THE INVESTMENT ASSOCIATION

STRENGTHENING FINANCIAL STABILITY

EUROPEAN MARKET INFRASTRUCTURE REGULATION (EMIR) – OVERVIEW AND INDUSTRY PRIORITIES

BACKGROUND AND CONTEXT

In the wake of the 2008 Financial Crisis, world leaders met in 2009 at the G20 Summit in Pittsburgh and agreed on a broad set of measures to increase the stability of the derivatives market, "The Pittsburgh Commitments" (set out overleaf). The European Market Infrastructure Regulation (EMIR) is the European implementation of these commitments.

EMIR's main objective is to reduce systemic risk, by increasing the transparency of derivatives not traded on exchange, i.e. of the "over-the-counter" (OTC) derivatives market, mitigating the counterparty credit risk and reducing the operational risk associated with OTC derivatives. To this end, EMIR sets out requirements for OTC derivatives, central counterparties (CCPs) and trade repositories (TRs) on the following:

1. Central clearing of standardised OTC derivative contracts
2. Margin requirements for OTC derivatives contracts that are not centrally cleared
3. Operational risk mitigation requirements for OTC derivative contracts that are not centrally cleared
4. Reporting obligations for derivative contracts
5. Requirements for CCPs
6. Requirements for TRs

EMIR applies to the counterparties of derivatives transactions. From an asset manager's point of view, that means it applies to their clients, for example a pension fund (PSA). Counterparties are split into four different categories for the purposes of determining which obligations fall on them, and when those obligations begin.

EMIR REFIT

In May 2017 the European Commission published proposals for a technical review of the EMIR framework (referred to as the EMIR “Refit”). The proposals do not seek to review the fundamental framework of EMIR – which was deemed to function well overall. Instead, they focus on a number of targeted modifications, in particular, to simplify the rules and make them more proportionate.

TIMELINE

APRIL 2018

Vote in European Parliament on Rapporteur’s Draft Report

Q4 2018

Political deal following European Commission / Parliament / Council Trilogues

Q2 2019

Publication in Official Journal / Entry into force

IMPLEMENTING THE PITTSBURGH COMMITMENTS

EMIR AND THE WIDER EUROPEAN REGULATORY CONTEXT

G20 PITTSBURGH COMMITMENTS:

- Mandatory central clearing for “standardized” derivatives
- Increased risk control requirements for all other derivatives
- Trading on exchanges / platforms
- Greater Transparency including reporting to trade repositories
- More capital for broker-dealers (higher for non-cleared derivatives)

EUROPEAN REGULATORY IMPLEMENTATION OF PITTSBURGH COMMITMENTS:

EMIR (2012)

- Clearing obligation
- Uncleared margin
- Reporting to a repository
- Other risk mitigation techniques including reconciliation and compression

Capital requirements Directive IV (CRD IV) (2013)

- Revised capital requirements for banks

Markets in Financial Instruments Directive II (MiFID II) (2014)

- Trade and transparency reporting

MAJOR REQUIREMENTS UNDER EMIR:

Central Clearing

Standardised derivatives contracts cleared through a central counterparty (CCP)

Trading Obligation

Subsection of cleared contracts under EMIR to be traded on a regulated market (RM) under MiFID II (MiFIR)

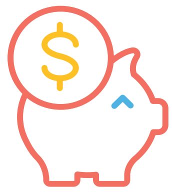
Trade Repositories

Transactions data reported to trade repositories for OTC derivatives contracts

INDUSTRY PRIORITIES

A number of the targeted modifications proposed in the EMIR Refit have been identified as key priorities for the asset management industry.

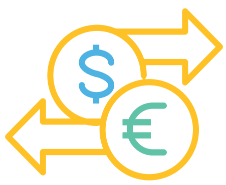
They include the following:



Pension fund exemption from the obligation to centrally clear

Proposals to improve access to clearing and the effectiveness of the new “FRAND” principle

Single-Sided Reporting



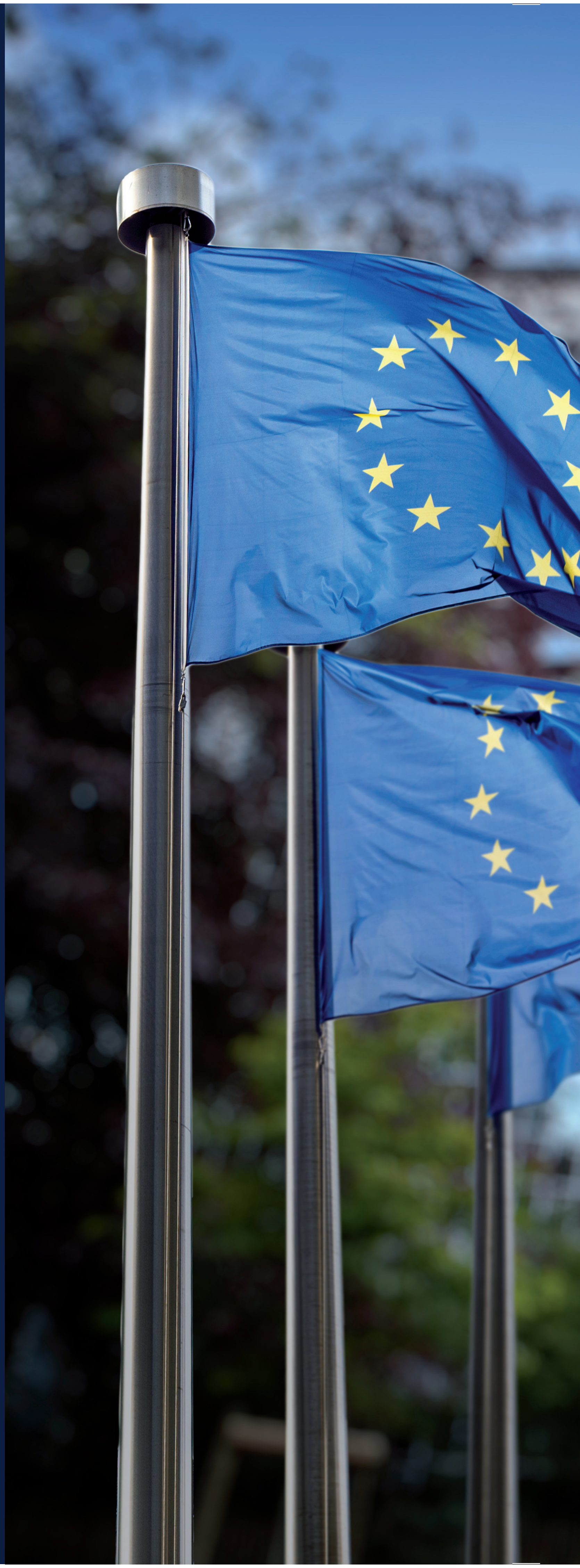
Exemption from the obligation to post variation margin for certain physically settled foreign exchange derivatives

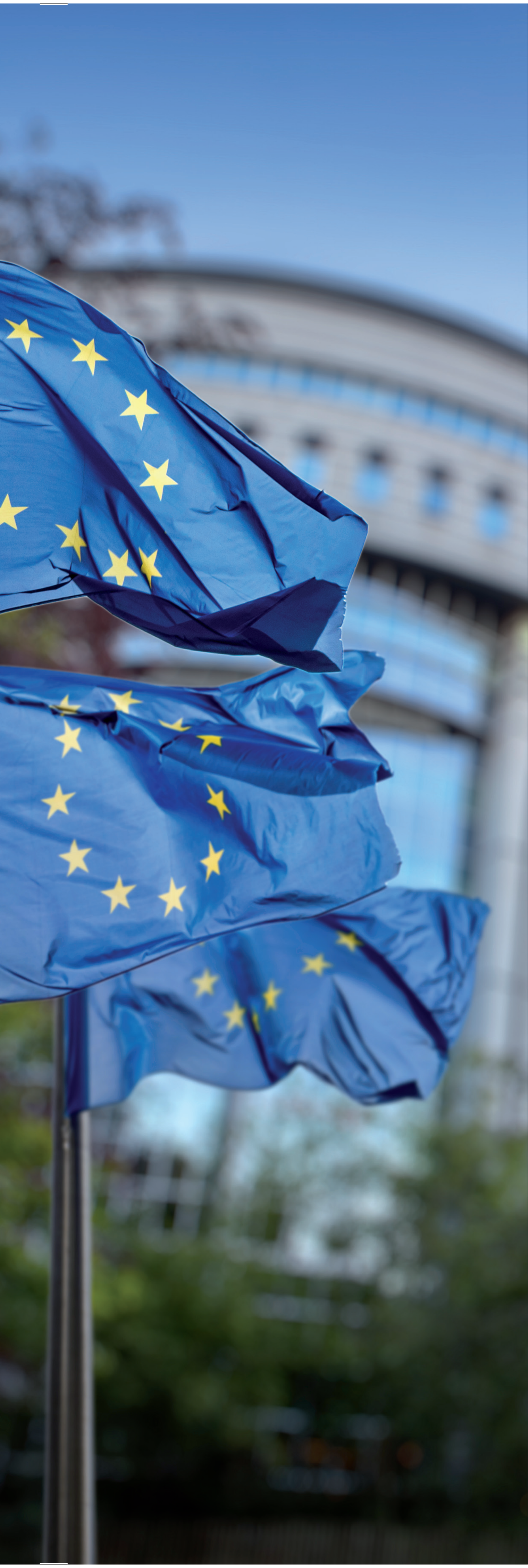
01 PENSION FUND EXEMPTION FROM THE OBLIGATION TO CENTRALLY CLEAR

This exemption was established under EMIR given that there was no viable solution for pension funds, or pension scheme arrangements (PSAs), to post non-cash variation margin (VM) to a CCP. There is still no viable solution. Accordingly, the EMIR Refit proposes to extend the exemption. Failure to find a viable solution could have serious consequences for financial stability in the event of PSAs having to post cash margin in a crisis situation.

02 PROPOSALS TO IMPROVE ACCESS TO CLEARING AND THE EFFECTIVENESS OF THE NEW “FRAND” PRINCIPLE

The original Commission proposal sets out that clearing members should provide clearing services to their clients on the basis of fair, reasonable and non-discriminatory (FRAND) terms. This is intended to improve client access to clearing, particularly for smaller firms. We would also argue that these terms should be transparent to ensure they are easily comparable. To help the FRAND principle work in practice, we advocate a targeted assessment by ESMA and the Commission to gauge the effectiveness of the new principle in the market and its improvement to access to clearing. This would focus the attention of clearing members on the new requirements and should serve to accelerate the practical application of this new principle.





03 SINGLE-SIDED REPORTING

The Commission proposal sets out that, for exchange-traded derivatives transactions (ETDs), single-sided reporting by the CCP should be introduced – the rationale being that the CCP will typically hold the vast majority of details on these contracts. By the same rationale, we would argue that single-sided reporting by the CCP should be extended to all cleared derivatives contracts (not only ETDs), as the CCP would also hold the details of these contracts. This would help to improve proportionality, removing the obligation to report from a significant number of market participants and in many cases building a clearer picture of the transactions taking place in the market. Furthermore, whether single-sided reporting is restricted to ETDs or extended further, we would ask that it is clarified in the drafting that the CCP will report on behalf of both the clearing member and the clearing member's client.

04 EXEMPTION FROM THE OBLIGATION TO POST VARIATION MARGIN FOR CERTAIN PHYSICALLY SETTLED FOREIGN EXCHANGE DERIVATIVES

In conjunction with the EMIR Refit, European authorities are reviewing the obligation for variation margin (VM) to be posted on certain physically settled foreign exchange (FX) derivatives, namely physically settled FX Forwards and FX Swaps. According to the international IOSCO-BCBS framework, certain counterparties are not obligated to post VM on these derivatives transactions. Moreover, these types of transactions are critically important to currency hedging. If they require variation margin, this could see certain - particularly smaller - firms withdraw from currency hedging altogether. The IA is engaging with European authorities to assist in carving out the appropriate transactions and counterparties from this obligation in the interests of international harmonisation and to help ensure continued currency hedging activity.

KEY ASPECTS OF EMIR EXPLAINED – EXCHANGE OF MARGIN AND CENTRAL CLEARING

Exchange of Margin

Even before the 2008 financial crisis, counterparties would often exchange collateral known as “initial margin”. This was intended to cover the costs to a counterparty that would be incurred if the other counterparty were to default on its payments. This would include a contribution to the cost of the remaining counterparty closing out its position.

By contrast, in terms of day-to-day risk mitigation, counterparties were able to hold positions where the amount that one side owed the other could build up substantially over time – this could be over months, or sometimes even years. Methods were not always employed to rebalance amounts between counterparties prior to the point at which one or either of the counterparties wanted to close out their position.

Today, EMIR dictates that counterparties exchange daily “margin” to mitigate this large build up of risk – this is referred to as variation margin.

Variation Margin

The use of variation margin involves counterparties carrying out what is called “mark-to-market” exchange of margin, or “margining”. Mark-to-market margining refers to counterparties rebalancing the amounts owed between them depending on the market value of the underlying asset(s) on which their derivative contract is based.

When two counterparties have entered into a derivatives contract, the relative value of that contract for each counterparty will differ each day as the value of the underlying asset(s) fluctuates. Each day, one of the counterparties will be “in-the-money”, i.e. their position has gone up in value, whist the other will be “out-of-the-money”, i.e. their position has lost value. The counterparty that is out-of-the-money transfers variation margin to the counterparty that is in-the-money.

Exchanging daily mark-to-market variation margin prevents huge imbalances developing between counterparties to a trade, which – when the time came that either counterparty had to sell out of their position – could destabilise the entire market.

Central Clearing

The obligation to centrally clear is applied to certain classes of derivative that have been deemed sufficiently standardised. The date from which the obligation applies is determined by the categorisation of the counterparties to the trade (Categories 1-4, from large brokers to very small non-financial counterparties).

With respect to mark-to-market variation margin, one of the major benefits of clearing is that counterparties are able to take advantage of “netting” opportunities, that is, they are able to net off their exposures against one another. This results in far lower volumes of daily margin payments.

By comparison, uncleared contracts will not be able to benefit from CCP netting. However, derivatives traders putting on these contracts could choose to “compress” them to achieve a similar result across their derivatives positions, but on a smaller scale than through CCP.

Whilst netting benefits are significant, it can be economically challenging for many firms – in particular smaller ones – to access a CCP. Clearing contracts can be very difficult to put in place, given that there are very few clearing members through which to access a CCP. Moreover, certain requirements from the CCP can pose serious difficulties, including the obligation to post cash VM (see Industry Priority 1 above).

The IA continues to engage with policy-makers and regulators to ensure that EMIR fulfils its overarching objective of safeguarding financial stability whilst increasing the effectiveness and efficiency of EMIR’s implementation by focusing the reform on proportionality, transparency of derivatives positions and access to clearing.

THE INVESTMENT ASSOCIATION

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- Help people achieve their financial aspirations
- Enable people to maintain a decent standard of living as they grow older
- Contribute to economic growth through the efficient allocation of capital

The money our members manage is in a wide variety of investment vehicles including authorised investment funds, pension funds and stocks & shares ISAs.

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