11th July 2014

Record Currency Management Limited response to European Supervisory Authorities Consultation Paper – Draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012

Record Currency Management Limited ("Record") is a leading independent currency management firm managing $51.9 billion, at 31st March 2014, for institutional investor clients in the UK, continental Europe and North America. The principal activities undertaken by Record are passive and dynamic currency hedging services for pension funds and other institutional investors (i.e. services which seek to reduce the currency risk associated with international equity and fixed income investing) and currency for return products. Record always acts as agent for its clients, rather than as principal; hedging services are typically offered through separate accounts, whilst currency for return products are offered as separate accounts or pooled funds.

Summary views

Record's primary concern with the draft regulatory technical standards ("RTS") is the requirement for a much wider range of counterparties than internationally envisaged to post and collect variation margin on deliverable foreign exchange forward contracts and foreign exchange swaps implicit in Article 2 GEN paragraph 1, and discussed in paragraphs 14 through 20 of the Draft Impact Assessment. Applying such a requirement to a wide range of market participants would be at odds with international standards, unduly burdensome and disproportionate, for the following reasons:

i. this requirement would be in direct contrast to the treatment of such contracts under the United States Determination of Foreign Exchange Swaps and Foreign Exchange Forwards under the Commodity Exchange Act dated 16th November 2012, whereby the Secretary of the Treasury determined that foreign exchange swaps and foreign exchange forwards should be exempt from the definition of "swap" as provided for by the Commodity Exchange Act as amended by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (collectively "Dodd-Frank"). This exemption ensures margining or clearing requirements do not apply to such contracts, although reporting requirements are still applicable;
ii. this requirement would be unduly burdensome as applying variation margin to foreign exchange swaps and foreign exchange forwards does not offer any meaningful risk reduction, since the most significant risk in such contracts – settlement risk – is already largely addressed by the Continuous Linked Settlement (CLS) system; and

iii. this requirement would be disproportionate and may actually lead to an increase in risk, by discouraging pension funds and other long-term institutional investors (including insurance companies, family offices, foundations, charities, etc.), who may wish to avoid the costs of posting and collecting variation margin and lack the operational infrastructure to do so, from a legitimate risk reduction activity in the form of currency hedging.

Record's suggested course of action instead is to maintain consistency with the Dodd-Frank requirements in respect of deliverable foreign exchange forwards and foreign exchange swaps, by fully and unconditionally exempting such instruments from the requirements for bank counterparties other than financial institutions and systemically important non-financial entities to post and collect margin, whether variation or initial. Such counterparties should be defined more narrowly than in Article 1 DEF paragraph 1(a), so as to exclude pension funds and other long-term institutional investors.

International consistency would be maintained by limiting the requirement to exchange variation margin to contracts between banks and counterparties that are financial institutions and systemically important non-financial entities, as envisaged under the Basel Committee on Banking Supervision ("BCBS") "Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions", February 2013[1]. The draft RTS at present are not consistent with BCBS-IOSCO guidance, by virtue of extending variation margin requirements to a much wider range of parties.

The wider definition encompassed in Article 1 DEF paragraph 1(a) would still be appropriate for e.g. reporting requirements for such instruments under the European Market Infrastructure Regulation (EMIR) – we recognise that doing so would cause a discrepancy in the categories of parties subject to reporting requirements on the one hand, and margin requirements on the other, but believe this is appropriate given the vast difference in cost and operational burdens between the two activities. Other instruments such as non-deliverable forwards may still be subject to variation margin requirements without prejudicing international consistency or imposing unduly burdensome or disproportionate requirements.

Relying on the variation margin threshold of €500,000 being sufficiently high not to apply to pension funds or other long-term institutional investors is not sufficient. The best solution is for the RTS to make clear that these requirements only apply to contracts between banks and counterparties that are financial institutions and systemically important non-financial entities, as envisaged by the Basel Committee on Banking Supervision, and to define such counterparties more narrowly than currently envisaged so as to exclude pension funds and other long-term institutional investors.

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

Alternative approaches would be either to exempt hedging contracts from variation margin requirements, or to provide an exemption for pension funds and other long-term institutional investors.

Finally, should variation margin requirements be maintained in respect of hedging activity undertaken by pension funds and other long-term institutional investors, notwithstanding such a requirement being at odds with international standards, unduly burdensome and disproportionate, and since the majority of pension funds and other long-term institutional investors today implement currency hedging programs without variation margin, we would propose that the proportionate phase-in requirements set out in Article 1 FP paragraph 3 be applied to variation margin as well.

Background information

In all cases the primary instrument Record uses is the forward foreign exchange contract ("fx forward") entered into between an institutional investor client and a bank counterparty, with Record acting as the client's agent. While some clients choose to use prime brokers, many institutional investors including credit-worthy pension funds continue to use bi-lateral FX credit line-based dealing arrangements, for which no margin – whether variation or initial – is required.

Given Record's core products are currency-based, we feel our experience and understanding of the users of such products (i.e. our clients), as well as our understanding of the logistical and operational implications of the draft regulatory technical standards, put us in a position to comment on the implications of the proposed technical standards for the fx institutional investment management community.

Record has previously responded to the European Commission public consultation on Derivatives and Market Infrastructures in July 2010. Furthermore Record (through the FX Investor Group) provided comments to the United States Treasury as part of its consultation process in November 2010 as well as to the follow up comments in response to the Treasury's request for additional comments in June 2011.

Record is, and always has been, a strong supporter of regulation that ensures appropriate oversight of all participants as well as providing a framework for consistency of treatment amongst providers. Where there is multi-jurisdictional impact, harmonisation across jurisdictions ensures there is little or no regulatory arbitrage. Regulatory arbitrage is not, in our opinion, to be ignored as it means some market participants have to compete on unfair terms, costs and operational structures and this in turn can lead to increased risks for clients and consumers who should in fact be benefiting from global providers.

Comments on RTS

Record believes there to be a material new requirement in the draft RTS which would create regulatory arbitrage between the European Union and the United States, contrary to the aims of the G20 and indeed inconsistent with comments made throughout the RTS. In this instance we are referring specifically to the proposed requirement to impose variation margin on physically settled foreign exchange forwards and physically settled foreign exchange swaps (as defined) for a much wider range of counterparties than internationally envisaged, which is implicit in Article 2 GEN paragraph 1, and discussed in paragraphs 14 through 20 of the Draft Impact Assessment. Our reasons for objecting to this draft requirement are outlined below:

i. Requiring variation margin for fx forwards and fx swaps breaches international consistency as foreign exchange forwards and foreign exchange swaps have been fully exempted by the US Treasury from all Dodd-Frank requirements (except reporting and other business conduct requirements). The effect of this is that in cases where it is permitted, business will leave the EU in favour of US execution.

   In particular, if the RTS adopt a broad definition of "financial institutions and systemically important non-financial entities", non-EU entities that are not themselves subject to the RTS will naturally favour non-EU bank counterparties in their execution of fx forwards and fx swaps, so as to avoid the variation margin requirements. This competitive disadvantage, imposed by regulation, would be to the detriment of the EU banking sector.

ii. The application of variation margin for fx forwards is not mitigating risk in any material way over and above the existing framework – this view is supported by the US Global FX Division who have stated that settlement risk is the only potential systemic risk in the FX markets, comprising 94% of maximum loss exposure in foreign exchange transactions with a maturity of less than six months[2]. Even in transactions of more than six months maturity, settlement risk is by the far the largest component since 100% of the notional amount is at risk at settlement (prior to any mitigants), whereas the mark-to-market or replacement cost risk will only represent the exchange rate movement over the contract's lifetime, so typically in the order of 5-10%.

   Risks associated with foreign exchange along with some comments are:

   a) Settlement risk

      Fx forward transactions cash settle on maturity. While bi-lateral credit risk occurs it takes place in two distinct ways. Settlement risk is the risk of a party making payment on one leg of the transaction but due to default of the counterparty not receiving payment from the other leg; e.g. if a counterparty sells Dollars and buys Yen and delivers the Dollars on settlement but does not receive the Yen. There are two important mitigants already in place. The first is the use of Continuous Linked Settlement (CLS) - a secure payment vs. payment system that ensures there is

[2] http://www.gfma.org/initiatives/foreign-exchange-(fx)/gfma-submits-comments-on-the-consultation-document-issued-by-the-european-commission-on-fx-financial-instruments/

simultaneous transfer of consideration, thereby avoiding gross default on settlement altogether. The percentage of relevant global fx transactions (i.e. excluding contracts that are between counterparties within the same entity, and give ups to prime brokers) settling via CLS is estimated at 70%-90%. The second is that even where CLS is not applicable, netting arrangements can be agreed between counterparties, if there are offsetting obligations. Settlement risk has therefore been successfully mitigated if transacted under these or equivalent arrangements.

b) Pre-settlement risk

Pre-settlement risk is the risk of default of the counterparty prior to settlement. If the defaulting party owes value to the non-defaulting counterparty then there is clearly a risk that some or all of the value is lost through the liquidation process. While default is a risk to value, assuming transactions have netting arrangements it is the risk to the net profits outstanding on all outstanding transactions with that counterparty. Though this loss may be significant, (1) arrangements can be made at the parties' discretion through negotiation and establishment of Credit Support Annexes to protect this risk and (2) it is unlikely to be a default risk to the receiving party and therefore not likely to have any further implications to systemic risk.

This of course does not imply the loss is not potentially significant, simply that there are unlikely to be wider implications for the stability of the financial system as a result.

All major participants are bound by the terms of International Foreign Exchange Master Agreements (a standard contract between counterparties that is sponsored by the Foreign Exchange Committee of New York, the British Bankers Association, the Canadian Foreign Exchange Committee and the Tokyo Foreign Exchange Market Practices Committee) or International Swaps and Derivatives Association Master Agreements. These documents are specifically designed to address the needs of the counterparties in such transactions. For example, they set out procedures for dealing with default as well as containing netting agreements to reduce pre-settlement risk.

Buy side users, unlike banks, are not mutually interconnected, nor do they employ leverage or debt in their balance sheets. To ask them to continuously adjust their cash collateral to counterparty banks is likely to prove both pro-cyclical and damaging to their long-term returns.

The reality of the global credit crisis was that the naturally highly-geared and mutually interconnected banks were most at risk. Generally, banks' fx clients were under much less pressure over this period and were able to fulfil their fx contract obligations. In this context, while variation margin for the market-making fx banks may provide a valuable firebreak in the global financial system, nevertheless maintaining the ability of banks to choose the terms on which they conduct business with their credit-worthy non-bank customers (including pension funds and other long-term institutional investors) would not be expected to compromise the stability of the system.

iii. The application of variation margin to fx forwards imposes a unnecessary cost burden on a well established and prudent risk management process adopted by many global entities including pension funds, other long-term institutional investors, corporates and government entities. It is entirely feasible that some of these entities would abandon their risk mitigation program in light of the additional costs, which would actually lead to an increase in systemic risk rather than achieving the G20 aim of reducing systemic risk.

Variation margin will come at a cost which will be borne by the buy side user. Firstly, the margin demanded will yield significantly less than the return of the assets the margin would otherwise be invested in. Secondly, for a fully-invested fund margin flows would need to be met by purchases and sales of their invested assets with the associated cost of forced sales. The greater the amount of the forced sale the greater the likelihood of the sale being made into a weak (or at least volatile) market with likely wider bid-offer spreads.

This could lead to two results: the first is simply a greater cost of fx forwards to be borne by pension funds and other long-term institutional investors, and hence poorer investment performance leading to reduced fund solvency or member benefits. Secondly, the investor may take the strategic decision no longer to hedge in recognition of the increased operational and administrative burden of posting and collecting margin. This would lead to investors (many of whose long term trend has been a sustained increase in overseas investment) either investing more narrowly in domestic securities to avoid fx risk they can no longer economically mitigate and thereby increasing concentration risk, or maintaining the overseas positions unhedged introducing greater fx risk into their portfolios.

A proxy for the increased administrative cost of meeting variation margin calls, in addition to the interest foregone, may be found in the "per account" minimums imposed by some prime brokers. In addition to the usual "dollar per million" fee model, prime brokers increasingly charge "per accounts" minimums, often in the region of €100,000 p.a. or so. This cost is enough to deter many clients from using prime brokers, which explains both the ongoing prevalence of the bi-lateral FX credit line-based dealing model, for which no margin – whether variation or initial – is required, as well as the risk that similar costs could deter pension funds and other long-term institutional investors from hedging altogether.

A significant aspect of fx forwards and swaps is that buy-side users of fx contracts are also in large part pension funds and other long-term institutional investors (including insurance companies, family offices, foundations, charities, etc.) which were not the cause of the financial crisis. They did not present default risk to the market, nor did they need Government support to continue in business. Measures to constrain irresponsible trading and speculation are welcome, but should be implemented in a way that does not penalise stable, long term investors and must be in line with global requirements.

The fx market has addressed the greatest risk to counterparty default by secure settlement processes such as CLS. While this does not make fx less suited for regulation it is important to note that many of the benefits the regulation seeks to address have been sufficiently mitigated by market practice without the cost implications, particularly in relation to collateralisation through variation margin being imposed rather than subject to agreement between counterparties.

Record does not object to clearing and related margin requirements for non-deliverable foreign exchange contracts as this is in line with other major global requirements such as Dodd-Frank in the US. Furthermore, Record also fully accepts the inclusion of all foreign exchange contracts in EMIR reporting obligations as this will ensure the appropriate regulatory bodies have the desired oversight to monitor and take proactive steps to address impending issues.

However, in order to maintain consistency with the Dodd-Frank requirements in respect of deliverable foreign exchange forwards and foreign exchange swaps and not to exceed the BCBS requirements, such instruments should be fully and unconditionally exempt from the requirements for bank counterparties other than financial institutions and systemically important non-financial entities to post and collect margin, whether variation or initial. Such counterparties should be defined more narrowly than in Article 1 DEF paragraph 1(a), so as to exclude pension funds and other long-term institutional investors.

We recognise that so doing would cause a discrepancy in the categories of parties subject to EMIR reporting requirements on the one hand, and margin requirements on the other, but believe this is appropriate as the cost and operational burdens of reporting, whilst not trivial, are manageable and indeed are currently being met, whilst the much greater burdens of variation margin are likely to be sufficient so as to deter this risk management activity. The draft RTS at present are not consistent with BCBS-IOSCO guidance, by virtue of extending variation margin requirements to a much wider range of counterparties than internationally envisaged.

Relying on the variation margin threshold of €500,000 being sufficiently high to not apply to pension funds or other long-term institutional investors is not sufficient, as this would readily be met by as little as a ½% move on a hedging portfolio as modest as €100 million. The best solution therefore is for the RTS to make clear that these requirements only apply to contracts between banks and counterparties that are financial institutions and systemically important non-financial entities, as envisaged by the Basel Committee on Banking Supervision, and to define such counterparties more narrowly than currently envisaged so as to exclude pension funds and other long-term institutional investors.

Alternative approaches would be either (i) to exempt contracts entered into in the course of legitimate hedging activity from variation margin requirements, with hedging activity including hedging financial commitments such as pension obligations as well as commercial commitments, or (ii) to provide an exemption for pension funds and other long-term institutional investors, analogous to that currently in place in respect of certain clearing requirements.

Finally, should variation margin requirements be maintained in respect of hedging activity undertaken by pension funds and other long-term institutional investors, notwithstanding such a requirement being at odds with international standards, unduly burdensome and disproportionate, and since the majority (based on Record's client base) of pension funds and other long-term institutional investors today implement currency hedging programs through the bi-lateral FX credit line-based dealing model, for which no variation margin is required, we would propose that the proportionate phase-in requirements set out in Article 1 FP paragraph 3 be applied to requirements to collect variation margin as well as those in respect of initial margin.

On behalf of Record Currency Management Limited