



## Collateralising Uncleared Derivatives Trades under EMIR – Draft Regulatory Technical Standards

On April 14, 2014, the European Supervisory Authorities (“ESAs”)<sup>1</sup> published the anticipated first draft regulatory technical standards (“RTS”) on risk-mitigation techniques for over the counter (“OTC”) derivatives contracts that are not cleared by a central clearing counterparty (“CCP”) under Article 11(15) of the European Market Infrastructure Regulation (“EMIR”)<sup>2</sup>. Article 11(15) requires that technical standards be developed by the ESAs in respect of risk management procedures that will ensure timely, accurate and appropriately segregated exchange of collateral. This requirement is a component of EMIR’s broader aim of improving the safety and transparency of OTC derivatives markets as a whole. However, given the recent results of the International Swaps and Derivatives Association 2014 Margin Survey<sup>3</sup>, which stated that “90% of non-cleared OTC derivatives trades were subject to collateral agreements at the end of 2013”, it remains to be seen how much of an impact the new rules will actually have on the OTC derivatives market.

In order to restrict possibilities for international arbitrage and to ensure that there is consistency at an international level, the ESAs have made efforts to try and ensure, where possible, that the RTS are consistent with international standards on margin requirements for non-centrally cleared trades, as represented by the September 2013 paper from the Basel Committee for Banking Supervision (“BCBS”) and the International Organisation of Securities Commissions (“IOSCO”) (the “BCBS/IOSCO Standards”).

### Who is affected by the RTS?

The collateralisation requirements of the RTS are a risk-mitigation requirement under Article 11 of EMIR. As such, they primarily (although not exclusively) impact entities that are established in the EU. In particular, EMIR requires that such collateralisation requirements apply to EU financial counterparties and non-financial counterparties that are trading OTC derivatives in excess of the clearing threshold (so called “NFC+” entities and referred to in the RTS collectively, with financial counterparties, as “Counterparties”). As with other risk-mitigation requirements, non-EU entities will only be directly obligated by the requirements of the RTS, to the extent that they trade non-cleared OTC derivatives with certain other non-EU entities and such transactions have a “*direct, substantial and foreseeable*” effect within the EU<sup>4</sup>. However, non-EU entities that trade with EU-established entities (who are subject to the margin requirements) are likely to find that they will still need to put collateralisation procedures in place, in order to allow their EU-established counterparties to comply with the RTS.

<sup>1</sup> Comprised of the European Securities and Markets Authority (“ESMA”), the European Banking Authority (“EBA”) and the European Insurance and Occupational Pensions Authority (“EIOPA”).

<sup>2</sup> <https://www.eba.europa.eu/documents/10180/655149/JC+CP+2014+03+%28CP+on+risk+mitigation+for+OTC+derivatives%29.pdf>

<sup>3</sup> <http://www2.isda.org/functional-areas/research/surveys/margin-surveys/>

<sup>4</sup> <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0285&from=EN>

## Exemptions

It is proposed that certain Counterparties will not have to comply with all of the margin requirements set out in the RTS. These include financial counterparties trading with other financial counterparties or non-financial counterparties<sup>5</sup>, where the total amount of margin to be exchanged between them at a group level, would be equal to or less than €50 million. In this case, such Counterparties can agree that initial margin does not need to be posted, and instead they will hold capital against their exposure to their counterparties. Variation margin, however, must still be posted and collected (see below for discussion on initial and variation margin).

Financial counterparties and NFC+s may also agree that where the total collateral exchanged between two counterparties would be equal to or lower than €500,000 (the minimum transfer amount), they will not exchange collateral (initial or variation).

Collateral need not be exchanged in respect of any transactions entered into by Counterparties trading with entities that are exempt from EMIR. This means that non-cleared OTC trades entered into with exempt entities such as EU-based central banks and certain listed multilateral development banks will not be subject to margin requirements (initial or variation). However, the same trades entered into with third-country central banks (not including those exempted by the EU Commission under Article 1(6) of EMIR) and non-listed multilateral banks will be subject to margin requirements.

It is also possible for Counterparties to agree that they do not have to post initial margin on physically settled foreign exchange swaps or forwards, or on the exchange of principal with respect to a currency swap. Variation margin, however, must still be posted and collected. This approach is in line with the BCBS/IOSCO Standards and as a consequence, the ESAs' view is that requiring initial margin to be posted for these types of transactions would place the EU at a competitive disadvantage vis-à-vis these markets.

Finally, it should also be noted that neither initial nor variation margin need be posted by covered bond issuers or cover pools, provided that certain conditions are met. These include (amongst others) a requirement that the relevant derivative is not terminated if the covered bond issuer defaults, that the derivative counterparty ranks at least equally with covered bond holders and that the covered bond programme must be subject to a legal collateralisation requirement of at least 102%. These conditions are proposed in order to provide the derivative counterparty with an element of protection, while accepting that covered bond issuers and cover pools will find it difficult to post collateral if it is required<sup>6</sup>.

It is noticeable, however, that the RTS are silent as regards any possible exemptions for securitisation vehicles. In many cases, this will not be a concern, since such vehicles will most often not qualify as financial counterparties or NFC+s<sup>7</sup>. However, for larger, multi-issuance, EU-established vehicles that may trip the clearing threshold tests, this suggests that they will be required by their swap counterparties to post collateral. This would make no economic sense in a case where the swap counterparty already benefits from a shared interest in other security provided by the vehicle over its assets, and is one area in which clarification of the RTS may be needed.

<sup>5</sup> This includes non-financial counterparties that trade either above or below the clearing threshold

<sup>6</sup> Recital 24 of EMIR specifically requires that ESMA should take account of the impediments facing covered bond issuers and cover pools when developing the RTS

<sup>7</sup> We would expect that most securitisation vehicles will be non-financial counterparties that fall below the clearing threshold ("NFC-entities"). The clearing threshold is €3 billion in gross notional value for interest rate derivative contracts and the same with respect to foreign exchange derivative contracts

## Margin Requirements

### *Variation Margin*

It is proposed that Counterparties will be required to collect variation margin on a daily basis from the business day that follows the date that an uncleared OTC derivative contract is executed. The amount of variation margin that is required to be posted shall be a function of each contract's mark-to-market valuation (which is also required to be determined by Counterparties on a daily basis in accordance with Article 11(2) of EMIR).

### *Initial Margin*

Counterparties will be required to collect initial margin by no later than the business day following the execution of an uncleared OTC derivatives contract. To do this, they must agree, in writing (or other equivalent permanent electronic means), on a method used to calculate such initial margin. This can either be the Standardised Method set out in the RTS (at Annex IV), or via use of an initial margin model ("IMM"). An IMM can be developed by the counterparties or by a third-party, in either case provided that it complies with certain conditions as specified in the RTS.

### *The Standardised Method*

The Standardised Method operates by breaking down derivatives contracts entered into between two Counterparties into "netting-sets". This is not a new concept and is derived from the Capital Requirements Regulation<sup>8</sup>. It refers to a group of transactions between an institution and a single counterparty that is subject to a legally enforceable bilateral netting arrangement. Counterparties are required to take the notional amounts (or underlying values) of each derivative contract within a netting-set and multiply them by an 'add-on factor' determined by the categorisation of each derivative (based on its underlying asset class), as set out in the RTS (e.g., the commodities add-on factor is 15%, FX is 6% and equity is 15%). Provisions are made for circumstances where a particular derivative falls into more than one category. The gross-initial margin of a netting-set is determined by adding together the resulting values from each derivative in that netting-set. A Counterparty's initial margin requirements (net-initial margin) can then be calculated, by application of a formula, using its gross-initial margin as one of the inputs.

### *Initial Margin Models*

The application of IMMs is not new to the derivatives industry. However, the RTS require that certain key conditions must be met, including assumed variations of valuations within a netting-set calibrated to a 99% confidence interval over a risk horizon of 10 days, a requirement that at least 25% of the data used in the model must be 'stressed data' (i.e., data deemed representative of a period of significant financial stress) and the model must capture all the risk drivers (e.g., exposure to interest rate, FX and correlation risk) relevant to the particular netting-set. In addition, the IMM must be subject to back-testing, it must be recalibrated every six months and is subject to governance processes and independent auditing that continually assess and test the effectiveness of the model.

## Eligible Collateral

The RTS requires that for assets to be deemed eligible for margining purposes, they must be sufficiently liquid, not exposed to excessive credit, market or FX risk, and hold their value during times of financial stress. As such, although the RTS contains an extensive list of potentially eligible collateral that can be used as both initial and variation margin, there is also a list of additional eligibility criteria that must be satisfied in order to determine if

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<sup>8</sup> Article 272(4) of Regulation (EU) 575/2013

any particular items on the list can be posted. That said, the list of eligible collateral is noticeably broader than the one provided for in the BSCS/ISCO Standards. In particular, in addition to the more traditional use of cash and government issued debt, the RTS provide for the possible use of senior tranches of securitisations, as well as certain quoted shares and units in UCITS funds.

### *Wrong-Way Risk*

In order to avoid 'wrong-way risk' (i.e., the risk that an entity's exposure increases as the probability of its counterparty's default increases), the RTS provides that posted collateral must not have been issued by the posting Counterparty (i.e., an entity cannot provide its own bonds as margin for a transaction) or by entities which are part of the same group of the posting Counterparty.

### *Concentration Limits*

Given all the collateral that may potentially have to be posted as a consequence of these rules, one concern for the ESAs in preparing the RTS is that there is a risk that particular counterparties could become overly exposed to particular assets or issuers. As a consequence, the RTS provide for diversification requirements, intended to ensure that Counterparties cannot collect more than a certain amount of collateral from any one particular source and therefore, during times of economic stress, are less likely to have to liquidate significant individual positions. This could, however, create difficulty for Counterparties who post smaller amounts of collateral, since operationally it could be more problematic for them to break up their margin requirements into multiple forms of collateral from different issuers. It remains to be seen how this issue will be addressed by the ESAs.

## **Operational Requirements**

Counterparties must put 'robust risk management procedures' in place, which shall include (amongst other things) policy and procedures regarding the exchange of collateral (covering collateral levels, types and eligibility and details of applicable haircuts), processes for escalating disputes with counterparties and reporting material exceptions to senior management, as well as procedures and controls ensuring the timely notification of margin calls, measuring and mitigating risks arising from accepted collateral assets and verifying the liquidity of eligible collateral.

### **Segregation**

All collateral that is collected in the form of initial margin is required to be segregated from proprietary assets on the books and records of the custodian (or third-party) that is holding it. The collecting Counterparty must, however, offer the posting Counterparty the right to segregate the collateral also from the assets of other posting Counterparties (individual segregation).

### **Re-Hypothecation**

Counterparties that collect initial margin are prohibited from re-hypothecating, re-pledging or otherwise re-using the collateral. The ESAs concern is that where collateral is re-hypothecated, this could result in third-parties obtaining a legal or beneficial entitlement to that collateral. This potentially dilutes the effectiveness of its role in reducing overall systemic risk, since the counterparty runs the risk of its margin being trapped by that third party, in the event of the re-hypothecator's default. This is a slightly more restrictive approach than provided for in the BSCS/ISCO Standards, where re-hypothecation would be allowed, subject to a stringent set of conditions. Since the ESAs have concerns that such conditions could result in technical and legal issues, the stricter approach has been taken in the RTS. However, market participants have been asked to provide feedback on this issue. Given the importance of re-hypothecation to the market and to prime brokers in particular, it remains to be seen where the final rules will come out.

## Intra-Group Contracts

In accordance with Article 11(3) of EMIR, intragroup transactions can be subject to exemption from the collateralisation rules, provided certain conditions are met. These are that (i) risk management procedures must be sound, robust and consistent with the complexity of derivatives transactions; and (ii) there must not be any practical or legal impediments to the transfer of funds or repayment of liabilities between Counterparties. However, any such exemption is subject to a decision of the competent authority(ies) governing the two connected Counterparties. As such, the RTS set out detailed procedures that such Counterparties are required to follow in order to avail themselves of any such exemption.

## Phase-in and Next Steps

The requirements set out in the RTS are not proposed to come into force until December 1, 2015. However, given the ESAs' desire to implement the RTS on a proportionate basis (giving smaller market participants additional time to develop the systems necessary to implement the RTS), only market participants who trade, in aggregate, non-centrally cleared OTC derivatives exceeding €3 trillion in aggregate notional amount (taking into account the notional amount of trades outstanding at month-end), will be subject to the requirements from that date. This threshold will be substantially reduced, however, so that as from December 1, 2019, it will capture entities that are part of any group with aggregate trades in excess of €8 billion in notional amount.

The consultation paper is open to comments until July 14, 2014, after which the ESAs will finalise the RTS and submit them to the European Commission before the end of 2014.

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