September 28, 2012

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Re: Margin requirements for non-centrally-cleared derivatives
Consultative Document, June 2012

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 consultative document on margin requirements for non-centrally-cleared derivatives issued by the Basel Committee on Banking Supervision ("BCBS") and the International Organization of Securities Commissions ("IOSCO") joint Working Group on Margin Requirements ("WGMR").

The GFXD was formed in cooperation 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 22 global foreign exchange market participants,[1] collectively representing more than 90% of the foreign exchange 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 foreign exchange market is the world's largest financial market. Effective and efficient exchange of currencies underpins the world's entire financial system. Corporations and investors regularly participate in the market for 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.

Many of the current legislative and regulatory reforms will have a significant impact upon the operation of the global foreign exchange market, and we feel it is vital that the potential consequences are fully understood and that new regulation improves efficiency and reduces risk. The GFXD welcomes the opportunity to set out its views in response to this consultative document, specifically in response to question 2 relating to foreign exchange transactions.

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[1] Bank of America Merrill Lynch, Bank of New York Mellon, Bank of Tokyo Mitsubishi UFJ, Barclays Capital, BNP Paribas, Citigroup, Credit Agricole, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan, Lloyds, Morgan Stanley, Nomura, Royal Bank of Canada, Royal Bank of Scotland, Société Générale, Standard Chartered Bank, State Street, UBS, and Westpac.
[2] According to Euromoney league tables.

Executive Summary

Foreign exchange is the world's largest financial market and a central component of the global payment system. The Bank for International Settlements ("BIS") estimates that average daily market turnover in foreign exchange increased to $4 trillion in April 2010, up from $3.3 trillion in April 2007.[3] Foreign exchange swaps and forwards are overwhelmingly instruments with short maturities,[4] and institutions across the globe rely heavily on them to fund their commercial and other payment obligations. Because transactions in foreign exchange swaps and forwards are integral to the global payment system, international trade, cross-border activity and monetary policy, it is essential that the smooth functioning of the foreign exchange market not be disrupted.

We support the international regulatory community's efforts to promote central clearing of standardized OTC derivatives, where appropriate, and strengthen bilateral counterparty credit risk management practices for uncleared OTC derivatives relating to the mitigation of credit and operational risks. While we agree with the key principle in the consultative document that "**appropriate margining practices** should be in place with respect to all derivative transactions," for the reasons set forth below, the proposed requirement that "margin requirements apply to all non-centrally cleared derivatives" is **not** appropriate for deliverable foreign exchange swap and forward transactions, and is inconsistent with the established and proven strategy of central banks, in consultation with supervisors, for addressing systemic risk in this market. Any mandatory margin regime for these products could cause serious harm to this well-functioning and systemically important market structure.

With the encouragement and at the direction of central banks and supervisors, foreign exchange market participants have been working diligently through a series of individual and collective actions to reduce risks generally in the foreign exchange market over the past several decades. The current regime of encouraging prudent supervision, practice guidelines and capital implications appropriately addresses the risks inherent in this market. Settlement risk, the predominant risk for foreign exchange transactions, has been dramatically reduced through the development and use of CLS Bank International ("CLS"). Further, the reduction of replacement cost risk is part of these efforts, as evidenced by high usage of credit support annexes and the trend towards even greater usage.

In 1996, the governors of the central banks of the Group of Ten ("G10") industrial countries[5] agreed and set in motion a strategy for the reduction of settlement risk in the foreign exchange market as a key priority for the industry. The supervisory guidance recently issued by the Basel Committee on Banking Supervision ("BCBS")[6] demonstrates the on-going implementation of this strategy. A mandatory margin regime for deliverable foreign exchange swaps and forwards, however, is inconsistent with this strategy and will jeopardize the use and role of CLS in reducing systemic risk. The costs associated with **mandatory replacement cost risk reduction** via margin will move focus away from **non-mandatory settlement risk reduction** via voluntary use of CLS. Any such margin regime at this time would represent a radical shift in regulatory policy – the prioritization of replacement cost risk reduction via mandatory margin above settlement risk reduction – which can cause harm to the foreign exchange market.

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[3] BIS, Monetary and Economic Department, *Triennial Central Bank Survey: Report on Global Foreign Exchange Market Activity in 2010*, at 6 (Dec. 2010) ("BIS 2010 Survey").

[4] BIS 2010 Survey.

[5] National Bank of Belgium, Bank of Canada, Bank of England, Bank of France, Deutsche Bundesbank, Bank of Italy, Bank of Japan, Netherlands Bank, Sveriges Riksbank, Swiss National Bank, Board of Governors of the Federal Reserve System and Federal Reserve Bank of New York.

[6] BCBS *Supervisory guidance for managing settlement risk in foreign exchange transactions, consultative document* (August 2012) ("2012 FX Supervisory Guidance").

Question 2 in consultative document
Should foreign exchange swaps and forwards with a maturity of less than a specified tenor such as one month or one year be exempted due to their risk profile, market infrastructure, or other factors? Are there any other arguments to support an exemption for foreign exchange swaps and forwards?

Recommendation of GFMA Global FX Division
Deliverable foreign exchange swaps and forwards should not be subject to any margin regime which *requires* the exchange, collection or posting, of variation margin or initial margin between transacting parties on a mandatory basis. Additionally, the deliverable foreign exchange swaps and forwards market should not be split based on tenor for the purpose of applying any such mandatory margin regime.

Basis for Recommendation

- Deliverable foreign exchange swaps and forwards are cash products which are **physically settled** through an exchange of two currencies and therefore distinguishable from most derivatives which are financially, cash settled products whose value and settlement amounts are derived by reference to one or more underlying assets.

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

- The **risks associated with the foreign exchange 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 ("CSAs").

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

  - This **strategy has been prudent and effective** in identifying, understanding and addressing **settlement risk as the key risk** in the foreign exchange market but also **applies to replacement cost risk** for deliverable foreign exchange swaps and forwards.

  - A mandatory margin regime raises costs of trading deliverable foreign exchange swaps and forwards bilaterally, even when end-user exemptions exist due to the interbank margining required, which will:

    - Attempt to incentivize central clearing for these products when there is **no approved robust and safe clearing solution** for them;

    - **Jeopardize the use and role of CLS** in reducing systemic risk as the costs associated with mandatory replacement cost risk reduction via margin move focus away from non-mandatory settlement risk reduction; and

    - Discourage legitimate trading in these products, which might **adversely affect global trade and cross-border activity** and potentially **disrupt activities of central banks**.

- The short-dated nature of the vast majority of deliverable foreign exchange swaps and forwards provide considerable flexibility in managing counterparty exposures in comparison to other OTC derivative contracts. Any mandatory margin regime based on tenor, however, will only result in a bifurcated foreign exchange market, an ineffective and undesirable outcome as market participants become incentivized to hedge their currency risk using shorter-dated foreign exchange products than desired.

For purposes of this letter and unless expressly stated otherwise, all references to foreign exchange swaps and forwards are to **deliverable** foreign exchange swaps and forwards.[7]

1. Mandatory Margin Should Not Apply To Deliverable Foreign Exchange Swaps And Forwards as Their Unique Characteristics And Role Qualitatively Distinguish Them From Other OTC Derivatives

1.1 Deliverable Foreign Exchange Swaps And Forwards Are Cash Products, Physically Settled Through An Exchange Of Two Currencies

Foreign exchange products perform a vastly different role in the global financial system than OTC derivatives. Foreign exchange is the critical medium of exchange used by all cross-border payment systems globally. Foreign exchange is overwhelmingly, and an integral part of, a cash market with fixed terms, i.e., non-contingent outcomes. The global foreign exchange market experiences an average daily turnover of USD 4 trillion, with 95% comprising spot (USD 1.5 trillion, or 38%), swaps (USD 1.8 trillion, or 45%) and forwards (USD 0.5 trillion, or 12%).[8]

In contrast to OTC derivatives which are entered into as financially, cash settled products, foreign exchange swaps and 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 deliverable foreign exchange spot transactions is a matter of duration, i.e., actual delivery takes place at a point in time longer than two business days. Except for the fact that it is a longer dated instrument than a foreign exchange spot transaction, it is largely the same instrument. Likewise, a foreign exchange swap is not a "derivative" in the traditional sense – it embodies an exchange of currencies within a funding transaction, whereby one party borrows a currency from another party and simultaneously lends to that same party another currency with a redelivery of each such currency on the maturity (settlement) date. Given the similarities between a foreign exchange swap and a traditional banking activity like lending and deposit-taking, the BIS has characterized foreign exchange swaps as "effectively collateralized transactions."[9] As a practical matter, the fact that foreign exchange swaps are funding vehicles and foreign exchange forwards are payment vehicles is also a distinction without a difference.

1.2 Deliverable Foreign Exchange Swaps And Forwards Provide A Critical Source Of Liquidity And Funding In The Foreign Exchange Market As A Global Payment System, And Underpins The Global Economy By Facilitating And Supporting International Trade And Cross-Border Activity

As the critical medium of exchange, foreign exchange is at the heart of all international commerce. The BIS has observed foreign exchange market activity becoming more global, with cross-border transactions representing 65% of trading activity in April 2010, while local transactions accounted for 35%, the lowest share ever.[10] 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. The foreign exchange market is the central component of the global payment system and underpins other financial markets and the global economy generally. As such, foreign exchange is the world's largest financial market. Further, it represents the most global, standardized and liquid of all markets and maintains a high level of price transparency.

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[7] Accordingly, the comments do not address other foreign exchange products, such as deliverable foreign exchange options, non-deliverable foreign exchange options ("NDOs") or non-deliverable foreign exchange transactions ("NDFs").

[8] BIS 2010 Survey.

[9] BIS, *From Turmoil to Crisis: Dislocations in the FX Swap Market Before and After the Failure of Lehman Brothers* (2009) ("BIS Lehman Study").

[10] BIS 2010 Survey.

As noted above, a foreign exchange forward is largely the same instrument as a foreign exchange spot, except for the fact that it is a longer dated instrument (greater than two business days) which provides delivery of desired currency to, and therefore currency risk mitigation for, corporations and investors beyond two business days. Foreign exchange swaps are used primarily for hedging; this product is perhaps the most efficient short-term funding vehicle worldwide and represents the most actively traded foreign exchange instrument by far, and are widely used by institutions to raise liquidity across money markets for different currencies.[11] During the financial turmoil following the failure of Lehman Brothers, global financial institutions turned to the foreign exchange swap market as a primary channel for raising dollar funding.[12]

2 Risks Associated With The Foreign Exchange Market Are Appropriately Mitigated By The Current Regime of Prudent Supervision, Practice Guidelines And Capital Implications

We agree with the key principle articulated in the consultation paper is that "appropriate margining practices should be in place with respect to all derivative transactions." However, the proposed requirement that "margin requirements apply to all non-centrally cleared derivatives" is **not appropriate** for deliverable foreign exchange swaps and forwards. The risks associated with these products are appropriately mitigated by the current regime of encouraging prudent supervision, practice guidelines and capital implications. This includes principal (or settlement) risk reduction through use of CLS, replacement cost risk reduction through appropriate usage of CSAs, and strengthened supervisory guidance focused on ensuring that sufficient capital is held against potential exposures to all foreign exchange settlement-related risks. Further, this regime is continuously reviewed and monitored by central banks who have a keen interest in the foreign exchange market, specifically its impact on payments in their respective home currencies from a broad policy perspective and because of its criticality to a central bank's ability to carry out monetary policy.

2.1 Settlement Risk Has Been Dramatically Reduced By Use Of CLS, With Trend of Further Settlement Risk Reduction By Foreign Exchange Dealers And CLS

The predominant risk associated with a counterparty default on uncleared deliverable foreign exchange swaps and forwards is principal risk, also commonly referred to as "settlement risk" or "Herstatt risk." Settlement risk in the context of the foreign exchange market is the risk of loss of principal, i.e., of paying out sold currency without receiving the purchased currency in return. Settlement risk is the predominant bilateral counterparty credit risk presented by foreign exchange swaps and forwards and is the source of systemic risk for this market. This risk has been dramatically reduced by the development and use of CLS, a private-sector initiative that settles payments for deliverable foreign spot, forward and swap transactions.[13] As explained in Section 4 that follows, a mandatory margin regime will distract participants from prioritizing efforts in further reducing settlement risk and create structural economic incentives to not use CLS.[14]

2.1.1 Following Decades Of Extensive Study, Central Banks Conclude Settlement Risk Is The Source Of Systemic Risk For The Foreign Exchange Market

In 1996, the governors of the G10 central banks endorsed a comprehensive strategy under which the private and public sectors can together seek to contain systemic risk inherent in the foreign exchange market.[15]

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[11] BIS 2010 Survey.

[12] See BIS Lehman Study.

[13] CLS processes for settlement a pair of payment instructions relating to an underlying single deliverable foreign exchange transaction, meaning a single foreign exchange spot transaction, a single foreign exchange forward transaction, a single leg of a foreign exchange swap transaction (i.e., CLS processes each leg, near and far, separately in its system), as well as the deliverable foreign exchange spot or forward transaction resulting from an exercised foreign exchange option transaction.

[14] As explained in Section 4, the consultative document proposes mandatory margin as the solution to replacement cost risk, which is in stark contrast to the current non-mandatory regime surrounding settlement risk reduction, including use of CLS remains voluntary even under revised supervisory guidance proposed.

[15] BIS Committee on Payment and Settlement Systems ("CPSS"), *Settlement Risk in Foreign Exchange Transactions (*1996) ("Allsopp Report"). As explained in that report, the work of the G10 central banks on international payment arrangements produced several studies, including the February 1989 *Report on Netting Schemes* (the "Angell Report"), the November 1990 *Report of the Committee on Interbank Netting Schemes* (the "Lamfalussy Report") and the September 1993 report on *Central Bank Payment and Settlement Services with*

Following the infamous 1974 failure of Bankhaus Hersatt failure, central banks and supervisors took a number of steps to increase their coordination and conduct a number of extensive studies spanning several decades, with a view towards ensuring that the structures and designs of systems supporting domestic and cross-border systems did not create unacceptable interbank credit exposures and did not generate liquidity risks for the financial markets or for the national or international banking systems.

The G10 central banks identified settlement risk as **the** source of systemic risk associated with foreign exchange spot, swaps and forward transactions, expressing their conclusions that (emphasis added):

> *To be sure, FX trading poses many other forms of risk, including market risk (the risk of loss from an unfavourable exchange rate movement), replacement risk (the risk of having to replace, at current exchange rates, an unsettled yet profitable FX transaction with a failed counterparty) and operational risk (the risk of incurring interest charges or other penalties for misdirecting or otherwise failing to make FX settlement payments on time owing to an error or technical failure). FX market participants must recognise and manage appropriately each of these risks. [footnote: For instance, the Basle Capital Accord currently covers replacement risk. In January 1996 the Accord was amended by the Basle Committee on Banking Supervision to explicitly cover market risk…]* ***Nevertheless, since the associated amounts at risk represent only a fraction of the underlying value of each transaction, they are dwarfed by the size of foreign exchange settlement exposures.***
>
> *[A] bank's maximum FX settlement exposure could equal, or even surpass, the amount receivable for three days' worth of trades, so that at any point in time - including weekends and public holidays - the amount at risk to even a single counterparty could exceed a bank's capital….*
>
> *Secure and well-functioning payments systems are necessary for the attainment of central banks' monetary, macroprudential, supervisory and other policy objectives. They are also essential mechanisms in the management by individual commercial banks of their assets and liabilities, and in the settlement of their own transactions as well as those of their customers. It is therefore appropriate that central banks should be concerned that the settlement arrangements in the foreign exchange markets should be structured so as to minimise systemic risk (the risk that the failure of one market participant to meet its required FX settlement or other obligations when due may cause significant liquidity or credit problems for other participants, and so may threaten the stability of the financial markets)….*
>
> *The vast size of daily foreign exchange (FX) trading, combined with the global interdependencies of FX market and payments system participants, raises significant concerns regarding the risk stemming from the current arrangements for settling FX trades. These concerns include the effects on the safety and soundness of banks, the adequacy of market liquidity, market efficiency and overall financial stability.*[16]

These conclusions were reached by the G10 central banks at a time when turnover in the foreign exchange market was estimated by the BIS to be USD 1.2 trillion, a fraction of the USD 4 trillion estimated in 2010. According to the result of a recent study, settlement risk comprises 94% of the maximum loss exposure in a

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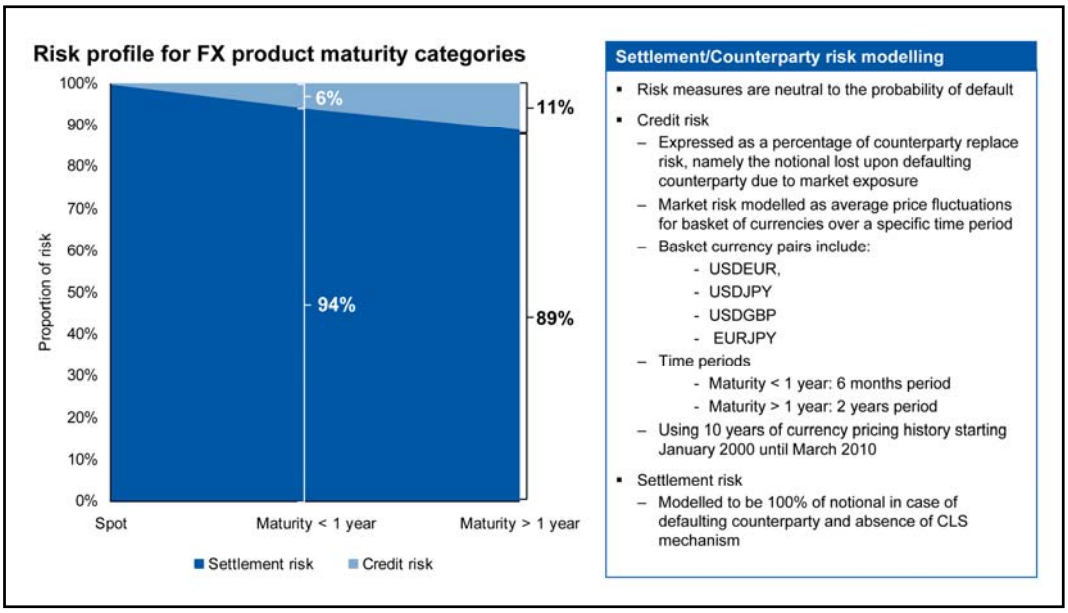
respect to Cross-Border and Multi-Currency Transactions (the "Noël Report"). The report further explains that through these studies, central banks identified issues that may be raised by cross-border and multi-currency netting arrangements, recommended minimum standards and an oversight regime for cross-border netting schemes, and examined possible central bank service options that might decrease risk in the settlement of foreign exchange trades; and in June 1994 the CPSS formed the Steering Group on Settlement Risk in Foreign Exchange Transactions to build upon this past work and to develop a strategy for reducing foreign exchange settlement risk.

[16] Allsopp Report. See also Noël Report ("the loss of principal in settling … a foreign exchange trade would dwarf any gain or loss that might have accrued to the counterparties to the original transaction.").

trade for foreign exchange instruments with maturity of less than one year, and 89% for instruments with maturity of greater than a year.[17] The chart below illustrates the break-down of the maximum risk of loss between settlement risk and the remaining risk, namely replacement cost risk, for foreign exchange contracts of different maturities. Only 6% of the maximum risk of loss associated with a counterparty default for these products is replacement cost risk which is dwarfed by the 94% which represents settlement risk.[18] This stands in sharp contrast to most OTC derivatives for which counterparty credit risk is comprised almost exclusively of replacement cost risk.



2.1.2 Central Banks And Foreign Exchange Dealers Prioritize Efforts To Address Settlement Risk As Source Of Systemic Risk Led To Creation of CLS

Building upon the results of the extensive studies conducted and on market surveys, and based on their stated belief that private sector institutions have the ability through individual and collective action to significantly reduce systemic risk associated with foreign exchange transactions, the G10 central bank governors agreed the following three-track strategy should be implemented:[19]

- Action by individual banks to control their FX settlement exposures
- Action by industry groups to provide risk-reducing multi-currency services
- Action by central banks to induce rapid private sector progress

This strategy has proven to be extremely effective for the foreign exchange market. In response, a study and efforts by a group of major financial institutions resulted in the "continuous linked settlement" concept, namely the simultaneous exchange – "payment vs. payment" – of each of the two legs of a foreign exchange transaction as the mechanism for eliminating settlement risk. This led to the formation in 1997 of CLS, which by 1998 had 61 major financial institutions as shareholders. Central banks played a critical role in this effort by achieving key enhancements to their national payment systems and in strengthening laws in their respective jurisdictions to support this effort of the private sector. CLS was established as an Edge corporation following approval by the Federal Reserve, and went live with its service in 2002. It is regulated by the Federal Reserve under a cooperative oversight arrangement with central banks whose currencies are settled in

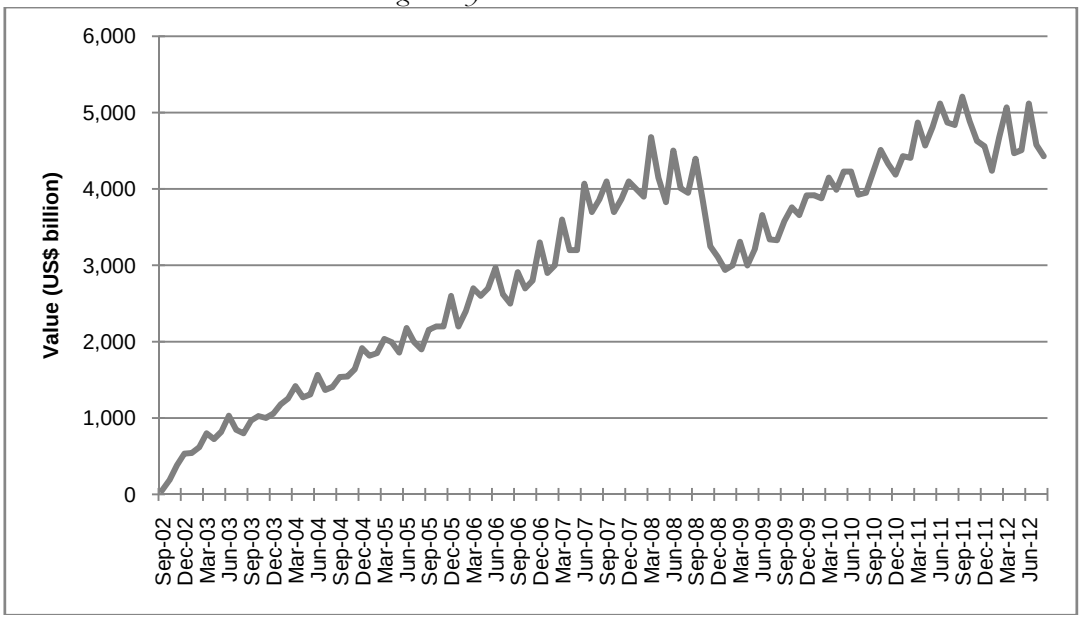
[17] Oliver Wyman analysis.
[18] Oliver Wyman analysis. All else being equal, the amount of replacement cost risk is higher for longer maturities because there is more time for the exchange rate to move.
[19] Allsopp Report.

CLS.[20] While historically regulated and overseen as a "systemically important payment system" since it launched its service,[21] CLS is now widely recognized as a "financial market infrastructure" and was designated this year as a "systemically important financial market utility" by the Financial Stability Oversight Council ("FSOC") in the United States.[22]

2.1.3 CLS Bank Eliminates Settlement Risk For Large Part Of Foreign Exchange Market, Including Almost 90% of Inter-Dealer Trades

The efforts of central banks to raise awareness of settlement risk and to improve banks' self-monitoring of settlement risk have been remarkably successful. CLS has extended its settlement risk reduction services for global foreign exchange activity from 7 currencies for 39 members in 2002 to 17 currencies and 63 members and their 7,000 third parties in 2011.[23] The tremendous growth in trades settled by CLS since its inception is illustrated in the chart below.[24] While the head or home offices of CLS' members are located in 23 jurisdictions, the foreign exchange activity of the members and their customers are transacted, confirmed and processed world-wide. CLS has had zero settlement failures since it was created. It now settles a large portion of foreign exchange transactions, including 87.7% of inter-bank foreign exchange trades,[25] the transactions most relevant to systemic risk.

Average Daily Settlement Value in CLS



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[20] See *Protocol for the Cooperative Oversight Arrangement of CLS*. http://www.federalreserve.gov/paymentsystems/cls_protocol.htm. CLS currently provides PvP settlement services in 17 currencies: Australian dollar (AUD), Canadian dollar (CAD), Danish krone (DKK), Euro (EUR), Hong Kong dollar (HKD), Israeli shekel (ILS), Japanese yen (JPY), Korean won (KRW), Mexican peso (MXN), New Zealand dollar (NZD), Norwegian krone (NKK), Singapore dollar (SGD), South African rand (ZAR), Swedish krona (SEK), Swiss franc (CHF), UK pound sterling (GBP) and US dollar (USD).

[21] As such, CLS was subject to the CPSS *Core Principles for Systemically Important Payment Systems*.

[22] http://www.treasury.gov/press-center/press-releases/Pages/tg1645.aspx.

[23] http://www.cls-group.com/About/Documents/CLS%20Bank%20-%20Core%20Principles%20Assessment.pdf. Approximately 7,000 third parties participated indirectly in CLS during the first three quarters of 2011. While over 90% of such third parties are funds, this group also includes banks, as well as corporations and other non-financial institutions.

[24] CLS August 2012. The reduction in transactions settled by CLS Bank around September 2008 appears consistent with the reduction in financial activity generally during the 2008 financial crisis

[25] *Compare* CLS Bank, *CLS Statistics on Foreign Exchange Activity* (2010) ("CLS Statistics") *with* BIS 2010 Survey.

According to the calculations of the CPSS in a 2008 progress report, "if the obligations settled by CLS had instead been settled via other available methods, settlement exposures would have been on average almost two to three times higher than reported."[26] The report also found that 92% of institutions surveyed subject foreign exchange settlement exposures to credit management controls (*e.g.*, credit limits) equivalent to the controls they apply to other similar exposures, and 80% apply the same weight to foreign exchange settlement exposures as to other similar exposures.

2.2 Replacement Cost Risk Is Appropriately Mitigated Through Collateral Exchanged Under CSAs, With Trend Of Increased CSA Usage

Following settlement risk, the remaining bilateral counterparty credit risk associated with foreign exchange swaps and forwards is "replacement cost risk", where the failure of one's counterparty may leave the non-failing party with an unhedged or open market position or deny it unrealized gains on the position. This resulting exposure is the cost of replacing, at current market prices, the original transaction.

2.2.1 Current Usage Of CSAs In The Foreign Exchange Market Is High And Appropriate Given Maturity Profile Of Foreign Exchange Swaps and Forwards

In addition to the achievements surrounding settlement risk reduction and despite the significant difference in maturity profiles between, on the one hand, foreign exchange swaps and forwards and, on the other hand, OTC derivatives generally (e.g., interest rate swaps and credit default swaps whose terms to maturity generally concentrate between two to thirty years, and five to ten years, respectively), the foreign exchange market has increasingly adopted use of master netting agreements and CSAs to further manage counterparty credit risk.[27] According to a recent study conducted by the FXC, the number of CSAs grew by 51% between 2007 and 2010; and as of September 2008, 88% of the total mark-to-market exposures of those reporting firms was covered under CSAs.[28] GFXD also performed an indicative analysis of dealers which indicated 85% or more of mark-to-market exposure in 2010 related to counterparties (excluding corporates) for which CSAs were in place.[29]

CSAs are widely used in the foreign exchange market to mitigate counterparty credit risk, including but not limited to replacement cost risk. CSAs used in the foreign exchange market mainly provide for variation margin ("VM"), but also initial margin ("IM") if warranted following an assessment of the credit risk profile of one's counterparty. As illustrated in the chart below, the vast majority of mark-to-market exposure is related to counterparties that are covered by CSAs to standard International Swaps and Derivatives Association ("ISDA") master agreements.[30] While very high, current industry practice of using CSAs is not universal for a number of reasons. Firstly, for many foreign exchange market participants such as corporates, exchanging currencies represents a basic treasury management or banking activity that falls within the normal credit parameters of their relationships with their banks and custodians. Foreign exchange transactions with corporate generally are unsecured. Corporates use foreign exchange swaps and forwards to hedge business risks and do not generally have excess capital to deploy for margining purposes. Secondly, for a significant number of participants (e.g., a long-only unleveraged pension fund or asset manager) who may present very little credit risk, requiring margin makes little commercial or economic sense.

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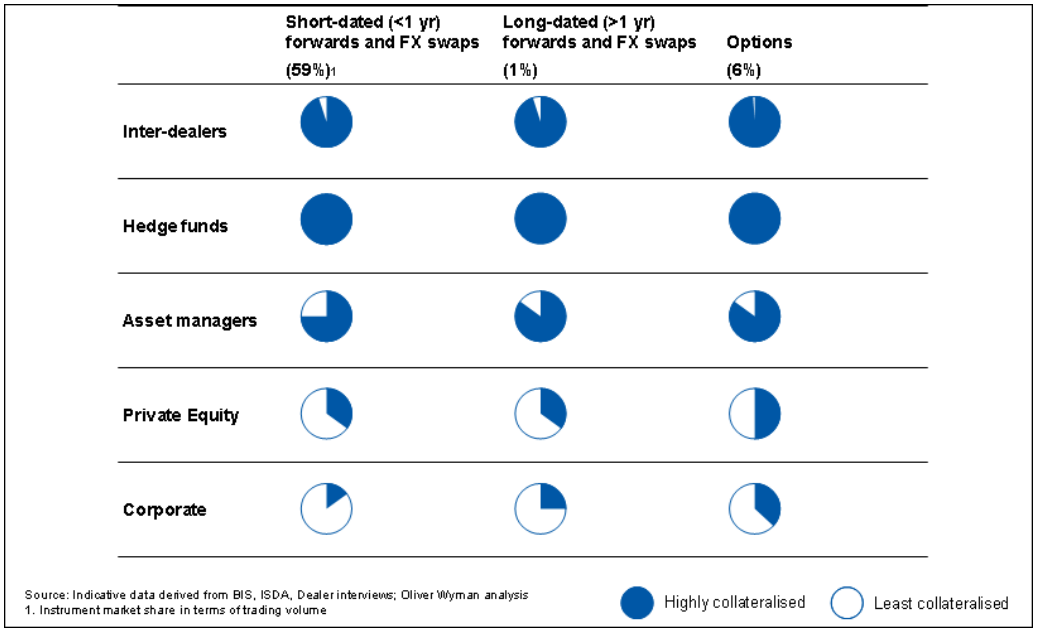
[26] BIS CPSS, *Progress in reducing foreign exchange settlement risk* (2008). ("CPSS 2008 Progress Report").

[27] Foreign Exchange Committee ("FXC"), *Overview of the OTC Foreign Exchange Market: 2009* (November 9, 2009) ("FXC Overview"). The Foreign Exchange Committee is an industry group that has been providing guidance and leadership to the global foreign exchange market since its founding in 1978. The FXC includes representatives of major financial institutions engaged in foreign currency trading in the United States and is sponsored by the Federal Reserve Bank of New York. Aware of the strong integration of the global foreign exchange market, the FXC is also an active partner to other foreign exchange committees and industry associations worldwide. http://www.newyorkfed.org/FXC/.

[28] *See* FXC letter to U.S. Department of Treasury (November 29, 2010) in response to request for comment on determination of foreign exchange swaps and forwards.

[29] These dealers accounted for approximately 66% of the dealer market according to Euromoney league tables.

[30] Oliver Wyman analysis.



The ability of parties to implement effective collateral management programs benefits from the significant price transparency that exists in the global foreign exchange market. Foreign exchange market participants can reliably determine the net amount of their exposures and the appropriate amount of collateral because foreign exchange is a highly liquid market in which prices are widely available 24 hours a day.[31] The deep liquidity of this market and the simple structure of the transactions also enable the non-defaulting party to get out of, and also back into, positions with extreme ease by executing foreign exchange spots, foreign exchange forwards, foreign exchange swaps or any combination thereof with other market participants during the course of any day and regardless of tenor.

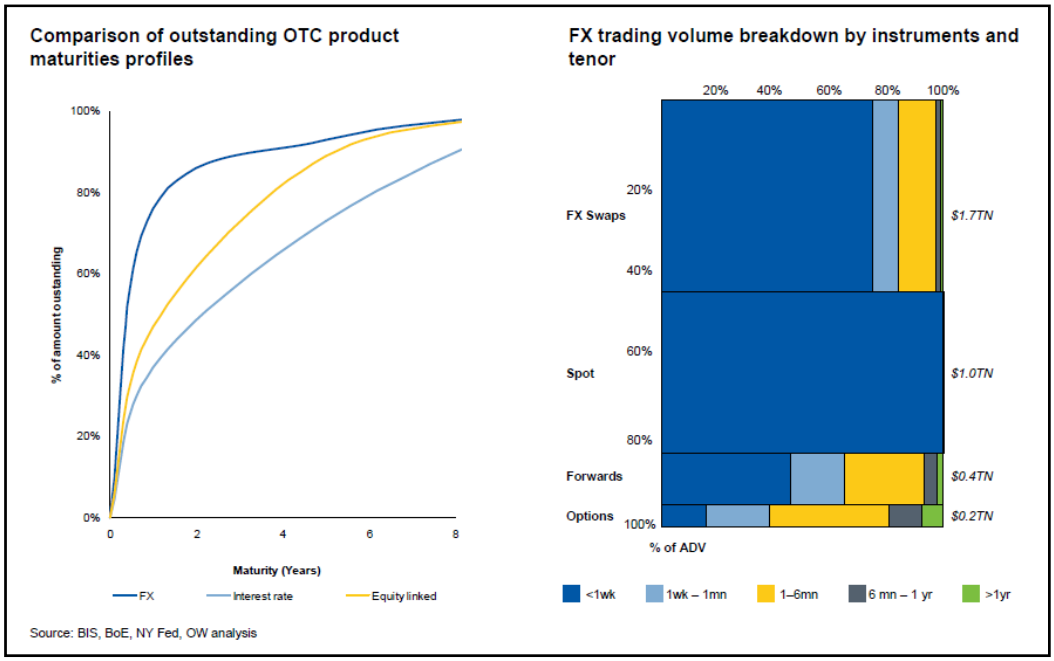
Additionally, a key and unique feature of the foreign exchange market which makes credit risk much easier to manage in absence of a CSA than for other OTC derivative contracts is the short-dated nature of the vast majority of foreign exchange contracts. Jump-to-default risk is virtually non-existent, as counterparties very rarely go from AAA to default overnight. Accordingly, there is a period of weeks or months of progressive deterioration before a final event that triggers default and/or bankruptcy. The short dated nature of foreign exchange products is such that when a counterparty begins to show signs of impairment, most of the existing foreign exchange contracts, and therefore replacement cost risk, with the counterparty institution will roll off during the initial signs of stress for that institution as those contracts come to maturity. (This is in contrast to the much longer-dated OTC derivative contracts for which counterparty credit risk is comprised almost exclusively of replacement cost risk.) In this situation, while dealers and custodians could stop creating new foreign exchange exposures with the counterparty, alternatively and more commonly, they will limit activity to shorter-dated foreign exchange trades with or without IM, and longer-dated foreign exchange trades with IM only. In this way, the dealer or custodian can readily control its future exposures to a counterparty, thereby allowing firms to keep to keep trading with a credit-impaired participant flexibly and safely.

The chart below contrasts the short maturity profile of outstanding foreign exchange instruments with those of interest rate and equity derivatives. The 16% of outstanding foreign exchange contracts with maturities longer than 2 years contrasts with 55% of interest rate derivatives and 40% of equity derivatives with maturities longer than two years.[32] Of daily traded volume in 2010, 99% of foreign exchange swaps and 98% of foreign exchange forwards were of maturities of less than a year. The global foreign exchange swaps and

[31] FXJSC Overview.
[32] Oliver Wyman analysis based on BIS data.

forwards daily traded market total of 81.3% under 1 month maturity and 97.5% under 6 months, with 1.5% maturity between 6 months and 1 year and only 1% over 1 year, specifically:

- Up to 7 days maturity = 68.0% of daily traded volumes;
- 7 days – 1 month = 13.3%; and
- 1 month – 6 month = 16.2%



2.3 Operational Risk In The Foreign Exchange Market Is Mitigated Through Its Strong Operational Infrastructure

The foreign exchange market in deliverable currencies is a deeply liquid and efficient market with high price transparency. This market led other markets over the past decade in converting to electronic trading platforms, which brought significant improvements in price transparency, liquidity and efficiency for foreign exchange products of all tenors. Prices are widely available in the foreign exchange market 24 hours a day, contributing to its narrow spreads and deep liquidity. Currently 89% of foreign exchange spot transactions, 72% of foreign exchange forwards and 41% of foreign exchange swaps use automated transaction processing.[33] In addition, more than 95% of foreign exchange transactions between dealers are processed via straight-through processing, meaning they are processed electronically without any human input, and trades are normally confirmed within 15 minutes.[34] The proliferation of multi-dealer and single-dealer electronic communications networks in this market over the years has also led to a high degree of systemic redundancy and resiliency. In the event that one trading system fails, market participants can easily route their trades to another electronic platform. These robust infrastructure advancements have significantly strengthened the integrity of the marketplace from a systemic risk standpoint.

Foreign exchange market participants have also committed to further strengthening the foreign exchange market's operational infrastructure, with broad support from foreign exchange dealers and central banks. Beginning in October 2008, the Foreign Exchange and Currency Derivatives Major Dealers[35] have made a

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[33] Oliver Wyman analysis.

[34] Deutsche Bank analysis.

[35] These dealers include Bank of America Merrill Lynch, Barclays Capital, BNP Paribas, Citigroup, Credit Suisse AG, Deutsche Bank AG, Goldman, Sachs & Co., HSBC Group, JP Morgan Chase, Morgan Stanley, The Royal Bank of Scotland plc, Société Générale,

series of commitments to a group of global supervisors[36] to improve the operational infrastructure of this market.[37] The foreign exchange industry has been working to meet specific targets related to the increased automation of transaction processing, and committed to providing transparency in the form of metrics around OTC foreign exchange contract execution and demonstrating even futher electronification of those contracts. And because having robust and well-understood legal documentation is central to reducing risk, opportunities to enhance and standardize trade documentation that would also help facilitate increased automation of the confirmation process are continually sought, with a number of successes achieved with the legal documentation underpinning foreign exchange transactions .[38]

3 Even With A Proven Track Record Of Withstanding Widespread Market Disruption Under The Current Regime, Trend In The Foreign Exchange Market Of Further Mitigation Of Credit (Settlement And Replacement Cost) Risk And Operational Risk

The foreign exchange market's liquid, transparent nature, strong operational infrastructure and simplicity of its products in deliverable currencies is evidenced by its proven track record of withstanding widespread market disruptions, including the crises of the 1990s, the bursting of the tech-stock bubble in 2000-2001 and various large bankruptcies. The most recent financial crisis in 2008-2009 provided a significant test of the foreign exchange market's ability to withstand major disruptions and continue operating in a safe and sound manner.

The FXC found in November 2009 that:

> *The market functioned well [during the financial crisis], despite strains seen in international funding and credit markets, and enabled participants to measure and mitigate risk dynamically in a global marketplace. During this time, transaction costs were elevated, owing to the volatility and spillover from U.S. dollar funding challenges. However, systemic risk mitigants built into the OTC foreign exchange market structure over the years proved successful in providing a liquid and continuous market despite the volatility, defaults, and disruptions of [2008 and 2009].*[39]

Similarly, the FXJSC found that the foreign exchange market's sophisticated settlement system, together with its well-established code of best practices and high degree of transparency and liquidity, allowed this market to function well throughout the 2008 financial crisis. [40] Close-out netting was particularly effective because the simple structure of foreign exchange transactions and the deep liquidity of the foreign exchange spot market made foreign exchange instruments easy to value and thus to net against one another. Market participants were "able to execute trades and manage their currency exposure on an uninterrupted, twenty-four hour basis

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UBS AG and Wells Fargo Bank, N.A. Participants in the process also include State Street Global Markets and Bank of New York Mellon.

[36] The Supervisors include the Board of Governors of the Federal Reserve System, Commodity Futures Trading Commission, Connecticut State Banking Department, Federal Deposit Insurance Corporation, Federal Reserve Bank of New York, Federal Reserve Bank of Richmond, French Prudential Supervisory Authority (*Autorité de Contrôle Prudentiel* - ACP), German Federal Financial Supervisory Authority, Japan Financial Services Agency, New York State Banking Department, Office of the Comptroller of the Currency, Securities and Exchange Commission, Swiss Financial Market Supervisory Authority, and United Kingdom Financial Services Authority.

[37] See Letters from the Foreign Exchange and Currency Derivatives Major Dealers to the OTC Derivatives Supervisors Group, dated October 31, 2008, June 2, 2009, March 10, 2010, September 27, 2010 and March 31, 2011.

[38] FXC Overview. E.g., standardizing NDF and NDO confirmations in selected emerging market jurisdictions, creation of common forms of give-up agreements and compensation agreements for use in OTC FX prime brokerage arrangements, development of master confirmation agreements, as well sponsorship by CLS's of protocols through which market participants have agreed to best practices for deliverable FX and NDF transactions regarding legally binding confirmations and standard terms for trades processed in its settlement system.

[39] FXC Overview.

[40] London Foreign Exchange Joint Standing Committee ("FXJSC"), *FXJSC Paper on the Foreign Exchange Market* (September 2009). The FX JSC was established in 1973 under the auspices of the Bank of England, in the main part as a forum for banks and brokers to discuss broad market issues and the focus of the Committee's regular work remains issues of common concern to the different participants in the foreign exchange market. The Bank of England provides the Committee's Chairman and Secretary. http://www.bankofengland.co.uk/markets/Pages/forex/fxjsc/default.aspx.

in a relatively liquid market" and had enough confidence in the payment system to continue executing foreign exchange transactions.[41]

The success of the central bank and supervisory strategy for addressing risks in the foreign exchange market – which called on private and public sector actions and close collaboration –cannot be understated. In the absence of this strategy and its implementation, the most recent financial crisis would have been much worse. Particularly noteworthy are remarks of the Chairman of the Board of Governors of the Federal Reserve, Ben Bernanke, that "[i]n the global foreign exchange market, CLS Bank International, a system that began operating in 2002 with the purpose of addressing settlement risk, is widely credited with maintaining confidence for continued interbank trading and settlement of foreign exchange."[42]

Notwithstanding the foregoing, risk management in the foreign exchange market continues to be strengthened in a number of areas by the private sector, with efforts directed at further mitigation of credit risk (settlement risk and replacement cost risk) and operational risk. Major industry participants have taken the position that increased use of CLS in concert with broader use of CSAs benefits the global foreign exchange market and, together, these tools provide significant risk mitigation while preserving the flexibility, accessibility, and efficiency of this highly important and interconnected market. In support of this, the best-practice guidance documents for the foreign exchange market were updated in 2010 in several material respects.[43] Firstly, language has been included to reflect the FXC's strong commitment to the importance of utilizing payment-versus-payment services, such as CLS, to further mitigate settlement risk and encourage participation in these services by those who are active in foreign exchange and are eligible to use them. Secondly, an overview of credit risk in foreign exchange, including a detailed discussion of the use of CSAs in the marketplace, has been introduced, as well as language on prudent management of credit risk. Institutions are encouraged to evaluate the benefits of having a CSA in place given the general creditworthiness of a counterparty and the type of activity in which that counterparty engages, such as tenor of transactions, style of trading, volatility and various other factors.

These efforts complement the work that has long been underway and continues to strengthen operational efficiency and legal documentation for the foreign exchange market. The best practices of the FXC and similar committees abroad are often cited as a benchmarking tool for market participants.[44] With respect to further settlement risk reduction, banks on the FXC and the FXJSC have publicly expressed support for efforts to add more currencies, settlement sessions and participants to CLS. CLS has also added a number of new settlement members since the financial crisis that began in 2008 and, as part of its strategic planning, is continuing its efforts to expand the products that CLS can settle, namely same-day foreign exchange transactions and additional currencies. Foreign exchange dealers have also expressed that clients that deal in foreign exchange as an asset class and take large speculative or highly leveraged positions in particular should adequately collateralize the positions.[45] And, as described earlier, efforts to standardize documentation and improve the operational efficiency of the OTC foreign exchange market are ongoing.

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[41] FXC Overview.

[42] Chairman Ben Bernanke, speech on *Clearinghouses, Financial Stability, and Financial Reform* (April 4, 2011): http://www.federalreserve.gov/newsevents/speech/bernanke20110404a.htm.

[43] FXC, *Guidelines for Foreign Exchange Trading Activities* (November 2010); and *Management of Operational Risk in Foreign Exchange* (November 2010).

[44] See also *Non-Investment Products Code* (November 2011) ("NIPS Code"), a code has been drawn up by market practitioners, which include the Bank of England and FSA, in the United Kingdom representing principals and brokers in the foreign exchange, money and bullion markets to underpin the professionalism and high standards of these markets. Most recently revised in 2011, the NIPS Code encourages market participants to, wherever practicable, utilize settlement services that reduce their exposures to settlement risk.

[45] FXC Overview.

4 Subjecting Deliverable Foreign Exchange Swaps And Forwards To A Mandatory Margin Regime Is Not Consistent With The Proven Strategy For Addressing Risks In The Foreign Exchange Market, And Creates Unsafe Structural Economic Incentives That Can Harm The Well-Functioning Market Structure

4.1 There is No Compelling Rationale For Regulators To Deviate From The Long-Established And Successful Strategy For Addressing Risks In The Foreign Exchange Market

The original approach and strategy towards settlement risk and its reduction in the foreign exchange market largely applies already to replacement cost risk. Through private and public sector action, both risks have been significantly reduced for this market, including deliverable foreign exchange swaps and forwards. While efforts were clearly prioritized on settlement risk, the overwhelming risk for these products, replacement cost risk has indeed been mitigated. In contrast to settlement risk, however, replacement cost risk for these products has not yet been examined with the same breadth and depth as for settlement risk. Such an examination is imperative before any solution for its reduction is *mandated*. If, based on these studies, a conclusion is reached that replacement cost risk is not being appropriately addressed by market participants, careful consideration must then be given to the development of an effective strategy to respond to any such deficiency. We share the belief expressed by the G10 central bank governors that private sector institutions can adequately address risk inherent in current practices for settling foreign exchange transaction. This has proven to be the case in the past several decades, and continues be the case for *all* risks in this market, i.e., settlement risk *and* replacement cost risk.

The various studies performed in the 1990s concluded that settlement risk was and remained a source of systemic risk because it was not being addressed by market participants. A three-track strategy was implemented which called for action on the part of individual firms, industry groups and regulators, respectively; progress of these actions was to be monitored; and specific supervisory measures[46] identified and suggested for potential use to stimulate satisfactory private sector action. In contrast, the consultative document's proposal of mandatory margin as a solution for replacement cost risk for deliverable foreign exchange swaps and forwards is a radical departure from the established approach used for the reduction of risks in this market. There is no compelling rationale to adopt an approach vastly different from one which has proven to be prudent and appropriate – and continues today – for these risks.

Further, the 2012 FX Supervisory Guidance is evidence of the continued implementation of the original three-track strategy agreed in 1996 for the foreign exchange market. In contrast to the "principles" and "requirements" set forth in the consultative document focused on replacement cost risk, the 2012 FX Supervisory Guidance contains "guidelines" with "key considerations" and addresses all risks associated with the settlement of foreign exchange, i.e., settlement risk, replacement cost risk, liquidity risk, operational risk and legal risk. With respect to settlement risk, the supervisory authorities have found that significant strides in reducing all these risks have been made in the last decade; however, substantial settlement risk still exists not least of which because of the growth in trading.[47] Under the proposed guideline on settlement risk, banks continue to be encouraged to use financial market infrastructures to eliminate this risk where practicable; and

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[46] See Allsopp Report. Because it was recognized that the identified inducements might not prove sufficient to stimulate rapid private sector action in every domestic market, the G10 central banks, through the CPSS, agreed to closely monitor progress and assess the need for further action. If appropriate and feasible, it was suggested that one or more of the following measures could be taken: supervisory guidelines for measuring FX settlement exposures in a manner consistent with the proposed methodology; regular confidential reporting of properly measured FX settlement exposures; regular public disclosure of properly measured FX settlement exposures; supervisory guidelines regarding the prudential management and control of properly measured FX settlement exposures; verification of compliance with the selected measures through bank examination and audit reports. It was further suggested, if necessary, one or more of the following stronger supervisory measures might also be considered: enforcement, by statute where available, of the use by individual banks of mechanisms to control their properly measured FX settlement exposures (e.g., setting of formal limits on those exposures); consideration, by agreement with banking regulators (G-10 and EU), of FX settlement risk in the set of risks subject to capital adequacy requirements; enforcement or imposition (by agreement with the relevant supervisors) of comparable measures applying to non-bank regulated financial institutions active in the FX market.

[47] This view is also shared by the major market participants on the FXC and FX JSC. See FXC Overview, and FX JSC Overview.

where not practicable, to properly identify, measure, control and reduce the size and duration of its remaining settlement risk. The guidelines go much further in also proposing capital implications for settlement risk, which reflects an escalating measure by supervisory authorities as originally envisioned in the Allsopp Report should there be a need to stimulate further / satisfactory private sector action.

Although the 2012 FX Supervisory Guidance addresses *all* risks in foreign exchange settlement, it is obvious by the introduction of capital implications for settlement risk that this remains the priority area of concern and focus in comparison to replacement cost risk. The following guidelines surrounding replacement cost risk are also consistent with the industry best-practice guidelines adopted by the FXC and other similar committees of major market participants regarding replacement cost risk and the trend observed of increased CSA usage:

- Proposed **guideline** on replacement cost risk: *A bank should employ prudent risk mitigation regimes to properly identify, measure, monitor and control replacement cost risk for FX transactions until settlement has been confirmed and reconciled.*

- Proposed **key consideration** (one of several) for this guideline: *A bank should use collateralisation (including an explicit policy on eligible collateral, haircuts and margin) to reduce replacement cost risk, where practicable.*

We agree with and support the approach proposed by supervisory authorities in the 2012 FX Supervisory Guidance for addressing replacement cost risk. A mandatory margin regime for deliverable foreign exchange swaps and forwards at this time would represent a radical shift in regulatory policy which can cause harm to the well-functioning market structure – i.e., the prioritization of replacement cost risk reduction via mandatory margin above settlement risk reduction, which is not mandatory for the deliverable foreign exchange market and on the assumption that enough progress has been made to reduce settlement risk. This is not only inconsistent with the 2012 FX Supervisory Guidance, but appears to be at direct odds with such guidance and efforts at continued implementation of the strategy regarding risks in the foreign exchange market. The achievements in reducing settlement risk in the foreign exchange market, including in the area of replacement cost risk, and the market's proven track record at withstanding widespread market disruption demonstrate the effectiveness of the existing strategy.

4.2 Regulators Have An Obligation To Not Cause Harm To The Well-Functioning Market Structure Of Foreign Exchange Given its Criticality

We agree with the US Treasury Secretary's statement made before the Senate Committee on Agriculture, Nutrition and Forestry in December of 2009:

> *The FX markets are different. They are not really derivative in a sense and they don't present the same sort of risk and there is an elaborate framework in place already to limit settlement risk. These markets actually work quite well. We have a basic obligation to do no harm, to make sure that as we reform we don't make things worse and our judgment is because of the protection that already exists in these foreign exchange markets and because they are different from derivatives, have different risks and require different solutions, they require a different approach.*[48]

[48] Testimony of Timothy Geithner, Secretary of the Treasury, Before the United States Senate Committee on Agriculture, Nutrition & Forestry Hearing on December 2, 2009 on Over-the-Counter Derivatives Reform (as reported in Reuters. "Highlights: Geithner's testimony on derivatives and risk." December 2, 2009. http://uk.reuters.com/article/ idUKTRE5B13JW20091202).

Regulatory intervention in the form of mandatory margin, however, creates unsafe structural economic incentives that can harm the well-functioning market structure. By raising the costs of trading these products bilaterally, even when end-user exemptions exist due to the interbank margining required, mandatory margin which will:

- Attempt to incentivize central clearing for these products when there is **no approved robust and safe clearing solution** for them;

- **Jeopardize the use and the role of CLS** in reducing systemic risk as mandatory margin costs move the focus away from settlement risk reduction; and

- Discourage legitimate trading in these products, which might **adversely affect global trade and cross-border activity** and potentially **disrupt activities of central banks.**

The regulatory community must do their utmost to avoid any such consequences. The well-established approach and strategy for understanding and then, as appropriate, addressing settlement risk in the foreign exchange market is the only prudent course of action for regulators to take with respect to replacement cost risk given the criticality of this market. There is no compelling reason to do otherwise. It is imperative that the well-functioning market structure for foreign exchange not be impaired by any perceived benefits of subjecting deliverable foreign exchange swaps and forwards to a mandatory margin regime.

As was the case for settlement risk, regulators must thoroughly examine replacement cost risk in the foreign exchange market, including the nature and size of this risk, how material this risk is to the market if it were to materialize from the perspectives of liquidity, efficiency and financial stability, and to prudential supervision; the relative importance of this risk to other risks associated with settlement of foreign exchange transactions; how to properly identify, measure, monitor and control this risk, and whether this has been appropriately done by market participants; and, if not, the consequences of this; etc. Only once such an examination has been thoroughly conducted and the size, scope and nature and the problem identified should a strategy be developed for addressing it appropriately (recognizing that the *strategy* may not itself provide the actual / direct solution(s) for mitigating the problem). The information provided to regulators in response to this consultative document, along with responses from market participants to the quantitative impact study (QIS), will be insufficient to reach conclusions on most or all of these areas.

Even with the foreign exchange market's proven track record of withstanding widespread market disruption, including during the most recent 2008-2009 financial crisis, (1) capital implications are only now being proposed for settlement risk; and (2) use of CLS remains voluntary, i.e., is encouraged by the best-practice guidelines of major market participants and by supervisors but not mandated. In comparison, there will soon be additional and immediate capital implications for uncleared deliverable swaps and forwards for replacement cost risk, which is dwarfed by settlement risk as a consequence of the G20 commitments on OTC derivatives. There is no similar requirement for a *mandatory* margin regime. There is no evidence suggesting that the enhanced capital implications do not appropriately reflect the replacement cost risk associated with uncleared deliverable foreign exchange products (accepting that these products should not be incentivized to clear for the reasons explained below). For deliverable forward exchange swaps and forwards, it is counter-intuitive and inappropriate to favor a defaulter-pay model through the mandatory collection of margin (as opposed to capital) to achieve replacement cost risk reduction, but preserve a non-defaulter pay model which proposes to flexibly accommodate the choice between settlement risk reduction or capital implications. More study is needed to ensure this would not be systemically de-stabilizing or undesirable.

4.2.1 Mandatory Margin Regime For Deliverable Foreign Exchange Swaps And Forwards Will Incentivize Participants To Attempt To Centrally Clear These Products In Absence Of A Robust and Safe Clearing Solution

Similar to capital incentives introduced to encourage central clearing of OTC derivatives, applying mandatory margin requirements to foreign exchange swaps and forwards provides structural economic incentives to centrally clear these transactions. Mandatory margin on these uncleared products will provide a structural economic incentive to centrally clear them to achieve multilateral margin netting efficiencies. For the reasons explained below, it is not appropriate and arguably unsafe to promote centralized clearing for these products, especially if determined by regulatory authorities that clearing is not appropriate for them.

It is widely recognized by legislative and regulatory authorities globally that directing foreign exchange swaps and forwards to centralized clearing is not, or may not be, appropriate. In contrast to other OTC derivatives that will not be centrally cleared due to lack of standardization or liquidity, clearing foreign exchange swaps and forwards is not appropriate because (1) while central clearing specifically addresses replacement cost risk, it is not, or may not be, the optimal solution for dealing with foreign exchange swaps and forwards where the main risk is settlement risk, and (2) central clearing of these products has the real potential of increasing, rather than decreasing, systemic risk, especially in times of crisis, thereby significantly outweighing the marginal benefits that central clearing would provide.

Unique challenge associated with clearing foreign exchange swaps and forwards. Notwithstanding numerous efforts to do so, no central counterparty ("CCP") has demonstrated an ability to implement safe and sound measures that ensure the foreign exchange market, with the CCPs, can appropriately manage the liquidity and credit risks associated with clearing foreign exchange swaps and forwards.

In the past few years, central banks[49] have expressed their need, from a broad policy perspective, to receive more information about the foreign exchange-related clearing proposals of each individual CCP to understand and review the potential implications of each proposal for their currencies and for the foreign exchange market. When approached by CCPs seeking to clear foreign exchange transactions, central banks whose currencies settle in CLS raised a number of issues and made requests for further information and analyses regarding the concept of clearing foreign exchange contracts. These issues include the potential effects of mandatory clearing on the central banks' home currencies and on the safety and soundness of the foreign exchange market generally, including on CLS.[50] The central banks' concerns stem from their need to understand and evaluate the impact of a CCP's activities on the foreign exchange market and on payments in their home currencies from a broad policy perspective. There is also an important policy interest in not seeing settlement risk reintroduced to the financial system. Since settlement risk comprises an overwhelming portion of the counterparty default risk for foreign exchange contracts, the failure of a foreign exchange CCP to guarantee settlement risk would largely defeat the purpose of clearing through the CCP, particularly for a market that is essentially a payment system. If a CCP that guaranteed settlement did not use CLS, the CCP would need to settle through a private bank, in which case any default by the private bank would pose serious liquidity and other risks to the clearing house and thus to all its participants. If a CCP did not guarantee settlement and did not use CLS, its clearing participants would be subject to settlement risk, which would be substituting settlement risk – by far the larger risk in a foreign exchange transaction – for replacement cost risk. In addition to their respective needs to determine the safety and soundness of any CCP's proposal to clear foreign exchange, central banks have also separately expressed a need to determine the safety and soundness of CLS' acceptance of such cleared transactions for settlement processing.

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[49] AUD (Reserve Bank of Australia), CAD (Bank of Canada), CHF (Swiss National Bank), DKK (Denmark), GBP (Bank of England), EUR (European Central Bank, National Bank of Belgium, Bank of France, Deutsche Bundesbank, Bank of Italy and Netherlands Bank), HKD (Hong Kong Monetary Authority), ILS (Bank of Israel), JPY (Bank of Japan), KRW (Bank of Korea), MXN (Bank of Mexico), NOK (Central Bank of Norway), NZD (Reserve Bank of New Zealand), SEK (Svergis Riksbank), SGD (Monetary Authority of Singapore), USD (Federal Reserve) and ZAR (South African Reserve Bank).

[50] See CLS letter to U.S. Department of Treasury (November 23, 2010) in response to request for comment on determination of foreign exchange swaps and forwards.

In addition, the CPSS and IOSCO jointly issued in 2012 final principles for financial market infrastructures.[51] These principles include a number of key principles to be considered when seeking to apply clearing to the OTC foreign exchange market. Notably these include principle VII on liquidity risk, principle VIII on settlement finality, and principle XII on exchange-of-value settlement systems. Taken as a whole against the unique characteristics of the foreign exchange swaps and forwards (e.g., the physically delivery aspect to these products), and confirmed through a number of discussions with regulatory authorities and market participants, these principles would require physically settled OTC foreign exchange products to be cleared only by CCPs that can provide a "guaranteed, on-time clearing and settlement model." Specifically, an OTC foreign exchange CCP must, for a physically settled market:

- Guarantee of the full and timely settlement of the currencies of the trade;[52] and
- Ensure the guarantee is credible and addresses extreme but plausible market conditions as identified by rigorous stress testing, including default scenarios.

To date, even for the foreign exchange options market which is substantially smaller than the foreign exchange swaps and forwards market, no model put forward by a CCP and/or market participants has demonstrated an ability to implement safe and sound measures that address the above requirements and ensure the market, with the CCPs, can appropriately manage the liquidity and credit risks associated with clearing these products.[53] It is reasonable to assume that central banks will be unlikely to embrace mandatory clearing and trading requirements for the foreign exchange market in the absence of evidence that it can be implemented without causing more harm than good to sovereign currencies and existing settlement processes.

Rationale for proposed clearing exemptions for foreign exchange swaps and forwards. In its notice of proposed determination to exempt foreign exchange swaps and forwards from clearing requirements in the United States, the Department of Treasury considered several factors to assess whether the required trading and clearing of these products would create systemic risk, lower transparency, or threaten the financial stability of the United States.[54] Many legislative and regulatory authorities globally have acknowledged the analysis of the Department of Treasury when considering a similar exemption from clearing for these products. In its proposed determination, the Department of Treasury concluded that, given the reduced counterparty credit risk profile of this market, the challenges of implementing central clearing within this market significantly outweigh the marginal benefits that central clearing and exchange trading would provide. Regulating foreign exchange swaps and foreign exchange forwards would require insertion of a central counterparty into an already well-functioning and highly interconnected settlement process, which could result in unnecessary operational and settlement challenges. Specifically, following an extensive study and consultation period, the Department of Treasury's proposed determination recognises the different characteristics of foreign exchange products and the way the market functions at present:

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[51] CPSS and Technical Committee of International Organization of Securities Commissions ("IOSCO"), *Principles for financial market infrastructures* (April 2012). http://www.bis.org/publ/cpss101a.pdf.

[52] This is in contrast to other OTC derivative transactions, such as interest rate swaps and credit default swaps, which create settlement obligations that equal only the change in the market price of the notional value.

[53] In contrast to deliverable foreign exchange swaps and forwards, deliverable foreign exchange options are derivatives, but once exercised, become a deliverable foreign exchange spot or forward transaction. Although deliverable foreign exchange options represent a very small portion of the foreign exchange market, they face the same challenges regarding central clearing as deliverable foreign exchange swaps and forwards, in which case incentivizing central clearing through mandatory margin requirements may also not appropriate for them. Accordingly, the margin regime for deliverable foreign exchange options should not be punitive, and should be carefully calibrated to collect or account only for the level of risk that makes sense from a risk or economic point of view. Additionally, the proposed scheduled-based approach for foreign exchange does not, but should, take into consideration tenor.
See also *GFMA GFXD FAQ: The FX Options Clearing & Settlement Project* (March 8, 2012). The objective of this project is to collect and analyze data from each of the 22 GFXD member firms going back over the last five years in order to will help inform potential CCP solutions for OTC FX options.
http://www.gfma.org/uploadedfiles/initiatives/foreign_exchange_(fx)/gfxd%20options%20clearing%20project%20-%20faq%20(final).pdf.

[54] U.S. Department of the Treasury, *Notice of Proposed Determination on Foreign Exchange Swaps and Forwards* (April 29, 2011) ("Treasury Proposed FX Determination").

- Acknowledges the *high levels of transparency and liquidity* existing in the foreign exchange markets as a result of the heavy trading on electronic platforms and the diverse availability of market pricing information.

- Points to *additional transparency through trade reporting to a trade repository*, the requirements of which are already being addressed with Global FX Division members.

- *Recognizes the unique factors limiting risks in the foreign exchange swaps and foreign exchange forwards market*, pointing to the fixed terms (i.e. non-contingent outcomes), the physical exchange of currencies, the well-functioning settlement process and the shorter duration of contracts.

- *Highlights the existing strong, comprehensive and internationally coordinated oversight framework prevalent in the foreign exchange markets.*

- Notes the *complexities around introducing CCP clearing* into the foreign exchange market – specifically:

  - The large currency and capital needs that would arise if CCPs were also responsible for guaranteeing settlement given the sheer size and volume of trades in the foreign exchange (forwards and swaps) market.

  - The operational challenges and potentially disruptive effects that arise from introducing a layer of clearing between trade execution and settlement – concluding that these significantly outweigh the marginal benefits from central clearing.

- Key unintended consequences of mandating clearing for foreign exchange forwards and swaps include potentially undermining the efforts that have been made in addressing settlement risk to date; creating a single point of failure where none exists today; and increasing costs and risk for corporate and buy-side end-users of foreign exchange.

4.2.2 Mandatory Margin Regime For Deliverable Foreign Exchange Swaps And Forwards Will Jeopardize The Use And Role of CLS In Reducing Systemic Risk As Mandatory Margin Costs Move Focus Away From Settlement Risk Reduction

CLS was designed to, and has dramatically reduced, the source of systemic risk for the foreign exchange market. A mandatory margin regime, however, will distract participants from prioritizing efforts in further reducing settlement by creating structural economic incentives to not use CLS due to increasing transaction costs from the *non-mandatory* reduction of settlement risk to the *mandatory* reduction of replacement cost risk. When faced with cost of using CLS voluntarily, as compared to the mandatory collection or posting of margin as proposed in the consultative document, participants may opt for the latter in lieu of the former in order to keep costs under control when executing a deliverable foreign exchange contract to ensure compliance with laws and regulations. This will jeopardize the use and role of CLS as a critical financial market infrastructure in reducing systemic risk. By raising costs of trading deliverable foreign exchange swaps and forwards which will remain in the bilateral world for the forseeable future, a proposed mandatory margin regime will undermine past and future efforts at settlement risk reduction.

4.2.3 Mandatory Margin Regime For Deliverable Foreign Exchange Swaps And Forwards Will Discourage Legitimate Trading In These Products, Which Might Adversely Affect Global Trade And Cross-Border Activity And Potentially Disrupt Activities Of Central Banks

By increasing the cost of trading in uncleared OTC derivatives, a mandatory margin regime will discourage market participants from trading in these products or otherwise limit their activity in them. This is not a desirable policy outcome for foreign exchange swaps and forwards given the role these instruments perform in foreign exchange as a global payment system.

Accepting that a margin regime that incentivizes central clearing for the deliverable foreign exchange swaps and forwards market is not appropriate for the reasons described above, nor is discouraging activity in these uncleared products, a margin regime for these products should only be considered appropriate if the quantity of margin held is proportionate to risk(s) that margin is intended to mitigate; and the implementation and maintenance costs for any given participant should not be so high as to create an unreasonably high barrier that would prevent the participant from being able to perform basic economic function of exchanging currency and managing currency risk. Any mandatory margin regime that seeks to incentive clearing will therefore be punitive to deliverable foreign exchange swaps and forwards by raising costs of legitimate trading these products which can only remain in a bilateral, uncleared world. As a result, many participants globally will find it much more expensive to do basic transactions in the currency market. This will disproportionately impact corporate and other buy-side end-users which rely upon foreign exchange swaps and forwards to hedge risks and adjust timing of currency payments and deliveries to match their business needs. Even if these end-users are exempt from mandatory margin requirements, the cost for the dealers in making these markets in these products will increase due to interdealer margin and ultimately be borne by the end-users.

Deliverable foreign exchange swaps and forwards are fundamental tools used by central banks to manage liquidity and market stability, and their importance and prevalence are increasing. Secure and well-functioning payments systems are necessary for the attainment of central banks' monetary, macroprudential, supervisory and other policy objectives.[55] Diminished liquidity caused by the subjecting these products to a mandatory margin regime will make it more difficult for central banks to manage fluctuations in currency values. The effects will be particularly acute during times of market impairment, as a mandatory margin regime would impede the ability of banks to transact in these products to help alleviate the pressures imposed when there is broad credit deterioration. How well the foreign exchange market, as a global payment system, functions has a direct effect on monetary policy implementation. Monetary policy implementation could be affected by the impact on the ability of the central bank to control the supply of and to forecast the demand for reserve balances, and by the impact on open market operations, central bank lending and other operating procedures. This might also affect interest rates and exchange rates.[56] Creating such friction in a fundamental mechanism such as the global payment system will not facilitate, and may instead harm, global trade and therefore hinder economic growth. To illustrate the relationship between foreign exchange and monetary policy: interest rate movements directly influence exchange rates, and the exchange rate affects demand for exports. The demand for exports in turn affects output for a country, the country's international competitiveness, and the composition of the country's gross domestic product. Similarly, exchange rates affect the currency's price of imports, which in turn affects inflation.

4.2.4 Other Considerations

Another stated regulatory objective for a shift to a mandatory margin regime, essentially a defaulter-pay model, for OTC derivatives is to reduce interconnectedness in the financial system. We wish to note that such a margin regime may in fact increase interconnectedness, rather than decrease it. This is because the requirement will lead to greater economic incentive for market participants to consolidate interbank counterparties to conserve margin. It is important to understand more clearly the impact of this on the foreign exchange market, including whether and the extent to which this may suppress foreign exchange

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[55] Allsopp Report.
[56] Allsopp Report.

market activity and impair access to foreign exchange risk transfer and risk intermediation in the interdealer market and for end-users.

Further, it has been suggested that margin, and to an extent capital, are being assessed on uncleared, nonstandarized derivatives to address the systemic risk that may be introduced by trading in these derivatives by financial institutions when the commercial prices for such derivatives might not fully reflect the social costs of the systemic risks that may materialize in a financial crisis. Accepting that this is not appropriate for deliverable foreign exchange swaps or forwards, any mandatory margin regime imposed for this reason, or to the extent that it is, will be punitive to such products.

5 Mandatory Margin Regime Based On Tenor Will Result In A Bifurcated Foreign Exchange Market, With Less Effective And Less Desirable Currency Risk Mitigation

A mandatory margin regime based on tenor will only result in a bifurcated foreign exchange market, as market participants will be incentivized to hedge their currency risk using shorter-dated foreign exchange products and be subject to greater foreign exchange currency risk than desired in absence of a mandatory margin requirement.

Currently, a firm may desire a longer dated foreign exchange forward (e.g., 1 or 2 years) to fully mitigate its currency risk. However, it may decide that the increased interest rate risk associated with a longer-dated foreign exchange product, relative to a shorter-dated foreign exchange product, is not desirable; in this case, it might execute a 1 or 3-month foreign exchange forward, and then as that contract matures, enter into another 1 or 3-month forward, and repeat this process until it no longer needs to hedge its currency risk. If mandatory margin were to apply to longer-dated foreign exchange swaps and foreign exchange forwards and not shorter-dated products ones, the margin cost will inevitably be factored into each market participant's decision as to whether to fully hedge its currency rate risk over a longer duration for reasons other than the interest rate risk associated with a longer-dated currency hedge as described above. Market participants will find the shorter-dated products to be more cost-effective purely as a function of the margin costs. Spreads are so tight in these products that small differences in the cost of trading a foreign exchange swap or forward based on tenor will dramatically affect market behavior. As a result, a mandatory margin regime based on tenor will reduce the number of longer-dated deliverable foreign exchange swaps and forwards from the relatively small percentage currently observed. For those end-users that may still have a need or desire for the longer-products, the cost for dealers in making these markets will increase and ultimately be borne by the end-users.

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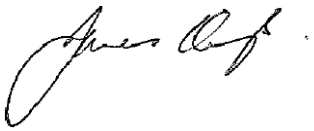
For a market as systemically relevant as foreign exchange, it is imperative that regulators globally proceed prudently when approaching and addressing risks in this market. Extreme caution is needed to ensure regulatory measures do not harm the well-functioning market structure. While we agree with the key principle in the consultative document that "appropriate margining practices should be in place with respect to all derivative transactions", for the reasons summarized in this comment letter, the proposed requirement that "margin requirements apply to all non-centrally cleared derivatives" is not appropriate for deliverable foreign exchange swap and forward transactions, is inconsistent with the established and proven strategy of central banks, in consultation with supervisors, for addressing systemic risk in this market. Any mandatory margin regime for these products could cause serious harm to this well-functioning and systemically important market structure.

We appreciate the opportunity to share our views on this consultation paper issued by BCBS-IOSCO WGMR. Please do not hesitate to contact me at +44 (0) 207 743 9319 or at jkemp@gfma.org should you wish to discuss any of the above.

Yours sincerely,



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[57] The Global Finanical Markets Association (GFMA) brings together three of the world's leading financial trade associations to address the increasingly important global regulatory agenda and to promote coordinated advocacy efforts. The Association for Financial Markets in Europe (AFME) in London and Brussels, the Asia Securities Industry & Financial Markets Association (ASIFMA) in Hong Kong and the Securities Industry and Financial Markets Association (SIFMA) in New York and Washington are, respectively, the European, Asian and North American members of GFMA.