Crisil
Coalition
Greenwich

Pondering whether uncleared swap margin rules matter

September 17, 2014

I'm of the belief that the regulatory changes with the biggest long term impact are those related to the cost of capital. Basel III, CRD IV and whatever the US regulators ultimately decide will prove to be both the carrot and the stick for OTC derivative market participants to change the way they operate. (Whether those changes are good or bad is a whole other blog post entirely.)

Coming in at a close second, in terms of mitigating systemic risk, is required initial margin. Its pretty easy to argue that had AIG been required to post initial and variation margin on its OTC derivatives trades than they would have been forced to unwind their positions before things got out of hand. Instead they were presented with an outsized collateral call all in one shot that sent them into the arms of the US government.

That being the case, I'm glad to see the CFTC finally approved proposed uncleared margin requirements on September 17th. The vote was a long time coming given that IOSCO finalized its policy framework for uncleared derivatives margin in September of 2013. The CFTC's proposed rule is largely in line with IOSCO's recommendations. If anything the CFTC's version of the rule is slightly more punitive, prohibiting the reuse of initial margin for any purpose and requiring the margin to not only remain segregated but to be deposited with a third party custodian (State Street, Bank of New York and Northern Trust rejoice!).

The question this leaves everyone with is what difference will these rules really make? While uncleared margin requirements are certainly important, my initial conclusion is the end result will not be as traumatic or dramatic as initially expected.

The main reason is the $65 million threshold. Swap entities only need to post initial margin when the amount required to be posted exceeds $65 million dollars. What does that mean in practice? If we assume an initial margin rate of 1% for an uncleared interest rate swap per the IOSCO framework, the $65 million IM threshold would be reached for a net notional position of $6.5 billion. $6.5 billion is not the required assets under management of the fund, but the notional size of only the net interest rate swap position. Furthermore, the investment community as a whole has a tremendous amount of cash on hand. Fixed income and equity markets both look overvalued leaving many sitting on the sidelines with no idea what to do with their money. The upside - plenty of cash to post as margin. Taking all of that into account, the economic impact on the buy side so far seems relatively limited.

For the sell side, the story is slightly different. The biggest impact of these new rules is the requirement for top tier banks to post initial margin with one another, whereas today virtually no margin is posted between large banks for OTC derivative transactions. However, given the limited amount of proprietary trading going on in the big banks today due to Volcker, most bank trading in uncleared swap products are done to facilitate

client needs. This means that the positions put on by the bank dealing desks are quickly hedged, which under the proposed rules, would keep the required amount of IM between banks to a minimum, assuming proper netting. The one catch here is that market participants can only net within each asset class; so various interest rate derivatives can offset one another, but an FX option and interest rate swap will provide no netting possibilities.

We believe the biggest impact from uncleared margin rules will be on bank operations and compliance departments. Even if all open bilateral swap trades net the required margin down to zero, a team of lawyers and operations folks will need to prove that down to the letter of the law. Not to mention the technology changes that must be implemented to track margin posted and received on products that never had an initial margin component to them before.

Uncleared margin rules do matter. They will take us a long way beyond the state of affairs that led to the financial crisis, and they will incentivize a move to clearing even if via death by paperwork rather than the high cost of posting collateral. But as written, given today's economic environment, a market wide collateral shortfall seems very unlikely in the foreseeable future.

---

www.greenwich.com | ContactUs@greenwich.com

Coalition Greenwich, a division of CRISIL, an S&P Global Company, is a leading global provider of strategic benchmarking, analytics and insights to the financial services industry.

We specialize in providing unique, high-value and actionable information to help our clients improve their business performance.

Our suite of analytics and insights encompass all key performance metrics and drivers: market share, revenue performance, client relationship share and quality, operational excellence, return on equity, behavioral drivers, and industry evolution.

About CRISIL

CRISIL is a leading, agile and innovative global analytics company driven by its mission of making markets function better. It is majority owned by S&P Global Inc., a leading provider of transparent and independent ratings, benchmarks, analytics, and data to the capital and commodity markets worldwide.

CRISIL is India’s foremost provider of ratings, data, research, analytics, and solutions with a strong record of growth, culture of innovation, and global footprint.

It has delivered independent opinions, actionable insights and efficient solutions to over 100,000 customers through businesses that operate from India, the U.S., the U.K., Argentina, Poland, China, Hong Kong, and Singapore.

For more information, visit www.crisil.com

Disclaimer and Copyright

This Document is prepared by Crisil Coalition Greenwich, which is a part of Crisil Ltd, a company of S&P Global. All rights reserved. This Document may contain analysis of commercial data relating to revenues, productivity and headcount of financial services organisations (together with any other commercial information set out in the Document). The Document may also include statements, estimates and projections with respect to the anticipated future performance of certain companies and as to the market for those companies' products and services.

The Document does not constitute (or purport to constitute) an accurate or complete representation of past or future activities of the businesses or companies considered in it but rather is designed to only highlight the trends. This Document is not (and does not purport to be) a comprehensive Document on the financial state of any business or company. The Document represents the views of Crisil Coalition Greenwich as on the date of the Document and Crisil Coalition Greenwich has no obligation to update or change it in the light of new or additional information or changed circumstances after submission of the Document.

This Document is not (and does not purport to be) a credit assessment or investment advice and should not form basis of any lending, investment or credit decision. This Document does not constitute nor form part of an offer or invitation to subscribe for, underwrite or purchase securities in any company. Nor should this Document, or any part of it, form the basis to be relied upon in any way in connection with any contract relating to any securities. The Document is not an investment analysis or research and is not subject to regulatory or legal obligations on the production of, or content of, investment analysis or research.

The data contained in the Document is based upon a particular bank's scope, which reflects a bank's data submission, business structure, and sales revenue Reporting methodology. As a result, any data contained in the Document may not be directly comparable to data presented to another bank. For franchise benchmarking, Crisil Coalition Greenwich has implemented equal ranking logic on aggregate results i.e., when sales revenues are within 5% of at least one competitor ahead, a tie is shown and designated by = (where actual ranks are shown). Entity level data has no equal ranking logic implemented and therefore, on occasion, the differences between rank bands can be very close mathematically.

The data in this Document may reflect the views reported to Crisil Coalition Greenwich by the research participants. Interviewees may be asked about their use of and demand for financial products and services and about investment practices in relevant financial markets. Crisil Coalition Greenwich compiles the data received, conducts statistical analysis and reviews for presentation purposes to produce the final results.

THE DOCUMENT IS COMPILED FROM SOURCES CRISIL COALITION GREENWICH BELIEVES TO BE RELIABLE. CRISIL COALITION GREENWICH DISCLAIMS ALL REPRESENTATIONS OR WARRANTIES, EXPRESSED OR IMPLIED, WITH RESPECT TO THIS DOCUMENT, INCLUDING AS TO THE VALIDITY, ACCURACY, REASONABLENESS OR COMPLETENESS OF THE INFORMATION, STATEMENTS, ASSESSMENTS, ESTIMATES AND PROJECTIONS, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE ARISING OUT OF THE USE OF ALL OR ANY OF THIS DOCUMENT. CRISIL COALITION GREENWICH ACCEPTS NO LIABILITY WHATSOEVER FOR ANY DIRECT, INDIRECT OR CONSEQUENTIAL LOSS OR DAMAGE OF ANY KIND ARISING OUT OF THE USE OF ALL OR ANY OF THIS DOCUMENT.

Crisil Coalition Greenwich is a part of Crisil Ltd., an S&P Global company. ©2025 Crisil Ltd. All rights reserved.