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OPINION

Portfolio margining requirements under Article 27 of Commission Delegated Regulation (EU) No 153/2013

1 Legal basis

1. ESMA's competence to deliver an opinion to competent authorities is based on Article 29(1)(a) of Regulation (EC) 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)[1](ESMA Regulation).

2. Pursuant to Article 29(1)(a) of ESMA Regulation, ESMA shall provide opinions to competent authorities for the purpose of building a common Union supervisory culture and consistent supervisory practices, as well as ensuring uniform procedures and consistent approaches throughout the Union.

3. ESMA has specific competence in respect of colleges of supervisors as set out in the ESMA Regulation. In particular, pursuant to Article 21(1) of the ESMA Regulation, ESMA shall contribute to promoting and monitoring the efficient, effective and consistent functioning of the colleges of supervisors. In addition, in accordance with Article 21(6) of Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories [2] (EMIR), ESMA shall fulfil a coordination role between authorities competent for the supervision of central counterparty (CCP) and across the CCP colleges, established pursuant to Article 18 of EMIR, with a view to building a common supervisory culture and consistent supervisory practices, ensuring uniform procedures and consistent approaches, and strengthening consistency in supervisory outcomes.

2 Background

4. According to paragraph 1 of Article 27 of the Commission Delegated Regulation (EU) No 153/2013[3] ("RTS"), a *"A CCP may allow offsets or reductions in the required margin across the financial instruments that it clears if the price risk of one financial instrument or a set of financial instruments is significantly and reliably correlated, or based on*

[1] OJ L 331, 15.12.2010, p. 48
[2] OJ L 201, 27.7.2012, p.1
[3] OJ L 52, 23.02.2013, p. 41

equivalent statistical parameter of dependence, with the price risk of other financial instruments".

5. Paragraph 4 of this Article specifies conditions on how much offsets can be allowed; "*Where portfolio margining covers multiple instruments, the amount of margin reductions shall be no greater than 80 % of the difference between the sum of the margins for each product calculated on an individual basis and the margin calculated based on a combined estimation of the exposure for the combined portfolio".*

6. Moreover, according to the last sentence of paragraph 4: "*Where the CCP is not exposed to any potential risk from the margin reduction, it may apply a reduction of up to 100 % of that difference"*.

7. The term "financial instrument" has been used in EMIR and defined in Article 4(1)(17) of Directive 2004/39/EC (MiFID I)[4]. However, the definition refers to the instruments specified in Section C of Annex 1[5] without providing the essential characteristics of each financial instrument within the types listed in Section C. Commission Regulation (EC) No 1287/2006[6] further specifies the different types of financial instruments.

8. EMIR uses part of this definition in order to define a "derivative" or "derivative contract". Indeed, Article 2(5) thereof defines a derivative as a financial instrument which falls within any of the groups of derivatives set out in points (4) to (10) of Section C of Annex I to MiFID I.

9. Further, Article 2(7) of EMIR defines the term "class of derivatives" as "a subset of derivatives sharing common and essential characteristics including at least the relationship with the underlying asset, the type of underlying asset, and currency of notional amount. Derivatives belonging to the same class may have different maturities".

10. However, there is no further clarification as to which instrument/product can be considered the same. Indeed, the same instrument/product should belong to the same class, but the degree of essential elements that need to be in common for an instrument or product to be considered the same need to be further specified in order to ensure a consistent application of Article 27 of the RTS.

11. This opinion aims at providing such clarification for the purposes of application of Article 27 of the RTS. In particular, it aims at clarifying:

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[4] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments and amending Council Directive 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, OJ L 145, 30.4.2004, p.1

[5] Section C divides the financial instruments in the following groups: (1) Transferable securities; (2) Money-market instruments; (3) Units in collective investment undertakings; (4) to (10) Derivatives, grouped on the basis of common characteristics.

[6] Commission Regulation (EC) No 1287/2006 of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards record-keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive, OJ L 241, 2.9.2006, p. 1–25

a. How to identify the same financial instruments or products;

b. The cases where margin reductions can be up to 100%.

12. ESMA is of the view that a common approach at EU level on the application of Articles 27 of the RTS would foster coherence of supervisory practices on CCPs, including in respect of the assessment by national competent authorities of the CCPs risk management models, and foster consistent application of the relevant provisions of the RTS on a matter that acquires crucial importance on general margining practices.

3 Opinion

3.1 Different instruments or products

13. ESMA is of the opinion that, for the purposes of portfolio margining:

    a. Two contracts which are not covered by the same default fund cannot be considered the same instrument or product.

    b. Two securities or two contracts in different asset classes cannot be considered as the same instrument or product. For securities, the following asset classes should be considered: i) equities and; ii) bonds (including repurchase agreements on bonds). For derivatives the following asset classes should be considered: i) Interest Rates; ii) Equity; iii) Credit; iv) FX; v) Commodities.

14. ESMA is of the opinion that the following classification should apply to identify different instruments or products.

15. For the following asset classes, the classification specified below should apply for the purpose of the application of Article 27(4) of the RTS. References to “instruments” should be understood also as references to “products”.

16. Where two contracts are considered as the same product following this opinion, the CCP may apply portfolio margining and acknowledge the full amount of offsets derived from its margin model.

17. Where two contracts are considered as different products following this opinion, the CCP must apply the cap on the amount of margin offsets prescribed in Article 27.4 of the RTS.

3.1.1 Securities

18. Securities within the same asset class and issued by the same legal entity may be considered the same instrument or product for the purpose of the application of Article 27(4) of the RTS. For example, two bonds issued by the same entity can be considered

as the same instrument; a bond and an equity issued by the same entity should be considered as different instruments.

3.1.2 Derivatives

A) Interest Rate Derivatives

19. Interest rates derivatives having different currencies should be considered different products.

20. An interest rate swap and a bond future should be considered different products.

21. An interest rate derivative and an inflation derivative should be considered different products.

22. Futures referencing bonds issued by different issuers should be considered different products.

23. Futures referencing bonds issued by the same issuer may be considered the same product.

24. Interest rates swaps of the same currency, but referencing a different index, such as a swap using Libor for its floating leg and a swap referencing OIS for its floating leg, may be considered as the same product.

25. Interest rates derivatives (swaps, FRAs, and swaptions), with the same currency and the same reference index, but having different maturities may be considered as the same product.

B) Equity Derivatives

26. Equity derivatives referencing different underlying instruments or indexes should be considered different products.

27. Equity derivatives on the same underlying with different strikes or maturities, may be considered as the same product. For example, this may include a future and an option on the same equity.

C) Credit Derivatives

28. Credit derivatives on different underlying names or indexes (including two series of the same index) should be considered different products.

29. Credit derivatives on the same underlying name or index with different maturities or coupons, may be considered as the same product.

D) FX Derivatives

30. FX derivatives on different pairs of currencies should be considered different products.

31. FX derivatives on the same pairs of currencies with different maturities may be considered as the same product.

E) Commodity Derivatives

32. Commodity derivatives on different underlyings should be considered different products.

33. Commodity derivatives on the same underlying with different maturities may be considered as the same products.

34. The different underlyings for commodity derivatives are listed in the second column, labelled "sub products" in Table 2 of Annex of Delegated Regulation EU 2017/585 of 14/07/2016 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council (RTS 23).

3.2 Situations where the CCP may apply more than 80% of margin reduction

35. ESMA considers that in order to properly apply the last sentence of Article 27(4) of the RTS stating that "*Where the CCP is not exposed to any potential risk from the margin reduction, it may apply a reduction of up to 100 % of that difference"*, it is important to acknowledge situations where arbitrage boundaries between relevant positions within the portfolio result in an absolute limit to the amount of losses that the CCP can suffer.

36. ESMA considers that the wording of the Article does not allow to consider cases where there is a "limited probability" that the losses of the portfolio would go beyond the level of Initial Margin. The reference to "*not exposed to any potential risk*" should be considered as the maximum loss that the CCP can experience from a given position, therefore there should be no possibility that the losses of the portfolio would go beyond the level of Initial Margin. For the avoidance of doubt, this implies that simply relying on back-test results would not be acceptable to justify allowing a reduction in margins beyond 80%.

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38. An example of a case where a CCP would be allowed to acknowledge margin reductions in excess of 80% is the case where a CCP clears a future on an index and futures on each of the constituents of the index, and when no rebalancing of the index is to occur before the expiry of the futures (the timing of such events is known in advance). A portfolio with a long position on the index and a short position of each of the constituents would represent a case where the CCP has no residual risk after the reduction of margins beyond 80% and up to 100% minus the maximum loss.

39. Another example of a case where a CCP would be allowed to acknowledge margin reductions in excess of 80% is the case where a CCP clears an equity and a future on the equity. The CCP may consider the full offsets between a short position on the future and a long position on the underlying stock. For example, if the portfolio has a long position on 100 shares and a short position on futures on 120 shares, then the CCP may consider the full offsets between the 100 shares and the portion of futures referencing 100 shares.

40. Another example where a CCP may apply margin reductions above 80% is the case where an account has the following three FX positions: long 1 unit in the pair A-B, long 1 unit in the pair B-C, long 1 unit in the pair C-A; and all three pairs have the same maturity. In this case, the CCP is not exposed to any potential risk due to the arbitrage relationship between the three pairs.