Position Paper

Response to consultation on FX Financial Instruments

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Contact person:	Ecofin department	E-mail:	mihai@insuranceeurope.eu
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Introduction

- **Derivatives are key for insurers' risk and efficient portfolio management**

Derivatives are often a key part of insurers' risk management strategies, used to hedge risk exposures by matching the profile of liabilities, for securing a pay-off promise made to policyholders or for hedging the value of an expected claim denominated in a foreign currency. To a lesser extent, where the local prudential regime does not prohibit it, derivatives are also used by insurers for achieving portfolio diversification across assets and currencies.

- **Clarity and consistency on EMIR definition is needed**

Insurance Europe welcomes the Commission's consultation on Foreign Exchange (FX) financial instruments. The lack of clear definitions has led to market uncertainty with regard to regulatory requirements and the Commission consultation is an appropriate initiative to address existing uncertainty among market players.

Insurance Europe believes it is important that the definition of financial instruments is clear for all market participants across all member states and consistent across currency pairs.

- **The scope of FX transactions primarily regards hedging or "payment instructions"**

FX transactions are primarily used to cover risk exposures in foreign currencies, as part of efficient risk management or to acquire foreign currency in order to gain exposure on foreign securities as part of efficient portfolio management (ie "payment instructions"). In these cases the existence of FX transactions can therefore not be separated from the existence of either a risk to hedge or a security to buy. Regulation should not disincentivise these transactions by defining them as FX financial instruments and imposing on them derivatives-related regulation.

- **A number of cross-border settlement challenges emerge and need to be carefully taken into account**

Insurance Europe believes that the cross-border nature of FX transactions and its implications in terms of eg different banking holidays or cross-border settlement challenges, needs appropriate reflection in the delimitation between spot and forward FX transactions. The well-established market conventions in both the FX and securities cross-border markets should be taken as references, and their implications should be appropriately reflected in the cut-off period.

Insurance Europe aisbl • rue Montoyer 51, B-1000 Brussels
Tel: +32 2 894 30 00 • Fax: +32 2 894 30 01
E-mail: info@insuranceeurope.eu
www.insuranceeurope.eu

For example, in the case of FX transactions used for buying foreign currency, two transactions are needed: to buy/sell foreign currency and to buy/sell foreign security. These are linked in scope and should ideally be linked in terms of settlement timeframes. The settlement timeframe for securities can range from T+2 to T+5 and T+7 (eg South Africa) and certain currency pairs will have more difficult constraints due to differing time zones and geographical locations. In addition, it's sometimes the case that buying foreign currency requires an intermediate leg (eg $), in which case the acquisition of foreign currency would expand over two settlement periods.

- **Insurance Europe supports a cut-off period of seven business days (T+7). A cut-off period of five business days (T+5) would also work as a more conservative but potentially less efficient solution**

Against the above background, we believe that a cut-off period of <u>at least five valid business days for each of the two currencies </u>would be appropriate. We would like to stress *"at least"* because in practice there exist sometimes challenges such as administrative or challenges related to proprietary market systems. To incorporate such challenges, a cut-off period of seven business days would be more appropriate to minimise any risk that a "normal" FX spot transaction would suddenly become a financial instrument with important and burdensome regulatory implications.

A seven business days cut-off period would cover 85% of all FX transactions and it would therefore allow for greater global alignment as, in the US for example, FX forwards and swaps were exempted from mandatory derivative requirements of the Dodd-Frank Act.

Once the cut-off period is defined, MiFID, EMIR and other derivative-related legislations should not cover FX transactions with a settlement period below the cut-off period. Given the upcoming work on pending EMIR technical standards, it's important that this topic is clarified ahead of discussions on eg the clearing obligation.

Detailed response

(1) Do you agree that a clarification of the definition of an FX spot contract is necessary?

Yes, we believe there is an urgent need for a more precise definition, especially in view of MIFID and EMIR implementation impacting all derivative market participants. Lack of clear definitions has recently led to market uncertainty with regard to regulatory requirements.

A clear and unique understanding of definitions across member states (and also globally) is important in order to create a level playing field for all market participants and prevent undesired arbitrage opportunities. This will ensure the effective functioning of global FX markets.

We also believe that it is important to clarify the definition and difference between a FX forward and a FX swap. It's sometimes the case that counterparties report FX swaps differently, namely one party records a FX swap as a combination of a FX spot and a FX forward while the other counterparty records it as FX swap. This gives rise to disputes and inconsistencies between counterparties' reports.

(2) What are the main uses for and users of the FX spot market? How does use affect considerations of whether a contract should be considered a financial instrument?

The FX market is key to cross border payments and facilitation of international trade through the means of currency conversion.

Insurers and reinsurers operate in cross-border environments and often cover insurance risks denominated in foreign currencies; managing such risks often implies making use of FX operations (either on the spot or on the derivatives market).

An example of where FX transactions are used as a natural component of usual business is the reinsurance business which, by definition, has a strong international and cross-border nature. When an insured event occurs, the corresponding reinsurance claim is hedged (eg via a FX forward) for a certain period of time (when the claim is expected to become due/settled). If the claim is still not due at maturity of the FX forward, the reinsurer acquires corresponding foreign currency, which it resells by spot contract. The reinsurer continues to hedge the risk by entering a new FX contract. This system of rolling FX hedging is continued, until the claim is finally due and settled.

Another example is the case of efficient portfolio management. Insurers have large portfolios of assets which they aim to diversify across asset classes and currencies subject to no local regulatory barriers. FX operations (for hedging or simply for gaining exposure on foreign assets) are therefore often used by insurance companies for asset management purposes. Gaining exposure on foreign securities implies the following two transactions: 1) a FX spot transaction to buy/sell foreign currency and 2) a transaction for buying/selling the foreign security. In an optimal case, the settlement dates for the two transactions should be perfectly aligned. In Europe, according to the Central Securities Depositories Regulation (CSDR), the settlement timeframe for securities will be set at T+2 business days. However, this is not the case outside Europe where the settlement timeframe for securities can significantly differ.

As soon as a FX trade becomes a financial instrument under the scope of eg EMIR, the operational implications are significantly different. Clarity in the delimitation between spot and derivative FX operations is therefore important for the proper implementation of regulatory requirements.

In addition, if the limit between FX spots and derivative transactions becomes too tight, it can potentially impact the investment decision making; for example, if a spot transaction that (traditionally) used to be settled in T+3 business days suddenly becomes a derivative transaction, the new requirement can potentially discourage the transaction.

(3) What settlement period should be used to delineate between spots contracts? Is it better to use one single cut-off period or apply different periods for different currencies? If so, what should those settlement periods be and for which currencies?

The well-established FX market conventions should be taken as an appropriate reference when delineating between FX transactions (spots vs. financial instruments). Market conventions sometimes differ by currency pair. Should regulations aim to introduce definitions which are different from well-established market conventions, an impact study would be absolutely necessary to assess the impact of such changes.

However, and as mentioned above, investors often use FX transactions for buying or selling foreign currency which is then used for buying or selling foreign securities. If there is an underlying securities trade (ie purchase or sale of securities), and that trade settles on a T+3/T+5/T+n basis (depending on the market practice in the country of issuance of the security), then an investor (or a custodian bank on behalf of an investor) may perform a FX trade to convert the settlement amount into the base currency of the investor. That FX trade will typically be performed with settlement date being the same with the settlement date of the underlying securities trade. Such FX trades are fundamentally "payment instructions" in the terminology of the Commission in its papers. They should therefore be classified as "payment instructions", ie as spot FX contracts, and not as FX financial instruments.

Against this background, we believe that a cut-off period of at least five valid business days (T+5) for each of the two currencies would be appropriate. We would like to stress *"at least"* because in practice there exist sometimes challenges such as administrative or challenges related to proprietary market systems. To also incorporate such challenges, a cut-off period of T+7 business days, would be more appropriate to minimise any risk that a "normal" FX spot transaction would suddenly become a financial instrument with important and burdensome regulatory implications.

A seven day cut-off would cover 85% of all FX transactions and it would therefore allow for greater global alignment as, in the US for example, FX forwards and swaps were exempted from mandatory derivative requirements of the Dodd-Frank Act.

(4) Do you agree that non-deliverable forwards be considered financial instruments regardless of their settlement period?

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(5) What have been the main developments in the FX market since the implementation of MiFID?

A development that we have witnessed on the FX market is represented by "electronification", which has been very rapid over the past years. The main driver of this was not MiFID as such, but technological development and the increasing number of end users providing increased liquidity. While electronification has happened, especially among large institutions, smaller market players are closely behind the trend which is expected to continue. This is especially the case with vanilla products; more complex products are still mainly traded over the phone, especially by smaller market players. This is mainly because of the relative complexity of non-vanilla products which makes it safer to agree the terms over the phone. It could be argued that electronification has actually moved the operational risk away from banks to the end user as increasing FX volumes are handled via electronic platforms which ultimately make the end user, solely responsible for the transaction details matching what was the original intention.

(6) What other risks do FX instruments pose and how should this help determine the boundary of a spot contract?

We strongly believe that the risks associated with foreign exchange markets are appropriately mitigated by the current global regime of prudent supervision, practice guidelines and capital implications. This includes principal (or settlement) risk reduction through use of Continuous Linked Settlement (CLS), replacement cost risk reduction by appropriate usage of Credit Support Annexes (CSAs), and strengthened supervisory guidance that focuses on ensuring sufficient capital is held against potential exposure to all foreign exchange settlement related risks.

(7) Do you think a transition period is necessary for the implementation of harmonised standards?

All market participants, including insurance companies, will need sufficient time to adapt their systems in order to comply with the harmonised standards. Ideally, the implementation period should be harmonized globally to create a level playing field and avoid any competitive disadvantages or premature requirements for EU financial companies.

(8) What is the approach to this issue in other jurisdictions outside the EU? Where there are divergent approaches, what problems do these create?

We believe that the larger differences are between jurisdictions, the higher the risk that transaction flows move to those jurisdictions that have the most flexible regulations.

Global regulatory alignment and transparency in the approach is important as currencies reflect global regulations.

(9) Are there additional implications to those set out above of the delineation of a spot FX contract for these and other applicable legislation?

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(10) Are there any additional issues in relation to the definition of FX as financial instruments that should be considered?

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