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30 November 2011

Re: Consultation paper on the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong

The Global Foreign Exchange Division (GFXD) welcomes the opportunity to comment on behalf of its members on the HKMA and SFC's consultation on the proposed regulatory regime for 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). Its members comprise 22 global FX market participants[1], collectively representing more than 90% of the FX market[2]. Both the GFXD and its members are committed to ensuring a robust, open and fair market place and welcome the opportunity for continued dialogue with Hong Kong 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.

[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, Morgan Stanley, Nomura, RBC, RBS, Société Générale, Standard Chartered Bank, State St., UBS, and Westpac

[2] According to Euromoney league tables

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 is committed to ensuring a robust, open and fair market place and welcomes the opportunity to set out its views in response to your consultation document.

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1. The Broad Framework

Q1. Do you have any comments on the proposed scope of the regulatory regime for the OTC derivatives market in Hong Kong and how it is proposed to be set out?

1.1. Spot trades

In defining 'OTC Derivatives Transactions' we would welcome clarification that spot trades are excluded from this definition. Accordingly and consistent with common market definitions, practice and understanding, transactions with value dates less than or equal to T+2 business days should therefore be excluded.

FX trades also act as supporting trades for security settlements, which may occur on a greater than T+2 basis. Such supporting transactions, up to the standard security settlement maturity in the relevant currency and market, which may be up to T+5, should be excluded from the scope of the rules.

1.2. Inter-affiliate / intra-group trades

We believe that trades that settle with affiliated third parties (intra-group transactions) should be out of scope of the regulation.

Inter-affiliate trades represent allocation of risk within a corporate group and do not give rise to the same systemic risk issues that are raised by trades by one corporate group with another. Many millions of trades occur daily between different affiliates of the same institution which are not relevant to that institution's external market positioning. They are a common feature of international financial markets and enable clients to deal with local entities whilst providing those firms with the ability to manage risk in a consolidated way. Regulators are able to consider a firm's consolidated risk position, the need for which is acknowledged in the consultation paper.

Unlike other asset classes, the FX market is characterised by a high number of both trades and participants. A clearing requirement for intra-group transactions would increase operational risk because of the amount of transactions that would be required to be cleared, without materially enhancing counterparty risk management. Similarly, a reporting requirement would significantly increase ticket volumes at any trade repository significantly without increasing transparency and without giving meaningful indications about the overall FX market or the overall exposure of the relevant corporate group.

1.3. Extra-territoriality

The extra-territorial reach of the proposed regulation appears to be overly broad. In committing to further regulatory oversight of the international financial markets, the G20 also undertook to 'take action at the national and international level to raise standards together so that our national authorities implement global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage.'

Extra-territorial application of one nation's laws to another nation's markets and firms is a fundamental concern in a global market such as foreign exchange, where it is common for counterparties based in different parts of the world to transact with each other, often in currencies independent of their jurisdiction of incorporation.

Serious concerns surrounding extra-territoriality have been raised regarding the Dodd Frank Act and equivalent European legislation, resulting in ambiguity, challenges and issues of legal uncertainty and misunderstanding which might give rise to material risk. These would only be compounded by further ambiguity and potential conflict regarding the territorial aspects of the Hong Kong legislation. Appropriately addressing systematic risk globally cannot be met without international coordination on market infrastructure, regulatory transparency and counterparty credit risk. We urge HKMA and SFC to work closely with other international regulators to ensure a consistent regime.

The HKMA and SFC are considering imposing mandatory reporting and clearing obligations that extend not only to transactions with Hong Kong counterparties (including transactions entered into by overseas-incorporated authorised institutions ("AIs") through the Hong Kong branch) but also transactions between two overseas entities which are "originated or executed" by regulated entities in Hong Kong or which have a Hong Kong nexus. We believe the extent of these obligations is too broad.

1.3.1.Reporting requirements

The requirement for overseas incorporated AIs to report transactions which they are counterparty to and which are denominated in Hong Kong dollars is likely to lead to duplicative reporting requirements. The rules should only apply to transactions booked by a Hong Kong counterparty and should not apply extra-territorially simply because the underlying currency is Hong Kong dollars. Rather than imposing dual-reporting requirements on participants, we believe this would be better addressed through regulatory cooperation (e.g. as under the ODRF) and highlights the importance of standardising a global data set.

1.3.2.Clearing requirements

We believe the requirement for overseas AIs to clear foreign exchange if the trades were executed or originated (including confirmed) in Hong Kong is excessive. Originating or executing trades in one location, including Hong Kong, and booking the trades offshore is a common practice among the global dealers. If the trades are not booked with its Hong Kong branch, the counterparty credit risk would not reside in Hong

Kong and therefore the proposed clearing requirement would not serve the purpose of mitigating systemic risk in the Hong Kong OTC derivatives market.

Whether the proposed exemption in paragraph 110(2) is adequate to alleviate this concern will depend on which jurisdictions the HKMA and SFC determine to be "acceptable overseas jurisdictions". In the case of a trade between overseas AIs in the United States or Europe, the trade would almost certainly be subject to the clearing requirements or exemptions of Dodd-Frank and EMIR, respectively. We assume that the exemptions in paragraph 110 (2) are intended to recognize the laws of such jurisdictions.

For purposes of determining whether a locally incorporated AI (i) has exceeded the specified clearing threshold or (ii) must ensure clearing eligible trades entered into by its subsidiaries are centrally cleared through a designated CCP (i.e., in Hong Kong), the proposed regulations state that the HKMA may require the AI to comply with the mandatory clearing obligation on an entity level or on a consolidated group basis.

It is important that the factors to be considered by the HKMA in making this determination be transparent. Moreover, the HKMA should not have the discretion to selectively choose which subsidiaries to include, i.e., either all or none of the locally incorporated AI's subsidiaries should be taken into consideration for these purposes. The same issue is relevant for reporting purposes and again, we would note that obligations for subsidiaries to report may result in duplicative requirements.

1.4. Confidentiality

A number of jurisdictions place restrictions on the counterparty details that may be reported to a trade repository. Reporting participants may therefore face legal conflicts arising from local data protection and client confidentiality laws. Whilst obtaining client consent may mitigate these risks, there are likely to be cases where such consent is unable to be obtained or certain jurisdictions that impose additional restrictions on disclosure of counterparty details to foreign trade repositories.

We believe the appropriate course is for relevant laws to be changed to allow disclosure of such details in specific circumstances to support data gathering by repositories. This provision is present in European legislation and work is being undertaken by the industry through ISDA to identify those jurisdictions where conflicts may arise. Until such time as reporting abilities are harmonised we urge the HKMA and SFC to recognise the conflicts and exempt reporting where local confidentiality laws prohibit such reporting. In the meantime, data may need to be submitted by masking certain trade details such as client names. Even in doing this, submitting firms may face legal and reputational risks.

Q2. Do you have any comments on the proposed division of regulatory responsibility between the HKMA and SFC?

No comment.

2. Mandatory obligations and products to be covered

Q3. Do you have any comments on the proposal to take a phased approach to extending any mandatory reporting and clearing obligations?

An orderly and efficient transition of the OTC derivatives market to the new market structure and regulatory regime required by financial reform in Hong Kong and other jurisdictions is critical. We agree that a phased approach to extending any of the mandatory obligations is sensible to limit implementation risks. In terms of sequencing, we believe the regulators should focus, and therefore prioritize, efforts on mandatory reporting. Once data begins to be compiled for FX, the HKMA and SFC will be well-positioned to determine which NDF trades should be subject to mandatory clearing obligations.

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 considered individually by the HKMA and SFC. 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. Notwithstanding that, we urge the HKMA and SFC to require specific information from designated CCPs for each FX NDF (reference) currency on (i) the end-to-end testing conducted with its clearing members and, (ii) the scenario analyses / stress testing performed by the CCP.

We also suggest that phasing should occur by sub-categories of market participant. Hence the initial phase should focus on major / systemically important AIs and LCs, with subsequent phases dealing with other financial institutions and corporates (if not subject to an exemption).

Q4. Do you have any comments on the proposal to initially limit the scope of any mandatory reporting and clearing obligations so that they apply in respect of certain IRS and NDF?

2.1. Product scope

We strongly support the proposal to limit the scope of mandatory obligations to FX non deliverable forwards (NDFs) and welcome the view expressed in paragraph 54 that HKMA "does not propose to mandate either the reporting or central clearing of foreign exchange derivatives (other than NDFs) at this stage but we will keep in view international developments in this area".

We agree that the vast majority of FX transactions represent simple exchanges of currency with no contingent liabilities and short maturities. The BIS 2010 report on global foreign exchange market activity sets out the following maturities for daily traded volumes for Honk Kong:

% share of trades	**<= 7 days**	**> 7 days and <= 1year**	**> 1 year**
Outright forwards	33	62	5
Swaps	78	21	1

Furthermore, outright forwards and swaps comprise, according to the BIS, USD 179bn USD of USD 187bn (c. 96%) of all non-spot foreign exchange activity with the remaining 4% representing options.

The addressing of the key risk – settlement risk – through CLS mitigates by far the majority of the risk present in an FX trade. Extending the scope of regulation (particularly as regards clearing) to include these trades would be a disproportionate. We have expressed this position to other international regulators and the different characteristics of the FX asset class and its products has been acknowledged in both legislation and consultation in a number of international jurisdictions including the US, Europe and Australia. In particular, the US Treasury has issued a proposed determination to exclude FX forwards and swaps from the mandatory clearing and execution obligations under Dodd Frank. We include in the appendix some further background on our rationale for viewing FX products differently but would be happy to discuss this in more detail.

Should HKMA consider extending the scope of the obligations to other FX products we believe this should be done following a full consultation process. This is particularly the case in light of the CPSS IOSCO's recently issued proposed Principles for Financial Market Infrastructures. The proposed principles raise the prospect of combined clearing and settlement resulting from the requirement for CCPs to guarantee full and final settlement on timely basis, i.e., potentially same day for a market such as foreign exchange. This would place significant liquidity requirements on a CCP to meet the full exchange of principal for foreign exchange trades – a problem for which there has been no satisfactory solution as yet.

2.2. Participant scope

It is our view that regulators should focus on the systemic risk arising from a participant's use of instruments. Where an end-user does not pose a material risk, it would be proportionate to exempt that end-user from mandatory clearing and capital, margin and / or collateral requirements. In cash flow terms, an exemption from mandatory clearing will only be beneficial where end-users are also exempt from mandatory collateralisation.

Affordable access to appropriate methods of hedging is vital to end-users to mitigate risks. We therefore support an approach that exempts certain classes of participants from any clearing and margin requirements, as the increased collateral and operational requirements would be too burdensome and the reduction in systemic risk is insufficient to justify the imposition of these costs. OTC positions which are hedges of business risk should be exempt from any central clearing or margin obligations. These requirements would affect end-users' ability to use derivatives for risk management purposes as many of these firms, especially non-financial end-users, need their most liquid assets for working capital and investment purposes.

Dealers facing end-users that do not pose a threat to financial stability should be permitted to evaluate and underwrite the credit risk of such end-users and negotiate bilateral collateral or credit support arrangements as they deem necessary.

These issues are particularly pertinent for the FX market, which differs from the OTC derivative markets in that it has many more participants and transactions that will be affected. The impact of clearing and margin / collateral requirements will therefore be felt widely.

3. Proposed mandatory reporting obligation

Q5. Do you have any comments on the proposed mandatory reporting obligation, and how it will apply to different persons?

3.1. Overview and current FX industry initiatives

The GFXD welcomes the goals of enhancing regulatory oversight and promoting greater transparency. Alongside HKMA's work to set up a trade repository, the GFXD is working with its members to implement a central trade repository for the FX industry that aims, to the greatest extent possible, to meet global regulatory needs. We welcome the dialogue that has been established with the HKMA to date to discuss how a centralised FX trade repository and the HKMA-TR could interoperate in order to streamline industry reporting. A particularly important element of this will be synchronising implementation timelines to enable reporting through the FX trade repository as an agent and we would welcome further dialogue in this regard.

GFXD members recently announced their recommendation to partner with DTCC and SWIFT to develop a global foreign exchange trade repository. This selection was the result of an open and transparent Request for Information (RFI) and Request for Proposal (RFP) process that began back in December 2010, with the RFP issued in April 2011.

The project has been running since August 2011 and has recently signed off the business requirements for phase 1. Work is now commencing on phase 2 requirements. This work has covered key areas such as technology, connectivity, messaging, data formats and regulatory permissioning and access, amongst other areas. However, we are conscious that this must be developed in the context of HKMA (and other regulators') objectives. The project's indicative deliverables are as follows:

- Phase 1: Mid 2012 – End of day snapshot reporting for all non-spot trades. Focus on GFXD dealers to deliver substantive proportion of the market for regulatory oversight.
- Phase 2: Beyond mid-2012 – Extended functionality for the repository (intra-day reporting, extended reporting fields). Move to full Dodd-Frank compliance. Connectivity to HKMA trade repository. Potential phasing in of other market participants
- Phase 3: Programme to meet needs of other global regulators (may be included in phasing above subject to when requirements come online)

The selection of a preferred partner for trade repository services arises from the general preference of the industry for the use of global trade repositories, rather than multiple, fragmented local repositories. This is because they provide comprehensive oversight and enhance efficiency of data capture for both regulators and market participants alike (see appendix B). This is particularly the case for the FX market which is characterised by vastly higher number of transactions and participants when compared to other asset classes given its position as the basis of the global payments system.

However, any global trade repository must meet the needs of the multiple regulators that it serves. In order to do that, the GFXD and its members support the efforts being made across international forums to standardise both data formats and reporting requirements. The current implementation status of global regulation does mean that final requirements have not yet been set and so any moves to implement trade repositories should be done so with flexibility in mind. It is important to stress that the development of the FX trade repository is being done so with global regulatory reporting in mind and not simply with a focus on the US's Dodd-Frank rules. This extends to reviewing the options for the legal entity structure to address any indemnity requirements, building data centres in location-neutral venues and submitting the FX trade repository for regulation in multiple jurisdictions.

Whilst the industry would prefer global data repositories to be implemented for the reasons set out above, the GFXD understands that HKMA has made significant progress in developing its own trade repository. We welcome the open and proactive approach taken by the HKMA to discuss how the HKMA-TR will work in the context of the existing FX market infrastructure and the proposed global FX trade repository.

3.2. Reporting through an agent

The consultation paper acknowledges that reporting to the HKMA-TR may be done directly or through an agent. There are various scenarios that would make this beneficial. Non financial intermediaries executing a low-volume of trades (depending on where the relevant thresholds are set), for instance, may not have, or desire to build, the necessary infrastructure to fulfil the reporting requirements. Such participants may find the build-out costs to be prohibitive, or will prefer to avoid them. This will be particularly prevalent given the number of market participants in FX.

We strongly agree that trade reporting through an agent should be permitted. Trade confirmation and matching vendors etc could all be potential providers of information to a trade repository. More importantly, we agree with previous proposals made by the HKMA that institutions may delegate reporting to a third party global trade repository. Ideally, the HKTR would allow a two-way feed with a global trade repository in order to ensure that any locally fed trades could be combined with a global data set, which the HK regulators would have access to.

3.3. Ownership of trade data

We would welcome confirmation as to the ownership status of information submitted to the HKNA-TR and assume that it is intended that reporting parties retain ownership of any data submitted. We also assume that any information submitted to the HKTR will be used solely for regulatory oversight purposes and not used or onward licensed or sold for any commercial purpose.

3.4. Overseas AIs

From a data collection perspective, the requirement to report trades that AIs are counterparty to, originated or executed the transaction through their Hong Kong branch will most likely require some AIs to record additional trade data fields to establish those transactions which are reportable. These fields will need to be incorporated into the global FX trade repository.

3.5. Public reporting of data

It is not clear from the paper whether trade data is intended to be made available for public dissemination. Any public reporting of data should be done so in a manner which protects the confidentiality of market participants, market liquidity and ability to lay off risk.

Certain jurisdictions have proposed addressing this through reporting delays or exemptions. Exemptions and delays should be tailored not just to asset classes but to categories of types of swaps within those asset classes. A one-size-fits-all approach is almost certain to be inappropriate given the different levels of liquidity in different markets. For FX, dynamic reporting periods and block sizes based on liquidity factors and taking into account size to average notional in the market is clearly appropriate when considering different types of transaction and the full range of currency pairs. The key determining factors would need to be reviewed more fully but for FX could cover the following: Currency pair, product; size and tenor; time of day / year; and strike price.

Determining the appropriate exemptions for such trades is critical to preserving liquidity for end-users. Sub-optimal disclosure may hinder a market maker's ability to hedge, impacting liquidity or increasing end-user costs to compensate for increased risk. It cannot be stressed enough how some corners of the FX market have very low liquidity and the adverse impact immediate public reporting would have on dealers' abilities to make reliable markets for end-users.

Q6. Do you have any comments on the proposal to adopt a specified reporting threshold for persons other than AIs and LCs, and how the threshold will apply?

We agree with the requirement to set a threshold for non-AIs and LCs to reduce the reporting burden. We assume that the threshold will be set based on gross notional trades executed (rather than net). Furthermore, for the purposes of calculating the threshold (both for reporting and clearing purposes) we would welcome clarification as to whether NDFs will be treated as a separate asset class to FX derivatives. In any event, the thresholds to apply should be unambiguous.

Q7. Do you have any comments on the proposed grace periods and how they will apply?

We agree with the proposal to provide grace periods for reporting. However, we would ask that in order to allow parties to be able to report through an agent (in this case the global FX trade repository) that effort be taken to synchronise the reference dates to allow backloading and reporting across both repositories.

Q8. Do you have any comments on the proposed mandatory clearing obligation, and how it will apply to different persons?

As noted above, we believe the requirement for overseas AIs to clear foreign exchange if the trades were executed or originated (including confirmed) in Hong Kong is excessive and does not serve the purpose of mitigating systemic risk in the Hong Kong OTC derivatives market. The usefulness of the exemptions cannot be determined until it is known which jurisdictions will qualify as "acceptable overseas jurisdictions" to the HKMA and SFC. In addition, the factors to be considered by the HKMA in determining whether to require a locally incorporated AI to comply with the mandatory clearing obligations on an entity level of consolidated group basis should be transparent and subsidiaries should be considered on an all-or-nothing basis.

Q9. Do you have any comments on the proposal to adopt a specified clearing threshold, and how the threshold will apply?

No comment.

Q10. Do you have any comments on the proposed grace periods and how they will apply?

As noted above, we suggested that the HKMA and SFC require specific information from designated CCPs for each FX NDF (reference) currency on (i) the end-to-end testing conducted with its clearing members and, (ii) the scenario analyses / stress testing performed by the CCP, before subjecting the product to mandatory clearing.

In determining an appropriate timeframe for applying any mandatory clearing obligation, the HKMA and SFC should also consider how to minimise the operational risks involved in moving to cleared markets. We believe that a designated CCP must develop a track record of safe and sound clearing processes for any given swap, group, category, type or class of swaps during the voluntary clearing phase before clearing is made mandatory. Each currency requires substantial development and end-to-end testing with a CCP's clearing firms and, thereafter, sufficient experience with market participants with respect to each individual currency pair must be gained during a voluntary clearing phase to identify and address any operational issues. Market participants will also be required to set up new cleared currencies in their internal risk management processes and must be given sufficient time between a CCP formally launching a new currency pair and a mandatory clearing obligation.

Q11. Do you have any comments on the proposal not to impose a mandatory trading obligation at the outset?

We agree with HKMA and SFC's approach to mandatory trading and their desire to review liquidity and trading venues. Mandatory trading on exchanges or other trading facilities is not a necessary condition for financial stability and could have a negative impact, for example, in reducing liquidity in the market where the mandatory trading rules apply.

The FX market has been at the forefront of electronic trading, developing a range of execution methods including multi-dealer and single dealer platforms. As an OTC marketplace, these venues take into account the specific nature of the end client, size of order and credit worthiness. The choice of venue for trading in OTC markets should be driven by both the type of contract and type of customer. Any requirements governing market structures and trading venues, to the extent that they are applicable, should preserve the flexibility that exists to trade across existing execution venues.

Mandatory trading obligations, depending on how they are applied, can restrict the ability of end-users to enter into hedging arrangements by forcing economic standardisation of products to fit e.g. an exchange-traded model. We are strongly against this since the main use of the OTC FX market is to allow users to hedge specific future exposures in a tailored manner. Many jurisdictions are mandating that clearing eligible products (that are standardised) should be subject to mandatory trading requirements. One of the key criteria for admitting such trades is the existence of ‘sufficient liquidity’. This assessment, the paper notes, is important and should be carried out on an instrument by instrument basis.

We assume that any proposals regarding mandatory trading would be subject to a full consultation process.

Q12. Do you have any comments on any aspect of our proposals for the designation and regulation of CCPs?

Q13. Do you have any comments on the proposed regulation of intermediaries in the OTC derivatives market?

Q14. Do you have any comments on the proposed regulatory oversight of large players?

We have no further comment to make on the above.

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We appreciate the opportunity to share our views on the HKMA and SFC’s consultation paper. 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.

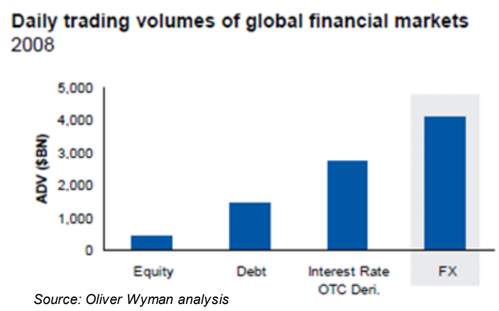
Yours sincerely,

James Kemp

Managing Director

Global Foreign Exchange Division

Appendix A

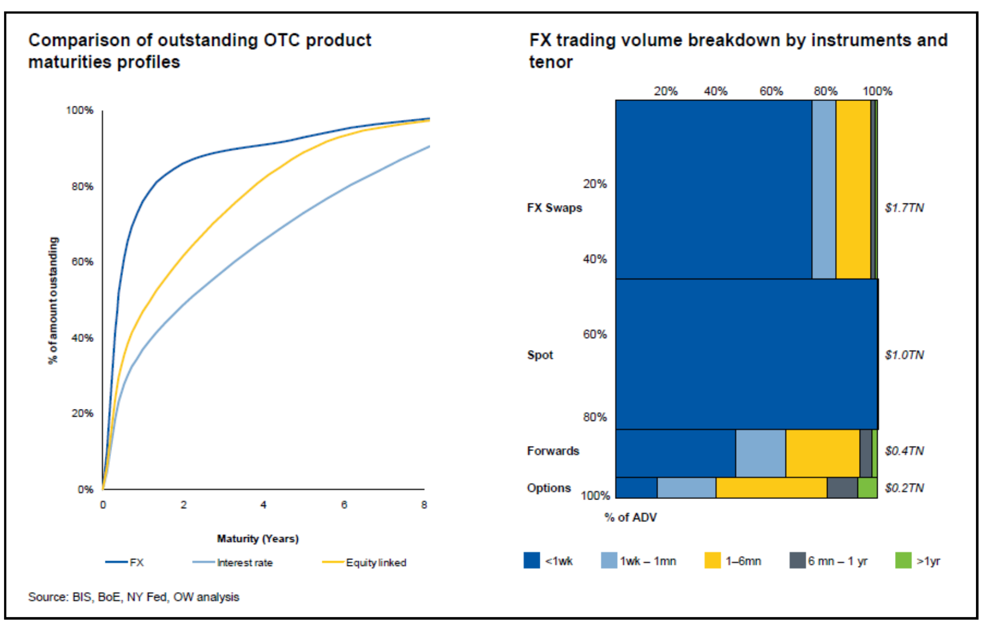


The FX market is the world's largest and most liquid financial market. It forms the basis for international trade and supports the functioning of the global payments system. Its importance in effecting monetary policy has been long established and as such has historically been subject to central bank oversight.

FX has many more participants and transactions than other asset classes. Notwithstanding this, the vast majority of transactions are simple, comprising spot, forward or swap transactions. Forwards are simply an agreement to exchange principle at a pre-determined rate, whilst swaps are simply a combination of i) a spot and a forward or ii) a forward and a forward. Crucially, there are no contingent outcomes for these types of transactions; cash flows are known at the outset. BIS data shows that these products accounted for 95% of 2010 daily traded volumes.

Instrument	**1998**	**%**	**2001**	**%**	**2004**	**%**	**2007**	**%**	**2010**	**%**
Spot	568	*37%*	386	*31%*	631	*33%*	1,005	*31%*	1,490	*38%*
Outright forwards	128	*8%*	130	*11%*	209	*11%*	362	*11%*	475	*12%*
Swaps	734	*48%*	656	*53%*	954	*50%*	1,714	*52%*	1,765	*45%*
Options and other	87	*6%*	60	*5%*	119	*6%*	212	*6%*	207	*5%*
Total	**1,517**	***100%***	**1,232**	***100%***	**1,913**	***100%***	**3,293**	***100%***	**3,938**	***100%***

Additionally, the vast majority of FX transactions are short term. The chart that follows on the left contrasts the short maturity profile of outstanding FX instruments with those of interest rate and equity derivatives. The 16% of outstanding FX contracts with maturities longer than 2 years contrasts with more than 55% of interest rate derivatives and 40% of equity derivatives with maturities longer than two years. Of daily traded volume in 2007, more than 98% of FX forwards and 99% of FX swaps were of maturities of less than a year, as illustrated in the chart that follows on the right.



To put this in local context, the BIS report sets out the following statistics for foreign exchange market activity for Honk Kong:

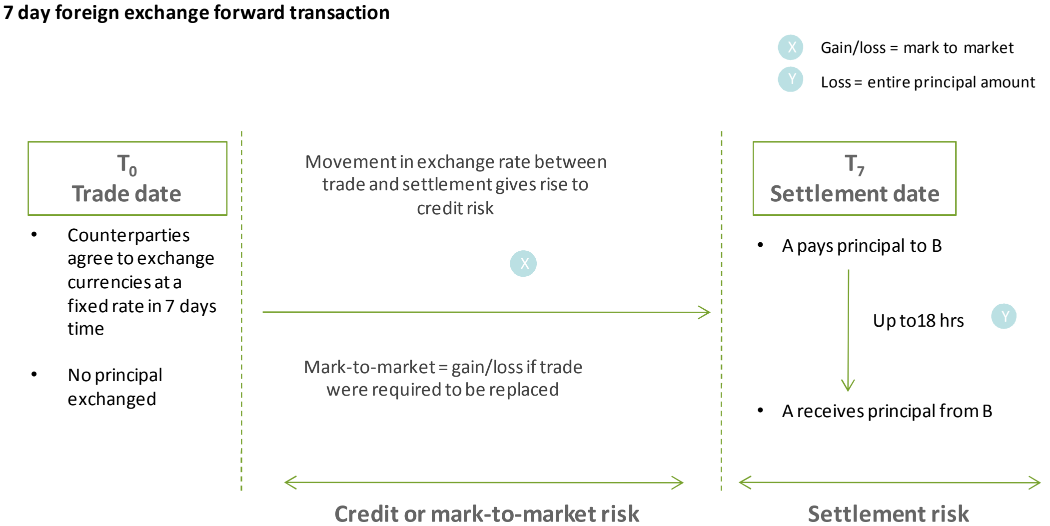
% share of trades	<= 7 days	> 7 days and <= 1year	> 1 year
Outright forwards	33	62	5
Swaps	78	21	1

Outright forwards and swaps comprise, according to the BIS, USD 179bn USD of USD 187bn (c. 96%) of all non-spot foreign exchange activity with the remaining 4% representing options.

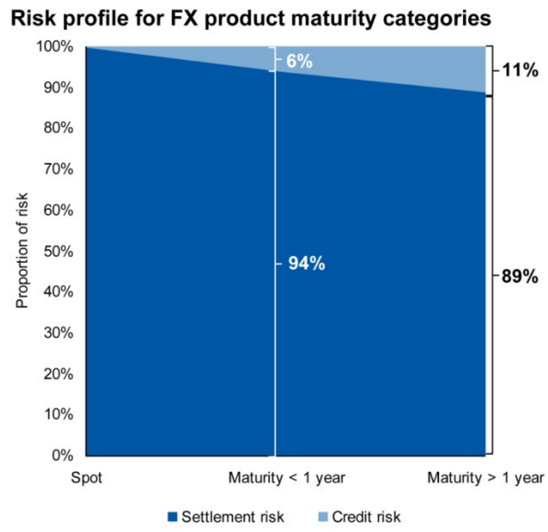
Settlement risk is the key risk in foreign exchange transactions

FX transactions typically involve exchange of principal. These settlement exposures represent the key risk in a transaction. Because of their size, settlement risk loss may be sufficient to trigger insolvency, with knock on effects to other counterparties (commonly referred to as Herstatt Risk).

7 day foreign exchange forward transaction



The graph below, based on an Oliver Wyman study, illustrates that settlement risk comprises 94% of the estimated maximum loss exposure in a trade for foreign exchange instruments with maturity of 6 months. This reduces to 89% for instruments with a maturity of 2 years.



Settlement/Counterparty risk modelling

- Risk measures are neutral to the probability of default
- Credit risk
  - Expressed as a percentage of counterparty replace risk, namely the notional lost upon defaulting counterparty due to market exposure
  - Market risk modelled as average price fluctuations for basket of currencies over a specific time period
  - Basket currency pairs include:
    - USDEUR,
    - USDJPY
    - USDGBP
    - EURJPY
  - Time periods
    - Maturity < 1 year: 6 months period
    - Maturity > 1 year: 2 years period
  - Using 10 years of currency pricing history starting January 2000 until March 2010
- Settlement risk
  - Modelled to be 100% of notional in case of defaulting counterparty and absence of CLS mechanism

Settlement risk is adequately addressed through CLS

CLS Bank was created in 1997 as a global settlement bank to address the concerns surrounding the systemic impact of potential settlement risk failures. By operating a payment versus payment model, whereby payments are process simultaneously, it eliminates virtually all settlement risk to its participants. CLS Bank settles almost 90% of all inter-dealer FX trades and has had no settlement failures since it was created. CLS is regulated directly by the Federal Reserve with the active support of all major central banks (including HKMA). Efforts to extend the reach of CLS Bank are under way, with broad support from both FX dealers and central banks around the globe.

CCPs address mark-to-market credit risk. This is relatively small for FX transactions because of their short maturities.

Mark to market risk is the main residual counterparty credit risk not addressed by CLS. Since most foreign exchange contracts have short maturities, the foreign exchange rate is unlikely to change significantly between the inception and maturity of most foreign exchange contracts. As a result, the in-the-money portion of the trade tends to be small relative to the principal value. Accordingly, the potential loss on foreign exchange transactions consists overwhelmingly of settlement risk.

To put this into context, for FX trades with a maturity of less than one year, Oliver Wyman analysis approximates that only 6% of the maximum risk of loss is mark-to-market credit risk. This rises to only 11% for instruments with a maturity of 2 years.

Because of their short duration, these transactions 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, which is the risk that CCPs are primarily designed to address.

Mark to market credit risk is addressed through the widespread use of CSAs. These are particularly effective because of high price transparency and deep liquidity.

Credit support annexes ("CSAs") are heavily used in the FX market and are a particularly effective risk mitigation tool for addressing mark-to-market credit risk.

The deep liquidity and high price transparency of the market allows for a high level of confidence that initial margin levels will cover losses in these markets. Because the FX market is a highly liquid market in which prices are widely available 24 hours a day, market participants can also reliably determine the net amount of their exposure and therefore the appropriate amount of mark-to-market collateral.

Upon a default, the liquidity in the FX market means that the non-defaulting party can generally replace a transaction quickly and easily. Due to these characteristics of the FX market, existing bilateral agreements have been successful in mitigating counterparty credit risk exposures following the default of large FX counterparties, such as Lehman Brothers in 2008.[3]

The only portion of the foreign exchange market where trades are generally unsecured is where transactions are effected with corporates. Corporates use FX transactions to hedge business risks and do not generally have excess capital to use for CCP margining purposes. Aside from the issue of whether certain classes of FX are exempt from any clearing obligation, we assume that corporate would be subject to some sort of non-financial counterparty exemption, in line with other international proposals. Mandatory clearing would therefore not result in mandatory clearing for the portion of the market that is most often unsecured.

The remaining mark-to-market credit risk that would be addressed by a CCP is therefore minimal

A CCP for FX would deliver almost no incremental credit risk mitigation because most of that risk has been covered by CSAs. The Global FX Division has undertaken indicative analysis of dealers accounting for approximately 66% of the market (by reference to Euromoney league tables). This analysis indicates that approximately 85% or more of mark-to-market exposure in 2010 relates to counterparties (excluding corporates) for which CSAs have been put in place.

Applying the Oliver Wyman analysis that 6 month instruments have potential mark to market risk of 6%, we estimate the total remaining uncovered risk to be only 0.9%. On the same basis for FX transactions with maturities greater than a year, where 11% of the potential loss is mark-to-market credit risk[4], we estimate the total remaining uncovered risk to be less than 1.7%.

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[3] Bank of England Foreign Exchange Joint Standing Committee. FXJSC Paper on the Foreign Exchange Market. September 2009. p. 2. ("**FXJSC**")

[4] These calculations assume that all trades under 1 year have the MTM credit risk vs. settlement risk breakdown of a 6 mo. trade, and that all trades over 1 year have the breakdown of a 2 yr trade (based on Oliver Wyman analysis). In reality, the MTM credit risk number is probably even lower, since 68% of FX forwards and swaps have a maturity of less than 1 week.

FX Market volume profile and Uncovered Credit Exposure (forwards & swaps)

	< 1yr Tenor	> 1 yr Tenor
Risk Profile:		
Credit / Counterparty Risk	6.00%	11.00%
Settlement Exposure %	94.00%	89.00%
CSA Usage @ 85%	5.10%	9.35%
Uncovered Credit Exposure	0.90%	1.65%

Introducing a CCP to address mark to market credit risk would be disproportionate, increase operational risk and potentially systemic risk, and undermine the effectiveness of existing efforts further to address settlement risk.

Settlement of FX transactions involves extensive interconnectedness across payment and foreign exchange systems. This is illustrated by the relationships that CLS has with central banks to facilitate the funding process that supports payment-vs-payment settlement.[5]

A central clearing regime would be either global or accomplished through a network of local CCPs. A global CCP for a market the size of the FX market would pose significant systemic risk. Local CCPs would fragment the market and reduce liquidity through the dispersal of trades, positions and collateral across many jurisdictions.

The charts below illustrate the increased operational complexity and interdependencies that one or more CCPs would likely introduce into the FX market. Given the importance of foreign exchange to the global payments system, any CCP would require the same operational infrastructure, robustness and oversight currently afforded to CLS Bank.

A CCP would also introduce concentration risk, creating a potential single point of failure where none exists today, simply to address limited residual credit risk exposure. CCPs can and have failed – largely as a result of financial distress arising as a result of unmet margin calls. Because the FX market is an integral part of the global payments system, the failure of an FX CCP would likely be significant, with destabilizing effects on foreign exchange and the global economy as a whole.

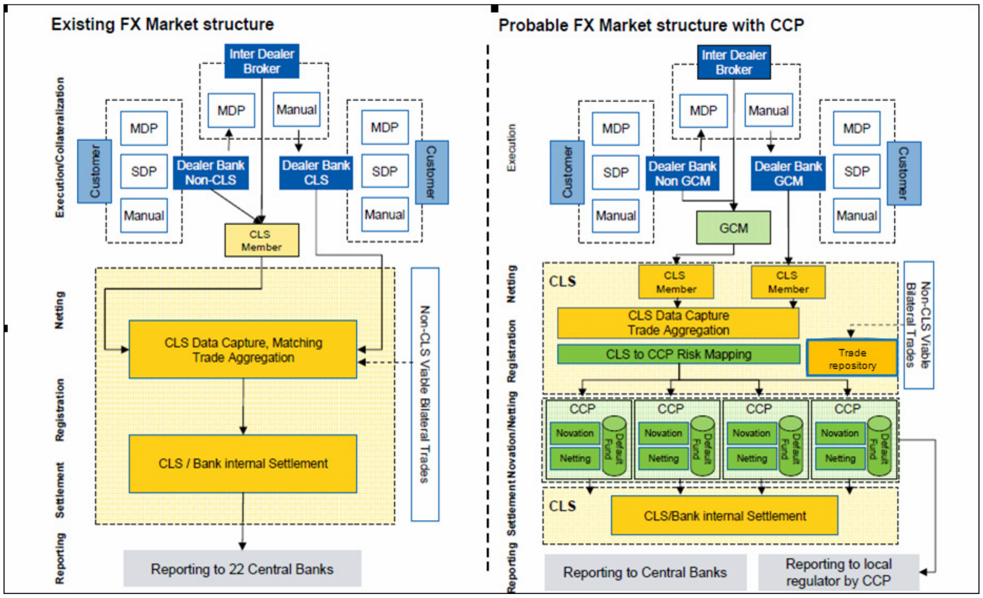
Introducing CCP clearing also risks undermining the significant gains that have been made in addressing settlement risk. Efforts to introduce a CCP model could either distract from current

[5] In its 2008 review of the interdependencies of payment and settlement systems, the CPSS concluded:

"Over the past 30 years, technological innovations, globalisation and financial sector consolidation have fostered a broad web of interconnections among a large number of payment and settlement systems, both within and across CPSS countries. These interconnections reflect efforts on the part of systems and institutions to seek new business opportunities and to reduce clearing and settlement costs. They also reflect efforts by central banks and the financial industry to promote the low-cost and safe transfer of money and financial instruments. The focus of the CPSS on reducing foreign exchange settlement risk and the work of the G30 to reduce risk in securities settlement systems, for example, have both led to tighter, more integrated settlement processes."

"The development of tighter interdependencies has helped to strengthen the global payment and settlement infrastructure by reducing several sources of cost and risk. Yet, tightening interdependencies have also increased the potential for disruptions to spread quickly and widely across multiple systems and markets." Interdependencies Report, p. 1.

industry plans to increase usage of CLS Bank, or worse, cause participants to cease using CLS Bank, for cost or operational reasons, thereby increasing settlement risk.



Overall, we believe that the significant operational risk and costs to the global payments system of implementing a mandatory CCP are disproportionate when compared to the benefits in addressing the 0.9% - 1.7% of mark-to-market credit risk for counterparties not using CSAs.

International convergence

The US Treasury is proposing to exclude FX forwards and swaps from the majority of regulations under the Dodd-Frank Act. The statute further exempts commodity swaps where physical delivery of the commodity is contemplated. FX is more closely related to this exempt class as it calls for the delivery of currencies. The Global FX Division has submitted a public response to US Treasury's recent invitation to comment on whether an exemption is warranted. It is also seeking to ensure that appropriate exemptions are secured under the equivalent European OTC derivatives legislation.

The proposed determination would mean that FX forwards and swaps would not be regulated as swaps under Dodd-Frank. Most importantly, this means they would be subject to neither mandatory clearing, nor mandatory trading on Swap Execution Facilities or DCMs, nor the real-time public reporting requirements. They would also be exempt from the proposed margin requirements for uncleared swaps. The proposal has clear implications for regulatory convergence, particularly in a market as liquid and global as FX.

In reaching its proposed determination, the US Treasury recognises the key characteristics of FX products and the way the market functions at present. 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 through the recent announcement of the DTCC and SWIFT as partners to provide global FX trade repository services.
- 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.

In terms of identifying OTC derivatives that are capable of being cleared, we believe the overriding objectives for regulators should be to implement measures that are proportionate to the systemic risks being addressed. Consideration should therefore be given to whether mandatory clearing is a proportionate response when taking into account the pertinent systemic risks, which for FX comprise settlement risk that far outweighs counterparty credit risks that CCPs address, and the measures that are already in place to deal with those risks. The analysis should also take into account factors such as the cost of clearing and the ability of the CCP to deal with and manage the volume and risks (including risk of default) associated with clearing of relevant contracts.

Appendix B – rationale for centralised data sets and repositories

Comprehensive oversight

Trade repository information must be consistent, complete and as non-duplicative as possible in order for it to be meaningful, both for market surveillance and systemic risk monitoring. Global trade repositories provide a centralised point for submission of data, giving regulators access to both on and offshore trades and allowing them to build a complete picture regarding the positions of overseen entities. Since local regulators may typically only exert jurisdiction over local firms, currencies traded offshore by offshore entities would not be subject to regulation. They would therefore not be reported to the local repository, limiting the usefulness of that subset of data. Building an accurate picture of systemic risk or trade activity becomes significantly more difficult where the trade population is fragmented across a number of localised trade repositories, particularly considering the volume of participants and transactions present in the FX market, and in the absence of standardised global formats. The value of a comprehensive data set can also extend to implementation of other regulatory initiatives, for example, in analysing whether to mandate clearing for particular products and in establishing block trade sizes and appropriate reporting delays.

Efficiency

There are a number of efficiency arguments for global trade repositories from all market participants' perspectives.

- Cost – global trade repositories reduce the implementation costs related to building out and connecting to relevant trade repositories for both regulators and market participants alike. For reporting parties, global trade repositories allow a centralised reporting channel with common technology, messages and trade formats. Given the number of market participants engaging in cross-border transactions, local repository reporting may add significant costs for both buy and sell side participants as they are required to report to a number of repositories. Hardest hit might be the smaller, regional banks that would likely be expected to undertake the burden of international reporting on behalf of their clients. Centralised client due diligence would also produce significant savings.
- Data consistency and common standards – agreed global data formats and standards for LEIs and product and trade identifiers would also promote significant benefits for all users. The industry is making progress in this regard and we fully support these efforts. Where local repositories prevail, regulators will need to be able to interpret and aggregate data across a number of differently formatted outputs, which can be inefficient at best. Timely access to and interpretation of a comprehensive data set will be important in times of market crisis and this will be hindered if regulators are required to seek trade and position data from a number of repositories.
- Implementation – global trade repositories may also help to minimise the risks of conflicting implementation deadlines and reduce time to market.