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**21 September 2012**

**Re: Canadian Securities Administrators  
CSA Consultation Paper 91-406 –Derivatives: OTC Central Counterparty Clearing  
(20 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 consultation paper issued by the Canadian Securities Administrators. 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 22 global FX market participants,<sup>1</sup> collectively representing more than 90% of the FX market.<sup>2</sup> Both the GFXD and its members are committed to ensuring a robust, open and fair marketplace and welcome the opportunity for continued dialogue with global regulators.

The FX market is the world's largest financial market. 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 FX market and we feel it is vital that the potential consequences are fully understood and that new regulation improves efficiency and reduces risk, not vice versa. The GFXD welcomes the opportunity to set out its views in response to your consultation paper.

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1. *Do you consider that product characteristics of any OTC derivative asset classes make them eligible for CCP clearing based on the factors set out herein? If so what asset classes would you exclude, and for what reasons?*

We support the product characteristics identified in the consultation paper as relevant to the a mandatory clearing determination. However, there are several other characteristics that are material to any such determination.

**International convergence accepting that CCP clearing may not be the optimal solution.** Canadian market authorities should specifically identify and take into consideration the predominant risks for the products and, in this context, international convergence. International convergence is paramount for deliverable FX forwards and FX swaps where the predominant risk is settlement risk.<sup>3</sup> Following extensive study of settlement risk by the central banks as a source of systemic risk for the FX market and therefore the global financial markets, the FX market went to considerable lengths to address this risk, ultimately leading to the creation of CLS Bank (CLS) in 2002. CLS' settlement system today eliminates virtually all settlement risk to its participants. Additionally, CLS' activities are subject to a cooperative oversight protocol arrangement among 22 central banks whose currencies are settled.

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<sup>1</sup> 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, Morgan Stanley, Nomura, RBC, RBS, Société Générale, Standard Chartered Bank, State St., UBS, and Westpac.

<sup>2</sup> According to Euromoney league tables

<sup>3</sup> For example, the recitals in the European Market Infrastructure Regulation (EMIR), specifically states: "In determining the subjection to the clearing obligation of classes of derivatives, due account should be taken of the specific nature of the relevant classes of OTC derivatives. The predominant risk for transactions in some classes of OTC derivatives may relate to settlement risk, which is addressed through separate infrastructure arrangements, and may distinguish certain classes (e.g. foreign exchanges) of OTC derivatives from other classes. CCP clearing specifically addresses counterparty risk, and may not be the optimal solution for dealing with settlement risk. The regime for such contracts should rely notably on preliminary international convergence and mutual recognition of the relevant infrastructure."

**Systemic relevance of the market and its distinguishing characteristics.** Canadian market regulators should take into account the systemic relevance of the relevant market in order to help ensure that the application of a clearing obligation would not result in undue risk being assumed by the market and overall financial system. Size should be measured not only in terms of volume, but also values. Unique characteristics of the derivative product, e.g., the physically delivery aspect to FX forwards and FX swaps, must also be taken into consideration.

- **FX is at the heart of all international commerce.** 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 FX market, which is the world's largest financial market, is a central component of the global payment system. It also underpins other financial markets and the global economy generally. The Bank for International Settlements estimated that average daily market turnover in FX increased to \$4 trillion in April 2010, up from \$3.3 trillion in April 2007.<sup>4</sup>
  
- **FX markets are different from other derivative markets.** The majority of FX trades are simple exchanges of currency. There are no contingent outcomes for FX forwards and swaps (cash flows are known at the outset of the trade) and they are overwhelmingly short-term in nature. For example, latest analysis conducted by Oliver Wyman of the BIS 2010 survey and the FXJSC/FXC figures (both collected in April 2010), estimates the following global maturity profile for FX forward and swap trades:
  - Up to 7 days maturity = 68.0% of daily traded volumes;
  - 7 days – 1 month = 13.3%; and
  - 1 month – 6 month = 16.2%

This evidences a global FX forwards and swaps 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. And unlike other OTC derivatives which are typically settled on a net, cash-settled basis, FX forwards and FX swaps are typically physically settled by delivery of the underlying currency.

- **FX faces different and specific risks when considering counterparty credit risk.** In FX forwards and swaps market, the main counterparty risk is settlement risk, not mark-to-market risk (settlement risk is the risk that one counterparty does not deliver their side of the currency exchange while the other counterparty has delivered their side). Unlike most derivatives markets where trades are settled financially, the FX market is currently predominantly physical, i.e. trades settle via exchange of currencies. For FX instruments with maturity less than 6 months: 94%

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<sup>4</sup> BIS, Monetary and Economic Department, *Triennial Central Bank Survey: Report on global foreign exchange market activity in 2010* (Dec 2010).

of max loss exposure is settlement risk; mark-to-market risk is only a residual risk (6%).<sup>5</sup>

- **CCPs are designed to mitigate “mark-to-market” risk – not settlement risk.** In FX markets, the residual mark-to market risk is today mitigated through credit support annexes (CSAs).
- **Mandatory clearing in FX markets could have unintended consequences whilst addressing a disproportionately low residual credit risk exposure.** The rules of the Canadian market regulators should specifically recognize that in some classes of OTC derivatives, such as FX, the CCP clearing mandate/solution may not be the optimal solution for dealing with the predominant risk for that market, such as settlement risk. Key unintended consequences of mandating clearing for FX forwards and FX 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 FX.

In addition, it is worth noting that the US Treasury has issued a Proposed Determination to exempt FX forwards and swaps from the definition of a ‘swap’. The proposed determination recognises the different characteristics of FX products and the way the market functions at present. Following a study and consultation over many months the US Treasury:

- Acknowledges the **high levels of transparency and liquidity** existing in the FX 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 GFXD members.
- **Recognises the unique factors limiting risks in the FX forwards and swaps 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 FX markets.**
- Notes the **complexities around introducing CCP clearing** into the FX 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 FX (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.

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<sup>5</sup> According to analysis conducted by Oliver Wyman.

In respect of the issues around guaranteeing settlement, current proposals for financial market infrastructures as issued by the BIS in conjunction with CPSS/IOSCO in March 2011<sup>6</sup> outline a number of key principles that need to be considered for CCPs in the FX market. The industry has been focused on these principles over the past twelve months in the context of FX Options. Notable are Principle 7 – Liquidity Risk, Principle 8 – Settlement Finality, and Principle 12 – Exchange-of-Value settlement systems. Taken as a whole, and confirmed through our conversations with key regulatory oversight groups, it is our understanding<sup>7</sup> that these principles require any CCP looking to clear FX products to meet fully the following requirements:

- An FX CCP will need to guarantee the full settlement of currencies of the trade<sup>8</sup>;
- An FX CCP must be able to deliver required currency at the latest by the end of the settlement day; and
- An FX CCP must be covered against Settlement Halt Risk<sup>9</sup>.

The FX industry has been working with regulators and CCPs and is acutely aware that to meet these requirements for the mainstream FX market a CCP would face significant challenges. This is especially true in light of the need for immediate access to sufficient liquidity in all currencies to be able to meet in full the settlement obligations of a defaulting member, and in a manner that does not put the CCP itself at significant risk during stressed market conditions. The specific settlement characteristics of the FX market make this issue significantly more acute than in other asset classes. This is a formidable challenge for which, to date, no satisfactory solution has been found.

Introducing CCPs into the FX market without ensuring that they only bear risks that they can properly manage would clearly increase, rather than decrease, potential systemic risk, especially in times of crisis.

**More granular grouping of OTC derivatives within product types.** With respect to “class of OTC derivatives”, we support the recognition that “grouping” of swaps needs careful consideration and believe that a one size fits all approach is inappropriate for determining whether swaps should be mandatorily cleared. Canadian market regulators should have the ability to subdivide a CCP’s submission for review. We firmly believe that appropriateness for mandatory clearing is likely to depend on the characteristics of each of the different underlying products. FX products are not homogenous, and the possibility of different trade features requires that each currency pair should be reviewed and separately approved. In particular, liquidity by currency pair varies significantly. We believe that clearing is only warranted for the most liquid currencies that offer a material reduction in replacement risk across the market. As CCP’s launch additional products, we believe that Canadian market

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<sup>6</sup> CPSS Technical Committee of the International Organization of Securities Commissions, “Principles for financial market infrastructures”, Bank for International Settlement IOSCO, Consultative Report March 2011.

<sup>7</sup> See Global FX Division Discussion Document at [http://www.afme.eu/AFME/What\\_We\\_Do/FX%20Clearing%20Settlement%20Challenges%20Discussion%20Document%201%203.pdf](http://www.afme.eu/AFME/What_We_Do/FX%20Clearing%20Settlement%20Challenges%20Discussion%20Document%201%203.pdf)

<sup>8</sup> This applies to the vast majority of FX trades where settlement is via exchange of principal; clearly it does not apply to the small proportion of FX trades involving non-deliverable contracts, e.g. NDFs.

<sup>9</sup> This is the potential risk of mark to market loss on settlement day if settlement is halted intra-day and therefore not all trades settle (NB: this is different from FX settlement risk).

regulators should give each new product due and careful consideration to ensure that any mandatory clearing is warranted. Approving FX derivatives (e.g., FX non-deliverable forwards (NDFs)) by currency will also enable consideration of the pace of development at competing CCPs to ensure market participants have a choice of venues to ameliorate systemic risk and encourage competition.

**Specific documentation / additional information requirements for CCPs to assist Canadian market regulators.** To assist in Canadian market regulators' review of a class of an OTC derivative for mandatory clearing, we urge Canadian market regulators to require specific information from the CCP on the end-to-end testing conducted with its clearing members for that market. For example, in the case of FX derivatives, specific information should be required on:

- (1) the scenario analyses / stress testing performed by the CCP, the default management processes for the CCP and resulting impact on the underlying liquidity in the FX Product(s) that the CCP clears or plans to clear, and the arrangements in place to address management of sovereign risk events (e.g., suspension of trading, sovereign default, unexpected bank holiday or other significant disruption to valuation, payment or settlement processes; and
- (2) a description of the manner in which the CCP has provided information to the central banks of the relevant currencies on its clearing of FX Products, including but not limited to (1) above, and a summary of any views expressed by the central banks to this information.

Because the FX market is a central component of the global payment system, central banks have expressed a need to understand and evaluate the impact of clearing by CCPs, individually and collectively, on the FX market from a broad policy perspective.

2. *For which asset classes do you consider CCP clearing is inappropriate or not currently feasible based on the factors described herein, and for what reasons?*

Please refer to our response to question 1 above.

3. *What are the costs and risks involved in moving particular derivatives or classes of derivatives transactions to CCP clearing that regulators should consider in determining if a derivative should be subject to a CCP clearing requirement?*

Please refer to our response to question 1 above.

4. *Does a deferred submission, be it measured in minutes, hours or days, engender significant counterparty or other risks that would make the imposition of a strict timeframe for submission to a CCP, and the acceptance by the CCP necessary?*

No comment.

5. *The Committee asks whether an exemption from mandatory CCP clearing for intra-group transactions is appropriate, including a description of the risks that they could pose to the market place and the costs of migrating such transactions to a CCP.*

We support an exemption for intra-group transactions from a clearing obligation for the reasons described (e.g., by commentators in the U.S.) in the consultation paper.

6. *Is it appropriate to ensure that Canadian market participants have meaningful input into operational decisions of a CCP operating in Canada?*

No comment.

7. *Do the Committee's proposals relating to corporate governance of a CCP address potential issues relating to conflicts of interest that may arise in the operation of a CCP? If not, what other measures would address such conflicts of interest?*

No comment.

8. *The Committee seeks public comment on the relevance of developing rules allowing for access to CCPs regardless of trading venue. Is this of concern in the Canadian marketplace at this time or in the future?*

No comment.

9. *The Committee asks for comment on the type of information that a CCP should provide and that should be made publicly available.*

No comment.

10. *Generally, the Committee has endeavoured to follow international recommendations in the development of the recommendations for Canada in this paper. Are there recommendations that are inappropriate for the Canadian market?*

In addition to following international recommendations surrounding the regulation and oversight of CCPs, we believe it is important for Canadian market authorities to specifically identify and take into consideration the predominant risks for each OTC derivative product and, in this context, international convergence. For the reasons described in our response to question (1), international convergence is paramount for deliverable FX forwards and FX swaps where the predominant risk is settlement risk.

11. *Are there changes to the existing regulatory framework that would be desirable to accommodate a move to CCP clearing?*

No comment.

12. *Do you consider that any changes need to be made to Canadian law to facilitate the efficiency of OTC derivatives clearing, either through a domestic or a foreign CCP? If so, what changes and for what reasons?*

No comment.

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We appreciate the opportunity to share our views on this consultation paper issued by Canadian Securities Administrators. Please do not hesitate to contact me at +44 (0) 207 743 9319 or at [jkemp@gfma.org](mailto:jkemp@gfma.org) should you wish to discuss any of the above.

Yours sincerely,



James Kemp

Managing Director

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<sup>10</sup> The Global Financial 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.