EMIR
Key business impacts for asset managers

Brian Jackson
Partner
Audit
Deloitte

Niamh Geraghty
Director
Audit
Deloitte

Patrick Rooney
Manager
Investment Management Activity
Deloitte

The OTC derivatives market is facing considerable changes not only in Europe but across the world, as new regulations are introduced to tackle the fallout from the financial crisis.

In September 2009 the G20 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."* (G20 Leaders Summit Statement, 2009)

In the United States, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) aims to fulfil the G20 commitment that all standardised OTC derivatives should be cleared through a central counterparty.

In Europe, the European Market Infrastructure Regulation (EMIR) provides the framework for implementing the bulk of these new requirements.

The four main pillars of EMIR are:

- All standardised OTC derivatives will be cleared through Central Counter parties (CCP) or clearing members
- A harmonised framework for the provision of clearing services within Europe
- Non-cleared derivatives will be subject to more extensive risk management requirements, including the need to collateralise positions
- All OTC and exchange traded derivatives will be reported to trade repositories

While the intended benefits of EMIR are clear (enhanced transparency, reduction in counterparty risk, reduction in operational risk, increased market stability, reduction in systematic risk) the cost of compliance with these new regulations is likely to be significant and could have a real impact on a firm's trading strategies.

Who do the regulations apply to?

The regulations apply to both financial counterparties to OTC derivative contracts authorised and/or regulated in the EU (banks, funds, insurance companies, etc.) and non-financial counterparties established in the EU. Non-financial counterparties will only be in-scope where the level of OTC derivative transactions exceeds a certain threshold, and there will also be carve-outs for genuine commercial hedging. Furthermore, 'Third Country Firms' will also be subject to the regulations if they trade with EU counterparties and if they would have been subject to the regulations had they been established within the EU. This is an anti-avoidance clause, to prevent market participants from structuring contracts outside the EU to avoid the regulations.

Which contracts are in-scope?

All standardised OTC derivatives contracts will be required to clear through a CCP. The process for determining what is sufficiently standardised to be eligible will follow a two-pronged approach. The CCPs themselves will determine which derivatives to clear with the approval of their national supervisors ('bottom-up approach').

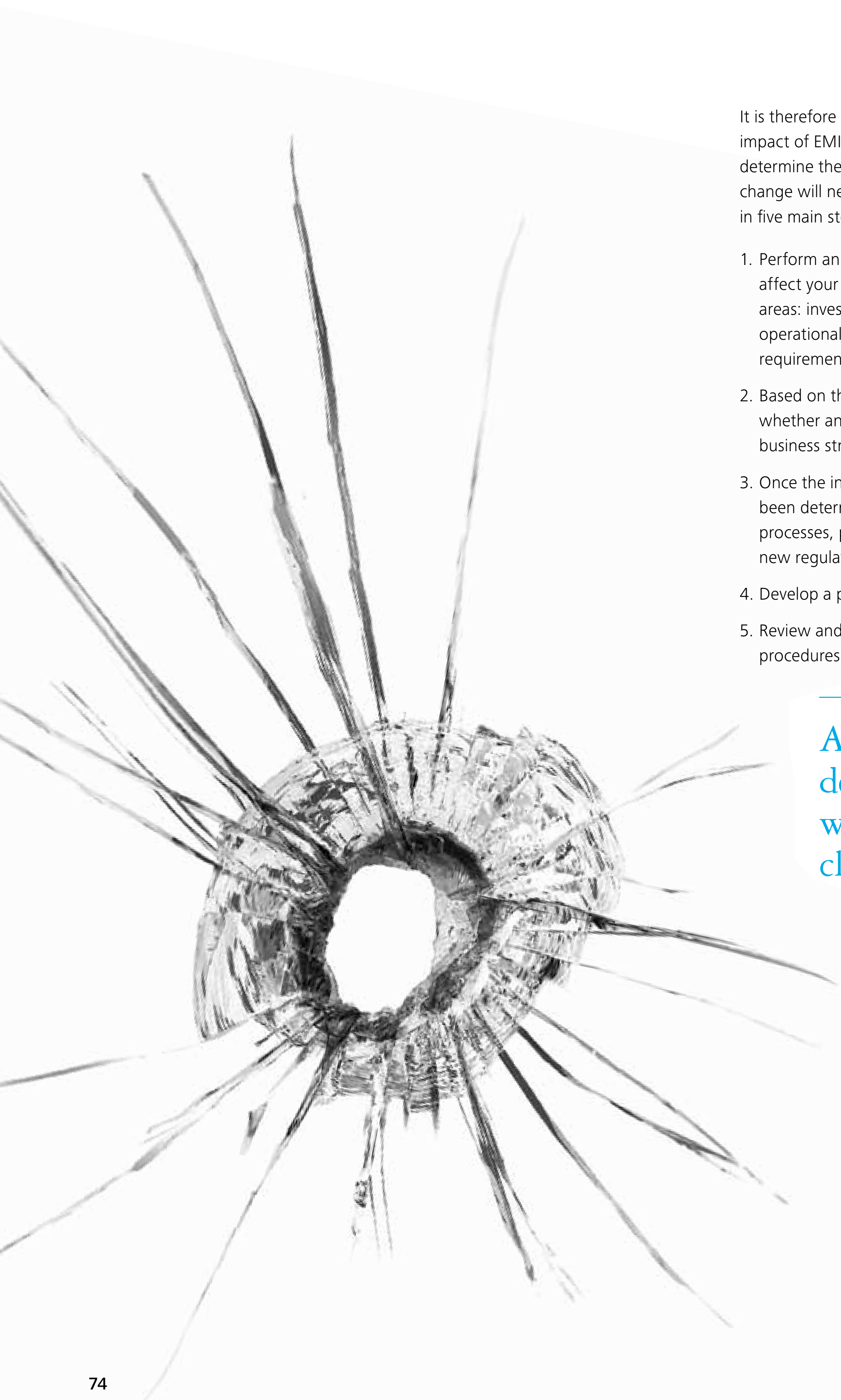
In addition, the European Securities and Markets Authority (ESMA) has the power to direct whether clearing obligations should apply when no CCP offers a product class for clearing ('top-down approach'). In both instances, ESMA will conduct a public consultation before a final decision is made. ESMA will also establish an online public register to identify the OTC derivative products subject to the clearing obligation, which will include details on authorised CCPs and the dates from which the clearing obligation takes effect.

The purpose of the requirement to report transactions to trade repositories is to address the concern that regulators have not had a full picture of the exposures of the firms they regulate and the possible systemic implications these may pose. A number of trade repositories have been established and others are in the process of being set-up.

The time to act is now

EMIR entered into force on 16 August 2012. However, the implementation of EMIR required further clarification through Regulatory Technical Standards (RTS), developed by ESMA. In December 2012 the European Commission adopted the RTS which subsequently entered into force on 15 March 2013.

The deadline for the trade repository reporting requirement with respect to credit and interest rate derivatives is July 2013 (for existing trade repositories, otherwise it is 90 days from the date of registration). The deadline for all other types of derivatives is January 2014. The reporting requirements relate to all derivative contracts in place on or after 16 August 2012. Firms will have to start clearing OTC derivatives through CCPs as early as Q1 2014.



It is therefore imperative that asset managers assess the impact of EMIR on their business now so that they can determine the level of change required and how this change will need to be managed. This may be achieved in five main steps:

1. Perform an impact analysis on how EMIR will affect your business in respect of the following key areas: investment performance, business model, operational processes, risk management, reporting requirements and collateral management
2. Based on the results of the impact analysis, consider whether any strategic changes to investment or business strategy are required
3. Once the investment and business strategy has been determined, identify the gaps in your current processes, policies and procedures compared to the new regulatory requirements
4. Develop a project plan to achieve compliance
5. Review and confirm the updated policies and procedures

All standardised OTC derivatives contracts will be required to clear through a CCP

Investment performance implications of EMIR

The cost of compliance with the new regulations will very likely make trading more expensive for managers. Cleared OTC transactions will be subject to increased transaction costs, new reporting obligations and strict collateral requirements. For un-cleared OTC transactions the cost will also increase, as EMIR is likely to require margin to be exchanged by both parties on a gross basis. Collateral collected as margin cannot be re-hypothecated or re-used. Firms will also be required to maintain new mandatory risk management processes. The impact of these increased costs will affect performance.

For smaller managers the cost of compliance with EMIR – along with the various other new regulations such as the Foreign Account Compliance Tax Act (FATCA) and the Alternative Investment Manager Fund Directive (AIFMD) – could become a significant barrier to entering the OTC markets. For larger managers, the increased cost will reduce performance by at least a few basis points. Managers need to consider whether they will continue to use these instruments and if not, how this will affect their product offerings to clients.

It is likely that the expanded requirements for certain types of collateral will also result in an increase to the cost of this type of collateral, putting further pressure on performance.

Business model implications of EMIR

The implications of EMIR on an asset manager's business model will also raise some questions.

How do we select the right clearing counterparty? It is important that the CCPs selected are the most appropriate for a firm in terms of margining levels and fees.

Do we have the in-house capability to manage collateral effectively or would it be more efficient to outsource the process? Ensuring sufficient and appropriate collateral is available at the right rate will be crucial in the operational and cost management of OTC derivatives.

Should we outsource the trade repository reporting requirements to a third party service provider? Existing service providers are likely to provide this product offering.

Operational impact of EMIR

There are numerous operational impacts of the new regulations that firms should consider. The following points are examples of what firms will need to do:

1. Analyse their derivatives portfolio to identify those that will be subject to centralised clearing and those that will not have to be centrally cleared. This analysis is an important step in determining the level of impact EMIR will have on your business, especially in the context of collateral management as discussed below
2. Establish appropriate risk management processes for non-cleared derivatives
3. Put new contractual agreements in place with clearing counterparties and also consider whether they need to update existing agreements with their brokers and collateral managers to take account of central clearing
4. Review their IT infrastructure and whether it is capable of performing automated execution, confirmation, trade processing and margin calls, and reporting associated with derivatives being cleared over an exchange
5. Consider what is required to be reported to the trade repositories and build the daily reporting file to be sent to them
6. Develop and monitor two separate processes for dealing with cleared and non-cleared derivative transaction

Managers need to consider whether they will continue to use these instruments and if not, how this will affect their product offerings to clients

Risk management impact of EMIR

While the regulators are pushing for more instruments to be centrally cleared, it is accepted that there will always be a universe of products that will not be standardised. EMIR introduces specific requirements aimed at strengthening the risk management of non-cleared trades, namely through the requirement for timely confirmation of trades, portfolio reconciliations, portfolio compression analysis and agreed valuation models.

Confirmations: The regulations set out when confirmations should be received by product type, with transitional measures in place. However, the end result is that by August 2014 all financial counterparties are required to have all non-cleared transactions confirmed by trade date plus one. Firms must report all trades that have remained unconfirmed for greater than five business days to their competent authorities on a monthly basis.

Portfolio reconciliations: Portfolio reconciliations must be performed by the two counterparties to trades at least each business day when counterparties have 500 or more OTC derivative contracts with each other or once a week for portfolios of 51 to 499 contracts. For portfolios of less than this, reconciliation must be performed quarterly.

Portfolio compression: EMIR also requires all counterparties with 500 or more non-centrally cleared contracts with a single counterparty to analyse the possibility of performing a portfolio compression exercise at least twice yearly. Financial counterparties must also mark to market the value of outstanding contracts on a daily basis, with the movement impacting the variation margin that firms will be required to post. Mark-to-model can be used in certain circumstances (e.g. inactive markets). We expect a reduction in the volume of non-standardised OTC derivatives traded and the risk management procedures required will be more onerous for many firms.

Reporting requirements

OTC and exchange traded derivative contracts – whether cleared or otherwise – must be reported to a trade repository no later than trade day plus one following the conclusion, modification or termination of a contract. For cleared trades executed on an exchange (where the identity of the counterparty is unknown) the CCP must report.

The reporting obligation will be phased in for different classes of derivatives:

- Credit and interest rate products will need to be reported from 1 July 2013 if a registered trade repository exists for that class of derivative by 1 April 2013. If no registered trade repository exists at 1 April 2013, then the reporting obligation for these classes of derivatives will be 90 days after a trade repository has been registered
- Other classes of derivatives will need to be reported from 1 January 2014 if a registered trade repository exists for that class of derivative by 30 October 2013. If no registered trade repository exists at 30 October 2013, then the reporting obligation for these classes of derivatives will be 90 days after a trade repository has been registered

While the regulators are pushing for more instruments to be centrally cleared, it is acknowledged that there will always be a universe of products that will not be standardised

Collateral management

Having determined the level of derivatives that will centrally clear and those that will not be centrally cleared, firms will need to assess the additional funding requirements in the context of the new regulations.

While collateral is currently required for OTC derivative transactions, the new regulations have specified the level and type of collateral to be posted. The type of collateral that will be required for initial and variation margins for standardised OTC derivatives must be highly liquid with minimal market and credit risk. This will include cash, gold, freely transferable securities and money market instruments. The collateral must be segregated and not re-used and the positions will have to be fully collateralised for the duration of the contract. It is expected that there will be a shortage of this type of collateral, resulting in higher costs.

Clarity is still required on the type and level of collateral that will be required for non-cleared derivatives, but it is expected that initial margin will have be to be exchanged by both parties on a gross basis with the variation margin being calculated daily. Optimisation of collateral will be crucial in managing costs and firms that do this well will gain a competitive advantage. Given the importance of this activity, firms will need to assess whether they have the right tools to efficiently manage and monitor their collateral requirements so that collateral can be optimised and costs kept to a minimum.

Other considerations

Clarity is still required over certain elements of the regulations. For example, what derivatives will have to be centrally cleared? From when exactly will firms be required to centrally clear derivatives?

Furthermore, EMIR is not the only set of regulations that will impact the trading of OTC derivatives. Firms must also consider the requirements, where appropriate, of MiFID the UCITS regulations, AIFMD and Dodd-Frank.

Conclusion

It is clear that EMIR will have a significant impact on the asset management industry. While clarity is still required on certain elements of the regulations, managers should act now to scope the impact of these regulations on their business. The regulations will not just affect the back-office and IT infrastructure of your business but could also more fundamentally impact your investment and trading strategies.

To the **point**:

- The cost of compliance with EMIR is likely to impact investment performance
- Effective collateral management will be critical to fund performance
- Managers may need to consider the impact of EMIR on their business model as well as on their operations and procedures
- Managers may need to establish connections with the most appropriate CCP for their business in terms of margining levels and fees