New EU Rules on Derivatives Trading

Introduction to EMIR for non financial counterparties

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Material in this presentation is based on the regulatory and implementing technical standards under the Regulation (EU) No 648/2012 on OTC Derivatives, CCPs and Trade Repositories.

Agenda

1. Introduction
2. Notification for exceeding the clearing threshold
3. Reporting requirement
4. Clearing obligation
5. Risk mitigation for uncleared trades
6. Implementation

Introduction

G20 statement in Pittsburgh:

All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest.

OTC derivative contracts should be reported to trade repositories.

Non-centrally cleared contracts should be subject to higher capital requirements.

Introduction

- Objective of the G20: to increase transparency and reduce systemic risk
- In the EU these reforms are introduced through EMIR, CRD IV and MiFID II. In the US the Dodd-Frank Act introduces similar reforms.
- EMIR came into force on **16 August 2012**.
- Many provisions only applied after technical standards came into force on **15 March 2013**

Introduction

- Legislators recognised the importance of maintaining cost effective access to derivatives markets for NFCs and broad exemptions have been granted. However, NFCs still need to understand and comply with new obligations.
- All derivatives transactions are in scope whether on exchange or OTC and regardless of scale or purpose.

Introduction

- **The EMIR requirements for most NFCs are in three broad categories:**
  - measuring level of non-hedging OTC derivatives transactions – "the clearing threshold"
  - reporting derivatives to trade repositories
  - risk mitigation for uncleared OTC derivatives
- **At a minimum, NFCs must report and confirm all derivative trades.**
- **NFCs with large speculative OTC derivatives positions are required to centrally clear or collateralise OTC derivative contracts**

Assessing whether an NFC is above the 'clearing threshold'

Implications

- NFCs with OTC derivative activity above the clearing threshold ("NFC+") are subject to the same requirements as a FC.
- NFC + are subject to additional reporting requirements; the clearing obligation; bilateral margin requirements; and stricter operational requirements.
- The clearing threshold is a two step test…

Step1: The ‘hedging’ definition

Transactions designed to reduce risk to commercial or treasury financing activity of an NFC do not count towards the threshold

- This is the case if an OTC derivative contract;
  - Covers the risk arising from the normal course of business (includes proxy hedging and stock options arising from employee benefits);
  - Covers indirect risks; or
  - Is consistent with IFRS hedging definition
- No hard and fast rules on interpretation, but firms should be able to demonstrate how each of the contracts they deem as hedging meets the definition

Step 2: The clearing thresholds

An entity is NFC+ for <u>all</u> future OTC derivative contracts once <u>one</u> of the following thresholds is reached

- €1bn in gross notional value for OTC <u>credit and equity derivatives</u> (individual thresholds)
- €3bn in gross notional value for <u>interest rate and FX</u> (individual thresholds)
- €3bn in gross notional value for <u>commodities and others</u> (combined threshold)

The clearing threshold calculation

- **When assessing its positions, an NFC must:**
  - include all contracts entered into by all non financial entities within the **consolidated group.**
  - monitor the threshold against the consolidated group's rolling 30 day average of gross notional by class.
  - notify the **FCA and ESMA** if a threshold is exceeded on any one day.
- **'Hedging' derivatives are excluded from the calculation, but not from the additional requirements if a threshold is breached.**
- **If a threshold is breached <u>all</u> future OTC derivatives are subject to additional requirements**

NFC clearing threshold notification

- From 15 March 2013, NFCs have been required to notify the FCA and ESMA if their gross notional position exceeds the clearing threshold.
- NFCs should also notify the FCA and ESMA if their rolling 30 day average position no longer exceeds the clearing threshold.
- Notification forms and guidance are available on the FCA website.

Reporting obligation

Reporting obligation

- **All counterparties (FCs and NFCs) to all derivatives contracts (OTC and exchange-traded) must**
  - report, post-trade, contract details to a registered trade repository
  - applies to all trades in the EEA
- **What is a trade repository?**
  - a database to provide transparency
  - known examples of trade repositories which have applied for authorisation are on our website
  - more expected to be set up

Reporting obligation

- **Information to be reported to TRs:**
  - the parties to the contract (or the beneficiary)
  - type of contract
  - maturity
  - notional value
  - price
  - settlement date

- **Reduces duplication by taking account of:**
  - MiFID transaction reporting
  - REMIT reporting requirements

Reporting of exposures

- **Essential for monitoring systemic risk**
- **Only financial and non-financial counterparties above the threshold (NFC+) are required to report exposures**
- **Information to be reported;**
  - Mark to market or model valuations
  - Collateral value and basis (transaction or portfolio)

How to fulfil reporting obligation

- Both counterparties MUST report each trade unless they delegate reporting to the other counterparty or a third party (such as dealer, a CCP or trading venue)
- Counterparties which delegate reporting are still responsible for ensuring reports submitted on their behalf are accurate
- The reporting requirement includes: all exchange and OTC derivative trades, intragroup trades, trades with non-financial counterparties

Timeline for reporting

Credit and interest rate derivatives;

- Reporting starts 90 days after recognition of a relevant TR by ESMA
- ESMA timetable anticipates reporting to begin in September 2013

For all other derivatives;

- If TR is recognised by 1 October - reporting begins 1 January 2014
- If no recognised TRs by 1 October – 90 days after registration

Reporting of exposures is required, for FC and NFC+ only, 180 days after the reporting start date

Timeline for reporting

Backloading existing trades

- **If outstanding at time of reporting date;**

\- 90 days to report to TR

- **If not outstanding, but were outstanding between 16 August 2012 and reporting date;**

- 3 years to report to TR

Risk mitigation for uncleared trades

Risk mitigation for uncleared trades

- **New risk mitigation requirements for uncleared OTC derivative trades**
  - Timely confirmation (15 March 2013)
  - Dispute resolution
  - Reconciliation
  - Portfolio compression

  15 September 2013
- **New margin requirements for counterparties subject to the clearing obligation (FC and NFC+)**
  - Initial and variation margin
  - Daily valuation

Timely confirmation

NFCs below the threshold;

Derivative type	Phasing until August 2013	Phasing until August 2014	Final Confirmation deadline (end of X business day)
Credit and Interest rate	T+5	T+3	<u>T+2</u>
All others	T+7	T+4	<u>T+2</u>

Timely confirmation

FC and NFC+ above the threshold;

Derivative type	Phasing		Final Confirmation deadline
Credit and Interest rate	T+2 until February 2014		T+1
All others	T+3 until August 2013	T+2 until August 2014	T+1

Dispute resolution

- **All counterparties (FC and NFC) must have agreed procedures and processes to:**
  - Identify record and monitor disputes relating contract recognition or valuation and exchange of collateral
  - Resolve disputes in a timely manner
- **Financial counterparties must report disputes of an amount or value greater than €15m and outstanding for at least 15 business days**

Portfolio reconciliation

Financial and NFC+ above threshold;

- Each BD for > 500 outstanding OTC contracts
- Once per week for 51-499
- Once per quarter for <50

NFCs below the threshold;

- Once per quarter for >100
- Once per year for <100

Portfolio compression

- All counterparties with 500 or more non cleared OTC derivative contracts outstanding with a single counterparty.
- Required to analyse the possibility of portfolio compression to reduce counterparty risk at least twice a year.
- Counterparties must be able to explain if they have concluded it is not appropriate.

Risk mitigation for uncleared trades

- **Initial and variation margin requirements**
  - Only apply to FCs and NFC+
  - No detail yet – options in BCBS/IOSCO paper
  - Initial margin likely to be required more broadly than currently
  - two-way IM would need to be segregated
- **Daily valuation requirements**
  - Mark-to-model permitted when the market is inactive; or the range of fair value estimates is significant and the probabilities of the various estimates cannot be assessed

Clearing obligation

Clearing obligation - procedure

- ESMA decides whether contracts already cleared by a CCP need mandatory clearing (bottom-up process)
- Is the contract standardised and liquid enough to warrant mandatory clearing?
- If mandatory clearing enforced, NFC+ must clear all newly executed contracts of that type
- "Frontloading": contracts entered into after bottom-up process begins but before mandatory clearing takes effect must also be cleared

Next steps / what it means for NFC+

- National authorities and ESMA have already started assessing contracts for the clearing obligation
- May use a phased-in approach when implementing the mandatory clearing obligation
- NFC+ will need to decide whether to set up client clearing arrangements
- NFC+ will need to be able to post daily collateral (variation margin) in cash, which may prove challenging.
- First clearing obligations likely <u>during 2014</u>

EMIR Implementation

Exemptions

Exemption for intragroup transactions from the clearing obligation

- NFC+ may apply for an exemption from clearing if;
  - both counterparties are included in the same consolidation on a full basis
  - appropriate centralised risk evaluation, measurement and control procedures are in place

Exemptions

Exemption for intragroup transactions from margin requirements

- NFC+ trades may be exempt if certain conditions are met, including;
  - risk management procedures are adequately sound, robust and consistent, with the level of complexity of the contract
  - there are no practical or legal impediments to the prompt transfer of own funds or repayment of liabilities.

Exemptions

- **Pension Scheme Arrangements:**
  - Trades may be exempt from clearing until August 2015, extendable to August 2018
- **Details of how to apply for all exemptions will be available on the FCA website during 2013.**

Implementing EMIR in the UK

- EMIR is a regulation, so no transposition required
- FCA has powers of investigation and enforcement, including for non-financials
- FCA is the primary regulatory authority for financial and non financial counterparties
- The Prudential Regulatory Authority (PRA) has responsibility for enforcement of margin requirements for PRA regulated firms

Implementation timetable

- NFC Notifications: 15 March 2013
- Confirmation requirements: 15 March 2013

Still subject to a number of dependencies
However, current estimates are:

- Reporting requirements: September 2013 for credit and interest rate derivatives; January 2014 for all other classes. (90 days for back-loading)
- Dispute resolution; portfolio reconciliation and compression: 15 September 2013
- First clearing obligations: 2014
- Margin for non-cleared trades: 2014/15

Further information – visit our website

http://www.fca.org.uk/firms/markets/international-markets/emir

- Latest news and events
- Information about notifications and how to notify
- FCA Supervisory Approach
- Implementation timetable
- EU Commission and ESMA publications
- FCA Handbook changes
- EMIR Updates mailing list

Any questions?