DeNederlandscheBank
EUROSYSTEEM

EMIR (European Market Infrastructure Regulation): points for attention

For whom are the points for attention intended?
The points for attention are intended for:
1) banks, pension funds and insurers that enter into OTC derivative transactions, and
2) banks that are or intend to become individual clearing members or general clearing members for OTC derivative contracts.

Below is a summary of a number of micro- and macroprudential points for attention on the implementation of EMIR for banks, pension funds, insurers and general clearing members (CMs). This summary of points for attention was prepared in part based on interviews with institutions and tested at a round-table conference with market parties. This is not an exhaustive summary. DNB intends to evaluate the points for attention at a later date in a dialogue with supervised institutions. The summary of points for attention is preceded by a concise explanation of the structure of the summary and of EMIR.

For the sake of completeness, DNB notes that the impact of the transparency requirements (reporting requirements) and the supervision of central counterparties (CCPs) under EMIR are not included in this summary of points for attention. In addition, the summary does not address the changes for the clearing of non-OTC derivatives resulting from the supervision of CCPs. Lastly, the possible concurrence of EMIR and the legislation of other non-EU jurisdictions governing international OTC derivative transactions (i.e. outside the EU) also falls outside the scope of this publication.

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G20 call
In 2009, the government leaders of the 20 largest economies, united in the G20, called for measures to make the OTC derivatives market safer and more transparent. The call was induced by the lack of transparency of over-the-counter derivatives (OTC derivative contracts), given that they are privately negotiated contracts and any information concerning them is only available to the contracting parties. They create a complex web of interdependencies, which can make it difficult to identify the nature and level of risks involved. The G20 call prompted the European Union to draft and adopt legislation on OTC derivatives, which is also laid down in the European Market Infrastructure Regulation (EMIR).

European Market Infrastructure Regulation (EMIR)
EMIR aims to reform the OTC derivatives market and contains a large number of far reaching measures, for instance the requirement to report data on all derivatives to a trade repository. EMIR also stipulates that certain OTC derivatives be cleared through a CCP, referred to as '**central clearing**'. The European Commission decides which types of OTC derivatives are subject to the clearing obligation on the proposal of the European Securities and Markets Authority (ESMA). It is to be expected that by the end of 2014 or in 2015, institutions need to clear certain types of OTC derivatives through a CCP unless an exemption applies. Institutions are required (as of 15 March 2013 or, where applicable, 15 September 2013) to control risks inherent in non-centrally cleared OTC derivatives using the '**risk mitigation techniques**' laid down in EMIR. For a further explanation of central clearing and risk-mitigation techniques (in Dutch), see below and other DNB 'Open Boek' webpages: (http://www.toezicht.dnb.nl/4/1/50-228769.jsp).

Objective of EMIR and consequences of its implementation
The purpose of rules for central clearing and mandatory use of risk-mitigation techniques is to reduce counterparty risk for financial and other market parties and

to promote financial stability. However, such rules are expected to have operational and legal implications for parties concluding OTC derivative transactions. They also affect collateral, liquidity and capital needs and have systemic implications, including increasing interdependencies and changes in concentration, liquidity and procyclicality risks.

Some risks play a role in particular in the implementation process (such as operational and legal risks in the design of the central clearing infrastructure). Other risks are ongoing (such as liquidity risks) and certain risks may materialise in specific stress scenarios (for instance the risk that positions and collateral cannot be transferred in the event of a general clearing member's default).

How do institutions tackle new issues?
Mandatory central clearing and mandatory use of risk-mitigation techniques entail new issues. DNB has performed an impact analysis of the specific risks that may arise at banks, insurers, pension funds and CMs due to these new rules. In connection herewith, DNB also consulted several large supervised institutions.

Round-table conference
DNB discussed a number of micro- and macroprudential points for attention emerging from the impact analysis with market parties (banks, pension funds, pension providers, insurers, CMs and CCPs) at a round-table conference on 22 May 2014. In a survey, DNB had asked these market parties beforehand which points for attention they considered to be of major and which of minor importance and whether they felt that any points for attention were missing.

Points for attention
The summary of a number of micro- and macroprudential points for attention that was shared with the market parties participating in the round-table conference is set out below. It incorporates the insights that DNB gained during the conference. The points for attention considered to be of major importance by the round-table participants are highlighted in blue. The summary distinguishes between the impact of central clearing and the impact of mandatory risk-mitigation techniques for non-centrally cleared OTC-derivatives.

- In the **central clearing** section, a distinction is made between points for attention for banks, pension funds and insurers as end users and points for attention for CMs. Incidentally, some risks affect end users and CMs alike, such as the risk of collateral scarcity. The relevant points for attention are identified for both.
  Note: intragroup OTC derivative transactions (within the meaning of EMIR) and pension funds are exempted from central clearing, the latter temporarily. For more information (in Dutch), see Open Boek: http://www.toezicht.dnb.nl/4/1/50-228769.jsp). It is nevertheless important to realise that the OTC derivatives market is about to change as a consequence of EMIR. Applying the exemption may not be the most appropriate strategy in all cases.

- The **non-centrally cleared OTC derivative transactions** section contains two points for attention: one specific point for banks acting as a protection seller and one general concern for parties entering into non-centrally cleared OTC derivative transactions.

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Further explanation of central clearing and risk-mitigation techniques under EMIR

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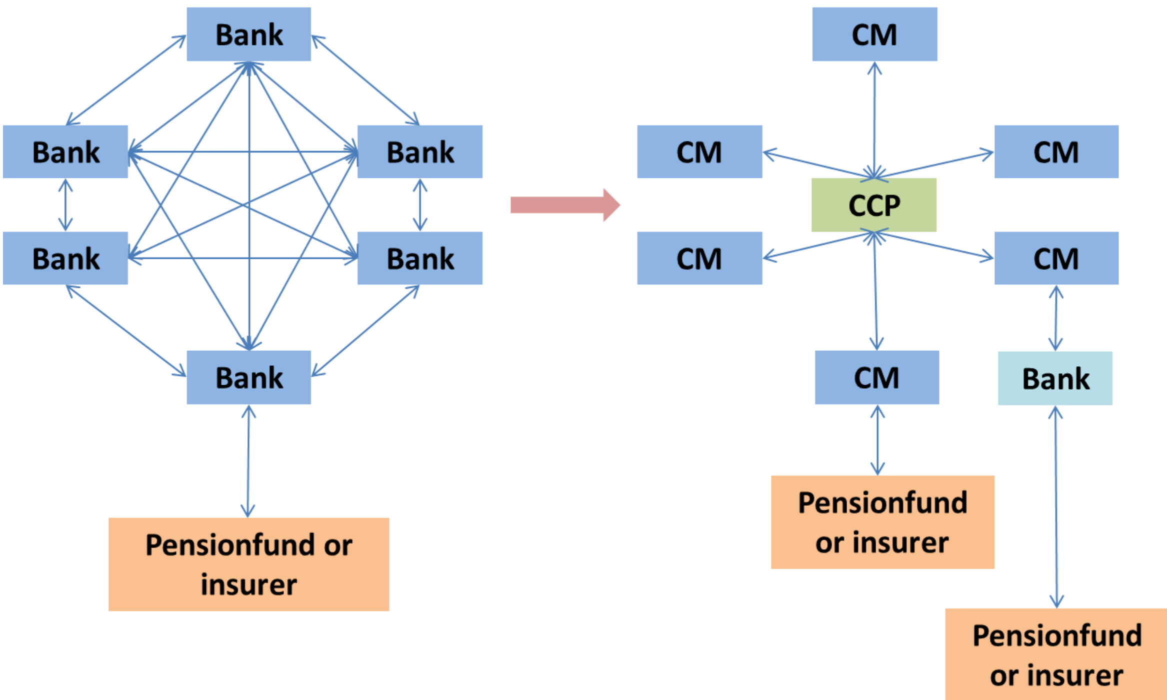
Mandatory central clearing

EMIR stipulates that designated standardised OTC derivative transactions be cleared through a CCP. This implies that transactions between original contracting parties are replaced by two new transactions: one between the first party and the CCP and one between the second party and the CCP. As a result, the two parties no longer run risks vis-à-vis one another but solely vis-à-vis the CCP. Insurers, pension funds and most banks (end users) generally do not have direct access to a CCP. This is because institutions must meet a large number of specific requirements to become a CM (most CMs are banks). End users either obtain a connection through a CM or use so-termed 'indirect client arrangements' (a connection through a CM's client). In the Netherlands, such 'indirect client arrangements' are still in the process of being designed. **Expectations are that central clearing will be made mandatory for certain types of OTC derivative transactions in 2015.** Intragroup OTC derivative transactions (within the meaning of EMIR) and pension funds are exempted from central clearing, the latter temporarily. For more information (in Dutch), see Open Boek: http://www.toezicht.dnb.nl/4/1/50-228769.jsp).

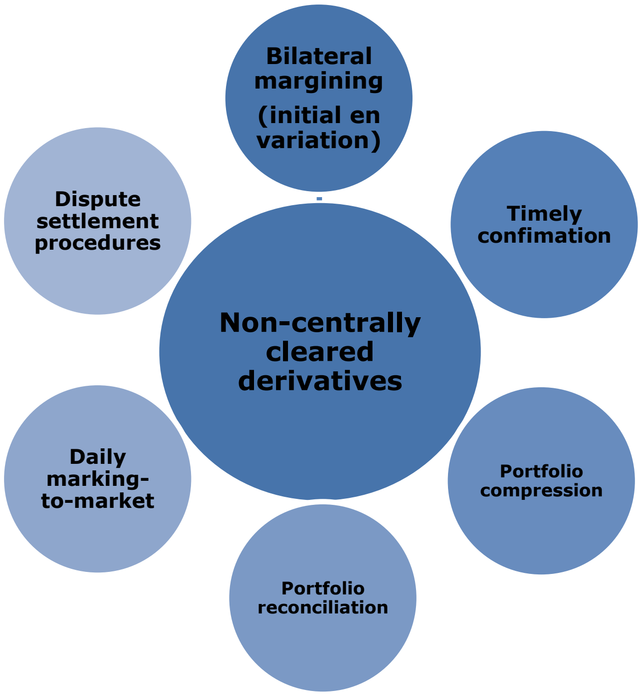
Figure 1: from bilateral clearing to central clearing



Mandatory risk-mitigation techniques for non-centrally cleared OTC derivative transactions

Only OTC derivative contracts that are sufficiently liquid are designated for central clearing by the European Commission on the proposal of ESMA. Contracting parties must apply risk-mitigation techniques with respect to other non-centrally cleared (bilateral) OTC derivative transactions. **These risk-mitigation techniques have been in effect since 15 March 2013 or, where applicable, 15 September 2013. Bilateral margining rules are expected to be available late 2014/early 2015.** See Figure 2 for an overview. Further information is available from Open Boek (http://www.toezicht.dnb.nl/4/1/50-228769.jsp).
Pension funds may use the temporary exemption from mandatory central clearing. This implies that they may enter into OTC derivative transactions though subject to the clearing obligation, bilaterally (non-centrally cleared). In that case, however, they must apply risk-mitigation techniques also in respect of these transactions.

Figure 2: mandatory risk-mitigation techniques



Overview of points for attention

	CENTRAL CLEARING
	Points for attention for clearing members (CMs) and end users
1.	**Collateral scarcity** Demand for high-quality collateral (liquidity) is expected to increase, mainly due to initial margin and variation margin payments and increasing contributions to a CCP's default fund. As a consequence, parties may face (i) higher collateral costs, and/or (ii) deficits.
2.	**Concentration risk due to potentially limited number of CCPs and CMs** With a view to achieving economies of scale, it is likely that there will only be a limited number of CCPs in the market. In addition, these CCPs will initially specialise in specific types of derivative products. For end users, the number of CMs may also be limited. This may lead to concentration risk.
3.	**Risk of modification of collateral requirements by CCPs** A CCP may decide to modify its collateral requirements in the short term, for instance: • a higher initial margin. • a higher variation margin. • higher haircuts on existing collateral. • stricter quality requirements for collateral. In that case, the collateral must be substituted at short notice (through the CM). An additional concern for end users is that CMs may call for additional collateral (the so-termed 'multiplier') for purposes of their own risk management, depending on the arrangements between the parties involved.
4.	**Bankruptcy risk vis-à-vis CCP (CCP's financial soundness)** If a CCP defaults, it is liable only vis-à-vis the CM (and not vis-à-vis end users) on account of initial margin payments, variation margin calls and transaction settlements. The structure of the arrangements between a CM and an end user determines the extent to which the latter is entitled to recover losses ensuing from the CCP's bankruptcy from the CM. For example, the CM may be held liable only for what it, in turn, is able to claim from the CCP. Depending on the relevant arrangements, such a situation may result in a replacement risk for the end user. This means that if the CCP goes into bankruptcy, the end user's transactions will be terminated and the end user will need to conclude new transactions (possibly at higher costs). It is important to note in this context that, pursuant to EMIR, CCPs must apply for authorisation for the central clearing of OTC and other types of derivatives and must meet specific requirements. One of the requirements for CCPs is to set up and maintain a default fund to absorb losses. In addition, CCPs must observe rules of conduct and must meet organisational and prudential requirements, including internal governance rules, audits and capital requirements.
5.	**Risk of incorrect administrative segregation by CCP and CM** CCPs and CMs must meet the requirements in respect of administrative segregation. EMIR contains segregation requirements for assets held in accounts with CCPs, depending on the type of account structure (see the explanatory notes to the point for attention regarding contract risk). CMs are also required to keep separate records and accounts on the positions and the underlying collateral for the chosen account structure based on EMIR and depending on the contractual arrangement between CM and end user.

	Specific points for attention for end users
6.	**Higher contingent liquidity risk due to new margin requirements** End users must provide the CCP through their CM with initial margins and variation margins for centrally cleared OTC derivative transactions. Initial margins may be paid in securities. CCPs generally accept cash only as variation margins, although this is not required by EMIR. CCPs will be required to adjust the variation margin frequently on the basis of market valuations of the relevant OTC derivative contract. End users may need to adjust their liquidity management accordingly. End users failing to provide the required collateral in good time and in full run the risk of a close-out of the derivative contracts.
7.	**Access to central clearing** Smaller end users in particular may need to rely on indirect client arrangements. In that case, rather than entering into a direct business relationship with a CM, an end user seeking central clearing of its derivative contracts engages a bank affiliated with a CM. Indirect client arrangements within the meaning of EMIR are still being developed. It is important to properly examine the rights and obligations under such arrangements as well as, for example, the relevant operational requirements and security levels.
8.	**Increased costs of OTC derivative transactions** Mandatory clearing may increase the costs of OTC derivative transactions, in part because end users are required to adjust their operational policies and processes. The adjustments include e.g. the following: • concluding new contracts with CMs. • providing the CCP with margins (both initial and variation margins) through the CM. • training staff. End users may also need to pay higher fees to parties enabling the central clearing infrastructure (such as CMs and CCPs).
9.	**Credit risk vis-à-vis CM (CM's financial soundness)** Margin transit: the margin that an end user has paid to a CM in cash – to be passed on to the CCP – is part of the CM's insolvent estate if the CM goes into bankruptcy before the margin is passed on. Margin in securities are not part of the CM's estate if the protection pursuant to the Securities Book-Entry Transfer Act (Wet giraal effectenverkeer) applies. CM bankruptcy: only the CM has a direct claim on the CCP on account of initial margin payments, variation margin calls and transaction settlements (the end user does not). The CM may, in principle and depending on the specific arrangements, pledge such a claim on the CCP to the end user.[1] Additional margin: the end user runs a credit risk vis-à-vis the CM on account of additional margin (i.e. margin in addition to the margin required by the CCP). In the case of individual client segregation (ISA), CMs must pass on this additional collateral to the CCP and the end user (only) runs a transit risk vis-à-vis the CM. See the point for attention on contract risk for an explanation of account structures.
10.	**Liquidity and collateral management** End users must adjust their liquidity and collateral management processes and systems in at least five respects: • End users must provide initial and variation margins for central clearing. The 'pre-EMIR' OTC derivatives market generally did not have an initial margin requirement. Moreover, the exchange of variation margins was less frequent than it will be in the context of central clearing.

[1] In this context, reference is made to the draft 2016 Act amending the Financial Markets Act, which addresses the protection of holders of derivatives against their intermediary's backruptcy.

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	• Changes in the initial margin (for instance due to modified haircuts and collateral downgrading) and the variation margin (due to market valuations) are also expected to occur more frequently than they did in the pre-EMIR OTC derivatives market. • End users must take into account concentration limits that will or may be imposed. • The use of collateral optimisation and transformation techniques imposes requirements on liquidity and collateral management. Lastly, collateral management must primarily be geared to 'daily processes' to enable end users to absorb intra-day margin calls.
11.	**Contract risk** End users must ensure that the contract documents with CMs are aligned with their operational policies and processes. Key aspects include termination rights – does the end user retain access to central clearing? – and the portability of positions and collateral. End users must examine which account structures are suitable given their operations and which CMs offer these account structures. It is important is to make an informed decision based on the available account structures and available levels of protection. Pursuant to EMIR, CCPs must set up two types of account structures: individually segregated accounts and omnibus accounts. The account structures provided by the relevant CM must match these. Further explanation: • In the case of individually segregated accounts (individual client segregation or ISA), the CCP keeps the assets and positions held for a CM's client administratively separate from the assets and positions held for the CM's other clients. Moreover, the CM must directly pass on any additional collateral it requires (the so-termed 'multiplier') to the relevant CCP. In that context, end users may have the option of excluding substitution risk, meaning that they will at all times receive the same collateral they provided (if they are the margin recipient) rather than 'eligible' collateral. From a financial stability perspective, the use of individually segregated accounts is, in principle, to be preferred. • In the case of omnibus accounts (omnibus client segregation), a distinction is made between the assets and positions of the CM itself and those the CCP holds for the account of the CM's clients. This means that clients do not run risks vis-à-vis their CM but do vis-à-vis the CM's other clients in the relevant omnibus account (this is referred to as 'fellow client risk').
12.	**Position and concentration limit risk** End users may 'face a closed door' if their CM has used its limit with the relevant CCP in full. CCPs generally impose certain position limits and possibly other limits including concentration limits on their CMs. CMs must incorporate these limits into their processes and systems and observe them in the provision of services to their clients (end users). Also see the point for attention on liquidity and collateral management for concentration limits and collateral management. Note: a situation may occur in which an end user is unable to hedge its risk because the CM has reached its clearing limit. End users must take this aspect into account in their decision-making on contracting with one or more CMs, also bearing in mind their need for OTC derivatives.
13.	**Reduced hedging of business risks by end users due to cost factor** End users may hedge fewer of their business risks due to the cost factor (see the above point for attention on higher costs). As a consequence, end users may face greater market, interest or credit risks.

	Specific points for attention for CMs
14.	**Communication risk** CMs must provide end users with accurate and complete information on the risks inherent in the available account structures in a timely manner.
15.	**Transformation services risk** If a CM transforms collateral of deteriorating quality, this may leave a CM with a 'residual' risk.
	NON-CENTRAL CLEARING
16.	**Client reduction risk (for protection sellers)** The anticipated shift of a portion of the previously bilateral (private) OTC derivatives market to central clearing will change the market for non-centrally cleared OTC derivatives. In addition, EMIR imposes requirements on parties in respect of non-centrally cleared OTC derivatives. This may cause protection sellers focusing on this type of product in their business models to lose clients. Barring exceptions, the Capital Requirements Regulation (CRR) imposes more stringent capital requirements on non-centrally cleared derivatives (i.e. the CVA charge) than on centrally cleared OTC derivatives. As a consequence, protection sellers targeting the non-centrally cleared OTC derivatives market may see their business models come under pressure.
17.	**Bilateral margining requirements** For non-centrally cleared OTC derivatives, parties must observe bilateral margining rules. It is likely that these rules will include margin requirements (both initial and variation margins) and requirements for models that institutions use to calculate margin and the quality and composition of collateral. This may ask for more intensive collateral management than institutions were used to in the past.