A Spotlight on OTC Regulation - Succeed in the New World

Co-hosted by CFA Society Toronto, PRMIA Toronto and AIMA Canada,
with the support of TriOptima

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Panel Discussion

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Panelists:

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Trade Reporting

Canadian OTC Derivatives Reform

OTC Derivative Trade Reporting Dates

Dec.31,2013	Oct.31,2014	Jun.30,2015	Jul.29,2016
Effective Date of TR Rule	Dealer & Cleared Transaction Reporting Obligation	Local End-User Reporting Obligation	Public Dissemination of Transaction-level TR Data

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OSC 91-507 Rule Amendment

- Public dissemination of transaction level data:
  - To consider notional capping and rounding;
  - Dissemination delay;
  - Only for liquid products;
- End user inter-affiliate treatment;
- LEI requirements for local counterparties;

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OSC 91-507 Rule Compliance

- Staff Notice 91-704 outlining scope of compliance program for OSC Rule 91-507
- Purpose of compliance program:
  - Reinforce importance of reporting;
  - Educate participants of requirements;
  - Assess level of compliance;
  - Identification of reporting obstacles;
- Review of first market participant to commence Q4 2015;

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International Data Harmonization

- CPMI IOSCO Data Harmonization Group
  - Consultation paper on harmonization of the Unique Transaction Identifier (Aug 2015);
  - Consultation paper on first batch of other data elements (Sept 2015);
  - Consultation paper on the harmonisation of UPIs (Q4 2015);
- Global LEI Foundation
  - Global standard for entity identification for derivatives transactions;
  - 400,000 LEIs issued globally;

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Portfolio Reconciliation Requirements

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IOSCO Risk Mitigation Standards

The final Risk Mitigation Standards framework was published by IOSCO in January 2015*

- ODRG commitment to reference this document as their Risk Mitigation Standards
- Canadian provincial regulators to implement rules aligned to framework
- Portfolio Reconciliation and Dispute Resolution included
- Covers all non-cleared derivatives traded by financials and "systemically important non-financials"

*http://www.iosco.org/library/pubdocs/pdf/IOSCOPD469.pdf

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IOSCO Risk Mitigation Standards

Portfolio Reconciliation

Item	Description
Agreement	Covered entities should agree on the process and method of reconciliation
Reconciliation frequency	Reconciliation should occur at regular intervals *authorities may seek to impose specific frequencies
Terms for reconciliation	"Material terms" and valuation

IOSCO Risk Mitigation Standards

Dispute Resolution

Item	Description
Dispute identification	Covered entities should agree a process to determine when a discrepancy in material terms or valuation is a dispute
Dispute Reporting	Authorities may seek to impose a dispute reporting requirement

Uncleared Margin Rules

Background

2009

Group of Twenty (G20), in light of the recent financial crisis, initiates an over-the-counter (OTC) derivatives reform program to improve the transparency and increase regulation of OTC derivatives market-participants in an attempt to reduce the excess and opaque risk-taking and systemic risk posed by OTC derivative transactions, markets and practices.

The G20's reform program consists of four key elements:

- All standardized OTC derivatives should be traded on exchanges or electronic platforms, where appropriate.
- All standardized OTC derivatives should be cleared through central counterparties (CCPs).
- OTC derivative contracts should be reported to trade repositories
- Non-centrally cleared derivative contracts should be subject to higher capital requirements

2011

G20 agreed to margin requirements for non-centrally cleared derivatives, the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) was called upon to develop global standards for margin requirements for non-centrally cleared derivatives.

2012

Initial consultation paper is released resulting in the release of a Quantitative Impact Study by large market participants assessing the potential liquidity and other quantitative impacts associated with mandatory margining.

2015

BCBS/IOSCO final policy framework establishing the minimum standards for margin requirements for non-centrally cleared derivatives is published in March.

Uncleared Margin Rules – Key Principles and Requirements

BCBS/IOSCO's final policy is comprised of eight key principles for all derivative transactions that are not cleared by Central Counterparties (CCPs):

1. Appropriate margining practices are to be in place.
2. All financial firms and systemically important non-financial entities ('covered entities') must exchange initial margin (IM) and variation margin (VM) suitable to the counterparty risks posed by such transactions.
3. Methodologies for calculating IM and VM should be:
   - Consistent across entities covered and reflect the current exposure (VM) and potential future exposure (IM) with the portfolio.
   - All counterparty risk exposures are to be fully covered with a high degree of confidence
4. To ensure that collateral posted for IM and VM can be liquidated within a reasonable time frame to generate proceeds to sufficiently protect collecting entities from incurring loses in the event of a default, assets should be highly liquid and should, after accounting for an appropriate haircut, be expected to hold their value.
5. IM should be exchanged by both parties on a gross basis without netting amounts collected by each party. In addition IM is to be held in a manner that provides for:
   Margin collected is immediately available to the collecting party in the event of a counterparty's default; and
   Collected margin must be subject to arrangements that fully protect the posting party to the extent possible under applicable law in the event that the counterparty declares bankruptcy.

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Uncleared Margin Rules – Key Principles and Requirements

6. Transactions between a firm and its affiliates should be subject to appropriate regulation in a manner consistent with each jurisdiction's legal and regulatory framework.
7. Regulatory regimes should cooperatively work together to ensure that requirements are consistent and not duplicated across jurisdictions.
8. Requirements to be phased in to allow for systemic risk reductions and incentive benefits are appropriately balanced against the liquidity, operational and transition costs of implementation to covered entities. In addition, a coordinated review of the new requirements post implementation is recommended by regulators to ensure that the intent of the regulations are effectively maintained across nation jurisdictions as well as across related regulatory initiatives.

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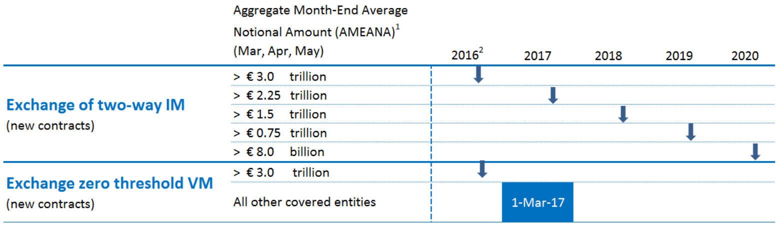
Framework phase-in timelines

The framework will be phased in over five years as follows:



[1] All outstanding notional amounts of non-centrally cleared OTC derivatives to be included in AMEANA calculation, including physically-settled FX forwards and FX swaps.

[2] Time period September 1 to August 31 annually, based on AMEANA for March, April, May of that year.

Industry Impacts

- Margin call volumes and amounts anticipated to increase substantially.
- Introduction of a bifurcated model for IM and VM to a post compliance transactions.
  - Need for post-compliance CSAs to be negotiated and finalized prior to compliance dates. Potential for post-compliance ISDAs to establish new master netting agreements, otherwise legacy trades may be swept into the new rules.
  - Firms must be prepared to support multiple CSA agreements per counterparty; the same transactions can be applicable for margining under multiple agreements simultaneously.
  - Potential for a higher number of disputes related to IM, VM and collateral asset valuations.
  - Canadian FRFI's may be subject to cross-border implications when facing a counterparty under another regulator's jurisdiction.

Initial Margin (IM):
- Liquidity impact of inability to re-hypothecate collateral.
- Requirement for IM to be held at 3rd party custodians will increase the number of custodial relationships and tri-party control agreements.
- Model-based IM calculations versus scheduled-based IM calculations will introduce more complexity, potentially resulting in more disputes; however, will reduce capital requirements.
- Determination of IM across a related group of counterparties.
- Additional 8% haircut on collateral when currency of derivative differs from currency of collateral.

Variation Margin (VM):
- Mandatory threshold set at zero will be operationally burdensome.
- Eligible collateral restricted to cash only will have liquidity implications (US rules).
- Requirement to identify location, jurisdiction and ultimate beneficiary of re-hypothecated collateral will be challenging.

Industry Challenges

- Phase-in calculation of Aggregate Month-End Average Notional amounts and disclosure requirements, to identify in-scope Counterparties.
- Lack of harmonization across multiple regulatory regimes:
  - Cross-border rules may be difficult to interpret and apply.
  - Operationally challenging and costly to potentially comply with multiple regulatory regimes.
- Policies and Procedures:
  - Written dispute resolution policies and procedures to be documented and agreed with counterparties prior to transacting.
  - Implementation and on-going calibration of ISDA Standard Initial Margin Model (SIMM) with required governance, back-testing and oversight.
- Substantial increase in legal documentation:
  - ISDA, CSA, Custodian and Tri-party Control agreements (new, amended) required to support the new regulatory landscape and diverse regulatory jurisdiction requirements.
- Potential punitive impact to capital for long running disputes:
  - Margin period of risk doubling in instances where there are more than two margin call disputes with the same counterparty over the previous two quarters.
- Daily management of collateral is becoming more complex/specialized:
  - Day-to-day management of collateral including the determination of IM will require more quantitative expertise, a skill set not typical of current collateral management middle/back-office groups.

Regulator Progress – Uncleared Margin Rules

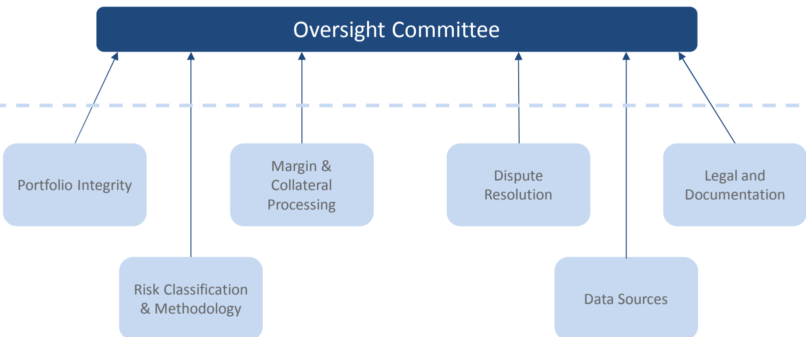
2013	September	Basel Committee on Banking Supervision (BCBS) / The International Organization of Securities Commissions (IOSCO) Framework for Margin Requirements for Non-centrally Cleared Derivatives - *draft*
2014		*Draft rules emerge from other jurisdictions*
	April	European Supervisory Authorities (ESMA/EBA/EIOPA)
	July	The Japanese Financial Securities Authority (JAPAN FSA)
	September	The Prudential Regulators (FRB/FDIC/OCC/FCA/FHFA)
	October	The Commodities Future and Trading Commission (CFTC)
2015	March	Basel Committee on Banking Supervision (BCBS) / The International Organization of Securities Commissions (IOSCO) Framework for Margin Requirements for Non-centrally Cleared Derivatives - *final*
	October	The Prudential Regulators (FRB/FDIC/OCC/FCA/FHFA) - *final*
		Policy Consultation on Margin Requirements for Non-Centrally Cleared OTC Derivatives (Singapore MAS) - *draft for public comment*
		OSFI Margin Requirements Guideline - *draft for public comment*

Industry Initiatives

ISDA WGMR Implementation

The complexity of the new rules has initiated an organized and focused market response

https://www2.isda.org/functional-areas/wgmr-implementation



ISDA Working Groups Responsibilities

- Portfolio Integrity:
  - What trade populations are effected
  - Which entities are "Covered Entities" in each jurisdiction
  - Related portfolio reconciliation needs
- Margin & Collateral Processing:
  - IM processing needs
  - VM processing needs
  - IM segregation/limited rehypothecation processing needs
- Risk Classification & Methodology:
  - SIMM model development, backtesting discussions, regulatory approval

ISDA Working Groups Responsibilities

- Data Sources:
  - Standards for mapping trades to model risk buckets and associated risk weights
- Dispute Resolution:
  - IM dispute resolution procedures
  - VM dispute resolution procedures
  - Dispute reporting requirements
- Legal & Documentation:
  - New document requirements
  - New self-disclosure requirements

Preparing for New Rules – initial steps

- Addressing Documentation for "Covered Entities"
  - CSA's must conform to regulatory standards
  - In advance of final rules catalogue where/how do your CSAs diverge from BCBS-IOSCO standards
  - Where does it make sense to split legacy and new
- Preparing for self-declaration
  - ISDA working on enhancements to ISDA Amend to allow entities to self declare certain items (heavily dependent on final rule announcements):
    - Party status under each jurisdiction (e.g. end user, NFC+, NFC-)
    - AANA under each jurisdiction
    - Party group they belong to

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New rules,
New challenges

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Margin Desk Challenges

Increasing margin desk complexity:

- Multiple daily calls against a given entity:
  - Legacy VM
  - Legacy IM/Independent Amount
  - Regulatory VM
  - Regulatory IM
- Increased call volume
  - Zero thresholds, daily calls, mandatory collateralization
- Segregation/Custodian arrangements
  - Tri-party vs. Third party

Dispute Related Challenges

- Margin disputes will be subject to capital penalties for Banks.
- Coherent and proactive dispute prevention needed
- Enhanced reporting is required for each jurisdiction & margin type
- Better analysis tools are required
- Dispute investigation processes need to be efficient

The Process Fragmentation Challenge

- Firms currently have separate processes for related functions:
  - Margin Desk (CMS with email)
  - Disputes Analysis & Reporting (mostly manual)
  - Portfolio Reconciliation (triResolve)
  - Workflow systems
- Not scalable, not efficient, not sustainable

Industry process transformation is urgently needed!!!!

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Future Needs Assessment

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Full Process Digitization

- Manual steps need to be removed from the process
- All areas need to be digitized to support regulatory needs:
  - Margin amount agreement process
  - Dispute analysis & reporting
  - Audit trails for difference/dispute investigation steps
- Paves the way for exception-based STP automation

Extend Portfolio Reconciliation Capabilities

- Algorithmic MTM Difference Attribution to speed investigation
  - Population differences:
    - New unmatched
    - Aged unmatched
    - Broken matches
  - MTM quality assessment:
    - Stale MTM
    - Large MTM Swings
    - Zero or blank MTM
  - Time-series analysis:
    - Poor MTM Correlation
    - Persistent MTM diffs
    - Non-persistent MTM diffs

Market-wide Solution for IM

- Market Participants will have to use the same IM model to minimize potential for disputes:
- ISDA SIMM™ (Standard Initial Margin Model)
  - Sensitivity Based Approach
  - Central Risk Weights & Correlations
  - Calculation of Initial Margin
  - Reconciliation of sensitivities across SIMM buckets

Coherent Investigation Tools

- Add rules based capability to automatically assign items to groups/individuals for investigation
- Fully capture internal and external communication around differences (transparency)
- Root cause assignment/analysis
- Ability to automatically close case / reopen case based on rules
- Full audit trail
- MI Reporting

Integrate Processes

- Join margin call to portfolio reconciliation processes
  - Portrec surfaces differences to case management
  - Case management root causes inform margin disputes
- Track and age margin disputes
  - Different aging required for difference jurisdictions
- Send dispute information to group finance
  - For use in capital calculations etc.

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Lay Groundwork for Dispute Resolution

- Enhanced transparency makes resolution of Margin Disputes possible:
- Call corrections:
  - Portfolio reconciliation differences
  - Explained by root causes
  - May help parties actually correct inaccurate margin calls effectively resolving erroneous disputes
- Collateral and CSA reconciliations:
  - Disclose other potential dispute drivers

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Arriving at the "Next" Normal

- Industry utilities can help to transform markets in a low cost and efficient manner
  - Easy take up by utility users
  - Globally scalable solutions
- Formation of the Collateral Hub
  - AcadiaSoft
  - TriOptima
  - DTCC