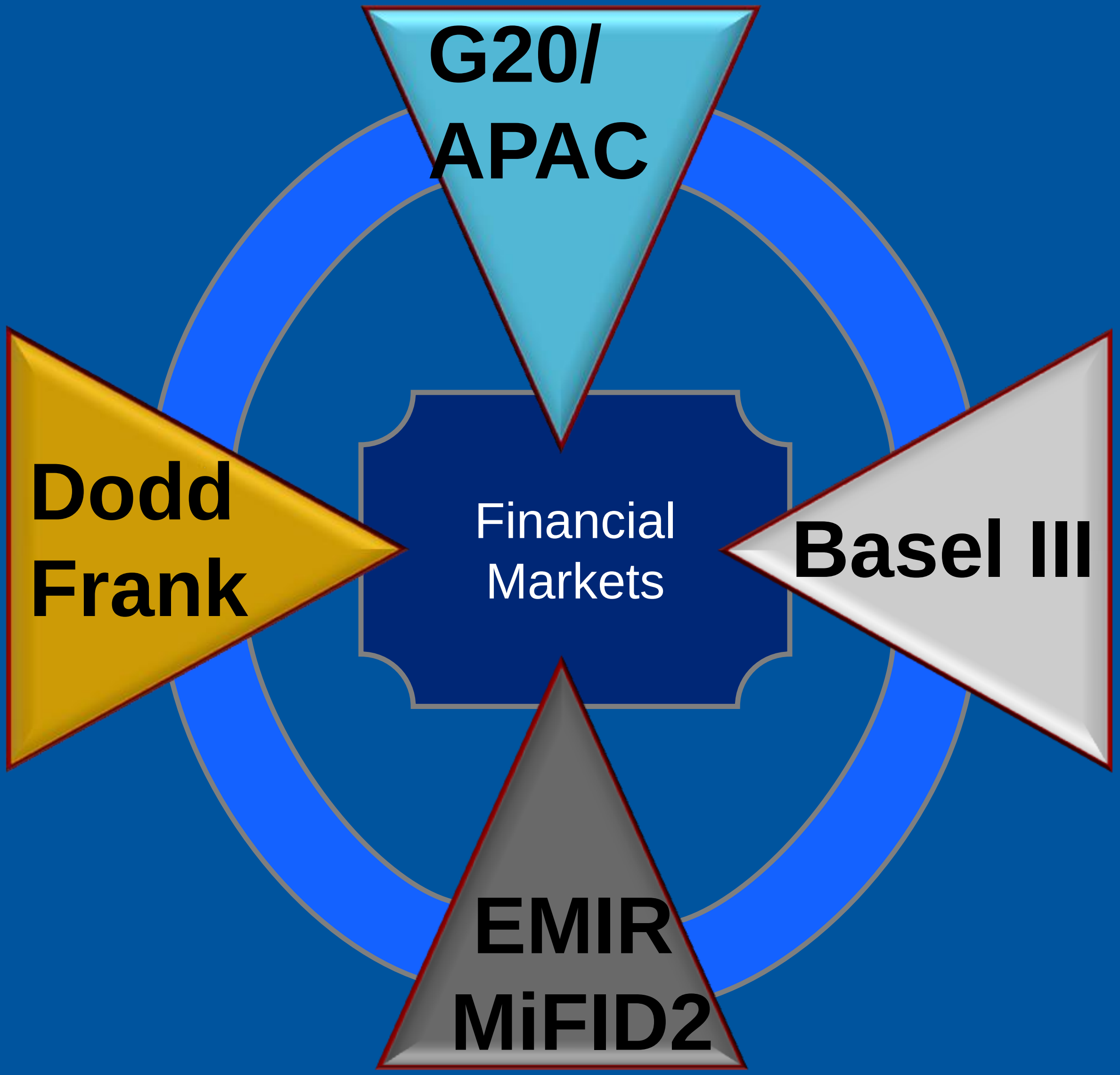
The G20 Commitment

"Major failures in the financial sector and in financial regulation and supervision were fundamental causes of the crisis. Confidence will not be restored until we rebuild trust in our financial system. We will take action to build a stronger, more globally consistent, supervisory and regulatory framework for the future financial sector, which will support sustainable global growth and serve the needs of business and citizens."

"Improving over-the-counter derivatives markets: All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse."

Leader's Statement, The Pittsburgh Summit, September 24-25, 2009, Page 9.

Regulatory Landscape



Why do Extra-Territoriality Issues Arise?

- OTC derivatives market is a cross-border market.
- Regulatory implementation timelines have differed across jurisdictions.
- OTC derivatives activity had largely been an unregulated activity.
- Banks are key market participants. They largely operate on a branch basis => home vs host country regulation?
- CCPs and TRs – key players in the new OTC derivatives marketplace => how to regulate them?

What are the Extra-Territoriality Concerns?

- Duplicative requirements that increase the cost of transacting.
- Or worst, incompatible or conflicting requirements that prevent a transaction from taking place.
- Distortion of competition/reduction of customer choice.
- Unintended impact on clients/counterparties not directly subject to regulation.
- Lack of process for mutual recognition or comparability.
- Regulatory uncertainty and disproportionate compliance burden.

Mixed results to date

Clearing

☑ ***Substantial OTC volume has moved permanently to the cleared space***
☒ ***Implementation of clearing mandates has not been coordinated***
☑ ***Cleared pricing is generally favorable to that of non-cleared pricing***
☒ ***A basis has opened up between the same products cleared at LCH and CME***
☒ ***Third country CCP recognition has been an exhaustive process and is incomplete***
☑ ***Additional products are becoming clearable***
☑ ***Overall a success***

Trade Reporting

☑ ***Mandatory trade reporting implemented in the majority of G20 countries***
☒ ***Reporting fields not sufficiently standardized to allow cross-border data aggregation***
☒ ***Lack of standardization has significantly increased IT costs***
☒ ***Results so far generally below expectations***

Platform Trading

☑ ***Has allowed new participants to enter the market***
☒ ***Has led to fragmentation between US "SEF" and non-US platforms***
☒ ***Has arguably reduced liquidity***

Capital

☑ ***Increased capital requirements have made banks safer and more resilient***
☒ ***Capital rules not coordinated with other policy objectives (e.g. leverage ratio/client clearing)***
☒ ***Driving less profitable firms to close business lines thereby increasing concentration***

How Should we Address Extra-Territoriality?

- Agree on a roadmap and international standards.
- Implement reforms at home.
- Set up a cooperation mechanism to make sure that regulatory frameworks work together.
  - Mechanisms that ensure that regulators can rely on each other's supervision.
  - Clear rules that show the market which rules apply, and when.
  - Procedures that help enforcement of the rules.

Regulatory convergence, reliance and prudential cooperation.

Speech by European Commissioner Michel Barnier on Feb 15, 2013, http://europa.eu/rapid/press-release_SPEECH-13-125_en.htm?locale=en

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Non-cleared Margin Framework

- G-20 leaders agreed to develop jointly regulatory margin requirements for uncleared swaps. In September 2013, the Basel Committee on Banking Supervision and the International Organization of Securities Commissions published a framework for margin requirements for non-centrally cleared derivatives ("BCBS-IOSCO Framework") that was intended to be used by G-20 regulators in adopting their own rules.
- In March 2015, BCBS IOSCO updated the implementation timetable.
- The BCBS-IOSCO Framework needs to be implemented by national regulators.

WGMR Scope

- All uncleared derivatives between “covered entities”:
  - Generally requires margin collection in trades between "financial entities" and "systemically important non-financial entities".
  - "Financial entity" defined by national regulator.
  - Physically-settled FX forwards and swaps excluded.
  - Exception from IM requirement for entities that are part of a consolidated group with OTC derivative notionals below € 8 billion.

WGMR Key Requirements

- Margin Requirements:
  - Both parties must collect VM with no threshold.
  - Two-way IM, if IM requirements apply, €50 million threshold can be applied to consolidated group.
  - Potential future exposure covered should be consistent with a one-tailed 99% confidence interval over 10 days.
- Variation margin should be subject to an enforceable netting agreement.
- Collateral should be liquid and stable and should not correlate with credit of provider.

Operational Implications

- Client classifications
  - Multiple sets of rules in different jurisdictions means multiple classifications for each entity in each location
  - Self disclosure
    - Bilateral
    - ISDA amend
- Operational difficulties of bespoke collateral arrangements. For example, separate CSA for a branch
- Custodian readiness and capacity
- Cross-border implementation – ‘strictest rule applies’?
  - Timelines, eligible collateral, counterparty and product scope, model approval, non netting jurisdictions/ cross-border treatment
- Legal documentation
  - Compliant legal documentation must be in place in order to trade
  - Bottlenecks in re/ papering close to effective date for each phase
  - Multiple legal documents:
    - Two VM CSAs – legacy and new
    - IM CSD
    - ISDA self-disclosure form or bilateral disclosures
    - Custodian and repo agreements
    - VM ISDA protocol

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Uncleared Margin Rules - Implementation Timetable

Rules finalization (Timing uncertain)

–Final rules

Sep 2016

– **First wave VM and IM**

March 2017

– **VM phase in complete**

Sep 2017

Sep 2018

Sep 2019

Sep 2020

Now

– Awaiting final rules.

– Work on new infrastructure and documentation in process.

First Wave

– Exchange of VM and IM if average aggregate notional amount of non-centrally cleared derivatives for group for the March, April and May prior to September (**AANA**) exceeds **<u>€3 trillion</u>**

March 2017

– VM requirements apply to **<u>all</u>** other covered entities

Sep 2017 - 2020

– IM AANA threshold decreases annually;

– Sep 2017 – € 2.25 trillion

– Sep 2018 – €1.5 trillion

– Sep 2019 – €0.75 trillion

– Sep 2020 – **<u>€8 billion</u>**

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Stop the press…

EU Aims for Final Swap Collateral Rules by Year-End, Mock Says
2016-06-09 14:33:43.127 GMT

By Silla Brush
(Bloomberg) -- The European Commission aims to complete collateral rules for the multi-trillion-dollar swap market by the end of the year, spokeswoman Vanessa Mock says.

* "As the original timeline would not have allowed for the standards to be finalized by September, the date of application for the requirements applying to the small number of firms covered by the first wave of the rules will be modified and a new date set," Mock says by e-mail. "Our objective is to deliver the standard before the end of the year and for firms covered by the first wave of the rules to be required to comply before the middle of next year."
* Commission is "stongly supportive" of global standards on non-cleared margin, Mock says.
* "The small number of firms covered by the first wave of the requirements will in many cases also be covered by rules in other jurisdictions and therefore should continue to prepare for implementation," she says.

Questions?