European Commission Public Consultation on Derivatives and Market Infrastructures

Response from the Association for Financial Markets in Europe on proposals relating to Foreign Exchange markets

The Association for Financial Markets in Europe (AFME) welcomes the 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, and effective and efficient exchange of currencies underpins the world's entire financial system. As many of the current legislative proposals may have a significant impact upon the operation of the global FX market it is vital that the potential consequences of regulatory changes are fully understood, and that new regulation improves efficiency and reduces risks, not vice versa. The following comments summarise our observations on the points within the consultation paper that are of particular relevance to the FX market.

Eligibility for the clearing obligation

We welcome a process whereby ESMA would assess each class of instrument individually for subjection to mandatory clearing, rather than adopting a one size fits all approach. We note that ESMA would apply objective criteria based upon systemic risk reduction, and that it would undertake a public consultation for each class of instruments.

Without wishing to anticipate ESMA's consultation with respect to FX, we believe that FX should not be subject to a <u>mandatory</u> clearing requirement for the following reasons:

- The systemically important counterparty risk in the FX market is settlement risk (addressed e.g. by CLS) not credit risk, as addressed by CCPs. Mandating use of CCPs for FX participants would divert attention from addressing the important systemic risk;

- A mainstream CCP in the global FX market would introduce a significant concentration risk into the world's financial system;

- Exchanging currencies is a ubiquitous activity involving far more participants and far more transactions than the financial derivatives markets that have been regulators' principal focus. Any adverse consequences of new regulation would be felt much more widely in FX than for most other asset classes; Thus

[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

- Mandating use of CCP clearing for FX transactions would subject a great number of participants to additional costs while doing little to reduce systemic risk in the financial system. Indeed, it might actually increase it.

The importance of these considerations specific to the FX market has been recognised in the new financial regulation currently being passed in the United States of America.

Risk mitigation techniques for non-cleared contracts

The FX market provides a good example where these principles for handling non-cleared contracts are applied successfully in practice. This was amply demonstrated during the recent financial crisis.

Participation requirements

The EU consultation paper envisages a future environment whereby clearing is effected:

a. directly between clearing members of a clearing house

b. indirectly by third party clients, who are not clearing members themselves but clear via a clearing member.

It is important to consider that there may be a small but important minority of participants, each of whom:

- Performs a valuable function e.g. in a local market
- Falls under a mandatory clearing requirement
- Does not qualify to become a direct clearing member
- Struggles to find anyone willing to take them on as a third party client (e.g. because of counterparty risk concerns), or is willing to do so only at prohibitive cost.

It is worth noting that third party clearing arrangements almost always expose the clearing member to counterparty risk with respect to a client, at least from an operational risk perspective.

Such participants would, on the face of it, be excluded from the foreign exchange market. This may have advantages; it may also cause significant disutility within local economies as local companies may not impeded from accessing the FX markets through their national banks who may not be clearing members. This may be particularly an issue in the FX market due to the ubiquity of foreign exchange and the very large numbers of highly diverse participants who need access to the market. This issue should be studied carefully before clearing is mandated.

Obvious solutions to this issue would be either:

a. do not make clearing compulsory, or

b. mandate clearing only for participants who would qualify to become direct members of a clearing house.

Default fund, default waterfall

We welcome the European Commission's focus on ensuring the soundness and robustness of CCPs within the EU.

If CCP clearing were mandated upon the FX market, due to its global systemic importance a mainstream FX CCP would be widely perceived as being "Too Big To Fail". Market supervisors would be assumed to have contingency plans (i.e. to act as the ultimate default fund) in case the FX CCP were threatened with failure. In a crisis a perception that the FX CCP were threatened but that there was no such contingency plan, could well by itself provoke a systemic crisis across the world's financial system.

In this context, possibly the greatest risk of failure for an FX CCP would arise from failure in other asset classes also cleared by the same CCP, which in turn could overwhelm the resources of the entire CCP. The extent to which a significant CCP could sustain a major collapse in one of its asset classes without experiencing concerns over its ongoing ability to clear other asset classes is untested. In this respect the configuration of default funds and the commitments of the clearing members are obviously important, but these resources will always be finite and limited.

These points should be given explicit consideration when determining whether FX should be subject to mandatory clearing.

Relations with third countries

One major factor underpinning significant advances in the efficiency and effectiveness of the global FX market over recent years has been the ability to trade FX contracts seamlessly and fungibly, regardless of geography or time zone. This has helped bring about very high levels of market transparency and straight through processing efficiency. There is clearly a risk that new regulatory regimes might impair this global efficiency by imposing new restrictions on who can trade with whom and under what conditions.

In the FX market a significant proportion of business is transacted between counterparties in different jurisdictions, sometimes in currencies that are foreign to both counterparties (e.g. a US and an EU counterparty executing a CHF-JPY trade). The potential negative impact of CCP clearing can be reduced if each mainstream FX CCP (if there is more than one) that meets appropriate standards is mutually recognised by all jurisdictions, and the counterparties to the trade can agree between themselves where the contract is to be cleared:

- This avoids potential conflict where each counterparty would be required to clear the same trade in a different jurisdiction.

- It allows counterparties to select the CCP that is most efficient in terms of cost and collateral efficiency for that trade (e.g. where there are offsetting positions).

- It avoids needlessly proliferating CCPs, which is inefficient for the market as a whole.

The worst case would be for each jurisdiction to mandate use of local CCPs, which (a) would lead to an unnecessary proliferation of CCPs in each asset class and (b) would likely lead to each major participant having to set up new legal entities within each jurisdiction, especially for FX as it is ubiquitous. This would significantly diminish the efficiency of the global FX market, the cost of which would be felt as much by end users as by market professionals.

Finally, it is important to note that, unlike most financial derivatives, the fundamental asset being exchanged in most FX transactions is sovereign currency *per se*, and this is often the sovereign currency of a third country and is therefore of significant interest to the third country's central bank. CLS provides a good model whereby the utility is lead regulated by one central bank (the Federal Reserve) but on behalf of a college of the other main central banks. This aspect should be explicitly considered with respect to an FX CCP.

Interoperability

Interoperability between CCPs is potentially attractive at a conceptual level, but making it work in reality without compromising the robustness of the mainstream FX CCP/s will be a significant challenge. Clearly this is critically important for the FX market. The worst outcome would be a web of FX CCPs that is only as strong as its weakest link.

Trade Repositories

The FX industry supports the introduction of a central trade repository. The market already has a *de facto* central repository in the form of the CLS database, which proved useful to regulators during the recent financial crisis.

Specific points relating to the FX market:

- The highly global nature of the FX market strongly points towards having a single global repository rather than multiple local repositories. In addition to clear advantages in terms of cost etc, having a single central repository will greatly help achieve the level of oversight desired by regulators.

- The vast and diverse nature of the FX market presents some formidable practical challenges in creating an FX repository:
    - vast number of transactions daily including technical transactions effected across internal books and records.

    - the very large number and diversity of participants presents formidable static data challenges in achieving consistent counterparty identification.

We recommend, at least initially, focusing the requirement for FX trade reporting to *externally settling transactions between counterparties with SWIFT (BIC) codes*. This needs further discussion, but would capture the majority of risk between financial institutions in a manner that is relatively easily achievable.

09 July 2010

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