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ACTIVE CURRENCY MANAGEMENT

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Adrian Lee & Partners response to the 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.

Lee Overlay Partners Limited, trading as Adrian Lee & Partners ("ALP"), is an independent employee owned investment management firm that specializes in research-led currency and fixed income management for institutional investors. The company currently manages assets in excess of $5 billion from offices in Dublin and London for clients primarily based outside of the European Union.

ALP has the following primary concerns with the draft regulatory technical standards ("RTS"), with details of these concerns being set out in the remainder of this response:

1. The scope of derivative instruments to which the margin requirements apply.
2. The entities included in the scope of the RTS.
3. The potential for regulatory arbitrage.

1. The scope of derivative Instruments

The requirement to post and collect variation margin on physically settled foreign exchange forwards and physically settled foreign exchange swaps implicit in Article 2 GEN paragraph 1, and in paragraphs 14 to 20 of the Draft Impact Assessment, would be highly inconsistent with the requirements for such instruments under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") thus causing disharmony in the global regulatory framework.

ALP would instead strongly recommend maintaining consistency with the Dodd-Frank Act in respect to physically settled foreign exchange forwards and physically settled forward exchange swaps by fully exempting such instruments from the requirements outlined in the RTS.

On November 16 2012, the US Department of the Treasury issued a determination that both foreign exchange swaps and foreign exchange forwards should not be regulated under the Commodity Exchange Act ("CEA") and should, therefore, be exempt from the definition of the term "swap" under the CEA as amended by the Dodd-Frank Act.

The Secretary of the Treasury issued the determination to exempt foreign exchange swaps and forwards because of the distinctive characteristics of these instruments. Unlike most other swaps, foreign exchange swaps and forwards have fixed payment obligations, are settled by the exchange of actual currency and are predominantly short-term instruments.

Pre-settlement risk of foreign exchange swaps and foreign exchange forwards

The Secretary of the Treasury noted in the determination that the short term nature of such instruments significantly reduces the counterparty credit risk prior to settlement.

It should also be noted that parties to foreign exchange contracts 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 and set out procedures for dealing with default as well as containing netting agreements to reduce settlement risk.

Settlement risk of foreign exchange swaps and foreign exchange forwards

Settlement risk is primarily addressed in foreign exchange swaps and forwards through the use of payment-versus-payment ("PVP") settlement arrangements. The use of PVP settlement arrangements permit the final transfer of one currency to take place only if the final transfer of the other currency also takes place which virtually eliminates settlement risk.

70 per cent to 90 per cent of global foreign exchange transactions are settled via Continuous Linked Settlement ("CLS"), the predominant global PVP settlement system, which currently provides settlement services for 17 currencies that represent 93 per cent of the total daily value of foreign exchange swaps and forwards traded globally. CLS is a specialized system that operates a multilateral PVP settlement system specifically designed to reduce foreign exchange settlement risk.

The application of variation margin to foreign exchange swaps and forwards would potentially introduce operational risks and challenges to the current settlement process and would impose an unnecessary cost burden on a well established, efficient and effective risk management process adopted by global entities including pension funds, other long term institutional investors, corporates and government entities.

The potential impact of the application of variation margin to such instruments is that pension funds and other long term institutional investors may take the strategic decision to no longer invest in foreign exchange swaps and forwards given the increased operational and administrative burden.

This would lead investors (many of whose long term trend has been a sustained increase in overseas investment) either investing more narrowly in domestic securities to avoid foreign exchange risk they can no longer economically mitigate and thereby increasing concentration risk, or maintaining the overseas positions unhedged introducing greater foreign exchange risk into their portfolios.

Foreign exchange forwards and swaps used by pension funds and other long-term institutional investors 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.

While fully supporting measures to constrain irresponsible trading and speculation they should be implemented in a way that does not penalize stable long term investors and should be consistent with global standards.

The proposal by the ESAs to apply variation margin to foreign exchange forwards and swaps is in direct contrast to the US regulations and, rather than reduce the risks associated with such instruments, would potentially introduce new, unforeseen risks in the market.

ALP 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.

2. The entities included in the scope of the RTS

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 Basel Committee on Banking Supervision ("BCBS") requirements, such instruments should be fully and unconditionally exempt from the requirements for counterparties other than financial institutions and systemically important non-financial entities to post and collect margin, whether variation or initial.

The definition of such counterparties should be clarified in Article 1 DEF paragraph 1(a), so as to exclude pension funds and other long-term institutional investors. We recognize 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 RTS 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 per cent move on a hedging portfolio as modest as €100 million.

In the firm's opinion the RTS should clarify that the margin requirements only apply to contracts between banks and counterparties that are financial institutions and systemically important non-financial entities, as envisaged by the BCBS, and to define such counterparties more narrowly than currently envisaged so as to exclude pension funds and other long-term institutional investors.

3. Regulatory arbitrage

Market participants are subject to regulations derived from multiple sources. While the requirements of EMIR are being outlined after those of Dodd-Frank, it was expected that they would be closely aligned.

The margin requirements contained in the RTS will create possibilities for regulatory arbitrage between the EU and the US. This would appear to be contrary to the objectives of the G20 and indeed inconsistent with comments made throughout the RTS.

Section 1.1.1 of the Draft Impact Assessment addresses the issue of regulatory arbitrage and identifies the need to address the lack of harmony in the regulatory framework.

If there are variations between margin requirements across jurisdictions for non-centrally cleared derivatives, the regulatory framework will give a competitive advantage to financial institutions based in locations where the margin requirements are less onerous.

Given that US regulations exempt foreign exchange forwards and swaps from margin requirements and EU regulations subject such instruments to margin requirements (albeit only variation margin depending on the thresholds), it can only result in incentivizing EU institutions with US clients to relocate their business activities to the US and only trade with US banks.

Conclusion

As a result of the new standards contained in the RTS, all non cleared OTC derivatives will become more expensive for end users. The move to margin requirements will lead to a significant increase in the costs of trading and is contrary to "consistent global standards".

ALP strongly supports the view that it is of paramount importance to align international standards to avoid regulatory arbitrage. It was expected that the RTS would be very much in line with the standards set by regulators in other jurisdictions such as the US. This does not appear to be the case as the application of margin requirements to deliverable foreign exchange swaps and forwards is (as previously discussed in this response) in direct contrast to US regulations.

The application of margin to all OTC derivatives will prevent the ESAs in meeting their objectives with regard to converging the EU regulatory framework to international practice.

ALP believes that the regulatory gaps need to be closed in order to avoid the potential for regulatory arbitrage between the EU, the US and other major jurisdictions.

ALP would be delighted to engage further with the ESAs in relation to the guidelines or any queries it may have in respect of the above.