Group Briefing

November 2016
(UPDATED JANUARY 2017)

EMIR – Margin Rules for Uncleared Transactions

KEY CONTACTS

For further information please speak to your usual Arthur Cox contact or:

PHIL CODY
PARTNER
+353 1 618 0604
phil.cody@arthurcox.com

AIDEN SMALL
PARTNER
+44 207 832 0207
aiden.small@arthurcox.com

VARIATION MARGIN TO BE PROVIDED FROM 1 MARCH 2017

The Commission Delegated Regulation under EMIR setting out the margining requirements for uncleared OTC derivatives (the **Margin Rules**) has been published in the Official Journal (here) and came into force on 4 January 2017. **Variation margin will be required from 1 March 2017**.

WHAT ARE THE MARGIN RULES?

Parties to OTC derivatives will be required to exchange variation margin and initial margin.

» *Variation Margin* is calculated by reference to the current market value of the OTC derivative and is to be collected from the party that is '*out-of-the-money*'.

» *Initial Margin* is collateral collected by a counterparty to cover its exposure in the interval between the last collection of variation margin and the liquidation of positions or hedging of market risk following a default of the other counterparty.

WILL THE MARGIN RULES APPLY TO YOU?

ENTITY	WILL THE MARGIN RULES APPLY?
Corporates	If all OTC derivatives are hedging transactions (for EMIR purposes) or the non-hedging transactions do not exceed the applicable EMIR clearing threshold, the Margin Rules will not apply
Authorised investment funds	The Margin Rules will apply to all UCITS and most AIFs
Banks, MiFID firms, insurance undertakings and pension funds	The Margin Rules will apply
SPVs	If all OTC derivatives are hedging transactions (for EMIR purposes) or the non-hedging transactions do not exceed the applicable EMIR clearing threshold, the Margin Rules will not apply

WHEN WILL THE MARGIN RULES APPLY?

Obligations in relation to variation margin will apply from 1 March 2017.

The obligations in relation to initial margin for entities with between €8 billion and €3,000 billion of uncleared OTC derivatives will be phased-in over the next 4 years. A table setting out those application dates is set out later in this Briefing.

For the largest users of OTC derivatives (i.e. those with > €3,000 billion of uncleared derivatives) the margin obligations will apply from an earlier date.

APPLICATION OF MARGIN RULES DEPENDS ON EMIR CLASSIFICATION OF ENTITY

The impact of the Margin Rules will depend on the EMIR classification of the transacting parties. These classifications are summarised below:

CLASSIFICATION	SCOPE
FC (a Financial Counterparty)	An entity authorised under certain EU Directives (i.e. credit institutions, MiFID firms, insurance undertakings, pension funds, UCITS and AIFs (where the manager is authorised/ registered under AIFMD))
NFC (a Non-Financial Counterparty)	An entity established in the EU which is not an FC
NFC+	An NFC with uncleared OTC derivatives above certain thresholds
NFC-	An NFC with uncleared OTC derivatives below certain thresholds
TCE	A non-EU entity that would either be an FC or an NFC+ if it were established in the EU

FCs, NFC+s and TCEs (**Affected Parties**) are affected by the Margin Rules. The Margin Rules apply where the following transact with each other:

MARGIN RULES APPLY TO TRANSACTIONS BETWEEN:	POINTS TO NOTE
FC & FC	-
NFC+ & NFC+	-
FC & NFC+	-
FC/NFC+ & TCE	The obligation doesn't apply directly to the TCE but the FC/NFC+ must exchange, and not just collect, collateral
TCE & TCE	The Margin Rules can apply to TCE & TCE transactions in certain circumstances involving an EU connection

WHAT TRANSACTIONS ARE CAUGHT?

The Margin Rules apply to all uncleared OTC derivatives which are entered into at a time when each Affected Party is subject to the margin obligation.

NETTING SET

What is it?

A "*netting set*" is a "*set of non-centrally cleared OTC derivative contracts between two counterparties that is subject to a legally enforceable bilateral netting agreement*" (e.g. an ISDA Master Agreement).

Why is it relevant?

The Regulation requires that variation margin be collected for all transactions within a "*netting set*". As a "*netting set*" could contain transactions entered into before and after the relevant phase-in date under the Regulation, a party that wishes to avoid the application of the variation margin requirements to those legacy transactions needs to ensure that their contractual arrangements are updated.

FX TRANSACTIONS

FX forwards, FX swaps and cross-currency swaps are OTC derivatives under EMIR. As a result, they are within the scope of the Margin Rules.

Initial margin

No initial margin requirements apply to physically settled FX forwards or FX swaps or to exchange of principal in cross-currency swaps. However, initial margin is still required in respect of any exposures created by the interest rate element of cross-currency swaps.

Variation margin

Physically settled FX forwards (but not FX swaps) have a temporary exemption from variation margin requirements until the earlier of:

- 31 December 2018; and
- the later of:
  - the date from which MiFID II applies (currently expected to be 3 January 2018); and
  - the relevant phase-in date for variation margin.

As the application date for MiFID II is likely to be 3 January 2018, this seems to be the most likely date from which variation margin will be required to be exchanged for physically settled FX forwards.

Spot FX

The Margin Rules do not apply to spot FX.

A draft Level 2 Regulation under MiFID II provides that spot FX is limited to transactions which settle in T+2 or less. This Regulation is expected to take effect from the same date as MiFID II (most likely 3 January 2018). From then, subject to limited exceptions, physically settled FX transactions which settle T+3 or over will constitute FX forwards for EMIR purposes.

Commercial purpose exemption

The above draft Level 2 Regulation under MiFID II provides that a physically settled FX contract:

- to which at least one of the parties is an NFC;
- which is for identifiable goods, services or investment; and
- which is not traded on a trading venue,

is not a MiFID II financial instrument (and accordingly will not be subject to the Margin Rules).

VARIATION MARGIN

Amount of Variation Margin

A party must collect variation margin equal to the positive mark-to-market value of its OTC derivatives. The variation margin requirements must be calculated on each business day based on the prior day's values. Haircuts must be applied in calculating the amount of non-cash variation margin to be collected. Parties may agree a minimum transfer amount of margin (€500,000 in aggregate between variation margin and initial margin). There is no threshold for the collection of variation margin which means that, once the minimum amount is exceeded, the full amount of the collateral must be collected.

When must variation margin be provided?

The posting party must provide variation margin "*within the same business day*" of the date of the calculation of the amount of the variation margin.

Type of collateral

Eligible collateral includes:

» cash;

» gold (of a certain type);

» certain debt securities (including issued by governments, central banks, credit institutions or investment firms);

» corporate bonds; and

» certain listed equities.

There are liquidity requirements in relation to collateral. Further, the collecting party must evaluate collateral for credit quality, concentration limits and "*wrong-way risk*" (i.e. the risk that the value of the collateral correlates with the creditworthiness of the collateral provider, arising for example if the collateral is issued by the posting counterparty group).

INITIAL MARGIN

From when does the initial margin obligation apply?

The initial margin obligation is being phased-in over a number of years and its application depends on a party's Aggregate Average Notional Amount of uncleared derivatives (**AANA**). A party's AANA is calculated as the average across the last business days of the immediately preceding March, April and May.[1]

AANA	IMPLEMENTATION DATE
> €3,000 billion	4 February 2017
> €2,250 billion	1 September 2017
> €1,500 billion	1 September 2018
> €750 billion	1 September 2019
> €8 billion	1 September 2020

Type of collateral

Eligible collateral is the same as for variation margin (see above).

Segregation

Collateral posted as initial margin must be segregated from the collecting party's assets. Currently segregation is the exception (e.g. in the case of UCITS which use it to manage counterparty exposure restrictions). Under the Margin Rules, segregation of initial margin will become the norm. The collecting party will not be able to re-hypothecate initial margin collateral.

How much initial margin must be collected?

The Regulation provides a standardised method for calculating initial margin but parties may instead use an initial margin model developed independently, jointly or by a third party agent. Where an initial margin model is used it must comply with the minimum requirements set out in the Regulation. The collecting party remains responsible for ensuring that its model complies with the minimum requirements set out in the Regulation.

When is initial margin calculated?

Initial margin is not just calculated on a one-off basis. It must be calculated within one business day of certain events including the entry into a new uncleared OTC derivative, the expiry or removal of an OTC derivative from the netting set, a payment or delivery (other than margin) on an existing OTC derivative, on certain reclassifications where the standardised method is used, and in any case where there has been no calculation in the preceding 10 business days.

When must initial margin be provided?

As with variation margin, the posting party must provide the initial margin "*within the same business day*" of the date of calculation of the amount of initial margin.

REVIEWS AND PROCEDURES

The Regulation requires that each Affected Party performs an independent review of the enforceability of its netting and collateral agreements and must put certain other policies and procedures in place.

NEXT STEPS

Where an Affected Party has not previously collateralised its trades, internal collateral processes and Credit Support Annexes (**CSAs**) will need to be put in place. Where an Affected Party already exchanges collateral, its existing CSAs will need to be amended or replaced so as to reflect the new requirements for variation margin.

1 This calculation includes all uncleared OTC derivatives in a counterparty's portfolio (including those not subject to the Margin Rules). For UCITS or alternative investment funds with a manager that is authorised or registered under AIFMD, AANA is calculated on a per fund (or sub-fund in the case of umbrellas) basis (provided certain conditions are met).

Dublin
+353 1 618 0000
dublin@arthurcox.com

London
+44 207 832 0200
london@arthurcox.com

Silicon Valley
+1 650 943 2330
siliconvalley@arthurcox.com

Belfast
+44 28 9023 0007
belfast@arthurcox.com

New York
+1 212 782 3294
newyork@arthurcox.com