



asset management group

For the attn. of:

Mr Steven Maijor, Chair
European Securities and Markets Authority

Mr Andrea Enria, Chair
European Banking Authority

Mr Gabriel Bernardino, Chair
European Insurance and Occupational Pensions Authority

Mr. Patrick Pearson
European Commission

Mr Toomas Vapper
European Council

Mr. Roberto Gualtieri MEP
Mr. Werner Langen MEP
European Parliament

17-1085

3 October 2017

Dear Sir, dear Madam,

Re: Request for Deferral and Reconsideration of Uncleared Swap Variation Margin (“VM”) Requirements for Physically-Settled Foreign Exchange Derivative Contracts (“FX Contracts”)

Beginning in January 2018, EU investors subject to the European Market Infrastructure Regulation (“EMIR”) will face application of Variation Margin (“VM”) requirements for FX forwards¹, the only remaining type of FX Contract without VM requirements available for hedging EU clients’ FX risk.

¹ Article 37 of the European Supervisory Authorities’ (the “ESAs”) Regulatory Technical Standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP derogates the application date VM obligations for FX forwards until the date of entry into application of the Commission Delegated Regulation (2016) 2398, which specify some technical elements related to the definition of financial instruments. See Commission Delegated Regulation (EU) 2016/2251 of 4 October 2016 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty (the “RTS”).

Although Article 27 of the RTS finalized under EMIR (see footnote 1) excludes initial margin (“IM”) for FX Contracts, it does not provide a parallel exclusion for VM.

The undersigned Associations wish to express their concern regarding aspects of the application of the RTS that are forcing the collateralisation of FX Contracts. In particular, the signatories to this letter are concerned that a requirement to exchange VM for FX Contracts for counterparties such as fund management companies will:

- undermine funds and their asset managers’ ability to hedge risks, increasing underlying risk levels;
- undermine pension funds’ use of derivative contracts for risk management purposes. Pension funds use derivatives to manage their risks in their balance sheet by hedging – among others – their currency risks. The IORP Directive explicitly allows pension funds to use derivatives for mitigating investment risks or and for efficient portfolio management.
- prevent such counterparties from being able to use FX Contracts on a cost-efficient basis, or indeed at all.

Therefore, we ask the ESAs to request to the Commission the authorisation to review the currently proposed text and to act quickly in seeking deferral of the upcoming VM requirements that will be imposed upon FX forwards, the only remaining FX Contracts over which VM does not yet apply in the EU.

We further request that the above-listed authorities reconsider whether the EU’s VM requirements for FX Contracts are needed for regulatory or systemic objectives. FX Contracts are crucial to the management of currency mismatches in investment strategies when an investor’s home currency is different from the currency of the portfolio’s investments.

As raised previously by the undersigned² and as has been demonstrated by the path taken in other major jurisdictions, the Associations believe that a more principled, risk-based approach to collateral for FX Contracts achieves the best balance of regulatory objectives against the costs ultimately borne by pension funds, regulated funds (UCITS and AIFs) and other investors served by asset managers. Further, for many smaller U.S. advisers whose clients do not generally trade derivatives but that occasionally use FX Contracts to hedge currency risk (e.g., in long-only equity strategies) the new VM requirements will be unduly burdensome. Since FX Contracts are not typically in-scope for uncleared swap margin requirements in the United States, these advisers do not have not infrastructure in place to exchange margin (e.g., ISDAs, CSAs, and other processes).

In contrast to the EU, investors subject to the laws of other major jurisdictions do not face similar prescriptive VM requirements for FX Contracts. Authorities in Switzerland, the U.S., Canada, and a number of Asia-Pacific jurisdictions have taken a risk-based supervisory approach, excluding FX Contracts from their uncleared swap margin rules in favor of the 2013 Basel Committee on Banking Supervision’s (“BCBS”) supervisory guidance.³

² See, e.g., EFAMA’s reply to the EU Consultation on EMIR Refit, *available at*: http://www.efama.org/Publications/Public/Derivatives/EFAMA_reply_EC_CP_EMIR_REFIT.pdf; AMG’s Letter regarding EMIR Refit, *available at*: <https://www.sifma.org/resources/submissions/supporting-european-commission-proposal-to-amend-emir/>.

³ FX supervisory guidance for managing risks associated with the settlement of foreign exchange transactions, *available at*: <http://www.bis.org/publ/bcbs241.pdf>.

If, however, VM must be exchanged due to EU law applying, EU clients and their asset managers are left to decide whether the client's interests are best served by accepting the negative consequences or leaving the currency risk unhedged. This decision is more acute for smaller clients for whom the costs are proportionally larger. In addition, if the client is not in the EU, the client or its asset manager may decide that the client's interests are best served by restricting trading to non-EU banks to avoid automatic VM that EU banks must impose under EMIR.

Deferral of these requirements until further review can be undertaken is needed urgently. Much work remains to implement these requirements, especially for investors who engage in no other products requiring VM under the RTS. While we have been raising this issue for some time, we believe the practical differences and consequences between the EU standards for FX contracts and the other major jurisdictions have only recently come into focus. As such, a deferral of application beyond January 2018 is needed to allow careful consideration of the impact upon investors in the EU subject to the requirements, and the broader impact on a cross-border basis.

Consequently, the Associations ask that:

- (1) the ESAs request a deferral of the VM requirements for FX forwards sufficiently beyond January 2018 so that the above-listed authorities can reconsider the EU's approach;
- (2) the ESAs in combination with the European Commission and National Authorities implement a deferral; and
- (3) the authorities reconsider the VM requirements for FX Contracts via the EMIR Refit or other legislative processes.

In making this request, we recognize the procedural difficulties of deferral in the EU; however, if the authorities believe, as the Associations do, that investors and pension beneficiaries' interests are best served by delaying this requirement, we hope that a procedural path can be found to achieve this result.

Should you have any questions, please contact the undersigned.

Respectfully submitted,

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