European Market Infrastructure Regulation (EMIR)

The European Supervisory Authorities issued an amending draft RTS related to the margining of FX forwards with physical settlement

21 December 2017

In brief

The European Supervisory Authorities (ESAs) issued an amended draft RTS aiming to soften the obligation of variation margins on physically settled FX Forward contracts, where at least one of the counterparties is a non-institution firm (e.g. investment fund), as defined by the Capital Requirement Regulation n°575/2013.

The text is being submitted to the European Commission and is due to enter into application after 3 January 2018, allowing National Competent Authorities to define on a risk based basis the margin requirements for such contracts in the meantime.

In detail

Regulatory background

Following the statement released on 24 November 2017 regarding the application of mandatory variation margin on FX forwards contracts that are physically settled, the ESAs published on 19 December 2017 a draft regulatory technical standards (RTS) aiming to amend the EMIR delegated regulation 2016/2251 on non-centrally cleared derivatives by introducing a new article 31a (available here).
The ESAs, which initially applied strictly the BCBS-IOSCO margin framework, has decided to address concerns of both sell-side and buy-side players by softening the variation margin requirements for specific transactions on FX forwards with physical settlement to partially meet the current rules applied in other key jurisdictions.

Scope of Transactions impacted by the exemption

The new article 31a introduced by the draft RTS only concerns **institution to non-institution transactions** where:

- ***Institution*** is defined in Article 4(1)(3) of the Regulation n°575/2013 (CRR, available here), i.e. a credit institution or an investment firm. Furthermore, it would encompass third country counterparty which would meet the definition of “institution” in the sense of Article 4(1)(3) of CRR, if it were established in the Union.
- ***Non-institution*** would include, but is not limited, to other financial counterparties defined in Article 2(8) of EMIR (e.g. an insurance undertaking, a reinsurance undertaking, a UCITS and where relevant its management company, and an alternative investment fund managed by AIFMs authorised or registered in accordance with Directive 2011/61/EU), as well as non-financial counterparties.

Scope of Instruments impacted by the exemption

The draft RTS concerns only “**Physically-settled FX forwards Derivatives**” contracts that **can** result in physical delivery of currency (exchange of principal) if participants wish, whether by intention at inception or by subsequent election. For clarity purposes, these contracts should not be confused with Cash-settled FX forwards Derivatives (i.e. where there is no physical delivery of the designated currencies at maturity) for which variation margin and initial margin already apply. However, as often market practice, in case of share class hedging, a roll-over of such contracts without physical settlement is allowed.

Next Steps

Application of amended rules would most likely only start to apply after 3 January 2018 (the date when the requirement to exchange variation margin for physically-settled FX forwards is due to enter into force). Consequently, for institution to non-institution transactions, the competent authorities should apply the EU framework in a risk-based and proportionate manner until the amended RTS enter into force.

How we can help

Our professional and qualified team, responsible for operational and regulatory matters, can assist you:

1. In ***assessing the impacts*** of the collateral exchange obligation;
2. In ***identifying the gaps and recommending solutions***;
3. Enhancing your efforts in the ***implementation*** of these requirements both for compliance with regulatory requirements and the enhancement of service level (i.e. collateral management).

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