ESAs propose to amend bilateral margin requirements to assist Brexit preparations for OTC derivative contracts

The European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA), together the European Supervisory Authorities (ESA), have today published a final report with draft regulatory technical standards (RTS) proposing to amend the Commission Delegated Regulation on the risk mitigation techniques for OTC derivatives not cleared by a CCP (bilateral margin requirements) under the European Market Infrastructure Regulation (EMIR). The draft RTS propose, in the context of the United Kingdom's (UK) withdrawal from the European Union (EU), to introduce a limited exemption in order to facilitate the novation of certain OTC derivative contracts to EU counterparties during a specific time-window. The amendments would only apply if the UK leaves the EU without the conclusion of a withdrawal agreement – a no deal scenario. The draft RTS complement the similar proposal published by ESMA on 8 November[1] with respect to the clearing obligation.

In the context of the on-going withdrawal negotiations between the EU and the UK, and to address the situation where a UK counterparty may no longer be able to provide certain services across the EU, counterparties in the EU may want to novate their OTC derivative contracts by replacing the UK counterparty with an EU counterparty. However, by doing this, they may trigger the clearing obligation or the bilateral margin requirements for these contracts, therefore facing costs that were not accounted for when the contract was originally entered into.

Limited exemption from the bilateral margin requirements to facilitate novations

The draft RTS allows UK counterparties to be replaced with EU ones without triggering the new procedures defined in the bilateral margin RTS. This limited exemption would ensure a level playing field between EU counterparties and the preservation of the regulatory and economic conditions under which the contracts where originally entered into. Its scope, time and intent are aligned with the draft RTS regarding the clearing obligation that ESMA published on 8 November.

The window for the novation of OTC derivative contracts which fall under the scope of this amending regulation and the one published by ESMA would be open for twelve months following the withdrawal of the UK from the EU. Counterparties can however start repapering their contracts ahead of the application date, making the novation conditional upon a no-deal Brexit, given the conditional application date of these two amending regulations.

Participants Brexit preperations

The ESAs and other EU authorities and institutions have been clear on the importance for market participants to be prepared for Brexit, including the possibility of a no-deal scenario. These draft RTS provide regulatory solutions to support counterparties' Brexit preparations and to maintain a level playing field between EU counterparties, while addressing potential risks to orderly markets and financial stability.

As regards non-centrally cleared OTC derivative contracts, these two measures will be the only regulatory measures the ESAs intend to propose to help address the legal uncertainty raised by the withdrawal of the UK from the EU and to ensure a level-playing field between EU counterparties.

Counterparties should start negotiating as soon as possible the novations of their transactions which are in the scope of these amending regulations, given the twelve month timeframe to benefit from it.

Next steps

The draft RTS have been submitted to the European Commission for endorsement, and they are subject to the scrutiny of the European Parliament and of the Council.

Background

1. Final Report
2. Commission Delegated Regulation on the risk mitigation techniques for OTS derivatives not cleared at a CCP (No)
3. Commission Delegated Regulations on the clearing obligation (No 2015/2205, No 2016/592 and No 2016/1178).
4. The clearing obligation and bilateral margin requirements apply to EU firms that are counterparties to an OTC derivative contract including interest rate, foreign exchange, equity, credit and commodity derivatives.
5. The ESAs' mission is to enhance investor protection and promote stable and orderly financial markets.

The ESAs achieve this mission within the European System of Financial Supervision (ESFS) through active cooperation between the EBA, EIOPA, ESMA, the European Systemic Risk Board, and with national competent authorities.

ESMA's publication regarding the clearing obligation is available at the following address: https://www.esma.europa.eu/press-news/esma-news/esma-proposes-regulatory-change-support-brexit-preparations-counterparties