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EMIR-REFIT

New rules for derivatives clearing

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In February 2019, the European Parliament and the Council agreed to change the European rules on derivatives clearing via an amendment to the EMIR-Regulation. This cepAdhoc presents and assesses the results.

- **Easing the clearing obligations for both financial and non-financial counterparties that are only active on derivatives markets to a limited extent is acceptable, because the burden for those counterparties to clear their derivative contracts is regularly higher than the gain in increased financial stability.**
- **Extending the exemption for pension scheme arrangements for two more years is acceptable due to structural problems. However, this should be the final deadline, as it distorts competition to the detriment of market participants that must clear OTC-derivative contracts.**
- **The introduction of FRAND-conditions (fair, reasonable, non-discriminatory and transparent commercial terms) for direct and indirect suppliers of clearing services is critical.**
- **Powers for the Commission to suspend clearing more quickly for categories of OTC derivatives are necessary for the stability of financial markets.**

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1 Introduction

In 2012, in reaction to the financial crisis, the EU adopted the European Markets Infrastructure Regulation (EMIR) [Regulation (EU) 648/2012, see cep**PolicyBrief**]. Inter alia, it introduced new rules for counterparties of derivative contracts to report derivatives transactions to trade repositories – registered by the European Securities and Markets Authority (ESMA) – and to make data on derivatives transactions available to supervisory authorities. Furthermore, it forced counterparties to standardised over the counter (OTC) derivative contracts to clear such contracts through central counterparties (CCPs). Additionally, the EMIR-Regulation provided for prudential, organisational and conduct-of-business requirements with respect to CCPs and rules for their proper supervision.

In 2017, the Commission proposed amendments to the EMIR-Regulation to "simplify the rules and make them more proportionate". It proposed changes to the clearing obligation and to the rules regarding access to clearing, transparency, reporting obligations and supervision of trade repositories [see cep**PolicyBrief**].

After almost two years of intense negotiations, the European co-legislators reached an agreement on the amendment to the EMIR Regulation in February 2019. This cep**Adhoc** provides an overview of the agreed new rules and assesses them briefly.[1,2]

2 Trilogue agreement – results and assessment

2.1 Clearing obligation

2.1.1 Changes for non-financial counterparties and for financial counterparties

"Non-financial counterparties" – companies outside the finance sector – are less interconnected with the wider financial system and they do not pose systemic risks in the same way as financial counterparties. Thus, they benefit from less strict clearing obligations in comparison to financial counterparties.

Nonetheless, "non-financial counterparties" in general have to clear the categories of OTC derivatives specified by the Commission through a central counterparty (CCP) where their volume exceeds a clearing threshold. This general rule will also apply in future. However, in order to lower the administrative burden for the counterparties, the way they have to calculate the clearing threshold will change:

- Until now, the counterparties had to calculate their "rolling average position over a period of 30 working days" in a continuous manner.
- In future, the counterparties will have to calculate the threshold once a year based on their "aggregate month-end average position for the previous 12 months".

[1] This cep**Adhoc** does not deal with the two other proposals by the Commission for amendments to the EMIR Regulation. In November 2016, a few months after the Brexit referendum, the Commission presented a proposal for a Regulation amending the EMIR rules on the recovery and resolution of CCPs. As a direct result of Brexit, the Commission also proposed rules on the future handling of third country CCPs in June 2017 (so-called EMIR 2.2, see cep**Input**).

[2] Quotations in this paper refer to the (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 (see here), (2) Proposal COM(2017) 208 for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 648/2012 as regards the clearing obligation, the suspension of the clearing obligation, the reporting requirements, the risk-mitigation techniques for OTC derivatives contracts not cleared by a central counterparty, the registration and supervision of trade repositories and the requirements for trade repositories (see here), (3) Impact Assessment on the Proposal [SWD(2017) 148 final] (see here) and (4) the texts of the trilogue agreement on the Proposal (see here).

Furthermore, the EU legislators also decided to make a change concerning which categories of OTC derivatives contracts have to be cleared by non-financial counterparties:

- Until now, the clearing obligation applied to all categories of OTC derivatives contracts specified by the Commission, even when the non-financial counterparty only exceeded the clearing threshold for a single category of OTC derivative contracts.
- In future, they will only have to clear OTC derivatives contracts for those categories where they exceeded the clearing threshold. However, if a non-financial counterparty decides to abstain from calculating their position against a clearing threshold, it will automatically be subject to the clearing obligation for all categories of OTC derivative contracts, irrespective of their engagement in OTC trading.

The trilogue agreement entails three changes regarding the clearing obligation for financial counterparties. Firstly, it stipulates changes to the definition of "financial counterparties" per se:

- Until now, banks, (re-)insurance undertakings, investment firms, investment funds (UCITS and AIF) and institutions for occupational retirement provision (IORPs) were considered "financial counterparties".
- In future, "central securities depositories" – i.e. entities that offer post-trade infrastructure for the settlement of securities transactions – will also be financial counterparties for the purpose of this Regulation. On the other hand, as a means to "foster retail investment", UCITS and AIF, which are set up as "employee share purchase plans" will no longer be financial counterparties. This holds true also for AIFs, which are securitisation special purpose entities (SSPEs).

Secondly, the legislators have changed the conditions under which financial counterparties are subject to the clearing obligation. Financial counterparties with only a low volume of activity in OTC derivatives markets are seen as less systemically risky and may profit from clearing exemptions:

- Until now, two financial counterparties concluding an OTC derivative contract covered by the Commission's clearing obligation had to clear the contract via a CCP, irrespective of its volume.
- In future, the volume of the contract matters. Financial counterparties will only be obliged to clear such a contract, where it exceeds the clearing thresholds applicable to non-financial counterparties.

Thirdly, as with non-financial counterparties, the procedure to calculate the clearing threshold for financial counterparties will change in the same way:

- In future, counterparties, thus, have to calculate the clearing threshold once a year based on their "aggregate month-end average position for the previous 12 months".

As before, exceeding the clearing threshold of a single category of OTC derivative contracts will trigger the clearing obligation for all categories of OTC derivatives specified by the Commission. This contrasts with the situation for non-financial counterparties.

Assessment

The default risk for counterparties to derivative contracts can be minimised through CCP-clearing. CCPs net multiple reciprocal claims and thus strengthen the stability of financial markets. The decision taken by the EP and the Council to ease the clearing obligations for both financial and non-financial counterparties that are only active on derivatives markets to a limited extent is nonetheless acceptable. That is so because the burden for those counterparties to clear their derivative contracts is regularly higher than the gain in increased financial stability.

The co-legislators' decision to change the method for calculating clearing thresholds from a "rolling average position over a period of 30 working days" to a once a year calculation based on "aggregate month-end average positions for the previous 12 months" reduces the costs for counterparties. Furthermore, it reduces the risk of regulatory arbitrage, inherent in the Commission's original proposal, which focused on a three-month cycle from March to May. This might have led counterparties shifting the time of derivative contracts in order to remain below the thresholds.

2.1.2 Exemptions for pension scheme arrangements (PSAs)

The EMIR Regulation establishes that pension scheme arrangements (PSAs) – i.e. institutions for occupational retirement provision (IORPs) – that use OTC derivative contracts to reduce investment risks directly relating to their financial solvency are exempt until 16 August 2018 from the obligation to centrally clear such contracts. This is because no "suitable technical solution [has been] developed by CCPs for the transfer of non-cash collateral as variation margins". As no "suitable technical solution" yet exists, the EU legislators decided to extent the exemption for "at least a further two years" from the date of entry into force of the amended Regulation. As the deadline – 16 August 2018 – has already expired, the trilogue agreement additionally foresees that the exemption shall apply retroactively.[3]

Each year – following the date of entry into force of the amended Regulation – the Commission will have to report on the progress made to find a viable technical solution. If no solution can be found, the Commission may extend the two-year exemption by a maximum of two more years via delegated acts. Consequently, PSAs will have to clear OTC derivative contracts at the latest in mid-2023.[4]

[3] On 3 July 2018 ESMA issued a communication stating that "there would be a timing gap during which PSAs would need to have clearing arrangements in place and start clearing their derivative contracts before they are once again no longer required to do so" as both, the European Parliament in their Report and the Council in their General Approach signaled that they want to extend the exemption. Consequently, ESMA stated that it "expects competent authorities to not prioritise their supervisory actions towards entities that are expected to be exempted again in a relatively short period of time" […].

[4] It is likely that the Regulation will enter into force at some date in mid-2019.

Assessment

Due to their structure, pension scheme arrangements may not have the liquid funds necessary for meeting margin calls. Extending the exemption for pension scheme arrangements by a further “two years” is acceptable due to structural problems. However, two years should be the final deadline for finding a proper solution, as exempting pension scheme arrangements distorts competition to the detriment of market participants that must clear OTC-derivative contracts and thus bear higher costs. Giving the Commission the ability to extend the exemption for another two years – as a maximum – is, thus, not appropriate.

2.1.3 Suspension of the clearing obligation and the trading obligation

In certain circumstances, compliance with the clearing obligation may no longer be possible or advisable. This may be the case, for instance, if a CCP exits the derivatives clearing market.

- Until now, it has been difficult to suspend the clearing obligation for categories of OTC derivate contracts in a timely manner. For such a step, regulatory technical standards must be amended. This takes time and leaves the opportunity for the EP and the Council to block the suspension.
- In future, ESMA may request the Commission to “temporarily” suspend the clearing obligation for certain categories of OTC derivatives or types of counterparties where
  - the derivative category is no longer suitable for central clearing, i.e. due to low liquidity, or
  - a CCP is likely to cease clearing a specific class of derivatives and no other CCP is available as adequate replacement or
  - this is necessary and proportionate to avoid a “serious threat” to financial stability.
- Furthermore, competent authorities may request ESMA to ask the Commission for a temporary suspension. Competent authorities must provide reasons for their request and they must demonstrate that at least one of the conditions mentioned above are met. Within 48 hours, ESMA shall request the Commission to suspend the clearing obligation or reject the request of the competent authority.
- The Commission has to decide “without undue delay” whether it wants to follow ESMA’s request or not. The Commission can suspend the clearing obligation by adopting an implementing act.[5] The Commission may extent the suspension in three-monthly steps. However, the suspension should not last more than 12 months in total.

As before, a “permanent” suspension is possible only via an amendment of a delegated act.

Assessment

The ability to suspend clearing more quickly for categories of OTC derivatives is necessary for the stability of financial markets. The current procedure requires the amendment of regulatory technical standards and is too time consuming, especially in crises. However, it would have been better if ESMA, as independent regulatory authority, were to take the decision and not the politicised Commission,

[5] The implementing act is immediately applicable. However, the examination procedure applies. Thus, a committee composed of representatives of the Member States may provide an opinion on the adoption of the implementing act. If the committee delivers a negative opinion, the Commission has to repeal its decision immediately.

2.3 Access to clearing

Counterparties may experience problems in accessing central clearing, especially when the volume of their OTC derivatives trading is limited. However, the co-legislators see a "public interest in a functioning central clearing system and compliance with the clearing obligation". Thus, the EMIR-Refit stipulates that counterparties that are connected to a CCP ("clearing members"), or their clients that provide clearing services, directly or indirectly, to other counterparties, have to do so under "fair, reasonable, non-discriminatory and transparent commercial terms" ("FRAND conditions"). However, this should not result in an "obligation to contract". The Commission may adopt delegated acts to specify "under which commercial terms" conditions may be considered "fair, reasonable, non-discriminatory and transparent".

Assessment

The introduction of "fair, reasonable, non-discriminatory and transparent commercial terms" (FRAND-conditions) for direct and indirect suppliers of clearing services is critical. There is also potential access to clearing for small market participants, even though these may face challenges in finding clearing members that want to enter into a contract. The obligation to provide for FRAND conditions may be a first step towards the introduction of an obligation to contract and an access price regulation.

2.4 Transparency regarding the level of additional initial margins

Additional initial margins serve as a safeguard for CCPs against default by counterparties or to even out daily profits and losses. According to the Commission's impact assessment, increasing the transparency and predictability of initial margins would ensure that clearing members have "sufficient liquid resources to meet a future margin call" and "would reduce the probability of the clearing member being unable to meet a margin call as market volatility increases, and so would have an anti-procyclical effect".

- In future, CCPs will have to provide their clearing members with "simulation tools" allowing them to gain an idea of the amount of additional initial margin prior to the clearing of a transaction. The results of such simulations are non-binding. Furthermore, CCPs will also provide information on the models used to determine the initial margin.

Assessment

Enhanced transparency of margin requirements increases their predictability for CCP clearing members. It ensures that, although the simulations are non-binding, clearing members are better able to prepare for likely future margin-calls, which are, e.g. the result of increased market volatility. This may foster the stability of financial markets.

2.5 Reporting requirements

According to the Commission, the reporting of certain historic transactions, as provided for in the EMIR-Regulation, "has proven to be difficult" and "resulted in a high reporting failure rate and poor quality of reported data". With the entry into force of the EMIR-Regulation, counterparties were expected to report detailed data about derivative transactions. This data may not have been available, given that the reporting duty only became applicable after contracts had been concluded.

- Until now, CCPs and counterparties had to report the details of any derivative contracts which they entered into on or after 16 August 2012, or before 16 August 2012 if they remain outstanding on that date, to a trade repository.
- In future, the relevant date is 12 February 2014.

Intragroup transactions with the participation of non-financial counterparties “represent [only] a relatively small fraction of all OTC derivative transactions”. Such transactions are often concluded for hedging purposes. System risks are thus limited.

- In future, the reporting obligation will no longer apply to intra-group transactions if at least one of the counterparties is a non-financial counterparty. The respective non-financial counterparty does not need an establishment in the EU. The exemption only applies, if both counterparties are subject to the same consolidation, appropriate centralised risk evaluations are in place and the parent undertaking is not a financial counterparty.

Additionally, the co-legislators decided to lower the reporting burden for non-financial counterparties regarding OTC-derivative contracts not subject to a clearing obligation.

- Until now, in an OTC-derivative contract between a financial counterparty and a non-financial counterparty, which is not subject to the clearing obligation, both parties had to report the details of the transaction to a trade repository.
- In future, the responsibility for reporting will lie with the financial counterparty, which has to report on behalf of both counterparties. The financial counterparty has to “ensure the accuracy of the reported details” and will also be “legally liable” for reporting. The non-financial counterparty has to provide the financial counterparty with all the information that the latter requires in order to provide an adequate report. However, a non-financial counterparty may still choose to do the reporting itself.

Assessment

It is to be welcomed that the co-legislators decided to simplify the reporting requirements for counterparties. This reduces red tape without withholding important information for regulatory authorities to supervise derivative markets. Current bilateral reporting – reporting by both the financial and the non-financial counterparty – often led to diverging reports due to varying standards, formats and forms. Shifting the burden onto a single counterparty – the financial one – may therefore increase the quality of reporting and lower the burden for the non-financial counterparty. However, it would have been advisable to oblige the financial counterparty to report only on its own behalf rather than on behalf of the non-financial counterparty as well. To avoid incorrect reporting – which is more likely, where only one party of a derivative contract is obliged to report – penalties could have been introduced for (1) deliberate incorrect reporting by the financial counterparty and (2) deliberate incorrect provision of relevant information to the financial counterparty by the non-financial counterparty.

2.6 Quality and transparency of reported data and competition issues

The co-legislators want to further improve the quality and transparency of reported data to enhance the ability of regulators and supervisors to monitor the derivatives markets. Thus, they decided that trade repositories have to comply with additional duties.

- In future, trade repositories have to establish procedures for the “effective” reconciliation of data between different trade repositories and to ensure the completeness and accuracy of reported data.

ESMA may develop regulatory technical standards with respect to the procedures to be established.

Assessment

Increased harmonisation on data reporting makes it easier for regulators and supervisors to monitor derivatives markets and thus enables them to fulfil their tasks in a proper manner.

2.7 Supervision of trade repositories

Some trade repositories have already been registered by ESMA under the Regulation on securities financing transactions [Regulation (EU) 2015/2365] to fulfil the tasks foreseen in that Regulation. The co-legislators have now decided that for such trade repositories, there is no necessity for comprehensive re-registration with ESMA for the tasks of the EMIR-Regulation.

- In future, such trade repositories only have to submit an application for an "extension" of their existing registration. ESMA must develop regulatory technical standards on the details of this simplified registration procedure.

The co-legislators want to give competent authorities in third countries – under certain conditions – access to data which counterparties have reported to trade repositories in the EU, with the intention that competent authorities within the EU also receive the same information from repositories in those third countries.

- In future, relevant authorities of third countries in which trade repositories are established, may have direct access to information in trade repositories in the EU. However, access may only be granted provided the Commission has agreed to this via an implementing act. The trade repository in the third country must be duly authorised and effectively supervised, must guarantee the protection of business secrets and be obliged to grant the EU access to their transaction data.

Assessment

Simplifying the registration for trade repositories already registered under the Regulation on securities financing transactions is appropriate. It lowers the administrative burden for such repositories without undermining the ability of supervisors to fulfil their tasks properly.

3 Entry into force

Most of the new provisions will apply from the date of entry into force of the amended EMIR-Regulation, so most probably in mid-2019. However, some of the new rules will only apply later:

- The provision that CCPs have to provide their clearing members with "simulation tools" will apply 6 months from the date of entry into force, i.e. approx. by the end of 2019;
- The provision that financial counterparties will be responsible and legally liable for reporting on transactions on behalf of non-financial counterparties will apply 12 months from the date of entry into force, i.e. by approx. mid-2020;
- The provisions on "fair, reasonable, non-discriminatory and transparent commercial terms" ("FRAND conditions") will apply 24 months from the date of entry into force, i.e. by approx. mid-2021;
- The provision that trade repositories have to implement new procedures and policies with regard to the quality and transparency of reported data and competition issues, will apply 24 months from the date of entry into force, i.e. by approx. mid-2021.