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EU Regulators Issue Regulatory Standards for Margin for Uncleared Derivatives

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TO: DERIVATIVES MARKETS ADVISORY COMMITTEE No. 8-16
ICI GLOBAL TRADING & MARKETS COMMITTEE No. 10-16
INTERNATIONAL COMMITTEE No. 18-16
SECURITIES OPERATIONS ADVISORY COMMITTEE RE: EU REGULATORS ISSUE REGULATORY STANDARDS FOR MARGIN FOR UNCLEARED DERIVATIVES

The European Securities and Markets Authority, the European Banking Authority, and the European Insurance and Occupational Pensions Authority (collectively, "European Supervisory Authorities" or "ESAs") recently issued final draft regulatory technical standards ("RTS") for margin requirements for non-centrally cleared over-the-counter ("OTC") derivatives ("covered transactions"). [1] The final draft RTS are generally consistent with the international final policy framework, issued by the Basel Committee on Banking Supervision ("BCBS") and the Board of the International Organization of Securities Commissions ("IOSCO"), establishing minimum standards for margin requirements for non-centrally cleared derivatives. [2]

The RTS prescribe the minimum amount of initial and variation margin to be posted and collected for covered transactions and the methodologies by which this amount would be calculated. The RTS also outline the collateral eligible for the exchange of margin and the methods for determining appropriate collateral haircuts. The RTS would require appropriate risk management procedures, including specific operational requirements. The European Commission has until early June to endorse the draft RTS as submitted. Alternatively, the European Commission could endorse the draft RTS in part only, or with amendments. The draft RTS are scheduled to apply to major market participants starting on September 1, 2016, and would be fully phased in over a period of four years.

This memorandum briefly summarizes the draft final RTS. Unless noted otherwise, these RTS are consistent with the ESAs' consultations.

Scope of the Requirements

The RTS would require counterparties to covered transactions to exchange initial and variation margin, including in circumstances where a transaction involves an EU entity and non-EU entity as requested by ICI Global. [3] Initial margin covers the potential future exposure resulting from a counterparty default. The RTS would require the exchange of initial margin for all covered transactions starting in January of each calendar year where both of the counterparties belong to a group that has an aggregate month-end average notional amount of non-centrally cleared derivatives of at least €8 billion during the months of March, April, and May of the preceding year. The RTS would require recalculation of initial margin at least when the portfolio between two counterparties has changed or every 10 business days. The RTS also would require the daily exchange of variation margin to cover the change in exposure between the counterparties.

Under the RTS, counterparties may agree not to collect initial margin on physically-settled foreign exchange (“FX”) forwards and swaps or the principal in cross-currency swaps. Counterparties however, must post and collect variation margin for these contracts.

Consistent with BCBS/IOSCO Standards, the RTS include two thresholds designed to mitigate potential operational burdens that could arise in connection with exchanging small amounts of margin. One threshold takes the form of a minimum transfer amount of €500,000; an exchange of collateral is necessary only if the change in the initial and variation margin requirement exceeds this amount. [4] The RTS include a threshold level of €50 million under which initial margin would not have to be exchanged. The initial margin threshold applies at the “group” level and, for investment funds, the threshold would be counted per single fund.

Margin Methods

Consistent with the ESAs’ consultations, the RTS would permit counterparties to use one of two methods to calculate initial margin requirements: a standardized method or an initial margin model. Either method would calculate the initial margin requirement for all covered transactions in a particular netting set.

The standardized method consists of two steps. First, the notional amount of a covered transaction is multiplied by a specified add-on factor that depends on the transaction’s asset class and maturity date, resulting in a gross initial margin requirement. Second, the gross initial margin requirement is reduced to take into account potential offsetting benefits in the netting set. Annex IV of the RTS sets forth the standardized method for margin calculation.

Alternatively, counterparties may use initial margin models that comply with the requirements of the RTS. Initial margin models may be developed by the counterparties or by a third-party agent. All initial margin models must assume variations in the value of covered transactions in the netting set at a confidence level of 99% with a risk horizon of at least 10 days. Models must be calibrated on a historical period of at least three years and not exceeding five years, and must include data representative of periods of financial stress. The RTS include a number of additional requirements designed to ensure the integrity of the modelling approach, including requirements to subject models to initial validation, periodic back-testing, and regular audit processes. The RTS specify that counterparties may choose to adopt different models to calculate initial margin. [5]

Eligibility and Treatment of Collateral

The RTS specify minimum requirements for collateral to be eligible for the exchange of margin and the treatment of collateral, including its valuation and the application of haircuts. The RTS would require that risk management processes include appropriate collateral management procedures. The RTS further set out a list of operational requirements designed to ensure each counterparty has the capability to manage collected collateral in the event of the default by the other counterparty.

The RTS include a broad set of asset classes (e.g., cash, gold, government securities, corporate bonds, certain securitizations, equities, and shares or units in UCITs) as eligible collateral, provided these assets meet additional eligibility criteria, such as low credit, market, and FX risk. The ESAs note that counterparties can use bilateral agreements to restrict eligible collateral in a way that is compatible with their complexity, size, and business. To reduce the reliance on external ratings, the RTS would allow the use of either an internal or external credit assessment process that would stipulate a minimum level of credit quality. To avoid wrong-way risk, the RTS generally would prohibit the use of own-issued securities as eligible collateral. The RTS also include concentration limits on certain types of collateral posted as initial margin for trades between systemically important counterparties and between individual counterparties if the total amount of initial margin to be collected by each counterparty from the other counterparty exceeds €1 billion. [6]

The RTS would require appropriate haircuts to reflect the effects of potential market and FX volatility on posted collateral. The RTS would allow either the use of internal models for the calculation of haircuts or the use of standardized haircuts. [7]

Operational Procedures

The RTS would require counterparties to implement operational procedures that ensure documentation is in place between counterparties and internally at a particular counterparty. [8] The operational requirements include, among other things, clear senior management reporting, escalation procedures (internally and between counterparties) and requirements to ensure sufficient liquidity of the collateral. Counterparties also would be required to conduct tests on these procedures at least annually. The RTS also would require segregation requirements to be in place to ensure that collateral is available if a counterparty defaults. [9] In addition, operational and legal arrangements generally must be in place to ensure that the collateral is bankruptcy remote. Where cash is collected as initial margin, the RTS require the counterparties to deposit it with a third-party holder or custodian that is not part of the same group as either of the counterparties or with a central bank. Finally, the RTS do not allow for the collecting party to re-hypothecate, re-pledge or otherwise re-use collateral collected as initial margin.

Phase-in of Requirements

The RTS would enter into force on September 1, 2016. Initial margin requirements would fully phase-in over a four-year period. Consistent with the BCBS/IOSCO Standards, market participants that have an aggregate month-end average notional amount of non-centrally cleared derivatives exceeding €3 trillion would be subject to the requirements starting September 1, 2016. From September 1, 2020, any counterparty belonging to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives exceeds €8 billion would be subject to the requirements. Similarly, the requirements for the implementation of variation margin will be binding for the largest market participants starting on September 1, 2016. [10] Variation margin requirements would take effect for other counterparties on March 1, 2017.

To avoid any retroactive effect of the RTS, margin requirements would apply to new covered transactions entered into after the relevant phase-in dates. Exchanges of variation margin and initial margin on uncleared OTC derivatives transactions entered into before these dates would be subject to existing bilateral agreements.

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endnotes

[1] 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, March 8, 2016, available at http://www.eba.europa.eu/documents/10180/1398349/RTS+on+Risk+Mitigation+Techniques+for+OTC+contracts+%28JC-2016-+18%29.pdf. The final draft RTS follow two consultation papers on this matter. For summaries of those consultation papers, see ICI Memorandum No. 29116 (June 22, 2015), available at https://www.ici.org/my_ici/memorandum/memo29116; ICI Memorandum No. 28043 (April 15, 2014), available at https://www.iciglobal.org/iciglobal/pubs/memos/memo28043.

[2] Margin Requirements for Non-Centrally-Cleared Derivatives, Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, September 2013, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD423.pdf (“BCBS/IOSCO Standards”).

[3] In the ESA’s first consultation paper, an EU entity would be required to collect margin but not post margin to a non-EU entity.

[4] Unfortunately, the ESAs did not address whether an entity that does not transact regularly in Euros can rely on an average exchange rate between Euros and its common currency calculated on a periodic basis. The ESAs also did not address procedures for rounding amounts that are converted to Euros from a different currency.

[5] Despite comments from ICI Global, the draft final RTS require that one counterparty shall provide, at the request of the other counterparty, all the information necessary to explain the determination of a given value of initial margin in a way that a knowledgeable third-party would be able to verify the calculation. ICI Global had recommend that a requesting counterparty be given all information necessary to replicate the initial margin calculation without the “knowledgeable third-party” standard.

[6] Despite ICI Global’s request, the ESAs did not clarify explicitly that non-systemically important institutions would not be subject to collateral concentration requirements. The RTS, however, did not include a number of comprehensive concentration limits that the ESAs originally proposed to apply to initial and variation margin.

[7] Annex III of the RTS sets out standardized haircuts for collateral.

[8] As recommended by ICI Global, the RTS would permit an internal independent unit or an

external independent third-party to perform an independent legal review of the legal enforceability of bilateral netting arrangements and of compliance with those arrangements at each counterparty.

[9] Where collateral is held by the collecting party or by a third-party holder or custodian on behalf of the collecting party, the collecting party must always provide the posting party with the option to segregate its collateral from the assets of other posting counterparties.

[10] The ESAs note that in the EU there is currently no unique definition of physically settled FX forwards. Therefore, the draft RTS introduce a delayed application of the requirement to exchange variation margin for physically settled FX forwards to provide the European Commission with more time to provide certainty about the scope of these transactions. In addition, due to uncertainty over whether equity options or options on equity indexes will be subject to margin in other jurisdictions, the draft RTS include a phase-in of three years for these kinds of options to avoid regulatory arbitrage.