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ISDA FAQs on the Procedures for Excluding Non-EU Non-financial Counterparties Under the Capital Requirements Regulation

These FAQs address the Regulatory Technical Standards[1] (RTS) published in the EU Official Journal in May 2018, which set out the procedures for excluding third-country non-financial counterparties (NFCs) from the Credit Value Adjustment (CVA) capital risk charge under the Capital Requirements Regulation (CRR).

We have divided the FAQs into three sections related to the scope of the RTS, the requirements applicable under the RTS and the potential effects resulting from the current review of the European Market Infrastructure Regulation (EMIR Refit) and Brexit.

The responses to these FAQs involve an assessment of the existing requirements and their implications for firms; but do not constitute exhaustive nor definitive answers.

Disclaimer: This page does not contain legal advice and merely is intended as an information resource to assist market participants in planning and assessing for the identification of non-EU NFCs for the purpose of CVA requirements under CRR. For a legal interpretation of the rules, market participants should take independent counsel advice on the points addressed in these FAQs.

Scope

1. **Who does the RTS apply to?**

   The RTS applies to all CRR institutions that apply the exclusion from CVA for non-EU based NFCs.

2. **Which NFCs can be excluded from CVA capital calculation?**

   The European Market Infrastructure Regulation (EMIR) sets out the clearing obligations of EU counterparties. Non-financial counterparties that do not meet the clearing thresholds are considered to be NFC that can be excluded from the CRR capital calculation (NFC-). The clearing thresholds are calculated on the basis of the aggregated derivative positions of an NFC and of any non-financial entity in its group, excluding hedging transactions.

   Article 382(4)(a) CRR provides that transactions may be excluded from the own funds requirements for CVA risk where they are "transactions with non-financial counterparties as defined in point (9) of Article 2 of Regulation (EU) No 648/2012, or with non-financial counterparties established in a third country, where those

[1] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2018.123.01.0001.01.ENG&toc=OJ:L:2018:123:TOC

transactions do not exceed the clearing threshold as specified in Article 10(3) and (4) of that Regulation".

Article 2 of the RTS provides that:

'For the purpose of excluding transactions with a non-financial counterparty established in a third country from the own funds requirements for CVA risk in accordance with point (a) of Article 382(4) of [CRR], institutions shall verify, for each class of OTC derivative contracts referred to in Article 11 of Delegated Regulation (EU) No 149/2013, that the gross notional value of the OTC derivative contracts of that non-financial counterparty within that class does not exceed the relevant clearing threshold referred to in Article 11 of that Regulation'.

The EBA clarified in its Final Report on the RTS[2] that the intention was not to exclude particular transactions where they do not exceed the clearing threshold, but rather to align with EMIR as far as the definition of the counterparties was concerned (i.e. you still need to look at the group-wide derivative positions for the NFC's consolidated group). As a result, transactions with an NFC are excluded when the NFC is NFC- according to EMIR or would qualify as NFC- if it were established in the EU.

3. **How are the clearing thresholds calculated?**

The gross notional value of any OTC contracts must be compared to the following clearing thresholds. At time of first publication of this FAQ these were:

- credit derivatives: €1 billion gross notional value
- equity derivatives: €1 billion gross notional value
- interest-rate derivatives: €3 billion gross notional value
- foreign exchange derivatives: €3 billion gross notional value
- commodity and other derivatives: €3 billion gross notional value

If a non-financial counterparty exceeds one of the clearing thresholds for a particular asset class, they will need to clear all future hedging or speculating OTC derivative contracts in all of the above asset classes for as long as they are over the clearing threshold.

When assessing its positions, a non-financial counterparty must:

- include all contracts entered into by all non-financial entities within the consolidated group, including the entities outside the EU that would qualify as a non-financial counterparty under EMIR if they were located within the EU
- monitor the threshold against the consolidated group's rolling 30-day average of gross notional by class

[2] https://eba.europa.eu/documents/10180/1748059/Final+draft+RTS+on+procedures+for+excluding+3rd+country+NFCs+%28EBA-RTS-2017-01%29.pdf

Derivatives that are designed to reduce risks directly related to the commercial activity or treasury financing activity of the non-financial counterparty do not count towards the clearing threshold.

4. **Why were the RTS issued?**

   EU-incorporated NFCs are subject to EMIR, and have an obligation to assess if they are in scope and whether they breach the clearing thresholds. However, non-EU NFCs are not obliged to do so as they are not subject to EMIR directly.

   The onus of NFC determination therefore rests with the EU dealers with whom they trade.

Requirements under the RTS

5. **What requirements apply as a result of the RTS?**

   Banks are required to "substantiate" whether a counterparty with which it has CVA risk is:

   - a third country non-financial counterparty (NFC); and
   - if it is an NFC, whether the counterparty's positions exceed any of the clearing thresholds for any OTC asset class.

   In doing so, the bank must cross-refer to the EMIR definitions of a NFC and clearing thresholds.

   The counterparty's status must be assessed at trade inception, or on an annual basis. However, the assessment must move to being quarterly where the counterparty has positions in any OTC class greater than 75% of the relevant clearing threshold.

6. **From when does the RTS apply?**

   The RTS applies from 7th June 2018, i.e. 20 days after it was published in the Official Journal.

   As the RTS require an annual verification of the counterparty's status, institutions have until June 7, 2019 to complete the first full cycle of assessment.

7. **Can an institution rely on a representation from the client as a way of verifying and substantiating their status?**

   The RTS do not clarify what steps an institution would need to take in order to "verify and substantiate" its opinion that a counterparty is below the clearing threshold, and there are currently no EBA Q&A on this point.

   In principle, a representation from a party as to its status should be an acceptable starting point to validate that status, as long as the CRR institution does not have information in its possession, which clearly demonstrates that the statement is incorrect. As set out below, where periodic verification is required, a party will need

to consider whether it needs to refresh the representation periodically, or whether a continuing representation might satisfy the requirement.

An obligation on the party giving an NFC representation to inform the CRR institution of any change relating to its NFC status, may, satisfy that obligation, particularly if it is combined with a periodic internal verification exercise to confirm that the institution does not hold any contradictory information.

8. **In its assessment of whether transactions with a non-financial counterparty established in a third country can be excluded from the calculation of own funds requirements for CVA risk, can a credit institution use a variety of information sources, including internal, publicly available, or information provided by their non-financial counterparties?**

Yes, it is permissible to use a range of information sources available to perform the assessment.

The draft RTS attached to the EBA Final Report stated that "institutions shall base their decision on internal or publicly available information, as well as any other information submitted by counterparties". This wording was deleted in the final RTS and replaced by the references to institutions substantiating their opinion. However, we understand that institutions may still use a range of information sources to substantiate their opinion, including internal or publicly available information as well as information submitted by their counterparties.

For example, if the annual report of a non-financial counterparty clearly states that it only ever undertakes derivative transactions designed to reduce risks directly related to the commercial activity or treasury financing activity (i.e. 'hedging transactions'), then this could be taken into account in determining whether or not the counterparty is an NFC- for that assessment period. The annual report or other publicly available information may state the gross notional amount of OTC derivatives of the group of which the NFC counterparty is a part. If this is below the clearing thresholds, this could also be taken into account in determining whether or not the counterparty is an NFC- for the relevant assessment period.

Similarly, the counterparty may have made public disclosure or representations regarding its NFC- status.

As discussed above, institutions should confirm that they do not have information in their possession which clearly demonstrates that information available from other sources is incorrect.

9. **How can the verification exercise be satisfied?**

Parties are required under the RTS to verify the classification of the non-EU NFCs, at inception of each trade or on a periodic basis. The frequency of the periodic verification will depend upon how close the non-EU NFC is to a clearing threshold.

If a party is carrying out periodic verification, this should be carried out on an annual basis, or on a quarterly basis where the gross notional value of OTC derivative

transactions of the NFC- counterparty is greater than 75% of the clearing threshold value for the relevant class.

If an institution is carrying out verification on a periodic basis and wishes only to perform annual verification, it will need to assess whether or not the gross notional value of OTC derivative transactions of the counterparty is greater than 75% of the clearing threshold, for the relevant class. If there is no publicly available information on this, the institution may wish to obtain representations from its counterparty.

If the institution has information (see the discussion on sources of information in question 8 above) to support a conclusion that a counterparty only conducts hedging transactions, it should be able to assume that the gross notional value of OTC derivative transactions of the counterparty will not be greater than 75% of the clearing threshold and so should be able to conduct only annual verification.

The responses to questions 7 and 8 discuss the information that institutions may wish to take into account when conducting the verification exercises.

10. Do the requirements for verification apply only when a non-financial counterparty is transacting with an EU-based credit institution?

No, the CVA risk capital requirements and therefore the RTS apply to banking groups calculating their capital in accordance with the CRR. This means the RTS apply on a group-consolidated basis to an EU bank, including its non-EU subsidiaries.
This is broader than the scope of EMIR, which is restricted to the EU counterparty and its branches, EU and non-EU.

11. Will a non-EU NFC- potentially have to provide the same information to a number of EU credit institutions?

Yes. This may be the case if the NFC- has more than one derivative EU financial counterparty subject to EMIR requirements for OTC derivatives.
Alternatively, non-EU NFC- can self-disclose such information publicly, either in their annual accounts or in their website, for example.

12. If an NFC entity within the counterparty's group publicly discloses that it is an NFC-, can this be relied upon to characterize all NFCs in that group as NFC-?

Because the determination of whether an entity is an NFC- or NFC+ is made by reference to the aggregated notional amount of all non-hedging OTC derivatives entered into by all NFCs in that entity's consolidated group, a public statement from an NFC entity declaring that it is part of an NFC- group should indicate that all NFCs in that group are NFC-s.

13. What should an institution do if it cannot obtain the relevant information about its counterparties?

Under the RTS, the institution would not be able to make use of the CRR Article 382(a) exemptions, and would have to calculate CVA RWA for that counterparty.

14. How is the CVA risk charge applied to outstanding transactions in case an NFC- changes its status to NFC+?

If an existing NFC- counterparty becomes an NFC+, outstanding contracts shall be exempted until their maturity. In other words, the CVA charge should apply only for transactions entered into as of the date it becomes an NFC+, and all outstanding trades should be grandfathered, and not subject to the CVA risk charge.

Firms can choose to be more conservative and apply the CVA risk charge for the entire portfolio with that counterparty if they are unable to effect a split based on date.

However, CRR firms have the ability to apply a CVA risk charge to exempt firms on the basis of additional conservatism. This may be necessary for operational reasons.

15. What about if transactions are novated or extended?

Lifecycle events which alter the economic substance of a trade will be treated as new trades which are potentially subject to the CVA risk requirements.

EMIR Refit and Brexit implications

16. How will this RTS be impacted by the EMIR Refit?

The RTS cross-refers to EMIR. As and when EMIR changes that may impact how banks assess counterparties for the purposes of whether they are NCF+ or NFC-. At this stage, banks will need to apply the RTS on the basis of current EMIR.

17. Will UK banks have to treat EU27 exposures as a third country under the RTS post-Brexit and vice versa?

This will depend on the nature of the regulatory relationship between the UK and EU. It does not impact the need for UK banks to comply with the RTS as it stands.

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