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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 (Text with EEA relevance)

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

(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 repositories[(1)], and in particular Article 11(15) thereof,

Whereas:

(1) Counterparties have an obligation to protect themselves against credit exposures to derivatives counterparties by collecting margins where those contracts are not cleared by a central counterparty. This Regulation lays out the standards for the timely, accurate and appropriately segregated exchange of collateral. These standards should apply on a mandatory basis to the collateral that counterparties are required to collect or post pursuant to this Regulation. However, counterparties which agree to collecting or posting collateral beyond the requirements of this Regulation should be able to choose whether or not to exchange such collateral in accordance with these standards.

(2) Counterparties subject to the requirements of Article 11(3) of Regulation (EU) No 648/2012 should take into account the different risk profiles of non-financial counterparties that are below the clearing threshold referred to in Article 10 of that Regulation when establishing their risk management procedures for over-the-counter ('OTC') derivative contracts concluded with such entities. It is therefore appropriate to allow counterparties to determine whether or not the level of counterparty credit risk posed by those non-financial counterparties that is below that clearing threshold needs to be mitigated through the exchange of collateral. Given that non-financial counterparties established in a third country that would be below the clearing threshold if established in the Union can be assumed to have the same risk profiles as non-financial counterparties below the clearing threshold established in the Union, the same approach should be applied to both types of entities in order to prevent regulatory arbitrage.

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(3) Counterparties to non-centrally cleared OTC derivatives contracts need to be protected from the risk of a potential default of the other counterparty. Therefore, two types of collateral in the form of margins are necessary to properly manage the risks to which those counterparties are exposed. The first type is variation margin, which protects counterparties against exposures related to the current market value of their OTC derivative contracts. The second type is initial margin, which protects counterparties against potential losses which could stem from movements in the market value of the derivatives position occurring between the last exchange of variation margin before the default of a counterparty and the time that the OTC derivative contracts are replaced or the corresponding risk is hedged.

(4) Since central counterparties ('CCPs') might be authorised as a credit institution according to Union legislation, it is necessary to exclude non-centrally cleared OTC derivative contracts that CCPs enter into during a default management process from the requirements of this Regulation since those contracts are already subject to the provisions of Commission Delegated Regulation (EU) No 153/2013[(2)] and therefore they are not subject to the provisions of this Regulation.

(5) For non-centrally cleared OTC derivative contracts that involve the payment of a premium upfront to guarantee the performance of the contract, the counterparty receiving the payment of the premium ('option seller') does not have a current or potential future exposure to the counterparty. Also, the daily mark-to-market value of such contracts is already covered by the payment of this premium. Therefore, where the netting set consists of such option positions, the option seller should be able to choose not to collect initial or variation margins for these types of OTC derivatives as long as the option seller is not exposed to any credit risk. The counterparty paying the premium ('option buyer') should however collect both initial and variation margins.

(6) While dispute resolution processes contained in bilateral agreements between counterparties are useful for minimising the length and frequency of disputes, counterparties should, in the first instance, collect at least the undisputed amount in case the amount of a margin call is disputed. This will mitigate the risk arising from the disputed transactions and therefore ensure that non-centrally cleared OTC derivative contracts are collateralised to the extent possible.

(7) In order to guarantee a level playing field across jurisdictions, where a counterparty established in the Union enters into a non-centrally cleared OTC derivative contract with a counterparty that is established in a third country, initial and variation margins should be exchanged in both directions. Counterparties established in the Union transacting with counterparties established in third countries should remain subject to the obligation of assessing the legal enforceability of the bilateral agreements and the effectiveness of the segregation agreements.

(8) It is appropriate to allow counterparties to apply a minimum transfer amount when exchanging collateral in order to reduce the operational burden of exchanging limited sums when exposures move only slightly. However, it should be ensured that such minimum transfer amount is used as an operational tool and not with the view to serving

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as an uncollateralised credit line between counterparties. Therefore, a maximum level should be set out for that minimum transfer amount.

(9) For operational reasons, it might be more appropriate in some cases to have separate minimum transfer amounts for the initial and the variation margin. In those cases it should be possible for counterparties to agree on separate minimum transfer amounts for variation and initial margin. However, the sum of the separate minimum transfer amounts should not exceed the maximum level of the minimum transfer amount. For practical reasons, it should be possible to define the minimum transfer amount in the currency in which margins are normally exchanged, which may not be the euro.

(10) Some third-country jurisdictions may determine a different scope to Regulation (EU) No 648/2012 for the purposes of their requirements for the exchange of collateral in relation to OTC derivative contracts that are not centrally cleared. Therefore, were this Regulation to require that only non-centrally cleared OTC derivative contracts governed by Regulation (EU) No 648/2012 are included in the margin calculations for cross-border netting sets, counterparties in different jurisdictions would potentially have to duplicate required calculations to take into account different definitions or different scopes of products under the respective margin requirements. This could lead to distorted margin calculations. Furthermore, this would likely increase the risk of disputes. Therefore, allowing the use of a broader set of products in cross-border netting sets that includes all the OTC derivative contracts that are subject to exchange of collateral in one or the other jurisdiction would facilitate a smoother process of margin collection. This approach is consistent with the systemic risk-reduction goal of Regulation (EU) No 648/2012, since a broader range of products would be subject to the margin requirements.

(11) Counterparties may choose to collect initial margins in cash, in which case the collateral should not be subject to any haircut, provided that the currency of the collateral matches the currency in which the contract is expressed. However, where initial margins are collected in cash in a currency different than the currency in which the contract is expressed, currency mismatch may generate foreign exchange risk. For this reason, a currency mismatch haircut should apply to initial margins collected in cash in another currency. For variation margins collected in cash no haircut is necessary in line with the BCBS-IOSCO framework, even where the payment is executed in a different currency than the currency of the contract.

(12) When setting the level of initial margin requirements, the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions have explicitly considered two aspects, as reflected in their framework, 'Margin requirements for non-centrally cleared derivatives' of March 2015 ('BCBS-IOSCO framework'). The first aspect is the availability of high credit quality and liquid assets covering the initial margin requirements. The second is the proportionality principle, as smaller financial and non-financial counterparties might be hit in a disproportionate manner from the initial margin requirements. In order to maintain a level playing field, this Regulation should introduce a threshold that is exactly the same as in the BCBS-IOSCO framework below which two counterparties are not required to exchange

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initial margin. This should substantially alleviate costs and operational burden for smaller participants and address the concern about the availability of high credit quality and liquid assets without undermining the general objectives of Regulation (EU) No 648/2012.

(13) While the thresholds should always be calculated at group level, investment funds should be treated as a special case as they can be managed by a single investment manager and captured as a single group. However, where the funds are distinct pools of assets and they are not collateralised, guaranteed or supported by other investment funds or the investment manager itself, they are relatively risk remote in relation to the rest of the group. Such investment funds should therefore be treated as separate entities when calculating the thresholds, in line with the BCBS-IOSCO framework.

(14) With regard to initial margin, the requirements of this Regulation are likely to have a measurable impact on market liquidity, as assets provided as collateral cannot be liquidated or otherwise reused for the duration of the non-centrally cleared OTC derivative contract. Such requirements represent a significant change in market practice and present certain operational and practical challenges that will need to be managed as the new requirements come into effect. Taking into account that the variation margin already covers realised fluctuations in the value of non-centrally cleared OTC derivatives contracts up to the point of default, it is considered proportionate to apply a threshold of EUR 8 billion in gross notional amounts of outstanding contracts to the application of the initial margin requirements. This threshold applies at the group level or, where the counterparty is not part of a group, at the level of the single entity. The aggregated gross notional amount of outstanding contracts should be used as an adequate reference given that it is an appropriate metric for measuring the size and complexity of a portfolio of non-centrally cleared OTC derivative contracts. It is also a reference that is easy to monitor and report. These thresholds are also in line with the BCBS-IOSCO framework for non-centrally cleared OTC derivative contracts and are therefore consistent with international standards.

(15) Exposures arising either from contracts or counterparties that are permanently or temporarily exempted or partially exempted from margins, should also be included in the calculation of the aggregated gross notional amount. This is due to the fact that all the contracts contribute to the determination of the size and complexity of a counterparty's portfolio. Therefore, non-centrally cleared OTC derivative contracts that may be exempted from the requirements of this Regulation are also relevant for determining the size, scale and complexity of the counterparty's portfolio and should therefore also be included in the calculation of the thresholds.

(16) It is appropriate to set out special risk management procedures for certain types of non-centrally cleared OTC derivative contracts that show particular risk profiles. In particular, the exchange of variation margin without initial margin should, consistent with the BCBS-IOSCO framework, be considered an appropriate exchange of collateral for physically-settled foreign exchange contracts. Similarly, as cross-currency swaps can be decomposed into a sequence of foreign exchange forwards, only the interest rate component should be covered by initial margin.

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(17) Account should be taken of the impediments faced by covered bonds issuers or cover pools in providing collateral. Under a specific set of conditions, covered bonds issuers or cover pools should therefore not be required to post collateral. This should allow for some flexibility for covered bonds issuers or cover pools while ensuring that the risks for their counterparties are limited. Covered bond issuers or cover pools may face legal impediments to posting and collecting non-cash collateral for initial or variation margin or posting variation margin in cash since variation margin payment could be considered a claim that ranks senior to the bond holder claims, which could result in a legal impediment. Similarly, the possibility to substitute or withdraw initial margin could be considered a claim that ranks senior to the bond holder claims facing the same type of constraints. However, there are no constraints on a covered bond issuer or cover pool to return cash previously collected as variation margin. Counterparties of covered bond issuers or cover pools should therefore be required to post variation margin in cash and should have the right to get back part or all of it, but the covered bond issuers or cover pools should only be required to post variation margin for the amount in cash that was previously received.

(18) Counterparties should always assess the legal enforceability of their netting and segregation agreements. Where, with respect to the legal framework of a third country, these assessments turn out to be negative, counterparties should rely on arrangements different from the two-way exchange of margins. With a view to ensuring consistency with international standards, to avoid that it becomes impossible for Union counterparties to trade with counterparties in those jurisdictions, and to ensure a level playing field for Union counterparties, it is appropriate to set out a minimum threshold below which counterparties can trade with counterparties established in those jurisdictions without exchanging initial or variation margins. Where the counterparties have the possibility to collect margins and can ensure that for collected collateral, as opposed to posted collateral, the provisions of this Regulation can be met, Union counterparties should always be required to collect collateral. Exposures from contracts with counterparties established in third-country jurisdictions that are not covered by any exchange of collateral because of the legal impediments in those jurisdictions should be constrained by setting a limit, as capital is not considered equivalent to margin exchange in relation to the exposures arising from non-centrally cleared OTC derivative contracts and not all counterparties subject to the margin requirements under this Regulation are also subject to capital requirements. This limit should be set in such a way that it is simple to calculate and verify. To avoid the build-up of systemic risk and to avoid that such specific treatment creates the possibility to circumvent the provisions of this Regulation, the limit should be set at a conservative level. These treatments would be considered sufficiently prudent, because there are also other risk mitigation techniques as an alternative to margins.

(19) In order to safeguard against the case where collateral cannot be liquidated immediately after the default of a counterparty, it is necessary, when calculating initial margin to take into account the time period from the most recent exchange of collateral covering a netting set of contracts with a defaulting counterparty until the contracts are closed out and the resulting market risk is re-hedged. This time period is known as the