MACFARLANES

IMPLEMENTATION OF EMIR MARGIN RULES FOR UNCLEARED OTC DERIVATIVES - JANUARY 2017 UPDATE

On 4 January 2017 new EU regulatory technical standards under EMIR[1] came into force that in the next two months will require parties to uncleared OTC derivatives to exchange variation margin (**VM**). The largest market participants will also need to exchange initial margin (**IM**). This briefing sets out the obligations imposed under the regulatory technical standards (the **Margin RTS**)[2].

This note updates and replaces our note of October 2016 on the same topic, reflecting the now-final terms of the Margin RTS

WHY ARE THESE OBLIGATIONS BEING IMPOSED?

The rules on margin are the remaining substantive elements of EMIR's risk mitigation obligations for OTC derivatives. The others are largely already in force or on a timeline to do so (see our previous EMIR briefing notes here). These obligations are part of the European implementation of commitments made by the G-20 group of countries to reduce risk in derivatives markets. Europe, along with a number of other G-20 members, has delayed implementation of margin obligations, in contrast to the United States, Canada and Japan where the first stages of equivalent rules went live on 1 September 2016.

Moving uncleared OTC derivatives to a collateralised model has been a key goal of regulators internationally, as the exchange of collateral significantly reduces counterparty credit risk.

The margining obligation has been delayed on a number of occasions, in part to give those entities subject to IM requirements an opportunity to implement what is a significant change to their operations. It also allowed those drafting the relevant legislation to work through the complexities involved in keeping within the global framework. However, the obligations are now imminent.

WHEN WILL THE MARGIN OBLIGATIONS APPLY?

For parties with over €3trn of uncleared OTC derivatives, IM and VM obligations will take effect on **4 February 2017**.

For other users of derivatives, VM obligations will take effect on **1 March 2017**.

IM obligations for parties with between €3trn and €8bn of uncleared OTC derivatives will then be phased in over the next 4 years.

See page 2 for the timelines that apply under the Margin RTS (which are further detailed in this note).

WHO IS AFFECTED?

When considering who is affected, we need to refer to the categorisations used by EMIR:

- A Financial Counterparty (**FC**) is an entity authorised under EU directives (which includes not just banks[4] and investment firms[5] but also insurance undertakings[6], UCITS, pension funds[7] and alternative investment funds with managers which are authorised or registered under AIFMD[8]). Branches of FCs outside of the EU are part of the FC itself and so are subject to EMIR.
- A Non-Financial Counterparty (**NFC**) is an entity established in the EU, including its branches outside the EU. If an NFC has aggregate OTC derivatives (excluding any derivatives that hedge commercial or treasury financing activity) above any of the EMIR clearing thresholds (as set out below), it is an **NFC+**.

Class of OTC derivative	Clearing threshold[9]
Credit derivatives	€1bn
Equity derivatives	€1bn
Interest rate derivatives	€3bn
FX derivatives	€3bn
Commodity derivatives and any other OTC derivative contracts not provided for above	€3bn (combined threshold)

- A third country entity (**TCE**) is potentially also subject to EMIR if it would be an FC or NFC+ if established in the EU.

Each of an FC, an NFC+, and a TCE that would be an FC or NFC+ if established in the EU, is known as a **Covered Entity**.

[1] Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories

[2] The text of the Margin RTS as published in the EU Official Journal can be found here

[3] The International Swaps and Derivatives Association.

[4] Credit institutions authorised in accordance with Directive 2006/48/EC

[5] Authorised in accordance with the Markets in Financial Instruments Directive (Directive 2004/39/EU)

[6] The insurance undertakings covered are direct life and non-life insurance undertakings, and reinsurance undertakings, each as authorised under the EU Solvency II Directive

[7] Specifically, Institutions for Occupational Retirement Provision (IORPs)

[8] AIFMD means the Alternative Investment Fund Managers Directive 2011/61/EU

[9] The clearing threshold is determined based on the gross notional value of a party's outstanding OTC derivatives, excluding hedging trades, calculated on a 30-day rolling basis, and on a group basis where relevant

2016	15 DECEMBER	Publication of Margin RTS in the Official Journal of the EU
2017	4 JANUARY	Margin RTS comes into force
	4 FEBRUARY	IM and VM obligations apply for parties with over €3trn of uncleared OTC derivatives
	1 MARCH	VM obligations apply for other users of derivatives
	4 JULY	IM and VM obligations apply to intragroup transactions
	1 SEPTEMBER	IM obligations apply for parties with over €2.25trn of uncleared OTC derivatives
2018	MOST LIKELY 3 JANUARY	VM requirements apply to physically settled FX forwards
	1 SEPTEMBER	IM obligations apply for parties with over €1.5trn of uncleared OTC derivatives
2019	1 SEPTEMBER	IM obligations apply for parties with over €0.75trn of uncleared OTC derivatives
2020	4 JANUARY	VM and IM requirements apply to single stock equity options and index options
	1 SEPTEMBER	IM obligations apply for parties with over €8bn of uncleared OTC derivatives

Covered Entities are subject to the margin obligations in the following circumstances:

- When two FCs, two NFC+s, or an FC and an NFC+ trade with each other.
- When an FC or NFC+ trades with a Covered Entity TCE, in which case the TCE doesn't have a direct obligation to comply with the EMIR rules but the FC or NFC+ is obliged to exchange collateral with the TCE. The obligation on the EU entity to exchange (rather than just collect) collateral is intended to create a level playing field when dealing with TCEs that are not subject to an equivalent margin regime.
- Two Covered Entity TCEs must exchange VM and IM with each other if:
  - both are acting through a branch in the EU and both would be FCs if established in the EU; or
  - either benefits from a guarantee by an FC established in the EU if the guarantee covers a notional amount over €8bn and is equal to at least 5 per cent of the guarantor FC's total exposures to OTC derivative contracts.

WHICH TYPES OF TRANSACTION ARE COVERED?

The margin obligations apply to all OTC derivative contracts that are not cleared by a central counterparty (**CCP**), and which are entered into at a time when both parties are past their relevant phase-in date.

The Margin RTS is silent on whether a material amendment to a transaction that was in existence prior to the phase-in date would constitute a new transaction. It would be reasonable, however, to expect that a purported amendment that in substance constitutes a new transaction risks being deemed by a regulator to be an attempt to circumvent the obligations.

Post phase-in assignments and novations of existing trades will be deemed to lead to new transactions, since the assignment or novation would involve the derivative forming part of a new "netting set".

NETTING SETS

As margin must be collected equal to the value of all contracts in a "netting set", this is a key definition for determining the obligations' scope. The Margin RTS defines a netting set as *"a set of non-centrally cleared OTC derivative contracts between two counterparties that is subject to a legally enforceable bilateral netting agreement"*, such as an ISDA master agreement.

Any collateral agreement entered into to meet the obligations under the Margin RTS must specify to which netting set the collateral agreement applies.

WHICH FX TRANSACTIONS ARE IN SCOPE?

FX forwards, FX swaps and cross-currency swaps

FX forwards, FX swaps and cross-currency swaps are all in scope, as they constitute "OTC derivatives" under EMIR. This contrasts with the approach in the United States where physically deliverable foreign exchange forwards and foreign exchange swaps are not subject to variation margin requirements under Dodd-Frank.

There are no IM requirements for physically settled FX forwards and FX swaps, and for the exchange of principal in cross-currency swaps. However, IM is still required for the relatively small exposures created by the interest rate component of cross-currency swaps.

Physically settled FX forwards are exempt from VM requirements until the earlier of:

i. 31 December 2018; and
ii. the date from which MiFID II[10] is to be applied by Member States.

MiFID II is currently scheduled to be applied from 3 January 2018, which appears to be the most likely date from which VM will be required for FX forwards.

Note that this VM exemption does not apply to FX swaps, despite FX swaps being economically identical to a linked spot FX and FX forward. Those that trade such products will therefore need to consider how to categorise their transactions in order to apply the correct VM start date.

SPOT FX

Spot FX is excluded from the requirement to collect margin. A debate in the past few years has been the point at which an FX transaction with delayed settlement should be considered to be an FX forward rather than spot. This was resolved with the publication of a draft delegated regulation pursuant to MiFID II in April 2016[11] (**the FX Regulation**), which defined spot FX narrowly. The FX Regulation provides that for most major currencies settlement must occur within two trading

[10] The Second Markets in Financial Instruments Directive (2014/65/EU)

[11] Commission Delegated Regulation of 25.4.2016 supplementing MiFID II, Article 10

days in order to be considered spot, with longer settlement cycles permitted for minor currencies and when settlement is in connection with a sale or purchase of securities.

The FX Regulation further provides that rolling spot transactions are not spot FX if there is an understanding between the parties to the contract that delivery of the underlying is not to be performed within the normal settlement cycle.

The FX Regulation will apply from the date MiFID II comes into force (scheduled to be 3 January 2018), and from that date, with only limited exceptions, physically-settled FX transactions that settle T+3 or over will constitute an FX forward for the purposes of EMIR.

"Commercial purposes"

The FX Regulation also provides a "commercial purposes" FX exception, which is that a physically-settled FX contract:

- to which at least one of the parties is an NFC,
- which is for identifiable goods, services or investment, and
- which was not traded on a trading venue,

is not subject to regulation as a "Financial Instrument" under MiFID II and so will also not be subject to the margin requirements under EMIR.

VARIATION MARGIN

A party must collect VM equal to the positive mark-to-market value of its OTC derivative contracts. The mark-to-market value reflects the current mid-market replacement cost of those OTC contracts. VM must be collected netting set by netting set.

When must VM be calculated?

The VM requirements must be calculated **on each business day** based on the previous business day's values for the transactions that were in the netting set on that previous business day. If the counterparties to the netting set are in two different time zones, the population of the netting set is determined as of 4pm in the earlier of the two time zones on that previous business day.

When must VM be collected?

The posting party must **"provide [the VM] within the same business day of the [date of calculation of the amount of VM]"** (unless additional collateral has already been posted to cover a longer "margin period of risk", as discussed below). This obligation to provide collateral on the same day is a significant tightening of time periods for many buy-side firms that currently meet margin calls one or two days later. The timing will be particularly difficult for Asian counterparties facing margin calls late in their working day. It remains to be seen whether regulators will be willing to apply a generous interpretation of the words "within the same business day of the calculation date" to give some leeway to parties in different time zones, potentially allowing Asian parties called late in the day to deliver early on the following Asian business day.

Prior to the adoption of a final text by the European Commission in October 2016, the previous draft of the Margin RTS stated that the timing obligation was on the *collecting party to collect* VM within a business day of calculation. Risk Magazine has reported that in response to a question posed by a member of the European parliament's Committee on Economic and Monetary Affairs, the European Commission clarified that collateral "can be deemed to be provided when the posting counterparty instructs their custodian"[12]. In response to this change, ISDA has since published documents for collateral that reflect that the posting party may meet its obligation by issuing a delivery instruction to its custodian on the calculation date, irrespective of whether the custodian then makes the delivery the same day.

Finally, the "margin period of risk" mentioned above is the time between a potentially defaulting counterparty last having posted sufficient margin and the time when closeout can occur following a default. The Margin RTS allows a party to call for VM to be delivered one or two business days later (rather than same day) if the party calling for collateral already holds additional IM (over and above any mandatory IM) sufficient to cover that margin period of risk. In many currently existing relationships one party agrees contractually to give another IM in circumstances where no IM would be required under the Margin RTS. For those relationships the party holding IM may therefore be in a position to agree to delay collection of VM for up to two days.

Minimum Transfer Amount

Counterparties can agree a minimum transfer amount of no more than €500,000 (or its equivalent in another currency) such that calls below this amount do not need to be made. This is to help reduce the operational burden of exchanging small amounts of collateral. A separate minimum transfer amount can be agreed for IM and VM, provided the aggregate of the two does not exceed €500,000. If the collateral required exceeds the minimum transfer amount then the full amount must be transferred, not just the excess.

[12] Article on www.risk.net, *"Regulators deaf to variation margin concerns, say dealers"*, 17 November 2016.

What collateral can be posted as VM?
See Eligible Collateral below for a summary of eligible collateral that can be posted as VM. Unlike the normal CCP rules for cleared derivatives, VM for uncleared derivatives is not restricted to cash.

What if a party due to collect VM under the Margin RTS has contractually agreed to post title transfer IM?
It is common for smaller users of derivatives to be obliged to agree to post IM on a title transfer basis under an ISDA Credit Support Annex **(CSA)** to a larger provider of derivatives, which means that the recipient becomes the outright owner of the collateral rather than segregating it from its own assets. Such a smaller party might be required contractually to post, say, €10 of cash IM in respect of a derivative despite having no obligation to do so under the Margin RTS. Suppose the derivative then developed a €3 mark-to-market in favour of the party posting IM. The posting party calls for and receives €3. But on a net basis that smaller party is not holding a positive balance of margin, but rather is still posting a net €7 of margin to the recipient. This would appear to contravene the spirit of the margin obligations, as the smaller user of derivatives is still bearing credit risk on its counterparty.

Such a situation can be viewed as compliant with the Margin RTS by taking the interpretation that the VM obligation is merely to "collect" VM. On this interpretation, the act of collecting the €3 of VM is enough, irrespective of whether a net amount of margin is then held as a consequence. An interpretation that VM must be "held" as well as collected would be unworkable as it would in effect require contractually agreed IM to be segregated, so we hope this will be clarified prior to the implementation of the VM requirements.

INITIAL MARGIN

IM is collected to cover movements in value of OTC derivative transactions in the period between the last collection of VM and the time when the transactions can be liquidated or hedged against market risk following a default by a counterparty. A complexity of IM that the Margin RTS must deal with is that if IM is not segregated from the assets of the recipient then the party posting collateral is exposed to the credit risk of the recipient, which would be contrary to any intention to reduce risks in entering into derivatives.

Timing of the initial margin requirement
The initial margin obligation applies in a staggered fashion over several years, depending on the relevant entity's uncleared OTC derivative volumes, as shown below:

Aggregate average notional amount of uncleared derivatives exceeds	Implementation date
€3tn	4 February 2017
€2.25tn	1 September 2017
€1.5tn	1 September 2018
€0.75tn	1 September 2019
€8bn	1 September 2020

The aggregate average notional amount of uncleared derivatives is calculated:

a. as the average across the last business days of the immediately preceding March, April and May;

b. for umbrella UCITS and alternative investment funds with a manager that is authorised or registered under AIFMD on a per fund basis (provided the fund is bankruptcy remote from other funds and the fund's investment manager, and is not collateralised or guaranteed by them, so sub-funds of an umbrella fund SICAV, for example, will be looked at separately); and

c. for members of a group as the aggregate of all entities within the group[13], including intragroup derivatives, but counting each derivative only once.

Counterparties must continue to make this calculation for each March, April and May after 2020, to see if the €8bn threshold has been exceeded. After 2020, if the threshold is exceeded by a party, it will need to start posting IM from the following 1 January. Equally, if the party no longer exceeds the threshold, the IM obligation will cease to apply from the following 1 January.

The requirement in (b) above, that for a fund to be considered independently of other funds in an umbrella it must be a UCITS or managed by a manager that is authorised or registered under AIFMD, has been criticised as unfairly disadvantaging third country funds. It is to be hoped that the unequal treatment will be remedied before the date when umbrella funds are likely to exceed any of the thresholds.

[13] "Group" is defined in EMIR as the group of undertakings consisting of a parent undertaking and its subsidiaries within the meaning of Articles 1 and 2 of *Directive 83/349/EEC (the Company Law Directive)* or the group of undertakings referred to in Article 3(1) and Article 80(7) and (8) of *Directive 2006/48/EC (the Bank Consolidation Directive)*

Minimum Transfer Amount
As noted earlier, parties can agree a minimum transfer amount of no more than €500,000 in aggregate between VM and IM. To the extent that VM calls are more frequent than IM, parties may find it more convenient to allocate the greater proportion of the minimum transfer amount to VM.

Thresholds for IM
The amount of IM that must be collected can be reduced by up to €50m by agreement between two counterparties. The €50m figure must be calculated on a group-wide basis, so if multiple entities in a group face another counterparty or counterparty group, the €50m reduction must be allocated among entities within the group. Unlike for the minimum transfer amount, this reduction applies even if the threshold is exceeded: for example, if a party calculates a €52m IM requirement then only €2m need be collected.

If both counterparties are part of a single group the threshold is reduced to €10m. This €10m is calculated per bilateral relationship, so a single group could apply the €10m reduction to an unlimited number of intra-group relationships.

For umbrella UCITS and alternative investment funds with a manager that is authorised or registered under AIFMD, the IM threshold applies on a per fund basis provided that (a) the fund is bankruptcy remote from other funds and the fund's investment manager, and (b) it is not collateralised or guaranteed by them. The failure to extend this principle to third country umbrella funds is a point of concern, as it is with the calculation of the threshold for the IM obligations applying mentioned in the section "Timing of the initial margin requirement", above.

Segregation of IM
Collateral required under the Margin RTS to be posted as IM must be segregated from the collecting party's assets to protect against the default or insolvency of the collecting party. Current practice is that IM is typically not segregated, though there are some market participants that already deal with IM under a separate segregated arrangement (including some, such as US '40 Act funds[14], which have to put in place such arrangements). The segregation of IM from the collecting party's assets will become the rule, rather than the exception, for those obliged to post IM under the new regime. A party posting non-cash IM can require that the IM be individually segregated from the assets of other posting parties as well as those of the collecting party.

[14] An SEC-registered investment company regulated by the United States Investment Company Act of 1940

The collecting party cannot borrow (often referred to as "rehypothecate") or otherwise reuse the IM collateral, as to do so would create a credit risk for the posting party on the recipient of the collateral.

Cash collateral posted as IM must be deposited in an account with a central bank or third party credit institution authorised in accordance with CRD IV[15] that is not in the same corporate group as either counterparty. Unlike under the equivalent US rules, there is no obligation to use a third party custodian to hold non-cash IM.

When must IM be calculated?
IM must be calculated within one business day of:

a. a new transaction being executed or otherwise added to a netting set;

b. an existing transaction expiring or otherwise being removed from a netting set;

c. an existing transaction triggering a payment or delivery other than margin payment; or

d. a transaction subject to the "standardised" model in the Margin RTS being reclassified due to a reduction in time to maturity; and

must in any event be made where no calculation has been made in the preceding 10 business days.

When is IM collected?
As with VM, the posting party must provide the IM within the same business day of the date of calculation of the amount of IM.

How is IM calculated?
IM can be calculated using one or both of the "standardised" model set out in the Margin RTS and an IM model developed by one or both counterparties or by a third party. Counterparties do not need to use the same methodology, but must agree characteristics and data that will be used to calibrate it. A party collecting IM remains responsible for ensuring the model complies with the requirements, even where it is developed by a third party.

ISDA has developed a Standard Initial Margin Model (**SIMM**) that is intended to help reduce disputes as to the required amount of IM. Using SIMM means that the parties share a

[15] Authorised in accordance with Directive 2013/36/EU (CRD IV) or authorised in a third country whose supervisory and regulatory arrangements are equivalent in accordance with Article 142(2) of Regulation (EU) No 575/2013, also known as the Credit Requirements Regulation (CRR)

methodology in determining the amount of IM, although it does not mean that the IMs calculated will be identical as each party will still be inputting their own estimates of some parameters, such as volatility estimates, into the model. SIMM produces an IM requirement that is significantly less than that required under the standardised model. SIMM is being used as the standard methodology for those jurisdictions where the IM obligations are now live.

What collateral can be posted as IM?

See Eligible Collateral below for a summary of eligible collateral that can be posted as IM.

EXEMPTIONS FROM THE RULES

Non-Financial Counterparties below the clearing threshold. The rules do not apply to transactions where one or both of the parties is a non-financial counterparty below the clearing threshold under EMIR or a TCE that would be a non-financial counterparty below the threshold if established in the EU (known as an NFC-).

CCPs. The rules do not apply to uncleared OTC derivatives entered into with CCPs that are authorised as credit institutions.

Sovereign entities. EU member states, their central banks and public bodies involved in the management of public debt are exempted from the margin requirements, as is the Bank for International Settlements. The Commission has the power to exempt third country sovereigns, central banks and public bodies involved in the management of public debt if those entities are subject to appropriate risk management standards. At the time of writing the Commission has only exempted the United States and Japan on this basis.

In addition, some multilateral entities and entities subject to a government guarantee are exempted from all parts of EMIR other than reporting. This appears to mean that government-guaranteed third country entities are exempt from the margin requirements while an unguaranteed third country sovereign entity is subject to them.

FX trades. As noted earlier, no IM is required for physically settled FX forwards and FX swaps and the exchange of principal in cross-currency swaps, while physically settled FX forwards are exempt from VM requirements until the earlier of:

i. 31 December 2018; and

ii. the date from which MiFID II is to apply

Equity options. Single stock equity options and index options are subject to a three year exemption from the requirement to post VM and IM. The exemption is intended to provide time for the Commission to monitor regulatory developments in other jurisdictions where these contracts are not subject to equivalent margin requirements, and to phase in margin requirements to avoid regulatory arbitrage.

Option Sellers. If an option seller collects the entire premium upfront under an option, such that it has no credit risk on the option buyer, the option seller is not obliged to collect VM or IM. However, an option buyer subject to EMIR must still collect VM and, if applicable, IM.

Intra-group trades. A full or partial exemption from the requirements to exchange VM and IM is available for intragroup OTC derivative contracts if the parties have adequate risk management procedures and there are no practical or legal impediments to the transferability of their own funds and the repayment of liabilities (such as currency and exchange controls or limits imposed by their constitutional documents). If the entities are in different countries then an application to the national regulators of any entity in an EU country is required. There is a six month general exemption for all intragroup transactions from the need to exchange VM and IM; and a separate three year transitional exemption for intragroup transactions with entities outside the EU while waiting for the Commission to make an equivalence determination for the relevant non-EU country.

Covered Bonds. Covered bond issuers (such as issuers of *Pfandbriefe*) and similar covered pools are not required to post IM or VM when entering into OTC derivatives as interest rate or currency hedges if a set list of risk management processes are put in place to protect derivative counterparties. However, a covered bonds issuer or a covered pool must still collect VM (and return any excess VM).

Netting concerns. EU counterparties are not required to:

a. post VM or IM for OTC derivative contracts with TCEs where an independent legal review confirms that the enforcement of netting and exchange of collateral lacks certainty; or

b. post or collect VM or IM for OTC derivative contracts with a TCE where:

    a. an independent legal review confirms that:

        i. the enforcement of netting or collateral lacks certainty; and

ii. collecting collateral in accordance with the Margin RTS is not possible, even on a gross basis; and

b. the sum of the notional amounts of the affected transactions is less than 2.5 per cent of the notional amounts of all outstanding OTC derivative contracts of the corporate group to which that counterparty belongs (excluding intra-group transactions).

ELIGIBLE COLLATERAL

What can be posted?

Counterparties can agree to accept collateral from a set of asset classes set out in the Margin RTS, subject to meeting credit quality and wrong-way risk requirements and the concentration limits set out below. See Appendix I for a list of the permitted collateral.

Minimum credit quality

The collecting counterparty will be required to assess the credit quality of debt securities collected, and may do so using:

a. an internal ratings-based model if they are authorised to use one under CRR,

b. an internal ratings-based model of their counterparty if the counterparty is authorised to use one under CRR or an equivalent international law; or.

c. a credit quality assessment issued by a recognised credit rating agency or central bank[16].

Debt securities of EU member states issued or funded in its domestic currency are exempted from the need to assess credit quality, as is the debt of some multilateral organisations. A country that issues its own currency can, at the extreme, avoiding defaulting on its domestic currency debt by printing more currency to meet its debt obligations, so there is some logic in excluding such debt from an assessment of credit risk. However, the application of this principle in the Margin RTS has the result that a credit assessment is needed for a third country that can issue debt in its own currency such as the United States, but no credit assessment is needed for the debt of a Eurozone country that has no direct right to issue its own currency.

Haircuts on value of collateral

- **Cash VM** is not subject to a haircut.
- The collecting party must apply a haircut to the value of all **non-cash IM and VM** that reflects the collateral's market risk and credit risk. The applicable haircut can either be calculated using a standard methodology set out in the Margin RTS, or by the collecting counterparty itself so long as its process for determining the haircuts meets requirements set out in the Margin RTS.
- A further 8 per cent currency mismatch haircut applies to **non-cash VM** denominated in a currency other than those currencies agreed in the governing master agreement or collateral agreement, or in a confirmation.
- An 8 per cent currency mismatch haircut applies to **cash and non-cash IM** denominated in a currency other than the currency in which payments on default are required (typically meaning the "Termination Currency" specified in the ISDA master agreement).

Eligibility criteria to avoid wrong way risk

Non-sovereign debt securities used as **non-cash IM or VM** must not have been issued by the posting counterparty group or otherwise be subject to significant "wrong way risk" such that the value of the collateral and the creditworthiness of the collateral provider both fall at the same time[17].

Concentration risk

Non-cash IM is subject to concentration limits on securities issued by a single issuer (including issuers belonging to the same corporate group) and on equity and equity-linked securities as follows.

The general concentration limit is that a posting counterparty must not provide as IM:

i. debt securities of a single issuer or issuing group more than the greater of:

  a. €10m or the equivalent in another currency; and

  b. 15 per cent or the total amount of IM collected from the posting counterparty,

or

ii. equities, convertible bonds and the most senior tranches of securitisations that are in aggregate more than the greater of:

  a. €10m or the equivalent in another currency; and

[16] An External Credit Assessment Institution, as defined in Article 4(98) CRR

[17] Wrong-way risk for these purposes is as defined in Article 291(1)(a)&(b) of the Capital Requirements Regulation, which is Regulation (EU) 575/2013.

b. 40 per cent of the IM collected from the posting counterparty.

In addition, where both counterparties are:

i. systemically important institutions[18]; or

ii. entities (excluding pension scheme arrangements) for which the sum of collateral required to be collected is more than €1bn,

then no more than 50 per cent of any IM in excess of €1bn can be:

a. sovereign-linked[19] debt securities of a single country or issuer, or

b. cash held with a single third party or custodian.

Where a pension scheme arrangement posts or collects IM in excess of €1bn, the collecting party must establish procedures to manage concentration risk of sovereign-linked debt securities.

When a systemically important institution collects cash IM from another systemically important institution, no more than 20 per cent of that cash IM may be held with a single custodian.

The concentration limits do not apply if the collateral is in the same form as the underlying instrument of the derivative that is being collateralised. This permits collateral that is closely aligned with the value of the derivative to be taken, such as an option buyer taking collateral in the form of the financial instrument that it would receive if the option was exercised.

Every time a collecting party calculates IM it must also assess compliance with concentration risk limits, but as an exception some types of pension scheme arrangements[20] may assess compliance on a quarterly basis provided that the amount of IM collected from each individual counterparty is below €800m at all times in the quarter prior to the assessment.

[18] Institutions identified as Global Systemically Important Institutions (G-SIIs) or Other Systemically Important Institutions (O-SIIs) in accordance with Article 131 of the Capital Requirements Directive 2013/36/EU

[19] The range of securities we are encompassing by "sovereign-linked" includes those of some regional government and local authorities, and of some multilateral development banks and international organisations.

[20] The pension scheme arrangements with the less frequent assessment obligation are institutions for occupational retirement provision, occupational retirement provision businesses of life-insurance undertakings or institutions operating social-security schemes, as provided in Article 2(10) (a), (b) and (c) of EMIR.

COLLATERAL MANAGEMENT

Counterparties must perform an independent legal review (which can be by an internal unit or a third party) of the enforceability of their netting and collateral agreements.

Counterparties must establish policies to assess on a "continuous" basis the enforceability of netting and collateral agreements that they enter into. This policy would be easiest to satisfy by restricting netting and collateral agreements to industry-standard documents that are supported by an industry association that arranges for the regular issuing of enforceability and netting opinions, as is the case for the ISDA master agreement and CSA.

Counterparties must have documented risk management procedures for the exchange of collateral for uncleared OTC derivatives. The procedures should be drafted to ensure compliance with the requirements of the Margin RTS.

Counterparties are required to conduct an independent legal review (which can be done by an independent third party or an independent internal unit) that they have met their regulatory obligations to ensure that:

i. IM is freely transferable to the posting party in a timely manner in the case of default of the collecting party;

ii. IM is segregated on the books and records of a third party custodian or via another legally binding arrangement;

iii. non-cash IM is segregated from the proprietary assets of the entity holding IM; and

iv. where non-cash IM is held by the collecting party or third party custodian, the collecting party provides the posting party an option to segregate their collateral from the collateral of other parties.

A counterparty must give evidence of its compliance with the requirement to conduct a legal review to its competent authority. The competent authority can require that counterparties establish policies ensuing that the obligation to conduct a legal review is continuously complied with.

It is common in many bank to client relationships for the bank to take collateral, often acting as both custodian and banker to the client, but for no collateral to be collected by the client, such as in a prime brokerage relationship. These structures will need to be amended to ensure that the client's obligation to collect VM is adequately dealt with.

SUBSTITUTED COMPLIANCE WITH EQUIVALENT REGIMES

The global implementation of different margin rules for uncleared OTC derivatives means that when entities based in different jurisdictions trade with each other, they may face conflicting obligations regarding their exchange of collateral. Further, an entity incorporated in one jurisdiction that is also subject to the rules of another (for example, through being a branch, or through the location of its manager, investors, or guarantor) may face an obligation to comply with two sets of obligations at once.

In recognition of these difficulties, EMIR in some cases permits entities subject to EMIR rules to instead comply with the rules of regimes deemed equivalent when dealing with parties subject to those regimes, known as "substituted compliance". The Commission may declare the regime of a non-EU country to be equivalent of EMIR, based on advice from ESMA. Where one non-EU party to a derivative is subject to a regime that has been recognised as equivalent, both parties may be able to comply with that non-EU equivalent margin regime. However, in respect of the Margin RTS, ESMA had asked the Commission not to make any decisions on equivalence until the EU margin rules have been finalised.

STATUS OF EQUIVALENT RULES IN OTHER COUNTRIES

The status of equivalent rules in other significant jurisdictions is:

- The United States, Canada and Japan implemented margin requirements for the largest users of uncleared derivatives as originally scheduled on 1 September 2016, with the VM requirements for other users due to apply from 1 March 2017.
- Switzerland has published final margin rules, but has yet to publish a timetable for implementation.
- On 22 August 2016, regulators in Australia, Singapore and Hong Kong made announcements deferring the implementation of margin requirements for uncleared derivatives. Australia published final rules on 17 October 2016, and on 6 December 2016 published an implementation schedule for larger users of derivatives, with the first obligations commencing on 1 March 2017. Also on 6 December 2016, Singapore published final rules and Hong Kong published near-final rules.

WHAT STEPS DO DERIVATIVES USERS NOW NEED TO TAKE?

- The largest derivatives users facing the 4 February 2017 phase-in date have typically taken steps to ensure their compliance, so the date of most immediate concern for most users of derivatives subject to the EMIR requirements is 1 March 2017. From this date no new uncleared OTC derivative transactions can be entered into unless the parties to the transaction have a written collateral agreement that complies with the VM requirements, itself supplementing an appropriate master agreement that creates a netting set. Almost all existing collateral agreements will require change in order to comply with the new requirements.
- Parties that are in scope and that have not collateralised their derivative transactions up until now will need to put in place an internal collateral process, CSAs will need to be negotiated and put in place, and a supply of collateral will need to be ensured.
- Parties that already exchange collateral will need to amend or replace their existing CSAs to document the new requirements for VM and update internal collateral processes to reflect the new requirements. Clients of firms such as prime brokers that do not currently provide collateral will need to establish a process to meet the requirement to collect VM.
- A number of different means are available to comply with the new VM requirements:
  - Parties can bilaterally enter into one of the recently published English law and New York law versions of the *ISDA 2016 Credit Support Annex for Variation Margin* (the **VMCSA**), which deal with the new VM requirements.
  - Alternatively, parties can amend individual terms of current CSAs to bring them into compliance.
  - A party can adhere to the ISDA 2016 Variation Margin Protocol (the **Protocol**) to multilaterally change their CSAs or put in place new VMCSAs and, where needed, new ISDA master agreements with other parties that adhere to the Protocol. The complexity of the Protocol has been criticised by a number of market participants, with some larger users of derivatives stating that they do not intend relying on the protocol.

- A preliminary step that can be taken in the process of agreeing bilateral changes, and which is a necessary step in the use of the Protocol, is to complete the Regulatory Margin Self-Disclosure Letter (the **Letter**). The Letter provides counterparties with necessary information in order to meet the obligations for compliance across different jurisdictions. The Letter includes information to determine:
  - whether the party is systemically significant;
  - which jurisdictions' laws the parties need to comply with; and
  - which obligations each side faces, and when they apply.

The Letter can be exchanged electronically using the ISDA Amend, a joint service provided by Markit and ISDA, available on http://www.markit.com/product/isda-amend.

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APPENDIX I

ELIGIBLE COLLATERAL FOR INITIAL AND VARIATION MARGIN

SUMMARY

- Cash in any currency or money market deposits.
- Gold in the form of allocated pure gold bullion of recognised good delivery.
- Debt securities issued by:
  - Member States' central governments or central banks.
  - Member States' regional governments or local authorities.
  - Member States' public sector entities.
  - multilateral development banks (such as the International Bank for Reconstruction and Development).
  - international organisations (such as the International Monetary Fund and the Bank for International Settlements).
  - third countries' governments or central banks.
  - third countries' regional governments or local authorities.
  - credit institutions or investment firms and certain related bonds.
- Corporate bonds.
- The most senior tranche of a securitisation (but not a re-securitisation).
- Equities included in a main index and bonds convertible into those equities.
- Units or shares in UCITS that have daily price quotes and which meet the criteria for risk-weighting under CRR , but only to the extent that the UCITS invests in assets that are otherwise eligible as collateral under the Margin RTS.

Asset classes for which the counterparty has no market access or which cannot be liquidated in a timely manner are not eligible collateral.

For further details, please see Article 4 on page 11 in the following link:

http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R2251&from=EN