

DFA & EMIR: update re. FX derivatives transactions

Foreign Exchange Contact Group

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The views expressed herein do not necessarily reflect those of the European Central Bank

Overview of proposed EU regulation

- **European Parliament:**
 - 5 July 2011: EP voted on amendments to the Commission's proposal of 15 September 2010;
 - First reading concluded once a legislative resolution is adopted; planned for 14 February 2012.
- **Council:**
 - Last available draft under Danish Presidency dated 9 January 2012 for discussion at attachés' level.
- **Next (last?) trilogue on 23 January 2012**
 - + meetings at technical level for finalisation

EMIR: status as regards FX derivatives

- **European Parliament's position:**

- *Relevant (new) recitals:*

- “(12a) *In determining whether a class of derivatives is to be subject to clearing requirements, ESMA should aim for a reduction in systemic risk and avoidance of systemic repercussions. This includes taking into account in the assessment factors such as the future date from which the clearing obligation takes effect, the interconnectedness of the relevant class of derivative in the market, the level of contractual and economic standardisation of contracts, the effect on the performance and competitiveness of EU companies in the global markets, the operational and risk management ability of CCPs to handle the volume and obligations of this directive, the degree of settlement risk and counterparty credit risk and the impact of cost on the real economy and investment in particular.*

- (12b) The characteristics of the foreign exchange market (daily volume of the transaction, currency pairs, importance of third country transactions, settlement risk addressed through a robust existing mechanism) call for an appropriate regime that would rely notably on preliminary international convergence and mutual recognition of the relevant infrastructure.

EMIR: status as regards FX derivatives

- **European Parliament's position (cc'd):**
 - *Article 3: clearing obligation covers:*
 - Financial counterparties
 - Non-financial counterparties if the rolling average position over 50 business days exceeds a threshold to be specified by ESMA (excluded are contracts that are objectively measurable as directly linked to the hedging of commercial or treasury financing activity);
 - All OTC derivatives classified by ESMA as derivatives eligible for the clearing obligation;
 - *Exemption* for OTC derivatives entered into before the date from which the clearing obligation takes effect for that class of derivatives;
 - *Exemption* for intra-group OTC derivatives under specific conditions.

EMIR: status as regards FX derivatives

- **European Parliament's position (cc'd):**
 - *Article 4: eligibility for clearing obligation – criteria:*
 - reduction of systemic risk in the financial system (...);
 - liquidity of contracts;
 - availability of fair, reliable and generally accepted pricing sources.

In applying the above criteria ESMA shall also take account of international consensus.

EMIR: status as regards FX derivatives

- **Council's position as of 9 January 2012 (not final yet):**
 - *Relevant recitals:*
 - “(12bb) In determining whether a class of OTC derivatives is to be subject to clearing requirements, ESMA should aim for a reduction in systemic risk. (...);
 - (12b) In determining the subjection to the clearing obligation of classes of derivatives, due account should be taken of the specific nature of the relevant classes of OTC derivatives. The predominant risk for transactions in some classes of OTC derivatives may relate to settlement risk, which is addressed through separate infrastructure arrangements, and may distinguish certain classes (e.g. foreign exchanges) of OTC derivatives from other classes. CCP clearing specifically addresses counterparty risk, and may not be the optimal solution for dealing with settlement risk. The regime for such contracts should rely notably on preliminary international convergence and mutual recognition of the relevant infrastructure.”

EMIR: status as regards FX derivatives

- **Council's position as of 9 January 2012 (cc'd):**
 - *Article 3: clearing obligation covers:*
 - All OTC derivative contracts pertaining to a class of OTC derivatives subject to clearing obligation pursuant to Article 4;
 - Financial counterparties;
 - Non-financial counterparties if the rolling average position over 30 business days exceeds a threshold to be determined by ESMA (included are all OTC derivatives that are not objectively measurable as reducing risks directly related to commercial activity or treasury financing activity);
 - *Exemption* for contracts entered or novated before the date from which the clearing obligation takes effect;
 - *Exemption* for intra-group transactions.

EMIR: status as regards FX derivatives

- **Council's position as of 9 January 2012 (cc'd):**
 - *Article 4: clearing obligation procedure:*

ESMA to prepare draft implementing technical standards

Overarching aim = reduction of systemic risk

Criteria:

 - degree of standardisation of the relevant class of OTC derivatives;
 - volume and liquidity of the relevant class of OTC derivatives;
 - availability of fair, reliable and generally accepted pricing information in the relevant class of OTC derivative contracts.

ESMA may take into consideration the interconnectedness between counterparties using the relevant classes of OTC derivative contracts, the anticipated impact on the levels of counterparty credit risk between counterparties as well as the impact on competition across the Union.

Dodd-Frank Act and FX: latest status

- **Treasury Secretary's Proposed Determination of Foreign Exchange Swaps and Foreign Exchange Forwards under the Commodity Exchange Act is not final yet:**
 - proposal made on 29 April 2011: FX swaps and FX forwards should not be regulated as 'swaps' under the Commodity Exchange Act
 - => no mandatory central clearing, no exchange trading
 - Justification: FX swaps and forwards:
 - have fixed payment obligations;
 - are physically settled;
 - are predominantly short-term instruments.
- Focus on settlement risk (vs. counterparty credit risk).

Dodd-Frank Act and FX: latest status

- Exclusion of FX swaps and FX forwards effective upon the Secretary's submission of the determination to the appropriate Congressional Committees.
- Only once the CFTC/SEC have adopted final rules with respect to the definition of 'swap', 'swap dealer' and 'major swap participant'
(expected between January and March 2012)
- Even if proposed determination is adopted, FX swaps and FX forwards will remain subject to:
 - trade reporting requirements;
 - anti-evasion rules;
 - strengthened business conduct standards for swap dealers and major swap participants.

Dodd-Frank Act: latest final rules

- **Real-Time Public Reporting of Swap Transaction Data**
 - published on 9 January 2012 (effective 60 days thereafter)
 - Not applicable to FX swaps and FX forwards if proposed determination becomes final
- **Swap Data Recordkeeping and Reporting Requirements**
 - published on 13 January 2012 (effective 60 days thereafter)
- Upcoming: **Registration of Swap Dealers and Major Swap Participants** and **Business Conduct Standards for Swap Dealers and Major Swap Participants**
- **Implementation/Compliance date** depends on adoption and effective dates of other regulatory provisions and definitions: 16 July 2012 at the latest (see CFTC Final Order of 23 December 2011).