A major milestone in the ongoing implementation of global over-the-counter (OTC) derivatives regulation will be reached this year. By March 2017, the new variation margin rules for non-cleared OTC derivatives will be in effect and, unlike the initial margin rules that began to phase in last September, the global variation margin rules for investment managers take effect immediately. The new rules also capture securities that were not previously required to be collateralized, such as certain foreign exchange (FX) derivatives. Given the scope of the rules and the rapidly approaching deadlines, asset managers should be working on their documentation updates and related operational enhancements required to comply with the new rules.
DOCUMENTATION UPDATES
The first step in preparation is to ensure all governing documentation complies with the regulations. This primarily requires the revision of all existing Credit Support Annexes (CSA) (or implementation if no CSA exists), which govern collateral arrangements for derivative transactions between trading counterparties. This is a considerable exercise given the short time remaining to the deadline. The new CSAs may amend key terms such as settlement timing, eligible collateral, and haircut sizes for transactions.

OPERATIONAL CONSIDERATIONS
Once the new CSAs are in place, any revisions will need to be managed operationally. The new rules will result in two major operational impacts:

1. Significant increase in margin call volumes
2. Sourcing and settling eligible collateral in compressed timeframes

The new rules will increase the amount of collateral transactions significantly since more transactions will require collateralization. Historically, the frequency of collateral movements has been determined bilaterally. Starting in March, variation margin will be required to be exchanged as necessary on a daily basis. Margin calls must also be satisfied the day after a position is valued. Asset managers need to have the infrastructure in place to receive and validate margin calls, source eligible collateral to meet the call, and then ensure the required collateral moves within this short timeframe. These challenges may be exacerbated when the trades are across multiple time zones; such as when a Japanese asset manager trades with a US broker.

The requirement for high-quality collateral, which is generally defined as cash, highly-rated government bonds, or blue chip equities, may pose challenges for some asset managers. For example, an emerging market fund might not ordinarily hold sufficient eligible collateral within its portfolio. In the past, a portfolio manager may have sold a security to raise cash to honor margin calls. Under the new rules, there may not be enough time to generate the cash from securities sales since the collateral has to settle the day after valuation. As a result, the manager may be forced to hold a pool of cash as a contingency to honor margin calls. This may be a drag on performance or at least constrain the asset manager from being fully invested.

Finally, in order to meet the tighter timelines for collateral delivery and receipt, there will be an industry-wide push for asset managers to automate systems linkages to industry utilities and counterparty brokers.

INITIAL MARGIN
Adding to the complexity are the new initial margin rules. This is another step in a rolling five-year timetable that began in September 2016 and comes into force for different asset classes, trading entities, and jurisdictions through 2020. Institutions are being phased into these requirements according to the size of their outstanding derivatives book. The process began with the largest broker dealers and will continue every September until 2020.

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>&gt; $3.0tr</td>
</tr>
<tr>
<td>2017</td>
<td>&gt; $2.25tr</td>
</tr>
<tr>
<td>2018</td>
<td>&gt; $1.5tr</td>
</tr>
<tr>
<td>2019</td>
<td>&gt; $.75tr</td>
</tr>
<tr>
<td>2020</td>
<td>&gt; $8.0bn</td>
</tr>
</tbody>
</table>

Amounts are EUR/USD equivalent

BEYOND COMPLIANCE
Overall, the OTC regulation has pushed collateral management forward as an important focus for asset managers. Collateral is becoming a valuable but scarce resource, and management should place collateral management front and center of risk, credit, and portfolio management. Beyond simply complying, asset managers should be assessing whether they have an organization optimized to manage the dramatic changes to margin and collateral coming through these new rules.

US VS EU
Though a global initiative, the rules for OTC regulation are ultimately driven by local legislation. For asset managers the two most noteworthy OTC regulations are the US Dodd-Frank Act and the European Market Infrastructure Regulation. Like many ambitious global regulatory initiatives, in practice implementation has been disjointed with rules drafted similarly but not identically. For example, certain swap transactions have been granted exemptions from the collateral requirements by US authorities, but included by European regulators. Adding to the challenge, the various deadlines mean asset managers operating globally cannot utilize a single consistent margin and collateral program.

Firms need to have a process in place to identify circumstances when one counterparty includes FX forwards/swaps while the other counterparty excludes them. Counterparty management programs will need to be updated to reflect with which set of derivatives regulations their counterparties to the trades need to comply.