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## In Practice

Authors Joseph Wren and Nick Morgan

# The initial margin “big bang”: the aftermath

In this article the authors consider the key issues and challenges which remain for buy-side entities following the final phase-in of initial margin requirements under EMIR and UK EMIR.

In 2019, we published an article ((2019) 7 JIBFL 453) considering the initial margin (IM) “big bang” anticipated ahead of the then Phase 5 deadline of September 2020. Our article outlined the challenges for buy-side entities that would fall in scope for the IM collateral requirements under the European Market Infrastructure Regulation (EU) 648/2012 (EMIR) and the UK’s onshored version of EMIR (UK EMIR) (the IM Requirements).

A combination of industry pressure and the COVID-19 pandemic meant that the IM Requirements were implemented somewhat belatedly for Phase 5 and Phase 6 entities. However, now that the final phase-in date has passed, in this article we provide a refresher on the challenges facing such entities. These challenges (in summary, the funding and liquidity implications of posting IM, the volume and complexity of the IM Documents, and the issue of choosing collateral) remain live because many Phase 6 entities are still in the process of papering IM arrangements (required should, in the future, they exceed the €50m threshold permitted for exchanging IM under those arrangements).

### IM: A REMINDER

IM is collateral collected by an entity to cover its current and potential future exposure to its counterparty during the interval between:

- the last collection of variation margin (VM); and

- the liquidation of positions or hedging of market risk following a default of the other counterparty.

IM is not calculated on the basis of daily mark-to-mark valuations like VM; rather, the quantum of IM required to be posted by an entity is calculated on the basis of approved margin models (including ISDA SIMM™) which meet certain criteria.

IM also differs to VM in other key respects: IM must be exchanged on a gross two-way basis, cannot be rehypothecated and any IM collected by an entity must be segregated from its own property (meaning that both parties will typically open segregated accounts with a third-party custodian to hold eligible collateral for the purposes of IM).

### DOCUMENTARY ARCHITECTURE

As we noted in 2019, the documentation required for compliance with the IM Requirements is more complex and voluminous than the documentation required to comply with VM. Though the nature and number of documents to be entered into will vary on a case-by-case basis, entities may need to enter into a combination of the following documents (the IM Documents):

- 2018 Credit Support Deed for Initial Margin (IM CSD):** this is an English law document published by ISDA that creates a security interest over the posted IM and the segregated account where the IM is held in favour of the secured party.
- Account Control Agreement (ACA):** this document sets out the circumstances in which the IM posted to the custodian’s segregated

**TABLE 1: EMIR AND UK EMIR IM APPLICATION DATES**

OUTSTANDING AGGREGATE AVERAGE NOTIONAL AMOUNT (AANA) OF NON-CENTRALLY CLEARED OTC DERIVATIVES TRANSACTIONS OF COUNTERPARTY (OR ITS GROUP)	IM REQUIREMENTS APPLICATION DATE
Phase 1: above €3trn	4 February 2017
Phase 2: above €2.25trn	1 September 2017
Phase 3: above €1.5trn	1 September 2018
Phase 4: above €750bn	1 September 2019
Phase 5: above €50bn	1 September 2021
Phase 6: above €8bn	1 September 2022
€8bn or below	IM Requirements do not apply

#### Notes:

This table does not reflect specific rules which apply in relation to certain FX over-the-counter derivatives transactions, single-stock equity options and index options, and certain derivatives transactions concluded between counterparties forming part of the same consolidation group – different phase-in dates apply to these (indeed in some cases, the phase-in dates do not apply at all).

**Biog box**

Joseph Wren is a partner and Nick Morgan is an associate in the Derivatives and Structured Products Group at Travers Smith LLP. Joseph and Nick advise asset and investment managers, financial institutions, corporates, fintechs and pension scheme trustees on derivatives, repo, securities lending, collateral, clearing, security structures and associated regulation. Email: [joseph.wren@traverssmith.com](mailto:joseph.wren@traverssmith.com) and [nick.morgan@traverssmith.com](mailto:nick.morgan@traverssmith.com)

account can be transferred to one counterparty in the case of a default by the other counterparty.

- **2019 Collateral Transfer Agreement (CTA) and 2019 Security Agreement (SA):** the CTA is an English law document which governs the transfer of IM to the segregated IM account. It is commonly used in conjunction with the SA, which creates the security interest over the segregated IM account and is governed by the law of the country where the segregated IM account is held. In addition to the CTA and SA published by ISDA, CTAs and SAs for Euroclear and Clearstream also exist.
- **Eligible Collateral Schedule (ECS):** this document sets out the details of the type of collateral that can be posted and/or collected as IM, including haircuts, currency, jurisdiction and concentration limits.

As IM is collected on a two-way gross basis, in-scope entities will need to enter into IM Documents covering both the posting and collecting legs. If a party is not an existing client of a custodian, additional contractual documentation such as a custody agreement appointing the custodian will also need to be entered into.

Further bespoke documentation may also be required. For example, entities that are not onboarded with Euroclear or Clearstream but wish to use one of those platforms to receive IM can make use of documentation providing the “representative model”, under which the entity’s custodian (that is onboarded with Euroclear/Clearstream) can receive IM on the entity’s behalf. Alternatively, entities can receive and post IM through Euroclear/Clearstream directly by becoming a member of Euroclear/Clearstream.

## KEY TRENDS IN THE NEGOTIATION OF IM DOCUMENTS

The IM Documents have been standardised by ISDA to a great extent, however, given the differing commercial needs of smaller buy-side entities, it is common for a number of points to be negotiated:

- **Choice of regime:** the regulatory regime(s) applying to each counterparty must be specified in the IM Documents. Where multiple regimes are selected as being applicable to a counterparty, the “Strictest Of” principle contained in each IM Document will mean that the counterparty will need to comply with the strictest applicable regulatory regime.
- **Calculation of IM:** counterparties have to elect the method used to determine the amount of IM required to be posted (be that ISDA SIMM™ or another prescribed method).
- **Margin Approach:** counterparties have to elect “Margin Approach” that governs the relationship between IM posted under the IM Documents and any Independent Amount posted under other existing credit support documents; the choice of which will depend on the nature of any Independent Amount required to be posted under other existing collateral arrangements.
- **Choice of collateral:** counterparties must negotiate the type of collateral they are each willing to post and accept as IM. This determination will be driven by the availability and creditworthiness of the underlying collateral so long as the

collateral falls within the eligibility criteria set out under EMIR/UK EMIR.

- **Thresholds:** EMIR/UK EMIR provides for a consolidated threshold of €50m at group level. Counterparties are free to allocate this threshold among its in-scope entities within the group in any manner they see fit as long as the cumulative total does not breach the consolidated threshold of €50m. An in-scope entity is not required to post or receive IM until this consolidated threshold is breached.
- **Minimum Transfer Amount (MTA):** counterparties may agree an MTA, below which IM that would otherwise have to be posted need not be posted. Counterparties wishing to specify an MTA will need to be cognisant of MTAs under VM documentation, because MTAs across VM and IM arrangements cannot cumulatively exceed €500,000 under EMIR/UK EMIR.
- **Additional terms?** Further bespoke terms may be negotiated between the counterparties, depending on the circumstances. For example, entities subject to resolution regimes may seek to insert language ensuring that the IM Documents are covered by such resolution regime.

The outcome of these negotiations will depend on each counterparty’s needs, legal obligations and operational capabilities. Where counterparties have a similar level of bargaining power, it may be possible to agree to mirror terms for posting and collecting legs (which reduces the length of time spent on negotiations).

## FOCUS ON UK PENSION SCHEMES

For UK pension schemes that are Phase 5 or Phase 6 entities, one challenge that is perhaps more acute than ever in light of the 2022 LDI crisis is the choosing of collateral. The LDI crisis resulted in some schemes being forced to sell liquid assets in order to acquire sufficient assets of the types required to meet collateral calls under their hedging programmes. One consequence of the shortfall of assets now faced by some such schemes is that they may need to widen the scope of eligible collateral specified in the ECS for both their IM posting and collecting legs. Whilst this may give those schemes more flexibility, one drawback of using less liquid and/or less creditworthy collateral as IM is that a larger regulatory haircut will be applied to such collateral meaning a greater value of such collateral will need to be posted in order to satisfy the collateral call.

## CONCLUSION

The issues we described in 2019 as facing Phase 5 entities (ie the funding and liquidity implications of posting IM, the volume and complexity of the IM Documents, and the difficulty of choosing collateral) continue to impact Phase 5 and Phase 6 entities, and the time expended on IM arrangements by the mid-office and legal functions of those Phase 5 and Phase 6 entities remains high.

As ISDA have noted, the phase-in of the IM Requirements for Phase 6 entities may have passed without major incident, however, many challenges remain live for a wide number of market participants, and will continue to remain so whilst IM arrangements continue to be established. ■