

**MEMO# 30491**

December 20, 2016

# European Union Finalizes Margin Requirements for Uncleared Derivatives

[30491] December 20, 2016 TO: ICI Global Members

Derivatives Markets Advisory Committee

ICI Global Trading & Markets Committee

Securities Operations Advisory Committee SUBJECTS: Exchange-Traded Funds (ETFs)

Trading and Markets RE: European Union Finalizes Margin Requirements for Uncleared Derivatives

The European Union has finalized regulatory technical standards (“RTS”) establishing margin requirements for non-centrally cleared over-the-counter (“OTC”) derivatives (“covered transactions”).<sup>[1]</sup> 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 should be calculated. The RTS also outline the types of collateral that counterparties potentially can use to satisfy margin requirements, the methods for applying collateral haircuts, and risk management procedures for firms to follow when exchanging margin. The RTS will become effective on January 4, 2017.

The RTS will require firms with the greatest notional amount of uncleared derivatives contracts—more than €3 trillion—to begin exchanging initial and variation margin on February 4, 2017. For other firms, variation margin requirements will take effect on March 1, 2017, while initial margin requirements will phase in gradually, depending on the size of the firm’s uncleared derivatives positions. The margin requirements apply only prospectively. Margin arrangements for uncleared OTC derivatives transactions entered into before the application of the rules remain subject to existing bilateral agreements.

## Scope of the Requirements

The RTS require counterparties to covered transactions to exchange initial and variation margin, including in circumstances where a transaction involves an EU entity and a non-EU entity. The RTS require the exchange of initial margin for all covered transactions during a 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 initial margin threshold applies at the “group” level.<sup>[2]</sup>

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.

## Margin Amounts

The RTS require 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 RTS require recalculation of initial margin at least when the portfolio between two counterparties has changed or every 10 business days. Variation margin must be exchanged daily to reflect the change in value of counterparties' covered transactions.

The RTS include two mechanisms designed to reduce potential operational burdens that could arise in connection with exchanging small amounts of margin. One mechanism takes the form of a minimum transfer amount of €500,000; an exchange of collateral is necessary only if the initial and variation margin required exceeds this amount. The RTS also permits counterparties to agree not to exchange margin up to €50 million.

## Eligible Collateral and Operational Requirements for Posting and Holding Collateral

The RTS include a broad set of asset classes (e.g., cash, gold, government securities, corporate bonds, certain securitizations, and shares or units in UCITs) as eligible collateral, subject to certain restrictions.[\[3\]](#) Counterparties, however, may narrow the range of eligible collateral through bilateral agreements. The RTS subject posted collateral to haircuts that vary according to the attributes of the collateral.[\[4\]](#)

The RTS require counterparties to implement risk management procedures that ensure margin documentation is in place between counterparties and internally at a particular counterparty. The risk management procedures also must include certain senior management reporting obligations and procedures for verifying the liquidity of collateral. The RTS require counterparties to test, review and update their risk management procedures at least annually. In addition, the RTS require a counterparty to perform an independent legal review of the enforceability of its netting and exchange of collateral agreements. This review may be conducted by an internal independent unit or by an independent third party.[\[5\]](#)

The RTS also require segregation requirements to be in place to ensure that collateral is available if a counterparty defaults.[\[6\]](#) 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

As noted above, the RTS require firms with the greatest notional amount of uncleared derivatives contracts to begin exchanging initial and variation margin on February 4, 2017. Initial margin requirements will phase in for all counterparties by September 1, 2020.[\[7\]](#) Variation margin requirements take effect much sooner; generally, all counterparties must comply by March 1, 2017. However, variation margin requirements will not apply to physically settled FX forwards until the earlier of December 31, 2018 or the date of application of RTS establishing a European Union-wide definition of foreign exchange forward.[\[8\]](#)

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#### **endnotes**

[1] Commission Delegated Regulation (EU) 2016/2251 of 4 October 2016 supplementing regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives central counterparties and trade repositories with regard to regulatory technical standards for risk mitigation techniques for OTC derivative contracts not cleared by a central counterparty (December 15, 2016), *available at* <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R2251&from=EN>. These RTS were developed by the European Securities and Markets Authority, the European Banking Authority, and the European Insurance and Occupational Pensions Authority (collectively, “European Supervisory Authorities” or “ESAs”) in March of this year. See ICI Memorandum No. 29785 (March 22, 2016), *available at* <https://www.iciglobal.org/iciglobal/pubs/memos/ci.memo29785.global>.

[2] The term “group” is defined in the European Market Infrastructure Regulation (“EMIR”) by reference to the accounting directives. According to these directives, entities are in the same group if they must prepare consolidated financial statements, which generally occurs when one entity has the ability to control the other one—or when both are commonly controlled—whether through an ownership interest, voting rights, or otherwise. Separately, the RTS provide that UCITS and alternative investment funds managed by alternative investment fund managers authorized or registered under EU law “shall be considered distinct entities and treated separately” for purposes of calculating this threshold amount, provided the funds are distinct segregated pools of assets for bankruptcy purposes and they are not collateralized, guaranteed or otherwise financially supported by other investment funds or their managers. See Article 28(3). This disaggregation provision does not apply to third-country funds (such as US regulated funds), which must consolidate their non-cleared derivatives exposure with other entities in the same group—i.e., other entities with which they consolidate for accounting purposes.

[3] For example, a counterparty may not accept as collateral certain types of debt securities unless that party determines the securities are of adequate credit quality.

[4] Annex II of the RTS sets out standardized haircuts ranging from 0-24 percent.

[5] The RTS provide that this legal review shall be considered satisfied if the netting agreement meets the criteria of Article 296 of Regulation (EU) No. 575/2013, which provides a process for competent authorities to recognize mutual netting agreements.

[6] 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.

[7] The initial margin compliance date will be: (1) September 1, 2017 for transactions between counterparties that have, or belong to groups each of which has, an aggregate average notional amount of non-centrally cleared derivatives that is above €2.25 trillion

and no more than €3 trillion; (2) September 1, 2018 for transactions between counterparties that have, or belong to groups each of which has, an aggregate average notional amount of non-centrally cleared derivatives that is above €1.5 trillion and no more than €2.25 trillion; (3) September 1, 2019 for transactions between counterparties that have, or belong to groups each of which has, an aggregate average notional amount of non-centrally cleared derivatives that is above €750 billion and no more than €1.5 trillion; and (4) September 1, 2020 for transactions between counterparties that have, or belong to groups each of which has, an aggregate average notional amount of non-centrally cleared derivatives that is above €8 billion and no more than €750 billion.

[8] This provision reflects ICI Global's request that the European Commission clarify ambiguity in the final draft RTS submitted by the ESAs that could have caused variation margin requirements for these FX contracts to take effect earlier than anticipated. See ICI Memorandum No. 29962 (June 6, 2016), *available at* <https://www.iciglobal.org/iciglobal/pubs/memos/memo29962>. 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.