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Transaction Services Newsletter

Is the Fog Clearing?

Even though Summer is nearly here, its still pretty murky in the land of clearing notwithstanding a further attempt by the EU Presidency at reaching some sort of consensus on the new clearing requirements for derivatives trades. The proposed "Regulation on derivative transactions, central counterparties and trade repositories" - formerly known as EMIR, is still far from settled.

What will we need to do?

The basic requirement is that standard derivatives contracts which have been accepted for clearing by a CCP must be cleared on that CCP. The types of derivatives which must be cleared and the CCPs authorised to clear them will be listed in registers maintained by ESMA.

When will we need to do it?

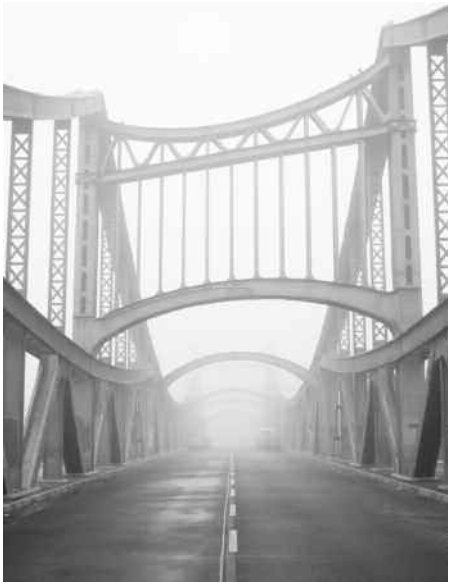
The requirement is triggered when an EU financial counterparty (basically any financial entity that's authorised under a Directive) or an EU corporate which does enough speculative derivatives trading to exceed a specified "clearing threshold" (let's call these qualifying corporates) deals with another financial counterparty or qualifying corporate. The requirement also applies to these entities if they deal with a third country counterparty which would be a financial counterparty or qualifying corporate if it were established in the EU. Looking at it the other way round, there will be *no* requirement on *anyone* to clear trades if their counterparty is neither a financial counterparty or a qualifying corporate. Unfortunately this does not mean that these uncleared trades can enjoy unbroken sunshine far away from the EMIR mists - as we will see later.

On a practical level, a couple of questions spring to mind for financial counterparties and qualifying corporates…. The obligation is on these parties to ensure that an eligible trade is actually cleared. How easy will it be to work out whether or not a counterparty has exceeded the clearing threshold? This may be particularly troublesome with counterparties trading from third country locations. And, to what extent might there be an expectation that the financial counterparty or qualifying corporate conduct some degree of due diligence to ensure that the clearing obligation has not been triggered?

Uncleared trades - unclear

Even if your trades do not qualify for mandatory clearing, EMIR will still rain on your parade. For *all* uncleared derivative trades you will have to apply "risk mitigation techniques" which vary depending on who the counterparties are. Everyone, whether or not regulated, will have to have in place procedures to measure, monitor and mitigate operational credit risk – including timely confirmation of terms; auditable processes for portfolio reconciliation marking to market and contract valuation, dispute resolution, and collateral management. However, if the trade involves a financial counterparty or a qualifying corporate, the trade must also be marked-to-market daily and backed by collateral. Financial counterparties will additionally have to hold appropriate capital. We will have to wait until Level 2 for confirmation of the levels of collateral and capital that will be required. The Capital rules are currently set out in the revisions (paragraphs 103-104 of Basel III) of the Basel II rules on counterparty exposures on derivatives.

Some limited shelter from the risk mitigation obligations is provided by a proposed group exemption. On the upside, the exemption applies to both the clearing obligation and the risk mitigation techniques. However, the group exemption will only apply if the



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counterparty is incorporated in the EU or another jurisdiction with equivalent clearing obligations, and for financial counterparties there are additional conditions to be met.

Risk of collateral drought

It has not escaped anyone's notice that the clearing requirement – triggering calls for initial and variation margin by the CCPs, coupled with the risk mitigation rules - demanding collateral calls for uncleared trades, will put a squeeze on the availability of the good quality collateral required for these purposes. Add to the mix the liquidity coverage rules to be imposed on financial institutions under Basel III and we may well be looking at a drought of 1976 proportions.

The US climate

Similar clearing obligations will come into effect in the US under the Dodd-Frank Act - counterparties will have to clear trades on designated US CCPs. This poses some conundrums where we have trades between US and EU counterparties – one subject to Dodd-Frank; the other, EMIR. Storm clouds are brewing and thunder is forecast from the clash of these opposing regimes.

How the US will react to any perceived EU liberalism in the area of derivatives clearing and trading is one to watch. There seems to be some flexing of muscle from the US tying-in the jurisdictional reach of Dodd-Frank to how EMIR comes out on certain issues – such as real time reporting, swap execution facility rules etc. The suggestion is very much: the weaker the EU on these areas; the longer the arm of Dodd-Frank. Beware EU branches and subsidiaries of US parents!

Other weather systems on the horizon

EMIR is not the only regulation affecting derivatives trading. The proposals for MiFID 2 also include some key changes. There are proposals to:

- apply pre- and post-trade transparency requirements and transaction reporting to derivatives trades
- make it compulsory to trade derivatives on a regulated market, MTF or organised trading facility if the derivatives are eligible for clearing under EMIR and sufficiently liquid
- give regulators power to ban certain trades if they believe a derivative should be cleared on systemic grounds, but no CCP is offering to clear them
- give regulators power to intervene in the life of a derivative and impose position limits.

Long term forecast

One of the most frustrating things about EMIR at the moment is that there are still some major points which are not yet clear. This is seriously impeding business planning and the quality of advice institutions can give to their clients. Some of the areas still under negotiation are:

- **Scope** – still not clear whether the clearing obligation will apply only to OTC derivatives, or also to on-exchange trades. Also, it is not clear what types of derivatives might be caught - will foreign exchange be in or out?
- **Qualifying corporates** – we will have to wait until Level 2 to find out what the clearing threshold will be.
- **Margin and collateral requirements** – again, Level 2 will confirm the levels of collateral and capital needed to meet the requirements for uncleared trades.

Rising barometer for clearing services providers?

Given that so much remains to be sorted out, the position for transaction services providers contemplating offering OTC derivatives clearing services still looks enveloped in late-spring haze.

In the first place, there will be plenty of financial counterparties and a fair few qualifying corporates who will need to clear their trades. Others, who can escape the obligation to clear, will still have to use the risk mitigation techniques, which may require dealers or corporate to seek services externally in order to meet their obligations.

This looks like a good business opportunity for transaction services firms. However, we have to look at the impact on the clearing firm as well as the dealer, bearing in mind that the clearing firm will typically become liable as principal on the trade. Here, the capital rules will bite, as the firm will be exposed to both the client and the CCP – and under Basel III, exposures to CCP will no longer be zero-risk-weighted. And managing stocks of liquid assets, providing margin facilities for clients, and handling the data required for compliance all come with some cost and risk. Clearing firms will need to start weatherproofing their houses soon.

EMIR 27 May Council Compromise text
http://register.consilium.europa.eu/pdf/en/11/st10/st10811.en11.pdf

Basel Committee paper on capital for derivatives
http://www.bis.org/publ/bcbs189.pdf

Basel Committee proposals on exposures to CCPs
http://www.bis.org/publ/bcbs190.pdf

Market Developments

Securities services

1. On Core

The Bank for International Settlements' Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions have issued a consultative report on "Principles for financial market infrastructures". Once settled, this will form the re-vamped soft-law rulebook for all CSDs, CCPs, Payment Systems and Trade Repositories, replacing the existing Recommendations for CSDs and CCPs and the ten-year-old Core Principles for Systemically Important Payment Systems. Whether a single rulebook for such a wide range of infrastructures is workable is a core question. The consultation period ends on 29 July.

CPSS-IOSCO consultative report:
http://www.iosco.org/library/pubdocs/pdf/IOSCOPD350.pdf

2. Client Assets

The subject of client assets just won't go away. Or, to put it another way, if you are a Lehman client and you have still not yet got back your client assets, they just stay where they are. This, frankly, is not good enough. The International Organization of Securities Commissions has written a learned report on the problems with client asset regimes in 16 countries. None gets a clean report. Expect changes.

IOSCO report:
http://www.iosco.org/library/pubdocs/pdf/IOSCOPD351.pdf

3. Is Geneva part of Europe?

The Geneva Securities Convention is a proposed global measure to create some harmony on the question of what you actually get if you hold securities by means of a credit entry on someone's books. The European Union's response to Geneva is a Securities Law Directive, and earlier this year the European Commission held a consultation on what a possible directive might contain. The Commission has now published a summary of the consultation responses. Unsurprisingly, respondents from different legal traditions hold rather different views.

Summary of Responses:
http://ec.europa.eu/internal_market/consultations/docs/2010/securities/extended_summary_responses_en.pdf

Cash management and payments

1. Sound FX

The Basel Committee on Banking Supervision and the Committee on Payment and Settlement Systems are making a noise. They are going to revise their guidance for managing settlement risk in foreign exchange transactions, with the goal of ensuring that financial institutions adequately control their foreign exchange settlement exposures. The previous BCBS guidance pre-dates the success of CLS. Users of CLS, and providers of third-party CLS services, may discover that there are unexpected risks which they need to consider.

CPSS press announcement:
http://www.bis.org/press/p110317.htm

2. On-line gambling

America exports its regulatory ideas to Europe. You all know about the US Unlawful Internet Gambling Enforcement Act, which can impose policing duties on payment service providers. Europe doesn't want to be left behind, and in the European Commission's consultation on the subject of internet gambling there is a chapter of suggestions on prevention of fraud, money laundering and crime. Bankers, who are themselves accused of operating casinos, may have to switch sides.

Commission consultation:
http://ec.europa.eu/internal_market/consultations/docs/2011/online_gambling/com2011_128_en.pdf

3. Atomic money – waves and particles

Electronic, anyway. EMD2 (the new Electronic Money Directive) had to be transposed into Member State law by 30 April. So the UK's Financial Services Authority has issued an "approach document" which explains what it thinks will be subject to regulation under the new regime. The subject is negatively charged, because it is not always clear where the Payment Services Directive stops and the EMD begins. The FSA is also consulting on a revised version of its approach document on the PSD. And, on the subject of waves rather than particles, the European Payments Council has issued a paper on contactless card payments in SEPA.

Second Electronic Money Directive:
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:267:0007:0017:EN:PDF

FSA approach document on EMD2:
http://www.fsa.gov.uk/pubs/international/approach_emoney.pdf

FSA document on PSD:
http://www.fsa.gov.uk/pubs/other/psd_approach_february_2011_review.pdf

EPC paper:
http://www.europeanpaymentscouncil.eu/knowledge_bank_download.cfm?file=EPC178-10 Draft Mobile Contactless SEPA Card Payments Interoperability IG.pdf

4. No end of debate on SEPA

The European Payments Council has also weighed in on the European Commission's proposals to bring about a transition to the SEPA schemes for credit transfers and direct debit. The problem is not the idea itself, but the way the Commission proposes to go about it. In particular, the EPC does not like the extent to which details of the schemes are set into legislative concrete, or the proposals for regulating inter-bank charges for direct debit collections.

EPC paper:
http://www.europeanpaymentscouncil.eu/knowledge_bank_download.cfm?file=EPC468-10%20v%202.0%20AN%20UPDATE%20-%20Executive%20Summary-EPC%20Comments%20on%20SEPA%20Regulation.pdf

5. Now check this out

The UK's payment service providers have been trying to get rid of cheques. But they just don't want to check out. The UK Parliament's influential Treasury Committee has re-opened an enquiry into the future of cheques: in other words, politicians get lots of complaints from voters who still love cheques. The UK's Payments Council, the stakeholder body responsible for UK payments policy-making, including phasing-out of cheques, is also to be checked up on. The Payments Council itself is consulting on the future direction of payments policy in the UK.

Press release:
http://www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/news/new-inquiry-the-future-of-cheques/

Payments Council consultation:
http://www.paymentscouncil.org.uk/files/payments_files/2011_review_consultation_final.pdf

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