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Risk of margin posting and clearing for securitisation SPVs

On 4 May 2017, the European Commission published a proposal for a Regulation to amend the European Market Infrastructure Regulation (**EMIR**). These proposals could result in securitisation SPVs being required to clear derivative transactions they enter into and to post margin. This would be the case even where the swap counterparty is a senior or super senior secured creditor of the SPV, as is usually the case in securitisations.

A related impact assessment (plus executive summary) and a set of questions and answers on the proposed Regulation have also been published.

Why are the changes of interest to those involved in securitisations?

The main change of significance to the securitisation industry is the proposal to extend the definition of "Financial Counterparty" (FC) in EMIR to include a "securitisation special purpose entity as defined in Article 4(1)(66) of Regulation No 575/2013".

Currently, under EMIR, a SPV is generally classified as non-financial counterparty (**NFC**) and therefore only needs to comply with less stringent requirements under EMIR as long as the notional of its aggregate eligible swap liabilities (ie excluding hedging transactions) falls below the relevant threshold (**an NFC-**). If reclassified as FCs, SPVs would be subject to the clearing and margin requirements unless other exemption was available.

FCs are required to clear any OTC derivative trades that are subject to the clearing obligation through a central counterparty (**CCP**) and to do so they would need to post collateral to the CCP.

Under the margin requirements, certain counterparties are required to post collateral in respect of any trades not cleared by a CCP. Currently, most SPVs are exempt from these requirements by virtue of being an NFC-. If reclassified as FCs, SPVs could therefore be required to post collateral in respect of their derivatives contracts regardless of whether they are used for hedging liabilities.

This will have huge implications for SPV issuers as SPVs will not have eligible collateral available to post and may therefore find themselves unable to hedge mismatches on transactions.

The proposed amendment to EMIR would make certain other changes to the current requirements under EMIR, including the clearing obligation and trade reporting requirements as set out further below.

What about the margin requirements?

Under EMIR, FCs and non-financial counterparties that exceed the clearings threshold in EMIR (**NFC+s**) will be subject to initial and variation margin requirements for uncleared trades. However, participants will only need to exchange initial margin from the relevant phase-in date if it and its counterparty both have, or belong to, groups each of which has an aggregate month-end average notional amount of uncleared derivatives that is above EUR 8 billion. This EUR 8 billion threshold does not apply to the requirement to post variation margin which applies to all FCs and NFC+s.

All uncleared OTC derivatives except physically settled FX swaps and forwards and certain currency swaps are in scope of the initial margin requirements. The variation margin requirements will apply to all uncleared OTC derivatives including physically settled FX swaps and forwards and currency swaps. Given the inconsistent interpretation of FX derivatives across the EU, there is a delayed application of the variation margin requirements to physically settled FX forwards until 31 December 2018 or the date of entry into force on the delegated act under MiFID II which would provide a common definition of FX forwards.

Although most SPVs will not exceed the EUR 8 billion threshold so the initial margin requirements will not apply, they will have to comply with the variation margin requirements.

What is the exemption from clearing for small FCs?

The European Commission has also proposed a new category of "small FC" that would not be subject to the clearing obligation which may be helpful for many smaller SPVs.

In order to benefit from this exemption, an FC would need to calculate annually its aggregate month-end average position of all OTC derivative contracts entered it by it or any other entities within its group for March, April and May. If any of its positions exceed the clearing thresholds set out below, an FC would need to notify the European Securities and Markets Association (**ESMA**) and its competent authority. Conversely, if an FC does not exceed any of the clearing thresholds below, it would not need to comply with the clearing obligation.

Type of derivative contract	**Clearing threshold (gross notional amount)**
OTC credit derivatives	€1 billion
OTC equity derivatives	€1 billion
OTC interest rate derivatives	€3 billion
OTC foreign exchange derivatives	€3 billion
OTC commodity and any other OTC derivatives	€3 billion

If the above clearing thresholds are exceeded, an FC would then need to start clearing its derivative contracts in all asset classes within 4 months. If an FC subsequently demonstrates that its aggregate month-end average position for March, April and May no longer exceeds the clearing thresholds, it would no longer be subject to the clearing obligation and would need to inform ESMA and its competent authority accordingly.

What derivatives could be subject to the clearing obligation?

When considering whether to subject a particular class of OTC derivatives to the clearing obligation under EMIR, ESMA needs to take into account certain criteria in respect of that class, including:

– the degree of standardisation of the commercial terms, such as whether the contractual terms include standard terms commonly used by counterparties;

– the volume and liquidity, including the number and value of transactions and the stability of market size and depth over time; and

– the availability of fair, reliable and generally accepted pricing information.

Many securitisation swaps will therefore fall outside of those classes of derivatives that have been declared subject to the clearing obligation due to the nature of the bespoke terms of the swaps.

Securitisation swaps usually contain legal, economic and structural features that mean that they do not fit within the requirements imposed by CCPs in order to be accepted for clearing. Typically, the terms of securitisations swaps are non-standard. For example, the payments under the swap in a securitisation tend to be tailored to match the various cashflows in the structure and the calculation of any termination payment usually mirrors actual upfront payments made in connection with entering into a replacement swap with a new swap counterparty rather than the market standard close-out calculation. The limited recourse nature of a securitisation transaction also makes securitisation swaps unsuitable for clearing. In respect of rated transactions, credit rating agencies would need to analyse the risks and impact of a CCP default on the securitisation and, given that it is usually not possible to change CCP rules, the securitisation may encounter difficulties in meeting the credit rating agencies' requirements.

Will simple, transparent and standardised (STS) securitisations benefit from any relief?

The Capital Markets Union Action plan proposed high level amendments which contemplated relief to EMIR for simple, transparent and standardised (**STS**) securitisations and covered bond swaps. However, there has been little further concrete detail on this since then. It is thought that there is some appetite for aligning the treatment of derivatives used for hedging purposes associated with STS and covered bonds such that they may benefit from an exemption. The STS regulation is currently progressing through trilogue negotiations between the European Commission, European Council and European Parliament so there may be more clarity on this once these discussions have concluded.

What are the other proposed changes?

There are also proposals to streamline the reporting obligation. NFC-s would no longer need to report their trades themselves but instead they could automatically delegate the reporting to their FC counterparty and FCs would be responsible for reporting on behalf of both counterparties. Trade repositories will need to allow counterparties that delegate reporting to another entity to view the data that was reported on their behalf. In addition, NFCs would also no longer need to report their intragroup trades. The requirement (known as the "blackloading requirement") to report derivative transactions entered into before 12 February 2014 but no longer outstanding on that date will be removed.

In terms of clearing, NFC+s would only have to clear products subject to mandatory clearing in the asset class(es) in which they exceed the clearing threshold and not in all asset classes, as in the current regime. The frontloading requirement, where certain counterparties are required to clear in advance, will be removed and the European Commission will have new powers to suspend the clearing obligation for a specific class of OTC derivatives or a specific type of counterparty, for reasons of financial stability, lack of availability of clearing houses or because the particular class of OTC derivatives is no longer suitable for clearing.

Next steps

The proposed amendments to EMIR will now be discussed and amended by the European Parliament and Council, with agreement likely in 2018 at the earliest.

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