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TO:

Mr. Pat Brennan
General Manager, Policy Development
Australian Prudential Regulation Authority
Level 26, 400 George Street
Sydney 2000, NSW
Australia

Via email: policydevelopment@apra.gov.au

28 June, 2016

Re: Discussion Paper on Margining and Risk Mitigation for Non-Centrally Cleared Derivatives

Dear Mr Brennan,

Further to our original response to the Discussion Paper on *Margining and Risk Mitigation for Non-Centrally Cleared Derivatives (the Discussion Paper) and corresponding draft prudential standard CPS 226 (Prudential Standard)*, each issued by the Australian Prudential Regulation Authority (APRA) on 25 February, 2016, we wish to bring to your attention an industry concern regarding the requirement for variation margin exchange on FX Security Conversion transactions. We describe below our reasons for asking that APRA exclude these types of transactions from within scope of the variation margin requirements in the Prudential Standard.

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). Our members comprise 24 global foreign exchange (FX) market participants,[1] collectively representing approximately 85% of the FX inter-dealer market.[2].

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[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, Mizuho, Morgan Stanley, Nomura, RBC, RBS, Société Générale, Standard Chartered Bank, State Street, UBS, Wells Fargo and Westpac.

Many of our members act as custodian for their customers who are asset managers. Due to increased access to and investor interest in foreign financial markets, growing numbers of these customers are invested in foreign securities. To facilitate the purchase or sale of these foreign securities, these custodians, as part of their service offering, often enter into an FX transaction that is incidental to and for the purpose of effecting their customer's foreign security transaction ("FX Security Conversion transaction"). For example, when a non-US customer wishes to purchase a US dollar-denominated security, its broker-dealer or bank custodian will enter into a corresponding FX transaction so that the customer has US dollars available to meet the cash currency requirements necessary to complete purchase or sale of the security. These FX transactions are, therefore, integral to the settlement of the security.

Typically, the settlement cycle for most non-EUR denominated securities is trade date plus three days (T+3). Accordingly, the bank custodian or broker-dealer would enter into a FX transaction with its customer 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 (T+7).

In the European Commission's Delegated Act[3] published on 25th April, 2016, an FX spot contract includes "a contract for the exchange of one currency against another currency….where the contract for the exchange of those currencies is used for the main purpose of the sale or purchase of a transferable security or a unit in a collective investment undertaking, [and delivery is scheduled to be made within] the period generally accepted in the market for the settlement of that transferable security or a unit in a collective investment undertaking is the standard delivery period or 5 trading days, whichever is shorter." By being classified as a spot transaction, these FX Security Conversion transactions are not a "financial instrument" for the purposes of, and therefore are outside the scope of, MiFID/MiFIR.

Similarly, in the United States, the CFTC considers transactions for the sale or purchase of an amount of foreign currency to effect the actual delivery of a security by the relevant securities deadline to be a bona fide spot FX transaction, and therefore outside of the definition of a "swap"[4].

However, under the Payment Systems and Netting Act 1998, FX Security Conversion transactions are not included within the definition of a spot FX transaction, and therefore are a derivative covered under the Prudential Standard.

With the requirement, under the Prudential Standard, to exchange variation margin on physically-settled FX forwards and swaps effective from 31st March, 2017, asset managers will need to put in place the infrastructure to meet the requirements of the Prudential Standard. Whilst the relative value of the variation margin required to be exchanged as a result of entering into FX Security Conversion transactions will be small, there will be significant operational and infrastructural overheads that will need to be addressed.

For example, bank custodians and broker dealers will need to put in place ISDA Master Agreements and credit support annexes with asset managers that they have not previously exchanged collateral with on a voluntary basis. This would be a significant overhead for these market participants as each agreement would have to be negotiated for each underlying customer rather than at the asset manager level. For banks, this

[2] According to 2016 Euromoney league tables.

[3] http://ec.europa.eu/transparency/regdoc/rep/3/2016/EN/3-2016-2398-EN-F1-1.PDF

[4] https://www.gpo.gov/fdsys/pkg/FR-2012-08-13/pdf/2012-18003.pdf

would place an additional burden on existing resources that are already under pressure to document relationships with customers that trade OTC derivatives in advance of the relevant compliance dates.

In addition, because not all asset managers have previously exchanged collateral on a voluntary basis, there will be additional operational overheads for this group of customers that are not required to exchange collateral under the margin regimes of other jurisdictions. Given FX Security Conversion transactions are short dated in nature and attract a very low level of risk, the benefit of variation margin exchange does not outweigh the cost.

For the reasons highlighted above, the fact that the regulatory authorities in both the United States and Europe have defined these FX Security Conversions transactions as spot transactions and those in the US, Japan, Singapore and Canada have excluded physically settled FX forwards and swaps from both initial and variation margin requirements in their uncleared margin regulations, custodian banks may be unwilling to continue executing FX Security Conversion transactions with APRA regulated entities potentially resulting in unhedged FX risks for the asset managers.

Finally, we note that the Australian Securities & Investment Commission (ASIC) has exempted FX Security Conversion transactions from its mandatory reporting obligations. In the *ASIC Corporations (Derivative Transaction Reporting Exemption) Instrument 2015/844*[5] dated 21 September 2015, ASIC provided a temporary exemption from the reporting obligation for FX Security Conversion transactions with a maturity of up to trade date plus 7 business days until 30 September 2016. Based on a conversation with ASIC on 23 June 2016, we understand that ASIC will extend the exemption pending guidance from the CPMI-IOSCO Harmonisation Group.

In light of the above, we urge APRA to exclude physically-settled FX forwards and swaps from the scope of the variation margin provisions in the Prudential Standard.

More broadly, we repeat the comments we made in our 20 May, 2016 letter with respect to APRA's treatment of variation margin for physically settled FX products. As indicated in the March 2015 *Margin requirements for non-centrally cleared derivatives* by the Basel Committee on Banking Supervision and International Organization of Securities Commissions (the International Margin Framework)[6], these FX products merit certain exclusions from the scope of the margin requirements due to their unique characteristics.

The International Margin Framework excepts physically-settled FX forwards and swaps from its margin requirements entirely, although stating that standards apply for variation margin for physically-settled FX forwards and swaps[7] and citing the 2013 BCBS *Supervisory Guidance for managing risks associated with the settlement of foreign exchange transactions* (BCBS FX Supervisory Guidance, see Guideline 3 – Replacement cost risk)[8].

APRA's application of the variation margin requirements to physically-settled FX forwards and swaps contrasts with the treatment of these deliverable FX products in the US, Japan, Singapore and Canada. Physically-settled FX forwards and swaps are excluded from both initial and variation margin requirements under the final US Prudential Regulators' Rules, US CFTC Rules, the Canadian and Japanese rules. The

[5] https://www.legislation.gov.au/Details/F2016C00230

[6] http://www.bis.org/bcbs/publ/d317.htm

[7] http://www.bis.org/bcbs/publ/d317.htm (see p.7)

[8] http://www.bis.org/publ/bcbs241.pdf

recent Draft Guidelines on Margin Requirements in Singapore also exclude physically-settled FX forwards and swaps from both initial margin and variation margin requirements. These jurisdictions have, instead, handled variation margin for these FX products under the BCBS Supervisory Guidance.

An important element of the International Margin Framework is the goal of promoting global consistency and reducing regulatory arbitrage opportunities with respect to the treatment of physically-settled FX forwards and swaps. If jurisdictions were to differ in their approach to physically-settled FX forwards and swaps, we would have significant concerns about potential impacts on pricing and liquidity.

In the event that APRA elects to continue to include physically-settled FX forwards and swaps within the scope of the Prudential Standard's variation margin provisions, we would recommend that, as a minimum, FX Security Conversion transactions are treated as spot transactions and are excluded from the variation margin obligations to ensure the continued prudent hedging of FX risk on foreign asset sales and purchases and to achieve global consistency in the treatment of these transactions.

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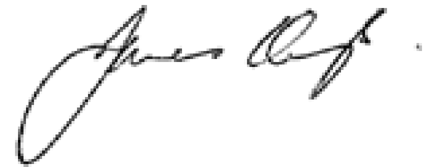
Please do not hesitate to contact John Ball on +852 2531 6512, email jball@gfma.org should you wish to discuss any of the above.

Yours faithfully,



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