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Below the Threshold

How Phase 5 & 6 firms can save time and money by monitoring initial margin

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Jon Cronin (JC), Lansons: Hello and welcome to ahead of the curve the - podcast from Acadia, where we take time to get under the skin of the margin and collateral industry to dig deep and present topical perspectives and insights on this hugely important sector.

Now 2022 promises to be a significant year. September we'll see the sixth and final phase of the uncleared margin rules or UMR. UMR regulations are essential as they mandate the exchange of initial margin when specific over the counter, or OTC, derivative products are traded. The biggest investment banks were the first to be covered by uncleared margin rules in 2016. Since then, more and more firms have come into scope dependent upon the size of their derivatives portfolio. Phase Five went live in September this year, and next year, Phase Six could see up to 750 smaller firms coming into scope.

So how can this new wave of firms make their path to UMR Compliance simpler, faster and cheaper? And what are the core benefits for monitoring initial margin? With me to discuss this, I'm joined by two expert guests. Jeff Rosen is a managing director at Société Générale based in New York and Mark Demo is Head of Community Development at Acadia.

Jeff, I want to come to you first because we've got lots to discuss here before we before we discuss initial margin monitoring. Give me an update on how Phase Five of uncleared margin rules is doing.

Jeff Rosen

Managing Director & COO, Americas Global Markets | Société Générale

Jeff Rosen (JR): So far, so good. We haven't seen any regulatory breaches and we continue to work through customer documentation. Phase Five was really a challenge for the entire market. It was especially a challenge for the custodians who had a tough time managing the volume.

I would definitely say that it went fine. And we picked up a few lessons that will help us through Phase Six. When we started, I didn't realise how long and complicated the documentation exercise would be, and how many issues would emerge that needed resolution. I would say that early communication and prioritization were keys to ensuring that we focused on the right relationships. I also think that the process was a little bit complicated for a European bank, with the European custodian when we're facing customers in the US with a US custodian. It highlighted the differences in regulations, which were largely around termination and other related default conditions. I know this became frustrating for us; I suspect it became frustrating for our counterparts as well. But we did work through it.

I was also a little bit surprised with the number of accounts that we ended up monitoring, at least on a temporary basis because some of the accounts weren't set up, the documentation wasn't completed. **Meeting the custodial deadlines proved critical.** I didn't really appreciate the custodial onboarding effort, though we probably should have. I would advise people, the earliest you can KYC with your custodian, the better, it will prove beneficial and easier in the long run.

JC: Jeff, that's a great refreshing analysis there I think of the experience - getting there in the end, but a few complications on the road. Mark, what's your perspective on this from Acadia's position?

Mark Demo

Head of Community Development

Mark Demo (MD): Well, from our perspective, Phase Five went extremely well. We saw about 350 firms in total in Phase Five, and we ended up doing business with about 300 of them. We set up over 2200 Reg IM CSAs. And as Jeff mentioned, the volume of monitoring agreements was quite large, we set up over 6000 regulatory monitor agreements. And we ended up onboarding four times more firms in Phase Five than we onboarded in all four prior phases combined. So just a smashing success from our standpoint.

JC: And then we get into a bit more detail here with you both. How did the need for initial margin monitoring come about and why is it so important?

JR: Since the uncleared margin rules were first released many years ago dealers and custodians have been warning the market and regulators about the volume of clients that will need to be repapered and the need for an orderly repapering of these institutions.

With Phases Five and Six as the numbers grew, it became more acute and lobbying by ISDA and other market participants allowed documentation to be delayed till you hit a $50 million or Euro threshold. This was proposed in 2019 and was implemented by global regulators in 2020. With this relief as a dealer, we need to collect and understand a lot about initial margin (IM) and our exposures.

It becomes our responsibility to be sure that both us and our clients don't breach this threshold. **We need to understand growth in IM so we can avoid active breaches of the threshold and so that we can actively allocate resources to re-document those institutions.** Institutions need to understand where their IM is, so they can allocate their 50 million threshold to different entities under their structure. Early warnings about threshold levels allow us to proactively complete documentation. As I mentioned, this allows us to focus on areas where we have the biggest risk. But moreover, and as important, it allows us to identify areas where we have the highest risk of a passive breach, as IM is recalculated on a portfolio basis daily, we could passively breach the threshold by market moves. So we have to make sure that we have enough room to cover such risk and put in place strategies to manage that risk. That could include restricting certain trades with counterparts or putting on risk reducing trades with those counterparts.

JC: So, the thresholds clearly is all important here. Mark, what are your thoughts?

MD: Well, as Jeff mentioned, there were a large number of Phase Five firms that weren't going to move margin initially. Additionally, every one of the Phase Five firms was looking to take advantage of the regulatory relief. And then when COVID hit, and the regulator's extended Phase Five by another year, many Phase Five firms were in full execution mode with their compliance projects and wanted to keep going. So, one of the things that Acadia did was we came up with the idea of a threshold monitoring soft launch. This enabled firms to go live in their production environment and our production environment without the need for a Reg IM CSA in place. If both firms could calculate, then both firms can compare their Reg IM exposures as if they went live on the original pre-COVID compliance date.

Firms could also compare exposures to the Reg IM threshold that they were expected to put in place between them to get an early warning as to where and how quickly their exposures were growing and would require documentation. For firms who didn't expect to exceed the Reg IM threshold, Acadia created a free version that enabled Phase Five and Six firms to login to a central place to view the exposure that their dealer counterparties calculated against them. And **we estimate that the financial benefit to firms who can delay their operational readiness is significant**, totalling in the hundreds of thousands of dollars in one-time, upfront fee savings and ongoing year after year savings as well.

JC: And those savings are important, obviously for the various different players involved here. How has the market responded to all of this, Jeff?

JR: Yes, so like Mark said, **we did see a number of firms that wanted to take advantage of monitoring to avoid the cost and effort of implementing uncleared margin rules.** But now that Phase Five is completed, we're seeing a steady stream of those clients who have realized that they want to repaper some or most of their OTC relationships. **Without monitoring and the priority driven approach that it allows on both the dealer side and the client side, we would have seen greater delays** because of the throughput requirements. In other words, there would have been too much volume for the system to handle. IM monitoring allows both sides to prioritize the relationships with which they will enter into documentation.

JC: And Mark, what would you add to that?

MD: We saw the market implement monitoring in two different ways. Some in scope dealers created their own internal monitoring solution. But others with the help of Acadia, we designed a central monitoring solution that the entire market could use, which leveraged our existing position in calculating and reconciling initial margin for virtually every Phase One through Four firm. And as the Phase Five numbers that I mentioned previously, bear themselves out, hundreds of firms created 1000s of reg monitor agreements using our threshold monitoring solution.

JC: Let's just consider some of the benefits then and the drawbacks to each of these approaches. What do you see as the main benefits and in a sense, those drawbacks as well, Jeff?

JR: Well, this sounds very simple, right? We monitor the thresholds and reach a certain level. We enter into documentation, and we take other risk reducing strategies on but it really it gets very complicated particularly when clients have multiple entities that are separately managed or trade separately. T**o allocate threshold across different entities gets very complex.** We see a lot of threshold breaches at a sub entity level. They're not regulatory breaches, but they are in fact breaches and to reallocate thresholds requires contract changes. And many may not realize this, but it gets very tough. So, understanding of prioritising is important. I would also say, the **monitoring clients may not realize how restricted future trading can be as they approach the 50 million threshold**, most banks will put in place a threshold and a limit, it could be at 50, or 75%, of the aggregated 50 million regulatory allowance. This can restrict their trading in the future. Clients who choose to exclusively monitor in Phase Five will not be as familiar with the documentation process, it will be more complicated for them. And as their needs change, it's going to be tougher for them to move forward. I would also say that from a client perspective, having a single portal, like **Acadia's monitoring portal, allows them to see the data from all their dealers in one place**, the same way that Acadia allows us to see all of our client's data in one place.

JC: So, Mark, clearly that the challenge here is dealing with the complexity of all this.

MD: Yes, and pulling it all together in one place. As Jeff mentioned, the dealer only version is effective, but only for the dealer. And I call that the "I'm okay, how about you approach" but in all seriousness, it makes for a scenario where the Phase Five firm who wants to monitor to leverage the reg relief, and who might trade with

dozens of dealers has to cobble together a consistent view of exposure in in different formats with different start dates. It's a solution that just doesn't scale. But the industry solution that that Acadia has designed gives Phase Five and Six firms, the exact same thing that Phase One through Four firms benefit now from which is a central place to view the Reg IM exposure, calculated by the counterparties in one single format in one single place.

JC: So, let's just wrap this up here. Finally, what decisions does an initial margin monitoring solution help Phase Five and Phase Six firms to make? Jeff, what are your thoughts there?

JR: Well, first and foremost, it helps us define our priorities. It keeps our costs down and our resources focused. We're focused on our most significant relationships. And I think that's critically important for us as a dealer. And I think it's important for our clients, particularly those that have a number of different dealers. And of course, this helps us remain in compliance with our global regulations.

JC: And Mark, let me give the final word on this to you.

MD: Thank you, John, just to emphasise a few of Jeff's points. Monitoring does help firms prioritise their compliance effort, and it also helps them delay the need to become operationally ready for as long as possible, potentially saving hundreds of 1000s of dollars in the process. And maybe most importantly, it helps avoid surprises from both the Phase Five or Six firm and the dealer perspective. You don't want to stop trading all of a sudden, because your exposure has grown to a point where you need to begin documentation efforts and you haven't even started them yet.

For more information

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