New EU Rules on Derivatives Trading

Introduction to EMIR for insurers

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Material in this presentation is based on the regulatory and implementing technical standards under the Regulation (EU) No 648/2012 on OTC Derivatives, CCPs and Trade Repositories.

Agenda

1. Introduction
2. Reporting requirement
3. Clearing obligation
4. Risk mitigation for uncleared trades
5. Implementation

Introduction

G20 statement in Pittsburgh:

All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest.

OTC derivative contracts should be reported to trade repositories.

Non-centrally cleared contracts should be subject to higher capital requirements.

Introduction

- **EMIR effects insurers using derivatives**
  - reporting to trade repositories
  - clearing obligations
  - risk mitigation and bilateral collateralisation of uncleared trades
- **The greatest impact is likely to be on:**
  - annuity writers which make use of interest rate swaps
  - with-profits funds which use OTC derivatives to hedge guarantees and options
  - insurers which have defined benefit pension schemes that use OTC derivatives

Introduction

- **The EMIR Regulation came into force on 16 August 2012.**
- **Many provisions only applied after technical standards came into force on 15 March 2013**

- **Technical standards still to be finalised:**
  - Risk mitigation for non cleared trades
  - Contracts with direct substantial and foreseeable effect in the Union or to prevent the evasion of EMIR

Reporting obligation

Reporting obligation

- **All counterparties to all derivatives contracts (OTC and exchange-traded) need to**
  – report, post-trade, contract details to a registered trade repository
  – applies to all trades in the EEA
- **What is a trade repository?**
  – a database to provide transparency
  – examples: DTCC, LSE and Regis-TR for multiple asset classes, ICE Trade Vault for commodities
  – more expected to be set up

What it means for insurers

- **Trade information must be reported to TRs:**
  – contracting parties - type of contract
  – maturity - notional value
  – price - settlement date
- **Insurers are also required to report exposure information daily**
  - Mark to market or model valuations
  - Collateral value and basis (transaction or portfolio)

Timeline for reporting

Credit and interest rate derivatives;
- Reporting starts 90 days after recognition of a relevant TR by ESMA
- ESMA timetable anticipates reporting to begin in September 2013

For all other derivatives;
- If TR is recognised by 1 October - reporting begins 1 January 2014
- If no recognised TRs by 1 October – 90 days after registration

- **Back loading of existing outstanding trades (90 days / 3 years)**

Clearing obligation

Clearing obligation

- **OTC derivatives contracts that ESMA has determined subject to a mandatory clearing obligation must be cleared by a central counterparty (CCP)**
- **What is a CCP?**
  - A CCP stands between the two original counterparties to a contract and guarantees the performance of obligations i.e. removing counterparty risk

What mandatory clearing will apply to

- **A clearing obligation will apply to contracts between any combination of a:**

(A) Financial Counterparty; and

(B) Non Financial Counterparty above the clearing threshold ('NFC+')

- **Mandatory clearing obligations will apply to trades between such firms where:**
  - One or more of the counterparties is in the EU; and
  - In limited circumstances, neither in the EU

How to meet the clearing obligation

- Counterparties may meet the clearing obligation as a direct clearing member, client of a clearing member or indirectly through a clearing member.
- CCPs and clearing members must offer:
  - individual client segregation; and
  - omnibus client segregation
- CCPs may offer other levels of segregation but the minimum level is omnibus segregation.

Next steps / what it means for insurers

- National authorities and ESMA have already started assessing contracts for the clearing obligation
- May use a phased-in approach when implementing the mandatory clearing obligation
- Insurers need to decide whether to set up client clearing arrangements
- Insurers will need to be able to post daily collateral (variation margin) in cash, which may prove challenging.
- First clearing obligations likely during 2014

Risk mitigation for uncleared trades

Risk mitigation for uncleared trades

- **New risk mitigation requirements for uncleared OTC derivative trades**
  - Timely confirmation (15 March 2013)
  - Dispute resolution
  - Reconciliation
  - Portfolio compression

  15 September 2013
- **New margin requirements for counterparties (FC and NFC+) subject to the clearing obligation**
  - Initial and variation margin
  - Daily valuation

Summary: main implications for insurers

- Daily reporting requirements for all derivative transactions
- For cleared trades:
  - Need to decide how to access clearing
  - daily variation margin posted in cash
  - CCPs manage counterparty default procedures
- For non-cleared trades, insurers will need to comply with risk mitigation requirements including bilateral margining

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Summary: What should insurers do next?

- Understand how investment and risk-management processes and objectives may be affected

- Start preparing for operational changes as the requirements come into force

- Consider the impact on any new hedging strategies, rebalancing of existing hedging strategies or new products that involve the use of OTC derivatives

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Implementing EMIR in the UK

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Implementing EMIR in the UK

- EMIR is a regulation, so no transposition required
- FCA has powers of investigation and enforcement, including for non-financials
- FCA is the primary regulatory authority for financial and non financial counterparties under EMIR
- The Prudential Regulatory Authority (PRA) has responsibility for enforcement of margin requirements for PRA regulated firms

Notifications and exemptions

- **Pension Scheme Arrangements:**
  - Pension schemes and pensions business written by insurers may be exempt from clearing for a transitional period
  - Providing time for CCPs to look into accepting non-cash assets as collateral for daily variation margin calls.
  - This exemption only applies to the clearing requirements. Risk mitigation requirements still apply for non-cleared trades.

Notifications and exemptions

Exemption for intragroup transactions from the clearing obligation

- Trades may be exempt from clearing if certain conditions are met, including;
  - both counterparties are included in the same consolidation on a full basis
  - appropriate centralised risk evaluation, measurement and control procedures are in place

Notifications and exemptions

Exemption for intragroup transactions from margin requirements

- Trades may be exempt if certain conditions are met, including;
  - risk management procedures are adequately sound, robust and consistent, with the level of complexity of the contract
  - there are no practical or legal impediments to the prompt transfer of own funds or repayment of liabilities.

Implementation timetable

- **Still subject to a number of dependencies However, current estimates are:**
  - Confirmation requirements: 15 March 2013
  - Reporting requirements: September 2013 for credit and interest rate derivatives; January 2014 for all other classes. (90 days for back-loading)
  - Dispute resolution; portfolio reconciliation and compression: 15 September 2013
  - First clearing obligations: 2014
  - Collateralisation of non-cleared trades – consultation later in 2013

Further information – visit our website

http://www.fca.org.uk/firms/markets/international-markets/emir

- Latest news and events
- FCA Supervisory Approach
- Implementation timetable
- EU Commission and ESMA publications
- Information about notifications
- FCA Handbook changes
- EMIR Updates mailing list

Any questions?