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Via email: jackecheung@tma.org.hk

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Re: Consultation on the application of initial margin to physically-settled FX forward contracts

Dear Mr. Cheung,

The Global Foreign Exchange Division ('GFXD') of the Global Financial Markets Association ('GFMA') welcomes the opportunity to provide comment to the Treasury Markets Association ('TMA') on the application of initial margin ('IM') to physically-settled forward foreign exchange ('FX') transactions.

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 FX market participants,[1] collectively representing over 80% 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, 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.

Executive Summary

We are concerned that any action to subject physically settled FX forward contracts to IM in Hong Kong, which will differ to the approach already taken in other global jurisdictions, will raise liquidity, operational, documentation and regulatory risks and burdens for in-scope entities.

Furthermore, the BCBS-IOSCO March 2015 Margin requirements for non-centrally cleared derivatives[3] (the 'Margin Framework') notes that the effectiveness of margin requirements could be undermined if its requirements are not consistent internationally, with activity moving to locations with lower margin requirements due to regulatory arbitrage and an unlevel playing field. These risks are particularly pertinent given the global nature of the FX markets and the significant levels of cross-border activity.

The predominant risk associated with a counterparty default on uncleared physically-settled FX forwards is principal risk, or settlement risk. However, this risk has been dramatically reduced by the development and use of CLS that settles payments for FX spot, forward and swap transactions on a payment vs payment basis.

Other than settlement risk, the remaining bilateral counterparty credit risk associated with FX forwards is replacement cost risk. However, unlike other OTC derivatives, physically-settled FX forwards are overwhelmingly short-term instruments; the 2016 Triennial Central Bank Survey[4] ('2016 Triennial Survey') stated that 98% of FX forwards and 99% of FX swaps had maturities of less than one year. This risk has been substantially reduced through the use of bilateral credit support annexes and the implementation of the 2013 BCBS Supervisory guidance for managing risks associated with the settlement of FX transactions[5] (the 'Supervisory Guidance').

A mandatory IM regime for physically-settled FX forwards at this time would represent a radical shift in regulatory policy which could cause harm to the well-functioning market structure.

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[3] Available at https://www.bis.org/bcbs/publ/d317.pdf.

[4] https://www.bis.org/publ/rpfx16.htm

[5] Available at http://www.bis.org/publ/bcbs241.pdf. See Guideline 3 – Replacement cost risk: "A bank should use legally enforceable collateral arrangements and should have an explicit policy on margin, eligible collateral and haircuts to reduce replacement cost risk. A bank should exchange (i.e., both receive and deliver) the full amount of variation margin necessary to fully collateralise the mark-to-market exposure on physically settled FX swaps and forwards with counterparties that are financial institutions and systemically important non-financial entities. Variation margin should be exchanged with sufficient frequency (e.g. daily) with a low minimum transfer amount."

1. **IM is not required by the BCBS-IOSCO 'Margin requirements for non-centrally cleared derivatives' and this is reflected in local margin regulations in jurisdictions globally.**

The Margin Framework specifically excludes physically-settled FX forwards and swaps from within its scope:

> "1.1 Except for physically settled FX forwards and swaps, the margin requirements apply to all non-centrally cleared derivatives. The margin requirements described in this paper do not apply to physically settled FX forwards and swaps."

The Margin Framework refers to the fact that consideration was given by the Working Group on Margining Requirements ('WGMR') as to whether certain types of transactions may merit exclusion from the scope of the margin requirements because of their unique characteristics or particular market practices. It was determined physically-settled FX forwards and swaps do merit such exclusion.

Consistent with the Margin Framework, we are not aware of any jurisdiction that subjects physically-settled FX forwards to mandatory IM under their non-cleared margin regulations:

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

With respect to the interaction of national regimes in cross-border transactions, the Margin Framework notes that the effectiveness of margin requirements could be undermined if its requirements are not consistent internationally, with activity moving to locations with lower margin requirements raising two concerns:

- Regulatory arbitrage, and
- Financial institutions that operate in the low-margin locations could gain a competitive advantage, i.e. unlevel playing field.

BCBS-IOSCO strived to achieve a framework that would ensure that implementation of margin requirements at a national jurisdiction-level would be appropriately interactive, with complementary national jurisdictions' rules, to limit regulatory arbitrage opportunities, achieve a level playing field and avoid application of duplicative or conflicting margin requirements to the same transaction or activity.

Given the global nature of the FX markets, and significant cross-border activity, it is particularly important that uncleared margin requirements are applied consistent internationally - a key principle within the Margin Framework.

As reported in the 2016 Triennial Survey, over 77% of FX activity was executed by market participants across five global jurisdictions, 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.

Furthermore, it may be helpful to outline why we consider IM to not be appropriate for physically-settled FX transactions.

2. Consistent regulatory approach for the treatment of variation margin (VM) for FX forwards under the margin regime.

To reiterate the importance of global consistency to avoid regulatory arbitrage and an unlevel playing field, all jurisdictions, except the EU, have excluded deliverable FX contract excluded from VM under local regulations. Instead, VM requirements for local entities may be implemented via adoption of the Supervisory Guidance.

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

Furthermore, on 24 November 2017, the European Supervisory Authorities (ESAs), in recognition of the challenges posed to certain end-users, issued a statement[6] stating that they were undertaking a review of the Regulatory Technical Standards (RTS) on risk mitigation

[6] https://esas-joint-committee.europa.eu/Pages/News/Variation-margin-exchange-for-physically-settled-FX-forwards-under-EMIR-.aspx

techniques for non-centrally cleared derivatives. The revised draft RTS[7] were subsequently issued on 18 December 2017. The RTS do not required the exchange of VM where one of the parties to the FX forward contract is an "institution" as defined in point (3) of Article 4(1) of the Capital Requirements Regulation[8]. The ESAs indicated that the changes will require the exchange of VM in a risk-based and proportionate manner thereby aligning the treatment of physically settled FX forwards with the Supervisory Guidance applicable in other jurisdictions.

3. Physically-settled FX forwards are physically-settled through an exchange of two currencies and therefore distinguishable from most derivatives contracts which are cash-settled and whose value and settlement amounts are derived by reference to one or more underlying assets.

FX, and by extension physically-settled FX forwards, is overwhelmingly a cash market with fixed terms, i.e. non-contingent outcomes. As such, in contrast to OTC derivatives from other asset classes which are entered into as cash settled-products, FX forwards are entered into on the basis of physical settlement, i.e. the physical exchange of two currencies between transacting parties. Their only "derivative" characteristic that distinguishes them from physically-settled FX spot transactions, which are not subjected to a mandatory IM regime, is their duration. Except for the fact that it is a longer dated instrument than a FX spot transaction, it is largely the same instrument.

4. The FX market is a global payment system that underpins the global economy by facilitating and supporting international trade and cross-border activity. FX forwards are an essential part of the FX market by providing a critical source of liquidity and funding.

FX products perform a vastly different role in the global financial system than OTC derivatives. Indeed, as the critical medium of exchange, FX is at the heart of all international commerce. Most international transactions require an exchange of currency, and most international economic activity, trade, and investment involves exposure to currency risk which needs to be managed. Corporations and investors regularly participate in the market for real 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 finance outside home markets.

[7] https://esas-joint-committee.europa.eu/Publications/Technical%20Standards/Joint%20Draft%20RTS%20on%20margin%20requirements%20for%20non-centrally%20cleared%20OTC%20derivatives%20(JC-2017-79).pdf

[8] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0575&from=EN

The FX market is the central component of the global payment system and underpins other financial markets and the global economy generally. As such, FX is the world's largest financial market. Further, it represents the most global, standardised, and liquid of all markets and maintains a high level of price transparency.

5. **The risks associated with the FX market are appropriately mitigated by the current regime of encouraging prudent supervision, practice guidelines and capital implications. This regime is continuously reviewed and enhanced, and includes settlement risk reduction via CLS and replacement risk reduction through appropriate usage of credit support annexes.**

The predominant risk associated with a counterparty default on uncleared physically-settled FX forwards is principal risk, or settlement risk, i.e. the risk of paying out the sold currency without receiving the purchased currency in return.

A study by Oliver Wyman[9] shows that that settlement risk comprises 94% of the maximum loss exposure in an FX trade with a maturity of less than one year, and 89% for trades with a maturity of greater than a year.

However, this risk has been dramatically reduced by the development and use of CLS Bank, a private-sector initiative that settles payments for FX spot, forward and swap transactions on a payment vs payment basis. The creation of CLS was a direct response to central banks and FX dealers prioritising efforts to address settlement risk as the main source of systemic risk.

Since 2002, CLS has extended its settlement risk reduction services for global FX activity from 7 currencies for 39 members to 18 currencies and over 60 members and thousands of third parties in 2017, and in doing so settles a significant portion of global FX transactions.

6. **The short-dated nature of the vast majority of physically-settled FX forwards provide considerable flexibility in managing counterparty exposures in comparison to other OTC derivative contracts.**

Other than settlement risk, the remaining bilateral counterparty credit risk associated with FX forwards is replacement cost risk, i.e. the failure of a counterparty may leave the non-failing party with an unhedged or open market position or deny it unrealised gains on the position. This resulting exposure is the cost of replacing, at current market prices, the original transaction.

[9] Available at https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/market-infrastructure-and-trading/openCommentFile?refNo=11CP6&commentRefNo=12

Unlike other OTC derivatives, physically-settled FX forwards are overwhelmingly short-term instruments. The 2016 Triennial Survey reported that 98% of FX forwards and 99% of FX swaps had maturities of less than one year. Given the liquid and short-dated nature of the FX market, the replacement risk of FX trade with a maturity of less than one year has been calculated to be 6% of the maximum loss exposure, and 11% for trades with a maturity of greater than a year.

As important, is the fact that the jump-to-default risk is minimal as counterparties very rarely go from AAA to default overnight. Rather, there is a period of progressive deterioration before a final event that triggers default and/or bankruptcy. The result being, given the short-dated nature of FX forwards, once a counterparty begins to show signs of impairment it is likely that most of the existing forward exposure to the counterparty will have matured by the time of any default.

This risk has also been substantially reduced through the implementation of the Supervisory Guidance.

7. **Subjecting physically-settled FX forwards to a mandatory IM regime is not consistent with the well-established strategy of central banks, in consultation with supervisors, for addressing systemic risk in the FX market and creates unsafe structural economic incentives that can harm the well-functioning market structure.**

A mandatory IM regime for physically-settled FX forwards at this time would represent a radical shift in regulatory policy which could cause harm to the well-functioning market structure. This is not only inconsistent with the Margin Framework and Supervisory Guidance, but appears to be at direct odds with such guidance and efforts to continue the implementation of the strategy regarding risks in the FX market.

The achievements in reducing settlement risk in the FX market and the market's proven track record at withstanding widespread market disruption demonstrate the effectiveness of the existing strategy.

Conclusion

In light of the above and in order to achieve effective global consistency across jurisdictions, both to maintain the competitiveness of entities subject to the HKMA's uncleared margin requirements and to avoid potential jurisdictional conflicts, we urge that IM requirements for physically-settled FX forwards are not imposed.

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We appreciate you giving us the opportunity to share our views. Please do not hesitate to John Ball on +852 2531 6512, email jball@gfma.org or Victoria Cumings on +1 212 313 1141, email vcumings@gfma.org, should you wish to discuss the above.

Yours sincerely,

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