KPMG

Implementation of the bilateral initial margin requirements ("CR-G-14")

January 2021

Overview of the Amended Rules

On 3 April 2020, the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) published a joint statement announcing a one-year deferral of the September 2020 and September 2021 phase-ins of the global initial margin requirements for non-centrally cleared derivatives.

The deferral intends to provide additional operational capacity for impacted firms to respond to the immediate challenges of coronavirus (Covid-19) and facilitate firms' readiness to comply with the requirements by the revised deadline.

Firms with an aggregate average notional amount (AANA) of uncleared derivatives exceeding EUR 50bn will now become subject to the initial margin requirements from 1 September 2021. Similarly, firms with an AANA of uncleared derivatives exceeding EUR 8bn will now become subject to the initial margin requirements from 1 September 2022. These changes have been reflected in the revised BCBS-IOSCO global initial margin standards.

The HKMA subsequently announced in a circular on 25 May 2020 to adopt the 1 year deferral and kicked started consultation on relevant changes to the SPM CR-G-14.

AANA Threshold	Phase-in Date
HKD 375 Billion	1 September 2021
HKD 60 Billion	1 September 2002

As noticed and experienced from implementation of earlier phases, the requirements will impact various parts of the collateral management and the OTC derivative processing such as the calculation of the initial margin, the exchange of the initial margin that needs to be segregated, risk management processes and liquidity management.

Challenges

From experiences with previous phases' implementation, we have noticed some common challenges faced by banks; we have worked closely with banks to address all these challenges too.

The covered entities are advised to consider the illustrated areas and challenges to make the entire eco-cycle robust against counterparty credit risk.

1. The calculation of sensitivities required for the SIMM model has been one of the biggest, if not the biggest, challenges for users. This requires the in-scope entities to either enhance their existing valuation systems to generate the sensitivities or implement a new system for calculating the sensitivities (most of the well-known SIMM vendors would be capable to calculate sensitivities).
2. Efficient exchange and settlement of margin calls have been challenging for entities with no or limited automation. For these entities, they have to exchange margin calls and make agreements through emails which can be very onerous.
3. Even if entities use the same IM model, i.e. the SIMM, differences will still arise due to difference in data sources, risk factor mapping and sensitivity calculations. As such, entities have to reconcile sensitivities to identify the dispute-driving factors in order to resolve them.
4. Given that the initial margin rules in different jurisdictions are slightly different, and some of the jurisdictions are non-netting, re-papering of contracts (e.g. the ISDA legal master agreement and CSA) can be very time and resource demanding.
5. Different entities have their own priorities on the counterparties to negotiate with for entering into the repapering of contracts. It is challenging for some of the entities to even kick start with the negotiation process.
6. Entities are using different custodial service providers, they either need to change to tri-party arrangements or enhance connectivity between custodians for margin exchange.
7. Entities are not required to exchange margin if their initial margin amounts with counterparties at group level are below the initial margin threshold (e.g. Euro 50 million). It could be challenging in allocation of IM across legal entities (within the same group) to make sure such thresholds are not breached.

The full chain of OTC derivative processing is affected

Pre-trade
- Pre-trade analysis and simulation
- Consideration of collateral costs within the pre-trade decision ("cost of collateral")
- Counterparty credit risk pre-deal limit check

Trade
- Consideration of all costs of an OTC product
- Integration of Front Office and Treasury Systems for a fast transfer of collateral instructions
- Contracting: Multi-CSA framework

Initial margin
- Calculation of the initial margin via standard approach or internal model (including the SIMM)
- Trade-to-contract assignment (Multi-CSA)

Margin call
- Electronic messaging and matching of margin calls
- Increased demand of dispute management and dispute resolution
- Portfolio reconciliation

Collateral selection
- Choice of provided collateral
- Consideration of collateral eligibility criteria
- Consideration of collateral haircuts

Settlement
- Segregation of initial margin via custodian, i.e. for pledging of securities
- Connectivity towards one or more custodians
- Use of tri-party arrangement

Client-tailored Approach

IT landscape and infrastructure for collateral management of larger and medium-sized banks differ and so does efficient target processes and procedures. For this reason, KPMG follows a client-tailored approach rather than offering a finalized concept off-the-shelf. Thereby, KPMG leverages the experience from similar projects across the globe and bring in outside views and benchmarking in order to develop with its clients best-in class solutions.

For example:

- Banks with strong functional ambitions may be required to use a separate calculation engine in order to compute forward sensitivities for steering and transfer price purposes.
- Organizations planning to enhance their current system landscape benefit from our deep market insights and broad knowledge of vendor solutions and service providers either for outsourcing purposes or in-house solutions.
- Clients that have not yet initiated an initial margin project would benefit from the end-to-end support by KPMG. Thus, our gap analysis tool becomes crucial.
- Financial institutions with small trading books might be able to avoid margin obligations. They benefit from our different strategies to achieve avoidance of posting IM.

How KPMG can help?

KPMG has assisted numerous local and international banks in implementing bilateral margin rules framework, thereby defining best-in class processes. We have a dedicated local team with an added benefit of our global talent sharing regional and market practices, benchmarking and SME support. We actively participate in contributing market insights, white papers and trainings on bilateral margin rules.

KPMG can offer a suite of tools and services to help you in your journey of building an implementation framework for bilateral margin rules. Below are some practice-proven quantitative and qualitative implementation and validation solutions we have provided to our clients:

Qualitative Validation

Governance & Operating Model

- Review and comment on the bank's model governance, maintenance and controls
- Develop a detailed roadmap to implement the action items and their respective timeline by key stakeholders

Gap Analysis

- Perform current state analysis on existing system functionalities (e.g. for front office, risk management and data sources) and identify required enhancements

Re-papering of Legal Agreements

- Relationship documentation with Contracting Parties
- Relationship documentation with Custodian Banks

Post-implementation Compliance Review

- Perform a post-implementation review against the requirements set out by the HKMA in the SPM CR-G-14 and comment on the status of compliance

Quantitative Validation

Implementation of Margin Requirements

- Establish ***initial margin management*** procedures
- Assist with ***vendor selection*** in view of their capabilities and drawbacks, finalize implementation scope and contract terms with selected vendor
- Prepare and review ***user requirements*** for system changes
- Perform ***margining and collateral management solution readiness assessment***
- Assist with ***custodian set-up***

Model & Data Validation

- Review the bank's model documentation; assess the ***soundness and completeness of the model components***
- Assess the ***completeness, accuracy and timeliness of key data elements*** for IM calculations
- Perform testing on ***SIMM model***
- Validate the SIMM approach IM calculations by ***benchmarking*** and by replication

Contact us

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