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EMIR for asset servicers and custodians
An opportunity or a challenge?

Leading business advisers

The European Market Infrastructure Regulation (EMIR) introduces sweeping new requirements aimed at reducing risk and improving transparency in OTC derivatives markets. EMIR is the EU's response to an international commitment to centrally clear OTC derivatives. The changes will affect not only those who trade in derivatives but also the asset servicers and custodians. While the detailed rules are onerous, EMIR represents a potential opportunity for these providers to enhance their service offering to their clients.

What is EMIR?

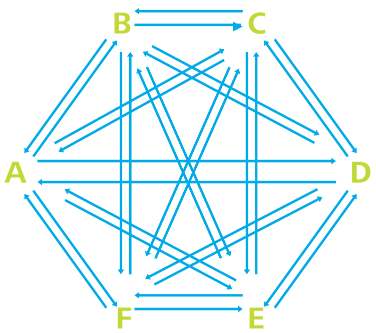
In the current bilateral model each market participant has a legal relationship with, and exposure to the other parties to the contract, creating a tangled web of exposures across the various buy side and sell side participants. However, in September 2009 the G-20 leaders agreed that:

"all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements."

EMIR is a regulatory response to the risks emerging from the interconnection of the OTC derivative markets

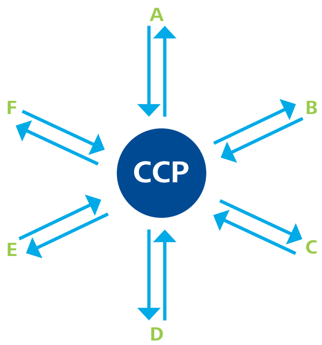
PROBLEM

In the bilateral model each market participant has a legal relationship with, and separate (gross) exposure to each of the other participants, creating a tangled web of exposures.



SOLUTION

In the CCP model, each market participant has a legal relationship with and (gross) exposure to the CCP only, regardless of the identity of their counterparty in the underlying trade.



Weaknesses exhibited during the crisis

Counterparty credit risk
Possible systemic implications that a default can have due to the interconnected web of market participants.

Lack of transparency
Regulators did not have sufficient oversight of the global positions to detect the accumulations of pockets of risk within the financial system.

Weak risk management
for bespoke transactions, led to realised losses in times of market stress.

Regulatory response

- All standardised derivatives should be centrally cleared
- Non centrally cleared derivatives should be bilaterally collateralised and subject to higher capital requirements
- All OTC derivatives should be reported to a Trade Repository (TR)
- All standardised and sufficient liquid OTC derivatives should be traded on an exchange or electronic platforms

This change means each market participant must contract directly with the central counterparty (CCP) in order to enter into a derivative contract with a counterparty. The counterparties must report such contracts to trade repositories and they must adhere to additional collateral, risk management and reconciliation requirements. EMIR provides the framework for implementing the bulk of these requirements in Europe and will be complemented by changes to the Markets in Financial Instruments Directive (MiFID II / MiFIR) and changes to the Capital Requirements Directive (CRD IV).

EMIR applies to all financial counterparties and across the five main asset classes (interest rate, equity, credit, commodity and foreign exchange). The process for deciding which products are sufficiently standardised to clear will follow a two-pronged approach. Under the "bottom-up approach" CCP will determine themselves which derivatives to clear with the approval of national regulators and ESMA.

Under the "top-down approach" ESMA will direct CCP which classes of derivatives should be cleared. The criteria for deciding whether an OTC contract will be centrally cleared include:

- Level of contractual and operational standardisation of contracts
- Volume of trading and liquidity
- Availability of fair, reliable, generally accepted pricing information

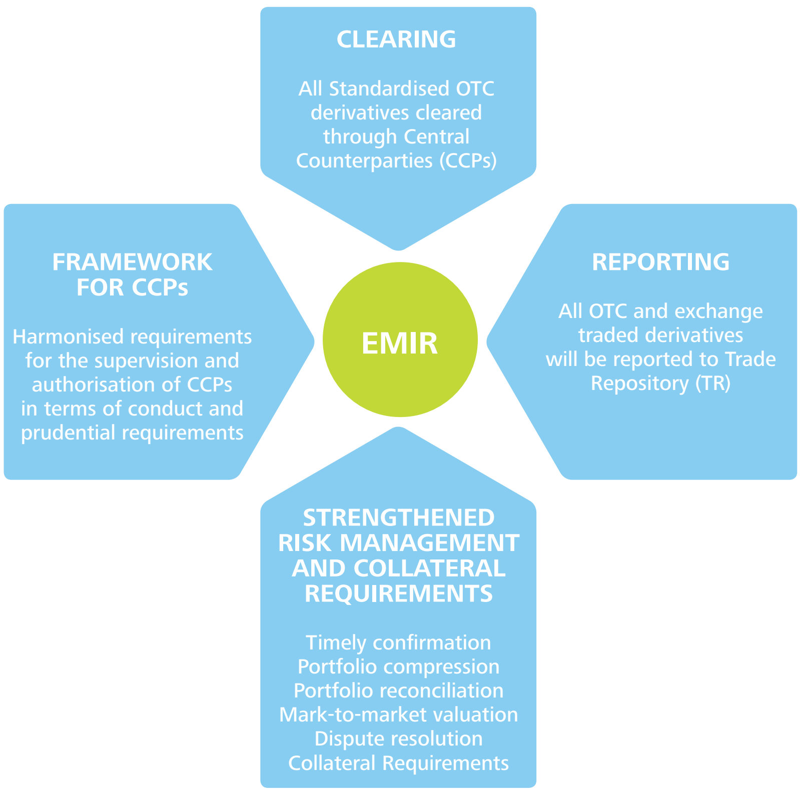
ESMA will establish an online public register to identify the OTC derivative products subject to clearing, which will include details on authorised CCPs and the dates from which the clearing obligation for each product takes effect. Interest rate swaps will likely be the first class of derivate to clear.

Contracts that are not sufficiently standardised to meet clearing obligations, must meet new risk management requirements through the timely confirmation of trades, portfolio reconciliations, portfolio compression analysis and agreed valuation models.

Counterparties must also meet new collateral requirements which specify the level and type of collateral that will be required for initial of variation margins.

All derivatives contracts – whether centrally cleared or otherwise – must be reported to a trade repository no later than T+1.

The four pillars of EMIR

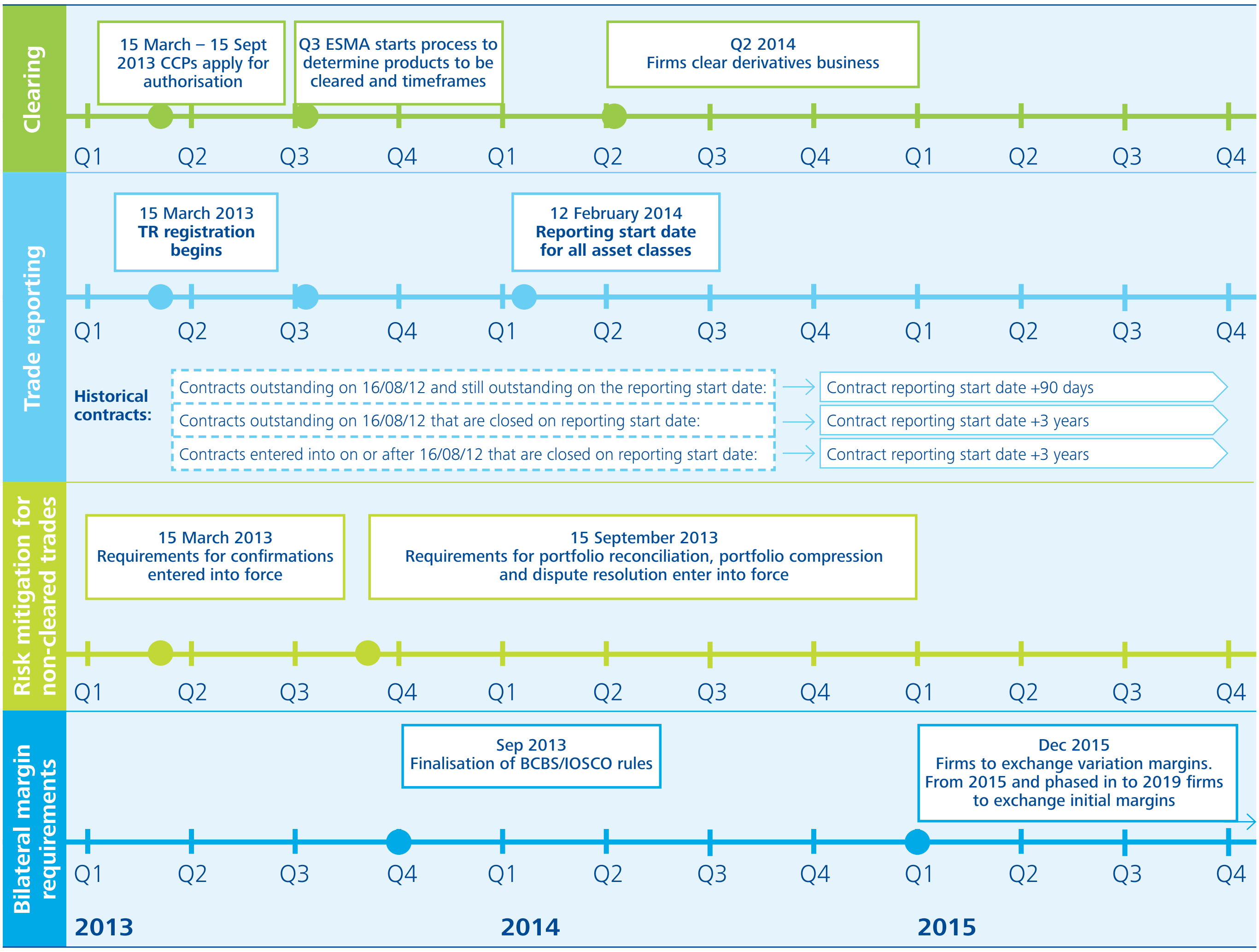


EMIR timeline

EMIR is being implemented through a phased approach that requires the adoption of a range of technical measures, several of which have already gone live. Risk mitigation requirements for non-centrally cleared OTC derivatives relating to confirmations, portfolio reconciliation, portfolio compression and dispute resolution have entered into force. A number of TRs have also been authorised, with the reporting start date for all classes of new OTC and exchange traded derivatives set for 12 February 2014.

The authorisation process for CCPs is underway and should facilitate the commencement of centralised clearing at some stage in 2014. EMIR is therefore already a reality and with further measures due to be adopted in the coming months, implementation will be a key focus for market participants throughout 2014.

Implementation throughout 2013/2014/2015



Impact of EMIR

The new requirements will, in some shape or form, affect all participants in OTC derivative markets.

One of the key impacts of EMIR is on IT systems. New collateral management systems may need to be implemented along with considerations around new reporting fields, data formatting and data gathering mechanisms.

In the area of collateral management, counterparties will need to choose a CCP or a Clearing Member (CM), and undertake the legal agreements and documentation requirements that this will entail. New processes will be required to monitor collateral positions daily and the counterparties will need to agree the model for collateral requirements calculation (non-cleared OTC) and for liquidity planning. Counterparties will also need to ensure that their collateral is held in segregated accounts, and they will be restricted from the re-use of that collateral.

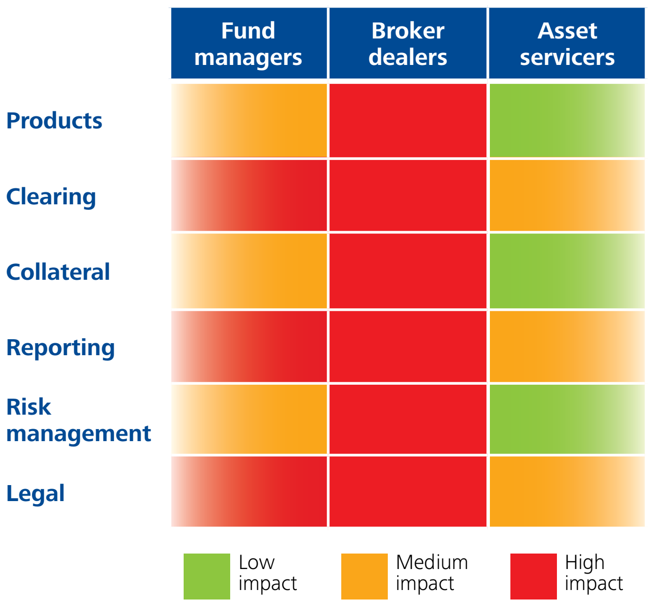
In order to comply with the new reporting requirements, CPs must select a Trade Repository. New reporting fields will need to be developed in counterparties' IT systems and must include specific new identifiers.

Counterparties will be required to implement increased operational risk mitigation processes for non-cleared OTC derivatives such as portfolio reconciliation, portfolio compression, timely confirmation and mark-to-market or mark-to-model valuation, and will also need to review legacy contracts such as ISDA agreements and CSAs especially around collateral calculation for example.

Value chain of OTC derivative management

EMIR impacts can be identified and categorised along the entire OTC derivatives value chain

Impact heat map



“One of the key impacts of EMIR is on IT systems. New collateral management systems may need to be implemented along with considerations around new reporting fields, data formatting and data gathering mechanisms.

Dodd Frank and cross-border issues

Transactions involving non-EU counterparties raise a number of extraterritorial issues in the context of EMIR, which is part of a wider G-20 international commitment to centrally clear OTC derivatives.

A key comparison must be drawn with Dodd Frank Title VII in the US. While the overall frameworks are similar, there are some differences in the detail of the requirements that need to be understood. These are predominantly in terms of the timing of reporting, the assets covered and the data captured. However concerns that the same transactions may be subject to duplicative reporting have been eased recently with the agreement of a "path forward" between the European Commission and the Commodity Future Trading Commission (CFTC) stating that firms "should be subject to only one set of rules" and allowing US and EU firms to "choose which rules apply to a trade" as the rules are "essentially identical in important areas".

ESMA has published reports with technical advice on equivalence standards with the US, Japan, Australia, Hong Kong, Singapore and Switzerland. The advice covers the recognition of non-EU CCPs and TRs, the clearing obligation, reporting obligation, non-financial counterparties and risk mitigation obligations under EMIR (i.e. portfolio reconciliation, dispute resolution, portfolio compression and margin requirements for non-centrally cleared OTC derivatives). Technical advice on further regimes such as India and South Korea is planned.

What all this means for asset servicers and custodians

Counterparty obligations

Asset servicing firms may have the requirement to enter into intercompany derivative contracts in order to fulfil their duties as service providers for their clients e.g. to mitigate the risk in restricted markets. In such cases, asset servicers must ensure that they are in full compliance of the rules of the regulation as they pertain directly to a counterparty.

Collateral and clearing requirements

Under the new architecture, all standardised OTC derivatives will be cleared through CCPs, including new initial and variable margin requirements (IM and VM). Non-cleared derivatives will be subject to strengthened risk management requirements, including the need to collateralise positions. All OTC and exchange traded derivatives will be reported to TRs. What this means is that depositaries have a complete responsibility on both collateral pledged and received for the funds they service (i.e. there is an obligation of oversight and restitution).

Importantly, collateral must be deposited in segregated accounts with sub custodians which is a direct impact for asset servicers even though they will not be a counterparty to the contract in the majority of cases, and there can be no reuse of collateral. In addition, there are new due diligence requirements which must be performed by asset managers – e.g. contracts review on ISDAs and CSAs, collateral calculation and dispute resolution.

Support opportunities

Asset servicers are in a strong position in the OTC value chain, as they service multiple counterparties and are well connected across jurisdictions. By fully assessing the impact of the regulations on theirs and their clients' business, asset servicers can develop a programme to reach out to their clients and provide the foundation to support them as they go through the process of understanding and implementing the operating model changes as a result of the new requirements within their own organisations.

Key areas of opportunity for assset servicers

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Reporting opportunities

Counterparties may be concerned about the implementation of systems and processes to fulfil their trade repository requirements. This will require them to identify data sources and begin planning around system developments considerations and testing etc. Therefore, they may consider delegating reporting to a third party which is explicitly permissible under the regulation. In addition, as receiver of trade information for administrative purposes global asset servicing providers have access to the data to be reported and are in a strong position to evaluate the impact the regulation has on its clients.

All this creates the opportunity for asset servicers to enhance the service suite they offer to their clients by performing the trade repository reporting duties on their clients' behalf and adding the service as an addition to the standard offering. Asset servicers must first fully assess the requirements and the trade repository model of the various providers. They must then put the appropriate framework in place to develop compliant reporting. This involves completing the project in a timely manner and on-boarding their clients onto the new service. By using their regulatory expertise to drive the appropriate system changes to build compliant reporting extracts, asset servicers can meet the client demand in this regard.

How we can help

Strategic diagnostic and business impact analysis	Detailed implementation planning	Delivery to compliance	Opportunity realisation
✓ Up to the minute regulatory updates ✓ 360º "As is" review of business and operations ✓ 360º assessment ✓ Dodd Frank and other EU regulation overlap	✓ Detailed assessment of business impacts ✓ Development of detailed project planning for implementation of change	✓ Action plan execution for full adaption of EMIR ✓ TR and CCP selection	✓ Development of potential opportunities ✓ Client outreach planning

Regulatory centre of excellence, impact assessment diagnostic toolkit, and implementation expertise

Deloitte expertise

Deloitte supports clients on their journey towards compliance based on a proven customised gap assessment diagnostic toolkit designed specifically for EMIR business impact analysis and implementation. This allows us to work with our clients to design a road map and a plan to achieve compliance and realise the opportunities that EMIR presents.

Our EMIR team

Cormac Dinan
Director
Financial Services
Consulting
E: cdinan@deloitte.ie
T: +353 1 417 2949

Niamh Geraghty
Director
Investment Management Advisory
Audit
E: ngeraghty@deloitte.ie
T: +353 1 417 2649

Sean Smith
Director
Enterprise Risk Services
E: seansmith1@deloitte.ie
T: +353 1 417 2306

Investment Management Team:

David Dalton
Partner
Financial Services
Consulting
E: ddalton@deloitte.ie
T: +353 1 407 4801

Mike Hartwell
Partner
Head of Investment Management
Audit
E: mhartwell@deloitte.ie
T: +3531417 2303

Deirdre Power
Partner
Head of Investment Management Advisory
Taxation
E: depower@deloitte.ie
T: +3531417 2448

Contacts

Dublin
Deloitte & Touche
Deloitte & Touche House
Earlsfort Terrace
Dublin 2
T: +353 1 417 2200
F: +353 1 417 2300

Cork
Deloitte & Touche
No.6 Lapp's Quay
Cork
T: +353 21 490 7000
F: +353 21 490 7001

Limerick
Deloitte & Touche
Deloitte & Touche House
Charlotte Quay
Limerick
T: +353 61 435500
F: +353 61 418310

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