MARGIN REFORM

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COLLATERAL: A DIFFERENT LENS

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Author: Shaun Murray

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Executive Summary

Following the recent extension from the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions (BCBS-IOSCO), Uncleared Margin Rules (UMR) will enter the final two phases of implementation on the 1st September 2021 (Phase five), 1st September 2022 (Phase six) respectively.

During these phases up to 1100[1] newly in-scope counterparties are expected to enter the market, and the Regulatory Technical Standards (RTS) they face present several challenges for those new entrants, not least of which is the requirement to exchange gross two-way Initial Margin (IM).

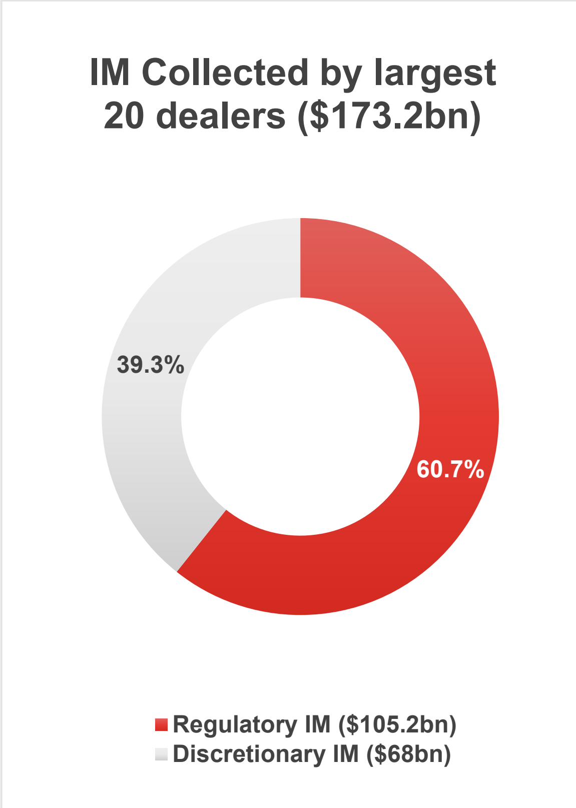
The eligible collateral requirements for IM are prescribed within each jurisdictions RTS and include government and corporate bonds, equities, gold, cash, and MMFs. All IM is required to be pledged to a segregated account at a third party using either a Tri-Party or Third-Party custodian mechanism.

As per the last International Swap and Derivatives Association (ISDA) collateral survey, year-end 2019, $173.2bn of IM was collected by the largest 20 dealers, a 10% increase year-over-year from 2018. Of this, $105.2bn was regulatory IM to satisfy UMR (25% increase), and $68bn was discretionary IM from counterparties or transactions that were not then in scope (8% decrease).

For regulatory IM, 83.9% of the collateral was pledged in the form of government securities thereby locking up High-Quality Liquid Assets (HQLA) into segregated accounts and reducing collateral velocity. [2]

As UMR expands with phases five and six, we expect to see an increasing demand for solutions that meet IM requirements. In comparing 2018 and 2019 ISDA survey results, we note an increase in the usage of non-government securities for IM (11.6% to 16.1%), suggesting that users are starting to consider alternative forms of collateral outside of government bonds.

In this paper, we will present some of the issues that the EU RTS offer to those who utilise MMF's. The types of funds that could be used by clients and how some of the solutions available can be accessed and are likely to operate on a day-to-day basis.



[1] https://www.risk.net/regulation/
[2] https://www.isda.org/2020/

Introduction

What are MMFs?

Money market funds are open-ended mutual funds managed with the goals of capital preservation, liquidity, and risk-adjusted returns, by investing in high quality short-term debt securities such as, government securities, reverse repurchase agreements, time deposits, certificates of deposits and commercial paper. They typically trade and settle on a same-day basis, which allows investors to meet their short-term liquidity requirements.

Investing in these funds allows investors to participate in diversified high-quality portfolio of eligible securities whilst receiving interest income in the form of dividends. European MMFs are categorised as either short-term MMFs or standard MMFs under EU Regulation 1131/2017 and must adhere to strict rules on liquidity, portfolio construction and duration. Additionally, many short-term MMFs are triple-A-rated by Fitch, Moody's and / or Standard & Poor's and can provide cash and cash equivalents status. They play an essential role in providing solutions for cash management and treasury functions across the investment landscape.

There are three Short-Term MMF types available:

1. **Public debt constant net asset value (CNAV)** offer a constant net asset value of 1.00 per unit or share at which investors purchase or redeem shares. These MMFs are obliged to invest at least 99.5% of their assets in government debt.

2. **Low volatility net asset value (LVNAV)** have a stable share price of 1.00 if the underlying mark-to-market net asset value for the portfolio remains within a 20-basis points collar (0.9980- 1.0020). LVNAV funds remain the dominant category used by investors, the funds invest primarily in money market instruments, deposits, and other short-term assets.

3. **Variable net asset value (VNAV)** offer redemptions or purchases at a price equal to the fund's mark-to-market pricing of the net asset value per share. These funds invest primarily in money market instruments, deposits, and other short-term assets.

All three of these fund categories meet the EU RTS requirement of utilising an Undertaking for Collective Investment in Transferable Securities (UCITS) for IM. A UCITS is a fund investing in liquid assets that can be distributed publicly to retail investors across the EU and is governed by the EU UCITS fund legislation. Additionally, most/all offer same day value on redemptions / intraday liquidity, with no penalty.

The EU RTS also goes into considerable length on what constitutes a MMF for IM purposes.

There is a definition for eligible collateral alongside other components to understand and consider including:

- The UCITS being established in the EU.
- The MMF units having a public daily price quote.
- The UCITS being limited to investing in specific instruments, namely those which are eligible for Variation Margin (VM) and IM.

For eligible collateral in the EU there are additional assessments required on credit quality, valuations, and haircuts. Other parameters to be managed and interpreted include concentration and wrong-way risk[3].

[3] Wrong-way risk is defined by the International Swaps and Derivatives Association (ISDA) as the risk that occurs when "exposure to a counterparty is adversely correlated with the credit quality of that counterparty".

Why do investors use MMFs?

There is a broad range of investor types utilising MMFs; these are predominantly institutional investors including Corporates, Banks, Hedge Funds, Insurers, Private Equity firms and Asset Managers.

MMFs have seen significant growth in popularity in the EU over the last few years, and are generally managed with investment objectives of capital preservation and liquidity; certain MMFs are widely considered as cash and cash equivalents

Investors need to ensure that their exposures, including collateral, are diversified, safe and liquid. Often there can be concerns about taking credit risk, which could be against the bank counterparty, or against the custodian who will be holding their cash and the issuers of bonds and equities. Investing in MMFs is another way of diversifying risk and maximising returns on a portfolio of collateral.

In addition to diversification, investors need liquidity. The ability to access liquidity from an MMF on an intraday basis enables investors to manage their funding requirements in a more controlled manner, and the ease with which this is possible allows investors to manage their liquidity profile more accurately.

From a pricing perspective, CNAV and LVNAV MMFs are operationally very similar to cash in that they maintain a value of 'one' per share. All excess earnings are then distributed back to investors in the form of dividends, providing regular returns for investors, which can be more lucrative than having left that money as cash.

For IM exchange purposes the critical objective for in-scope counterparties is to be able to satisfy the regulatory requirements in a way that works as a solution for your firm. MMFs provide an opportunity to do this in a simplified way.

Mark Higgins, Managing Director, Business Development EMEA from Bank of New York Mellon comments that: "the larger dealers generally seem open to the use of MMFs".

This ties in with several of the Phase 5 IM negotiations that are underway across the industry where the CNAV MMF is forming part of the eligible collateral suite.

"Given the extensive investments in these products by the buy-side, the usage of MMFs for IM makes total sense, particularly given the high-quality assets that sit within the portfolios. The combination of high levels of liquidity, scale, and attractive returns offered by MMFs makes them a viable alternative to cash collateral. ”

James Morek,
Managing Director and Co-Head of EMEA Liquidity and short duration sales at BlackRock

Money market funds in the EU

Money market funds manage total assets worth roughly €760BN

100% of all assets managed by money market funds in the EU belong to the top 200 money market funds

100%

20 money market funds manage assets exceeding 10 billion

The largest single money market fund manages assets worth 57 billion

Money market funds represent around 15% of the European fund industry

15%

Eligibility of money market funds for Initial Margin

For incorporated counterparties in an EU jurisdiction exchanging an EU MMF for IM purposes is fully acceptable.

Clients incorporated outside of the EU, can also exchange MMFs for IM. As an example, a Cayman Island (KY) buy-side entity who chooses to transact under the EMIR regime when trading with an EU bank can exchange EU MMFs as IM as long as they do not have a US nexus.

This table identifies some scenarios of counterparty jurisdiction and applicable regimes:

C/P 1 - Incorporation	CSA regime	C/P 2 - Incorporation	CSA regime
EU	EMIR	EU	EU MMF
EU	EMIR	KY	EU MMF
UK	EMIR/PR	US	MMFs not currently eligible
EU	CFTC	KY	MMFs not currently eligible

To be able to utilise MMFs as eligible collateral for IM purposes, they will need to form part of your eligible collateral suite.

Higgins commented further on the legal and documentation requirements by stating that,

"subject to the use of 3rd party or Triparty BNY Mellon platforms, both cash and the specific ISIN of the UCIT would need to be listed in the legal agreements for uncleared margin rules, namely the Account Control Agreement (ACA), the Eligible Collateral Schedule (ECS) and the Credit Support Annex (CSA).

He went on to say "In the event a client misses the selected fund's investment cut off when pledging collateral, the cash will be held until the following day, after which it will be swept to the MMF. In this case, cash may then appear as collateral overnight."

For collateral givers, being long cash and being able to convert to MMFs requires your custodian or potentially your collateral technology provider to have the tools available for you to use.

James Cherry, Senior Vice President, Collateral & Liquidity Management at Clearstream explained, "once a client sends an order through the portal and the investment is made, it becomes simultaneously visible alongside the clients' Equity and Fixed income positions in their ICSD account and available for use as collateral, supported in the same way as all other asset classes".

Custodial Operations

When considering some of the challenges for clients utilising MMFs as IM, they need to understand how funds are set up and accessed

> "It is more often the case that funds sit in a silo apart from Fixed Income and Equity holdings, so integration across asset classes is crucial to mobilise the inventory.
>
> **James Cherry, Senior Vice President,**
> Collateral & Liquidity Management at Clearstream

Describing how this operates for investors, Cherry went on to say, "for many investors, funds are held in a direct investor setup with the investors' position recorded on the register of the Transfer Agents (TA). In terms of mobilising assets, the holding is locked in a box which needs to be "unlocked" for the funds to be used as collateral. The assets need to be moved into the world of the IM custodian and then connected to the client's holdings. Facilitation between the parties enables clients to subscribe and redeem on a same-day basis

The overarching consensus in terms of the treatment of interest earned by the MMFs has been to opt for a distributing share class rather than an accumulating type of share.

In this scenario the distribution or dividend is returned to the collateral provider. It could be left to the custodian to determine which type they can support and the counterparty as to which share class they accept. In the context of distributing share class, counterparties may need to consider the impact on the supporting contractual agreements.

It follows that for MMFs the integration of funds into collateral management and settlement processing is not only beneficial to meet regulatory deadlines but is critical for efficiency and to support market growth.

Regional differences

Cash has long been used to satisfy collateral requirements and is widely used for variation margin and discretionary IM. However, using cash for regulatory IM is operationally challenging and not widely available to clients as a feasible option.

For regulatory IM, the EU RTS[4][5] for UMR sets out the requirements and standards for MMF usage. Within the EU, there is an existing MMF regulation to which all Investment Managers must adhere before they can establish and market a fund to investors. Furthermore, there is additional legislation that needs cross-referencing to ensure compliance with the regulation when utilising MMFs as collateral.

> “While UMR is derived from a global framework, there are differences in the detail across jurisdictional rule sets meaning it doesn’t always work in combination. This can be disruptive in global markets where there is a preference for-market coalescence on interpretation.”
>
> **Emma Dwyer, Partner,**
> Derivatives and Structured Finance at Allen & Overy

In instances where regulations have been open to interpretation, and a market view is required, advocacy efforts are coordinated by ISDA.

Dwyer highlighted that “a challenge for global markets has been the interpretation of MMF usage between clients incorporated in the US and the EU, ‘crossing-the-Atlantic”, which is where ISDAs latest efforts led by Tara Kruse, Global Head of Data, Infrastructure, and Non-Cleared Margin have been advocating on behalf of members that the use of MMFs be coordinated between US and EU regulators.

Kruse described the issue “as seeking further support in the quest for cross border harmonisation in the global derivatives market. In the US, when cash is posted, regulations require cash to be reinvested to another type of eligible collateral within a reasonable timeframe, this framework makes MMFs a very useful form of eligible collateral.

MMFs are generally permitted to be posted and collected as eligible collateral under both EU and US Margin Rules, provided they meet certain conditions. However, MMFs that would typically satisfy those conditions under the EU RTS would not constitute eligible collateral under the US Margin Rules.

If US policy makers were to allow repurchase agreements and reverse repurchase agreements within MMFs that are used as initial margin as well as non-US MMF issuers, a much broader range of MMFs serving the global market could be used. Otherwise, only a limited number of MMFs could be utilised among US counterparties.”

[4] https://eba.europa.eu/sites/Risk Mitigation Techniques.pdf
[5] https://www.esma.europa.eu/bilateral_margin_amendments.pdf

Conclusion

The broader use of funds is a natural progression, not only for UMR purposes but also for cleared derivatives at CCP's.

Cherry at Clearstream believes that "UMR could be a major catalyst in creating a liquid secondary market for Mutual Funds and invoking change in client behaviours when considering how they finance these positions in the securities lending and repo markets utilising triparty".

"Including MMFs as part of your collateral arsenal for Initial Margin purposes brings multiple benefits. If you are pledging collateral and are long cash, the convenience and efficiency will be virtually impossible to beat, especially with the lack of market opportunities to use cash for IM.

James Morek, Managing Director and Co-Head of EMEA Liquidity and short duration sales at BlackRock

To prepare, engage with your risk teams to seek their agreement and update your eligible collateral policy. Discuss with your IM custody provider that they can support the product through your chosen segregation route and that your internal technology teams or external suppliers have no restrictions to overcome.

For entities that hold and can pledge different classes of collateral, it makes sense to broaden and deepen your available inventory for optimisation, capital, and efficiency purposes.

Although there is no one-size-fits-all approach to collateral, it is clear, that the largest dealers are working towards a widening of eligible collateral and that MMFs are forming part of the negotiation process.

The buy-side community who will need to meet the IM requirements for phases five and six of UMR are engaging with their dealers to utilise MMFs and consider this an easy way to transform into eligible assets without the costs of full optimisation.

About

About the author

Shaun Murray
Managing Director, CEO
shaun@marginreform.com

About Margin Reform

Margin Reform is the leading management consultancy focused on margin, collateral and legal. Serving clients who operate in the financial sector to provide strategy, insight and delivery across derivatives, repo, and securities lending.

Understanding your requirements whether at the starting point of design, enhancing existing practices and operating procedures or further developing internal capabilities and expertise, we provide the implementation experience and know-how to meet those goals.

Margin Reform has been created to address engagements through an agile, client focused and scalable model.

Margin Reform is headquartered in London with an office in Paris.

For more information, please visit http://www.marginreform.com or contact info@marginreform.com

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