



FINAL REPORT ON AMENDING THE REQUIREMENTS FOR RISK-MITIGATION TECHNIQUES FOR OTC-DERIVATIVE CONTRACTS NOT CLEARED BY A CCP WITH REGARD TO PHYSICALLY SETTLED FOREIGN EXCHANGE FORWARDS

JC/2017/79

18/12/2017

Draft regulatory technical standards

on amending Delegated Regulation (EU) 2016/2251 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on risk-mitigation techniques for OTC derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012 with regard to physically settled foreign exchange forwards

Contents

Executive summary	3
Background and rationale	4
Draft regulatory technical standards	7
Accompanying documents	12
Draft cost-benefit analysis/impact assessment	12
Views of the ESAs' stakeholder groups	18
Feedback on the public consultation and on the opinion of the SGs	19

Executive summary

The requirement to exchange variation margin for physically settled FX forwards is part of the globally agreed BCBS-IOSCO framework, which aims to ensure safer derivatives markets by limiting the counterparty risk from derivatives trading partners. The international standards allow the national implementation of this specific requirement through either national regulation or supervisory guidance. In the EU, this requirement has been implemented through the regulatory technical standards (RTS) on risk mitigation techniques for OTC derivatives not cleared by a central counterparty to ensure a consistent implementation in the EU. However, the European Supervisory Authorities (ESAs) have been made aware of challenges for certain end-user counterparties, as it became apparent that the adoption of the international standards in other jurisdictions via supervisory guidance has led to a scope of application that is more limited than the scope the ESAs have proposed.

In the light of this, the ESAs have undertaken a review of the RTS and have developed draft amendments to these RTS, which align the treatment of variation margin for physically settled FX forwards with the supervisory guidance applicable in other key jurisdictions.

Specifically, the amendment of the RTS and their subsequent implementation would reiterate the commitment to apply the international standards with a more comparable scope to that of other key jurisdictions. In particular, this would imply that the requirement to exchange variation margin for physically settled FX forwards should target only transactions between institutions (credit institutions and investment firms).

The ESAs are aware that the amended RTS would most probably enter into force after 3 January 2018, when the requirement to exchange variation margin for physically settled FX forwards is due to enter into force. Consequently, the ESAs are of the view that, 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.

Background and rationale

The ESAs have been entrusted with the development of RTS on risk mitigation techniques for non-centrally cleared over-the-counter (OTC) derivatives under Article 11(15) of Regulation (EU) No 648/2012 (European Market Infrastructure Regulation – EMIR). In the development of the RTS, the ESAs took into account the proposals of the Basel Committee on Banking Supervision (BCBS) and of the International Organization of Securities Commissions (IOSCO) on margining requirements for non-centrally cleared derivatives (BCBS-IOSCO margin framework)¹, the BCBS supervisory guidance on the settlement of foreign exchange (FX) transactions² and the IOSCO standards on risk mitigation for non-centrally cleared OTC derivatives³. This reflects the strong belief of the ESAs that, in this area of the margining of non-centrally cleared derivatives, a global level playing field is necessary, such that regulatory competition and a ‘race to the bottom’ are avoided.

EMIR was published in the *Official Journal of the European Union* in July 2012 and the ESAs published the RTS on 8 March 2016. The Commission adopted the Delegated Regulation on 4 October 2016⁴. After the non-objection from the European Parliament and Council, Delegated Regulation (EU) 2016/2251 was published in the *Official Journal* on 15 December 2016 and entered into force on 4 January 2017⁵, with its implementation being gradually phased in since.

EU and international implementation of the standards for physically settled FX forwards

The BCBS-IOSCO margin framework gives explicit guidance on physically settled FX forwards: ‘*BCBS and IOSCO agree that standards apply for variation margin to be exchanged on physically settled FX forwards and swaps in a manner consistent with the final policy framework set out in this document and that those variation margin standards are implemented either by way of supervisory guidance or national regulation*’⁶.

Therefore, the requirement to exchange variation margin for physically settled FX forwards is part of a globally agreed framework (‘the international standards’), which aims to ensure safer derivatives markets by limiting the counterparty risk from derivatives trading partners. The international standards state that variation margining of physically settled FX forwards is both an established practice among significant market participants and a prudent risk management tool that limits the

¹ [Margin requirements for non-centrally cleared derivatives](#), issued by BCBS and IOSCO on 18 March 2015.

² [Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions](#), issued by BCBS on 15 February 2013.

³ [Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives](#), issued by IOSCO on 28 January 2015.

⁴ http://ec.europa.eu/finance/financial-markets/derivatives/index_en.htm.

⁵ OJ L 340, 15.12.2016, p. 9-46.

⁶ See the BCBS-IOSCO margin framework, section 1.1, p. 7.

build-up of systemic risk, and thus that variation margining should apply to physically settled FX forwards.

The international standards recommend implementing this requirement by way of national regulation or supervisory guidance. The ESAs implemented these international standards by way of regulation applicable to transactions in the scope of EMIR. To be specific, Article 27(a) of Delegated Regulation (EU) 2016/2251 on risk-mitigation techniques for OTC derivative contracts not cleared by a CCP exempts physically settled FX forwards from the exchange of initial margin, to be in line with the international framework. Moreover, Article 37(2) of Delegated Regulation (EU) 2016/2251 establishes a deferral implementation of variation margin for physically settled FX forwards. This deferral is only applicable until 3 January 2018, which is the date of application of the revised Markets in Financial Instruments Directive (MiFID II).

After the application of Delegated Regulation (EU) 2016/2251, the ESAs have, however, been made aware of challenges for certain counterparties to exchange variation margin for physically settled FX forwards by the deadline of 3 January 2018. Based on the material presented to the ESAs, it has become apparent that the adoption of the international standards in other jurisdictions via supervisory guidance has led to an international scope of application that is more limited than the scope the ESAs have proposed. Whereas the requirement remains relevant for transactions between institutions, the implementation appears to pose a challenge regarding transactions between institutions and end-users.

Content of these amending RTS

The ESAs have assessed all the considerations related to FX derivatives in detail during the drafting of the RTS⁷, including the exchange of variation margin for physically settled FX forwards, and are of the opinion that the EU regulatory standards fully reflect the international standards agreed in the BCBS-IOSCO margin framework. In addition, it also reflects a sound prudential stance, which ensures that the risks related to physically settled FX forwards are adequately mitigated. Furthermore, the challenges and costs, but also the benefits, associated with the implementation of the new requirement to exchange variation margin for physically settled FX forwards were well considered and accepted by the international regulator community. Hence, the ESAs generally consider that the implementation should not tilt towards further exemptions, especially as most parts of the framework have been successfully implemented.

Nonetheless, it is the view of the ESAs that the regulatory framework implemented in non-EU jurisdictions may put EU counterparties at a disadvantage, especially for EU institutions trading with non-EU counterparts. Therefore, the ESAs have put forward an amendment, such that EU

⁷ See p. 14 of the feedback table for RTS on OTC contracts (JC-2016-19): <https://www.eba.europa.eu/documents/10180/1398349/Feedback+table+for+RTS+on+OTC+contracts+%28JC-2016-19%29.pdf/8893188e-2d83-42c3-80d3-203f8e9e6519>.

counterparties are not disadvantaged by the lack of implementation of the requirement in other key jurisdictions.

The solution put forward by the ESAs therefore limits the requirement to collect variation margin for physically settled FX forwards to only transactions concluded between ‘institutions’, within the meaning of the Capital Requirements Regulation (CRR), i.e. credit institutions and investment firms⁸, or with an equivalent entity located in a third country that would meet the definition of ‘institution’ if located in the EU.

Implementation in the EU

In view of the remaining steps that the draft RTS need to go through before being finalised and the time of this publication, the ESAs are aware that the new treatment for physically settled FX forwards under the amended RTS would most likely only start to apply some time 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, the ESAs are of the view that, 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.

Summary of <https://esas-joint-committee.europa.eu/Pages/News/Variation-margin-exchange-for-physically-settled-FX-forwards-under-EMIR-.aspx>

⁸ It is to be noted that the EMIR definition of financial counterparties under Article 2(8) cross-refers to the CRR for credit institutions and investment firms.



FINAL REPORT ON AMENDING THE REQUIREMENTS FOR RISK-MITIGATION TECHNIQUES FOR OTC-DERIVATIVE CONTRACTS NOT CLEARED BY A CCP WITH REGARD TO PHYSICALLY SETTLED FOREIGN EXCHANGE FORWARDS

Draft regulatory technical standards

COMMISSION DELEGATED REGULATION (EU) No .../..**of XXX**

[...]

amending Delegated Regulation (EU) 2016/2251 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty with regard to physically settled foreign exchange forwards

(Text with EEA relevance)

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories⁹, and in particular the third subparagraph of Article 11(15) thereof,

Whereas:

- (1) Commission Delegated Regulation (EU) 2016/2251¹⁰ specifies, among others, the risk management procedures, including the levels and type of collateral and segregation arrangements, required for compliance with Article 11(3) of Regulation (EU) No 648/2012. In this context, it provides, among others, for the requirement to exchange variation margin for physically settled foreign exchange forwards in the sense of Article 27(a) of Delegated Regulation (EU) 2016/2251. As explained in recital 16 of Delegated Regulation (EU) 2016/2251, this requirement is consistent with the international standards detailed in the BCBS-IOSCO framework.
- (2) Developments subsequent to the publication of Delegated Regulation (EU) 2016/2251 have resulted in the implementation of the BCBS-IOSCO framework internationally, mostly via risk-based supervisory guidance, leading to a scope of application that is more limited than the scope originally envisaged in that Regulation. Considering the importance of a level playing field for the appropriate functioning of international derivative markets and in particular in order to avoid distorting the economic and hedging incentives of market participants in the global market of physically settled

⁹ OJ L 201, 27.7.2012, p. 1.

¹⁰ Commission Delegated Regulation (EU) 2016/2251 of 4 October 2016 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty (OJ L 340, 15.12.2016, p. 9).

foreign exchange forwards, Delegated Regulation (EU) 2016/2251 should be revised. That revision should ensure that variation margins should be exchanged on a mandatory basis only for those transactions between institutions as defined in point (3) of Article 4(1) of Regulation (EU) No 575/2013, or between institutions and counterparties established in a third country which would meet the definition of ‘institution’ in the sense of that Article, variation margins should be exchanged on a mandatory basis, as those entities hold the most significant positions in those derivative transactions. This would also be consistent with the actual implementation of the BCBS-IOSCO framework in other major jurisdictions and would continue to ensure the reduction of any systemic risks arising from those physically settled foreign exchange forward contracts.

- (3) With regard to transactions in physically settled foreign exchange forwards where at least one counterparty is a counterparty other than an ‘institution’ in the sense of point (3) of Article 4(1) of Regulation (EU) No 575/2013, counterparties involved in the transaction should employ prudent risk mitigation measures to properly identify, measure, monitor and control risks arising from these transactions until their settlement has been confirmed and reconciled in a way consistent with the requirements of Delegated Regulation (EU) 2016/2251. This is consistent with the overall requirements of Article 11(1) and (2) of Regulation (EU) No 648/2012.
- (4) This Regulation is based on the draft regulatory technical standards submitted to the European Commission by the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority.
- (5) Given that the necessary amendments to Delegated Regulation (EU) 2016/2251 are proposed as a result of a large consensus among market participants to call for such a change, and given the urgency with which it is necessary to amend these standards in order to ensure that the potentially negative impact on the market of foreign exchange forwards in the Union is averted, in accordance with the second subparagraph of Article 15(1) of Regulation (EU) No 1093/2010 of the European Parliament and of the Council¹¹, the second subparagraph of Article 15(1) of Regulation (EU) No 1094/2010 of the European Parliament and of the Council¹² and the second subparagraph of Article 15(1) of Regulation (EU) No 1095/2010 of the European Parliament and of the Council¹³, the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority have not conducted any additional open public consultation. They consider that it would be disproportionate in relation to the scope and impact of the draft regulatory technical standards concerned. They nevertheless consulted the Banking Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1093/2010, consulted the Insurance and Reinsurance Stakeholder Group and the Occupational Pensions Stakeholder Group established in accordance with Article 37 of Regulation (EU)

¹¹ 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).

¹² 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).

¹³ 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).

- No 1094/2010, and consulted the Securities and Markets Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1095/2010.
- (6) Given the urgency with which it is necessary to amend Delegated Regulation (EU) 2016/2251 with regard to the foreign exchange forwards, this Regulation should enter into force on the day following that of its publication.
 - (7) The European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority should continue to engage with the international community of regulators in support of a consistent and prudent approach for the margining requirement of physically settled foreign exchange forwards and should continue to monitor the implementation of the BCBS-IOSCO framework. As a result, where changes occur in the international framework on physically settled foreign exchange forwards and its implementation, they should carry out a review of the application of this Regulation and propose amendments, where appropriate.
 - (8) Delegated Regulation (EU) 2016/2251 should therefore be amended accordingly.

HAS ADOPTED THIS REGULATION:

Article 1
Amendment to Delegated Regulation (EU) 2016/2251

Delegated Regulation (EU) 2016/2251 is amended as follows:

1. A new Article (31a) is inserted after Article 31:

'Article 31a
Treatment of physically settled foreign exchange forward derivatives

By way of derogation from Article 2(2), counterparties may provide in their risk management procedures that variation margins are not required to be posted or collected for physically settled foreign exchange forward contracts in any of the following cases:

- (a) where one of the counterparties is a counterparty other than an 'institution' in the sense of point (3) of Article 4(1) of Regulation (EU) No 575/2013;
- (b) where one of the counterparties is established in a third country and would not meet the definition of 'institution' in the sense of that Article, if it were established in the Union.

Article 2
Entry into force

This Regulation shall enter into force on the 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.



FINAL REPORT ON AMENDING THE REQUIREMENTS FOR RISK-MITIGATION TECHNIQUES FOR OTC-DERIVATIVE CONTRACTS NOT CLEARED BY A CCP WITH REGARD TO PHYSICALLY SETTLED FOREIGN EXCHANGE FORWARDS

Done at Brussels,

*For the Commission
The President*

*[For the Commission
On behalf of the President*

[Position]

Accompanying documents

Draft cost-benefit analysis/impact assessment

1. The implementing approach adopted by the ESAs (EBA, ESMA and EIOPA) for what concerns the variation margin requirement for physically settled FX forwards effectively amends the current RTS (EU/2016/2251) on risk mitigation techniques for the OTC derivatives not cleared by a central counterparty (CCP).
2. As per Article 10(1) of the ESA regulations (Regulations (EU) No 1093/2010, No 1094/2010 and No 1095/2010 of the European Parliament and of the Council), any RTS developed by the ESAs shall be accompanied by an Impact Assessment (IA) annex that analyses ‘the potential related costs and benefits’ before submitting to the European Commission. Such annex shall provide the reader with an overview of the findings as regards the problem identification, the options identified to remove the problem and their potential impacts.
3. For the purposes of the IA section of the Final Report, the ESAs prepared the IA with a cost-benefit analysis of the policy options included in the RTS described in this Final Report. Given the nature of the study, the IA is high level and qualitative in nature and includes some quantitative analysis when possible.

A. Problem identification

4. From MIFID II’s start date on 3 January 2018, the delayed application of variation margins for physically settled FX forwards set by the RTS (EU/2016/2251) of 4 October 2016 with regard to risk mitigation techniques for variation margins will be no longer applicable.
5. Concerns have been expressed by market participants (including both the sell side and the buy side) to both the Commission and the ESAs on the unintended consequences of the entry into application of these risk mitigation requirements in the EU, resulting in an uneven playing field between G20 jurisdictions.
6. In addition to potential regulatory arbitrage, stakeholders have raised concerns about the operational risk in the implementation of variation margin requirement for physically settled FX forwards with regard to the capacity of clients falling within the scope of the requirements – including corporates, pension funds and asset managers – to access the market and appropriately hedge their currency risk exposures.
7. The implementation of the variation margin requirement for physically settled FX forwards might lead to a situation where EU market participants accept the negative consequences of leaving their currency risk unhedged. This might be particularly true for smaller clients for which

the amount of variation margin exchanges would not be large, but would require the development of complex legal and operational processes associated with significant costs in disproportion to the risks they pose. Moreover, clients outside the EU may for their part decide to trade away from EU banks to avoid the EU variation margin requirement for physically settled FX forwards. These trends, based on anecdotal evidence, already appear to be materialising.

B. Policy objectives

8. The main objective of the ESAs amendment is to align the EU variation margin implementation for physically settled FX forwards in the current RTS (EU/2016/2251) on risk mitigation techniques for the OTC derivatives not cleared by a central counterparty with the treatment in other jurisdictions and in accordance with the globally agreed BCBS-IOSCO framework.
9. As a result, the specific objectives of the Final Report are to:
 - amend the scope of the application of the variation margin requirement for physically settled FX forwards in the current RTS by differing between institution-to-institution transactions and institution-to-non-institution transactions;
 - align the regulatory requirements for EU and non-EU counterparties.
10. The general objectives of the Final Report are to:
 - reduce administrative burden and compliance costs without putting financial stability at risk;
 - ensure accurate risk profile adjustment and risk assessment of the OTC derivatives' risk mitigation techniques.

C. Baseline scenario

11. While EMIR itself does not provide a specific exemption from variation margins for physically settled FX forwards, the RTS exempted these products from initial margins and introduced a delayed application of variation margins.
12. This transitional regime aimed to take into account both (i) their specific risk profile and (ii) the absence of a common definition across the EU for these contracts at the time of its adoption. This inconsistency will be resolved with the entry into application of MiFID II on 3 January 2018; FX forwards will thus be subject to variation margins on that date.
13. The proposed regime for physically settled FX forwards follows an internationally agreed guidance developed in 2013, confirmed in 2015 in 'Margin requirements for non-centrally

cleared derivatives’¹⁴. In their guidance, BCBS and IOSCO recognise that the exchange of variation margin ‘is a prudent risk management tool that limits the build-up of systemic risk’ and accordingly encourage variation margining for FX forwards. The decision to implement such requirements by way of supervisory guidance or national regulation is, however, left to each jurisdiction.

14. The EU is the only jurisdiction to directly include physically settled FX forwards within the scope of its variation margin requirements. All other jurisdictions – such as the USA, Japan, Singapore and Canada – have not included physically settled FX forwards, leaving it to the discretion of national banking supervisors to decide to develop variation margin requirements for such derivatives.

15. For example, in December 2013, the US Federal Reserve issued a letter supporting the BCBS supervisory guidance for managing risks associated with the settlement of FX transactions¹⁵ and ‘encourages’ large financial institutions supervised by the Federal Reserve (companies with consolidated assets of USD 50 billion) to exchange variation margins for physically settled FX forwards.

16. It is challenging to provide an accurate quantification of the variation margins to be exchanged in accordance with the requirement in the RTS.

17. Nonetheless, some data can be found in the BIS 2016 Central Bank survey¹⁶, where it is specified that the FX market is mainly a cross-border market, with 65% of transactions executed on a cross-border basis in April 2016 (table 4 of the BIS Report). Furthermore, the BIS Report provides, in table 5, the volume of daily OTC foreign exchange turnover¹⁷, allocated by instruments, currencies and counterparties. The total OTC foreign exchange daily turnover amounts globally to USD 5.067 billion of notional. Of those, only 14% (USD 700 billion) are the ‘Outright forwards’¹⁸, the category that most closely approximates the EU definition of FX forwards. It is important to note that this amount largely overestimates the scope of EU regulation of the suggested Article 31a because it also includes non-deliverable forwards (NDFs) and other forward contracts for differences. Moreover, it is to be noted that the figure is gross of centralised exchanges, for instance with CCPs, and it is defined in terms of gross value, i.e. without distinction between sales and purchases (e.g. a purchase of USD 5 million against pound sterling and a sale of USD 7 million against pound sterling would amount to a gross turnover of

¹⁴ <http://www.bis.org/bcbs/publ/d317.pdf>.

¹⁵ <http://www.bis.org/publ/bcbs241.pdf>.

¹⁶ <http://www.bis.org/publ/rpfx16.htm>.

¹⁷ Turnover data provide a measure of market activity and can also be seen as a rough proxy for market liquidity. Turnover is defined as the gross value of all new deals entered into during a given period and is measured in terms of the nominal or notional amount of the contracts.

¹⁸ Transactions involving the exchange of two currencies at a rate agreed on the date of the contract for value or delivery (cash settlement) at some time in the future (more than two business days later). This category also includes forward foreign exchange agreement transactions (FXAs), non-deliverable forwards (NDFs) and other forward contracts for differences. Outright forwards are generally not traded on organised exchanges and their contractual terms are not standardised.

USD 12 million); therefore, no hedging benefits can be considered. Moreover, it should be noted that the EU regulation refers to physically settled FX forwards, which is again a subset mostly used by the buy side of the markets.

18. Another important aspect to be considered of the USD 700 billion figures is that table 5 in the BIS report is not disaggregated by markets, so the overall scope of application of EU regulation is not identified. It can be approximated, though, if it is considered that the EUR currency alone amounts to 25.4% of the market (USD 178 billion/USD 700 billion). A similar share of the market can be approximated if table 2 of the report is considered, where the Eurozone currencies appear in 24.3%¹⁹ of the contracts.

19. Overall, the volume of the market covered by a dealer-to-dealer transaction is approximately 27% (USD 189 billion/USD 700 billion) of the market, with the remaining 73% being dealer-to-client transactions. Of this 73%, the financial clients ('other financial institutions' are USD 431 billion/USD 700 billion, i.e. 62%) represent the biggest proportion, while the non-financial customers represent just 11% of the market ('other financial institutions' are USD 80 billion/USD 700 billion).

20. Moreover, among the financial clients ('other financial institutions'), a significant proportion, 24.4% (USD 171 billion/USD 700 billion), is covered by institutional investors such as mutual funds, pension funds, insurance and reinsurance companies and endowments, of which the primary motives for market participation are to trade FX instruments for hedging, investing and risk management purposes.

21. Finally, according to data provided by a series of stakeholders' associations, collected from 22 significant entities, which give an indication of the size of the issue, approximately 74 000 counterparty relationships would be newly brought into the scope of variation margin requirements for physically settled FX forwards as a result of the EU Margin RTS' requirements.

D. Options considered

22. In developing the final report with the amendments to the RTS on risk mitigation techniques for OTC-derivative contracts not cleared in line with the international implementation described in paragraphs 12 to 14, the following options have been considered:

- full exemption from variation margins for FX forwards;
- restriction of the mandatory exchange of variation margins for FX forwards to transactions between the largest financial entities (dealer-to-dealer transactions).

¹⁹ In table 2, 24.3% is the sum of EUR, GBP, SEK, DKK, PLN, HUF, CZK and ROM divided by 2.

E. Assessment of the options and the preferred option(s)

23. As specified, EMIR does not provide a specific exemption from variation margins for physically settled FX forwards, but the RTS exempted these products from initial margins and introduced a delayed application of variation margins, which will enter into force with MiFID II on 3 January 2018.
24. The proposed regime for physically settled FX forwards follows an internationally agreed guidance developed in 2013, confirmed in 2015 in ‘Margin requirements for non-centrally cleared derivatives’, where the exchange of variation margin is defined as ‘a prudent risk management tool that limits the build-up of systemic risk’ and accordingly encourages variation margining for physically settled FX forwards.
25. None of the major jurisdictions have included physically settled FX forwards, leaving it to the discretion of national banking supervisors to decide to develop variation margin requirements for such derivatives. For instance, in December 2013, the US Federal Reserve issued a letter supporting the BCBS supervisory guidance for managing risks associated with the settlement of FX transactions and ‘encourages’ large financial institutions supervised by the Federal Reserve (companies with consolidated assets of USD 50 billion) to exchange variation margins for FX forwards.
26. The EU is the only jurisdiction to directly include physically settled FX forwards within the scope of its variation margin requirements.
27. On the one hand, the option of maintaining the status quo, i.e. the implementation of the variation margins for physically settled FX forwards as it is, might lead to a situation where EU market participants accept the negative consequences of leaving their currency risk unhedged. This might be particularly true for smaller clients for which the amount of variation margin exchanges would not be large, but would require the development of legal and operational processes, which are associated with significant costs in disproportion to the risks they pose. It is worth mentioning that, according to data provided in paragraph 19²⁰, 73% of the transactions represent dealer-to-client transactions. Moreover, clients outside the EU may for their part decide to trade away from EU banks to avoid the EU variation margin requirements for physically settled FX forwards. According to the data provided in paragraph 17, 65% of transactions were executed on a cross-border basis in April 2016.
28. On the other hand, the option of a full exemption from variation margins for physically settled FX forwards seems to contradict the BCBS and IOSCO guidance that encourages the exchange of variation margins.
29. Overall, the preferred option, as implemented in these amending RTS, would be to restrict the mandatory exchange of variation margins for physically settled FX forwards to transactions

²⁰ Taking into account the disclaimers explained in ‘C. Baseline scenario’ for this data.



FINAL REPORT ON AMENDING THE REQUIREMENTS FOR RISK-MITIGATION TECHNIQUES FOR OTC-DERIVATIVE CONTRACTS NOT CLEARED BY A CCP WITH REGARD TO PHYSICALLY SETTLED FOREIGN EXCHANGE FORWARDS

between institutions, as defined by the CRR, in a way similar to the US approach, which captures the dealer-to-dealer transactions.

Views of the ESAs Stakeholders Groups

30. The ESAs submitted the draft amending RTS to their respective Stakeholders Groups. The main outcome of these consultations is reported in this section. Furthermore, in the next section, specific aspects are examined.
31. Given the short timeframe for a response, the Securities and Markets Stakeholder Group (SMSG) was not able to provide an advice paper that reflects the opinion of the whole group. Nonetheless, the SMSG has discussed the draft RTS and have shared with the European Securities and Markets Authority (ESMA) the observations and opinions of six members of the SMSG who have considered the draft amendment to the RTS and the background and rationale presented by the joint ESAs. Those observations and views are reported in the next section.
32. As a conclusion, in their response, the SMSG members consider that the approach taken by the joint ESAs is appropriate in that, by ensuring that exchange of variation margin remains mandatory between institutions as defined by the CRR (or entities that would have been classified as institutions had they been established in the Union), the framework remains effectively similar to the US approach. In this manner, it appropriately limits risks of systemic contagion, while limiting competitive distortion and ensuring that end-users can benefit from the appropriate exemptions.
33. The Banking Stakeholder Group basically endorses the proposal by the ESAs, which aims to align EU regulation with international standards. The Banking Stakeholder Group also asked for clarification on a number of issues, as reported in the table below.
34. In conclusion, in the opinion of the Banking Stakeholder Group, the proposed amendments would align the treatment of such variation margins in Europe with their treatment in other jurisdictions. The proposal is therefore consistent with the idea of a level playing field and the Banking Stakeholder Group supports this proposal.
35. The Insurance and Reinsurance Stakeholder Group and the Occupational Pensions Stakeholder Group provided positive feedback on the proposal. The Insurance and Reinsurance Stakeholder Group and the Occupational Pensions Stakeholder Group also asked for clarifications, as reported in the table below.

Feedback on the public consultation and on the opinion of the Stakeholders Groups

36. As already specified in recital 5 of these amending RTS, given that the necessary amendments to Delegated Regulation (EU) 2016/2251 are proposed as a result of a large consensus among market participants to call for such a change, and given the urgency with which it is necessary to amend these standards in order to ensure that the potentially negative impact on the market of physically settled FX forwards in the Union is averted, in accordance with the second subparagraph of Article 15(1) of Regulation (EU) No 1093/2010 of the European Parliament and of the Council, the second subparagraph of Article 15(1) of Regulation (EU) No 1094/2010 of the European Parliament and of the Council and the second subparagraph of Article 15(1) of Regulation (EU) No 1095/2010 of the European Parliament and of the Council, the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority have not conducted any additional open public consultation.

37. The ESAs consider that it would be disproportionate in relation to the scope and impact of the draft RTS concerned. They nevertheless requested the opinions of the Banking Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1093/2010, the Insurance and Reinsurance Stakeholder Group and the Occupational Pensions Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1094/2010, and the Securities and Markets Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1095/2010.

Summary of responses to the stakeholder group consultation and the ESAs' analysis

Comments	Summary of responses received	ESAs' analysis	Amendments to the proposals
General comments			
Lack of proportionality	Some respondents in the SGs indicated that they were not able to fully reconcile how the proposed RTS apply the risk-based and proportionate approach described in the background of these RTS with the actual amendment in the main article of the draft RTS. Indeed, the proposed amendment provides a waiver to the VM requirement for all transactions involving a counterparty different from an institution, regardless of the riskiness of the deal.	<p>In the current framework, not considering the suggested amendment, all the counterparties in the scope of EMIR are subject to the variation margin requirement, from 3 January 2018, for their physically settled FX forwards. Exempting the transactions between institutions and non-institutions would exempt a large number of counterparties, please see the Impact assessment section, for a share of the market; this would imply, on average, a smaller FX position for non-investment counterparties, therefore the proportionality application of the amendment.</p> <p>The more specific inclusion of a threshold for excluding certain entities would have implied a long process for calibrating it, which would be incompatible with the urgency of this solution, as asked explicitly by the wide range of market participants making the case for this amendment.</p> <p>Furthermore, a threshold based on the volume of transactions would open the approach to the risk of regulatory arbitrage in the application of the variation</p>	The background and rationale have been amended in a manner that addresses the point raised by the SGs, i.e. that, given the clear scope defined in the new article of the draft RTS, the risk-based and proportionality aspects are needed for only the interim period between 3 January and the entry into force of the new RTS.



FINAL REPORT ON AMENDING THE REQUIREMENTS FOR RISK-MITIGATION TECHNIQUES FOR OTC-DERIVATIVE CONTRACTS NOT CLEARED BY A CCP WITH REGARD TO PHYSICALLY SETTLED FOREIGN EXCHANGE FORWARDS

Comments	Summary of responses received	ESAs' analysis	Amendments to the proposals
Unclear application of Article 31a(c)	Some SG members are unsure of the intent and correct interpretation of paragraph (c) of new Article 31a and recommend that the joint ESAs provide interpretative guidance in the draft RTS.	margin requirement for physically settled and non-physically settled FX forwards. Fund management has to be clearly distinguished from the institutions in accordance with Article 6(2) of the UCITS Directive and Article 6(2) and (3) of the AIFMD; this is in addition to the Q&A at the top of page 5 of the European Commission Q&A on the AIFMD ²¹ . Therefore, the specific case of transaction in physically settled FX forwards related to CIUs is already covered by Article 31a paragraph (a).	Paragraph (c) in the draft text of Article 31a as proposed to the SGs has been dropped.
Risk in the transaction exempted	Some SG members are sensitive to the risk that certain of such exempted transactions could generate large counterparty credit risk exposures for an institution, and recommend that the ESAs, via their supervisory convergence tools, ensure that the competent authorities verify that the institutions have the appropriate risk framework to ensure that such risks are monitored, limited and appropriately capitalised.	The appropriate risk framework for monitoring is already specified in recital 3 of these amending RTS.	No change to the text as proposed to the SGs.
Extension to FX swaps	Some SG members note that, while the draft RTS refers specifically to FX forwards and does not refer to FX swaps, the latter instrument is a simultaneous purchase and sale of two FX forwards of different maturities and is commonly booked as two forward transactions. They understand that a purchase and sale of two FX forwards would be exempt under the draft RTS, which would be consistent with US supervisory guidance that applies to both FX forwards and FX swaps. Here, again,	FX swaps were not benefiting from the deferral linked to MiFID II and thus have been in scope since the start of the variation margin requirement. As developed in the explanatory part of the Final Report, the aim of this review was not to introduce new exemptions for cases already in scope, but to focus on a targeted review of the treatment for physically settled FX	No change to the text as proposed to the SGs.

²¹ The European Commission Q&A can be found at the following link: https://ec.europa.eu/info/sites/info/files/aifmd-commission-questions-answers_en.pdf.



FINAL REPORT ON AMENDING THE REQUIREMENTS FOR RISK-MITIGATION TECHNIQUES FOR OTC-DERIVATIVE CONTRACTS NOT CLEARED BY A CCP WITH REGARD TO PHYSICALLY SETTLED FOREIGN EXCHANGE FORWARDS

Comments	Summary of responses received	ESAs' analysis	Amendments to the proposals
	<p>SMSG members consider that interpretative guidance could be useful to ensure that the scope of application is similar to the US approach.</p>	<p>forwards, which were the only products concerned with the deferral linked to MiFID II.</p>	
<p>Extension to non-physically settled FX forwards</p>	<p>Some SG members suggested that the draft RTS extend the exemption provided for physically settled FX forwards to non-physically settled FX forwards (i.e. non-deliverable FX forwards or cash-settled FX forwards).</p>	<p>Non-physically settled FX forwards were not benefiting from the deferral linked to MiFID II and thus have been in scope since the start of the variation margin requirement. As developed in the explanatory part of the Final Report, the aim of this review was not to introduce new exemptions for cases already in scope, but to focus on a targeted review of the treatment for physically settled FX forwards, which were the only products concerned with the deferral linked to MiFID II.</p>	<p>No change to the text as proposed to the SGs.</p>
<p>Entry into force – forbearance</p>	<p>Some SG members note that the date of entry into application of the proposed exemption is likely to come some weeks after the entry into application of the mandatory exchange of margins for FX forwards on 3 January 2018, and recommend that the ESAs provide guidance to the national competent authorities to ensure that supervisory practices are convergent during the interim period and do not create a risk of disruption for users of FX derivatives.</p>	<p>Please find below the link to the statement on the Joint Committee's website: https://esas-joint-committee.europa.eu/Pages/News/Variation-margin-exchange-for-physically-settled-FX-forwards-under-EMIR.aspx</p>	<p>This is now included in the executive summary and in the background and rationale.</p>