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Adrian Lee & Partners response to the Second Consultation Paper on 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 US\$6 billion from offices in Dublin and London for clients primarily based outside of the European Union.

ALP is greatly concerned that the Second Consultation Paper on Draft Regulatory Technical Standards (“RTS”) does not appropriately address the proposed collateral requirements for Foreign Exchange Forwards (“FX Forwards”) and Foreign Exchange Swaps (“FX Swaps”) referred to in Article 5 GEN (a) and (b).

While the extension of the phase-in requirements for initial and variation margin is welcome, ALP strongly disagrees with Article 5 GEN which exempts FX Forwards and FX Swaps from initial margin only. The firm proposes that Article 5 GEN be amended to exempt such instruments from the requirement to collect variation margin in addition to the exemption for initial margin.

The move to margin requirements for FX Forwards and FX Swaps will lead to a significant increase in the costs of trading and is contrary to “consistent global standards”. As a result of the new standards contained in the RTS, the use of non-cleared OTC derivatives may become prohibitively expensive for end users, such as pension funds, who often use these instruments to reduce currency risk in their portfolios. These prohibitive costs will also negatively impact on the decision of investors to diversify their portfolios internationally.

Unlike most other swaps, FX Forwards and FX Swaps have fixed payment obligations and are settled by the exchange of actual currency. They are predominantly short-term instruments with already well established risk mitigation techniques in place.

The short term nature of such instruments and the use of trading contracts with netting agreements significantly reduce pre-settlement risk. The use of Continuous Linked Settlement virtually eliminates settlement risk.

Lack of Harmony in the Regulatory Framework.

As discussed in the firm’s response to the First Consultation Paper, in order to maintain consistency with the Dodd-Frank requirements in respect of FX Forwards and FX 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.

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The proposed margin requirements 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.

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 FX Forwards and FX 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

ALP strongly urges the European Supervisory Authorities (ESAs) to reconsider the proposed requirements to exchange variation margin on FX Forwards and FX Swaps entered into by institutional investors such as pension funds.

The application of variation margin to these instruments will prevent the ESAs in meeting their objective with regard to converging the EU regulatory framework with other major jurisdictions and would only result in putting EU financial institutions at a competitive disadvantage.

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.

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