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Financial Services Risk and Regulation

Hot topic

Getting ready for EMIR II

Highlights

The proposed changes to EMIR will impose new operational requirements on trade repositories and CCPs, which warrants early engagement and gap analysis. The EC indicates that more changes may be on the way for CCPs as additional supervisory requirements may be imposed so as to bring euro-clearing business to the EU27. While financial firms will have many obligations reduced, they still need to be engaged so as to avoid over-reporting and to take full advantage of theses

Overview

The EC published a proposed regulation to amend and update EMIR on 4 May 2017 officially starting the first legislative stage of 'EMIR II'. Through its amendments, the European Commission (EC) seeks to lighten reporting and clearing obligations for firms with smaller derivatives exposures while heightening the responsibilities for market infrastructure, most notably trade repositories (TRs).

Recognising the complexity of imposing a wide range of requirements on a diverse group of market participants, the EC originally laid out an EMIR Level I requirement to review the effectiveness and appropriateness of the regulation. The wider CMU agenda underscores this point, which seeks to recalibrate EU regulation to facilitate a more progrowth agenda and to make it easier for smaller firms to participate in financial markets.

Despite the extensive tweaks, the EC has not implemented more structural alterations that were suggested by some stakeholders. This included adopting single-sided reporting across the board, removing the hedging exemption from the clearing threshold analysis and exempting smaller non-financial firms from reporting altogether. The EC also confirms that all of the fundamental pillars of EMIR will remain – Reporting, clearing, bilateral margin and risk mitigation more broadly.

Expanding TRs' responsibilities

Higher fines

While EMIR II will probably expand TR responsibilities, the real headline is the enforcement focus. The EC's proposals would dramatically increase the fines for TRs, raising them significantly to €200,000. As regulators have so far only fined market infrastructure, the proposed amendments support a wider trend of prioritising facility enforcement in EU derivatives reform. TRs will find this very sobering as they begin to prepare for new operational requirements and possibly expanded regulatory responsibilities.

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Stricter data validation
The proposed EMIR amendments indicate that TRs may need to take a more active role in ensuring that transaction reporting data is accurate and readily accessible for regulators. While the proposed Level 1 amendments only outline these new requirements, which will be fleshed out by ESMA regulatory technical standards at a later date, it is possible that TRs will have more direct obligations to review and validate counterparty submissions. TRs currently perform this role voluntarily via service agreements by sending submitters error messages. But there are currently no consistent standards for how TRs should track accuracy and quality. This means that, practically, the responsibility lies with the counterparties to report accurately and regulators to validate the data.

As the EC, per ESMA recommendations, will likely subject TRs to stricter validation requirements under the Securities Financing Transactions Regulation (SFTR) it could well be that any future EMIR II regulatory standards will align with these new requirements. The proposed SFTR standards include the authentication of users/participants, the performance of schema and logical validation, among others. On the other hand, the technical standards could end up pushing TRs beyond ESMA's SFTR recommendations and more into a de facto first-line reviewer. Doing so would impose additional operational responsibilities and significantly heighten their regulatory exposure when reporting errors are discovered by regulators.

While TRs may find this new role burdensome, it could benefit both counterparties and regulators. Counterparties will welcome having another entity, especially one with the technical resources of a repository, invested in the accuracy of their reporting. Likewise, regulators will be able to better harness their supervisory and enforcement resources by effectively outsourcing some of their oversight role to TRs.

Concerns around reconciliation
Just as significantly, the proposed amendments could require TRs to put in place policies to ensure effective intra-repository reconciliation. In a dual-sided reporting regime, such as EMIR, reconciliation is essential when a different TR is used for each side of the report. If TRs have too much difficulty reconciling such data, then regulators are unable to accurately understand the terms of the transaction and whether they have been reported correctly.

Counterparties will also benefit from improved intra-repository reconciliations, as such reconciliation would likely require increased uniformity of submission criteria. Currently, TRs impose individualistic data requirements for submissions, beyond EMIR requirements, and this imposes additional reporting burdens and costs. As reconciliation can only be achieved by better aligning these divergent requirements, derivative counterparties could find that the submission process becomes simpler and more stream-lined as a result.

Data transference and access
More immediately, TRs under EMIR II will need to devise new policies around successful transference of data (such as when a counterparty wishes to switch repositories) as well as providing access in delegated reporting scenarios. Counterparties are sometimes impeded in their data reconciliation efforts if they have delegated reporting obligations. This is because TRs have sometimes been reluctant to share data since they have a contractual relationship with the entity reporting on behalf of the counterparty as opposed to the counterparty with the ultimate regulatory responsibility. This arrangement creates a problematic gap whereby the entity with the responsibility is unable to do an end-to-end reconciliation because of the allowed intermediation of a delegated submitter, and the proposed EMIR amendments would address this.

Finally, the EC seeks to improve data access and reconciliation globally, not just within the EU, by establishing conditions by which third country regulators can access data held in EU TRs. Such access would not be contingent on a formal agreement between the two jurisdictions, instead only requiring domestic rules allowing EU authorities access to third country trade repository data on equal terms. While unlikely to be a significant burden for EU TRs, such efforts will improve international data sharing and will be an important precondition for mutual regulatory access post-Brexit.

Improving clearing access and accountability

In contrast to the increase in TR duties, there are only a few new requirements for CCPs under the proposals. The most notable of these is the obligation for CCPs to provide clearing members with a tool to determine their likely margin requirements, as well as more transparency around their initial margin models. While counterparties will likely welcome these new resources, as they will help clarify the costs of derivatives transactions, the tools could be burdensome too. The extent of this won't be clear until the regulatory parameters of the tool are better defined.

But EMIR II may end up imposing a larger burden on clearing members. The marketplace gives clearing members discretion as to whom they can take on as clients for clearing services, with the unfortunate result that smaller entities are often excluded from clearing access despite being subject to a mandatory clearing obligation. While there has been no indication that regulators will attempt to force clearing members to take on clients, EMIR II attempts to address this issue by requiring clearing

members to provide their clearing services on fair, reasonable and non-discriminatory (FRAND) terms.

It's unclear whether this will be sufficient to address the problem, as FRAND principles appear to only preclude deterrent activities (such as charging smaller clients much more than larger clients) but will not change the fact that such clearing services are not very profitable and there is a corresponding business incentive to limit the client-base. Regardless of whether FRAND principles will dramatically open up the market for smaller clients, its imposition on clearing members could force them to establish more robust client on-boarding processes.

Reducing reporting burdens

Firms complained that some of the reporting obligations under EMIR failed to make sense. Acknowledging that CCPs capture all of the pertinent trade details for exchange-traded derivatives (ETDs) as the automatic intermediary for such trades, the proposed EMIR amendments would transfer the reporting responsibility for ETDs from the counterparties to the CCP. Likewise, firms had observed that intragroup transactions involving non-financials (NFCs) don't pose the same systemic risk concerns as those between financial entities (FCs). As a result the EC proposes to exclude such intragroup transactions from the reporting obligation. In addition, the EC proposes to remove the requirement to report historic trades since its unclear how such transactions would contribute to current systemic risk.

The EC also proposes to lighten the reporting burden for smaller non-financials by shifting the reporting responsibility to their financial entity counterparties. While the EU reporting regimes have a dual-sided model, EMIR II would follow SFTR's lead in creating a limited single-sided reporting regime for transactions between FCs and non-financial firms with lower exposures (NFC-s).

These changes should be relatively easy for firms to implement, especially since the EC is shifting reporting obligations to those entities best equipped to meet them. While firms will need to make some changes to processes and systems to ensure their reporting parameters are adjusted to limit or expand the scope of their reporting duties, this should be manageable. The most complex adjustment will likely be for FCs as they will need to implement systems that will accurately flag those trades where they must report for both themselves and for NFC-counterparties. This is especially the case since the pool of trades that this would apply to isn't perfectly aligned with SFTR, a comparable regulatory framework for securities financing transactions.

While firms will welcome lighter reporting burdens, it's important they make the necessary system and process changes, as they can be fined for over-reporting as much as for under-reporting.

Reducing clearing burdens

Similarly to its approach to reporting, the EC seeks to reduce the clearing obligations for entities with smaller derivatives exposures which struggle to meet the requirements. NFCs that exceed a clearing threshold for one instrument class (such as credit derivatives) will only have to clear those instruments as opposed to all instruments subject to mandatory clearing. Likewise, EMIR II would introduce the first exemption for some financial firms, as FCs whose exposures are below all of the clearing thresholds would not be subject to the clearing obligation. Currently, all FCs are automatically required to clear all in-scope derivatives.

Ever since EMIR's implementation, firms had argued that pension schemes should be excluded from the clearing requirements since their business model precludes them having the collateral on hand to meet CCP margin requirements for cleared transactions. The EC had correspondingly been exempting pension schemes from the requirement, and its proposed amendments continue this approach by extending the exemption for an additional three years.

Finally, similar to its approach for reporting historic trades, the EC proposes to remove obligations around clearing transactions entered into prior to the start of mandatory clearing. While the EC is primarily concerned with lightening clearing burdens for non-financials and smaller financial entities, this proposal would benefit all entities subject to the clearing obligation.

Focus on asset management

The EC also looks to expand the scope of which entities are deemed to be financial counterparties, and therefore automatically subject to the full range of EMIR requirements. Alternative investment funds (AIFs) are now specifically defined as FCs and therefore automatically subject to bilateral margin requirements and EMIR II's FC clearing regime. Previously, they were only indirectly included as FCs to the extent that they were managed by an alternative investment fund manager (AIFM) authorised under AIFMD. But, given the passive nature of these funds, their derivatives activity was deemed financial counterparty activity as a result of their management company's responsibility and direction over their EMIR obligations. The expectation of fund passivity is reinforced under EMIR II by the explicit requirement for managers of AIFs and UCITS to report on behalf of their funds.

Not all AIF managers are authorised under AIFMD, though. Exemptions include when a manager is below the authorisation threshold of €500m. Currently, these managers and their funds would be deemed to be NFCs and therefore only subject to the clearing and bilateral margin requirements if they exceed any of the instrument-specific clearing thresholds. By categorically defining all alternative funds as financial counterparties, as is the case for UCITS already, EMIR II will ensure that all investment fund activity is automatically subject to clearing and margin requirements. Of course, any new AIFs reclassified as financial counterparties will benefit from EMIR II's lighter treatment of smaller financial firms in applicable circumstances.

Changes on the horizon

In a communication published with the EMIR II proposals, the EC signalled that there are additional regulatory changes to CCP rules on the horizon in response to Brexit. The EC may look to limiting market access for third country CCPs with a focus on the significant market share enjoyed by UK CCPs for euro-denominated clearing. But, instead of altering the equivalence criteria, which would affect all foreign CCPs equally, any new changes could focus on increased supervisory and location criteria for CCPs clearing EU member-state currencies, including the euro.

The EC discusses the possibility of increasing the supervisory role of central banks of issue, which could allow the EU to argue that UK CCPs are incapable of being adequately supervised on a cross-border basis. It also references the potential need for location criteria and enhanced EU supervision more broadly. Also, the EC's suggestion that it may focus on 'systemic risk' as a factor in enhanced supervision could be a rationale for targeting UK CCPs that clear much higher volumes while sparing US and Asian clearing houses

Moving euro-clearing to the continent has been a long-standing political goal of both EU regulators and the continental financial services industry. While the ECJ rejected an earlier attempt by the ECB to unilaterally move such clearing, the EC's communication indicates that any new effort would be done on a different basis (i.e. would be done legislatively and wouldn't discriminate between euro and non-euro zone) and therefore would avoid the ECB's earlier pitfalls. As a result, Brexit could provide the circumstances whereby the EU could move clearing business away from the UK and towards the EU27.

What do firms need to do now?

The EC's proposed changes are at an early stage, and TRs and CCPs will need to wait for the proposed regulation to be finalised and for technical standards. But it's important that firms take note of the proposals now, as EMIR II and Brexit pose challenges to their business model. Consequently, they should begin to assess how they will respond to worst-case scenarios and how they can engage with regulators and authorities to advocate for more favourable outcomes.

Given that the EC and ESMA will be expanding their data accuracy role through SFTR, and could well expand upon this with future EMIR II technical standards, TRs would be well advised to interrogate their existing validation capabilities through a gap analysis. Likewise, TRs should recognise that any new SFTR requirements could be used as a baseline for even stricter standards under EMIR II, and should prioritise SFTR compliance accordingly.

By contrast, firms such as investment banks and asset managers should take comfort that EMIR II largely seeks to lighten their derivatives regulatory burden. But, there are a number of potential areas of concern that could get lost in the shuffle.

All firms should assess how difficult it will be to redesign their reporting parameters to ensure that any de-scoped reporting obligations are no longer submitted, as the failure to do so could result in significant over-reporting. Likewise, firms will need to make sure that they establish clearing policies that take advantage of lighter obligations but still meet regulatory requirements.

Certain financial entities will have a wider range of automatic requirements under the EMIR II proposals, such as sub-threshold AIFs. They should begin to assess how they will adjust their operations and whether they will become subject to higher costs due to clearing or exchange of bilateral margin.

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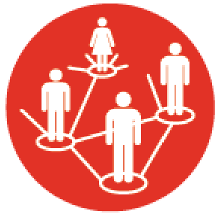

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