Deloitte.

# European Market Infrastructure Regulation (EMIR)

## How will it impact your business?

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# Agenda

| | |
|---|---|
| 1 | Why EMIR |
| 2 | What the regulation is about ? |
| 3 | What are the business impacts ? |
| 4 | Way forward |

# EMIR

## Executive summary

- In September 2009 G-20 Leaders agreed that **‘All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements’**.

- EMIR provides the framework for implementing the bulk of these requirements in the EU and will be complemented by changes to the Markets in Financial Instruments Directive (MiFID II / MiFIR) and changes to the Capital Requirements Directive (CRD IV)

- EMIR introduces sweeping requirements aimed at reducing counterparty risk, improving transparency and mitigating systemic risk. The requirements will, in some shape or form, affect all participants in OTC derivative markets

- Some relief from the clearing and margining requirements has been granted to non-financial firms, pension funds and intra-group transactions, although strict conditions apply

**All standardised OTC derivatives will be cleared through central counterparties (CCPs)**

**Non-cleared derivative**s will be subject to strengthened risk management requirements

**All OTC and exchange traded derivatives will be reported to Trade Repositories (TRs)**

**Harmonised** framework for the provision of **clearing services** within Europe

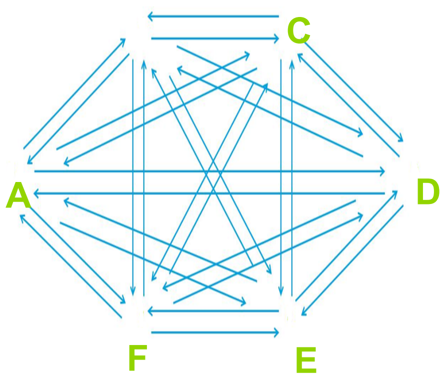
# Why EMIR ?

## Addressing the interconnectedness in OTC derivatives markets

EMIR is a regulatory response to the risks emerging from the interconnectedness in the OTC derivative markets

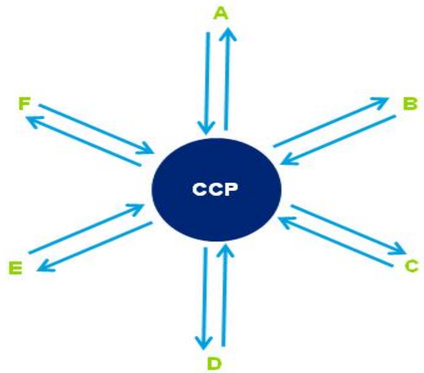
### Problem

In the **bilateral** model each market participant has a legal relationship with, and separate (gross) exposure to each of the other participants, creating a tangled web of exposures.




### Solution

- Each market participant has a legal relationship with and (gross) exposure to the CCP only. Counterparty will be required to post:
  - Initial margin – protect against losses suffered under the contract
  - Variable margin – protect against market fluctuations




### Weaknesses exhibited during the crisis

**Counterparty credit risk**
Possible systemic implications that a default can have due to the interconnected web of market participants

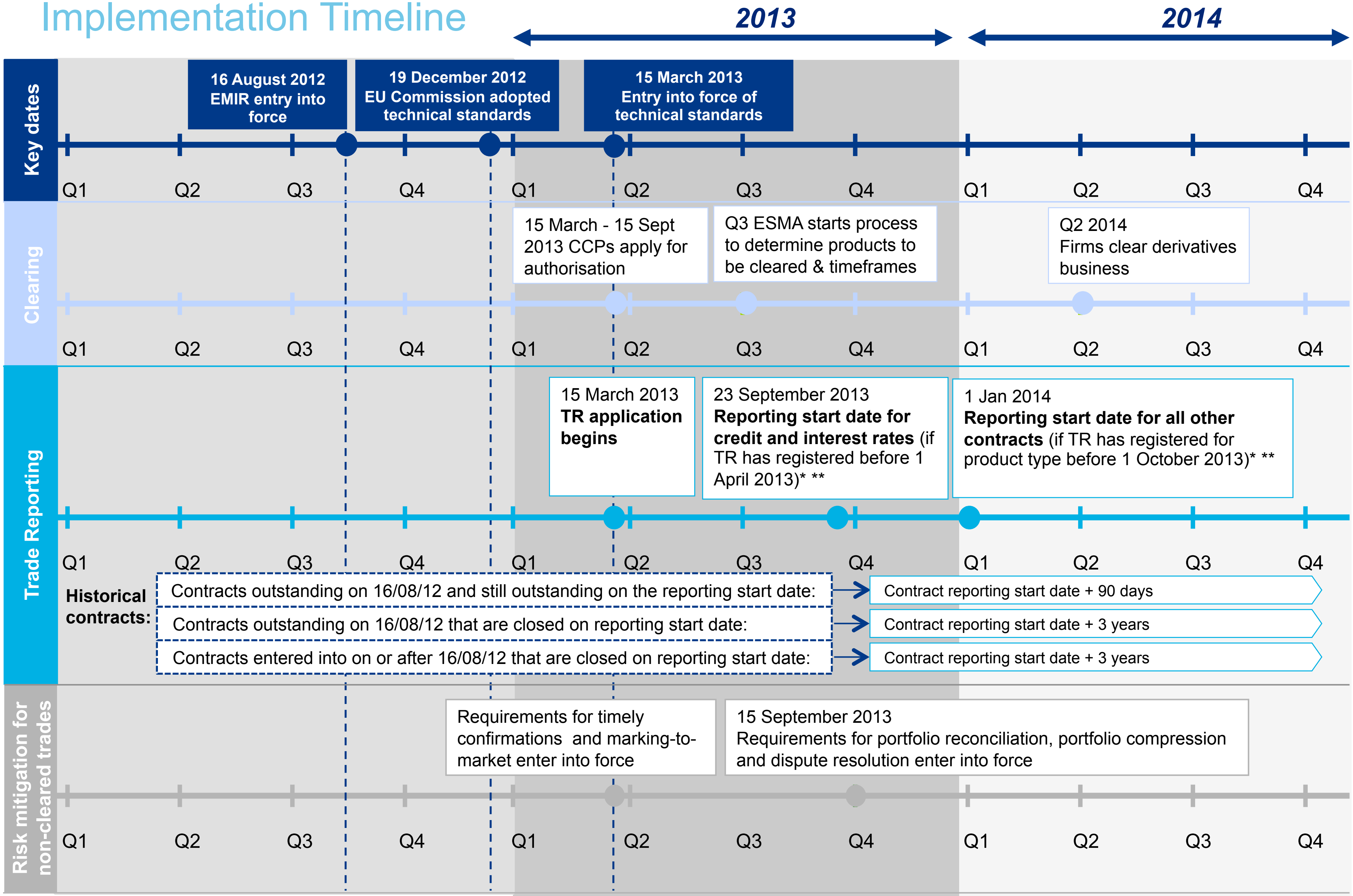
**Lack of transparency**
Regulators did not have sufficient oversight of the global positions to detect the accumulations of pocket of risk within the financial system

**Weak risk management**
for bespoke transactions, led to realised losses in times of market stress

### Regulatory response

- All standardised derivatives should be centrally cleared
- Non centrally cleared derivatives should be bilaterally collateralised and subject to higher capital requirements
- All OTC derivatives should be reported to a Trade Repository
- All standardised and sufficient liquid OTC derivatives should be traded on an exchange or electronic platforms

# EMIR
## Implementation Timeline




*Where a TR registers after 1 April 2013 (credit and interest rates) or 1 October 2013 (other contracts) firms must start reporting within 90 days of the date of registration. If there is no TR registered by 1 July 2015 reports must be sent to ESMA **Information on collateral must be reported 180 days later

Source: ESMA, Deloitte Analysis

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4 Way forward

# What EMIR is about ?

## Key Requirements

EMIR is a new European regulatory framework which addresses the risk of over-the-counter trading by imposing new requirements:

| EMIR Requirements | | |
|---|---|---|
| | **Clearing** | Standardized derivative contracts should be cleared through central counterparties in order to reduce the risk in the financial system |
| | **Risk Mitigations Non Cleared** | Contract not cleared by a CCP require exchange of collateral and counterparties shall hold adequate capital and have mitigation techniques in place |
| | **Reporting** | All OTC derivative contracts should be reported to trade repositories |

# What is EMIR ?

## Key Requirements Clearing

**Clearing**

**Which Entity ?**

- **Financial counterparty** (regulated entities)
  - Investment firm, Credit institutions, insurers
  - UCITS, ManCos, AIF managed by AIFM
- **Non financial counterparty** (whose OTC derivatives position exceeds a clearing threshold
- Exemption  for clearing requirements:
  - Financial institutions involved in the management of public debt
  - Pension funds will have a three years transition period
  - Intra-group transactions
  - Non-financial counterparties (below clearing threshold)

**Which Products ?**

**Bottom Up approach :**

- Competent authority authorises CCP to clear a class of OTC derivatives
- ESMA to review and authorise (within 6 months)

**Top  Down approach :**

- ESMA identify contract  which can be but not yet cleared by a CCP

The criteria to be followed in identifying class of contract subject to clearing:

- Degree of standardization,
- Volume of trading and liquidity,
- Availability of pricing information

# What is EMIR ?

## Key Requirements non cleared transaction

Mitigations for non-cleared

What?

Mitigations techniques will apply on non-cleared transactions :

- Financial and non-financial counterparties (above the clearing threshold) must have timely, accurate and appropriately segregated exchange of collateral. This collateral should not be reused
- Financial counterparties will need to hold capital to manage the risk not covered by exchange of collateral
- Timely confirmation of OTC contracts
- Portfolio compression, reconciliation and dispute resolution (via ISDA contracts)
- Financial counterparty shall mark-to-market on a daily basis the value of outstanding contracts

**Technical standards still need to voted for non cleared transactions. International standards on margins for non-cleared derivatives are expected to be reflected in EMIR**

- Initial Margin (IM) and Variable Margin (VM) must be exchanged for non-cleared derivatives
- Collateral collected as IM must be fully protected and should not be re-hypothecated or re-used
- A quantitative portfolio margin model (supervisor approved) or a standardized schedule can be used to calculate IM
- VM must be calculated and collected frequently (e.g. daily)
- Cash; high quality government, central bank securities; corporate and covered bonds are eligible collateral ;

**Under Consultation (March 2013)**

- Product: considering exempting foreign exchange
- Phase in framework
- Re-used of collateral

# What is EMIR ?
## Key Requirements Reporting

**Reporting**

**Scope**

- **OTC and exchange traded derivative contracts, whether cleared or not**, must be reported to a TR no later than T+1 following the conclusion, modification or termination of the contract

**Who?**

- **No exemptions** - every counterparty, financial and non-financial, must report.
- Responsibility falls on both counterparties although counterparties can delegate reporting to a third party including CCPs

**What?**

- **Common data -** class of derivative, contract details and terms, mark-to-market valuation and contract modifications (Common data only needs to be reported by one counterparty
- **Counterparty data -** Information on both counterparties, reported separately by each counterparty or their appointed reporting entity
- **Information on collateral exchanged** by the counterparties must be reported.
- **Mark-to-market valuations** of the contract must be updated and reported
- **Record keeping:** Counterparties must retain records of all derivative contracts (and modifications) for at least 5 years

# What is EMIR ?

## A focus on the Intragroup transactions

### What is an Intragroup transaction?

EMIR classifies counterparties to be part of the same group provided all of the following are met:

- both counterparties are established in the EU or, if one is established in a third country, the Commission has declared that third country equivalent;
- both counterparties are subject to appropriate centralised risk evaluation, measurement and control procedures;
- both counterparties are included in the same accounting consolidation on a full basis;
- if one counterparty is financial, it must be subject to appropriate prudential requirements.

### Exemptions available

Exemptions are available from the

- clearing obligation,
- exchange of collateral requirements (non cleared)

### But still applicable ……

- Reporting obligations
- Other risk mitigations techniques

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# Collateral management within cross regulatory frameworks

## Linking the dots to get an holistic regulatory impacts assessment

### EMIR: New Requirements for OTC derivatives (IRS, CDS, FX) contracts

- All standardized OTC derivatives will be cleared through central counterparties (CCPs) including **new margin requirements (IM & VM)**
- Non-cleared derivatives will be subject to **strengthened risk management requirements**, including the need to collateralise positions
- All OTC and exchange traded derivatives will be reported to trade repositories (TRs)

### AIFMD: New Depositary Bank responsibilities

- Collateral requirements under AIFMD give the Depositary Bank an **obligation of results on financial assets collateral** for the funds they service (i.e. obligation of results)
- **No reuse of collateral** unless express consent of the fund has been obtained.
- **Segregation requirements** apply to non-cash collateral


### Basel III / CRD IV: Amended capital requirements and new liquidity standards

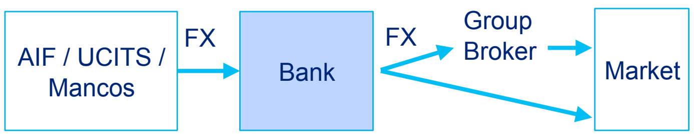
- Increased capital requirements for **counterparty credit risk** (CCR) via the addition of a **credit valuation adjustment** (CVA) for derivatives transactions
- **Initial Margin (IM) and daily Variable Margin ("VM") requirements** for both cleared and non-cleared trades
- Strong **incentives for heavier reliance on CCPs** through reduced capital requirements
- New liquidity standards will call for a **revised allocation of securities used as collateral** in repo-style transaction, central bank funding and derivatives trading

### UCITS: New criteria to be respected by collateral received in the context of OTC FDI or EPM transactions

- **Highly liquid collateral**
- **Valuation on a daily basis**
- Issuer credit quality
- Collateral **diversification** and **no correlation** with counterparty
- Limitation in re-investment of collateral
- **Stress testing and haircut policy**

# Collateral management within cross regulatory frameworks

## The (EMIR) regulation impacts Luxembourg

| | What ? | Impacts |
|---|---|---|
| 1 Bank | The Bank is hedging position for its own business with swaps, options, or takes active positions in OTC market | • All derivatives transactions are within the scope of the regulation<br>• Banks have to set up arrangements with Clearing members to access CCP in case of cleared products<br>• For both cleared and non-cleared trades, the collateral requirements will increase and will require:<br>  • Monitoring of collateral positions and needs<br>  • Proactive funding strategy<br>• Reporting obligations for cleared and non-cleared transactions to trade repository |
| 2 FX Hedging for Funds | • The Bank is acting as intermediary between the funds and the market in FX Hedging<br><br> | |
| 3 Depositary Bank | Depositary Bank has a complete responsibility on both given and received collateral for the funds they service (i.e. there is an obligation of supervision and restitution) | • Collateral to be deposited in segregated accounts with other (sub) custodians<br>• No reused of collateral<br>• New due diligence exercise to be performed |

# Agenda

# EMIR – The journey to the compliance starts now

## What do you need to do ?

**Clearing**

- Setting up clearing arrangements
- Making sure the necessary arrangements are in place to access the clearing house/s
- The practical challenges around segregation requirements
- Consider the intra-group exemption
- Analyse treasury demands/liquidity needs as a consequence of collateral requirements

**Non-cleared derivatives**

- Review existing systems and processes to adequately implement the new operational risk mitigation requirements
- Ensure that daily mark to market valuation capabilities and collateral agreements are in place
- Assess collateral available to collateralise non-cleared OTC derivative trades

**Reporting**

- Setting up trade repository arrangements
- Consider report directly to the trade repository or delegate reporting to your counterparty or a third party ?
- Identify data sources; planning around systems developments and user-acceptance testing; consideration of data protection issues

**Business conduct**

- Documentation review including existing ISDA agreements; compliance check on record keeping requirements etc.

(*) Technical standards to be finalised : 1) risk mitigations techniques for OTC derivatives not centrally cleared (level of collateral to be exchanged / level of capital required) 2) implementing acts concerning the **equivalence** between the legal and supervisory frameworks of certain third countries