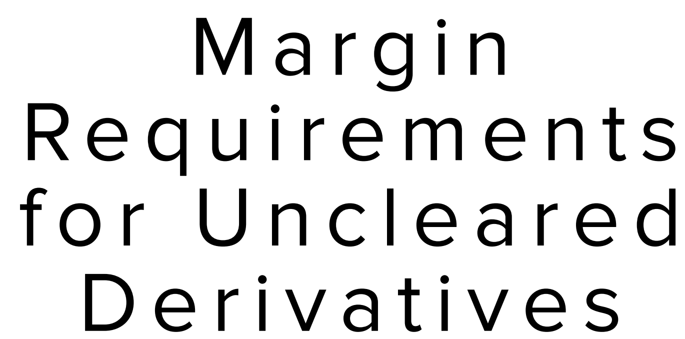

Update

THE FIELD EFFECT

Contents

MRUD Update 1

Regulatory update 2

Jurisdictional Dislocation – a stay of execution? 3

Repapering – The prioritisation trap 4

Documentation processes 5

Reducing costs & optimising/extending collateral 6

Conclusions 7

MRUD Update

The race to be ready for the bi-lateral margining of OTC derivatives is reaching its closing stage but there is still work to be done. As the February Initial Margin (IM) has passed and the March Variation Margin (VM) deadline looms, many firms are still not ready. There may be a method for some entities to continue trading without posting IM until August 2017. For the vast majority of jurisdictions, however, we have reached crunch time. Some firms are still lagging behind with operational work to exchange margin. For those with margin processes in place some key challenges remain:

* The prioratisation trap for buy-side / corporate clients

* A reduction in the number of trading partners

* Collateral squeeze

* Challenges around the scale of renegotiating contracts

* Operational impacts on both sell side and buy side firms

Operational efficiency, effective collateral management & automated legal agreement management are key ingredients to mitigating current market changes, whilst providing a platform for continued success. We will explore, briefly, each of these key points below.

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Regulatory Update

Implementation dates are now set in stone for both Variation and Initial Margin: From 1st March 2017 all counterparties (regardless of size) will need to exchange VM for non-cleared OTC trades – with specific requirements for two-way margining, minimum transfer amounts and removal of thresholds. (Note: At the point of going to press the CFTC announced that some trades would be exempt from VM from 1st March. ISDA has also called on local regulators to adopt the same approach.) Initial Margin is a more complicated phased approach coupled with transitional arrangements in some jurisdictions.

IM phase in requirements are based on the gross month end notional value of non-cleared OTC. European dates are outlined below:

DATE	PHASE	VALUE
4th February 2017	Phase 1	€ 3 trillion
1st September 2017	Phase 2	€ 2.25 trillion
1st September 2018	Phase 3	€ 1.5 trillion
1st September 2019	Phase 4	€ 0.75 trillion
1st September 2020	Phase 5	€ 8 billion

Institutions have not been active in getting ready for both IM and VM deadlines, and dealing with the complexity of multiple legal agreements covering VM and IM, whilst providing transitional arrangements to capture existing Independent Amounts (IA) in current documentation before new IM requirements come in to force. Operational processes need to be in the final stages of implementation to exchange margin – most see this as doing more with existing infrastructure, certainly whilst the impact becomes more evident, but this could put strains on operational efficiency. The biggest challenge faced last year was the volume of re-papering required to integrate margin rules into pre-existing legal agreements. Later in this article we will explore how this contributes to a prioritisation trap.

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Jurisdictional Dislocation – a stay of execution?

Singapore, Hong Kong and Australia are implementing IM rules differently to other jurisdictions. Instead of implementing phase 1 requirements with a single cut-off point (4th February 2017), they have opted for a transitional period up to 31st August 2017. Trades within these jurisdictions will be exempt from IM requirements in force elsewhere.

Some entities will be able to continue trading as normal until August 2017. Could this be an opportunity to take advantage of the delayed transitional arrangements? The practicalities (time-zones etc.) and balance sheet requirements of effected entities may still make trading in EMEA & North American regions more palatable, whilst it may make sense to move business to other entities, there will still be an impact on the business operating model.

Collateral Squeeze

Regulators intended to make OTC derivatives less attractive with bi-lateral margin regulation, & mandatory clearing. Some firms are moving away from OTC altogether, for those that remain significant challenges are ahead:

Collateral squeeze is a very real concern, the size of new demand on collateral is made worse by VM requirements being mostly covered with cash and/or government bonds. Equities and corporate bonds are mostly out of scope. Furthermore, the universe of acceptable government bonds has been eroded as credit departments exclude countries such as Italy, Spain & Portugal. Whilst cash is the natural backstop, it isn't desirable and will attract unappealing reinvestment rates especially when considering the extremely low (and sometimes negative) interest rate environment we find ourselves in. This squeeze will naturally affect all collateralised products, as the supply of high quality and liquid collateral remains finite. The cost of trading collateralised products will therefore increase making them a less attractive investment and leading firms to seek alternatives.

Being able to manage the source of collateral, optimise what is available within the firm, and leverage custodial and triparty arrangements will become more important, as well dealing with the risk and operational processes required to deal with a more diverse collateral book.

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Repapering – The prioritisation trap

The re-papering prioritisation trap presents a number of problems and opportunities for buy-side businesses and brokers. Low volume or value trading firms have and will find themselves lower down the priority list for re-papering, posing the very real possibility that they will not be able to trade quickly and efficiently with their preferred counterparty after deadlines pass. This may not be a general concern, but in an uncertain world and volatile trading environment it could lead to real business issues and a focus on corporate / buy-side treasury management.

Brokers will, naturally, focus on high volume/value counterparts to ensure agreements are in place. They may also incorrectly categorise buy-side counterparts into the wrong phasing tranche for initial margin. Buy-side firms should start pro-active dialogue with their counterparts to ensure they are aware of when phasing requirements apply to them and potentially seek out alternative trades or suppliers, and asses any costs and operational impacts that could arise.

Re-papering may present an opportunity for brokers who have an efficient agreement management process in hand. Buy-side firms will either take advantage of the opportunity to re-negotiate their existing agreements, to ‘shop around’ for a better deal, or consider seeking new counterparty relationships rather than face being unable to trade.

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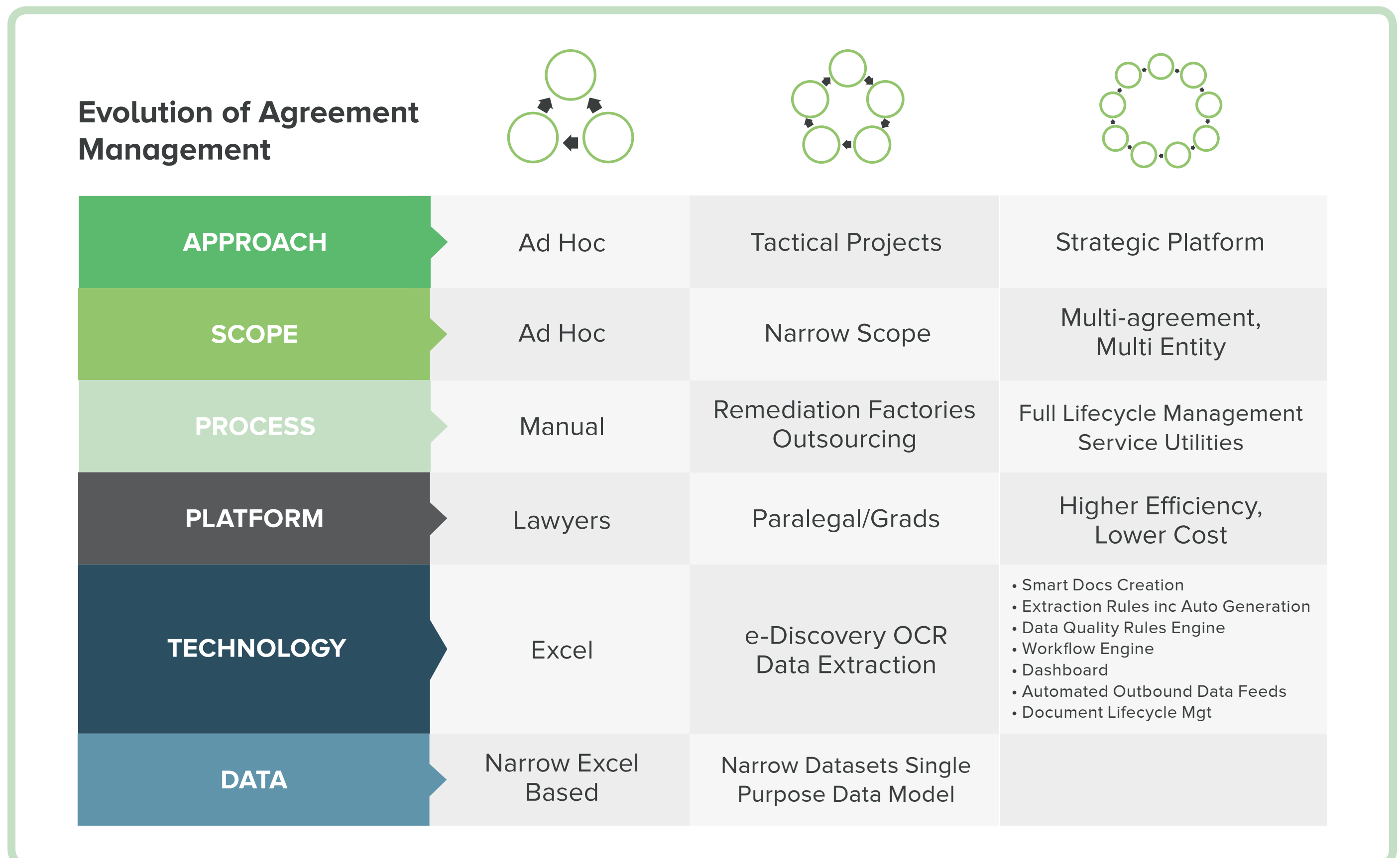
Documentation Processes

Some of the difficulties for brokers mentioned above are exacerbated by manual negotiation & capture of legal agreements data. Through our extensive work on this subject over the past few years, we see three stages of maturity on the journey towards a more robust platform. Manual processes and tactical projects are no longer fit for purpose when considering the volume of re-papering we have seen recently and expect to continue:



Evolution of Agreement Management

APPROACH	Ad Hoc	Tactical Projects	Strategic Platform
SCOPE	Ad Hoc	Narrow Scope	Multi-agreement, Multi Entity
PROCESS	Manual	Remediation Factories Outsourcing	Full Lifecycle Management Service Utilities
PLATFORM	Lawyers	Paralegal/Grads	Higher Efficiency, Lower Cost
TECHNOLOGY	Excel	e-Discovery OCR Data Extraction	• Smart Docs Creation • Extraction Rules inc Auto Generation • Data Quality Rules Engine • Workflow Engine • Dashboard • Automated Outbound Data Feeds • Document Lifecycle Mgt
DATA	Narrow Excel Based	Narrow Datasets Single Purpose Data Model	

Tactical solutions, if effectively managed, can only provide you with a snapshot of data at that time. Once finished, the quality of data you possess will erode quickly. Increasingly, firms are looking to integrate vendor solutions or build in-house software to provide a more strategic 'BAU' platform for documentation processing. This reduces manual expenditure and processing timeframes. There are opportunities to realise operational efficiencies and better automation at every stage of the agreement management process:

• Origination: vendors and service providers are offering electronic negotiation tools allowing counterparties to create and maintain legal agreements and, if integrated correctly, data can be passed automatically to downstream systems. This eliminates the possibility of manual 're-keying' errors when capturing terms from physical documentation and delays in processing.

• Backload/BAU digitisation & extraction: there are a number of solutions in this space, allowing the digitisation of physical contracts and automatic extraction of terms with minimal remediation requirements.

• Governance: new platforms are emerging to provide governance rules against which golden source contract data can be interrogated, checked & remediated if required.

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Reducing costs & optimising/extending collateral

Demands for the correct type of collateral as well as amounts is expected to increase the cost of trading OTC derivatives. This is creating for a greater push on the flexibility of collateral given and taken, whilst effectively managing risk and operational processes around it, inevitability leading to pressures on a firm's operating model.

Along with increasing demands for better, up to date (if not real-time) contract information, and the downstream compliance of trading / collateral systems to this golden source, there needs to be input in to trading decisions – during the immediate execution, when considering long-term viability of trades and the overall book of business for pricing and risk management purposes.

All the above will involve a change to your business operating model. When implementing new processes or technologies we recommend considering six key dimensions:

- People
- Processes
- Technology
- Products & Services
- Geography
- Controls

Considering the implications of these six dimensions in conjunction with each other will help you to define a robust Target Operating Model in preparation for change.

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Conclusions

We live in interesting times! It isn't yet clear whether firms will be ready to meet the regulatory deadlines outlined above. Perhaps some entities can be prioritised, bearing in mind the jurisdictions with transitional arrangements. For those who do face early compliance, the pressures on collateral availability will have an impact on the cost of collateral not just for OTC trades but all collateralised products. Buy-side firms need to be aware of and prepare for the possibility of falling into the prioritisation trap, proactively seeking to re-negotiate agreements with existing brokers or seeking new relationships. We know that re-papering has been a significant challenge to the industry and some agreements will not be ready before deadlines. Capture and management of legal agreements data is becoming increasingly costly. With the pace of regulatory change unlikely to slow and clear signals that the UK will be leaving the single market more work is likely to be required to legal agreements data. Implementing a 'light touch' more automated platform for managing legal agreements data is an approach to mitigating the risk posed by short-term tactical projects. Change is the status-quo, effective change preparation is the only way to ensure projects meet their strategic objectives.

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