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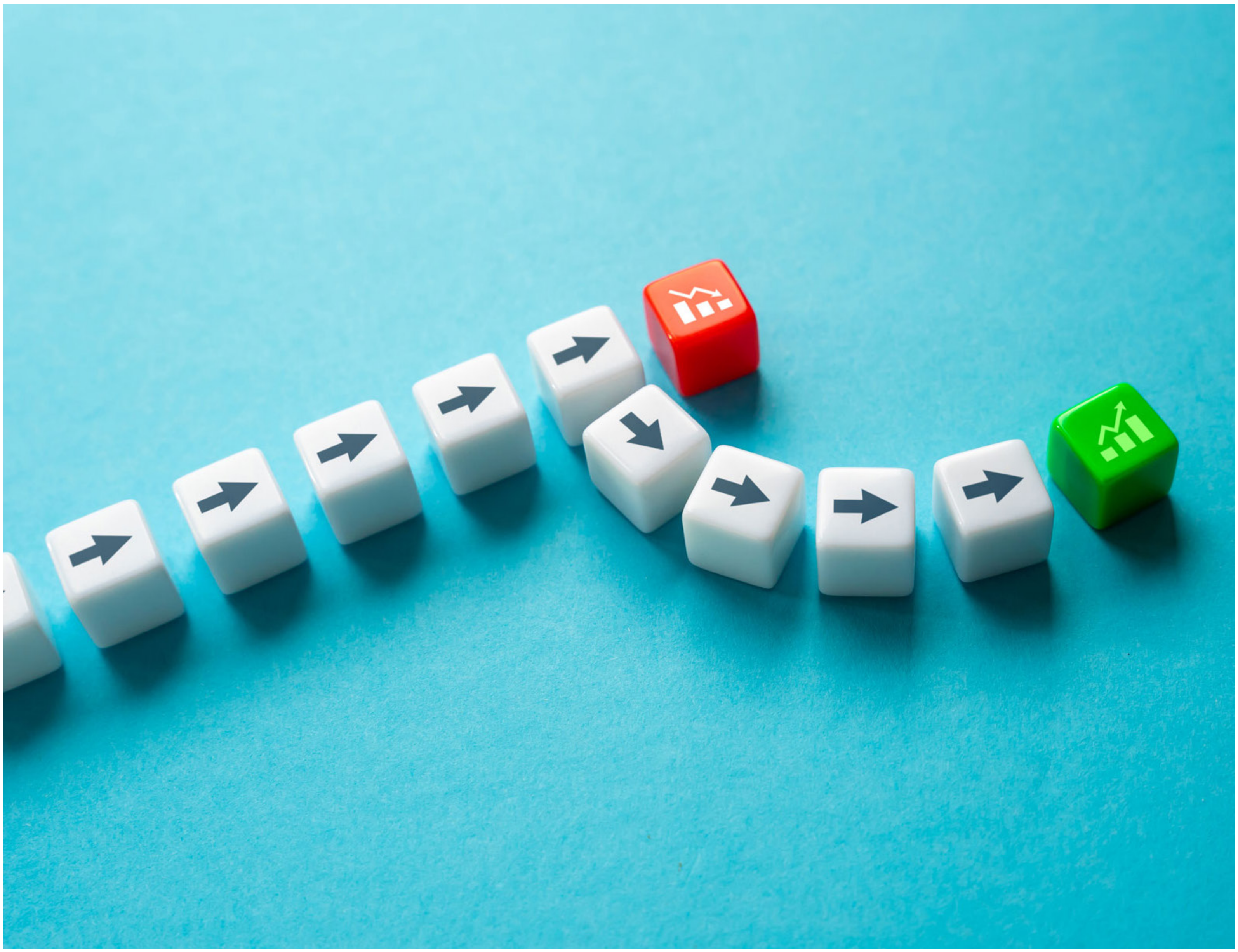

In a world of uncleared margin rules, Isda Simm adapts and evolves

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A look back at progress and challenges one year on from UMR and Phase 6 implementation. By *Stuart Smith*

In September 2022, the derivatives industry passed a significant milestone in post-financial crisis market reform. The initial margin requirements of uncleared margin rules (UMR) ushered in by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions, were extended to the final group of market participants – or Phase 6 of their implementation.

This progression also marked the final phased go-live for the International Swaps and Derivatives Association's Standard Initial Margin Model (Isda Simm) – an industry-wide risk-based framework designed to calculate initial margin for non-cleared derivatives trades.

Banks and vendors working with Isda have updated and refined Simm to reflect the needs of different market participants

Since its September 2016 rollout – which targeted firms with average aggregate notional amounts (AANA) greater than $3 trillion or its equivalent – banks and vendors working with Isda have updated and refined Simm to reflect the needs of different market participants, including a growing number of Phase 6 firms, or those with AANA of $8 billion.

Around 400 firms are now exchanging initial margin (IM), while many more have breached the AANA threshold yet remain below the $50 million exchange threshold.

Because regulatory IM is only calculated on trades executed after go-live, in-scope portfolios

There is still significant debate over the correct approach for calculating lifetime margin costs

tend to grow rapidly for up to five years as legacy positions are replaced. This means firms that have been able to delay full compliance are gradually pulled into scope as their first portfolio breaches the $50 million threshold.[1]

Since Q3, 2022, when Phase 6 went live, 275 firms have breached the threshold and started to exchange initial margin.

It's reasonable to assume firms will continue to increase exposures for another three to four years, meaning at least another 100 will start to exchange regulatory IM. More than 600 firms are currently still under threshold and being monitored.

Meanwhile, the number of agreements coming into scope is also growing rapidly at around 90 a month – so it's also reasonable to assume that over the next three to four years, we could see an additional 3,000 agreements in scope, increasing the total number of reg IM portfolios to around 10,000.

Margin plateaus

While the number of firms exchanging margin – and the number of agreements in scope – continue to rise, margin posted is not.

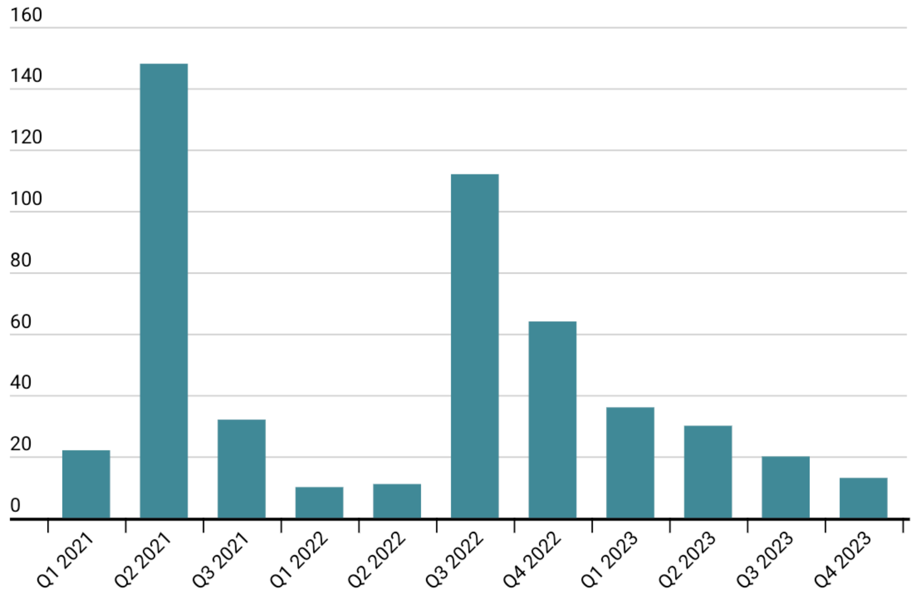
From 2021 through to early 2023, the increase in margin is relatively smooth, peaking at around $640 billion. It then drops significantly, staying relatively constant at $400 billion.

While this seems counter-intuitive, the drop is most likely explained by two key factors.

Interest rate rises in 2022 and 2023 have had a major impact on the cost of posting margin, and forced firms to reconsider their trading strategies – coupled with greater adoption of formal and informal margin optimisation.

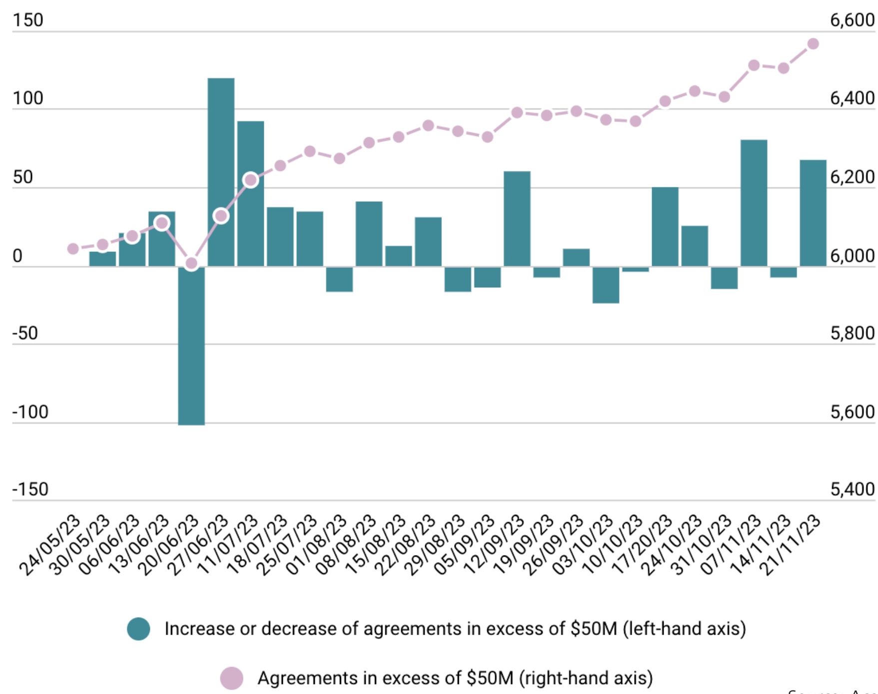
A sudden increase in margin requirements, combined with the availability of a common data format – Isda's common risk interchange file, or Crif – paved the way for specialist vendors offering new ways of reducing exposure by eliminating counterparty risk within a network of participants.

1 Number of firms reconciling exposure for the first time



Source: Acadia

2 Number of firms reconciling exposure for the first time



Source: Acadia

As the cost of posting margin increases, the cost-benefit analysis of placing a new optimisation trade changes and makes hedging the more likely winner. At the same time, smaller firms are more likely to informally optimise by selecting agreements with little or no margin impact from new trading.

There is still significant debate over the correct approach for calculating lifetime margin costs, as forward projections are complicated by the key role optimisation solutions play within the ecosystem, where they minimise costs of Isda Simm through effective risk hedges.

For many fund administrators, Isda Simm

compliance and management has become a competitive advantage. Firms that have embraced the model have demonstrated their commitment to best practices in risk management and have since attracted more counterparties and business opportunities.

Operational challenges

But implementing Isda Simm has not been without its challenges.

The need for robust data infrastructure, accurate risk-factor modelling and timely data provision has put significant operational pressures on market participants. Many have had to invest in technology and data management solutions to comply with requirements – or engage with vendors specialising in Isda Simm solutions.

As an industry collaboration, rather than a methodology managed by a single organisation, the calibration of Isda Simm was always going to be more challenging than that of other risk or margin methodologies.

Regular recalibration of Isda Simm must be implemented by hundreds of firms, updated in dozens of vendor systems, with a co-ordinated go-live over a single weekend. What's more, this recalibration must account for a much wider range of portfolios and risks than other margin methodologies, which are typically focused on a single asset class or limited range of instruments.

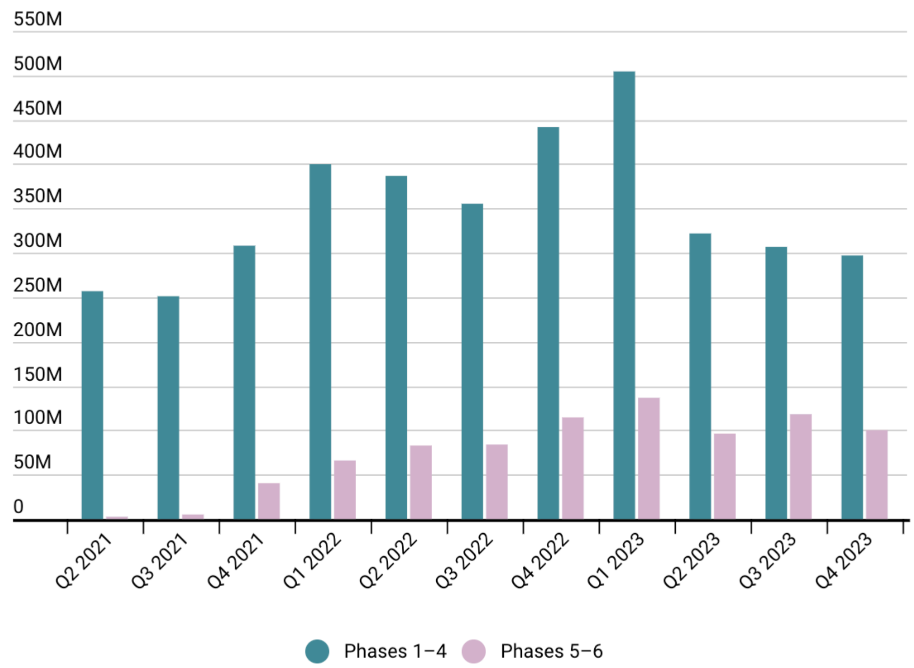
The initial process of creating a new calibration was understandably slow and methodical, taking virtually a full calendar year for data collection, followed by 12 months to calibrate and ultimately go live.

This process was shown to be a significant weakness during the Covid pandemic in 2020. While markets moved dramatically, significantly increasing volatility, the subsequent change in the Isda Simm calibration was not released until 21 months later in December 2021.

To deal with the issue, new off-cycle recalibrations were introduced, where a previous quarter represented a new stress period. Isda Simm 2.5A, the first off-cycle release, went live in July 2022. Almost immediately, a new semi-annual calibration cycle was announced, replacing both the current annual cycle and off-cycle recalibrations.

The industry will have to improve the speed at which it can implement and back-test new versions, as the recalibration period will be squeezed into a much shorter timeframe. At the same time, Phase 3-6 firms and vendors will need to be prepared to implement new versions more frequently and manage the additional costs of more regular model changes.

3 Margin plateaus



Source: Acadia

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The road ahead

While challenges remain, particularly in the realm of data quality and consistent use of options – such as an alternative method for index decomposition – the derivatives industry has demonstrated its resilience and ability to adapt to regulatory changes.

Isda Simm has enabled greater collaboration between market participants, vendors and service providers. In-scope firms have had to work more closely with their counterparties to ensure consistent margin calculations, fostering a better sense of industry partnership in risk management.

While many hedge funds are now in the scope of Isda Simm, few post collateral based on its calculation. Rather they still post house independent amounts (IA) based on an internal dealer model, because of the 'greater of' rule, which requires in-scope firms to post the higher margin amount from IA and reg IM calculations. This is coming under scrutiny as dealer models are mainly risk insensitive. Given the success of Isda Simm, there's a push for a more risk-sensitive model to be used in the calculation of house IA.

A year after its extension to Phase 6, the derivatives industry stands more informed, risk-aware and collaborative than before. Challenges persist, but the industry's ability to adapt and thrive in this new environment bodes well in a constantly evolving regulatory landscape. ■

The author is co-head of business development at Acadia

[1] *Defined as a firm that uploads exposure in excess of $50 million to the initial margin exposure manager solution for five days within one month.*