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<u>TO</u>:
The Principal Chief General Manager
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Via email: fmrdfeedback@rbi.org.in

14 October, 2020

Re: Draft Variation Margin (Reserve Bank) Directions, 2020

Dear Financial Markets Regulation Department,

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 *Variation Margin (Reserve Bank) Directions, 2020 - Draft* (the "Draft VM Directions") issued by the Reserve Bank of India (RBI) on September 7, 2020.

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 a significant portion of the foreign exchange inter-dealer market. 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, Northern Trust, RBC, RBS, Standard Chartered Bank, State Street, UBS, Wells Fargo and Westpac.

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 emphasize 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 2019, sales desks in five countries – the United Kingdom, the United States, Hong Kong SAR, Singapore and Japan – facilitated 79% of all foreign exchange trading,[2] hence the 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

Whilst we support the RBI taking initiatives to implement the G20 commitments to reform the OTC derivative market, we highlight below some key points of particular importance to our members from an FX perspective. We respectfully ask these points are taken into account by the RBI in finalizing the relevant rules, in order to preserve robust market liquidity and avoid causing any bifurcation of the FX market.

To summarise our comments:

1. **Exclusion of physically-settled FX swaps and forwards from variation margin**: to achieve alignment with other regulators around the world, we continue to urge the RBI to exempt physically-settled FX swaps and physically-settled FX forwards from mandatory regulatory variation margin ("VM").

2. **FX spot/ FX security conversion transactions**: whilst not specific to VM, we would like to take this opportunity to reiterate comments we have made previously in respect of the application of margin and FX spot and FX Security Conversion Transactions.

3. **Allow posting of collateral offshore**: we request that the RBI allow the posting of collateral offshore under a multi-branch ISDA Master Agreement and centrally managed single Credit Support Annex ("CSA") which collateralizes the net mark-to-market exposure under all the transactions entered into between two banks.

[2] BIS 2019 Triennial Survey, available at https://www.bis.org/statistics/rpfx19_fx.pdf

4. **Allow full substituted compliance/margin for cross-border transactions**: we request the RBI to allow full substituted compliance in line with other global regulators and ask that the RBI confirm all WGMR jurisdictions are comparable with India, or provide a list of comparable jurisdictions, prior to VM requirements being implemented.

5. **Entity scope**: we ask that the RBI make certain clarifications in respect of the "Domestic Covered Entity" definition, and exclude corporates and NBFIs from within scope.

6. **Implementation timeline**: we respectfully ask the RBI to ensure that, in establishing final VM rules, the implementation timeline for VM provides sufficient lead time given the documents and processes that would need to be put in place from a legal and infrastructure standpoint to facilitate the exchange of VM.

7. **Other comments**: we also make several comments in respect of FX haircuts, VM transfer timing and minimum transfer amounts.

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We set out below our detailed comments. In several places we refer back to our comment letter submitted to the RBI in 2016[3] (our "2016 FX Letter") in response to the RBI's May 2016 *Discussion Paper on Margin Requirements for non-Centrally Cleared Derivatives*. In some other places we reference the letter submitted to you in response to these Draft VM Directions by The International Swaps and Derivatives Association, Inc. (the "ISDA Letter").

1. Exclusion of Physically-settled Foreign Exchange (FX) Swaps and Forwards from VM

As mentioned in our 2016 FX Letter, we welcome and support the RBI's exemption of physically-settled FX swaps and forwards from initial margin requirements. However, for the reasons set forth below, as previously detailed in our 2016 Letter, we continue to urge the RBI to exempt physically-settled FX swaps and physically-settled FX forwards from mandatory regulatory VM as well.

[3] https://www.gfma.org/correspondence/gfma-fx-division-submits-comments-to-the-reserve-bank-of-india-on-its-discussion-paper-on-margin-requirements-for-non-centrally-cleared-derivatives/

International Harmonization of VM Expectations

Looking at the current global regulatory landscape, it can be seen that physically-settled FX swaps and forwards have overwhelmingly been excluded from regulatory VM under final margin rules:

Physically-settled FX swaps and forwards included / excluded for VM under final uncleared margin rules							
U.S.	Excluded	Singapore	Excluded	Europe	Excluded[4]	Brazil	Excluded
Japan	Excluded	Australia	Excluded	Hong Kong	Excluded	South Africa	Excluded
Canada	Excluded	Switzerland	Excluded	Korea	Excluded		

If the RBI were to apply regulatory VM to physically-settled FX swaps and forwards, the RBI would therefore take a contrasting approach as compared with other countries around the world, as illustrated above.

An important element of the BCBS IOSCO International Margin Framework[5] is the goal of promoting global consistency and reducing regulatory arbitrage opportunities with respect to the treatment of physically-settled FX swaps and forwards. We are concerned that the RBI's approach under the Draft VM Directions could create an uneven playing field for India, and incentivize regulatory arbitrage. If this were to result, we would have significant concerns about potential impacts on pricing and liquidity.

In order to avoid inconsistency in VM treatment for physically-settled FX swaps and forwards in India as compared with other jurisdictions, we urge the RBI to explicitly exclude physically-settled FX swaps and physically-settled FX forwards from the scope of VM under final VM Directions. This could be effected by including in the final VM Directions an exclusion for physically-settled FX swaps and forwards from the scope of the Directions, for

[4] Amendments made to the relevant EU regulations, which are in the final stages of enactment, allow parties to exclude physically-settled FX swaps and forwards from VM where one or both counterparties are not "Institutions" ("credit institutions" / "investment firms") under the EU Capital Requirements Regulation ("CRR"). These amendments were made to avoid regulatory divergence between the EU and other jurisdictions in respect of the exchange of VM for physically-settled FX swaps and forwards by essentially limiting VM only to transactions between the most systemic counterparties (e.g., "dealer-to-dealer"). We note that the exchange of VM for physically-settled FX swaps and forwards is already common practice for dealer-to-dealer transactions.

[5] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD651.pdf

example along the lines of the specific carve-outs implemented in Hong Kong[6] and Singapore[7] uncleared margin regulations.

VM for Physically-settled FX via BCBS Supervisory Guidance

As also suggested in our 2016 FX Letter, and in light of the above, to the extent the RBI still wants to establish VM expectations for these FX products, a preferable and more globally consistent approach to VM for physically-settled FX swaps and forwards would be to establish any such expectations via the 2013 BCBS FX Supervisory Guidance[8].

In our 2016 letter we cited examples of how this was done in Singapore by the MAS[9], in the US by the Federal Reserve System[10] and in Canada by the Office of the Superintendent of Financial Institutions Canada (OSFI)[11] Additionally, the HKMA has taken a similar approach in Hong Kong.[12]

Rather than impose stringent VM requirements on physically-settled FX forward and swaps, this would allow for a more risk-based approach to VM for these FX products in India, and ensure VM is limited in respect of physically-settled FX transactions to where it is deemed necessary and appropriate in light of the risks posed. In our view, this would achieve closer and better alignment with other jurisdictions, whilst still enabling an approach that ensures the relevant risks are adequately addressed.

Finally, in addition to the challenges which arise where regulatory approaches are not consistent between regulatory bodies, we note that implementing necessary capabilities for mandatory exchange of VM for physically-settled FX swaps and forwards requires significant cost, infrastructure build, creation of a counterparty classification/categorization system, as well as the commitment of cash or other liquid assets as collateral.

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[6] HKMA "Non-centrally Cleared OTC Derivatives Transactions – Margin and Other Risk Mitigation Standards", available at: https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/CR-G-14.pdf (See section 2.1.2(iii) on p. 9).

[7] MAS "Guidelines on Margin Requirements for Non-Centrally Cleared OTC Derivatives Contracts", available at: https://www.mas.gov.sg/-/media/MAS/Regulations-and-Financial-Stability/Regulations-Guidance-and-Licensing/Securities-Futures-and-Fund-Management/Regulations-Guidance-and-Licensing/Guidelines/Guidelines-on-Margin-Requirements-for-NonCentrally-Cleared-OTC-Derivatives-Contracts-8-Apr-2020.pdf (See section 4.2 on p. 5).

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

[9] 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)

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

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

[12] https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2013/20130219e1.pdf

It is crucial to ensure that regulatory obligations take into account and reflect the nature and extent of the risks posed and that are to be mitigated, and avoid unnecessary burdens on FX end-users. If the obligations are not commensurate with the risks posed, entities within scope of the RBI's VM rules may be challenged in managing their currency risk through the use of physically-settled FX swaps and forwards, and their counterparties who do not themselves bear these obligations under their own regulatory framework may be deterred from trading with them, which could have adverse liquidity impacts.

Conclusion

Physically-settled FX swaps and forwards are relied upon by entities around the world to hedge currency risk exposures, so coordinated regulation in respect of these straightforward, predominantly short-dated FX products is vital. In order to achieve better global consistency across jurisdictions, both to maintain the competitiveness of entities subject to the RBI's regulatory scope and to avoid potential jurisdictional conflicts, we urge the RBI to follow the approach taken by other regulators globally and explicitly exempt physically-settled FX swaps and physically-settled FX forwards from mandatory regulatory VM requirements under final Variation Margin (Reserve Bank) Directions.

2. FX Spot / FX Security Conversion Transactions

Related to the above, as per our comments in our 2016 FX Letter (pages 5-6), we would like to take this opportunity to urge the RBI to classify as "FX spot" those FX transactions entered into in connection with the funding of a purchase or sale of a foreign security, even where the settlement period for the securities transaction, and thus the accompanying FX transaction, is greater than T+2 (the typical spot settlement period). This would be consistent with the classification of these "FX Security Conversion Transactions" in other jurisdictions.

Inconsistent treatment of FX Security Conversion Transactions globally should be avoided. Any lack of an exclusion for FX Security Conversion Transactions from OTC derivatives/margin requirements regulation in some jurisdictions, such as India, could create unnecessary disincentives from transacting in securities in those jurisdictions by raising their transactional costs relative to other jurisdictions which have excluded FX Security Conversion Transactions from derivatives regulations, such as the United States and EU.

In our 2016 FX Letter we also requested the RBI ensure there are clear definitions of "physically settled foreign exchange forward" and "physically-settled foreign exchange swap" under India margin regulation[13] and maintain a clear distinction between FX spot (which are not derivatives and not subject to swaps regulation, including margin) and FX forward

[13] There are examples of definitions for these products in other jurisdictions, for example the US Commodity Exchange Act, Sections 1(a)(24) and 1(a)(25, available here: https://www.law.cornell.edu/uscode/text/7/1a

transactions. As we see it, deeming FX Security Conversion Transactions as spot, and excluding physically-settled FX swaps and forwards from mandatory regulatory margin (as we request above) would sensibly align the RBI's approach to VM with the BCBS-IOSCO International Margin Framework and global approach for all types of deliverable FX contracts: physically-settled FX swaps and forwards, FX spot and FX Security Conversion Transactions.

3. Allow Offshore Posting of Collateral

We support and reiterate the comments and requests made in the ISDA Letter (Section 2.b.) regarding the posting of collateral offshore. Requesting a foreign bank's onshore branch to keep VM exchanged in India will entail use of two CSAs with the same counterparty and represents a major departure from international best practice. A global CSA construct as described in the ISDA Letter is also relevant in the case of cross-border trades, and we request that the RBI recognize such a construct in allowing offshore posting of collateral.

4. Allow Full Substituted Compliance/Margin Requirements for Cross-Border NCCD Transactions, paragraph 7

We support and reiterate the comments made in the ISDA Letter (Section 2.c.) requesting that the RBI allow full substituted compliance in line with other global regulators. For substituted compliance for cross-border transactions, we support the points made in the ISDA Letter (Section 3.j.) and equally ask the RBI to confirm all WGMR jurisdictions are comparable under paragraph 7(2) of the Draft VM Directions, similar to Hong Kong and Singapore, or provide a list of comparable jurisdictions prior to VM requirements being implemented.

5. Entity Scope

We also support the comments made in the ISDA Letter (Section 3.b.) regarding the definition of "Domestic Covered Entity" being unclear. When finalising the Draft VM Directions, we ask that the RBI clarify that the final VM Directions only apply to trades entered into by the onshore branch of entities headquartered offshore (to the extent that such entities are regulated by the relevant regulators). This would be consistent with similar requirements in HK, Singapore and Australia.

Furthermore, we also request the RBI consider exempting transactions undertaken by corporates and NBFIs to hedge underlying business risks from VM requirements, in line with other global jurisdictions. Such end-user exemptions will ensure that corporates that undertake derivative trades to hedge business risks are not burdened with VM requirements. Requiring non-financial end users who transact in derivatives to hedge underlying business risk to exchange VM may discourage such entities from entering into derivative trades for genuine business purposes if the cost of hedging is substantially increased for them, which could lead to the unintended consequence of disincentivising hedging activities.

6. Implementation Schedule

Even if physically-settled FX swaps and forwards are excluded from the scope of the final VM Directions as we request, the VM requirements will be a significant policy change for most market participants in respect of other derivatives/FX derivatives that are in scope. The new VM requirements will call for operational enhancements and additional amounts of collateral for which liquidity planning will have to be undertaken by entities within scope.

Final VM rules are required before firms will be able to begin necessary work, including legal, documentary, technology systems, operational and risk management work, all of which will take some time. We therefore urge the RBI to ensure the implementation period provides sufficient lead time.

7. Other Comments

We also make the following points, in support of the same comments in the ISDA Letter:

- **FX mismatch haircut**: in respect of the FX haircut, we ask that the RBI clarify that "currency of derivative obligation" could also refer to either the termination currency of the master agreement or the base currency or eligible currencies of the CSA (ISDA Letter Section 3.h.).

- **Transfer timing**: we support the comments made in the ISDA Letter (Section 3.g.) in respect of the timing of exchange of VM, given that some firms may have collateral operations located outside India.

- **VM scope threshold/MTA**: the concept of "threshold" referred to in paragraph 4(4) of the Draft VM Directions appears to refer to a VM minimum transfer amount ("MTA") which is intended to reduce operational burden (not a threshold for the application of the VM requirements as a whole). To be clearer, the RBI should define this as an MTA. We also agree with the ISDA Letter (Section 3.g.) that an MTA of INR 500,000 is too low and is inconsistent with global standards. Such a low MTA will require frequent exchange of collateral and will be operationally challenging, and defeats the purpose of having an MTA. We request that the RBI increase the MTA to a level which is close to the one used in other jurisdictions and the BCBS-IOSCO International Margin Framework, as illustrated in the ISDA Letter. The RBI should also clarify whether rounding may apply.

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We appreciate the opportunity to share our views on the Draft VM Directions and look forward to commenting on draft initial margin ("IM") regulations in due course.

Please do not hesitate to contact John Ball on +852 2531 6512, email jball@gfma.org or Victoria Cumings on +1 212 313 1141, email vcumings@gfma.org should you have questions about our comments or wish to discuss any of the above.

Yours sincerely,

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