Regulatory Reform and Collateral Management:
The Impact on Major Participants in the OTC Derivatives Markets
The new regulations that will take effect in the wake of the global financial crisis are expected to have a particularly profound impact on the $560 trillion OTC derivatives market. A combination of the Dodd-Frank Act, the European Markets Infrastructure Regulation (EMIR) and Basel III will result in wholesale changes to how OTC derivatives are settled, collateralized and reported.

The amount of collateral held against OTC trades, and the operational complexity of moving and segregating margin, are both expected to increase sharply. Virtually all experts predict that costs will rise, and many expect a resulting drop in volumes.

The impact of these changes to the buy-side has received wide media attention given that mandatory clearing of swaps and initial margin are both new requirements that will affect pension funds, asset managers and other institutions trading derivatives. According to Mike Reece and Jason Paltrowitz, J.P. Morgan market executives for banks and broker-dealers in Europe and the Americas, respectively, the impact to banks, broker-dealers and clearinghouses has been less well covered.

“These institutions cannot risk being caught off-guard by the systemic changes to trading and collateralizing OTC derivatives,” they note.

**Highlights of the new regulations**

In April 2009 the G20 nations made a commitment to “promote the standardization and resilience of credit derivatives markets, in particular through the establishment of central clearing counterparties subject to effective regulation and supervision.”\(^1\) Dodd-Frank and EMIR contain key provisions intended to deliver on this commitment, although implementation timetables and details differ.

While the full extent and timing of the new regulations are still being defined, it is likely that many reforms aimed at major banks and broker-dealers will be implemented during 2012. The broad intentions of the regulators are also clear:

- **Increase transparency** by pushing OTC derivative trading to central clearing and via swap execution facilities (SEFs) with trade repositories for the monitoring of all trading activity.
- **Reduce counterparty risk** by significantly increasing the amount of collateral held against all OTC derivative transactions, whether centrally cleared or otherwise.

Under Dodd-Frank, most banks and broker-dealers will fall under one of two regulatory designations. Most large banks are expected to identify themselves as swaps dealers (SDs). Other institutions that trade swaps in the greatest volumes (smaller banks and broker-dealers, insurance companies, large hedge funds and the like) will be classified as major swap participants (MSPs). Governed by essentially the same set of regulations, SDs and MSPs will be the most affected by the new regulations and are likely to be the first to migrate to the new operating environment. This creates an immediate and pressing series of structural, systemic and, ultimately, strategic challenges.

**Expected regulation covering cleared trades**

Under Dodd-Frank and similar European legislation, it is expected that approximately two-thirds to three-quarters of the current bilateral trade volume will shift and be cleared through central counterparties (CCPs). When two SDs and/or MSPs enter into a centrally cleared transaction, both will be required to post initial margin, which will be held by the CCP. Variation margin will be passed through the CCP from one counterparty to another.

In common with current CCP operating practices, variation margin will move on a T+0 basis rather than the current T+1 model used for bilateral transactions. While institutions trading bilaterally have long been required to post variation margin to account for daily

A recent ISDA paper found that mandatory clearing called for by the Dodd-Frank Act would increase variation margin by $30 - $50 billion among U.S. banks. Clearing requires payment of initial margin as well. The U.S. Office of the Comptroller of the Currency estimated that initial margin requirements could total over $2 trillion globally under certain circumstances. Other estimates of initial margin start at the hundreds of billions of dollars of new collateral needed.

—derivatViews, September 6, 2011
price fluctuations, requiring initial margin is new and will substantially increase the amount of collateral required. For initial margin, CCPs will accept only highly liquid, high grade collateral, which will put pressure on supply as demand for this limited pool of collateral continues to increase. The influx of cash resulting from mandatory initial and variation margin is likely to prove challenging to the CCPs who have few options for managing that cash.

Expected regulation covering non-cleared trades

While most derivatives trades between banks, broker-dealers and other major swaps participants will be subject to mandatory centralized clearing mandates, there will be notable exceptions. Certain instruments will not be accepted by CCPs, principally due to a lack of liquidity, and will thus be exempted. Trades where one of the counterparties is not a financial entity and is using swaps to hedge or mitigate commercial risk will also be exempted (for example, an airline hedging against the price of fuel). The continuing existence of the bilateral market alongside centrally cleared derivatives creates a bifurcated market model which will cause overall costs to rise as bilateral netting is reduced and operational complexity increases.

Margin requirements will vary depending on the regulatory designation of the participants in the trade. As currently proposed:

- **Trades between SDs and MSPs:** Counterparties must collect initial and variation margin for each trade, which must be held with an independent third-party custodian and may not be rehypothecated. Collateral eligibility will be defined, and haircuts will be specified, by the Commodity Futures Trading Commission (CFTC).
- **Trades between SDs/MSPs and non-SD/MSP financial entities:** Requirements are the same as above, except the SD/MSP must offer, and the non-SD/MSP may choose, whether or not to have margin segregated.
- **Trades between SDs/MSPs and non-financial entities:** The SD/MSP is not required to collect margin for each trade but is required to enter into a credit support agreement (CSA). The SD/MSP must offer to keep collateral segregated. Non-financial entities will be allowed to post non-CCP eligible collateral as negotiated with SD/MSP. CFTC rules will not specify haircuts.

While EMIR is approximately one year behind Dodd-Frank, the two are expected to be very closely aligned. Any major long term divergence might result in regulatory arbitrage, something all regulators are carefully watching and seeking to avoid.

Impact

According to Reece, the sheer breadth and depth of new regulation creates significant challenges for banks, broker-dealers and other major participants in the global derivatives markets. As Dodd-Frank and EMIR intersect with Basel III and a raft of other complex and broad-ranging reforms, it is exceptionally difficult for firms to achieve a holistic understanding of the new market reality. SDs and MSPs are being asked to make major strategic decisions with uncertain inputs. Paltrowitz notes that there are some areas where the likely impact of new regulation is clear:

1. **More collateral will be needed.** The imposition of mandatory initial margin payments for both cleared and non-cleared transactions, in addition to charges imposed by Basel III for non-collateralization, is forecast to increase

Three Key Implications of Reform

1. **Bifurcated market model, where some derivatives transactions are bilateral while others must be centrally cleared through a clearinghouse**
2. **Requirement to post initial margin for most, if not all, centrally cleared trades**
3. **Restrictions on the type of collateral CCPs will accept for initial and variation margin**

Greater operational complexity

Significant increase in the demand for collateral

Limited availability of highly liquid, high grade collateral—already in demand due to other regulatory and capital adequacy reforms
the value of collateral held against all OTC derivatives by $2 trillion, an increase of 50% from current levels.  

2. High grade collateral will be in short supply. Collateral eligibility standards will get tighter under the proposed regulations. Demand will significantly increase for the same high quality collateral called for by Basel III, Solvency II, etc. (essentially G7 government bonds or major currencies). While it is difficult to accurately predict the impact on supply and demand, the consensus is that there will be a significant reduction in availability allied with a commensurate increase in cost. Options for transforming collateral will play a key role in helping institutions meet the more rigorous eligibility requirements set forth by the CCPs.

3. T+0 margin movements will place further demands on collateral. SDs and MSPs will need to keep substantially more eligible collateral on hand, as they will effectively now have to pre-fund all of their OTC derivatives trades with the new requirement to post initial margin.

4. Operational complexity will increase. The introduction of central clearing, coupled with the substantial remaining volume of bilateral trading, will require that two market processes be put in place by virtually all market participants.

5. Collateral optimization will become a strategic priority. As the cost of collateral increases, collateral management and optimization will become the new battleground for efficiency. Those who can efficiently manage margin across cleared and non-cleared derivatives will enjoy a significant competitive advantage.

Finally, and not insignificantly, the CCPs that are requiring initial and variation margin face challenges in holding that cash and collateral. The amount of margin to be held with CCPs will increase substantially, representing a challenge for those institutions as they seek to reinvest cash. Those options are limited. At the same time, the amount of collateral held is also expected to rise as noted above. The current mechanisms for managing collateral are neither sufficient to meet the expected volume nor able to cope with the operational and asset servicing complexities that will ensue.

Conclusion

Although some of the finer detail remains unclear, Dodd-Frank and EMIR (along with Basel III) will soon become the new reality. Though the rule-making continues, banks and broker-dealers cannot delay their preparation. Managing the interrelation between the new and existing regulatory demands is critical to achieving a favourable outcome for any firm—more critical, in fact, than the demands of any single new reform.

In this context, all the new regulations represent both risk and opportunity. The banks and broker-dealers that adopt and implement the right approach will enjoy a substantially enhanced competitive advantage. Clearly the inverse can also be true.

According to John Rivett, J.P. Morgan business executive for collateral management, “The ability to comingle cleared and non-cleared derivatives trades, and manage the operational complexity of a split market model, requires support for a common approach to collateral management that most market participants don't currently have in-house.” As a major player in both the cash management and securities servicing markets and an expert collateral agent, J.P. Morgan is uniquely positioned to work closely with all industry participants and bodies to understand the regulations, assess the holistic impact of the changes and devise/propose solutions. Rivett notes that “through J.P. Morgan’s engagement with the regulators, CCPs, clearing members and end clients, we are able to offer a comprehensive range of solutions designed to facilitate the continued use of OTC derivatives while reducing the associated costs of collateral and effectively managing risk.”

Ultimately, whether it is OTC derivatives collateral, exchange-traded derivatives collateral, repo collateral, stock loan collateral or any other collateral, Rivett says that firms are taking an enterprise-wide view of collateral. “Increasingly, institutions are looking at this collectively as ‘collateral’ in order to be truly efficient in their balance sheet usage.”

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