



Final European Standards for Derivatives Collateralisation

On 8 March 2016, the three European Supervisory Authorities (ESAs)¹ published their final draft regulatory technical standards² in relation to the collateralisation of non-centrally cleared derivatives. The standards are to become binding on some counterparties as from 1 September 2016 and thereafter will be phased in for other counterparties. Apart from compulsory clearing requirements, the provisions for mandatory collateralisation of uncleared derivatives represent the biggest change to derivatives markets since the financial crisis, entailing the posting of billions of dollars worth of collateral, much of which will have to remain segregated and therefore not re-usable. The draft Regulatory Technical Standards (RTS) will, *inter alia*, need to be adopted by the European Commission before they can become effective, but when they do, they will affect not only EU parties engaging in uncleared OTC derivatives, but also non-EU counterparties.

Background

Article 11(3) of the EMIR Regulation³ requires that financial counterparties, and non-financial counterparties whose OTC derivatives trades exceed one or more clearing thresholds (NFC+s), must put in place risk management procedures in relation to the timely, accurate and appropriately segregated exchange of collateral, or “margin”, and Article 11(15) mandates the three ESAs to draft regulatory technical standards, specifying further details of these obligations.

Parties Affected

The margin obligations will be directly applicable to financial counterparties and to NFC+s. An entity will qualify as a “financial counterparty” if it is subject to any of the EU financial regulations contained in a list specified for this purpose by the EMIR Regulation. This term therefore includes banks, investment firms, insurers, reinsurers, funds and pension plans. A “non-financial counterparty” is an undertaking established in the EU that is not a financial counterparty or a clearing counterparty. In order to determine whether or not it is an NFC+, a non-financial counterparty would need to undertake an assessment of its existing positions in OTC derivative contracts and consider whether those positions exceed any one of the clearing threshold amounts established by ESMA for different asset classes.

¹ The three ESAs are the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority.

² Final 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

<http://www.esa.europa.eu/documents/10180/1398349/RTS+on+Risk+Mitigation+Techniques+for+OTC+contracts+%28JC-2016-18%29.pdf>

³ 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.

Subject to various exceptions provided by the RTS, financial counterparties and NFC+s are obliged to collect variation margin and initial margin from each counterparty with whom they transact uncleared OTC derivative contracts, and they must conclude an upfront agreement with such counterparties on a list of eligible collateral that fulfils the various conditions and criteria prescribed for collateral by the RTS.

Margin

“Variation margin” is defined as the collateral collected to reflect the results of the daily marking-to-market of outstanding contracts between the two counterparties. “Initial margin” is defined as the collateral required for a counterparty to cover its current and potential future exposure in the time period between the last delivery of margin and the successful liquidation of positions following a default or the successful re-hedging of the risk.

Calculation of Margins

In-scope counterparties are obliged to calculate variation margin on at least a daily basis and to calculate initial margin at least once every 10 business days and more regularly in the event that one of a number of specified intervening circumstances occurs, such as where a new OTC derivative contract is concluded between the two counterparties.

The amount of variation margin to be collected must equal the difference between the aggregate value of all outstanding contracts in the netting set between the two counterparties and the value of all variation margin previously posted or collected.

The amount of initial margin to be collected must be calculated using either a standardised approach set out in Annex IV to the RTS or, alternatively, using an initial margin model. The initial margin model may be developed by one or both of the counterparties or, alternatively, by a third-party agent. In this regard, it is worth noting that the International Swaps and Derivatives Association, Inc. has developed a standard initial margin model, complying with the guidelines published by BCBS and IOSCO, on which guidelines the ESAs have based these RTS. Whether this initial margin model, or another model, is used to calculate the initial margin to be collected, the RTS provide that the model must comply with certain specified criteria in relation to the following:

- the confidence interval and margin period of risk;
- calibration of the model;
- diversification, hedging and risk offsets across underlying classes;
- the integrity of the modelling approach; and
- certain qualitative requirements.

The RTS also set out requirements regarding the calculation and application of haircuts, and they allow the use of either internal models or standardised haircuts as provided for in Annex II to the RTS.

Eligible Collateral

Only collateral from specified asset classes shall be eligible for compliance with the RTS. The list of assets includes the following:

- cash;
- gold;
- debt securities issued by certain sovereign entities, multinational and regional public entities;
- certain covered bonds;
- corporate bonds; and
- certain securitisation bonds, convertible bonds, equities and units in European UCITS funds.

The RTS also prescribe that certain types of assets shall be subject to specific eligibility criteria, including criteria designed to avoid wrong-way risk. In addition, initial margin is subject to certain specified concentration limits.

Use and Management of Margin

Although variation margin may be re-used by the collecting counterparty, the RTS mandate that initial margin may not be re-hypothecated, re-pledged or otherwise re-used. This absolute prohibition represents a stricter approach than the one taken in the BCBS/IOSCO guidelines.

The collecting counterparty is required to assess the credit quality of certain assets using its approved internal model, or that of its counterparty (in certain circumstances), or a credit quality assessment issued by an external rating agency. The collecting counterparty is also subject to various obligations in connection with the management of, and custody arrangements in relation to, the collected margin.

Segregation

Initial margin must be segregated, either in the records of a third-party custodian or via other legally binding arrangements, so that the initial margin is protected from the insolvency of the collecting counterparty. Where collateral is a proprietary asset of the collecting counterparty, it must be segregated from the other proprietary assets of the collecting counterparty, and, in other circumstances, it must be segregated from the proprietary assets of the posting counterparty. It also must be segregated from the proprietary assets of the third-party holder or custodian. In addition, a collecting counterparty must provide the posting counterparty with an option to require the segregation of its collateral from the assets of other posting counterparties. The collecting counterparty must perform an independent legal review to verify that its segregation arrangements meet the criteria in the RTS.

Cash collected as initial margin must be deposited with a third-party holder or custodian that does not belong to the same group as either of the counterparties or, alternatively, with a central bank.

Exceptions and Exemptions

Non-financial Counterparties

No variation or initial margin is required to be exchanged where one of the counterparties is a below-threshold, non-financial counterparty or a non-EU entity that would be considered to be a below-threshold, non-financial counterparty if it were established in the EU. This therefore means that each non-EU entity that transacts an uncleared derivative with a financial counterparty (as defined above) or an NFC+ (as defined above) will have to

assess whether it is “equivalent” to a financial counterparty or to a non-financial counterparty and, if the latter, whether its outstanding uncleared trades would place it in the category of an NFC+ equivalent or not. If it is equivalent to a financial counterparty or an NFC+, it will be required by its EU counterparty to post both initial and variation margins.

Minimum Transfer Amount

The RTS allow a counterparty not to collect collateral where the increase in the amount of required collateral is less than a pre-agreed minimum transfer amount, so long as that amount does not exceed EUR500,000 or its equivalent.

FX Derivatives

The RTS allow the counterparties to agree that no initial margin shall be collected in respect of physically settled foreign exchange forward contracts or foreign exchange swaps, or in relation to the exchange of principal in respect of a currency swap contract.

Notional Amount Threshold

Initial margin can also be waived for all new contracts, as from January in each calendar year, where either of the two counterparties or their respective groups had an aggregate month-end average notional amount of uncleared derivatives below EUR8 billion for the months March, April and May of the preceding year.

Initial Margin Amount Threshold

The requirement for a counterparty to collect initial margin can also be waived where:

- neither counterparty belongs to a group, and the sum of initial margins required to be collected by that counterparty does not exceed EUR 50 million;
- the counterparties belong to different groups and the sum of all initial margins to be collected from all counterparties belonging to the posting group, by all parties belonging to the collecting group, is not in excess of EUR 50 million; and
- both counterparties belong to the same group, and the sum of all initial margins to be collected by that counterparty does not exceed EUR 10 million.

Covered Bonds

The RTS provide that derivatives related to the issuance of covered bonds are, subject to meeting certain conditions below, exempt from the posting of variation margin by the covered bond issuer or the cover pool and from the posting or collecting of initial margin, or both. However, the covered bond issuer or the cover pool shall not be exempt from collecting variation margin, which must be collected in cash. The conditions to be fulfilled for these exemptions include the following:

- the derivative is being used only to hedge interest rate or currency mismatches of the cover pool;
- the derivative contract is not terminated in the event of the insolvency or resolution of the covered bond issuer or cover pool;

- as a general matter, the counterparty to the derivative contract ranks at least *pari passu* with the covered bondholders;
- the derivative contract is recorded in the cover pool in accordance with national covered bond legislation;
- the cover pool is subject to a regulatory collateralisation requirement of at least 102%; and
- the covered bond meets the requirements of Article 129 of the Capital Requirements Regulation. This article sets out various criteria to be met in order for a preferential risk weight to be applied to covered bonds held by entities subject to that regulation. Among other criteria, the bonds must be issued by a credit institution which has its registered office in a member state of the European Economic Area.

Therefore, derivatives in respect of covered bonds issued by non-EEA entities are, potentially, going to become subject to the requirement to post variation and initial margin where the other counterparty to the derivative contract is a financial counterparty or an NFC+. The same is true in relation to securitisation derivatives, and therefore these markets will need to develop efficient ways of addressing the new margin requirements. Otherwise, these requirements will impose significant additional expense on these structures, given that derivatives counterparties are already typically fully secured by the assets in the cover pool or the securitised assets, as the case may be.

Third Countries

Variation margin and initial margin does not need to be posted by a counterparty in respect of contracts with counterparties in a non-EEA jurisdiction where a legal review cannot confirm either that the bilateral netting arrangements can be legally enforced in that jurisdiction or that the segregation arrangements with a counterparty located in such jurisdiction meet the above-mentioned segregation requirements of the RTS.

In addition, the RTS provide a counterparty with an exemption from collecting or posting variation or initial margin for contracts of the type specified in the preceding paragraph and for which a legal review concludes that collecting collateral in accordance with the RTS is not possible, so long as the outstanding notional amount of all such contracts is lower than 2.5% of the total notional outstanding amount for all OTC derivative contracts of that counterparty's group, excluding intra-group transactions.

Trading Documentation

The RTS also provide that documentation must be executed in writing between the counterparties, in respect of their trading relationship, either prior to or contemporaneously with entering into uncleared OTC derivatives. The documentation must comprise, at a minimum, terms in respect of payment obligations, netting of payments, events of default and other termination events, methods of calculation, any netting obligations upon termination, transfers of rights and obligations and the governing law of the transactions.

An independent legal review of the enforceability of the bilateral netting arrangements must be conducted by an external, independent third party or by an internal, independent unit of the counterparty.

Timing

The initial margin provisions of the RTS will apply as from 1 September 2016 where both counterparties, or their respective groups, have an aggregate average notional amount of uncleared derivatives above EUR 3 trillion. For counterparties with smaller outstanding derivatives portfolios, the initial margin commencement date will apply on a staggered basis between 1 September 2017 and, in respect of the smallest counterparty pairings with aggregate derivative notional amounts above EUR 8 billion, 1 September 2020.

The provisions in respect of variation margin shall apply as from 1 September 2016 for those parties required to comply with the initial margin requirements from that date. For all other counterparties, the variation margin provisions shall apply as from 1 March 2017.

One exception to this is for options on single equities or on equity indices, where the application of the initial and variation margin provisions will be postponed for three years after the entry into force of the RTS. This postponement has been driven by uncertainty about whether or not such derivatives will be subject to margin requirements in other jurisdictions and a desire for the international margin treatment of these products to be aligned.

Observations

For the largest EU derivatives participants, who will need to comply with the RTS from 1 September 2016, there is very little time to finalise all the necessary changes to their existing systems and procedures and put in place the documentation needed for compliance.

Counterparties to such participants, in many cases, will find that they are required to post initial margin and variation margin, even where they have an established history of uncollateralised derivatives trades with such participants. This will apply just as much to non-EU entities as to EU entities.

Non-EU entities, in particular, will (if they have not already done so for the purpose of determining clearing obligations) need to assess their status and the purpose and size of the derivatives entered into by them and other members of their group to determine whether they are equivalent to financial counterparties or to above- or below-threshold non-financial counterparties.

Non-EU entities will also need to consider the collateral requirements imposed on them by the laws of their own jurisdiction and whether any overlaps or conflicts will arise as between their local laws and the requirements imposed on their EU counterparties.

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