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ESAs Publish Draft Margin Requirements for non-cleared OTC Derivatives

On 14th April 2014, the European Banking Authority, the European Securities Markets Authority, and the European Insurance and Occupational Pensions Authority (the "ESAs") published draft regulatory technical standards detailing the requirements for exchange of collateral under Article 11(3) (the "Draft RTS"). The Draft RTS are intended to be consistent with international standards, and so are expressed to "consider" the equivalent standards published jointly by the Basel Committee and IOSCO in September 2013 although there is some divergence from the Basel/IOSCO proposal. Once finalised, the RTS are expected to apply from 1st December 2015, but will apply to contracts entered into after the RTS come into force (which is likely to be at the end of 2014 or early 2015). However in a structured finance context, the Draft RTS require consideration of the location of SPVs for transactions being executed now.

In summary, the Draft RTS require financial counterparties and non-financial counterparties over the EMIR clearing thresholds who enter OTC derivatives transactions which are not subject to the clearing obligation, to collect initial and variation margin from the party facing them in the trade. The Draft RTS also impose various operational requirements aimed at reducing risk in the OTC derivatives market including, in the case of initial margin, a requirement to segregate and a restriction on re-hypothecation of the collateral.

The Collection Requirement

Under the Draft RTS, "Counterparties" must collect initial and variation margin for non-cleared derivatives unless an opt-out is available. "Counterparties" is defined as (i) Financial Counterparties ("FCs") as defined in EMIR and (ii) Non-Financial Counterparties over the clearing thresholds referred to in Article 10 of EMIR ("NFC+s"). Such Counterparties must collect margin from all entities they face in non-cleared OTC derivative trades, whether the facing entity is in the EU or not, and whether the entity is above the clearing threshold or not.

Opt-outs from the collection requirement are available in the following circumstances:

(a) If one of the parties belongs to a group (as defined in EMIR) whose gross aggregate notional amount of non-centrally-cleared derivatives is below a certain threshold (the "Initial Margin Threshold"), the two parties may agree in writing that initial margin will not be collected. As of 1st December 2015 the Initial Margin Threshold will be EUR3 trillion, but it is lowered each year so that by 1st December 2019 the threshold will be EUR8 billion. This opt-out does not apply to variation margin.

(b) Counterparties can agree with NFCs below the EMIR clearing thresholds ("NFC-"s) not to exchange initial and variation margin.

(c) Counterparties may agree not to collect initial margin on physically-settled FX forwards and swaps, or on the exchange of principal in currency swaps. There is no such flexibility for interest rate swaps or other types of derivative.

(d) Counterparties can agree not to exchange margin with certain public entities, central banks, multilateral development banks etc.

(e) Counterparties may agree not to exchange either variation margin or initial margin for indirectly cleared transactions intermediated through a clearing member of a CCP and subject to CCP margin requirements.

There is no opt-out under (b) for collection of margin from non-EU entities which would be NFC-s if they were established in the EU. This means that FCs and NFC+s must still collect variation margin for non-cleared derivatives from non-EU entities, and must also collect initial margin if both counterparties to the trade are over the Initial Margin Threshold. Unless changes are made to the Draft RTS before they come into force, structures which use non-EU SPVs would need to be avoided as they will be unable to comply with any such calls for variation margin.

Where both parties are FCs or NFC+s, Initial Margin will need to be collected unless one party (on a group basis) is below the Initial Margin Threshold. The definition of "group" in EMIR is complex and will be based on the facts in each case, but may bring in members of the consolidated accounting group as well as members of an entity's consolidated supervision group. Unlike the clearing thresholds, the Initial Margin Threshold is calculated with reference to all members of the group, including financial counterparties, and there is no exclusion for transactions which are entered into for hedging purposes.

Minimum transfer amounts and capital alternatives

The Draft RTS allow for minimum transfers to reduce the operational burden on counterparties.

An FC may agree with its FC or NFC counterparties (though again, it appears, not with non-EU counterparties) that, if the initial margin otherwise to be exchanged between the parties at group level for all non-cleared OTC derivatives is equal to or less than EUR 50 million, no initial margin will be exchanged and instead it will hold capital against its exposure to their counterparty, and may reduce the amount of initial margin exchanged by this amount.

FCs and NFC+s may agree that if the total collateral amount (i.e. the total initial and variation margin and any excess provided) is calculated to be equal to or less than EUR500,000 across all OTC derivative trades between the two parties then they will not exchange collateral. It is not clear whether the trades discounted in (e) above are counted toward this threshold. Although the EUR 500,000 amount is referred to as a "minimum transfer amount", the definition appears to catch the total amount of collateral provided or to be provided rather than the amount to be transferred on a particular day.

Exemption for covered bond swaps but not for securitisation swaps

Whilst covered bond issuers can agree with their hedge counterparty not to post either initial or variation margin provided certain structural protections for the swap counterparty are built in to the transaction, no such relief is provided in the Draft RTS for securitisation vehicles such as CLOs. Such issuers will have to rely on the opt-outs available in (a) to (e) above in order to avoid being required to post margin.

Opting Out

It should be noted that the various opt-out provisions referred to above operate as agreements between the parties and not as exemptions. This will require counterparties to existing ISDA credit support arrangements to document these opt-outs before the requirements come into force.

Calculation of Margin and Modelling

The collection of initial margin amounts is to be done without provision for netting the initial margin amounts between each other. Initial margin must be collected within a business day of the trade and variation margin must be collected daily starting on the day following the trade. Initial margin must be recalculated on the occurrence of various events such as the execution of a new contract with the counterparty, expiry of a contract, or the making of a payment under a contract (other than collateral) but at a minimum every 10 business days.

Counterparties may either use standardised margin models set out in the Draft RTS to calculate initial margin, or use an initial margin model agreed with the facing counterparty. The standardised models are likely to be less flexible and require more collateral in general than bespoke initial margin models. The ESAs have stated that as they do not have a clear mandate in the EMIR text to approve non-standard margin models, there will need to be some thought given to agreed models within the industry. With this in mind, ISDA is currently working on an industry-standard margin model for use by market participants, and published a white paper outlining its proposals in December 2013. The ESAs have acknowledged that development of models may be difficult for smaller counterparties so the RTS allow the use of models provided by the facing counterparty, although as these are generally proprietary this may not be practicable. The ESAs have indicated that further work will be needed in this area before the final rules are published.

Eligibility of Collateral

The requirements for eligible collateral for both initial and variation margin are also set out in the Draft RTS. These include cash, gold, gilts, debt securities issued by certain public entities meeting certain criteria, bank bonds including covered bonds, senior securitisation bonds, equities included on a main index (and related convertibles), and units in UCITS. Each category is subject to various credit quality thresholds, and must not include significant wrong-way risk (i.e. positive correlation with the creditworthiness of the counterparty). There are also concentration limits (subject to possible proportionality thresholds below which concentration limits would not apply).

Although the ESAs have indicated some support for a phase-in requirement of the eligibility requirement, no such phase-in is provided for in the Draft RTS. As parties to existing ISDAs will have privately negotiated the eligibility of collateral used as credit support, this means that many ISDAs will have to be renegotiated by December 2015 unless an industry protocol can be adopted. As the final Draft RTS are unlikely to be published until the end of 2014, there is a need for a clearer indication that phase-in will be included in the final draft.

Collected collateral is also subject to haircuts, either on the basis of standard discounts set out in the Draft RTS or by own estimates based on prescribed requirements. The standard haircuts are based on rating, residual maturity and type of collateral and vary from 0% for cash and 0.5% for highly-rated government debt with less than a year to maturity, to 24% for securitisation positions with 5 year residual maturity and a rating between A+ and BBB-. There is an additional 8% haircut applied to margin in a currency which differs from the settlement currency of the trade. As the OTC derivatives market had been moving toward standard credit support documents which allow currency mismatch for variation margin, this provision in the draft has not been well received.

Segregation and ban on re-hypothecation of margin

Once collected, initial margin must be segregated from proprietary assets of the collecting party who must also give the posting party the option to segregate its initial margin from that of other posting parties (i.e. individual segregation). Where initial margin is in cash, it must be segregated individually unless the receiving counterparty can prove to its counterparty and to its competent authority that legally effective arrangements are in place to segregate it from proprietary assets. Segregation must allow the collecting party the immediate use of the margin on default, and must ensure that the posting entity is "sufficiently protected" from the collecting entity's insolvency. This must be supported by a satisfactory legal opinion to be renewed annually, although the ESAs have indicated they will not be giving further clarification as to what is meant by "sufficiently protected". Furthermore, on the basis of the Draft RTS, collected initial margin cannot be re-hypothecated.

Such segregation and the ban on re-hypothecation make problematic the use of a title transfer mechanic such as that provided by the ISDA Credit Support Annex for the transfer of initial margin, as such title transfer arrangements allow the transferee to deal freely with the collateral received. Any modification to the title transfer arrangements to provide on the one hand for ring-fencing of initial margins would need on the other hand to be consistent with the transfer of full legal and beneficial title to the recipient and allow the recipient immediate access to the margin in the event of the transferor's default. It may be difficult to satisfy both requirements. Alternatively, parties will need to arrange for initial margin to be provided by way of security rather than title transfer. Either way, the receiving party will not be able to make use of the collateral under the current proposals, which will be a significant constraint on liquidity.

Credit Support Annexes could still be used for the transfer of variation margin, but they must also comply with the rules below regarding management of collected margin, and some changes may need to be made to standard credit support documentation to ensure they do so.

As well as the segregation requirement, the collecting party must have certain operational capabilities with respect to ensuring it can realise the collected margin in the event of the default of the posting party. It is not clear whether these requirements apply only to FCs and NFC+s which are obliged to collect margin, or to any person which receives margin as counterparty to a transaction. The capabilities include daily re-evaluation, legal arrangements for holding and access to collateral if held by a third party custodian, and access to an outright sale or repo market for the collateral in the event of default of the collateral provider, even in stressed market conditions (which may be difficult to determine in practice). There must also be arrangements in place to ensure that in the event of the default of the collecting party, the collateral is freely transferable and can be returned to the collateral provider free of third party claims or regulatory or legal constraints. This requirement may be problematic: for example, if the collateral is provided by way of a security interest granted by the collateral provider, its return may be constrained by the terms of the security.

Grandfathering

The Draft RTS do not include express grandfathering provisions for existing derivative contracts. Instead, the accompanying commentary from the ESAs states that only "new contracts at the time of entry into force" of the RTSs will be caught when the rules start to apply, but that market participants should endeavour to apply the principles to the widest set of non-cleared derivatives possible. Whilst the statement is of some comfort, it is far from clear and it may not form part of the final version of the RTS. This leaves OTC derivative market participants without clear guidance as to what action should be taken in respect of transactions entered prior to the coming into force of the rules.

Next Steps

The Draft RTS are subject to public consultation, which remains open for comment until 14th July.

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