



# Bilateral Margin Headache Solved

Since 2008, regulatory changes to prevent another crisis from occurring have been incrementally rolled out. The US is ahead of Europe with mandated clearing and electronic trade execution already in effect and with trade reporting a requirement in both jurisdictions. From September 2016, Europe will see the introduction of mandatory margining for non-cleared OTC derivatives. Only the largest dealers are in the first wave of firms impacted by the new requirements, but the scope broadens year on year out to 2019 to encompass a wide range of firms active in the OTC derivatives markets.

by JAMES CHERRY

**T**he first wave of firms must exchange both Variation and Initial Margin from likely 1 September 2016, with all firms to exchange Variation Margin from 1st March 2017. The industry is working hard to figure out legal and technical solutions to align portfolios in order to achieve an accurate exposure calculation, as disputes are potentially to be penalised with a significant capital increase through the doubling of the Margin Period of Risk. Forensic methods of uncover-

ing both population and valuation differences beyond anything undertaken so far will need to be found.

New regulations require firms that are bilaterally trading non cleared derivatives to apply a model for Initial Margin calculation which is either a very simple schedule using a percentage of notional, or a super complex Value at Risk approach. A universally unwelcome outcome would be a different Initial Margin calculation from both firms leading to an increased credit exposure. ISDA has been facilitating a solution by promoting the implementation of a Standard Initial Margin Model (SIMM) for use by member firms.

Once firms arrive at a value for the Initial Margin,

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the process of calling margin, moving assets and observing the regulatory restrictions comes into play. Key challenges include:

- Agreeing a legal basis to move the assets via an agreed settlement provider
- Ensuring the two way exchange happens as close to simultaneous as possible
- Using an agent who can hold the assets in escrow
- Preventing re-hypothecation, as determined by the regulations
- Flexibility in the range of assets possible to pledge against the exposure
- Achieving effective segregation of all asset classes
- Receiving timely and accurate reporting on the settlement process

**The DIY Option vs Clearstream’s TCMS**

Lets imagine how a firm would meet the new regulations in-house using their own people and systems and compare this with an outsourced triparty collateral management solution. At a high level, here’s how you might approach the problem (See Table 2)

The burden of investment and implementation falls squarely on each firm to meet the new regulations, as explained below. Clearstream as part of its

triparty collateral management offering, provides the necessary technical and operational infrastructure for the segregation and the management of Initial Margin (IM) for uncleared derivatives.

**Legal Basis**

Traditionally, putting a credit support document in place between two parties involves a bespoke negotiation to try and meet both firms views on what works for them practically and economically. The latest ISDA Margin Survey shows there are nearly 140,000 bilateral margin agreements in place and these potentially need replicating to cover new trades from September 2016 onwards. There doesn’t seem to be a consensus on what works for them practically and economically. The latest ISDA Margin Survey shows there is rapidly gaining traction amongst the dealer community for a multi-lateral pledge agreement provided by Clearstream. Clearstream already offer a multilateral document to meet the needs of clients wishing to transact Triparty Repo in a standardized form (the Clearstream Repurchase Conditions or CRCnse) building upon success in the repo market Clearstream have turned an eye to swaps documentation.

The agreement would provide a common margin agreement which each firm only signs once, ■■■

**Table 1: The DIY Option vs Clearstream’s TCMS**

	Sept 2016 - DIY	Sept 2016 - With Clearstream	Cleared	
Regulation	Implemented by national regulators		DFA / EMIR	
Legal Basis	Bilateral Credit Support Docs	<b>Clearstream Multilateral</b>	CCP Rule book	
Portfolio Reconciliations	Internal / Bilateral	Internal / Bilateral	Not required	
Variation Margin			<b>Clearstream Triparty Collateral Management Service (TCMS)</b>	CCP
Initial Margin				
Margin Calculation				
Margin Call				
No rehypothecation				
Selection of Assets				
Delivery of Assets				
Record Keeping of Assets				
Reporting & Communication				

rather than signing for each and every bilateral party subject to the new regulations. The document would then automatically extend to any number of counterparties who have also signed it, greatly reducing implementation time. The nature of the agreement is a common framework for the core terms governing the exchange of IM with specific customisation still available for each bilateral party around concentration limits and eligible collateral and haircuts. The Clearstream structure also provides for standardised baskets of assets which can be elected easily, rather than making each relationship bespoke; again this is an area in which a number of dealers are expressing an interest.

### Re-hypothecation

One feature of the new regulations is a ban on re-use of assets provided as Initial Margin. In the current environment, under a transfer of title legal structure, an asset received as margin can be treated as fungible and be traded onwards as a receiver sees fit. In the new world, with the legal basis for the transfer of assets being pledge or securities interest, an asset cannot be freely re-used and must remain in the collateral account without being passed to a third party. The asset can be replaced (substituted) with another eligible asset, but otherwise this restriction on re-use must be enforced to remain compliant.

### Matching instructions

An indirect outcome under the new bilateral rules would be a new dispute over the amount of IM required by each party. In a perfect world, the IM calculations for both parties produce the same number, but in reality, each firm is free to use either the VaR or schedule based approach and to implement their calculations using whatever software they choose and with whatever market data and scenarios they choose.

Without a central service, each firm ought not to instruct delivery to their counterparty until both sides have made their call, to avoid a credit risk of delivering assets to your counterparty without the expectation of a delivery in return. With a central service, the existence of a pair of margin calls and a comparison of the amount of IM can be performed, leading to the movement of the undisputed amount being the lower of the two IM values. The amount remaining will become a dispute and needs to be resolved.

TCMS provides support for receiving two margin calls, comparing the IM amounts and moving the undisputed amount between the parties. Resolving the dispute then becomes a bilateral exercise between the parties.

### Selection of Assets

Once a firm is part of the TCMS platform, and having agreed which assets can be pledged to cover the

VM or IM exposure, it is helpful if the selection of assets can include concentration and risk limits for classes of asset. Each receiver may have their own risk tolerance levels for specific issues, assets or groups of assets, which can be cumbersome to apply without automation. TCMS provides tools to handle all these requirements, meeting both parties' interests, which includes setting a bespoke asset allocation order to find the cheapest-to-deliver securities.

### Delivery of Assets

Under normal circumstances the delivery of assets is asynchronous, but with the new regulations requiring two way exchange of IM - you wouldn't want to deliver assets to your counterparty unless you knew they were delivering at the same time - otherwise there is a credit risk that your counterparty defaults before delivery leaving an uncovered exposure.

TCMS provides for the simultaneous settlement of assets against the two IM requirements and ensures that this is both legally and operationally guaranteed.

### Asset Servicing

The regulations require that the assets covering IM are held by an independent party and segregated from other assets in an escrow model. TCMS does exactly this but also handles automatic substitution, corporate actions and reporting in real-time on activity in your account.

In addition assets are re-valued daily, and automatically topped up / returned as the market value changes.

### Asset Sources

The Global Liquidity Hub provides the ability for a firm to post assets held outside of the Clearstream custody network in favour of exposures managed within the Clearstream network, through a series of reciprocal relationships that Clearstream has in place with local or global custodians (Liquidity Hub Connect). This helps customers seamlessly unlock silos of assets held in various domestic custody arrangements, greatly increasing available inventory and collateral velocity. The Global Liquidity Hub provides the legal and operational means for securities held by a local custodian to be included in the TCMS service, giving a much wider range of eligible assets than those simply held directly within Clearstream. This gives clients of Clearstream the option to use a larger portion of their possible inventory than otherwise would be the case; equities, fixed income securities, fund units and cash are all possible collateral types. With increasing quantities of collateral being locked down for non cleared IM requirements and a focus on the Basle liquidity coverage ratio (LCR) this flexibility offers significant advantages for customers of Clearstream Banking Luxembourg.

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**Table 2: A detailed comparison**

Function	DIY Approach	Clearstream's TCMS
Legal Basis	<ul style="list-style-type: none"> <li>Negotiate and sign one bilateral agreement per collateralised relationship.</li> <li>Re-negotiate all bilateral agreements to meet the Sept 2016 regulations.</li> <li>Potentially thousands of agreements to be put in place</li> </ul>	<ul style="list-style-type: none"> <li>Sign a single multi-lateral margin agreement (most dealers in fact already have Clearstream's core documentation in place)</li> <li>Customise limits and eligible collateral once for yourself, and once for each counterparty if you need to deviate</li> </ul> <p>In addition to the triparty documents that govern operation mechanics Clearstream are also exploring the idea of a multi-lateral pledge document to govern the terms of the transfer margin.</p>
No rehypothecation	<ul style="list-style-type: none"> <li>Tag each asset with a "no rehypothecation" flag</li> <li>Implement adherence to that flag in all relevant internal systems</li> <li>Build a compliance report on each asset to track any breach of the regulation</li> </ul>	Already built - rule applied by TCMS to all parties for reg IM.
Asset Selection	<ul style="list-style-type: none"> <li>Implement a collateral management system with sophisticated rule sets to select assets per counterparty</li> <li>Configure the system per bilateral relationship</li> </ul>	<ul style="list-style-type: none"> <li>Already built - configure your own acceptable assets, which will automatically be adhered to (Clearstream map the existing terms of your eligibility set, concentration limits and haircuts into it's own systems.)</li> </ul> <p>Configure your own outgoing delivery preferences (additional selection criteria algorithms are applied, based on for example funding costs specified by the client)</p>
Delivery of Assets	<ul style="list-style-type: none"> <li>Open custody accounts at relevant I/CSDs with your counterparties</li> <li>Instruct movement of assets using a SWIFT / XML message</li> <li>Receive back account statements and reconcile back to your collateral management system</li> <li>Handle any fails and reinstruct</li> </ul>	<ul style="list-style-type: none"> <li>Already built - once IM values are received and instructions matched, the selection and delivery of assets is automated.</li> <li>Account opening is triggered automatically by the creation of a collateralised relationship (signing of docs) within Clearstream triparty programme.</li> <li>Account statement reports provided electronically</li> <li>Access to a global network of CSDs via the Liquidity Hub mobilises the widest range of deliverable securities. Equities, Fixed Income, Fund Units, Cash (no hard limits) securitized commodities such as Gold, further physical Gold is an option currently being explored based on the ability to house in Clearstream's vaults in Frankfurt.</li> </ul>
Matched Deliveries	Not possible without a central service	TCMS will move collateral to cover the exposure only when both parties send in their instructions, and sufficient assets are available from both parties. The instructions can be consumed from both parties and matched by Clearstream or a single instruction can be pre matched and received from an external market utility. CBL accommodates both scenarios.
Assets held in Escrow	Must be via a third party	Clearstream can be that third party
Record keeping of assets	<ul style="list-style-type: none"> <li>Build this into your collateral management system</li> <li>Receive account statements from multiple I/CSDs and reconcile</li> <li>Handle any mismatches</li> </ul>	Already built-in, statements provided electronically through a variety of communications media.
Reporting and Communication	Self build around your collateral management system	Provided electronically through a variety of communications media.

### Summary

Amongst the challenges in implementing the new margin requirements, solving of the post-call process is ready and available now. Firms have just over a year to put new processes and agreements in place, including opening accounts to handle the exchange of IM. At Clearstream, this process is well underway notably with no charge for 'pre-reservation' of accounts and the

setup of the required operational structure. Bilateral settlement of assets against IM requires firms to handle the asset servicing requirements themselves, whereas TCMS provides a tried and tested full service platform already in operation. Firms can integrate messaging via SWIFT into their own Collateral Management Systems to receive real-time updates on the processes at TCMS, making the service transparent and simple to use.