Are you ready to comply with the UMR?

Phase 5 of the uncleared margin rules (UMR) for OTC derivatives transactions will come into effect in September 2020, bringing many more buy-side firms into scope. Scott Fitzpatrick explains what they should be doing to prepare.

Scott Fitzpatrick

Director of Collateral Business and Client Operations

Phase 5: September 2020

We are now in the final phases of the introduction of the new margin rules for uncleared over-the-counter (OTC) derivatives transactions. The rules were introduced around the world in 2016, and now just two more phases remain. Phase 4 comes into effect in September 2019, and phase 5 in September 2020.

So which firms fall within the scope of these final phases? And specifically, what will firms in scope for Phase 5 have to do to comply? And when should they start preparing?

First a bit of background. Although every local prudential regulator is responsible for writing and implementing its own detailed uncleared margin rules (UMR), they are all based on a framework created by the Basel Committee on Banking Supervision (BCBS) and the International Organisation of Securities Commissions (IOSCO) in response to the G20's reforms introduced after the 2008 financial crisis.

What are Uncleared Margin Rules?

The rules require financial firms and "systemically important non-financial entities" to post initial margin (IM) and variation margin (VM) when trading uncleared OTC derivatives. The margins are intended to ensure that enough collateral is available to offset any losses caused by the default of a counterparty in an uncleared OTC derivatives trade, thus reducing systemic risk in the market and incentivising central clearing. This puts uncleared OTC derivatives on a similar footing to centrally cleared OTC derivatives where strict margin rules already exist.

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Currently, the VM rules apply to all firms, but the IM rules apply only to entities trading aggregate average notional amounts (AANA) of uncleared OTC derivatives over €1.5 trillion. These are all sell-side banks and broker-dealers, plus a few large buy-side firms.

When Phase 4 comes into effect, the IM rules will apply to firms with notional amounts above €750 billion, but most buy-side firms will still be exempt because of their lower trading volumes. When Phase 5 comes in the rules will apply to firms with notional amounts above €8 billion, capturing all but the smallest buy-side firms. From that date, in-scope firms will have to post IM to dealers and receive IM from dealers, a process most will be unfamiliar with. It will present them with fresh legal and operational challenges.

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So how should these buy-side firms approach the challenges of Phase 5 compliance?

For a start, they will need to understand their portfolios, what their AANAs are and whether they will come under Phase 4 or 5. They will have to make sure they have the correct legal documentation with their trading counterparties, the large banks. They must also be aware of how many of their trading relationships will be above the €50 million IM threshold, the level at which an exchange of initial margin is required.

There are several other steps to follow, such as establishing relationships with relevant custodians, building up capacity for compliance and last-minute testing before the deadline kicks in. ISDA, the International Swaps and Derivatives Association, has produced a useful eight-step guide to help Phase 4 and 5 firms prepare.

Here at AcadiaSoft we are devoting a lot of management time to help buy-side firms get ready. We are the leading industry provider of risk and collateral management services for uncleared OTC derivatives transactions. We are owned by 13 global banks and three market infrastructures, with 99% of Phase 1, 2 and 3 firms achieving UMR compliance by using AcadiaSoft’s solutions. The knowledge and expertise built up over that period is now being used to help Phase 4 and 5 firms.

AcadiaSoft’s Risk Services Suite

We have brought to market the Risk Services Suite, our “low touch” service that enable buy-side firms achieve compliance through “One Connection, One Solution”. It’s a single contract, with a cost-effective set price, giving the buy-side connectivity to all Phase 1, 2 and 3 firms and access to the entire AcadiaSoft community, including:

1. **AgreementManager:** Establishes an authoritative source of Collateral agreement through common standards and a unified workflow.
2. **Sensitivities Calculation:** Fully automates the IM process, calculates sensitivities and generates the Common Risk Interchange Format (CRIF) file that forms the input to the SIMM™ calculation.
3. **IM Exposure Manager:** Provides end-to-end IM reconciliation and calculation, helping bring firms into compliance with the new regulatory requirement.
4. **MarginManager:** A full STP workflow for calculation of IM margin calls, collateral management and access to the entire counterparty network.

We call it SIMM™ Made Simple.

We have established market wide working groups dedicated to the buy-side firms that are in-scope. Over the next three months we are holding workshops and hosting road shows in key financial centres around the world to explain to firms what they should be doing to prepare for Phase 5. We are also creating webinars and podcasts to supplement this activity.

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Listen to the full interview at http://bit.ly/AcadiaPod_SF

For more in-depth information about navigating Uncleared Margin Rules, visit our dedicated UMR compass site: www.acadiasoft.com/umr_compass or email info@acadiasoft.com to book a demo with one of our experts.