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

of **XXX**

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

(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.

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(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 repositories¹, and in particular the third subparagraph of Article 11(15) thereof,

Whereas:

- (1) Counterparties have an obligation to protect themselves against credit exposures to derivatives counterparties by collecting margins. This Regulation lays out the standards for the timely, accurate and appropriately segregated exchange of collateral. These standards apply on a mandatory basis only to the portion of collateral that counterparties are required by this Regulation to collect or post. However, counterparties which agree to collecting or posting collateral beyond the requirements of this Regulation should be able to choose to have such collateral to be covered by these standards or not.
- (2) Over-the-counter derivatives (OTC derivative contracts) entered into by clients or indirect clients cleared by a central counterparty (CCP) may be cleared through a clearing member intermediary or through an indirect clearing arrangement. Under the indirect clearing arrangement, the client or the indirect client posts the margins directly to the CCP, or to the party that is between the client or indirect client and the CCP. Indirectly cleared OTC derivative contracts are considered as centrally cleared and are therefore not subject to the risk management procedures set out in this Regulation.
- (3) 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 with such entities. It is therefore appropriate to allow counterparties to determine whether or not the level of counterparty credit risk posed by a non-financial counterparty that is below that clearing threshold needs to be mitigated through the exchange of collateral. When taking this decision, the counterparty credit risk resulting from the transactions with the non-financial counterparty should be taken into account together with the size and nature of the OTC derivative contracts. Given that non-financial entities established in a third country that would be below the clearing

¹ OJ L 201, 27.7.2012, p.1.

threshold if established in the Union can be assumed to have the same risk profile 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.

- (4) A CCP may enter into non-centrally cleared OTC derivative contracts in the context of customer position management upon the insolvency of a clearing member. These trades are subject to requirements on the part of the CCP as referred to in point 2 of Annex II of Delegated Regulation (EU) No 153/2013² and are reviewed by the competent authorities. These non-centrally cleared OTC derivative contracts are an important component of a robust and efficient risk management processes for a CCP. The additional liquidity needs that those trades could trigger, were they covered by regulatory margin requirements, would fall under the responsibility of the CCP. As this would potentially increase systemic risk, instead of mitigating it, the risk management procedures set out in this Regulation should not apply to such trades.
- (5) Counterparties of 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 expected 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.
- (6) Initial margins cover current and potential future exposure due to the default of the other counterparty and variation margins reflect the daily mark-to-market of outstanding contracts. For OTC derivative contracts that imply 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 if the counterparty paying the premium defaults. Also, the daily mark-to-market is already covered by the premium paid. Therefore, where the netting set consists solely of such option positions, the option seller should be able to choose not to collect additional initial or variation margins for these types of OTC derivatives, whereas the option buyer should collect both initial and variation margins as long as the option seller is not exposed to any credit risk.
- (7) While dispute resolution processes contained in bilateral agreements between counterparties are useful for minimising the length and frequency of disputes, counterparties should, at a first stage, 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 OTC derivative contracts are collateralised in accordance with this Regulation. However, both parties should make all necessary and appropriate efforts, including timely initiation of dispute resolution protocols, to resolve the dispute and exchange any required margin in a timely fashion.
- (8) In order to guarantee a level playing field across jurisdictions, where a counterparty established in the Union enters into a OTC derivative contract with a counterparty that

² Commission Delegated Regulation (EU) No 153/2013, of 19 December 2012, supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on requirements for central counterparties (OJ L 52, 23.2.2013, p.41).

is established in a third country and would be subject to the requirements of this Regulation if it was established in the Union, initial and variation margins should be exchanged in both directions. Counterparties should remain subject to the obligation of assessing the legal enforceability of the bilateral agreements and the effectiveness of the segregation agreements. When such assessments highlight that the agreements might not be in compliance with this Regulation, counterparties established in the Union should identify alternative processes to post collateral, such as relying on third-party banks or custodians domiciled in jurisdictions where the requirements in this Regulation can be guaranteed.

- (9) 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.
- (10) For operational reasons, it might in some cases be more appropriate 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 two 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. However, recalibration of the minimum transfer amount should be frequent enough to maintain its effectiveness.
- (11) The scope of products subject to the proposed margin requirements is not consistent across the Union and other major jurisdictions. Where this Regulation require that only OTC derivative contracts governed by Regulation (EU) No 648/2012 are included in the margin calculations for cross-border netting sets, the two counterparties would have to double the calculations to take into account different definitions or different scope of products of the margin requirements. Furthermore, this would likely increase the risk of disputes. 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 regulation in one or the other jurisdiction would facilitate the process of margin collection. This approach is consistent with the systemic risk-reduction goal of this Regulation, since all regulated products will be subject to the margin requirements.
- (12) Counterparties may choose to collect initial margins in cash, in which case the collateral should not be subject to any haircut. 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.
- (13) 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 below which two counterparties are not required to exchange initial margin that is exactly the same as in the BCBS-IOSCO framework. 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.

- (14) 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. 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. This approach is consistent with the BCBS-IOSCO framework.
- (15) With regard to initial margin, the requirements of this Regulation will likely 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 will represent a significant change in market practice and will present certain operational and logistical 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. Further, counterparties that are above this threshold and therefore subject, *prima facie*, to the initial margin requirements should have the option of not collecting initial margin for an amount of up to EUR 50 million, calculated at group level, and an amount of up to EUR 10 million, calculated at intragroup level. The aggregated gross notional amount of outstanding OTC derivative contracts should be used as the measure given that it is an appropriate benchmark, or at least an acceptable proxy, for measuring the size and complexity of a portfolio of non-centrally cleared OTC derivatives. It is also a benchmark that is easy to monitor and report. These thresholds are also in line with the BCBS-IOSCO framework for non-centrally cleared OTC derivatives.
- (16) Exposures arising from either 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 such as physically-settled foreign exchange swaps and forwards, cross currency swaps, swaps associated to covered bonds for hedging purposes and derivatives entered into with exempted counterparties or with respect to

exempted intragroup transactions 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.

- (17) It is appropriate to set out in this Regulation special risk management procedures for certain types of products that show particular risk profiles. The exchange of variation margin without initial margin should, consistently with the BCBS-IOSCO framework, be considered an appropriate exchange of collateral for physically-settled foreign exchange products. Similarly, as cross-currency swaps can be decomposed in a sequence of foreign exchange forwards, only the interest rate component should be covered by initial margin.
- (18) The Commission Delegated Act referred to in Article 4(2) of Directive 2014/65/EU introduce a harmonised definition of physically-settled foreign exchange forwards within the Union. At this juncture, 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 entry into force of that 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.
- (19) In order to ensure a level playing field for Union counterparties on a global level, in order to avoid market fragmentation, 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 aligned to international practices. This can be achieved by a delayed implementation of the requirements concerning the margin exchange given there is no international alignment on the margins for those types of options.
- (20) Recital 24 of Regulation (EU) No 648/2012 states that this Regulation should take into account 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 includes the case where the relevant OTC derivative contracts are only used for hedging purposes and where a regulatory overcollateralization is required. This should allow for some flexibility for covered bonds issuers or cover pools while ensuring that the risks for their counterparties are limited.
- (21) 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. 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. 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.

- (22) Counterparties should always assess the legal enforceability of their netting and segregation agreements. Where, because of the legal framework of a third country, these assessments turn out to be negative ('non-netting jurisdictions'), it can happen that counterparties have to 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 those non-netting jurisdictions without exchanging initial or variation margins. Where the counterparties have the possibility to collect margins and it is ensured that for the collected collateral, as opposed to the posted collateral, the provisions of this Regulation can be met, Union counterparties should always be required to collect collateral. Exposures from those contracts that are not covered by any exchange of margin because of the legal impediments in non-netting 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. The 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 would create the possibility to circumvent the provisions of this Regulation, the limit should be set at a very low level. These treatments would be considered sufficiently prudent, because there are also other risk mitigation techniques as an alternative to margins. For example, credit institutions usually have to hold capital for cross border OTC derivative contracts with counterparties in non-netting jurisdictions on a gross basis because the netting arrangements are not legally enforceable and therefore not recognised for regulatory purposes.
- (23) In case that collateral cannot be liquidated immediately after default, it is necessary 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, which is known as '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 Council³. 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. Normally, both initial and variation margin are exchanged no later than the end of the following business day. An extension of the time for the exchange of variation margin could be compensated by an adequate rescaling of the MPOR. Therefore, taking into account possible operational issues, it should be allowed to extend the time for the exchange of variation margin where such an extension is included in the rescaling of the MPOR. Alternatively, where no initial margin requirements apply an extension is allowed if an appropriate amount of additional variation margin has been collected.
- (24) When developing initial margin models and when estimating the appropriate MPOR, counterparties should take into account the need to have models that capture the

³ 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).

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 solve disputes. Therefore counterparties should be allowed to calibrate the model and estimate 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 initial margin, and that the initial margin requirements are not symmetrical.

- (25) 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 allow counterparties to have enough time to comply with margin calls resulting from the recalibration.
- (26) Collateral should be considered as being freely transferable in the case of a default of the collateral provider if there are no regulatory or legal constraints or third party claims, including those of the third party custodian. However, certain claims, such as costs and expenses incurred for the transfer of the collateral, in the form of liens routinely imposed on all securities' transfer should not be considered an impediment. Otherwise it would lead to a situation where an impediment would always be identified.
- (27) The collecting counterparty should have the operational capability to appropriate and, where necessary, to liquidate the collateral in the case of a default of the collateral provider. 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 be a pre-requisite for the collateral taker to enable it to either sell the collateral or repo it within a reasonable amount of time. This capability should be independent of the collateral provider and should therefore include having broker arrangements and repo arrangements with other counterparties or comparable measures.
- (28) Collateral collected must be of sufficiently high liquidity and credit quality to allow the collecting counterparty to liquidate the positions without significant price changes 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. These 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.
- (29) 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 particular, counterparties should ensure that the collateral collected is reasonably diversified in terms of individual issuers, issuer types and asset classes.
- (30) The impact on financial stability of collateral liquidation by non-systemically important counterparties may be expected 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. 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 and that should include 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/EU⁴ 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 the existing classifications of systemically important institutions but which should nonetheless be subject to concentration limits because of the size of their OTC derivative portfolio. Recital (26) of the EMIR suggests that counterparties such as pension scheme arrangement should be subject to the bilateral collateralisation requirements; the same recital, however, recognises the need to avoid excessive burden from such requirements on the retirement income of future pensioners. Therefore it would be disproportionate to require those counterparties to apply the requirements to monitor the concentration limits in the same manner as for other counterparties. Consequently, it is appropriate to provide that the monitoring of such exposures is carried out on a less frequent basis than for other counterparties, provided that the exposures of such counterparties remain significantly below the level where the concentration limits start applying. For the same reasons, where this condition is only temporarily not met it is appropriate to provide the possibility for those counterparties to return to the monitoring of such exposures on a less frequent basis.

- (31) In order to limit the effects of the interconnectedness between financial institutions that may arise from non-centrally cleared derivative contracts, different concentration limits should apply to the different classes of debt securities issued by the financial sector. Therefore, stricter diversification requirements should be set out for debt securities issued by institutions and used as collateral for initial margin purposes. On the one hand, the difficulties in segregating cash collateral should be acknowledged by allowing participants to post a limited amount of initial margin in the form of cash and by allowing custodians to reinvest this cash collateral in accordance with the relevant rules on custody services. On the other hand, 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 relying in more than one custodian.
- (32) The value of collateral should not exhibit a significant correlation with the creditworthiness of the collateral provider or the value of the underlying non-centrally

⁴ 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).

cleared derivatives portfolio, since this would undermine the effectiveness of the protection offered by the collateral collected. Accordingly, securities issued by the collateral provider or its related entities should not be accepted as collateral. Counterparties should be required to monitor that collateral collected is not subject to more general forms of wrong way risk.

- (33) It should be possible to liquidate assets collected as collateral for initial or variation margin in a sufficiently short time in order to protect collecting counterparties from 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.
- (34) In order to ensure 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 provide an operational framework for efficient calculation, notification and finalisation of margin calls can lead to disputes and fails 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 standards 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.
- (35) Trading relationship documentation should be produced by counterparties entering into multiple OTC derivative contracts in order to provide legal certainty. As a result, the trading relationship documentation should include all material rights and obligations of the counterparties applicable to non-centrally cleared OTC derivative contracts. Where parties enter into a single, one-off OTC derivative contract, the trading relationship documentation could take the form of a trade confirmation that includes all material rights and obligations of the counterparties.
- (36) 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 collateral collected does not increase the risk 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.
- (37) The re-hypothecation, re-pledge or re-use of collateral collected as initial margins would create new risks 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 taker 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.
- (38) Given the difficulties in segregating cash, the current practices on the exchange of cash collateral in certain jurisdictions and the need of relying 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. Credit institutions that are not able to segregate cash collateral should be allowed to reinvest cash deposited as initial margin.

- (39) When a counterparty notifies the relevant competent authority regarding 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.
- (40) 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. 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, which are consistent with the complexity of the intragroup transactions.
- (41) In order to 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.
- (42) 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, and where appropriate segregate, variation and 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 completing the process to produce the equivalence determination, while not requiring an inefficient allocation of resources to the groups with subsidiaries domiciled in third-countries.
- (43) 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 achieve international consistency and minimise possibilities of regulatory arbitrage with the view to avoiding economic disruptions, a phase-in period of the requirements is necessary. The phase-in period for the requirements introduced in this Regulation are consistent with the schedule agreed in the BCBS-IOSCO framework.

- (44) 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.
- (45) This Regulation is based on the draft regulatory technical standards submitted by the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority to the Commission.
- (46) 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 1093/2010⁵, 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 1094/2010⁶, and the Securities and Markets Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1095/2010⁷,

HAS ADOPTED THIS REGULATION:

Chapter I

Counterparties' Risk Management Procedures required for compliance with paragraph 3 of Article 11 of Regulation (EU) No 648/2012

SECTION 1

RISK MANAGEMENT PROCEDURES

Article 1

General requirements

1. The risk management procedures required for compliance with Article 11(3) of Regulation (EU) No 648/2012 (the 'risk management procedures') shall apply to financial counterparties within the meaning of Article 2(8) of Regulation (EU) No 648/2012 and non-financial counterparties referred to in Article 10 of Regulation (EU) No 648/2012 (the 'counterparties').
2. 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

⁵ 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).

⁶ 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).

⁷ 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).

(‘OTC’) derivative contracts that were subject to the requirements of this Regulation at the contract’s inception date.

3. The risk management procedures shall provide for all of the following, unless otherwise provided in Articles 2, 3 and 4:
 - (a) the collection of collateral as initial margin, in accordance with Article 14, without the possibility of offsetting the initial margin amounts between the two counterparties;
 - (b) the collection of collateral as variation margin in accordance with Article 13;
 - (c) the *ex-ante* agreement between the counterparties on a list of eligible collateral fulfilling the requirements of Article 22.
4. For the purposes of this Regulation, initial margin means the collateral collected by a counterparty to cover its current and potential future exposure in the interval between the last margin exchange and the liquidation of positions following a default of the other counterparty or hedging the risk.
5. For the purposes of this Regulation, variation margin means the collateral collected to reflect the results of the daily marking-to-market of outstanding contracts referred to in Article 11(2) of Regulation (EU) No 648/2012.
6. The collateral referred to in points (a) and (b) of paragraph 3 shall meet the eligibility criteria referred to in Section 5, and shall be adjusted according to the modalities referred to in Articles 28 and 29 of that Section.

SECTION 2

RISK MANAGEMENT PROCEDURES FOR SPECIFIC CASES ARTICLE 2

Subsection 1

Potential exemptions from the requirement to collect collateral

Article 2

Non-financial counterparties

The risk management procedures may provide that no collateral is exchanged in relation to transactions with non-financial counterparties other than those referred to in Article 10 of Regulation (EU) No 648/2012, or with non-financial entities established in a third country that would be considered non-financial counterparties other than those referred to in Article 10 of Regulation (EU) No 648/2012 if they were established in the Union.

Article 3

Transactions with third country counterparties

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.

Article 4
Minimum transfer amount

1. The risk management procedures may provide that no collateral is collected from a single counterparty where the amount due from the last collection of collateral is equal to or lower than a certain amount to be agreed by the counterparties ('minimum transfer amount') and which cannot be greater than EUR 500 000 or the equivalent amount in another currency.
2. Where counterparties agree on a minimum transfer amount, the amount due shall be calculated as the sum of:
 - (a) the variation margin due from its last collection calculated in accordance with Article 13;
 - (b) the initial margin due from its last collection calculated in accordance with Article 14;
 - (c) any excess collateral that may have been provided to or returned by both counterparties.
3. Counterparties may agree on separate minimum transfer amounts for initial and variation margins, provided that the sum of those two minimum transfer amounts is equal to or lower than the amount set out in paragraph 1.
4. Where the amount of collateral due to the collecting counterparty 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. Counterparties that agree to separate the minimum transfer amount in accordance with paragraph 3 shall collect the full amount of initial or variation margin due, without any deduction where it exceeds the minimum transfer amount for initial or variation margin, respectively.

Article 5
Margin calculation with third country counterparties

1. Where a counterparty is domiciled in a third country using a definition of OTC derivative contracts that is different from that of Regulation (EU) No 648/2012, counterparties shall calculate margins for all contracts that meet either definition of an OTC derivative contract, provided that the counterparty domiciled in the third country is subject to margin requirements for those contracts which are considered as OTC derivative contracts under the third country regulatory regime.
2. For the purposes of calculation of the margins, where a netting agreement is in place between two counterparties, one of which is domiciled in a third country, that agreement has to meet the same conditions as if both counterparties were domiciled in the EU.

Article 6
Treatment of OTC derivative contracts in the context of a CCP's position management upon the insolvency of a clearing member

Where a central counterparty (CCP) is an authorised credit institution and therefore qualifies as a financial counterparty in accordance with Article 2(8) of Regulation (EU) No 648/2012, the risk management procedures may provide that no initial margin or variation margin is

collected in relation to the OTC derivative contracts referred to in Annex II, paragraph 2 of Commission Delegated Regulation (EU) No 153/2013.

Subsection 2
Potential exemptions in calculating levels of initial margin

Article 7
Foreign exchange contracts

1. The risk management procedures may provide 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 at the inception 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 at the inception 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 at the inception of the contract covering the exchange ('foreign exchange swaps');
 - (c) the exchange of principal of an OTC derivative contract by which the two counterparties solely exchange the principal and any interest payments in one currency, for the principal and any interest payments in another currency, at specified points in time according to a specified formula ('currency swap').

Article 8
Threshold based on notional amount

1. The risk management procedures may provide that initial margins are not collected for all new contracts from January of each calendar year where one of the two counterparties has at entity level an aggregate month-end average notional amount or belongs to a group which has an aggregate month-end average notional amount of non-centrally cleared derivatives for the months March, April and May of the preceding year below EUR 8 billion.
2. Both of the following shall be included in the calculation of the group aggregate month-end average notional amount:
 - (a) all non-centrally cleared OTC derivative contracts of the group;
 - (b) all intragroup non-centrally cleared OTC derivative contracts of the group, taken into account only once.
3. Investment funds may be considered distinct entities and treated separately when applying the thresholds referred to in paragraph 1, only where the funds are distinct segregated pools of assets for the purposes of the fund's insolvency or bankruptcy that are not collateralised, guaranteed or supported by other investment funds or the investment managers.

Article 9
Threshold based on initial margin amount

1. The risk management procedures may provide that a counterparty is not required to collect initial margins where:
 - (a) neither counterparty belongs to any group and the sum of all initial margins required to be collected by that 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 is equal to or lower than EUR 10 million.
2. Where a counterparty applies one of the thresholds referred to in paragraph 1, all of the following shall apply:
 - (a) the counterparty applying the threshold referred to in paragraph 1 may reduce the amount of initial margin collected by the value of the threshold;
 - (b) the risk management procedures of the group applying the threshold referred to in paragraph 1(b) shall determine how to allocate the received initial margin amongst the relevant entities within the group;
 - (c) the risk management procedures of the group applying the threshold referred to in paragraph 1(b) shall include provisions on monitoring, at group level, whether the threshold is exceeded and provisions on the maintenance of appropriate records of the group's exposures to each single counterparty in the same group.
3. Investment funds may be considered distinct entities and treated separately when applying the thresholds referred to in paragraph 1, only where the funds are distinct pools of assets for the purposes of the fund's insolvency or bankruptcy that are not collateralised, guaranteed or supported by other investment funds or the investment managers.

Subsection 3

Potential exemptions from the requirement to post or collect initial or variation margin

Article 10

Treatment of derivatives associated to covered bonds for hedging purposes

1. Subject to the conditions set out in paragraph 3, the risk management procedures relating to derivatives associated to covered bonds may specify the following:
 - (a) that variation margin is not posted by the covered bond issuer or cover pool;
 - (b) that initial margin is not posted or not collected or neither.
2. The covered bond issuer or cover pool shall collect variation margin, in cash and shall return the collected amount where it is no longer due.
3. 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 contract ranks at least *pari passu* with the covered bond holders. A more junior ranking of the counterparty to the OTC derivative contract concluded with covered bond issuers or with cover pools for covered bonds is permitted only where the counterparty 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 as defined in Article 272(4) of Regulation (EU) 575/2013 ('netting set') does not include OTC derivative contracts unrelated to the cover pool of the covered bond;
- (f) the covered bond to which the derivatives are 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 11

Treatment of derivatives with counterparties in jurisdictions where legal enforceability of netting agreements or collateral protection may not be ensured

1. Where a counterparty concludes OTC derivative contracts with counterparties domiciled in the third-country jurisdictions meeting the conditions of paragraph 4, that counterparty does not need to post any variation or initial margin for those contracts.
2. Where a counterparty concludes OTC derivative contracts with counterparties domiciled in a third-country jurisdiction, that counterparty does not need to either collect or post variation or initial margin for those contracts, where all of the following conditions are met:
 - (a) the OTC derivative contracts are entered into with a counterparty domiciled in a third-country jurisdiction meeting the conditions of paragraph 4;
 - (b) the legal reviews referred to in paragraph 4 conclude that collecting collateral in accordance with this Regulation is not possible;
 - (c) the ratio calculated in accordance with paragraph 3 is lower than 2.5%.
3. A counterparty shall calculate the ratio referred to in paragraph 2(c) as follows:
 - (a) it shall add the notional outstanding amounts of the OTC derivative contracts of the group to which it belongs, for which no margin is collected for all the counterparties in all the jurisdictions meeting the conditions of paragraph 4;
 - (b) it shall calculate the notional outstanding amount for all the OTC derivative contracts of the group to which it belongs, excluding intragroup transactions;

- (c) it shall divide the amount resulting from point (a) with that resulting from point (b).
4. In order to apply the treatment laid down in paragraphs 1, 2 and 3, either of the following conditions shall be met:
- (a) the legal review referred to in Article 32(2) does not confirm that the bilateral netting arrangements in the jurisdiction concerned can be legally enforced with certainty at all times;
 - (b) the legal review referred to in Article 33(5) confirms that no segregation arrangement with a counterparty domiciled in the jurisdiction concerned can meet the requirements referred to in paragraphs 1 to 3 of Article 33.

SECTION 3

CALCULATION AND COLLECTION OF MARGINS

Article 12

Calculation date

1. Counterparties shall calculate variation margin at least on a daily basis and initial margin at least as prescribed in Article 14(3).
2. For the purpose of setting the dates for the margin calculation, the following shall apply:
 - (a) where two counterparties are located in the same time-zone the calculation shall refer to the netting set of the previous business day;
 - (b) where two counterparties are not located in the same time-zone, the calculation shall refer to the transactions in the netting set entered into before 16:00 hours of the previous business day of the time-zone where it is first 16:00 hours.

Article 13

Calculation of variation margin

1. The amount of variation margin to be collected by a counterparty shall be the outstanding balance between the aggregated value of all contracts in the netting set calculated in accordance with Article 11(2) of Regulation (EU) No 648/2012, and the value of all variation margin previously posted, collected or settled.
2. Variation margins shall be collected in one of the following ways:
 - (a) by collecting in cash in accordance with point (a) of Article 22(2);
 - (b) by collecting in non-cash collateral in accordance with points (b) to (r) of Article 22(2), subject to the requirements referred to in Section 5 and the haircut requirements referred to in Section 6.
3. Variation margins shall be collected within one of the following:
 - (a) within the business day of the calculation;
 - (b) where the conditions in paragraph 4 are met, within two business days after the calculation date.
4. The collection of variation margin in accordance with paragraph 3(b) may be applied only to netting sets that meet either of the following conditions:

- (a) for all the derivative contracts not subject to initial margin requirements by virtue of Regulation (EU) No 648/2012 and this Regulation, where the collecting counterparty has collected, at or before the calculation date of the variation margin, an amount of variation margin calculated in the same manner as that applicable to initial margins in accordance with Article 17, adjusted by 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 rescaled in accordance with paragraph 5.
5. For the purpose of paragraph 4(b), initial margin may be adjusted in one of the following ways:
- (a) by increasing the margin period of risk ('MPOR') referred to in Article 17(2) by the number of days in between, and including, the calculation date and the collection date;
 - (b) by increasing the initial margin calculated in accordance with Article 15 by the number of days in between, and including, the calculation date and the collection date adjusted using an appropriate methodology.
6. The part of the collateral related to variation margin referred to in paragraph 4(a) shall be collected in accordance with Article 22.
7. In the event of a dispute over the amount of variation margin due for collection, counterparties shall collect, in the same time frame as referred to in this Article, at least the part of the variation margin amount that is not being disputed.

Article 14
Calculation of initial margins

1. A counterparty shall calculate the amount of initial margin to be collected using either the standardised approach laid down in Article 15 ('standardised approach') or the initial margin models referred to in Article 16 ('initial margin models') or both. Where both of these approaches are used, the total initial margin requirements for a netting set shall be the sum of the initial margins calculated according to the two approaches.
2. The counterparties shall agree on the method each counterparty uses to determine the initial margin it has to collect. Where one or both counterparties rely on an initial margin model they shall agree on the characteristics of the model and the data used for the calibration referred to in Article 18. Counterparties are not required to agree on a common methodology.
3. The total amount of initial margins shall be calculated no later than the business day following one of these events:
 - (a) where a new OTC derivative contract is executed or added to the netting set;
 - (b) where an existing OTC derivative contract expires or is removed from the netting set;
 - (c) where an existing 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 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.
4. Initial margins shall be collected in one of the following ways:
 - (a) by collecting in cash, in accordance with point (a) of Article 22(2);
 - (b) by collecting non-cash collateral in accordance with points (b) to (r) of Article 22(2), subject to the requirements referred to in Section 5 and the haircut requirements referred to in Section 6.
 5. Initial margin shall be collected within the business day of calculation.

In the event of a dispute over the amount of initial margin due for collection, counterparties shall collect, in the same time frame as referred to in this Article, at least the part of the initial margin amount that is not being disputed.

SECTION 4

APPROACHES FOR CALCULATING INITIAL MARGIN

Article 15

Standardised approaches

Where a counterparty uses the standardised approach, the initial margin for each netting set shall be calculated in accordance with Annex IV.

Article 16

Initial margin models

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.
2. 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.
3. At the request of one of the two counterparties the other counterparty shall provide all the information necessary to explain the determination of a given value of initial margin in a way that a knowledgeable third party would be able to verify the calculation.

Article 17

Confidence interval and margin period of risk

4. The assumed variations in the value of the contracts in 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.
5. The MPOR of a netting set for the calculation of initial margins using an initial margin model 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 or hedge the risks taking into account the level of liquidity of the market where that type contracts or risks are traded, the total volume of the OTC derivative contracts in that market and the number of participants in that market.

Article 18
Calibration of the model

1. Initial margin models shall be calibrated based on historical data from a period of at least three years and not exceeding five years.
2. The data used in initial margin models shall include the most recent continuous period from the calibration date and shall contain at least 25% of data representative of a period of significant financial stress ('stressed data').
3. Where the most recent data period does not contain at least 25% of stressed data, the least recent data in the time series 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 set.
4. The period of financial stress used for calibration shall be identified and applied separately at least for each of the asset classes referred to in Article 19(2).
5. The model shall be calibrated using equally weighted data.
6. The parameters may be calibrated for shorter periods than the MPOR and adjusted to the MPOR by an appropriate methodology.
7. The model shall be recalibrated at least every 12 months. Counterparties shall have written policies which set out the circumstances that would trigger an earlier recalibration.
8. Counterparties shall establish procedures for adjusting the margins to be collected in response to changing market conditions. These procedures may allow each counterparty to post the additional initial margin resulting from the recalibration of the model over a period that ranges between one and thirty business days.
9. The quality of the process relating to the data used in the model in accordance with paragraph 1, including the selection of appropriate data provider, the cleaning of the data and interpolation of the data, shall be ensured.
10. Proxies shall be used only where both of the following conditions are met:
 - (a) where available data is insufficient or is not reflective of the true volatility of an OTC derivative contract or portfolio of OTC derivative contracts;
 - (b) where the proxies lead to a conservative level of margins.

Article 19
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:
 - (a) interest rates, currency and inflation;
 - (b) equity;
 - (c) credit;
 - (d) commodities and gold;
 - (e) other.

Article 20

Integrity of the modelling approach

1. Initial margin models shall be conceptually and practically sound and shall capture all the material risks arising from entering into the OTC derivative contracts included in the netting set.
2. Counterparty Counterparties shall calculate the initial margin to be collected without taking into account any correlations between the unsecured exposure and the collateral.
3. Initial margin models shall meet the following requirements:
 - (a) the model shall incorporate risk factors corresponding to the individual currencies in which the OTC derivative contracts in the netting sets are denominated;
 - (b) the model shall incorporate interest rate risk factors corresponding to the individual currencies in which the OTC derivative contracts are denominated;
 - (c) for exposures to interest-rate risk in the major currencies and markets, the yield curve shall be divided into a minimum of six maturity buckets;
 - (d) the model shall capture the risk of movements between different yield curves and between different maturity buckets;
 - (e) the model shall use a separate risk factor at least for each equity or equity index that is significant for the OTC derivative contracts within the netting set;
 - (f) the model shall use a separate risk factor at least for each commodity or commodity index which is significant for the OTC derivative contracts within the netting set;
 - (g) the model shall account for, in a conservative manner, the risk arising from less liquid positions and positions with limited price transparency under realistic market scenarios;
 - (h) the model shall capture the idiosyncratic risk for credit underlyings;
 - (i) the model shall capture the risk of movements between similar, but not identical, underlying risk factors and the exposure to changes in values arising from maturity mismatches;
 - (j) the model shall capture main non-linear dependences.
4. A counterparty shall monitor the performance of the model on a continuous basis. The performance analysis shall include a comparison between the risk measures generated by the model and realized market value of the derivatives in the netting set

(‘back-testing’) every three months. The counterparties shall retain records of the results of that analysis.

5. The risk management procedures shall outline the methodologies used for undertaking back-testing, including statistical tests of performance.
6. The risk management procedures shall describe what results of the back-testing would lead to a model change, recalibration or other remediation action.
7. The modelling approach shall reflect the nature, scale and complexity of the risks inherent in the underlying OTC derivative contracts. The initial margin model shall reflect factors like parameter uncertainty, correlation, basis risk and data quality in a prudent manner.

Article 21

Qualitative requirements

1. Initial margin models shall be subject to an internal governance process that continuously assesses the validity of the outcome produced by the initial margin model.
2. For the purposes of paragraph 1, a counterparty shall carry out all of the following:
 - (a) it shall ensure that suitably qualified parties, independent from the parties developing the model, carry out an initial validation;
 - (b) a follow up validation whenever a significant change is made to the initial margin model and at least once a year;
 - (c) a regular audit process to assess the integrity and reliability of the data sources and the management information system used to run the model, the accuracy and completeness of data used, the accuracy and appropriateness of volatility and correlation assumptions.
3. The documentation of the risk management procedures shall meet all of the following conditions:
 - (a) it shall be sufficient to ensure that any knowledgeable third-party would be able 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 should no longer be considered valid.
4. The counterparties shall maintain clear documentation showing all changes to the initial margin model and detailing the results of the validation carried out after those changes.

SECTION 5

ELIGIBILITY AND TREATMENT OF COLLATERAL

Article 22

Eligible collateral for initial and variation margin

1. For the purposes of Article 11(3) of Regulation (EU) No 648/2012, asset classes for which the counterparty has no access to the market or is unable to liquidate the

collateral in a timely manner in case of default of the posting counterparty shall not be eligible for initial and variation margin.

2. 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 accounts;
 - (b) gold in the form of allocated pure gold bullion of recognised good delivery;
 - (c) debt securities issued by Member States' central governments and central banks;
 - (d) debt securities issued by Member States' regional governments or local authorities according to Article 115(2) of Regulation (EU) No 575/2013;
 - (e) debt securities issued by Member States' public sector entities according to Article 116(4) of Regulation (EU) No 575/2013;
 - (f) debt securities issued by Member States' regional governments or local authorities not meeting the requirements of Article 115(2) of Regulation (EU) No 575/2013;
 - (g) debt securities issued by Member States' public sector entities not meeting the requirements of Article 116(4) of Regulation (EU) No 575/2013;
 - (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 and central banks;
 - (k) debt securities issued by third countries' regional governments or local authorities that meet the requirements of the first subparagraph of Article 115(2) of Regulation (EU) No 575/2013 and third countries' public sector entities that meet the requirements of Article 116 (4) of Regulation (EU) No 575/2013;
 - (l) debt securities issued by third countries' regional governments or local authorities not meeting the requirements of the first subparagraph of Article 115(2) of Regulation (EU) No 575/2013 or third countries' public sector entities not meeting the requirements of the first subparagraph of Article 116 (4) of Regulation (EU) No 575/2013;
 - (m) debt securities issued by credit institutions and 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(62) of Regulation (EU) 575/2013, that is not a re-securitisation as defined in Article 4(64) of that Regulation;
 - (p) convertible bonds provided that they can be converted only into equities which are included in a main index as referred to in point (a) of Article 197 (8) of Regulation (EU) No 575/2013;
 - (q) equities included in a main index as referred to in 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 criteria in Article 26 are met.

Article 23

Collateral management

The risk management procedures of the counterparty collecting collateral shall ensure that all of the following are in place:

- (a) a re-evaluation on a daily basis of the assets held as collateral;
- (b) legal arrangements and a collateral holding structure that allow access to the received collateral where it is held in third party custody;
- (c) where initial margin is maintained with the collateral provider, that the securities are maintained in insolvency-remote custody accounts;
- (d) that cash accounts for initial margin are maintained at central banks or credit institutions which fulfil both of the following conditions:
 - (i) they are authorised in accordance with Regulation (EU) No 575/2013;
 - (ii) they are neither the posting nor the collecting counterparties;
- (e) that the unused collateral can be made available to the liquidator or other insolvency official of the defaulting counterparty;
- (f) that, in the event of the default of the collecting counterparty, the initial margin is freely transferable back in a timely manner to the posting counterparty;
- (g) that the 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;
- (h) that the collateral is returned in whole other than costs and expenses incurred for the process of appropriation of collateral.

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 22(2) that are not denominated or funded in the issuer's domestic currency and in points (f), (g), (j) to (n) and (p) of Article 22(2) using one of the following methodologies:
 - (a) an approved internal model as referred to in Article 25;
 - (b) the approved internal model referred to in Article 25 of its counterparty, where the counterparty is established in the Union, or third country counterparty, where the third country 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) according to Article 4(98) of Regulation (EU) No 575/2013 or 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 22(2) using the methodology referred to in point (c) of paragraph 1.
 3. The risk management procedures shall require that assets referred to in in points (f), (g), (j) to (p) of Article 22(2) are only eligible as collateral for the purposes of Article 11(3) of Regulation (EU) No 648/2012 where their credit quality has been assessed as credit quality step 3 or above.
 4. The risk management procedures shall require that assets referred to in points (c), (d) and (e) of Article 22(2) that are not denominated or funded in the issuer's domestic currency are only eligible as collateral for the purposes of Article 11(3) of Regulation (EU) No 648/2012 where their credit quality has been assessed as credit quality step 4 or above.
 5. For the purposes of paragraphs 3 and 4 the credit quality assessment shall be mapped to credit quality steps in accordance with Articles 136 and 270 of Regulation (EU) No 575/2013.
 6. The counterparties shall have procedures in place for the case where the credit quality of the collateral assessed using the methodology referred to in paragraphs 1 and 2, falls below the limits set out in paragraphs 3 and 4. Such procedures shall meet all of the following requirements:
 - (a) they shall prohibit the counterparties from accepting additional collateral assets which no longer meet the level referred to in paragraphs 3 and 4;
 - (b) they shall define a schedule by which already accepted collateral is to be replaced over a period of time not exceeding two months;
 - (c) they shall set a credit quality step level that is below the levels set out in paragraphs 3 and 4, which, when exceeded, requires immediate replacement;
 - (d) they shall enable counterparties to increase the haircuts on the relevant collateral over the period set out in point (b).

Article 25

Credit risk assessment by the collateral taker using the Internal Rating Based Approach

1. A counterparty authorised to use the Internal Rating Based (IRB) approach in accordance with Section 6 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.
2. A counterparty using the IRB approach for the purpose of this Regulation in accordance with paragraph 1, shall determine the credit quality step of the collateral based on Table 1 CQS in Annex I as the highest credit quality step corresponding to a probability of default ('PD'), in the sense of point (54) of Article 4(1) of Regulation (EU) No 575/2013, equal or lower than the internal rating.
3. A counterparty using the IRB approach for the purpose of this Regulation in accordance with paragraph 1, shall communicate to the other counterparty the credit quality step associated to the securities that are eligible to be posted as collateral.

Article 26
Eligibility criteria for units or shares in UCITS

1. For the purposes of Article 22, counterparties may 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 instruments that are eligible for recognition under Article 22;
 - (c) the UCITS meet the conditions 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 paragraph 1 shall apply equally to any such underlying UCITS.

The use of derivative instruments to hedge permitted investments by a UCITS shall not prevent units or shares in that UCITS from being eligible as collateral.

2. For the purposes of paragraph 1, where a UCITS ('the original UCITS') or any of its underlying UCITS are not limited to investing in instruments that are eligible under Article 22, institutions may use units or shares in that UCITS as collateral to an amount equal to the value of the eligible assets held by that UCITS under the assumption that that UCITS or any of its underlying UCITS have invested in non-eligible assets to the maximum extent allowed under their respective mandates.

Where any underlying UCITS has underlying UCITS of its own, institutions may use units or shares in the original UCITS as eligible collateral provided that they apply the methodology in the paragraph 1.

Where non-eligible assets of a UCITS can have a negative value due to liabilities or contingent liabilities resulting from ownership, counterparties shall apply the following steps:

- (a) calculate the total value of the non-eligible assets;
- (b) where the amount obtained from point (a) is negative, subtract the absolute value of that amount from the total value of the eligible assets.

Article 27
Eligibility criteria to avoid wrong way risk

1. The risk management procedures shall ensure that the asset classes referred to in points (f), (g) and (k) to (r) of Article 22(2) also fulfil all of the following criteria:
 - (a) they are not issued by the posting counterparty;
 - (b) they are not issued by entities which are part of the group to which the posting counterparty belongs;
 - (c) they are not otherwise subject to significant wrong way risk, as defined in paragraph 1 of Article 291 of Regulation (EU) 575/2013.
2. Points (a), (b) and (c) of paragraph 1 shall apply to the risk exposures arising from third party holders or custodians holding initial margin collected in cash.

Article 28
Concentration limits for initial margin

1. The risk management procedures shall provide that the collateral collected as initial margin in accordance with Article 14 from an individual counterparty meets all of the following conditions:
 - (d) the sum of the values of the collateral collected in the form of the asset classes referred to in points (b), (f), (g), (l) and (m) to (r) of Article 22(2) issued by a single issuer or by entities which are part of the same group does not exceed the greater of the following values:
 - (i) 15% of the collateral collected from that individual counterparty;
 - (ii) EUR 10 million or the equivalent in another currency;
 - (e) the sum of the values of the collateral collected in the form of the asset classes referred to in points (o), (p), (q), of Article 22(2), 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 that individual counterparty;
 - (ii) EUR 10 million or the equivalent in another currency.

This limit shall also apply to shares in UCITS referred to in point (r) of Article 22(2) where the UCITS is primarily invested in the securities mentioned in this paragraph.
2. The risk management procedures shall provide that the collateral collected as initial margin in accordance with Article 14 from an individual counterparty in excess of EUR 1 billion meets the conditions set out in paragraph 4 where each of the counterparties belong to one of the categories listed in paragraph 3.
3. The categories referred to in paragraph 2 are:
 - (a) institutions identified as global systemically important institutions ('G-SIIs') in accordance with Article 131 of Directive 2013/36/EU;
 - (b) institutions identified as other systemically important institutions ('O-SIIs') in accordance with Article 131 of Directive 2013/36/EU;
 - (c) individual counterparties, for which the total amount of initial margin to be collected by the counterparty itself from an individual counterparty exceeds EUR 1 billion.
4. The conditions referred to in paragraph 2 are:
 - (a) the sum of the values of the collateral collected in the form of the asset classes (c), (d), (e), (f), (g), (h), (i), (j), (k) and (l) of Article 22(2) issued by a single issuer or by issuers domiciled in the same country shall not exceed 50% of the collateral collected from that individual counterparty.
 - (b) point (a) shall apply to the risk exposures arising from third party holders or custodians holding initial margin collected in cash.
5. Where G-SIIs or O-SIIs collect initial margin in cash from a single counterparty that is also a G-SII or O-SII, the collecting counterparty shall ensure that not more than 20% of that initial margin is held in cash by a single third party custodian.

6. Where the collateral is collected in the form of an asset class that is the same as the underlying asset class of the OTC derivative contract, the collecting counterparty may not apply the diversification requirements set out in paragraphs 1 to 4.
7. By way of derogation from the frequency set out in Article 14(3), 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.
8. 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 7 has to apply the frequency set out in Article 14(3) from that point onwards with the possibility to revert to the lower frequency of paragraph 7 under the conditions set out therein.

SECTION 6

COLLATERAL VALUATION

Article 29

Calculation of the adjusted value of collateral

1. The risk management procedures shall include the application of haircuts to the market value of collected collateral using either the standard methodology referred to in Annex II or using own estimates as referred to in Article 30.
2. In calculating the requirements referred to in Article 30 and Annex II, counterparties may disregard positions in currencies which are subject to a legally binding intergovernmental agreement to limit their variation relative to other currencies covered by the same agreement.

Article 30

Own estimates of the adjusted value of collateral

1. Counterparties may use their own volatility estimates for calculating the haircuts to be applied to collateral where the requirements set out in this Article are met.
2. For debt securities that have a credit assessment from an ECAI, counterparties may use their own volatility estimate for each category of security.
3. In determining relevant categories of securities for the purposes of paragraph 2, 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.
4. The calculation of the adjusted value of the collateral shall be subject to all the conditions set out in Annex III.
5. Counterparties shall update their data sets and calculate haircuts at least once every three months and whenever the level of market prices' volatility changes materially. Procedures shall determine in advance the levels of volatility that trigger a recalculation of the haircuts.

6. The estimation of haircuts shall meet all of the following criteria:
 - (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 of Annex III 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 paragraph 1 of Annex III;
 - (c) a counterparty shall have in place established procedures for monitoring and ensuring compliance with a documented set of policies, for controlling the operation of its system for the estimation of haircuts and for the integration of such estimates into its risk management process;
 - (d) the system for the estimation of haircuts shall be subject to an internal review that meets all of the requirements of paragraph 7.
7. The review referred to in paragraph 6(d) shall meet all of the following requirements:
 - (a) it shall be carried out regularly within the internal auditing process of the counterparty;
 - (b) the integration of the adjustments into the risk management process of the counterparty shall take place at least once a year;
 - (c) the review shall cover at least the following aspects of the system:
 - (i) the integration of estimated haircuts into daily risk management;
 - (ii) the validation of any significant change in the process for the estimation of haircuts;
 - (iii) the verification of the consistency, timeliness and reliability of data sources used to run the system for the estimation of haircuts, including the reliability of such data sources;
 - (iv) the accuracy and appropriateness of the volatility assumptions.

SECTION 7

OPERATIONAL PROCEDURES AND DOCUMENTATION

Article 31

Operational process for the exchange of collateral

1. Robust risk management procedures shall be in place in order to ensure the timely exchange of collateral for non-centrally cleared OTC derivative contracts. Those risk management procedures shall include:
 - (a) a detailed documentation of policy and procedures with regards to the exchange of collateral for non-centrally cleared OTC derivative contracts and any related limitation or constraint, covering collateral levels, types and eligibility to be reviewed and updated as necessary and at least annually;
 - (b) documented, consistent and robust processes for escalation with counterparties' organisations, authorisation and recording of any exceptions to the existing policy and procedures referred to in point (a);
 - (c) reporting of material exceptions to senior management;

- (d) agreement of terms with all counterparties in accordance with this Regulation in respect of the operational process for the exchange of collateral, including:
 - (i) the levels and type of collateral required and any segregation arrangements;
 - (ii) the OTC derivative contracts to be included in the calculation of margin;
 - (iii) the procedures for notification, confirmation and adjustment of margin calls and settlement of margin calls;
 - (iv) the procedures for settlement of margin calls in respect of all relevant types of collateral;
 - (v) the methods, timings and responsibilities for calculating margin and valuing collateral.
 - (e) processes for setting collateral levels;
 - (f) procedures to periodically verify the liquidity of the eligible collateral;
 - (g) procedures for timely re-appropriation by the posting counterparty of the collateral in the event of default of the counterparty collecting the collateral.
2. A counterparty using an initial margin model shall be prepared to supply relevant trading documentation referred to in Article 32 to its competent authority at any time.
 3. The risk management procedures referred to in paragraph 1 shall be tested on a periodic basis and at least once a year.
 4. For any collateral already posted to the collecting counterparty as initial or variation margin may be substituted by other collateral ('alternative collateral'), provided that all of the following conditions are met:
 - (a) the substitution is made in accordance with the terms of the agreement between the counterparties;
 - (b) the alternative collateral is eligible according to Section 5;
 - (c) the value of the alternative collateral after applying any relevant haircut is sufficient to meet all margin requirements.

Article 32
Trading documentation

1. 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.
- 2. A counterparty shall perform an independent legal review of the legal enforceability of the bilateral netting arrangements and of compliance with the arrangements in each jurisdiction and set up policies ensuring the continuous assessment of compliance. Such legal review may be conducted by an internal independent unit, or by an external independent third party.
- 3. The independent legal review referred to in paragraph 2 shall be considered to have been performed for netting agreements that have been recognised in accordance with Article 296 of Regulation (EU) No 575/2013.

Article 33
Segregation of initial margins

- 1. 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.
- 2. Collateral collected as initial margin shall meet all the following requirements:
 - (a) where collateral is a proprietary asset of the collecting counterparty, it shall be segregated from the other proprietary assets of the collecting counterparty;
 - (b) where collateral is not proprietary asset of the collecting counterparty, it shall be segregated from the proprietary assets of the posting counterparty;
 - (c) it shall be segregated from the proprietary assets of the third-party holder or custodian.
- 3. Where the collateral is held by the collecting party or by a third party holder or custodian on behalf of the collecting party, the collecting counterparty shall always provide the posting counterparty with the option to segregate its collateral from the assets of other posting counterparties.
- 4. The segregation arrangements shall ensure that collateral posted as initial margins are available to the posting counterparty in a timely manner in case the collecting counterparty defaults.
- 5. A counterparty shall perform an independent legal review in order to verify that the segregation arrangements meet the requirements referred to in paragraphs 1 to 4. A counterparty shall provide documentation to its competent authority supporting the compliance of the arrangements in each jurisdiction and set up policies ensuring the continuous assessment of compliance upon request. Such legal review may be conducted by an internal independent unit, or by an external independent third party.
- 6. By way of derogation from paragraphs 1 and 2, where cash is collected as initial margin, the counterparties shall deposit it with a third party holder or custodian that is not part of the same group as either of the counterparties or with a central bank. The collecting counterparty shall take into account the credit quality of the third party custodian by using a methodology that does not solely or mechanistically rely on external credit quality assessments.

Article 34
Treatment of collected initial margins

1. The collecting counterparty shall not rehypothecate, repledge nor otherwise reuse the collateral collected as initial margin.
2. The requirement laid down in paragraph 1 shall be deemed to be met where a third party holder or custodian reinvests the initial margin received in cash.

CHAPTER II
Procedures for the counterparties and the relevant competent authorities when applying exemptions for intragroup derivative contracts

Article 35
Procedures for the counterparties and the 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 at the time of receipt by the competent authority of all of the following information:
 - (a) all the information necessary to assess whether the conditions specified in Article 3 and in points (6) to (10) of Article 11 of Regulation (EU) No 648/2012, as applicable, have been fulfilled;
 - (b) the information and documents referred to in Article 18 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 the complete application.
4. Where a competent authority takes 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 including all of the following information:
 - (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;
 - (c) any additional relevant information.
5. Where a competent authority takes 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 its negative decision or objection to the counterparty in writing and shall include all of the following information:
 - (a) the identification of the conditions of Articles 3 and 11 (6) to (10) of Regulation (EU) No 648/2012 that are not fulfilled;

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

Where one of the competent authorities notified under Article 11(7) of Regulation (EU) No 648/2012 considers that the conditions referred to in point (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 by the relevant counterparty.

6. The competent authorities shall notify the non-financial counterparties of the objection within three months of receipt of the notification referred to in paragraph 5.
7. 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 the complete application.
8. A decision by the competent authority of a financial counterparty among those referred to in 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 complete application for exemption and to the counterparties within three months of receipt of the complete application for exemption.
9. Counterparties that have submitted a notification or received a positive decision according to points (6) to (10) of Article 11 of Regulation (EU) No 648/2012 shall immediately notify the relevant competent authority of any change in circumstance that could affect the fulfilment of the conditions of Article 3 and points (6) to (10) of Article 11 of that Regulation, 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.
10. Where a negative decision or objection is communicated by a competent authority, the relevant counterparty shall submit any other application or notification only if there has been a material change in the circumstances that formed the basis of the competent authority's decision or objection.
11. The application or notifications referred to in paragraph 1 shall be submitted on the following date, whichever is latest:
 - (a) the date of entry into force of this Regulation;
 - (b) six months before the date of application of the variation margin requirements for the relevant counterparty, as referred to in Article 39(5).

Article 36

Prompt transfer of own funds and repayment of liabilities between the counterparties in intragroup derivatives

The risk management procedures shall ensure the regular monitoring of the exposures arising under intragroup transactions and the timely settlement of the obligations resulting from the intragroup OTC derivative contracts.

CHAPTER III

Applicable criteria for applying exemptions for intragroup derivative contracts

Article 37

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 Council⁸ are met, as a result of which the supervisor 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 purpose or the legal structure of the counterparty undertaking, as defined in its statutes, instruments of incorporation and internal rules.

Article 38

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

- (a) insufficient availability of unencumbered or liquid assets to the relevant counterparty when due;
- (b) operational obstacles for such transfers or repayments when due.

⁸ 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).

CHAPTER IV

Final provisions

Article 39

Transitional Provisions

1. The requirements of this Regulation shall apply from 1 September 2016 with the exception of:
 - (a) Articles 35, 36, 37 and 38 which shall apply from the entry into force of this Regulation;
 - (b) Articles 1 (3)(a), 8, 9, 14, 33, 34 and Section 4 which shall apply in accordance with paragraph 2;
 - (c) Article 13 which shall apply in accordance with paragraph 5.
2. The Articles referred to in point (b) of paragraph 1, shall apply as follows:
 - (a) from 1 September 2016, 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 3.0 trillion;
 - (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 2.25 trillion;
 - (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 1.5 trillion;
 - (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 0.75 trillion;
 - (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.
3. The aggregate average notional amount referred to in points (a) to (e) of paragraph 2 shall be calculated as the average of the total gross notional amount that meets all of the following conditions:
 - (a) recorded in the last business day of the months March, April and May of the year referred to in each of the points (a) to (e);
 - (b) including all the entities of the group;
 - (c) including all the non-centrally cleared OTC derivative contracts of the group;
 - (d) including all the intragroup non-centrally cleared OTC derivative contracts of the group, counting each one of them once.
4. For the purpose of the calculation of the aggregate notional amount referred to in paragraph 3, investment funds shall be considered distinct entities and treated as separate investment funds, in accordance with Article 8(3).
5. The Articles referred to in paragraph 1(c), shall apply as follows:
 - (a) from 1 September 2016 for all the counterparties referred to in paragraph 2(a);

- (b) from 1 March 2017 for the other counterparties.
6. By way of derogation from paragraphs 2 and 5, in respect of contracts referred to in point (a) of Article 7, the requirements set out under paragraph 5 shall apply on one of the following dates, whichever is earlier:
- (a) 31 December 2018;
- (b) the entry into force of the Commission Delegated Act 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.
7. Articles 13 and 14 shall apply from [please insert date: 3 years after the date of entry into force of this Regulation] for all non-centrally OTC derivatives on single-stock equity options and index options.
8. By way of derogation from paragraphs 1 and 5, where the conditions of paragraph 9 are met, the requirements set out under points (b) and (c) of paragraph 1 shall take effect on either of the following dates:
- (a) [please insert date: 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) 60 days 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 date when the requirements set out under points (b) and (c) of paragraph 1 take effect.
9. The derogation referred to in paragraph 8 shall only apply where all of the following conditions are met:
- (a) the counterparty established in a third country is either a financial counterparty or a non-financial counterparty;
- (b) 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;
- (c) both counterparties are included in the same consolidation on a full basis in accordance to Article 3(3) of Regulation (EU) No 648/2012;
- (d) both counterparties are subject to appropriate centralised risk evaluation, measurement and control procedures;
- (e) the requirements of Articles 35, 36, 37 and 38 are met.

10. 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 initial margin set out under point (b) of paragraph 1 shall take effect on 1 March 2017.

Article 40
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
On behalf of the President