

**EU Regulation:
It Don't Stop**
Regulatory Update
February 2015

This white paper provides a business-oriented overview of the progress made by EMIR and the outlook for future EU regulatory activity



Introduction

The financial regulatory landscape has changed significantly over the last few years. The impact on all financial market participants during this time has been considerable, both in terms of the resources needed to monitor and assess new regulatory developments but also the costs of adapting business models to ensure compliance.

Going forward, it is painfully clear that the regulatory process will remain dynamic for some years to come and will continue to put significant strains on all market participants and companies offering services to the sector. They will all need to find a way to manage these changes.

EMIR

European Market Infrastructure Regulation (EMIR) is a European Union (EU) initiative aimed at increasing the stability of financial markets. It addresses the leveraged segment of the market by putting an infrastructure in place for financial derivatives contracts.

The regulation is the EU's response to the September 2009 G20 meeting in Pittsburgh where it was decided, according to the Leaders Statement, see **[G20]**:

“All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse.”

EMIR introduces the following four initiatives which we will explore in more detail:



Reporting obligation for derivatives contracts

The EMIR legislation came into force shortly after its publication in the Official Journal of the European Union on July 4th 2012, see **[EMIR]**. Implementation is ongoing and has had several key milestones and a fair share of problems.

From the point of view of market participants, the first significant step was the reporting of all relevant derivative trades, something which had to be completed by February 12th 2014 to ensure compliance. In principle, this was a relatively simple task but one which was, nevertheless, significant because it forced people to decide on which derivatives to report, making it difficult to change their mind at a later stage. As with much regulation, the devil proved to be in the detail.

For example, people were divided on whether (all) foreign exchange (FX) forwards should be considered a derivative under the MiFID definition EMIR is built upon. (This is an issue that is unresolved at the time of writing). FX forwards, often with very short maturities, are used frequently and in high volumes by long-only asset managers wanting to hedge out currency risks. No surprise that a non-derivative classification would greatly simplify their reporting obligations.

'As with much regulation, the devil proved to be in the detail.'

The next significant challenge was to address the counterparty risk arising from these positions by supplementing the trade reporting with daily reporting of position valuations and valuation information about the collateral potentially posted with trading counterparties.

This is essentially reporting the structure of all CSA agreements and equivalent margin agreements. This was to address the exposure reporting requirement discussed in **[EMIR]**, article 9, and **[RTS]**, article 3. This new obligation became effective for relevant derivatives positions on August 11th 2014, with the first reporting to be completed no later than T+1 (that is, by end of day on August 12th 2014).

Unfortunately market participants in general and trade repositories in particular, were still struggling with poor data quality, a low matching rate, and limited reconciliation tools. As a result, there have been problems adding complexity to a trade reporting process which had not yet stabilised. Presumably in recognition of their aggressive and ambitious reporting deadline (which had arguably been based on technical documents lacking sufficient details), the European Securities and Markets Authority (ESMA) published a consultation paper on November 10th 2014, see **[RTS_9]**, aimed at clarifying some of the issues which had caused people problems.

We can hope that this implicit extension (in spirit only, given that the legal deadline is still in force) will give everybody involved some much needed time to tidy up their processes.

Looking to the future The European Commission is working on legislation related to the reporting and transparency of Securities Financing Transactions, see **[SFT]**. This is likely to be one of the next important areas of regulatory activity to monitor once the problems we currently face regarding the reporting obligations have settled down.

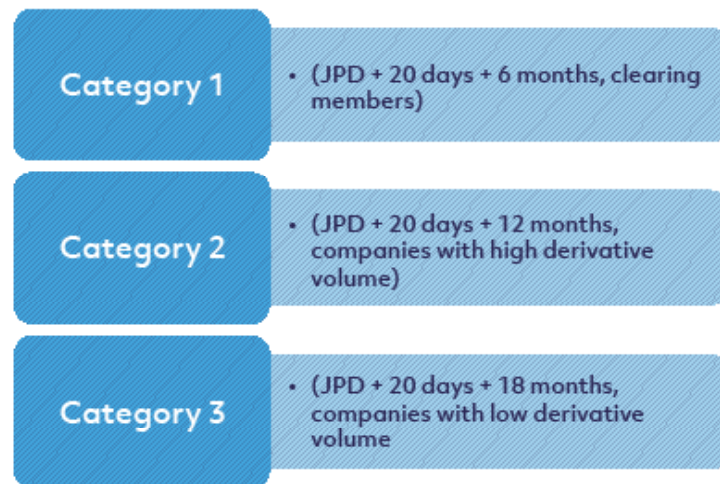
Clearing obligation

The concept of CCPs, also known as clearing houses, is not new. Their role can be traced back several hundred years, in particular for exchange traded products. Today they are highly integrated in markets and serve several important roles. Most importantly they mutualise counterparty credit risk, but they also provide transparency and standardisation. (See **[CCP]** for a good introduction to CCP's).

Even for Interest Rate Swaps (IRS), the first instrument ESMA is targeting, about half of all outstanding contracts are already centrally cleared – something which undoubtedly explain why this is the first instrument class to be considered. So what is new is that EMIR makes clearing an obligation for (OTC) instruments appearing on the public register to be cleared, see **[PR]**.

At the time of writing, ESMA has prepared draft technical standards for three asset classes: certain IRSs, see **[IRS]**, certain Credit Default Swaps (CDS), see **[CDS]**, and Foreign Exchange Non-Deliverable Forwards, see **[NDF]**. The final draft Regulatory Technical Standards (RTS) for IRSs has been submitted to the Commission for processing and we expect that the final legislation on IRS clearing will be published in the Official Journal sometime in early 2015.

From the Journal Publishing Date (JPD) the clearing obligation takes effect depending on the categorisation of the market participant:



See **[IRS]** for details.

ESMA has decided that a clearing obligation for Futures & Options on Equities and Interest Rates is not necessary at this stage.



Pension Funds are exempt from the clearing obligation until August 15th 2015 at the earliest and Non-Financial Counterparties (NFC) (see **[EMIR]** for definition), are subject to a clearing threshold. This is obviously in order to avoid putting unnecessary strain on companies operating in non-financial sectors with limited derivatives exposure.

Credit and operational risk-mitigation techniques for non-cleared OTC derivatives

For some Asset Managers, where derivatives' trading has not traditionally been a large or core activity, one can find that legal agreements with dealers do not require/mention collateral posting for derivatives. In other cases, collateral posting agreements are in place but they may be bespoke in nature and possibly outdated.

While this probably reflects the fact that dealers are often comfortable with the credit risk of the counterparty relationship, it still demonstrates a level of untidiness in the system and is far from the standards promoted by EMIR.

By introducing authorised CCP's with legislation on margin rules and the general collateral process, EMIR obliges market participants to adopt common terms when signing up as counterparty to the CCP, at least for all applicable derivatives.

This leaves us with the true OTC segment of derivatives which is not liquid and standardised enough to fit into the clearing framework. A joint consultation paper from the European Banking Authority (EBA), European Insurance and Occupational Pension Authority (EIOPA) and ESMA published April 14th 2014, see **[RISK]**, seek comments on a risk mitigation framework for non-cleared OTC derivatives. It is expected that draft RTS on this subject will be submitted to the Commission soon so when the regulatory work on clearing starts to settle attention will surely shift to this area.

Finally, it is worth noticing that a reasonable collateral posting system was in place between 'sophisticated' market participants prior to the 2008 market crash. The unsurprising lesson here was that you still need eligible collateral for posting to avoid a default - something which turned out to be a problem for Lehman Brothers and Bear Sterns - so, at best, losses can be limited by having a solid collateral system in place but they can't be fully avoided.

Common requirements for trade repositories, clearing houses/central counterparties (CCP)

A large part of the EMIR legislative text is dedicated to outlining rules and operating principles for new regulatory entities such as trade repositories and CCPs. While these aspects are of great importance, they are really only of academic interest to most market participants as they spell out what it takes to become authorised by the regulator.

The practical implications of the rules will become clear when signing, for example, margin agreements with CCP's or through reading the trade repositories guidelines for required data and formats. For this reason most market participants can probably skip these parts of EMIR unless they are looking for specific background information in order to understand the reasoning behind the decisions that went in to the agreements and CCPs.

Axxsys Regulatory Practice

We help investment management businesses understand and meet the regulatory challenges they face. Axxsys' operational expertise and long track record of working with the buy-side community are supported by our strong regulatory network and long-standing relationships with trade repositories, system vendors, clearing houses and ARMs. As a result, our technical specialists are uniquely placed to see regulation from the point of view of the client business, providing tailor-made solutions that manage regulatory risk and create value within the operating model.

For more information about EMIR and the strategic and operational impact it may have on your investment management business, please contact Stephen McDermott on smcdermott@axxsysconsulting.com or +44 (0) 207 526 4900.

References

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