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EU Regulators Issue Second Consultation Paper on Margin Requirements for Uncleared Derivatives

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TO: SECURITIES OPERATIONS ADVISORY COMMITTEE RE: EU REGULATORS ISSUE SECOND CONSULTATION PAPER ON MARGIN REQUIREMENTS FOR UNCLEARED DERIVATIVES

On June 10, 2015, the European Securities and Market Authority, the European Banking Authority, and the European Insurance and Occupational Pensions Authority (collectively "European Supervisory Authorities" or "ESAs") issued a second consultation paper on draft regulatory technical standards ("RTS") for margin requirements for non-centrally cleared OTC derivatives. [1] The Second Consultation Paper builds on the proposal outlined in the First Consultation Paper, [2] addresses many of the concerns expressed by commenters (including those of ICI Global), [3] and is largely consistent with the international margin standards adopted by the Basel Committee on Banking Supervision ("BCBS") and International Organization of Securities Commissions ("IOSCO"). [4]

The draft RTS prescribe the regulatory amount of initial and variation margin to be posted and collected and the methodologies by which that minimum amount would be calculated. The draft RTS also outline the collateral eligible for the exchange of margin and the methods for determining appropriate collateral haircuts. In addition, the draft RTS require certain risk management procedures, including specific operational requirements. Because the ESAs believe most of the concerns with the draft RTS have been addressed in the Second Consultation Paper, they seek comment on a narrow set of topics (which are described in the last section of this memorandum). Comments on the Second Consultation Paper are due by July 10, 2015.

This memorandum briefly summarizes the changes to the draft RTS in the Second Consultation Paper that may be relevant to regulated funds and the issues on which the ESAs are seeking feedback.

Margining with Non-EU Entities

The ESAs have modified the draft RTS to require two-way margining when an EU entity engages in a derivatives transaction with a non-EU entity in response to comments, including those of ICI Global. [5] ICI Global had expressed concern that the draft RTS impose “an obligation on EU entities to collect margin . . . regardless of whether they are facing EU or non-EU entities” [6] but that the text of the draft RTS does not require the posting of collateral by EU entities to non-EU entities. To address this concern, the Second Consultation Paper requires the risk management procedures to include the exchange of margin between the counterparties in a situation in which an EU entity subject to the RTS enters into an OTC derivatives contract with a counterparty that is established in a third country and would be subject to the RTS if it were established in the European Union.

In addition, the Second Consultation Paper would not require the exchange of margin with non-financial entities established in a third country that would be below the clearing threshold if they had been established in the European Union. The ESAs are of the view that the risk profile of exposures to non-financial counterparties should be treated in the same way regardless of whether the non-financial counterparties are domiciled in the European Union.

Initial Margin Models

Transparency

The draft RTS permit initial margin models either to be developed by one or both of the counterparties or by a third-party agent. The Second Consultation Paper clarifies that, at the request of one of the two counterparties, the other counterparty will provide 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 replicate the calculation. [7] Moreover, all key assumptions of the model, its limitations, and operational details are required to be documented appropriately.

This clarification addresses in part ICI Global’s request that, if a proprietary model of a counterparty is being used, the counterparty be required to provide full transparency of that model to its counterparty both to ensure that margin is being calculated appropriately and to permit the counterparty to use the model. ICI Global was of the view that it is critical to ensure the integrity of the model by providing the other party with full transparency of the model, including the assumptions, limitations, and operational details.

Risk Offsets

The draft RTS allow initial margin models to account for diversification, hedging and risk offsets arising from the risks of OTC derivative contracts that are in the same netting set. The Second Consultation Paper modifies the underlying asset classes for purposes of the netting set. [8]

Eligible Collateral

The draft RTS propose a list of eligible collateral, eligibility criteria, requirements for credit assessments, and requirements regarding the calculation and application of haircuts. The RTS also include measures to prevent wrong-way risk on collateral and concentration limits.

Concentration Limits for Sovereign Debt Securities

Under the draft RTS, sovereign debt of a particular country may not account for more than 50% of the collateral collected for each counterparty. The ESAs have amended the draft RTS to apply the concentration limits for sovereign debt securities only to systemically important entities in response to comments, including those of ICI Global, [9] that this limitation could increase rather than reduce risk for counterparties. Therefore, the diversification requirement for sovereign debt securities would only apply to transactions between systemically important counterparties [10] and not to those between a systemically important counterparty and a non-systemically important counterparty. Counterparties would be categorized as systemically important if they are institutions identified as global systemically important institutions ("G-SIIs") or as other systemically important institutions ("O-SIIs") or counterparties for which the total amount of initial margin to be collected by the counterparty or its group exceeds €1 billion.

Haircuts for Foreign Exchange Mismatches

The ESAs are of the view that it is necessary to apply appropriate haircuts to reflect the potential sensitivity of the collateral to market and foreign exchange ("FX") volatilities. The draft RTS allow the use of either an internal model for the calculation of haircuts or the use of standardized haircuts. The Second Consultation Paper clarifies the identification of a reference currency for the calculation of the FX haircut under the standardized approach. Where the agreement between the two counterparties includes a "termination currency," the counterparties would be required to apply a haircut of 8% to the market value of the assets where the collateral posted as initial margin is denominated in a currency other than the termination currency. In addition, where the agreement between the two counterparties includes a "transfer currency," the counterparties would be required to apply the 8% haircut to the market value of the assets posted as collateral for the unsettled variation margin where the collateral is denominated in a currency other than the transfer currency of the variation margin. Where "transfer currency" and "termination currency" do not appear in a bilateral agreement, the FX haircut would be required to be applied to the entire collected collateral.

Frequency of Variation Margin

The draft RTS require that counterparties calculate their variation margin at least on a daily basis. In response to concerns that the requirement to complete the collection of margin within the following business day may be unfeasible, the ESAs have identified limited circumstances in which the exchange of variation margin could occur less frequently than on a daily basis. [11] Specifically, variation margin must be collected within three business days from the calculation date. For all netting sets for which the collection of variation margin can exceed one business day, the margin period of risk ("MPOR") [12] for initial margin using an initial margin model must be increased by the number of days in between the calculation and the collection.

Segregation

Under the draft RTS, segregation requirements must be in place to ensure that collateral is available if a counterparty defaults. [13] The ESAs have modified this requirement in response to comments, including ICI Global, that obtaining a legal opinion on the effectiveness of the segregation for each of different agreements would be difficult. In the Second Consultation Paper, the legal opinion requirement is removed and the ESAs clarify that operational and legal arrangements must be in place to ensure that the collateral is bankruptcy remote. [14] In addition, a counterparty is required to perform an independent legal review annually to verify that the segregation arrangements meet the requirements of the RTS and be able to provide documentation supporting the legal basis for compliance of the arrangements in each jurisdiction.

The draft RTS do not contain the possibility to re-hypothecate, re-pledge, or re-use initial margin. The Second Consultation Paper, however, permits re-investment of initial margin posted in cash as long as the investments are used for no other purpose than protecting the collateral poster. [15]

Trade Documentation

In the Second Consultation Paper, the draft RTS include a more general requirement for trading documentation to avoid creating unnecessary burden on market participants. [16] Under the draft RTS, a counterparty would be required to perform an independent legal review at least annually to verify the legal enforceability of the bilateral netting arrangements and be able to provide documentation supporting the legal basis for compliance of the arrangements in each jurisdiction.

Phase-in of Requirements

The Second Consultation Paper proposes a phase-in schedule of the requirements that is consistent with the revised timeline recently adopted by the BCBS and IOSCO. [17] The requirements would enter into force on September 1, 2016, and would be phased-in over a four-year period.

Initial margin requirements would be phased-in each year over a four-year period, starting with the largest market participants (i.e., those with an aggregate month-end average notional amount of non-centrally cleared derivatives exceeding €3 trillion) on 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 exceed €8 billion would be subject to the requirements. Variation margin requirements will apply from September 1, 2016 for the major participants and from March 1, 2017 for all other counterparties.

Further Feedback Requested in Second Consultation Paper

The ESAs believe that the amended version of the draft RTS addresses many of the issues in the First Consultation Paper. Therefore, the ESAs are requesting feedback on the following matters:

- Question 1: The treatment of non-financial counterparties domiciled outside the EU. Some of the respondents to the First Consultation Paper commented that the treatment of non-financial counterparties domiciled outside the European Union could be seen as inconsistent with the BCBS/IOSCO Standards. Recognizing that the risk profile of exposures to non-financial counterparties should be treated in the same way, the ESAs are therefore consulting on this new approach.
- Question 2: The timing of calculation, call and delivery of initial and variation margin. Some respondents to the First Consultation Paper noticed that the requirement to complete the collection of margin within the following business day ("T+1") may be unfeasible because it was not considering some of the operational delays that, in certain circumstances, are unavoidable. In particular, these include time zone differences and margin call reconciliations. Because the daily exchange of margins is considered a core component of the entire framework, the approach in the Second Consultation Paper remains similar to the one in the First Consultation Paper. The Second Consultation Paper, however, identifies very limited circumstances in which the exchange of variation margin can occur less frequently than on a daily basis
- Question 3: Whether the draft RTS might produce unintended consequences concerning the design or the implementation of initial margin models. Respondents to the First Consultation Paper commented that the requirement to assign every single

trade to a specific asset class instead of calculating all the sensitivities to the relevant risk factors had two major drawbacks. First, the approach would have been more restrictive than the wording in the BCBS/IOSCO Standards. Second, the approach would have implied a substantial increase of the initial margin requirements. Operational processes also would need to change. To avoid unintended consequences and with the intention of preserving the overall principle of limiting the offset between well-defined asset classes, the new draft of the RTS allows more flexibility in the modelling phase while upholding the principle in the BCBS/IOSCO Standards.

- Question 4: Whether the requirements concerning the concentration limits address the concerns express on the previous proposal. In accordance with the BCBS/IOSCO Standards, collateral should be diversified "in terms of an individual issuer, issuer type and asset type." Recognizing that some participants might have constraints in posting collateral different from government debt securities (most often issued by the government of the country where the entity is domiciled), the ESAs are of the opinion that, for this particular asset class, the diversification requirements should only be applied to systemically important institutions.
- Question 5: Any concerns on the requirements on trading relationship documentation. Respondents to the First Consultation Paper noted that having a written agreement with all the counterparties including those that would not be subject to the margin requirements could result in an excessive operational burden with limited risk-reduction benefits. Although proper trading documentation is deemed necessary, the ESAs do not intend to create unnecessary burden on market participants. The Second Consultation Paper includes a more general requirement covering all aspects related to trading documentation.
- Question 6: The requirements concerning the legal basis for compliance with segregation. The ESAs recognize that obtaining a legal opinion on the effectiveness of the segregation for each of the different agreements would result in an excessively cumbersome process. The ESAs, however, state the need for the counterparty to comply with the fundamental due diligence principle of producing an internal assessment of the reliability of the agreements and their enforceability.
- Question 7: Whether the approach addresses the concerns on the use of cash for initial margin. Respondents noticed that the difficulties in segregating cash in accordance with the requirements could result in a de-facto ban of cash as eligible collateral for initial margin. To avoid unwanted effects of the segregation requirements, the obligation concerning the re-use of collateral should exclude cash to the extent that the collected margin is reinvested to protect the liability that the counterparty collecting the collateral has towards the posting party. Securities obtained from the (re)investment of cash collateral should be segregated and not re-used in line with the treatment of initial margin.
- Question 8: The requirements concerning the treatment of FX mismatch between collateral and OTC derivatives. The Second Consultation Paper proposes to clarify the proposal concerning the identification of a reference currency for the calculation of the FX haircut under the standardized approach. According to the ESAs, cash for variation margin is considered the pure settlement of a claim and should not be subject to any haircut. Furthermore, variation margin and initial margin should be considered separately when identifying the reference currency for this purpose: the transfer currency is the most natural choice for variation margin and the termination currency is the most natural for initial margin. Where "transfer currency" and "termination currency" do not appear in a bilateral agreement, the FX haircut should apply to the entire collected collateral.

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endnotes

[1] Second 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, June 10, 2015, available at https://www.eba.europa.eu/documents/10180/1106136/JC-CP-2015-002+JC+CP+on+Risk+Management+Techniques+for+OTC+derivatives+.pdf ("Second Consultation Paper").

[2] 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 ("First Consultation Paper"). For a summary of the First Consultation Paper, see ICI Memorandum No. 28043 (Apr. 15, 2015), available at http://www.iciglobal.org/iciglobal/pubs/memos/memo28043.

[3] Letter from Dan Waters, Managing Director, ICI Global, to European Supervisory Authorities, dated July 14, 2014, available at http://www.iciglobal.org/pdf/28264.pdf.

[4] 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").

[5] See Section 2, Article 3 GEN.

[6] First Consultation Paper, supra note 2, at 7 (emphasis added).

[7] For initial margin models, the draft RTS would require the counterparties to agree on the characteristics of the model and on the data used for the calculation. See Article 1 EIM – Initial margins, paragraph 2.

[8] See Article 4 MRM, Paragraph 2.

[9] In response to the First Consultation Paper, ICI Global requested that the draft RTS include an exemption from the concentration limits for certain types of sovereign debt, such as US Treasuries. See ICI Global Letter, supra note 3.

[10] Between systemically important counterparties, the diversification requirements for sovereign debt securities would apply to collateral collected in excess of €1 billion. See Article 7 LEC, Paragraph 2.

[11] See Section 3, Article I VM.

[12] MPOR refers to the time period from the most recent exchange of collateral covering a netting set of OTC derivative contracts with a defaulting counterparty until the OTC derivative contracts are closed out and the resulting market risk is re-hedged.

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

[14] See Section 6, Article 1 SEG.

[15] See Section 6, Article 1 REU.

[16] See Section 6, Article 2 OPD.

[17] For a summary of the revised phase-in schedule for the BCBS/IOSCO Standards, see ICI Memorandum No. 28842 (Mar. 19, 2015), available at http://www.iciglobal.org/iciglobal/pubs/memos/memo28842.
