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<u>TO</u>:

Ms. Karen Kemp, Executive Director, Banking Policy
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<u>Via email</u>:

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3rd June, 2016

Re: Treatment of Securities Conversion Transactions under the Margin and Other Risk Mitigation Standards

Dear Sir/Madam,

Further to our original response to the Consultation Paper on *Non-centrally Cleared OTC Derivative Transactions – Margin and Other Risk Mitigation Standards* (CP 15.02) (the Standards) dated 29th January, 2016, we wish to bring to your attention an industry concern regarding the requirement for variation margin exchange on FX Security Conversion transactions. We describe below our reasons for asking that the HKMA exclude these types of transactions from within scope of the variation margin requirements in the Standards.

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 24 global foreign exchange (FX) market participants,[1] collectively representing more than 90% of the FX inter-dealer market.[2].

Many of our members act as custodian for their customers who are asset managers. Due to increased access to and investor interest in foreign financial markets, growing numbers of these customers are invested in foreign securities. To facilitate the purchase or sale of these foreign securities, these custodians, as part of their service offering, often enter into an FX transaction that is incidental to and for the purpose of effecting their customer's foreign security transaction ("FX Security Conversion transaction"). For example, when a non-US customer wishes to purchase a US dollar-denominated security, its broker-dealer or bank custodian will enter into a corresponding FX transaction so that the customer has US dollars available to meet the cash currency requirements necessary to complete purchase or sale of the security. These FX transactions are, therefore, integral to the settlement of the security.

Typically, the settlement cycle for most non-EUR denominated securities is trade date plus three days (T+3). Accordingly, the bank custodian or broker-dealer would enter into a FX transaction with its customer on a T+3 basis as well. In some securities markets, for example in South Africa, the settlement cycle can take up to seven days (T+7).

In the European Commission's Delegated Act[3] published on 25th April, 2016, an FX spot contract includes "a contract for the exchange of one currency against another currency….where the contract for the exchange of those currencies is used for the main purpose of the sale or purchase of a transferable security or a unit in a collective investment undertaking, [and delivery is scheduled to be made within] the period generally accepted in the market for the settlement of that transferable security or a unit in a collective investment undertaking is the standard delivery period or 5 trading days, whichever is shorter." By being classified as a spot transaction, these FX Security Conversion transactions are not a "financial instrument" for the purposes of, and therefore are outside the scope of, MiFID/MiFIR.

Similarly, in the United States, the CFTC considers transactions for the sale or purchase of an amount of foreign currency to effect the actual delivery of a security by the relevant securities deadline to be a bona fide spot FX transaction, and therefore outside of the definition of a "swap"[4].

However, under the Securities and Futures Ordinance, FX Security Conversion transactions are not included within the definition of a spot FX transaction, and therefore are an OTC derivative[5] covered under the Standards.

With the requirement, under the Standards, to exchange variation margin on physically-settled FX forwards and swaps effective from 31st March, 2017, asset managers, who generally do not trade derivatives, will need to put in place the infrastructure to meet the requirements of the Standards. Whilst the relative value of the

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[1] Bank of America Merrill Lynch, Bank of New York Mellon, Bank of Tokyo Mitsubishi, Barclays Capital, BNP Paribas, Citi, Credit Agricole, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan, Lloyds, Mizuho, Morgan Stanley, Nomura, RBC, RBS, Société Générale, Standard Chartered Bank, State Street, UBS, Wells Fargo and Westpac.

[2] According to Euromoney league tables.

[3] http://ec.europa.eu/transparency/regdoc/rep/3/2016/EN/3-2016-2398-EN-F1-1.PDF

[4] https://www.gpo.gov/fdsys/pkg/FR-2012-08-13/pdf/2012-18003.pdf

[5] http://www.legislation.gov.hk/blis_pdf.nsf/6799165D2FEE3FA94825755E0033E532/5167961DDC96C3B7482575EF001C7C2D/$FILE/CAP_571_e_b5.pdf

variation margin required to be exchanged as a result of entering into FX Security Conversion transactions will be small, there will be significant operational and infrastructural overheads that will need to be addressed.

For example, bank custodians and broker dealers will need to put in place ISDA Master Agreements and credit support annexes (Master Agreements) with asset managers that they have not previously exchanged collateral with on a voluntary basis. This would be a significant overhead for these market participants as each agreement would have to be negotiated for each underlying customer rather than at the asset manager level. Historically, the take-up in the use of Master Agreements has been very low across Asia and their initial negotiation can take several months and may require the involvement of external legal counsel. For banks, this would place an additional burden on existing resources that are already under pressure to document relationships with Asian domiciled customers that trade OTC derivatives in advance of the relevant compliance dates.

In addition, because not all asset managers have previously exchanged collateral on a voluntary basis, there will be additional operational overheads for this group of customers that are not required to exchange collateral under the margin regimes of other jurisdictions. Given FX Security Conversion transactions are short dated in nature and attract a very low level of risk, the benefit of variation margin exchange does not outweigh the cost.

For the reasons highlighted above, the fact that the regulatory authorities in both the United States and Europe have defined these FX Security Conversions transactions as spot transactions and those in the US, Japan, Singapore and Canada have excluded physically settled FX forwards and swaps from both initial and variation margin requirements, it is unlikely that the custodian banks would be willing to continue executing FX Security Conversion transactions with HKMA regulated entities resulting in unhedged FX risks for the asset managers.

Finally, in the joint HKMA/SFC *Consultation conclusions and further consultation on introducing mandatory clearing and expanding mandatory reporting*[6] issued in February 2016, the HKMA recognised that the inclusion of FX Security Conversion transactions under mandatory reporting would be of minimal value. Consequently, FX Security Conversion transactions with a T+7 day cap on the settlement period were excluded from mandatory reporting.

In light of the above, we urge the HKMA to exclude physically-settled FX forwards and swaps from the scope of the variation margin provisions in the Standards.

More broadly, we repeat the comments we made in our January 29th letter with respect to the HKMA's treatment of variation margin for physically settled FX products. As indicated in the March 2015 Margin requirements for non-centrally cleared derivatives by the Basel Committee on Banking Supervision and International Organization of Securities Commissions (the International Margin Framework)[7], these products merit certain exclusions from the scope of the margin requirements due to their unique characteristics.

The International Margin Framework excepts physically-settled FX forwards and swaps from its margin requirements entirely, although stating that standards apply for variation margin for physically-settled FX

[6] http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=15CP4

[7] http://www.bis.org/bcbs/publ/d317.htm

forwards and swaps[8] and citing the 2013 BCBS Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions (BCBS FX Supervisory Guidance, see Guideline 3 – Replacement cost risk)[9].

The HKMA's application of the variation margin requirements to physically-settled FX forwards and swaps contrasts with the treatment of these deliverable FX products in the US, Japan, Singapore and Canada. Physically-settled FX forwards and swaps are excluded from both initial and variation margin requirements under the final US Prudential Regulators' Rules, US CFTC Rules, the Canadian and Japanese rules. The recent Draft Guidelines on Margin Requirements in Singapore also exclude physically-settled FX forwards and swaps from both initial margin and variation margin requirements.

An important element of the International Margin Framework is the goal of promoting global consistency and reducing regulatory arbitrage opportunities with respect to the treatment of physically-settled FX forwards and swaps. If jurisdictions were to differ in their approach to physically-settled FX forwards and swaps, we would have significant concerns about potential impacts on pricing and liquidity.

In the event that the HKMA elects to continue to include physically –settled FX forwards and swaps within the scope of the Standards' variation margin provisions, we would recommend that, as a minimum, FX Security Conversion transactions are treated as spot transactions and are excluded from the variation margin obligations to ensure the continued prudent hedging of FX risk on foreign asset sales and purchases and to achieve global consistency in the treatment of these transactions.

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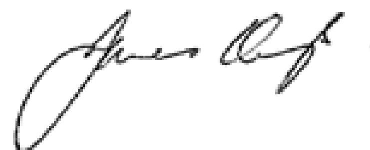
Please do not hesitate to contact John Ball on +852 2531 6512, email jball@gfma.org should you wish to discuss any of the above.

Yours faithfully,



James Kemp
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[8] http://www.bis.org/bcbs/publ/d317.htm (see p.7)

[9] http://www.bis.org/publ/bcbs241.pdf