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Opinion of the European Supervisory Authorities

On the European Commission's amendments of the final draft Regulatory Technical Standards on risk mitigation techniques for OTC derivatives not cleared by a central counterparty under Article 11(15) of Regulation (EU) No 648/2012

1. Legal basis and procedure

1. On 8 March 2016, the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA), jointly referred to in the following as the European Supervisory Authorities (ESAs) submitted for endorsement to the European Commission (henceforth 'the Commission') the final draft regulatory technical standards (RTS) under Article 11(15) of Regulation (EU) No 648/2012[1] (EMIR).

2. The EMIR delegates powers to the Commission to adopt RTS specifying a) the risk-management procedures for non-centrally cleared OTC derivatives; b) the procedures for counterparties and competent authorities concerning intragroup exemptions for this type of contract; and c) the criteria for the identification of practical or legal impediment to the prompt transfer of funds between counterparties. The EMIR mandates the ESAs to develop standards that set out the levels and type of collateral and segregation arrangements required to ensure the timely, accurate and appropriately segregated exchange of collateral. These final draft RTS were accompanied by the ESAs report including a cost-benefit analysis and summaries of the public consultations.

[1] 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.

3. With its letter dated 28 July 2016, the Commission, acting in accordance with the procedure set out in the fifth and sixth sub-paragraphs of Article 10(1) of Regulation (EU) No 1093/2010[2], in the fifth and sixth sub-paragraphs of Article 10(1) of Regulation (EU) No 1095/2010[3], and in the fifth and sixth sub-paragraphs of Article 10(1) of Regulation (EU) No 1094/2010[4], informed the ESAs that it intends to amend the draft RTS with amendments.

4. The competence of the ESAs to deliver an opinion is based, respectively for each of the ESAs, on the sixth sub-paragraphs of Article 10(1) of Regulation (EU) No 1093/2010, the sixth sub-paragraphs of Article 10(1) of Regulation (EU) No 1095/2010, and the sixth sub-paragraphs of Article 10(1) of Regulation (EU) No 1094/2010, as the risk mitigation techniques for OTC derivatives not cleared by a central counterparty is a topic which relates to the areas of competence of all three ESAs.

5. In accordance with Article 14(5) of the Rules of Procedure of the EBA Board of Supervisors, Article 4(3) of the Rules of Procedure of the ESMA Board of Supervisors, and Article 2(8) of the Rules of Procedure of the EIOPA Board of Supervisors, the ESAs have adopted this opinion.

2. Executive summary

6. On 8 March 2016, the ESAs submitted the final draft regulatory technical standards (RTS) under Article 11(15) of Regulation (EU) No 648/2012[5] (EMIR) on the risk-mitigation techniques for OTC-derivative contracts not cleared by a central counterparty.

7. The Commission informed the ESAs on the delay of the endorsement on the RTS on 9 June 2016. The ESAs sent a letter to the Commission on 30 June 2016[6] recommending keeping the delay as short as possible with the Commission confirming such an intention in its response of 18 July 2016[7].

[2] Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority) amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC.

[3] Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC.

[4] Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC.

[5] 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.

[6] Joint letter of the ESAs' Chairs, Delayed adoption of the Joint draft Regulatory Technical Standards on risk mitigation techniques for non-centrally cleared OTC derivatives, of 28 June 2016.

[7] Letter from Olivier Guersent, European Commission, Delayed adoption of the Joint draft RTS on risk mitigation techniques for non-centrally cleared OTC derivatives, of 18 July 2016.

8. On 28 July 2016, the Commission sent a letter to the ESAs (henceforth the 'Commission's letter') informing them of its intention to endorse with amendments this draft RTS and submitted to the ESAs a modified version of the RTS. On the same date, the Commission also informed the ESAs of certain further amendments regarding the dates of application of the RTS.

9. These notifications from the Commission open a period of six weeks during which the ESAs may amend their draft RTS on the basis of the Commission's proposed amendments and resubmit it to the Commission in the form of a formal opinion (henceforth the Opinion). The ESAs have to send a copy of their formal opinion to the European Parliament and to the Council.

10. As specified below, the ESAs reject the amendments specified in the section 'Specific comments' and provide the reasoning behind such decision. The other changes are considered of non-substantive nature. However, there are some points that the ESAs consider should be reviewed or improved. These are included in the sections 'Changes highlighted in the Commission's letter' and 'Unintended consequences of the drafting changes'. The Annex includes a revised version of the RTS reflecting all these comments.

11. Henceforth, the '**Commission's version of the RTS**' means the version of the RTS (including the corresponding annexes) sent by the Commission with amendments to the ESAs on 28 July 2016, whereas the '**RTS submitted by the ESAs**' means the version of the RTS (including the corresponding annexes) as submitted by the ESAs on 8 March 2016. The version of the RTS provided in the annex (including the corresponding annexes) is simply referred to as the '**Annexed RTS**'.

3. ESAs opinion

12. The ESAs' regulations provide them the opportunity to consider the amendments made by the Commission and to provide further technical input where the draft RTS can benefit from it.

13. The ESAs reject the amendments specified in the following section 'Specific comments', which also provides the technical reasoning behind such decisions, and invite the Commission to restore the original proposal. These aspects have been reflected in the version of the draft RTS submitted to the Commission in the Annexed RTS.

14. The ESAs understand that further changes were introduced by the Commission with the intention to improve the clarity of the RTS. There are, though, some points among the further changes that should be reviewed or improved and that are consequently also discussed in this Opinion.

15. The changes already highlighted in the Commission's letter that are included in the section 'Specific comments' are considered of substantive nature and should not be maintained in the delegated regulation. If the changes in section 'Unintended consequences of the drafting changes' are not reversed to the original text proposed by the ESAs in the final version of the delegated regulation, the ESAs would have to reject them as they would constitute substantive changes. The Annexed RTS suggest how to amend the text to avoid the unintended consequences, using the original text proposed by the ESAs. All the other changes may be considered of a non-substantive nature. The ESAs, however, note that the introduction of changes to the RTS intended to clarify the drafting risks introducing unintended consequences and should, unless strictly necessary, be avoided.

3.1 Specific comments

1. Concentration limits on initial margin for pension scheme arrangements

16. The diversification requirement for collateral is an important element for protecting counterparties to OTC derivatives transactions against losses resulting from the default of their counterparty.

17. In the draft RTS submitted by the ESAs, concentration limits have been amended on a number of aspects with respect to the text proposed by the ESAs during the public consultations. In particular, in the draft RTS submitted by the ESAs, concentration limits apply only to initial margin while in the consultation papers they applied to all the collateral collected. The overall requirements specified in the draft RTS submitted by ESAs were more flexible than those proposed in the text during the public consultations, allowing for a lower frequency of the monitoring.

18. However, where more than EUR 1 billion in initial margin has to be collected, the counterparties involved are large entities and the potential loss can be substantial also from a systemic risk perspective.

19. The reasons provided by the Commission to amend the draft RTS submitted by the ESAs were 1) the existence of new evidence; and 2) the fact that certain pension scheme arrangements would be required to enter into foreign exchange transactions to meet the requirements.

20. On the first point, while the letter by the Commission referred to new evidence, it was not included in the letter itself. Subsequently, following a specific request of such new evidence, the Commission did not provide any data or supporting material substantiating that the draft RTS submitted by the ESAs were disproportionate.

21. On the second point, the ESAs understand that the Commission is referring to pension scheme arrangements (or any counterparty) domiciled in a non-Eurozone country that are close to exceeding the EUR 1 billion threshold. In this case, the pension scheme can simply diversify

the derivative contracts with two counterparties, without the need to enter into any FX transaction. Therefore, the costs for meeting the diversification requirement are not considered to be disproportionate.

22. Against this background, from the perspective of the ESAs the situation has not changed compared to the submission of the draft RTS.

23. Moreover, the ESAs are concerned that the alternative requirement proposed by the Commission is rather unspecific when referring to 'adequate' diversification in case counterparties collect sovereign debt securities from a pension scheme arrangement and this could result in a non-harmonised application of the rules within the Union.

24. Finally, the ESAs note, that paragraphs 7 and 8 of Article 28 of the draft RTS submitted by the ESAs on the monitoring frequency for pension schemes arrangements were removed. This amendment would force pension scheme arrangements to monitor whether collected collateral meets the diversification requirements on a possibly daily basis instead of the quarterly frequency suggested by the ESAs.

25. For these reasons, the ESAs reject the amendments proposed by the Commission and suggest restoring the text in the RTS submitted by the ESAs.

2. Calculation of the threshold against non-netting jurisdictions.

26. In paragraph 3(a) of Article 30 'Treatment of derivatives with counterparties in third countries where legal enforceability of netting agreements or collateral protection cannot be ensured' of the Commission's version of the RTS, the Commission is proposing to amend the methodology for the calculation of the threshold, without providing an explanation for that change.

27. In the RTS submitted by the ESAs, counterparties are required to exchange collateral with counterparties outside the EU. Where the legal enforceability of netting agreements or collateral protection cannot be ensured, Union counterparties are required, if possible, to collect collateral from the counterparties in non-netting jurisdictions without posting. Where also collecting collateral is not possible and no alternative solution for the collateral exchange is available, the Union counterparty may still enter in uncollateralised derivatives contracts under the condition that the exposure arising from uncollateralized derivatives, with respect to the overall portfolio of non-centrally cleared OTC derivatives, is limited.

28. This is achieved by setting a threshold equals to 2.5% of the ratio of all non-centrally cleared derivative contracts of a counterparty or group with counterparties in non-netting jurisdictions, and all non-centrally cleared derivative contracts of a counterparty or group. The calculation should include both legacy and new contracts entered into after the relevant application date of the RTS. It is worth recalling that, although such calculation refers to legacy and new contracts

(as other thresholds in the same RTS); only new contracts are subject to the margin requirements.

29. With the proposed amendment, the Commission suggests modifying the way the calculation should be performed, including in the calculation of the numerator only the contracts with counterparties in non-netting jurisdictions concluded after the entry into force of the Regulation. This modification in the calculation of the threshold would certainly lead to an increase of risk taken by Union counterparties.

30. Considering that this substantive change is not supported by any new evidence and that the number of counterparties that would be required to reduce their exposure to these jurisdictions would be extremely limited, the ESAs reject these amendments and invite the Commission to restore the original calculation method. For sake of clarity, the ESAs would suggest stating clearly in the RTS that the calculation applies to all the contracts, before and after the relevant dates of application, to avoid a Q&A later on. The Annexed RTS includes this clarification.

3. Covered bonds

31. The ESAs would like to highlight that in the draft RTS submitted by the ESAs, the treatment of derivatives associated to covered bonds was designed around Recital 24 of the EMIR. That Recital, on this particular aspect, recommends to: "take due account of impediments faced by covered bond issuers or cover pools in providing collateral in a number of Union jurisdictions" and "[…] the fact that preferential claims given to covered bond issuers counterparties on the covered bond issuer's assets provides equivalent protection against counterparty credit risk".

32. In line with that recommendation, the draft RTS submitted by the ESAs allow for a special treatment of derivatives associated to covered bonds under certain conditions. It comes without saying that, in order to ensure that "claims given to covered bond issuers counterparties on the covered bond issuer's assets provides equivalent protection", derivative contracts counterparties have to have at least the same rank as the bond holders. Otherwise, the derivative contracts counterparties would rank after the bond-holders and therefore would not be protected by the assets in the cover pool.

33. Paragraph 2(b) of Article 29 'Treatment of derivatives associated to covered bonds for hedging purposes' of the Commission's version of the RTS is different from the RTS submitted by the ESAs. Therein, the Commission proposes to add to that article an additional conditions, "or waives the pari-passu rank" which would result in the derivative contracts counterparties ranking after the bond-holders and therefore not being protected by the assets in the cover pool.

34. The ESAs understand that the Commission aligned the conditions applicable to cover bonds for the purpose of the exemption from the clearing obligation and for the purpose of bilateral margins. However, the two regimes are quite different and with reference to bilateral margins,

the counterparties of the covered bond will still be required to post variation margins. Therefore the level of protection envisaged in Recital 24 of EMIR is much more relevant for the purpose of bilateral margins than for an exemption from the clearing obligation.

35. Therefore, the ESAs reject this change and suggest restoring the original text as in the RTS submitted by the ESAs.

36. Furthermore, Recital 18 does no longer include the explanation of what legal impediments a covered bond issuer or cover pool would face in collecting certain types of collateral for the purpose of these RTS. The ESAs would suggest restoring this explanation for the sake of clarity.

4. Treatment of bilateral derivative contracts where a counterparty is a central counterparty

37. It is the ESAs' understanding that the references to the exemption for the scope of application of the derivatives concluded by CCPs were deleted because the Commission considers that CCPs are neither financial nor non-financial counterparties. However no interpretative decision has been issued in this respect. Moreover, as highlighted by the industry stakeholders during the first public consultation, certain CCPs hold a banking license and therefore might be considered financial counterparties. In this case, a CCP would be required to post and collect margins like any other bank. Usually, a CCP with a banking license does not hold deposit, does not provide credit and has substantial restrictions in its investment policy. In fact, these CCPs hold a banking license to have access to central bank liquidity facilities. Furthermore, all the CCPs, with or without a banking license, can only enter in derivative contracts when managing the portfolio of a defaulting clearing member.

38. Therefore, it is the opinion of the ESAs that they should not be required to post or collect margin in that phase because they are performing activities related to the core functions of central-clearing. Article 6 of the draft RTS submitted by the ESAs aimed to explicitly address this case and to provide clarity, to the central counterparties and their clearing members, on this aspect.

39. Given the potential difficulties of the text originally proposed from a legal perspective, the ESAs propose including the necessary clarification for CCPs counterparties in a recital.

5. Transactions with third country counterparties

40. It should also be noted that Article 3 of the draft RTS submitted by the ESAs was not a simple re-statement of what is already included in the EMIR. The treatment of counterparties outside the EU needs to be clarified in the RTS. In particular, third countries often do not have an equivalent classification of 'non-financial counterparties below the clearing threshold'. Therefore, Article 3 in the draft RTS submitted by the ESAs was introduced to avoid that a

Union counterparty would be required to collect and post margins with third country counterparties that would be exempted from these requirements if domiciled in the EU.

41. Without that article there would be divergence from the BCBS-IOSCO framework and possibly an inconsistent application of the principles at global level, which is one of the objectives of this Regulation. Therefore, it is recommended restoring that article in the final delegated regulation.

6. Process for competent authorities on exemption of intragroup derivative contracts

42. It should be noted that Article 39(10) of the draft RTS submitted by the ESAs, related to the entry into force of the margining requirement, was removed in the Commission's version of the RTS. Most likely, the Commission judged this article superfluous after the delay on the application of the RTS with respect to what originally envisaged.

43. However, dropping that article would force counterparties of the same group to exchange margins until their applications for the exemption of intragroup derivative contracts have been decided upon by the competent authorities. This is because competent authorities were not allowed to complete the approval process as prescribed in Article 31 of the Commission's version of the RTS prior to the coming into force of the margining requirements. It should also be noted that the ESAs introduced Article 39(10) in the RTS submitted by the ESAs with the intention to give around six months to the competent authority for completing that approval process in its first application.

44. The ESAs therefore suggest restoring Article 39(10), specifying that it includes variation margins and to change the date therein allowing around six months from the entry into force of the delegated regulation.

3.2 Changes highlighted in the Commission's letter

45. The following amendments and clarifications, which were already highlighted in the Commission's letter, are in line with the original intentions of the ESAs and therefore are not considered substantive changes.

    a) the introduction of a recital containing the reasoning for a delayed phase-in of the requirements for equity options (Recital 17 of the Commission's version of the RTS);

    b) the clarification on the process around the intragroup exemption (Article 36.4, letter (b) of the Commission's version of the RTS);

    c) the clarification that cash initial margin may be also held with equivalent third country institutions (Article 19(1) letter b, point (i) of the Commission's version of the RTS); and

d) the clarification on the date that requirements concerning foreign-exchange derivative contracts should start to apply from the date of application of the relevant Delegated Act (Article 36(4), letter b) of the Commission's version of the RTS).

46. Furthermore, Article 1 of the Commission's version of the RTS includes definitions of terms 'variation margin' and 'initial margin' that are repetitively used throughout the text, which are also in line with the original intention of the ESAs and therefore are not considered substantive changes. The definition of 'netting agreement', however, may be problematic; therefore, a dedicated analysis is devoted to this in the next section.

3.3 Unintended consequences of the drafting changes

47. The ESAs understand that the following amendments may be omissions or oversights inadvertently introduced during the revision of the RTS. Although unintentionally, such amendments may lead to an application of those provisions different from the one originally envisaged by the ESAs and it is suggested to amend them in line with the original text. The same remarks are provided in the Annexed RTS.

48. If those amendments are not reversed in the final version of the delegated regulation, the ESAs would have to reject them as they would constitute substantive changes.

1. Definition of netting set

49. Article 1(3) of the Commission version of the RTS introduces the definition of 'netting set'. The draft RTS submitted by the ESAs does not include any definition and netting set was used in the sense of the CRR. For example, Article 3(4) of the RTS submitted by the ESAs includes a direct reference to the CRR.

50. The ESAs understand that the Commission considers the definition of netting set in the CRR not appropriate for the purposes of the EMIR because the CRR definition includes a direct reference to 'institutions' whereas the scope of the EMIR is much broader.

51. However, the focus of the proposed definition is on the collateral exchange agreement whereas the CRR definition focuses on the netting agreement. It is already current practice having netting agreements without a corollary collateral agreement. This might be less common as the regulation enters into force, but it is a practice that might persist in cases where, for example, derivative contracts are not subject to initial margin but only to variation margin.

52. Therefore, the definition introduced by the Commission might have unintended consequences on other provisions of the RTS, in particular where a legal assessment of the legal enforceability of the netting agreement is required (Article 3(3)) or where counterparties use the special treatment of Article 30 with counterparties in non-netting jurisdictions.

53. The Annexed RTS includes drafting suggestions on the definition and on the articles mentioned above.

2. Trading documentation

54. Following the modifications introduced by the Commission, a section dedicated to the trading documentation is missing. This is problematic because the RTS submitted by the ESAs includes specific requirements on the trading documentation that are necessary for proper risk management of these contracts. Furthermore, these requirements follow the IOSCO principles on OTC derivatives. Since a dedicated section is not available anymore, the Annexed RTS includes these requirements under Article 2 'general requirements'.

3. Offsetting of initial margin amounts

55. Article 1(3) of the draft RTS submitted by the ESAs stated initial margin should be collected without offsetting the respective initial margin amounts. Removing such provision would, in principle, allow the offsetting of the two amounts and therefore both counterparties would then be not fully covered. Such requirement is not implicit in any of the text and should therefore be restored. Since Article 1 was removed in the Commission's version of the RTS, the Annexed RTS includes that requirement in Article 11, 'Calculation of initial margin'.

4. Trading documentation

56. Since the ESAs are suggesting a different definition of netting set, the references throughout the text should not be to the 'collateral agreement' only but to both, the netting agreement and the collateral agreement. It is advisable to clarify that these two documents may be part, individually or jointly, of the trading documentation at the top of Article 3. This would allow, where necessary, a clearer distinction in the rest of the RTS between the two agreements.

5. Scope and application of the diversification requirements

57. Article 8 of the Commission's version of the RTS proposes a number of simplifications with respect to the draft RTS submitted by the ESAs. Apart from what is already highlighted in the Section 'Specific comments', the new text is open to a number of misinterpretations.

58. Article 8(2) is not explicit on the fact that the diversification requirements apply only to the part of initial margin that is in excess of EUR 1 billion and not to the entire amount of initial margin.

59. Similarly, Article 8(2) of the Commission's version mandates that 'each counterparty' applies the diversification requirements. The ESAs' version specifies that diversification is required where 'each counterparties belongs to one of the categories in paragraph 3' (the categories are G-SII, O-SII, and counterparties exceeding EUR 1billion in initial margin with a single counterparty). Therefore the revised text may lead to misinterpretation and, potentially, expand the scope of application to many other counterparties.

60. Furthermore, Article 8(2) is not explicit on the fact that diversification applies only to initial margin and often refers to 'collateral'. This might be interpreted as the requirements applying to variation margin as well and this would lead to a different application with respect to the ESA' version.

61. The amendments included in the Annexed RTS should be enough to clarify all those aspects. However, in order to avoid other oversights, it is suggested restoring the text of the RTS submitted by the ESAs.

6. Use of different calculation approaches within the same netting set

62. Article 11(1), second subparagraph, of the Commission's version of the RTS includes additional text with respect to the draft RTS submitted by the ESAs, namely: "[…] they shall be used consistently over time for each of the OTC derivative contracts within the same underlying asset class". The ESAs understand this is intended to avoid cherry–picking between the two approaches, where one or both counterparties would switch over time between the standardised approach and an initial margin model, depending on which one is cheaper in a particular point in time.

63. Although the ESAs share the overall objective, it may happen that for certain underlying asset classes, two counterparties decide to switch from one approach to the other. For example, this may happen where an initial margin model ceases to be appropriate for a particular subset of contracts in that netting set. It would then be advisable to use the wording suggested in the Annexed RTS.

7. Requirements on initial margin models

64. Article 19 of the draft RTS submitted by the ESAs includes two provisions for the calculation of initial margin. The first one requires that the initial margin calculation is restricted only to non-centrally cleared OTC derivatives within a specific netting set, i.e., no calculation can be performed across netting sets including only non-centrally cleared OTC derivatives and no other product, such as repos, can be included in the calculation. This provision is not present in the Commission's version of the RTS and may lead to a reduction of the amount of exchanged initial margin. The second provision limits the extent to which diversification across underlying asset classes can be performed; this is set out in paragraph 2 of Article 17 in the Commission's version. However, as it is now drafted, that paragraph would impose to calculate initial margin in a more stringent way than what was envisaged in the RTS submitted by the ESAs.

65. Broadly speaking, there are two ways to obtain the above-mentioned diversification. One possibility is to calculate the sensitivities of each product to a given set of risk factors and then to group risk factors, independently from the products originating that risk, in broader asset classes; the initial margin is then calculated for each asset class without any further benefit from hedging or risk-offsetting. An alternative way is to allocate each product to a broad asset

class and calculate the initial margin in that asset class; in this case, initial margin would be calculated allowing further benefits from hedging or risk-offset of different risk factors within the set of products allocated to the same asset class. In this second case, a conservative calculation of initial margins is obtained with the 'product-allocation'. If considered in isolation, neither of the two approaches can be considered correct or not; they have to be assessed in the overall modelling framework.

66. However, if taken literally, the wording in Article 17(1) of the Commission's version of the RTS would preclude the second approach; this would result in an additional constraint that was not present in the version proposed by the ESAs. It is therefore suggested restoring the original text as drafted in the RTS submitted by the ESAs.

67. The ESAs understand that Article 20(7) of the draft RTS submitted by the ESAs was removed because of the use of an imprecise language and not for a change in policy. It is opinion of the ESAs, however, that those requirements cover aspects that might be important and should be addressed in the development of any initial margin model.

68. Therefore, the ESAs would suggest restoring that provision simply removing the language that could give rise to misinterpretation. The Annexed RTS include the suggested wording in the new paragraph 6 of Article 14.

69. The two subparagraph (j) and (k) in Article 14(2) should not be part of the list but separate paragraph, because they are not structural model requirements but relate to the back-testing requirements.

70. Subparagraph (b) of Article 16(10) of the Commission version of the RTS includes a language that is not found in other EU financial regulation; it is not advisable requiring that a model approach is compared to non-existing data as this would be impossible for the model developer to implement. The text in the previous version of the draft RTS submitted by the ESAs would be in line with similar provision in other EU Regulations.

71. In Article 19(1), letter (d) of the Commission's version a precise reference is missing to the exact article of the CRR specifying which implementing act would be required for a third-country to be deemed CRR-equivalent and therefore a credit institution domiciled therein would become an eligible custodian. A reference to Article 142(2) of the CRR was added to the annexed RTS,

8. Segregation of initial margin

72. Article 19 of the Commission's version, different from Article 23(c) of the draft RTS submitted by the ESAs, does not seem to include a general requirement on the segregation of collateral posted as initial margin. Although the current version does consider some specific case, the overall segregation requirements should be made explicit. Furthermore, the text suggested by

the ESAs clarifies that segregation of non-cash initial margin can be performed using a third-party custodian or can be performed by one of the two counterparties, as long as the collateral holder is able to segregate it. It is therefore suggested restoring the original text; this is included in Article 19(3) of the Annexed RTS.

73. Subparagraph (b) of Article 19(4) is meant to address the specific case where the posting counterparty pledges the initial margin (i.e., without title transfer) but hold the collateral offering custody services to the collecting party. This scenario obviously excludes that IM is posted in cash, where a third party custodian is required. The collateral is also certainly segregated from the collecting counterparty's other assets because the collateral is only pledged. Therefore, it should be clear in the RTS that the initial margin should be segregated from the proprietary assets of the posting party. The Commission's revision of the RTS does not address this scenario, and therefore this article needs to be slightly modified in line with the original RTS submitted by the ESAs.

74. The wording of Article 19(5) in the Commission's version of the RTS might lead to the situation where the posting counterparty requests the segregation from the other collateral posted by other parties but the collecting counterparty refuses, as there is no corresponding obligation.. The draft RTS submitted by the ESAs included a more binding approach requiring that the collecting counterparty 'always' provide the choice to the posting counterparty to segregate that collateral from the assets of other counterparties. This should be restored to the original proposal or it would result in an important substantive change.

9. Application of the requirements to new contracts

75. It should be noted that, in line with the BCBS-IOSCO framework, Article 1(2) of the draft RTS submitted by the ESAs specified that the provisions of the RTS apply only to new contracts entered into after the relevant dates of application. The Commission's version of the RTS does not contain the same clarification.

76. It is the ESAs' understanding that there is no intention to extend the application to legacy contracts as well. This is confirmed in Recital 48 of the Commission's version of the RTS that, however, has no corresponding provision in the RTS.

77. The ESAs would suggest restoring the previous text as suggested in the Annexed RTS.

10. Calculation of thresholds where investment funds meet certain conditions

78. The Commission's version of the RTS clarifies the term 'investment funds' as UCITS authorised in accordance with Directive 2009/65/EC and alternative investment funds managed by AIFMs authorised or registered in accordance with Directive 2011/61/EU.

79. The ESAs support such a clarification as an improvement of the original draft. However, it should be highlighted that such a clarification might have unintended consequences. First, it would exclude third country entities performing similar activities and being part of groups subject to the calculation of the threshold. Secondly, it was the understanding of the ESAs that such treatment should apply also to a MiFID investment firm, when acting as a portfolio manager, as long as the funds managed by the investment firms meet all the conditions laid down in the RTS.

80. The ESAs would therefore suggest maintaining the wording of the Commission's version of the RTS, with the following amendments: 1) allow all AIF, whether managed by a European or a third country manager to benefit from the special treatment; 2) including also portfolio managers authorised under MiFID. Indeed, all the additional conditions originally included in the draft RTS should be met by those entities for the special treatment envisaged in Articles 27(3), 28(3) and 34(2) of the annexed RTS.

11. Procedures for the application of the thresholds based on initial margin amount

81. The ESAs would like to highlight the fact that these RTS include a number of different 'thresholds' and that these work in different ways. In some cases counterparties may exchange only the amount in excess of the threshold (which is the case for the thresholds based on the initial margin amount) where in other cases, once the threshold is exceeded, they have to post the whole amount without deductions (which is the case for the minimum transfer amount).

82. For this reason the draft RTS submitted by the ESAs included an explicit provision clarifying that, in the case of the threshold based on the initial margin amount, the amount below the thresholds specified in Article 9(1) can be deducted. This would be valid for both thresholds, the one set at EUR 50 mln and the one set at EUR 10 mln for intragroup transactions.

83. Furthermore, based on the wording suggested by the ESAs the threshold would be checked at the level of the individual counterparty. This may result in one counterparty having to collect while the other is exempted due to the threshold. The amendments suggested by the Commission seem to imply that both counterparties are exempted if one has to collect not more than 50 million in initial margin.

84. The ESAs understand that the Commission had no intention to change these procedures but simply considered them as 'implicit' in the definition of threshold. The ESAs would suggest restoring these provisions in the delegated regulation.

85. Please also note that, where referring to absolute amounts, the Commission's version of the RTS makes an inconsistent use of the reference to 'or the equivalent amount in another currency'. This is used in Articles 24(1) and 24(4), but nowhere else. As this aspect should be obvious, it is suggested removing it.

12. Conditions to be met to apply the threshold when counterparty are domiciled in non-netting jurisdictions

86. In Article 30(1) letter (a) of the Commission's version of the RTS, the reference to 'netting agreement' was modified to 'collateral agreement'. It should be noted that, especially with counterparties in non-netting jurisdictions, it is possible that netting agreements are not accompanied by a separate collateral agreement (such as a credit support annex or credit support deed). In particular, this might be the case for netting sets where initial margin is not required. It is therefore suggested to refer to both cases and ensure the legal enforceability of netting agreement and collateral agreement, in case the latter is used. This would allow counterparties to choose whether to use a separate collateral agreement and, in case it is not used, to assess only the legal enforceability of the netting agreement. This is reflected in the annexed RTS.

87. Article 30(2) letter (a) is not explicit on the application of the two conditions that allow the use of the threshold referred to in Article 30.3. In particular, it is not clear whether the condition in Article 30(2), letter (b) should always be met or only when collateral is segregated (i.e. where contracts are subject to initial margin requirements). This should be made explicit to avoid that the special treatment below the threshold becomes inapplicable to netting set that are only required to exchange variation margin. In this case, the draft RTS submitted by the ESAs is not much clearer than the Commission's revision and therefore the annexed RTS includes some minor amendment for clarification (in Articles 30(1), letter (b) and 30(2), letter (a)) different from both drafts.

13. Eligibility of debt securities issued by Member States' central or regional governments, central banks and public sector entities

88. In Articles 6(1) and Article 7(2) of the the Commission's version of the RTS, the Commission replaced: 'funded' with 'guaranteed' as a requirement for certain debt securities issued by Member States' central or regional governments, central banks and public sector entities. This is most likely an oversight, because this condition should reflect the possibility of these issuers to raise money via taxation. It is suggested to restore the original wording.

14. References to collateral requirements

89. In Article 12(1) of the Commission's version of the RTS, the cross references to the section on the treatment of collateral were changed from a precise reference to the Article containing the list of eligible collateral (Article 22(2) in the draft RTS submitted by the ESAs) to a more generic reference to Section 5. This is most likely an oversight, as this would imply that certain conditions in Section 5, including segregation requirements, may inadvertently apply to variation margin. The Annexed RTS does not include that cross references because the only conditions valid for variation margin in Section 5 is the daily mark-to-market valuation which is already covered under Articles 9(1) and 10.

90. Furthermore the RTS should allow to offset the collateral posted as originally proposed by the ESAs. In this context, collateral may be posted in form of securities or in form of cash. In case collateral is posted in cash, it is not useful having the same resources being posted and immediately collected back, and therefore the regulation should allow offsetting the two amounts. Where this collateral is posted in form of securities and where segregation arrangements are already in place, it is safer for the posting counterparty to segregate these amounts. However, where no segregation arrangement is in place, it is the opinion of the ESAs that requiring collateral agreements for the purpose of segregating this specific collateral would be excessively expensive. Therefore, two counterparties should be allowed to offset both cash and non-cash collateral. This is included in Article 12(2) of the Annexed RTS.

91. Articles 12(1) and 13(2) of the Commission's version of the RTS are different from the ESAs' version of the RTS. This is because the Commission's version refers to 'posting counterparty providing the collateral' whereas the ESAs' version focused on the collecting counterparty. Referring to the collected collateral or collecting counterparty is suggested because this implies that the collateral transfer and, where required, its segregation are completed by the times prescribed in the RTS. Most of the time, there is no lag between posting and collecting collateral as this is not more than transferring securities form one account to another within the same custodian or across custodians, Requiring to post the collateral by the deadline does not ensure that the collateral is protected and that the collecting counterparties has effectively covered its exposure. In contrast, requiring the collateral collection by the deadline set out in the RTS would ensure such protection. Therefore, in both articles, it is preferable to clarify that the obligation is for the collecting counterparty.

15. Foreign exchange contracts

92. Article 26(1), letter (c) of the Commission version would completely exempt cross currency swaps from initial margin. It should be noticed that, in line with the BCBS-IOSCO framework, only the part of a cross currency swap that can be replicated with simpler FX products, i.e., FX swaps and forwards, should be subject to initial margin. The exchange of principal, instead, should not be included when calculating the initial margin amount for a netting set.

16. Process to for competent authorities concerning intragroup exemptions for third-country counterparties

93. A further inconsistency, already present in the draft RTS submitted by the ESAs, concerns the scenario where the Commission issues a decision on the equivalence of a third country regime to the EMIR. Article 36(7) of the RTS currently provides that the margin requirements apply 60 days after the date of entry into force of the equivalence decision. The RTS, however, was based on the premise that after an equivalence decision is made, groups would need to re-apply for the exemption of intragroup OTC derivative contracts and the competent authorities would then follow the process prescribed in Article 31. Therefore, paragraph b of Article 36(6) should set the timing not to 60 days but rather to 4 months, i.e., 1 month to allow firms to re-

apply for the exemption and 3 months for the competent authorities to decide whether or not to grant the exemption.

94. Article 32 of the Commission’s version introduces the concepts of “actual and potential” impediments. Not only do these concepts find no equivalent in the EMIR and are not defined anywhere else in the RTS, but they would also substantially change the application of those provision. It is therefore suggested to adhere strictly to the terminology used in the EMIR, as suggested in the Annexed RTS.

17. Withdrawal of the exemption for intragroup derivative contracts

95. The exemption regarding exemption for intragroup derivative contracts is only justified as long as the corresponding conditions are met. While the national legislation would normally give the competent authority the right to withdraw its decision following any change in circumstances that could affect the fulfilment of these conditions, it seems useful to state this also in the RTS. The corresponding provision should therefore be restored, as suggested in Article 31(10) of the Annexed RTS.

18. Calculation of aggregate average notional amount

96. As proposed, subparagraphs (a) and (b) Article 34(1) of the Commission’s version of the RTS are in conflict as both dates seem to apply at the same time. It is suggested to avoid repeating the threshold amounts but rather to refer directly to Article 36 where the thresholds for the deferred application of the requirements are laid down. This correction is included in the Annexed RTS.

19. Formal inconsistencies and typos

97. Finally, a number of formal inconsistencies and typos were corrected throughout the whole text, including the recitals, aiming to a more consistent terminology and more precise cross references. Many of these are not related to the Commission’s review and were present also in the version submitted by the ESAs. They are all included in the annexed RTS.

Conclusions

For all the considerations above, the ESAs reject the amendments specified in section ‘Specific comments’ while also highlighting a number of concerns about some of the changes introduced with the intention to provide additional clarity to the RTS.

A version of the draft RTS containing the above-mentioned corrections is attached in the Annex to this Opinion, as a reflection of the above views.

This Opinion will be published on the ESAs’ websites.

Done at Frankfurt, London and Paris - 8 September 2016

[signed]

Gabriel Bernardino	Andrea Enria	Steven Maijoor
Chair, EIOPA	Chairperson, EBA	Chair, ESMA

Annex

EUROPEAN COMMISSION

Brussels, XXX
[…](2016) XXX draft

COMMISSION DELEGATED REGULATION (EU) No …/..

of XXX

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)

EXPLANATORY MEMORANDUM

1. CONTEXT OF THE DELEGATED ACT

Article 11(15) of Regulation (EU) No 648/2012 ('the Regulation') as amended by Regulation (EU) No 575/2013 ('CRR') empowers the Commission to adopt, following submission of draft standards by the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Market Authority, which constitute the European Supervisory Authorities (ESA), and in accordance with either Articles 10 to 14 of Regulation (EU) No 1093/2010, Regulation (EU) No 1094/2010 and Regulation (EU) No 1095/2010 delegated acts specifying the risk-management procedures, including the levels and type of collateral and segregation arrangements required for compliance with paragraph 3 of Article 11 of the Regulation, the procedures for the counterparties and the relevant competent authorities to be followed when applying exemptions under paragraphs 6 to 10 and the applicable criteria referred to in paragraphs 5 to 10 including in particular what should be considered as practical or legal impediment to the prompt transfer of own funds and repayment of liabilities between the counterparties.

In accordance with Article 10(1) of Regulation (EU) No 1093/2010, Regulation (EU) No 1094/2010 and Regulation (EU) No 1095/2010 establishing the ESA, the Commission shall decide within three months of receipt of the draft standards whether to endorse the drafts submitted. The Commission may also endorse the draft standards in part only, or with amendments, where the Union's interests so require, having regard to the specific procedure laid down in those Articles.

2. CONSULTATIONS PRIOR TO THE ADOPTION OF THE ACT

In accordance with the third subparagraph of Article 10(1) of Regulation (EU) No 1093/2010, Regulation (EU) No 1094/2010 and Regulation (EU) No 1095/2010, the ESA have carried out a public consultation on the draft technical standards submitted to the Commission in accordance with Article 11(15) of Regulation (EU) No 648/2012. A discussion paper and two consultation papers were published on the ESA websites respectively on 6 March 2012, 14 April 2014 and 10 June 2015. Together with these draft technical standards, the ESA have submitted an explanation on how the outcome of these consultations has been taken into account in the development of the final draft technical standards submitted to the Commission.

Together with the draft technical standards, and in accordance with the third subparagraph of Article 10(1) of Regulation (EU) No 1093/2010, Regulation (EU) No 1094/2010 or Regulation (EU) No 1095/2010, the ESA have submitted its impact assessment, including its analysis of the costs and benefits, related to the draft technical standard submitted to the Commission. This analysis is available at https://eiopa.europa.eu/Pages/Publications/Draft-Regulatory-Technical-Standards-on-margin-requirements-for-non-centrally.aspx.

3. LEGAL ELEMENTS OF THE DELEGATED ACT

This delegated act covers three mandates in the following areas:

(a) the risk-management procedures, including the levels and type of collateral and segregation arrangements;
(b) the procedures for the counterparties and the relevant competent authorities to be followed when applying exemptions for intragroup OTC derivative contracts;
(c) the applicable criteria on what should be considered as practical or legal impediment to the prompt transfer of own funds and repayment of liabilities arising from OTC derivative contracts between the counterparties belonging to the same group.

Therefore, this delegated act is structured in three chapters in line with each of the areas covered by the mandate. Since the first chapter is more complex, it was necessary to split it further in various sections. A final chapter includes transitional and final provisions.

The first chapter covers all the requirements concerning the risk management procedures for the margin exchange, detailed procedures for specific cases, the approaches to be applied for the margin calculation, the procedures around the margin collection, the eligibility, valuation and treatment of collateral, the operational aspects and requirements concerning the trading documentation.

The second chapter includes the procedures for the counterparties and the relevant competent authorities when applying exemptions for intragroup derivative contracts including process, timing and notifications to authorities.

The criteria for applying exemptions for intragroup derivative contracts and what has to be considered a practical or legal impediment are specified in the third chapter. In particular, legal impediments include not only regulatory constraints but also constraints that may arise by internal restrictions or legally binding agreements within and outside the group.

A fourth chapter includes transitional and final provisions. The need for international convergence, regulatory arbitrage and specific characteristic of the OTC derivative market within the Union make necessary a staggered implementation of these requirements in some specific cases such as intragroup transactions, equity options and foreign exchange forwards.

In developing this delegated act, the ESA took into account the Basel Committee-IOSCO margin framework for non-centrally cleared OTC derivatives and the Basel Committee guidelines for managing settlement risk in foreign exchange transactions.

COMMISSION DELEGATED REGULATION (EU) No …/..

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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) 648/2012 of 4 July 2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories[8], 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) 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 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

8 OJ L 201, 27.7.2012, p.1.

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.

(3) Counterparties to non-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 CCPs might have different licences according to European legislation, it might be unclear to their counterparties if non-centrally cleared OTC derivative contracts that CCPs enter into during a default management process should be subject to the requirements of this Regulation. Therefore, there is a need to clarify that, because of their specific function, these trades are already subject to the provisions of the Delegated Regulation (EU) No 153/2013 and therefore they are not subject to the provisions of this Regulation.

(5) For 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') is not exposed to 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 in accordance with these standards 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-cleared OTC derivative contracts are collateralised in accordance with this Regulation to the extent possible..

(7) In order to guarantee a level playing field across jurisdictions, where a counterparty established in the Union enters into an OTC derivative contract with a counterparty that is established in a third country, initial and variation margins should be exchanged in both directions in accordance with this Regulation. 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 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 with respect to OTC derivative contracts subject to this Regulation. However, the sum of the separate minimum transfer amounts should not exceed the maximum level of the minimum transfer amount set out in this Regulation. 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 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 international standard setting bodies referred to in Recital 24 of Regulation (EU) No 648/2012 have explicitly considered two aspects in their framework. This framework is the Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions Margin requirements for non-centrally cleared derivatives, 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 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 from 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 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 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 OTC derivative contracts to the application of the initial margin requirements under this Regulation. 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 OTC derivative 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 derivatives. 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 derivatives and are therefore consistent with international standards.

(15) Exposures arising either from OTC derivative contracts or to counterparties that are permanently or temporarily exempted or partially exempted from margins according to this Regulation, 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 derivatives 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 in this Regulation special risk management procedures for certain types of 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.

(17) The Commission Delegated Act referred to in Article 4(2) of Directive 2014/65/EU clarifies the definition of physically-settled foreign exchange forwards within the Union. However, at this juncture, that definition is not in force and these products are defined in a non-homogenous way in the Union. Therefore, in order to avoid creating an un-level playing field within the Union, it is necessary that the corresponding risk mitigation techniques in this Regulation are aligned to the date of application of the relevant Delegated Act. A specific date on which the margin requirements for such products will enter into force even in absence of that Delegated Act is also laid down in this Regulation to avoid excess delays in the introduction of the risk mitigation techniques set out in this Regulation, with respect to the BCBS-IOSCO framework.

(18) In order to avoid market fragmentation and ensure a level playing field for Union counterparties established in the Union on a global level, and acknowledging the fact that in some jurisdictions the exchange of variation and initial margin for single-stock options and equity index options is not subject to equivalent margin requirements, the treatment of those products should be phased-in. This phase-in period will provide time for monitoring regulatory developments in other jurisdictions and ensuring that appropriate requirements are in place in the Union to mitigate counterparty credit risk in respect of such contracts whilst avoiding scope for regulatory arbitrage.

(19) Recital 24 of Regulation (EU) No 648/2012 explains that 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. The reason behind this is that a 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.

(20) 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 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.

(21) 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 OTC derivative contracts with a defaulting

counterparty until the OTC derivative contracts are closed out and the resulting market risk is re-hedged. This time period is known as the 'margin period of risk' ('MPOR') and is the same tool as that used in Article 272(9) of Regulation (EU) No 575/2013 of the European Parliament and of the Council[9], with respect to counterparty credit risk of credit institutions. Nevertheless, as the objectives of the two Regulations differ, and Regulation (EU) No 575/2013 sets out rules for calculating the MPOR for the purpose of own funds requirements only, this Regulation should include specific rules on the MPOR that are required in the context of the risk management procedures for non-centrally cleared OTC derivatives. The MPOR should take into account the processes required by this Regulation for the exchange of margins.

(22) In accordance with this Regulation, both initial and variation margin should generally be exchanged no later than the end of the business day following the day of execution. However, an extension of the time for the exchange of variation margin is permitted where compensated by an adequate calculation of the MPOR. Alternatively, where no initial margin requirements apply in accordance with this Regulation, an extension should be allowed if an appropriate amount of additional variation margin is collected.

(23) When developing initial margin models and when calculating the appropriate MPOR, counterparties should take into account the need to have models that capture the liquidity of the market, the number of participants in that market and the volume of the relevant OTC derivative contracts. At the same time there is the need to develop a model that both parties can understand, reproduce and on which they can rely to resolve disputes. Therefore counterparties should be allowed to calibrate the model and calculate MPOR dependent only on market conditions, without the need to adjust their estimates to the characteristics of specific counterparties. This in turn implies that counterparties may choose to adopt different models to calculate the amounts of initial margin to be exchanged between them, and that those amounts of initial margin may not be symmetrical.

(24) While there is a need for recalibrating an initial margin model with sufficient frequency, a new calibration might lead to unexpected levels of margin requirements. For this reason, an appropriate time period should be established, during which margins may still be exchanged based on the previous calibration. This should give counterparties enough time to comply with margin calls resulting from the recalibration.

(25) Collateral should be considered as being freely transferable if, in the case of a default of the poster of collateral, there are no regulatory or legal impediments or third party claims, including those of the third party custodian. However, certain

[9] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

claims, such as costs and expenses incurred for the transfer of the collateral, in the form of liens routinely imposed on all securities transfers, should not be considered an impediment as that would lead to a situation where an impediment would always be identified.

(26) The collecting counterparty should have the operational capability to liquidate the collateral in the case of a default of the poster of collateral. The collecting counterparty should also be able to use the cash proceeds of liquidation to enter into an equivalent contract with another counterparty or to hedge the resulting risk. Having access to the market should therefore be a pre-requisite for the collector of collateral to enable it to either sell the collateral or repo it within a reasonable amount of time. This capability should be independent of the poster of collateral .

(27) Collateral collected must be of sufficiently high liquidity and credit quality to allow the collecting counterparty to liquidate the positions without suffering a loss due to significant changes in value in case the other counterparty defaults. The credit quality of the collateral should be assessed relying on recognised methodologies such as the ratings of external credit assessment institutions. In order to mitigate the risk of mechanistic reliance on external ratings, however, this Regulation should introduce a number of additional safeguards. Those safeguards should include the possibility to use an approved Internal Rating Based ('IRB') model and the possibility to delay the replacement of collateral that becomes ineligible due to a rating downgrade, with the view to efficiently mitigating potential cliff effects that may arise from excessive reliance on external credit assessments.

(28) While haircuts mitigate the risk that collected collateral is not sufficient to cover margin needs in a time of financial stress, other risk mitigants are also needed when accepting non-cash collateral in order to ensure that it can be effectively liquidated In particular, counterparties should ensure that the collateral collected is reasonably diversified in terms of individual issuers, issuer types and asset classes.

(29) The impact on financial stability of liquidating the collateral posted by non-systemically important counterparties is assumed to be limited. Further, concentration limits on initial margin might be burdensome for counterparties with small OTC derivative portfolios as they might have only a limited range of eligible collateral available to post. Therefore, even though collateral diversification is a valid risk mitigant, non-systemically important counterparties should not be required to diversify collateral. On the other hand, systemically important financial institutions and other counterparties with large OTC derivative portfolios trading with each other should apply the concentration limits at least to initial margin including with respect to eligible collateral comprising Member States' sovereign debt securities. Those counterparties are sophisticated enough to either transform collateral or to access multiple markets and issuers to sufficiently diversify the

collateral posted. Article 131 of Directive 2013/36/EU [10] provides for the identification of institutions as systemically important under Union law. However, given the broad scope of Regulation (EU) No 648/2012, a quantitative threshold should be introduced so that the requirements for concentration limits apply also to counterparties that might not fall under those existing classifications of systemically important institutions but which should nonetheless be subject to concentration limits because of the size of their OTC derivative portfolios. Pension scheme arrangements are subject to bilateral collateralisation requirements but, in line with Regulation (EU) No 648/2012 as reflected in its Recital (26), it is necessary to avoid excessive burden from such requirements on the retirement income of future pensioners. Pension scheme arrangements' liabilities to retirees are denominated in local currencies and their investments must therefore be denominated in the same currency in order to avoid the costs and risks of foreign currency mismatches. It is therefore appropriate to provide that the concentration limits should not apply to pension scheme arrangements in the same manner as for other counterparties. However, it is important that adequate risk management procedures are in place to monitor and address potential concentration risks arising from that special regime. The application of these provisions with regard to pension scheme arrangements should be reviewed after three years of their application.

(30) Difficulties in segregating cash collateral should be acknowledged by allowing counterparties to post a limited amount of initial margin in the form of cash and by allowing custodians to reinvest this cash collateral. However, cash held by a custodian is a liability that the custodian has towards the posting counterparty, which generates a credit risk for the posting counterparty. Therefore, in order to address the general objective of Regulation (EU) No 648/2012 to reduce systemic risk, the use of cash as initial margin should be subject to diversification requirements at least for systemically important institutions. Systemically important institutions should be required to either limit the amount of cash initial margin collected for the purpose of this Regulation or to diversify the exposures by using more than one custodian.

(31) The value of collateral should not exhibit a significant positive correlation with the creditworthiness of the poster of collateral or the value of the underlying non-centrally cleared derivatives portfolio since this would undermine the effectiveness of the protection offered by the collateral collected. Accordingly, securities issued by the poster of collateral or its related entities should not be accepted as collateral. Counterparties should also be required to monitor that collateral collected is not subject to other forms of wrong way risk.

[10] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).

(32) It should be possible for the non-defaulting counterparty to liquidate assets collected as collateral as initial or variation margin in a sufficiently short time in order to protect against losses on non-centrally cleared OTC derivatives contracts in the event of a counterparty default. These assets should therefore be highly liquid and should not be exposed to excessive credit, market or foreign exchange risk. To the extent that the value of the collateral is exposed to these risks, appropriately risk-sensitive haircuts should be applied.

(33) In order to ensure the timely transfer of collateral, counterparties should have efficient operational processes in place. This requires that the processes for the bilateral exchange of collateral are sufficiently detailed, transparent and robust. A failure by counterparties to agree upon and establish an operational framework for efficient calculation, notification and finalisation of margin calls can lead to disputes and failed exchanges of collateral that result in uncollateralised exposures under OTC derivative contracts. As a result, it is essential that counterparties set clear internal policies and standards in respect of collateral transfers. Any deviation from those policies should be rigorously reviewed by all relevant internal stakeholders that are required to authorise those deviations. Furthermore, all applicable terms in respect of operational exchange of collateral should be accurately recorded in detail in a robust, prompt and systematic way.

(34) An exchange of collateral agreement should be concluded between counterparties entering into OTC derivative contracts in order to provide legal certainty. As a result, the exchange of collateral agreement should include all material rights and obligations of the counterparties applicable to non-centrally cleared OTC derivative contracts.

(35) Collateral protects the collecting counterparty in the event of the default of the posting counterparty. However, both counterparties are also responsible for ensuring that the manner in which collateral collected is held does not increase the risk of a loss of excess posted collateral for the posting counterparty in case the collecting counterparty defaults. For this reason, the bilateral agreement between the counterparties should allow both counterparties to access the collateral in a timely manner when they have the right to do so, hence the need for rules on segregation and for rules providing for an assessment of the effectiveness of the agreement in this respect, taking into account the legal constraints and the market practices of each jurisdiction.

(36) The re-hypothecation, re-pledge or re-use of collateral collected as initial margins would create new risks for counterparties due to claims of third parties over the assets in the event of a default. Legal and operational complications could delay the return of the collateral in the event of a default of the initial collateral collector or the third party or even make it impossible. In order to preserve the efficiency of the framework and ensure a proper mitigation of counterparty credit risks, the re-hypothecation, re-pledge or re-use of collateral collected as initial margin should therefore not be permitted.

(37) Given the difficulties in segregating cash, the current practices for the exchange of cash collateral in certain jurisdictions and the need for reliance on cash instead of securities in certain circumstances where transferring securities may be impeded by operational constraints, cash collateral collected as initial margin should always be held by a central bank or third party credit institution, since this ensures the separation from the two counterparties in the OTC derivative contract. To ensure such separation, the third party credit institution should not belong to the same group as either of the counterparties.

(38) When a counterparty notifies the relevant competent authority regarding its intention to take advantage of the exemption of intragroup transactions, in order for the competent authority to decide whether the conditions for the exemption are met, the counterparty should provide a complete file including all relevant information necessary for the competent authority to complete its assessment.

(39) For a group to be deemed to have adequately sound and robust risk management procedures, a number of conditions have to be met. The group should ensure a regular monitoring of the intragroup exposures, and the timely settlement of the obligations resulting from the intragroup OTC derivative contracts should be guaranteed based on the monitoring and liquidity tools at group level that are consistent with the complexity of the intragroup transactions.

(40) In order for the exemption for intragroup transactions to be applicable, it must be certain that no legislative, regulatory, administrative or other mandatory provisions of applicable law could legally prevent the intragroup counterparties from meeting their obligations to transfer monies or repay liabilities or securities under the terms of the intragroup transactions. Similarly, there should be no operational or business practices of the intragroup counterparties or the group that could result in funds not being available to meet payment obligations as they fall due on a day-to-day basis, or in prompt electronic transfer of funds not being possible.

(41) This Regulation includes a number of detailed requirements to be met for a group to obtain the exemption from posting margin for intragroup transactions. In addition to those requirements, where one of the two counterparties in the group is domiciled in a third-country for which an equivalence determination under Article 13(2) of Regulation (EU) No 648/2012 has not yet been provided, the group has to exchange, variation and appropriately segregated initial margins for all the intragroup transactions with the subsidiaries in those third-countries. In order to avoid a disproportionate application of the margin requirements and taking into account similar requirements for clearing obligations, this Regulation should provide for a delayed implementation of that particular requirement. This would allow enough time for completion of the process to produce the equivalence determination, while not requiring an inefficient allocation of resources to the groups with subsidiaries domiciled in third-countries.

(42) Taking into account the principle of proportionality, counterparties that have smaller portfolios and therefore generally smaller operations should be allowed more time to adapt their internal systems and processes in order to comply with the requirements of this Regulation. In order to achieve a proper balance between mitigating the risks of OTC derivatives and the proportionate application of this Regulation, as well as to achieve international consistency and minimise possibilities of regulatory arbitrage with the view to avoiding market disruption, a phase-in period of the requirements is necessary. The phase-in period for the requirements introduced in this Regulation takes into account the schedule agreed in the BCBS-IOSCO framework, which was established by reference to a quantitative impact study involving Union credit institutions.

(43) In order to avoid any retroactive effect of this Regulation, the requirements hereunder should apply only to new contracts entered into after the relevant phase-in dates. Exchanges of variation margin and initial margin on contracts entered into before these dates should not be subject to the regulatory obligation to modify the existing bilateral agreements as this would impact their market value.

(44) This Regulation is based on the draft regulatory technical standards submitted to the Commission by the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority.

(45) The European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority have conducted open public consultations on the draft regulatory technical standards on which this Regulation is based, analysed the potential related costs and benefits and requested the opinion of the Banking Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1093/2010[11], the opinion of the Insurance and Reinsurance Stakeholder Group and the Occupational Pensions Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1094/2010[12], and the Securities and Markets Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1095/2010[13].

(46) In accordance with the procedure set out in the fifth, sixth and seventh sub-paragraphs of Article 10(1) of Regulation (EU) No 1093/2010, in the fifth, sixth and seventh sub-paragraphs of Article 10(1) of Regulation (EU) No 1095/2010 and

[11] Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2010, p. 12).

[12] Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC (OJ L 331, 15.12.2010, p. 48).

[13] Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC (OJ L 331, 15.12.2010, p. 84).

in the fifth, sixth and seventh sub-paragraphs of Article 10(1) of Regulation (EU) No 1094/2010, this Regulation incorporates amendments to the draft regulatory technical standards, resubmitted in the form of a formal opinion to the Commission by the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority, on the basis of the Commission's proposed amendments.

HAS ADOPTED THIS REGULATION:

Chapter I

General Provisions on Risk Management Procedures

SECTION 1

DEFINITIONS AND GENERAL REQUIREMENTS

Article 1
Definitions

For the purposes of this Regulation, the following definitions apply:

(1) 'initial margin' means the collateral collected by a counterparty to cover its current and potential future exposure in the interval between the last collection of margin and the liquidation of positions or hedging of market risk following a default of the other counterparty;

(2) 'variation margin' means the collateral collected by a counterparty to reflect the results of the daily marking-to-market or marking-to-model of outstanding contracts referred to in Article 11(2) of Regulation (EU) No 648/2012;

(3) 'netting set' means a group of non-centrally cleared OTC derivative contracts between two counterparties that is subject to a legally enforceable bilateral netting arrangement and may be accompanied by an exchange of collateral agreement. Each transaction that is not subject to a legally enforceable bilateral netting arrangement shall be treated as its own netting set.

Article 2
General requirements

1. Counterparties shall establish, apply and document risk management procedures for the exchange of collateral for non-centrally cleared OTC derivative contracts.

2. The risk management procedures referred to in paragraph 1 shall include procedures providing for or specifying the following:

(a) eligibility of collateral for non-centrally cleared OTC derivative contracts in accordance with Section 2;

(b) the calculation and collection of margins for non-centrally cleared OTC derivative contracts in accordance with Section 3;

(c) the management and segregation of collateral for non-centrally cleared OTC derivative contracts in accordance with Section 5;

(d) the calculation of the adjusted value of collateral in accordance with Section 6;

(e) the exchange of information between counterparties and the authorisation and recording of any exceptions to the risk management procedures pursuant to this Regulation, as referred to in paragraph 1;

(f) the reporting of the exceptions set out in Chapter II to senior management;

(g) the terms of the agreement to be entered into by counterparties in accordance with Article 3;

(h) the periodic verification of the liquidity of the collateral to be exchanged;

(i) the timely re-appropriation of the collateral in the event of default by the posting counterparty from the collecting counterparty; and

(j) the regular monitoring of the exposures arising from OTC derivative contracts that are intragroup transactions and the timely settlement of the obligations resulting from those contracts.

3. The risk management procedures referred to in paragraph 1 shall be tested, reviewed and updated as necessary and at least annually.

4. Upon request, counterparties using initial margin models in accordance with Section 4 shall provide competent authorities with any documentation relating to the risk management procedures referred to in paragraph 2(b) at any time.

5. The risk management procedures required for compliance with Article 11(3) of Regulation (EU) No 648/2012 shall apply throughout the life of all over-the-counter ('OTC') derivative contracts that were subject to the requirements of this Regulation at the contract's inception date.

6. Where a counterparty established in the Union enters into an OTC derivative contract with a counterparty that is established in a third country and would be subject to this Regulation if it was established in the Union, the risk management procedures shall provide that initial and variation margin are exchanged between the counterparties and that the collateral is maintained and protected, in accordance with this Regulation.

7. Where counterparties enter into one or multiple OTC derivative contracts, the risk management procedures shall ensure that written trading relationship documentation is executed between them prior to or contemporaneously with entering into non-centrally cleared OTC derivatives transactions. Such documentation shall comprise all material terms governing the trading relationship between the counterparties, including the following:

(a) any payment obligations;

(b) netting of payments;

(c) events of default or other termination events;

(d) calculation methods;

(e) any netting of obligations upon termination, transfer of rights and obligations;

(f) the governing law of the transactions.

Article 3

Netting agreement and exchange of collateral agreement

1. The trading documentation referred to in Article 2(7) may comprise a netting agreement and an exchange of collateral agreement .

2. The exchange of collateral agreement referred to in paragraph 1 shall include at least the following terms:

(a) the levels and type of collateral required;

(b) the segregation arrangements;

(c) the netting set to which the exchange of collateral refers;

(d) the procedures for notification, confirmation and adjustment of margin calls;

(e) the procedures for settlement of margin calls for each type of eligible collateral;

(f) the procedures, methods, timeframes and allocation of responsibilities for the calculation of margins and the valuation of collateral;

(g) the events that are considered to be default or termination events;

(h) the law applicable to the non-cleared OTC derivative contract; and

(i) the law applicable to the exchange of collateral agreement.

3. Counterparties shall perform an independent legal review of the enforceability of the netting agreement and of the exchange of collateral agreement referred to in paragraph 1. Such review may be conducted by an internal independent unit or by an external independent third party.

4. Paragraph 3 of this Article shall be considered to be satisfied where the netting agreement referred to in paragraph 1 is recognised in accordance with Article 296 of Regulation (EU) No 575/2013.

5. Counterparties shall establish policies to assess the enforceability of netting agreement and the exchange of collateral agreement referred to in paragraph 1 on a continuous basis.

SECTION 2
ELIGIBILITY

Article 4
Eligible collateral

1. A counterparty shall only collect collateral from the following asset classes:

(a) cash in the form of money credited to an account in any currency, or similar claims for the repayment of money, such as money market deposits;

(b) gold in the form of allocated pure gold bullion of recognised good delivery;

(c) debt securities issued by Member States' central governments or central banks;

(d) debt securities issued by Member States' regional governments or local authorities whose exposures are treated as exposures to the central government of that Member State in accordance with Article 115(2) of Regulation (EU) No 575/2013;

(e) debt securities issued by Member States' public sector entities whose exposures are treated as exposures to the central government, regional government or local authority of that Member State in accordance with Article 116(4) of Regulation (EU) No 575/2013;

(f) debt securities issued by Member States' regional governments or local authorities other than those referred to in point (d);

(g) debt securities issued by Member States' public sector entities other than those referred to in point (e);

(h) debt securities issued by multilateral development banks listed in Article 117(2) of Regulation (EU) No 575/2013;

(i) debt securities issued by the international organisations listed in Article 118 of Regulation (EU) No 575/2013;

(j) debt securities issued by third countries' governments or central banks;

(k) debt securities issued by third countries' regional governments or local authorities that meet the requirements of points (d) and (e);

(l) debt securities issued by third countries' regional governments or local authorities other than those referred to in points (d) and (e);

(m) debt securities issued by credit institutions or investment firms including bonds referred to in Article 52(4) of Directive 2009/65/EC;

(n) corporate bonds;

(o) the most senior tranche of a securitisation, as defined in Article 4(61) of Regulation (EU) 575/2013, that is not a re-securitisation as defined in Article 4(63) of that Regulation;

(p) convertible bonds provided that they can be converted only into equities which are included in an index specified pursuant to point (a) of Article 197 (8) of Regulation (EU) No 575/2013;

(q) equities included in an index specified pursuant to point (a) of Article 197(8) of Regulation (EU) No 575/2013;

(r) shares or units in undertakings for collective investments in transferable securities (UCITS), provided that the conditions set out in Article 5 are met.

2. A counterparty shall only collect collateral from the asset classes referred to in points (f), (g) and (k) to (r) of paragraph 1 where all the following conditions apply:

(a) the assets are not issued by the posting counterparty;

(b) the assets are not issued by entities which are part of the group to which the posting counterparty belongs;

(c) the assets are not otherwise subject to any significant wrong way risk, as defined in points (a) and (b) of paragraph 1 of Article 291 of Regulation (EU) 575/2013.

3. Points (a), (b) and (c) of paragraph 2 shall apply to risk exposures arising from third party holders or custodians holding initial margin collected in cash.

Article 5 (old Article 26)
Eligibility criteria for units or shares in UCITS

1. For the purposes of point (r) of Article 4(1), a counterparty may only use units or shares in UCITS as eligible collateral where all the following conditions are met:

(a) the units or shares have a daily public price quote;

(b) the UCITS are limited to investing in assets that are eligible in accordance with Article 4(1);

(c) the UCITS meet the criteria laid down in Article 132(3) of Regulation (EU) 575/2013.

Where a UCITS invests in shares or units of another UCITS, the conditions laid down in the first subparagraph shall also apply to the underlying UCITS.

For the purposes of point (b), UCITS may use derivative instruments to hedge the risks arising from the assets in which they invest.

2. By way of derogation from point (b) of paragraph 1, where a UCITS or any of its underlying UCITS do not only invest in assets that are eligible in accordance with Article 4(1), only the value of the unit or share of the UCITS that represents investment in eligible assets may be used as eligible collateral pursuant to paragraph 1 of this Article

The first subparagraph shall apply to any underlying UCITS of a UCITS that has underlying UCITS of its own.

3. Where non-eligible assets of a UCITS can have a negative value, the value of the unit or share of the UCITS that may be used as eligible collateral pursuant to paragraph 1 shall be determined by deducting the maximum negative value of the non-eligible assets from the value of eligible assets.

Article 6 (old Article 24)
Credit quality assessment

1. The collecting counterparty shall assess the credit quality of assets belonging to the asset classes referred to in points (c), (d) and (e) of Article 4(1) that are not denominated or funded in the issuer's domestic currency and in points (f), (g), (j) to (n) and (p) of Article 4(1) using one of the following methodologies:

   (a) the internal ratings referred to in paragraph 3 of this Article;

   (b) the internal ratings referred to in paragraph 3 of this Article of the posting counterparty, where that counterparty is established in the Union or where the posting counterparty is subject to laws applying prudential supervisory and regulatory requirements equivalent to those applied in the Union in accordance with Article 127 of Directive 2013/36/EU;

   (c) a credit quality assessment issued by a recognised External Credit Assessment Institution (ECAI) as defined in Article 4(98) of Regulation (EU) No 575/2013 or a credit quality assessment of an export credit agency referred to in Article 137 of that Regulation.

2. The collecting counterparty shall assess the credit quality of assets belonging to the asset class referred to in point (o) of Article 4(1) using the methodology referred to in point (c) of paragraph 1 of this Article.

3. A counterparty permitted to use the Internal Rating Based (IRB) approach pursuant to Article 143 of Regulation (EU) No 575/2013 may use their internal ratings in order to assess the credit quality of the collateral collected for the purposes of this Regulation.

4. A counterparty using the IRB approach in accordance with paragraph 3, shall determine the credit quality step of the collateral in accordance with Annex I.

5. A counterparty using the IRB approach in accordance with paragraph 1, shall communicate to the other counterparty the credit quality step referred to in paragraph 4 associated to the assets to be exchanged as collateral.

6. For the purposes of paragraphs 1(c) and 2, the credit quality assessment shall be mapped to credit quality steps specified pursuant to Articles 136 and 270 of Regulation (EU) No 575/2013.

Article 7 (old Article 23)
Specific requirements for eligible assets

1. Counterparties shall only use the assets referred to in points (f), (g), (j) to (p) of Article 4(1) as collateral where their credit quality has been assessed as credit quality steps 1, 2 or 3 in accordance with Article 6.

2. Counterparties shall only use the assets referred to in points (c), (d) and (e) of Article 4(1) that are not denominated or funded in the issuer's domestic currency as collateral where their credit quality has been assessed as credit quality steps 1, 2, 3 or 4 in accordance with Article 6.

3. Counterparties shall establish procedures for the treatment of assets exchanged as collateral in accordance with paragraphs 1 and 2 whose credit quality is subsequently assessed to be:

   (a) step 4 or beyond for assets referred to in paragraph 1;

   (b) beyond step 4 for assets referred to in paragraph 2.

4. The procedures referred to in paragraph 3 shall meet all of the following requirements:

   (a) they shall prohibit counterparties from exchanging additional assets assessed to be of the credit quality referred to in paragraph 4;

   (b) they shall establish a schedule by which assets assessed to be of the credit quality referred to in paragraph 4 and already exchanged as collateral are replaced over a period of time not exceeding two months;

   (c) they shall set a credit quality step that requires the immediate replacement of the assets referred to in paragraph 4;

   (d) they shall allow counterparties to increase the haircuts on the relevant collateral insofar as the collateral has not been replaced in accordance with the schedule referred to in point (b).

   Counterparties shall not use assets classes referred to in Article 4(1) as collateral where they have no access to the market for those assets or where they are unable to liquidate those assets in a timely manner in case of default of the posting counterparty.

Article 8 (old Article 28)
Concentration limits for initial margin

1. Where collateral is collected as initial margin in accordance with Article 13, the following limits shall apply for each collecting counterparty:

   (a) the sum of the values of the initial margin collected from the asset classes referred to in points (b), (f), (g), and (l) to (r) of Article 4(1) issued by a single issuer or by entities which belong to the same group does not exceed the greater of the following values:

      (i) 15% of the collateral collected from the posting counterparty;

      (ii) EUR 10 million or the equivalent in another currency;

   (b) the sum of the values of the initial margin collected from the asset classes referred to in points (o), (p) and (q) of Article 4(1), where the asset classes referred to in points (p) and (q) of that Article are issued by institutions as defined in Regulation (EU) No 575/2013, does not exceed the greater of the following values:

      (i) 40% of the collateral collected from the posting counterparty;

      (ii) EUR 10 million or the equivalent in another currency.

   The limits laid down in this paragraph shall also apply to shares or units in UCITS where the UCITS primarily invests in the asset classes referred to in that point.

2. Where collateral is collected as initial margin in accordance with Article 13 in excess of EUR 1 billionand where each of the counterparties belong to one of the categories listed in paragraph 3, the following limits shall apply to the amount of initial margin in excess of EUR 1 billion:

   (a) the sum of the values of the initial margin collected from the asset classes referred to in points (c) to (l) of Article 4(1) issued by a single issuer or by issuers domiciled in the same country shall not exceed 50% of the collateral collected from that counterparty.

   (b) the 50% concentration limit referred to in point (a) shall apply to the risk exposures arising from a single third party holder or custodian holding initial margin collected in cash.

3. The counterparties referred to in paragraph 2 shall be one of the following:

   (a) institutions identified as G-SIIs in accordance with Article 131 of Directive 2013/36/EU;

(b) institutions identified as O-SIIs in accordance with Article 131 of Directive 2013/36/EU;

(c) a counterparty for which the sum of the values of the collateral to be collected exceeds EUR 1 billion.

4. Where institutions referred to in points (a) and (b) of paragraph 3 collect initial margin in cash from a single counterparty that is also an institution referred to in those points, the collecting counterparty shall ensure that not more than 20% of that initial margin is held by a single third party custodian.

5. Paragraphs 1 to 4, shall not apply to collateral collected in the form of the financial instruments that are the same as the underlying financial instrument of the non-centrally cleared OTC derivative contract.

6. By way of derogation from the frequency set out in Article 9(2), a counterparty referred to in points (a), (b) and (c) of Article 2(10) of Regulation (EU) 648/2012 may assess compliance with the conditions laid down in paragraph 2 with a frequency of at least three months, provided that the amount of initial margin collected from each individual counterparty was at all times below EUR 800 million during the three months preceding the assessment.

7. Where the amount of initial margin collected from any individual counterparty was at least once equal to or exceeded EUR 800 million during the three months preceding a subsequent assessment, a counterparty making use of the derogation referred to in paragraph 6 has to apply the frequency set out in Article 9(2) from that point onwards with the possibility to revert to the lower frequency of paragraph 6 under the conditions set out therein.

SECTION 3
CALCULATION AND COLLECTION OF MARGINS

Article 9
Frequency of calculation and determination of the calculation date

1. Counterparties shall calculate variation margin in accordance with Article 10 at least on a daily basis.

2. Counterparties shall calculate initial margin in accordance with Article 11 no later than the business day following one of these events:

(a) where a new non-cleared OTC derivative contract is executed or added to the netting set;

(b) where an existing non-cleared OTC derivative contract expires or is removed from the netting set;

(c) where an existing non-cleared OTC derivative contract triggers a payment or a delivery other than the posting and collecting of margins;

(d) where the initial margin is calculated in accordance with the standardised approach referred to in paragraph 1 of Article 11 and an existing contract is reclassified in terms of the asset category referred to in paragraph 1 of Annex IV as a result of reduced time to maturity;

(e) where no calculation has been performed in the preceding ten business days.

3. For the purpose of determining the calculation date for initial and variation margin, the following shall apply:

(a) where two counterparties are located in the same time-zone, the calculation shall be based on the netting set of the previous business day;

(b) where two counterparties are not located in the same time-zone, the calculation shall be based on the transactions in the netting set which are entered into before 16:00 hours of the previous business day of the time-zone where it is first 16:00 hours.

Article 10
Calculation of variation margin

The amount of variation margin to be collected by a counterparty shall be the aggregation of the values calculated in accordance with Article 11(2) of Regulation (EU) No 648/2012 of all contracts in the netting set, minus the value of all variation margin previously collected, minus the net value of each contract in the netting set at the point of entry into the contract, and plus the value of all variation margin previously posted.

Article 11
Calculation of initial margin

1. Counterparties shall calculate the amount of initial margin to be collected using either the standardised approach set out in Annex IV or the initial margin models referred to in Section 4 or both. The collection of initial margin shall be performed without offsetting the initial margin amounts between the two counterparties.

2. Where counterparties use both the standardised approach set out in Annex IV and the initial margin models referred to in Section 4 to calculate the amount of the initial margin for OTC derivative contracts in the same netting set, they shall only be used where this results in a better reflection of the risks.

3. Counterparties calculating the initial margin in accordance with Section 4 shall not take into account any correlations between the value of the unsecured exposure and the collateral in that calculation.

4. Counterparties shall agree on the method each counterparty uses to determine the initial margin it has to collect but are not required to use a common methodology.

5. Where one or both counterparties rely on an initial margin model they shall agree on the model developed pursuant to Section 4.

Article 12
Collection of variation margin

1. Variation margin shall be collected either:

   (a) within the same business day of the calculation date determined in accordance with Article 9(3);

   (b) where the conditions in paragraph 2 are met, within two business days of the calculation date determined in accordance with Article 9(3).

2. The collection of variation margin in accordance with paragraph 1(b) may only be applied to netting sets that meet either of the following conditions:

   (a) for all the derivative contracts not subject to initial margin requirements in accordance with this Regulation, where the collecting counterparty has collected, at or before the calculation date of the variation margin, an advance amount of collateral calculated in the same manner as that applicable to initial margins in accordance with Article 15, for which the collecting counterparty has used a margin period of risk ('MPOR') at least equal to the number of days in between and including the calculation date and the collection date; in case no mechanism for segregation is in place between the two counterparties, these may offset the amounts to be collected.

   (b) for derivative contracts subject to initial margin requirements, where the initial margin has been adjusted in one of the following ways:

      (i) by increasing the MPOR referred to in Article 15(2) by the number of days in between, and including, the calculation date determined in accordance with Article 9(3) and the collection date determined in accordance with paragraph 1 of this Article;

      (ii) by increasing the initial margin calculated in accordance with the standardised approach referred to in Article 11 using an appropriate methodology taking into account a MPOR that is increased by the number of days in between, and including, the calculation date determined in accordance with Article 9(3) and the collection date determined in accordance with paragraph 2 of this Article.

3. The part of the collateral related to variation margin referred to in paragraph 4(a) shall be collected in accordance with Article 4(1) and second subparagraph of Article 7(5).

4. In the event of a dispute over the amount of variation margin due for collection, counterparties shall collect, in the same time frame referred to in paragraph 2, at least the part of the variation margin amount that is not being disputed.

Article 13
Collection of initial margin

1. The collecting counterparty shall collect the initial margin in accordance with Section 5.

2. Initial margin shall be collected within the same business day of the calculation date determined in accordance with Article 9(3).

3. In the event of a dispute over the amount of initial margin due for collection, counterparties shall collect at least the part of the initial margin amount that is not being disputed within the same business day of the calculation date determined in accordance with Article 9(3).

SECTION 4
INITIAL MARGIN MODELS

Article 14
General requirements

1. Where a counterparty uses an initial margin model, that model may be developed by any of, or both, counterparties or by a third party agent.

   Where a counterparty uses an initial margin model developed by a third party agent, the counterparty shall remain responsible for ensuring that that model complies with the requirements referred to in this Section.

2. Initial margin models shall be developed in a way that captures all the significant risks arising from entering into the OTC derivative contracts included in the netting set, including the nature, scale, complexity of those risks and shall meet the following requirements:

   (a) the model incorporates risk factors corresponding to the individual currencies in which the OTC derivative contracts in the netting set are denominated;

   (b) the model incorporates interest rate risk factors corresponding to the individual currencies in which the OTC derivative contracts are denominated;

   (c) the yield curve is divided into a minimum of six maturity buckets for exposures to interest-rate risk in the major currencies and markets;

(d) the model captures the risk of movements between different yield curves and between different maturity buckets;

(e) the model incorporates separate risk factors at least for each equity, equity index, commodity or commodity index which is significant for the OTC derivative contracts within the netting set;

(f) the model captures the risk arising from less liquid positions and positions with limited price transparency within realistic market scenarios;

(g) the model captures the risk, otherwise not captured by other features of the model, arising from derivative contracts where the underlying asset class is credit;

(h) the model captures the risk of movements between similar, but not identical, underlying risk factors and the exposure to changes in values arising from maturity mismatches;

(i) the model captures main non-linear dependencies;

3. The risk management procedures referred to in Article 2(1) shall ensure that the performance of the model is monitored on a continuous basis including by back-testing the model at least every three months.

For the purposes of this paragraph, back testing shall include a comparison between the values produced by the model and the realized market values of the OTC derivatives in the netting set.

4. The risk management procedures shall outline the methodologies used for undertaking back-testing, including statistical tests of performance.

5. The risk management procedures shall describe what results of the back-testing would lead to a model change, recalibration or other remediation action.

6. The risk management procedures referred to in Article 2(1) shall ensure that counterparties retain records of the results of the back-testing referred to in paragraph 3.

7. Counterparties shall provide all the information necessary to explain the calculation of a given value of the initial margin model to the other counterparty in a way that a knowledgeable third party would be able to verify that calculation.

8. The initial margin model shall reflect parameter uncertainty, correlation, basis risk and data quality in a prudent manner.

Article 15
Confidence interval and margin period of risk (MPOR)

1. The assumed variations in the value of the contracts within the netting set for the calculation of initial margins using an initial margin model shall be based on a one-tailed 99 percent confidence interval over a MPOR of at least 10 days.

2. The MPOR for the calculation of initial margins using an initial margin model referred to in paragraph 1 shall include:

(a) the period that may elapse from the last margin exchange of variation margin to the default of the counterparty;

(b) the estimated period needed to replace the OTC derivative contracts within the netting set or hedge the risks arising from them, taking into account the level of liquidity of the market where those types of contracts are traded, the total volume of the OTC derivative contracts in that market and the number of participants in that market.

Article 16
Calibration of the parameters of the model

1. Parameters used in initial margin models shall be calibrated based on historical data from a time period with a minimum duration of three years and a maximum duration of five years, and shall be calibrated at least annually.

2. The data used for calibrating the parameters of initial margin models shall include the most recent continuous period from the date on which the calibration referred to in paragraph 1 is performed and at least 25% of those data shall be representative of a period of significant financial stress ('stressed data').

3. Where stressed data referred to in paragraph 2 does not constitute at least 25% of the data used in the initial margin model, the least recent data of the historical data referred to in paragraph 1 shall be replaced by data from a period of significant financial stress, until the overall proportion of stressed data is at least 25% of the overall data used in the initial margin model.

4. The period of significant financial stress used for calibration of the parameters shall be identified and applied separately at least for each of the underlying asset classes referred to in Article 17(2).

5. The parameters shall be calibrated using equally weighted data.

6. The parameters may be calibrated for shorter periods than the MPOR determined in accordance with Article 15. Where shorter periods are used, the parameters shall be adjusted to that MPOR by an appropriate methodology.

7. Counterparties shall have written policies setting out the circumstances triggering a more frequent calibration.

8. Counterparties shall establish procedures for adjusting the value of the margins to be exchanged in response to a change in the parameters due to a change in market conditions. Those procedures shall provide for counterparties to be able to exchange the additional initial margin resulting from that change of the parameters over a period that ranges between one and thirty business days.

9. Counterparties shall establish procedures regarding the quality of the data used in the model in accordance with paragraph 1, including the selection of appropriate data providers and the cleaning and interpolation of that data.

10. Proxies for the data used in initial margin models shall be used only where both of the following conditions are met:

(a) available data is insufficient or is not reflective of the true volatility of an OTC derivative contract or portfolio of OTC derivative contracts within the netting set;

(b) where the proxies lead to a conservative level of margins.

Article 17

Diversification, hedging and risk offsets across underlying classes

1. Initial margin models shall include only non-centrally cleared OTC derivative contracts within the same netting set. Initial margin models may account for diversification, hedging and risk offsets arising from the risks of OTC derivative contracts that are in the same netting set, provided that the diversification, hedging or risk offset is carried out within the same underlying asset class referred to in paragraph 2 and not across such classes.

2. For the purpose of accounting for diversification, hedging and risk offsets referred to in paragraph 1, the following underlying asset classes shall be considered:

(c) interest rates, currency and inflation;

(d) equity;

(e) credit;

(f) commodities and gold;

(g) other.

Article 18

Qualitative requirements

1. Counterparties shall establish an internal governance process to assess the appropriateness of the initial margin model on a continuous basis, including all of the following:

(a) an initial validation of the model by suitably qualified persons who are independent from the persons developing the model;

(b) a follow up validation whenever a significant change is made to the initial margin model and at least annually;

(c) a regular audit process to assess the following:

(i) the integrity and reliability of the data sources

(ii) the management information system used to run the model

(iii) the accuracy and completeness of data used

(iv) the accuracy and appropriateness of volatility and correlation assumptions.

2. The documentation of the risk management procedures referred to in point (b) of Article 2(2) relating to the initial margin model shall meet all of the following conditions:

(a) it shall allow a knowledgeable third-party to understand the design and operational detail of the initial margin model;

(b) it shall contain the key assumptions and the limitations of the initial margin model;

(c) it shall define the circumstances under which the assumptions of the initial margin model are no longer valid.

3. Counterparties shall document all changes to the initial margin model. That documentation shall also detail the results of the validations, referred to in paragraph 1, carried out after those changes.

SECTION 5

COLLATERAL MANAGEMENT AND SEGREGATION

Article 19

Collateral management and segregation

1. The procedures referred to in Article 2(2)(c) shall include the following:

(a) a daily valuation of the collateral held in accordance with Section 6;

(b) the legal arrangements and a collateral holding structure that allow access to the received collateral where it is being held by a third party;

(c) where initial margin is maintained with the collateral provider, that the securities are maintained in insolvency-remote custody accounts;

(d) that non-cash initial margin is maintained in accordance with paragraphs 3 and 4;

(e) that cash collected as initial margin is maintained in cash accounts at central banks or credit institutions which fulfil all of the following conditions:

(i) they are authorised in accordance with Directive 2013/36/EU or are authorised in a third country whose supervisory and regulatory arrangements have been found to be equivalent in accordance with Article 142(2) of Regulation (EU) No 575/2013;

(ii) they are neither the posting nor the collecting counterparties, nor part of the same group as either of the counterparties;

(f) the availability of unused collateral to the liquidator or other insolvency official of the defaulting counterparty;

(g) the initial margin is freely transferable to the posting counterparty in a timely manner in case of the default of the collecting counterparty;

(h) that non-cash collateral is transferable without any regulatory or legal constraints or third party claims, including those of the liquidator of the collecting counterparty or third party custodian, other than liens for fees and expenses incurred in providing the custodial accounts and other than liens routinely imposed on all securities in a clearing system in which such collateral may be held;

(i) that any unused collateral is returned to the posting counterparty in full, excluding costs and expenses incurred for the process of collecting and holding the collateral.

2. Any collateral posted as initial or variation margin may be substituted by alternative collateral where all of the following conditions are met:

(a) the substitution is made in accordance with the terms of the agreement between the counterparties referred to in Article 3;

(b) the alternative collateral is eligible in accordance with Section 2;

(c) the value of the alternative collateral is sufficient to meet all margin requirements after applying any relevant haircut.

3. Collateral collected as initial margin shall be segregated in either or both of the following ways:

(a) on the books and records of a third party holder or custodian;

(b) via other legally binding arrangements;

so that the initial margin is protected from the default or insolvency of the collecting counterparty.

4. Counterparties shall ensure that non-cash collateral exchanged as initial margin is segregated as follows:

(a) where collateral is held by the collecting counterparty on a proprietary basis, it shall be segregated from the rest of the proprietary assets of the collecting counterparty;

(b) where collateral is held by the posting counterparty on a non proprietary basis, it shall be segregated from the rest of the proprietary assets of the posting counterparty;

(c) where collateral is held on the books and records of a custodian or other third party holder, it shall be segregated from the proprietary assets of that third-party holder.

5. Where non-cash collateral is held by the collecting party or by a third party holder, the collecting counterparty shall always provide the posting counterparty with the option to segregate its collateral from the assets of other posting counterparties.

6. Counterparties shall perform an independent legal review in order to verify that the segregation arrangements meet the requirements referred to in paragraphs 1(g), and 3 to 5.

7. Counterparties shall provide evidence to their competent authorities of compliance with the paragraph 6 of this article in relation to each relevant jurisdiction and, upon request by a competent authority, shall establish policies ensuring the continuous assessment of compliance. Such legal review may be conducted by an independent internal unit, or by an independent external third party.

8. For the purposes of paragraph 1(e), the counterparties shall assess the credit quality of the credit institution referred to therein by using a methodology that does not solely or mechanistically rely on external credit quality assessments.

Article 20
Treatment of collected initial margins

1. The collecting counterparty shall not rehypothecate, repledge nor otherwise reuse the collateral collected as initial margin.

2. Notwithstanding paragraph 1, a third party holder may use the initial margin received in cash for reinvestment purposes.

SECTION 6
VALUATION OF COLLATERAL

Article 21
Calculation of the adjusted value of collateral

1. Counterparties shall adjust the value of collected collateral in accordance with either the methodology set out in Annex II or a methodology using own volatility estimates accordance with Article 22.

2. When adjusting the value of collateral pursuant to paragraph 1, counterparties may disregard the foreign-exchange risk arising from positions in currencies which are subject to a legally binding intergovernmental agreement limiting the variation of those positions relative to other currencies covered by the same agreement.

Article 22
Own estimates of the adjusted value of collateral

1. Counterparties shall adjust the value of collected collateral using own volatility estimates in accordance with Annex III.

2. Counterparties shall update their data sets and calculate the own volatility estimates referred to in Article 21 whenever the level of market prices' volatility changes materially and at least quarterly.

3. For the purposes of the first subparagraph, counterparties shall pre-determine the levels of volatility that trigger a recalculation of those haircuts.

4. The procedures referred to in Article 2(2)(d) shall include policies to monitor the calculation of the own volatility estimates and the integration of those estimates into the risk management process of that counterparty.

5. The policies referred to in paragraph 4 shall be subject to an internal review that includes all of the following:

   (a) the integration of the estimates into the risk management process of the counterparty, which shall take place at least annually;

   (b) the integration of estimated haircuts into daily risk management;

   (c) the validation of any significant change in the process for the calculation of the estimates;

   (d) the verification of the consistency, timeliness and reliability of data sources used to calculate the estimates;

   (e) the accuracy and appropriateness of the volatility assumptions.

   The review referred to in the first subparagraph shall be carried out regularly within the internal auditing process of the counterparty.

CHAPTER II

Specific Provisions on Risk Management Procedures

SECTION 1
EXEMPTIONS

Article 23
Non-financial counterparties and third country counterparties

By way of derogation from Article 2(2), counterparties may provide in the risk management procedures referred to in Article 2(1) that no collateral is exchanged in relation to non-cleared OTC derivative contracts entered into with non-financial counterparties that do not meet the conditions of Article 10(1)(b) of Regulation (EU) No 648/2012, or with non-financial entities established in a third country that would not meet the conditions of Article 10(1)(b) of Regulation (EU) No 648/2012 if they were established in the Union.

Article 24
Minimum transfer amount

1. By way of derogation from Article 2(2), counterparties may provide in their risk management procedures referred to in Article 2(1) that no collateral is collected from a counterparty where the amount due from the last collection of collateral is equal to or lower than the amount agreed by the counterparties ('minimum transfer amount').

   The minimum transfer amount shall not exceed EUR 500 000 or the equivalent amount in another currency.

2. Where counterparties agree on a minimum transfer amount, the amount of collateral due shall be calculated as the sum of:

   (a) the variation margin due from its last collection calculated in accordance with Article 10, including any excess collateral;

   (b) the initial margin due from its last collection calculated in accordance with Article 11, including any excess collateral;

3. Where the amount of collateral due exceeds the minimum transfer amount agreed by the counterparties, the collecting counterparty shall collect the full amount of collateral due without deduction of the minimum transfer amount.

4. Counterparties may agree on separate minimum transfer amounts for initial and variation margins, provided that the sum of those minimum transfer amounts is equal to or lower EUR 500 000 or the equivalent amount in another currency.

   Where counterparties agree on separate minimum transfer amounts in accordance with the first subparagraph, the collecting counterparty shall collect the full amount of initial or variation margin due without any deduction of those minimum transfer amounts where the amount of initial or variation collateral due exceeds the minimum transfer amount.

Article 25
Margin calculation with third country counterparties

Where a counterparty is domiciled in a third country, counterparties may calculate margins on the basis of a netting set that includes the following types of contracts:

(a) non-centrally cleared OTC derivatives subject to margin requirements under this Regulation;

(b) contracts that meet both of the following conditions*:*

(i) they are identified as non-centrally cleared OTC derivatives by the regulatory regime applicable to the counterparty domiciled in the third-country;

(ii) they are subject to margin rules in the regulatory regime applicable to the counterparty domiciled in the third-country.

SECTION 2
EXEMPTIONS IN CALCULATING LEVELS OF INITIAL MARGIN

Article 26 (old Article 7)
Foreign exchange contracts

By way of derogation from Article 2(2), counterparties may provide in their risk management procedures referred to in Article 2(1) that initial margins are not collected with respect to:

(a) physically settled OTC derivative contracts that solely involve the exchange of two different currencies on a specific future date at a fixed rate agreed on the trade date of the contract covering the exchange ('foreign exchange forwards');

(b) physically settled OTC derivative contracts that solely involve an exchange of two different currencies on a specific date at a fixed rate that is agreed on the trade date of the contract covering the exchange, and a reverse exchange of the two currencies at a later date and at a fixed rate that is also agreed on the trade date of the contract covering the exchange ('foreign exchange swaps');

(c) the exchange of principal of OTC derivative contracts under which counterparties exchange solely the principal amount and any interest payments in one currency for the principal amount and any interest payments in another currency, at specified points in time according to a specified formula ('currency swap').

Article 27 (old Article 8)
Threshold based on notional amount

1. By way of derogation from Article 2(2), counterparties may provide in their risk management procedures referred to in Article 2(1) that initial margins are not collected for all new OTC derivative contracts entered into within a calendar year where one of the two counterparties has an aggregate month-end average notional amount of non-centrally cleared OTC derivatives for the months March, April and May of the preceding year of below EUR 8 billion.

The aggregate month-end average notional amount referred to in the first subparagraph shall be calculated at the counterparty level or at the group level where the counterparty belongs to a group.

2. Where a counterparty belongs to a group, the calculation of the group aggregate month-end average notional amount shall include all non-centrally cleared OTC derivative contracts of the group including all intragroup non-centrally cleared OTC derivative contracts.

For the purposes of the first subparagraph, OTC derivative contracts which are internal transactions shall only be taken into account once.

3. UCITS authorised in accordance with Directive 2009/65/EC, alternative investment funds and investment firms authorised in accordance with Directive 2004/39/EC where acting as portfolio managers shall be considered distinct entities and treated separately when applying the thresholds referred to in paragraph 1 where the following conditions are met:

(a) the funds are distinct segregated pools of assets for the purposes of the fund's insolvency or bankruptcy;

(b) the segregated pools of assets are not collateralised, guaranteed or otherwise financially supported by other investment funds or their managers.

Article 28 (old Article 9)
Threshold based on initial margin amount

1. By way of derogation from Article 2(2), the risk management procedures referred to in Article 2(1) may provide that a counterparty reduce the initial margin collected by an amount up to EUR 50 mln from another counterparty where:

(a) neither counterparty belongs to any group and the sum of all initial margins required to be collected by that counterparty from the other counterparty is equal to or lower than EUR 50 million;

(b) the counterparties are part of different groups and the sum of all initial margins to be collected from all counterparties belonging to the posting group by all counterparties belonging to the collecting group is equal to or lower than EUR 50 million;

(c) both counterparties belong to the same group and the sum of all initial margins required to be collected by that counterparty from the other counterparty is equal to or lower than EUR 10 million.

2. Where a counterparty does not collect initial margins in accordance with paragraph 1(b), the risk management procedures referred to in Article 2(1) shall include provisions on monitoring, at group level, whether that threshold is exceeded and for the retention of appropriate records of the group's exposures to each single counterparty in the same group.

3. UCITS authorised in accordance with Directive 2009/65/EC, alternative investment funds and investment firms authorised in accordance with Directive 2004/39/EC where acting as portfolio managers shall be considered distinct entities and treated separately when applying the thresholds referred to in paragraph 1 where the following conditions are met:

   (a) the funds are distinct segregated pools of assets for the purposes of the fund's insolvency or bankruptcy;

   (b) the segregated pools of assets are not collateralised, guaranteed or otherwise financially supported by other investment funds or their managers.

SECTION 3

EXEMPTIONS FROM THE REQUIREMENT TO POST OR COLLECT INITIAL OR VARIATION MARGIN

Article 29 (old Article 10)

Treatment of derivatives associated to covered bonds for hedging purposes

1. By way of derogation from Article 2(2) and where the conditions set out in paragraph 2 are met, counterparties may, in their risk management procedures referred to in Article 2(1), provide the following in relation to OTC derivative contracts concluded in connection with covered bonds:

   (a) variation margin is not posted by the covered bond issuer or cover pool but is collected from its counterparty in cash and returned to its counterparty when due;

   (b) initial margin is not posted or collected.

2. Paragraph 1 applies where all of the following conditions are met:

   (a) the OTC derivative contract is not terminated in case of resolution or insolvency of the covered bond issuer or cover pool;

   (b) the counterparty to the OTC derivative concluded with covered bond issuers or with cover pools for covered bonds ranks at least pari passu with the covered bond holders except where the counterparty to the OTC derivative concluded with covered bond issuers or with cover pools for covered bonds is the defaulting or the affected party;

   (c) the OTC derivative contract is registered or recorded in the cover pool of the covered bond in accordance with national covered bond legislation;

   (d) the OTC derivative contract is used only to hedge the interest rate or currency mismatches of the cover pool in relation to the covered bond;

(e) the netting set does not include OTC derivative contracts unrelated to the cover pool of the covered bond;

(f) the covered bond to which the OTC derivative contract is associated meets the requirements of paragraphs (1), (2) and (3) of Article 129 of Regulation (EU) No 575/2013;

(g) the cover pool of the covered bond to which the OTC derivative contract is associated is subject to a regulatory collateralisation requirement of at least 102%.

Article 30 (old Article 11)

Treatment of derivatives with counterparties in third countries where legal enforceability of netting agreements or collateral protection cannot be ensured

1. By way of derogation from Article 2(2), counterparties established in the Union may provide in their risk management procedures referred to in Article 2(1) that variation and initial margins are not required to be posted for contracts concluded with counterparties established in a third-country for which any of the following apply:

(a) the legal review referred to in Article 3(3) confirms that the netting agreement and, where used, the exchange of collateral agreement cannot be legally enforced with certainty at all times;

(b) for derivative contracts subject to initial margin in accordance with this Regulation, the legal review referred to in Article 19(6) confirms that the segregation requirements referred to in Article 19(3) to (5) cannot be met.

Counterparties established in the Union referred to in this paragraph shall collect margin on a gross basis.

2. By way of derogation from Article 2(2), counterparties established in the Union may provide in their risk management procedures referred to in Article 2(1) that variation and initial margins are not required to be posted or collected for contracts concluded with counterparties established in a third-country where all of the following conditions apply:

(a) point (a) and, where applicable, point (b) of paragraph 1 apply;

(b) the legal reviews referred to in points (a) and (b) of paragraph 1 confirm that collecting collateral in accordance with this Regulation is not possible, even on a gross basis;

(c) the ratio calculated in accordance with paragraph 3 is lower than 2.5%.

3. The ratio referred to in paragraph 2(c) shall be the result of dividing the amount resulting from point (a) with that resulting from point (b):

(a) the sum of the notional amounts of any outstanding OTC derivative contracts of the group to which it belongs that were concluded before and after the entry into force of this Regulation and for which no margin has been collected from counterparties established in a third country for which point (b) of paragraph 2 applies;

(b) the sum of the notional amounts of all outstanding OTC derivative contracts of the group to which it belongs, excluding OTC derivative contracts that are intragroup transactions.

CHAPTER III

Intragroup derivative contracts

SECTION 1
PROCEDURES FOR COUNTERPARTIES AND COMPETENT AUTHORITIES WHEN APPLYING EXEMPTIONS FOR INTRAGROUP DERIVATIVE CONTRACTS

Article 31
Procedures for counterparties and relevant competent authorities

1. The application or notification from a counterparty to the competent authority pursuant to points (6) to (10) of Article 11 of Regulation (EU) No 648/2012 shall be deemed to have been received when the competent authority receives all of the following information:

   (a) all the information necessary to assess whether the conditions specified in paragraphs (6), (7), (8), (9) or (10), as applicable, of Article 11 of Regulation (EU) No 648/2012 have been fulfilled;

   (b) the information and documents referred to in Article 18(2) of Commission Delegated Regulation (EU) No 149/2013.

2. Where a competent authority determines that further information is required in order to assess whether the conditions referred to in point (a) of paragraph 1 are fulfilled, it shall submit a written request for information to the counterparty.

3. A decision by a competent authority under Article 11(6) of Regulation (EU) No 648/2012 shall be communicated to the counterparty within three months of receipt of all the information referred to in paragraph 1.

4. Where a competent authority reaches a positive decision under Articles 11(6), 11(8) or 11(10) of Regulation (EU) No 648/2012, it shall communicate that positive decision to the counterparty in writing, specifying at least the following:

(a) whether the exemption is a full exemption or a partial exemption;

(b) in the case of a partial exemption, a clear identification of the limitations of the exemption.

5. Where a competent authority reaches a negative decision under Articles 11(6), 11(8) or 11(10) of Regulation (EU) No 648/2012 or objects to a notification under Articles 11(7) or 11(9) of that Regulation, it shall communicate that negative decision or objection to the counterparty in writing, specifying at least the following:

(a) the conditions of paragraphs (6), (7), (8), (9) or (10), as applicable, of Articles 11 of Regulation (EU) No 648/2012 that are not fulfilled;

(b) a summary of the reasons for considering that such conditions are not fulfilled.

6. Where one of the competent authorities notified under Article 11(7) of Regulation (EU) No 648/2012 considers that the conditions referred to in points (a) or (b) of the first subparagraph of Article 11(7) of that Regulation are not fulfilled, it shall notify the other competent authority within two months of receipt of the notification.

7. The competent authorities shall notify the non-financial counterparties of the objection referred to in paragraph 5 within three months of receipt of the notification.

8. A decision by a competent authority under Article 11(8) of Regulation (EU) No 648/2012 shall be communicated to the counterparty established in the Union within three months of receipt of all the information referred to in paragraph 1.

9. A decision by the competent authority of a financial counterparty referred to Article 11(10) of Regulation (EU) No 648/2012 shall be communicated to the competent authority of the non-financial counterparty within two months from the receipt of the all the information referred to in paragraph 1 and to the counterparties within three months of receipt of that information.

10. Counterparties that have submitted a notification or received a positive decision according to paragraphs (6), (7), (8), (9) or (10), as applicable, of Article 11 of Regulation (EU) No 648/2012 shall immediately notify the relevant competent authority of any change that may affect the fulfilment of the conditions set out in those paragraphs, as applicable. The competent authority may decide to object to the application for the exemption or to withdraw its decision following any change in circumstance that could affect the fulfilment of those conditions.

11. Where a negative decision or objection is communicated by a competent authority, the relevant counterparty may only submit another application or notification where there has been a material change in the circumstances that formed the basis of the competent authority's decision or objection.

12. The application or notifications referred to in paragraph 1 may be submitted from the following date, whichever is latest:

(a) the date of entry into force of this Regulation;

(b) six months before the date determined pursuant to point (a) of Article 36(3).

SECTION 2
APPLICABLE CRITERIA FOR APPLYING EXEMPTIONS FOR INTRAGROUP DERIVATIVE CONTRACTS

Article 32
Applicable criteria on the legal impediment to the prompt transfer of own funds and repayment of liabilities

A legal impediment to the prompt transfer of own funds or repayment of liabilities between the counterparties as referred to in paragraphs 5 to 10 of Article 11 of Regulation (EU) No 648/2012 shall be deemed to exist where there are current or foreseen restrictions of a legal nature including any of the following:

(a) currency and exchange controls;

(b) a regulatory, administrative, legal or contractual framework that prevents mutual financial support or significantly affects the transfer of funds within the group;

(c) any of the conditions on the early intervention, recovery and resolution as referred to in Directive 2014/59/EU of the European Parliament and of the Council[14] are met, as a result of which the competent authority foresees an impediment to the prompt transfer of own funds or repayment of liabilities;

(d) the existence of minority interests that limit decision-making power within entities that form the group;

(e) the nature of the legal structure of the counterparty, as defined in its statutes, instruments of incorporation and internal rules.

Article 33
Applicable criteria on the practical impediments to the prompt transfer of own funds and repayment of liabilities

A practical impediment to the prompt transfer of own funds or repayment of liabilities between the counterparties as referred to in paragraphs 5 to 10 of Article

14 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council (OJ, L 173, 12.6.2014, p. 190).

11 of Regulation (EU) No 648/2012 shall be deemed to exist where there are current restrictions of a practical nature, including any of the following:

(a) insufficient availability of unencumbered or liquid assets to the relevant counterparty when due;

(b) impediments of an operational nature which effectively delay or prevent such transfers or repayments when due.

Article 34
Calculation of aggregate average notional amount

1. For the purposes of Article 36, the aggregate average notional amount referred to shall be calculated as the average of the total gross notional amount that meets all of the following conditions:

   (a) that are recorded on the last business day of March, April and May of 2016 with respect to counterparties referred to in subparagraph (a) of paragraph 36(3);

   (b) that are recorded on the last business day of March, April and May of the year referred to in each of the points in Article 36(3);

   (c) it includes all the entities of the group;

   (d) it includes all the non-centrally cleared OTC derivative contracts of the group;

   (e) it includes all the intragroup non-centrally cleared OTC derivative contracts of the group, counting each one of them once.

2. For the purpose of this Article, UCITS authorised in accordance with Directive 2009/65/EC, alternative investment funds and investment firms authorised in accordance with Directive 2004/39/EC where acting as portfolio managers shall be considered distinct entities and treated separately, where the following conditions are met:

   (a) the funds are distinct segregated pools of assets for the purposes of the fund's insolvency or bankruptcy;

   (b) the segregated pools of assets are not collateralised, guaranteed or otherwise financially supported by other investment funds or their managers.

Article 35
Counterparties to intragroup OTC derivative contracts

The derogation referred to in paragraph 6 of Article 36 shall only apply where counterparties to a non-centrally cleared OTC derivative contract meet all of the following conditions:

(a) one counterparty is established in a third country and the other counterparty is established in the Union;

(b) the counterparty established in a third country is either a financial counterparty or a non-financial counterparty;

(c) the counterparty established in the Union is one of the following:

(i) a financial counterparty, a non-financial counterparty, a financial holding company, a financial institution or an ancillary services undertaking subject to appropriate prudential requirements and the counterparty referred to in point (a) is a financial counterparty;

(ii) either a financial counterparty or a non-financial counterparty and the counterparty referred to in point (a) is a non-financial counterparty;

(d) both counterparties are included in the same consolidation on a full basis in accordance to Article 3(3) of Regulation (EU) No 648/2012;

(e) both counterparties are subject to appropriate centralised risk evaluation, measurement and control procedures;

(f) the requirements of Sections 1 and 2 of this Chapter are met.

CHAPTER IV
Final provisions

Article 36
Application

1. This Regulation shall apply from one month after the date of its entry into force.

2. However, the following Articles shall apply as follows:

(a) Articles 9(2), 11 ,13 to 18, 19(1)(c)(d) and (f), 19(3) and 20 shall apply in accordance with paragraph 3;

(b) Articles 9(1), 10 and 12, shall apply as follows:

(i) from one month after the date of its entry into force of this Regulation for counterparties both of which have, or belong to groups each of which has, an aggregate average notional amount of non-centrally cleared OTC derivatives above EUR 3 000 billion;

(ii) from the date that is the latest of 1 March 2017 or 1 month following the date of its entry into force of this Regulation for other counterparties.

3. The Articles referred to in point (a) of paragraph 2, shall apply as follows:

(a) from one month after the date of entry into force of this Regulation, where both counterparties have, or belong to groups each of which has, an aggregate average notional amount of non-centrally cleared derivatives that is above EUR 3000 billion;

(b) from 1 September 2017, where both counterparties have, or belong to groups each of which has, an aggregate average notional amount of non-centrally cleared derivatives that is above EUR 2 250 billion;

(c) from 1 September 2018, where both counterparties have, or belong to groups each of which has, an aggregate average notional amount of non-centrally cleared derivatives that is above EUR 1 500 billion;

(d) from 1 September 2019, where both counterparties have, or belong to groups each of which has, an aggregate average notional amount of non-centrally cleared derivatives that is above EUR 750 billion;

(e) from 1 September 2020, where both counterparties have, or belong to groups each of which has, an aggregate average notional amount of non-centrally cleared derivatives that is above EUR 8 billion.

4. By way of derogation from paragraph 2(b) in respect of contracts foreign exchange forwards referred to in point (a) of Article 26, Articles 9(1), 10 and 12 shall apply on one of the following dates, whichever is earlier:

(a) 31 December 2018, where the Regulation referred to in point (b) does not yet apply;

(b) the date of entry into application of the Commission Delegated Regulation referred to in Article 4(2) of Directive 2014/65/EU specifying some technical elements related to the definition of financial instruments with regard to physically settled foreign exchange forwards or the date determined pursuant to paragraph 2(b), whichever is later.

5. By way of derogation from paragraph 2, in respect of all non-centrally OTC derivatives which are single-stock equity options or index options, Articles 9(1) 9(2), 10 to 18, 19(1)(c)(d) and (f), 19(3) and 20, shall apply from 3 years after the date of entry into force of this Regulation.

6. By way of derogation from paragraph 2, where the conditions of Article 35 are met, Articles 9(2), 11 ,13 to 18, 19(1)(c)(d) and (f), 19(3) and 20 shall apply as follows:

(a) 3 years after the date of entry into force of this Regulation where no equivalence decision has been adopted pursuant to Article 13(2) of Regulation (EU) No 648/2012 for the purposes of Article 11(3) of that Regulation in respect of the relevant third country;

(b) the later of the following dates where an equivalence decision has been adopted pursuant to Article 13(2) of Regulation (EU) No 648/2012 for the purposes of Article 11(3) of that Regulation in respect of the relevant third country:

(i) four months after the date of entry into force of the decision adopted pursuant to Article 13(2) of Regulation (EU) No 648/2012 for the purposes of Article 11(3) of that Regulation in respect of the relevant third country;

(ii) the applicable date determined pursuant to paragraph 3.

7. By way of derogation from paragraph 1, where a Union counterparty enters into an OTC derivative contract with an entity of the same group domiciled in the Union or in a third country, the requirements on the exchange of margins set out under paragraph 2 shall take effect on [please insert date: 6 months after the date of entry into force of this Regulation].

Article 37
Entry into force

This Regulation shall enter into force on the twentieth day following that of its publication in the Official Journal of the European Union.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels,

For the Commission
The President
Jean-Claude Juncker

EUROPEAN COMMISSION

Brussels, XXX
[…](2016) XXX draft

ANNEXES 1 to 4

ANNEXES

to the

COMMISSION DELEGATED REGULATION (EU) No .../...

supplementing Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories of the European Parliament and of the Council with regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty

ANNEXES

ANNEX I

Correspondence of Probability of default ('PD') to Credit quality steps for the purposes of Articles 6 and 7

1. An internal rating with a PD equal to or lower than the value in Table 1 shall be associated to the corresponding credit quality step.

Table 1

Credit Quality Step	Probability of default, as defined in Article 4(54) of Regulation (EU) 575/2013 lower than or equal to:
1	0.10%
2	0.25%
3	1%
4	7.5%

ANNEX II
Methodology to adjust the value of collateral for the purposes of Article 21

1. The value of the collateral shall be adjusted as follows:

$$C_{value} = C \cdot (1 - H_C - H_{FX})$$

where:

C = the market value of the collateral;

H_C = the haircut appropriate to the collateral, as calculated under paragraph 2;

H_{FX} = the haircut appropriate to currency mismatch, as calculated under paragraph 6.

2. Counterparties shall apply at least the haircuts provided in the following Tables 2 and 3 to the market value of the collateral:

Table 2
Haircuts for long term credit quality assessments

Credit quality step with which the credit assessment of the debt security is associated	Residual maturity	Haircuts for debt securities issued by entities described in Article 22 (2) (c) to (e) and (h) to (k), in (%)	Haircuts for debt securities issued by entities described in Article 22 (2) (f), (g), (l) to (n) in (%)	Haircuts for securitisation positions meeting the criteria in Article 22 (2) (o) in %
1	≤ 1 year	0.5	1	2
	>1 ≤ 5	2	4	8
	> 5 years	4	8	16
2-3	≤ 1 year	1	2	4
	>1 ≤ 5	3	6	12
	> 5 years	6	12	24
4 or below	≤ 1 year	15	N/A	N/A
	>1 ≤ 5	15	N/A	N/A
	> 5 years	15	N/A	N/A

Table 3
Haircuts for short term credit quality assessments

Credit quality step with which the credit assessment of a short term debt security is associated	Haircuts for debt securities issued by entities described in Article 22(2) (c) and (j) in (%)	Haircuts for debt securities issued by entities described in Article 22(2) (m) in (%)	Haircuts for securitisation positions and meeting the criteria in Article 22(2) (o) in (%)
1	0.5	1	2
2-3 or below	1	2	4

3. Equities in main indices, bonds convertible to equities in main indices and gold shall have a haircut of 15%.
4. For eligible units in UCITS the haircut is the weighted average of the haircuts that would apply to the assets in which the fund is invested.
5. Cash variation margin shall be subject to a haircut of 0%.
6. For the purpose of exchanging variation margin, a haircut of 8% shall apply to all non-cash collaterals posted in a currency other than those agreed in an individual derivative contract, the relevant governing master netting agreement or the relevant credit support annex.
7. For the purpose of exchanging initial margin, a haircut of 8% shall apply to all cash and non-cash collaterals posted in a currency other than the currency in which the payments in case of early termination or default have to be made in accordance with the single derivative contract, the relevant exchange of collateral agreement or the relevant credit support annex ('termination currency'). Each of the counterparties may choose a different termination currency. Where the agreement does not identify a termination currency, the haircut shall apply to the market value of all the assets posted as collateral.

ANNEX III
Own volatility estimates of the haircuts to be applied to the market value of collateral for the purposes of Article 22

1. The calculation of the adjusted value of the collateral shall meet all of the following conditions:

   (a) counterparties shall base the calculation on a 99th percentile, one-tailed confidence interval;

   (b) counterparties shall base the calculation on a liquidation period of at least 10 business days.

   (c) counterparties shall calculate the haircuts by scaling up the daily revaluation haircuts, using the following square-root-of time formula:

   $$H = H_M \cdot \sqrt{\frac{N_R + (T_M - 1)}{T_M}}$$

   where:

   H = the haircut to be applied;

   H_M = the haircut where there is daily revaluation;

   N_R = the actual number of business days between revaluations;

   T_M = the liquidation period for the type of transaction in question.

   (d) counterparties shall take into account the lesser liquidity of low quality assets. They shall adjust the liquidation period upwards in cases where there are doubts concerning the liquidity of the collateral. They shall also identify where historical data may understate potential volatility. Such cases shall be dealt with by means of a stress scenario;

   (e) the length of the historical observation period institutions use for calculating haircuts shall be at least one year. For counterparties that use a weighting scheme or other methods for the historical observation period, the length of the effective observation period shall be at least one year.

   (f) the market value of the collateral shall be adjusted as follows:

   $C_{value} = C \cdot (1 - H)$

   where:

   C = the market value of the collateral;

   H = the haircut as calculated in point (c) above.

2. Cash variation margin may be subject to a haircut of 0%.

3. For debt securities that have a credit assessment from an ECAI, counterparties may use their own volatility estimate for each category of security.

4. In determining relevant categories of securities for the purposes of paragraph 3, counterparties shall take into account the type of issuer of the security, the external credit assessment of the securities, their residual maturity, and their modified duration. Volatility estimates shall be representative of the securities included in the category.

5. The calculation of haircuts resulting from the application of point (c) of paragraph 1 shall meet all of the following conditions:

   (a) a counterparty shall use the volatility estimates in the day-to-day risk management process including in relation to its exposure limits;

   (b) where the liquidation period used by a counterparty is longer than that referred to in point (b) of paragraph 1 for the type of OTC derivative contract in question, that counterparty shall increase its haircuts in accordance with the square root of time formula referred to in point (c) of that paragraph.

ANNEX IV

Standardised Method for the calculation of initial margin for the purposes of Articles 9 and 11

1. The notional amounts or underlying values, as applicable, of the |OTC derivative contracts in a netting set shall be multiplied by the percentages in the following Table 1:

Table 1

Category	Add-on factor
Credit: 0–2 year residual maturity	2%
Credit: 2–5 year residual maturity	5%
Credit 5+ year residual maturity	10%
Commodity	15%
Equity	15%
Foreign exchange	6%
Interest rate and inflation: 0-2 year residual maturity	1%
Interest rate and inflation:: 2-5 year residual maturity	2%
Interest rate and inflation:: 5+ year residual maturity	4%
Other	15%

2. The gross initial margin of a netting set shall be calculated as the sum of the products referred to in paragraph 1 for all OTC derivative contracts in the netting set.

3. The following treatment shall be applied to contracts which fall within more than one category:

(a) where a relevant risk factor for an OTC derivative contract can be clearly identified, contracts shall be assigned to the category corresponding to that risk factor;

(b) where the condition referred to in point (a) is not met, contracts shall be assigned to the category with the highest add-on factor among the relevant categories;

(c) the initial margin requirements for a netting set shall be calculated in accordance with the following formula:

Net initial margin = 0.4 * Gross initial margin + 0.6 * NGR * Gross initial margin.

where:

(i) net initial margin refers to the reduced figure for initial margin requirements for all OTC derivative contracts with a given counterparty included in a netting set;

(ii) NGR refers to the net-to-gross ratio calculated as the quotient of the net replacement cost of a netting set with a given counterparty in the numerator, and the gross replacement cost of that netting set in the denominator;

(d) for the purposes of point (c), the net replacement cost of a netting set shall be the bigger between zero and the sum of current market values of all OTC derivative contracts in the netting set;

(e) for the purposes of point (c), the gross replacement cost of a netting set shall be the sum of the current market values of all OTC derivative contracts calculated in accordance with Article 11(2) of Regulation (EU) No 648/2012 and Articles 16 and 17 of Commission Delegated Regulation No 149/2013 with positive values in the netting set;

(f) the notional amount referred to in paragraph 1 may be calculated by netting the notional amounts of contracts that are of opposite direction and are otherwise identical in all contractual features except their notional amounts.