

Next Steps for EMIR

For all the appropriate safeguards built into the derivatives regulatory framework after the financial crisis, certain aspects of the reforms impose unnecessary compliance costs and burdens on end users, for little benefit. Regulators in both the US and Europe are now reviewing their rules with an eye to making them more efficient and less complex. By recognizing what works well and what could work better, the objective is to make the regulatory framework stronger and reduce the excessive burdens that discourage trading, investment and hedging.

In the European Union (EU), one part of this process has been effected via a review of the European Market Infrastructure Regulation (EMIR). According to the European Commission (EC), the aim is to “eliminate disproportionate costs and burdens to small companies” that might impede their access to markets, without putting financial stability at risk.

The EC has already proposed a number of possible changes to EMIR that go some way to meeting this objective. However, ISDA believes certain other, targeted modifications would further strengthen the framework, create greater certainty for derivatives users, and eliminate remaining areas of complexity. This paper outlines some of those proposed modifications.

The EMIR review aims to reduce inappropriate costs and burdens on derivatives users

INTRODUCTION

EMIR entered into force in August 2012, and sets a number of key requirements for derivatives, including clearing, reporting and margining. In line with EMIR Article 85(1), the EC was required to conduct a review of EMIR by August 2015 and to prepare a report to the European Parliament and Council of the European Union. Similar reviews are also under way in the US, by the US Treasury and the Commodity Futures Trading Commission.

Following a public consultation on EMIR in 2015, and input from market participants and multiple national and pan-EU supervisory agencies, the EC reported in November 2016¹ that the fundamental requirements of EMIR are crucial to ensuring transparency and mitigating systemic risk, and would therefore remain in place. But it noted that some amendments may be needed to reduce disproportionate costs and burdens on end users. As a result, the review of EMIR was included in the EC's 2016 Regulatory Fitness and Performance program (REFIT). The first set of proposed changes were published on May 4² (see box), which set out a number of modifications to reduce costs and burdens but without affecting financial stability.

While positive, ISDA believes certain other amendments would help further simplify and strengthen the framework.

EMIR Review – May 4 Proposals

The European Commission's proposals of a review of the European Market Infrastructure Regulation include:

- Non-financial counterparties (NFCs) below the clearing threshold would automatically delegate reporting to financials, with responsibility for accuracy also falling on the financial counterparty.
- Non-financials would not have to report their intragroup trades, although this only applies to intragroup trades within European Union borders.
- Removal of the backloading requirement, which requires reporting of derivatives transactions entered into before February 12, 2014, but no longer outstanding on that date.
- Removal of the frontloading (retrospective clearing) requirement.
- A 'fair, reasonable and non-discriminatory' (FRAND) requirement to be imposed on clearing members in relation to their clearing and indirect clearing offer to clients.
- Suspension of the clearing obligation within 48 hours, for renewable periods of three months, for reasons of financial stability, lack of availability of clearing houses, or changes to the suitability of products for clearing.
- Exempts small financials from clearing if their activity falls below threshold levels applied for the purpose of the NFC+/- test. These small financials would be required to comply with non-cleared margin rules.
- Non-financials exceeding the clearing thresholds would only have to clear products subject to mandatory clearing in the asset classes where they exceed the clearing threshold.
- Pension schemes to obtain a further three-year (post entry into force) exemption from clearing, extendable by a further two years.

¹ http://europa.eu/rapid/press-release_IP-16-3750_en.htm

² http://europa.eu/rapid/press-release_IP-17-1150_en.htm

REPORTING

An entity based approach to trade reporting would reduce the burden on derivatives users without reducing data quality

The EC has proposed changing its reporting rules so responsibility for reporting transactions with a non-financial counterparty (NFC) not subject to the clearing obligation would fall entirely on the financial counterparty. Placing the liability on the financial entity to report on behalf of itself and the NFC marks a change to current rules, which require both parties to separately report each trade. An end user can delegate its reporting requirements to a dealer under the current rules, but it retains liability for the accuracy of what is reported.

ISDA welcomes the recognition by regulators that proportionality is needed in the requirements imposed on market participants. With this in mind, the reporting regime would be further enhanced by introducing an entity based reporting framework, where sole responsibility for reporting is assigned to one counterparty. This would bring the EU in line with other major jurisdictions, including the US. Dual-sided reporting imposes significant cost burdens on end users, but without improving the quality of reported data, as pairing and matching rates are low. While regulators and the industry have worked hard to improve these rates, a single-entity system would bring greater simplicity and accuracy.

The current proposal is likely to increase the burdens on each side of the transactions covered by the mandatory delegation regime. In particular, ISDA is concerned about the lack of clarity on the legal responsibility of financial counterparties when receiving incomplete or inaccurate information from their NFC counterparty, which will possibly result in the drafting of burdensome and costly legal agreements. Furthermore, if a reconciliation requirement is imposed on the NFC in regulatory technical standards, as happened under the Securities Financing Transactions Regulation (SFTR), then the burden will not be reduced at all. In practice, it will simply be exacerbated, with end users forced to connect with multiple trade repositories, and both counterparties to the trade facing an additional reporting compliance regime.

SCOPE AND TIMING

Further clarity on scope and timing is needed in some cases

The EMIR review proposals modify the definition of a financial counterparty to include alternative investment funds (AIFs), which are currently categorized as NFCs. While the proposal attempts to ensure consistency in the treatment of hedge funds under EMIR, the specific AIFs that would be captured by this redefinition may not pose risk to the EU system. The change could also have unintended consequences – the definition is not territorially limited, so in theory covers all hedge funds globally, regardless of where they are domiciled or where they trade.

Changes to the financial counterparty definition would be particularly damaging for securitization special purpose entities (SSPEs), which would become subject to clearing and margining rules – even though the securitization swaps conducted by these entities are already fully collateralized. SSPEs typically do not have the systems, controls, staff or authority to exchange further regulatory margin or clear derivatives, which would fundamentally alter the economics of securitization. An adjustment in the proposed re-categorization would be needed to avoid potential impacts to the EU securitization sector.

ISDA also believes all transactions with EU and non-EU central banks, debt management offices and multilateral development banks should be exempt from the EMIR requirements, in line with the treatment in other jurisdictions.

When it comes to timing, many of the changes would take effect just 20 days after publication in the EU's Official Journal. This causes major practical difficulties and is too short a time to deal with the necessary changes in counterparty classification and reclassification. It is therefore important that a longer effective date is introduced in these instances.

There is also uncertainty over the effective dates of some of the proposals. Some firms that will become financial counterparties for the first time under the proposals will not benefit from the small financials exemptions until six months after they are brought into force. This creates an awkward window that may increase the operational burden for end users. Further consideration needs to be given to the alignment of the EMIR proposals and the revised Markets in Financial Instruments Directive (MIFID II). For instance, supervisors should consider whether the ability to suspend the clearing obligation for certain products under EMIR should also apply for those products in the context of MIFID II's trading obligation.

CLEARING

The EC has proposed important changes to the clearing obligation, but further adjustments would help smaller users

The EC proposed various changes to the clearing rules, with the intention of reducing costs for smaller derivatives users and improving access to clearing. For example, the review suggests a new clearing threshold for small financial counterparties should be introduced, so those entities that trade infrequently and do not pose a systemic threat are not subject to the clearing obligation. The EC has also proposed that the clearing requirement for NFCs should only apply for a particular asset class where a clearing threshold has been breached. That marks a change from current rules, where a breach of a clearing threshold in one asset class would require an NFC to clear instruments subject to a clearing obligation in all asset classes.

ISDA believes these changes are helpful, but the proposals could be further enhanced in a number of ways. For the small financials proposal, the EC should make the threshold calculation optional, so those firms that want to clear, or think their derivatives activity is in excess of the threshold, are not required to conduct the calculation. This would reduce the operational burden on financial counterparties. There is also a case for consideration of a broader exemption for certain small financial end users that also includes margining requirements for non-cleared derivatives below a specified de minimis threshold. Such an approach is in place in the US, where an exemption exists for commercial banks, savings banks, farm credit institutions and credit unions with total assets at or below \$10 billion.

The NFC proposal, meanwhile, could be made more consistent by clarifying that NFCs exceeding the clearing threshold in one asset class should also be exempt from non-cleared derivatives margining requirements in other asset classes, as well as being exempt from clearing. In both instances, however, there are systems, documentation, capital, netting (in the case of bilateral trades) and re-pricing issues with the introduction of a broader exemption regime, so NFCs and small financial entities should be allowed to clear and post non-cleared margin if they choose to.

Another important focus for the EMIR review is access to clearing. As part of that, the EC has proposed that clearing members should be required to offer services to clients on a fair, reasonable and non-discriminatory (FRAND) basis. ISDA supports this aim in principle, but further clarity is required on the meaning of this phrase, particularly on the interpretation of 'non-discriminatory'.

FRAND requirements should not result in a mandatory clearing offering, and should not prevent firms from offering and operating clearing services in a competitive, commercial and prudent manner. Firms should not be obliged to provide clearing services to an existing or prospective client if that customer does not meet the risk or commercial requirements of the firm's onboarding policy. Failure to do so may discourage firms from providing clearing services, and may actually reduce the availability of client clearing services in the market.

Other proposed enhancements to the EMIR review relate to the clearing obligation. The EC proposes a mechanism to temporarily suspend a clearing obligation if, for example, a clearing house fails or liquidity in a particular product evaporates. However, the suspension mechanism could be further improved by providing more power to the European Securities and Markets Authority (ESMA), and giving it the flexibility to act in a wide range of circumstances. There should also be transparency over when a suspension is being considered, and regulators should have the ability to back-date the exemption in situations where it was difficult to clear in the run-up to the suspension. Furthermore, participants should not be required to clear trades executed during the suspension period once it has been lifted.

Additional changes are necessary to ensure there is greater clarity over the scope of the clearing obligation. To avoid the accidental extension of the clearing obligation as central counterparties (CCPs) clear non-standard variants of a product already mandated to clear, EMIR should be amended so the only products mandated to clear are those that were offered by CCPs at the time of ESMA's clearing determination.

The EC proposals seek to improve the transparency of CCP initial margin requirements by obliging CCPs to provide a margin simulation tool to clearing members, and to provide greater disclosure of information on the margin model. ISDA welcomes these changes, as CCP resilience is one of the highest priorities for systemic risk management. However, further enhancements to initial margin transparency should be made. Margin simulation tools should be able to produce the initial margin for a given portfolio, the additional margin required to clear new trades, and the initial margin needed to clear any given transaction on a standalone basis. It would also be useful for the simulation to provide incremental default fund contributions for these cases. These could then be used to estimate additional default fund contributions for new client portfolios or changes in the overall portfolio.

ISDA also recommends that CCPs produce a self-assessment versus the Principles for Financial Market Infrastructures established by the Committee on Payments and Market Infrastructures and the International Organization of Securities Commissions (CPMI-IOSCO).

MARGIN

Greater global consistency is required on margin rules, especially on the treatment of FX

As it stands, EMIR requires market participants to post variation margin on physically settled FX swaps and forwards – a requirement that will come into force for FX forwards from January 3, 2018 as a result of their classification as financial instruments under MIFID II. The EU is the only jurisdiction to have this variation margin requirement hard-coded in regulation, and it will impact the ability of firms to hedge, broader FX market liquidity and EU banks' global competitiveness. A proportionate treatment for these instruments – particularly for client-facing trades – would bring the EU closer in line with the regimes in the US, Japan, Hong Kong and elsewhere.

ISDA believes European authorities should urgently address this regulatory asymmetry in the short term, given the effective date for margin requirements for physically settled FX forwards is set for early next year, long before the impact of any changes to EMIR level one could take effect.

The EC has also expressed a desire to validate initial margin models. However, these models would have been in use in some cases for a number of years by the time the EMIR revisions come into effect. This means less sophisticated, smaller firms at the end of the initial margin phase-in may be subject to burdensome validation procedures that did not apply to larger firms that had to post regulatory initial margin earlier. In addition, there are concerns that EU validation would mean an inconsistent application of initial margin requirements between the EU and other jurisdictions. ISDA has already established an open and transparent Standard Initial Margin Model (ISDA SIMM) that has been in use since the first phase of initial margin implementation and is responsive to regulatory modifications.

EQUIVALENCE

More clarity is required on how the equivalence process will work in practice

The lack of equivalence decisions, particularly for the purposes of clearing and margin requirements, could put the international operations of many firms at a competitive disadvantage by requiring, for example, that margin be posted and collected multiple times. This outcome would harm both banks and their clients, many of which are major European corporates that make significant contributions to outbound and inbound trade and investment flows from EU to non-EU markets.

ISDA believes further detail is required on the practical application of EMIR's equivalency framework. When EU counterparties trade with counterparties established in, or subject to the rules of, an equivalent jurisdiction, they should be allowed to mutually agree which set of equivalent rules would apply to a particular trade between them. EMIR should also allow for separate equivalence decisions to be made for specific EMIR obligations, rather than a single, all-encompassing equivalence decision. This would allow for greater flexibility and greater choice for EU market participants. All equivalence decisions should be made using an outcomes-based approach.

CONCLUSION

The EMIR review proposes changes that will reduce complexity for end users, but there is an opportunity to further enhance the framework

Continual evaluation and assessment of complex pieces of regulation are vital if they are to work smoothly and efficiently. This is particularly true in financial markets, where small errors and inaccuracies can have major unintended consequences.

ISDA welcomes the proposals made by the EC in its EMIR review to ease the cost and compliance burdens on end users.

However, these proposals can be taken further in some areas to bring greater benefit to the market. There is room to provide further efficiency in clearing, reporting and margin rules, without diluting the intention of the EMIR framework to combat systemic risk. Tackling complexity and unnecessary costs and burdens in the rules would further encourage trading, investment and hedging.

Further Reading

Read ISDA's full response to the EC's May 4 proposals at:

<http://www2.isda.org/attachment/OTU1OQ==/ISDA-comments-on-EMIR-Refit-proposal%20-%20Final%2018%20July%202017.pdf>

ABOUT ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient.

Today, ISDA has more than 875 member institutions from 68 countries. These members comprise a broad range of derivatives market participants, including corporations,

investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, clearing houses and

repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

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