November 24, 2014


The Global Foreign Exchange Division (“GFXD”) of the Global Financial Markets Association (“GFMA”) welcomes the opportunity to comment on behalf of its members on the Bank Margin Proposal and CFTC Margin Proposal (together, the “Proposed Rules”) published by the Board of Governors of the Federal Reserve System (the “Board”), the Office of the Comptroller of the Currency (the “OCC”), the Federal Deposit Insurance Corporation (the “FDIC”), the Federal Housing Finance Agency (the “FHFA”) and the Commodity Futures Trading Commission (the “CFTC”) (collectively, the “Agencies”).

The GFXD was formed in cooperation 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 24 global FX market participants, collectively representing more than 90% of the foreign exchange (“FX”) dealer market. Both the GFXD and its members are committed to ensuring a robust, open and fair marketplace and welcome the

---

4 According to Euromoney league tables.
opportunity for continued dialogue with global regulators.

The FX market is the world’s largest financial market. Effective and efficient exchange of currencies underpins the world’s entire financial system. Sovereign entities, central banks and other governmental sponsored entities rely on this market being well-functioning and available at all times. Corporations and investors regularly participate in the market for operational needs: to reduce risk by hedging currency exposures; to convert their returns from international investments into domestic currencies; and to make cross-border investments and raise finance outside home markets. Many of the current legislative and regulatory reforms have had, and will continue to have, a significant impact upon the operation of the global FX market, and we feel it is vital that the potential consequences are fully understood and that any new regulation improves efficiency and reduces risk in this market.

Summary Position

The GFXD supports the Agencies’ efforts to establish margin requirements which would help ensure the safety and soundness of covered swap entities and would be appropriate for the risk to the financial system associated with non-cleared swaps held by such entities. We view the proposed margin regime in the U.S. as achieving the international regulatory framework’s goal of promoting global consistency and reducing regulatory arbitrage opportunities with respect to the treatment of physically-settled OTC FX forwards and swaps, specifically that (i) initial margin not apply to these contracts and (ii) variation margin be applied via supervisory guidance or national regulation. Separately, we wish to highlight a unique challenge facing the physically-settled OTC FX options market whose contracts are subject to the initial and variation margin requirements in the Proposed Rules.

Physically-Settled OTC FX Forwards and Swaps. With respect to the physically-settled FX forwards and swaps, we believe that the Proposed Rules are consistent with the international regulatory framework, i.e., the minimum standards for margin requirements for non-centrally cleared derivatives established in September 2013 by the Basel Committee on Banking Supervision (“BCBS”) and the International Organization of Securities Commissions (“IOSCO”) (the “International Margin Framework”). The International Margin Framework:

- recommends that appropriate margining practices be in place with respect to all derivative transactions that are not cleared by CCPs;
- does not include a margin requirement for physically settled FX forwards and swaps;
- states that variation margin standards for physically settled FX forwards and swaps should be implemented in a manner consistent with the International Margin Framework, either by way of supervisory guidance or national regulation; and
- with respect to variation margin, refers specifically to the BCBS Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions (the “FX Supervisory Guidance”)

5 http://www.bis.org/publ/bcbs261.pdf. This was developed by BCBS and IOSCO in consultation with the Committee on Payment and Settlement Systems (CPSS) and the Committee on the Global Financial System (CGFS).

6 http://www.bis.org/publ/bcbs241.pdf.
While the Proposed Rules do not apply to physically-settled FX forwards and swaps due to the determination by the U.S. Treasury to exempt such products from certain swap requirements, including margin requirements, that Title VII of the Dodd-Frank Act added to the Commodity Exchange Act, the Bank Proposal acknowledges that variation margin for these products is addressed in the U.S., e.g., by the Board’s implementation of the FX Supervisory Guidance in December 2013.8

Because transactions in FX are integral to the global payment system, international trade, cross-border activity and monetary policy, it is essential that the smooth functioning of the FX market not be disrupted. The source of systemic risk for this market – loss of principal – has been effectively mitigated via the use of CLS Bank International and its continued development of its services to more users, more currencies and more settlement sessions for deliverable FX contracts. Other risks for this market – replacement cost risk, liquidity risk and operational risk – are appropriately mitigated by a regime of encouraging prudent supervision, practice guidelines and capital implications.

**Physically-Settled OTC FX Options.** We wish to take this opportunity to highlight a unique challenge presented by the physically-settled OTC FX options market whose contracts represent approximately 6 percent of average daily global OTC FX market turnover.9 These contracts are subject to the international framework for margin on uncleared derivatives and therefore the Proposed Rules. GFXD completed a quantitative study 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” associated with clearing this deliverable market. While the results of the GFXD analysis represented a significant step forward in responding to regulatory expectations, we are concerned that an appropriate solution for clearing and settling these contracts might not be available when the phase-in period for initial margin is proposed to begin in December 2015.

The *Principles for financial market infrastructures* (“PFMIs”) published in April 2012 by the Committee on Payment and Settlement Systems (“CPSS”) and IOSCO establish the clear and fundamental principle that all payment obligations – including all payment obligations related to physically-settled FX – should be settled when due, notwithstanding any liquidity shortfall caused by the largest or two largest participants. However, due to insufficient understanding in the industry of the size and nature of risks for which a clearing solution has previously been sought, no OTC FX options clearing model put forward by CCPs and considered by industry has demonstrated an ability to implement safe and sound measures that (i) address the OTC FX options clearing challenge; and (ii) ensure the market can appropriately manage its liquidity and credit risks. In response to this situation, GFXD collected and analyzed transactional level data for OTC FX options traded globally (both interdealer and client activity) from January 2007 through December 2011 from 22 of its members who represent over 90% of OTC FX dealer flow.10

---

7 77 FR 69694 (November 20, 2013).
While the results of the GFXD analysis do not provide a solution, it has successfully shed light on the size and nature of the same-day liquidity risk shortfall for the OTC FX options market. In doing so, market participants and interested stakeholders, including central banks and derivative regulators, are now much better informed of the same day liquidity risk that CCPs must ensure their respective systems are capable of managing to ensure full and timely settlement of the currencies traded for this product and to ensure the guarantee is credible. As a result, the results are informing and shaping how CCPs, with industry, develop clearing models for physically-settled OTC FX options and the manner in which regulatory authorities might assess the robustness and resiliency of these solutions against the PFMI s. Notable progress has been made this year, as illustrated by roundtable discussions involving the private sector and public sector in spring/early summer 2014, and continued engagement between market participants with CCPs and, importantly, CLS Bank International. Notwithstanding such progress, there remains much work to be done by market participants and infrastructures, with derivative regulators and central banks whose currencies are involved in these physically-settled contracts, to solve for the same-day liquidity challenge associated with clearing and settlement in this global currency market.

* * *

We appreciate the opportunity to share our views on this Consultation Paper. Please do not hesitate to contact James Kemp (+44 (0) 207 743 9319; jkemp@gfma.org), Mandy Lam (+1 212 313 1229) or Andy Harvey (+44 (0) 207 743 9312; aharvey@gfma.org) should you wish to discuss any of the above.

Yours sincerely,

James Kemp
Managing Director
Global Foreign Exchange Division

date”? The answer to this question represents minimum, baseline capabilities CCPs must demonstrate for converting funds, same day, into the currencies which its other (non-failing) clearing firms were expecting to receive on that date in satisfaction of the PFMI “cover 2” liquidity requirement.

- 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.

- Results from the GFXD analysis indicate that if these physically-settled FX options had been cleared, CCPs would have needed to demonstrate an ability to maintain minimum capabilities of converting funds, same day, into currencies non-failing clearing firms were expecting to receive – in an amount equal to 161 billion (in USD equivalent) and in no fewer than 17 currencies. This liquidity risk shortfall is in addition to the replacement cost risk and market risk which a CCP manages but which must be understood, analyzed and managed in relation to those (and other) risks.