White Paper

The Potential Impact of New Regulation on End Users in the FX Market

A White Paper from the ACI - the Financial Markets Association, produced by Adsatis Limited

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SUMMARY

This paper has been written in collaboration between the ACI and financial market consultants Adsatis Limited. Its purpose is to examine, through direct consultation with market users, the impact of the new regulations on the FX market in Europe.

Though supporting the overall objectives of the new regulation, many corporates, pension funds and their asset managers felt that the problems with derivatives did not sit in the FX markets, certainly not in vanilla FX Forwards and Swaps. Consequently, many questioned the need or desirability of imposing the main strictures of trade level reporting, transacting on approved venues and central clearing on a relatively transparent market with little obvious systemic risk.

With trade reporting chronologically at the front of the queue, the implementation here attracted most feedback. Most felt this could have been better handled, with unnecessary confusion and time pressure caused by the lack of timely definitions. The (post implementation) request from ESMA to the European Commission to rule on these matters confirmed this impression. All respondents had managed to meet the deadline in some form but most felt the benefits of requiring end users to report were unclear and certainly some way off being realised.

Central clearing and the move towards trading on approved venues, reinforced with the Basel3/CRD4 capital requirements are potentially going to have much more impact. The feedback here is also analysed and, although not immediate, there are fears that the cost and inconvenience may dissuade corporates from hedging their FX risks, unless the "commercial purposes" exemptions are clearly and effectively carried through to the final definition. This was presumably not the intention of the authorities and it was felt critical that the definitions are suitably framed to allow normal commercial hedging to continue.

BACKGROUND

During the period since the financial crisis, specifically since the G20 Pittsburgh Summit in September 2009, participants in financial markets have been hit with waves of legislation primarily aimed at improving transparency and reducing systemic risk. The commitment agreed at the G20 summit focused on the world of OTC derivatives. The proposals concentrated on moving execution to electronic markets, clearing these trades through central counterparties (CCPs) and reporting all transactions to recognised trade repositories (TRs). The relevant European regulation is EMIR, MiFID2 and MiFIR and, in the US, the Dodd Frank Act. Globally, the implementation of Basel3 (through CRD4 in Europe) is also relevant in that it significantly increases the capital requirements for most assets, in particular OTC (bilateral) swaps and thus will make them more expensive for users.

In the legislation that was passed, and subsequent rules and regulations imposed, a policy of "in unless ruled out" was followed by most jurisdictions in respect of applicability to participants, instruments and underlying asset classes. The political debate and regulators' focus, however, seemed to be firmly on the interest rate and credit derivative markets as the prime suspects in terms of causing of the crisis. Although FX markets were not explicitly excluded at that time, the relatively smooth operation of FX through the crisis (albeit also benefitting from the large amounts of liquidity pumped into the banking system) seemed likely to exempt most of the high volume FX spot, forward and swap activity from much of the regulation. Corporates' treasury activity "for commercial purposes" also seemed likely to escape and only those whose volumes were significant or which operated like banks were likely to be caught in the net.

As rules were clarified in the US late in 2012, these expectations seemed to be realised. Although FX Options, Currency Swaps and NDFs remained in, FX Spot, Swaps and Forwards were determined by the US Treasury Secretary to be excluded from electronic trading and mandatory clearing, though reporting to TRs (by one party to the transaction, normally the bank) was still required. In Europe, however, the position of FX was less clear and still to be resolved. As regards participant scope, the European regulations did exempt corporate entities with turnover below the thresholds (Non-financial Companies Minus or "NFC-") from most of the requirements. However, many NFC- companies were unclear whether this also exempted them from reporting and, in the absence of that clarification, commenced reporting to a nominated TR on 12 February, rather than risk non-compliance.

This paper examines the implications for European legal entities of all the new regulation and current confusion around interpretation. In writing this, we were particularly concerned with the impact on those organisations that need to use FX contracts to support their business requirements rather than on the banks and financial market participants that derive an

income from making markets and trading currencies. Consequently, it is based primarily on interviews with market users, particularly corporates, pension funds and their asset managers. We consulted with a wide range of organisations, large and small to assess how the regulation directly impacted their FX activity and their business and we also asked their views on the wider implications. This feedback was supplemented by independent research by Adsatis Ltd and members of the ACI FX Committee.

THREE ASPECTS TO THE IMPACT OF NEW REGULATION

Detailed discussions with market users reveal that there are three distinct aspects to the impact of new regulation; the first is the impact from the process of forming the regulation; the second aspect (to some extent a consequence of the first), the impact of implementation process and; the third is whether the changes will achieve the desired impacts or regulatory goals, i.e. increased transparency and reduced risk. As the route is a long one and only partially complete, it is important that these are distinguished as there is still the opportunity to learn from experience and improve outcomes, both for the processes and the goals. Market users had views on all three aspects and these are documented below. However, it is worth noting at the outset that although opinion was divided on the ultimate efficacy of the regulation, the overwhelming majority of organisations consulted felt that there was significant room for improvement in the processes of defining the regulations and their implementation.

HEDGING?

Although some financial institutions obviously position in FX to generate alpha, for the vast majority of those consulted their FX activity was driven by the need to hedge currency exposures. For corporates, this is generally regarded as an essential activity. The main grey area was that some large corporate treasury operations operate as profit centres within their group, providing efficient execution of FX hedges for the other trading entities or divisions but sometimes taking a view on a currency when deciding whether to lay off the risk with an external counterparty. For pension funds and their asset managers, their mandates (or local regulation) generally require them to hedge currency exposures resulting from investment in other assets, or at least keep the exposure within a defined limit. Given the regulators' general desire to avoid rules that pass risk from the banking sector to the non-financial sector, the distinction between hedging and other FX activity becomes a key principle.

THE DEFINITION PROBLEM

The trade reporting requirements in Europe significantly pre-date the clearing and (electronic) trading venue requirements, in that trade reporting has already arrived (on 12 February 2014) whereas mandatory clearing and the requirement to trade on "specified venues" will not take place until 2015-16. However, the implementation of trade reporting has already highlighted a problem, i.e. what actually constitutes a derivative for the purposes of the regulation? EMIR passed the definitional problem onto MiFID2. However, as a directive, MiFID2 left it to the national regulators (the "National Competent Authorities") in the member states to adopt the rules and their interpretation of the MiFID2 definitions have varied. This is particularly relevant and a critical aspect for this paper, in the classification between Spot and Forward for FX and the definition of FX Forwards "for commercial purposes". ESMA have now requested in a letter, sent on 14 February 2014, that the European Commission clarifies these definitions and passes an implementing act, or similar measure, to create a standardised definition across all jurisdictions within the EU.

Apart from the regulators' desire for consistent application across the EU, these definitions are obviously a critical determinant of which companies are impacted by the new regulatory requirements. For a company to determine whether its transactions are relevant for the regulation and whether they exceed thresholds for compliance, it obviously has to be provided with precise definitions. It is absolutely clear that this uncertainty and confusion has added to the burden on all market users and we now examine how this has impacted them in regard to the different requirements.

TRADE REPORTING

As we conducted our research through January and February 2014, trade reporting was uppermost in most respondents' thinking. From the Spring of 2013, it was clear that the US approach of excluding FX Forwards and only requiring one of the counterparties to report a trade was not necessarily going to be the case in Europe. This led to considerable concern regarding all three aspects of market impact.

The Regulatory Process

The nature of regulatory process in Europe, involving all member states, is inevitably more complex and slower moving than in the US. Also, the bias in the EU towards principle based, rather than rule based, regulation allows more scope for ambiguity.

That accepted nearly all those organisations consulted felt that the process was unnecessarily confused and prolonged which added considerably to the burden of meeting the reporting deadline. It was pointed out that, even for companies whose FX activities were likely to be below any threshold and therefore unlikely to have to report, there was a considerable management burden in following the debate and investigating contingency procedures. Traditionally, SMEs rely heavily on their banks as advisors with regard to regulatory obligations. However, without clear definitions from the regulators, the banks themselves were cautious about informing clients that there was no need for action on their part. Although, as stated above, ESMA is now seeking clarification for the whole EU, any decision will presumably take several months therefore prolonging the confusion.

The Implementation Process

Another area of criticism was that, even when there was a known obligation (i.e. for the financial companies and NFC+ corporates), although there was theoretically enough time to allow implementation, delays on important points of detail meant that there was insufficient time to put in place reliable processes and technology. For this to happen the Trade Repositories ("TRs") had to be authorised and they in turn had to agree and define required formats for reporting. Until that point, it was difficult for reporting entities to make real progress on implementation projects. It was also impossible for those banks and service companies that intended to offer third party reporting to be precise about what their service offering, timing and cost.

Companies consulted also highlighted other specific problems related to reporting:

1. Legal Entity Identifiers ("LEIs") – the providers of LEIs were also relatively late to the game and it was not clear until late in the process whether LEIs were needed for all subsidiaries, given the European requirement for the large groups to report intra-group trades.
2. Unique Trade Identifiers ("UTIs") - although guidelines for UTIs were provided, it was not clear in all cases which counterparty was responsible for generating the identifier. Although most respondents were intending to use the UTI from the bank or platform they dealt with, this again left the problem for intra-group trades. It was unclear for some time whether identifiers generated from the group's treasury system would meet the requirements.
3. Trade Matching – the EU requirement for both parties to report a trade means that it is quite possible that the two counterparties enter slightly different details and, obviously, they could also be submitting these through different TRs. However, the matching reports which highlight discrepancies on a field by field basis are not permitted to provide

counterparty A with the data that counterparty B has entered (or vice-versa). This has resulted in an onerous reconciliation process that is almost totally manual and, even where the differences might be immaterial; a market user can't simply accept the counterparty's value for the data item.

Unsurprisingly, nearly all respondents reported increased costs associated with the implementation of trade reporting. Although some of these costs will be permanent, it is assumed that once the above issues are resolved, reporting will become a largely automatic process for corporates and not one with heavy costs associated. Larger companies undertaking their own reporting typically reported having dedicated 3-4 person project teams, plus dependency on the subject matter expertise of BAU staff. With delays to implementation, it is likely that these teams will be in place for 15-18 months.

For the asset management companies with multiple end clients, the burden of reporting will be a more permanent cost, as generally they will undertake this for their clients. For those with clients in multiple jurisdictions, standardisation would be particularly beneficial, as managing varied rules would be confusing, costly and burdensome.

Another dimension to this process was the fact that, although reporting could be delegated, the responsibility remained with the principals to the trade. This meant that although some organisations might have delegated responsibility, no acceptable, comprehensive solutions were presented to them on a timely basis. Rather than run the risk of non-compliance, they had to undertake their own projects. From a macro perspective, this probably meant that far more organisations than necessary had to dedicate resources to reporting and the economies of scale that might have been achieved with larger scale outsourcing were not realised.

Despite the issues noted here, all respondents that deemed themselves to be obligated believed they would meet (or had met) the requirements for reporting by the deadline.

The Regulatory Objectives

It is too early to say the extent to which the reporting requirements will help achieve the overall objectives of the regulations. However, the companies consulted did make a number of observations on this.

The first was that the European authorities had not adequately explained why they needed such a comprehensive collection of data from both sides of a trade and which aspects they were going to analyse to enable better management of systemic risks. It was generally assumed that data would be centralised and analysed to identify concentrations of risk that would then be subject to further forensic investigation. However, many pointed out that this had never been stated explicitly nor had any guidance been given on what the authorities might be looking for. Many believed that, if this had been made clear, it would be easier to prioritise and resolve issues that arose during the implementation process. In particular, given that intra-group trades were nearly always zero sum and that it was the net position between the group treasury and external counterparties that mattered, several large companies observed that reporting intra-group activity was a burden without obvious benefit. It was additionally observed that it was easier to get senior management support and budget for projects when the benefits of the commitment could be clearly articulated and explained.

Lessons Learned

As always through change, effective communication is the key and most users expressed the view that the authorities have room for improvement. Even if information dissemination is delayed because of the absence of a decision, it would be helpful if there was a clear explanation. Many market users referred favourably to their various trade bodies' attempts to clarify requirements and recommend on implementation tactics but it was inevitable that much of this was conditional advice until the official position was made clear.

The "big bang" approach also seems sub-optimal. Given that most end users were not regarded as systemically important, it would have made sense to work out many of the definitional and practical implementation issues of reporting by starting with a relatively few large organisations (banks, repositories, service providers) who would have the resources and the expertise to resolve these issues and implement solutions for themselves and third parties. The remaining reporting entities could subsequently be brought into the regime with a clearly defined set of requirements and solutions, giving them clear and informed options on how they can proceed. The Australian authorities are broadly adopting this approach and it would appear to have merits, with little or no effective weakening of transparency and control. Phasing implementation may bring benefits to the other components of the regulatory framework and the ACI would recommend this approach be considered wherever possible.

THE IMPACT OF MANDATORY CLEARING

The Regulatory and Implementation Processes

With deadlines still some way off there was less comment on the regulation and implementation processes for mandatory clearing. The temporary reprieve for pension funds until 2016 (which many believed might be extended further) put this firmly on the back burner for these organisations. It was clear that there was some hope that the final definition of scope and rules could still be influenced. The view was expressed that the timelines appeared primarily designed to enable the industry time to develop acceptable and sufficiently liquid exchange traded alternatives to OTC products, so that transparently priced and centrally cleared derivatives became the norm. However, whilst financial organisations were often relatively sanguine about this in respect of FX derivatives, some corporates pointed out that their FX hedging requirements would always have to be bespoke and standardised derivatives would not be an acceptable alternative.

The Regulatory Objectives

Prior to conducting this research, it seemed intuitively that the move towards mandatory clearing would be one of the more significant drivers of changed behaviour for derivatives users. As discussed above, the final definitions will impact the extent to which this is the case. However, it was clear from the consultation that most respondents expected the exemptions to exclude most corporates' FX activity from mandatory clearing. However, the debate also revolved around the overall cost of using OTC derivatives after the new regulations come into force. The combination of mandatory clearing and Basel3/CRD4 capital costs

seemed designed to drive as much derivative activity as possible on exchange, leaving those required to use OTC with a choice of clearing and posting collateral and/or facing significant increase in costs, unless the activity could be proven to be exempt.

The ability to manage the provision of initial margin and collateral requirements is something that varied considerably between respondents. Amongst the financial institutions, Hedge Funds typically have these arrangements handled by their prime broker so see no material change, apart from potentially higher costs. Pension Funds and their asset managers mostly have ISDAs with CSAs in place, so can also generally handle the process but expressed concern about the percentage levels of initial margin that might be imposed. The longer-term nature of their positions (and the mandate of many, particularly public sector, funds to fully hedge currency exposure) could be significant. However, those consulted indicated that much of their currency hedging was conducted on a rolling, shorter-term basis and the impact would be greater for interest rate derivatives than FX. Intuitively, financial institutions would be better equipped to handle hedging through exchange-traded derivatives but that may not always be the case and the risk of unhedged FX exposures might remain.

From the corporate treasury viewpoint, most of those consulted were relying on the "commercial purposes" and threshold exemptions to avoid a burdensome commitment. As described above, the precise definition that determines whether a derivative is for the reduction of risks from commercial activities is back with the European Commissioner. However, most treasurers said they only used derivatives for hedging and were confident of exemption. The larger companies that we consulted were mostly already comfortable with the clearing process, had ISDAs in place and either already posted collateral or understood the potential burden. The responses varied considerably as to how mandatory clearing might change behaviour but, on balance, they were concerned that, without exemption, tying up working capital in collateral would directly impact their commercial operations (see also "Broader Economic Impact" below). The smaller (NFC-) companies that we interviewed were assuming that the threshold exemptions would apply and had made no real provision for handling clearing at this point.

THE IMPACT OF MOVING EXECUTION TO OTFS, MTFS OR REGULATED MARKETS

At this point in time, the requirement to move sufficiently liquid derivatives to specified trading venues is not exercising most users of the market. Several respondents argued that the FX market was sufficiently liquid, transparent and, at the shorter end, largely executed over platforms that would qualify under the wider definitions of MiFID, in contrast to SEFs in the US. Some questioned whether there would be sufficient liquidity in the longer term Swaps and Forwards for them to be viable instruments on an exchange type model. However, the prevailing view here was that the general trend towards platform trading of FX, already in place before the legislation, would continue and that the regulation would not make a significant difference.

However, it is clear that many users believe that standardising FX to fit with an exchange model is neither necessary nor desirable. Although they may meet criteria for liquidity and transparency, FX Forwards and Swaps are core banking products supporting commercial transactions and the bespoke nature of each contract needs to be maintained for the majority of users. The OTF definition may not require such standardisation but, in those circumstances, many users do not see the benefits that would be derived from the requirement to move these instruments on to a platform.

THE BROADER ECONOMIC IMPACTS

There were a number of different views on how behaviour might be changed by the combined impact of the regulation, whether the overall objectives would be met and whether there may be unintended consequences. In the opinion of some market participants, relatively few non-financial companies would be caught by the legislation, perhaps no more than 150 in total across the EU, and these would predominantly be organisations that had treasury operations capable of handling the risks and processes.

Some of the larger corporates with well-resourced, central treasury operations and relatively short production cycles for their commercial activity endorsed this view. They recognised they would be impacted but said they could change the way they operate in FX relatively easily if the combined cost of the regulation made hedging uneconomic. They could shorten the duration of their hedges and roll these, a practice already prevalent in the market. They could accept more FX risk into their balance sheets, recognising that this may result in more volatility in P&L and would require changes to their (board approved) treasury mandates. However, they believed their ability to understand and control these risks would be manageable without serious economic consequences. Their concerns were the many mid-tier corporates with significantly smaller treasury operations and competitive pricing environments for their end product. If these were not exempted and bespoke OTC derivative pricing became too expensive, then commercial risks and corporate failure would inevitably increase. Many felt that the politicians, in their zeal to deal with systemic risks, might have inadvertently made the environment more risky for many users.

For other large companies, however, change would be more problematic if the “commercial purposes” exemptions did not cover their activities. For example, manufacturers of large capital equipment, particularly those supplying government entities on long term contracts would be significantly impacted. Pricing of these contracts is normally by open book tender with tightly defined profit margins. They are mostly longer term, cross-border transactions, thus incurring significant currency risk for several years. The nature of their business normally enables them to receive competitive pricing from the banks on long term FX Swaps and Forwards, without imposition of CSAs and collateral requirements. However, taking the currency risk on their books would be hazardous and, given possible movements in exchange rates over 5+ years, could result in significant, maybe fatal, losses. If the new regulations change any aspects of these arrangements, or resulted in a significant change in the cost of the hedges, then the commercial impact would be serious as avoiding long term OTC derivatives is not an option.

For all companies, managing the exposures in emerging market currencies was potentially the biggest challenge, if hedging through OTC derivatives became uneconomic. There are often no “natural hedges” to these exposures and, as trade builds between the developed markets and the main emerging economies, exposures will grow. Most respondents felt that hedging through the OTC market in Forwards and Swaps would continue to be the only realistic option. However, it was observed that the cost of these trades had already risen, not just as a result of regulation but more because of uncertainty and increased volatility in the target currencies. Whatever the driver, it is clear that this will be a growing problem and an area where rising costs will have to be taken into account and will have an impact on corporate net revenues and pension fund performance.

CONCLUSIONS

Unsurprisingly, the users of financial markets are supportive of the overall intentions of the regulations and generally resigned to the impacts. However, it is clear from our research that the majority of market users feel that the inclusion of FX Swaps and Forwards in the EMIR and MiFID2 regulation is unnecessary and will bring few benefits in terms of transparency or the reduction in systemic risk. Basel3/CRD4 capital requirements will inevitably push up the cost of longer term, OTC derivatives and most respondents believed that this legislation is the most important in terms of reduction of risk in the banking sector. There is a definite concern that efficient hedging of cash flows might be discouraged and, as a result, there will be increased risks undertaken by end users or at least greater volatility in reported profits and performance. This would be exacerbated if there is a concerted pressure from the combined regulations to drive FX on exchange. However, many companies are working on the assumption that FX Swaps and Forwards "for commercial purposes" would be exempt from most EMIR/MiFID2 requirements.

If the costs of hedging became uneconomic, very large Corporates with fully staffed central treasury operations would probably be able to manage the risks. However, there is a general concern that the mid-tier corporates will leave more FX risk on the books and this is an undesirable outcome that would have real economic consequences.

Lastly, the experience of implementing trade reporting phase is one that most end users feel could have been better managed by the authorities. The risk of different interpretation of the definitions, resulting from using a directive, was one that could have been foreseen and avoided. This confusion has resulted in a prolonged implementation process placing additional burdens on the resources, time and cost, of market users and, effectively, delaying a meaningful implementation of the reporting of FX transactions. It is critical that these definitions are clarified before the remaining provisions are implemented. Respondents believe that if salient lessons are learned from the process of implementing the reporting regulations the result would be an improved and more efficient approach to future regulatory changes, benefiting both regulators and market participants.

One observation from all the direct feedback that could potentially improve the process of future regulatory changes is for the relevant European regulatory authorities to adopt a more coordinated and clear communication strategy to keep all market participants and relevant trade associations adequately informed.

ACI and Adsatis Limited - March 2014.

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