FX INDUSTRY AT REGULATORY CROSSROADS

The Foreign Exchange (FX) event hosted in Brussels on 12 January 2011 by the Association for Financial Markets in Europe (AFME), in conjunction with HSBC, arrived at a critical time for an industry under the regulatory spotlight in Europe and the US.

With the Dodd Frank Act stirring debate on the exemption for FX forwards and swaps and the European Commission to follow the US lead under two separate legislative umbrellas, EMIR and MiFID, time is running out to make the case for FX exclusion from mandatory clearing.

And, as delegates at the AFME event learned, the unintended consequences of the proposed legislation could have a serious economic impact on both corporates and pension funds.

A model of evolved efficiency

The first panel session, moderated by HSBC’s Joe Norena chronicled the evolution of the FX market, with the introduction of electronic trading partly responsible for the increase in trades from $500 billion per day to today’s estimated $4 trillion. In the context of this dramatic market rise, the European Central Bank (ECB) is regularly examining how the market is handling growth and how the trades are executed, according to Holger Neuhaus, D-G of the ECB’s Market Operations.

Looking ahead, as the banks continue to make markets, they need to continue to invest in risk management, observed Richard Anthony, FX eRisk at HSBC, as well as to find new ways to differentiate themselves.

The ‘corporate’ perspective, provided by Christian Held, Head of Corporate Treasury at Bayer, highlighted serious repercussions that could arise from a one-size fits all regulatory approach.

Moving trade in foreign exchange swaps onto regulated exchanges would result in serious unintended consequences. “For us as a corporate, the whole debate on regulation will always have a bad impact because we produce in Euroland and we export our goods to the rest of the world, so we need hedging.” Whilst Held understands the need to make the market more efficient and transparent, he stressed that corporates require “a tailored rather than standardised approach”.

Held concluded that, if the regulatory threat materialises, it could force corporates to “move production away from Euroland and into countries where we are selling”.

Managing settlement risk

The second session featured a comprehensive examination of CLS, given by its President and CEO, Alan Bozian. Owned by the major FX banks, CLS settles 70% of the market and has a unique oversight arrangement with 22 central banks.

The key market benefit of CLS, however, is that it eliminates settlement risk, which, according to an AFME/Oliver Wyman study in October 2010, accounts for...
94% of maximum loss exposure on FX trades for products with a maturity of six months and 89% for two-year maturities. FX market credit risk is short-term (less than 75% of CLS trades settle in four months or less and liquidity requirements are reduced by 98%.

Converging regulation

The final session of the day saw Patrick Pearson, head of Financial Markets Infrastructure at the European Commission and Kay Swinburne MEP give their views on the FX market, acknowledging that FX is bespoke and not necessarily appropriate for clearing. “Many of these products cannot be standardised,” said Pearson, “but should we clear FX derivatives? It’s open to debate. Should we exempt FX outright? The US isn’t going to and it’s too early to take a dramatic and outright decision.”

Kay Swinburne noted that, whilst it was hard to separate the clearing aspects of EMIR legislation and trading aspects of MiFID, the FX market has worked well for years and there is little more to add in terms of transparency.

US regulation is on a faster track, effective from 15 July this year David Felsenthal from Clifford Chance highlighted that whilst the US Treasury can decide whether FX forwards and swaps fit into a general category of swaps, even if swaps are exempted, there is still a trade reporting requirement – an intermediary category of what has to be recorded. Felsenthal also called for a mutual recognition of Trade Repositories in both the US and Europe.

Pension funds to disinvest

As it stands, the proposed legislation will have a significant negative impact on pension fund activity, argued Neil Record, FX Investor Group. “We have seen huge growth in the internationalisation of pension funds and when they invest abroad, they hedge out all or part of their international FX exposure. Making pension funds post collateral (under proposed EMIR legislation) will disrupt this hedging.”

Pension funds understandably do not like retaining large cash holdings and the potential level of disinvestment would amount to a fall from 100% to around 90-95%, according to Record. “However,” he concludes, “in reality, the pension funds will make a clear retreat to domestic investment.”

MEP urges regulatory caution

Sharon Bowles MEP acknowledged industry concerns that “cost matters” and noted that moving the FX market to a centrally cleared model might raise the possibility of deflecting efforts away from the expansion of CLS. In addition, she raised the issue inherent in all derivative clearing, that of the introduction of concentration risk within the clearing house.

Given that FX underpins how the world trades, any increase in end user cost would be detrimental. “Now is not the time to put on the brake,” warned Bowles. In the event that regulation is prescribed, she called for clarity “in the illness, as
well as the side-effects,” at the same time recognising that it is investors who will pick up the bill.

**FX watershed**

The AFME’s FX event aired industry concerns that, firstly, regulation needs to identify the most appropriate risk in the market – for the FX sector, this is settlement risk and the already-developed CLS represents a highly effective system, backed by 22 central banks and overseen by the Federal Bank of New York.

Secondly, moving the FX market to a centrally cleared model raises the possibility of amplifying risk, according to the industry, by deflecting efforts away from the expansion of CLS and by introducing concentration risk within the clearing house.

Finally, the call was made loudly and clearly that requiring central clearing runs the risk of increasing costs for corporates and for pensions funds. With corporates considering relocating production operations, and pension funds threatening to disinvest whilst employing a greater domestic investment focus, there is little doubt that the industry finds itself at a critical juncture. The effect of imposing new regulations on the FX market could have serious repercussions that will live on for decades to come.