New EU Rules on Derivatives Trading

Introduction to the EMIR technical standards

OTC Derivatives & Post Trade Policy
Financial Conduct Authority

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. Reporting requirement
3. Clearing obligation
4. Risk mitigation for uncleared trades
5. 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

- **EMIR (European Markets Infrastructure Regulation) brings in:**
  - reporting to trade repositories
  - clearing obligations
  - risk mitigation for uncleared trades
  - requirements for central counterparties (CCPs) and trade repositories (TRs)
- **EMIR will apply to EU firms even when trading with non-EU firms**

Introduction

- **Technical standards yet to be finalised:**
  i. Arrangements for the establishment and functioning of CCP colleges (ESMA)
  ii. Risk mitigation techniques for OTC derivatives that are not centrally cleared (joint ESA's)
  iii. Contracts that are considered to have a direct substantial and foreseeable effect in the Union or to prevent the evasion of EMIR (ESMA)

- **The EU Commission will set a new deadline for delivery of ii. and iii.**

Reporting obligation

Reporting obligation

- **All counterparties to all derivatives contracts (OTC and exchange-traded) need to**
  - 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 (NFC) above the clearing threshold 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 by prior arrangement, one party can report on behalf of both counterparties
- The reporting party may be the counterparty to the trade, or a third-party (such as a CCP or trading platform)
- 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

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

Clearing obligation

Clearing obligation

- **OTC derivatives contracts that ESMA has determined subject to a mandatory clearing obligation must be cleared by a central counterparty (CCP)**

- **What is a CCP?**
  - A CCP stands between the two original counterparties to a contract and guarantees the performance of obligations i.e. removing counterparty risk

What mandatory clearing will apply to

- **A clearing obligation will apply to contracts between any combination of:**

  (A) Financial Counterparties; and

  (B) NFCs that are above the clearing threshold ('NFC+')

- **Mandatory clearing obligations will apply to trades between such firms where:**
  - One or more of the counterparties is in the EU; and
  - In limited circumstances, neither in the EU

Hedging definition

- **An OTC derivative contract is objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity of the NFC if;**
  – It covers the risk arising from the normal course of business (includes proxy hedging and stock options arising from employee benefits)
  – It covers indirect risks
  – It is consistent with the IFRS hedging definition

Clearing Threshold

Clearing thresholds

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

Clearing Threshold

- **The clearing obligation applies to <u>all</u> OTC derivative contracts once <u>one</u> of the thresholds is reached**
- Transactions designed to reduce risks to commercial activity or treasury financing activity do not count towards the clearing threshold
- When calculating its positions, a NFC must include all contracts entered into by all non financial entities within its group

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, all newly executed contracts of the determined type must be cleared
- "Frontloading": contracts entered into after bottom-up process begins but before mandatory clearing takes effect must also be cleared

How to meet the clearing obligation

- Counterparties may meet the clearing obligation as a direct clearing member, client of a clearing member or indirectly through a clearing member.
- CCPs and clearing members must offer:
  - individual client segregation; and
  - omnibus client segregation
- CCPs may offer other levels of segregation but the minimum level is omnibus segregation.

Timeline

- National authorities and ESMA have already started assessing contracts for the bottom-up approach
- ESMA will determine product-by-product on an ongoing basis as part of the top down approach
- May use a phased-in approach when implementing the mandatory clearing obligation
- Counterparties need to decide whether to set up client clearing arrangements
- First clearing obligations likely <u>during 2014</u>

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 (FC and NFC+) subject to the clearing obligation**
  - Initial and variation margin
  - Daily valuation

Timely confirmation

Financial and NFCs above 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

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	T+2
All others	T+7	T+4	T+2

Dispute resolution

- **All counterparties 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 NFCs 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**
  - applies to firms subject to mandatory clearing
  - 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

EMIR Implementation

Notifications and exemptions

Non Financial Counterparties (NFCs) exceeding the clearing threshold

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

Notifications and exemptions

Exemption for intragroup transactions from the clearing obligation

- Trades may be exempt from clearing if certain conditions are met, including;
  - both counterparties are included in the same consolidation on a full basis
  - appropriate centralised risk evaluation, measurement and control procedures are in place

Notifications and exemptions

Exemption for intragroup transactions from margin requirements

- 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.

Notifications and exemptions

- **Pension Scheme Arrangements:**
  - Trades may be exempt from clearing until August 2015, extendable to August 2018

- **Details of how to apply for exemptions will be available on the FSA 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 under EMIR
- 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
- FCA Supervisory Approach
- Implementation timetable
- EU Commission and ESMA publications
- Information about notifications
- FCA Handbook changes
- EMIR Updates mailing list

Any questions?