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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

20 May, 2016

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

Dear Mr Brennan,

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 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.

The GFXD was formed in co-operation with the Association for Financial Markets in Europe (AFME), the Securities Industry and Financial Markets Association (SIFMA) and the Asia Securities Industry and Financial Markets Association (ASIFMA). Its members comprise 24 global foreign exchange (FX) market participants,¹ collectively representing more than 90% of the FX inter-dealer market.² 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.

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.

² According to Euromoney league tables.

The FX market is the world's largest financial market. Effective and efficient exchange of currencies underpins the world's entire financial system. 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 GFXD wishes to emphasise the desire of our members for globally coordinated regulation which we believe will be of benefit to both regulators and market participants alike.

The FX market is also the basis of the global payments system. The volume of transactions is therefore very high and these transactions are often executed by market participants across geographical borders. As reported by the Bank for International Settlements (BIS) in their Triennial Central Bank Survey: Foreign Exchange Turnover in April 2013, over 75% of the FX activity was executed by market participants across five global jurisdictions,³ hence the continued view from the GFXD that regulations should be harmonised at the global level. Cross-border markets cannot operate in conflicting regulatory landscapes and the natural outcome, should this be the case, is unwanted fragmentation of what is an already highly automated and transparent FX market.

EXECUTIVE SUMMARY

Margin Requirements

We fully support APRA in implementing the G20 commitments to reform the OTC derivative markets. We especially welcome the fact that relevant international developments and margin requirements for non-cleared derivatives introduced in other jurisdictions have been taken into account. Whilst we do not specifically address every one of the provisions in the Prudential Standard, we highlight below, either expressly or through indicating our support for comments made by ISDA in its comment letter dated 19 May, 2016 (ISDA Comment Letter), some key points that are of particular importance to our members from an FX perspective and that we ask to be taken into account by APRA in order to preserve market liquidity and avoid causing a bifurcation of the FX market. To summarize:

Application of margin standards to FX - we welcome the exemption of physically-settled FX forwards and swaps from the initial margin requirements in the Prudential Standard. However, in order to avoid inconsistency with the treatment of these types of transactions in other jurisdictions we request that APRA also exclude physically-settled FX forwards and swaps from within scope of the Prudential Standard's variation margin provisions and instead address variation margin via its adoption of the 2013 BCBS FX Supervisory Guidance.

³ BIS 2013 Triennial Survey, available at <http://www.bis.org/publ/rpfx13fx.pdf>

Application of margin requirements to Level 2 group entities – we believe the margin requirements should only apply to transactions involving the specific entity or entities meeting the “APRA covered entity” definition.

Definition of covered counterparties - we encourage APRA to harmonise the definitions for covered counterparties as far as possible with other jurisdictions.

Timing for calling and exchange of margin - we support the proposal to require that initial margin and variation margin be settled “promptly” and urge APRA to stay involved in ongoing global discussions regarding the timing for posting of collateral.

Netting margin calculations - we ask that APRA follow the US approach of permitting netting sets under separate credit support annexes and allow netting amongst broad product sets.

Segregation of initial margin - in assessing whether margin arrangements comply with the requirements of the Prudential Standard, we ask that entities be able to rely on industry-wide legal advice developed by market participants.

Timing for initial margin - an “immediately available” standard will not be possible to apply in practice and should instead be replaced with a requirement for initial margin to be available in a “timely manner”.

Due diligence in respect of covered counterparties - we request that APRA covered entities be permitted to rely on good faith representations by their counterparties for purposing of assessing the counterparties against margin thresholds.

Intra-group transactions – we are concerned that discretionary power to bring intra-group trades into scope of the margin rules undermines the legal certainty of the margin framework, and believe further clarification as to the basis on which APRA will provide exemptions would be helpful.

Transacting with counterparties in ‘non-netting’ jurisdictions - we strongly support APRA’s exemption of APRA covered entities from initial margin and variation margin requirements when transacting with counterparties in jurisdictions where netting of derivatives is not enforceable upon insolvency or bankruptcy of the counterparty, or where collateral arrangements are questionable or not legally enforceable upon default of the counterparty.

FX haircuts - APRA should take a consistent approach to FX haircuts applying to non-cash initial and variation margin.

Risk Mitigation Standards

The GFXD welcomes APRA's principles-based approach to risk mitigation standards and adherence with the IOSCO framework. However we would like to request provision for the use of long form confirmations for trades where there is no Master Agreement in place with the counterparty.

We set out below in more detail comments and points on the Prudential Standard that are of particular importance to our FX members. Paragraph references are to the Prudential Standard.

MARGIN FRAMEWORK

Application of the margin standards to FX products (Paragraphs 13 and 19)

The GFXD welcomes the exemption of physically-settled FX forwards and swaps from the initial margin requirements in the draft Prudential Standard. 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),⁴ these products merit exclusion from the scope of the margin requirements due to their unique characteristics.

However, in order to avoid inconsistency with the treatment of physically-settled FX forwards and swaps in other jurisdictions and, potentially create an uneven playing field and incentivize regulatory arbitrage, for the reasons set forth below we urge APRA to exclude physically-settled FX forwards and swaps from the scope of the Prudential Standard's variation margin provisions as well.

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 swaps⁵ 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).⁶

APRA's application of the Prudential Standard's variation margin provisions 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 and

⁴ Available at <http://www.bis.org/bcbs/publ/d317.htm>

⁵ See <http://www.bis.org/bcbs/publ/d317.htm> (see p.7)

⁶ Available at <http://www.bis.org/publ/bcbs241.pdf>

the Canadian and Japanese rules. The uncleared margin proposals in Singapore also exclude physically-settled FX forwards and swaps from both initial margin and variation margin requirements.

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, this may well result in different requirements being mandated across borders. If this were to result, we would have significant concerns about potential impacts on pricing and liquidity.

In light of the above, in our view, a preferable and more globally consistent approach to variation margin for physically-settled FX forwards and swaps would be to establish any variation margin requirement for such FX swaps and forwards via reference to the BCBS FX Supervisory Guidance, rather than include these FX products within scope of the Prudential Standard's variation margin provisions.

For example, in Singapore the Monetary Authority of Singapore (MAS) in its October 2015 Policy Consultation on Margin Requirements for Non-Centrally Cleared OTC Derivatives states that physically-settled FX forwards and swaps are exempted from the margin requirements, but that entities are expected to appropriately manage the risks associated with such FX transactions, referencing the BCBS FX Supervisory Guidance.⁷ In Canada, physically-settled FX forwards and swaps are excluded from the entirety of the uncleared margin requirements,⁸ however the Office of the Superintendent of Financial Institutions Canada (OSFI) has separately issued an Advisory which establishes OSFI's expectations regarding the management of FX settlement risk by banks, on the basis of the BCBS FX Supervisory Guidance.⁹ In the US, the BCBS FX Supervisory Guidance is adopted by way of a Federal Reserve System Supervisory Letter.¹⁰

In order to achieve better consistency across global jurisdictions, both to maintain the competitiveness of entities subject to the Prudential Standard's margin requirements and to avoid potential jurisdictional conflicts, we recommend that physically-settled FX forwards and swaps be

⁷ See <http://www.mas.gov.sg/~media/MAS/News%20and%20Publications/Consultation%20Papers/Policy%20Consultation%20on%20Margin%20Requirements%20for%20NonCentrally%20Cleared%20OTC%20Derivatives%20Oct.pdf> (Footnote 7)

⁸ See <http://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/e22.aspx#01> (see para. 20)

⁹ See <http://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/adv-prv/Pages/FXSR.aspx>

¹⁰ See <http://www.federalreserve.gov/bankinforeg/srletters/sr1324.htm>

excluded from the scope of both the Prudential Standard's initial margin provisions (Paragraph 19) as well as variation margin provisions (Paragraph 13), and that any variation margin obligations for physically-settled FX forwards and swaps be addressed instead via APRA's adoption of this recommendation in the BCBS FX Supervisory Guidance.

Application of margin requirements to every entity in a Level 2 group (Paragraphs 4 and 6)

We agree with ISDA that, per the reasons set forth in its letter, the margin requirements should only apply to transactions involving the specific entity or entities within a margining group that meet the "APRA covered entity" definition. Furthermore, it is unclear to our members what the composition of Level 2 (as defined in Prudential Standard APS 001 Definitions) is, and how this impacts who is in scope of the margin requirements, particularly in relation to intra-group transactions and what is included and what is excluded.

Definition of covered counterparties (Paragraphs 10(f) and (i))

We support ISDA in encouraging APRA to harmonise the Prudential Standard's definitions for covered counterparties as far as possible with other jurisdictions, and to define the terms by reference to objectively available sources or existing foreign definitions. We agree that "financial institution" being defined as broadly as it is could lead to difficulty in determining counterparty status and that the definition would benefit from more specificity.

Timing for calling and exchange of margin (Paragraphs 15 and 22)

We are in favor of APRA's principles-based approach to margin settlement times and support the proposal to require that initial margin and variation margin be settled "promptly", given that T+1 is not always feasible. We too urge APRA to stay abreast of and involved in ongoing discussions regarding the timing for posting of collateral, to best ensure the practical advantages of the principles-based approach are acknowledged, such that a consistent, sensible and realistic outcome for margin collection timing can be achieved globally.

Netting margin calculations (Paragraph 17)

We support ISDA's comment with respect to the treatment of legacy derivatives and agree that APRA should follow the US approach of permitting netting sets under separate credit support annexes.

We also would support APRA allowing netting amongst broad product sets, including across transaction portfolios containing products both in and out-of-scope of the Prudential Standard. This

may be particularly relevant if APRA were to implement variation margin via the BCBS FX Supervisory Guidance, as per our request, in order for an APRA covered entity's physically-settled FX forwards and swaps which may be covered under their own credit support annex to be netted against other derivatives when calculating variation margin.

Segregation of initial margin (Paragraph 27)

We agree with ISDA that obtaining bespoke legal advice with respect to each new segregation agreement could prove time consuming and expensive and that, in assessing whether margin arrangements comply with the requirements of the Prudential Standard, entities should be able to rely on industry-wide legal advice developed by market participants.

Initial Margin should be made available in a "timely manner" (Paragraph 27(a))

Paragraph 27(a) of the Prudential Standard proposes that APRA covered entities be required to collect and hold initial margin such that it is immediately available to the collecting party in the event of the posting party's default. We agree with ISDA: we support the creation of robust segregation regimes but also believe the "immediately available" standard will not be possible to apply in practice and should instead be replaced with a requirement for initial margin to be available in a "timely manner".

Due diligence in respect of covered counterparties (Paragraph 30)

An APRA covered entity will not have the full, reliable, relevant knowledge of its counterparties' derivatives activities to be able to conduct reasonable due diligence on their business such as to be able to assess whether or not its counterparties have exceeded relevant notional amount thresholds.

As suggested by ISDA, in line with the requirement in the US, we request that APRA permit a covered entity to rely on good faith representations made to it by its counterparty in this regard, including those made in industry-standard self-disclosure documents.

Intra-group transactions (Paragraphs 61 and 62)

We agree with ISDA that APRA having discretionary power to bring intra-group trades within scope of the margin rules undermines the legal certainty of the margin framework. We also believe that further clarification as to the basis on which APRA will provide exemptions for certain intra-group transactions would be helpful.

Transacting with counterparties in jurisdictions where netting and/or collateral is not enforceable (Paragraphs 68 and 69)

We strongly support APRA's proposal that APRA covered entities be exempt from initial margin and variation margin requirements in respect of transactions where either: (i) netting of derivatives is not enforceable upon insolvency or bankruptcy of the counterparty; or (ii) collateral arrangements are questionable or not legally enforceable upon default of the counterparty (non-netting jurisdictions).

We agree with ISDA's comments as to the additional risks that arise where close-out netting is not enforceable and/or where it cannot be assured that posted collateral is sufficiently protected against the default of the counterparty and that, furthermore, frequently counterparties in emerging market jurisdictions do not have infrastructure in place to calculate, exchange and manage margin, thus raising the potential for disruption of established trading relationships and limitation of hedging and financial flows between Australia and the affected jurisdictions.

This issue is particularly important to our members because FX forms the basis of the global payments system and, as such, both the number of global market participants and volume of transactions are very high.¹¹ In emerging market economies, which includes the majority of the non-netting jurisdictions, FX accounts for over 50% (US\$535 billion)¹² of the turnover of OTC derivatives, reflecting the greater relevance of exchange rate risk in these economies.

We also agree with and support ISDA's comment, with regard to standards for determining the applicability of the exemption, that firms should be able to make their own individual determinations as to the conclusions to be drawn from their legal netting analysis.

FX haircuts (Attachment B)

We agree with ISDA that APRA should ensure that the haircut applying to non-cash variation margin does not have a broader scope of application than other regimes, by taking a more consistent approach in the language used to address haircuts for non-cash collateral posted as variation margin.

We also agree that parties should be able to agree on two termination currencies for purposes of exchanging initial margin and variation margin, to best align with other jurisdictions, and that APRA should follow the US-regulations approach for initial margin haircuts.

¹¹ Notional turnover, per the 2013 Bank for International Settlements ("**BIS**") Triennial Review, was US\$5.3 trillion/day, see <https://www.bis.org/publ/rpfx13fx.pdf>.

¹² BIS Quarterly Review: International banking and financial market developments, December 2013.

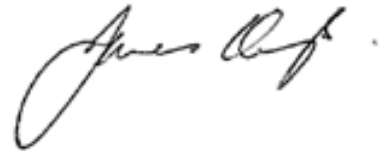
RISK MITIGATION STANDARDS

The GFXD welcomes APRA's approach to risk mitigation standards as outlined in the Discussion Paper. In particular, we welcome the decision to apply a principles-based approach, using the IOSCO standards as key requirements.

We would like to raise with APRA one concern, regarding the proposed standards for trading relationship documentation. Particularly when trading with smaller counterparties, it can be an accepted practice to trade using a long-form confirmation without a master agreement in place. The long form confirmation covers all the terms requirements for the trade, but is by nature produced after execution of the trade. We would encourage APRA to allow long-form confirmations to be used in place of master agreements and make allowances in their deadlines for the production of long-form confirmations following trade execution.

We appreciate the opportunity to share our views on the Consultation Paper. 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 sincerely,

A handwritten signature in black ink, appearing to read 'James Kemp', with a small flourish at the end.

James Kemp
Managing Director
Global Foreign Exchange Division, GFMA