

Uncleared margin
rules – 10 actions
Phase 5 and 6
counterparties must
take now



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Introduction

The uncleared margin rules (UMR) present an opportunity for the industry to implement scalable and robust collateral management processes while in parallel delivering against regulatory requirements. The Basel Committee of Banking Supervision (BCBS) and International Organization of Securities Commission (IOSCO) introduced the global margin policy framework to reduce systemic risk in the over-the-counter (OTC) derivatives market by requiring the exchange of both variation margin (VM) and initial margin (IM), based on a phased-in compliance schedule. The first four phases are behind us, and covered entities with an average aggregate notional (AANA) of OTC derivative exposure greater than €50 billion will come into scope on September 1, 2021 (Phase 5), and covered entities with an AANA greater than €8 billion but less than €50 billion will come into scope on September 1, 2022 (Phase 6). Incoming firms across both Phase 5 and 6 need to act now and accelerate their programs so that required capabilities are implemented in time, while capitalizing on relevant optimization opportunities.

Despite the one-year deferral of compliance schedules, as outlined the Regulatory and advocacy section below, we still observe that many organizations are behind schedule for Phase 5 and 6 compliance; some of which are considering tactical over strategic selections due to time constraints. Not acting now will put the firm's ability to continue to transact in OTC bilateral derivatives at significant risk. Firms should be using this opportunity to look holistically at their collateral management shortcomings and invest in the right solutions and make enhancements to strategically meet their infrastructure needs.

Phases 5 and 6 are anticipated to bring over 1,000 entities across banks, asset managers, hedge funds, pension funds, insurance and corporate firms, swap dealers and governmental entities in-scope for the UMR¹. This large increase in the number of counterparties subject to the regulations presents various challenges for the industry that we will discuss in this paper.

¹ IM Phase-in Estimates, International Swaps and Derivatives Association, 2019.

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Firms across Phases 5 and 6 need to act now and accelerate their efforts to make sure certain capabilities are in place on time. Failing to act now will put the firm's ability to transact in OTC bilateral derivatives at significant risk. This is not the time to slow down, but an opportunity to reassess and make sure you meet your long-term needs.

- Mark Nichols, EY Collateral Lead

It is imperative that all Phase 5 and 6 firms have programs in place to accelerate readiness and work with their dealers and vendors on implementing appropriate strategic solutions. This will allow them to better prepare for the impacts of the inevitable challenges of scoping assessments (e.g., ultimate beneficiary owner identification, IM threshold monitoring plan), documentation and onboarding (e.g., delays in documentation and repapering), margin calculation (e.g., model development and implementation, incomplete and stale data usage), collateral workflow determination (e.g., definition of roles and responsibilities), and custody and segregation (e.g., custody model, technology capabilities) are minimized and an appropriate long-term capability delivered.



Regulatory and advocacy updates

To address growing concerns about market disruption due to the volume and relative size of new in-scope counterparties, various regulatory authorities have published amended rules. In response, industry organizations have released industry advocacy and public comments regarding compliance timelines, as highlighted below.

1

In December 2020, the Commodity Futures Trading Commission (CFTC) approved amendments related to margin requirements for uncleared swaps for swap dealers and major swap participants that included the following updates: (a) permitted the application of a minimum transfer amount (MTA) up to \$50,000 for each separately managed account, (b) permitted application of separate MTAs for initial margin and variation margin, (c) allowed in-scope firms to use the risk-based model calculation of a CFTC-registered swap dealer (SD) (or major swap participant (MSP)) counterparty to determine both the IM to be collected and whether IM thresholds have been exceeded (thereby requiring documentation on exchange and custody of IM) and (d) revised the definition of material swaps exposure and AANA calculation period/method to align the CFTC margin rule with the BCBS and IOSCO framework. Specifically, the final rule revised the calculation period to March, April and May of the current year, requiring the average of month-end AANA instead of daily AANA.

2

Due to the impact of the COVID-19 pandemic on the global financial industry, the International Swaps and Derivatives Association (ISDA) sent a letter to BCBS-IOSCO on behalf of 21 industry associations requesting a suspension of the current timeline for IM phase-in. On April 3, 2020, BCBS granted ISDA's request and extended the compliance timelines by a year for both Phase 5 (now September 2021) and Phase 6 (now September 2022). This year extension is now pending adoption from local regulators into their respective regulatory or legislative frameworks. In line with the BCBS-IOSCO framework, the European Supervisory Authorities (ESAs) have also confirmed the extension in November 2020².

3

In 2020, the CFTC and the US Prudential Regulators (US PR) published proposed rules on Margin and Capital Requirements for Covered Swap Entities, which clarified that trading documentation must be completed with a counterparty when a covered swap entity is required to post or collect IM and included technical changes to address amendments to legacy swaps subject to Qualified Financial Contract Rules.

ESA's proposed amendments confirmed that no documentation is required for entities below the €50 million threshold, proposed that VM exchange for foreign exchange (FX) swaps and FX forwards with physical settlement is optional, and confirmed that VM and IM requirements for single-stock equity option and index option derivatives shall be deferred until January 4, 2024.

Additionally, further amendments to the European market infrastructure regulation (EMIR) Margin regulatory technical standards (RTS) in February 2021, includes relief from VM requirements for physically settled foreign exchange swaps and forwards when one of the counterparties is a credit institution of an investment firm and relief for trades novated from UK-established counterparties to EU-established counterparties until January 1, 2022. The Clearing Obligation RTS also provided relief for the same trades for 12 months from entry into force, i.e., February 18, 2022.

The release of these policy frameworks and advocacy letters for IM requirements provides sufficient clarity to enable firms that are subject to the rules to move forward with their programs and make the required decisions to enable operational and technology readiness for UMR compliance.

²Final Report: EMIR RTS on various amendments to the bilateral margin requirements in view of the international framework as well as on novations from UK to EU counterparties, European Securities and Markets Authority, 2020.

10 actions Phase 5 and 6 counterparties must take now

From our work supporting over half of the industry that is operating under the Global Margin Policy Framework today, we have identified 10 actions that firms who are subject to the regulations need to be progressing to so that they are ready for compliance. As this regulatory framework impacts multiple functions of an institution, preparation starts with establishing an enterprise governance structure and conducting an impact assessment across the organization. As part of these programs, detailed plans and cross-functional roles and responsibilities must be defined to support regulatory compliance. Highlighted below are the top 10 activities firms should focus on to initiate and prepare for UMR compliance

1. Establish UMR program and governance framework

- ▶ Formulate a cross-functional UMR compliance plan for implementation
- ▶ Define executive in charge and program ownership across key stakeholders responsible for key functional areas (i.e., legal, operations, risk)
- ▶ Establish timelines for key steps and requirements, including end-to-end industry testing

2. Perform AANA calculation and scoping assessment

- ▶ Perform AANA calculation and, if applicable, communicate results specifically focusing on funds close to IM thresholds
- ▶ Re-perform AANA, on an ongoing basis, as needed to confirm the appropriate compliance timeline
- ▶ Understand entity and fund structure, parent ownership of funds, and type of accounts to determine scope and applicability
- ▶ Self-disclose to relevant counterparties and engage early with clients to accelerate implementation and onboarding

10 actions to take now

1. Establish UMR program and governance framework
2. Perform AANA calculation and scoping assessment
3. Determine appropriate operating model from a people, process and technology perspective
4. Negotiate trading documentation with defined in-scope population
5. Determine and calculate IM calculation methodology
6. Implement changes to operational infrastructure
7. Establish custody model and structure
8. Obtain model approval and testing (if applicable)
9. Assess opportunities for collateral optimization
10. Plan for post-compliance and beyond



3. Determine appropriate operating model from a people, process and technology perspective

- ▶ Determine whether to build components in-house, leverage external solution(s), or leverage counterparty calculated IM requirements in consideration of the following:
 - ▶ Current state infrastructure capabilities and integration of systems
 - ▶ Maturity of current workflow processes (i.e., manual vs. automated)
 - ▶ Data availability and quality
 - ▶ Size of derivatives portfolios across entities and expected workflow impacts
 - ▶ Internal governance and control standards
- ▶ Depending on the regulatory jurisdiction, firms may be able to leverage the risk-based model calculation of their counterparty (i.e., CFTC registered SD or MSP) to determine the amount of IM to be collected and to monitor IM thresholds that may trigger documentation requirements
- ▶ Evaluate third-party vendors and determine suitable option(s) given firm's business strategy, infrastructure and portfolio
 - ▶ **Asset servicers and outsource providers:** Collateral management outsource providers perform valuation services, as well as support AANA calculations, IM threshold determinations and IM calculations. In some cases, providers can also help firms identify in-scope funds to support the AANA calculation. Additionally, firms with manually intensive processes may consider outsourcing their collateral operational processes.
 - ▶ **Vendor software providers:** Firms can also leverage vendor software and technology platforms as either add-on to existing infrastructure or as net-new capabilities to enhance its current collateral management capabilities. Vendor solutions can be used specifically for IM calculations or can be implemented more broadly to support its collateral operations and workflow.

Preparation starts with establishing an enterprise governance structure and conducting an impact assessment across the organization. As part of this program, detailed plans and cross-functional roles and responsibilities must be defined to support regulatory compliance and strategic implementation.

4. Determine IM calculation methodology

- ▶ Determine IM calculation methodology (e.g., risk-based model (Standard Initial Margin Model (SIMM)), grid-based approach), in consideration of OTC derivative portfolio, business strategy, model governance (if applicable - e.g., back testing) and regulatory process (if applicable)
- ▶ Determine whether to build the IM calculation or components thereof (e.g., sensitivity generation, Common Risk Interchange Format (CRIF)) in house or leverage vendor or counterparty IM solutions
- ▶ If electing to outsource to a vendor or utilize counterparty's IM calculation, review vendor and/or counterparty solutions to determine suitability for your portfolio (e.g., portfolio composition) and build internal governance processes (e.g., ongoing reconciliations, testing) as appropriate (see item No. 8)
- ▶ Determine how to allocate the group-level \$50m threshold across funds and entities that transact with a common counterparty

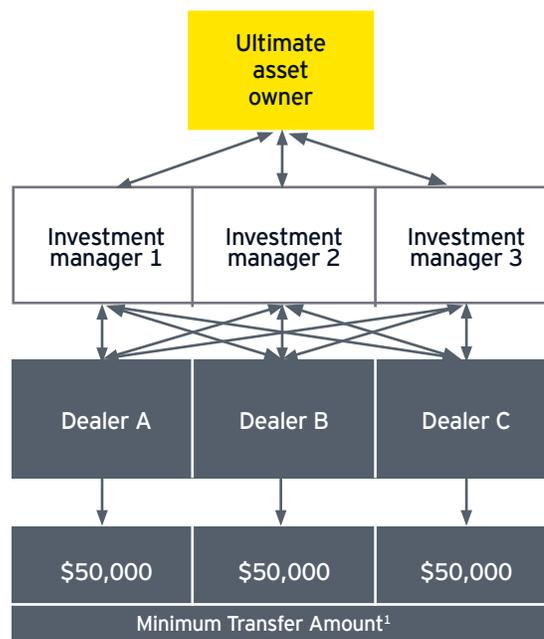
10 actions Phase 5 and 6 counterparties must take now

5. Negotiate trading documentation with defined in-scope counterparty population

- ▶ Establish a negotiation road map early, including an evaluation of your current state such as the location of documentation, quality of contract metadata in the system of record, and the capacity of the legal negotiation team
- ▶ Determine the population of counterparties that are in scope for Phases 5 and 6 and prioritize counterparties for negotiation of IM documentation and account set-up, based on the importance of each account and trading relationship
- ▶ Determine the custodian(s) you will leverage, based on the custodian(s) that best suit your business, the custodians your counterparties are anticipated to use and the timetable each custodian will require to set up independent collateral accounts
- ▶ Establish appropriate program management and oversight to monitor the workflow and report progress to key stakeholders
- ▶ Establish IM documentation playbook, outlining preferences, elections and fallback approaches, and an escalation and approval process
- ▶ Prepare for synchronization with the operational infrastructure teams, including a path to provide newly agreed collateral terms to collateral management, updating the system of record, allocation of IM threshold across entities and custodial documentation terms aligned with operational capacity

6. Implement changes to operational infrastructure

- ▶ Assess scalability of existing infrastructure and maturity of current processes to support increased complexity and volume
- ▶ Implement collateral operational processes to support daily exchange of IM, risk and dispute management, connectivity to custodians, and internal and external data feeds
- ▶ Assess current operating model and determine opportunities for enhancements and potential vendor support (refer to No. 10 for further detail)
- ▶ Establish IM reporting requirements for regulatory and internal downstream (credit, risk, compliance and finance) purposes



- 1 Does ultimate asset owner (UAO) in aggregate for managed funds relationship exceed the defined AANA level for gross derivative notional?
- 2 Where **yes**, UAO needs to inform investment manager of the allocated split of the IM threshold per dealer:
 - ▶ Investment manager and UAO need to agree on a rebalancing schedule in the event that they need to redistribute the allocation
 - ▶ Initial splits could be even across relationships or based on a risk-adjusted allocation
- 3 Investment manager must then communicate the IM threshold allocation to the dealer for relationship documentation (investment manager to dealer) and identify selected segregation agent.

¹The September 2020 CFTC Margin Rule amendment permits the application of separate MTA for IM and VM and the application of a MTA of up to \$50,000 for separately managed accounts.



7. Establish custody and segregation model and structure

- ▶ Determine custody and segregation model to adopt between triparty or third party
- ▶ Build connectivity with current custodians as well as dealers' custodian with appropriate feeds for daily movement of IM collateral requirements
- ▶ Engage in conversations with custodians to determine suitability and confirm capacity, given the expected number of new in-scope entities, business strategy and required geographical support

8. Obtain model approval/testing (if applicable)

- ▶ For regulated entities, implementation of the Standard Initial Margin Model (SIMM) model developed by ISDA, which is a risk factor sensitivity-based calculation, to meet the firm's internal model approval standards, as appropriate, requires regulatory approval from the firm's prudential regulator (depending on the regulatory jurisdiction)
- ▶ Provide relevant documentation to regulators for review in advance of and during the on-site model exam
- ▶ Determine the appropriate data sources for risk sensitivities, risk bucket mapping, and P/L generation for back testing

9. Assess opportunities for collateral optimization

- ▶ Develop optimization strategy given range of eligible collateral for regulatory initial opportunity
- ▶ Confirm counterparty appetite and custodian capability to support collateral optimization approach
- ▶ Leverage analytic tools for "what-if" scenarios to help determine optimal trading decisioning

10. Plan for post-compliance and beyond

- ▶ Firms need to additionally evaluate their initial program and business decisions, including scalability of their internal infrastructure for upcoming phases, including geographical coverage of custodians, custody model, IM calculation method and in-scope entities
- ▶ Firms need to embed ongoing monitoring processes to maintain compliance beyond the current compliance timelines (e.g., ongoing AANA monitoring, threshold monitoring, building feeds to new product approval processes)

Are you on track to UMR compliance?

The below timeline is based on leading practices and includes illustrative activities and milestones required by all in-scope firms. Many of these requirements are complex and require collaboration across the organization. Firms should start to mobilize to stand up their UMR programs now to allow for additional time to execute the necessary actions and activities that are required to achieve compliance.

Months	Indicative UMR compliance timeline
T-18	<ul style="list-style-type: none"> ▶ Perform preliminary AANA calculation across entities ▶ Establish internal governance framework and cross-functional program ▶ Understand entity/fund structure, parent ownership of funds, and account types to confirm scope and applicability ▶ Review vendors and determine in-house or external vendor for IM calculation (i.e., SIMM vs. grid)
T-15	<ul style="list-style-type: none"> ▶ Finalize AANA calculation across entities (depending on the jurisdiction, the process can also be repeated in T-6 months) ▶ Complete self-disclosure documentation ▶ Determine IM calculation methodology (i.e., SIMM vs. Grid) ▶ Allocate IM threshold across entities ▶ Establish appropriate operating model from a people, process and technology perspective
T-12	<ul style="list-style-type: none"> ▶ Determine custodian and segregation model (i.e., third party vs. triparty) ▶ Perform SIMM testing and obtain model approval (if applicable)
T-9	<ul style="list-style-type: none"> ▶ Begin to implement changes to operational infrastructure ▶ Develop optimization strategy
T-6	<ul style="list-style-type: none"> ▶ Establish IM reporting requirements for regulatory and internal downstream purposes ▶ Develop operational and dispute procedures based on new functionality ▶ Agree to mandated custodian and contractual framework ▶ Perform SIMM testing and obtain model approval (if applicable) ▶ Finalize AANA calculation across entities (if applicable)
T-3	<ul style="list-style-type: none"> ▶ Execute agreements with custodians and onboard into margin system, including updated eligibility restrictions ▶ Complete testing, systematic implementation, and connectivity to custodians and IM calculation vendors
Compliance date	<ul style="list-style-type: none"> ▶ Perform and monitor ongoing entity AANA and threshold checks

Regardless of the changes to the implementation timelines, derivative trading entities will need to take immediate action to implement solutions that address their compliance needs. Compliance with the global margin framework requires cross-functional coordination across your firm (particularly across operations and technology, risk and the front office), significant outreach with counterparties, involvement with third parties and regulators (as applicable) as well as significant technological enhancements to support the IM calculation, ongoing monitoring, and daily exchange of collateral.

Firms need to work now to ensure the timely implementation of UMR compliance and to efficiently capitalize on collateral optimization opportunities. Many firms across both remaining compliance phases are significantly behind and need to quickly accelerate and focus on key activities. The time, effort and coordination have been grossly underestimated by many Phase 5 and 6 firms. The time to act is now.

How EY US can help

Ernst & Young LLP (EY US) has extensive experience and industry knowledge in supporting half of phase 1 through 6 firms with end-to-end implementation activities for their uncleared margin programs. Our solutions support clients with accelerating IM compliance readiness and are tailored to each client's portfolio, business strategy and compliance needs, including, but not limited to, the following:

- ▶ Program management and mobilization
- ▶ Technology implementation
- ▶ Model development, testing and regulatory approval readiness
- ▶ Collateral assessment and implementation of enhanced margin workflows
- ▶ Regulatory assessment and remediation support
- ▶ Strategic collateral operating model initiatives
- ▶ Vendor assessments
- ▶ Contract negotiation services
- ▶ Controls, compliance and audit review

The EY UMR Cross-disciplinary Offering Team includes advisors who have been dedicated to this topic since 2014, having worked with the largest dealer organizations, industry bodies, key custodians, vendors, as well as smaller organizations subject to the framework. We have authored a broad range of articles; presented at industry and webinars on the impact of the uncleared margin requirements jointly with ISDA, Securities Industry and Financial Markets Association (SIFMA), Managed Funds Association (MFA) and International Securities Association for Institutional Trade Communication (ISITC); and supported industry trade associations. For further detail, please reach out to our offering leads.

The EY team has extensive knowledge and industry experience with supporting over 50% of Phase 1-4 firms with their uncleared margin programs.



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