European
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Federation

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Launched in 1960, the European Banking Federation is the voice of the European banking sector from the European Union and European Free Trade Association countries. The EBF represents the interests of some 4,500 banks, large and small, wholesale and retail, local and cross-border financial institutions. Together, these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the EU alone.

Key Points

- The EBF welcomes the Commission's consultation on what should be considered an FX financial instrument. Lack of clear definitions has led to market uncertainty with regard to regulatory requirements.

- The EBF supports a harmonised European definition of what is considered an FX financial instrument so as to avoid inconsistencies with regimes outside the European Union such as Dodd Frank Act and in order to ensure for equivalence of rules and substituted compliance as far as possible.

- It is important that, for EMIR, the definition of financial instruments is clear and uniform for all market participants so that reporting obligations do not apply to instruments that are not considered financial instruments. With reference to MiFID, its requirements apply only to FX transactions when they are related to the provision of investment services or the provision of foreign exchange services connected to the provision of investment services.

- The EBF considers that FX spot contracts should not be considered to be financial instruments.

- The EBF considers that is critical to ensure that contracts which should properly be considered to be spot are treated as such. This is because there will be significant regulatory commitments (e.g. LEI, systems, capital requirements, contractual provisions) for both clients and financial institutions in relation to contracts which fall within the scope of MiFID and EMIR which should not be imposed on payments. The burden and cost of this would fall upon the real economy.

- As the market practice for a cut-off settlement period is 2 banking days we would support this approach where some flexibility for FX spot transactions which need to mirror the settlement cycle of securities transactions is allowed. Alternatively, the adoption of a T+7 settlement period could be introduced which would accommodate the need for these exemptions.

- Further clarification should be also provided on how harmonisation would be set up, from an operational, market arbitrage and cross regulatory perspective.

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(1) Do you agree that a clarification of the definition of an FX spot contract is necessary?

The Federation agrees with the Commission that there is a need for a more precise definition in view of MIFID and EMIR which will benefit all market participants. Lack of clear definitions has led to market uncertainty with regard to regulatory requirements. For example, it is still unclear which contracts in practise are required to be reported under EMIR.

Clarifying the definition of an FX spot is particularly relevant because CRR (Regulation 575/2013) provides for capital charges related to counterparty risk only in relation to FX forwards and not for spot FX transactions. An FX forward should also reflect the new requirements under EMIR.

Art. 271 CRR defines instruments subject to counterparty risk with reference to Annex II: in the list of instruments "forward foreign exchange contracts" are quoted. Art. 272(2) makes reference to market standard for the definition of "long settlement transactions" which are also subject to capital requirements for CCR. Therefore, we strongly invite the Commission to clarify the boundaries between FX spot and FX forwards so as to have a harmonised definition to be applied across the EU in order to avoid an unlevel playing field.

While we welcome the move to clarify the definition of FX spot, it is important to note that within the EU, there is no inconsistency among the member states regarding the exclusion of FX spot contracts from MiFID regulation - there is only an inconsistency with how individual member states may have defined or not defined an FX spot contract. The EBF firmly believes that it was not the intention on the part of the European legislators to capture FX spot contracts as a financial instrument under the MiFID definitions. We note that in 2007 the European Commission expressly stated in its MiFID Q&A 191 a position which supports this conclusion:

"derivatives on currencies listed in Section C(4) of Annex I of MiFID are financial instruments.... spot market foreign exchange agreements are not considered to be financial instruments for the purposes of MiFID."

This statement reflects a globally accepted regulatory and market position that transactions in FX spot contracts are transactions in payments - they are transactions which contractually obligate the buyer and seller to exchange one currency for another currency for immediate delivery. Importantly, this approach to FX spot has been generally accepted by global regulators.

(2) What are the main uses for and users of the FX spot market? How does use affect considerations of whether a contract should be considered a financial instrument?

Regardless of the characteristics of the users of FX spot – whether it be businesses, commercial banks, funds, governments or central banks – each market participant transacts its FX spot contracts in a global, standardised and liquid FX market. With FX at the heart of all international commerce, attempts to regulate this deep and very liquid market in a way which is inconsistent with the global nature of the market and the actions of other global regulators will severally impact users and global trade as a whole.

FX Spot contracts are cash products which are physically settled via the exchange of two different currencies. They are fundamentally different from OTC derivatives in both function and form - OTC

derivative contracts are most of the time financially, cash settled products based on the price of an underlying asset, whereas FX spot contracts are products which are characterised by the physical exchange of two currencies between transacting parties and is an integral part of the global cash market.

Corporates, institutional investors, banks and central banking authorities use the FX market spot for to fund their imports and exports; in order to hedge exposure to foreign currencies; in order to make payments to foreign suppliers; in order to invest their capital in businesses and business lines abroad; to pay tax and other obligations in foreign jurisdictions; and to repatriate profits and capital to home jurisdictions for the benefits of their investors. Banks use it for their currency trading (which gives service to its clients) and for building up liquidity in this market.

The EBF is against acquiring binding information about the use of the instrument. This will be very onerous in many cases and prohibitively costly in some. Thus we think that information about uses and users of the spot market should be implemented only very carefully for the definition as a financial instrument. This approach would also considerably impact the industry practice of payment netting for settlement related purposes, a practice which reduces the value at risk by replacing multiple gross obligations with one netted obligation.

In addition, one must consider that according to MiFID, its requirements apply only when FX transactions are related to the provision of investment services or the provision of foreign exchange services connected to the provision of investment services.

(3) What settlement period should be used to delineate between spots contracts? Is it better to use one single cut-off period or apply different periods for different currencies? If so, what should those settlement periods be and for which currencies?

The EBF recommends that the European Commission adopt a consistent cut-off period application when considering the definition of FX spot.

The EBF notes that general market practice is for an FX spot transaction to settle within two valid banking days in the two currencies being exchanged in the transaction, with the term banking days important in order to ensure that the systems of the two central banks whose currencies are involved in the transaction are both open in order to facilitate settlement. EBF proposes that a T+2 definition is adopted providing that the following conditions are fulfilled:

Some specific transactions need to be exempted from this cut-off period due to their specificities.

This is mainly the case for contingent transactions (primary market/secondary market) as securities conversion FX transactions for which the settlement cycle is aligned with that of the security. If there is an underlying securities trade (i.e. purchase or sale of securities), and that trade settles up to a T+7 basis (depending on the market practice in the country of issuance of the security), then an investor (or a custodian bank on behalf of an investor) may perform an FX trade to convert the settlement amount into the base currency of the investor. That FX trade will typically be effected on trade date (for settlement on the settlement date of the underlying securities trade). This transaction is incidental to and for the sole purpose of effecting the foreign securities transaction, but is a crucial part of the cross-border securities settlement process. Such FX trades are fundamentally "payment instructions" in the terminology of the Commission in its papers. They should still be classified as "payment

instructions" i.e. as spot FX contracts, and not as FX financial instruments, otherwise they would for instance fall under the EMIR reporting obligations.

Whenever a currency pair, due to market convention and market practice settles per this market convention or market practice later than T+2, we would still consider this an FX spot transaction.

In addition it is crucial that there is a transition period to give market participants sufficient time to adapt. We also know that many securities will move to a T+2 settlement cycle in the coming years, so it would not be relevant to require significant developments for a very short period only.

An alternative to adopting the current market practice T+2 settlement period including the above mentioned exemptions would be to adopt a T+7 settlement period. A T+7 cut-off period would accommodate the above exemptions and allow a harmonised approach to be adopted across the EU.

Where there are OTC securities settlements that settle beyond T+7 and which have a securities conversion, these should be also be subject to an exemption, regardless of the settlement period of the linked security.

(4) Do you agree that non-deliverable forwards be considered financial instruments regardless of their settlement period?

A majority of EBF members agree that non-derivable forwards (NDFs) should be considered as financial instruments regardless of their settlement period. The settlement of NDFs is completely different from that of FX spots as there is no physical settlement (exchange of the currency) but instead a net cash settlement will be made by one party to the other.

The EBF would like to see consistency regarding the regulatory treatment of NDFs across jurisdictions, particularly with regard to the application of mandatory clearing.

(5) What have been the main developments in the FX market since the implementation of MiFID?

The evolution as described in the consultation paper is not a consequence of MiFID, but rather of the technological developments. Many of these contributing facts have their roots in market developments which preceded or occurred independently of MiFID, with the spot market experiencing a profound change thanks to the deeper pools of liquidity, faster and more accurate price discovery and increased trade flows.

The effect of MiFID and the capital reservation has been far bigger on outrights and options, with MiFID clearly having an effect on the selling of more complex products to customers who have not been fully informed.

(6) What other risks do FX instruments pose and how should this help determine the boundary of a spot contract?

Settlement risk is considered to be by far the highest risk in the FX spot market and this has already been addressed for the largest portion of the FX transactions with the setting up of CLS Bank.

Market risk is also regulated and FX contracts (both spot and forward) are reported in the market risk framework according to CRR rules.

Other risks, such as counterparty risk, is governed by the CRR, which provides for the capital charge requirements and the risk mitigation rules which are represented by legally enforceable netting and collateral agreements.

(7) Do you think a transition period is necessary for the implementation of harmonised standards?

The EBF supports a transition period as market participants will need sufficient time to adapt their systems in order to comply with the harmonised standards. Consideration must also be given as to how the adoption of a uniform definition could expand the range of market participants brought into other pieces of EU legislation. For example, industry would need considerable time in order to comply with each specific requirement under MiFID regulation and, separately, under EMIR regulation.

Considering the number of contracts and participants or counterparties that such harmonisation would affect – particularly for non-sophisticated corporates who may not be currently subject to EU financial services legislation – the impact on could be considerable on what is a critical component of global economic activity. Ideally, the implementation period should be harmonised within the EU as well as outside the EU to prevent arbitrage and ensure the competitiveness of EU firms operating globally.

(8) What is the approach to this issue in other jurisdictions outside the EU? Where there are divergent approaches, what problems do these create?

The EBF understands that FX spots are not financial instruments in other 3rd country jurisdictions. This risks creating conflicts of laws and legal challenges. It would be advisable that the European Commission makes a comparable study of the most relevant non-European Union regimes before finalising the European Union regime.

The EBF notes that, even within the EU, the UK has its own approach by classifying FX contracts for hedging purposes and up to 7 days settlement period as FX spot and therefore they are not considered as financial instruments.

The harmonisation of delineation definitions used in countries closely related to the EU and those whose economies are highly interwoven with the EU-member states' economies will be important to make these future rules effective.

Divergent approaches will drive technical complexity while EU and U.S. entities will need to adapt to separate regulatory regimes and market standards. Examples of this are both requirements of reporting obligation and risk mitigation techniques, where the definition of financial instruments will affect operational procedures.

(9) Are there additional implications to those set out above of the delineation of a spot FX contract for these and other applicable legislation?

The "conversion" status to financial instruments may impact the services and operations of financial and other actors. This will add delay, costs and burden to a trade that remain for spot and forward a simple, non-complex and straightforward trade for which except since the arrival of EMIR has triggered no issues.

The delineation of a spot FX contract should be reflected in the markets view on FX derivatives, e.g. how an FX Swap is delineated. In this case the far leg of the FX Swap should be aligned with a FX Forward, and the tenor of a FX Swap would have the same rules applied as a FX Forward.

(10) Are there any additional issues in relation to the definition of FX as financial instruments that should be considered?

Due to the fact of many market participants are governed by multiple regulations, i.e. EMIR and Dodd-Frank Act, there is a need to clarify the reportability for relevant FX contracts, hence minimising the risk of under and/or over reporting. In addition, we find that the keywords Transparency, Complexity and Short term Tenor are important to consider when looking at financial instruments. Spot contracts bear full transparency, no complexity and have an extremely short tenor. These 3 characteristics are very different from any derivative contract as currently included in the financial instrument definition.