Response to the Discussion Paper on the Clearing Obligation under EMIR

A. Respondent

Name: *GFMA Global FX Division*

Country: *UK (and global)*

Category: please use the table below

Category	Please select
Audit/Legal/Individual	
Banking sector	*X*
Central Counterparty	
Commodity trading	
Government, Regulatory and Enforcement	
Insurance and Pension	
Investment Services	
Non-financial counterparty subject to EMIR	
Regulated markets/Exchanges/Trading Systems	
Other Financial service providers	

B. Introduction – General comments

The Global Foreign Exchange Division (GFXD) of the Global Financial Markets Association (GFMA) welcomes the opportunity to comment on behalf of its members on ESMA's *Discussion Paper – The Clearing Obligation under EMIR* (ESMA/2013/925). The GFXD 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 22 global FX market participants,[1] collectively representing more than 90% of the FX market.[2] The GFXD and its members are committed to ensuring a robust, open and fair marketplace, and welcome the opportunity for continued dialogue with global regulators and to set out our views in response to your discussion paper.

Given the global nature of the FX market, we wish to emphasize the importance in ensuring that the regulatory treatment of FX products in multiple, global jurisdictions remains consistent. We cover below, in particular in the response to Question 15, the detailed rationale behind the exemption to any central clearing obligation of deliverable OTC FX forwards and swaps by the US Department of Treasury and strongly recommend that ESMA follow a similar approach by not issuing a clearing obligation for such products. As specified in recital 19 of EMIR, ESMA should identify and take into consideration the predominant risks for OTC derivative products and, in this context, international convergence – specifically, recital 19 affirmatively recognizes that in some classes of OTC derivatives, such as FX, the CCP clearing mandate/solution may not be the optimal solution for dealing with the predominant risk for that market, such as settlement risk. International convergence is paramount for deliverable OTC FX forwards and swaps where the predominant risk is settlement risk. Following extensive study of settlement risk by the central banks as a source of systemic risk for the FX market and therefore the global financial market, FX market participants, in close collaboration with central banking and legislative authorities in numerous jurisdictions, went to considerable lengths to address this risk, ultimately leading to the creation of CLS Bank International (CLS) in 2002. CLS' settlement system today eliminates virtually all settlement risk to its participants. Additionally, CLS' activities are subject to a cooperative oversight protocol arrangement among 22 central banks whose currencies are settled in CLS. Key unintended consequences of mandating clearing for deliverable OTC FX forwards and FX swaps include potentially undermining the efforts that have been made in addressing settlement risk to date; creating a single point of failure where none exists today; and increasing costs and risk for corporate and buy-side end-users of FX.

[1] Bank of America Merrill Lynch, Bank of New York Mellon, Bank of Tokyo Mitsubishi, 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 St., UBS, and Westpac.

[2] According to Euromoney league tables

To ensure the continued effectiveness and functioning of, and access to, the global payment system which underpins the international financial system, it is critical that the single deliverable FX market which exists today remains whole, *i.e.*, is not bifurcated into a cleared v. un-cleared market for these key products whose main purpose is to facilitate payments. Any such bifurcation would negatively impact liquidity and increase funding costs for the end user. Most importantly, as detailed in our comments below, introducing clearing into the deliverable FX market without ensuring that CCPs only bear risks that they can properly manage – which they currently cannot in response to established regulatory standards – would increase, rather than decrease, potential systemic risk, especially in times of crisis.

We would also like to take this opportunity to acknowledge our support of the final policy framework released by the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) which establishes minimum standards for margin requirements for non-centrally cleared OTC derivatives – in particular, the exemption of physically settled FX forwards and swaps from initial margin requirements.[3] We respectfully urge ESMA to support this agreed global framework by ensuring its regulations are consistent with it by not applying initial margin requirements to deliverable FX forwards and swaps. Further, we believe that any determination by ESMA to issue a clearing obligation for these two products would run contrary to the emerging international view not only on the clearing of these products but also to this agreed global framework on margin for them.[4]

We also urge ESMA to consider an FX transaction that is entered into solely to effect the purchase or sale of a foreign security to be a bona fide spot transaction in situations where the settlement period for the security is greater than two days (*i.e.*, > trade date +2) and therefore outside the scope of EMIR. [5] Because this approach has been adopted by the CFTC and SEC in the final product definitions issued last year pursuant to the US Dodd-Frank Act,[6] and by the Canadian regulatory authorities in proposed updated model rules and guidance issued this year on OTC derivatives regulation,[7] we encourage ESMA to adopt the same approach.

C. Comments on the discussion paper and answers to questions

2.4. Foreign Exchange derivatives

Comments on paragraphs 75 to 78:

Question 14 (FX derivatives): Do you consider that the main characteristics of the FX derivatives are adequately captured by the proposed structure? Are there any other variables which you consider as relevant in the context of the clearing obligation?

Answer 14:

While we support the rationale behind separating contracts in a manner which is consistent with industry taxonomies, the relevance of the "economic purposes" of the contracts (a concept referred to in paragraph 76) is not clear. With this in mind, we draw ESMA's attention to the FX taxonomy which has been widely adopted for purposes of derivatives regulation by market participants, *e.g.*, in the context of trade reporting in the United States. A copy of this taxonomy is attached as Appendix 1 for convenience.[8] As noted therein, the classifications include non-deliverable forwards (NDF), non-deliverable options (NDO), forwards, vanilla options, simple exotic options (with further breakdown into two sub-products – barrier and binary/digitals) and complex exotic options.

---

3 http://www.bis.org/publ/bcbs261.pdf.

4 *See* letter from GFXD, dated September 28, 2012, in response to the *Consultative document on margin requirements for non-centrally cleared derivatives* issued by BCBS and ISCO joint working group on margin requirements (GFXD Margin Letter), available at http://gfma.org/correspondence/item.aspx?id=367. This letter identifies a number of serious risks and consequences associated with the imposition of mandatory margin requirements on uncleared deliverable OTC FX forwards and swaps.

5 Many of our members act as custodian for the securities of, in the case of broker-dealers, their customers and, in the case of banks, for their customers and those of their affiliated broker-dealers. Due to the increased access and investor interest in foreign markets, growing numbers of these customers are invested in foreign securities. To facilitate the purchase or sale of these foreign securities, bank custodians and broker-dealers, as part of their duties, often enter into a FX transaction that is incidental to and for the sole purpose of effecting the foreign securities transaction. For example, when a customer wishes to purchase a Euro-denominated security, the broker-dealer or bank custodian will enter into a corresponding FX transaction to have Euros on hand to effect the securities transaction. These FX transactions are an integral part of the settlement process. Typically, the settlement cycle for most securities is trade date plus three days ("T+3"). Accordingly, the bank custodian or broker-dealer would enter into a FX transaction on a T+3 basis, as well. In some securities markets, for example in South Africa, the settlement cycle can take up to seven days.

6 *See* http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-18003a.pdf (pages 48256-48258).

7 *See* Canadian Securities Administrators (CSA) CSA Staff Notice 91-302 Updated Model Rules – Derivatives Product Determination and Trade Repositories and Derivatives Data Reporting available at http://www.bcsc.bc.ca/uploadedFiles/securitieslaw/policy9/91-302_%5BMultilateral_CSA_Staff_Notice%5D.pdf; and equivalent from the Ontario Securities Commission (OSC) at http://www.osc.gov.on.ca/en/SecuritiesLaw_rule_20130606_91-506_91-507_rfc-derivatives.htm.

8 www.gfma.org/uploadedFiles/Initiatives/Foreign_Exchange_(FX)/GFMA%20FX%20Division%20Paper%20(2011-11-30)%20-%20FX%20Market%20Architecture%20Group%20-%20FX%20Taxonomy%20Proposal.pdf.

The two classes of FX products included in section 2.4, paragraph 77, are (1) non deliverable forward (NDF) class in table 14; and (2) cash settled forward (CSF) class in table 15. However, these two classes proposed in the consultation paper are more appropriately and accurately classified as a single class only. The transactions listed in tables 14 and 15 involve two transacting parties executing an FX forward contract on the basis of non-delivery (*i.e.*, cash, not physical, settlement) which involves the fixing (*i.e.*, valuation) of the contract and therefore settlement in single reference currency. We appreciate that the term non-deliverable forward in the FX context often refers to trades involving currencies subject to restrictions such as general capital controls or other governmental actions, but we believe that distinction is without meaning for purposes of these classifications when the contract is traded on the basis of delivery in a single reference currency. By way of illustration, the Korean won is known as a restricted currency, but may be traded as a non-deliverable forward or a deliverable forward. CLS Bank International, the multi-currency payment system for the institutional FX market, introduced the Korean won into its settlement service in 2004 for deliverable FX spot, forward and single leg of FX swap trades and only subsequently, in 2007 supported settlement services for non-deliverable forwards involving Korean won when its settlement service was extended to non-deliverable forward trades. For these reasons, we strongly recommend that the two classes (NDF and CSF) currently identified in section 2.4 are classified as a single NDF class only. This will also avoid the unnecessary proliferation of classes within and overly complex taxonomy for the FX market.

We also wish to note that within the single class of NDFs we propose, there is not a further breakdown with respect to "product type". The only further product breakdown necessary – and we stress that this is indeed necessary– is based on currency pairs as currently illustrated in section 2.4 tables, along with notional currency, settlement currency and maturity; as currently indicated in the section 2.4 tables, for the single class of NDFs we propose, the "settlement type" will always be cash.

Because liquidity by currency pair varies significantly, clearing is only warranted on a product eligible-for-clearing basis (in this case, the NDF class) for those contracts in the NDF class which (1) are highly standardized; and (2) involve very liquid currency pairs of sufficient volume. Only clearing of such contracts would offer a potential material reduction in replacement risk across the FX market and, importantly, be manageable by CCPs in a default situation. As CCPs launch their initial and additional FX products, and additional currency pairs within each class/ product over time, ESMA should give each product, by currency pair, due and careful consideration to ensure that any clearing obligation is warranted based on the criteria described above for the relevant currency pair. Approving FX derivatives by product class and, within each product class, by currency pair will also enable consideration of the pace of development at competing CCPs to ensure market participants have a choice of venues to ameliorate systemic risk and encourage competition.

> **Question 15 (FX derivatives): Do you have preliminary views on the specific items of the presented class which would be the best candidates for the clearing obligation, in view of the criteria to be assessed by ESMA, taking into consideration the overarching aim of reducing systemic risk and the criteria defined in Article 5(4) of EMIR?**

Answer 15:

As previously raised with ESMA[9] with respect to its review of a class of an OTC derivative for a clearing obligation, we urge ESMA to require specific information from the CCP on the end-to-end testing conducted with its clearing members for that market. Specifically, in the case of FX products, specific information should be required on: (1) the scenario analyses / stress testing performed by the CCP, the default management processes for the CCP and resulting impact on the underlying liquidity in the FX product(s) that the CCP clears or plans to clear, and the arrangements in place to address management of sovereign risk events (*e.g.*, suspension of trading, sovereign default, unexpected bank holiday or other significant disruption to valuation, payment or settlement processes); and (2) a description of the manner in which the CCP has provided information to the central banks of the relevant currencies on its clearing of FX products, including but not limited to (1) above, and a summary of any views expressed by the central banks to this information – especially if the CCP's services were extended to deliverable OTC FX contracts, whether forwards, swaps and even options. Because the deliverable FX market is a central component of the global payment system, central banks have expressed a need to understand and evaluate the impact of clearing by CCPs, individually and collectively, on the deliverable OTC FX market from a broad policy perspective.

With the foregoing in mind and consistent with Article 5(4) of EMIR and Article 7 of Regulation (EU) No 648/2012, ESMA should include in its evaluation of the specific items in the presented class such as non-deliverable forwards the availability of relevant market practice recommendations and documentation through industry groups such as EMTA[10] which address, *e.g.*, the types of market disruption events referenced above, if applicable for the reference currency traded. It will also be extremely important for ESMA to be aware of the value and volume of contracts in the product class actually being processed not only by the CCP for which ESMA has received notification referred to in EMIR Article 5(1), but other CCPs for which notice has not yet been received, and their value and volume relative to the overall trading activity which may exist for the product (in particular, the currency pair for that product) regionally

[9] *See* http://www.gfma.org/Initiatives/OTC-Derivatives/GFMA-Submits-Comments-to-the-European-Securities-and-Markets-Authority-on-Draft-Technical-Standards-for-Regulation-of-OTC-Derivatives/ (GFXD Letter March 2012).

[10] *See, e.g.*, http://www.emta.org/doc.aspx.

and globally. While low values or volumes (including zero) for a given currency pair in a product class could theoretically be attributable to the service offerings being new, it is prudent and necessary to confirm this through appropriate consultation with market participants, both buy-side and sell-side, as such consultation may surface the very types of issues raised above. It is for these reasons that the rate and pace which CCPs are listing new products should not drive the rate or pace with which, or importantly the decision, of ESMA to subject a class of contracts to a clearing obligation. It is also worth noting that there are existing/historical markets in the specific items listed in the first table in section 2.4, which is stark contrast to the specific items in the second table where no such market currently/historically exists. Finally, to further consistency in the treatment of products in the global FX market, we urge ESMA and all regulators to investigate whether other similarly situated jurisdictions have imposed a mandatory clearing obligation for a given currency pair in an FX product class before imposing such a clearing obligation in its own jurisdiction and, in doing so, consider whether the underlying reasons for imposing – or not imposing – such an obligation are also applicable / relevant for its own jurisdiction.

Based on all the reasons noted above, the products in the second category (currently categorized as "cash settled forwards class") would, *prima facie*, not be appropriate for, and therefore not satisfy, the requirements of EMIR Article 5(4) or Article 7 of Regulation (EU) No 648/2012.

3. Preliminary analysis of the readiness of asset classes vis-à-vis the clearing obligation

Comments on paragraphs 85 to 105:

Question 19 (readiness of the classes): Do you agree with this analysis?

Answer 19:

We agree with ESMA's conclusion that the FX asset class should not be given a high priority, as compared to the interest rate and credit derivatives, in the context of the clearing obligation for many of the reasons articulated in the discussion paper.

We also wish to note that, with respect to paragraph 88 in the discussion paper, we welcome the explicit reference to ESMA's consideration of international agreements and consultations prior to making any final determinations regarding which derivatives products will be subject to a mandatory clearing requirement and encourage other regulators globally to do the same. This is consistent with recital 19 of EMIR and, as detailed in our response to question 33 below, is particularly relevant for deliverable OTC FX products in light of the systemic relevance, and unique characteristics of the FX market, and the need expressed by central banks to understand and evaluate the impact of clearing by CCPs, individually and collectively, on the deliverable FX market from a broad policy perspective.[11]

5.2. Foreign exchange OTC derivatives

Comments on paragraphs 139 to 140:

Question 33 (FX derivatives): Within the foreign exchange asset class, for which type of contracts do you consider that settlement risk is the predominant risk, and what criteria or characteristics should be used by ESMA to identify those contracts?

Answer 33:

As previously noted to ESMA[12] and other regulatory authorities globally, within the FX asset class, the contracts for which settlement risk is the predominant risk are FX forwards and FX swaps contracts executed on a deliverable basis, *i.e.,* on the basis of physical settlement and not on the basis of cash settlement in a single reference currency (which are the subject of the FX products currently listed in the tables in section 2.4 of the discussion paper).

The shared key characteristic of deliverable FX forwards and swaps is that each contract is executed between two transacting parties as an agreement to deliver one currency in exchange for another on a gross basis at a pre-determined fixed rate of exchange. FX forwards and FX swaps are simple exchanges of currency and have are no contingent outcomes because cash flows are known at the outset of such contracts. Further, the main counterparty risk is settlement risk, not mark-to-market risk; settlement risk is the risk that one counterparty does not deliver their side of the currency exchange while the other counterparty has delivered their side. CCPs are designed to mitigate "mark-to-market" risk – not settlement risk.

The G10 central banks identified settlement risk as **the** source of systemic risk associated with FX spot, swaps and forward contracts, expressing their conclusions that (emphasis added):

---

[11] *See* http://www.gfma.org/Initiatives/Foreign-Exchange-(FX)/GFMA-Submits-Comments-to-the-ESMA-on-Technical-Standards-for-the-Regulation-on-OTC-Derivatives,-CCPs-and-Trade-Repositories/ (GFXD Letter August 2012).

[12] *See* GFXD Letter March 2012 and GFXD Letter August 2012.

> *To be sure, FX trading poses many other forms of risk, including market risk (the risk of loss from an unfavourable exchange rate movement), replacement risk (the risk of having to replace, at current exchange rates, an unsettled yet profitable FX transaction with a failed counterparty) and operational risk (the risk of incurring interest charges or other penalties for misdirecting or otherwise failing to make FX settlement payments on time owing to an error or technical failure). FX market participants must recognise and manage appropriately each of these risks. [footnote: For instance, the Basle Capital Accord currently covers replacement risk. In January 1996 the Accord was amended by the Basle Committee on Banking Supervision to explicitly cover market risk...]* ***Nevertheless, since the associated amounts at risk represent only a fraction of the underlying value of each transaction, they are dwarfed by the size of foreign exchange settlement exposures.***
>
> *[A] bank's maximum FX settlement exposure could equal, or even surpass, the amount receivable for three days' worth of trades, so that at any point in time - including weekends and public holidays - the amount at risk to even a single counterparty could exceed a bank's capital....*
>
> *Secure and well-functioning payments systems are necessary for the attainment of central banks' monetary, macroprudential, supervisory and other policy objectives. They are also essential mechanisms in the management by individual commercial banks of their assets and liabilities, and in the settlement of their own transactions as well as those of their customers. It is therefore appropriate that central banks should be concerned that the settlement arrangements in the foreign exchange markets should be structured so as to minimise systemic risk (the risk that the failure of one market participant to meet its required FX settlement or other obligations when due may cause significant liquidity or credit problems for other participants, and so may threaten the stability of the financial markets)....*
>
> *The vast size of daily foreign exchange (FX) trading, combined with the global interdependencies of FX market and payments system participants, raises significant concerns regarding the risk stemming from the current arrangements for settling FX trades. These concerns include the effects on the safety and soundness of banks, the adequacy of market liquidity, market efficiency and overall financial stability.*[13]

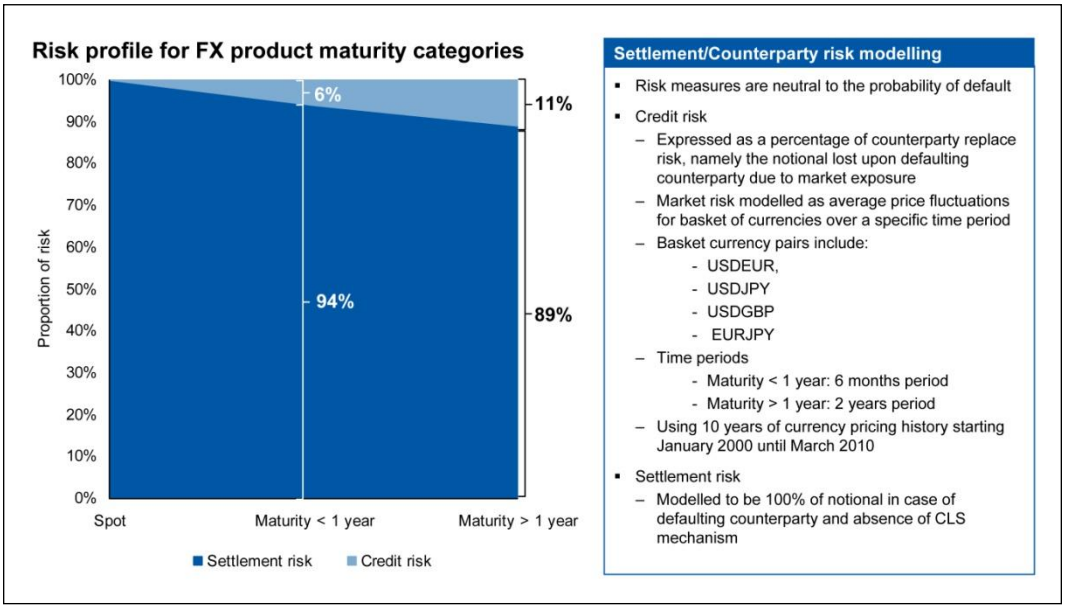
These conclusions were reached by the G10 central banks at a time when turnover in the FX market was estimated by the BIS to be USD 1.2 trillion, a fraction of the USD 4 trillion estimated in 2010 and USD 5.3 trillion estimated in 2013.[14] According to the result of a recent study, settlement risk comprises 94% of the maximum loss exposure in a trade for FX instruments with maturity of less than one year, and 89% for instruments with maturity of greater than a year.[15] The chart below illustrates the break-down of the maximum risk of loss between settlement risk and the remaining risk, namely replacement cost risk, for FX contracts of different maturities. Only 6% of the maximum risk of loss associated with a counterparty default for these products is replacement cost risk which is dwarfed by the 94% which represents settlement risk.[16] This stands in sharp contrast to most OTC derivatives for which counterparty credit risk is comprised almost exclusively of replacement cost risk.

[13] *See* BIS CPSS *Settlement Risk in Foreign Exchange Transactions,* 1996 (Allsopp Report) available at http://www.bis.org/publ/cpss17.pdf. See also BIS *Central Bank Payment and Settlement Services with respect to Cross-Border and Multi-Currency Transactions,* 1993 (Noël Report)("the loss of principal in settling ... a foreign exchange trade would dwarf any gain or loss that might have accrued to the counterparties to the original transaction") available at http://www.bis.org/publ/cpss07.pdf.

[14] *See* BIS 2013 FX Survey.

[15] Oliver Wyman analysis.

[16] Oliver Wyman analysis. All else being equal, the amount of replacement cost risk is higher for longer maturities because there is more time for the exchange rate to move.



CCP Offerings in FX. With respect to the statement in paragraph 140 of the discussion paper that "some CCPs already clear OTC FX derivatives and other CCPs are planning to add this asset class to their current offer of services", existing clearing services are in fact limited to non-deliverable forwards (as noted in our commentary to section 2.4, question 15 above). And, most importantly, while CCPs may wish to extend their services to other FX products – such as deliverable forwards, swaps *and* options – to date, no CCP appears to have addressed the challenges faced with clearing deliverable FX contracts which are unique to this market, namely same-day liquidity issues, in a manner which satisfies global regulatory expectations. CCPs are historically designed to mitigate "mark-to-market" risk – not settlement risk. In the deliverable OTC FX markets, the residual mark-to market risk is today effectively mitigated through credit support annexes (CSAs).[17]

It is widely recognized by legislative and regulatory authorities globally that directing deliverable OTC FX forwards and swaps to centralized clearing is not, or may not be, appropriate. We believe that a determination by ESMA that such products are not appropriate for a clearing obligation is the only conclusion consistent with recital 19 of EMIR.[18] In contrast to other OTC derivatives that will not be centrally cleared due to lack of standardization or liquidity, clearing deliverable FX forwards and swaps is not appropriate because (1) while central clearing specifically addresses replacement cost risk, it is not the optimal solution for dealing with FX forwards and swaps where the main risk is settlement risk, and (2) central clearing of these products has the real potential of increasing, rather than decreasing, systemic risk, especially in times of crisis, thereby significantly outweighing the marginal benefits that central clearing would provide.

Unique challenge associated with clearing FX forwards and swaps. Notwithstanding numerous efforts to do so, no CCP has demonstrated an ability to implement safe and sound measures that ensure the deliverable FX market, with the CCPs, can appropriately manage the liquidity and credit risks associated with clearing deliverable FX forwards and swaps.

In the past few years, central banks[19] have expressed their need, from a broad policy perspective, to receive more information about the FX-related clearing proposals of each individual CCP to understand and review the potential implications of each proposal for their currencies and for the FX market. When approached by CCPs seeking to clear

[17] *See* GFXD Margin Letter, and U.S. Department of the Treasury, *Final Determination on Foreign Exchange Swaps and Forwards Under the Commodities Exchange Act* (November 20, 2012) (Treasury Final FX Determination) at http://www.gpo.gov/fdsys/pkg/FR-2012-11-20/pdf/2012-28319.pdf.

[18] Recital 19 of EMIR: "In determining which classes of OTC derivative contracts are to be subject to the clearing obligation, due account should be taken of the specific nature of the relevant classes of OTC derivative contracts. The predominant risk for transactions in some classes of OTC derivative contracts may relate to settlement risk, which is addressed through separate infrastructure arrangements, and may distinguish certain classes of OTC derivative contracts (such as foreign exchange) from other classes. CCP clearing specifically addresses counterparty credit risk, and may not be the optimal solution for dealing with settlement risk. The regime for such contracts should rely, in particular, on preliminary international convergence and mutual recognition of the relevant infrastructure."

[19] AUD (Reserve Bank of Australia), CAD (Bank of Canada), CHF (Swiss National Bank), DKK (Denmark), GBP (Bank of England), EUR (European Central Bank, National Bank of Belgium, Bank of France, Deutsche Bundesbank, Bank of Italy and Netherlands Bank), HKD (Hong Kong Monetary Authority), ILS (Bank of Israel), JPY (Bank of Japan), KRW (Bank of Korea), MXN (Bank of Mexico), NOK (Central Bank of Norway), NZD (Reserve Bank of New Zealand), SEK (Svergis Riksbank), SGD (Monetary Authority of Singapore), USD (Federal Reserve) and ZAR (South African Reserve Bank).

FX transactions, central banks whose currencies settle in CLS raised a number of issues and made requests for further information and analyses regarding the concept of clearing FX contracts. These issues include the potential effects of mandatory clearing on the central banks' home currencies and on the safety and soundness of the deliverable FX market generally, including on CLS.[20] The central banks' concerns stem from their need to understand and evaluate the impact of a CCP's activities on the FX market and on payments in their home currencies from a broad policy perspective. There is also an important policy interest in not seeing settlement risk reintroduced to the financial system. Since settlement risk comprises an overwhelming portion of the counterparty default risk for FX contracts, the failure of an FX CCP to guarantee settlement risk would largely defeat the purpose of clearing through the CCP, particularly for a market that is essentially a payment system. If a CCP that guaranteed settlement did not use CLS, the CCP would need to settle through a private bank, in which case any default by the private bank would pose serious liquidity and other risks to the clearing house and thus to all its participants. If a CCP did not guarantee settlement and did not use CLS, its clearing participants would be subject to settlement risk, which would be substituting settlement risk – by far the larger risk in an FX transaction – for replacement cost risk. In addition to their respective needs to determine the safety and soundness of any CCP's proposal to clear deliverable OTC FX products, central banks have also separately expressed a need to determine the safety and soundness of CLS' acceptance of such cleared transactions for settlement processing.

FMI Principles. In addition, the CPSS and IOSCO jointly issued in 2012 final principles for financial market infrastructures.[21] These principles include a number of key principles to be considered when seeking to apply clearing to the OTC FX market. Notably these include principle VII on liquidity risk, principle VIII on settlement finality, and principle XII on exchange-of-value settlement systems. Taken as a whole against the unique characteristics of the FX forwards and swaps (*e.g.*, the physically delivery aspect to these products), and confirmed through a number of discussions with regulatory authorities and market participants, these principles would require physically settled OTC FX products to be cleared only by CCPs that can provide a "guaranteed, on-time clearing and settlement model." Specifically, an OTC FX CCP must, for a physically settled market:

- Guarantee of the full and timely settlement of the currencies of the trade;[22] and
- Ensure the guarantee is credible and addresses extreme but plausible market conditions as identified by rigorous stress testing, including default scenarios.

To date, even for the deliverable OTC FX options market which is substantially smaller than the deliverable OTC FX forwards and swaps market, no model put forward by a CCP and/or market participants has demonstrated an ability to implement safe and sound measures that address the above requirements and ensure the market, with the CCPs, can appropriately manage the liquidity and credit risks associated with clearing these products.[23] It is reasonable to assume that central banks will be unlikely to embrace mandatory clearing and trading requirements for the deliverable FX market in the absence of evidence that it can be implemented without causing more harm than good to sovereign currencies and existing settlement processes.

The FX industry has continued to work with regulators and CCPs with respect to the clearing of deliverable OTC FX products and is acutely aware that to meet these requirements for the mainstream FX market a CCP would face significant challenges. This is especially true in light of the need for immediate access to sufficient liquidity in all currencies to be able to meet in full the settlement obligations of a defaulting member, and in a manner that does not put the CCP itself at significant risk during stressed market conditions. CCPs would require immediate access to sufficient liquidity in all currencies to be able to meet in full the settlement obligations of a defaulting member, and in a manner that does not put the CCP itself and its members at significant risk during stressed market conditions. As noted above, the specific settlement characteristics of the FX market make this issue significantly more acute than in other asset classes. As a result, this is a formidable challenge for which, to date, no satisfactory solution has been found. The complexities around introducing CCP clearing into the FX market are significant – such as the large currency and capital needs that would arise if CCPs were also responsible for guaranteeing settlement given the sheer size and volume of trades in the deliverable FX forwards and swaps market; and the operational challenges and potentially disruptive effects that arise from introducing a layer of clearing between trade execution and settlement. These would significantly outweigh the marginal benefits from a mandatory clearing obligation.

---

[20] See CLS letter to U.S. Department of Treasury (November 23, 2010) in response to request for comment on determination of foreign exchange swaps and forwards.

[21] CPSS and Technical Committee of International Organization of Securities Commissions (IOSCO), *Principles for financial market infrastructures* (April 2012), available at http://www.bis.org/publ/cpss101a.pdf.

[22] This is in contrast to other OTC derivative transactions, such as interest rate swaps and credit default swaps, which create settlement obligations that equal only the change in the market price of the notional value.

[23] In contrast to deliverable FX forwards and swaps, deliverable FX options are derivatives, but once exercised, become a deliverable FX spot or forward transaction. Although deliverable FX options represent a very small portion of the FX market, they face the same type, though not the same scale, of liquidity challenge as clearing deliverable FX forwards and swaps. See *GFMA GFXD FAQ: The FX Options Clearing & Settlement Project* (March 8, 2012). The objective of this project is to collect and analyze data from each of the 22 GFXD member firms going back over the last five years in order to will help inform potential CCP solutions for OTC FX options. http://www.gfma.org/uploadedfiles/initiatives/foreign_exchange_(fx)/gfxd%20options%20clearing%20project%20-%20faq%20(final).pdf.

Deliverable OTC FX options We also wish to draw attention to a quantitative study commenced last year to understand the scale of transactions in the physically-settled OTC FX options market in order to size the same day liquidity challenge for clearing this market.[24] In contrast to physically-settled FX forwards and swaps, physically-settled FX options are derivatives but, once exercised, become a physically-settled FX spot or forward transaction. Although physically-settled FX options represent a very small portion (6%) of the FX market,[25] they face the same challenges regarding clearing as physically-settled FX forwards and swaps. Quantifying the size of this problem informs CCPs interested in extending their services to deliverable FX products, in this case, for OTC FX options products, of the same day liquidity risk that they must be capable of managing in order to (i) guarantee full and timely settlement of the currencies traded for this product; and (ii) ensure the guarantee is credible. In contrast to other markets, the FX market – as a global payments system – is fundamentally about liquidity, *i.e.*, ensuring funds in the correct (needed) currency are received *when* they are expected to be received by transacting parties.

Quantifying the size of this problem informs not only potential solutions to the problem but how interested stakeholders approach solutioning in the first instance. Further, the same day liquidity risk for physically-settled OTC FX options is *in addition to* the replacement cost risk and market risk which a CCP must manage with respect to its clearing service and which must also be understood and analyzed in relation to those (and other) risks. In light of the size of the same day liquidity challenge identified, whether and when a credible, robust and safe solution for clearing this physically-settled FX product will in fact be implemented remains unknown.

Rationale for not applying a clearing obligation for deliverable OTC FX forwards and swaps. In the United States, the Department of Treasury has evaluated the appropriateness of mandating clearing of deliverable FX forwards and swaps and, following extensive study and consultation, determined not to apply such a requirement to such products.[26] In doing so, the Department of Treasury considered several factors to assess whether the required clearing of these products would create systemic risk, lower transparency, or threaten the financial stability of the United States. Many other legislative and regulatory authorities globally have acknowledged the analysis of the Department of Treasury when considering a similar exemption from clearing for these products. In its determination, the Department of Treasury concluded that, given the reduced counterparty credit risk profile of this market, the challenges of implementing central clearing within this market significantly outweigh the marginal benefits that central clearing and exchange trading would provide. Regulating deliverable FX forwards and swaps would require insertion of a central counterparty into an already well-functioning and highly interconnected settlement process, which could result in unnecessary operational and settlement challenges. Specifically, the Department of Treasury's determination recognizes the different characteristics of these FX products and the way the market functions at present:

- Acknowledges the *high levels of transparency and liquidity* existing in the FX markets as a result of the heavy trading on electronic platforms and the diverse availability of market pricing information.

- Points to *additional transparency through trade reporting to a trade repository*, the requirements of which were being addressed with GFMA Global FX Division members. [we note this is currently live in the United States]

- *Recognizes the unique factors limiting risks in the FX forwards and swaps market*, pointing to the fixed terms (*i.e.*, non-contingent outcomes), the physical exchange of currencies, the well-functioning settlement process and the shorter duration of contracts.

- *Highlights the existing strong, comprehensive and internationally coordinated oversight framework prevalent in the FX markets.*

---

[24] *See* http://www.gfma.org/initiatives/foreign-exchange-(fx)/fx-options-clearing/. The question asked and answered by this study: "What is the largest combined funding deficit which could have resulted from the failure of two clearing firms representing the largest combined funding requirements on any given settlement date with respect to executed OTC FX options that were exercised and due for settlement on such date"? The answer to this question informs CCPs desiring to clear these deliverable products of the funds required to cover that deficit and the capabilities needed to convert such funds, same day, into the currencies which its other (non-failing) clearing firms are expecting to receive on that date, in satisfaction of the "cover 2" liquidity requirement under the FMI Principles.
Deliverable OTC FX is traded and settled on the basis of physical settlement, *i.e.*, the exchange of principal in two currencies on the settlement date; the expectation is for CCPs to ensure transacting parties are made "whole" by guaranteeing they will receive what they were expecting to receive on settlement date, *i.e.*, the currencies they purchased (in exchange for currencies they sold). In contrast, most OTC derivatives are traded and settled on basis of net cash settlement in a single currency that reflects the mark-to-market value of the trade; CCPs for these products ensure transacting parties are made "whole" by guaranteeing they will receive what they were expecting to receive during the life of the instrument and on settlement date, *i.e.*, the mark-to-market each day, including on the settlement date.

[25] *See* BIS *Triennial Central Bank Survey: Foreign exchange turnover in April 2013: preliminary global results* (September 2013) (BIS 2013 FX Survey).

[26] *See* Treasury Final FX Determination; and *Notice of Proposed Determination on Foreign Exchange Swaps and Forwards Under the Commodities Exchange Act* (April 29, 2011) (Treasury Proposed FX Determination).

- Notes the *complexities around introducing CCP clearing* into the FX market – specifically:
    - The large currency and capital needs that would arise if CCPs were also responsible for guaranteeing settlement given the sheer size and volume of trades in the FX (forwards and swaps) market,
    - The operational challenges and potentially disruptive effects that arise from introducing a layer of clearing between trade execution and settlement – concluding that these significantly outweigh the marginal benefits from central clearing.
- Key unintended consequences of mandating clearing for FX forwards and swaps include potentially undermining the efforts that have been made in addressing settlement risk to date; creating a single point of failure where none exists today; and increasing costs and risk for corporate and buy-side end-users of FX.

Conclusion. For the reasons set forth above, it would not be appropriate or prudent to apply a mandatory clearing obligation to deliverable OTC FX forwards, swaps – and also options – at this time. Introducing CCPs into the deliverable FX market without ensuring that they only bear risks that they can properly manage would clearly increase, rather than decrease, potential systemic risk, especially in times of crisis. Adoption by ESMA of this view would be consistent with the emerging views of regulators globally and in recognition of international convergence on the treatment of deliverable OTC FX forwards and swaps with respect to clearing requirements.

We appreciate the opportunity to share our views on this Discussion Paper. Please do not hesitate to contact us should you wish to discuss any of the above.

Appendix 1
Copy of FX Taxonomy

GFMA Global FX Division

FX Market Architecture Group

Proposed FX Taxonomy

Background to the FX Market Architecture Group (MAG)

The Global Financial Markets Association (GFMA) joins together some of the world's largest financial trade associations to develop strategies for global policy issues in the financial markets, and promote coordinated advocacy efforts. The member trade associations count the world's largest financial markets participants as their members. GFMA currently has three members: the Association for Financial Markets in Europe (AFME), the Asia Securities Industry & Financial Markets Association (ASIFMA), and, in North America, the Securities Industry and Financial Markets Association (SIFMA).

The GFMA Global FX Division, headquartered at AFME in London, was formed in June 2010 to support efforts to promote an efficient global FX market, monitor regulatory developments that could affect the foreign exchange markets and assist the industry in building out the infrastructure of the future. Its members comprise 22 global FX market participants, collectively representing more than 90% of the FX market.

The MAG is a working group made up of volunteer FX Division member banks. On behalf of division members, it is fostering industry dialogue and discussion towards developing industry trade workflow standards in response to the new regulatory environment.

In order to contact the MAG, please email to: FXMAG@gfma.org

Introduction

The proposed FX taxonomy has been developed to assist regulatory reporting initiatives, including risk aggregation. The taxonomy forms the first stage of development of unique product identifiers (UPI), which will be assigned to a particular level of the taxonomy.

Proposed taxonomy

FX Taxonomy

Base Product	Spot	NDF	NDO	Forward	Vanilla Options	Simple Exotic	Complex Exotic
Sub-product						Barrier Binary/Digitals	

The table above summarises the working group's proposed FX taxonomy. In arriving at this, the working group looked first and foremost at the intended use – the aggregation of risk for regulatory reporting. The key omission from the taxonomy relates to FX swaps. In this regard, it was determined that the use of "spot", "forward" and "Non Deliverable Forward" (NDF) allowed for the categorization of risk on both the near and far-leg of the FX swap and enables the regulator to aggregate risk as per common practice in the FX market – by value date / tenor rather than by making a product distinction which was deemed immaterial to the aggregation and presentation of risk.

Further, the working group considered the lack of standard representation for FX swaps in the industry and determined that there is a subset of the FX market who represent FX swaps as two distinct legs, without retaining the referential integrity between those legs and that a requirement to report or verify swap transactions as a single transaction would impose great costs on those parties to re-architect their systems in order to comply with the reporting requirement.

Detailed FX Taxonomy

FX Derivatives Summary

#	Asset Class	Base Product Std Product Matrix	Sub-Product
1	FX	Spot	
2	FX	NDF	
3	FX	NDO	
4	FX	Forward	
5	FX	Vanilla Options	
6	FX	Simple Exotic	Barrier
7	FX	Simple Exotic	Binary/Digitals
8	FX	Complex Exotic	