SLAUGHTER AND MAY

Physically-settled FX forwards: margin requirement expected to be lifted for some end-users

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Recent statements by the European Supervisory Authorities (**ESAs**) and the Financial Conduct Authority (**FCA**) propose to exempt certain users of physically-settled FX forwards from the obligation to provide variation margin. The precise scope of the exemption is not yet clear, but based on these statements it is expected to cover insurance and re-insurance firms, pension funds, alternative investment funds (AIFs), UCITS and non-financial counterparties above the clearing threshold (**NFC+**).

Prior to these statements, it was expected that variation margin would be required to be exchanged starting on 3 January 2018 in respect of physically-settled FX forwards between entities which are financial counterparties (**FC**) or NFC+ entities (and equivalent non-EU entities). See our previous briefings, Margining for Non-cleared Derivatives: get ready to exchange variation margin and European Margin Rules for Non-Cleared Derivatives.

It is now expected that this requirement will apply only to physically-settled FX forwards between 'institutions', specified in the ESA statement as credit institutions and investment firms. Legislative amendments will be needed to make this change. In the interim period until those changes are made, the ESA statement recommends that national regulators should only enforce the requirements in respect of such positions.

The ESA and FCA statements

This development stems from a desire to harmonise the scope of the EU variation margin requirements with other key jurisdictions such as the U.S., which have more limited regimes than the impending EU requirements. The ESAs state that they are 'aware of challenges for certain counterparties to exchange variation margin'.

The ESAs propose to limit mandatory exchange of variation margin for physically-settled FX forwards under EMIR to transactions between 'institutions (credit institutions and investment firms)'. Although the precise meaning of 'institutions' is not set out in the ESA statement, in using the terms 'credit institutions' and 'investment firms' it seems likely that the ESAs' intention is to refer to the definitions in Article 4.1 of the Capital Requirements Regulation (**CRR**). It is expected that third country entities will be treated in a comparable way, as has been the case under other EMIR legislation.

For physically-settled FX forward transactions where one or both of the counterparties are not 'institutions', there should be no regulatory requirement to exchange variation margin. The ESA's statement phrases this in an indirect way, noting that national competent authorities (**NCAs**) should consider whether requiring the exchange of variation margin in respect of some institution-to-non-institution transactions would mitigate or introduce additional risk.

The FCA's statement supports the ESA statement and notes that the FCA 'will not require firms whose physically settled FX forwards are likely to be outside the scope of the amended requirements to continue putting processes in place to exchange variation margin'.

Amending Provisions

The ESA proposal will require legislative change before it is effective but the ESAs themselves do not have the power to implement this. The ESA statement suggests that changes to variation margin requirements for physically-settled FX forwards may be made through Regulatory Technical Standards. This should result in a significantly swifter implementation of these changes than if they were to be included in the wider, proposed EMIR Amending Regulation, which is currently going through the EU legislative process.

However, it is not possible for the legislative change proposed by ESA to come into effect prior to 3 January 2018, when the new FX requirements will apply. Assuming legislation implementing the exemption is ultimately agreed, there will be an interim period from 3 January 2018 until the legislative change is effective during which all FC and NFC+ entities will be technically required to exchange variation margin for physically-settled FX forwards, notwithstanding the ESA and FCA statements.

The FCA's statement is helpful for market participants in the UK which are confident they will be exempted, as it will give them a reasonable basis to conclude that they should not need to comply with that technical requirement during the interim period. Where a person is subject to regulation in an EU jurisdiction other than the UK, the approach of the relevant NCA should be taken into account. In the absence of any clear guidance from other NCAs, market participants in those other jurisdictions will face greater uncertainty during the interim period.

Communication between parties

Many market participants have already agreed to exchange variation margin on physically-settled FX forwards. In light of the ESA proposals, entities which are potentially exempt but have already agreed to provide variation margin for such transactions will need to decide whether they wish to exchange variation margin for commercial reasons in the absence of a regulatory obligation. If they do not, they should consider how they want to address any inconsistent language in their collateral documentation.

The International Swaps and Derivatives Association Inc. (**ISDA**) does not propose to implement a standard protocol for such changes, due to the short time available before 3 January and the varied arrangements that parties may have agreed with their counterparties. Instead, parties should consider bilateral communications.

ISDA's margin working group has prepared common text to facilitate this communication. We would be happy to advise on how this could be adapted to your specific circumstances.

If you would like to discuss further, please contact a member of our team.

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