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EU Regulators Issue Consultation Paper on Margin Requirements for Uncleared Derivatives

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TO: DERIVATIVES MARKETS ADVISORY COMMITTEE No. 28-14

ICI GLOBAL MEMBERS No. 15-14

INVESTMENT ADVISER MEMBERS No. 14-14

INTERNATIONAL MEMBERS No. 14-14 RE: EU REGULATORS ISSUE CONSULTATION PAPER ON MARGIN REQUIREMENTS FOR UNCLEARED DERIVATIVES

On April 14, the European Securities and Markets Authority, the European Banking Authority, and the European Insurance and Occupational Pensions Authority (collectively “European Supervisory Authorities” or “ESAs”) issued a consultation paper on draft regulatory technical standards (“RTS”) for margin requirements for non-centrally cleared OTC derivatives. [\[1\]](#) The Consultation Paper is generally consistent with the international final policy framework 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 and the methodologies by which the minimum 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. Comments on the RTS are due by July 14, 2014. The ESAs plan to finalize the RTS and submit them to the European Commission by the end of the year.

This memorandum briefly summarizes the Consultation Paper.

Scope of Requirements

The RTS would require counterparties to exchange variation margin daily. Moreover, the RTS would require counterparties (both financial and non-financial counterparties) to exchange two-way initial margin (on a gross basis) to cover the potential future exposure resulting from a counterparty default. Counterparties would be required to recalculate

initial margin at least when the portfolio between the two entities has changed, the underlying risk measurement approach has changed, or every 10 business days. The RTS would impose an obligation on EU entities to collect margin regardless of whether they are facing EU or third-country entities.

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

Consistent with BCBS/IOSCO Standards, the RTS also propose a minimum transfer threshold. Therefore, an exchange of collateral would be only necessary if the change in the margin requirements exceeds €500,000. The RTS also propose a threshold level of €50 million under which initial margin would not have to be exchanged. When the amount of initial margin to be collected by a counterparty is below this threshold, it may hold capital against its counterparty exposure in lieu of collecting initial margin.

The initial margin threshold applies at the “group” level, and for investment funds, the threshold would be counted per single fund. The RTS note that application at the fund level is consistent with international standards where investment funds that are managed by an investment adviser should be considered distinct entities and treated separately when applying the threshold.

Margin Methods

The RTS prescribe the methods that counterparties may use to calculate initial margin requirements: the standardized method and initial margin models. The standardized method is a two-step approach: (1) derivative notional amounts are multiplied by add-on factors that depend on the asset class and the maturity, resulting in a gross requirement and (2) the gross requirement is reduced to take into account potential offsetting benefits in the netting set. The standardized method is set forth in Annex IV of the Consultation Paper.

Alternatively, counterparties may use initial margin models that comply with the requirements in the RTS. Initial margin models may either be developed by the counterparties or by a third-party agent. [\[3\]](#) The initial models are required to assume the maximum variations in the value of 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, including financial stress. The RTS would impose additional quantitative requirements, including those to ensure that all relevant risk factors are included and that all basis risks are appropriately captured. The models must be subject to an initial validation, periodical back-tests, and regular audit processes. The RTS also would require all key assumptions of the model, its limitations, and operational details to be document appropriately.

Eligibility and Treatment of Collateral

The RTS provide the minimum requirements for collateral to be eligible for the exchange of margins by counterparties and the treatment of collateral, including the haircuts to be applied. The RTS propose a list of eligible collateral, eligibility criteria, requirements for credit assessments and requirements regarding the calculation and application of haircuts. The RTS would require that risk management procedures include appropriate collateral

management procedures, and a set of operational requirements is included to ensure that counterparties have the capabilities to manage the collected collateral in the event of the default of the other counterparty.

The RTS include a broad set of asset classes (e.g., cash, gold, government securities, corporate bonds, specific securitizations, equities, UCITs) as eligible collateral but all collateral has to meet additional eligibility criteria such as low credit, market and FX risk. To reduce the reliance on external ratings, the use of either an internal or external credit assessment process would be allowed, which will stipulate a minimum level of credit quality. The RTS also include measures to prevent wrong-way risk on collateral and diversification requirements. The RTS generally would not allow own-issued securities as eligible collateral. The RTS include diversification requirements on three different asset classes: (1) sovereign bonds (and equivalent); (2) non-sovereign bonds; and (3) securities issued by credit institutions and investment firms.

The RTS would require appropriate haircuts to reflect potential market and FX volatility on the collateral. The RTS would allow the use of an internal model for the calculation of haircuts (Annex III of the Consultation Paper) or the use of standardized haircuts (Annex II of the Consultation Paper).

Operational Procedures

The RTS would require counterparties to implement operational procedures that ensure that documentation is in place between counterparties and internally at the counterparty. The operational requirements include, among other things, clear senior management reporting, escalation procedures (internally and with counterparties) and requirements to ensure sufficient liquidity of the collateral. Counterparties would be required to conduct tests on the procedures at least on an annual basis. Segregation requirements also must be in place to ensure that collateral is available if a counterparty defaults. [\[4\]](#) In addition, operational and legal arrangements must be in place to ensure that the collateral is bankruptcy remote. Finally, the RTS do not contain the possibility to re-hypothecate, re-pledge, or re-use initial margin because these practices would create new risks due to claims of a third party over the margin.

Phase-in of Requirements

The RTS propose that the requirements would enter into force on December 1, 2015, and the requirements would be phased-in each year 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 December 1, 2015. From December 1, 2019, 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. To avoid any retroactive effect of the RTS, margin requirements would apply to new contracts not cleared by a central counterparty (“CCP”) entered into after the relevant phase-in dates. Exchanges of variation margin and initial margin on contracts not cleared by a CCP entered into before these dates would be subject to existing bilateral agreements.

endnotes

[1] Consultation Paper on 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, April 14, 2014, available at http://www.esma.europa.eu/system/files/jc_cp_2014_03_cp_on_risk_mitigation_for_otc_derivatives.pdf (“Consultation Paper”).

[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] The counterparties would be required to notify the relevant competent authorities regarding the use of an initial margin model and be prepared to provide the relevant documentation. The documentation must be sufficient to ensure that any knowledgeable third party would be able to understand the design and operational details of the initial margin model.

[4] The collecting counterparty must always provide the posting counterparty with the option to segregate its collateral from the assets of other posting counterparties.