Implementing EMIR's variation margin obligations for uncleared derivatives

Introduction

As the clock ticks down towards the 1st March 2017 deadline for implementing the EMIR variation margin exchange requirements, we recap on the main requirements.

EMIR's variation margin obligations are principally set out in Article 11(3) of Regulation No 648/2012 of the European Parliament and of the Council ("**EMIR**") and the Commission Delegated Regulation (EU) 2016/2251 (the "**Margin Regulatory Technical Standards**").

For background information on EMIR, please refer to the previous briefings issued by Dillon Eustace entitled "EMIR - Key Points & Dates Applicable to Financial Counterparties" and "EMIR Update & Next Steps"

Do these requirements apply to me?

The requirements apply to certain OTC derivative contracts that are not subject to the central clearing obligation under EMIR, that are entered into by two financial counterparties or by two systemically significant non-financial counterparties or by one of each. To assess whether the rules apply to you and what you must do to comply, you must first look at your own categorisation, that of your counterparty, the contracts into which you propose to enter and whether the requirements are subject to phased implementation under EMIR or the Margin Regulatory Technical Standards and whether any exemptions apply.

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A "derivative" is defined by reference to its meaning under MiFID, which broadly includes swaps, futures, options and forwards in each case where the underlying is a financial instrument, currency, rate or index, whether settled physically or in cash, or a commodity if settled in cash (or physically settled in certain circumstances), credit derivatives, climate and emissions derivatives which can be settled in cash, and financial contracts for difference. For the purpose of the margining requirements, an "OTC" derivative is a derivative contract not executed on a regulated market. A "regulated market" for this purpose is a market authorised under MiFID, or a third country market considered equivalent for the purposes of MiFID.

A "financial counterparty" is defined broadly to include EU investment firms, credit institutions, insurance/reinsurance companies, UCITS funds and their managers, institutions for occupational retirement provision and alternative investment funds managed by authorised or registered alternative investment fund managers.

A "non-financial counterparty" refers to entities which are established in an EU Member State that are not financial counterparties and not CCPs, trade repositories or trading venues. A non-financial counterparty will only be subject to the rules if the gross notional value of its outstanding OTC derivatives, excluding hedging trades, calculated on a 30 day rolling basis, and on a group basis where relevant, exceeds the relevant EMIR clearing threshold. The clearing threshold for credit derivatives and equity derivatives respectively is €1 billion, for interest rate derivatives and FX derivatives respectively is €3 billion and for commodity derivatives and other derivatives is €3 billion in aggregate. The margin rules do not apply to non-financial counterparties who are below the relevant clearing threshold.

In the context of investment funds, this means that UCITS are subject to these rules as are EU AIFs with EU authorised or registered AIFMs and non-EU AIFs with EU authorised or registered AIFMs. Other AIFs will need to meet the same criteria as all non-financial counterparties in order for the rules to apply.

The requirements are being phased in in two stages. Where both counterparties have, or belong to groups each of which has, an average notional amount of non-cleared OTC derivatives over a threshold of €3 trillion, they have been required to exchange variation margin since 4th February 2017. All other counterparties are required to exchange variation margin in respect of contracts entered into from 1st March 2017.

Where an EU counterparty to which the rules apply enters into an in scope derivative contract with a non-EEA entity where that entity would be a financial counterparty or a systemically relevant non-financial counterparty if it were established in the EU, the EU entity is obliged to exchange margin with the non-EEA entity. The margin exchange requirements also apply to contracts entered into between two third country entities that would be financial counterparties or systemically relevant non-financial counterparties if they were established in the EU, where the contract has a "direct, substantial and foreseeable effect within the Union". Such an effect exists where both trade through their EU branches or where at least one such entity benefits from a guarantee provided by an EU financial counterparty that covers all or part of its liability resulting from that OTC derivative contract, subject to certain conditions. The requirements to exchange margin are part of a globally coordinated approach developed by the Basel Committee on Banking Supervision and the

International Organisation of Securities Commissions and several non-EEA jurisdictions, including the US, are implementing similar rules along a similar timeline, though some differences exist between the various regimes. The U.S. CFTC announced on 13th February 2017 that it would allow swap dealers a six-month grace period to comply with the 1 March 2017 variation margin rules deadline that was applicable in the U.S. If you are an EU financial counterparty or systemically significant non-financial counterparty trading with a non-EEA entity, care should be taken to ensure that you continue to be in a position to comply with the relevant EU requirements that apply to you.

OTC derivatives not subject to the clearing obligation are in scope unless specifically exempted. To date, only certain interest rate swap and credit default swap contracts have been designated by the European Commission as being subject to the clearing obligation[1]. Until the clearing obligation applies to a particular type of OTC derivative and that obligation comes into force for the relevant category of counterparty, the margin exchange rules will continue to apply in respect of that OTC derivative for that counterparty. Deliverable FX forwards will not be in-scope until, most likely, 3rd January 2018. Single stock options and options on equity indices are exempted for 3 years.

A number of other exemptions apply; the rules will not apply to non-cleared OTC derivatives that are entered into with a CCP that is authorised as a credit institution; the rules will not apply to sovereigns; central banks; multilateral development banks and the Bank of International Settlements; the issuers of covered bonds and covered pools have a specific exemption from the posting of margin if certain conditions are met, but must collect variation margin; a full or partial exemption is available for intragroup OTC derivative contracts if the parties have certain risk management procedures in place and if there are no practical or legal impediments to the transferability of their own funds and the repayment of liabilities.

How is variation margin calculated?

The amount of variation margin to be collected by a counterparty is the aggregation of the marked to market values of all of the uncleared OTC derivative contracts which are the subject of a legally enforceable bilateral netting agreement between the two counterparties (a "**Netting Set**"), minus the value of all variation margin previously collected, minus the net value of each contract in the Netting Set at the point of entry into the contract, plus the value of all variation margin previously posted. Where market conditions prevent marking-to-market, "reliable and prudent" marking-to-model may be used.

Variation margin must be calculated at least on a daily basis. For the purpose of determining the calculation date for variation margin, (a) where two counterparties are located in the same time-zone, the calculation shall be based on the Netting Set of the previous business day; (b) where two counterparties are not located in the same time-zone, the calculation shall be based on the transactions in the Netting Set which are entered into before 4pm of the previous business day of the time zone where it is first 4pm. The counterparty will need to be able to measure marked-to-

[1] fixed-to-float IRS (also known as plain vanilla interest rate derivatives) denominated in EUR, GBP, JPY, USD, NOK, PLN, SEK; forward rate agreements denominated in EUR, GBP, USD, NOK, PLN, SEK; float-to-float swaps (also known as basis swaps) denominated in EUR, GBP, JPY, USD; overnight index swaps denominated in EUR, GBP, USD; untranched iTraxx Index CDS (Main, EUR, 5Y); and untranched iTraxx Index CDS (Crossover, EUR, 5Y).

market / marked-to-model values and compute collateral requirements on a daily basis: it would be anticipated that the practice will continue whereby one party will be appointed as the "Valuation Agent" (generally, the dealer), however, it may be prudent for the other party to verify the valuations and the non-dealer should have the ability to challenge calculations via a dispute resolution mechanism. This mechanism is generally provided for in industry standard collateral documentation such as that of ISDA.

The parties may agree that no variation margin is required to be transferred (as opposed to being due) until the aggregate amount transferable is €500,000 or greater (in ISDA terms, this is the "**Minimum Transfer Amount**").

What form of collateral is permitted?

In order to be eligible, collateral must be sufficiently liquid and not exposed to excessive credit, market or FX risk. Subject to the foregoing, counterparties are permitted to use the following as margin:

- Cash or gold bullion;
- Debt securities issued by EU member states' central banks; governments and local authorities, third countries governments, local authorities and central banks;
- Corporate bonds;
- The most senior tranche of a securitisation;
- Convertible bonds;
- Equities included in an index; and
- Shares or units in a UCITS scheme (subject to certain conditions).

No haircuts are required to be applied to cash variation margin. The collecting party must apply a haircut to the value of all non-cash variation margin that reflects the collateral's market risk and credit risk. The haircut can either be calculated using the methodology set out in Annex II of the Margin Regulatory Technical Standards, or by the collecting counterparty itself so long as its process for determining the haircut meets the requirements set out in the Margin Regulatory Technical Standards. An 8 per cent haircut applies to non-cash variation margin denominated in a currency other than those currencies agreed in the governing master agreement or collateral agreement or in a confirmation.

How are my contracts impacted?

From 1st March, 2017, no new in scope OTC derivative contracts can be entered into by an entity to which these requirements apply unless the parties to the contract have in place a written collateral agreement that reflects the requirements and an appropriate master netting agreement (the latter being a requirement which the ISDA Master Agreement will satisfy). Counterparties are also required to undertake an "independent legal review" of the legal enforceability of netting under their contracts when they enter into them. That review may be conducted by an internal independent unit or by an independent third party. It should not be necessary for counterparties to obtain formal legal opinions to comply with this requirement (though some counterparties may be subject to this requirement separately under their own regulatory capital requirements[2]). ISDA obtains netting opinions in respect of multiple jurisdictions, generally on an annual basis, which are available to its members via its website and this, for example, should be one way of meeting this requirement. It may, however, sometimes be prudent to take appropriate legal advice to ensure that the netting mechanism is enforceable in a particular jurisdiction. Where netting cannot be enforced with certainty at all times with respect to the legal framework of a third country, the requirement to post margin with such counterparties does not apply, though EU counterparties are required to continue to collect margin from such counterparties unless the trading with such a party is below a minimum threshold[3] in which case counterparties can trade without exchanging initial or variation margins.

It is expected that all existing collateral agreements will need to be amended to comply with the new requirements by 1st March. Parties can choose to adhere to the ISDA 2016 Variation Margin Protocol, via the ISDA website, which can be useful where there are multiple counterparty relationships. In practice dealers typically take the lead role in ensuring that appropriate collateral documentation is put in place. In our experience, most dealers have tended to propose documentation reflecting the ISDA 2016 Credit Support Annex for Variation Margin to be entered into bilaterally, rather than use the Protocol. In any event, the principal areas where collateral agreements will address the new rules will be common to all approaches and will be with respect to the eligibility of collateral, the application and calculation of collateral haircuts, the timing of margin calculations and transfers and with respect to dispute resolution. It is worth bearing in mind that where counterparties have an existing master agreement and collateral documentation in place and amend the collateral document so that it reflects the new variation margin rules, existing transactions and new transactions will form a single "Netting Set" under the master agreement and as such will be brought within the scope of the new rules for margin purposes, assuming the rules apply to the contracts in question. Unsurprisingly, in practice, dealers have tended to look to apply the new margining requirements to both existing OTC derivative transactions and new transactions entered into after 1st March, 2017.

Do I need to update my internal procedures?

Yes. Counterparties are required to establish, apply and document risk management procedures for the timely and accurate exchange of collateral for non-centrally cleared OTC derivatives. The risk management procedures must include procedures identifying eligible collateral, how to calculate margin requirements, how to manage and value collateral, how to establish the liquidity of collateral to be exchanged and the exchange of information between counterparties. These procedures must be reviewed and updated as necessary and at least annually and tested at least once a year.

What is next?

The initial margin requirements of the Margin Regulatory Technical Standards are being phased-in between 4th February, 2017 and 1st September, 2020. The initial margin requirements currently apply only where both counterparties have, or belong to groups each of which has, an aggregate average notional amount of uncleared derivatives of over €3 trillion. This threshold will reduce, and

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[2] For example, pursuant to Article 296 of Regulation (EU) No 575/2013

[3] See Article 31(2) of the Margin Regulatory Technical Standards

the initial margin requirements will begin to apply, on an annual basis from 1st September, 2017 until 2020 when the threshold will be €8 billion. At that point, initial margin will only apply where counterparties have an average total gross notional amount of all uncleared derivatives in excess of €8 billion. This figure is calculated by counterparty group and is as recorded on the last business day of the months of March, April and May of the relevant year. Our next EMIR bulletin will address this, and other developments, in greater detail.

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