August 2019

UNCLEARED INITIAL MARGIN

SEGREGATED APPROACHES – TRIPARTY & THIRD PARTY – EXPLAINED

Introduction

With global uncleared initial margin rules continuing to impact entities in September 2019, September 2020, and September 2021, preparation is key for a smooth implementation and to avoid any disruption to derivatives trading.

Although there are many steps to a successful uncleared initial margin implementation, working with custodians and counterparties to meet the segregation requirements will require your operations, technology, and legal resources to be well coordinated.

One of the first steps in the custodian onboarding process is to decide the segregation structure:

Triparty or Third party?

Depending on your collateral velocity, operations, documentation responsibilities and authority to enter or not to enter into custodian relationships on behalf of clients, and cost implications, each structure has its pros and cons. If you are establishing structures for multiple legal entities or clients, there are varying factors to consider, and you may choose a different structure for dissimilar circumstances.

Key Differences in Service Offerings:

Triparty: The parties agree to the initial margin amount and a required value ("RQV") is sent to the triparty provider to fulfill the collateral requirement. The triparty provider carries out other activities, including automated settlement of collateral from the pledgor's own account (called the "longbox") to the segregated account, collateral valuation, optimization, substitutions, validating eligibility, monitoring concentration limits, applying haircuts, and reporting.

Third party: In contrast to the triparty structure, the pledgor, its manager, or an administrator values the collateral, selects the collateral to be pledged along with confirming eligibility and concentration limits, attributes necessary haircuts and provides settlement instructions to the custodian. The custodian only provides settlement, segregation, and reporting services.

Practical considerations include:

- The triparty structure may offer more operational efficiencies, however the additional benefits are reflected in the fee structure.
- The familiarity with procedures with your current third party or triparty custodian compared to implementing a new workflow.

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Documentation

The documentation for each relationship includes an agreement for the control on the account (e.g. Account Control Agreement (ACA) or equivalent type of agreement depending of the service provider.)

With the **Triparty** structure, there is an additional eligible collateral schedule.

With the **Third Party** structure, the eligible collateral schedule is documented outside the custody agreement within the bilateral documents: Credit Support Annex (CSA), Credit Support Deed (CSD) or Collateral Transfer Agreement (CTA).

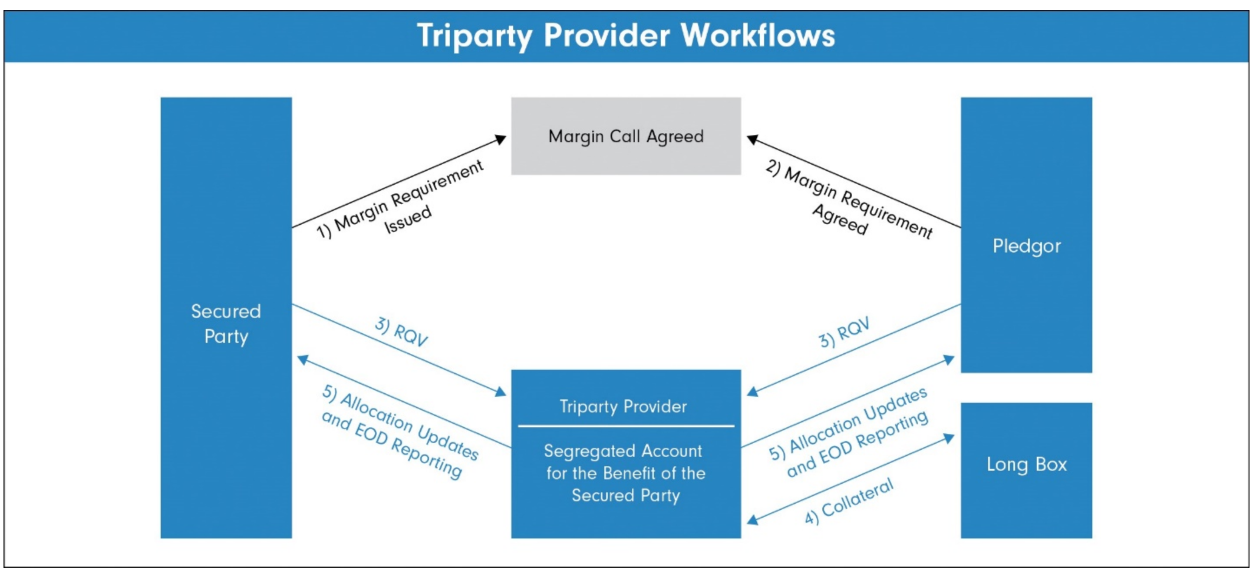
Differences with workflows

When using the **Triparty** structure, counterparties agree to the initial margin and translate this into an RQV of collateral to be transferred (on a gross basis.) They then send the message to the triparty provider or log onto the triparty provider's portal to enter the RQV for processing.

The triparty provider assesses the amount of collateral that needs to be moved based on the current collateral value compared to the RQV and selects the collateral based on the pledgor's preferences to be moved from the populated long box of the pledgor to the account of the secured party. During the business day, this process can be continued in real-time, and allocation updates are made available to both the pledgor and the secured party.

Because both parties agree to the eligible collateral to be posted and received within the eligibility schedule document, the triparty provider is able to allocate positions without the need for day to day selection or affirmation. Collateral reports are available throughout the day. Position reports are available at the end of the day.

The streamlined process can reduce time to settlement and increase operational efficiencies. The triparty provider workflow is shown below:

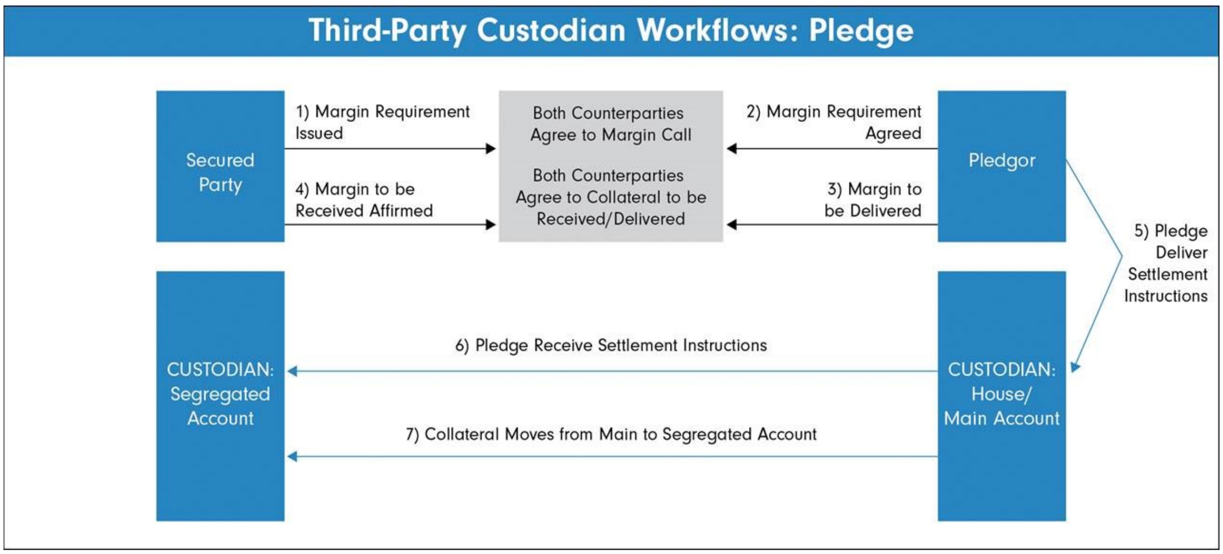


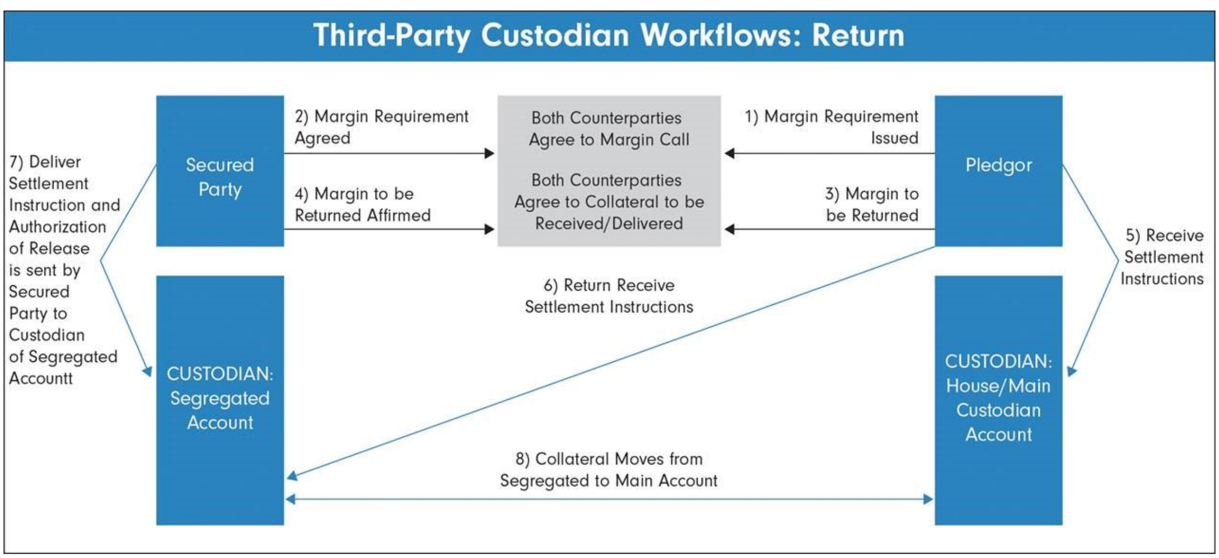
With the **Third Party** structure, counterparties set up accounts at a custodian for margin segregation, and the pledgor instructs the custodian to move collateral to the segregated account on behalf of the secured party. This is after both counterparties agree to the initial margin and affirm the collateral to be transferred.

With the third party structure, an authorization of release is necessary to move excess collateral back to the pledgor. In the ACAs, there are two methods of release – dual authorization (both parties instruct and authorize), and single (both parties instruct and one party authorizes), and this reference in the ACA can impact workflow and settlement instruction details.

Settlement updates and EOD position reports are sent from the custodian(s) to the pledgor and the secured party.

Below is a description of the Pledge and Return workflows for the Third Party structure.





Generally, the custodian used for the segregated account is the same as the custodian for the pledgor’s other activities.

It is possible that within a counterparty pair, one counterparty may pledge via triparty and the other via third party.

Summary

Although similarly named, the two segregation structures have distinctions that should be carefully analyzed. No matter what structure is used, it is important to assess which structure is most beneficial for you and to begin the documentation negotiations and review operational workflow changes and system upgrades necessary as soon as possible.