COMMERCIAL BANKING

DERIVATIVE MARKET REFORM: UNDERSTANDING EMIR

Introduction

Most businesses in Europe that undertake derivative transactions, including FX forwards, will be impacted by the European Market Infrastructure Regulation (EMIR). This factsheet outlines the regulatory obligations that EMIR imposes, whilst explaining how these obligations vary in scope according to organisation type. It also contains a useful checklist of EMIR action points and a contact point should you require further information.

EMIR – Overview

On 16 August 2012, 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 (TRs) – (better known as the **European Market Infrastructure Regulation** or **EMIR**) came into force. As a Regulation of the European Union (EU), EMIR is directly applicable in all EU member states.

Unlike previous legislation covering financial regulation, which applied only to prudentially regulated entities such as banks or investment firms, EMIR imposes obligations on all EU derivatives market participants.

EMIR affects almost all entities "established" in the EU (banks, insurance companies, pension funds, investment firms, corporates, SPVs) that enter into derivatives, whether they do so for trading purposes, to hedge commercial exposure or as part of their investment strategy.

Key Obligations:

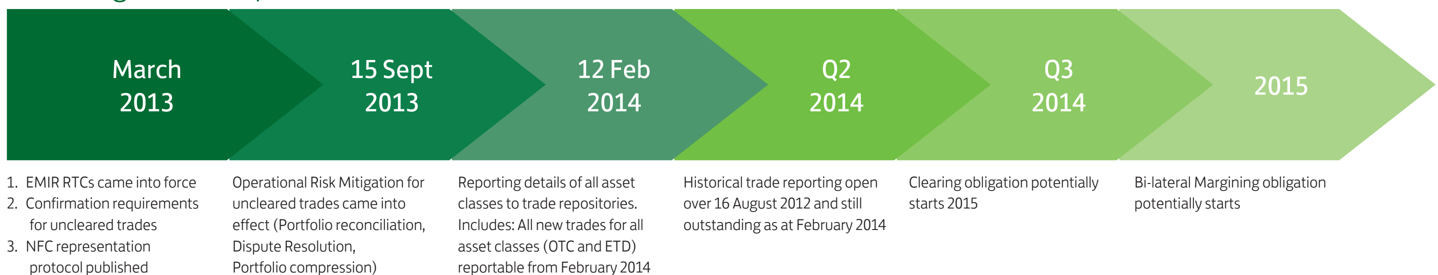
EMIR introduces four key obligations; however, these vary according to the type of organisation that is party to the contract – and this is explained further in the 'Counterparty Classifications' section of this factsheet.

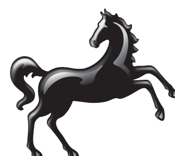
1. **Clearing**. OTC derivatives, as determined by the European Securities and Markets Authority (ESMA), must be cleared on a recognised Clearing House, unless the counterparty has an exemption. Cash FX products are exempt.
2. **Mandatory Bi-lateral Margining**. Certain non-clearable derivatives to be subject to mandatory margin requirements. A similar counterparty exemption applies.
3. **Reporting**. All derivatives are to be reported to a regulated TR by all counterparty types. FX spot transactions are out of scope.
4. **Risk Mitigation**. Mandatory confirmation timelines and mandatory portfolio reconciliation for all counterparty types.

The planned timeframe for these obligations to take effect is from 2013 to 2015.

An outline of the key dates is set out below. Please note that these dates may be subject to change.

EMIR Regulation Implementation – Timeline





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Counterparty Classifications

EMIR distinguishes between financial counterparties (FCs) and non-financial counterparties (NFCs) and these terms are important to understanding your obligations under EMIR.

An **FC** is generally a regulated entity such as an investment firm, credit institution (i.e. bank), insurance, assurance or reinsurance undertaking, undertaking for collective investments in transferable securities (UCITS), institution for occupational retirement provision or an alternative investment fund.

An **NFC** is an undertaking established in the EU that is not an FC, a central counterparty or a trade repository (TR) – in more general terms, it is a non-financial company, or a corporate entity.

Under EMIR, NFCs will be classified as either:

- **NFC–**: an NFC which meets the hedging test or if not does **not** exceed the clearing threshold.
- **NFC+**: an NFC which **exceeds** the clearing thresholds (outlined below). NFC+ is subject to similar requirements on clearing and margining as an FC. If a corporate determines itself to be an NFC+, it must confirm its status as an NFC+ to its counterparties, ESMA and the local regulator. In the UK, the local regulator is the Financial Conduct Authority (FCA).

NFC Tests:

1. Commercial purposes hedging test

   An NFC's derivative contracts are exempt from EMIR's clearing obligations under the 'hedging for commercial purposes' definition: "Derivatives that are...objectively measurable as reducing risks related to commercial activity or treasury financing activity of the NFC or of that group".

   To meet the above definition just one of the following conditions needs to be met:

   - The derivative is used to hedge the risk arising from the normal course of business (includes proxy hedging and stock options arising from employee benefits).
   - The derivative covers indirect risks.
   - The derivative is consistent with the International Financial Reporting Standards (IFRS) hedging definition.

   Derivatives that do not meet the definition are aggregated and then subject to the clearing threshold test.

Guide to determining NFC status:

2. Clearing Threshold test

   An NFC will exceed the clearing threshold if its average rolling position over 30 working days (excluding hedging positions that are "objectively held for the purpose of directly reducing commercial risks or treasury financing activity") remains above the following thresholds:

   - €1 billion* in credit or equity derivative contracts;
   - €3 billion* in interest rate, FX, commodity or other OTC derivative contracts not captured in the above categories.

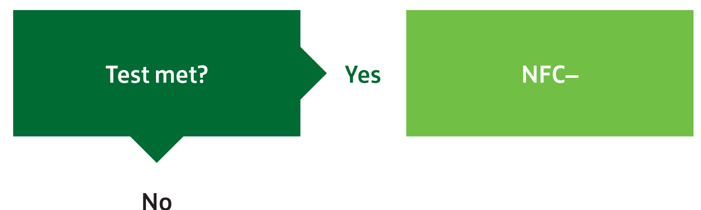
   * In gross notional value

Importantly, exceeding the threshold in **any** individual asset class will require an NFC to clear transactions in **all** asset classes. When calculating its positions, an NFC must include all contracts entered into by other NFCs within its group.

Commercial purpose hedging test

To meet the commercial purpose hedging test one of the following conditions needs to be met:

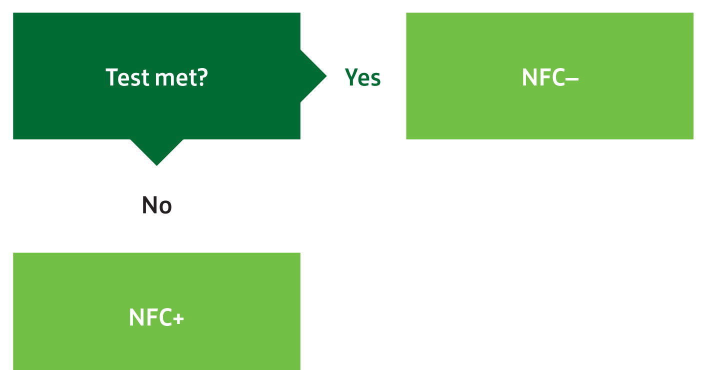
- The swap covers the risk arising from the normal course of business (includes proxy hedging and stock options arising from employee benefits)
- The swap covers indirect risks
- The swap is consistent with the IFRS hedging definition



Clearing Threshold hedging test

Thresholds for Clearing for NFC:

Credit derivative contracts	EUR 1 billion
Equity derivative contracts	EUR 1 billion
Interest rate contracts	EUR 3 billion
FX derivative contracts	EUR 3 billion
Commodity derivative contracts	EUR 3 billion
"Other" derivative contracts	EUR 3 billion



Note:

- The clearing obligation applies to all OTC derivative contracts once one of the thresholds is breached
- When calculating its positions, an NFC must include all contracts entered into by other NFCs within its group

Timely Confirmations

The requirements for timelines confirmations came into force on 15 March 2013. All OTC derivative trades must be confirmed within the EMIR timelines which range between one and four business days. The timelines are dependent on the counterparties classification and the type of derivative contract.

Credit Derivatives/Interest Rate Derivatives:

		NFC–	NFC+/FC
Trade Date	01/09/13 to 28/02/2014	T+3	T+2
	01/03/14 to 31/08/2014	T+3	T+1
	From 01/09/2014	T+1	T+1

FX/Equity/Commodity/Other Derivatives:

		NFC–	NFC+/FC
Trade Date	01/09/13 to 31/08/2014	T+4	T+2
	From 01/09/2014	T+2	T+1

*T+4 = Trade date + 4 days etc.

Portfolio Reconciliation

All counterparties (FC and NFC) are required to agree terms for portfolio reconciliation for outstanding trades. From 15 September 2013, the terms need to be agreed before entering into OTC derivative trades with counterparties. The reconciliation will cover 'key' trade attributes and valuations. The reconciliation frequency required will depend on the counterparty classification and the trade volumes outstanding:

		NFC–	NFC+	FC
Reconciliation Frequency	Daily		> 500	> 500
	Weekly		≥50 – ≤500	≥50 – ≤500
	Quarterly	> 100	< 50	< 50
	Annually	≤ 100		

Dispute Resolution

From 15 September 2013 all counterparties are obliged to agree procedures to resolve disputes. A specific process must be in place for resolving disputes that have been outstanding for more than five business days.

Trade Reporting

The Trade reporting obligation comes into effect on 12 February 2014. All derivatives (except FX spot) are to be reported to a regulated TR by all counterparty types.

All new OTC derivatives and any live trades which are still "open/live" as at 12 February 2014 will need to be reported from then onwards. Closed trades, which were open at 16 August 2012, and closed prior to 12 February 2014 do not need to be reported until 12 February 2014 + 3 years.

Trade Reporting Timeline

Contracts entered into	Condition	Reporting Deadline
On or after 16 August 2012	If outstanding on 12 February 2014	12 February 2014
Before 16 August and still outstanding on 16 August 2012	If outstanding on 12 February 2014	12 February 2014 + 90 days
Before 16 August and still outstanding on 16 August 2012, or **On or after 16 August 2012**	If no longer outstanding on 12 February 2014	12 February 2017 (12 February 2014 + 3 years)

What you need to do now

All counterparty types (FC, NFC+ or NFC–) are subject to certain **minimum EMIR requirements** including the following:

1. You **need to determine whether you are an FC, NFC+ or NFC–.**

   If uncertain, seek further advice from your legal advisers or regulatory specialist.

   You will need to **inform your counterparties** as to your classification. If you are an NFC+ you also need to inform your local regulators such as the UK's FCA. Industry bodies and regulators are currently working on automated solutions for recording classifications. ISDA have opened an EMIR NFC Protocol where you can make your representation to multiple counterparties. You can find more information at **www2.isda.org/functional-areas/protocol-management/protocol/11**

2. You **need to agree portfolio reconciliation arrangements and dispute resolution techniques.**

   There is also an ISDA EMIR Portfolio Reconciliation, Dispute Resolution and Disclosure Protocol available at **www2.isda.org/functional-areas/protocol-management/protocol/15**

3. You **need to comply with the confirmation timelines.**

4. You will **need to be in a position to report derivative transactions to a TR by 12 February 2014.**

   The minimum reporting details are specified in the ESMA Technical Standards relating to EMIR.

   Please note you can delegate reporting to your counterparty, or a third party, who will report the trade to the TR on your behalf. Lloyds Bank (Lloyds Bank plc and Bank of Scotland plc) is offering to report trades which you execute with Lloyds on your behalf.

   Please refer to our **Delegated Reporting offering** provided alongside this communication.

Contact:

If you have any questions, please contact your Lloyds Bank Relationship Manager or the Lloyds Bank EMIR team at **DF&EMIRQueries@lloydsbanking.com** or fax number: **+44 207 158 3155.**

You can find more information at The ESMA (European Securities and Markets Authority) website:
www.esma.europa.eu/page/European-Market-Infrastructure-Regulation-EMIR

And at the FCA (Financial Conduct Authority) website:
www.fca.org.uk/firms/markets/international-markets/emir

This information sheet is intended to provide basic information regarding EMIR and does not cover all aspects of EMIR nor address specific requirements or obligations of either party in connection with it. No part of this document is intended to be advice (legal or otherwise) by Lloyds Bank plc or Bank of Scotland plc on EMIR, or rules and regulations promulgated as a result thereof. Recipients should conduct their own independent enquiries and obtain their own professional, legal, regulatory, tax or accounting advice as appropriate. Neither Lloyds Bank plc nor Bank of Scotland plc accepts liability for the content of this document, or for the consequences of any actions taken on the basis of the information provided. We recommend clients obtain their own advice to assist them in understanding how EMIR will impact their business.

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