Linklaters

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Final Margin Call

RTS on margin for non-cleared derivatives published in the Official Journal

Contents

Background

On 15 December 2016 the Regulatory Technical Standards (RTS) on margin requirements for non-cleared OTC derivatives[1] were finally published in the Official Journal. The new margin requirements form one of the central pillars in the framework for the regulation of OTC derivatives agreed by the G20 in the wake of the 2008 financial crisis.

There are few surprises in the final text. The published RTS follows largely the version published in March 2016. The European Supervisory Authorities (ESAs) had proposed various changes in their opinion of 6 September 2016, partly to avoid unintended consequences in the July re-draft by the Commission, but with some substantive comments. Several of the more substantive comments were not included in the final text, including the proposal by the ESAs to include pension schemes within the rules for concentration limits on initial margin. Further details on this are included below.

In this note, we provide a summary of the key provisions of the final RTS and consider the practical implications for participants in the OTC derivatives market.

Introduction

What are the new rules?

The new rules implement Article 11(3) of EMIR and set out requirements for the collection of variation margin (VM) and initial margin (IM) in respect of OTC derivative transactions not cleared by a central counterparty (CCP). At its simplest, the collection of margin is intended to reduce the counterparty credit risk taken by parties that are “in-the-money” under an OTC derivative.

When will the RTS come into effect?

The RTS will enter into force on the twentieth day following the date of publication in the Official Journal (15 December 2016), and phase-in of the

1 http://ec.europa.eu/finance/financial-markets/docs/derivatives/161004-delegated-act_en.pdf.

provisions will start from one month after the date of its entry into force.[2] Consequently, phase-in will commence from 4 February 2017.

Why does margin reduce risk?

Broadly, upon a default of the collateral-provider, the margin received by the collateral-taker is used to discharge the amount due from the collateral-provider under the derivative position. The collateral-taker is therefore insulated from the risk that it will not be paid by its counterparty. The new rules are also intended to reduce the systemic risk posed by counterparty default.

Who is affected by the new obligations?

Financial counterparties (FCs) and non-financial counterparties above the clearing threshold (NFC+s) as defined in EMIR are both caught by the new requirements.[3] Entities in these categories (including their foreign branches) will be required to collect margin from each other, subject to the exemptions and the phase-in thresholds below.

What about third country entities?

In-scope European entities are also required, subject to limited exceptions, to exchange collateral with third country entities (TCEs) that would be FCs or NFC+s if they were established in the EU.[4] Two TCEs may also be required to exchange margin under EMIR where there is a direct, substantial and foreseeable effect; or the application of EMIR would otherwise be evaded.[5]

How will I know if my counterparty is an FC, NFC+ or equivalent TCE?

Parties will need to put in place appropriate information exchange procedures. ISDA has published a self-disclosure letter, available on ISDA Amend, that allows a party to confirm its status under not only the regime applicable to it but also under any regimes applicable to its counterparty.[6]

How do I complete the ISDA Regulatory Margin Self-Disclosure Letter?

Linklaters has developed guidance for each regime covered by the self-disclosure letter, including assistance with categorisation, the definitions of 'group' and calculation of the average aggregate notional amount. For further information, please email sdlroadmap@linklaters.com.

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[2] Article 40 and Article 36(1)(a) of the RTS.

[3] Article 24 (*Non-financial counterparties and third country counterparties*) of the RTS when read with Article 2(1) (*General requirements*) of the RTS.

[4] *Ibid.*

[5] Commission Delegated Regulation (EU) No 285/2014 of 13 February 2014 supplementing Regulation (EU) No 648/2012.

[6] http://www.isda.org/publications/pdf/35345836_14_WGMR_Self_Disclosure_Letter_Template.pdf.

Are there any exemptions from the requirements?

The rules do not apply to transactions involving entities that are classified as non-financial counterparties falling below the clearing threshold under EMIR (NFC-s) including TCEs that would be NFC-s if established in the EU.[7]

The requirement to post and collect IM will only apply to transactions between two FCs or NFC+s (including TCEs that would be FCs or NFC+s if established in the EU) that both (or whose groups both) have a substantial notional amount of uncleared derivatives.[8]

There are limited exemptions from the rules available for:

(i) CCPs managing positions following clearing member insolvency;[9]

(ii) certain hedging by covered bond issuers;[10] and

(iii) intra-group transactions (see further below).

Physically settled FX swaps and forwards and cross-currency swaps are outside the scope of IM.[11] The rules also provide for the delayed implementation of (i) VM requirements for physically settled FX forwards[12] and (ii) VM and IM requirements for single stock options and equity index options.[13]

What is the difference between VM and IM?

VM is calculated by reference to the current market value of the OTC derivative and is to be collected from the party that is "out-of-the-money". Although the valuation used to calculate the VM requirement will be continually refreshed, there is always some risk that the market value of a particular contract increases and a default occurs before additional VM is delivered. The IM requirement creates an additional buffer that is intended to reduce the risk of a shortfall in that scenario. IM, where applicable, is posted by both parties and the amounts to be posted are not offset against each other.[14]

Why is IM a more sensitive issue?

Although IM is required in order to protect against short term movements in the value of the derivative contract following a default, if taken on a title

7 Article 24 (*Non-financial counterparties and third country counterparties*) of the RTS.
8 Following the end of the phase-in period in 2020, IM will only apply where counterparties have an AANA, as described below, for the relevant period in excess of EUR 8 billion. Article 28(1). (*Threshold based on notional amount*) of the RTS
9 Article 23 (*CCPs authorised as credit institutions*) of the RTS.
10 Article 30 (*Treatment of derivatives associated to covered bonds for hedging purposes)* of the *RTS.* If the conditions for application of the exemption are met, then neither party is required to post initial margin, and the covered bond issuer is exempted from providing variation margin.
11 Article 27 (*Foreign exchange contracts*) of the RTS.
12 Article 37(2) (*Application of Articles 9(1), 10 and 12*) of the RTS. The delayed application is due to the lack of unified approach to the definition of a physically settled foreign exchange forward in the EU. A definition is due to be set out in the Commission Delegated Regulation referred to in Article 4(2) of Directive 2014/65/EU. Application of the VM requirements is therefore delayed until the later of 31 December 2018 and the date of entry into force of the Commission Delegated Regulation.
13 Article 38 (*Dates of application for specific contracts*) of the RTS.
14 Article 11(2) (*Collection of initial margin*) of the RTS.

transfer basis, it could increase the credit risk each party takes against the other party. To avoid introducing more credit risk into the system, the rules set out stringent requirements for IM posted by each party to be held on a segregated basis.[15]

Are these the only margin rules I need to worry about?

The new rules have their roots in the BCBS/IOSCO principles published in July 2012 (as subsequently revised in March 2015).[16] Other jurisdictions have also introduced, or are in the process of introducing, rules consistent with the same principles. The margin rules of various U.S. bank regulators (the Prudential Regulators) and the U.S. Commodity Futures Trading Commission, the rules of the Canadian Office of the Superintendent of Financial Institutions and the rules of the Financial Services Agency of Japan, came into force in time for phase-in of the rules from 1 September 2016.

It may be that non-EU margin rules will also apply to you or your counterparty. Variations between these rules and in the applicable local legal frameworks therefore complicate cross-border compliance.

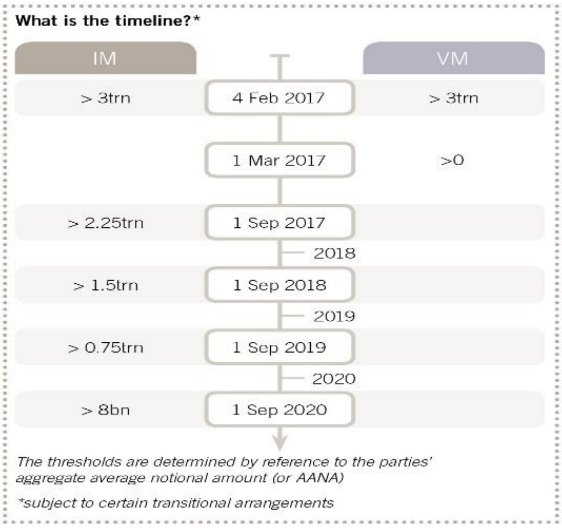
Phase-in timeline

Are existing transactions affected?

No, only a transaction that is subject to the margin rules on its trade date will be caught (although transactions that are amended may constitute a new transaction and may be caught).[17] However, parties may choose to provide and collect margin in relation to legacy trades as well as in-scope trades.

The IM and VM requirements are being phased in for transactions entered into from the date which is one month after the entry into force of the RTS. This phase in is summarised below.[18]

[15] Articles 19(3) to (5) (*Collateral management and segregation)* of the RTS.
[16] Margin requirements for non-centrally cleared derivatives – final document, issued by BCBS and IOSCO on March 2015. http://www.bis.org/bcbs/publ/d317.pdf.
[17] Article 35 (*Transitional provisions*) of the RTS.
[18] Article 36(1) (*Application of 9(2), Article 11, Articles 13 to 18, points (c), (d), and (f) of Article 19(1), Article 19(3) and Article (20)* and Article 37(1) (*Application of Articles 9(1), 10 and 12*) of the RTS.



What is AANA?

AANA is the average of the total gross notional amount of all uncleared OTC derivatives of an entity, calculated across its group,[19] recorded on the last business day of the months March, April and May of the relevant year.[20] This calculation includes all uncleared OTC derivatives in a counterparty's group portfolio (including those not subject to IM or VM[21]), but counting intra-group transactions only once. So the last business day of March, April and May 2016 will be the relevant days for the purposes of determining the AANA in respect of the first phase-in date.

Variation margin

How much VM needs to be collected?

Relevant entities will be required to collect VM with a value equal to the aggregated net value of all contracts in the relevant netting set (as defined in Article 272(4) of the CRR[22]).[23] The comparison of that target value and the value of collateral already collected needs to be made on *at least* a daily basis.[24] Where two entities are located in the same time zone, the constituents of the netting set are determined as of the previous business day. Where two entities are not located in the same time zone, the

[19] "Group" is defined in EMIR as the group of undertakings consisting of a parent undertaking and its subsidiaries within the meaning of Articles 1 and 2 of Directive 83/349/EEC (the *Company Law Directive*) or the group of undertakings referred to in Article 3(1) and Article 80(7) and (8) of Directive 2006/48/EC (the Bank Consolidation Directive).
[20] Article 39(1)(b) (*Calculation of aggregate average notional amount*) of the RTS.
[21] Recital 15 of the RTS.
[22] Regulation (EU) 575/2013.
[23] Article 10 (*Calculation of variation margin*) of the RTS.
[24] Article 9(1) (*Frequency of calculation and determination of the calculation date*) of the RTS.

constituents of the netting set are determined at 4pm on the previous business day in the earlier time zone.[25]

How often does VM need to be provided?

The rules require VM to be provided on the same business day on which it is calculated i.e. daily.[26] However, this timing may be extended to permit VM to be provided within two business days where the relevant parties increase the margin period of risk for IM, or otherwise increase the amount of IM, or, if not subject to IM, transfer additional VM in the same amount.[27] The previous draft RTS had referred to both "posting" of variation margin by the posting counterparty and "collection" of variation margin by the collecting counterparty within the specified timeframes, raising concern as to compliance with the requirements where the settlement of the transfer does not occur within the deadline. The final RTS is consistent in its reference to "provision" of margin by the posting counterparty. Although on the face of the text, there is nothing to suggest that this is a different approach, the ESAs expressed the view in their September opinion that "collect" implied an obligation to have completed the transfer, whereas "provide" implies that the obligation is to instruct the transfer by the prescribed deadline. The ESAs were in fact arguing that the requirement should be to "collect" and the market view of the Commission's express rejection of this change by amending references to "provide" is to construe the obligation to be to instruct the transfer by the deadline, even if settlement occurs later.

In the event of a valuation dispute, the undisputed portion must be provided within the same timeframe pending resolution of that dispute.[28]

Is there a minimum transfer amount?

Yes, parties have discretion to agree a minimum transfer amount subject to a maximum of €500,000 (or an equivalent amount in another currency in which margins are normally exchanged)[29]. Parties may specify separate minimum transfer amounts for both the VM and IM obligations provided that the aggregate does not exceed €500,000 (or equivalent).[30]

There is no threshold for the collection of VM, which means that, once the minimum amount is exceeded, the full amount of the collateral must be collected.[31]

What will the VM documentation look like?

If parties have an existing collateral document, they may choose to amend that document. Alternatively, they may sign an entirely new document based

[25] Article 9(3) (*Frequency of calculation and determination of the calculation date*) of the RTS.
[26] Article 12(1)(a) (*Provision of margin*) of the RTS.
[27] Article 12(1)(b) and 12(2) (*Provision of margin*) of the RTS.
[28] Article 12(3) (*Provision of margin*) of the RTS.
[29] Recital (9) and Article 25(1) (*Minimum transfer amount*) of the RTS.
[30] Article 25(4) (*Minimum transfer amount*) of the RTS.
[31] Article 25(3) (*Minimum transfer amount*) of the RTS.

on any existing agreement or starting afresh from the VM CSA published by ISDA.

ISDA has published a protocol to allow parties to make the necessary amendments across their existing relationships.[32]

Initial margin

How much IM needs to be collected?

IM necessitates calculation methods which assess both changes in the risk position and market conditions. The RTS provide a standardised method for calculating IM but parties may instead use an IM model developed independently, jointly or by a third party agent.[33] Where an IM model is used it must comply with the minimum requirements set out in the RTS.[34] It is expected that a compliant IM model will be the more favourable approach.

The parties need not have a common methodology but do need to agree on the method each counterparty uses to determine the initial margin (i.e. standardised approach or initial margin model) and if one or both parties are using an initial margin model, both parties need to agree on the model developed.[35] Regardless of the source of its IM model, the collecting party remains responsible for ensuring its model complies with the minimum requirements set out in the RTS.[36] These are extensive and include initial independent validation of the model,[37] the provision to the counterparty of all information necessary to explain the determination of a given value of initial margin,[38] recalibration of the model every 12 months,[39] and ongoing performance monitoring to assess the appropriateness of the initial margin model.[40] The requirement to disclose methodology may impact the use of proprietary models.

ISDA has developed a standard model (the SIMM™) for use as an IM model with the aim of minimising disputes and discrepancies.[41]

Is IM calculated on a one-off basis?

No, IM is not only ‘initial’. It must be calculated within one business day of certain events including the entry into a new uncleared OTC derivative, the expiry or removal of an OTC derivative from the netting set, a payment or delivery (other than margin) on an existing OTC derivative, on certain

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32 http://www2.isda.org/functional-areas/wgmr-implementation/isda-2016-variation-margin-protocol/.

33 Article 11(1) (*Calculation of initial margin*) and Article 14(1) (*Initial Margin Models – General requirements*) of the RTS.

34 The requirements for the initial margin model are set out in Article 14(2) (*Initial Margin Models – General Requirements)* and include requirements for back-testing every three months.

35 Articles 11(5) and 11(6) (*Calculation of initial margin)* of the RTS.

36 Article 14(1) (*Initial Margin Models – General requirements*) of the RTS.

37 Article 18(1) (*Qualitative requirements*) of the RTS.

38 Article 14(7) (*Initial Margin Models – General requirements*) of the RTS.

39 Article 16(1) (*Calibration of the parameters of the model*) of the RTS.

40 Article 18(1)(c) (*Qualitative requirements)* of the RTS.

41 http://isda.link/simmlicensing.

reclassifications where the standardised method is used, and in any case where there has been no calculation in the preceding 10 business days.[42]

IM must then be provided within the business day of calculation.[43] As in the case of VM, if the amount of IM required is disputed, the undisputed amount must be provided within the same timeframe.[44] See also the remarks in respect of "provision" of collateral under the sub-heading "*How often does VM need to be posted?"* above.

Why is IM required to be segregated?

As both parties are required to exchange IM, if IM were posted on a title transfer basis, it would increase the exposure of each party to the other. The RTS therefore provide that IM must be segregated to protect the IM from the default or insolvency of the collecting party.[45] An earlier draft of the RTS also required equivalent protection against insolvency of a third party holder or custodian. This cast doubt as to whether cash could, in practice, be used as IM. This was because, owing to the legal nature of cash, it is simply not possible to protect against the insolvency of the entity with whom a cash deposit has been made. In the final RTS, such equivalent protection is not required in the context of cash. Sensitivities around the credit risk associated with cash remain, however. Only central banks and certain regulated banking institutions are eligible to hold cash IM.[46] Diversification requirements apply where IM is posted and collected between systemically important institutions (**SIIs**) which mandate that no more than 20 per cent. of cash IM is held with a single third party custodian. For transactions involving SIIs and other counterparties (other than pension schemes) that post/collect more than EUR 1 billion in IM, the excess over EUR 1 billion must be diversified, including by ensuring that no more than 50 per cent. is exposed to the credit risk of a single custodian.

The rules include a prohibition on the reuse of collateral posted as IM with an exception allowing for the reinvestment by a third party custodian of cash IM.[47]

The segregation arrangements must ensure that IM is available to the posting counterparty in a "timely manner" should the collecting counterparty default.[48] This requirement needs to be balanced with certain EU security regimes, particularly in the context of financial collateral arrangements, and has implications for the way in which IM will need to be documented.

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[42] Article 9(2)(a) to (e) (*Frequency of calculation and determination of the calculation date*).
[43] Article 13(2) (*Provision of initial margin*) of the RTS.
[44] Article 13(3) (*Provision of initial margin*) of the RTS.
[45] Article 19(3) (*Collateral management and segregation*) of the RTS.
[46] Article 19(1)(e) (*Collateral management and segregation*) of the RTS.
[47] Article 20 (*Treatment of collected initial margins*) of the RTS.
[48] Article 19(g) (*Collateral management and segregation*) of the RTS.

Are there any circumstances where IM is not required to be collected?

As already noted, if a party to a transaction has (or its group has) an AANA below the then-applicable threshold (which will be EUR 8 billion at the end of the phase-in period in 2020), IM will not apply. If parties are subject to the IM requirements, the rules permit unrelated parties to agree that IM need not be collected where the total IM to be collected from a counterparty, at group level, does not exceed EUR 50 million. Where the collateral required to be collected exceeds the threshold, this can also be used to reduce the amount of IM to be collected by EUR 50 million.[49] As the threshold applies at group level, this threshold can be allocated between group members.[50]

The rules also provide for an equivalent EUR 10 million threshold on a counterparty basis for intra-group transactions where the intra-group exemption does not apply.[51] In addition, the first phase-in date for IM for intra-group transactions which would otherwise have been subject to IM from the date falling one month after the date of entry into force of the RTS (as to which, see above) has been postponed to six months after such date.[52] This is to allow groups time to apply for the intra-group exemption (see "*Intra-group exemption*" below).

As already noted, parties can agree a maximum EUR 500,000 minimum transfer amount (or equivalent amount in another currency) in aggregate across IM and VM on a counterparty by counterparty basis.[53]

What will the IM documentation look like?

IM will necessitate new documentation for transactions subject to IM.

The requirement for segregation means that the 1995 English law ISDA CSA which provides for full title transfer will not be appropriate. Where a custodian is used, as is expected to be the case, custody agreements, security agreements and account control agreements will need to be negotiated. In the case of tri-partite arrangements with custodians such as Euroclear and Clearstream, the documentation will differ.

Other obligations

Are there any other things those parties caught by the EU rules need to consider?

In addition to being operationally prepared for the implementation of margin requirements, including in relation to settlement obligations, and, where

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[49] Article 29(1) (*Threshold based on initial margin amounts*) of the RTS.

[50] Although this was expressly set out in a previous draft of the RTS (Art 9(2)(b) of the draft RTS published on 8 March 2016), the final RTS is silent on this point. However, it is implicit that where the threshold is applied to a group, the threshold can be allocated between those group companies engaged in non-cleared OTC derivatives.

[51] Article 29(1)(c) (*Threshold based on initial margin amounts*) of the RTS.

[52] Article 38(2) (*Dates of application for specific contracts*) of the RTS.

[53] Article 25(1) (*Minimum transfer amount*) of the RTS and see also the paragraph headed "Is there a minimum transfer amount?" above.

relevant, running multiple CSAs per counterparty, parties will need to ensure that they have established written risk management procedures.[54] These procedures will need to cover points such as eligibility of collateral, the verification of collateral liquidity, application of haircuts and the reporting of any exceptions to these procedures to senior management.[55] Parties are also required to establish policies to assess, on a continuous basis, the enforceability of their netting and exchange of collateral arrangements.[56]

Eligible assets

Which assets can be delivered?

Provided that the collateral-taker has access to the relevant markets and is able to liquidate such assets in a timely manner following the default of the posting party,[57] parties may agree to deliver the following eligible assets:[58]

> cash (or similar, such as money market deposits)

> gold (in the form of allocated bullion)

> sovereign securities

> debt securities issued by credit institutions and investment firms

> corporate bonds

> the senior tranche of certain securitisations

> equities included in a main index (or related convertible instruments)

> shares or units in UCITS

These broad classes are also subject to separate credit quality[59] and wrong-way risk[60] requirements and, in the case of IM, concentration limits.[61] The RTS confirm that IM may be collected in cash, as long as it is held in accounts with a central bank or a credit institution authorised in the EU or in a third country whose regulatory arrangements have been found to be equivalent under CRR that, in each case, is not affiliated with the collateral-provider or collateral-taker. The extension to third country credit institutions in the final RTS is a welcome amendment.[62]

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[54] Article 2(1) (*General requirements*) of the RTS.
[55] Article 2(2) (*General requirements*) of the RTS.
[56] Article 2(4) (General requirements) of the RTS.
[57] Article 7(5) (*Specific requirements for eligible assets*) of the RTS.
[58] Article 4(1) (*Eligible Collateral*) of the RTS.
[59] Article 6 (*Credit quality assessment*) and Article 7 (*Specific requirements for eligible assets*) of the RTS.
[60] Article 4(2)(c) (*Eligible collateral*) of the RTS.
[61] Article 8 (*Concentration limits for initial margin*) of the RTS.
[62] Article 23(d) of the draft RTS published by the ESAs on 8 March 2016 limited permissible custodians of cash IM to central banks or EU credit institutions.

What is the requirement with respect to credit quality?

The RTS set out minimum credit quality step requirements for the various categories of assets (other than cash, gold, equities, UCITIS shares and certain debt securities of multilateral banks and international organisations).[63]

In most cases, the assessment is to be made on the basis of an internal model approved in accordance with CRR (belonging to the party itself or to its counterparty – including those approved under equivalent third country regimes) or by reference to an assessment produced by a recognised External Credit Assessment Institution.

Non-cash collateral will be subject to haircuts determined either by reference to the standard methodology set out in the RTS or to a counterparty's own estimates subject to the minimum requirements of the RTS.[64]

The standard methodology includes additional haircuts of 8 per cent. on non-cash collateral posted as VM denominated in a currency other than those agreed in the applicable agreements. There is no requirement for any haircut on cash VM but both cash and non-cash IM will be subject to the same 8 per cent. haircut where posted in a currency other than that specified as the termination currency. The rules expressly allow the parties to choose different termination currencies.[65]

What is wrong-way risk?

The risk that the value of the collateral assets correlates with the creditworthiness of the collateral-provider, such that they depreciate precisely when they are required to offset an amount due under the derivatives positions. To avoid this risk arising, the rules restrict the ability of parties to post their own debt as collateral (or debt of members of their group) or to post any other asset that is subject to significant wrong way risk.[66] The restriction also prohibits the custody of cash IM with affiliates of the collateral-provider and collateral-taker.[67]

What are the concentration limits?

Concentration limits restrict the proportion of specific forms of collateral to promote diversification and reduce risk. The rules apply concentration limits solely to IM and, while limits on certain types of collateral apply generally to parties collecting IM of that type above a minimum level,[68] restrictions on sovereign debt apply more extensively to the IM in excess of EUR 1 billion between counterparties both of which are (i) identified as a systemically important institutions (G-SIIs or O-SIIs) or (ii) counterparties (other than pension schemes) for which the total IM to be collected from an individual

63 Article 6 (*Credit quality assessment*) and Article 7 (*Specific requirements for eligible assets*) of the RTS.

64 Article 21 (*Calculation of the adjusted value of collateral*) of the RTS.

65 Paragraphs 3, 4 and 5 of Annex 2 to the RTS.

66 Article 4(2) (*Eligible collateral*) of the RTS, with the exception of certain sovereign and public sector debt.

67 Article 19(1)(e)(ii) (*Collateral management and segregation*) of the RTS.

68 Article 8(1) (*Concentration limits for initial margin*) of the RTS.

counterparty exceeds EUR 1 billion.[69] G-SIIs and O-SIIs are also subject, when transacting with each other, to obligations to diversify cash IM so that not more than 20 per cent. of that cash IM is held with one custodian.[70] To reduce the operational burden on pension schemes, these concentration limits do not apply where the pension scheme is the posting or collecting counterparty. Instead, pension schemes are subject to an obligation to establish procedures to manage concentration risk and ensure adequate diversification with respect to the same sovereign debt securities.[71] One of the key specific changes inserted by the ESAs in their September 2016 amendments was the inclusion of pension schemes within the specific rules on concentration limits for IM. The ESAs' reasoning rests on the potential systemic risk posed by such large counterparties when collecting in excess of EUR 1 billion in collateral. This change was rejected by the European Commission and replaced by the obligation to establish risk procedures to manage concentration risk as described above. The recitals of the RTS state that these provisions will be reviewed in light of market developments[72] and so it is possible that the specific concentration limits may yet be applied to pension schemes.

Intra-group exemption

How does the intra-group exemption from IM and VM apply?

Margin requirements will not apply to intra-group transactions if, broadly, the counterparties have adequate risk management procedures and there is 'no current or foreseen practical or legal impediment to the prompt transfer of own funds or repayment of liabilities between counterparties'.[73] While the rules clarify what would constitute such an impediment,[74] uncertainty is likely to persist around the general availability of the exemption. Except where both parties to the intra-group transaction are based in the same EU member state, an application to relevant competent authorities needs to be made in order to rely on the exemption.[75]

With respect to intra-group transactions with a group member based outside the EU, the rules provide for a delay of the IM requirements of the RTS (though not the VM requirements as initially included in the March 2016 draft RTS), of up to three years from the date on which the rules enter into force, where the requirements for the intra-group exemption are met but no equivalence decision has been adopted in respect of that third country.[76]

To allow counterparties time to apply for the intra-group exemption, and for competent authorities to respond, the application of both VM and IM

[69] Articles 8(2) and 8(3) (*Concentration limits for initial margin)* of the RTS.
[70] Article 8(5) (*Concentration limits for initial margin)* of the RTS.
[71] Article 8(4) (*Concentration limits for initial margin*) of the RTS.
[72] Recital 28 of the RTS.
[73] Articles 11(5) to 11(10) of Regulation (EU) No 648/2012 ("EMIR").
[74] Article 33 (*Applicable criteria on the legal impediment to the prompt transfer of own funds and repayment of liabilities*) and Article 34 (*Applicable criteria on the practical impediments to the prompt transfer of own funds and repayment of liabilities*) of the RTS.
[75] Articles 11(6) to 11(10) of Regulation (EU) No 648/2012.
[76] Article 36(2) (*Application of 9(2), Article 11, Articles 13 to 18, points (c), (d), and (f) of Article 19(1), Article 19(3) and Article (20)* of the RTS.

requirements to EU intra-group transactions has been postponed to six months after the date of entry into force of the RTS.[77]

Non-netting jurisdictions

What is the concern regarding non-netting jurisdictions?

An area of significant concern raised in respect of an earlier draft RTS was the obligation of EU counterparties to post collateral to TCEs on in-scope transactions even where the legal enforceability of netting and/or segregation agreements in the relevant third country could not be confirmed. The adopted RTS do seek, to some extent, to address this concern, introducing, broadly, exemptions from the obligations:

(i) to post VM or IM to TCEs in these circumstances;[78] and

(ii) to collect VM or IM, subject to certain conditions (including where collecting gross is not possible) and provided that the notional outstanding amounts of transactions for which no collection is made do not exceed a very small proportion (2.5 per cent.) of the OTC derivatives transactions of the group.[79]

Questions have arisen, however, on the interpretation and application of these provisions, in particular the calculation required to determine if the 2.5 per cent. threshold is breached for transactions with counterparties in non-netting jurisdictions. The ESAs had sought in their September 2016 opinion to clarify that the calculation applied to all outstanding OTC derivatives contracts with counterparties in non-netting jurisdictions, both legacy and new contracts

[77] Article 38(2) (*Dates of application for specific contracts*) of the RTS.
[78] Article 31(1) (*Treatment of derivatives with counterparties in third countries where legal enforceability of netting agreement or collateral protection cannot be ensured*) of the RTS.
[79] Article 31(2) (*Treatment of derivatives with counterparties in third countries where legal enforceability of netting agreement or collateral protection cannot be ensured)* of the RTS.

entered into after the relevant application date, as to apply the ratio to only new trades would increase the risk to which EU counterparties are exposed. The Commission rejected this change and the 2.5 per cent. applies only to OTC derivatives contracts with counterparties in non-netting jurisdictions entered into after the entry into force of the RTS. Further concerns remain due to the requirements (i) for a negative assessment on the unenforceability of the netting/collateral agreement, and (ii) for the legal review to confirm that "collecting collateral is not possible", in order to rely on the exemptions. Neither requirement is consistent with the way in which conclusions in netting/collateral opinions are generally expressed.

Conclusion

The EU margin rules have been a long time in the making and the RTS has been through numerous iterations. Although these final rules do not diverge substantially from the March 2016 draft and their publication brings certainty on certain aspects, there remain a number of areas of ambiguity on which Level 3 guidance would be welcome. The challenge now, with so little time remaining, will be achieving compliance within the phase-in timetable, particularly for those having to comply with the VM requirement from 1 March 2017. The establishment of appropriate models, systems, segregation and documentation are only some of the challenges faced by OTC market participants and time will tell whether the margin requirements, which present such a significant shift in approach for the OTC market, will result in any change in behaviour as a result of the significant requirements of the RTS.

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