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# EMIR: Variation Margin requirements for uncleared OTC derivatives

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## The exchange of collateral for Variation Margin

### Introduction

The European Market Infrastructure Regulation ("EMIR") is  part of the European Union's response to the G20 commitment to mitigate the perceived risks in the OTC derivatives market which were exposed by the financial crisis of 2007/8.

One to the key elements of EMIR is the requirement to reduce the risks involved in trading derivatives.  The rules on variation margin ("VM"), which will come into force in the EU on 1 March 2017[1] (the "VM Rules") are designed to do this by requiring parties to  non-cleared OTC trades to exchange variation margin.  It is hoped that this will, to some extent, simulate the margining requirement of cleared derivatives, which require the posting of both initial and variation margin, and thus bring the risks of counterparty failure on un-cleared trades more in line with that of cleared trades.

ESMA also believes that requiring margin to be posted for no-cleared transactions will also promote the use of central clearing as the economic benefits of trading non-margined products will be reduced.

### The VM Rules

Currently, parties to non-cleared OTC trades are free to negotiate their own CSAs and agree their own margin requirements.

*In-scope counterparties and trades*

The VM Rules relate to almost all OTC un-cleared trades entered into between:

1. all financial counterparties ("FCs");
2. non-financial counterparties which are above the EMIR threshold ("NFC+"); and
3. third country entities in relation to OTC derivative contracts entered into between them where: (i) they would be subject to the EMIR requirements if they were established in the EU; and (ii) the contracts have direct, substantial and foreseeable effect within the EU or the requirements are necessary or appropriate to prevent the evasion of any provision of EMIR.

*Exclusions*

There are a number of carve-outs for intragroup transactions in certain circumstances, provided that there is no current or foreseen practical or legal impediment to the prompt transfer of own funds or repayment of liabilities between counterparties[2].

In addition, FX forward trades which settle at T+2 will not be in scope from 1 March 2017 but are expected to become so in January 2018 when MiIFD II comes into force as this legislation should provide a definition of FX forwards which is harmonised across member states.

### Legal documentation

All firms which are in-scope for EMIR VM will need to have legally correct and enforceable documentation in place on 1 March 2017 if they are to continue trading from that date.  This means that all firms must have executed ISDA Master Agreements and CSAs which set out the required terms to allow VM to be calculated and exchanged on a bi-lateral basis in accordance with EMIR.  The Master ISDA Agreement must allow for close-out netting provisions  which are found in the 2002 ISDA.

Thus, all firms must carry out the following steps:

1. conduct a full legal review of their current arrangements and determine which trades and counterparties are in-scope;

1 Pursuant to Delegated Regulation (C(2016) 6329 final), plus annexes (the "Delegated Regulation") setting out the final RTS required under Article 11(15) of EMIR)

2 Article 11 paragraphs (5) to (11) of EMIR

2. determine which documents require amendment/re- and negotiation; and
3. implement all operational changes which are needed.

ISDA has produced a "Variation Margin Protocol" intended to help market participants implement the VM Rules. Parties using the Variation Margin Protocol will exchange questionnaires in order to establish which rules apply and then the changes which they need to make to their existing collateral agreements.

ISDA has set out three methods of the amendment of CSAs, being:

1. *the new CSA method,* whereby parties who have an existing ISDA Master Agreement agree to add a new CSA for VM. If used, the new CSA will only cover new transactions and legacy transactions will remain subject to the parties' existing CSA; or
2. *the amendment method,* whereby the parties agree to amend an existing CSA to ensure compliance with the VM Rules The amended CSA will cover both new transactions and legacy transactions; or
3. *the replicate and amend method,* whereby the parties amend an existing ISDA Master Agreement and CSA by creating a replica of the existing CSA and then amending the CSA to the extent required to comply with the VM Rules. If used, this CSA will only cover only new transactions while legacy transactions will remain governed by the existing CSA.

Parties may however choose to use none of these methods and instead negotiate their own bi-lateral amendments e.g negotiate and enter into both a new ISDA 2002 Master Agreement and a new CSA.

## Risk management

The Delegated Regulation[3] requires counterparties to perform an independent legal review of the enforceability of its legal agreement for netting and the exchange of collateral and establish policies to assess this enforceability on a continuing basis.

In addition, it lists a number of risk management procedures that counterparties must establish, apply and document[4]. These include procedures providing for or specifying:

1. the eligibility of collateral for non-centrally cleared OTC derivative contracts in accordance with Section 2 of the Delegated Regulation;
2. the calculation and collection of margins for non-centrally cleared OTC derivative contracts in accordance with Section 3 of the Delegated Regulation; .
3. the management and segregation of collateral for non-centrally cleared OTC derivative contracts in accordance with Section 5 of the Delegated Regulation; and
4. the calculation of the adjusted value of collateral in accordance with Section 6 of the Delegated Regulation.

## Eligible Collateral

Article 4 of the Delegated Regulation specifies the asset classes from which a counterparty may collect collateral. The list consists of 18 different asset types which includes cash, this being the asset type most commonly used for collateral in current trading arrangements.

Other types of eligible collateral include gold, certain debt securities, equities (subject to specific requirements) and shares or units in UCITS (also subject to specific requirements).

3 Article 2(3) of the Delegated Regulation
4 Article 2(2) of the Delegated Regulation

## Calculation and collection of margins

Articles 9 to 13 of the Delegated Regulation set out rules for calculation and collection of margins.

VM must be calculated at least on a daily basis[5]. Where both parties to a trade are in the same time-zone, the constituents of the netting set must be determined as of the previous business day following the events set out below, whereas where the parties to a trade are in the different time zones, the constituents of the netting set must be determined as at 4.00pm on the previous business day in the earlier of the two time zones following the events set out below.

Initial margin must be calculated no later than the business day following one of certain events, these being[6]:

1. a new non-centrally cleared OTC derivative contract is executed or added to the netting set;
2. an existing non-centrally cleared OTC derivative contract expires or is removed from the netting set;
3. an existing non-centrally cleared OTC derivative contract triggers a payment or delivery other than the posting or collection of margin;
4. initial margin is calculated according to the standardised approach[7] and an existing contract is reclassified in terms of the asset category[8] due to reduced time to maturity; or
5. no calculation has been performed in the preceding ten business days.

The amount of VM to be collected is calculated as follows:

1. the aggregation of the values (calculated in accordance with EMIR)[9] of all contracts in the netting set (defined as a set of non-centrally cleared OTC derivative contracts between two counterparties that is subject to a legally enforceable bilateral netting agreement), minus
2. the value of all VM previously collected and the net value of each contract in the netting set as at the point of entry into the contract, plus
3. the value of all VM previously posted.[10]

## Exemptions

There are exemptions from the requirements to exchange collateral or collect variation margin, and these are set out in articles 23 to 31 the Delegated Regulation.  These include exemptions for intragroup derivative contracts.

5 Article 9 (1) of the Delegated Regulation
6 Article 9(2) of the Delegated Regulation
7 As referred to in Article 11(1) of the Delegated Regulation
8 As referred to in paragraph 1 of Annex IV (Standardised Method for the calculation of initial margin for the purposes of Articles 9 and 11 of the Delegate Regulation)
9 Article 11(2) of EMIR
10 Article 10 of the Delegated Regulation.

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