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EMIR SFT Regulations

Leading Business Advisors

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Agenda

1. Current status of EMIR – where do we stand on implementation and final technical rules

2. What is still outstanding – what rules need to be finalised and when do we expect this

3. Future challenges – what are the challenges still facing market participants on implementing EMIR
   a) collateral
   b) Clearing

4. SFTR
   a) What is it
   b) What does it do
      i. Disclosure
      ii. Trade reporting
      iii. Re-hypothecation
   c) What is the expected timeframe
   d) What should the market be thinking about now?

EMIR: Derivative Clearing Obligation ("DCO")

Clearing Requirements

ESMA has commenced the process of identifying, from the eligible derivatives authorised to be cleared by NCAs, the derivative classes that should be subject to the clearing obligation.

Derivative Classes

Draft RTS

Interest rate (EUR, GBP USD, JPY):
- Fixed-to-float,
- basis swap,
- forward rate agreements (exl. JPY),
- overnight index swaps (exl. JPY)

Credit: European untranched index CDS (for two indices)

Draft RTS but further consideration being given

FX: Non deliverable forwards, cash settled forwards

Expected Future Classes

Equity:
- Vanilla single name Europe and North America classes; Vanilla Index Europe, North America and Other (FTSE Russia) classes;
- Dividend single name North America and Dividend Index Europe classes

Commodity: Total of 17 classes from agriculture, energy, environmental, freight, index and metals

MiFID II/MiFIR

All derivatives entered trading on a regulated market must be cleared by a CCP.

Methodology

For the specification of the classes of OTC derivatives that should be subject to the clearing obligation the ESMA took the below criteria into account:

A. The degree of standardisation of the contractual terms and operational processes of the relevant class of OTC derivatives;
   i. Level of standardisation of contractual terms
   ii. Standardisation of the operational processes

B. The volume and liquidity of the relevant class of OTC derivatives;
   i. Proportionate margins: whether the margins or financial requirements of the CCP would be proportionate to the risk that the clearing obligation intends to mitigate
   ii. Stability of market size and depth in respect of the product over time
   iii. Market dispersion: the likelihood that market dispersion would remain sufficient in the event of the default of a clearing member
   iv. Number and value of transactions

C. The availability of pricing information in the relevant class of OTC derivatives.

EMIR: Derivative Clearing Obligation (“DCO”)

Phase-in of the DCO for IRS

Timeline

The DCO is phased-in based on the category of the counterparty. Category 1 and 2 counterparties will be subject to the frontloading requirements on a phased in basis. Categories 3 and 4 are not subject to frontloading requirements.

Clearing Obligation

- **Entry into force of the RTS**
- **6 Months:** Cat. 1 CO applies
- **12 Months:** Cat. 2 CO applies
- **18 Months:** Cat. 3 CO applies
- **36 Months:** Cat. 4 CO applies

Frontloading

- **2 Months:** Cat. 1 Frontloading applies
- **5 Months:** Cat. 2 Frontloading applies

Counterparty Category Classification

Category 1	Counterparties who are clearing members for at least one of the classes for a CCP currently clearing a class subject to the clearing obligation.
Category 2	FC whose average of outstanding gross notional of cleared derivatives for 3 months after the publication of the RTS excluding the month of publication is above EUR 8 billion.
Category 3	FCs not in category 1 or 2
Category 4	NFCs

Counterparty Category Classification

Derivatives trades entered into by category 1 and 2 counterparties **after the relevant frontloading commencement date but before the DCO takes effect** must also be cleared from the date of the DCO.

Minimum remaining maturity: frontloading will only apply to trades entered into between the frontloading phase-in date and the DCO where there is a minimum remaining maturity. The maturity is differs between the subclass of IRS.

EMIR: Non-cleared derivatives

BCBS/IOSCO framework and ESA proposals for margining

BCBS/IOSCO policy framework on margins for non-cleared derivatives (Final – March 2015)

- **Initial Margin (IM) and Variation Margin (VM) must be exchanged by all financial firms and systemically-important non-financial entities**

- **IM** should be exchanged by both parties on a gross basis
  - Optional IM threshold of €50mln, so that IM need not be posted if <50mln EUR and if threshold is exceeded then a 50mln EUR reduction in IM would be applicable
  - Requirements phased in from September 2016 to September 2020 according to volume of trades, starting with institutions trading over €3trln
  - Margin must be immediately available and fully protected.
  - Firms can use a quantitative portfolio margin model (supervisor approved) or a standardised schedule to calculate IM.

- **VM:** must be calculated and collected frequently (e.g. daily) for all non-cleared derivatives (phased in from September 2016 – March 2017).

- **Eligible collateral:** Cash; high quality government and central bank securities; high quality corporate and covered bonds; equities included in major stock indices; and gold.

- **Exemptions:**
  - **Products:** Physically settled FX swaps and forwards are exempted from IM requirements
  - **Counterparties:** Non-financial entities that are not systemically-important, sovereigns and central banks

- **Re-hypothecation of initial margin collateral**: IM collateral can only be re-hypothecated under strict **conditions**: Re-hypothecation of collateral is only permitted for the purpose of **hedging** the IM collector's derivatives position arising out of customer transactions.

- **Main conditions:**
  - Customer has to express **consent** with re-hypothecation in writing
  - Collateral has to be **segregated** from the IM collector's assets and re-hypothecated collateral has to be segregated from the third party's assets
  - Re-hypothecation is only permitted **once**: the third party is not allowed to re-hypothecate the collateral again
  - The customer and the third party may **not** be within the same **group**
  - The IM collector and the third party must keep appropriate **records**

EMIR: Non-cleared derivatives

Draft EU RTS and BCBS phase-in timeline

ESA Draft Regulatory Technical Standard

- Overall, the ESA's **draft RTS is broadly in line with the BCBS-IOSCO standard**
- A few **significant differences** between the BCBS-IOSCO standard and the draft RTS:
    - Broader list of **eligible collateral**, e.g. debt securities issued by credit institutions and investment firms, convertible bonds or the most senior tranche of securitisations that is not re-securitisation
    - Proposed **explicit diversification requirement**. Initial margin and variation margin would be subject to concentration limits to avoid counterparties becoming overly exposed to specific assets or issuers.
    - Proposed outright **ban on re-hypothecation** and other re-use of collateral as initial margin.
- We expect the final framework will enter into force in line with the BCBS/IOSCO framework.

Timeline for phase-in of BCBS requirements

The requirements are phased in for covered entities which belong to a group whose aggregate three month-end average notional amount of non-centrally cleared derivatives exceeds:

Initial Margin

- 1 September 2016 - €3.0 trillion
- 1 September 2017 - €2.25 trillion
- 1 September 2018 - €1.5 trillion
- 1 September 2019 - €0.75 trillion
- 1 September 2020 - €8 billion

Variation Margin

- 1 September 2016 - €3.0 trillion
- 1 March 2017 – all covered entities

EMIR: The new cost of trading

An estimated additional annual cost of €15.5bn for the OTC derivatives market

We estimated a total additional annual cost of €15.5bn resulting from the OTC derivatives market. Made up of €2.5bn for trades subject to clearing and €13bn for trades not subject to mandatory clearing[1].

Costs not considered in the estimates below: variation margin, costs of model development and approval, costs for liquidity management and collateral optimisation.

Centrally Cleared Trades – additional cost per €1 million notional

€10 + €3 + €0.60 = €13.60

Margin Requirements + Capital Charges + Reporting and other compliance costs

Non-Centrally Cleared Trades – additional cost per €1 million notional

€50 + €120 + €0.50 = €170.50

Margin Requirements + Capital Charges + Reporting and other compliance costs

1. Source: 'OTC Derivatives: The new cost of trading', Deloitte ECRS, 2014.

Securities Financing Transactions Regulation (SFTR)

EU proposal on securities lending and repos

Securities financing transactions: Repos, securities and commodities lending, collateral swap transactions, total return swaps (TRS)

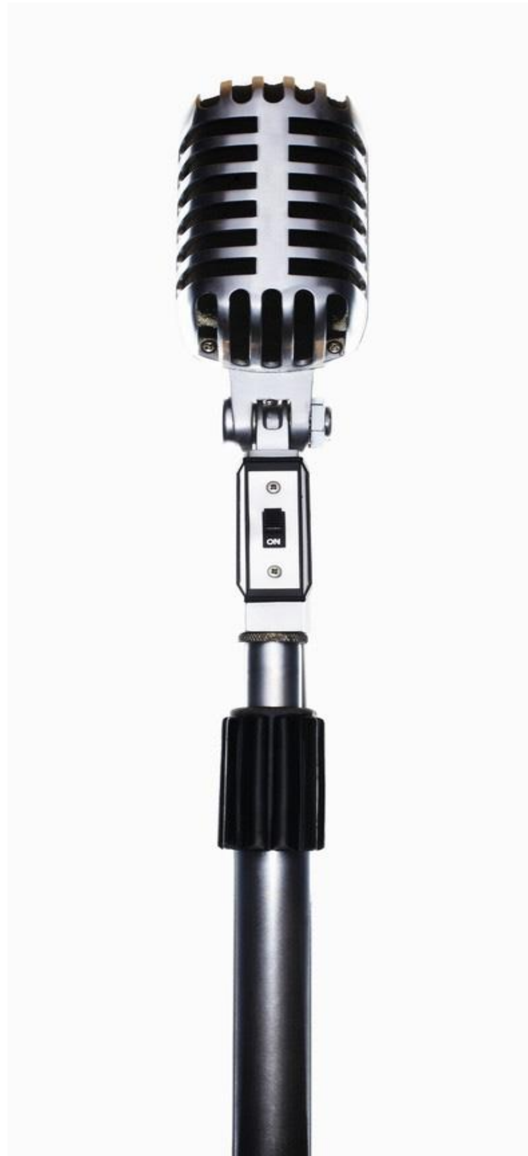
Scope of the Regulation:

All counterparties (including non-financial) engaging in SFTs and re-hypothecation	✚	Additional disclosure requirements for UCITS and AIFMD investment funds

Key proposals:

Reporting to trade repositories	• Drawing on EMIR implementation infrastructure, counterparties will be required to report SFT transactions to trade repositories. • Some historical trades may also be captured. • Reported information will include the parties to the SFT, the collateral used, the repo rate or lending fee, whether the trade has been re-hypothecated, the haircut and relevant dates.
Transparency requirements for investment funds	• Management companies of UCITS, UCITS investment companies and AIFMs will need to disclose additional information to investors about their use of SFTs, as well as other financing structures, over and above current requirements under the AIFMD and the UCITS Directive.
Re-hypothecation	• Stricter rules set out that counterparties that receive financial instruments as collateral will only be permitted to re-hypothecate them with the express consent of the providing counterparty, once they have been informed of the inherent risks, and only after the collateral has been transferred to the counterparty's account.

Q&A



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