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TO:

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29 January, 2016

Re: Consultation Paper on Non-Centrally Cleared OTC Derivatives Transactions – Margin and Other Risk Mitigation Standards

Dear Sir/Madam,

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 *Consultation Paper on Non-Centrally Cleared OTC Derivatives Transactions – Margin and Other Risk Mitigation Standards* issued by the Hong Kong Monetary Authority (HKMA) on 2 December, 2015 (the Consultation Paper).

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

[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.

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 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 the HKMA in implementing the G20 commitments to reform the OTC derivative markets. We especially welcome the fact that relevant international developments and the 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 proposals discussed in the Consultation Paper, we highlight below, either expressly or through indicating our support for comments made by ISDA in its comment letter dated 29 January, 2016 (the ISDA Comment Letter), some key points that are of particular importance to our FX members and that we believe should be taken into account and addressed by the HKMA in order to preserve market liquidity and avoid causing a bifurcation of the FX market. For example:

Application of the margin standards to FX products

- The GFXD welcomes the exemption of physically-settled FX forwards and swaps from the initial margin requirements in the SPM. However, in order to avoid inconsistency with the treatment of physically-settled FX forwards and swaps in other jurisdictions, potentially, creating an uneven playing field, we set forth below our reasons for requesting that the HKMA also exclude physically-settled FX forwards and swaps from within scope of the SPM's variation margin provisions.

[2] According to Euromoney league tables.

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

Transacting with counterparties in non-netting jurisdictions

- For the reasons set forth below, we strongly support the HKMA implementing a threshold with respect to margin requirements when trading with jurisdictions in which netting, collateral or third party custodian arrangement may not be legally enforceable and urge the HKMA to coordinate with key foreign regulators to adopt consistent approaches to non-netting jurisdictions.

Risk Mitigation Standards

The GFXD welcomes the HKMA's general approach to risk mitigation standards and broad alignment with approaches in the US and EU. However we would like to bring to the HKMA's attention the following points:

- We suggest that counterparties should be able to trade using long form confirmations where no master agreement is in place.
- We urge the HKMA to consider how the characteristics of the local market will affect implementation, notably lower levels of sophistication amongst NFCs.
- We ask that the HKMA adjusts its confirmations text to allow counterparties to choose between 1-way and 2-way confirmations according to their internal policies and procedures.
- We raise to the HKMA's attention the potentially limited benefits of portfolio compression in the FX market, and support the HKMA's drafting that it should be used only 'as appropriate'.

We have organized our comments as follows:

A) Comments on certain of the enumerated margin standards proposed in the SPM.

B) Comments on certain of the topics raised in the Consultation Paper in relation to margin standards.

C) Comments on the topics raised in the Consultation Paper in relation to the risk mitigation standards.

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MARGIN FRAMEWORK

The GFXD supports the HKMA's efforts to establish margin requirements to reduce the build-up of systemic risk arising from uncleared derivatives.

We are in favor of the HKMA adopting margin regulations that are harmonised and consistent with those in other jurisdictions, and comparable with the standards for margin requirements for non-centrally cleared derivatives established 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]

[4] Available at http://www.bis.org/bcbs/publ/d317.htm

A) Margin Standards Proposed in the SPM

Application of the margin standards to FX products *(SPM section 2.1.1.)*

The GFXD welcomes the exemption of physically-settled FX forwards and swaps from the initial margin requirements in the SPM. As indicated in the International Margin Framework, 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 the HKMA to exclude physically-settled FX forwards and swaps from the scope of the SPM's variation margin provisions as well.

The HKMA's application of the SPM'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 and final US CFTC Rules. The uncleared margin proposals in Japan, Singapore and Canada also exclude physically-settled FX forwards and swaps from both initial margin and variation margin requirements.

Furthermore, the International 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 and citing the 2013 *BCBS Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions*[5] (BCBS FX Supervisory Guidance).[6]

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 differ in their approach to inclusion of physically-settled FX forwards and swaps in local uncleared margin rules, 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 the full scope of the SPM's variation margin provisions. For example, in Singapore the Monetary Authority of Singapore 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

[5] Available at http://www.bis.org/publ/bcbs241.pdf

[6] See http://www.bis.org/bcbs/publ/d317.htm at p.7

[7] See http://www.mas.gov.sg/~/media/MAS/News%20and%20Publications/Consultation%20Papers/Policy%20Consultation%20on%20Margin%20Requirements%20for%20NonCentrally%20Cleared%20OTC%20Derivatives%201Oct.pdf (Footnote 7)

[8] See http://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/e22.aspx#01

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 SPM margin requirements and to avoid potential jurisdictional conflicts, we recommend that physically-settled FX forwards and swaps be excluded from the scope of the SPM's margin provisions in their entirety, and that any variation margin obligations for physically-settled FX forwards and swaps be addressed instead via the HKMA's adoption of the recommendations in the BCBS FX Supervisory Guidance.[11]

Timing for the exchange of margin *(SPM section 3.7.)*

We support the comments made by ISDA in this regard.

Treatment of intra-group transactions *(SPM sections 2.1.16 and 2.1.17.)*

We support the HKMA exempting intra-group transactions from the margin requirements. Inter-affiliate swaps provide an important risk management tool, allowing entities within a corporate group to transfer risk to the group entity best placed to handle it. However, we share the concerns raised in the ISDA Comment Letter regarding the HKMA retaining discretionary power to bring intra-group trades within scope of the margin rules.

Significant non-financial counterparty definition *(SPM section 1.1.1.)*

We urge the HKMA to aim to achieve consistency with regulators in other jurisdictions in terms of the scope of application of the margin requirements to non-financial entities. The consequences of not achieving this consistency are, potentially, an uneven playing field as between jurisdictions, and regulatory arbitrage.

Related to this, we support the comments in the ISDA Comment Letter requesting the HKMA to include an end-user exemption for non financial counterparties and smaller financial institutions with total assets under a certain threshold using swaps to hedge their risk, as other jurisdictions have done. We agree that the imposition of margin requirements on such entities could disincentivise them from using derivatives to hedge their risks.

Foreign incorporated subsidiaries of locally incorporated AIs *(SPM section 2.1.4.)*

We support the comments made in the ISDA Comment Letter in this regard and agree that the provision as drafted could undermine the legal certainty of the exemption for foreign incorporated banking subsidiaries of locally incorporated AIs.

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[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

[11] For example, in Module TA-2 ("Foreign Exchange Management") of the SPM, as per the 2013 HKMA guidance letter to Authorized Institutions on the topic of the BCBS FX Supervisory Guidance., available at: http://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2013/20130219e1.pdf

Requirement for AI to substantiate information provided by counterparties on a best efforts basis *(SPM section 2.4.7. and footnote 19)*

We support the comments in the ISDA Comment Letter as we agree that an AI will not have the relevant knowledge relating to the derivatives business of its counterparty to be able to substantiate, even on a best efforts basis, whether or not its counterparty has exceeded the relevant notional amount threshold. As suggested by ISDA, in line with the requirement in the US, we request that the HKMA instead permit an AI to rely on good faith representations made to it by its counterparty, including those made in industry-standard self-disclosure documents.

Segregation of initial margin *(SPM section 3.5.2.)*

We support the comments made in the ISDA Comment Letter. We are also in favour of the creation of robust segregation regimes, however, agree that 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 provided in a "timely manner." The timing of the availability of initial margin will depend upon the procedures and operational steps required by the independent third party custodian holding the margin, and there may be some wait for delivery of securities held in a clearing system in accordance with standard settlement cycles. Therefore, the SPM should allow some flexibility in its requirements for segregation arrangements.

Independent legal review for initial margin arrangements *(SPM section 3.5.7.)*

We support the comments made in the ISDA Comment Letter. It would prove very time-consuming and expensive for counterparties to have to obtain bespoke legal advice with respect to each new segregation arrangement. The SPM should make it clear that counterparties may rely on standard industry-wide legal advice developed by market participants.

FX haircuts *(SPM sections 3.9.3. and 3.9.4.)*

As acknowledged by the HKMA, it is important to aim for global consistency in establishing margin requirements. This is particular important for the FX market, where a significant proportion of activity is executed by market participants across several global jurisdictions.

For global consistency, we agree with the ISDA comment that it would be prudent for the HKMA to finalize its rules regarding the FX-haircut only after the publication of the proposed European uncleared margin regulations[12] and any further clarification from the US Prudential Regulators regarding this issue.

B) <u>General Comments on Margin Topics Raised in the Consultation Paper</u>

Transacting with counterparties in non-netting jurisdictions

We strongly support the HKMA implementing a threshold whereby an AI would be subject to margin standards when trading with non-netting jurisdictions only if its aggregate exposure to covered entities located

[12] *Second Consultation Paper on Draft Regulatory Technical Standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012 (June 10, 2015)*, available at: http://www.eba.europa.eu/documents/10180/1106136/JC-CP-2015-002+JC+CP+on+Risk+Management+Techniques+for+OTC+derivatives+.pdf

in such non-netting jurisdictions exceeds a certain threshold (measured by notional amounts). In this regard, we agree with ISDA's recommendation for a 5% de minimis exemption from the margin requirements for OTC derivatives transactions with covered entities in jurisdictions in which netting, collateral or third party custodian arrangement may not be legally enforceable.

We view this approach as being preferable to a "collect only" requirement when facing counterparties in non-netting jurisdictions as there is a risk that counterparties from non-netting jurisdictions will refuse to trade on a collect-only basis. Direct limits on the risks incurred by AIs as a result of their trading with non-netting jurisdictions could achieve the same intended outcome at less cost and with significantly less disruption.

In order to promote competitive parity across jurisdictions that implement the International Margin Framework, and to avoid potential market disruption, fragmentation and a detrimental effect on market liquidity, we urge the HKMA to coordinate with key foreign regulators to adopt consistent approaches in this regard.

With respect to the proposal for variation margin to be exchanged with non-netting jurisdictions, we see the risk of an administrator "cherry picking" transactions applying equally to variation margin as to initial margin. We therefore suggest that variation margin not be required to be exchanged with non-netting jurisdictions.

Transacting with counterparties not subject to margin standards

We agree with the comments made in the ISDA Comment Letter urging the HKMA to exclude from the margin requirements transactions with counterparties in non-margin jurisdictions, including the proposal that those transactions be included in the 5% de minimis threshold discussed above.

We share ISDA's concerns that, absent an exemption, the margin requirements will disrupt established trading relationships, skew competition in favour of local dealers or those supervised by jurisdictions that do not impose their margin regulations in the affected jurisdictions, and curtail hedging and financial flows to those jurisdictions.

Introduction of partial compliance in addition to substituted compliance

We support the comments made in the ISDA Comment Letter in this regard and share ISDA's concerns that a partial compliance proposal will add another layer of complexity to the implementation of the proposed margin rules.

Furthermore, we emphasize the importance of ensuring that the regulatory treatment of FX products remains internationally consistent. Global co-ordination in respect of uncleared margin requirements is particularly important for our members because the FX market is a central component of the global payment system and the FX markets are cross-border in nature.

RISK MITIGATION STANDARDS

The GFXD welcomes the HKMA's approach to risk mitigation standards as outlined in the Consultation Paper. In particular, we welcome the broad alignment with existing standards in the US and EU. We provide below out specific comments on the areas covered.

C) <u>Comments on Risk Mitigation Topics Raised in the Consultation Paper</u>

Trading Relationship Documentation

The GFXD largely supports the HKMA's proposals for trading relationship documentation. However, we would like to bring to the HKM's attention that, 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 the HKMA 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.

Trade confirmation

The GFXD is supportive of the HKMA's aim to improve confirmation timeliness. Given the existing deadlines under EMIR[13] and Dodd Frank[14], global institutions already have in place systems for issuing confirmations within given deadlines. However, it must be recognised that many smaller Hong Kong counterparties, and in particular non-financial counterparties (NFCs), will be required to adapt to the new, shorter timeframes. These counterparties tend to be less sophisticated and trade less frequently than financial counterparties. They may also currently be unable to process electronic confirmations, relying on the exchange of paper confirmations, which is a significantly slower process. We would therefore ask that HKMA considers that meeting the deadlines for improving confirmation timeliness may be more of a challenge for NFCs, particularly where there is a need to implement systems changes such as electronic confirmation capability.

We would also like to raise to the HKMA's attention the final sentence of paragraph 4.2.3 on page 32 of the consultation paper, which seems to encourage use of 1-way confirmations (negative affirmation) for trades between AIs and non-financial counterparties**.** The GFXD believes that both 1-way and 2-way confirmation processes reduce operational risk when applied within an appropriate, robust and legally binding framework, but that market participants should be permitted to set their own policies and procedures as regards which method to use. Therefore, rather than mandate when 1-way or 2-way confirmations should apply, the GFXD suggests that the HKMA either:

1. Seeks closer alignment with the guidance given by ESMA on complying with the confirmation requirement under EMIR "the counterparties must reach a legally binding agreement to all the terms of an OTC derivative contract"[15]; or
2. Acknowledges the IOSCO approach that "Negative affirmation may be used as long as it is not prohibited under the applicable laws and regulations of a jurisdiction, and the outcome of the confirmation is legally binding on both parties"[16].

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[13] Commission Delegated Regulation (EU) No 149/2013, Article 12

[14] 17 CFR 23.501

[15] ESMA Q&A on EMIR – OTC Answer 5, paragraph (a) - https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-1485_qa_xiv_on_emir_implementation_october_2015.pdf

[16] Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives – 28 January 215 – paragraph 3.6, available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD469.pdf

Valuation with counterparties

The GFXD supports the HKMA's proposals for valuation.

Portfolio reconciliation

The GFXD supports the HKMA's proposals for portfolio reconciliation.

Portfolio compression

The GFXD supports the HKMA's proposals for portfolio compression. A market survey conducted for the GFXD by Oliver Wyman in 2015 calculated that 98% of traded volume in FX has a maturity of less than 1 year, with the majority less than 1 week. This limits the potential benefit available to firms in terms of risk reduction. Therefore we support the HKMA's phrasing that portfolio compression should be used only "to the extent appropriate".

Dispute resolution

The GFXD supports the HKMA's proposals for dispute resolution.

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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 faithfully,

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