European Union: mandatory bilateral margin rules for investment funds

On 15 December 2016, the Official Journal of the European Union published the Commission Delegated Regulation supplementing the European Market Infrastructure Regulation (EMIR) on regulatory technical standards for risk-mitigation techniques for Over-The-Counter (OTC) Non-Centrally Cleared Derivatives (NCCDs).Under the EMIR, financial counterparties, like investment funds, and large non-financial counterparties have the obligation to protect themselves against credit exposures to their derivatives counterparties by collecting margins where those contracts are not centrally cleared. Since 16 August 2012, financial counterparties have been required to ensure the timely, accurate and appropriately segregated exchange of collateral with respect to OTC derivative contracts.In force since 4 January 2017, the Margin Rules establish the mandatory technical standards for the approaches to be applied for the margin calculation, the procedures to be followed for the margin collection, the eligibility, valuation and treatment of collateral, the operational aspects and requirements concerning the trading documentation.

Mandatory requirements for OTC derivative contracts

The Margin Rules spell out the requirements concerning the risk management procedures for the margin exchange for NCCDs. These procedures must inter alia include or specify the following: the calculation and collection of margins, i.e., variation margin and, if applicable, initial margin, the assessment of the eligibility of collateral received as margins, the management and segregation of collateral received as margins.

Variation Margin (VM)

A party must collect VM equal to the positive mark-to-market value of its OTC derivatives. The VM needs to be calculated every day based on the values of all the outstanding derivatives contracts under the relevant master agreement on the previous business day. Parties may agree on a minimum transfer amount (MTA) so as to avoid small transfers. However, once the MTA is exceeded, the full amount must be provided. Parties are required to meet strict delivery timing requirements for collateral, which means generally on the same business day as the date of the calculation.

Initial Margin (IM)

The IM must be calculated not only on each trade date but also at least every 10 business days. Moreover, an IM calculation is due after certain specified events, such as a payment or delivery date, an expiry date and every time the underlying risk measurement has changed. If the IM requirement is over the MTA (applied on an aggregate basis across both VM and IM amounts), then the initial margin must be provided on the same business day as the calculation date. The collection of IM must be performed without offsetting the IM amounts to be exchanged between the two counterparties. A counterparty can calculate the IM requirement using either a standardised approach set out in the Annex to the Margin Rules, or an IM model, provided that it satisfies certain requirements set out in the Margin Rules.The same collateral that is eligible to satisfy the VM requirement is also eligible for the IM requirement. Collateral posted as IM must be segregated from the collecting party's assets to protect it from the insolvency or default of the collecting counterparty. The collecting party may not re-hypothecate the IM collateral but the third-party holder/custodian or central bank may reinvest any cash collateral in other Eligible Collateral.

Collateral and collateral haircuts

The Margin Rules set out a wide range of collateral that is eligible to satisfy both the VM and IM obligations (see below). The value of any eligible collateral collected or posted to satisfy the Margin Rules is subject to the application of haircuts. Haircuts may be determined using either the standard methodology provided for under the Margin Rules or the party's own estimates using internal models (based on volatility estimates) compliant with the Margin Rules. Under the standard methodology, no haircut is applied to cash collateral posted as VM; however, an 8% haircut is applied to VM which is non-cash eligible collateral denominated in a currency other than those agreed in the parties derivatives documentation, and an 8% haircut is also applied to cash and non-cash collateral posted as IM if it is denominated in a currency other than the agreed termination currency with respect to such counterparty.

General Exemptions from Initial Margin or Variation Margin

The Margin Rules provide for a range of exemptions and thresholds with regard to the new margin requirements.

Phase-in timetable for Margin Rules

- ***VM phase-in:*** VM requirements will apply in two stages: from 4 February 2017, for those counterparties with more than EUR 3 trillion aggregate average notional of non-centrally cleared OTC derivatives and, from 1 March 2017, for all other in-scope counterparties
- ***IM phase-in:*** IM requirements will apply as follows:
    - From 4 February 2017, where both counterparties have, or belong to groups each of which has, an aggregate average notional amount of non-centrally cleared derivatives that is above EUR 3,000 billion;
    - 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 that is above EUR 2,250 billion;
    - 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 that is above EUR 1,500 billion;
    - 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 that is above EUR 750 billion;
    - 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 that is above EUR 8 billion.
- ***Product specific phase-in:*** physically settled foreign exchange forwards and single-stock equity options and index options are subject to additional phase-in periods such that, with respect to:
    - Physically settled foreign exchange forwards: no VM is required to be exchanged before one of the following dates (whichever is earlier): 31 December 2018 and the date when the MiFID technical standards come into force
    - Single-stock equity options and index options - no variation margin or initial margin is required to be exchanged until 3 years from the entry into force of the margin rules.

- ***Intragroup phase-in:*** where an entity established in the EU enters into an OTC derivatives contract with another entity which belongs to the same group, then no initial margin or variation margin requirements will apply until 4th July 2017 at the earliest.

Eligible Collateral

The Margin Rules list a wide range of eligible collateral for both the IM and VM requirements including:

- Cash in the form of money credited to an account in any currency, or similar claims for the repayment of money (e.g., money market deposits accounts);
- Gold in the form of allocated pure gold bullion of recognised good delivery;
- Certain debt securities issued by EU central governments, EU central banks, certain regional and local authorities of EU Member States and certain public sector entities of EU Member States, multilateral development banks or international organisations;

- Certain debt securities issued by third countries’ governments, central banks and certain regional and local authorities;
- Certain debt securities issued by credit institutions or investment firms;
- Corporate bonds;
- Most senior tranche of a securitisation that is not a re-securitisation;
- Certain convertible bonds provided that they can be converted only into equities which are included in a main index;
- Certain equities included in a main index; and
- Shares or units in UCITS, where specified conditions are satisfied.