KEY POINTS

- The initial margin (IM) application date for Phase 5 entities is 1 September 2020.
- When determining whether the IM requirements under EMIR potentially apply, an entity will need to calculate its outstanding aggregate average notional amount of non-centrally cleared OTC derivatives transactions.
- IM collateral must be segregated from the collecting party's proprietary assets, which requires both parties to open segregated accounts with a custodian – and the choice of custodian will dictate the type of documentation required.
- Most Phase 5 buy-side entities will be facing large global banks in their negotiations of the IM collateral arrangements.
- Various industry bodies in the derivatives space are lobbying regulators to make changes to the Phase 5 threshold which will bring into scope approximately 1,100 entities.

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Challenges ahead of the initial margin "big bang"

In this article the authors consider the challenges ahead for Phase 5 buy-side entities in their negotiation of initial margin collateral arrangements under the European Market Infrastructure Regulation.

One would be hard-pressed in the derivatives space to not see an alert or article reminding them of the upcoming deadlines for compliance with the initial margin requirements (IM Requirements) under the European Market Infrastructure Regulation (EU) 648/2012 (EMIR). The Phase 4 deadline is in just a few short months and the "big bang" of Phase 5 will be here in just over a year. Various industry bodies in the derivatives space are lobbying regulators to make changes to the Phase 5 threshold which will bring into scope approximately 1,100 entities. This "big bang" brings with it not only new entities but new challenges as well.

BACKGROUND ON INITIAL MARGIN

What is initial margin?

Initial margin (IM) means the collateral collected by an entity to cover its current and potential future exposure to its counterparty in the interval between:

- the last collection of collateral; and
- the liquidation of positions or hedging of market risk following a default of the other counterparty.

While similar to variation margin (VM), one of the key differences is that IM is not calculated on a daily basis based on mark-to-market valuations. Rather, IM is typically calculated based on an entity's creditworthiness and on market conditions at the outset of a transaction. While under VM there is a one-way posting of collateral on a net basis, with IM there is a two-way posting of collateral on a gross basis, resulting in further liquidity and funding implications. Also, while VM is exchanged under a title transfer collateral arrangement, IM collateral must be segregated from the collecting party's proprietary assets and held by a third-party custodian or under a legally binding arrangement to ensure that it is protected from the default or insolvency of the collecting party.

Initial margin requirements

The IM requirements, which only apply to non-centrally cleared OTC derivatives, are being phased-in under EMIR and are currently applicable to the largest users of OTC derivatives. Since the entry into force of the Regulatory Technical Standards (EU) 2017/323 (RTS) on 4 January 2017, a phased implementation began one month later and thereafter on an annual basis from 1 September 2017 to 1 September 2020.

When determining whether the IM requirements potentially apply, an entity will need to calculate the AANA in respect of its (and in most cases, its group's) non-centrally cleared OTC derivatives transactions. In respect of certain alternative investment funds (AIFs) and Undertakings for the Collective Investment in Transferable

TABLE 1: EMIR INITIAL MARGIN APPLICATION DATES

OUTSTANDING AGGREGATE AVERAGE NOTIONAL AMOUNT (AANA) OF NON-CENTRALLY CLEARED OTC DERIVATIVES TRANSACTIONS	INITIAL MARGIN APPLICATION DATE
Phase 1: Counterparty (or its group): above **€3trn**	One month after entry into force of RTS (4 February 2017)
Phase 2: Counterparty (or its group): above **€2.25trn**	1 September 2017
Phase 3: Counterparty (or its group): above **€1.5trn**	1 September 2018
Phase 4: Counterparty (or its group): above **€750bn**	1 September 2019
Phase 5: Counterparty (or its group): above **€8bn**	1 September 2020
Counterparty (or its group): **€8 bn or below**	**IM DOES NOT APPLY**

Notes:
This table does not reflect specific rules which apply in relation to certain FX OTC derivatives transactions, single-stock equity options and index options, and certain OTC derivatives transactions concluded between EU counterparties and non-EU counterparties forming part of the same accounting consolidation group – different phase-in dates apply to these (in some cases, the phase-in dates do not apply).

Securities (UCITS) this calculation is to be conducted at fund level. UCITS and AIFs managed by alternative investment fund managers authorised or registered under AIFMD should be treated as distinct entities when calculating the AANA of its non-centrally cleared OTC derivatives transactions, provided, and to the extent that, "(a) the funds are distinct segregated pools of assets for the purposes of the fund's insolvency or bankruptcy; (b) the segregated pools of assets are not collateralised, guaranteed or otherwise financially supported by other investment funds or their managers". Unlike the clearing thresholds under EMIR, these thresholds are calculated irrespective of whether the OTC derivatives transactions are speculative in nature or used to hedge a real exposure an entity has to market risk.

The rules set out under EMIR for determining whether the IM Requirements apply require the AANA of non-centrally cleared OTC derivatives transactions to be an average of the aggregate notional amount of OTC derivatives transactions as recorded on the last business day of March, April and May in each year with respect to an entity and, where applicable, its group (ie March, April and May 2019 for compliance from 1 September 2019, and March, April and May 2020 for compliance from 1 September 2020). It is necessary to include in this calculation all OTC derivatives transactions outstanding on those dates (including physically-settled FX forwards, physically-settled FX swaps and currency swaps). However, no IM needs to be collected in respect of physically-settled FX forwards, physically-settled FX swaps or currency swaps.

The EMIR Requirements provide for IM thresholds. Parties to a derivatives transaction (who are not members of the same group) may agree to apply a threshold of up to €50m for exchange of IM – ie no IM is required until the IM due from all entities within the group exceeds €50m. Where the parties are members of the same group, the maximum threshold will be €10m.

Several industry associations have been vocal in supporting a change to the IM Requirements as Phase 5 approaches. A more detailed discussion of the status of these efforts is outlined at the end of this article.

THE DOCUMENTATION

The documentation required for compliance with the IM Requirements is a far more significant endeavour than that which was required during compliance with VM. Not only is the content more complex but also the pure volume of documentation required is greater. IM collateral must be segregated from the collecting party's proprietary assets, which requires both parties to open segregated accounts with a custodian – and the choice of custodian will dictate the type of documentation required.

2018 Credit Support Deed for Initial Margin

ISDA has produced template credit support documents to assist compliance by in-scope entities with the IM Requirements. Late in 2018, ISDA updated the 2016 Phase One IM Credit Support Deed (2016 IM CSD) and published the 2018 Credit Support Deed for Initial Margin (2018 IM CSD).

ISDA's updates to the credit support documentation are based on some of the experiences that in-scope entities had while negotiating the documentation during Phases 1-3 and take into account recent regulatory developments that have occurred in respect of IM compliance, globally. They are also aimed at providing further flexibility to the parties, by setting out additional elections which take into account that a broader range of entities will be within scope of the IM Requirements.

Some of the changes implemented in the 2018 IM CSD include:

- Election of method of calculating margin: delivery and return amounts will be calculated on the basis of one of the following approaches: "Allocated Margin Flow (IM/IA)", "Distinct Margin Flow (IM)" and "Greater of Margin Flow (IM/IA)".
- Addition of provisions covering the relationship between the ACA (as referred to below) and the obligations set out in the 2018 IM CSD. This includes an election for parties to choose whether the ACA would be a credit support document for the purposes of the ISDA Master Agreement (this election is especially pertinent to s 5(a)(iii) of the ISDA Master Agreement regarding an Event of Default).
- Addition of a negative pledge restricting the collateral provider from permitting any other security interest to be granted over the collateral, the collateral account or associated rights.
- Addition of a restriction on the collateral provider's ability to sell, pledge, rehypothecate, assign or invest the collateral.

2019 Collateral Transfer Agreements and 2019 Security Agreement

ISDA has published two template documents which are commonly used by Clearstream Banking S.A. (Clearstream) or Euroclear SA/NV (Euroclear) when acting as custodian: (i) the 2019 Collateral Transfer Agreements (CTA); and (ii) the 2019 Security Agreements (SA).

The provisions of the CTA mirror those in the 2018 CSD however, the security interest over the IM collateral is created under a separate SA which, in respect of Clearstream, are governed by Luxembourg law and, in respect of Euroclear, are governed by Belgian law.

Additional documentation

As a result of the requirement to hold IM in segregated accounts, it is also necessary to execute an Account Control Agreement (ACA). The ACA sets out the custodian's role and the circumstances in which the collateral may be released and transferred to the collateral receiver.

In the last few years, four custodians have been providing the majority of the custody services available in connection with IM (ie The Bank of New York Mellon, J.P. Morgan, Euroclear and Clearstream) on the basis of their template documentation and their own legal opinions. However, it is likely that additional custodians will break into the market soon. The entry of additional custodians into this market might result in new documentation being proposed to be

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used to comply with IM and, thus, further consideration by in-scope entities as to the legal risks and operational challenges involved.

CHALLENGES FACING PHASE 5

It is important for entities that will be brought within scope of the IM Requirements under Phase 5 to consider the potential challenges they may shortly face. Those who went through the VM implementation in late 2016 and early 2017 can attest that it was challenging to negotiate the VM documentation with multiple counterparties in a relatively short period of time. The "big bang" in September 2020 will bring similar challenges with even more documentation.

Assessing Phase 5 status, self-disclosure and determining funding and liquidity implications

Entities are likely to face operational challenges as part of the process of establishing that they are indeed within scope of the final phase of the IM Requirements, when notifying their counterparties, and when considering the potential funding and liquidity implications resulting from the need to comply with the IM Requirements. This will be discussed in further detail below in "How to Get Ahead".

Volume and complexity of documentation

As discussed above, the documentation required for IM compliance will depend on the choice of the custodian and in most cases will include the use of:

- either a 2018 IM CSD or a CTA together with an SA;
- an eligible collateral schedule; and
- an ACA.

This set of IM documents (IM Documentation) may be doubled in volume depending on the choice of custodians by the parties to a derivatives arrangement. An entity will need to ensure that it has in place custody arrangements for both: (i) the IM posted by it to its counterparty; and (ii) the IM collected by it from its counterparty. Where the parties have selected different custodians, this will likely result in double the documentation, double the negotiation and potentially double the cost.

The IM Documentation is also more complex than that which was required for VM. The 2016 VM CSA tracked what was already in existence in the industry standard ISDA 1995 Credit Support Annex (Transfer – English Law) (1995 CSA) whereas the 2018 IM CSD could be construed as a brand-new document. The 2018 IM CSD contains some of the elections that are also included in both the 1995 CSA and the 2016 VM CSA (eg minimum transfer amounts and thresholds). However, there are substantial differences in its overall structure and the way its collateral arrangements operate. The 2018 IM CSD contains new provisions to reflect the introduction of a third-party custodian into the collateral arrangements. It also includes new elections relating to the IM calculation methodology to be used by the parties, the approach for calculating IM for certain product types and eligible collateral schedules with new types of collateral. The documentation requires significant commercial consideration and negotiation.

Lack of experience

Most Phase 5 entities will be facing large global banks in their negotiations of the IM Documentation. These banks have been subject to the IM Requirements for more than two years (as part of Phases 1-3) and have already gone through multiple rounds of document negotiation. Phase 5 entities will most likely not have experience negotiating the IM Documentation so will be one step behind their bank counterparties. Finding the right negotiators will prove to be a difficult (and expensive) endeavour – increased demand with little supply.

The final phase is expected to bring challenges not only to the buy-side, but also to sell-side entities. Although the Phase 1-3 bank counterparties might have experience negotiating IM arrangements with other major banks, they will not be as well-versed in negotiating IM arrangements with buy-side counterparties. However, it is helpful that later this year, as part of Phase 4, there will be an increase in negotiations with buy-side entities, as around 100 buy-side institutions are expected to be brought within scope of the IM Requirements from September 2019.

Choice of collateral

EMIR provides for an extensive list of types of collateral that are eligible to be posted as IM. Eligible collateral includes cash, money markets deposits, gold, sovereign debt, corporate bonds, convertible bonds, equities, etc. The types of collateral that have predominantly been posted in Phases 1-3 include fixed income and other non-cash collateral, such as government debt.

The types of collateral will expand as the types of collateral used between large banks are likely to be different from those used by the buy-side. Types of collateral that have not been widely used but the market is likely to see in the context of IM include money market funds and UCITS. The addition of these types of collateral may cause some operational issues as it might require custodians and counterparties to adapt their documents, policies and operational systems.

HOW TO GET AHEAD

To alleviate some of these burdens, Phase 5 entities should look to get ahead of the challenges they will likely face.

Discussing internally

Entities will need to discuss within their own organisations in order to:

- assess whether their AANA could potentially bring them within scope of the IM Requirements;
- consider their risk appetite;
- select their preferred custodians (by no later than Q4 2019);
- determine their preference for calculation methodology (ie grid methodology or ISDA SIMM – preference is fact-specific and depends on cost, operational and technical considerations);
- make commercial decisions on various elections and on the treatment to be given to any legacy transactions;
- assess the potential liquidity and funding

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implications resulting from the IM Requirements, and any new sources of liquidity; and

- consider any potential new IT systems required.

It will also be important for entities to consider how any existing independent amount (IA) will be treated as they become within scope of the IM Requirements – from an operational and commercial perspective, would these entities seek to use any existing IA to comply with the upcoming IM Requirements, or should the relevant collateral pools be kept separate?

In their internal discussions, entities will need to determine which of their derivatives counterparties are within scope and begin the self-disclosure process.

Self-disclosure and discussing externally with counterparties and custodians

Once entities have concluded that they will be within scope of the final phase of IM they should promptly disclose their anticipated status to their counterparties. This step will likely represent challenges given the complexities involved when conducting the calculations. For example, where a fund uses multiple managers, each asset manager will need to consider which entity should make the calculations and disclosures, and ensure disclosures are made to all counterparty banks. Also, there will be greater complexities to be considered in circumstances where a fund holds trade portfolios which are governed by multiple jurisdictions with different applicable rule sets.

Self-disclosure allows entities to obtain information on their counterparties' custodians and the IM Documentation required.

When discussing with counterparties and custodians, it is also important to understand what to expect in the on-boarding and negotiation processes and where an entity fits in the priority list of other parties and negotiations.

Entities should seek to have their custody and collateral management arrangements (including the relevant custodian accounts) agreed and tested with their custodians early in the process.

In conjunction with their counterparties, entities should determine if multiple credit support arrangements will be used to maintain legacy transactions, or whether all (new and legacy) transactions will be subject to the IM Documentation as of the Phase 5 go-live date.

Efficient document negotiation

Efficiently negotiating documents is one of the best ways to keep time and costs down. This can be achieved by preparing an internal playbook on how to handle negotiations and commercial decisions, template documentation to be used for negotiations and a term sheet of commercial elections.

In lieu of exchanging lengthy documentation, a term sheet could be exchanged between counterparties during the negotiation process. Once agreed, the IM Documentation can then be completed with the elections selected.

CURRENT MARKET DISCUSSIONS ON PHASE 5 IMPLEMENTATION

ISDA and other industry bodies have expressed concerns over the implementation of the final phase of the IM Requirements. Their view is that there will be significant obstacles and disruption for smaller counterparties that pose little or no systemic risk to the derivatives market. They have suggested to the Basel Committee on Banking Supervision and International Organization of Securities Commissions (BCBS/IOSCO) that the IM Requirements be adjusted, specifically:

- to raise the threshold to €100bn (currently €8bn);
- to remove physically-settled FX forwards and physically-settled FX swaps from the *calculation* of AANA; and
- to remove the requirement to put legal documentation in place for counterparties with IM amounts below the €50m threshold.

In response, BCBS/IOSCO released a statement in which they recognised that the current framework does not provide specifications with regards to documentation, custody or operational requirements if the bilateral IM amount does not exceed the framework's €50m IM threshold and that they expect entities only to enter into the necessary arrangements when the threshold is exceeded.

According to ISDA, if the BCBS/IOSCO's statement is adopted, a significant portion of Phase 5 entities (approximately 70-80%) will be able to defer much of their compliance with IM Requirements. However, Phase 5 entities will still be required to conduct AANA calculations, conduct self-disclosure to counterparties and create internal policies and procedures to monitor IM thresholds within the entity. In May 2019 ISDA published helpful guidance to assist Phase 5 entities that will not exceed the €50m IM threshold.

It is still unclear if further statements will be issued by BCBS/IOSCO to deal with these issues – market participants are advised to keep an eye on any additional developments.

The fate of the Phase 5 entities continues to be in flux and is one that we will continue to hear about following the Phase 4 implementation in September 2019 and the eventual "big bang" in September 2020. ■

Further Reading:

- How soon is now? Release of collateral in initial margin arrangements (2019) 7 JIBFL 431.
- The benefits and pitfalls of triparty collateral arrangements (2013) 10 JIBFL 627.
- LexisPSL: Banking & Finance: Practice Note: Margin requirements for uncleared derivatives.