



European Commission proposed regulation on OTC derivatives, central counterparties and trade repositories

Briefing note: Treatment of FX instruments under EMIR

Introduction

This note sets out the position of the Global FX Division of AFME, SIFMA and ASIFMA regarding the treatment of FX instruments under the proposed regulation covering OTC derivatives, central counterparties and trade repositories, commonly known as EMIR.

With a turnover of some EUR2.9 trillion / US\$4 trillion per day the FX market is the world's largest financial market. It is the means by which cross border payments are effected and currency risk is managed in the world's financial system. It differs from the OTC derivative markets in that it has many more participants and transactions, which are much simpler and short term. We are therefore concerned with treating the vast majority of FX transactions, which are simple exchanges of currency, as if they are "derivatives".

Scope and eligibility for mandatory clearing

The Commission's guidance on the scope of MiFID is that foreign exchange spot and forward contracts are not covered by the definition of financial instruments as these are not derivative transactions. We fully endorse that view.

We would also point out that an FX swap is simply either i) an FX spot trade combined with an FX forward trade or ii) two FX forward trades combined. There are no contingent outcomes; cash flows are determined and known at the outset of the transaction. As an economic matter, FX swaps and FX forwards are too interrelated to be distinguishable.

To the extent that such products do fall under the scope of this legislation, we believe that they should be exempted from the requirements of mandatory clearing. Our rationale is as follows (for further information see Appendix A):

- FX is an integral part of the global payments systems and is closely monitored by central banks.
- CCPs address mark-to-market credit risk. This is relatively small for FX because of its short maturities.
- Settlement risk dwarfs credit risk for FX transactions, even in the case of longer dated trades, because there is a single exchange of payments at maturity. Oliver Wyman analysis illustrates that settlement risk comprises 94% of the estimated maximum loss exposure in a trade for foreign exchange instruments with maturity of 6 months.
- Settlement risk is adequately addressed through CLS; it covers almost 90% of all inter-dealer trades and is regulated by a college of central banks.
- Mark to market credit risk is addressed through the widespread use of CSAs. These are particularly effective because MTM is easily calculated by reference to traded prices, which are readily available because of the large volumes and deep liquidity in the market.
- The remaining mark-to-market credit risk that would be addressed by a CCP is therefore minimal.
- Introducing a CCP to address mark to market credit risk would be disproportionate. It may introduce concentration risk and increase both operational risk and potentially systemic risk. Implementing a CCP model has the potential to undermine the effectiveness of existing efforts further to address settlement risk.

We acknowledge that as the text presently stands the determination of what constitutes an eligible class of derivatives for mandatory clearing will be made by ESMA (subject to certain considerations and public consultation) at a later stage.

Nonetheless, we believe it would be helpful for the Level 1 recitals to reflect that the vast majority FX transactions are **not** derivatives and are therefore distinct from the classes of derivatives being regulated in order to assist ESMA in framing its determination when it comes to this asset class. We would suggest a simple addition to the recitals as follows:

“In making its determination under Article 4 in respect of OTC derivatives relating to foreign exchange, ESMA should take into account that the vast majority of foreign exchange instruments are not derivatives. The foreign exchange market is an integral part of the global payment system and as such is monitored by central banks. The key risk in respect of foreign exchange instruments relates to settlement risk. There are existing and effective measures in place to address settlement risk.”

This distinction is made explicit in Dodd Frank’s treatment of foreign exchange forwards and swaps by allowing US Treasury to make a determination to exclude those classes of FX transactions from mandatory clearing. The statute further exempts commodity swaps where physical delivery of the commodity is contemplated. FX is more closely related to this exempt class as it calls for the delivery of currencies. The Global FX Division has submitted a public response to US Treasury’s recent invitation to comment on whether an exemption is warranted¹.

The application of any exemption, or indeed differential regulatory application, is particularly important in a market that is as global and liquid as foreign exchange. We note Patrick Pearson’s recognition of the need for regulatory convergence in his comments at the Risk Conference in New York (appendix B). The potential for regulatory arbitrage in FX would significantly damage Europe’s leading position in foreign exchange transactions; 49% of traded FX volumes occur in the EU, according to the BIS, with Asia and the US accounting for 20% and 18% respectively.

Trade repositories

There are a number of challenges for the FX industry regarding a trade repository which need careful consideration. Trade repository information must be consistent and complete (and non-duplicative as far as possible) in order for it to be meaningful. This is particularly the case if assessing systemic risk based on position reports, where omission of a single, systemically relevant trade may render position information inaccurate. This means that the trade repository must either cover all asset classes or that regulators be able to access all relevant information and aggregate data in a consistent manner. Any collateral or capital held would also need to be taken into account.

There are significant barriers to achieving sufficient coverage of data at present, in particular jurisdictional differences concerning confidentiality of counterparty data and consistent counterparty identification. We also note that the international agreement, cooperation and equivalency processes for trade repositories as set out in EMIR may well be complex.

That said, the members of the Global FX Division are committed to assisting regulators with access to trade repository information and have launched a selection process for a provider of trade repository services. We believe the most sensible approach would be to have a single trade repository that allows regional regulators appropriate access to information. This will provide the most meaningful source of reporting information.

The key issues for FX are as follows:

- The universe of participants in the FX market is significantly wider than for other asset classes given that FX forms the basis of the global payments system. There is simply a practical issue ensuring that all relevant reporting participants are able to report. It also means that consistent counterparty identifiers become even more important.

¹ <http://www.regulations.gov/search/Regs/home.html#docketDetail?R=TREAS-DO-2010-0006>

- There are a vast number of "FX trades". Consideration needs to be given to what trades are therefore material from a regulatory perspective. For example, there are a large number of technical transactions that occur across internal bank books and records which are presumably not relevant from a systemic or transaction reporting perspective. We believe the appropriate trades to capture are those that externally settle and there should be consideration of whether a minimum cut-off would be appropriate.
- The biggest architectural issue relates to position versus trade data. Recognising that there is a desire for trade repositories to provide both trade event and position data, we believe that the legislation should leave flexibility for repositories to infer the position data from the trade data, gather it separately or do a mixture as appropriate.

This will allow trade repositories to provide complete and useful position data before backfilling of historic trade data and allows the provision of useful position data if some trades are not reported to the trade repository.

"Calculating" meaningful positions from the trade population may be unrealistic:

- It requires sufficiently complete trade population
- Non-linear risks (e.g. FX options) cannot be simply aggregated across repositories
- Position information needs to show net bilateral positions across asset classes (requires consistent counterparty mapping, combined trade population, consistent parameters)

We believe the last point could be more flexibly addressed in the legislation (Article 66(3)).

Given all of these issues, we believe the key is for regulators to be clear as to the types of information that they require, which will enable participants and trade repositories to determine how best to deliver it e.g. for position reporting, in ways that may be similar to current central bank reporting mechanisms. In addition, our preference would be that regulators take a flexible and phased approach to the implementation and delivery of trade repository data.

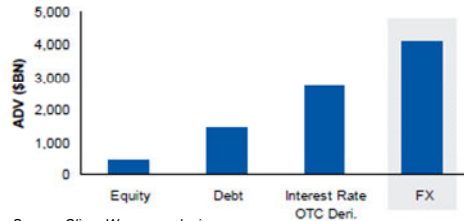
Appendix A

Introduction

The FX market is the world's largest and most liquid financial market. It forms the basis for international trade and supports the functioning of the global payments system. Its importance in effecting monetary policy has been long established and as such has historically been subject to central bank oversight.

FX has many more participants and transactions than other asset classes. Notwithstanding this, the vast majority of transactions are simple, comprising spot, forward or swap transactions. Forwards are simply an agreement to exchange principle at a pre-determined rate, whilst swaps are simply a combination of i) a spot and a forward or ii) a forward and a forward. Crucially, there are no contingent outcomes for these types of transactions; cash flows are known at the outset. BIS data shows that these products accounted for 95% of 2010 daily traded volumes.

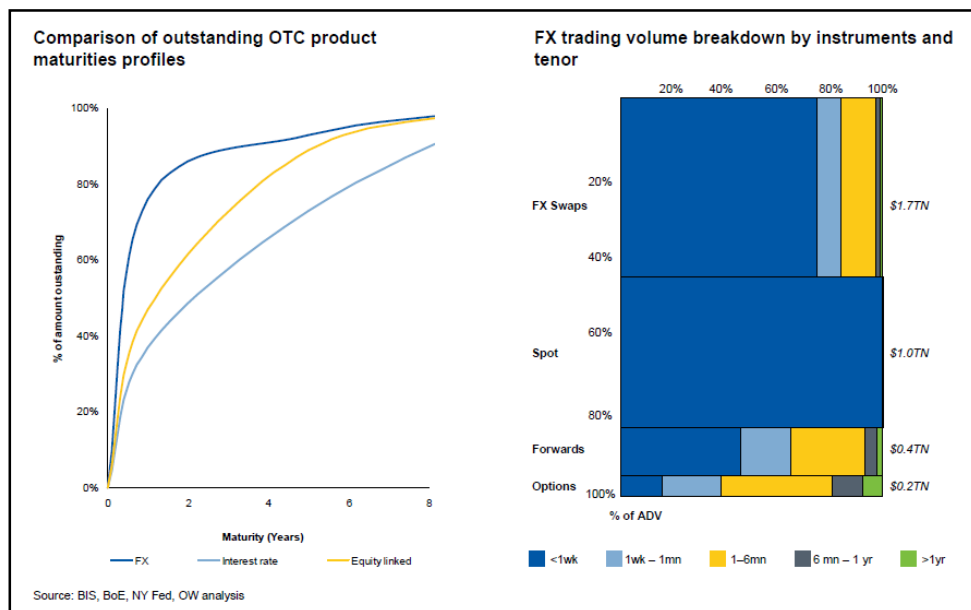
Daily trading volumes of global financial markets 2008



Source: Oliver Wyman analysis

Instrument	1998	%	2001	%	2004	%	2007	%	2010	%
Spot	568	37%	386	31%	631	33%	1,005	31%	1,490	38%
Outright forwards	128	8%	130	11%	209	11%	362	11%	475	12%
Swaps	734	48%	656	53%	954	50%	1,714	52%	1,765	45%
Options and other	87	6%	60	5%	119	6%	212	6%	207	5%
Total	1,517	100%	1,232	100%	1,913	100%	3,293	100%	3,938	100%

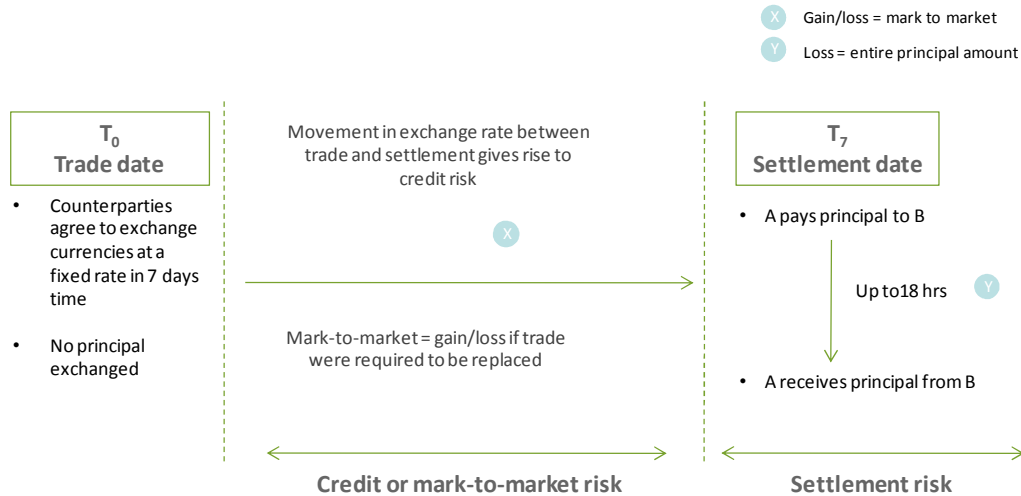
Additionally, the vast majority of FX transactions are short term. The chart that follows on the left contrasts the short maturity profile of outstanding FX instruments with those of interest rate and equity derivatives. The 16% of outstanding FX contracts with maturities longer than 2 years contrasts with more than 55% of interest rate derivatives and 40% of equity derivatives with maturities longer than two years. Of daily traded volume in 2007, more than 98% of FX forwards and 99% of FX swaps were of maturities of less than a year, as illustrated in the chart that follows on the right.



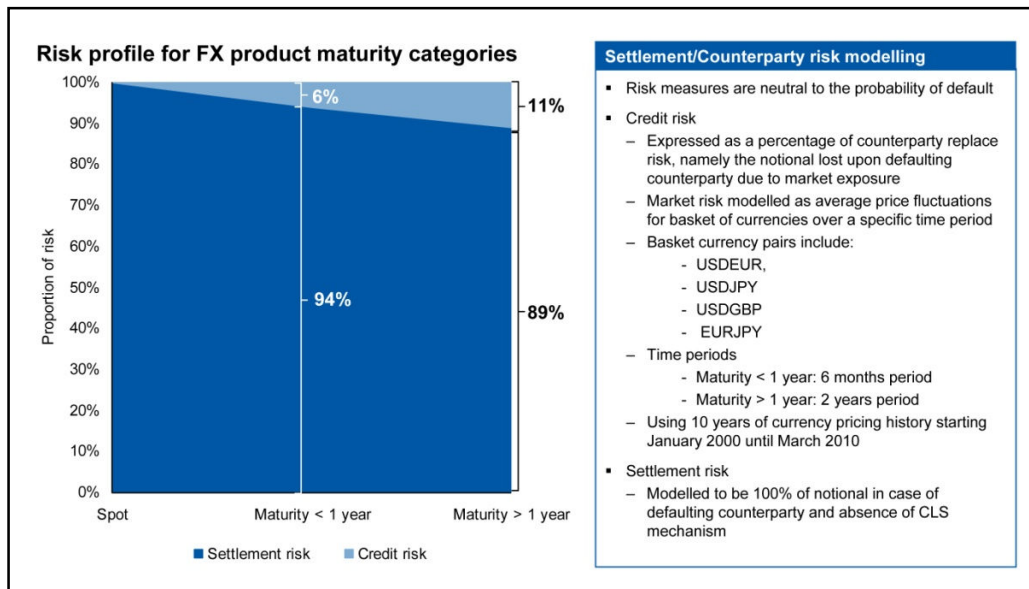
Settlement risk is the key risk in foreign exchange transactions

FX transactions typically involve exchange of principal. These settlement exposures represent the key risk in a transaction. Because of their size, settlement risk loss may be sufficient to trigger insolvency, with knock on effects to other counterparties (commonly referred to as Herstatt Risk).

7 day foreign exchange forward transaction



The graph below, based on an Oliver Wyman study, illustrates that settlement risk comprises 94% of the estimated maximum loss exposure in a trade for foreign exchange instruments with maturity of 6 months. This reduces to 89% for instruments with a maturity of 2 years.



Settlement risk is adequately addressed through CLS

CLS Bank was created in 1997 as a global settlement bank to address the concerns surrounding the systemic impact of potential settlement risk failures. By operating a payment versus payment model, whereby payments are processed simultaneously, it eliminates virtually all settlement risk to its participants. CLS Bank settles almost 90% of all inter-dealer FX trades and has had no settlement failures since it was created. CLS is regulated directly by the Federal Reserve with the active support

of all major central banks. Efforts to extend the reach of CLS Bank are under way, with broad support from both FX dealers and central banks around the globe.

CCPs address mark-to-market credit risk. This is relatively small for FX transactions because of their short maturities.

Mark to market risk is the main residual counterparty credit risk not addressed by CLS. Since most foreign exchange contracts have short maturities, the foreign exchange rate is unlikely to change significantly between the inception and maturity of most foreign exchange contracts. As a result, the in-the-money portion of the trade tends to be small relative to the principal value. Accordingly, the potential loss on foreign exchange transactions consists overwhelmingly of settlement risk.

To put this into context, for FX trades with a maturity of less than one year, Oliver Wyman analysis approximates that only 6% of the maximum risk of loss is mark-to-market credit risk. This rises to only 11% for instruments with a maturity of 2 years.

Because of their short duration, these transactions stand in sharp contrast to most other swaps, for which counterparty risk is comprised almost exclusively of credit risk on the mark-to-market value of the swap, which is the risk that CCPs are primarily designed to address.

Mark to market credit risk is addressed through the widespread use of CSAs. These are particularly effective because of high price transparency and deep liquidity.

Credit support annexes (“CSAs”) are heavily used in the FX market and are a particularly effective risk mitigation tool for addressing mark-to-market credit risk.

The deep liquidity and high price transparency of the market allows for a high level of confidence that initial margin levels will cover losses in these markets. Because the FX market is a highly liquid market in which prices are widely available 24 hours a day, market participants can also reliably determine the net amount of their exposure and therefore the appropriate amount of mark-to-market collateral.

Upon a default, the liquidity in the FX market means that the non-defaulting party can generally replace a transaction quickly and easily. Due to these characteristics of the FX market, existing bilateral agreements have been successful in mitigating counterparty credit risk exposures following the default of large FX counterparties, such as Lehman Brothers in 2008.²

The only portion of the foreign exchange market where trades are generally unsecured is where transactions are effected with corporates. Corporates use FX transactions to hedge business risks and do not generally have excess capital to use for CCP margining purposes. Regardless of whether ESMA determines to exempt classes of FX from the mandatory clearing obligation, we assume that many of those contracts would likely fall within the non-financial counterparty exemption. Mandatory clearing would therefore not result in mandatory clearing for the portion of the market that is most often unsecured.

The remaining mark-to-market credit risk that would be addressed by a CCP is therefore minimal

A CCP for FX would deliver almost no incremental credit risk mitigation because most of that risk has been covered by CSAs. The Global FX Division has undertaken indicative analysis of dealers accounting for approximately 66% of the market (by reference to Euromoney league tables). This analysis indicates that approximately 85% or more of mark-to-market exposure in 2010 relates to counterparties (excluding corporates) for which CSAs have been put in place.

² Bank of England Foreign Exchange Joint Standing Committee. [FXJSC Paper on the Foreign Exchange Market](#). September 2009. p. 2. (“FXJSC”)

Applying the Oliver Wyman analysis that 6 month instruments have potential mark to market risk of 6%, we estimate the total remaining uncovered risk to be only 0.9%. On the same basis for FX transactions with maturities greater than a year, where 11% of the potential loss is mark-to-market credit risk³, we estimate the total remaining uncovered risk to be less than 1.7%.

FX Market volume profile and Uncovered Credit Exposure (forwards & swaps)

	< 1yr Tenor	> 1 yr Tenor
Risk Profile:		
Credit / Counterparty Risk	6.00%	11.00%
Settlement Exposure %	94.00%	89.00%
CSA Usage @ 85%	5.10%	9.35%
Uncovered Credit Exposure	0.90%	1.65%

Introducing a CCP to address mark to market credit risk would be disproportionate, increase operational risk and potentially systemic risk, and undermine the effectiveness of existing efforts further to address settlement risk.

Settlement of FX transactions involves extensive interconnectedness across payment and foreign exchange systems. This is illustrated by the relationships that CLS has with central banks to facilitate the funding process that supports payment-vs-payment settlement.⁴

A central clearing regime would be either global or accomplished through a network of local CCPs. A global CCP for a market the size of the FX market would pose significant systemic risk. Local CCPs would fragment the market and reduce liquidity through the dispersal of trades, positions and collateral across many jurisdictions.

The charts below illustrate the increased operational complexity and interdependencies that one or more CCPs would likely introduce into the FX market. Given the importance of foreign exchange to the global payments system, any CCP would require the same operational infrastructure, robustness and oversight currently afforded to CLS Bank.

A CCP would also introduce concentration risk, creating a potential single point of failure where none exists today, simply to address limited residual credit risk exposure. CCPs can and have failed – largely as a result of financial distress arising as a result of unmet margin calls. Because the FX market is an integral part of the global payments system, the failure of an FX CCP would likely be significant, with destabilizing effects on foreign exchange and the global economy as a whole.

Introducing CCP clearing also risks undermining the significant gains that have been made in addressing settlement risk. Efforts to introduce a CCP model could either distract from current

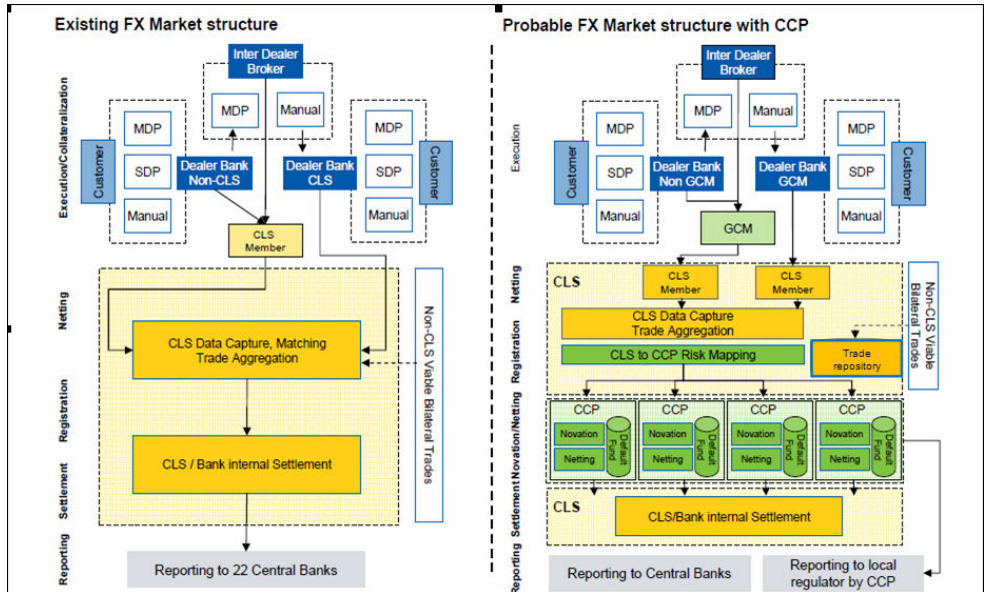
³ These calculations assume that all trades under 1 year have the MTM credit risk vs. settlement risk breakdown of a 6 mo. trade, and that all trades over 1 year have the breakdown of a 2 yr trade (based on Oliver Wyman analysis). In reality, the MTM credit risk number is probably even lower, since 68% of FX forwards and swaps have a maturity of less than 1 week.

⁴ In its 2008 review of the interdependencies of payment and settlement systems, the CPSS concluded:

“Over the past 30 years, technological innovations, globalisation and financial sector consolidation have fostered a broad web of interconnections among a large number of payment and settlement systems, both within and across CPSS countries. These interconnections reflect efforts on the part of systems and institutions to seek new business opportunities and to reduce clearing and settlement costs. They also reflect efforts by central banks and the financial industry to promote the low-cost and safe transfer of money and financial instruments. The focus of the CPSS on reducing foreign exchange settlement risk and the work of the G30 to reduce risk in securities settlement systems, for example, have both led to tighter, more integrated settlement processes.”

“The development of tighter interdependencies has helped to strengthen the global payment and settlement infrastructure by reducing several sources of cost and risk. Yet, tightening interdependencies have also increased the potential for disruptions to spread quickly and widely across multiple systems and markets.” Interdependencies Report, p. 1.

industry plans to increase usage of CLS Bank, or worse, cause participants to cease using CLS Bank, for cost or operational reasons, thereby increasing settlement risk.



Overall, we believe that the significant operational risk and costs to the global payments system of implementing a mandatory CCP are disproportionate when compared to the benefits in addressing the 0.9% - 1.7% of mark-to-market credit risk for counterparties not using CSAs.

Appendix B – Patrick Pearson and US Treasury public comments

We note Patrick Pearson's comments regarding convergence at the Risk Conference in New York on 2 November 2010:

"We would expect European regulators, before they even think of taking a decision on mandatory clearing of foreign exchange, to consult with the US and other jurisdictions. And you would probably have to wear a pretty big pair of boots to come up with a different decision. So the process and procedures and mechanics are in place for Europe to end up in the same place as South-east Asia or the US or anywhere else.

We have gone through Dodd-Frank, and we have only really identified seven or eight major discrepancies. This is not a coincidence. That is the way convergence has to work. You do convergence upstream, not afterwards. Convergence upstream is making sure the outcome is very similar - and that is what we have been doing.

It is critical that Europe and the US converge in the regulations and their approaches. It is critical because if we don't do it, the law of gravity will apply - the industry will seek the regulation that comes at the lowest cost."

We further note Secretary of the US Treasury's statement made before the Senate Committee on Agriculture, Nutrition and Forestry in December of 2009 on the nature of the foreign exchange markets.

"The FX markets are different. They are not really derivative in a sense and they don't present the same sort of risk and there is an elaborate framework in place already to limit settlement risk. These markets actually work quite well. We have a basic obligation to do no harm, to make sure that as we reform we don't make things worse and our judgment is because of the protection that already exists in these foreign exchange markets and because they are different from derivatives, have different risks and require different solutions, they require a different approach."⁵

⁵ Testimony of Timothy Geithner, Secretary of the Treasury, Before the United States Senate Committee on Agriculture, Nutrition & Forestry Hearing on December 2, 2009 on Over-the-Counter Derivatives Reform (as reported in Reuters. "Highlights: Geithner's testimony on derivatives and risk." December 2, 2009. uk.reuters.com/article/idUKTRE5B13JW20091202).

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About the Global FX Division

The Global Foreign Exchange (FX) Division was formed in co-operation with the Association for Financial Markets in Europe (AFME), the Securities Industry and Financial Markets Association (SIFMA) and the Asia Securities Industry and Financial Markets Association (ASIFMA). Its members comprise 20 global FX market participants, collectively representing more than 85% of the FX market.⁶

About AFME

AFME (Association for Financial Markets in Europe) promotes fair, orderly, and efficient European wholesale capital markets and provides leadership in advancing the interests of all market participants. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association through the GFMA (Global Financial Markets Association).

AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

For more information please visit the AFME website, www.AFME.eu.

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⁶ Bank of America Merrill Lynch, Bank of New York Mellon, Barclays Capital, BNP Paribas, Citi, Credit Agricole, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan, Lloyds, Morgan Stanley, Nomura, RBC, RBS, Société Générale, Standard Chartered Bank, UBS, and Westpac