EMIR - The new margin landscape

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Among other regulatory changes introduced by the European Market Infrastructure Regulation (EU) No 648/2012 (EMIR), there is now an obligation on OTC derivatives participants to collateralise their non-cleared OTC derivatives' positions. This is aimed at increasing the safety and transparency of the OTC derivatives markets in the EU. Specifically, EMIR requires counterparties to exchange both initial margin (IM) and variation margin (VM) with respect to their non-cleared OTC derivatives transactions. In simple terms, IM is designed to cover potential future credit exposure of a party to its counterparty whereas VM protects against trade exposure arising from market fluctuations.

In-scope entities "shall have risk-management procedures that require the timely, accurate and appropriately segregated exchange of collateral with respect to OTC derivative contracts". (Article 11(3) EMIR)

RTS and International Policy Framework

While the overarching principles for margining trades were established under EMIR, the implementation detail was separately developed under the draft Regulatory Technical Standards on risk-mitigation techniques (RTS). The RTS were developed on the basis of, and as contemplated under, Article 11(15) of EMIR. As part of a joint consultation, draft RTS were initially published in April 2014. Following subsequent engagement with authorities and stakeholders, a second consultation paper and revised draft RTS were published in June 2015. Final draft RTS were published on 8 March 2016 providing clarity on the new margin requirements. As at the time of writing, the final draft RTS were yet to be endorsed by the European Commission (and reviewed by the Parliament and Council) and are therefore still subject to change.

The EU margin rules need to be considered in conjunction with the international regulatory framework for non-cleared OTC derivatives: namely, in March 2015, a final policy framework for margin requirements for non-centrally cleared derivatives was set up by the International Organization of Securities Commissions (IOSCO) and the Basel Committee on Banking Supervisions (BCBS) (International Policy Framework). This international structure served as a framework for the European Supervisory Authorities (ESA s) when drafting the RTS.

On 9 June 2016, the European Commission announced that the original timeline proposed for finalising the RTS will not apply (i.e. the original proposed adoption date of September 2016), and the Commission instead proposes to finalise the RTS by the end of 2016. As at the time of writing (14 July 2016), the degree to which the timings for phase-in of exchange of IM and VM will change is not clear.

The European Commission has come under strong criticism from a number of stakeholders, most notably from the Joint Committee of the ESAs, for its delayed adoption of the RTS, particularly as it is now expected that the delay will mean that implementation of the RTS will not meet the implementation timeline set out in the International Policy Framework.

The ESA has asked the European Commission to ensure that the delay in adopting the RTS will be as short as possible.

Entities in-scope

The following entities (Covered Entities) fall within the scope of the RTS and in principle would be subject to the rules requiring the exchange of IM and VM:

- 'financial counterparties' (FCs)
- 'non-financial counterparties' above the applicable EMIR clearing thresholds (NFC+s), and
- non-EEA entities which would be FCs or NFC+s if they were established in the EU.

Timings and Scope

The requirements to exchange both IM and VM originally were to be phased in from September 2016. See separate table. The RTS are not retrospective in effect (ie the margining requirements will only apply to future transactions). However, where an existing Credit Support Annex is being amended to ensure compliance with the new margining rules (i.e. such that the legacy transactions and any new transactions will form a single netting set), then the legacy transactions will be brought within the scope of the rules for both IM and VM purposes (subject to the thresholds below).

The RTS prescribe, inter alia, the amount of IM and VM that counterparties should post and collect, the methodologies to be used for calculating the requisite amounts, the timing for posting and the collateral eligibility criteria. Collateral that can be used for this purpose and that complies with the collateral eligibility criteria is required to be agreed between the counterparties up front. Key elements of the RTS are further described below.

IM Rules: An Overview

- Two-way exchange: both parties must exchange an amount of IM on a gross basis (ie without any netting being applied).
- Segregation: IM must be segregated (operationally and legally) to ensure that collateral is available in the event of a counterparty defaulting. This is supplemented with restrictions on the ability of counterparties to re-use collateral. This means that IM will have to be subject to security arrangements rather than title transfer collateral arrangements.
- Methodologies: under the proposed rules, counterparties can use a standard method provided by the regulator or an IM model, agreed between the counterparties within the scope defined by the regulator. The collecting party is responsible for ensuring its model complies with the minimum requirements set out in the RTS (including, inter alia, recalibration of the model every 12 months and ongoing monitoring and independent validation). These models and the assumptions used have the potential to differ significantly, raising the possibility that counterparties will arrive at different IM figures for similar trades. To counteract this, ISDA has set up a Working Group on Margin Requirements (WGMR) to develop a Standard Initial Margin Model (SI MM) with the aim of developing a common IM methodology to be adopted by market participants globally and aiming to provide open and transparent methodology to all.
- Structure: on a practical level, in order to ensure successful repapering of their contracts, affected parties will have to choose the most appropriate form of structure and service provider/custodian for the segregation of collateral.
- Exceptions: covered Entities are not subject to the IM rules in all circumstances. Exceptions include:
  - FX and currency transactions: physically-settled foreign exchange swaps and forwards and crosscurrency swaps (subject to certain conditions).
  - Intra-group: intra-group transactions subject to certain conditions (which may include regulatory approval).
  - Covered Bonds: covered bond issuers or covered pools (again subject to certain conditions).
  - Thresholds: counterparties have flexibility to agree Minimum Transfer Amounts and IM Thresholds on a bilateral basis, subject to caps of €500,000 for the former (when aggregated with the MTA for VM) and €50 million (at group level, on an aggregated basis) for the latter.

Original IM implementation timeline[1]:

Both counterparties are Covered Entities with an AANA* (on a group level) in excess of:	IM to be posted for derivatives contracts entered into on or after:
€3 trillion	1 September 2016
€2.25 trillion	1 September 2017
€1.5 trillion	1 September 2018
€0.75 trillion	1 September 2019
€8 billion**	1 September 2020

*AANA – aggregate average notional amount. This is calculated across its group and recorded on the last business day of the months March, April, and May of the relevant year (including all uncleared OTC derivatives of the group and all intra-group non-centrally cleared OTC derivative contracts of the group, taken into account only once).** Notional Amount Threshold – IM not collected for all new contracts from January of each year where one of the two counterparties has or belongs to a group which has AANA of the preceding year of below €8 billion.

- Phased-in Implementation: there is a phase-in period linked to the counterparties' uncleared OTC derivatives' volume (see 'IM Implementation Timeline') and there are extended phase-in timings for certain transactions (eg intra-group).
- Documentation – IM Credit Support Annex: on 3 June 2016, ISDA published for discussion purposes a working draft of its Credit Support Deed for Initial Margin and is expected to produce a final version shortly.[2] This document has been prepared based on the existing English law CSD template, with changes to allow parties to agree collateral terms for initial margin that comply with the RTS requirements.

VM Rules: An Overview

- Exchange: the exchange of VM must be in an amount equal to the net mark-to-market exposure of all of the counterparties' non-centrally cleared derivatives transactions.
- Timings: VM is generally required to be posted daily, which could prove to be operationally challenging for smaller entities and trades across different time zones. For this reason, greater flexibility has been granted to smaller firms but only under strict conditions (including the pre-funding of margin).
- Exceptions: covered Entities are not subject to the VM rules in all circumstances. Exceptions include:
  - Intra-group: intra-group transactions subject to certain conditions (which may include regulatory approval).
  - Covered Bonds: covered bond issuers or covered pools (again subject to certain conditions).
  - Minimum Transfer Amounts: as agreed by counterparties on a bilateral basis (albeit not exceeding €500,000 when aggregated with the MTA for IM).

Original VM Implementation Timeline:[3]

Both counterparties are Covered Entities with anAANA (on a group level) in excess of:	VM to be exchanged for derivatives contractsentered into on or after:
€3 trillion	1 September 2016
€0	1 March 2017

(all Covered Entities subject to VM requirements)

- Phased-in Implementation: there is a phase-in period linked to the counterparties' uncleared OTC derivatives' volume: see 'VM Implementation Timeline'.
- Documentation:
  - VM Credit Support Annex: ISDA published the Credit Support Annex for Variation Margin (Title Transfer – English Law) on 29 April 2016. Parties will be able to choose between (i) the template ISDA VM CSA (ii) a bespoke new document based on their existing collateral documentation or (iii) an amendment to their existing collateral documentation (see below).
  - ISDA Protocol: it is anticipated that ISDA will in due course produce a protocol regulating the posting of VM, particularly its scope and methodology for calculating the amount of VM required. It is suggested that, when

published, the market will generally adhere to the protocol in order to ensure efficient implementation of the VM margin rules (i.e. adopting limb (iii) above).

Eligible Collateral

Parties may agree to collect, with respect to both IM and VM, the following collateral (provided the counterparty has access to the market and is able to liquidate the collateral in a timely manner):

- cash (in the form of money credited to an account in any currency or money market deposits accounts)
- gold (in the form of allocated pure gold bullion of recognised good delivery)
- sovereign Securities
- debt securities issued by credit institutions and investment firms
- corporate bonds
- the most senior tranche of certain securitisations
- equities included in a main index, and
- shares or units in UCITS.

It is important to note that, with respect to IM only, the RTS prescribe that any cash must be held in accounts with a central bank or an EU credit institution and the third party credit institution cannot belong to the same group as either of the counterparties. Interestingly, where IM is collected in cash in a currency different to the transaction currency, an additional currency mismatch haircut will apply (to counteract the foreign exchange risk); however, VM is not subject to the additional currency mismatch haircut in line with the International Policy Framework.

Summary

The introduction of the EU Margin Rules for non-centrally cleared derivatives presents significant commercial, operational and legal challenges for market counterparties, and it is important that, in-scope entities are considering the impact of these changes now so that the necessary contract repapering and related technological build-outs are put in place within the implementation timescales.

[1] Based on the European Commission’s announcement of 9 June 2016, discussed above, this timeline is now likely to change
[2] This is correct at the time of writing on 14 July 2016
[3] Based on the European Commission’s announcement of 9 June 2016, discussed above, this timeline is now likely to change