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TO:

Ms. Elmarie Hamman
Financial Services Board
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September 8, 2017

Re: Draft Notice of 2017 – Margin Requirements for OTC Derivatives

Dear Ms. Hamman,

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 "Draft Notice of 2017 – Margin Requirements for OTC Derivatives" issued by the Financial Services Board (FSB-SA) under section 6(7)(d) of the Financial Markets Act, 2012 on August 8, 2017 (the Draft Margin Notice).

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 25 global foreign exchange (FX) market participants,[1] collectively representing over 80% of the foreign exchange 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.

The FX market is the world's largest financial market and 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.

[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, Scotiabank, Société Générale, Standard Chartered Bank, State Street, UBS, Wells Fargo and Westpac.

[2] According to Euromoney league tables.

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 2016 Triennial Central Bank Survey: Foreign Exchange Turnover in April 2016, over 77% of FX activity was executed by market participants across five global jurisdictions,[3] hence the strong 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

We fully support the FSB-SA taking initiatives to implement the G20 commitments to reform the OTC derivative markets. We highlight below, however, several key points arising out of the Draft Margin Notice that are of particular concern to our members from an FX perspective, and that we ask the FSB-SA to take into account in finalizing the Draft Margin Notice.[4]

To summarise these points:

1. A preferable and more globally consistent approach to variation margin for physically-settled FX forwards and swaps would be to establish variation margin requirements for these products via reference to the 2013 BCBS FX Supervisory Guidance.
2. We urge that FX "security conversion transactions" (as defined below) entered into in connection with the funding of a purchase or sale of a security be deemed spot transactions and therefore not included within the scope of derivatives regulation in South Africa, including uncleared margin requirements, even if settled on a longer than T+2 basis.
3. We are concerned that the current implementation timeline proposed does not provide sufficient lead time, given the legal and infrastructure needs and challenges with preparing for exchange of margin between parties to FX transactions.
4. We support the points made by the International Swaps and Derivatives Association Incorporated (ISDA) in their letter to you dated September 8, 2017 commenting on the Draft Margin Notice.

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[3] BIS 2016 Triennial Survey: http://www.bis.org/publ/rpfx16.htm, see pp.8 and 14.

[4] In this regard, we also reference the same points made in our December 2016 letter to Mr. AJ Smal at the South African Reserve Bank regarding its Proposed Directive regarding Margin Requirements for Non-centrally Cleared Derivatives, available at http://www.gfma.org/correspondence/item.aspx?id=866

We set out below more detailed explanations of our concerns.

1. Margin requirements for deliverable FX transactions

The GFXD welcomes and supports the FSB-SA's exemption of physically-settled FX forwards and swaps from the initial margin requirements in the Draft Margin Notice. 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),[5] 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, potentially creating an uneven playing field and incentivizing regulatory arbitrage, we urge the FSB-SA to exclude physically-settled FX forwards and swaps from the scope of the 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 swaps[6] and citing the 2013 "BCBS Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions" (FX Supervisory Guidance, see Guideline 3 – Replacement cost risk).[7]

The FSB-SA's application of the variation margin requirements to physically-settled FX forwards and swaps (Section 2.3(3) of the Draft Margin Notice) contrasts with the treatment of these deliverable FX products in the US and most other jurisdictions around the world. As illustrated below, the EU is the only jurisdiction to include physically-settled FX forwards and swaps within scope of its uncleared margin rules. Other jurisdictions have excluded physically-settled FX forwards and swaps in respect of *both* IM and VM, though in several jurisdictions local bank supervisors have instead indicated certain expectations regarding VM for these FX contracts via adoption of, or reference to, the FX Supervisory guidance.[8] We are currently actively engaged in advocacy with the European Commission urging them to do the same.[9]

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

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

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

[8] http://www.bis.org/publ/bcbs241.pdf. BCBS/IOSCO, in the International Margin Framework, states that the margin requirements described therein do not apply to physically-settled FX forwards and swaps but that ". . . standards apply for [VM] to be exchanged on [these FX contracts] . . . [to be] implemented either by way of supervisory guidance or national regulation" and that "In developing variation margin standards for [these FX contracts], national supervisors should consider the recommendations in the [FX Guidance].".

[9] See our July 2017 letter to the European Commission in response to the recent EMIR Refit Review, available at http://www.gfma.org/correspondence/item.aspx?id=936 (see Section C on page 7).

Physically-settled FX forwards and swaps included or excluded for VM under local uncleared margin rules					
U.S.	Excluded	Singapore	Excluded	Europe	Included
Japan	Excluded	Australia	Excluded	Hong Kong	Excluded
Canada	Excluded	Switzerland	Excluded	Korea	Excluded

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 are to differ in their approach to physically-settled FX forwards and swaps, this may well result in different requirements applying across borders. If this were to result, we would have significant concerns about potential impacts on pricing and liquidity.

Physically-settled FX forwards and swaps are relied upon by entities around the world to hedge currency risk exposures. In addition to the challenges which arise where regulatory approaches are inconsistent as between jurisdictions, mandatory and prescriptive variation margin requirements for physically-settled FX forwards and swaps raise liquidity, operational, documentation and regulatory risks and burdens for those relying on these types of FX contracts for their hedging needs - for example, pension fund managers investing in diverse securities. Implementing necessary capabilities for mandatory exchange of variation margin for physically-settled FX forwards and swaps requires significant infrastructure build, as well as the commitment of cash or other liquid assets as collateral. These entities may, due to the variation margin requirements, be deterred from managing their currency risk through the use of physically-settled FX forwards and swaps with entities within scope of the Draft Margin Notice.

In light of the above, in order to achieve better global consistency across jurisdictions, both to maintain the competitiveness of entities subject to the FSB-SA's margin requirements and to avoid potential jurisdictional conflicts, in our view a preferable and more globally consistent approach to variation margin for physically-settled FX forwards and swaps would be to exclude physically-settled FX forwards and swaps from the Draft Margin Notice, and instead establish any variation margin expectations for such FX forwards and swaps via reference to the FX Supervisory Guidance.

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.[10] In Canada, physically-settled FX forwards and swaps are excluded

[10] See
http://www.mas.gov.sg/~/media/MAS/News%20and%20Publications/Consultation%20Papers/Policy%20Consultation

from the entirety of the uncleared margin requirements,[11] 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.[12] In the US, the BCBS FX Supervisory Guidance is adopted by way of a Federal Reserve System Supervisory Letter.[13]

On a related but separate note, we see that in the Press Release accompanying the Draft Margin Notice, the FSB-SA references the FMA regulations and, specifically, provides the following, " . . . *In terms of this revised notice, [foreign exchange spot contracts . . .] are excluded from initial margin requirements, however the exchange of variation margin is still applicable to such instruments.*"

Is what is meant in the Press Release, rather than FX spot, physically-settled foreign exchange forwards and swap contracts (ie. Section 2.1(3) of the draft Margin Notice)? FX spot is not a derivative and should not be in scope for mandatory margin regulations at all. We would appreciate the FSB-SA's clarification/confirmation regarding this point on FX spot.

2. Exclusion of FX transactions linked to securities settlements from the margin requirements

We also urge that FX transactions that are incidental to and for the purpose of effecting customers' foreign security transactions, entered into in connection with the funding of a purchase or sale of a foreign security (FX security conversion transactions), be deemed spot transactions and therefore not included within the scope of derivatives regulation in South Africa, including uncleared margin requirements, even if they are settled on a longer than T+2 basis. We note that in South Africa, for example, we understand securities settlement cycles can take up to seven days (T+7).

In this regard, we refer to our letter dated August 31, 2016 to Ms. Petula Sihlali at the South African National Treasury on the Third Draft of the Ministerial Regulations on Regulating OTC Derivative Markets, available at this link: http://www.gfma.org/correspondence/item.aspx?id=838.

3. Implementation schedule

The introduction of margin requirements for uncleared FX transactions is a significant policy change for most FX market participants. These new requirements will call for legal and operational enhancements, and additional amounts of collateral for which liquidity planning will have to be undertaken by covered entities within scope of the margin rules.

%20on%20Margin%20Requirements%20for%20NonCentrally%20Cleared%20OTC%20Derivatives%201Oct.pdf (Footnote 7)

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

[12] See http://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/adv-prv/Pages/FXSR.aspx

[13] See http://www.federalreserve.gov/bankinforeg/srletters/sr1324.htm

Although the FSB-SA contemplates a phasing-in of margin requirements, we are concerned that the January 1, 2018 start date for first phase entities to comply with the margin requirements does not provide sufficient lead time. Final rules are required before firms will be able to begin necessary work, including legal, documentary, technology systems, operational and risk management work, and even once this works begins, time will be needed for testing.

To avoid what could be significant disruption to the FX market, we urge the FSB-SA to provide further lead time before the margin requirements take effect, so that there is the opportunity for covered entities' legal and infrastructure needs and challenges to be properly and adequately addressed.

4. Additional comments

In addition to the comments above, we wish to express our support for the points made by ISDA in their letter to you dated September 8, 2017 commenting on the Draft Margin Notice.

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We appreciate the opportunity to share our views on the Draft Margin Notice. Please do not hesitate to contact Victoria Cumings on +1 212 313 1141, email vcumings@gfma.org, should you wish to discuss any of the above.

Yours sincerely,

James Kemp
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