

JC/CP/2015/002

10 June 2015

Second Consultation Paper

Draft Regulatory Technical Standards on risk-mitigation techniques
for OTC-derivative contracts not cleared by a CCP under
Article 11(15) of Regulation (EU) No 648/2012



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1. Responding to this consultation

The ESAs invite comments on all proposals put forward in this paper and in particular on the specific questions summarised in 5.2.

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the views expressed/ rationale proposed; and
- describe any alternative regulatory choices the EBA should consider.

Submission of responses

To submit your comments, click on the 'send your comments' button on the consultation page by 10 July 2015. Please note that comments submitted after this deadline, or submitted via other means may not be processed.

Publication of responses

Please clearly indicate in the consultation form if you wish your comments to be disclosed or to be treated as confidential. A confidential response may be requested from us in accordance with the EBA, EIOPA and ESMA's rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA, EIOPA or ESMA's Boards of Appeal and the European Ombudsman.

Data protection

The protection of individuals with regard to the processing of personal data by the European Supervisory Authorities (ESAs) is based on Regulation (EC) No 45/2001 of the European Parliament and of the Council of 18 December 2000 as implemented by the ESAs in their implementing rules. Further information on data protection can be found at www.esma.europa.eu, www.eba.europa.eu and www.eiopa.europa.eu under the heading 'Legal Notice'.

2. Executive summary

The European Supervisory Authorities (ESAs) have been mandated to develop common draft regulatory technical standards (RTS) that outline the concrete details of the regulatory framework which implements Article 11 of Regulation (EU) No 648/2012(EMIR)¹. The EMIR introduces a requirement to exchange margins on non-centrally cleared OTC derivatives. Specifically, the EMIR delegates powers to the Commission to adopt RTS specifying:

- a) The risk-management procedures for non-centrally cleared OTC derivatives;
- b) The procedures for counterparties and competent authorities concerning intragroup exemptions for this type of contracts; and
- c) the criteria for the identification of practical or legal impediment to the prompt transfer of funds between counterparties.

The EMIR mandates the ESAs to develop standards that set out the levels and type of collateral and segregation arrangements required to ensure the timely, accurate and appropriately segregated exchange of collateral. This will include margin models, the eligibility of collateral to be used for margins, operational processes and risk-management procedures. In developing these standards, the ESAs have also kept in mind the need for international consistency and have consequently used the internationally agreed standards as the natural starting point. In addition, a number of specific issues have been clarified so that the proposed rules will implement the international standards while taking into account the specific aspects of the European financial market.

This second consultation paper builds on the proposals outlined in our first ESAs' Consultation Paper² published in April 2014. The ESAs, after reviewing all the responses to the first consultation paper, engaged in intensive dialogues with other authorities and the industry stakeholders in order to identify operational issues that that may arise from the implementation of this framework. Therefore, the ESAs are specifically seeking feedback on a narrow set of topics as most of the issues which arose in the last consultation paper have been addressed in this amended version of the RTS. This should also give the in scope counterparties greater clarity as to the requirements that will be proposed to the European Commission for adoption which may assist the in scope counterparties in terms of their preparation for implementation.

¹ [Regulation \(EU\) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.](#)

² [Joint Consultation on draft RTS on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP \(JC/CP/2014/03\), issued by the EBA, EIOPA and ESMA on 14 April 2014.](#)

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These draft RTS prescribe the regulatory amount of initial and variation margin to be posted and collected and the methodologies by which that minimum amount would be calculated. Under both approaches, variation margins are to be collected to cover the mark-to-market exposure of the OTC derivative contracts. For the initial margin, counterparties can choose between a standard pre-defined schedule based on the notional value of the contracts and an internal modelling approach, where the initial margin is determined based on the modelling of the exposures. This allows counterparties to decide on the complexity of the models to be used.

The draft RTS also outline the collateral eligible for the exchange of margins. The eligible collateral covers a broad set of securities, such as sovereign securities, covered bonds, specific securitisations, corporate bonds, gold and equities. In addition, they establish criteria to ensure that collateral is sufficiently diversified and not subject to wrong-way risk. Finally, to reflect the potential market and FX volatility on the collateral the draft RTS prescribe the methods for determining appropriate collateral haircuts.

Significant consideration has also been given to the operational procedures that have to be established by the counterparties. Appropriate risk management procedures should include specific operational procedures. The draft RTS provide the option to apply an operational minimum transfer amount of up to €500,000 when exchanging collateral.

With regard to intragroup transactions, a clear procedure is established for the granting of intragroup exemptions allowed under the EMIR. This procedure will harmonise the introduction of operational procedures and provide clarity on these aspects.

The draft RTS also acknowledge that a specific treatment of certain products may be appropriate. This includes, for instance, physically-settled FX swaps, which may not be subject to initial margin requirements.

Furthermore, to allow counterparties time to phase in the requirements, the standard will be applied in a proportionate manner. Therefore, the requirements for the initial margin will, at the outset, apply only to the largest counterparties until all counterparties with a notional amount of non-centrally cleared derivatives in excess of EUR 8 billion are subject to the rules as from 2020. The scope of application for counterparties subject to initial margin requirements is therefore clearly specified.

Quantitative and qualitative aspects concerning costs and benefits of the proposed rules are discussed in the annex. The annex supplements the proposal and illustrates the reasoning behind the policy choices made.

3. Background and rationale

The EMIR establishes provisions aimed at increasing the safety and transparency of the over-the-counter (OTC) derivative markets. Among other requirements, it introduces a legal obligation to clear certain types of OTC derivatives through central counterparties ('CCP'). However, not all OTC derivative contracts will be subject to the clearing obligation or would meet the conditions to be centrally cleared. In the absence of clearing by a CCP, it is essential that counterparties apply robust risk mitigation techniques to their bilateral relationships to reduce counterparty credit risk. This will also mitigate the potential systemic risk that can arise in this regard.

Therefore, Article 11 of the EMIR requires the use of risk mitigation techniques for transactions that are not centrally cleared and, in paragraph 15, mandates the ESAs to develop RTS on three main topics: (1) the risk-management procedures for the timely, accurate and appropriately segregated exchange of collateral; (2) the procedures concerning intragroup exemptions; and (3) the criteria for the identification of practical or legal impediment to the prompt transfer of funds between counterparties belonging to the same group.

This second consultation paper builds on the proposals outlined in our first ESAs' Consultation Paper³ published in April 2014. The ESAs, after reviewing all the responses to the first consultation paper, engaged extensive dialogues with other authorities and the industry stakeholders in order to identify all the operational issues that may arise from the implementation of this framework. Therefore, the ESAs are specifically seeking feedback on a narrow set of topics as most of the decisions are included in this amended version of the RTS. This should also give in-scope counterparties greater clarity as to the requirements that will be proposed to the European Commission for adoption aiding preparation for implementation.

To avoid regulatory arbitrage and to ensure a harmonised implementation at both the EU level and globally, it is crucial for individual jurisdictions to implement rules consistent with international standards. Therefore, these draft RTS consider the minimum international standards on margin requirements for non-centrally cleared derivative transactions issued by the Basel Committee on Banking Supervision (BCBS) and the International Organisation of Securities Commissions (IOSCO) on September 2013.⁴ The international standards outline the final margin requirements, which the ESAs have endeavoured to transpose into the RTS.

The overall reduction of systemic risk and the promotion of central clearing are identified as the main benefits of this new framework. To achieve these objectives, the BCBS-IOSCO framework introduces eight key principles and a number of detailed requirements. It is the opinion of the ESAs that this Regulation is in line with the principles of the international framework.

³ [Joint Consultation on draft RTS on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP \(JC/CP/2014/03\)](#), issued by the EBA, EIOPA and ESMA on 14 April 2014.

⁴ [Margin requirements for non-centrally cleared derivatives – final document](#), issued by BCBS and IOSCO on September 2013.

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These draft RTS are divided into three main parts: the introductory remarks, a draft of the RTS and the accompanying material, including a cost-benefits analysis and an impact assessment. The draft RTS document is further split into a number of broad Sections covering:

1. general counterparties' risk management procedures;
2. margin methods;
3. eligibility and treatment of collateral;
4. operational procedures;
5. procedures concerning intragroup derivative contracts.

The sections below describe in greater detail the content of these draft RTS.

Counterparties' risk management procedures required for compliance with Article 11(3) of Regulation (EU) No 648/2012

The first section of these draft RTS outlines the scope of the application of these requirements by identifying the counterparties and transactions subject to the following provisions. The EMIR requires financial counterparties to have risk management procedures in place that require the timely, accurate and appropriately segregated exchange of collateral with respect to OTC derivative contracts. Similarly, non-financial institutions must have similar procedures in place, if they are above the clearing threshold. Consistent with this goal, to prevent the build-up of uncollateralised exposures within the system, the RTS require the daily exchange of variation margin with respect to transactions between such counterparties.

Subject to the provisions of the RTS, the entities mentioned above, i.e. financial and certain non-financial counterparties, will also be required to exchange two-way initial margin to cover the potential future exposure resulting from a counterparty default. To act as an effective risk mitigant, initial margin calculations should reflect changes in both the risk positions and market conditions. Consequently, counterparties will be required to recalculate initial margin, at least when the portfolio between the two entities or the underlying risk measurement approach have changed. In addition, to ensure current market conditions are fully captured, initial margin is subject to a minimum recalculation period.

In order to align with international standards, the requirements in the RTS will apply only to transactions between identified OTC derivative market participants. The provisions of the RTS on initial margin will therefore apply to entities that have an OTC derivative exposure above a predetermined threshold, defined in the draft RTS as above EUR 8 billion in gross notional outstanding amount. This reduces the burden on smaller market participants, while still achieving the margin framework's principle objective of a sizable reduction in systemic risk. These draft RTS impose an obligation on EU entities to collect margin in accordance with the prescribed procedures, regardless of whether they are facing EU or non-EU entities. Given that non-financial entities established in a third country that would be below the clearing threshold if established in the Union would share the same risk profile as non-financial counterparties below the clearing threshold established in the Union, the same approach should be applied to them in order to prevent regulatory arbitrage.



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During the development of the RTS, the issue of the risks posed by physically-settled foreign exchange contracts was carefully considered. To maintain international consistency, entities subject to the RTS may agree not to collect initial margin on physically-settled foreign exchange forwards and swaps, or the principal in cross-currency swaps. Nevertheless, counterparties are expected to post and collect the variation margin associated with these physically-settled contracts, which is assessed to sufficiently cover the risk.

The RTS recognise that the exchange of collateral for only minor movements in valuation may lead to an overly onerous exchange of collateral and that initial margin requirements will have a measurable impact. Therefore, the RTS include a threshold to limit the operational burden and a threshold for managing the liquidity impact associated with initial margin requirements. Both thresholds are fully consistent with international standards.

The first threshold ensures that the exchange of initial margin does not need to take place if a counterparty has no significant exposures to another counterparty. Specifically, it may be agreed bilaterally to introduce a threshold of up to EUR 50 million, which will ensure that only counterparties with significant exposures will be subject to the initial margin requirements.

The second threshold ('minimum transfer amount') ensures that, when market valuations fluctuate, new contracts are drawn up or other aspects of the covered transactions change; an exchange of collateral is only necessary if the change in the initial and variation margin requirements exceeds EUR 500 000. Similarly to the first threshold, counterparties may agree on the introduction of a threshold in their bilateral agreement as long as the minimum exchange threshold does not exceed EUR 500 000. Therefore, the exchange of collateral only needs to take place when recalculated changes to the margin requirements are above the agreed thresholds to limit the operational burden relating to these requirements.

In the first consultation paper, the RTS were developed on the concept that counterparties in the scope of the margin requirements are required to collect margins. As two counterparties that are subjected to EU Regulation they are both obliged to collect collateral, this implies an exchange of initial margins. The underlying assumption was also that counterparties in equivalent third country jurisdiction would also be required to collect, so EU counterparties trading with third country counterparties were expected to post initial and variation margins. Respondents to the first consultation and third country authorities highlighted that this would not always be the case as some entity might be exempted in a third country. This approach, same in the spirit, but different in the wording with respect to the BCBS-IOSCO principles, might place the EU counterparties in a competitive advantage.

The current RTS are drafted requiring to exchange IM when dealing with third country counterparties, i.e. including the requirement of posting IM to counterparties in jurisdiction where bankruptcy laws, and so netting and segregation agreements, are known to be disputable. However, posted collateral should not be considered at risk, as European counterparties have the obligation to assess the legal enforceability of the netting and segregation agreements. Where



this assessment turns out to be negative, counterparties will have to rely on alternative arrangements such as posting collateral to international custodians.

Margin Calculation

Another section outlines the methods that counterparties may use to calculate initial margin requirements: the standardised method and the initial margin models.

The standardised method mirrors the mark-to-market method set out in Articles 274 and 298 of Regulation (EU) No 575/2013 (CRR). It is a two-step approach: firstly, derivative notional amounts are multiplied by add-on factors that depend on the asset class and the maturity, resulting in a gross requirement; secondly, the gross requirement is reduced to take into account potential offsetting benefits in the netting set ('net-to-gross ratio'). Unlike the mark-to-market method, the add-on factors are adjusted to be aligned with those envisaged in the international standards.

Alternatively, counterparties may use initial margin models that comply with the requirements set out in the RTS. Initial margin models can either be developed by the counterparties or provided by a third-party agent. The models are required to assume the maximum variations in the value of the netting set at a confidence level of 99% with a risk horizon of at least 10 days. Models must be calibrated on a historical period of at least three years, including a period of financial stress; in particular, in order to reduce procyclicality, observations from the period of stress must represent at least 25% of the overall data set.

To limit the recognition of diversification benefits, a model can only account for offset benefits for derivative contracts belonging to the same netting set and the same asset class. Additional quantitative requirements are set out to ensure that all relevant risk factors are included in the model and that all basis risks are appropriately captured. Furthermore, the models must be subject to an initial validation, periodical back-tests and regular audit processes. All key assumptions of the model, its limitations and operational details must be appropriately documented.

Eligibility and treatment of collateral

Section 5 considers the minimum requirements for collateral to be eligible for the exchange of margins by counterparties and the treatment of collateral, in particular the haircuts to be applied.

Even if margin is exchanged in an amount appropriate to protect the counterparties from the default of a derivative counterparty, the counterparties may nevertheless be exposed to loss in case the posted collateral cannot be readily liquidated at full value should the counterparty default. This issue may be particularly relevant during periods of financial stress. The RTS provide counterparties the option to agree on the use of more restrictive collateral requirements, i.e. a subset of the collateral eligible as set out in the RTS, but given the risk posed by the collateral, minimum requirements on the collateral eligible are considered necessary.

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Assets that are deemed to be eligible for margining purposes should be sufficiently liquid, not be exposed to excessive credit, market and FX risk and hold their value in a time of financial stress. Furthermore, with regard to wrong-way risk, the value of the collateral should not exhibit a significant positive correlation with the creditworthiness of the counterparty. The accepted collateral should also be reasonably diversified. To the extent that the value of the collateral is exposed to market and FX risk, risk-sensitive haircuts should be applied. This ensures that the risk of losses in the event of a counterparty default is minimised.

The draft RTS set out the list of eligible collateral, eligibility criteria, requirements for credit assessments and requirements regarding the calculation and application of haircuts. Wrong-way risk and concentration risk are also addressed by specific provisions. Additionally, the RTS require that risk management procedures include appropriate collateral management procedures. A set of operational requirements is therefore included to ensure that counterparties have the capabilities to properly record the collected collateral and manage the collateral in the event of the default of the other counterparty.

The ESAs have adopted the key principles outlined in the international standards and have aligned these principles to EU-wide market conditions. This will ensure a harmonised EU implementation of the RTS whilst respecting the conditions of the respective markets. The ESAs consider appropriate allowing a broad set of asset classes as eligible collateral and expect that bilateral agreements will further restrict the eligible collateral in a way that is compatible with the complexity, size and business of the counterparties. As a starting point, the list of eligible collateral is based on the provisions laid down by Articles 197 and 198 of Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms, relating to financial collateral available under the credit risk mitigation framework of institutions, and includes only funded protection. All asset classes on this list are deemed to be eligible in general for the purposes of the RTS. However, all collateral has to meet additional eligibility criteria such as low credit, market and FX risk.

The ESAs have considered several methodologies to ensure that the collected collateral is of sufficient credit quality. In particular, in accordance with Regulation No 462/2013 on credit rating agencies (CRA 3), the ESAs introduced mitigants against an excessive reliance on external ratings.

Furthermore, the use of either an internal or external credit assessment process remains subject to a minimum level of credit quality. Namely, the RTS allows the use of internal-ratings-based (IRB) approaches to credit institutions authorised under the CRR. The current disclosure requirements are sufficient to allow counterparties the necessary degree of understanding of the methodology. If there is not an approved IRB for the collateral or if the two counterparties do not agree on the use of the internal-ratings-based approach developed by one counterparty, the two counterparties can define a list of eligible collateral relying on the external credit assessments of recognised external credit assessment institutions (ECAIs). The minimum Credit Quality Step (CQS) is set to two for most collateral types. The use of the CQS must be consistent with the Implementing Technical Standards (ITS) on the mapping of the credit assessments to risk weights

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of ECAIs under Article 136 of the Capital Requirements Regulation (CRR), currently under development by the three ESAs.

The risk of introducing ‘cliff effects’ possibly triggering a market sell-off after a ratings downgrade where counterparties would be required by the regulation to replace collateral, have also been addressed in the development of the RTS with the introduction of concentration limits and a ‘grace period’ that follows a rating downgrade.

As the risk of cliff effects may not be sufficiently mitigated by the introduction of internal credit assessments, these draft RTS also allow the minimum level of credit quality set out in the RTS to be exceeded for a ‘grace period’ following a downgrade. However, this is conditional on the counterparty starting a well-defined process to replace the collateral.

Two requirements are necessary on top of the other provisions on the collateral eligible for the exchange of margins: measures preventing wrong-way risk on the collateral and concentration limits. The RTS do not allow own-issued securities as eligible collateral, except on sovereign debt securities. However, this requirement extends to corporate bonds, covered bonds, other debt securities issued by institutions and securitisations. Broadly speaking, the draft RTS introduce diversification requirements on three different asset classes: (i) sovereign bonds (and equivalent securities); (ii) non-sovereign bonds; and (iii) securities issued by credit institutions and investment firms. These requirements will reduce concentration risk in the collateral placed in margins, and are considered necessary to fulfil the requirements of having sufficient high-quality collateral available following the default of a counterparty.

The ESAs considered the peculiar market characteristics of sovereign debt securities and their investors. As many smaller market participants tend to have substantial investments in local sovereign securities and a diversification may increase, instead of reducing, their risk profile, the ESAs are of the opinion that the concentration limits of this particular asset class should be required only for systemically important entities. However, the existing identification of systemically important banks (G-SIIs and OSII) would only be valid for that particular sector. Therefore the draft RTS includes an additional threshold that, referring to the total amount of collected initial margin, aims to identify other major participants in the OTC derivative market that are not banks. Coherently, the diversification requirements for this asset class only apply to trades between systemically important counterparties and not to trades between them and smaller counterparties.

The collateral requirements in the draft RTS strive to strike a good balance between two conflicting objectives. Firstly, there is the need to have a broad pool of eligible collateral that also avoids an excessive operational and administrative burden on both supervisors and market participants. Secondly, the quality of eligible collateral must be sufficient while limiting cliff effects in the form of introducing reliance on ECAI ratings. However, the risk of losses on the collateral is not only mitigated by ensuring collateral of sufficient high quality; it is also considered necessary to apply appropriate haircuts to reflect the potential sensitivity of the collateral to market and foreign exchange volatilities. The current draft RTS allows the use of an either internal models for



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the calculation of haircuts or the use of standardised haircuts. Haircuts methodologies provide transparency and are designed to limit procyclical effects.

In order to provide a standardised haircut schedule, haircuts in line with the credit risk mitigation framework have been adopted across the different levels of credit quality steps. It should be noted that the international standards provide haircut levels in the standardised method ('standard schedule'), also derived from the standard supervisory haircuts adopted in the Basel Accord's approach to the collateralised transactions framework. However, the standard schedule presented in the international standards only contains haircuts for collateral of very high credit quality with an external credit assessment equivalent to CQS 1. The list of eligible collateral in the draft RTS comprise collateral with a lower, albeit still sufficiently high, credit quality. The draft RTS extend the standardised schedule of haircuts based on the credit risk mitigation framework in Regulation (EU) No 575/2013.

The section on eligible collateral has been drafted ensuring full compliance with the international standards. It has been considered important to align the requirements to the specificities of the European markets, but also to provide a harmonised approach that ensures consistency in the implementation across EU jurisdictions.

Operational procedures

The RTS recognise that the operational aspects relating to the exchange of margin requirements will require substantial effort to implement in a stringent manner. It is therefore necessary for counterparties to implement robust operational procedures that ensure that documentation is in place between counterparties and internally at the counterparty. These requirements are considered necessary to ensure, that requirements in the RTS are implemented in a careful manner that minimises the operational risk of these processes.

The operational requirements include, among other things, clear senior management reporting, escalation procedures (internally and with counterparties) and requirements to ensure sufficient liquidity of the collateral. Furthermore, counterparties are required to conduct tests on the procedures, at least on an annual basis.

Segregation requirements must be in place to ensure that collateral is available in the event of a counterparty defaulting. In general, operational and legal arrangements must be in place to ensure that the collateral is bankruptcy remote.

The international standards do not generally allow re-use or re-hypothecation of initial margins and restrict the re-use to very specific cases. After considering the characteristics of the European Market, where the re-use and the re-hypothecation subject to the restrictions of the international standards would be of limited use the ESAs propose that the RTS do not include such possibility. As a special case, re-investment of initial margin posted in cash to secure the collateral posted seems to be common market practice and it should be allowed as long as the investments are used for no other purpose than protecting the collateral poster.



Procedures concerning intragroup derivative contracts

In accordance with Article 11(6) to (10) of the EMIR, intragroup transactions can be exempted from the requirement to exchange collateral if certain requirements on the risk-management procedures are met and there are no practical or legal impediments on the transferability of own funds and the repayment of liabilities. Depending on the type of counterparties and where they are established, there is either an approval or a notification process.

Without further clarification, there is a risk that competent authorities would follow very different approaches regarding the approval or notification processes. Therefore these draft RTS specify a number of key elements including the amount of time that competent authorities have to grant an approval or to object, the information to be provided to the applicant and a number of obligations for the counterparties.

To ensure that the criteria for granting an exception are applied consistently across the member states, the draft RTS further clarify which requirements on risk management procedures have to be met, and specify the practical or legal impediments on the prompt transfer of own funds and the repayment of liabilities.

Phase-in of the requirements

A last article deals with transitional provisions and phase-in requirements. In order to adapt a proportionate implementation, the RTS propose that the requirements will enter into force on 1 September 2016, giving counterparties subject to these requirements time to prepare for the implementation. The initial margin requirements will be phased-in over a period of four years. Initially, the requirements will only apply to the largest market participants. Subsequently, after four years, more market participants will become subject to the requirements. Specifically, from 1 September 2016, market participants that have an aggregate month-end average notional amount of non-centrally cleared derivatives exceeding EUR 3.0 trillion will be subject to the requirements from the outset. From 1 September 2020, any counterparty belonging to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives exceeds EUR 8 billion will be subject to the requirements. Similarly, but with a shorter timescale, the requirements for the implementation of variation margin will be binding for the major market participants from September 2016 and for all the other counterparties fall in the scope of these RTS by 1 March 2017. Therefore, this proposal fully aligns the requirements of these RTS with the BCBS and IOSCO standards, as amended in March 2015.⁵

The phase-in requirements give to smaller market participants more time to develop the necessary systems and implement the RTS. Moreover, it is important to streamline the implementation of this framework and to align it to international standards in order to achieve a global level playing field.

⁵ [Margin requirements for non-centrally cleared derivatives, issued by the Basel Committee and IOSCO on March 2015.](#)

4. Draft regulatory technical standards on risk-mitigation techniques for OTC derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012

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[...]

supplementing Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories of the European Parliament and of the Council with regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a CCP



THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) 648/2012 of 27 July 2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories⁶ and in particular the third subparagraph of Article 11(15) thereof,

Whereas:

- (1) Counterparties have an obligation to protect themselves against credit exposures to derivatives trading partners by collecting margins, as described in this Regulation. This Regulation lays out the standards for the timely, accurate and appropriately segregated exchange of collateral. These standards apply on a mandatory basis only to the portion of collateral that counterparties are required by this Regulation to collect and post. However, counterparties which agree collecting or posting collateral beyond the requirements of this Regulation may retain the right to have such collateral covered by these standards.
- (2) OTC derivative contracts from clients or indirect clients to be cleared by a CCP may be centrally cleared through a clearing member intermediary or through an indirect clearing arrangement. Under this type of clearing arrangement the client or the indirect client is subject to the margin requirements of the CCP, or the client or indirect client provides margins consistent with the relevant corresponding CCP's margin requirements. Indirectly cleared OTC derivative contracts are considered as centrally cleared and are therefore not subject to the risk management procedures prescribed in this Regulation.
- (3) Counterparties subject to the requirements of Article 11(3) of Regulation (EU) 648/2012 should take into account the different risk profiles of non-financial counterparties that are below the clearing threshold referred to in Article 10 of that Regulation when establishing their risk management procedures for OTC derivative contracts with such entities. It is therefore appropriate to allow counterparties to determine whether or not the level of counterparty credit risk posed by a non-financial counterparty that is below that clearing threshold needs to be mitigated through the exchange of collateral. When taking this decision the counterparty credit risk resulting from transacting with the non-financial counterparty should be taken into account together with the size and nature of the OTC derivative contracts. Given that non-financial entities established in a third country that would be below the clearing threshold if established in the Union can be assumed to have the same risk profile as non-financial counterparties below the clearing threshold established in the Union, the same approach should be applied to them in order to prevent regulatory arbitrage.

⁶ OJ L 201, 27.7.2012.

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- (4) A CCP may enter into non-centrally cleared OTC derivative contracts in the context of customer position management upon the insolvency of a clearing member. These trades are subject to requirements on the part of the CCP and are reviewed by the competent authorities. These non-centrally cleared OTC derivative contracts are an important component of a robust and efficient risk management processes for a CCP. The additional liquidity needs that those trades could trigger, were they covered by regulatory margin requirements, would fall under the responsibility of the CCP. As this would potentially increase systemic risk, instead of mitigating it, rules on the management procedures prescribed in this Regulation should not apply to the above-mentioned case.
- (5) Counterparties of OTC derivatives contracts need to be protected from the risk of a potential default of the counterparty. Therefore, two types of collateral in the form of margins are necessary to properly manage the risks to which those counterparties are exposed. The first type is variation margin, which protects counterparties against exposures related to the current market value of their OTC derivative contracts. The second type is initial margin which protects against expected losses which could stem from movements in the market value of the derivatives position occurring between the last exchange of variation margin before the default of a counterparty and the time that OTC derivative contracts are replaced or the corresponding risk is hedged.
- (6) Initial margins cover current and potential future exposure due to the default of the other counterparty and variation margins reflect the daily mark-to-market of outstanding contracts, for OTC derivatives that imply the payment of a premium upfront to guarantee the performance of the contract, the counterparty receiving the payment of the premium is not exposed to current or potential future exposure if the counterparty paying the premium defaults and the daily mark-to-market is already covered by the premium paid. Therefore the counterparty collecting the premium should not collect additional initial or variation margins for these type of OTC derivatives, whereas the counterparty paying the premium should collect both initial and variation margins.
- (7) While dispute resolution processes contained in bilateral agreements between counterparties are useful for minimising the length and frequency of disputes, counterparties should in a first stage collect at least the undisputed amount in case the amount of a margin call is disputed. This will mitigate the risk arising from the disputed transactions and therefore ensure that OTC derivative contracts are collateralised in accordance with this Regulation. However, both parties should make all necessary and appropriate efforts, including timely initiation of dispute resolution protocols, to resolve the dispute and exchange any required margin in a timely fashion.
- (8) In order to guarantee a level playing field across jurisdictions, where a counterparty established in the Union enters into a OTC derivative contract with a counterparty that is established in a third country and would be subject to the requirements of this Regulation if it was established in the Union initial and variation margin should be exchanged in both directions. Counterparties remain subject to the obligation of



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assessing the legal enforceability of the bilateral agreements of the effectiveness of the segregation agreements. When such assessments highlight the potential for the non-compliance of the agreements with this Regulation, European counterparties should identify alternative processes to post collateral, such as relying on third-party banks or custodians domiciled in jurisdictions where those requirements can be guaranteed.

- (9) It is appropriate to allow counterparties to apply a minimum transfer amount when exchanging collateral in order to reduce the operational burden of exchanging limited sums when exposures move only slightly. However, it should be ensured that such minimum transfer amount is used as an operational tool and not with the view to serving as an uncollateralised credit line between counterparties.
- (10) For operational reasons it might be more appropriate to have separate minimum transfer amounts for initial and variation margin. In those cases it should be possible for counterparties to agree on two separate minimum transfer amounts for variation and initial margin with respect to OTC derivative contracts subject to this Regulation. However, the sum of the separate minimum transfer amounts shall not exceed the maximum minimum transfer amount as set out in this Regulation.
- (11) Counterparties may choose to cover exposures arising from price variations of their OTC derivative contracts in cash. In this case, the credit arising in connection with such exposures shall be considered to have been settled, considered as a payment and therefore not subject to any haircut. Alternatively counterparties may opt to collateralise these exposures with eligible assets. In order to cover the credit, market or foreign exchange risks of these assets, appropriate haircuts should apply.
- (12) When setting the level of initial margin requirements that counterparties should collect from each other, the proposals of the international standard setting bodies referred to in Recital 24 of the Regulation (EU) No 648/2012 explicitly considered two aspects. The first one is the availability of high credit quality and liquid assets covering the initial margin requirements. The second is the proportionality principle, as smaller financial and non-financial counterparties might be hit in a disproportionate manner from the initial margin requirements. In order to maintain a level playing field, this Regulation should introduce a threshold below which two counterparties are not required exchanging initial margin that is exactly the same as in the international agreements. This should substantially alleviate costs and operational burden for smaller participants and address the concern on high credit quality and liquid assets without undermining the general objectives of Regulation (EU) No 648/2012.
- (13) While the thresholds should always be calculated at group level, investment funds should be treated as a special case as they can be managed by a single investment advisor and improperly captured as a single group. Therefore, where the funds are distinct segregated pool of assets, they are not collateralised, guaranteed or supported by other investment funds or the investment advisor itself, and as a result are relatively risk remote from the rest of the group, they should be treated as separate entities when calculating the thresholds. This approach is consistent with the



recommendations of the international standard setting bodies referred to in Recital 24 of Regulation (EU) No 648/2012.

- (14) In the case of initial margin, it is recognised that these new requirements will have a measurable impact on market liquidity, as assets provided as collateral cannot be liquidated or otherwise reused for the duration of the OTC derivative contract. It is also recognised that such requirements will represent a significant change in market practice and will present certain operational and logistical challenges that will need to be managed as the new requirements come into effect. Taking into account the variation margin already serves for realised fluctuations in the value of OTC derivatives contracts up to the point of default, it is considered proportionate to apply a threshold of EUR 8 billion in gross notional outstanding amounts to the application of the initial margin requirements under this Regulation. Further, counterparties that are above this threshold and therefore subject prima facie to the initial margin requirements would have the option of not collecting initial margin for an amount of up to EUR 50 million. The aggregated gross notional amount of outstanding OTC derivative contracts should be used as the measure as it is, in certain circumstances, an appropriate measure or at least an acceptable proxy for size and complexity of the portfolio of non-centrally cleared OTC derivatives. It is also a measure that is easy to monitor and report. These thresholds are in line with the BCBS-IOSCO framework for non-centrally cleared OTC derivatives.
- (15) Exposures under OTC derivative contracts or to counterparties that are subject to a special treatment according to this Regulation, should also count in the calculation of the aggregated gross notional amount, including those OTC derivative contracts that might not be subject to regulatory requirements on variation or initial margin. This is because they all contribute to the determination of size or complexity of the portfolio of a counterparty. Therefore non-centrally cleared OTC derivatives such as physically-settled FX swaps and forwards, cross currency swaps, swaps associated to covered bonds for hedging purposes and derivatives with respect to exempted counterparties are also relevant for determining the size, scale or complexity of the counterparty and should therefore count such OTC derivative contracts towards its calculation of the thresholds.
- (16) The definition of a group included in Regulation (EU) No 648/2012 is relevant also for all requirements prescribed in this Regulation when referring to ‘group’ or ‘group level’.
- (17) It is appropriate to set out in this Regulation special risk management procedures for certain types of products that show particular risk profiles. The exchange of variation margin without initial margin should be considered an appropriate exchange of collateral for selected physically-settled foreign exchange (‘FX’) products consistently with the proposals of the international standard setting bodies. Similarly, as cross-currency swaps can be decomposed in a sequence of foreign exchange forwards, only the interest rate component should be covered by initial margin.
- (18) Recital (24) of Regulation (EU) No 648/2012 states that this Regulation should take into account the impediments faced by covered bonds issuers or cover pools in



providing collateral. Under a specific set of conditions, covered bonds issuers or cover pools should therefore not be required to post collateral. This includes the case where the relevant OTC derivative contracts are only used for hedging purposes and where a regulatory overcollateralization is required. This should ensure that the risks for the counterparties of covered bonds issuers or cover pools are limited, while providing some flexibility for covered bonds issuers or cover pools.

- (19) Covered bond issuers or cover pools may face legal impediments to posting and collecting non-cash collateral for initial or variation margin or posting variation margin in cash. However, there are no constraints on a covered bond issuer or cover pool to return cash previously collected as variation margin. Counterparties of covered bond issuers or cover pools should therefore be required to post variation margin in cash and should have the right to get back part or all of it. Therefore this Regulation should require counterparties of the covered bond issuer or cover pool to post variation margin but not require the latter to post variation margin if not for the amount in cash that was previously received. The reason behind is that a variation margin payment could be considered a claim that ranks senior with respect to the bond holder claims and this could result in a legal impediment. Similarly, the possibility to substitute or withdraw initial margin could be considered a claim that ranks senior with respect to the bond holder claims facing the same type of constraints.
- (20) The concept of margin period of risk ('MPOR') is the same as that used in Article 272(9) of Regulation (EU) No 575/2013; as such, MPOR refers to the 'time period from the most recent exchange of collateral covering a netting set of OTC derivative contracts with a defaulting counterparty until the OTC derivative contracts are closed out and the resulting market risk is re-hedged'. Nevertheless, as the objectives of the two Regulations differ, and Regulation (EU) No 575/2013 sets out rules for calculating the MPOR for the purpose of own funds requirements, this Regulation should include appropriate rules on the MPOR that are required in the context of the risk management procedures in non-centrally cleared OTC derivatives. The MPOR should take into account the typical settlement cycle applied to exchange of the margins. This Regulation assumes that both initial and variation margin are exchanged by the end of the following business day. If counterparties agree to an extended settlement cycle for exchange of margins, any extension beyond the following business day should be included in the calculation of the MPOR.
- (21) When developing initial margin models and when estimating the appropriate MPOR, counterparties should take into account the need to have models that capture the liquidity of the market, the number of participants in that market and the volume of the relevant OTC derivative contracts. At the same time there is the need to rely on a model that both parties can understand, reproduce and on which they can rely to solve disputes. Therefore counterparties should be allowed to calibrate the model and estimate MPOR dependent only on market conditions without the need to adjust their estimates to the characteristics of specific counterparties. This in turn implies that counterparties may choose to adopt different models to calculate the initial margin from each other, and that the initial margin requirements are not symmetrical.

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- (22) While there is the need for recalibrating an initial margin model with sufficient frequency, a new calibration might lead to unexpected levels of margin requirements. For this reason, an appropriate time period should be established, during which margins may still be exchanged based on the previous calibration. This should allow counterparties to have enough time to comply with margin calls resulting from the recalibration.
- (23) Collateral should be considered as being freely transferable in the case of a default of the collateral provider if there are no regulatory or legal constraints or third party claims, including those of the third party custodian. However, certain claims, such as costs and expenses incurred for the transfer of the collateral, in the form of liens routinely imposed on all securities' transfer should not be considered an impediment. Otherwise it would lead to a situation where an impediment would always be identified.
- (24) The collateral taker should have the operational capability to appropriate and, if necessary, liquidate the collateral in the case of a default of the collateral provider. It should also be able to use the cash proceeds of liquidation to enter into an equivalent contract with another counterparty or to hedge the resulting risk. Existing access to the market should be a pre-requisite for the collateral taker to enable it to either sell the collateral or repo it within a reasonable amount of time. This capability should be independent of the collateral provider and should therefore include having broker arrangements, repo arrangements with other counterparties or comparable measures.
- (25) Collateral collected must be of sufficiently high liquidity and credit quality to allow the collecting counterparty to liquidate the positions without significant price changes in case the other counterparty defaults. The credit quality of the collateral should be assessed relying on recognised methodologies such as the ratings of external credit assessment institutions. In order to mitigate the risk of mechanistic reliance on external ratings, however, this Regulation should introduce a number of additional safeguards. These include the possibility to use an approved Internal Rating Based model and the possibility to delay the replacement of collateral that becomes ineligible due to a rating downgrade, with the view to efficiently mitigating potential cliff effects that may arise from excessive reliance on external credit assessments.
- (26) While haircuts mitigate the risk that collected collateral is not sufficient to cover margin needs in a time of financial stress, other risk mitigants should also be considered when accepting non-cash collateral. In particular, counterparties should ensure that the collateral collected is reasonably diversified in terms of individual issuers, issuer types and asset classes. As a result, this Regulation should include such requirements.
- (27) The impact on financial stability of collateral liquidation by when non-systemically important counterparties may be expected to be limited. Further, concentration limits on collateral might be burdensome for counterparties with small OTC derivative portfolios. Therefore, even though collateral diversification is a valid risk mitigant, non-systemically important counterparties should not be required to diversify



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collateral. On the other hand, systemically important financial institutions and other counterparties with large OTC derivative portfolios should apply the concentration limits to all collateral, including Member States' sovereign debt securities. It is considered that these counterparties are sophisticated enough to either transform collateral or to have access to multiple markets and issuers to sufficiently diversify the collateral posted. A number of institutions are already identified as systemically important under Union law in accordance with Article 131 of Regulation 575/2013. However, given the broad scope of Regulation (EU) 648/2012, a quantitative threshold should be introduced so that the requirements for concentration limits apply also to counterparties that might not fall under the existing classifications of systemically important institutions but that can nonetheless be considered systemically important because of the size of their OTC derivative portfolio.

- (28) In order to limit the interconnectedness between financial institutions that may arise from non-centrally cleared derivative contracts, concentration limits should apply to the classes of debt securities issued by the financial sector. Therefore, stricter diversification requirements for debt securities issued by institutions used as collateral for variation or initial margin purposes should be introduced.
- (29) The value of collateral should not exhibit a significant correlation with the creditworthiness of the collateral provider or the value of the underlying non-centrally cleared derivatives portfolio because this would undermine the effectiveness of the protection offered by the collateral collected. Accordingly, securities issued by the collateral provider or its related entities should not be accepted as collateral. Counterparties should be required to monitor that collateral collected is not subject to more general forms of wrong way risk.
- (30) It should be possible to liquidate assets collected as collateral for initial or variation margin in a sufficiently short time in order to protect collecting counterparties from losses on non-centrally cleared OTC derivatives contracts in the event of a counterparty default. These assets should therefore be highly liquid and should not be exposed to excessive credit, market or foreign exchange risk. To the extent that the value of the collateral is exposed to these risks, appropriately risk-sensitive haircuts should be applied.
- (31) In order to ensure timely transfer of collateral, counterparties should have efficient operational processes in place. This requires that the processes for the bilateral exchange of collateral are sufficiently detailed, transparent and robust. A failure by counterparties to agree and provide an operational framework for efficient calculations, notification and settlement of margin calls can lead to disputes and fails that result in uncollateralised exposures under OTC derivative contracts. As a result, it is essential that counterparties set clear internal policies and standards in respect of collateral transfers. Any deviation from those standards should be rigorously reviewed by all relevant internal stakeholders that are required to authorise those deviations. Furthermore, all applicable terms in respect of operational exchange of collateral should be accurately recorded in detail in a robust, prompt and systematic way.

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- (32) Trading relationship documentation should be executed by counterparties entering into multiple OTC derivative contracts in order to provide legal certainty. As a result, the trading relationship documentation should include all material rights and obligations of the counterparties applicable to non-centrally cleared OTC derivative contracts. Where parties enter into single, one-off OTC derivative contract, trading relationship documentation could take the form of a trade confirmation that includes all material rights and obligations of the counterparties.
- (33) Collateral protects the collecting counterparty from the default of the posting counterparty. However, both counterparties are also responsible for ensuring that the collateral collected does not increase the risk for the posting counterparty in case the collecting counterparty defaults. For this reason, the bilateral agreement between the counterparties should allow both counterparties to access the collateral in a timely manner when they have the right to do so, hence the need for rules on segregation and for rules providing for an assessment of the effectiveness of the agreement in this respect, taking into account the legal constraints and the market practices of each jurisdiction.
- (34) The re-hypothecation, re-pledge or re-use of collateral collected as initial margins would create new risks due to claims of third parties over the assets in the event of a default. Legal and operational complications could delay the return of the collateral in the event of a default of the initial collateral taker or the third party or make it even impossible. In order to preserve the efficiency of the framework and ensure a proper mitigation of counterparty credit risks, the re-hypothecation, re-pledge or re-use of collateral collected as initial margin should therefore not be permitted. Nevertheless, collateral taker or the custodian should be allowed to secure cash posted or deposited as initial margin by re-investing it in eligible securities as long as this is done to protect the collateral poster.
- (35) When a counterparty notifies the competent authority regarding the exemption of intragroup transactions, in order for the competent authority to decide whether the conditions for the exemption are met, the counterparty should provide a complete file including all relevant information.
- (36) For a group to be deemed to have adequately sound and robust risk management procedures a number of conditions have to be met. The group should ensure a regular monitoring of the intragroup exposures. The settlement of the obligations resulting from the intragroup OTC derivative contracts should also be guaranteed. Furthermore, the monitoring and liquidity tools at group level should be consistent with the complexity of the intragroup transactions.
- (37) In order to use the exemption for intragroup transactions, it must be certain that no legislative, regulatory, administrative or other mandatory provisions of applicable law could legally prevent the intragroup counterparties from meeting their obligations to transfer monies or repay liabilities or securities under the terms of the intragroup transactions. Similarly, there should be no operational or business practices of the intragroup counterparties or the group that could result in funds not

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being available to meet payment obligations as they fall due on a day-to-day basis, or in prompt electronic transfer of funds not being possible.

- (38) Taking into account the principle of proportionality, counterparties that have smaller portfolios and therefore generally smaller operations should be allowed more time to adapt their internal systems and processes in order to comply with the requirements of this Regulation. In order to achieve a proper balance between mitigating the risks of OTC derivatives and the proportionate application of this Regulation, as well as achieve international consistency and minimise possibilities of regulatory arbitrage with the view to avoiding economic disruptions, a phase-in period of the requirements is necessary. The phase-in period for the requirements introduced in this Regulation are consistent with the schedule agreed in the BCBS-IOSCO framework for non-centrally cleared OTC derivatives.
- (39) In order to avoid any retrospective effect of this Regulation, the requirements hereunder should apply only to new contracts entered into after the relevant phase-in dates. Exchanges of variation margin and initial margin on contracts entered into before these dates should not be subject to the regulatory obligation to modify the existing bilateral agreements as this would impact their market value.
- (40) The BCBS and IOSCO are expected to perform a coordinated review of the international standards on margins including implementation and interaction with other regulatory requirements once they are in place and there is some experience with their functioning across various jurisdictions. Given the need to be consistent with those international standards it may become necessary to review the provisions of this Regulation after such a review.
- (41) This Regulation is based on the draft regulatory technical standards submitted by the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority to the Commission.
- (42) The European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority have conducted open public consultations on the draft regulatory technical standards on which this Regulation is based, analysed the potential related costs and benefits and requested the opinion of the Banking Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1093/2010⁷, the opinion of the Insurance and Reinsurance Stakeholder Group and the Occupational Pensions Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1094/2010⁸, and the

⁷ Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2010, p. 12).

⁸ Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC (OJ L 331, 15.12.2010, p. 48).



Securities and Markets Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1095/2010⁹,

HAS ADOPTED THIS REGULATION:

CHAPTER 1 - Counterparties' Risk Management Procedures required for compliance with paragraph 3 of Article 11 of Regulation (EU) No 648/2012

Section 1 - Overview of the procedures

Article 1 GEN - General counterparties' risk management procedures

1. The risk management procedures required for compliance with paragraph 3 of Article 11 of Regulation (EU) No 648/2012 shall apply to financial counterparties within the meaning of Article 2(8) of Regulation (EU) No 648/2012 and non-financial counterparties referred to in Article 10 of Regulation (EU) No 648/2012 ('counterparties').
2. The risk management procedures required for compliance with paragraph 3 of Article 11 of Regulation (EU) No 648/2012 shall apply throughout the life of all OTC derivative contracts that were subject to the requirements of this Regulation at the contract's inception.
3. The risk management procedures required for compliance with paragraph 3 of Article 11 of Regulation (EU) No 648/2012 shall provide for all of the following, unless otherwise provided in accordance with Articles 2 GEN to 4 GEN:
 - (a) the collection of collateral, in the following two ways:
 - i. as initial margin, in accordance with Article 1 EIM, without the possibility of offsetting the initial margin amounts between the two counterparties;
 - ii. as variation margin in accordance with Article 1 VM;
 - (b) the ex-ante agreement between counterparties on a list of eligible collateral fulfilling the requirements of Article 1 LEC.
4. For the purposes of point (i) of paragraph 3(a), initial margin means the collateral collected by a counterparty to cover its current and potential future exposure in the interval between the last margin collection and the liquidation of positions following a default of the other counterparty or hedging the risk.

⁹ Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC (OJ L 331, 15.12.2010, p. 84).

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5. For the purposes of point (ii) of paragraph 3(a), variation margin means the collateral collected or paid out to reflect the results of the daily marking-to-market of outstanding contracts referred to in Article 11(2) of Regulation (EU) No 648/2012.
6. The collateral referred to in point (a) of paragraph 3 shall meet the eligibility criteria referred to in Section 5, and shall be adjusted according to the modalities referred to in Articles 1 HC and 2 HC of that Section.

Section 2 - Risk management procedures for specific cases

Sub-section 1 - Potential exemptions from the requirement to collect collateral

Article 2 GEN - Non-Financial Counterparties

Explanatory text for consultation:

Some of the respondents to the first Consultation Paper commented that the treatment of non-financial counterparties domiciled outside the Union could be seen as inconsistent with the principles of the Basel Committee and IOSCO. The ESAs, recognising the fact that the risk profile of exposures to non-financial counterparties should be treated in the same way as they were domiciled in the Union are therefore consulting on this new draft.

Question 1. Respondents are invited to comment on the proposal in this section concerning the treatment of non-financial counterparties domiciled outside the EU.

Risk management procedures required for compliance with paragraph 3 of Article 11 of Regulation (EU) No 648/2012 may include the provision that no collateral is exchanged in relation to transactions with certain non-financial counterparties other than those referred to in Article 10 of Regulation (EU) No 648/2012; or non-financial entities established in a third country that would be considered non-financial counterparties other than those referred to in Article 10 of Regulation (EU) No 648/2012 if established in the Union OTC derivative contracts.

Article 3 GEN – Transactions with third country counterparties

Where a counterparty referred to in Article 1(1) GEN, which is established in the Union enters into a OTC derivative contract with a counterparty that is established in a third country and would be subject to the requirements of this Regulation if it was established in the Union, the risk management procedures shall include that initial and variation margin are exchanged between the counterparties and that the collateral is maintained and protected, in accordance with this Regulation.

Article 4 GEN - Minimum Transfer Amount

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1. Risk management procedures required for compliance with paragraph 3 of Article 11 of Regulation (EU) No 648/2012 may provide that no collateral is collected where the amount due from the last collection of collateral is equal to or lower than a certain amount to be agreed by the counterparties ('minimum transfer amount') and which cannot be higher than EUR 500 000.
2. Where counterparties agree on a minimum transfer amount, the amount due shall be calculated as the sum of :
 - (a) the variation margin due from its last collection calculated in accordance with Article 1 VM;
 - (b) the initial margin due from its last collection calculated in accordance with Article 1 EIM;
 - (c) any excess collateral that may have been provided to or returned by both counterparties.
3. Where the amount due to the counterparty collecting collateral exceeds the minimum transfer amount agreed by the counterparties in accordance with paragraph 2, the risk management procedures shall provide that the counterparty collecting collateral collects the full amount without deduction of the minimum transfer amount.

Article 1 CCP - Treatment of OTC derivative contracts in the context of a CCP's position management upon the insolvency of a clearing member

Risk management procedures required for compliance with paragraph 3 of Article 11 of Regulation (EU) No 648/2012 may provide that no initial margin or variation margin is collected in relation to the OTC derivative contracts referred to in Annex II, paragraph 2 of Regulation (EU) No 153/2013¹⁰.

Sub-section 2 - Potential exemptions in calculating levels of initial margin

Article 5 GEN - Foreign Exchange Contracts

Risk management procedures required for compliance with paragraph 3 of Article 11 of Regulation (EU) No 648/2012 may include provisions that initial margins are not collected with respect to:

¹⁰ Commission Delegated Regulation (EU) No 153/2013 of 19 December 2012 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on requirements for central counterparties (OJ, L52, 23 February 2013, p.41).



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- (a) physically settled OTC derivative contracts that solely involve the exchange of two different currencies on a specific future date at a fixed rate agreed at the inception of the contract covering the exchange ('foreign exchange forwards');
- (b) physically settled OTC derivative contracts that solely involve an exchange of two different currencies on a specific date at a fixed rate that is agreed at the inception of the contract covering the exchange; and a reverse exchange of the two currencies at a later date and at a fixed rate that is agreed at the inception of the contract covering the exchange ('foreign exchange swaps');
- (c) the exchange of principal of an OTC derivative contract by which the two counterparties solely exchange the principal (and any interest) payments in one currency for the principal (and any interest) payments in another currency at some points in the future according to a specified formula ('currency swap').

Article 6 GEN - Threshold based on initial margin amount

1. Risk management procedures required for compliance with paragraph 3 of Article 11 of Regulation (EU) No 648/2012 may provide that initial margins are not collected where the total initial margin required to be collected from a counterparty, in accordance with Section 3, for OTC derivative contracts with that counterparty, calculated at the group level, is equal to or lower than EUR 50 million.
2. Where counterparties apply the threshold referred to in paragraph 1, the following shall apply:
 - (a) counterparties may reduce the amount of initial margin collected by the value of the threshold;
 - (b) the risk management procedures shall include determining how to allocate the received initial margin amongst the relevant entities within the group;
 - (c) the risk management procedures shall include monitoring, at the group level, of whether the threshold is exceeded and the maintenance of appropriate records of its exposures to each single counterparty in the same group.
3. Investment funds that are managed by a single investment advisor may be considered distinct entities and treated separately in the course of applying the thresholds referred to in paragraph 1, only where the funds are distinct segregated pools of assets for the purposes of fund insolvency or bankruptcy that are not collateralised, guaranteed or supported by other investment funds or the investment advisor itself.

Article 7 GEN - Threshold based on notional amount

1. Risk management procedures may provide that initial margins are not collected for all new contracts from January of each calendar year where one of the two counterparties has or belongs to a group which has an aggregate month-end average

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notional amount of non-centrally cleared derivatives for the months June, July and August of the preceding year below EUR 8 billion.

2. For the purposes of calculating the group aggregate month-end average notional amount all non-centrally cleared OTC derivative contracts of the group shall be included.
3. Investment funds that are managed by a single investment advisor may be considered distinct entities and treated separately in the course of applying the thresholds referred to in paragraph 1, only where the funds are distinct segregated pools of assets for the purposes of fund insolvency or bankruptcy that are not collateralised, guaranteed or supported by other investment funds or the investment advisor itself.

Sub-section 3 - Potential exemptions from the requirement to post or collect initial or variation margin

Article 8 GEN - Treatment of derivatives associated to covered bonds for hedging purposes

1. Subject to the conditions set out in paragraph 2, risk management procedures required for compliance with paragraph 3 of Article 11 of Regulation (EU) No 648/2012, relating to derivatives associated to covered bonds may specify the following:
 - (a) that variation margin is not posted by the covered bond issuer or cover pool;
 - (b) that initial margin is not posted or not collected or neither;
2. Paragraph 1 applies where all of the following conditions are met:
 - (a) the OTC derivative contract is not terminated in case of resolution or insolvency of the covered bond issuer or cover pool;
 - (b) the counterparty to the OTC derivative contract ranks at least pari passu with the covered bond holders except where the counterparty to the OTC derivative concluded with covered bond issuers or with cover pools for covered bonds is the defaulting or the affected party;
 - (c) the OTC derivative contract is registered or recorded in the cover pool of the covered bond in accordance with national covered bond legislation;
 - (d) the OTC derivative contract is used only to hedge the interest rate or currency mismatches of the cover pool in relation to the covered bond;
 - (e) the netting set as defined in Article 272(4) of Regulation (EU) 575/2013 ('netting set') does not include OTC derivative contracts unrelated to the cover pool of the covered bond;



- (f) the covered bond to which the derivatives are associated meets the requirements of Article 129 of Regulation (EU) No 575/2013;
- (g) the cover pool of the covered bond to which the OTC derivative contract is associated is subject to a regulatory collateralisation requirement of at least 102%.

Section 3 - Calculation and collection of margins

Text for consultation

Some respondents to the first public consultation noticed that the requirement to complete the collection of margins margin within the following business day ('T+1') of the first Consultation Paper may be unfeasible because it was not considering some of the operational delays that, in certain circumstances, are unavoidable. In particular this refers to time zone differences and margin calls reconciliations. However, as the daily exchange of margins is considered a core component of the entire framework, the current proposal remain similar to the one in the first consultation paper identifying very limited circumstances where the exchange of variation margin can occur less frequently than on a daily basis.

Question 2. Respondents are invited to comment on the proposal in this section concerning the timing of calculation, call and delivery of initial and variation margins.

Article 1 VM - Variation margin

1. Counterparties shall calculate their variation margin at least on a daily basis. The calculation shall be based on the current valuation, performed in accordance with Article 11(2) of Regulation (EU) No 648/2012 and Articles 16 and 17 of the Commission Delegated Regulation No 149/2013. The amount of variation margin to be collected is the outstanding balance between the aggregated value of all contracts in the netting set and the balance of all variation margin previously posted, collected or settled against this value.
2. Variation margins shall be collected in one of the following ways:
 - (a) by settling exposures in cash;
 - (b) by collecting non-cash collateral in accordance with Section 3, subject to the haircuts requirements referred to in Section 4.
3. Variation margins shall be collected within 3 business days from the calculation date.



4. For all netting sets for which the collection of variation margin can exceed one business day, the MPOR referred to in Article 2 MRM (2) shall be increased by the number of days in between the calculation and the collection.
5. For all netting sets where no initial margin is required, because of the potential exceptions of Section 1, Chapter 1 of this Regulation, the collection shall not exceed one business day.
6. In the event of a dispute over the amount of variation margin due for collection, counterparties shall collect at least the undisputed amount.

Article 1 EIM - Initial margins

1. Counterparties shall calculate and call initial margin in accordance with paragraphs 2 and 3 using either the standardised approach laid down in Article 1 SMI ('Standardised Method') or the initial margin models laid down in Articles 1 MRM to 6 MRM ('initial margin models').
2. The counterparties shall agree on the method each counterparty uses to determine the initial margin it has to collect. Where one or both counterparties rely on an initial margin model they shall agree on the characteristics of the model and on the data used for the calibration. Counterparties may use different methods to determine the initial margins they collect, and are not required to agree on a common methodology.
3. Counterparties shall calculate and collect the total amount of initial margins within one business day following one of these events:
 - (a) when a new OTC derivative contract is executed or added to the netting set;
 - (b) when an existing OTC derivative contract expires or is removed from the netting set;
 - (c) when an existing OTC derivative contract triggers a payment or a delivery other than the posting and collecting of margins;
 - (d) when, under the standardised method, an existing contract is reclassified in terms of the asset category referred to in Article 1 SMI as a result of reduced time to maturity;
 - (e) when no calculation has been performed in the preceding ten business days.
4. Initial margins shall be collected in one of the following ways:
 - (a) collecting in cash;
 - (b) by collecting non-cash collateral in accordance with Section 3, subject to the haircuts requirements referred to in Section 4.



5. In the event of a dispute over the amount of initial margin due for collection, counterparties shall collect at least the undisputed amount.

Section 4 - Margin methods

Explanatory text for consultation

Respondents to the first Consultation Paper noticed that the treatment of derivatives that present no counterparty credit risk for one of the two counterparties, such as short options with the premium paid in advance, was not clear. Therefore, the new Recital (6) under both the standardised method and the initial margin models, the counterparty that is not exposed to any counterparty credit risk is allowed not to include those trades in the initial margin calculations.

Article 1 SMI - Standardised Method

Where counterparties apply the Standardised Method, the initial margin for each netting set shall be calculated in accordance with Annex IV.

Article 1 MRM - Initial margin models

1. An initial margin model may be:
 - (a) developed by one of the two counterparties or jointly by the two counterparties;
 - (b) provided by a third party agent.
2. Where a model is provided by a third party, the counterparty collecting the margin shall remain responsible for ensuring compliance of the model with the requirements referred to in this Section.
3. If an initial margin model ceases to comply with the relevant requirements of this Section, a counterparty using that model shall calculate the initial margins to be collected using the Standardised Method for all the netting sets for which the requirements are not met.
4. At the request of one of the two counterparties the other counterparty shall provide all the information necessary to explain the determination of a given value of initial margin in a way that a knowledgeable third party would be able to replicate the calculation.

Article 2 MRM - Confidence interval and risk horizon

1. In order to qualify for the purposes of Article 1 EIM, the assumed variations in the value of the contracts in the netting set for the calculation of initial margins using an



initial margin model shall be based on a one-tailed 99 percent confidence interval over a margin period of risk of at least 10 days.

2. The margin period of risk of a netting set for the calculation of initial margins using an initial margin model shall include:
 - (a) the period that may elapse from the last collection of variation margin to the default of the counterparty;
 - (b) the estimated period needed to replace the OTC derivative contracts or hedge the risks taking into account the level of liquidity of the market where that type contracts or risks are traded, the total volume of the OTC derivative contracts in that market and the number of participants in that market.

Article 3 MRM - Calibration of the model

1. Initial margin models shall be calibrated based on historical data from a period of at least three years and not exceeding five years.
2. The data used in initial margin models shall include the most recent continuous period from the calibration date and shall contain at least 25% of data representative of a period of significant financial stress ('stressed data').
3. Where the most recent data period does not contain at least 25% of stressed data, the least recent data in the time series shall be replaced by data from a period of significant financial stress, until the overall proportion of stressed data is at least 25% of the overall data set.
4. The period of financial stress used for calibration shall be identified and applied separately at least for each of the asset classes referred to in Article 4 MRM (2).
5. The model shall be calibrated using equally weighted data.
6. The parameters may be calibrated for shorter periods than the margin period of risk and scaled up to the margin period of risk by an appropriate methodology.
7. The model shall be recalibrated at least every 12 months. Counterparties shall have written policies which set out the circumstances that would trigger an earlier recalibration.
8. Counterparties shall establish procedures for adjusting margin requirements in response to changing market conditions. These procedures may allow each counterparty to post the additional initial margin resulting from the recalibration of the model over a period that ranges between one and thirty business days.
9. The data used in the model shall be subject to a process that ensures their quality.



10. Proxies shall be appropriately conservative and shall be used only where available data is insufficient or is not reflective of the true volatility of an OTC derivative contract or portfolio of OTC derivative contracts;

Article 4 MRM - Diversification, hedging and risk offsets across underlying classes

Explanatory text for consultation

Respondents to the first Consultation Paper commented that the requirement to assign every single trade to a specific asset class instead of calculating all the sensitivities to the relevant risk factors had two major drawbacks. First, the approach would have been more restrictive than the wording in the BCBS-IOSCO framework and, second, that this would have implied a substantial increase of the IM requirements. On the top of that, operational processes would need to change. In order to avoid unintended consequences and with the intention to preserve the overall principle of limiting the offset between well-defined asset classes, the ESAs are consulting on a new draft of the RTS that allows more flexibility in the modelling phase which at the same time uphold the principle in the BCBS-IOSCO framework.

Question 3. Respondents are invited to provide comments on whether the draft RTS might produce unintended consequences concerning the design or the implementation of initial margin models.

1. Initial margin models shall include only OTC derivative contracts not centrally cleared. Initial margin models may account for diversification, hedging and risk offsets arising from the risks of OTC derivative contracts that are in the same netting set. Initial margin models may account for diversification, hedging and risk offsets within the same underlying asset class referred to in paragraph 2 and not across such classes.
2. For the purpose of paragraph 1, the following underlying asset classes shall be considered:
 - (a) interest rates, currency and inflation;
 - (b) equity;
 - (c) credit;
 - (d) commodities and gold;
 - (e) other.

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3. The total initial margin requirements for a netting set shall be the sum of initial margin requirements calculated for the OTC derivative contracts assigned to each underlying asset class within the netting set.

Article 5 MRM - Integrity of the modelling approach

1. Initial margin models shall be conceptually and practically sound and shall capture all the risk drivers that are material for the OTC derivative contracts included in the netting set.
2. Counterparties shall estimate the initial margin to be collected without taking into account any correlations between the unsecured exposure and the collateral.
3. Initial margin models shall meet the following requirements:
 - (a) the model shall incorporate risk factors corresponding to the individual foreign currencies in which the OTC derivative contracts in the netting sets are denominated;
 - (b) the model shall incorporate interest rate risk factors corresponding to the individual foreign currencies in which the OTC derivative contracts are denominated;
 - (c) for exposures to interest-rate risk in the major currencies and markets, the yield curve shall be divided into a minimum of six maturity buckets;
 - (d) the model shall capture the risk of less than perfectly correlated movements between different yield curves and between different maturity buckets;
 - (e) the model shall use a separate risk factor at least for each equity or equity index that is significant for the netting set;
 - (f) the model shall use a separate risk factor at least for each commodity or commodity index which is significant for the OTC derivative contracts within a netting set;
 - (g) the model shall conservatively assess the risk arising from less liquid positions and positions with limited price transparency under realistic market scenarios.
 - (h) the model shall capture the idiosyncratic risk for credit underlying;
 - (i) the model shall capture the risk of less than perfectly correlated movements between similar, but not identical, underlying risk factors and the exposure to changes in values arising from maturity mismatches;
 - (j) the model shall capture main non-linear dependences.

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4. The performance of the model shall be monitored on a continuous basis; this analysis shall include a comparison between the risk measures generated by the model and realized risk measures ('back-testing') every three months. The counterparties shall retain records of the results of this analysis.
5. Counterparties' policies and procedures shall outline the methodologies used for undertaking back-testing, including statistical tests of performance.
6. Counterparties' procedures shall clearly identify what results of the back-testing shall trigger a recalibration of the model.
7. The modelling approach shall reflect the nature, scale and complexity of the risks inherent in the underlying OTC derivative contracts. The initial margin model shall be calibrated in a sufficiently conservative manner such that aspects like parameter uncertainty, correlation, basis risk and data quality are properly captured.

Article 6 MRM - Qualitative requirements

1. Initial margin models shall be subject to an internal governance process that continuously assesses the validity of the risk assessments produced by the model and tests such assessments against realized data. In particular, they shall meet all of the following qualitative requirements:
 - (a) an initial validation shall be carried out by suitably qualified and independent parties;
 - (b) a follow up validation shall be conducted whenever a significant change is made to the initial margin model and at least once a year;
 - (c) an audit process shall be regularly conducted to assess the integrity and reliability of the data sources and the management information system used to run the model, the accuracy and completeness of data used, the accuracy and appropriateness of volatility and correlation assumptions.
2. The documentation of the risk management procedures shall meet all of the following conditions:
 - (a) it shall be sufficient to ensure that any knowledgeable third-party would be able to understand the design and operational detail of the initial margin model;
 - (b) it shall contain the key assumptions and the limitations of the initial margin model;
 - (c) it shall define the circumstances under which the assumptions of the initial margin model should no longer be considered valid.



3. The counterparties shall maintain clear documentation showing all changes to the initial margin model and detailing the tests performed.

Section 5 - Eligibility and treatment of collateral

Article 1 LEC - Eligible collateral for initial and variation margin

For the purposes of Article 11(3) of Regulation (EU) No 648/2012, asset classes for which the counterparty has no access to the market or is unable to liquidate the collateral in a timely manner in case of default of the posting counterparty shall not be eligible. A counterparty shall only collect collateral for the purposes of Article 11(3) of Regulation (EU) No 648/2012, from the asset classes listed below:

- (a) cash in the form of money credited to an account in any currency, or similar claims for the repayment of money, such as money market deposits;
- (b) gold in the form of allocated pure gold bullion of recognised good delivery;
- (c) debt securities issued by Member States' central governments and central banks;
- (d) debt securities issued by Member States' regional governments or local authorities according to Article 115 (2) of Regulation (EU) No 575/2013;
- (e) debt securities issued by Member States' public sector entities according to Article 116 (4) of Regulation (EU) No 575/2013;
- (f) debt securities issued by Member States' regional governments or local authorities not meeting the requirements of Article 115 (2) of Regulation (EU) No 575/2013;
- (g) debt securities issued by Member States' public sector entities not meeting the requirements of Article 116 (4) of Regulation (EU) No 575/2013;
- (h) debt securities issued by multilateral development banks listed in Article 117 (2) of Regulation (EU) No 575/2013;
- (i) debt securities issued by the international organisations listed in Article 118 of Regulation (EU) No 575/2013;
- (j) debt securities issued by non-Member States' governments and central banks;
- (k) debt securities issued by non-Member States' regional governments or local authorities that meet the requirements of the first subparagraph of Article 115 (2) of Regulation (EU) No 575/2013 and non-Member States' public sector entities that meet the requirements of Article 116 (4) of Regulation (EU) No 575/2013;



- (l) debt securities issued by non-Member States' regional governments, local authorities not meeting the requirements of the first subparagraph of Article 115 (2) of Regulation (EU) No 575/2013 or non-Member States' public sector entities not meeting the requirements of the first subparagraph of Article 116 (4) of Regulation (EU) No 575/2013;
- (m) debt securities issued by credit institutions and investment firms including bonds referred to in Article 52(4) of Directive 2009/65/EC;
- (n) corporate bonds;
- (o) the most senior tranche of a securitisation, as defined in Article 4(62) of Regulation (EU) 575/2013, that is not a re-securitisation, as defined in Article 4(64) of Regulation (EU) 575/2013;
- (p) convertible bonds provided that they can be converted only into equities which are included in a main index as referred to in point (a) of Article 197 (8) of Regulation (EU) No 575/2013;
- (q) equities included in a main index in accordance with Article 197(8)(a) of Regulation (EU) No 575/2013;
- (r) shares or units in UCITS, provided that the criteria in Article 5 LEC are met.

Article 2 LEC - Collateral Management

1. For the purposes of Article 11(3) of Regulation (EU) No 648/2012, the risk management procedures of the counterparty collecting collateral shall ensure that all of the following are in place:
 - (a) a daily re-evaluation of collateral;
 - (b) legal arrangements and a collateral holding structure to access the received collateral where it is held in third party custody;
 - (c) where initial margin is maintained with the collateral provider, the securities should be maintained in bankruptcy or insolvency remote custody accounts;
 - (d) cash accounts in all the acceptable currencies are maintained with a party other than the collateral provider for depositing cash collateral collected as initial margin and for crediting the proceeds of repurchase agreements on the collateral;
 - (e) the ability to make available the unused collateral to the liquidator or other insolvency official of the defaulted counterparty;



- (f) arrangements to ensure that, in the event of the default of the collecting counterparty, the initial margin is freely and transferable back in a timely manner to the posting counterparty;
- (g) the collateral shall be transferable without any regulatory or legal constraints or third party claims, including those of the liquidator of the collecting counterparty or third party custodian;
- (h) the collateral is returned in whole other than for costs and expenses incurred for that process or other than liens routinely imposed on all securities in a clearing system in which such collateral may be held.

Article 3 LEC - Credit Quality Assessment

1. The collecting counterparty shall assess the credit quality of assets belonging to the asset classes referred to in paragraphs (c), (d) and (e) of Article 1 LEC that are not denominated or funded in the issuer's domestic currency and in paragraphs (f), (g), (j) to (n) and (p) of Article 1 LEC using one of the following methodologies:
 - (a) an approved internal model as referred to in Article 4 LEC;
 - (b) the approved internal model defined in Article 4 LEC of its counterparty, where the counterparty is established in the Union, or third country counterparty, where the third country counterparty is subject to laws of a third country applying prudential supervisory and regulatory requirements equivalent to those applied in the Union in accordance with Article 127 of Directive 2013/36/EU;
 - (c) a credit assessment issued by a recognised ECAI according to Article 4(98) of Regulation (EU) No. 575/2013 or export credit agency referred to in Article 137 of that Regulation.
2. The collecting counterparty shall assess the credit quality of assets belonging to the asset class referred to in paragraph (o) [securitisation] of Article 1 LEC using the methodology referred to in paragraph 1, subparagraph (c) [ECAIs ratings].
3. The risk management procedures shall require that only assets whose credit quality has been assessed with the methodologies in points (a) and (b) internal models or (c) [ECAIs ratings] of paragraph 1 and associated to a credit quality step 3 or above are eligible as collateral for the purposes of Article 11(3) of Regulation (EU) No 648/2012.
4. The risk management procedures shall require that only assets referred to in paragraph 2 [Sovereign debt in non-local currency/ECAIs ratings] associated with credit quality step 4 or above are eligible as collateral for the purposes of Article 11(3) of Regulation (EU) No 648/2012.



5. For the purposes of paragraphs 2, 3 and 4 the credit quality assessment shall be mapped to credit quality steps in accordance with Articles 136 and 270 of Regulation (EU) No 575/2013.
6. The counterparties shall have procedures in place for the case where the credit quality of the collateral assessed using the methodology referred to in subparagraph (c) of paragraph 1 no longer meets the requirements set out in paragraphs 2 to 4. Such procedures shall:
 - (a) prohibit the counterparties from accepting additional collateral assets which no longer meet the level referred to in paragraphs 2 to 4;
 - (b) define a schedule by which already accepted collateral is to be replaced over a period of time not exceeding two months;
 - (c) set a credit quality step level below the levels set out in paragraphs 2 to 4 that requires immediate replacement, for which point (b) does not apply;
 - (d) enable counterparties to increase the haircuts on the relevant collateral over the period set out in subparagraph (b).

Article 4 LEC - Credit Risk Assessment by the collateral taker using the Internal Rating Based Approach

1. Counterparties authorised to use the Internal Rating Based (IRB) approach in accordance with Section 6 of Regulation (EU) No 575/2013 may use their internal ratings in order to assess the credit quality of the collateral collected for the purposes of this Regulation.
2. A counterparty using the IRB approach for the purpose of this Regulation in accordance with paragraph 1, shall determine the credit quality step of the issuer of the security based on Table 1 CQS in Annex I as the highest credit quality step corresponding to a PD equal or lower than the internal rating.
3. A counterparty using the IRB approach for the purpose of this Regulation in accordance with paragraph 1, shall communicate to the other counterparty the credit quality step associated to the securities that are posted as collateral.

Article 5 LEC - Eligibility Criteria for UCITS

1. For the purposes of Article 1 LEC, counterparties may use units or shares in UCITS as eligible collateral where all the following conditions are met:
 - (a) the units or shares have a daily public price quote;
 - (b) the UCITS are limited to investing in instruments that are eligible for recognition under Article 1 LEC;



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- (c) the UCITS meet the conditions laid down in Article 132(3) of Regulation (EU) 575/2013.
2. Where a UCITS invests in shares or units of another UCITS, the conditions laid down in paragraph 1 shall apply equally to any such underlying UCITS.
 3. The use of derivative instruments to hedge permitted investments by a UCITS shall not prevent units or shares in that UCITS from being eligible as collateral.
 4. For the purposes of paragraph 1, where a UCITS ('the original UCITS') or any of its underlying UCITS are not limited to investing in instruments that are eligible under Article 1 LEC, institutions may use units or shares in that UCITS as collateral to an amount equal to the value of the eligible assets held by that UCITS under the assumption that that UCITS or any of its underlying UCITS have invested in non-eligible assets to the maximum extent allowed under their respective mandates.
 5. Where any underlying UCITS has underlying UCITS of its own, institutions may use units or shares in the original UCITS as eligible collateral provided that they apply the methodology in the paragraph 1.
 6. Where non-eligible assets of a UCITS can have a negative value due to liabilities or contingent liabilities resulting from ownership, counterparties shall apply the following steps:
 - (a) calculate the total value of the non-eligible assets;
 - (b) where the amount obtained from point (a) is negative, subtract the absolute value of that amount from the total value of the eligible assets.

Article 6 LEC - Eligibility criteria to avoid wrong way risk

1. The risk management procedures required for compliance with paragraph 3 of Article 11 of Regulation (EU) No 648/2012, shall ensure that securities referred to in points (f), (g) and (k) to (r) of Article 1 LEC fulfil all of the following criteria:
 - (a) they are not issued by the posting counterparty;
 - (b) they are not issued by entities which are part of the same group, as defined in Article 2(16) of Regulation 648/2012, as that of the posting counterparty, nor by entities which have close links with the posting counterparty, as defined in Article 2 (24) of Regulation (EU) No 648/2012;
 - (c) they are not otherwise subject to significant wrong way risk, as defined in Article 291 of Regulation (EU) 575/2013.

Article 7 LEC - Concentration limits for initial and variation margins



Explanatory text for consultation

In accordance with the Basel Committee and IOSCO principles, collateral should be diversified “in terms of an individual issuer, issuer type and asset type”. Recognising that some participants might have constraints in posting collateral different from government debt securities (most often issued by the government of the country where the entity is domiciled), the ESAs are of the opinion that, for this particular asset class, the diversification requirements should only be applied to systemically important institutions.

Question 4. Respondents are invited to comment on whether the requirements of this section concerning the concentration limits address the concerns expressed on the previous proposal.

1. The risk management procedures required for compliance with paragraph 3 of Article 11 of Regulation (EU) No 648/2012, shall prescribe that the collateral collected from an individual counterparty for the purposes of Article 1 GEN meets all of the following conditions:
 - (a) the sum of the values of the securities from the asset classes (b) [gold], (f), (g), (l) [non-EU PSE and regional auth. not meeting conditions] and (n) to (r) referred to in Article 1 LEC] issued by a single issuer or by entities which are part of the same group, as defined in Article 2(16) of Regulation 648/2012 or entities which have close links, according to Article 2 (24) of Regulation (EU) No 648/2012 shall not exceed 10% of the collateral collected from that individual counterparty;
 - (b) the sum of the values of the securities (o), (p), (q) [securitisation, convert. bonds and equities] in Article 1 LEC (1), with (p) and (q) [convert. bonds and equities] issued by institutions as defined in Regulation (EU) No 575/2013, shall not exceed 40% of the collateral collected from that individual counterparty. This limit also applies for (r) [shares in UCITS] where the UCITS is primarily invested in the securities mentioned in this sub paragraph.
2. The risk management procedures shall provide that the collateral collected in excess of EUR 1 billion shall meet the conditions in paragraph 4 where each of the counterparties belong to one of the categories listed in paragraph 3.
3. The categories referred to in paragraph 2 are:
 - (a) institutions identified as global systemically important institutions (“G-SIIs”) in accordance with Article 131 of Directive 2013/36/EU;

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- (b) institutions identified as other systemically important institutions ('O-SIIs') in accordance with Article 131 of Directive 2013/36/EU;
 - (c) counterparties, for which the total amount of initial margin to be collected by the counterparty itself or from counterparties belonging to its group exceeds EUR 1 billion.
4. The conditions referred to in paragraph 2 are:
- (a) the sum of the values of the securities from the asset classes (c), (d), (e) [Sovereign, regional auth. and PSEs], (h),(i), (m) [multilateral development. Banks, International Organisations, non-Member States' regional governments, local authorities not meeting the requirements], (j) and (k) [non-EU Sovereign, regional auth. and PSEs] in Article 1 LEC issued by a single issuer or by issuers domiciled in the same country shall not exceed 50% of the collateral collected from that individual counterparty;
 - (b) for the purpose of (a) exposures to regional governments or local authorities shall be treated as exposures to the central government in whose jurisdiction they are established.

Section 6 - Collateral valuation

Article 1 HC - Calculation of the adjusted value of collateral

Risk management procedures shall include the application of haircuts to the market value of collected collateral using either the standard methodology referred to in Annex II or using own estimates as referred to in Article 2 HC.

Article 2 HC - Own estimates of the adjusted value of collateral

1. Counterparties may use own volatility estimates for calculating the haircuts to be applied to collateral where the requirements set out in this Article are met.
2. For debt securities that have a credit assessment from an ECAI, counterparties may use an own volatility estimate for each category of security.
3. In determining relevant categories of securities for the purposes of paragraph 2, counterparties shall take into account the type of issuer of the security, the external credit assessment of the securities, their residual maturity, and their modified duration. Volatility estimates shall be representative of the securities included in the category.
4. The calculation of the adjusted value of the collateral shall be subject to all the conditions referred to in Annex III.
5. Counterparties shall update their data sets and calculate haircuts at least once every three months and whenever the volatility of market prices changes materially.

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Procedures should determine ex ante the levels of volatility that trigger a recalculation of the haircuts.

6. The estimation of haircuts shall meet all the following governance criteria:
 - (a) a counterparty shall use the volatility estimates in the day-to-day risk management process including in relation to its internal exposure limits;
 - (b) where the liquidation period used by a counterparty is longer than that referred to in point (b) of paragraph 1 of Annex III for the type of OTC derivative contract in question, that counterparty shall increase its haircuts in accordance with the square root of time formula referred to in paragraph 1 of Annex III;
 - (c) a counterparty shall have in place established procedures for monitoring and ensuring compliance with a documented set of policies and controls for the operation of its system for the estimation of haircuts and for the integration of such estimates into its risk management process;
 - (d) an independent review of the system for the estimation of haircuts shall be carried out regularly within the internal auditing process of the counterparty. A review of the overall system for the estimation of haircuts and for the integration of those adjustments into the risk management process of the counterparty shall take place at least once a year. The subjects of that review shall include at least the following:
 - iii. the integration of estimated haircuts into daily risk management;
 - iv. the validation of any significant change in the process for the estimation of haircuts;
 - v. the verification of the consistency, timeliness and reliability of data sources used to run the system for the estimation of haircuts, including the independence of such data sources;
 - vi. the accuracy and appropriateness of the volatility assumptions.

Section 7 - Operational procedures and Documentation

Article 1 OPD - Operational process for the exchange of collateral

1. Robust risk management procedures shall be in place in order to ensure the timely exchange of collateral for non-centrally cleared OTC derivative contracts. Those risk management procedures shall include:
 - (a) a detailed documentation of policy and procedures with regards to the exchange of collateral for non-centrally cleared OTC derivative contracts and any related



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- limitation or constraint, covering collateral levels, types and eligibility to be reviewed and updated as necessary and at least annually;
- (b) documented, consistent and robust processes for escalation with counterparties' organisations, authorisation and recording of any exceptions to the existing policy and procedures referred to in point (a);
- (c) reporting of material exceptions to senior management;
- (d) agreement of terms with all counterparties in accordance with this Regulation in respect of the operational process for the exchange of collateral, including:
- i. the levels and type of collateral required and any segregation arrangements;
 - ii. the OTC derivative contracts to be included in the calculation of margin;
 - iii. the procedures for notification, confirmation and adjustment of margin calls and settlement of margin calls;
 - iv. the procedures for settlement of margin calls in respect of all relevant types of collateral;
 - v. the methods, timings and responsibilities for calculating margin and valuing collateral.
- (e) robust processes for setting collateral levels;
- (f) procedures to periodically verify the liquidity of the eligible collateral.
- (g) procedures for timely re-appropriation by the posting counterparty of the collateral in the event of default of the counterparty collecting the collateral.
2. A counterparty using an initial margin model shall be prepared to supply relevant documentation referred to in Article 6 MRM to its competent authority at any time.
 3. The risk management procedures referred to in paragraph 1 shall be tested on a periodic basis and at least once a year. Those tests shall include at least those tests referred to in Articles 12 to 15 of Regulation (EU) No 149/2013¹¹.
 4. Alternative collateral may be substituted for any collateral already posted to the collecting counterparty as initial or variation margin, provided that all of the following conditions are met:

¹¹ Commission Delegated Regulation (EU) No 149/2013 of 19 December 2012 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on indirect clearing arrangements, the clearing obligation, the public register, access to a trading venue, non-financial counterparties, and risk mitigation techniques for OTC derivatives contracts not cleared by a CCP (OJ L 52, 23.02.2013, p. 11).



- (a) the substitution is made in accordance with the terms of the agreement between the counterparties;
- (b) the alternative collateral is eligible according to Article 1 LEC;
- (c) the value of the alternative collateral after applying any relevant haircut is sufficient to meet all margin requirements.

Article 2 OPD - Trading Documentation

Explanatory text for consultation:

Respondents to the Consultation Paper noted that having a written agreement with all the counterparties including also those that would not be subject to the margin requirements could result in a excessive operational burden with limited risk-reduction benefits.

As proper trading documentation is deemed necessary but there is no intention to create unnecessary burden on the market participants, this consultation paper includes a more general requirement covering all the aspects related to trading documentation.

Question 5. Respondent to this consultation are invited to highlight their concerns on the requirements on trading relationship documentation.

1. Where counterparties enter into one or multiple OTC derivative contracts, robust risk management procedures shall be in place in order to ensure that written trading relationship documentation is executed between them prior to or contemporaneously with entering into non-centrally cleared OTC derivatives transaction. Such documentation shall comprise all material terms governing the trading relationship between the counterparties, including the following:
 - (a) any payment obligations;
 - (b) netting of payments;
 - (c) events of default or other termination events;
 - (d) calculation methods;
 - (e) any netting of obligations upon termination, transfer of rights and obligations;
 - (f) the governing law of the transactions.



2. A counterparty shall perform an independent legal review at least on an annual basis in order to verify the legal enforceability of the bilateral netting arrangements and always be able to provide documentation supporting the legal basis for compliance of the arrangements in each jurisdiction.

Article 1 SEG - Segregation of initial margins

Explanatory text for consultation

The ESAs recognize that obtaining a legal opinion on the effectiveness of the segregation for each of the different agreements would result in an excessively cumbersome process. It should be however recognized that need for the counterparty to comply with the fundamental due diligence principle of producing an internal assessment of the reliability of the agreements and their enforceability.

Question 6. Respondents are invited to comment on the requirements of this section concerning the legal basis for the compliance.

1. Collateral collected as initial margin shall be segregated from proprietary assets on the books and records of a third party holder or custodian, or via other legally binding arrangements made by the collecting counterparty to protect the initial margin from the default or insolvency of the collecting counterparty, third party holder or custodian.
2. The collecting counterparty shall always provide the posting counterparty with the option to segregate its collateral from the assets of other posting counterparties ('individual segregation').
3. Where initial margin is collected in cash it shall be segregated individually, unless the collecting counterparty has legally binding arrangements in place to segregate it from proprietary assets.
4. The segregation arrangements shall ensure that the initial margins are available to the posting counterparty in a timely manner in case the other counterparty defaults.
5. A counterparty shall perform an independent legal review at least on an annual basis in order to verify that the segregation arrangements meet the requirements referred to in paragraphs 3 and 4 and always be able to provide documentation supporting the legal basis for compliance of the arrangements in each jurisdiction.

Article 1 REU - Treatment of collected initial margins



Text for consultation

Respondents noticed that the difficulties in segregating cash according to the requirement on this Regulation could have resulted in a de-facto ban of cash as eligible collateral for IM. In order to avoid unwanted effects of the segregation requirements, the obligation concerning the re-use of collateral should exclude cash to the extent that the collected margin is reinvested to protect the liability that the counterparty collecting the collateral has towards the posting party. Securities obtained from the (re)investment of cash collateral should be segregated and not re-used in line with the treatment of IM. This would appear to solve the issue that may inadvertently have resulted in a de facto ban of cash as initial margin, which was not the intention of the ESAs.

Question 7. Does this approach address the concerns on the use of cash for initial margin?

1. The collecting counterparty shall not re-hypothecate, re-pledge nor otherwise re-use the collateral collected as initial margin.
2. Initial margin posted in cash can be re-invested by the collecting counterparty or the custodian only for the purpose of protecting the collateral poster, and subject to an agreement between the counterparties. The re-invested collateral shall be treated in accordance with Articles 1 LEC and 1 SEG [segregation and eligibility].

CHAPTER 2 - Procedures for the counterparties and the relevant competent authorities when applying exemptions for intragroup derivative contracts

Article 1 IGT - Procedures for the counterparties and the relevant competent authorities

1. The application or notification from a counterparty to the competent authority according to points (6) to (10) of Article 11 of Regulation (EU) No 648/2012 shall be deemed to have been received at the time of receipt by the competent authority of all of the following pieces of information:
 - (a) all the information necessary to assess whether the conditions specified in Article 3 and in points (6) to (10) of Article 11 of that Regulation, as applicable, have been fulfilled;
 - (b) the information and documents referred to in Article 18 of Commission Delegated Regulation (EU) No 149/2013.
2. Where a competent authority determines that further information is required in order to assess whether the conditions of Article 3 and points (6) to (10) of Article 11 of Regulation (EU) No 648/2012, as applicable, are fulfilled, it may submit a request for information to the counterparty which shall be in a written form.



3. A decision by a competent authority under Article 11(6) of Regulation (EU) No 648/2012 shall be communicated to the counterparty within 3 months of receipt of the complete application.
4. Where a competent authority takes a positive decision under Articles 11(6), 11(8) or 11(10) of Regulation (EU) No 648/2012, it shall communicate it to the counterparty in writing including all of the following pieces of information:
 - (a) whether the exemption is a full exemption or a partial exemption;
 - (b) in the case of a partial exemption, a clear identification of the limitations of the exemption;
 - (c) any additional relevant information.
5. Where a competent authority takes a negative decision under Articles 11(6), 11(8) or 11(10) of Regulation (EU) No 648/2012 or it objects to a notification under Articles 11(7) or 11(9) of that Regulation, it shall communicate this to the counterparty in writing and shall include both of the following pieces of information:
 - (a) the identification of the conditions of Articles 3 and 11 (6) to (10) of Regulation (EU) No 648/2012 that are not fulfilled;
 - (b) a summary of the reasons for considering that such conditions are not fulfilled.
6. Where one of the competent authorities notified under Article 11(7) of Regulation (EU) No 648/2012 considers that the conditions referred to in point (a) or (b) of the first subparagraph of Article 11(7) of that Regulation have not been fulfilled, it shall notify the other competent authority within two months of receipt of the notification by the relevant counterparty. The competent authorities shall notify the non-financial counterparties of the objection within three months of receipt of the notifications by the other competent authority.
7. A decision by a competent authority under Article 11(8) of Regulation (EU) No 648/2012 shall be communicated to the counterparty established in the Union within three months of receipt of the complete application.
8. A decision by the competent authority of the financial counterparty under Article 11(10) of Regulation (EU) No 648/2012 shall be communicated to the competent authority of the non-financial counterparty within two months from the receipt of the complete application for exemption and to the counterparties within three months of receipt of the complete application for exemption.
9. Counterparties that have submitted a notification or received a positive decision according to points (6) to (10) of Article 11 of Regulation (EU) No 648/2012 shall immediately notify the relevant competent authority of any change in circumstance that could affect the fulfilment of the conditions of Articles 3 and of points (6) to



(10) of Article 11 of that Regulation, as applicable. The competent authority may decide to object to the notification of the application of the exemption or to withdraw its decision following any change in circumstance that could affect the fulfilment of those conditions.

10. Where a negative decision or objection is communicated by a competent authority, the relevant counterparty shall not submit any other application or notification unless there has been a material change in the circumstances that formed the basis of the competent authority's decision or objection.

Article 2 IGT- Prompt transfer of own funds and repayment of liabilities between the counterparties in intragroup derivatives

Risk management procedures shall ensure the regular monitoring of the exposures arising under intragroup transactions and the timely settlement of the obligations resulting from the intragroup OTC derivative contracts.

CHAPTER 3 - Applicable criteria for applying exemptions for intragroup derivative contracts

Article 3 IGT - Applicable criteria on the legal impediment to the prompt transfer of own funds and repayment of liabilities

1. A legal impediment to the prompt transfer of own funds or repayment of liabilities between the counterparties as referred to in paragraphs 5 to 10 of Article 11 of Regulation (EU) No 648/2012 shall be deemed to exist where there are current or foreseen restrictions of a legal nature including any of the following:
 - (a) currency and exchange controls;
 - (b) the regulatory, administrative, legal or contractual framework in which the counterparties operate is such as to prevent mutual financial support or significantly affect the transfer of funds within the group;
 - (c) any of the conditions on the early intervention, recovery and resolution are met, as a result of which the supervisor foresees an impediment to the prompt transfer of own funds or repayment of liabilities;
 - (d) there are limitations on the prompt transfer of own funds or repayment of liabilities due, as a result of:
 - i. the existence of minority interests that limit decision-making power within entities that form the group;
 - ii. the purpose or the legal structure of the counterparty undertaking, as defined in its statutes, instruments of incorporation and internal rules.



Article 4 IGT - Applicable criteria on the practical impediment to the prompt transfer of own funds and repayment of liabilities

1. A practical impediment to the prompt transfer of own funds or repayment of liabilities between the counterparties as referred to in paragraphs 5 to 10 of Article 11 of Regulation (EU) No 648/2012 shall be deemed to exist where there are current restrictions of a practical nature including any of the following:
 - (a) Insufficient availability of unencumbered or liquid assets to the relevant counterparty when due; or
 - (b) there are operational obstacles for such transfers or repayments when due.

CHAPTER 4 - Final provisions

Article 1 FP - Final provisions

Explanatory text for consultation

With respect to the consultation paper the phase-in of the requirements has been amended. It consists of a staggered implementation of the initial margin requirements and a different staggered implementation of the variation margin requirements. The proposed implementation aims to give more time to market participants to adapt the legal documentation, develop internal and bilateral processes and implement operational changes.

1. This Regulation shall enter into force on the twentieth day following that of its publication in the Official Journal of the European Union.
2. The requirements of this Regulation shall apply from 1 September 2016 with the exception of:
 - (a) Articles 1 IGT, 2 IGT and 3 IGT which shall apply from the entry into force of this Regulation;
 - (b) Articles 1 GEN 3(a)i, 6 GEN, 7 GEN, , 1 EIM, 1 SEG, 1 REU and Section 4 [initial margin/segregation/re-use] which shall apply in accordance with paragraph 3;
 - (c) Article 1 VM which shall apply in accordance with paragraph 6.
3. The Articles referred to in point (b) of paragraph 2, shall apply as follows:



- (a) from 1 September 2016 where both counterparties have or belong to groups, each of which has an aggregate average notional amount of non-centrally cleared derivatives is above EUR 3.0 trillion;
 - (b) from 1 September 2017 where both counterparties have or belong to groups, each of which has an aggregate average notional amount of non-centrally cleared derivatives is above EUR 2.25 trillion;
 - (c) from 1 September 2018 where both counterparties have or belong to groups, each of which has an aggregate average notional amount of non-centrally cleared derivatives is above EUR 1.5 trillion;
 - (d) from 1 September 2019 where both counterparties have or belong to groups, each of which has an aggregate average notional amount of non-centrally cleared derivatives is above EUR 0.75 trillion;
 - (e) from 1 September 2020 where both counterparties have or belong to groups, each of which has an aggregate average notional amount of non-centrally cleared derivatives is above EUR 8 billion.
4. The aggregate average notional amount referred to in points (a) to (e) of paragraph 1 shall be calculated as the average of the total gross notional amount:
 - (a) recorded in the last business day of the months March, April and May of the year referred to in that point;
 - (b) including all the entities of the group;
 - (c) including all the non-centrally cleared OTC derivative contracts of the group.
 5. For the purpose of the calculation of the aggregate notional amount referred to in paragraph 1, investment funds shall be considered in accordance with Article 5 GEN(3) [Initial Margin Thresholds].
 6. The Articles referred to in point (c) of paragraph 2 [variation margin], shall apply as follows:
 - (a) from 1 September 2016 for all the counterparties referred to in Article 3(a);
 - (b) from 1 March 2017 for the other counterparties.
 7. This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels,



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*For the Commission
The President*

*[For the Commission
On behalf of the
President
[Position]*

ANNEX I - Mapping of PD to Credit quality steps

1. An internal rating with a PD equal to or lower than the value in Table 1CQS of shall be associated to the corresponding credit quality step.

Table 1 CQS

Credit Quality Step	Probability of default, as defined in Article 4(54) of Regulation (EU) 575/2013 lower than or equal to:
1	0.10%
2	0.25%
3	1%
4	7.5%

ANNEX II - Standard haircuts to the market value of collateral

1. The market value of the collateral shall be adjusted as follows:

$$C_{\text{value}} = C \cdot (1 - H_C - H_{\text{FX}})$$

where:

C = the market value of the collateral;

H_C = the haircut appropriate to the collateral, as calculated under paragraph 2;

H_{FX} = the haircut appropriate to currency mismatch, as calculated under paragraph 6.

2. Counterparties shall apply at a minimum the haircuts provided in the following Tables 1 and 2:

Table 1 VA
Haircuts for long term credit quality assessments

Credit quality step with which the credit assessment of the debt security is associated	Residual maturity	Haircuts for debt securities issued by entities described in Article 1 LEC (1) (c) to (e) and (h) to (l), in (%)	Haircuts for debt securities issued by entities described in Article 1 LEC (1) (f), (g), (m), (n) in (%)	Haircuts for securitisation positions meeting the criteria in Article 1 LEC (1) LEC (o) in %
1	≤ 1 year	0.5	1	2
	>1 ≤ 5	2	4	8
	> 5	4	8	16
2-3	≤ 1 year	1	2	4
	>1 ≤ 5	3	6	12
	> 5	6	12	24
4 or below	≤ 1 year	15	N/A	N/A
	>1 ≤ 5	15	N/A	N/A
	> 5	15	N/A	N/A

Table 2 VA
Haircuts for short term credit quality assessments

Credit quality step with which the credit assessment of a short term debt security is associated	Haircuts for debt securities issued by entities described in Article 1 LEC (1) (c) and (j) in (%)	Haircuts for debt securities issued by entities described in Article 1 LEC (1) (m) in (%)	Haircuts for securitisation positions and meeting the criteria in Article 1 LEC (1) (o) in (%)
1	0.5	1	2
2-3 or below	1	2	4

3. Equities in main indices, bonds convertible to equities in main indices and gold shall have a haircut of 15%.
4. For eligible units in UCITS the haircut is the weighted average of the haircuts that would apply to the assets in which the fund is invested.
5. Cash shall be subject to a haircut of 0%.

Explanatory text for consultation

This Article aims to clarify the proposal of the First Consultation Paper concerning the identification of a reference currency for the calculation of the FX haircut under the standardized approach. As cash for VM is considered the pure settlement of a claim, this should not be subject to any haircut. Furthermore, VM and IM should be considered separately when identifying the reference currency for this purpose: the transfer currency is the most natural choice for the VM, the termination currency the most natural for IM. Where “transfer currency” and “termination currency” do not appear in a bilateral agreement, the FX haircut should apply to the entire collected collateral.

Question 8. Respondents are invited to comment on the requirements of this section concerning treatment of FX mismatch between collateral and OTC derivatives.

6. Where the agreement between the two counterparties includes a termination currency, the counterparties shall apply a haircut of 8% to the market value of the assets where the collateral posted as initial margin is denominated in a currency other than the termination currency. Where the agreement does not identify a termination currency, the haircut will apply to the market value of all the assets posted as collateral for initial margin.



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7. Where the agreement between the two counterparties includes a transfer currency, the counterparties shall apply a haircut of 8% to the market value of the assets posted as collateral for the unsettled variation margin where the collateral is denominated in a currency other than the transfer currency of the variation margin. Where the agreement does not identify a transfer currency, the haircut will apply to the market value of all the assets posted as collateral for the unsettled variation margin.

ANNEX III - Own estimates of the haircuts to the market value of collateral

1. The calculation of the adjusted value of the collateral shall meet all of the following criteria:
 - (a) counterparties shall base the calculation on a 99th percentile, one-tailed confidence interval;
 - (b) counterparties shall base the calculation on a liquidation period of at 10 business days.
 - (c) counterparties shall calculate the haircuts by scaling up the daily revaluation haircuts, using the following square-root-of time formula:

$$H = H_M \cdot \sqrt{\frac{N_R + (T_M - 1)}{T_M}}$$

where:

H = the haircut to be applied;

H_M = the haircut where there is daily revaluation;

N_R = the actual number of business days between revaluations;

T_M = the liquidation period for the type of transaction in question.

- (d) counterparties shall take into account the lesser liquidity of lower quality assets. They shall adjust the liquidation period upwards in cases where there are doubts concerning the liquidity of the collateral. They shall also identify where historical data may understate potential volatility. Such cases shall be dealt with by means of a stress scenario;
- (e) the length of the historical observation period institutions use for calculating haircuts shall be at least one year. For counterparties that use a weighting scheme or other methods for the historical observation period, the length of the effective observation period shall be at least one year.
- (f) the market value of the collateral shall be adjusted as follows:

$$C_{\text{value}} = C \cdot (1 - H)$$

where:



C = the market value of the collateral;

H = the haircut as calculated in subparagraph (c) above.

2. Cash may be subject to a haircut of 0%.

*ANNEX IV - Standardised Method for the calculation of initial margin for the purposes of
Article 1 SMI*

1. The notional amounts or underlying values, as applicable, of the OTC derivative contracts in a netting set shall be multiplied by the percentages in the following Table 1 SMI:

Table 1 SMI

Category	Add-on factor
Credit: 0–2 year residual maturity	2%
Credit: 2–5 year residual maturity	5%
Credit 5+ year residual maturity	10%
Commodity	15%
Equity	15%
Foreign exchange	6%
Interest rate: 0-2 year residual maturity	1%
Interest rate: 2-5 year residual maturity	2%
Interest rate: 5+ year residual maturity	4%
Other	15%

2. The gross initial margin of a netting set shall be calculated as the sum of the products referred to in paragraph 1 for all OTC derivative contracts in the netting set.
3. The following treatment shall be applied to contracts which fall within more than one category:
- where a relevant risk factor for a OTC derivative contract can be clearly identified, contracts shall be assigned to the category corresponding to that risk factor;
 - where the condition referred to in point (a) is not met, contracts shall be assigned to the category with the highest add-on factor among the relevant categories;
 - the initial margin requirements for a netting set shall be computed in accordance with the following formula:

Net initial margin = 0.4 * Gross initial margin + 0.6 * NGR * Gross initial margin.

where:

- net initial margin refers to the reduced figure for initial margin requirements for all OTC derivative contracts with a given counterparty included in a netting set;

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- ii. NGR refers to the net-to-gross ratio calculated as the quotient of the net replacement cost of a netting set with a given counterparty in the numerator, and the gross replacement cost of that netting set in the denominator.
- (d) For the purposes of paragraph 3, the net replacement cost of a netting set shall be the bigger between zero and the sum of current market values of all OTC derivative contracts in the netting set.
- (e) For the purposes of paragraph 3, the gross replacement cost of a netting set shall be the sum of the current market values of all OTC derivative contracts calculated in accordance with Article 11(2) of Regulation (EU) No 648/2012 and Articles 16 and 17 of Commission Delegated Regulation No 149/2013 with positive values in the netting set.
- (f) A netted notional amount may be computed before applying the add-ons referred to in paragraph 1 between contracts that are of opposite direction but are identical in terms of all other contractual features with the only possible exemption of notional.



5. Accompanying documents

5.1 Draft Impact Assessment

5.1.1 Problem definition

1. This section identifies problems to be addressed by the draft RTS. The core problem that the RTS aim to address is the lack of a harmonised regulatory framework for margin requirements for non-centrally cleared derivatives and associated problems including high systemic risk, regulatory arbitrage and an uneven playing field in the EU market for OTC derivatives. Specifically it is noted that:
 - a) The high volume of non-centrally cleared derivatives¹² poses high systemic risk in the EU market as well as in the rest of the world¹³.
 - b) If the margin requirements for non-centrally cleared derivatives vary across the member states, then the regulatory framework would give competitive advantage to financial institutions that operate in the low-margin jurisdictions (uneven playing field for institutions in the EU). This would also incentivise institutions that initially operate in high-margin jurisdictions to relocate their business activities to another jurisdiction where the margin requirements are low (regulatory arbitrage).
2. These problems prevent the effective and efficient operation of not only the market for non-centrally cleared derivatives but also that of the internal market.
3. Section 2.1.4 presents an analysis of the alternative technical options that can effectively address these problems.

5.1.2 Objectives

4. The general and operational objectives of the EMIR¹⁴, as noted in the recitals of the EMIR, are to respond to the risks emerging from the interconnectedness between institutions operating in the OTC derivative markets by:
 - a) reducing counterparty credit risk, and
 - b) establishing robust risk management.
5. The objective of the current RTS is to establish a robust regulatory framework by:
 - a) improving prudential regulation so that non-centrally cleared derivatives are bilaterally collateralised and subject to either margin or capital requirements,

¹² See Section 5.1.5 where the key statistics in relation to the baseline are presented.

¹³ Such as the countries that are covered by the scope of BCBS/IOSCO.

¹⁴ Regulation (EU) No 648/2012.

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- b) harmonising regulatory practice on non-centrally cleared derivatives across the member states, and
 - c) converging the EU regulatory framework to international practice.
6. Article 11 of the EMIR outlines:
- a) the framework for risk management procedures for contracts for non-centrally cleared derivatives,
 - b) the overall procedures for intragroup exemptions that national competent authorities must follow, and
 - c) the criteria for the identification of practical and legal impediment for the prompt transfer of funds between counterparties.
7. However, this article does not specify what these procedures and criteria could be. As a result, the provisions may lead to variations in the interpretation of these criteria and procedures and a lack of harmonisation in margin requirements across the EU.
8. Article 11(15) of the EMIR gives the ESAs power to issue RTS to promote harmonisation in risk-management procedures, the procedures for exemptions and criteria to identify legal and practical impediment to the prompt transfer of own funds and repayment liabilities between counterparties.
9. Specification of the rules on the above-mentioned provisions is a crucial aspect of the market for non-centrally cleared derivatives. The objective is to mitigate the high risk that the market for non-centrally cleared derivatives currently carries, by complementing the provisions under Article 11 of the EMIR and ultimately to contribute to the effective and efficient functioning of the internal market.

5.1.3 Baseline

10. The quantitative analysis in Section 2.1.5 shows the estimated value of aggregate non-centrally cleared activity that is captured by the scope of the current RTS for major European banks. Currently, the estimated value of total gross notional outstanding for non-centrally cleared derivative activities is about EUR 146 trillion. This figure is expected to decrease to about EUR 74.9 trillion (or by 49%) after the implementation of the central clearing obligation, which will require about half of these transactions to be subject to mandatory central clearing. In other words, after the implementation of the margin requirements, about 49% of the OTC derivatives market will be captured by the current RTS, and the remaining 51% will be cleared centrally.
11. Similar figures that are based on a larger sample and cover countries outside the EU (e.g. the US and Japan) show that the policy impact in the EU is similar to the development in international market for OTC derivatives.



12. In terms of initial margin the estimated value of total initial margin currently, collected among financial institutions is about EUR 40 billion in the EU. The figure is about 40% of the global value.

5.1.4 Assessment of the technical options

13. The current section analyses major technical options that are considered under each Section of the current RTS. The assessment of the technical options presents the evidence and the logic behind the choice of a particular policy that shapes the current RTS, including:
- a) physically-settled foreign exchange swaps and forwards, and currency swaps;
 - b) scope of applicability of initial margin requirements;
 - c) covered bonds;
 - d) eligibility and treatment of collateral;
 - e) credit quality assessment;
 - f) concentration limits;
 - g) phase-in of initial margin requirements;
 - h) procedures concerning intragroup transactions.

Physically-settled foreign exchange swaps and forwards, and currency swaps

14. The assessment relates to the scope of derivative instruments to which the margin requirements apply. The Regulation covers all derivatives that are not centrally cleared, with the exception for derivatives with certain types of transactions.
15. The current options discuss the exclusion of the foreign exchange forwards and swaps from the scope of the margin requirements due to their unique characteristics (e.g. product availability) and due to their particular market practices (e.g. requirement on the product delivery).

Option 1: Exemption from the requirement to collect initial margin for physically-settled foreign exchange swaps and forwards, and currency swaps

16. Physically-settled foreign exchange swaps and forwards are the derivative instruments of which the underlying financial products (i.e. foreign currency) are physically delivered in exchange for a specific payment. The physical existence and the availability of the underlying financial instrument decrease the counterparty risk.
17. However, the physical settlement characteristics do not minimise the counterparty risk against unforeseen events such as counterparty default.

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Option 2: No exemption from the requirement to collect initial margin for physically-settled foreign exchange swaps and forwards, and currency swaps

18. An initial margin requirement for non-centrally cleared physically-settled foreign exchange swaps and forwards is expected to minimise the risk associated with counterparty default. This is true particularly for contracts with long maturities where the uncertainty is greater.
19. However, initial margin requirements will put additional costs on the industry, which may in turn downsize the market for physically-settled foreign exchange swaps and forwards. This is true particularly when the international market is taken into account, in particular EU trade with the US market and intra-EU trade across jurisdictions with different currencies.
20. Preferred option. The first option (exemption from IM) is the preferred option for the following reasons:
 - a) The BCBS-IOSCO framework specify that certain physically-settled foreign exchange products and swaps should be exempt from the exchange of initial margin, with the intention that the risks associated with the exemption will be considered by the monitoring group established in 2014.
 - b) Given the interconnectedness of the market and international practice, in particular in the US market, the initial margin requirement for physically-settled foreign exchange swaps and forwards would give the EU a comparative disadvantage vis-à-vis other players.
 - c) Therefore, to reflect the international dimension of the foreign exchange markets and to maintain international consistency between jurisdictions, it will be beneficial if the technical standards are consistent with the BCBS-IOSCO framework.

Scope of applicability of the initial margin requirements

21. The assessment relates to the scope of the RTS. It discusses the threshold for the size of the counterparties in terms of gross notional outstanding of OTC derivatives in order to establish which entities should be included in the scope of the current RTS.

Option 1: The RTS would apply to all entities undertaking OTC derivatives transactions

22. The option does not set a minimum threshold to differentiate the entities that can be exempt from the margin requirements. It sets uniform and comprehensive risk management requirements for participants in the OTC derivatives market. The approach is effective to achieve the objectives to reduce systemic risk in the OTC derivatives market.
23. However, the uniform application of margin requirements violates the proportionality principle. The Task Force recognises the significant change in market practice and potential costs associated with these requirements. This is also acknowledged in the BCBS-IOSCO



framework. These costs have the potential to fall disproportionately on smaller market participants, and, in extremis, discourage the use of derivatives markets, in particular for risk-reducing activities such as hedging.

Option 2: The RTS would apply to all entities undertaking OTC derivatives transactions, subject to a minimum level

24. In line with international principles, the option considers a threshold value of EUR 8 billion for gross notional outstanding of OTC derivatives. The entities with aggregated notional outstanding under this threshold are not subject to the initial margin requirements.
25. Preferred option: the second option is the preferred option since it respects the proportionality principle and is in line with the international practice.

Covered bonds

26. Covered bonds are debt securities backed by a cover pool of predominantly mortgages or public-sector loans serving as collateral. Derivatives can be used in cover pools to hedge interest rate and currency risks, for instance with the purpose of issuing covered bonds in currency denominations other than the underlying collateral. Bilateral collateral exchange, as mandated by the EMIR, will require the cover pool to provide collateral to its derivative counterparty. This will give the derivative counterparty a preferential claim to the assets in the cover pool over the covered bondholders, which is incompatible with the senior rights of covered bondholders usually prescribed by existing covered bonds across Europe.
27. In this respect, Recital 24 of Regulation(EU) No 648/2012 (EMIR) provides that:

‘When developing draft regulatory technical standards to specify the arrangements required for the accurate and appropriate exchange of collateral to manage risks associated with uncleared trades, ESMA should take due account of impediments faced by covered bond issuers or cover pools in providing collateral in a number of Union jurisdictions. ESMA should also take into account the fact that preferential claims given to covered bond issuers counterparties on the covered bond issuer’s assets provides equivalent protection against counterparty credit risk.’

Alternative 1: one-way margin requirement

28. Under this first alternative, the cover pool is exempted from posting and collecting collateral in the form of initial margin and from posting variation margin to its derivative counterparty if not previously collected.
29. This alternative relies on specific risk mitigants embedded in covered bond programmes to ensure the derivative counterparty a certain level of protection as an alternative to the exchange of collateral. These risk mitigants include the derivative counterparty benefiting from the appropriate segregation of the assets in the cover pool from the issuer’s insolvency estate and a minimum level of legal over-collateralisation.

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30. Specifically the ESA's consider that the following conditions must be met:
- a) the derivative is not terminated in case of a resolution or insolvency-related default of the covered bond issuer¹⁵;
 - b) the derivative counterparty ranks (at least) pari passu with the covered bond holders¹⁶;
 - c) the derivative is recorded in the cover pool of the covered bond programme in accordance with national covered bond legislation and is used only to hedge the interest rate, or currency mismatches of the cover pool;
 - d) the netting set does not include derivatives unrelated to the covered bond programme;
 - e) the covered bond programme meets the requirements of Article 129 of Regulation (EU) No 575/2013 (CRR);
 - f) the covered bond programme is subject to a regulatory¹⁷ collateralisation requirement of at least 102%¹⁸.
31. In cases where the conditions of alternative 1 are not met, the ESAs have considered the following alternative:
- Alternative 2: collateral provider**
32. Under this second alternative, the cover pool is not exempt from posting collateral to its derivative counterparty. Instead, this alternative relies on the interposition of a third-party collateral provider between the cover pool / covered bond issuer and its derivative counterparty to address the legal impediment faced by the cover pool when posting collateral.
33. Under this arrangement, the third party, as a collateral provider, acts as a guarantor for the derivative counterparty. In return, the third party receives a claim on the assets in the cover pool (ranking pari-passu or below the covered bond owners) and a fee paid by the covered bond issuer / cover pool.

¹⁵ For the cover pool to be eligible, most European jurisdictions require that the payments on the derivatives cannot be accelerated in the case of the covered bond issuer's default. Otherwise, the covered bondholders will lose the benefit of the protection provided by the hedge in of the covered bond issuer's insolvency.

¹⁶ Under most European covered bond regimes, the claims of the derivative counterparty can rank equally with, but not in priority, to the claims of the covered bond holders.

¹⁷ Voluntary over-collateralisation is not taken into account due to the lack of restrictions for the issuer to suddenly reduce it. In the worst-case scenario, the issuer could reduce over-collateralisation to the legally required amount shortly before going into default.

¹⁸ A minimum collateralisation of at least 102% in respect of the covered bonds in circulation is required in certain jurisdictions.



34. There is no need to explicitly take into account the use of a third-party collateral provider, as there is currently no provision preventing a counterparty from using a third-party provider to post the collateral, as long as the collateral is available to the counterparty in the event that the covered bond issuers default.
35. It is noted that there appears to be significant scope for market-based solutions that will preserve the risk mitigation, which is an overall principle across the technical standards.

Eligibility and treatment of collateral

36. The assessment specifies the type of collateral that can be used when posting margins bilaterally for non-centrally cleared derivatives. Specifically, the objective of the policy is to ensure that the characteristics of the collateral are sufficiently liquid and of sufficiently high credit quality.

Option 1: to specify a list of eligible collateral based on the list from the international standards and further detailed qualitative requirements

37. This option gives market participants leeway to agree on eligible collateral and sets a framework to facilitate the review of these agreements. The option can be easily applied by all market participants and ensures the highest degree of consistency and comparability across all counterparties. The option is expected to minimise the operational cost for the supervisory authorities, since no further assessment of the adequacy of accepted collateral is necessary.
38. This framework could rely on existing classifications, such as the eligible financial collateral in the credit risk mitigation framework of the CRR. This will ensure consistency in the framework and provide overall clarity of it.
39. However, this approach will to some extent rely on additional liquidity and credit criteria, such as external ratings, to ensure consistency. This may risk providing a less harmonised implementation if conditions are not clearly specified. However, it is also noted that credit and liquidity risk assessment is an area subject to significant market fluctuations; therefore some flexibility will be needed, regardless of the approach adopted.

Option 2: to provide qualitative requirements that are linked to the requirements set out for collateral posted to a CCP

40. Under this option, the counterparty would be allowed to define its own list of eligible financial collateral based on a set of qualitative minimum requirements provided in the RTS.
41. The approach is flexible and easy to adapt. It allows the use of a wide range of collateral as long as it provides sufficient protection against counterparty default. Under this approach, the market forces decide on the eligibility of items as collateral.



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42. With qualitative requirements, counterparties have the option to use their own assessment (e.g. of credit risk) instead of relying on external ratings. However, the approach does not harmonise the practice and gives counterparties considerable discretion in deciding on eligible collateral.
43. This is true particularly since the scope of the margin requirements for non-centrally cleared derivatives covers both financial and non-financial counterparties. This could lead to the collecting or posting of collateral that is not highly liquid and cannot be converted into cash rapidly and with minimal price impact.
44. The policy would put a high operational cost on national competent authorities. The competent authorities would have to ensure consistency amongst the individual market participants and to assess the adequacy of each market participant's implementation of the qualitative criteria. The competent authorities would have to approve the eligibility criteria and revise them as part of their supervisory activity.
45. The technical option would also put the cost on the industry. Counterparties would have to demonstrate explicitly to the competent authorities that the conditions have been fulfilled and that the conditions are comparable with the approach for CCPs in the technical standards of the EMIR.

Option 3: a framework linked to market-based indicators similar to the one under development for the Liquidity Coverage Ratio (LCR) – by adopting the definition of liquid assets used for the liquidity framework

46. The purpose of the liquidity buffer under the liquidity framework is to raise cash by selling the assets outright or entering into secured funding transactions. The horizon of the LCR is 30 days, which is slightly longer than a normal margin period. However, much emphasis is placed on both the liquidity and credit aspects in the definition of liquid assets. There appears to be strong similarities with the eligible collateral for margin requirements, since the assets/collateral in both cases need to be sold off in the market within a relatively short interval. Alignment with an LCR approach that is founded on market-based indicators is therefore a credible option.
47. However, the liquidity framework is currently not finalised and may not be finalised before the finalisation of the RTS, which leaves a period of uncertainty. Furthermore the LCR proposal is aimed at institutions, whereas the scope here is broader, as it will also include non-institutions. It may also be argued that given that the scope of application concerns the relationship between two counterparties, which is significantly smaller than the scope of the liquidity risk profile of an institution, a broader set of collateral should be allowed.
48. Preferred option: a list of eligible asset classes constrained by qualitative requirements is the preferred option because it more effectively addresses the problems relating to the harmonisation and creating a level playing field in the market. The option is less costly and finds a balance between flexibility and harmonisation. This however raises the issue of



specifying especially the credit quality in greater detail, bearing in mind the requirement of the CRA III regulation, which encourages the removal of mechanistic reliance on external ratings. This aspect is discussed in greater detail below.

Credit quality assessment

49. The policy objective is to provide a transparent and harmonised approach for counterparties without an approved internal model for a risk assessment. This approach should be easily applicable and traceable by the respective supervisory authority whilst ensuring that the accepted collateral is of appropriate credit quality.

Option 1: the RTS could provide only a very high-level definition of high credit quality (e.g. 'investment grade')

50. The technical option allows the use of a wide range of collateral as long as it provides sufficient protection against default by the counterparty. Market developments may suddenly render items on the list unsuitable as collateral. With qualitative requirements, counterparties have the option to use their own assessment (e.g. of credit risk) instead of relying on external ratings.
51. Adopting this approach, at least without requiring the counterparties to demonstrate to the competent authorities that the requirement is met, could leave the counterparties with a large amount of discretion. This could lead to the collection or posting of collateral that cannot be converted into cash rapidly and with minimal price impact. Requiring the counterparties to explicitly demonstrate to the competent authority that the criteria have been fulfilled (comparable with the approach for CCPs) will also most likely lead to a non-harmonised approach as the scope of the margin requirements for non-centrally cleared derivatives is extremely broad, covering financial and non-financial counterparties. An approach that works for a limited number of CCPs is more difficult for this very broad range of counterparties.

Option 2: identifying types of collateral where minimum Credit Quality Steps (CQS), would be required and thereby indirectly referring to ratings of external credit assessment institutions

52. This approach is, in part, similar to what is laid down by Regulation (EU) No 575/2013. In the case of deterioration in the quality of assets already accepted as collateral that leads to the non-eligibility of this collateral, the draft RTS also allow for a 'grace period' to replace this collateral.
53. The option provides an effective alternative for counterparties without an approved internal model. This would ensure transparency and accessibility for smaller market participants and non-banks to undertake their own assessments. The inclusion of a grace period would mitigate cliff effects by giving counterparties time to replace the collateral.
54. The institutions will need to rely on external credit assessments provided by ECAIs.



55. Preferred option: Option 2 is the preferred option as it provides an operational framework that also mitigates the mechanistic reliance on ratings. However, to mitigate the mechanistic reliance, the use of approved IRB models is allowed as an alternative, just as potential cliff effects are mitigated with the introduction of so-called 'grace periods', where counterparties are given time to exchange collateral no longer eligible after rating downgrades.

Concentration limits

56. The policy objective is to ensure that the collateral taker is able to realise sufficient value from the collateral to replace the OTC contracts associated with a defaulted counterparty.

Option 1: no concentration limit

57. Concentration limits make it more difficult for counterparties to find suitable collateral. They also put an additional operational burden on counterparties as the limits have to be monitored and collateral might occasionally have to be replaced in order not to breach the thresholds. Regulators incur additional costs as they have to check whether counterparties are complying with the restrictions.
58. However, this process of appropriating the collateral and entering a new contract might take a number of days. Without concentration limits, the initial and variation margins collected might be highly concentrated and not hold their value in a period of significant market stress. The collecting counterparty might also have difficulties in exiting a large position.

Option 2: concentration limits for exposures from collected margins that represent a significant proportion of the overall exposures for the collecting counterparty

59. Ideally this option achieves the advantages of Option 1 while avoiding unnecessary burdens.
60. Option 2 may result in an insufficient protection if the threshold is set too high.

Option 3: concentration limits for margins irrespective of position size

61. The requirement ensures a minimum level of diversification for the collected collateral. It also reduces potential problems arising from having to liquidate a large position. The restrictions arising from concentration limits in Option 3 are more predictable for both counterparties than in Option 2.
62. Option 3 makes it more difficult to find suitable collateral than Option 1. Compared to this option, it also puts an additional operational burden on counterparties. Option 3 might force the collection of diversified collateral even though the initial margin in total is small compared to the overall credit exposure that the collecting counterparty has. A disadvantage is that smaller counterparties may face difficulties or impediments in posting collateral different from local sovereign debt securities.

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63. Preferred option: given the considerations above, these draft RTS propose a variant of the Option 3 as the preferred option. The concentration limits related to sovereign debt securities are applied only to systemically important financial institutions or to parties that are collecting more than EUR 1 Bn from a single counterparty.

Phase-in of initial margin requirements

64. The assessment covers the approaches for transitional requirements. The policy objective is to specify the phase-in requirements of the current RTS.

Option 1: the option proposes the adoption of the approach of the international standards that implement a phase-in period of four years, starting with the largest market participants from 1 September 2016

65. The approach gives smaller participants more time in the transition period, i.e. more time to put into place all the necessary processes and systems. Additionally, by adopting the international standards, the policy accounts for the proportionality principle and sets a level playing field.
66. These requirements would privilege smaller players in terms of costs, but it also leaves smaller entities exposed to counterparty risk for this period.

Option 2: not to consider a phase-in schedule

67. An advantage is that there would not be any competitive advantage for smaller participants.
68. However, this option would put the smaller participants in a more disadvantaged position compared to the institutions in third countries.
69. Preferred option: given the considerations above, these draft RTS propose Option 1 as the preferred option. This will, furthermore, be aligned with internationally agreed standards.

Procedures concerning intragroup transactions

When is the application for intragroup transactions (IGT) deemed to have been received by the competent authority?

Option 1: the application is deemed to have been received when it is deemed complete by the competent authority. This option consists of including in the RTS a possibility for the competent authority to ask for more information.

70. The EMIR stipulates, in Article 11(6) to Article 11(10), that counterparties shall submit applications or notifications to their respective competent authorities. Depending on the nature of the counterparties (financial counterparties, non-financial counterparties or third-country entities), the exemption will be subject to either a decision or a potential objection from the competent authorities.



71. Advantages: this option adds flexibility to the intragroup exemption procedures. Instead of refusing or objecting to an exemption on the grounds that the competent authority does not have the necessary information to verify that the relevant conditions have been fulfilled, the competent authority will have the option to go back to the applicant and in this respect provide more time and explanations, which should be to the benefit of the counterparties seeking the exemption.
72. Another advantage is that the timeline within which the competent authorities are required to notify the counterparties of the outcome of the request for exemption will only start once the applications or notifications are deemed to be complete. Several requests for information may be sent, providing both the competent authorities and the counterparties with opportunities to reassess the files and complete the applications.
73. Disadvantages: the main disadvantage is the timing issue and the legal certainty. When counterparties apply for the exemption, they will not be able to determine the time required to grant the exemption until their application is deemed complete. This may be particularly problematic under Articles 11(6), 11(8) and 11(10) where counterparties can only start using the exemptions after the decision has been taken by the competent authorities. The risk is that the completeness phase of the application has no time limit.

Option 2: the application is deemed to have been received upon the initial receipt of the application sent by the counterparty to the competent authority. This option consists of not including in the RTS a possibility for the competent authority to ask for more information.

74. The advantages and disadvantages are the opposite of those in Option 1.
75. Preferred option: given the considerations above, these draft RTS propose Option 1 as the preferred option.

Procedure to be followed under Article 11(7)

Option 1: to set the length of the objection period at three months and to require the objection to be communicated to the other competent authority before it is communicated to the counterparties.

76. Article 11(7) specifies the procedure to be followed when two counterparties to an intragroup transaction are non-financial counterparties (NFC) within the meaning of Article 2(9) of the EMIR.
77. Under Article 11(7), each NFC shall notify its competent authority of its intention to apply the exemption, and the exemption is valid unless 'either of the competent authorities does not agree upon fulfilment of the conditions; as mentioned in the Article. Therefore, both competent authorities have the option to object, which, if exercised, prevents the counterparties from using the exemption.



78. Option 1 proposes to specify how the competent authority which chooses to object must communicate this objection to the counterparties and to the other competent authority. More specifically, it requires that (1) the competent authority which chooses to object notifies the other competent authority within two months of receipt of the application and (2) each competent authority notifies its respective counterparty of the objection within three months of receipt of the application.
79. If the procedure is not defined, the following situation could arise: for an intragroup transaction between a counterparty established in country A, and a counterparty established in country B, the exemption is objected in country A and is in country B. It is unclear from Article 11(7) whether the objecting competent authority is obliged to inform the other competent authority, let alone the other counterparty. It could therefore be the case that for the same intragroup transaction, the counterparty established in country A considers itself exempted while the counterparty established in country B does not, which may create disputes between the counterparties.
80. In addition, the timeline within which the competent authorities may object is not defined in Article 11(7), whereas it is set at three months in Article 11(9) concerning the possibility for competent authorities to object to exemptions for intragroup transactions between an NFC and a counterparty established in a third country. Therefore, Option 1 seeks to achieve similar treatment for NFCs whose request may be objected, irrespective of the fact that the other counterparty is established in the EU or in a third country. Setting the non-objection period at three months provides an NFC applying under Article 11(7) with certainty over the period of time during which their exemption may be objected, and ensures consistency with Article 11(9).
81. Finally, Option 1 foresees a period of one month (between the notification of the objection to the other competent authority and the notification of the objection to the counterparties) for the two competent authorities to reach an agreement in the event that only one of the two intends to object. This one-month period may avoid disputes between competent authorities taking place after the counterparties have started to make use of the exemption.
82. A disadvantage of this option is that it entails additional costs for the competent authorities as they are required to notify the other competent authority which may disagree. However this should foster co-operation between competent authorities.

Option 2: the procedure to be followed under Article 11(7) is not further specified

83. The advantages and disadvantages are the opposite of those in Option 1.
84. Preferred option: given the considerations above, these draft RTS propose Option 1 as the preferred option.

Procedure to be followed under Article 11(8)



Option 1: To set a maximum period of three months for the competent authority to notify the counterparty of its decision regarding the exemption

85. Article 11(8) specifies the procedure to be followed when the one counterparty to an intragroup transaction is a financial counterparty (FC) within the meaning of Article 2(8) of the EMIR, and the other counterparty is established in a third country.
86. Under Article 11(8), an IGT is exempted on the basis of a positive decision of the competent authority of the FC.
87. Option 1 requires the competent authority of the FC to communicate its decision to the FC within three months of receipt of the application.
88. Advantages: under Article 11(8), the counterparties are required to wait until the decision is made to make use of the exemption. There is no a priori exemption unlike in cases where the competent authorities merely have an option to object to the use of the exemption. Therefore, it is crucial for the counterparties to have a fixed timeline within which their request for exemption is granted or refused.
89. In addition, while the timeline within which the competent authority shall notify the counterparty of its decision is not defined in Article 11(8), it is set at 30 calendar days in Article 11(6) concerning intragroup transactions between two financial counterparties. Setting the non-objection period at three months provides the FC applying under Article 11(8) with certainty over the period of time during which their exemption shall be granted or refused. It also ensures consistency with Article 11(6), although a longer time period (3 months instead of 30 calendar days) is justified by the fact that the other counterparty is established in a third country, which may complicate the assessment to be made by the competent authority.
90. Disadvantage: it could be argued that the absence of a defined period of time within which the competent authority has to notify the counterparty of its decision was an intention of Article 11(8) and therefore Option 1 would contradict the initial intention of the text. In practice, this is unlikely to be the case, in view of the legal uncertainty created by the absence of a defined time period as specified above.

Option 2: not to further specify the procedure to be followed under Article 11(8)

91. The advantages and disadvantages are the opposite of those in Option 1.
92. Preferred option: given the considerations above, these draft RTS propose Option 1 as the preferred option.

Procedure to be followed under Article 11(9)

Option 1: not to further specify the procedure to be followed under Article 11(9)



93. Article 11(9) specifies the procedure to be followed when a counterparty to an intragroup transaction is a non-financial counterparty (NFC) within the meaning of Article 2(9) of the EMIR, and the other counterparty is established in a third country.
94. Under Article 11(9), an IGT is exempted unless the competent authority of the NFC does not agree on the fulfilment of the conditions defined in the article within three months of the date of notification.
95. Under Option 1, no further specification would be added to the RTS.
96. Advantages: the timeline for the competent authority to object is already defined in Article 11(9). Furthermore, the other competent authority involved in the process is the one of a counterparty established in a third country, and the EMIR does not foresee that a competent authority would play a role in granting or refusing the exemption. Therefore, it does not seem necessary to further specify the procedure to reach a similar outcome to that of the other cases mentioned in Article 11(6) to (10).
97. Disadvantages: it could be argued that the competent authority of the counterparty established in a third country could, at a minimum, be consulted or informed of the outcome of an application for exemption. However, this would be outside the mandate defined in Article 11(15)(c) which requires the ESAs to specify the procedures for the counterparties and the relevant competent authorities to be followed when applying exemptions under Article 11(6) to (10). The definition of “competent authorities” provided in Article 2(13) only includes the competent authorities designated by the member states.

Option 2: to further specify the procedure to be followed under Article 11(9)

98. The advantages and disadvantages are the opposite of those in Option 1.
99. Preferred option: given the considerations above, these draft RTS propose Option 1 as the preferred option.

Procedure to be followed under Article 11(10):

Option 1: to set a maximum period of three months for the competent authority to notify the counterparty of its decision regarding the exemption

100. Article 11(10) specifies the procedure to be followed when one counterparty to an intragroup transaction is a financial counterparty (FC) within the meaning of Article 2(8) of the EMIR, and the other counterparty is a non-financial counterparty (NFC) within the meaning of Article 2(9) of the EMIR.
101. Under Article 11(10), an IGT is exempted on the basis of a positive decision of the competent authority of the FC, under the condition that the competent authority of the NFC does not object.

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102. Option 1 requires that (1) the competent authority of the FC informs the competent authority of the NFC within two months of receipt of the application and (2) the competent authority of the FC notifies the FC of the decision within three months of receipt of the application.
103. Under Article 11(10), the counterparties are required to wait until the decision is made to make use of the exemption. There is no a priori exemption unlike in cases where the competent authorities merely have an option to object to the use of the exemption. Therefore, it is crucial for the counterparties to have a fixed timeline within which their request for exemption is granted or refused.
104. While the timeline within which the competent authority shall notify the counterparty of its decision is not defined in Article 11(10), it is set at 30 calendar days in Article 11(6) concerning intragroup transactions between two FCs. Setting the period at three months provides the FC applying under Article 11(10) with certainty over the period of time during which their exemption shall be granted or refused. It also ensures consistency with Article 11(6), although a longer time period (3 months instead of 30 calendar days) is justified by the fact that the other counterparty is a NFC.
105. Article 11(10) requires the competent authority of the financial counterparty to notify the other competent authority of its decision, and provides the latter with the option to object the decision of the former. Option 1 proposes the establishment of a timeline within which those communications should be made, to ensure that the FC is made aware of the final decision no later than three months after the submission of its application. Therefore, the competent authority of the financial counterparty should notify the other competent authority of its decision within two months, leaving one month for the two authorities to agree on the final decision to be communicated to the FC within three months.
106. A disadvantage of this approach would be that the main cost of this Option is borne by the competent authority of the FC as it must be ready to communicate its decision to the other competent authority within two months of receipt of the application.

Option 2: not to further specify the procedure to be followed under Article 11(10)

107. The advantages and disadvantages are the opposite of those in Option 1.
108. Preferred option: given the considerations above, these draft RTS propose Option 1 as the preferred option.

Procedure to be followed after an exemption has been granted

Option 1: to require counterparties benefitting from an exemption to inform the competent authority in the event of a change that could affect the fulfilment of the conditions under which the exemption has been granted

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109. An exemption from the requirements of Article 11(3) is granted on the basis of a number of conditions stipulated in Article 3 and in Article 11(6) to 11(10). It may be the case that at a certain point in time, a counterparty has been granted an exemption, and at later point in time, there is a change (e.g. in the risk management procedures of the counterparty) affecting the fulfilment of the conditions under which the exemption has been granted. This change could mean that if the counterparty was to submit another application after the change has occurred, the exemption would not be granted. By requiring the counterparties benefitting from an exemption to inform the competent authority in the event of a change that could affect the fulfilment of the conditions under which the exemption has been granted, Option 1 ensures equal treatment between all counterparties. Furthermore, it ensures that the competent authority is comfortable at all time that the conditions under which the exemption has been granted continue to be fulfilled, and that it is able to reassess the exemption after such a change has occurred.
110. A disadvantage of this option is that it entails additional costs for both the counterparty and the competent authority, as the exemption cannot be considered as having been granted once and for all. It requires counterparties to monitor the changes that may affect the fulfilment of the conditions under which the exemption has been granted. It requires competent authorities to reassess the conditions upon receipt of a notification of those changes.

Option 2: not to further specify the procedure to be followed after an exemption has been granted

111. The advantages and disadvantages are the opposite of those in Option 1.
112. Preferred option: given the considerations above, these draft RTS propose Option 1 as the preferred option.

How to define practical and legal impediments?

Option 1: define specific cases in which practical and legal impediments are envisaged

113. This option has the following advantages:
- a) Limiting legal uncertainty to counterparties applying for the exemption;
 - b) Providing guidance to the competent authorities on the criteria to grant the exemption;
 - c) Limiting the disputes or divergent assessments between competent authorities.
114. A disadvantage is that this approach might be seen as too specific, limiting significantly the cases in which the exemption can be granted. However, it should be noted that it was the specific intention of the legislator when adopting the EMIR to apply this exemption in a restrictive manner. This is the reason for all the different procedures to be followed depending on the counterparties involved and for the inclusion of the reference to practical



and legal impediments, with a mandate to ESMA to further specify what those practical and legal impediments are.

Option 2: define in a very broad manner what practical legal impediments might be

115. The advantages and disadvantages are the opposite of those in Option 1. In addition, this option would not respect in full the mandate given to ESMA to develop technical standards.
116. Preferred option: given the considerations above, these draft RTS propose Option 1 as the preferred option.

Should restrictions stemming from insolvency, resolution or similar regimes be included in the legal impediments?

Option 1: including the restrictions

117. This option has the advantage of specifying one particular case of legal impediment, with the advantages and disadvantages included in the previous section. In addition, these restrictions are the typical restrictions impeding the proper transfer of funds between entities of the same group.
118. If one entity within a group does not have access to the funds necessary to liquidate its exposure with another entity of the same group that has entered into insolvency and an IGT exemption is granted, the first entity would have an uncollateralised exposure with an entity of the same group and will face all the risks stemming from the default of the second entity, which is exactly the opposite of the purpose of the bilateral margins requirements.
119. However, there are different insolvency rules affecting IGT and many of those rules limit the prompt transfer of funds, from an operational or legal perspective. If applied in a restrictive manner, reference to insolvency proceedings might leave a very limited number of transactions benefitting from the exemption.

Option 2: excluding the restrictions

120. The advantages and disadvantages are the opposite of those in Option 1 (including the restrictions).
121. Preferred option: given the considerations above, these draft RTS propose Option 1 as the preferred option.

5.1.5 Quantitative analysis

122. This section provides the baseline for the RTS in the EU market for non-centrally cleared derivatives. The statistics are based on the most recent comparable data. Describing the baseline, i.e. the current situation in the EU market, helps the reader to understand the magnitude of the current problem and potential improvements in the market that the technical options under the current RTS will achieve.

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5.1.6 Introduction and main findings

123. The descriptive statistics partially complement the arguments presented in Section 2.1.1 on problem definition, Section 2.1.1 on baseline and Section 2.1.3 on the assessment of technical options, and provide insights on:
- a) the value of non-centrally cleared derivatives in the EU market,
 - b) the value of OTC derivatives that are cleared bilaterally under the current RTS and those that fall under the central clearing mechanism,
 - c) the impact of the threshold regime on the EU market for non-centrally cleared derivatives, and
 - d) the effect of the phase-in requirements on the total notional amount of derivatives.
124. The BCBS-IOSCO quantitative impact study on margins ('Basel-QIS') launched a quantitative survey in July 2012 before the final proposal for margin requirements on non-centrally cleared derivatives to assess the liquidity costs of margin requirements for non-centrally cleared OTC derivatives. The results for an international coverage were published together with the revised version of the international standards¹⁹ ('the second consultative document').
125. This section aims to give an overview of the liquidity costs that are generated by the margin requirements in the EU market. It is believed that the data available will be sufficient for the purposes of this impact assessment, considering that the further collection of data represents a significant burden on counterparties.
126. The ESAs have engaged with industry experts and stakeholders to monitor the initiatives of the market participants and the extent to which they will influence the impact of this Regulation, most notably, the introduction of common internal models with a widespread application.
127. Furthermore, an overview of the initial phase of the transitional provisions shows the coverage of the non-centrally cleared OTC derivatives markets during the transitional period, giving a rough indication of the number of counterparties.
128. The assessment has been undertaken under the assumption that the figures provided by the European contributors, despite their limited number, were a reasonably good representation of the liquidity costs across the EU. Furthermore, the implementation of the EUR 50 million threshold impacted heavily on the overall initial margin requirements. The BCBS-IOSCO quantitative impact study was conducted under the assumption that the

¹⁹ [Margin requirements for non-centrally cleared derivatives – Second consultative document](#), issued by BCBS and IOSCO in February 2013.



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threshold was available at counterparty level but the final framework only allows it at a consolidated group level.

129. This preliminary analysis shows that:

- a) looking both at notional amounts and at the initial margin requirements, the European institutions cover around one half of the overall sample;
- b) the results for the EU concerning the fraction of OTC derivatives expected to be subject to central clearing and the levels of initial margins estimated under the internal models are broadly in line with the results of the BCBS-IOSCO findings; and
- c) the overall estimate of initial margin requirements for the EU ranges from EUR 200 billion to EUR 420 billion. The details of the calculation of these estimates are reported in Section (iii). The following sections elaborate on all of these aspects in greater detail.

130. The ESAs will however continue to follow the work of the expert group that the BCBS and IOSCO set up for monitoring the implementation of the margin framework in the various jurisdictions. Therefore any potential deviations on the overall impact of this reform will be noted.

5.1.7 Methodology and assumptions

131. For the QIS, BCBS and IOSCO collected information with a reference date of 30 June 2012. Nonetheless, some of the respondents provided the most recent data available. For this analysis, the ESAs asked the national competent authorities that are also members of the BCBS or IOSCO to disclose the same datasets reported to the BIS for their exercise. Therefore, the global and European results should be comparable. For this analysis, the data sample comprises 20 institutions from 6 jurisdictions²⁰ in the EU against the 39 respondents (of which 36 banks or insurers) from ten jurisdictions of the global QIS. The data were reviewed by national supervisors in September 2012 to ensure quality, accuracy and consistency²¹.

132. For this analysis, the ESAs followed roughly the same approach used by BCBS-IOSCO in their analysis. The major degree of uncertainty on these results is due to the fact that the assumptions of the original survey do not perfectly fit the final framework, in particular:

- a) This study is based on two calculation methods, namely the standard schedule and internal estimates of the initial margins; the possible introduction of widespread used third parties' models is not included.

²⁰ 15 banks, two Insurers, one in the utility sector, one non-financial and one classified as 'other' from France, Germany, Italy, the Netherlands, Spain and the United Kingdom.

²¹ In addition to the data collected during the survey, other sources and references were used such as: the FSB progress report on OTC derivative reform, the BIS official statistics, and the data on EU banks provided by SNL Financial.

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- b) The estimates delivered for the QIS were based on the assumption of the first consultative document²² that the threshold could apply at counterparty level; the current draft RTS prescribe that the EUR 50 million threshold can be implemented only at group level.
- c) The results of the global QIS survey disclosed in the second consultative document were based on the assumption that no netting is allowed in the standard model (the 'standard schedule' in the BCBS-IOSCO terminology). However, the final draft RTS assume that using the standardised method netting benefits can be captured applying the net-to-gross ratio (NGR). Firstly, this analysis cannot really be adjusted for that. Secondly, this means that the estimates relating to the standardised model can be interpreted as an upper limit.
- d) The same correction factors are applied to rescale the data from the FSB estimates and the global QIS estimates to take into account differences in the sample of data providers. These adjustments may not perfectly fit the conditions of the European market.

133. For example, the overall activity of non-centrally cleared derivatives in the EU can be estimated by comparison with the results of the Basel-IOSCO QIS.

5.1.8 Summary of the results

134. Making an appropriate comparison to the QIS conducted by BCBS-IOSCO is a non-trivial exercise for which a number of considerations need to be taken into account. Firstly, the data presented by the BCBS-IOSCO underwent a data cleansing procedure that took into account double reporting, i.e. two counterparties reporting the same trade, and adjustments for the fact that the full sample did not cover all banks. This complicates an outright comparison, as the same procedures cannot be consistently applied to the EU sample.

135. Consequently a number of assumptions have to be made, in particular that the European markets mirror to a large extent the conditions in the global derivatives markets. This assumption does not appear to be widely controversial given the global nature of the derivatives markets. Any scaling being made in the BCBS-IOSCO quantitative impact study is consequently also reflected in the European analysis. However, this does introduce some elements of estimation error.

136. The following two tables provide idea on the share of European respondents in the BCBS-IOSCO sample.

²² [Margin requirements for non-centrally-cleared derivatives – consultative document](#), issued by BCBS and IOSCO on 6 July 2012.



Table 1: European and global derivatives activity according to underlying asset classes (in EUR billion). These results include centrally and non-centrally cleared derivatives.

Respondents	Foreign exchange	Interest rate	Credit	Equity	Commodity	Other	Current total gross notional outstanding
EU	26 182	107 029	8 912	3 208	478	132	145 939
BCBS-	54 958	230 136	24 265	6 596	2 027	515	318 497

137. The overall size of the EU OTC market, prior to the introduction of centralised clearing, is around EUR 146 billion among the participants in the EU sample, which covers the largest European counterparties. Table 1 shows that the EU counterparties consist of 46% of the overall QIS sample and that the majority of EU exposures stem from foreign exchange and interest rate derivatives. The total share is slightly higher than the figures presented in other surveys investigating the European derivatives market, probably reflecting an overweight of European institutions in the BCBS-IOSCO QIS.

138. However, the above figures are affected by a number of issues, as some contracts have been double counted, as counterparties have individually reported the overall activity. Therefore, trades where both counterparties have reported will be included twice. This is difficult to adjust given that it requires details of the specific counterparties, so the un-adjusted numbers are presented and provide an upper limit. However, adjustments have been made to account for the differences in sample size and the size of the overall derivatives market.

Table 2: QIS data for EU countries: non-centrally cleared derivative activity after central clearing takes effect (in EUR billion).

Respondents	Foreign exchange	Interest rate	Credit	Equity	Commodity	Other	Total gross notional outstanding
EU	21 447	48 338	3 392	1 469	233	42	74 920
BCBS-IOSCO ²⁴ (adjusted)	47 863	107 209	12 132	2 908	1 212	409	171 733

139. The notional amount of derivatives contracts, presented on a gross basis, shows that potentially 75 trillion of derivatives could fall under the scope of the current RTS. However, in practice, it will be significantly lower, as contracts between the large counterparties in the sample have been counted twice, not all counterparties will be above the EUR 8 billion threshold applying from 2019 and physically-settled foreign exchange contracts will not be subject to initial margins. Consequently, the overall potential for non-centrally cleared contract is expected to be substantially lower.

5.1.9 Estimates for the European market

²³ Compare with Table 2, row 1, p. 29 of the second consultative document.

²⁴ Table 3, p. 30 of the second consultative document.

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140. In this section, the estimates based on the European sample are compared to the results published in the second consultative document.

141. The estimates based on the European sample are labelled 'EU'. In all the tables below figures are reported in EUR billion and rounded to the nearest billion for readability.

Table 3: QIS data for EU countries: non-centrally cleared derivative activity before and after central clearing takes effect (in EUR billion)

Respondents		Foreign exchange	Interest rate	Credit	Equity	Commodity	Other	Total gross notional outstanding
EU	Before	26 181	107 029	8 912	3 208	478	132	145 939
	After	21 447	48 338	3 392	1 469	233	42	74 920
	Reduction	18%	55%	62%	54%	51%	68%	49%
BCBS- IOSCO ²⁵	Before	54 958	230 136	24 265	6 596	2 027	515	318 497
	After	47 863	107 209	12 132	2 908	1 212	409	171 733
	Reduction	13%	53%	50%	56%	40%	21%	46%

142. Table 3 summarise the previous tables presenting a breakdown of the derivatives that are expected to be centrally cleared and those non-centrally cleared as gross notional amounts. The last row in the table shows that the estimated reduction in total gross notional outstanding after mandatory clearing enters into force at about 49%.

143. Once an estimate of the overall activity for non-centrally cleared derivatives is available, a comparison can be carried out between the current practice concerning the exchange of initial margins and the amount of initial margins collected after the full implementation of the margin framework. This is based on the simplifying assumption that the overall activity in 2019, end of the phase-in period, and the data used for this analysis remain similar.

144. In line with the supervisory guidance on foreign exchange transactions,²⁶ these draft RTS prescribe minimum regulation for the exchange of variation margins but not for initial margins relating to physically-settled FX forward and swaps (and a similar treatment of cross currency swaps). Table 4 gives an overview of the activity relating to these kinds of derivatives and compares the EU estimates with the BCBS-IOSCO estimates.

Table 4: Gross notional outstanding amounts (EUR billion) of foreign exchange OTC derivatives (after CCP clearing) subject to these RTS.

Foreign exchange swaps and forwards

²⁵ Table 3, p. 30 of the second consultative document.

²⁶ [Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions](#), issued by BCBS in February 2013.

Foreign exchange swaps and forwards

Respondents	Maturity < 1 month	Maturity between 1 and 6 months	Maturity between 6 months and 1 year	FX derivatives after removing swaps and forwards included in the other columns
EU	2 247	3 548	1 252	14 401
BCBS-IOSCO ²⁷	8 225	12 510	4 212	47 863

145. It should be noted that refers to non-centrally cleared transactions after mandatory clearing. Those figures represent a significant amount yet a relatively small share of the overall derivatives subject to margin requirements. It should be noted that, under this proposal, physically-settled FX forward and swaps are subject to a variation margin but not to an initial margin.

146. With regard to existing practices, only very limited initial margins are exchanged today, as illustrated in Table 5.

Table 5: Comparison between estimated and provided initial margin amount under the current practice (EUR billion)

Respondents	Total notional outstanding	Initial margin posted	Initial margin collected
EU	145 939	2	37
BCBS-IOSCO ²⁸	318 497	6	95

147. The exchange of variation margins seems to be common practice among financial institutions but the exchange of initial margins is rare. Initial margins are currently collected under very specific circumstances and only with respect to certain counterparties. Therefore, the estimate of approximately EUR 100 billion on a global basis and less than EUR 40 billion in the EU for initial margins currently collected is in line with expectations.

148. The introduction of the EUR 50 million threshold ('the threshold') has a substantial impact on the overall amount of initial margin required. Data are available only under the assumption that the threshold is applied at counterparty level. These draft RTS prescribe that the threshold can be applied only to the total amount of initial margin required when calculated at consolidated group level.

149. BCBS and IOSCO report the final results as an estimate of the effects that the introduction of the threshold would have on top of the possibility of allowing netting among asset classes. These are reported in Table 6 and compared with the EU estimates in the following table. The netting effect is limited, although not negligible, to around 8–14%. The last column is obtained multiplying the estimates based on the QIS sample by 1.3, i.e. the assumption is that the Basel-QIS sample covers around 75% of the global market.

²⁷ Table 6, p. 33 of the second consultative document.

²⁸ Table 4a, p. 31 of the second consultative document.

Table 6: Initial margin requirements under the threshold regime, global estimates

Initial margin requirements				
	Threshold level (EUR(Euro million))	QIS-sample No netting across asset classes (EUR billion)	QIS-sample Netting across asset classes (EUR billion)	Rescaled to global market ²⁹ No netting (EUR billion)
BCBS-IOSCO ³⁰	0	1 271	1 095	1 652
	50	558	513	725

150. The results of the BCBS and IOSCO conclude that the overall impact, i.e. the amount of initial margin required once the framework enters fully into force, varies between EUR 1.7 trillion (threshold set to 0) and EUR 0.7 trillion (threshold set to EUR 50 million).³¹

151. With the same assumptions, a similar range can be estimated specifically for the EU, based on the European sample. To take note of that, to avoid double counting, the second and third columns were estimated using only the margins collected.

Table 7: Initial margin requirements under the threshold regime, European estimates

Initial margin requirements				
	Threshold level (EUR million)	European sample No netting across asset classes (EUR billion)	European sample Netting across asset classes (EUR billion)	Rescaled to EU market ³² - no netting (EUR billion)
EU	0	323	260	420
	50	155	116	201

5.1.10 Scheduled implementation in the European Union ('phase-in')

152. EBA evaluated the phase-in requirements using available public data. Data were extracted from SNL financial reports for year-end 2012. The data sample covers 143 banks from 25 different European countries representing a total notional amount of EUR 233 874 billion.

153. In the sample, the number of banks subject to initial margin requirements during the phase-in described in the final article of the draft RTS, assuming unchanged derivatives activity, will be relatively limited during the first four years. However, it should also be

²⁹ Rescaled to entire global market: second column (no netting) multiplied by 1.3 =1/75%

³⁰ Table 5, p. 32 of the second consultative document.

³¹ p. 33 of the second consultative document.

³² Rescaled to entire EU market: second column (no netting) multiplied by 1.3 =1/75%



noted that Table 8 refers only to banks and not to other counterparties and therefore only provides a lower limit of the counterparties subject to the requirements.

154. However, it should also be noted that the EUR 3 trillion threshold for the first period does not exactly identify the amount of transactions that will be subject to initial margins requirements in the first phase. This is due to the fact that counterparties exceeding the EUR 3 trillion threshold will be subject to initial margin requirements only if their counterparty also meets the same condition. In other words, the exchange of collateral for initial margin is required only if both counterparties are above the threshold. The ESAs estimate that fewer than half of the contracts will actually meet this condition as of September 2016.

Table 8: Phase in thresholds for initial margin requirements (EUR billion)

Phase-in dates	Thresholds	Number of institutions above the threshold
1 September 2016	3 000	12
1 September 2017	2 250	13
1 September 2018	1 500	14
1 September 2019	750	17
1 September 2020	8	59

155. In terms of number of institutions, and not necessarily in terms of the amount of margins to be collected, the largest implementation burden will be at the end of the phase-in period.

5.2 Summary of the questions for consultation

- Question 1.** Respondents are invited to comment on the proposal in this section concerning the treatment of non-financial counterparties domiciled outside the EU.
- Question 2.** Respondents are invited to comment on the proposal in this section concerning the timing of calculation, call and delivery of initial and variation margins.
- Question 3.** Respondent are invited to provide comments on whether the draft RTS might produce unintended consequence concerning the design or the implementation of initial margin models.
- Question 4.** Respondents are invited to comment on whether the requirements of this section concerning the concentration limits address the concerns expressed on the previous proposal.
- Question 5.** Respondent to this consultation are invited to highlight their concerns on the requirements on trading relationship documentation.
- Question 6.** Respondents are invited to comment on the requirements of this section concerning the legal basis for the compliance.
- Question 7.** Does this approach address the concerns on the use of cash for initial margin?
- Question 8.** Respondents are invited to comment on the requirements of this section concerning treatment of FX mismatch between collateral and OTC derivatives.