Clients&FriendsMemo

EMIR Clearing and Margin Consultation Paper Proposes Rules Which Will Impose Substantial Trading Costs on Market Participants

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Background and Significance

The European Market Infrastructure Regulation ("**EMIR**")[1] imposes a number of risk mitigation techniques on counterparties to uncleared swaps. Some of those involve much tighter operational procedures (such as the rules for timely confirmations, portfolio reconciliation and dispute resolution). However, the most significant increase in the costs of trading over-the-counter ("**OTC**") derivatives will arise as a result of the rules on margin and eligible collateral for such trades. New legal and risk issues will need to be addressed in the running of what will become multiple collateral posting flows: for initial margin ("**IM**"), for variation margin ("**VM**"), possibly with silos for different currencies and different jurisdictions and separately, for legacy trades pre-dating the new rules (each separate from cleared trades).

The latest consultation paper (the "**Consultation Paper**") on draft regulatory technical standards ("**RTS**") on risk-mitigation techniques for OTC derivatives contracts not cleared by a central counterparty[2], published by the three European Supervisory Authorities ("**ESAs**")[3]: (i) prescribes the minimum amount of IM and VM to be posted and collected and the calculation methodologies to be used; (ii) specifies the eligible collateral, (iii) stipulates certain thresholds to be applied to the posting of collateral, (iv) provides the permissible methods to calculate margin and (v) dictates a number of written agreements for inclusion of counterparties' risk management policies.

Market participants may comment on the impact of the RTS until 14 July 2014.

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[1] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, OJ L 201, 4.7.2012, pp. 1-59.

[2] *See* https://www.eba.europa.eu/documents/10180/655149/JC+CP+2014+03+%28CP+on+risk+mitigation+for+OTC+derivatives%29.pdf

[3] The ESAs are: (1) the European Securities and Markets Agency (ESMA), the European Banking Agency (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA).

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To whom does the RTS apply?

Counterparties are required to collect collateral if they are financial counterparties ("**FC**") or non-financial counterparties above the clearing threshold ("**NFC+**").

Excluded from the scope of the RTS are: (i) non-financial counterparties below the clearing threshold ("**NFC-**"), (ii) members of the European System of Central Banks and other Member States' bodies performing similar functions and other EU public bodies charged with or intervening in the management of the public debt, (iii) the Bank for International Settlements; (iv) the central banks and public bodies charged with or intervening in the management of the public debt; (v) multilateral development banks; (vi) public sector entities where they are owned by central governments that have explicit guarantee arrangements provided by central governments, and (vii) the European Financial Stability Facility and the European Stability Mechanism.

Are there exceptions for IM for certain types of derivatives?

Yes, for IM relating to (i) physically settled foreign exchange forwards, (ii) physically settled foreign exchange swaps and (iii) the principal exchange of currency swaps.

When is IM collected?

IM must be collected "within the business day following the execution of a new derivative contract" [4]. IM must be recalculated at a minimum of every 10 business days.

Group IM Threshold

Whilst the drafting is not entirely clear, and certain phase-in rules will apply, the draft RTS appears to suggest that:

a) If at least one of the counterparties to a transaction belongs to a "group" with an aggregate month-end average notional amount of non-centrally cleared derivatives for June, July and August of the year below €8 bn from December 2019 (higher thresholds apply before that)[5], that IM does not have to be posted.

b) After a margin calculation is complete for counterparties at a group level, and the IM requirement is €50 million or less, no IM need be exchanged.

"Group" is defined in EMIR, by reference to another directive- on consolidated accounts[6], which contains a fairly complicated definition of a group which may be difficult to apply,

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4 Article 1(3) EIM [initial margin], JC/CP/2014/03, Consultation Paper, Draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012 (14 April 2014)

5 Article 1(3) FP [final provisions] Consultation Paper, p. 46

6 Directive 83/349/EEC

especially in an international context (and also by reference to the banking consolidation directive[7], for credit institutions).

Can IM be re-used?

The re-hypothecation of IM collateral is not permitted. In the explanatory text, the ESAs justify this constraint, as the alternative creates "legal and technical difficulties"[8] This restriction is less flexible than the policy framework on margin prepared by the Basel Committee on Banking Supervision Board of the International Organization of Securities Commissions (BCBS-IOSCO)[9]. The Consultation Paper request public comment on this issue as to whether re-hypothecation could be an "essential component" for a company's business model.

Can IM or VM be netted?

The RTS currently contains two contradictory statements[10] [11], so it is not entirely clear if IM may be netted; it appears that margin might be netted within asset classes. VM may be netted[12].

Segregation of IM

IM must be segregated from the proprietary assets on the books and records of a third party holder or by some other legally effective arrangements[13]. Cash must be segregated on a party-by-party basis[14]. This requirement will necessitate significant changes to the parties' credit support annexes, especially if governed by English law: those have the legal effect of outright transfer of ownership and do not work, without more, with the controls required for effective segregation.

Third Country Reach

EU counterparties will be required to collect margin from third-country entities, even if the third-country entity would be considered an NFC- if it were established within the EU (subject to the €8 bn threshold)[15]. This creates potential for regulatory misalignment (especially as the US equivalent rules are not as advanced) and loss of competitiveness for EU counterparties.

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7 Directive 2006/48/EC

8 Consultation Paper, p. 43

9 http://www.bis.org/publ/bcbs242.pdf

10 Art 1 Gen. 3

11 Consultation Paper, p. 30-31

12 Consultation Paper, p. 23

13 Consultation Paper, p. 42

14 Consultation Paper, p. 42

15 Chapter 3 of Consultation Paper, p.7

Collateral Eligibility

The draft RTS defines eligible collateral in part by reference the Capital Requirements Regulation[16] (articles 197 and 198). This includes but is not limited to cash, gold, debt securities, corporate bonds, the most senior tranch of a securitisation that is not a re-securitisation, convertible bonds, equities, and shares or units in UCITS. Requirements for eligible assets apply to some of these types of collateral; they must be liquid, not exposed to high risk, and hold their value in periods of financial stress. Furthermore, collateral must be diversified and must not reflect the creditworthiness of one of the counterparties. Rules are proposed requiring the diversification of specific types of collateral. Haircuts must also be applied to adjust the value of this diversified collateral. The combined effect of all those requirements and especially the need to monitor the collateral liquidity and quality may result in counterparties accepting only the simplest forms of collateral, even possibly cash only.

Documentation

Counterparties are required to agree on the operational processes for the exchange of collateral, the storing of agreements, notification and settlement of margin calls, and any substitution of collateral. Through its requirements that a significant number of agreements relating to collateral are documented in writing, the RTS will result in an overhaul of risk management policies.

Timing of Implementation

The ESAs intend that the main provisions of the draft RTS will not apply until 1 December 2015. Then, a four year phase-in will be established. Initially, those market participants with an aggregate month-end average notional amount of non-centrally cleared derivatives which exceed €3 trillion will be subject to the IM requirements. This number gets progressively smaller each year until, on 1 December 2019, those with an aggregate month-end average notional amount of non-centrally cleared derivatives which exceed €8 billion must adhere to the IM requirements.

Given the substantial impact the draft RTS will have on market participants, they should give serious consideration to responding to the Consultation Paper, either directly or through an industry group.

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If you have any questions, please contact any of the below attorneys or your Cadwalader contact:

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[16] Article 197 and 198, Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms (Capital Requirements Regulation), OJ L 176, 26.6.2013, pp. 124-126.

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