REGULATION

OTC derivatives market reform

Sebastian Reger examines the details of the reform of the regulatory regime for OTC derivative transactions and what pension schemes need to be doing to prepare for this

WRITTEN BY SEBASTIAN REGER,
FINANCE AND INVESTMENT GROUP PARTNER, SACKERS

The reform of the regulatory regime for OTC derivative transactions was considered a distant challenge for pension schemes when EMIR hit the statute books in the summer of 2012.

Until now, the changes have kept a specialist audience busy. But we are about to enter a phase in which the practical implications will have a wider impact. The next wave of changes will also have a fundamental impact on the way OTC derivative transactions are traded. Investment strategies and risk management frameworks will need to keep up with these developments.

Clearing arrangements

Once the clearing obligation applies to a particular type of derivative (such as an interest rate or credit derivative), pension schemes will no longer be able to enter into new transactions of that type unless the transaction is cleared. Having clearing arrangements in place will therefore become essential for all schemes with an OTC derivatives book.

Mandatory clearing of the first set of interest-rate swaps is just around the corner. The relevant EU regulatory technical standards (RTS) hit the statute books in December 2015, starting the countdown. The clearing obligation will be phased in depending on the categorisation of each entity. Pension schemes will be classed as ‘Category 2’ or ‘Category 3’ entities, depending on their derivatives usage.

Clearing for the first set of interest rate swaps will apply to Category 2 entities 12 months after the RTS comes into force and to Category 3 entities from 18 months after the RTS comes into force. Pension schemes will therefore have to clear interest-rate derivatives from the end of 2016 (for Category 2 entities) or from the middle of 2017 (Category 3). Clearing may be delayed until August 2017 if the relevant transaction falls within the clearing exemption for pension schemes. The exemption applies to all OTC derivative transactions that are “objectively measurable as reducing investment risks directly relating to the financial solvency of pension schemes”. But as things stand, this would just be a temporary delay.

Category 2 or Category 3?

Counterparties will be categorised during the three-month period after the RTS has been published in the EU’s Official Journal (excluding the month of publication – which means January, February and March 2016). A pension scheme will be a ‘Category 2’ entity if its aggregate month-end average of outstanding gross notional amounts of non-centrally cleared derivatives (including forex forwards, swaps and currency swaps) over this period is more than €8 billion. If it is less, it will be a ‘Category 3’ entity.

ISDA EMIR classification letter: Use of the clearing exemption

The derivatives industry body, ISDA, has published a standard letter that banks can use to gather information from their derivative counterparties in order to classify them for regulatory purposes. If they have not already done so, banks are likely to approach schemes with a request for the classification letter. Completing the letter is largely straightforward, but schemes will have to decide whether they can, and want to rely on the clearing exemption. The scope of the exemption is not fully settled and it will be up to each scheme to decide how to apply it.

New collateral regime for non-cleared OTC derivatives

Pension schemes will become subject to mandatory collateral rules for all new non-cleared OTC transactions. As proposed, these rules would:

- require the exchange of collateral.
- introduce governance requirements relating to the margining process and its legal underpin. Even for those with experience of collateralising OTC derivatives, FX derivatives are likely to have been excluded. The new regime will also now require the

collateralisation of FX derivatives, so your overall collateral needs could increase.

The new rules were originally scheduled to apply from December 2015 but implementation has been delayed. The new governance requirements are now expected to apply from September 2016, while the variation margin for all new OTC transactions is expected to be required from 1 March 2017 (or 1 September 2016 for entities in a group whose aggregate month end average notional amount of non-centrally cleared derivatives for March, April and May 2016 exceeds €3 trillion).

Managing your OTC derivatives book in the future

The OTC derivatives market is not just being reshaped by EMIR. Once it comes in the impact of the new MIFID II framework will be felt across financial markets. For the OTC derivatives markets, MIFID II will bring important changes to the way OTC derivative transactions are traded and reported.

Managing an OTC derivatives book of cleared and non-cleared transactions within the new regulatory regime will bring new challenges. The impact of various factors on a scheme's overall hedging strategy will need to be considered, including:

Regulatory compliance: Do your particular mandates require you to comply simultaneously with two different regulatory regimes, such as those in the EU and the US? There is currently no mutual recognition of EU and US regimes, meaning that compliance in one may not result in compliance in the other.

• **Collateral**: What are the potential collateral requirements in normal and stressed circumstances, including risks, costs and opportunity costs associated with funding and providing the collateral?

• **Counterparty risk**: This no longer encompasses counterparty credit risk only – while clearing reduces or removes credit risk, counterparty business risk is introduced. Access to clearing houses will be channelled through clearing members; you will be reliant on available current and future trading lines and an ongoing commitment to the clearing business. You will need to consider scenarios in which designated clearing members withdraw clearing capacity and the need to clear existing transactions through alternative providers.

• **Commercial**: What are the full costs of clearing and the pricing differences between cleared and non-cleared transactions? Is there a pricing difference between different clearing houses (currently there appears to be)? How will the MIFID II trading and transparency requirements affect your quoted prices?

• **Governance/legal**: Do you have the relevant internal processes in place to satisfy the governance requirements both imposed by your scheme rules and the new requirements? ■