Commentary
Cash

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Uncleared Margin Rules: Now Is the Time to Act……

… or Risk Being Cut Off From OTC Derivatives Counterparties

Regulators globally are phasing in the Uncleared Margin Rules (UMR) — post-financial crisis regulations requiring margin to be posted on certain common derivatives. In 2022, many buy-side financial institutions and their counterparties will need to comply with UMR for the first time. The rules mandate complex calculations, counterparty agreements and custodial requirements.

If you have not yet established the necessary procedures and relationships, doing so in Q1 of 2022 is an urgent imperative. Although the deadline is rapidly approaching many firms remain unprepared, and regulators expect bottlenecks as firms negotiate compliance. Non-compliant firms risk being cut off from their counterparties.

This document — intended for US investors — answers common questions, helps firms comply efficiently, and discusses the benefits of Treasury-only money funds as a form of collateral.

When is the compliance deadline?

The deadline for UMR's sixth and final phase is September 1, 2022. Collateral agents have set deadlines as early as the end of January for contracts to be signed, to ensure that everyone is compliant in time for September.

Although fewer than half as many firms faced the September 2021 phase 5 deadline, many were unable to complete negotiations with all counterparties and were therefore forced to limit trading and/or reduce counterparties.

What derivatives are covered?

The rules apply to all derivatives that are unsuitable for clearing at central exchanges, for instance:

- FX swaps or forwards, currency swaps, cross-currency swaps
- Single-name credit default and narrow credit default swaps
- Interest rate swaps
- Equity swaps, forwards, and options
- Commodity swaps
- Inflation swaps
- Variance and volatility swaps
- Other non-cleared OTC instruments

What firms are in scope?

In 2022, the US threshold for compliance drops from $50 billion to $8 billion[1] in notional exposure of uncleared OTC derivatives. Globally, a lower threshold will bring into scope an estimated 750[2] insurers, hedge funds, beneficial owners, asset managers, public and private pension plans, and other financial institutions.

Counterparties to firms that exceed the threshold must also post UMR-mandated collateral for trades with those firms. Therefore, even if your firm is not close to the threshold, UMR may impact you.

How do we know if our firm's OTC derivatives exposure exceeds the threshold, putting us in scope for the rule?

Exposure is determined using a complex formula called an **Average Aggregate Notional Amount (AANA) calculation,** which is jurisdiction specific. It applies to each legal entity, over a three-month regulatory observation period. As discussed below, some custodians offer AANA monitoring as a service enabling firms to stay in compliance and/or helping them best apportion their derivatives budget if they seek to remain under the threshold.

What are the requirements if we are in scope?

Firms that exceed the threshold must determine the required initial margin and deposit collateral in segregated accounts. Margin is calculated using ISDA's **SIMM (Standard Initial Margin Model) methodology.** Segregation entails an operational workflow that includes account control agreements, collateral management agreements, and the like.

Is it possible to be in scope for UMR but not have to post margin collateral?

Yes, in certain circumstances firms are in scope but do not need to post collateral. The SIMM calculation that determines initial margin requirement strips out certain derivatives — such as physically settled FX — that are nonetheless part of the AANA calculation. For instance, a firm with $9 billion in physically settled FX derivatives and no other uncleared derivatives would be in scope, but would not be required to post margin.

Are the rules harmonized globally?

No. The rules were written by the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions (BCBS-IOSCO). Each jurisdiction is responsible for determining the details, and investors should check with the relevant authorities to verify applicable rules. (This document generally applies to the US.)

Jurisdictions enforcing UMR include the United States, European Union, Canada, Hong Kong, Japan, Korea, Singapore, Switzerland, and the United Kingdom.

What type of collateral is acceptable?

Eligible **assets vary by jurisdiction**. Although many firms have traditionally posted cash as collateral for variation margin, cash is not widely accepted as initial margin under UMR.

In the US, we believe that Treasury-only money market funds (MMFs) offer an ideal option. They provide yield enhancement potential, same-day liquidity, risk diversification and "set-it-and-forget-it" convenience. They are also widely held and accepted by counterparties, simplifying collateral negotiations.

Note that only MMFs that are 100% invested in Treasuries are eligible under UMR; some MMFs are ineligible because they reserve the right to invest a portion of assets in other instruments. State Street Global Advisors' Institutional Treasury Money Market Fund — available through all major intermediaries and platforms — is an eligible 100% Treasury fund.

Under US regulations, other UMR-compliant collateral types include exchange-traded funds and main-index equities, although both are subject to concentration limits and equity-level haircuts. Government securities may be used, but they require a greater administrative burden, as well as operational risk of failed trades.

Jurisdictions elsewhere were still considering the eligibility of MMFs in late 2021. If they do approve MMFs, we believe the same benefits would generally apply.

What actions can I take to promote compliance?

Some custodians offer **end-to-end or modular services** to monitor firm-wide AANA, calculate initial margin requirements (using SIMM), streamline collateral posting, and handle various other related requirements. Full-service custodians also offer account segregation for margin in two models: a third-party model offers custodial services and may be suitable for less complex derivatives books, while a triparty model offers greater automation and higher-touch service.

Endnotes

1 Each jurisdiction has its own threshold. See http://assets.isda.org/media/5e7ce0f1/4f4fc9ed-pdf/ for more information.

2 Source: ISDA.

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