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TO:

Financial Stability Board

Via email: fsb@fsb.org

September 7, 2018

Re: DAT consultation response - Incentives to centrally clear over-the-counter (OTC) derivatives

Dear Financial Stability Board,

The Global Foreign Exchange Division (“GFXD”) of the Global Financial Markets Association appreciates the opportunity to provide comments to the FSB, BCBS, CPMI and IOSCO (together, “the Committees”) on their consultative report on incentives to centrally clear OTC derivatives.

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). Our members comprise 25¹ global foreign exchange (FX) market participants collectively representing around 80%² of the FX inter-dealer market. We and our members are committed to ensuring a robust, open and fair marketplace and welcome the opportunity for continued dialogue with global bodies and regulators.

The FX market is the world’s largest financial market, and effective and efficient exchange of currencies underpins the global financial system. Sovereign entities, central banks and other government sponsored entities rely on the FX market to be well-functioning and liquid, and corporations and investors regularly participate in the market for important 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 funding outside home markets.

¹ Bank of America Merrill Lynch, Bank of New York Mellon, Barclays, BNP Paribas, Citigroup, Crédit Agricole, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan, Lloyds Bank, Mizuho, Morgan Stanley, MUFG Bank, Natwest Markets, Nomura, Royal Bank of Canada, Scotiabank, Société Générale, Standard Chartered Bank, State Street, UBS, Wells Fargo and Westpac.

² According to Euromoney league tables.

Many of the current legislative and regulatory reforms have had, and will continue to have, a significant impact upon the operation of the global FX market, and the potential consequences of reforms on the FX market should therefore be carefully evaluated before they are implemented.

We support the Committees taking the initiative to assess on an ongoing basis the G20 post-crisis reforms and provide the following input in respect of the consultative report on clearing incentives.

Incentives

1. Do you agree or disagree with the finding that, in general, there are strong incentives for dealers and larger (in terms of level of derivatives activity) clients to centrally clear OTC derivatives? Do you agree or disagree with the finding that some categories of clients have less strong incentives to use central clearing?

We agree that, in general, there are strong incentives for dealers and larger clients to centrally clear OTC derivatives. Larger market players will likely have direct access to CCPs and central clearing can offer potential economic and risk-reducing benefits. Multilateral netting and trade compression efficiencies achievable through clearing can also yield advantages.

Specifically, with respect to FX non-deliverable forward (NDF) transactions, whilst clearing mandates have not been imposed on these products³, we have observed that since the uncleared margin rules began to apply to these products in September 2016, imposing certain initial margin (IM) obligations, voluntary clearing of NDF transactions has increased significantly. This has been attributed to incentives for clearing arising from the costs of IM for uncleared versus the costs of cleared NDFs.

We agree that some categories of clients will have less strong incentives to use central clearing. Smaller FX end-users who are not subject to regulatory or contractual IM on their NDF transactions may not find there is an economic incentive to clear, given the costs, and FX clients holding directional positions may not fully benefit from the advantages to be gained from netting their cleared transactions.

2. Do you agree or disagree with the finding that relevant post-crisis reforms have, overall, contributed to the incentives to centrally clear? Is the consultative report's characterisation of distinctions in how the reforms have affected incentives for different types of clients consistent or inconsistent with your experience?

We agree that relevant post-crisis reforms have, overall, contributed to the incentives to centrally clear. Clearing mandates, for example, have driven up cleared volumes for IRS and CDS products, and uncleared margin appears to have led to an increase in voluntary clearing for non-mandated products

³ (With the exception of INR/USD forwards), and, in our view, are not a suitable incentive for NDF clearing at this time, see our response to Question 3 below.

where economic efficiencies are determined achievable. In terms of NDF transactions, we have observed that, since the post-crisis uncleared margin rules began to apply in September 2016, imposing IM on NDF transactions, voluntary clearing of NDF transactions has increased greatly.

3. Do the margin requirements for uncleared derivatives give a sufficient incentive to clear? How do these requirements interact with mandatory clearing obligations to incentivise clearing? Are there particular instruments, and specific types of entities where the incentive to clear is not adequate? In such cases, are there specific aspects of the requirements that diminish incentives to clear?

We see clearing mandates and mandatory margin for uncleared derivatives as different incentives for clearing. Clearing mandates dictate that a product must be cleared if it is transacted, so in that sense is not an incentive for clearing but rather a pre-condition for trading. Uncleared margin costs, on the other hand, are a factor to consider when assessing the economics of clearing a transaction or not, though it is still left to the counterparties to the transaction to decide as between them whether to clear the transaction.

In this regard, we wish to highlight the following important points as to clearing mandates for FX derivatives, which explain why it makes sense that cleared FX volumes will be lower overall, as compared to other asset classes:

- a. *Physically-settled FX transactions present different risks and challenges as compared with more traditionally centrally-cleared products such as interest rate and credit derivatives, and thus are not well suited for clearing mandates. Also, physically-settled FX options clearing is in its infancy.*

Physically-settled FX swaps and forwards stand in sharp contrast to most other swaps, for which counterparty risk is comprised almost exclusively of credit risk on the mark-to-market value of the swap (credit risk being the risk that CCPs are primarily designed to address). These types of FX transactions are simple exchanges of currency where the predominant risk by far is settlement risk: the risk that one party delivers its side of the currency exchange while the counterparty does not. Following extensive study of settlement risk by global central banks as a source of systemic risk in the FX market and therefore the global financial markets, the FX market went to considerable lengths to address settlement risk, ultimately leading to the creation of CLS Bank International (CLS) in 2002. Today, CLS's settlement system eliminates virtually all settlement risk for the currencies CLS settles for its participants. Where necessary, any residual mark-to-market risk is typically mitigated via credit support annexes and contractual exchange of margin. Furthermore:

- Physically-settled FX swaps and forwards are generally short-dated, so there is already significantly reduced counterparty credit risk as compared to other classes of derivatives with

more long-dated tenors, such as interest rate and credit derivatives.⁴ The FX market is also very liquid and transparent.

- Barriers to clearing physically-settled FX products exist, such as sufficient access to client clearing. Given they are frequently used for hedging currency risk from cross-border trade and related commercial activities, physically-settled FX products are often used by smaller, less sophisticated parties who may not have the operational capacity to build out the necessary infrastructure to be able to access, or qualify to access, CCPs directly, and client clearing services and default management for physically-settled FX products are not well developed. According to the DAT quantitative survey, client clearing services in OTC FX derivatives are offered by only 33% of the largest dealer respondents (as compared to 78% for OTC interest rate derivatives and 67% for OTC credit derivatives).
- Furthermore, given the size of the notional amounts to be exchanged in different currencies, significant issues with respect to CCPs ensuring systemically sound clearing and settlement of physically-settled FX swaps and forwards currently exist, such as same-day liquidity challenges. As noted in the US Treasury's November 2012 Fact Sheet discussing its exemption of FX swaps and forwards from mandatory clearing in the US: "settlement of the full principal amounts of the contracts would require substantial capital backing in a very large number of currencies, representing a much greater commitment for a potential clearinghouse in the FX swaps and forwards market than for any other type of derivatives market."⁵

As a general matter, we acknowledge the benefits that central counterparty clearing can bring to the OTC derivatives markets, for example in terms of operational efficiencies, transparency and counterparty credit risk reduction. In light of the above, however, we firmly believe that the significant operational risk and costs to the global payment system of implementing mandatory clearing for deliverable FX far exceed the benefits of mitigation for any small residual unsecured credit risk of physically-settled FX swaps and forwards. Central clearing for physically-settled FX products, in our view, has the potential of increasing, rather than decreasing, systemic risk, especially in times of crisis, thereby significantly outweighing the marginal benefits that mandatory central clearing would provide.

Whilst we do support market participants being able to choose to centrally clear FX products, as clearing capabilities continue to be developed and emerge for voluntary clearing across different asset classes, clearing mandates as incentives for clearing physically-settled FX transactions are not appropriate or necessary. The complexities around introducing CCP clearing into the FX market are significant – such as the large currency and capital needs that would arise if CCPs were also responsible

⁴ According to the BIS 2016 Triennial Survey, approximately 69% of the market for FX swaps and approximately 39% of the market for FX forwards (incl. NDF) matured in one week or less, and approximately 99% of the market for FX swaps and approximately 98% of the market for FX forwards (incl. NDF) matured in one year or less. See <http://www.bis.org/publ/rpfx16.htm>

⁵ US Treasury Press Release 'Fact Sheet: Final Determination on Foreign Exchange Swaps and Forwards', available at <http://www.treasury.gov/press-center/press-releases/Pages/tg1773.aspx>

for guaranteeing settlement, given the sheer size and volume of trades in the deliverable FX forwards and swaps market, and the operational challenges and potentially disruptive effects that arise from introducing a layer of clearing between trade execution and settlement.

Representing a very small portion (approximately 5%)⁶ of the FX market, physically-settled FX options face the same challenges regarding clearing as physically-settled FX forwards and swaps. Whilst capabilities for settling certain cleared options pairs through CLS have recently begun, and we expect the volume of FX options being voluntarily cleared may grow over time, FX options clearing is still at this time in its infancy and needs further time to mature. We are therefore of the view that mandates as incentives for clearing FX options transactions are also not suitable or necessary at this time.

b. Certain characteristics of the FX non-deliverable forward (“NDF”) market also warrant special attention when considering clearing mandates and distinguish NDFs from the markets for interest rate and credit derivatives, rendering NDFs unsuited to clearing mandates at this time.

Given that NDF transactions comprise only approximately 2.6%⁷ of the total FX market and are also overwhelmingly short-dated in nature⁸, it is unclear whether the reduction of counterparty credit risk that may be achieved by mandating participants to move bilateral NDF exposures to a centrally cleared environment at this time would reduce risk in the aggregate or reduce systemic risk. We acknowledge that, post implementation of uncleared margin rules globally, voluntary NDF clearing has grown considerably. However, as compared to the percentage of the market in interest swaps and credit derivatives already cleared when they were mandated for clearing,⁹ voluntary clearing of NDFs is still evolving at this time.¹⁰

Furthermore, processes around client clearing and default management for NDFs are still far less developed than for interest rate or credit derivatives, and need further time to evolve and mature. The number of CCPs offering NDF clearing is somewhat limited and the number of firms offering client clearing services for NDFs is still small (we note the DAT quantitative survey showing client clearing services in OTC FX derivatives are offered by only 33% of the largest dealer respondents). As such, the ability for market infrastructures to develop to support NDF clearing mandates, and implement processes for managing events such as a counterparty default, has not been broadly established or, more importantly, widely tested as yet. Given voluntary clearing is already being taken up, premature introduction of mandatory NDF clearing may unnecessarily introduce additional risk to the market

⁶ BIS 2016 Triennial Survey <http://www.bis.org/publ/rpfx16.htm>

⁷ BIS 2016 Triennial Survey: <http://www.bis.org/publ/rpfx16fxt.pdf>

⁸ See Footnote 4 above.

⁹ We understand approximately 60% of IRS contracts and 30% of CDS contracts were being voluntarily cleared when such mandates were being introduced.

¹⁰ We believe that currently around 16% of total NDF transactions are cleared: <https://www.clarusft.com/ndf-volume-data/>

and, as a result, undermine the benefits of central clearing for NDFs. We are therefore of the view that mandates as ‘incentives’ for clearing NDF transactions are not suitable or necessary at this time.

We also agree with the comments made by The International Swaps and Derivatives Association, Inc. (ISDA) in their letter to you dated September 7, 2018 (the “ISDA letter”) that incentives to clear do not work if a product is not suitable for clearing, and only serve to make tailored OTC derivative more expensive for clients, meaning that products that cannot be cleared safely (if at all) should not be incentivized for clearing. In this regard, we also agree with ISDA that, therefore, uncleared margin requirements should be appropriately calibrated.

4. The consultative report seeks to identify the most important regulatory and non-regulatory factors which affect incentives to centrally clear OTC derivatives for dealers, other financial intermediaries, large clients and small clients. Please identify any significant missing factors and comment on the relative strength of regulatory and non-regulatory factors discussed in the consultative report.

We believe the relevant factors which affect incentives to centrally clear OTC derivatives are those identified in the consultative report. We would, however, encourage further thought to be given to the cleared market structure, in terms of CCPs’ pricing, fee schedules, transparency in margin requirements, etc. It is important for regulators to ensure cleared infrastructure costs are appropriately calibrated, to properly incentivize clearing and enable market participants to make a real choice after assessing their costs and benefits of clearing FX.

Markets

5. Is the consultative report’s characterisation of the shift of activity and trading liquidity towards centrally cleared products, and the consequent impact on uncleared products, consistent or inconsistent with your experience?

With respect to the NDF market, the clearing incentives have not had an impact on ‘trading liquidity’ and NDF trading liquidity has not shifted into central clearing. As FX options clearing is still very much in its infancy, as mentioned in our response to Question 3 above, it is too early to tell, however we will continue to monitor for this.

6. There are various industry efforts underway to reduce the cost of clearing, including portfolio compression and direct clearing membership models. Based on your experience are these proposals, or other forthcoming changes to clearing infrastructure and models, likely to affect incentives to provide or use clearing services?

We agree with the comments made in the ISDA letter in response to this question. Portfolio compression can reduce gross notional amounts, leading to regulatory capital savings and reduction of operational and counterparty risk exposures.

Reforms

7. Do you agree or disagree with the report's characterisation of the effects of the following reforms on incentives to centrally clear?

a) central clearing mandates (both in terms of product scope and entity scope);

We agree that clearing mandates have driven central clearing of the products mandated for clearing in respect of the counterparties to whom the mandates apply. We also agree, however, with the comment in the ISDA letter that inter-affiliate transactions should not be subject to clearing mandates.

b) minimum standards for margin requirements for uncleared derivatives;

We agree that minimum standards for margin requirements for uncleared derivatives have prompted central clearing of products mandated for IM. We have observed that, since the post-crisis uncleared margin rules began to apply in September 2016, imposing IM on NDF transactions, voluntary clearing of NDF transactions has increased significantly.

c) capital requirements for credit valuation adjustment (CVA) risk;

d) capital requirements for jump-to-default risk (including where applicable the Standardised approach for counterparty credit risk (SA-CCR) and the Current exposure method (CEM));

e) G-SIB requirements; and

f) The leverage ratio.

We have no further comments in respect of sub-questions c) to f) above.

8. Do you agree or disagree with the consultative report's characterisation of the impact of these reforms on the incentives to provide client clearing services?

We agree that regulations aimed at improving institutional resilience may in some circumstances be discouraging individual firms from providing client clearing services which may in turn affect access challenges for clients and the concentration of client clearing service provision.

With respect to the supplementary leverage ratio (SLR) in the context of client-cleared transactions, we agree that the treatment of IM in the leverage ratio can be a disincentive for client clearing service providers to offer or expand client clearing. In this regard, we note the points made by CFTC Commissioner Quintenz where he raises concerns around the treatment of the risk-reducing nature of segregated margin under the SLR¹¹ and would encourage further analysis and discussion in this regard, to ensure the SLR calculation accurately reflects the purpose of margin and that the provision of client clearing services is encouraged rather than penalized.

¹¹ <https://www.cftc.gov/PressRoom/SpeechesTestimony/opaquintenz7>

9. Are there any areas where potential policy adjustments should be considered which would enhance the incentives for or access to central clearing of OTC derivatives, or the incentives to provide client clearing services?

We reiterate our previous comment encouraging further thought to be given to the cleared market structure, in terms of CCPs' pricing, fee schedules, transparency in margin requirements, etc. as it is important to ensure cleared infrastructure costs are appropriately calibrated, to properly incentivize the provision of client clearing services and enable market participants without direct access to CCPs the choice and ability to clear through a third-party service provider. Furthermore, we agree with the comments made in the ISDA letter in response to this question regarding targeted amendments to incentivize swaps dealers to provide client clearing services.

Access

10. Do you agree or disagree with the report's characterisation of the difficulties some clients, especially clients with smaller or more directional derivatives activity, face in:

- a) accessing clearing arrangements; and

We agree. FX products are often used by smaller, less sophisticated market participants who rely on FX derivatives to hedge currency risk arising from their cross-border trade and related commercial activities. These parties may not have the operational or financial capacity to build out the necessary infrastructure to be able to access, or qualify to access, CCPs directly, and will also need to consider the costs of clearing through a third-party.

We repeat our previous comment encouraging further thought to be given to the cleared market structure, in terms of CCPs' pricing, fee schedules, transparency in margin requirements, etc. to afford market participants without direct access to CCPs the ability to choose to voluntarily clear through a third-party service provider where desired.

- b) conducting trading and/or hedging activity given the restrictions imposed by their client clearing service providers?

We do not have a comment in response to this question.

11. Do you agree or disagree with the finding that the provision of client clearing services is concentrated in a relatively small number of banks? Does the current level of concentration raise any concerns about incentives to centrally clear, or risks to the continuity of provision of critical economic functions, including during periods of stress?

We agree that the provision of client clearing services is concentrated in a relatively small number of banks. The report states that five firms, all bank-affiliated, account for over 80% of total client margin for cleared OTC derivatives (IRS) in the United States, United Kingdom and Japan, which illustrates

this concentration. However, we think the correct focus should be the total clearing member capacity available to clients, rather than the specific number of individual CCSPs. In this respect we reiterate the points we make in response to Question 8 above regarding the treatment of the risk-reducing nature of segregated margin under the SLR. Aside from having the potential to further reduce the number of CCSPs and thus increase the concentration concerns, the leverage ratio acts as a limiting factor on the provision of overall client clearing capacity.

The capacity risk is something we believe should be borne in mind by regulators when considering whether or not to impose a clearing mandate. Client clearing offerings (including in the FX prime-brokered transactions context) need to be mature and sufficiently widely available/accessible before any FX clearing mandates could be considered. We also note from the consultative report that, for FX, according to the DAT quantitative survey, client clearing services in OTC FX derivatives are offered by only 33% of the largest dealer respondents.

12. Do you agree or disagree with the report's characterisation of the incentive effects created by up-front and ongoing fixed costs of:

- a) using clearing services?
- b) providing client clearing services?

As noted in the consultative report, client clearing service providers play a crucial role in providing access to central clearing. We would encourage further thought to be given to the elements of the cleared market structure, in terms of CCPs' pricing, fee schedules, transparency in margin requirements, etc. It is important for regulators to ensure cleared infrastructure costs are properly calibrated, to enable market participants without direct access to CCPs the ability to weigh the costs and benefits and employ voluntarily clearing through a CCSP where desired.

We also agree the high fixed costs of providing client clearing may in some cases also leave firms disinclined to provide access to clearing for some classes of clients. In this regard, we encourage that thought be given to the proper alignment of capital requirements in respect of clearing derivatives transactions, including the effect of the leverage ratio, versus the risks sought to be mitigated. Further analysis of the economics of client clearing and indirect effects of capital regimes and their application in respect of central clearing of derivatives is, in our view, warranted.

Furthermore, we again reiterate our comment in response to Question 8 above in noting the points made by CFTC Commissioner Quintenz about the treatment of the risk-reducing nature of segregated margin under the SLR. The leverage calculation is based on notional with limited recognition of position offsets. This treatment effectively increases the cost of providing clearing for options with low (absolute) delta values (i.e. those deep out of the money), compared with high (absolute) delta options.¹²

¹² https://www.cftc.gov/sites/default/files/About/Economic%20Analysis/oc_e_leverage_and_options.pdf

13. In light of the finding in this report that economic factors generally incentivize central clearing for certain market participants but perhaps not for others, please describe your views regarding the costs and benefits of the scope of the clearing mandates, both in terms of the products and entities covered.

We agree with the comments made in the ISDA letter in response to this question and believe that the current product scope mandated for clearing is appropriate and also agree with ISDA that the product scope for clearing mandates should be aligned globally, to ensure consistency in understanding and application of the clearing requirements. We also reiterate the points we have made in response to Question 3 above regarding clearing mandates not being suitable incentives for FX.

14. Should regulation seek to create incentives to centrally clear OTC derivatives for all financial firms, including the smallest and least active? If so, what would that imply for the costs of uncleared trades? If not, for which types of firm and product is it most important to have incentives for central clearing? Conversely for which types of firm and product would it be acceptable not to have incentives for central clearing? Please elaborate.

In terms of clearing mandates as ‘incentives’ for FX clearing, see our response to Question 3 above.

We also agree with the comments in the ISDA letter supporting exemptions from clearing for small firms that are not systemically important and that inter-affiliate transactions should not be subject to either clearing mandates or mandatory exchange of IM.

We greatly appreciate the opportunity to share our views on the consultative report. Please do not hesitate to contact Victoria Cumings on +1 212 313 1141, email vcumings@gfma.org, should you wish to discuss our comments above.

Yours sincerely,



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