# Global FX Division

## Committee of European Securities Regulators

## Consultation paper on standardisation and exchange trading of OTC derivatives

## Response from the Association for Financial Markets in Europe Global FX Division

The Association for Financial Markets in Europe (AFME) welcomes this consultation and the opportunity to respond. AFME's Foreign Exchange (FX) Division comprises 21 global FX market participants, collectively representing more than 85% of the FX market.[1]

The FX market is the world's largest financial market. Effective and efficient exchange of currencies underpins the world's entire financial system. As many of the current proposals may have a significant impact upon the operation of the global FX market it is vital that the potential consequences of regulatory action are fully understood and that new regulation improves efficiency and reduces risk, not vice versa.

We are aware of the joint response to this paper being submitted by AFME, BBA, ISDA, ASSOSIM and the NSA and are supportive of the views set out in their paper. We have sought here to focus on responses to the points within the consultation paper that are of particular relevance to the FX market.

### Standardisation and exchange trading of OTC derivatives

**Q2: Do you agree with the benefits and limitations of standardisation noted above? Please specify. Can you also describe and where possible quantify the potential impact of the limitations to standardisation? Are there any other elements that should be considered?**

We broadly agree with the description of the benefits and limitations of standardisation referred to in the report.

The foreign exchange market clearly demonstrates that products need not be standardised to be liquid. We welcome the Commission's recognition that bespoke products have an important role to play in meeting market participants' needs and would emphasise that this is particularly so in the foreign exchange market, where only c. 3.1% of global FX market derivatives turnover comprises exchange-traded derivatives[2].

[1] 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, State Street, UBS, and Westpac

[2] BIS Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity, 2007

As a general comment, we believe that standardisation should not be viewed as an objective in its own right. We believe that the emphasis should be placed on achieving beneficial outcomes for the market, participants and regulators, irrespective of whether standardisation is used as the means.

Key areas where we believe standardisation can play a role in achieving such benefits are in greater legal and process uniformity. The foreign exchange market is a truly global market, and this global nature and the very high numbers of participants and transactions involved have long required a very high degree of legal and process uniformity, as well as automation for the global financial system to function efficiently.

However, we are very cautious, given the nature of the FX market, about the reference within the consultation paper to product uniformity, which we would characterise as standardisation of the economic terms of products. The level of economic uniformity commonly required for classic exchange trading is simply inappropriate for foreign exchange, as the precise needs of each participant are as economically diverse as the multitude of cashflows that need to be managed daily

There is an emphasis placed, in the paper, on the need to preserve the ability of non-financial institutions to use OTC derivatives to hedge their risks. An ability to address hedging requirements solely through standardised i.e. economically standard products would inevitably create mismatch risk and have negative profit and competitiveness impacts on those firms.

However, we strongly feel that this rationale applies also to financial institutions both in terms of their ability to hedge exposures and take positions. We believe that sole availability of products whose economic terms are standardised would lead to inefficient risk management and position allocations with possible knock-on effects on capital requirements, competitiveness and / or pricing.

**Q3: Do you agree that greater standardisation is desirable? What should the goal of standardisation be?**

We agree that the industry should continue to promote greater process and legal standardisation as outlined in our response to Q2. The vast majority of FX contracts are already heavily standardised from a legal and process point of view. ISDA master agreements and credit support documentation are widely used, and there is a very large degree of standardisation and conventions to support automated electronic matching and straight-through trade processing. There are nevertheless some specific areas, for example some exotics and non-deliverable products, where full legal and process standardisation has not yet been achieved, but these represent a very small proportion of the market and they are actively being worked on.

However, as the paper acknowledges, there may be a need, even in the case of established products, for using non-standard documentation. For example, some clients may simply prefer to use less complex documentation or there may be special credit or other market reasons for additional or special terms. Accordingly, we would not support any regulatory requirement that would prohibit the use of non-standard documentation.

**Q4: How can the industry and regulators continue to work together to build on existing initiatives and accelerate their impact?**

We are supportive of the existing process around the industry commitment letters and, in terms of the work on standardisation, would note that we are already working on and investigating areas for further standardisation across the FX market with the aim of securing operational efficiency, mitigating operational risk and increasing the netting and clearing potential for appropriate products. This is in addition to the further commitments on transparency, bilateral collateralisation and operational performance.

The success of this approach can be seen in the successful implementation of a number of initiatives that have assisted in improving the structure of the market, highlights of which include:

- Implementation of a monthly metrics process benchmarking key market participants in the level of confirmation automation, and level of outstanding unconfirmed trades;
- Increased proportion of electronically confirmed non-deliverable forwards from 25-50% and subsequently to beyond 90%;
- Implementation of a standard method of electronically confirming non-deliverable options, resulting in more than 25% of trades being confirmed through method; and
- Definition and implementation of a standard method of electronically confirming simple barrier/binary trades

**Q7: CESR is exploring recommending to the European Commission the mandatory use of electronic confirmation systems. What are the one-off and ongoing costs of such a proposal? Please quantify your cost estimate.**

We believe that **artificially mandating** the use of electronic confirmation systems is neither desirable nor practical and would inevitably result in increased costs for all market participants including for corporate and other end users. The global nature of the FX market and its constituent transactions also exhibit a high degree of cross-border trade which would need to be taken into account, not just with respect to electronic confirmation (and particularly with regard to whether electronic confirmations would be legally binding in all jurisdictions) but across all regulatory actions. Electronic confirmation is widely used in the interbank market for forwards, swaps and vanilla options. Whilst some barrier products are also confirmed electronically, the more exotic options and bespoke structures are not. Further work on electronic confirmation is being progressed as a result of the industry commitment letters.

**Q8: Do you agree with the assessment done by CESR on the benefits and limitations of exchange trading of OTC derivatives? Should any other parameters be taken into account?**

Experience to date suggests that classic exchange trading is simply not appropriate for the FX market. The cashflows that need to be managed each day around the world are completely variable in terms of currencies involved, amounts, dates and times required and destinations.

This is true of both the FX cash and the derivatives market. For example, if a European aircraft manufacturer has offered a US customer a firm price in US dollars for delivery on a given date, but the contract has yet to be signed, the manufacturer may well buy an FX option to hedge the FX risk. Clearly the manufacturer needs the FX option to be for the precise amount and date (and currencies) contractually agreed with the customer, and not some approximation that may or may not be available on an exchange. For these reasons, although classic exchange trading has long existed in the FX market, it is predominantly used by participants who simply want general financial exposure to currency movements e.g. for speculation, and has thus never achieved more than c. 3% share of the overall market. There is also anecdotal evidence that recent growth in exchange trading has been driven by high frequency trading.

The FX market has been a leader in terms of electronic trading, particularly in the spot market. We acknowledge, however, that FX forwards, swaps and especially FX options have proven to be harder to migrate to electronic platforms. The greater number of parameters involved in making a price and the infinite number of possible grid points along the maturity curves and volatility surfaces means it is impractical to publish continuously updating real-time streaming prices for more than a limited number of the most popular tenors and grid points. Alternatively, the RFQ model enables clients quickly to obtain competing quotes from a number of market makers, so transparency is nevertheless easily achievable. Competition amongst the banks and the platforms is continually driving expansion of electronic trading.

The paper references price transparency as a benefit of exchange trading. Price competition amongst the market-making banks coupled with market competition between the various ECNs and aggregators is at a level where the FX market is clearly one of the most efficient markets in the world. Notably, in today's market a client can often obtain better prices than the banks themselves can achieve in the interbank market. This is achieved without the widespread use of exchange trading.

With respect to transparency for regulators, in the FX market, this would almost certainly be better achieved via a central transaction repository. FX market participants will typically manage their positions by trading globally across a variety of execution venues according to whichever venue has the best liquidity at any given time; for example, the highly fungible nature of FX means that positions established in Tokyo are routinely closed in London. Even for a participant dealing exclusively in standard products, any specific exchange or execution venue is therefore likely to have a highly distorted view of a participant's overall position. A central transaction repository that records all the relevant activity however it is executed is much more likely to achieve the desired benefit. This will be true for many OTC products, but it is particularly true for FX.

We would also note the important role played by CLS, as recently proven. As well as being a critical tool in eliminating settlement risk, CLS collects data on all the transactions that will be settled via the CLS mechanism, which comprises the vast majority of the interbank market and a growing proportion of transactions with non-banks. This data is akin to what is currently collected by trade data repositories for other asset classes. During the past year, the CLS data was an invaluable tool for market supervisors by providing detailed information on market conditions.

**Q9: Which sectors of the market would benefit from/ be suitable for (more) exchange trading?**

To promote liquidity, exchanges typically restrict the contracts available to be traded so that all market activity is clustered around a relatively small number of highly active contracts. Existing exchange trading of FX futures, for example, is clustered around a set of quarterly futures contracts.

While this may be sufficient for some participants who purely need financial exposure to these FX contracts for general hedging or speculation purposes, as discussed elsewhere in this paper, the specific needs of many or most FX market participants is as broad and diverse as the vast number of participants, therefore the traditional exchange-traded model will never meet the FX needs of more than a subset of the world's financial markets. This has been borne out in practice; traditional exchange traded FX has never gained more than a very small percentage of the market share of the wider FX market. The FX market is inherently OTC.

**Q10: In your view, for which sectors of the market will increased transparency associated with exchange trading increase liquidity and for which sectors will it decrease liquidity? Please specify.**

Increased transparency associated with exchange trading may well impact those products that inherently exhibit lower liquidity. The more transparency demanded of a less liquid product – whether by regulation directly or by being forced onto an exchange - the less attractive it is for market participants to provide market making services, as offsetting the risk is clearly more difficult where other market participants are aware of the position. This balance between liquidity and transparency is well recognised in the MiFID framework for reporting equity transactions where market volumes and trade size determine the appropriate delays in reporting. The danger of getting this wrong can be seen in the corporate bond markets subject to TRACE requirements where liquidity has been significantly impaired. Given the ubiquitous nature of FX, the negative impact of such a drop in liquidity would be significant and broad.

**Q14: Is the availability of CCP clearing an essential pre-determining factor for a derivative contract to be traded on an organised trading platform? Please provide supporting rationale.**

We would note that platform trading and CCP clearing are not intrinsically linked. CCP clearing is not an essential pre-condition for the use of organised trading platforms. There are execution models where dealers bilaterally clear transactions entered into through an organised trading platform. Likewise, just because a product may be capable of being cleared, it does not necessarily make it suitable for platform trading.

**Response to additional open hearing question**

It is true that contracts that exhibit any material difference in post trade characteristics (for example, different cashflow profiles due to daily payment of margin or differences in counterparty risk) are not economically equivalent; there will be basis risk between them. Where basis risk is judged immaterial, the market will treat those contracts as fungible.

Experience during the recent crisis showed that under conditions of market stress, many basis risks suddenly widened and traditional 'normal' market assumptions no longer held true. For example, in the stressed interest rate/funding environment, the options market was forced to resort to forward premiums as participants could no longer agree the discount curve. Settlement risk, and the role that CLS played in mitigating those risks, also became a dominant issue.

Classic exchanges function by having highly standardised front to back processes for their contracts so that the **only** difference is price. However, for that reason a contract traded on one exchange may not be easily fungible with a similar contract on another exchange. In the FX market, there are a vast number of participants with a wide spectrum of needs and, accordingly, a wide variation in specific post trade processes. This is one of the reasons the market is essentially OTC, as these variations need to be taken into account in pricing, execution and settlement.

There are a large number of FX execution venues (including single bank) that offer a greater or lesser extent of standardisation versus customisation and participants may currently choose whichever best suits their needs. Trying to limit the FX market to a small number of execution venues will, consequently, limit participants to a small number of front to back processes, which will not meet their needs. It is our view that the more important issue to be addressed are measures to mitigate settlement risk between market participants.