Swap dealers gain six-month reprieve from variation margin requirements

IA Watch (online edition) February 20, 2017

Through a new No-Action Letter, the CFTC has delayed the March 1 effective date for its new variation margin rules until Sept. 1, so as to help “avoid a disruption in the uncleared swap market.” The move comes after the regulator was heavily lobbied to delay the rule, citing the industry’s unpreparedness.

Regulators around the globe had hoped for unified margin rules. However, regulators in Singapore, Hong Kong and Australia had delayed their variation margin rules.

Earlier this month, the International Swaps and Derivatives Association and others dispatched a letter to 22 regulators around the world, including the CFTC and FCA, asking for “regulatory forbearance” concerning the March 1 compliance date. The groups sought a six-month transition period because “both market participants and the framers of the global implementation schedule underestimated how challenging this phase of the implementation would be.”

Two relevant Commodity Exchange Act rules are rule 23.155 (calculation of variation margin) and rule 23.153 (collection and posting of variation margin). They first went into place for larger uncleared swaps traders last September (**CPO/CTA Watch**, Dec. 17, 2015).

The rules really fall upon swap dealers but there are smart compliance steps you can take to avoid trouble with uncleared swaps trades after they take effect across the larger market in September. Advisers and others “get caught up because the dealers have to comply,” says Ben **Anderson**, principal with **Anderson** PLC in Minneapolis.

What is variation margin

Look to Commodity Exchange Act rule 23.700 (definitions) to spell out what variation margin means. It’s “a payment made by or collateral posted by a party to a swap to cover the current exposure arising from changes in the market value of the position since the trade was executed or the previous time the position was marked to market.”

The real impact of the new rules on advisers that deal in uncleared swaps comes in the need to revise existing CSAs, or credit support annex agreements, with counterparties. They spell out terms for such trades. If these agreements aren’t updated to take into account the new rules, counterparties may elect not to trade with you or could use “netting” to take collateral from your other deals with them to satisfy the original deal’s shifting margin, adds **Anderson**.

Kristina Lau, associate general counsel at Legal and General Investment Management America ($137B in AUM) in Chicago, explains the practical, operational effect of the rules using two examples:

Prior to September 1: You trade the uncleared swap bilaterally. It’s valued on a mark-to-market basis each day but you have two days to transfer the necessary margin change.
After September 1: You’d have one day to transfer the necessary new margin. Plus, the “haircut” that a counterparty can suffer will change.

Only three of 10 CSAs were revised to match the rules earlier this month at Commonwealth Opportunity Capital ($1.5B in AUM) in Los Angeles, said CCO Lior Kosovski. The revised

agreements change the amount of margin and when it's required to be posted to comply with the coming rules.

The ISDA developed a protocol to make it easier for parties to agree on revised CSAs. However, Kosovski and others say many have not embraced the protocol because it could erase long-held, favorable clauses negotiated over time.

"We amended our CSAs via an omnibus agreement, which will cover" a large portion of clients trading under the umbrella ISDAs, says Lau. Another step she took to prepare for the new rules was to hire the derivatives consulting firm **Derivatives Risk Solutions**.

Compliance steps to take

To prepare for the coming rules Lau recommends you adopt a strategy for managing the process of revising your CSAs. List your clients for which you trade uncleared swaps. Ensure your internal teams know of the new terms. "There cannot be a disconnect from what legal negotiates to what is operationally implemented on the back-end," she counsels.

Despite this age of technology, much of the work in synching up daily margin accounts is a human endeavor. "It's paper intensive," notes **Anderson**. This increases the pressure that operations and back-office staff have properly translated the CSA changes into its investment compliance programs, adds Lau. Advise fund managers of the new requirements. You could even help them convey the change to their clients, she continues.

Compliance should periodically test the process, recommends **Anderson**. He offers these additional steps compliance can take:

1. List your current CSAs by counterparty. Help your firm classify swap counterparties by the types of products traded and the complexity of their required documentation.

2. Assist in writing necessary P&Ps "for negotiating, documenting, and adhering to swap and VM documentation, including to assure that there is an appropriate allocation of duties to or among operations personnel, and an appropriate escalation process" should problems occur.

3. Identify staff who are responsible for "performing the necessary calculations on a daily basis," he continues.

Even after the September deadline, you'll have time to adjust. The CFTC won't be out enforcing compliance with the rule come Sept. 2, notes **Anderson**. The Commission usually gives the industry time to adjust to its new rules.

Anderson states that the SEC was to put out their own variation margin rule for security-based swaps but that never occurred.

The CFTC Feb. 13 also released a second new No-Action Letter that grants relief for firms from rules that would permit swaps dealers from treating each account as a separate counterparty when applying minimum transfer amounts for initial and variation margins.