MiFID II
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Module Benchmark Regulations & EMIR - EMIR

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In last year's course I discussed how recent developments pertaining to EMIR have impacted centralised and bilateral clearing of derivatives. While introduced back in 2012, EMIR has been updated many times. Today I will be focusing on a recent update known as EMIR Refit. In case you want to familiarize or remind yourself of the full EMIR legislation you could look at last year's course materials.

The European Markets Infrastructure Regulation ("EMIR") entered into force in 2012 and brought about significant reforms in the derivatives space covering clearing, reporting, risk mitigation, and margin and collateral exchange. The regulation has affected a large number of firms that are still wrestling with the requirements it introduced.
Between 2015 and 2016, the EU Commission conducted an extensive review of EMIR and its impact on the industry. The Commission found that, although no fundamental amendments needed to be made to the core requirements under EMIR, the legislation could benefit from amendments on certain aspects, in order to reduce disproportionate costs and burdens on counterparties without compromising the objectives of the regulation.
The agreed amendments (known as EMIR Refit or EMIR 2.1) will lead to some substantial changes. For example, key changes include the concept of Small Financial Counterparties that will be exempt from clearing, and the introduction of specific requirements around the accessibility and affordability of clearing services. EMIR Refit came into force on June 17 2019.

In this course I will summarize the key EMIR Refit changes and how they may affect firms. Slide 1 provides an overview of the main changes implemented under EMIR Refit. In the remainder of the course, I will discuss what these changes mean for the clearing obligation, margin requirements and reporting obligation.

A. Definition of financial counterparty

EMIR distinguishes between Financial Counterparties and Non-Financial counterparties. This classification determines the set of obligations that applies to an entity.

Financial Counterparty (FC) – broadly defined as an entity authorized under one of the EU's financial services directives – examples include a MiFID authorized investment firm or a bank.

Non-Financial Counterparty (NFC) – defined as an entity established in the EU that is not a FC. An example of a NFC is an airline company hedging its exposures. Depending on the notional value of their derivate trading positions, NFCs can be either a NFC+ which is subject to the clearing obligation, or a NFC- which is not subject to the clearing obligation.

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As can be seen on this slide, one of the changes under EMIR Refit is that the definition of financial counterparty was extended to capture European Union Alternative Investment Funds (irrespective of the location of the Alternative Investment Fund Manager) and, where relevant, their EU Alternative Investment Fund Managers. In this course I will refer to the Alternative Investment Funds as AIFs and their managers as AIFMs (Alternative Investment Fund Managers).

This also has an impact on the EMIR classification of a non-EU AIF with a non-EU AIFM. Originally, such non-EU AIFs were classified as third country entities that would be non-financial counterparties if they were established in the EU. However, from 17 June 2019, non-EU AIFs with non-EU AIFMs will be re-classified as third country entities that would be financial counterparties if they were established in the EU. One of the key impacts of this re-classification is that such non-EU AIFs with non-EU AIFMs will become subject, on an indirect basis, to the EMIR margin requirements when trading with EU dealers. This is the case even if such non-EU AIFs with non-EU AIFMs had previously avoided the indirect application of those margin requirements by virtue of being a “Hypothetical NFC” that was below the clearing thresholds.

B. Clearing obligation

The clearing obligation was introduced under EMIR as a means of reducing the operational and counterparty risks posed by uncleared OTC derivatives in the most standardized asset classes. It was not long before many smaller market participants found complying with the obligation would lead to a significant increase in costs when engaging in the relevant asset classes. For smaller counterparties, clearing services can incur high fees passed onto them from clearing members, not to mention the further operational considerations required by providers of indirect clearing.

Non-financial Counterparties faced challenges that they had not experienced before. Many smaller firms struggled with the administrative burden of calculating thresholds on a 30 working day rolling average basis, and others fell afoul of the large net caused by breaching any of the asset class thresholds. This left certain firms in a situation whereby their trading in a single asset class made their less frequent trades in other asset classes much more expensive–as they would be subject to the clearing obligation for all asset classes, not just the ones for which they breached the threshold.

These issues were identified during the EMIR review, and a number of changes are targeted at reducing the costs and mitigating the operational burden of clearing.

EMIR Refit changes both the clearing threshold calculation procedure and the implications for NFCs in the event that they do exceed a clearing threshold. If an NFC exceeds the clearing threshold, it will only be subject to the clearing obligation in respect of the asset class(es) in which has exceeded the clearing threshold. However, exceeding the clearing threshold in one asset class will make an NFC subject to the collateralisation requirement in respect of all asset classes.

Key changes to the clearing obligation are summarized on the next slides.

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Clearing obligation

● Potential reduction in operational burden
● Potential increase in operational burden

Changes	Financial counterparty	Non-financial counterparty (+)	Non-financial counterparty (-)	Central counterparty
I. Removal of frontloading requirement means certain financial counterparties will no longer be required to clear/novate relevant OTC derivative contracts.	●			
II. Introduction of fair, reasonable, nondiscriminatory, and transparent (FRANDT) commercial terms for the provision of clearing services will create a greater burden for clearing service providers, which will have to ensure compliance with specified principles, while other firms may benefit from greater access, and potentially less expensive and onerous provision of clearing services.	● FCs that access clearing indirectly or through clearing members ● FCs that provide clearing services	●		
III. Frequency for calculating clearing threshold for NFCs to be annual rather than over 30 working days, which will reduce the operational cost of monitoring the threshold.		●	●	

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Clearing obligation

● Potential reduction in operational burden
● Potential increase in operational burden

Changes	Financial counterparty	Non-financial counterparty (+)	Non-financial counterparty (-)	Central counterparty
IV. Definition of Financial Counterparty expanded to include certain additional Alternative Investment Funds, and Central Securities Depositories which may bring previously out of scope entities under the clearing and margining requirements.		●	●	
V. Introduction of "small financial counterparties" will exempt firms that fall under the threshold from the clearing obligation while remaining subject to the margin requirements.	●			
VI. NFCs that choose to calculate their position will be subject to the clearing obligation only with regard to the asset classes that exceed the threshold. NFCs that choose not to calculate their positions, will be subject to the clearing obligation in all asset classes. This reduction in scope of the clearing obligation means more flexibility for NFCs.		●	●	

Changes	Financial counterparty	Non-financial counterparty (+)	Non-financial counterparty (-)	Central counterparty
VII. Temporary exemption from the clearing obligation for pension scheme arrangements will be extended for another two years, with a possibility of two further one year extensions.				

C. Small financial counterparty

As can be seen on slide 4, one of the key changes under REFIT is the introduction of the "small financial counterparty" (SFC). An SFC is exempted from the clearing obligation but, will remain subject to the risk mitigation obligations such as the posting of margin.

The determination for whether an entity is an FC or an SFC will be made using the same clearing thresholds that apply to non-financial counterparties (NFCs). However, the determination would only need to be made once a year and would be based on the aggregate month-end average for the preceding 12 months. In light of ESMA's statement issued in March 2019, this initial calculation must be made as of the day on which the REFIT Regulation enters into force.

An FC that exceeds the clearing threshold for at least one asset class or does not calculate its positions, would become subject to the clearing obligation in respect of in-scope products across all asset classes. The positions need to be calculated at the group level or, for UCITS and AIFs, at the level of the fund.

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I will now discuss what these changes mean for the clearing obligation, margin requirements and reporting obligation.

D. Margin requirements

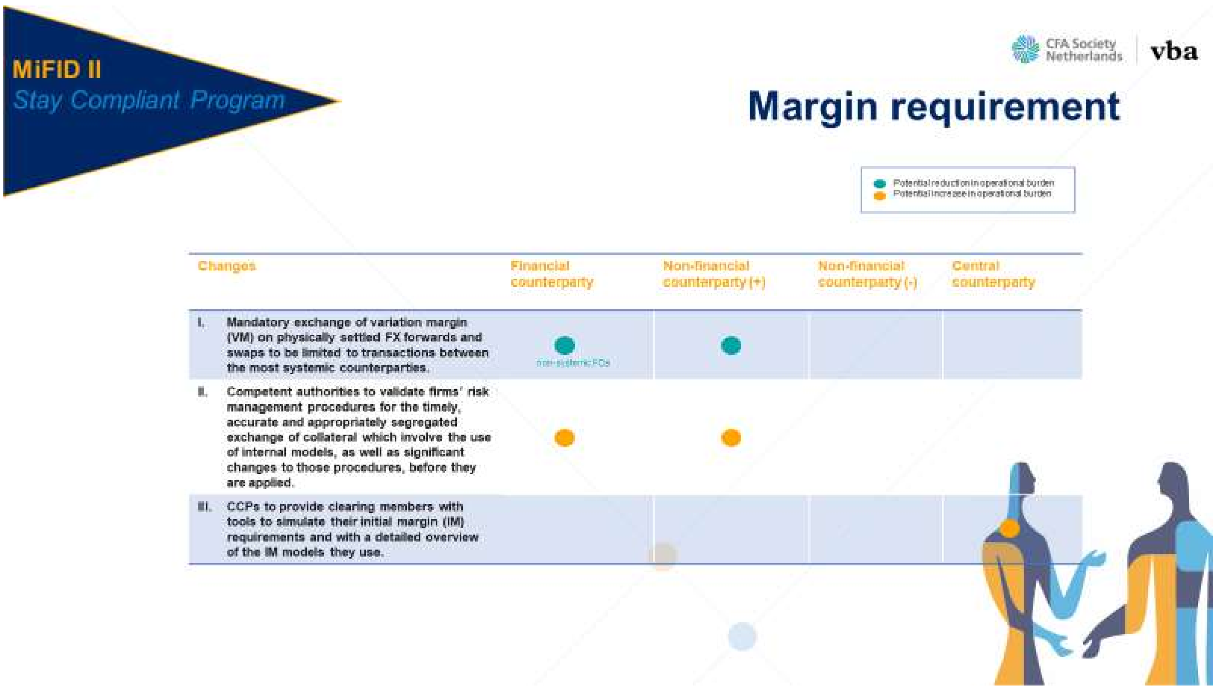
The margin requirements form part of the risk mitigation principles under EMIR and were formulated as a means to mitigate counterparty risk in uncleared OTC derivatives.
The margin requirements have been phased in with separate timelines for the initial margin and variation margin requirements. The obligation to exchange variation margin initially extended to physically settled FX Forwards, as there was no clear delineation between an FX Spot and FX Forward in the legislation. The variation margin obligation caused substantial disruption amongst smaller financial counterparties and non-financial counterparties as they tend to be light consumers of FX derivatives.
The regulatory technical standards on margin requirements offered regulatory relief for firms by delaying the variation requirements for FX Forwards until MiFIR entered into force in January 2018.

Arguably, one of the changes worth noting is that recital 21 to the EMIR Refit regulation includes a limitation on the requirement to exchange variation margin on physically settled FX forwards and swaps between the systemic counterparties.

This could limit the build-up of systemic risk, for systemic counterparties such as large banks or investment firms that could trigger severe instability for the financial industry, given their size, the level to which they are interconnected with other firms and therefore pose what we call systemic risk to the financial industry as whole.

The changes also include expanded requirements around the use of internal models for valuation and collateral exchange, where national competent authorities would have to validate risk management procedures.

Key changes to the margin requirements are summarized on this slide.



Changes	Financial counterparty	Non-financial counterparty (+)	Non-financial counterparty (-)	Central counterparty
I. Mandatory exchange of variation margin (VM) on physically settled FX forwards and swaps to be limited to transactions between the most systemic counterparties.	● non-systemic FCs	●		
II. Competent authorities to validate firms' risk management procedures for the timely, accurate and appropriately segregated exchange of collateral which involve the use of internal models, as well as significant changes to those procedures, before they are applied.	●	●		
III. CCPs to provide clearing members with tools to simulate their initial margin (IM) requirements and with a detailed overview of the IM models they use.				

E. Reporting obligation

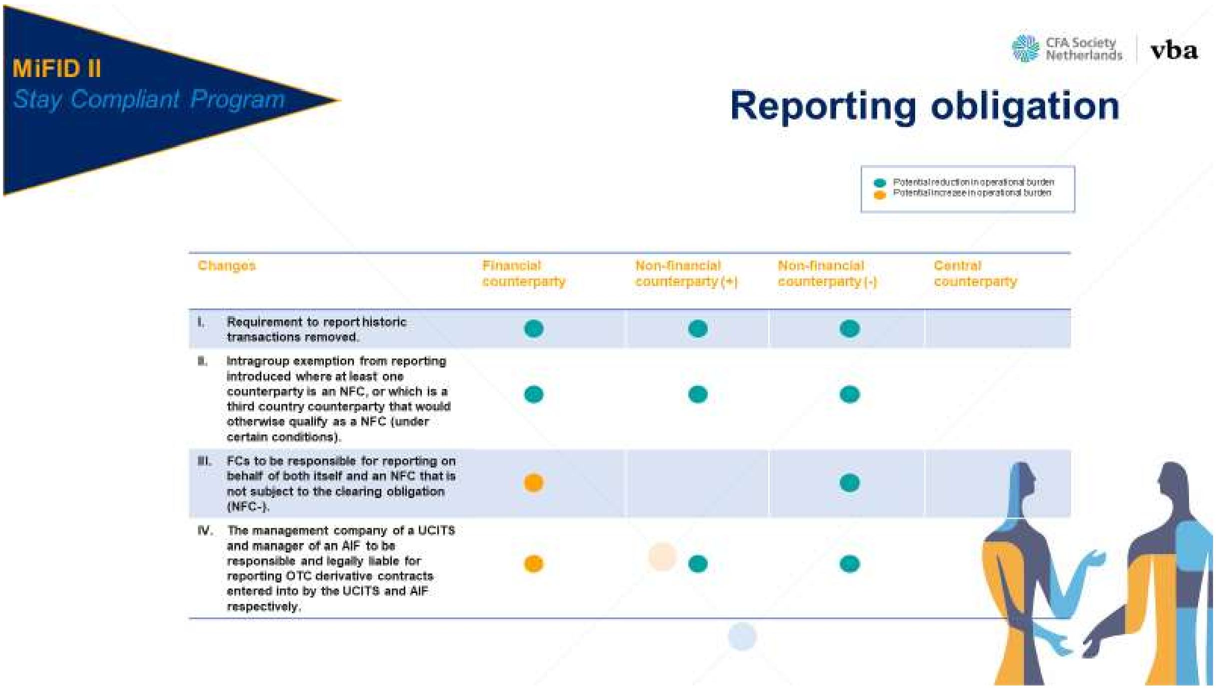
The reporting obligation under EMIR aimed to usher in a new era of transparency in the derivatives market. The dual reporting implementation was vast in scope and content, requiring all counterparties to submit reports for all OTC and ETD derivatives. The reporting obligation also required firms to report key events throughout the lifecycle of the trade, daily valuations for FCs and all collateral/margin exchanges.

Given the ambitious nature of the reporting obligation, it has not been an easy road for many firms to navigate. A number of factors such as the complexity of the reporting requirements, lack of nuanced guidance, and inconsistencies between reporting templates from each trade repository, have contributed to difficulties faced by firms.

Following feedback from the industry, ESMA introduced significant amendments to the reporting regime in November 2017. These changes sought to address technical issues, clarify reporting, and align reporting formats between MiFID II and EMIR.

The changes in Refit are directed towards expanding the EMIR regulatory framework to enable principles identified under the Securities Financing Transaction Regulation (SFTR), and streamlining the existing reporting requirements. The changes aim, for example, to clarify where the responsibility for reporting lies between an FC and an NFC.

Key changes to the reporting obligation are summarized on this slide.



Changes	Financial counterparty	Non-financial counterparty (+)	Non-financial counterparty (-)	Central counterparty
I. Requirement to report historic transactions removed.	●	●	●	
II. Intragroup exemption from reporting introduced where at least one counterparty is an NFC, or which is a third country counterparty that would otherwise qualify as a NFC (under certain conditions).	●	●	●	
III. FCs to be responsible for reporting on behalf of both itself and an NFC that is not subject to the clearing obligation (NFC-).	●		●	
IV. The management company of a UCITS and manager of an AIF to be responsible and legally liable for reporting OTC derivative contracts entered into by the UCITS and AIF respectively.	●	●	●	