

Final Report

EMIR RTS on the novation of bilateral contracts not subject to bilateral margins



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Acronyms used

Bilateral margining RTS	Commission Delegated Regulation (EU) No 2016/2251 of 4 October 2016 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty
CCP	Central Counterparty
EMIR	European Market Infrastructures Regulation – Regulation (EU) 648/2012 of the European Parliament and Council on OTC derivatives, central counterparties and trade repositories – also referred to as “the Regulation”
EBA	European Banking Authority
EBA Regulation	Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC
EIOPA	European Insurance and Occupational Pensions Authority
EIOPA Regulation	Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC
ESAs	European Supervisory Authorities, namely the EBA, EIOPA and ESMA
ESMA Regulation	Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC
ESRB	European Systemic Risk Board
NCA	National Competent Authority
OTC	Over-the-counter
RTS	Regulatory Technical Standards
TEU	Treaty on the European Union

1 Executive Summary

Reasons for publication

This final report presents new draft regulatory technical standards (RTS) on the risk mitigation techniques for OTC derivative contracts not cleared by a CCP (bilateral margining) that the European Supervisory Authorities (ESAs) have developed under Article 11(15) of Regulation (EU) No 648/2012 of the European Parliament and Council on OTC derivatives, central counterparties and trade repositories (EMIR). The draft RTS relate to the treatment of OTC derivative contracts novated from a counterparty established in the United Kingdom to a counterparty established in another Member State, as a consequence of the notification of intention of the UK to withdraw from the Union.

In the context of the withdrawal of the United Kingdom, stakeholders have asked for a general grandfathering for legacy OTC derivatives contracts between UK and EU counterparties, but the ESAs do not consider it to be appropriate to provide for a general grandfathering and it is not in their mandate.

However the ESAs consider it to be appropriate to preserve the characteristics of contracts for which bilateral margins were not required, and which contracts are subsequently novated from one counterparty established in the UK to another counterparty established in another Member State, in order to address the situation whereby the original UK counterparty may no longer be able to provide certain services across the EU after the UK has withdrawn from the EU.

The ESAs' proposal includes an amendment of the Commission Delegated Regulation on bilateral margining in order to facilitate certain novations of contracts to EU counterparties during a specific time-window.

Given the urgency with which it is necessary to provide this regulatory solution in order to facilitate the transfer of contracts to counterparties located in the EU in view of the UK withdrawal, where counterparties decide to do so, in accordance with Article 15(1) of the EBA¹, EIOPA² and ESMA³ Regulations respectively, the ESAs have not conducted any open public consultation.

Contents

This paper provides explanations on the draft RTS amending the current Commission Delegated Regulation on bilateral margining with respect to the treatment of novated contracts from a counterparty established in the United Kingdom to a counterparty which is established in another Member State. Section I explains the background to our proposals,

Section II details the rationale for the RTS amendments and Section III outlines the ESAs' proposal.

Next Steps

The Final Report is sent to the European Commission to submit the draft technical standards presented in Annex for endorsement in the form of a Commission Delegated Regulation, i.e. a legally binding instrument applicable in all Member States of the European Union. Following the endorsement, they are then subject to the review of the European Parliament and of the Council.

¹ Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC, OJ L 331, 15.12.2010, p. 12–47

² Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC, OJ L 331, 15.12.2010, p. 48–83

³ Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC, OJ L 331, 15.12.2010, p. 84–119

2 Final report

2.1 Background

1. In the context of the future withdrawal of the United Kingdom from the EU, stakeholders have asked for a general grandfathering for OTC derivative contracts and an exemption from certain requirements from EMIR.
2. Post-withdrawal, counterparties established in the United Kingdom will no longer be able to provide investment services in the EU under the current passport regime, so they might not be in a position to execute certain operations in relation to derivative contracts they have with EU clients, in particular certain so-called “life-cycle events” that can be construed in certain jurisdictions as the entering into new transactions (such as novations, unwinding by entering into an offsetting transaction, compression with new replacement contracts, etc.).
3. This means that after the withdrawal, and in the absence of an equivalence decision, the performance of certain restructuring operations on certain contracts could require authorisation in some Member States, in line with national third country regimes. Those counterparties established in United Kingdom would then face 27 national third country regimes.
4. In order to address this situation, these counterparties might have to novate their contracts to counterparties established in the EU, which would benefit from the single passport in financial services.
5. However, the resulting new contracts might be subject to new obligations that were not applicable at the time the original contracts were signed and for which, in the absence of such withdrawal, they might have continued enjoying an exemption (please see Section 2.2 below for more details on the rationale for the proposed amendments).
6. This would represent a clear disincentive to transfer contracts to firms established in the EU and the ESAs have thus considered some actions aiming at facilitating the transfer of contracts by the private sector to counterparties established in the EU (please see Section 2.3 below, for more details on the proposed amendments), to ensure that the regulatory characteristics of the original contracts are preserved.

2.2 Rationale

7. This final report focuses on bilateral non-centrally cleared OTC derivative contracts currently benefitting or that would benefit from the grandfathering arrangements under

EMIR, i.e. contracts in respect of which, to this date, parties did not have to apply the new procedures on the exchange of collateral (bilateral margins), either because the relevant dates set out in Commission Delegated Regulation (EU) No 2016/2251 have not applied yet, or because the contracts have not been novated after those dates (often referred to as “legacy contracts”).

8. If, due to the withdrawal from the EU of the United Kingdom in which one of the counterparties is established, the parties decide to novate their legacy contracts from that counterparty to a new counterparty established in the EU, the novation of the contracts will trigger the requirements for the bilateral margin procedures and the related margining requirements referred to in Article 36 to 38 of Commission Delegated Regulation (EU) No 2016/2251, if such novation occurs after the relevant dates of application specified in these articles for that type of contract. As a result, the parties will have to apply the bilateral margin procedures and the related margining requirements.
9. Therefore, the novation of such legacy contracts in the EU would make, *ceteris paribus*, the overall performance of the contracts more costly for the parties, due to the application of the EMIR margining requirements.
10. Given that these shortcomings are a direct consequence of the withdrawal of the United Kingdom from the EU, an event that is beyond the control of the parties, and that this may put the EU counterparties facing UK counterparties at a disadvantage compared to EU counterparties facing other EU counterparties, the ESAs consider that it is relevant to maintain a level playing field and are proposing amendments to the existing Commission Delegated Regulation on bilateral margining that would allow these counterparties to novate their contracts to EU counterparties without triggering the EMIR margining requirements.

2.3 Proposed amendments

11. Under Article 11(15) of EMIR, the ESAs have been entrusted to develop draft technical standards specifying, inter alia, the risk-management procedures, including the levels and type of collateral and segregation arrangements, required for compliance with paragraph 3 of the same article.
12. This mandate has led to Commission Delegated Regulation (EU) No 2016/2251 on bilateral margining, which is based on the corresponding draft RTS jointly developed by the ESAs.

13. For bilateral margining, EMIR Level 1 and Level 2 create the following main categories of requirements, depending on the date of conclusion (or novation) of the relevant non-centrally cleared OTC derivative contract:
- a. For contracts concluded before 16 August 2012, no requirement applies;
 - b. For contracts concluded between 16 August 2012 and the relevant dates of application set out in Articles 36 to 38 of Commission Delegated Regulation (EU) No 2016/2251, parties shall continue to apply the risk-management procedures they had in place at the date of entry into force of the Commission Delegated Regulation (EU) No 2016/2251 (Article 35 of the same Commission Delegated Regulation), which, in some instances, may well require no exchange of collateral;
 - c. For contracts concluded after the dates referred to in Articles 36 to 38 of Commission Delegated Regulation (EU) No 2016/2251, parties shall apply the risk-management procedures for the exchange of variation and initial margins set out in Commission Delegated Regulation (EU) No 2016/2251.
14. The ESAs have investigated the possibility to set out an exemption from the application of the bilateral margin procedures and the related margining requirements under EMIR, which would create a time-window to relocate trades in the EU27 without triggering the relevant EMIR obligations. This final report contains the proposed amendments to the Commission Delegated Regulation on bilateral margining mentioned in the previous paragraph.
15. The ESAs proposal (see Annex III) is to create *de facto*:
- a. a new transversal sub-category of contracts, comprised of those in respect of which either no bilateral margining requirement (variation and/or initial margin, as applicable) is applicable at the date of entry into force of this amending regulation, or those in respect of which parties are permitted to continue applying their own risk-management requirements, because entered into or novated before the relevant dates (see point (a) of proposed Article 35, second paragraph), and
 - b. a time window for the counterparties to novate such contracts to a counterparty established in the EU without triggering the application of the bilateral margin procedures and the related margining requirements (see point (b) of proposed Article 35, second paragraph).
16. Nonetheless, this exemption should not allow parties to fully restructure their transactions to take advantage of a pure business opportunity without ever being subject to the EMIR bilateral margining obligations. To this end, such exemption is proposed:
- a. For a limited scope: it would only apply to the novation to a new EU counterparty, which would not trigger the bilateral margin procedures and the related margining

requirements, and would not extend to other life-cycle events performed by the parties in relation to such contract, and

- b. For a limited period of time, which we have defined as going from the date of application of this amending regulation until twelve months after the date of application of this amending regulation, in order to allow for the repapering.
17. In order to benefit from this exemption, parties should thus start negotiating the novations of their transactions which are in the scope of this amending regulation as soon as possible, given the 12-month time period to benefit from it. Should the parties agree on the terms of a novation before the application date, they should provide that these novations would take effect only upon the date of application of this amending regulation to benefit from the exemption.
18. Finally, given the urgency with which it is necessary to provide this regulatory solution in order to facilitate these novations and to reduce some of the legal uncertainty attached to the situation described above, the ESAs have not conducted any open public consultation in accordance with the second subparagraph of Article 15(1) of Regulations (EU) No 1093/2010, No 1094/2010 and No 1095/2010 of the European Parliament and of the Council. That urgency has also rendered the prior consultation of the Banking Stakeholder Group, the Insurance and Reinsurance Stakeholder Group, the Occupational Pensions Stakeholder Group and the Securities and Markets Stakeholder Group impossible.

3 Annexes

3.1 Annex I - ESAs mandate to develop draft technical standards

Article 11(15) of Regulation (EU) No 648/2012

Risk-mitigation techniques for OTC derivative contracts not cleared by a CCP

15. In order to ensure consistent application of this Article, the ESAs shall develop common draft regulatory technical standards specifying:

- (a) the risk-management procedures, including the levels and type of collateral and segregation arrangements, required for compliance with paragraph 3;
- (b) the procedures for the counterparties and the relevant competent authorities to be followed when applying exemptions under paragraphs 6 to 10;
- (c) the applicable criteria referred to in paragraphs 5 to 10 including in particular what is to be considered as a practical or legal impediment to the prompt transfer of own funds and repayment of liabilities between the counterparties.

The level and type of collateral required with respect to OTC derivative contracts that are concluded by covered bond entities in connection with a covered bond, or by a securitisation special purpose entity in connection with a securitisation within the meaning of this Regulation and meeting the conditions of Article 4(5) of this Regulation and the requirements set out in Article 18, and in Articles 19 to 22 or 23 to 26 of Regulation (EU) 2017/2402 (the Securitisation Regulation) shall be determined taking into account any impediments faced in exchanging collateral with respect to existing collateral arrangements under the covered bond or securitisation.

The ESAs shall submit those common draft regulatory technical standards to the Commission by 18 July 2018.

Depending on the legal nature of the counterparty, power is delegated to the Commission to adopt the regulatory technical standards referred to in the first subparagraph in accordance with either Articles 10 to 14 of Regulations (EU) No 1093/2010, (EU) No 1094/2010 or (EU) No 1095/2010.

3.2 Annex II - Costs-benefits analysis

3.2.1 Executive Summary

Pursuant to Article 10(1) of the EBA Regulation, the EIOPA Regulation and the ESMA Regulation, the ESAs shall conduct open public consultations on draft RTS and analyse the related potential costs and benefits, where appropriate. Such consultations and analyses shall be proportionate in relation to the scope, nature and impact of the draft RTS. Given the urgency with which it is necessary to provide the regulatory solution in order to address the situation described in this report, the ESAs have not conducted any open public consultation in accordance with the second subparagraph of Article 15(1) of the EBA Regulation, the EIOPA Regulation and the ESMA Regulation.

3.2.2 Introduction

Under Article 11(15) of EMIR, the ESAs are mandated to develop and submit to the European Commission for endorsement draft technical standards specifying, inter alia, the risk-management procedures, including the levels and type of collateral and segregation arrangements, required for compliance with paragraph 3 of the same article.

The Commission Delegated Regulation on bilateral margining, based on draft RTS jointly developed by the ESAs under Article 11(15) of EMIR, has now entered into force. Articles 36 to 38 of Commission Delegated Regulation on bilateral margining contain the dates of application of the different requirements. In addition, Article 35 specifies the cases when counterparties can continue to apply the risk-management procedures they had in place at the time of the entry into force of the regulation.

Considering the future withdrawal of the United Kingdom from the Union, and the loss of passport of the UK counterparties to OTC derivative contracts, they might decide with their EU counterparties to novate such contracts to an EU counterparty. However, for contracts until then exempted from the bilateral margin procedures and the related margining requirements for various reasons, this would have the effect to trigger them.

In order to ensure that the regulatory and economic conditions under which the contracts were originally entered into are preserved, the ESAs propose to amend the Commission Delegated Regulation on bilateral margining.

3.2.3 Baseline

The purpose of the amending draft RTS proposed in Annex III hereto is to set out a limited exemption from the bilateral margin procedures and the related margining requirements, creating a limited time-window which could allow for the novation of OTC derivative contracts from UK counterparties to EU counterparties without triggering the application of the bilateral margin procedures and the related margining requirements in respect of the newly novated contracts.

3.2.4 Cost benefit analysis

Temporary exemption from the application of the bilateral margin procedures and the related margining requirements

Policy objective	<p>To ensure a level-playing field between EU counterparties to OTC derivative contracts which, until the date of entry into force of this proposed amending regulation, do not require the application of the bilateral margin procedures and the related margining requirements</p> <p>The future withdrawal of the UK from the Union creates a disadvantage for EU27 counterparties to OTC derivative contracts entered into with UK counterparties, as they might need to novate their contracts to a counterparty established in an EU27 Member State and this would trigger the application of the bilateral margin procedures and the related margining requirements to their contracts, if the Commission Delegated Regulation on bilateral margining is not amended.</p>
Technical proposal	<p>To create an exemption from the application of the bilateral margin procedures and the related margining requirements, limited in two ways:</p> <ul style="list-style-type: none"> - Limited in scope: novations of OTC derivative contracts to the exclusive effect of replacing a UK counterparty by an EU27 counterparty, and not any other type of novation or life-cycle event - Limited in time: novations carried out between the date of entry into force of this amending Regulation until one year after the date of application of this amending regulation.
Benefits	<ul style="list-style-type: none"> - Maintain a level-playing field between EU27 counterparties to OTC derivative contracts exempted from the application of

	<p>the bilateral margin procedures and the related margining requirements by preserving the regulatory and economic characteristics of the contracts as at the time it was initially entered into.</p> <ul style="list-style-type: none"> - Remove a disincentive (loss of exemption) to the novation of OTC derivative contracts from a UK counterparty to an EU27 counterparty.
Costs	<p>The costs are linked to the loss of passport of UK investment firms, which is linked to the withdrawal of the UK from the Union. The loss of passport might result in the impossibility of UK counterparties to continue serving the relevant contracts, given that depending on national laws in EU27 Members States, certain life cycle events might require an authorisation to be provided, so the lack of an authorisation might render it impossible for EU27 counterparties to benefit from the performance of certain life cycle events.</p> <p>To overcome this problem, counterparties might decide to repaper their contracts with EU27 counterparties. The repapering exercise has a cost, but again this cost is linked to the loss of passport and not to the proposed amended RTS. Therefore, there is no significant one-off or on-going additional costs to regulators or compliance costs for the relevant supervised entities linked to the amended RTS.</p>

3.3 Annex III - Draft technical standards

COMMISSION DELEGATED REGULATION (EU) No .../..
amending Delegated Regulation (EU) 2016/2251 as regards the date until
which counterparties may continue to apply their risk-management
procedures for certain OTC derivative contracts not cleared by a CCP

of []

(text with EEA relevance)

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories⁴, and in particular Article 11(15) thereof,

Whereas:

- (1) On 29 March 2017, the United Kingdom notified the European Council of its intention to withdraw from the Union pursuant to Article 50 of the Treaty on European Union. Consequently, unless another date is established in a withdrawal agreement, or the European Council, in agreement with the United Kingdom, unanimously establishes another date, Union law will cease to apply to the United Kingdom from 30 March 2019. The United Kingdom will then become a third country.
- (2) The requirement to exchange collateral set out in Regulation (EU) No 648/2012 in respect of over-the-counter ('OTC') derivative contracts not cleared by a central counterparty ('CCP') does not take into account the eventuality of a Member State withdrawing from the Union. The challenges faced by those parties to an OTC derivative contract whose counterparties are established in the United Kingdom are a

⁴ OJ L 201, 27.7.2012, p. 1.

direct consequence of an event that is beyond their control and may put them at a disadvantage compared to other counterparties in the Union.

- (3) Commission Delegated Regulation (EU) No 2016/2251⁵ specifies different dates of application of the procedures to exchange collateral for non-centrally cleared OTC derivative contracts, depending on the category of counterparty to those contracts.
- (4) Counterparties cannot foresee what the status of a counterparty established in the United Kingdom might become or to what extent that counterparty would be able to continue providing certain services to counterparties established in the Union. To address that situation, counterparties may want to novate the contract by replacing the counterparty established in the United Kingdom with a counterparty in a Member State.
- (5) Before Regulation (EU) No 648/2012 and Delegated Regulation (EU) 2016/2251 applied, counterparties to non-centrally cleared OTC derivative contracts were not required to exchange collateral and bilateral trades were therefore not collateralised or collateralised on a voluntary basis. If counterparties were required to exchange collateral as a result of novating their contracts to address the withdrawal of the United Kingdom from the Union, the remaining counterparty may not be able to agree to the novation.
- (6) In order to ensure the smooth functioning of the market and a level playing field between counterparties established in the Union, counterparties should be able to replace counterparties established in the United Kingdom with counterparties in a Member State without being required to exchange collateral in respect of those novated contracts. The date from which they should be required to exchange collateral for the novation of those contracts should be 12 months after the date of application of this amending Regulation.
- (7) Delegated Regulation (EU) 2016/2251 should therefore be amended accordingly.
- (8) This Regulation is based on the draft regulatory technical standards submitted by the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority to the Commission.
- (9) It is necessary to facilitate the implementation of efficient solutions by market participants as quickly as possible. Therefore, the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities

⁵ Commission Delegated Regulation (EU) 2016/2251 of 4 October 2016 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty (OJ L 340, 15.12.2016, p. 9).

and Markets Authority have analysed the potential related costs and benefits but have not conducted any open public consultation in accordance with the second subparagraph of Article 15(1) of Regulation (EU) No 1093/2010 of the European Parliament and of the Council⁶, the second subparagraph of Article 15(1) of Regulation (EU) No 1094/2010 of the European Parliament and of the Council⁷ and the second subparagraph of Article 15(1) of Regulation (EU) No 1095/2010 of the European Parliament and of the Council⁸. For the same reason, this Regulation should enter into force on the day following that of its publication.

HAS ADOPTED THIS REGULATION:

Article 1
Amendment to Delegated Regulation (EU) No 2016/2251

Article 35 of Delegated Regulation (EU) No 2016/2251 is replaced by the following:

“Article 35

Transitional provisions

Counterparties referred to in Article 11(3) of Regulation (EU) No 648/2012 may continue to apply the risk-management procedures that they have in place at the date of application of this Regulation in respect of non-centrally cleared OTC derivative contracts entered into or novated between 16 August 2012 and the relevant dates of application of this Regulation.

Counterparties referred to in Article 11(3) of Regulation (EU) No 648/2012 may also continue to apply the risk-management procedures that they have in place at [*OP: Please insert the date of entry into force* of the amending Regulation] in respect of non-centrally cleared OTC derivative contracts fulfilling all of the following conditions:

- (a) the non-centrally cleared OTC derivative contracts have been entered into or novated before either the relevant dates of application of this Regulation as set out

⁶ Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2010, p. 12).

⁷ Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC (OJ L 331, 15.12.2010, p. 48).

⁸ Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC (OJ L 331, 15.12.2010, p. 84).

- in Articles 36, 37 and 38 of this Regulation or [OP: Please insert the date of entry into force of this amending Regulation], whichever is earlier;
- (b) the non-centrally cleared OTC derivative contracts are novated for the sole purpose of replacing a counterparty established in the United Kingdom with a counterparty established in a Member State between the date of application of this amending Regulation and either the relevant dates of application as set out in Articles 36, 37 and 38 of this Regulation or a date that is 12 months from the date of application of this amending Regulation, whichever is later.”

Article 2
Entry into force and application

This Regulation shall enter into force on the day following that of its publication in the *Official Journal of the European Union*.

It shall apply from the date following that on which Union law ceases to apply to the United Kingdom in accordance with Article 50(3) of the Treaty on European Union.

However, this Regulation shall not apply if any of the following conditions is fulfilled:

- (a) a withdrawal agreement concluded with the United Kingdom in accordance with Article 50(2) of the Treaty on European Union applies;
- (b) a decision has been taken to extend the period referred to in Article 50(3) of the Treaty on European Union.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels,

For the Commission
The President

[For the Commission
On behalf of the President

[Position]