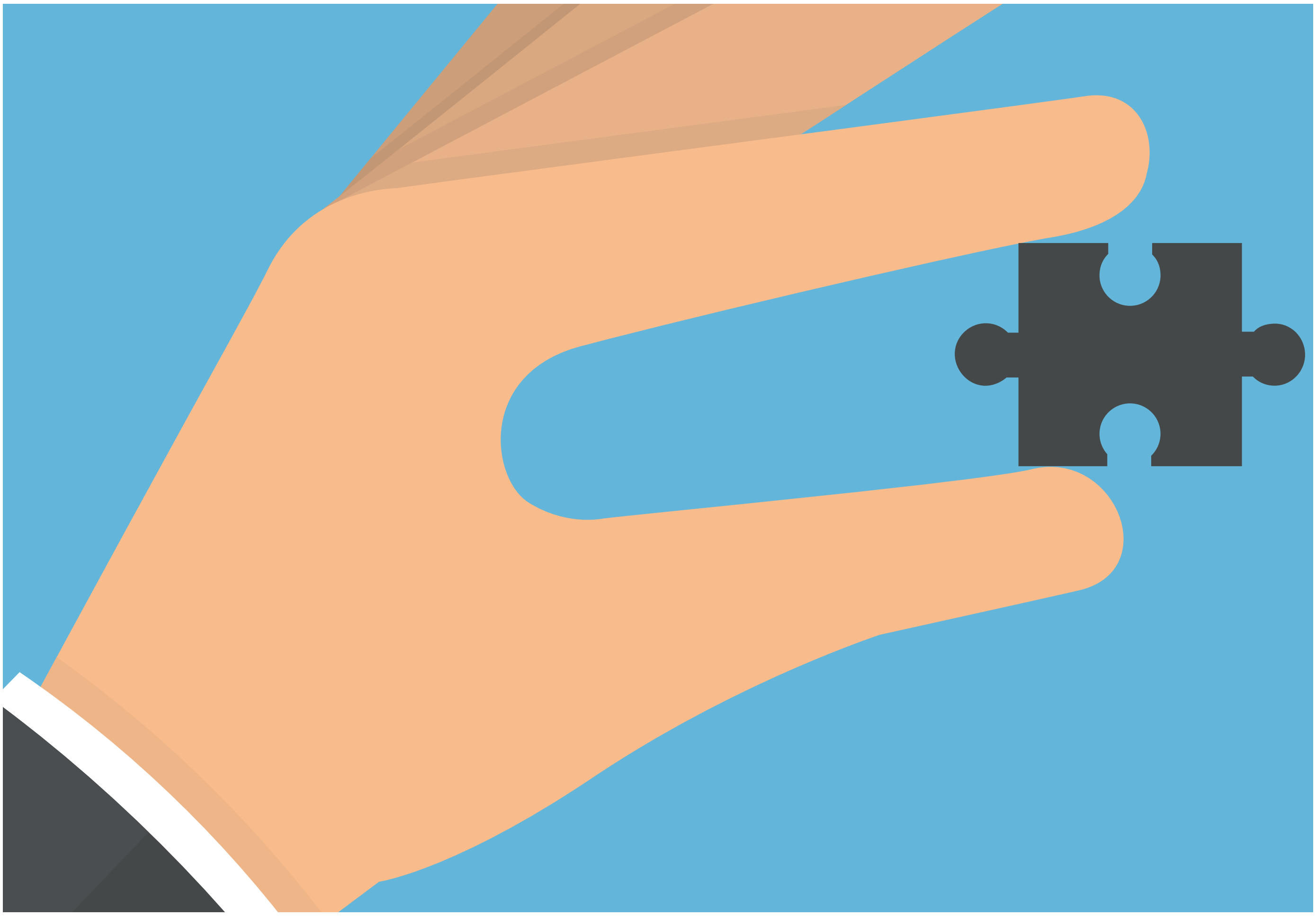


How do you solve a problem like BCBS-IOSCO?

Active management is a far better strategy than wait and see, according to Martin Seagroatt, head of global marketing at 4sight Financial Software

The forthcoming Basel Committee on Banking Supervision and International Organization of Securities Commissions (BCBS-IOSCO) uncleared margin rules are set to make the collateral management process far more demanding than in the current operating environment.

The most immediate impact will be on the sell side. However, there will also be far-reaching consequences for the buy side and other derivatives end-users.

Although the rules affect uncleared derivatives transactions and do not currently affect the securities lending and repo markets, the growing trend for centralising the collateral management function across all business lines means this is a relevant topic for most collateral managers.

The new rules will create a number of headaches for collateral teams, with the potential to increase workload and overwhelm operations.

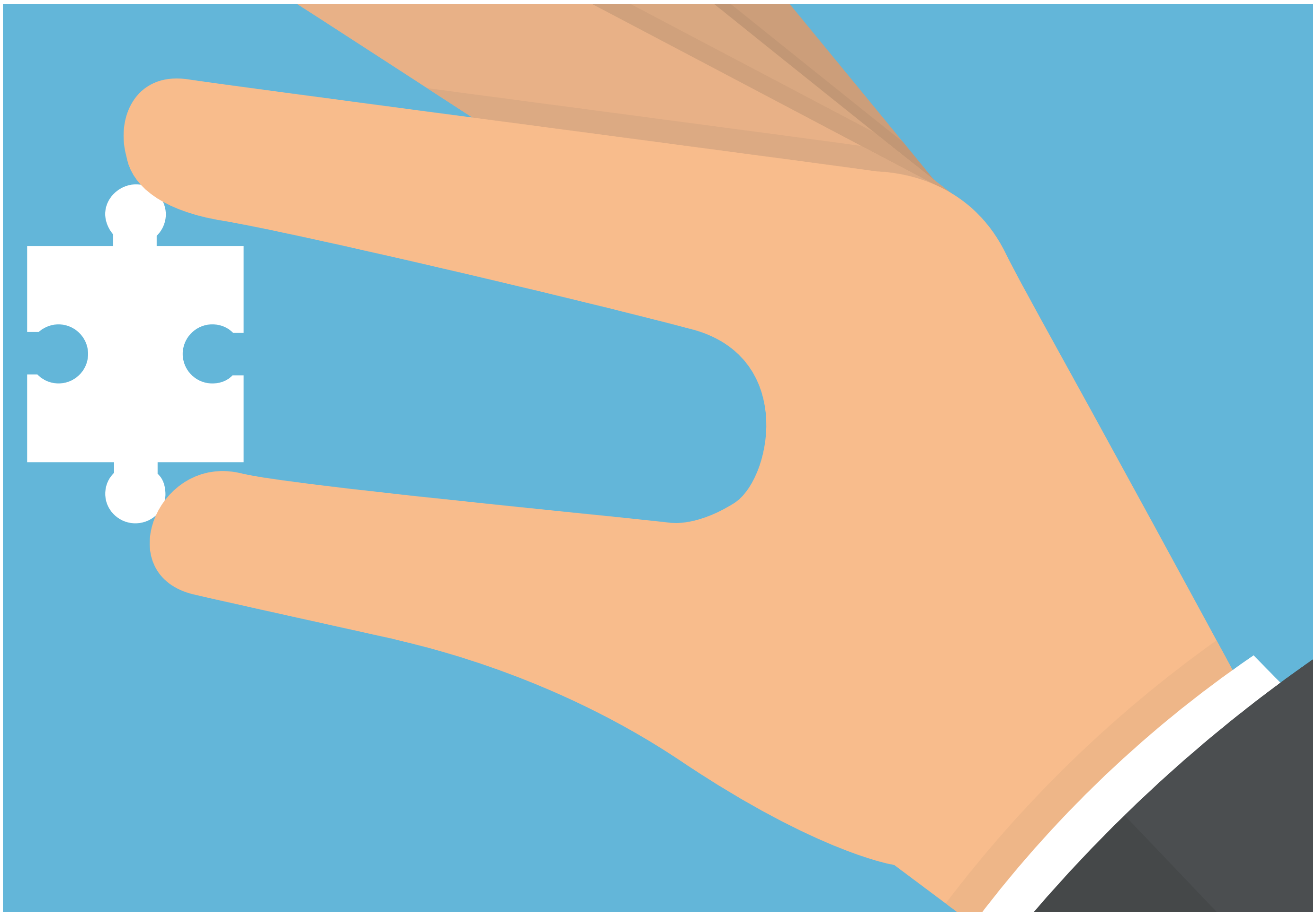
The changes will result in a need to:

- Source more collateral;
- Mobilise collateral more efficiently;
- Optimise the collateral that is pledged to manage costs;
- Deal operationally with the increase in margin calls and collateral movements;
- Appropriately segregate collateral;
- Manage the quality and concentration risk of the collateral portfolio more closely; and
- Ensure compliance with a more complex regulatory checklist.

This will mean legacy technology systems and unsupported spreadsheets that are currently widely used will no longer be able to cope with the new operating model.

Responses include increasing headcount, improving systems to enhance automation and straight through processing of margining, and leveraging industry utilities wherever possible. Some level of collateral optimisation will also most likely become the norm as collateral costs increase for all market participants.

The infographics overleaf provide a high-level overview of aspects of the US version of the BCBS-IOSCO rules that affect collateral management, as the US version of the regulations have now been finalised. Other jurisdictions are still some way behind in implementing the final rules, although at the time of writing, European regulators have published draft technical standards.



While the initial margin aspects of the new rules will take a number of years before they start to affect some in the market due to decreasing compliance thresholds, the variation margin rules will take effect from March 2017.

It is therefore important for all firms trading derivatives to perform an impact analysis and to begin outlining their future target state now to avoid bottlenecks further down the line. The rules require numerous technology system changes in order to comply smoothly.

Global inventory management is key

A fundamental step in preparing for the BCBS-IOSCO rules and the many other regulations creating increased demand for collateral is collating all of the firm's inventory and exposures into a single view.

The keystone for this matching process is the collateral management system. This provides the bridge from inventory to exposures, providing links between where and when, and all importantly, what the collateral must be.

An ineffective solution here prevents the maximisation of inventory efficiency in collateral use. Core to these processes are detailed contractual terms and collateral schedules.

The requirement to collect variation margin and initial margin on non-cleared derivatives is one of the last major changes imposed on the markets by regulators. But it is also one of the most disruptive. By pushing the exposure out of the banks, it makes markets safer, but the shift is now borne by investors.

While there is still some time for many market participants before the regulations begin to take effect, it is important to gain an understanding of how the rules will affect your firm.

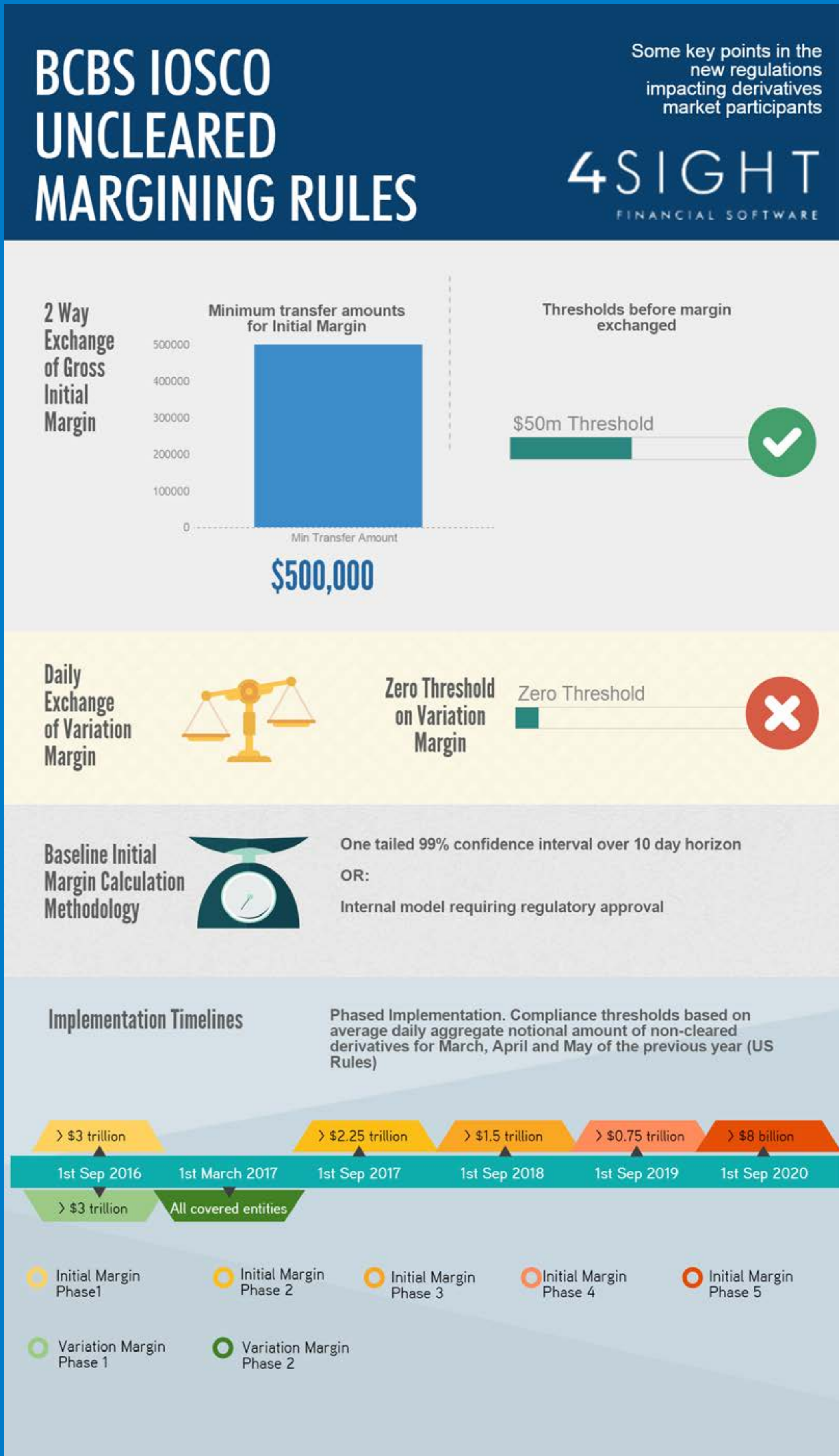
This allows you to understand the changes in process flows and business models and then estimate the potential costs of the regulations to your business. With that information in hand, one can move on to analysing the benefits of implementing new processes and technology.

From there, it is possible to clearly outline your required target state. This ensures you have an accurate picture of the end goal you want to reach and how your operational and systems architecture will look.

Implementing new technology solutions can be complex. However, there are immediate benefits to making the required improvements in collateral management systems. These benefits will only increase as the rules come in and moving now allows you to avoid a rush to comply when expertise is at a premium.

Firms that view collateral as a scarce resource that requires active management and invest strategically in technology solutions will also tend to outperform those that take a more passive, wait-and-see approach. **SLT**

This article is an excerpt from a whitepaper published by 4sight Financial Software entitled, Solving Collateral: BCBS IOSCO Uncleared Margin Rules: How to Adapt, http://www.4sight.com/products/4sight-collateral-management/bcbs-iosco-uncleared-margin-whitepaper


BCBS IOSCO UNCLEARED MARGINING RULES
Some key points in the new regulations impacting derivatives market participants
4SIGHT FINANCIAL SOFTWARE
2 Way Exchange of Gross Initial Margin
Minimum transfer amounts for Initial Margin
500000
400000
300000
200000
100000
0
Min Transfer Amount
$500,000
Thresholds before margin exchanged
$50m Threshold
Daily Exchange of Variation Margin
Zero Threshold on Variation Margin
Zero Threshold
Baseline Initial Margin Calculation Methodology
One tailed 99% confidence interval over 10 day horizon
OR:
Internal model requiring regulatory approval
Implementation Timelines
Phased Implementation. Compliance thresholds based on average daily aggregate notional amount of non-cleared derivatives for March, April and May of the previous year (US Rules)
> $3 trillion
> $2.25 trillion
> $1.5 trillion
> $0.75 trillion
> $8 billion
1st Sep 2016
1st March 2017
1st Sep 2017
1st Sep 2018
1st Sep 2019
1st Sep 2020
> $3 trillion
All covered entities
Initial Margin Phase1
Initial Margin Phase 2
Initial Margin Phase 3
Initial Margin Phase 4
Initial Margin Phase 5
Variation Margin Phase 1
Variation Margin Phase 2

BCBS IOSCO UNCLEARED MARGINING RULES

Some key points in the new regulations impacting derivatives market participants

4SIGHT FINANCIAL SOFTWARE

Restrictions on Rehypothecation and Segregation of Counterparty Collateral

Increased Collateral Demand

$315b

Additional $315 billion of extra collateral required for initial margin.

(FED impact analysis)

Increased Funding Cost

$2.5b

(FED impact analysis)

Uncleared 30% to 40% more expensive than cleared trades

(FED impact analysis)

More stringent Settlement Times

T+1

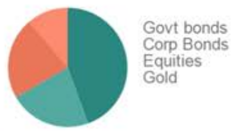
Exchange of margin must take place within one day of trade date

Cross Currency Haircuts

8%

Haircut on trades collateralized with collateral in currency different than settlement currency

Regional regulators define eligible collateral and concentration limits



Global Implementation of the Regulations

Differences in application of rules in different jurisdictions

Some key aspects of the rules differ in the US vs Europe. There are questions around which rules should apply when a US entity is trading with a European entity.

Asian regulators have not yet defined draft technical standards.

Cross border settlement

Margin must be exchanged on T+1 after the trade date.

This may result in difficulties around regional settlement cycles for US firms trading with APAC firms.