Regulatory initial margin considerations for MENA entities

Madhurima Basu - Senior Counsel - Banking and Finance
m.basu@tamimi.com - Kuwait City

You are a bank or large derivatives counterparty in the MENA region and your international counterparties have been enquiring if you are in scope for regulatory initial margin and if you have started implementing regulatory initial margin. Given you are operating in the MENA region, you are wondering whether the regulatory initial margin applies to you. In this article, we focus on certain requirements of regulatory initial margin relevant when dealing with European counterparties.

As a background, after the global financial crisis, the global regulators focused on revamping the over-the-counter ('OTC') derivatives market and introduced a range of measures including transaction reporting, clearing margin requirements for non centrally cleared derivatives.

The European Union adopted Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories ('EMIR'), as amended, as the umbrella regulation in this respect. More specifically, the Commission Delegated Regulation (EU) 2016/2251 supplemented the EMIR in respect of the margin rules for uncleared derivatives ('Margin Rules'). The Margin Rules include requirements to collect and post variation margin and initial margin ('IM').

IM coverage is effective in global jurisdictions such as the United States, Canada, Brazil, Switzerland, Japan, Hong Kong, South Korea, Singapore and Australia among others in addition to the EU with similar requirements.

What is IM?

IM is defined as "the collateral collected by a counterparty to cover its current and potential future exposure in the interval between the last collection of margin and the liquidation of positions or hedging of market risk following a default of the other counterparty". The IM should be collected on a gross basis without netting amounts collected by each party and segregated to protect from the insolvency or default of the collecting party.

Which entities are affected?

IM requirements apply where both parties to non centrally cleared derivatives are:

1. EU established financial counterparties ('FC') and non-financial counterparties above the clearing threshold set out under EMIR ('NFC+'); and
2. third country entities that would be a FC or NFC+ if established in the EU ('Covered TCE').

Most relevant to a Covered TCE, IM requirements apply (directly or indirectly):

1. when a Covered TCE is facing a FC or a NFC+; or

2. when two Covered TCEs trade with each other where: (a) both are acting through a branch in the EU and both would be FCs if established in the EU; or (b) either TCE is guaranteed by a FC established in the EU.

What is the threshold for application of IM requirements?

The IM requirements apply where both counterparties have, or belong to groups each of which has, an aggregate average notional amount ('AANA') of non centrally cleared derivatives, for the months of March, April and May of the preceding year, that is above €8 billion (approximately US$9.5 billion). The AANA should be calculated at the entity level or the group level if the entity belongs to a group.

When do the IM requirements commence?

The IM requirements have been phased out over several years with the largest entities coming into scope at the start.

On 3 April 2020, the Basel Committee on Banking Supervision ('BCBS') and the International Organisation of Securities Commissions ('IOSCO') announced their agreement to defer the deadline for completing the final two implementation phases of the IM requirements by one year. This additional time was recommended, bearing in mind the immediate impact of COVID-19 on the parties. The recommendation would now have to be formally approved by EU regulators.

These changes would result in covered counterparties with an AANA above €50 billion (approximately US$60 billion) becoming subject to the requirement to exchange initial margin from 1 September 2021, while covered counterparties with an AANA above €8 billion (approximately US$9.5 billion) becoming subject to the requirement from 1 September 2022.

What are the main obligations in respect of IM under the Margin Rules?

The main obligations in respect of IM under the Margin Rules are:

1. the IM requirement applies to all OTC derivatives which are non centrally cleared though there are certain exemptions;
2. no IM is required where IM due does not exceed €50 million (approximately US$60 million) though there are some differences in respect of some groups;
3. the IM should be calculated within one business day of any change to the netting set (such as a new trade being added or an existing trade being removed or having expired), a payment obligation being triggered, if no calculation has been made for the preceding ten business days or a trade is reclassified due to a reduction in maturity time;
4. the IM may be calculated using a standardised method or a proprietary method acceptable to regulators. In this respect, ISDA has developed the Standard Initial Margin Model ('SIMM') which has been almost universally adopted and, given its large scale acceptance, would lead to limited mismatches and disputes between trading counterparties;

5. IM must be segregated from the collecting party's own assets;
6. the collateral collected as IM should follow the eligibility requirements set out in the Margin Rules;
7. the collecting party cannot reuse the IM received from a trading counterparty; and
8. the parties should enter into collateral agreements covering the matters prescribed in the Margin Rules.

What is the concern with non-netting jurisdictions?

An area of concern for EU counterparties was their obligation to post collateral to Covered TCEs when the legal enforceability of netting and/or segregation in the relevant third party could not be conclusively determined.

Accordingly, the exchange of IM under the Margin Rules requires that an independent legal review of a netting agreement or an exchange of collateral agreement be legally enforced with certainty at all times and the requirements of segregation be met. When an independent legal review confirms that these standards may not be met, the Margin Rules grant certain limited exemptions.

What should be the next steps for a Covered TCE?

1. Covered TCEs should assess whether they are likely to be in-scope for IM requirements;
2. if in-scope, notify their trading counterparties so that preparations for compliance can be made in a timely manner. ISDA has prepared a standard form of disclosure letter which firms can use to indicate to their trading counterparty whether or not they may be in-scope for IM;
3. the Covered TCE should establish custodian relationships and open segregated accounts to post and collect IM. These may be bank custodians or securities depositories;
4. the Covered TCE should set up the operational capacity to calculate IM based on the ISDA SIMM or other models that are acceptable from a regulatory perspective; and
5. depending on the type of custodial relationships chosen by both the Covered TCE and its trading counterparty, the legal documents may include a bilateral IM credit support annex or credit support deed or collateral transfer agreement/security agreement for each counterparty pair and a trilateral account control agreement or similar document for each counterparty/custodian trio. The Covered TCE should set up procedures and teams to negotiate these legal documents prior to the implementation date.

While the issues raised in this note identify some of the more pressing questions to understanding when dealing with regulatory IM, they are certainly not exhaustive. Banks and other institutions in the MENA region dealing in derivative transactions should ensure a full understanding of the rules and requirements when dealing with international counterparties.

For further information, please contact Jody Waugh (j.waugh@tamimi.com), Omar Handoush (o.handoush@tamimi.com) or Madhurima Basu (m.basu@tamimi.com).