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Important Notes Regarding the Council Draft of March 17 2011 for European Market Infrastructure Regulation ("EMIR") Article 8, Paragraph 1b

Introduction

The March 17 Council text for EMIR Art.8 Para.1b has recently been amended from earlier drafts in a way which creates uncertainty and serious risks for the trading of derivatives.

This paper summarises the concern that the latest Council drafting on the treatment of collateral potentially introduces a right of counterparties to request during the term of a trade that the party that has received posted collateral should stop using such collateral in their general business and instead to put in place special arrangements such as specific trust arrangement or full segregation with a third party custodian.

The relevant Council text states:

> **1b. Each financial counterparty or a non-financial counterparty referred to in Article 7(2), if requested by the other party, shall distinguish in accounts the assets provided by the other party.**

For comparison, the corresponding provision in the 7 February version reads:

> **1a. Each financial counterparty or a non-financial counterparty referred to in Article 7(2), if requested by the other party, shall segregate in accounts collateral provided by the other party, in accordance with their agreement.**

This change raises the possibility that the regulation is intended (or could be construed) to require all recipients of collateral to segregate those assets upon request from the other party.

Background Information

Collateral can be sub-divided into Variation Margin ("VM") and Independent Amount ("IA", which is also sometimes call Initial Margin). VM is intended to cover the current mark-to-market value of the underlying derivatives. IA is intended to be a "cushion" of additional collateral that protects against the possibility that in a default situation the mark-to-market value of the underlying derivatives may increase; it may of course decrease as well.

A number of industry papers have been published which provide context around the potential impact of requirements to segregate collateral pledged against credit exposure between market participants. The ISDA Independent Amount White paper discusses in detail[1] why there is no need from a risk perspective to segregate VM, while focusing on the material detrimental economic impact across market participants (banks, asset managers, corporate, end-users and governments) of proposals to segregate VM.

It is important to be clear on terminology. In common market use in this context, to "segregate" collateral means that the recipient holds the assets in an account that is separate and distinct from other accounts that hold the assets of the recipient or other parties. Often this account will be held with a third party custodian or other

[1] http://www.isda.org/c_and_a/pdf/Independent-Amount-WhitePaper-Final.pdf

independent entity, although sometimes it may be held with an affiliated entity if there is adequate separation established to satisfy the party posting the collateral. Segregated collateral generally cannot be used or "rehypothecated" by the receiving party. Although an increasing amount of IA (not VM) has been subject to segregation by request of the posting party in recent years, this represents very much the minority of collateral posted. However, it should be noted that all collateral (IA and VM) is recorded by the recipient in such as way as to distinguish it from collateral received from others, and the recipient's own assets. This is necessary so that the recipient can keep track of incoming and outgoing collateral, and can then promptly return collateral to the posting party when no longer required or when substituted. This internal record keeping to distinguish collateral assets is not the same as segregation - it creates administrative distinction but not physical separation between different collateral balances, and it does not impede rehypothecation, which is a crucial aspect of efficient liquidity management for firms.

Total collateral in circulation as of the 2010 ISDA Margin Survey[2] is estimated to be approximately USD 3.2 trillion, of which VM would constitute the significant majority of this total.

The 2010 ISDA Margin Survey references that all but one respondent to the survey reported re-using or rehypothecating collateral. Among dealers the survey indicates that 82% of collateral received is rehypothecated, the majority of which is in the form of cash collateral pledged against VM requirements.

In addition the UK Financial Services Authority on behalf of the international group of OTC derivative supervisors requested ISDA to conduct a broad market review focused on bilateral collateralization practices for OTC derivatives, aimed at facilitating better understanding of current market practice. The ISDA Market Review of OTC Derivative Bilateral Collateralization Practices paper[3] addressed a broad range of considerations as it relates to current market practice concluded that it is often commercially important for the collateral taker to have the unrestricted right to use assets received as collateral until the collateral must be returned to the Collateral Provider under the terms of the relevant collateral arrangement.

The ISDA Market Review of OTC Derivative Bilateral Collateralization Practices paper recommended that all parties should, subject to local law requirements, continue to be able to hold collateral to cover VM free of any segregation requirement, restriction on rehypothecation or other limitation. The paper also highlights that segregation of any collateral taken under a title transfer form of collateral agreement common among market participants would raise significant risk of legal recharacterization of such agreements. The primary title transfer form of collateral agreement is the English Law Credit Support Annex, which is extensively used in Europe, and therefore this is perhaps a greater issue for European derivative market participants of all types than in other jurisdictions.

<u>Concerns with the March 17 Version</u>

The new text raises two questions

(a) Could a party make the request only <u>before</u> a trade, so that the "distinguishing" only needs to happen if so agreed at the outset of the trade?

(b) What does "<u>distinguish in accounts</u>" mean? Does it only mean that firms should be able to distinguish in their accounts what collateral the counterparty has provided? (which should be of no concern because all recipients of collateral must already make such internal notations simply to keep track of incoming and outgoing collateral) Or does it mean something more far-reaching which would prevent the use of the collateral in the general business of the party receiving the collateral? (which would be of very significant concern)

On both points there is at least substantial uncertainty.

2 http://www.isda.org/c_and_a/pdf/ISDA-Margin-Survey-2010.pdf

3 http://www2.isda.org/attachment/MjIyNQ==/Collateral-Market-Review.pdf

- On point (a) there is at least an argument that without any limiting wording in the regulation the request can be made any time and that it is not in the power of a counterparty to waive its statutory right at the time of the trade. The 7 February Council version was not very clear on this, but provided much better arguments than the 17 March version that the counterparty could contractually waive their right for "distinguishing" (the request needed to be made "in accordance with their agreement").
- On point (b), the wording "distinguish in accounts" may be read similarly to the same wording in Art. 37 where it refers to the distinction between the accounts of different clearing members and also to the distinction between house and client accounts for the same clearing member; there is certainly the danger that the terms "distinguish in accounts" may be read to exclude firms from using the collateral in their general business and to rather require firms to put in place specific trust arrangements or be required to hold the assets in a segregated account.

Segregation of collateral carries with it material costs, both in terms of the cost of putting in place the physical custodial arrangements to hold the assets in a segregated manner but also in terms of the opportunity cost of not being able to use or rehypothecate the collateral; these costs apply equally to derivative dealers, buy-side firms and end-users. Since the requirement to segregate collateral is a critical determinant of the pricing and economics of a transaction, if it were the case that a party could request segregation or a trust arrangement at any time, this would retrospectively change the economics of a transaction in unpredictable ways.

If the effect of this provision were to effectively prohibit the use or rehypothecation of a large proportion of the USD 3.2 trillion of collateral in circulation in the derivatives market, this would have an extremely detrimental effect on markets. In essence, any of this collateral removed from circulation by being segregated would need to be replaced by market participants (dealers, buy-side firms and end-users) on a one-for-one basis, either by the raising of new capital or by the creation of new debt.

It should also be noted that this provision will form part of a European regulation. Regulations are directly applicable law which is ultimately interpreted by the courts. This gives regulators a reduced ability to interpret and clarify.

There are also concerns of pro-cyclicality associated with this provision. A right of counterparties to request that collateral is segregated would likely be exercised especially in situations of financial stress. This could reduce funding at firms dramatically in times of stress and could introduce a level of systemic instability into markets and would thus be incompatible with the aims of EMIR.

The principle reason why collateral delivered to cover VM requirements need not be segregated from a risk perspective is that there is always a natural offset between that collateral and the underlying mark-to-mark of the derivative transactions. A party will only post an amount of VM because that party owes an equivalent amount in respect of the derivative position (sometimes referred to as being "out-of-the-money"). The risks between the parties here are symmetrical: if the pledging party defaults on the underlying derivatives, the secured party seizes their collateral and uses this to set off the resulting loss; if the secured party defaults by not returning collateral when due (for instance due to insolvency), the pledging party sets off the amount they owe on the underlying derivatives. In either case, both parties are whole. These concepts of netting and set-off are well-established in law, and have been promoted by market participants and regulators as best practice for the past 25 years. If VM were required to be segregated, it would obviate some of the benefits of netting legislation, be unnecessary from a risk perspective, and lead to dramatically increased costs for all market participants.

Proposals in the United States

The rules proposed by the Commodity Future Trading Commission on December 3rd 2010 to implement requirements of the Dodd Frank Act outline a model where certain collateral is segregated at the request of a counterparty, but importantly the right to require segregation applies only to IM and segregation is only triggered

if requested at the point of trade confirmation or earlier[4]. Variation Margin may be segregated, but only if the parties so agree.[5]

A European requirement to offer segregation also for VM or to give counterparties the right after execution of a trade to request segregation (and thus to apply it retroactively) will result in very substantial market liquidity implications.

Conclusion

Given the paramount importance for the systemic stability of markets that firms have certainty in managing their funding, and that the ability to use collateral they receive is a crucial aspect of liquidity management for all types of market participants, the current Council draft of this provision creates concerns that need to be addressed by market participants in a very explicit way with the appropriate authorities.

In Parliament, the amendments suggested by Mr. Gauzes and Mrs. Bowles deal with the issue in a much clearer and more satisfactory manner ("Financial counterparties … must offer counterparties the option of segregation of initial margin at the outset of the contract").

ISDA Collateral Committee, April 10 2011

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4 See 17 CFR § 23.601 Notification of right to segregation:

(a) At the beginning of each swap transaction that is not submitted for clearing, a swap dealer or major swap participant shall notify each counterparty to such transaction that the counterparty has the right to require that any Initial Margin the counterparty provides in connection with such transaction be segregated in accordance with §§ 23.602 and 23.603 of this part.

(b) The right referred to in paragraph (a) of this section does not extend to Variation Margin,

…

(f) A counterparty's election to require segregation of initial margin, or not to require such segregation, may be changed at the discretion of the counterparty upon written notice delivered to the swap dealer or major swap participant, which changed election shall be applicable to all swaps entered into between the parties after such delivery."

5 See 17 CFR § 23.602 Requirements for segregated margin:

Initial margin that is segregated pursuant to an election under § 23.601 of this part must be:

(2) held in an account segregated, and designated as such, for and on behalf of the counterparty. Such an account may, if the swap dealer or major swap participant and the counterparty agree, also hold Variation Margin.