

Opinion piece

Why populating the clearing obligation field will not be so easy 20 July 2016



On 10 June, 2016 the European Commission endorsed the delegated regulation for mandatory clearing of Interest Rate Swaps denominated in SEK, PLN and NOK currencies. This regulation extends the clearing obligation from the currency scope of certain EUR, GBP, JPY and USD Interest Rate Swaps and CDSs on the iTraxx main and crossover indices. This article will take a brief look at what contracts are caught by the clearing obligation and how to complete the clearing obligation field. Doing so will require great care as there are some hidden complexities which we consider below.

ESMA previously published [revised EMIR Q&As](#) to give firms more information on how to complete the “clearing obligation” field given that the clearing obligation will impact certain G4 currency interest rate products from 21 February 2016 and credit derivatives from 9 February 2017. The clearing obligation field tells ESMA whether the contract entered into is subject to mandatory clearing or not.

So what is the clearing obligation?

EMIR Article 4 introduces the clearing obligation for certain in-scope entities. Namely financial and non-financial counterparties, FCs and NFCs respectively, as well as third country entities who would be FCs or NFCs were they to be based in the EU, dependent on the nature of the contract they are entering into. So for certain OTC derivative contracts, if the counterparties and contracts are within scope, they will have to clear the contracts through a central counterparty (CCP) that has been [authorised or recognised](#) by ESMA under EMIR.

The delegated acts go into more detail, setting out:

1. The categories of counterparties within scope of the mandatory clearing obligation
2. The OTC instruments which will be in scope of the clearing obligation.

Categories of counterparty

So far ESMA has been consistent in the categories of counterparty subject to the obligation for both OTC credit and rates products as per the table below:

Firm Category	Category definition
Category 1	Clearing members of an authorised or recognised CCP.
Category 2	Financial Counterparties, NFC+ and AIFs which are not included in category 1, and which belong to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives for January, February and March 2016 is above EUR 8 billion
Category 3	Financial Counterparties and AIFs NFC+ which are not included in Category 1 or 2
Category 3b	Trades with a third country group entity meeting the conditions for derogation
Category 4	NFC+s ¹ that are not included in categories 1, 2 or 3

¹ NFC+ are non-financial counterparties whose consolidated group (excluding financial counterparties) is above the clearing threshold in terms of notional value for open in scope derivative contracts whilst those NFC- are non-financial counterparties below the threshold and are therefore exempt from the clearing obligation altogether whilst NFC+s are not subject to the frontloading obligation.

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For interest rate derivatives denominated in EUR, GBP, JPY and USD, from 21 June 2016 mandatory clearing will firstly affect firms who are individual or general clearing members of an [authorised or recognised central counterparty](#). Six months later, category 2 firms will be caught and

category 3 firms a further six months after that. This means that firms will need to assess what category they will fall within, but also what category their counterparties will fall within as that will determine if and when mandatory clearing applies.

In addition, firms will have to categorise third country entities where they enter into a derivative contract which has a “direct, substantial and foreseeable effect within the Union or where such an obligation is necessary or appropriate to prevent the evasion of any provisions of this Regulation” per Article 4 (v) of EMIR. Helpfully, ISDA has produced a [classification letter](#) which will assist firms in capturing the necessary details from their counterparties and clients.

Those firms that don't fall within category 1 will need to do some data crunching to calculate whether their group is above or below the €8bn clearing threshold during the period 1 January 2016 to 31 March 2016 and they should be notifying their counterparties either way.

When entering into a contract, the clearing obligation applies based on the lowest category of counterparty. So the clearing requirements for a category 1 counterparty entering into a contract with a category 3 counterparty will be based on the category 3 obligations.

Which instruments are within scope of the clearing obligation to date?

So far ESMA has brought within scope certain OTC interest rate and credit instruments; the full details of which are included in the annexes to the delegated acts. These are:

- **Interest rate instruments:** basis, fixed to float and forward rate agreements are in scope for the [G4 currencies EUR, GBP, JPY and USD](#).
- **Interest rate instruments:** basis, fixed to float and forward rate agreements are in scope for the [non-G4 currencies SEK, PLN and NOK](#).
- **Credit instruments:** the [iTraxx Europe main and crossover CDX series 17](#) onwards with a five-year tenor are in scope.

This may sound simple enough but not all of these contracts are caught. Existing contracts entered into by certain categories of counterparty which have a limited remaining maturity will not be subject to the clearing obligation. Such contracts can be identified by reviewing if they were entered into during a “frontloading period” and those that are below a minimum maturity period will not have to be cleared. Those contracts with reasonable remaining maturity will be subject to clearing to capture contracts which represent a significant risk.

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Below we set out the timings for the G4 interest rate swaps:

Firm Category	Date of application of clearing obligation	Frontloading obligation	Minimum remaining maturity Interest rate products
Category 1	21 June 2016	Yes: frontloading date of 21 February 2016	Pre-frontloading date: <ul style="list-style-type: none">• 50 years Table 1 or 2• 3 years Table 3 or 4 Post- frontloading date: <ul style="list-style-type: none">• 6 months Table 1 to 4.
Category 2	21 December 2016	Yes: frontloading date of 21 May 2016	Pre-frontloading date: <ul style="list-style-type: none">• 50 years Table 1 or 2• 3 years Table 3 or 4 Post- frontloading date: <ul style="list-style-type: none">• 6 months Table 1 to 4.
Category 3	21 June 2017	Yes: frontloading date of 21 June 2017	Pre-frontloading date: <ul style="list-style-type: none">• 50 years Table 1 or 2• 3 years Table 3 or 4
Category 3b	21 June 2017	Yes: frontloading date of 21 June 2017	Pre-frontloading date: <ul style="list-style-type: none">• 50 years Table 1 or 2• 3 years Table 3 or 4
Category 4	21 December 2018	Not applicable	Not applicable

Notes:

Table references: these refer to the instrument tables in the annex of the COMMISSION DELEGATED REGULATION (EU) 2015/2205 of 6 August 2015

NFC+: Non-financial Counterparty above the clearing threshold, as referred to in Article 10 of EMIR
AIF: Alternative Investment Funds

How should the clearing obligation field be populated?

The “clearing obligation” field tells ESMA whether the contract entered into is subject to mandatory clearing obligation or not. The Q&A guidance is aimed at category 1 and 2 counterparties. In essence, the guidance states that these firms must identify whether or not a contract is subject to mandatory clearing obligations from the point that the obligation takes effect for that category of counterparty rather than when the contract is to be cleared. That means that any contracts entered into that will have to be cleared in the future, (i.e. contracts between two category 1 or 2 counterparties entered into after the front-loading period begins for that category of counterparty), the clearing obligation field must be flagged as “Y” in the clearing obligation field and “N” if not.

For contacts that aren't subject to the clearing obligation and contacts in the other asset classes the clearing obligation is not applicable so “it is considered that counterparties should report “X.” We believe that “N” would also be acceptable as the contracts are not subject to the clearing obligation.

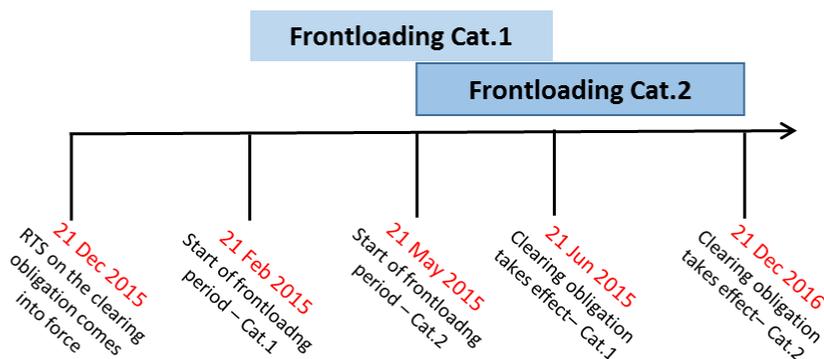
Although not crystal clear, for interest rate derivatives we think that the obligation to flag either Y or N will apply to all categories of counterparty from the first frontloading date of 21 February for G4 interest rate swaps. This is based on the diagram ESMA provides which shows category 2 counterparties having to flag their contracts with an “N” where they are entered into before the

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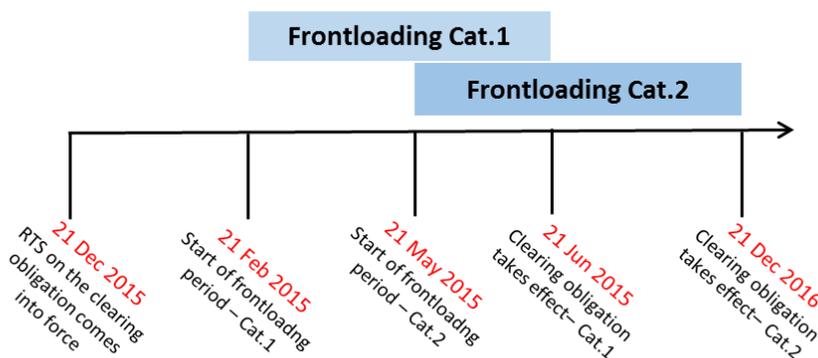
category 2 front loading period begins but after the category 1 frontloading period commencement date of 21 February 2016.

Cat.1	28	Clearing Obligation	X	Y	
Cat.2	28	Clearing Obligation	X	N	Y



The above diagram is a copy of the one presented by ESMA in the Q&As (page 92). We believe that it can be extended for category 3 and 4 counterparties by extrapolating from the requirements for category 2 counterparties. Using this approach category 3 and 4 counterparties will have to populate the clearing obligation field with an “N” until the frontloading obligation come in for category 3 counterparties on 21 June 2017 and the clearing obligation takes effect for category 4 counterparties on 21 December. Similarly, non-financial counterparties below the clearing threshold (NFC-) should continue to populate the “clearing obligation” field with “X”:

Cat.1	28	Clearing Obligation	X	Y	
Cat.2	28	Clearing Obligation	X	N	Y
Cat.3	28	Clearing Obligation	X	N	N
Cat.4	28	Clearing Obligation	X	N	N
NFC -	28	Clearing Obligation	X	X	X



So FCs and NFC+ firms should have already been populating the clearing obligation field for their interest rate products.

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Novations and swaptions

The ESMA Q&As also provide clarity on dealing with novations and swaptions. These should be dealt with as below:

1. All novations of any type which result in a new counterparty will be subject to the clearing obligation.
2. For swaptions entered into prior to the frontloading window the resultant swaps will not be subject to the clearing obligation irrespective of when the swaption is exercised.
3. For swaptions entered into after the start of the frontloading period:
 - a. Mandatory clearing applies where the swaption is exercised during the frontloading period and the resultant swap is above the minimum remaining maturity per the [RTS](#).
 - b. And for any swaptions exercised after the clearing obligation takes effect the resultant swap will be subject to the clearing obligation.