New EU Rules on Derivatives Trading

Introduction to the EMIR technical standards

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Note: 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

- **EMIR: European Markets Infrastructure Regulation to deliver this across Europe**
- **Brings in:**
  - reporting to trade repositories
  - clearing obligations
  - risk mitigation requirements for uncleared trades
  - requirements for central clearing counterparties (CCPs) and trade repositories (TRs)
- **EMIR will apply to EU firms even when trading with non-EU firms**
- **MIFID/MIFIR and CRD IV will deliver more regulation for derivatives in the near future**

Introduction

- EMIR came into force on the 16 August.
- Many provisions only apply after technical standards come into force
- ESMA submitted technical standards to the EU Commission which adopted them on 19 December
- EU Parliament and Council agreed them unchanged and they were published in the EU Official Journal on 23 February
- Come into force on 15 March 2013, 20 days after publication in the Official Journal

Introduction

- **Technical standards that are yet to be finalised**
  - Practical arrangements for the establishment and functioning of CCP colleges
  - Risk mitigation techniques for OTC derivatives that are not centrally cleared (joint ESA's)
  - 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 the delivery of these standards**

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
  - currently organised per asset class
  - examples: DTCC and Regis-TR for multiple asset classes, ICE Trade Vault for commodities
  - 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;

- If a TR is registered by 1 April – reporting begins 1 July 2013
- If no registered TRs by 1 April – 90 days after registration

For all other derivatives;

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

Timeline for reporting

Backloading existing trades

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

\- <u>90 days</u> to report to TR

- **If not outstanding, but remained outstanding on 16 August 2012;**

- <u>3 years</u> 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 mandatory clearing obligation will apply to contracts between any combination of:**

(A) Financial Counterparties

(B) NFCs that are above the clearing threshold

- **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 other NFCs 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

Timeline

- **ESMA to begin assessing contracts from <u>Q2 of 2013</u> as part of the bottom-up approach**
- **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**
- **Decide whether you need to set up indirect 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 all uncleared OTC derivative trades**
  - Timely confirmation
  - Dispute resolution
  - Reconciliation
  - Portfolio compression
- **Last three requirements enter into force 6 months after adoption of RTS (15 September 2013)**
- **Additional requirements for counterparties subject to the clearing obligation**
  - Initial and variation margin
  - Daily valuation

Timely confirmation

Financial and NFCs above threshold;

Derivative type	Phasing until August 2013	Phasing until August 2014	Final Confirmation deadline (end of X business day)
Credit and Interest rate	T+2	T+2	<u>T+1</u>
All others	T+3	T+2	<u>T+1</u>

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>

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

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

Implementing EMIR in the UK

- EMIR is a regulation, so no transposition required
- FSA to get broader enforcement and investigation powers, including for non-financials
- FCA will be main authority after regulatory reform
- More details in the FSA October Quarterly Consultation Paper

Implementation timetable

- **Still subject to a number of dependencies However, current estimates are:**
  - Confirmation requirements: 15 March 2013
  - Reporting requirements: July 2013 for credit and interest rate derivatives, January 2014 for all other classes. 90 days for backloading
  - Reconciliation, dispute resolution and Compression: 15 September 2013
  - First clearing obligations: 2014
  - Collateralisation of non-cleared trades – consultation during 2013
- **Input welcome on implementation challenges**

Notifications and exemptions

- From 15 March 2013, NFCs must 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

- **Intragroup transactions clearing exemption:**

  Trades may be exempt from clearing if certain conditions are met, including;

  - the EU Commission has recognised the equivalence of requirements in a non EU country
  - subject to same consolidation on a full basis
  - appropriate centralised risk evaluation, measurement and control procedures are in place

Notifications and exemptions

- **Intragroup transaction margin exemption:** Trades may be exempt from margin requirements for uncleared trades if certain conditions are met, including;
  - the risk management procedures of the counterparties are adequately sound, robust and consistent, with the level of complexity of the derivatives contract.
  - there are no practical or legal impediments to the prompt transfer of own funds or repayment of liabilities between counterparties.

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 these exemptions will be available on the FSA website during 2013.**

Further information – visit our website

www.fsa.gov.uk/about/what/international/emir

- Links to Commission and ESMA publications
- EMIR one-minute guide
- Link to FSA consultations
- Information about the notification process
- EMIR mailing list

Any questions?