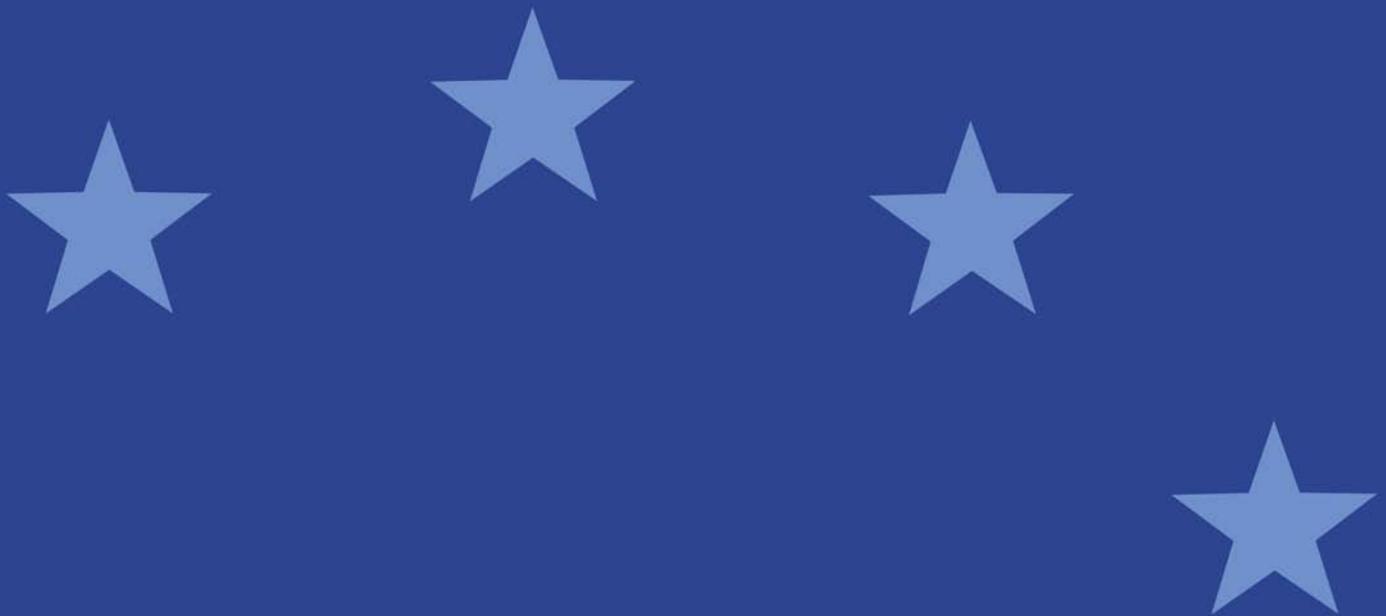




European Securities and  
Markets Authority

## **Reply form for the Consultation Paper On the Clearing Obligation under EMIR (no. 3)**



## Responding to this paper

The European Securities and Markets Authority (ESMA) invites responses to the specific questions listed in the ESMA Consultation Paper - Clearing Obligation under EMIR (no. 3), published on the ESMA website.

Responses are most helpful:

- i. if they respond to the question stated;
- ii. contain a clear rationale, including on any related costs and benefits; and
- iii. describe any alternatives that ESMA should consider

To help you navigate this document more easily, bookmarks are available in “Navigation Pane” for Word 2010 and in “Document Map” for Word 2007.

Responses must reach us by **6 November 2014**.

All contributions should be submitted online at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading ‘Your input/Consultations’.

## Instructions

Please note that, in order to facilitate the analysis of the responses, you are requested to use this file to send your response to ESMA so as to allow us to process it properly. Therefore, please follow the instructions described below:

- i. use this form and send your responses in Word format;
- ii. do not remove the tags of type < ESMA\_CA3\_QUESTION\_1> - i.e. the response to one question has to be framed by the 2 tags corresponding to the question; and
- iii. if you do not have a response to a question, do not delete it and leave the text “TYPE YOUR TEXT HERE” between the tags.

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All contributions received will be published following the end of the consultation period, unless otherwise requested. **Please clearly indicate by ticking the appropriate checkbox in the website submission form if you do not wish your contribution to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure.** Note also that a confidential response may be requested from us in accordance with ESMA’s rules on access to documents. We may consult you if we receive such a request. Any decision we make is reviewable by ESMA’s Board of Appeal and the European Ombudsman.

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### **General information about respondent**

Are you representing an association?	Yes
Activity:	Banking sector
Country/Region	International



## Introduction

### Please make your introductory comments below:

<ESMA\_CO3\_COMMENT\_1>

#### BACKGROUND

The **Global FX Division (“GFXD”)** of the **Global Financial Markets Association (“GFMA”)** welcomes the opportunity to comment on the Consultation Paper issued by the European Securities and Markets Authority (“**ESMA**”) on Clearing Obligation under EMIR (no. 3) (“**Consultation Paper**”). 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 foreign exchange (“**FX**”) market participants,<sup>1</sup> collectively representing more than 90% of the FX dealer market.<sup>2</sup> Both 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.

The FX market is the world’s largest financial market. Effective and efficient exchange of currencies underpins the world’s financial system. Sovereign entities, central banks and other government 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 funding 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 the potential consequences reforms should be carefully evaluated.

#### SUMMARY

***Distinguishing characteristics of the FX NDF market.*** In the view of the GFXD, certain characteristics of non-deliverable FX forward (“**FX NDF**”) contracts distinguish this market from the markets for interest rate and credit derivatives and those differences should necessarily be reflected in any recommendation by ESMA to introduce a clearing obligation for these contracts. These characteristics of the FX NDF market include: (1) the standardisation of its contracts; (2) the relatively small size of this market, particularly as compared to other OTC derivative asset classes; (3) the limited development of pre-existing voluntary clearing in this market, particularly client-clearing; (4) the relative unfamiliarity of CCPs with managing disruption events affecting the currencies of emerging market jurisdictions and thus the valuation and settlement of these contracts; (5) the concentration of trading in short-dated tenors; and (6) the importance of emerging market financial institutions as liquidity providers.

***Because of the relatively undeveloped status of FX NDF clearing, a clearing obligation applied to FX NDF contracts would have to be implemented with great care.*** As a result of the above and other factors detailed in our response to this Consultation Paper, any clearing obligation introduced at this time for FX NDF contracts would need to be sufficiently tailored to cover only standardised and sufficiently liquid products; accompanied by a sufficient phase-in period to address fundamental operational issues; and imple-

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<sup>1</sup> Bank of America Merrill Lynch, Bank of New York Mellon, Bank of Tokyo Mitsubishi UFJ, Barclays, BNP Paribas, Citigroup, Credit Agricole, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan, Lloyds Bank, Mizuho, Morgan Stanley, Nomura, Royal Bank of Canada, Royal Bank of Scotland, Société Générale, Standard Chartered Bank, State Street, UBS, Wells Fargo and Westpac.

<sup>2</sup> According to Euromoney league tables.

mented in a well-coordinated fashion among global regulator and with due consideration of potential trading mandates for such contracts.

- *Application of EMTA published currency templates, without modification.* To ensure the level of standardisation achieved to date for in the FX NDF market is preserved, any clearing obligation for FX NDF contracts must be sufficiently clear that it only applies to standardised contracts which incorporate industry standardised currency templates, in the form published by EMTA (i.e., without modification). This ensures the clearing obligation does not encompass instruments with different economic terms.
- *Tenor of One-Year.* Any clearing obligation for FX NDFs should be limited to contracts with a tenor of one year or less. Open interest in these contracts is concentrated in shorter-dated tenors, there is insufficient liquidity in these contracts beyond one year to support clearing and, given the limited liquidity, CCPs would find it difficult to manage the default of a clearing member responsible for transactions with maturities greater than one-year.
- *Extended Phase-In Period.* Any determination to introduce a clearing obligation for FX NDFs at this time requires a sufficiently extended phase-in period to allow for market participants to address fundamental outstanding issues. These issues arise, largely, from the fact that FX NDF clearing is in its infancy. Currently, the single CCP authorised under EMIR to clear these contracts clears an estimated 0.4%-3.6% of these contracts, almost none of which includes client business.

***It important that there be a high degree of confidence that the introduction of a clearing obligation at this time for FX NDF contracts would in fact reduce risk, in the aggregate, and reduce systemic risk before these contracts are moved into a mandatory clearing regime.*** While GFXD is supportive of central clearing, where appropriate, and the benefits it can bring to the OTC derivatives markets in such areas as operational efficiencies and counterparty credit risk reduction, GFXD believes it is not clear whether a clearing mandate for these contracts at this time would appropriately address the objective of reducing *systemic* risk as required by EMIR Article 5(4).

- *FX NDF clearing is in its infancy.* FX NDF clearing is relatively new and therefore has not achieved the same depth as IRS and CDS clearing had when the clearing mandate was, or is being, introduced to those asset classes in the U.S. by the CFTC and in Europe by ESMA. While an estimated 0.4%-3.6% FX NDF contracts are currently being cleared, the introduction of the clearing mandate for the IRS and CDS was predicated on far more developed markets with many start-up issues addressed while clearing was still voluntary (i.e., approximately 60% of IRS contracts and 30% of CDS contracts were being voluntarily cleared since 1999 and 2009, respectively, when such mandates were or are being introduced). Further, key technical matters associated with FX NDF clearing remain unresolved. Because FX clearing services need time to mature, for their practices to be properly bedded down and “battle-tested” and for fundamental unresolved issues to be properly addressed, GFXD is concerned that additional risk may be unnecessarily introduced to this global currency market and, as a result, undermine the benefits of central clearing.
- *Relatively limited credit risk reduction to be achieved with FX NDF clearing.* As illustrated in the table below, while mandating FX NDF clearing would transfer a certain amount of bilateral exposure which exists between market participants to CCPs, the amount of risk in the FX NDF market is orders of magnitude less than in rates and credit derivatives markets.

figures in billions

OTC Derivatives <sup>3</sup>	Rates	Credit	FX NDFs
<b>Average daily turnover</b>	\$2,000		\$127
Cleared	\$1,700-1,800 (76-79%)		\$4.6 (3.6%)
Uncleared	\$500-600 (21-24%)		\$122.4 (96.4%)
<b>Total market value</b>	\$14,000	\$700	\$90
<b>Total notional outstanding</b>	\$584,000	\$21,000	\$2,800
Cleared	\$443,000-461,000 (76-79%)	\$5,500 (26%)	\$101 (4%)
Uncleared	\$123,000-141,000 (21-24%)	\$15,500 (74%)	\$2,700 (96%)
<b>Tenor of total notional outstanding</b>			<i>Based on DTCC dataset<sup>4</sup></i>
Less than three months			\$2,520 (90%)
Over three months up to six months	\$198,302 (34%)	\$3,655 (17%)	\$224 (8%)
Over six months up to one year			\$28 (1%)
Over one year up to five years	\$234,284 (40%)	\$16,162 (77%)	\$28 (1%)
Over five years	\$151,778 (26%)	\$1,203 (6%)	

**Recommendation.** In light of the above considerations, GFXD recommends that ESMA consider whether the reduction of counterparty credit risk to be achieved from mandating participants to move their bilateral exposures to a centrally cleared environment for FX NDF contracts at this time would *reduce risk in the aggregate* and, most importantly, also *reduce systemic risk*. If ESMA were to conclude that it would do so and, as a result, recommend to the European Commission that a clearing obligation be introduced for FX NDF contracts at this time, a sufficiently tailored clearing obligation, lengthened phase-in for compliance and global coordination would be necessary to minimise the risk that the implementation of clearing obligations (and with due consideration of trading obligations) in Europe and elsewhere is not unnecessarily disruptive to this global currency market.

<ESMA\_CO3\_COMMENT\_1>

<sup>3</sup> See BIS Monetary and Economic Department, *Statistical release, OTC derivatives statistics at end-December 2013* (May 2014) (“BIS December 2013 Stats”) at [http://www.bis.org/publ/otc\\_hy1405.pdf](http://www.bis.org/publ/otc_hy1405.pdf); Consultation Paper at <http://www.esma.europa.eu/system/files/esma-2014-1185.pdf>; and *Size and Uses of the Non-Cleared Derivatives Market: An ISDA Study* (April 2014) (“ISDA April 2014 Study”) at <http://www2.isda.org/attachment/NjQ0MA==/FINAL%20-%20Size%20and%20Uses%20of%20the%20Non-Cleared%20Derivatives%20Market.pdf>.

<sup>4</sup> See Consultation Paper, page 32. Figures in the table above exclude CNY (one of the less liquid FX NDF currencies among the 11 considered by this Consultation Paper) where the share of trades with a maturity between six months and 1 year is 10%.



## **1. The clearing obligation procedure**

### **Q1: Do you have any comment on the clearing obligation procedure described in Section 1?**

<ESMA\_CO3\_QUESTION\_1>

GFXD agrees with and supports the response from the ISDA and FIA Europe to this Question 1 (see Response to ESMA Consultation Paper No. 3 from International Swaps and Derivatives Association, Inc. and FIA Europe, dated 6 November 2014 (“[ISDA-FIA Europe FX NDF Response](http://www2.isda.org/functional-areas/public-policy/europe/)”) available at <http://www2.isda.org/functional-areas/public-policy/europe/>).

<ESMA\_CO3\_QUESTION\_1>

## 2. Structure of the non-deliverable forward derivatives classes

### Q2: Do you consider that the proposed structure for the FX NDF classes enables counterparties to identify which contracts are subject to the clearing obligation?

<ESMA\_CO3\_QUESTION\_2>

GFXD believes it is imperative that any RTS issued by ESMA be sufficiently clear and granular in identifying the instruments subject to a clearing obligation. A clearing mandate can serve to drive standardisation or, in the case of the FX NDF market, avoid undermining the level of standardisation achieved to date only when it is sufficiently detailed such that it does not encompass instruments with different economic terms. While GFXD agrees with the proposed structure for the FX NDF classes, it is important that some additional detail is provided in the RTS with respect to the contract characteristics to ensure the class is sufficiently standardised.<sup>5</sup> For the reasons noted below, we strongly urge ESMA to expand the list of characteristics to be used to define the FX NDF classes in Annex I of the RTS to include:

- EMTA published currency template (without modification), which takes the value “YES.”

This will ensure that any recommendation of a clearing mandate based on a bottom-up approach, as is currently the case with respect to contracts of the CCP currently authorised to clear these products under EMIR (LCH.Clearnet Limited (“LCH")), would *not* apply to contracts that have *not* adopted the relevant currency template in the form published by EMTA as those contracts would have different economic terms. While we believe FX NDFs can be cleared, and are being voluntarily – cleared, it is important for regulatory authorities in Europe, U.S. and the Asia Pacific region to coordinate to ensure that there is sufficient agreement concerning FX NDF contract specifications, including the adoption of these templates, before any clearing determinations are introduced in their respective jurisdictions.<sup>6</sup>

GFXD also agrees with and supports the response in the ISDA-FIA Europe FX NDF Response on this Question 2 as it relates to mitigation of trading ban situations.

***Standardisation achieved in the FX NDF market is due to development and use of industry standards memorialised in EMTA templates.*** The market for FX NDF contracts widely relies upon well-established industry terms and conditions, templates and fallbacks in the form of currency specific EMTA templates published at [www.emta.org](http://www.emta.org). Each provision contained in an EMTA template is an essential part of the overall risk component of FX NDF contracts and thus material to the parties, including CCPs, to the contract – from trade execution through to settlement. Each EMTA currency template provides (i) a primary fixing source to be used for valuing the contract for settlement, and (ii) fall-back conventions which address the risk of potential market/sovereign events disrupting the value or settlement of the emerging market currencies underlying these contracts (e.g., suspension of trading, sovereign default, an unexpected bank holiday or other significant disruption to valuation, payment or settlement processes).

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<sup>5</sup> See GFXD response to 2013/925 Discussion Paper – The Clearing Obligation under EMIR, available at [http://www.esma.europa.eu/system/files/gfxd\\_response\\_esma\\_discussion\\_paper\\_on\\_clearing\\_esma\\_2013\\_925\\_submission\\_1.pdf](http://www.esma.europa.eu/system/files/gfxd_response_esma_discussion_paper_on_clearing_esma_2013_925_submission_1.pdf).

<sup>6</sup> GFXD believes that voluntary clearing, over time, may lead to even greater standardisation of contract terms. Certain products will attract more liquidity than others and network effects should result in market participants migrating to those products. Further, as the new Basel III capital requirements come into effect, market participants will have an incentive to embrace a particular standard and margin on uncleared trades will likely mirror those standardised terms because of the portfolio benefits. As such, it may be prudent to allow these processes to play out through a delay in a clearing mandate as suggested in our response to Question 3. Should however FX NDF contracts be subject to a clearing mandate, an appropriately lengthened phase-in for compliance with such a mandate would be necessary at this time.

The management by market participants of their current and future FX NDF contracts, and such contracts alongside their other trading activities, is affected by the consistency, or inconsistency, in the contractual terms of these FX contracts – including that the same fixing sources and fall-back conventions apply to these contracts, regardless of which CCP is used to clear the contract and which platform/venue is used to trade the contract. Consistency in this respect can only be achieved when an EMTA template is adopted *ex ante and in its entirety* (i.e., without modification) by transacting parties, including CCPs, for the contract. In circumstances where an EMTA template is modified, the standardisation developed by the industry for a given currency pair is compromised and can result in discrepancies in the valuation and settlement of the contract, including when the specified fixing source publishes or, importantly, fails to publish, a fixing price. This also creates asymmetric risk between a bank's FX NDF contracts with a client which are centrally cleared CCP under non-standard EMTA terms, and FX NDF contracts with a client that chooses not to centrally clear (and is exempt from clearing) under standard EMTA terms.

***G20 commitment to clearing and trading mandates relies on standardisation in contracts, which is compromised by unilateral modifications to EMTA templates and may result in new asymmetric risks for market participants.*** As part of their commitment to derivatives reform, the G20 Leaders agreed that all *standardised* contracts would be traded on exchanges or electronic trading platforms, where appropriate, and cleared through CCPs. As the Consultation Paper itself notes in its assessment of the degree of standardisation present for FX NDF contracts, “[t]he level of standardisation of NDF has increased as a result of industry initiatives led by associations such as the Emerging Markets Trade Association (“EMTA”).”<sup>7</sup> However, standardisation is not achieved – and is in fact compromised – when industry terms memorialised in EMTA templates are modified outside the governance process which established them; by definition, templates modified by one or more CCPs no longer reflect industry standards.

While LCH has adopted the EMTA templates without modification, at least one other CCP (e.g., CME Clearing in the U.S.) has modified EMTA standard fall-back conventions.<sup>8</sup> As a result, the original transacting parties will face risks asymmetric to dealers' commercial flow resulting from these disparities. This type of risk arises with the modification by a CCP of any provision in the EMTA template.

***Any clearing determination for FX NDF contracts must expressly define the class of derivatives to include only those contracts for which an EMTA published currency template (without modification) applies.*** Because this Consultation Paper results from a “bottom-up” approach triggered by the authorisation of LCH to clear OTC FX NDFs, the characteristics of the NDF class for which ESMA may mandate clearing must reflect the particular conventions adopted by LCH including, in this case, EMTA published templates without modification. As evidenced in the preceding paragraph, there are no assurances that CCPs other than the one CCP currently authorised in the European Union will adopt the same EMTA conventions.<sup>9</sup> The CFTC recently stated that the specifications for any proposed class of FX NDF contracts for clearing “are intended to cover such contracts executed according to standardised templates published by EMTA” and

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<sup>7</sup> See Consultation Paper, section 3.2.1, paragraph 30.

<sup>8</sup> That CCP has indicated that it is shortening the duration of the disruption event provided for in the published EMTA templates from 30 days to 15 days. This means that two NDF FX contracts in, e.g., BRL/USD, that appear to be identical but where one is cleared at LCH and the other is cleared at the other CCP will be settled differently if the fixing source is unavailable for a prolonged period of time. Further, that CCP has informed multiple GFXD members that with respect to currencies where the EMTA template specifies a fallback reference price that is not determined by EMTA,<sup>8</sup> but rather a third party, they are unwilling to adopt the EMTA disruption fallback waterfall and will instead apply “Force Majeure.” For these purposes, “Force Majeure” means that the CCP will utilise its discretion to determine a fallback reference price.

<sup>9</sup> To ensure standardisation achieved by the market to date is not compromised, especially in the context of a clearing mandate, any proposed modifications to EMTA published currency templates should be vetted through the governance process which established them in the first instance, i.e., via EMTA with its membership. Such a process would ensure that any modifications made apply to all contracts involving the currency pair, either (1) regardless of whether or not centrally cleared; or (2) only centrally cleared contracts, and thus preserve the prerequisite established by the G20 that clearing and trading mandates only apply to standardised contracts.



“would not include non-standard NDFs.”<sup>10</sup> For these reasons, we strongly urge ESMA to make clear that one of the characteristics of any class of FX NDF contracts subject to a clearing mandate is the adoption of the EMTA published templates, without modification. If ESMA were to decline to do so, the risk of non-standardisation could even extend to the reference (or fixing) price for these contracts, a key contract term which Consultation Paper itself refers to as “the most important characteristic” of these contracts.

<ESMA\_CO3\_QUESTION\_2>

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<sup>10</sup> See CFTC Global Markets Advisory Committee (GMAC) on October 9, 2014 (presentation by Brian O’Keefe, Deputy Director, Division of Clearing and Risk, CFTC).



### 3. Determination of the classes of OTC derivatives to be subject to the clearing obligation

#### **Q3: In view of the criteria set in Article 5(4) of EMIR, do you consider that the determination of this class addresses appropriately the objective of reduction of the systemic risk associated to NDF derivatives?**

<ESMA\_CO3\_QUESTION\_3>

While GFXD is supportive of central clearing, where appropriate, and the benefits it can bring to the OTC derivatives markets in such areas as operational efficiencies and counterparty credit risk reduction, GFXD believes it is not clear whether a clearing mandate for these contracts at this time would appropriately address the objective of reducing *systemic* risk. While mandating FX NDF clearing would transfer a certain amount of bilateral exposure which exists between market participants to CCPs, the amount of risk in the FX NDF market is orders of magnitude less than in rates and credit markets. Because FX NDF clearing is relatively new in comparison to IRS and CDS clearing when clearing mandates were introduced to those markets, the FX clearing services need time to mature, for their practices to be properly bedded down and “battle-tested” and for fundamental unresolved issues to be properly addressed, GFXD is concerned that additional risk may be unnecessarily introduced to the this global currency market and, as a result, undermine the benefits of central clearing.<sup>11</sup> In light of these considerations which are explained in greater detail below, GFXD recommends that ESMA consider whether the reduction of counterparty credit risk to be achieved from mandating participants to move their bilateral exposures to a centrally cleared environment for FX NDF contracts at this time would *reduce risk in the aggregate* and, most importantly, also *reduce systemic risk*.

***Comparison of FX NDF market to IRS and CDS markets.*** It is well understood that FX NDF contracts are defined and treated as OTC derivatives globally and, as such, are or will be subject to measures designed to strengthen the financial system, e.g., trade reporting, real-time price dissemination, margin on uncleared derivatives, etc.<sup>12</sup> Although certain FX NDF contracts are certainly capable of being centrally cleared, the size of and amount of risk in the FX NDF market is orders of magnitude less than in rates and credit and thus the level of risk reduction that a clearing mandate for FX NDFs would bring in comparison to rates and credit would be similarly less.

FX NDFs represent 2.4% of the average daily turnover of the global OTC FX market,<sup>13</sup> with approximately \$2.8 trillion in notional outstanding and approximately \$90 billion in market value.<sup>14</sup> Gross credit exposures between dealers, after taking into account legally enforceable netting agreements, is a fraction of that number, representing the actual reduction in bilateral exposure between market participants. GFXD believes that an FX NDF clearing mandate would result in the mutualisation within CCPs of some fraction of the \$90 billion figure and the concordant reduction in counterparty credit risk. However, as illustrated in the table below, the size and risk of the NDF market in its entirety is dramatically less than the cleared or uncleared rates and credit products.

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<sup>11</sup> Please see footnote 7.

<sup>12</sup> Requirements applicable to OTC derivatives generally include, among other things, reporting to trade repositories to increase transparency to regulators in an effort to identify sources of systemic risk, margin on uncleared derivatives to reduce systemic risk and promote central clearing and, in some jurisdictions, pre-trade / post-trade requirements to increase public price and volume transparency. See, e.g., G20 commitments on OTC derivatives agreed in Pittsburgh in September 2009.

<sup>13</sup> See BIS Triennial Central Bank Survey: Global foreign exchange market turnover in 2013 (February 2014); available at <http://www.bis.org/publ/rpfx13fxt.pdf>.

<sup>14</sup> Estimates suggest there is approximately \$71 trillion notional outstanding of FX derivatives. That notional figure represents \$2.3 trillion in market value, which is roughly equivalent to exposure before margin or netting. These figures include FX forwards (deliverable and non-deliverable), swaps and options. Approximately four percent of those figures are attributable to FX NDFs. See BIS December 2013 Stats.

figures in billions

OTC Derivatives <sup>15</sup>	Rates	Credit	FX NDFs
<b>Average daily turnover</b>	\$2,000		\$127
Cleared	\$1,700-1,800 (76-79%)		\$4.6 (3.6%)
Uncleared	\$500-600 (21-24%)		\$122.4 (96.4%)
<b>Total market value</b>	\$14,000	\$700	\$90
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Uncleared	\$123,000-141,000 (21-24%)	\$15,500 (74%)	\$2,700 (96%)
<b>Tenor of total notional outstanding</b>			<i>Based on DTCC dataset<sup>16</sup></i>
Less than three months			\$2,520 (90%)
Over three months up to six months	\$198,302 (34%)	\$3,655 (17%)	\$224 (8%)
Over six months up to one year			\$28 (1%)
Over one year up to five years	\$234,284 (40%)	\$16,162 (77%)	\$28 (1%)
Over five years	\$151,778 (26%)	\$1,203 (6%)	

While the Consultation Paper suggests that the overall systemic risk of the OTC derivatives market achieved by subjecting FX NDF classes meeting the criteria of EMIR to a clearing obligation would be “significant”, the basis for this appears to be the comparison of the average daily turnover of \$127 billion of FX NDF contracts with \$187 billion of interest rate OTC derivatives denominated in GBP. Because it is estimated that interest rates derivatives denominated in GBP represent approximately 9% of interest rates turnover globally, the more appropriate comparison of average daily turnover – and therefore systemic relevance – would be to compare \$127 billion of FX NDF contracts *across all currencies* with \$2 trillion of interest rate OTC derivatives *across all currencies* and not simply rates products denominated in GBP.

**Considerations re “Systemic” Risk.** As reflected in the text of EMIR, the overarching aim of reducing systemic risk when reaching a clearing determination is central to any such determination:

- Recital 15: “Ensuring that the clearing obligation reduces systemic risk requires a process of identification of classes of derivatives that should be subject to that obligation.”
- Recital 21 – “In determining whether a class of OTC derivative contract is to be subject to clearing requirements, ESMA should aim for a reduction in systemic risk.”
- Article 5(4) – Clearing determinations should be reached “with the overarching aim of reducing systemic risk.”

As the European Central Bank (ECB) has recognised, “[a] commonly accepted definition of systemic risk does not exist at present” but “can be broadly characterised as the risk that financial instability becomes so widespread that it impairs the functioning of a financial system to the point where economic growth and welfare suffer materially.”<sup>17,18</sup> While FX NDF contracts are OTC derivatives, GFXD strongly urges ESMA to con-

<sup>15</sup> See BIS December 2013 Stats; Consultation Paper; and ISDA April 2014 Study.

<sup>16</sup> See Consultation Paper, page 32. Figures in the table above exclude CNY (one of the less liquid FX NDF currencies among the 11 considered by this Consultation Paper) where the share of trades with a maturity between six months and 1 year is 10%.

<sup>17</sup> European Central Bank, *The concept of systemic risk*, *Financial Stability Review* (December 2009).

<http://www.ecb.europa.eu/pub/fsr/shared/pdf/ivbfinancialstabilityreview200912en.pdf?3fef6891f874a3bd40cd00aef38c64f>. Also referenced in U.S. Department of the Treasury, Office of Financial Research, Working Paper #0001, *A Survey of Systemic Risk Analytics* (January 5, 2012).

<sup>18</sup> See Group of Ten, *Report on Consolidation in the Financial Sector*, 2001 (IMF working definition of systemic risk); available at <http://www.bis.org/publ/gten05.pdf>. See also Gerlach, Stefan of the European Parliament’s Policy Department: Economic and Scientific Policies, *Defining and Measuring Systemic Risk* (2009) (report produced at the request of the European Parliament’s Committee on Economic and Monetary Affairs, which highlights three important characteristics of the IMF’s working definition: First, it must

sider whether the reduction of counterparty credit risk to be achieved from mandating participants to move their bilateral exposures to a centrally cleared environment for these contracts would *reduce risk in the aggregate and, most importantly, reduce systemic risk* in light of the figures noted above and the concerns detailed in our response to Question 5 of this Consultation Paper and, if not, revisit this question at a later time after such concerns have been appropriately addressed or resolved:

- Supervisory considerations concerning a potential clearing mandate are materially different when clearing services are in their infancy, which is the case for FX NDFs.
- FX NDF clearing is in its infancy and therefore has not achieved the same depth as IRS and CDS clearing had when the clearing mandate was introduced to those asset classes.
- Key technical matters associated with FX NDF clearing remain unresolved.
- Analysis to support a clearing determination for FX NDFs is substantively more akin to a “top-down” approach even though technically a “bottom-up” approach.

As part of ESMA’s systemic risk reduction analysis, GFXD also believes appropriate consideration should be given to the potential concentration risk which arises when there is only a single CCP authorised for clearing FX NDFs. *This is particularly relevant for the FX NDF market where clearing offerings are in their infancy.* While the Consultation Paper indicates that FX NDF contracts are “expected to be cleared by additional European CCPs”, there are no assurances that this will be the case. Further, there are no assurances that their offerings will cover the same contracts as LCH – i.e., with EMTA published currency templates (without modification) – which has triggered this “bottom-up” clearing obligation analysis.<sup>19</sup> In fact, our experience to date has been that CCPs which have initiated, or attempted to initiate, clearing services (and, in the U.S., swap execution facilities or “SEFs”) for FX NDF contracts are not consistent on this critical issue. It is also worth noting that, as the Consultation Paper acknowledges, LCH has no experience in managing an actual failure of a reference (fixing) source to publish a reference (fixing) price which is needed for the valuation and settlement of FX NDF contracts.

<ESMA\_CO3\_QUESTION\_3>

**Q4: For the currency pairs proposed for the clearing obligation on the NDF class, do you consider there are risks to include longer maturities, up to the 2 year tenor?**

<ESMA\_CO3\_QUESTION\_4>

GFXD does not believe that it is appropriate to recommend a clearing mandate for tenors exceeding one year. There is insufficient liquidity in those products to support clearing and, given the limited liquidity, CCPs would find it difficult to manage the default of a clearing member responsible for transactions in those maturities.<sup>20</sup>

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impact on a “substantial portion” of the financial system. Thus, it is risk to the financial system as a whole. Second, systemic risk involves spillovers of risk from one institution to many others. In turn, this implies that in measuring it, attention should presumably be focused on the ways in which adverse shocks affecting one or a few institutions can be transmitted to the financial system at large, that is, on the interlinkages between institutions. Third, episodes in which systemic risk materialized would typically be associated with highly adverse macro economy efforts in the absence of rapid and strong policy responses. By this standard, it is clear that the current episode of financial instability [2008-2009], reflects a systemic crisis.); available at <http://www.europarl.europa.eu/document/activities/cont/200911/20091124ATT65154/20091124ATT65154EN.pdf>.

<sup>19</sup> This risk is exacerbated by the lack of mutual recognition of CCPs between Europe and the U.S.

<sup>20</sup> GFXD believes this to be the case notwithstanding the fact that the size of the problem would also be limited since the number of contracts with a tenor between 1 and 2 years is low.



As the Consultation Paper notes, open interest in FX NDFs is concentrated in instruments with maturities shorter than one year; more than ninety-five percent of trading arises from the shorter tenors with most of it concentrated in tenors shorter than 3 or 6 months. The Consultation Paper acknowledges this distribution in the 11 proposed currency pairs on page 34, indicating that but for one pair, more than ninety percent of trading is in tenors 6 months or shorter. In contrast, aggregating trade data from the DTCC and Bloomberg's data repository, in the week from 15 October to 22 October in 2014, there were 4, 11, 5, and 2 total (cleared and uncleared) NDF transactions with tenors between 1Y and 2Y in BRL, INR, CNY, and KRW, four of the more liquid NDF currencies.<sup>21</sup> As such, GFXD believes that longer-dated instruments, those in excess of 6 months or 1 year, at this time, do not have sufficient liquidity to support clearing.

GFXD appreciates the concerns raised in the Consultation Paper with establishing a one-year tenor cut-off – that market participants may structure trades to be just over one year to avoid a clearing obligation. However, GFXD believes that other factors may disincentivise any efforts to structure around a cut-off for shorter-dated tenors. As the Consultation Paper notes, the overwhelming majority of FX NDF contracts have a maturity of less than 6 months. The phase-in of margin requirements for uncleared derivative transactions will begin at the end of 2015, which will increase the cost of continuing to transact FX NDFs bilaterally. (ESMA could perhaps also consider adopting a cut-off that is slightly longer than one year (e.g., the Singapore Stock Exchange (“SGX”) currently lists 7 currencies for FX NDF clearing on its website, all against USD, out to 375 days). Adopting this kind of cut-off may help to address any concerns with evasive behaviour without unnecessarily introducing the risk associated with clearing illiquid products to the CCPs.<sup>22</sup>)

<ESMA\_CO3\_QUESTION\_4>

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<sup>21</sup> <http://sdrview.clarusft.com/#FX>.

<sup>22</sup> As the Consultation Paper notes, not all of the proposed currency pairs are as liquid as others. The four currency pairs referenced above (INR, CNY, KRW, and BRL) account for the vast majority of volume in the 11 currency pairs suggested in the Consultation Paper – well more than 75 percent. In addition, some currency pairs trade in greater size, though in fewer number of trades, suggesting that there are fewer market participants, and sources of liquidity. Regardless of which currency pairs are ultimately subject to a mandate, it will be important that the scope of the mandate be relatively consistent from one jurisdiction to the next but also mindful of the trading activity – and thus liquidity – in those currency pairs within a particular region. Currently LCH offers 11 currency pairs, Chicago Mercantile Exchange (CME) offers 12, and SGX offers 7. As stated later in our response to Question 5, because liquidity profiles for any given currency pair may shift, consideration should be given to the establishment of liquidity thresholds for purposes of a clearing determination that will inform the appropriateness of the mandate for a given currency pair, including tenor, per jurisdiction and across jurisdictions, when any such mandate is initially made and, importantly, periodically reviewed.



#### **4. Determination of the dates on which the obligation applies and the categories of counterparties**

**Q5: Do you have any comment on the analysis presented in Section Error! Reference source not found.?**

<ESMA\_CO3\_QUESTION\_5>

As noted in the Consultation Paper and our response to Question 3 above, the current proportion of cleared FX NDF turnover is relatively limited and NDF clearing is relatively recent. Although the Consultation Paper further notes that “[i]t can therefore be expected that the CCPs have developed their clearing offer for NDF taking into account the expected volumes that the clearing obligation would bring” and “scalability of the CCPs is part of the authorisation process of CCPs under EMIR which in the case of LCH taken place recently,” there are significant differences between clearing a class of products that is relatively new – which is the case for FX NDFs – and a class of products with which both the CCP(s) and market participants have developed experience and comfort – such as IRS and CDS – especially in the context of a mandatory clearing obligation.

*Supervisory considerations concerning a potential clearing mandate are materially different when clearing services for the product are in their infancy.* Further, we believe that considerations a supervisor would analyse in the context of authorising a CCP to commence its services for a class of contracts is different from the considerations a supervisor would analyse in the context of a clearing mandate. Permitting a CCP to offer clearing of a product results in the small-scale offering of services which may grow over time. A clearing mandate, in contrast, would likely dramatically increase the volume/value of contracts processed by CCPs authorised to clear such contracts (presently there is only LCH) and rigorously test the resilience and robustness of its design in that context (e.g., default of clearing firms, liquidity available to close out, potential loss if significant position being liquidated/wound-down, etc.).<sup>23</sup>

*FX NDF clearing is in its infancy and therefore has not achieved the same depth as IRS and CDS clearing had when the clearing mandate was introduced to those asset classes.* In contrast to FX NDF clearing which was first launched in 2011/2012, IRS and CDS contracts began voluntarily clearing in 1999 and 2009. At the time when the first clearing mandates were introduced, approximately 60% of the IRS contracts and 30% of CDS contracts were being voluntarily cleared.<sup>24</sup> This differential can be explained by the introduction of clearing for CDS only five years ago, and 10 years after the introduction of clearing for IRS. Voluntary clearing has not expanded to the same degree for FX NDFs, which represent 2.4% of the average daily turnover of the OTC FX market, as it did in rates and credit and is estimated to be 0.4%-3.6% depending on the currencies involved. Clearing services for IRS and CDS contracts were able to mature and, through experience and time, resolve a number of issues before clearing mandates were ultimately imposed/considered for those markets as a result of G20 derivatives reform. In addition, entities transitioning to clearing for FX NDF contracts are likely to be far less familiar with clearing. Because FX NDF contracts are often used to hedge currency risk associated with underlying commercial activity in emerging market jurisdictions with restricted currencies, many entities which will be subject to an FX NDF clearing obligation will not be subject to an existing / proposed IRS or CDS clearing obligation.

*Key technical matters remain unresolved.* Regardless of the precise timing, GFXD believes there are certain key technical matters which need to be resolved before any clearing mandate becomes binding. These include:

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<sup>23</sup> See, e.g., remarks provided at the CFTC GMAC meeting on October 9, 2014 by David Bailey, Financial Market Infrastructure, Bank of England.

<sup>24</sup> See CFTC GMAC meeting, October 9, 2014 (presentation by Rodrigo Buenventura, ESMA).

- Proper and uniform adoption / application of standardised terms. We address this issue more fully in our response to Question 2.
- Additional CCPs offering clearing. The Consultation Paper notes that there is currently only one CCP authorised to clear FX NDFs in Europe, but that two others are in the process of listing contracts for clearing. Should these additional CCPs not offer FX NDF clearing, it would be imprudent to mandate clearing through a single CCP due to the concentration risk issues raised in our response to Question 3.
- Certainty of clearing. Discussions surrounding certainty of clearing issues that commenced well over four years ago were focused on IRS and CDS and, as a result, enhancements made by infrastructure and service providers to support clearing obligations were focused on those markets. And, as noted above, these markets had pre-existing clearing services well before clearing obligations were introduced/considered – 1999 for IRS and 2009 for CDS. In contrast, these discussions are only just now starting for FX, which is further complicated by the highly decentralised market infrastructure which has historically supported this market in its function as a global payment system as well as the importance of emerging market financial institutions that often serve as sources of liquidity in these currencies.
- Management of currency disruption events. As noted above, it is critical that the mandate recognise that certain additional terms concerning fixing source and pricing references in a disruption event are key elements of the FX NDF contract and thus are incorporated into any clearing mandate. However, in addition, it is important that CCPs develop expertise in managing disruption events which affect the valuation and settlement of FX contracts. Disruption events may include suspension of trading, sovereign default, an unexpected bank holiday or other significant disruption to valuation, payment or settlement processes. Especially as clearing occurs in greater volume, the ability of CCPs to manage disruption events and the unavailability of fixing sources, including over a prolonged period of time, will be of critical importance. To our knowledge (and as acknowledged in the Consultation Paper with respect to LCH), no CCP has yet had to respond to a disruption event and it may be appropriate to give CCPs sufficient time to develop that expertise before any clearing mandate becomes fully implemented. In contrast to CCPs as new entrants in this market, dealers have a long history and therefore experience in managing these circumstances in a non-centrally cleared environment.
- EMIR recognition of local CCPs. As noted in the Consultation Paper, certain third-country CCPs are beginning to offer FX NDF clearing services in a number of the currency pairs proposed to come within the mandate. It will be important that these CCPs become recognised by ESMA prior to the full implementation of any clearing mandate.
- Developing a framework for how contracts that have become less liquid would move out of the clearing mandate. As the Consultation Paper notes, as capital controls are removed, trading in FX NDFs in particular currency pairs tends to lessen over time. As such, GFXD believes, ideally, ESMA would have some mechanism to remove a contract from mandated clearing in a relatively short period of time. This is not a new issue and ESMA acknowledged these concerns in its final RTS for the Clearing Obligation – Interest Rate Derivatives. It specifically noted its limitations in being able to remove a contract from clearing, given the structure of EMIR and suggested that the issue need to be included in the review process of EMIR.<sup>25</sup> GFXD recognises the structure of EMIR and ESMA's limitations in removing an instrument from the clearing mandate. However, because of the nature of

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<sup>25</sup> See Final Report, Draft Technical Standards on the Clearing Obligation – Interest Rate OTC Derivatives (1 October 2014); available at [http://www.esma.europa.eu/system/files/esma-2014-1184\\_final\\_report\\_clearing\\_obligation\\_irs.pdf](http://www.esma.europa.eu/system/files/esma-2014-1184_final_report_clearing_obligation_irs.pdf).

these instruments, and their uses, unlike IRS and CDS products, liquidity in some currency pairs may be more likely to decrease over time, rather than increase. As such it is important to resolve how an instrument would be treated should liquidity in it erode, prior to subjecting it to a mandate. A longer phase-in period, as discussed in the ISDA-FIA Europe FX NDF Response to Question 6, could allow more time for a review of EMIR to address this concern. This could then allow for the establishment of a liquidity threshold which could automatically trigger a review of the RTS as applied to a particular currency pair.<sup>26</sup>

- Residual issues that have arisen in IRS and CDS in response to clearing and trading mandates.
  - *Packages.* It is important to make clear *ex ante* that the clearing mandate will not apply in the context of package transactions, where multiple trades are executed simultaneously but only certain portions are subject to clearing and trading requirements. With respect to FX NDFs, for example, FX NDF transactions that are delta hedges of uncleared FX options executed together should be exempted as package transactions. Similarly, the clearing mandate should not apply where an FX NDF transaction is paired with an emerging market bond.
  - *Bunched orders (allocations).* As detailed in our response to Question 7 below, a trading mandate is anticipated to follow a clearing mandate for OTC derivatives in Europe and the U.S. Concerns with operational and documentation readiness of U.S. registered trading platforms (SEFs), namely the platforms' ability to support pre/post-allocation and pre-execution checks at the allocated fund level, relating to clearable bunched orders continue to persist for credit products which are already subject to a trading mandate.
  - *NARs:* In the U.S., industry requested no-action relief from the CFTC relating to the above and other issues concerning the implementation of clearing and trading mandates for rates and credit products. In some cases, some form of no-action relief was granted and, in other cases, not granted. Even if these issues have been resolved, or are resolved soon, for rates and/or credit products, material differences exist in the type of market participants, infrastructure and service providers for FX NDFs as compared to rates and credit. Given there is no ability on the part of ESMA to suspend a clearing obligation, please refer to our responses to Question 3 and Question 7.
- Allow parties to manage the portfolio margining effects of a move to clearing. Because clearing for IRS and CDS developed over a long phase-in period and largely happened through voluntary moves ahead of the mandate, entities were able to adjust their portfolios. Entities need the same opportunity with their FX books.

***Analysis to support a clearing determination for FX NDFs is substantively more akin to a “top-down” approach though technically a “bottom-up” approach.*** While ESMA’s Consultation Papers on clearing obligation (no. 1 for IRS, no. 2 for CDS, and no. 3 for FX NDFs) are each considered the result of a “bottom-up approach,” the evolution of clearing for these three markets is such that the consideration of FX NDFs for a clearing obligation is much more substantively akin to a “top-down” approach given that FX NDF clearing is, in comparison to IRS and CDS clearing, in its infancy. When the clearing mandate was introduced to IRS and CDS, it was predicated on a far more developed market with many start-up issues addressed while clearing was still voluntary, both before and after the recent financial crisis. FX NDF clearing has not achieved the same critical mass. The share of FX NDFs currently cleared is significantly below the share of IRS and CDS when ESMA considered mandates in those asset classes. Further, there are currently

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<sup>26</sup> See footnote 22.

no readily available client clearing solutions for FX NDF clearing which can appropriately support the clients transacting in these FX NDF contracts. For these reasons, a mandate at this time would enable a single and thus only CCP currently authorised to clear FX NDF contracts relatively recently to drive these contracts into a clearing regime without demonstrating an appropriate level of maturity in and experience with its service offering, including the proper bedding down and “battle-testing” of practices and resolution of key unresolved issues. ESMA’s conclusion that IRS and CDS contracts were appropriate for a clearing mandate via a “bottom-up” approach was predicated on a market infrastructures which had demonstrated real operational capacity to clear such contracts, as evidenced by the statistics noted above (i.e., approximately 60% of IRS contracts and 30% of CDS contracts were being voluntarily cleared since 1999 and 2009, respectively). Making a clearing determination now, in the context of the FX NDF market as currently constituted, may be better analysed *substantively* through the lens of a “top-down” rather than a “bottom-up” approach.

<ESMA\_CO3\_QUESTION\_5>

**Q6: Do you agree with the proposal to keep the same definition of the categories of counterparties for the NDF classes than for the credit and the interest rate classes? Please explain why and possible alternatives.**

<ESMA\_CO3\_QUESTION\_6>

Please refer to our response to Question 8 below.

<ESMA\_CO3\_QUESTION\_6>

**Q7: Do you consider that the proposed dates of application ensure a smooth implementation of the clearing obligation? Please explain why and possible alternatives.**

<ESMA\_CO3\_QUESTION\_7>

As indicated in our response to Question 3, GFXD recommends that ESMA consider whether the reduction of counterparty credit risk to be achieved from mandating participants to move their bilateral exposures to a centrally cleared environment for FX NDF contracts at this time would *reduce risk in the aggregate* and, most importantly, also *reduce systemic risk*. If ESMA were to conclude that it would do so and, as a result, recommend to the European Commission that a clearing obligation be introduced for FX NDF contracts at this time, a sufficiently tailored clearing obligation, lengthened phase-in for compliance and global coordination would be necessary to minimise the risk that the implementation of clearing obligations (and with due consideration of trading obligations) in Europe and elsewhere is not unnecessarily disruptive to the this global currency market. With this in mind, GFXD suggests the following phase-in schedule (taking into account the modifications suggested in the ISDA-FIA Europe FX NDF Response to Question 6):

- Twelve (12) months after the entry into force of the RTS, category 1 entities would become subject to the clearing mandate with respect to trades with other category 1 entities;
- Twenty-four (24) months after the entry into force of the RTS, category 2 entities would become subject to the clearing mandate with respect to trades with category 1 entities and other category 2 entities;
- Thirty (30) months after the entry into force of the RTS, category 3 entities would become subject to the clearing mandate with respect to trade with category 1 and 2 entities, and trade with other category entities; and
- Thirty-six (36) after the entry into force of the RTS, category 4 entities would become subject to the clearing mandate.

GFXD believes the above suggested minimum phase-in schedule is necessary for a variety of reasons:

1. As noted previously, clearing services for FX NDFs are in their infancy compared to rates and credit. At a similar stage, far more market participants had voluntarily adopted clearing of rates and credit products. FX NDF clearing is simply starting from a much lower baseline.
2. Client clearing, in particular, is far less developed in FX NDFs. While ESMA correctly notes in its Consultation Paper that there are currently 17 clearing members in NDFs at LCH, only 2 of those currently offer client clearing. Financial counterparties likely do not have operational capacity to build out the necessary infrastructure, and in some cases even qualify, to become clearing members themselves, and thus will need to clear their FX NDF contracts indirectly through other clearing members. Any phase-in schedule will need to include sufficient time for existing clearing members to build out systems to support client clearing as such capacity today does not meaningfully exist.
3. The entities transitioning to clearing in these markets are likely to be far less familiar with clearing. This is due to the fact that FX NDF contracts are often used to hedge currency risk associated with underlying commercial activity in emerging market jurisdictions with restricted currencies, many entities which will be subject to an FX NDF clearing obligation will not be subject to an existing / proposed IRS or CDS clearing obligation. This phenomenon is, in contrast to other OTC derivative products, particularly acute for the FX NDF market where firms in developed markets (e.g., Europe or U.S.) are sourcing liquidity (and thus “price-takers”) from local providers (e.g., Latin America or Asia, and thus “price-makers”) who will then be brought into scope of clearing obligations which do not exist, or do not yet exist, in their local jurisdictions.
4. This phase-in schedule will hopefully give ESMA and other regulators sufficient time to coordinate the timing of clearing requirements and mandatory trading requirements such that they can be aligned as closely as possible. While the proposal at issue here concerns only the clearing of these 11 instruments under EMIR, the practical impact of a recommendation by ESMA in favour of a clearing mandate as applied to FX NDFs may be to set in motion the clearing and mandatory trading of NDFs in other jurisdictions. It is important that in adopting a mandate, ESMA and other regulators carefully manage and coordinate the knock-on regulatory effects and the timing of both clearing and trading requirements, both in the EU and elsewhere, so as not to create unnecessary risks.

For the above reasons, should ESMA recommend a clearing mandate but the U.S. regulator does not, the market would be significantly impacted, to its detriment. If the CFTC adopts a clearing mandate as well, it will be critically important to align the timing of those mandates to eliminate or minimise any timing differences and a longer phase-in schedule should facilitate this coordination. Alignment of clearing implementation dates is particularly important for the global FX NDF market. Absent global coordination on the introduction of a clearing mandate for FX NDF contracts, emerging market liquidity providers not subject to a clearing requirement in their home jurisdiction may opt not to provide prices to counterparties subject to a clearing mandate, given the costs of clearing, resulting in a bifurcation of liquidity in these currency markets.

In addition, because of the structure of U.S. law, mandatory trading of NDFs on SEFs would likely follow a U.S. clearing mandate as a matter of course.<sup>27</sup> In addition to the residual issues that have arisen in the IRS and CDS markets in response to clearing and trading mandates in the U.S. noted in our response to Question 5 above, it has been widely observed the registration of SEFs and the mandatory trading of IRS and CDS

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<sup>27</sup> Under U.S. law, the process for made available to trade or “MAT” determinations are such that the implementation dates for clearing can be almost identical to the implementation dates for mandatory SEF trading. This contrasts with the standards in the EU where, by law, trading cannot be mandated any sooner than January 2017 under MiFID II. As a result, GFXD believes that the recommendation of a clearing mandate must be made with careful consideration of SEF readiness as well and that allowing for a sufficient transition period to coordinate regulatory processes is critical.



products under U.S. law, but not under EU law, has created certain dislocations.<sup>28</sup> The broad definition of SEF required many platforms offering FX products to register which has resulted in a split in liquidity between that offered on-SEF and that offered off-SEF.<sup>29</sup> When considering a recommendation of a clearing mandate for FX NDFs, ESMA should factor in a sufficient phase-in to allow for coordination among jurisdictions. It is paramount that a stable and robust cleared liquidity pool for standardised FX NDF contracts emerges before any trading mandate is implemented, especially given (in contrast to other OTC derivatives markets), U.S. and European counterparties are often “price-takers” in the FX NDF market.

<ESMA\_CO3\_QUESTION\_7>

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<sup>28</sup> See *Footnote 88 and Market Fragmentation: An ISDA Survey* (December 2013); and *Made-Available-to-Trade (MAT): Evidence of Further Market Fragmentation* (April 2004); available at <http://www2.isda.org/functional-areas/research/research-notes/>.

<sup>29</sup> Due to these and other considerations raised in our responses to this Consultation Paper, alternatives for ensuring alignment of go-live dates for trading mandates in, at a minimum, U.S. and Europe, could include: (i) a determination that while certain FX NDFs are capable of being (and are being) cleared, this class is not appropriate for a clearing mandate *at this time* but this should be revisited at a later time (to be specified); (ii) a determination that certain FX NDFs should be subject to a clearing mandate at this time, but with go-live dates as suggested in our response to Question 7 of the Consultation Paper, *provided* the U.S. SEF rules relating to MAT determinations are appropriately amended (or footnote 88 of the U.S. SEF rules which requires many-to-many trading facilities to register as SEFs is repealed or no-action relief provided from the requirement); (iii) a determination that a clearing mandate should be issued at this time, but with a go-live date no earlier than January 2017; or (iv) no action relief from the CFTC with respect to compliance with any trading mandate until January 2017 and, separately, with respect to footnote 88 of the U.S. SEF rules until January 2017.



## 5. Remaining maturity and frontloading

### Q8: Do you have comments on the minimum remaining maturities for NDF?

<ESMA\_CO3\_QUESTION\_8>

Given the concentration of open interest in FX NDFs in very short-dated tenors and the relatively limited size of this market, GFXD believes that there would be limited value in applying a “frontloading” requirement to FX NDF contracts, and that any clearing obligation for these contracts only apply to FX NDF contracts entered into or novated *on the date of the clearing obligation takes effect* (i.e., the compliance date for Category 1, Category 2, etc.).<sup>30</sup>

A frontloading requirement for FX NDF contracts would, as a practical matter, require clearing a number of FX NDF contracts transacted before the clearing compliance date into a CCP after the compliance date while, at best, achieving minimal credit risk reduction because of how little duration would remain on these already short-dated contracts. The additional operational complexities of moving this population of FX NDF contracts would come at a time when market participants would be attempting to address other fundamental challenges ahead of any compliance dates – which necessitates the extended phase-in schedule suggested by GFXD in the first instance (see our response to Question 7 above). These issues include building out client clearing systems in a market that currently has virtually no client clearing, unlike IRS and CDS markets at comparable stages, and introducing clearing to emerging market financial institutions (see our response to Question 5 above). Layering frontloading on top of these challenges would introduce complications that GFXD does not believe are justified by the amount of risk reduction that frontloading aims to achieve given the size of this market and especially in comparison to IRS and CDS.

*figures in billions*

OTC Derivatives <sup>31</sup>	Rates	Credit	FX NDFs
<b>Total notional outstanding</b>	\$584,000	\$21,000	\$2,800
<b>Tenor of total notional outstanding</b>			<i>Based on DTCC dataset<sup>32</sup></i>
Less than three months			\$2,520 (90%)
Over three months up to six months	\$198,302 (34%)	\$3,655 (17%)	\$224 (8%)
Over six months up to one year			\$28 (1%)
Over one year up to five years	\$234,284 (40%)	\$16,162 (77%)	\$28 (1%)
Over five years	\$151,778 (26%)	\$1,203 (6%)	

To the extent ESMA nonetheless concludes that a frontloading requirement is necessary or desirable for FX NDF contracts, GFXD believes it would be more appropriate for ESMA to set the minimum remaining maturity (“MRM”) at six months (6) months for category 1 and category 2 entities, *provided* that the modifications suggested in the ISDA-FIA Europe FX NDF Response to Question 6 of this Consultation Paper are adopted. In both the IRS and CDS clearing obligation consultations, ESMA determined that risk associated with contracts became substantial if the trade matured in over six months; and that a six month MRM for IRS contracts would capture nearly 90 percent of the trade population. In contrast, ESMA notes in this Consultation Paper that the reduction of MRM to 3 months for the FX NDF class takes into account the fact that the maximum maturity of the FX NDF classes is lower than the maximum maturity in the IRS class. There is no

<sup>30</sup> GFXD is of the view that ESMA has the authority to either (i) not apply the frontloading requirement to a class of OTC derivatives – in this case FX NDFs – under Article 4(1)(b)(i) by specifying that the clearing obligation applies to the contracts entered into or novated on or after the date on which the clearing obligation takes effect (i.e., the compliance date for Category 1, Category 2, etc.); or (ii) apply the frontloading requirement under Articles 4(1)(b)(ii) and 5(2)(c) to FX NDFs with a remaining minimum maturity of one year (i.e., the tenor of the contracts which we suggest in our response to Question 4 above).

<sup>31</sup> See BIS December 2013 Stats; and Consultation Paper.

<sup>32</sup> See Consultation Paper, page 32. Figures in the table above exclude CNY (one of the less liquid FX NDF currencies among the 11 considered by this Consultation Paper) where the share of trades with a maturity between six months and 1 year is 10%.



reason, however, to suggest that FX NDFs with a residual maturity between three and six months will contribute to systemic risk any more than IRS and/or CDS with the same residual maturity. Lowering the MRM for FX NDFs to capture a greater share of the contracts, because most contracts in this asset class are overwhelmingly short-dated, is inconsistent with ESMA's earlier analysis. Accordingly, GFXD recommends that ESMA determine, with due consideration to the figures included in the table above, that FX NDFs present greater *systemic risk* at maturities of three months in comparison to the IRS and CDS asset classes with maturities of six months before establishing a shorter MRM for the FX NDF asset class.

<ESMA\_CO3\_QUESTION\_8>

## **Annex I - Draft Regulatory Technical Standards on the Clearing Obligation**

### **Q9: Please indicate your comments on the draft RTS other than those already made in the previous questions.**

<ESMA\_CO3\_QUESTION\_9>

The application of a clearing mandate to FX NDFs is categorically different than applying one to IRS and CDS asset classes. If ESMA were to recommend to the European Commission that a clearing obligation be introduced for FX NDF contracts, GFXD suggests that, with respect to promulgating an RTS on a clearing obligation, ESMA should take particular care to:

1. ensure the standardisation of FX NDF instruments by specifying that only contracts accepting the EMTA published currency templates, i.e., without modification, are within the mandate's scope (see our response to Question 1);
2. apply the mandate only to instruments in tenors liquid enough to support clearing, i.e., 1 year (see our response to Question 4);
3. provide for a sufficiently lengthened phase-in period (see our response to Question 7); and
4. not apply the frontloading requirement (or, if applied, only as necessary to achieve the goal of material risk reduction, i.e., to categories 1 and 2 with a MRM of 6 months) (see our response to Question 8).

<ESMA\_CO3\_QUESTION\_9>

## Annex II – Impact assessment

### Q10: Please indicate your comments on the Impact Assessment.

<ESMA\_CO3\_QUESTION\_10>

Because clearing of FX NDFs remains largely undeveloped, a clearing mandate may have significantly greater impact on market participants than did the transition to a clearing in the IRS and CDS asset classes.

In our response to this Consultation Paper, GFXD outlines many of the specific issues that raise important considerations regarding the level of risk reduction and systemic risk reduction which would be achieved with the introduction of a clearing obligation for FX NDF contracts at this time (see our response to Question 3).

If ESMA were to recommend to the European Commission that a clearing obligation be introduced for FX NDF contracts, factors which complicate the implementation of any such mandate at this time and therefore are relevant to defining the categories of counterparties, and scope of clearing members to be included in Category 1, include:

1. the modest overlap between clearing members in FX NDFs, on the one hand, and IRS and CDS on the other (see our response to Question 1 – only counterparties which are clearing members for the FX NDF classes should be included in Category 1 for the purposes of the FX NDF clearing obligation; and our response to Questions 6 and 8 – threshold tests for Category 2 / 3); and
2. the importance of emerging market financial institutions in these markets (see our response to Question 7).

<ESMA\_CO3\_QUESTION\_10>