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Kirvelä Elina

Federation of Finnish Financial Services represents banks, insurers, finance houses, securities dealers, fund management companies and financial employers operating in Finland. Its membership includes employee pension, motor liability and workers compensation insurers, all three providers of statutory insurance lines that account for much of Finnish social security. The Federation has about 460 members who employ a total of 43,000 people.

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Consultation document 10 April 2014 on FX financial instruments

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FFI RESPONSE TO EUROPEAN COMMISSION CONSULTATION ON FX FINANCIAL INSTRUMENTS

The Federation of Finnish Financial Services (hereinafter “FFI”) welcomes the opportunity to respond to the Commission consultation on FX Financial Instruments launched on April 10th 2014.

KEY POINTS

- FFI gladly welcomes the Commission consultation on what should be considered an FX financial instrument. Lack of clear definitions has led to market uncertainty with regard to regulatory requirements and poses a risk to the level playing field across markets.
- It is important that the definition of financial instruments is clear and uniform for all market participants. Following this, for example the scope of EMIR reporting obligation will be clarified.
- A cut-off settlement period of 7 days for all currencies would best draw the line between spot and forward contracts. MiFID, EMIR and other legislations should therefore not cover FX transactions with a settlement period of 7 days or less.
- In general, simplified procedures will best ensure proportionality of the rules and ensure the workability of these rules also for small and medium-sized market participants with fewer resources. This applies both to the scope of these FX instruments and to the cut-off settlement period.



DETAILED QUESTIONS

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

Yes, there is an urgent need for a more precise definition in view of MIFID and EMIR which will benefit all market participants. Lack of clear definitions has led to market uncertainty with regard to regulatory requirements. For example, many of the market participants (both financial and non-financial) are still trying to find out which contracts in practise are required to be reported under EMIR.

Harmonization of the definitions across EU and globally is also important in order to create level playing field for all market participants and prevent undesired arbitrage opportunities. This will ensure the effective functioning of global FX market.

(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?

Main users of FX spot market are different kind financial institutions and corporates that engage in foreign trade. Basically, each market participant transacts its FX spot contracts in a global, standardized and liquid FX market. The main uses are often purely related to commercial purposes. In the case of financial institutions, FX spots are also used to ensure proper diversification of portfolios or to hedge expected obligations, such as insurance claims.

Too broad definition of financial instrument could unnecessarily complicate the procedures of these simple, daily transactions. It should be kept in mind that FX spot market is very global and too tight requirements may affect global trade. FX Spot contracts are cash products which are physically settled via the exchange of two different currencies. They are fundamentally different from OTC derivatives in both function and form - OTC derivative contracts are financially, cash settled products based on the price on an underlying asset, whereas FX spot contracts are products which are characterised by the physical exchange of two currencies between transacting parties and is an integral part of the global cash market.

As the settlement times (T+n) vary in different instruments, flexibility (e.g. 0-7 days settlement period) is needed in the settlement periods of the FX transactions in order to avoid unwanted open FX positions. Such FX transactions should never be regarded as derivatives on the sole ground that the settlement is longer than T+2 (see also our response to Q3). However, other than spot transactions can be regarded as financial instruments.

(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?

Current practice and experience in the FX markets result in the definition of different settlement periods for spot contracts. In addition, bank holidays, which vary across



jurisdictions, represent a parameter that deserves due consideration; bank holidays usually lengthen settlement cycles and therefore longer settlement periods are needed for spot transactions. In addition, most of the transactions up to approximately one week are closely related to daily, short term liquidity management activities of corporates. With institutions it usually means straight forward purchases of assets in foreign currencies in order to diversify investment portfolios. Settlement instructions and periods of these assets may vary, but nevertheless should they fall easily in the scope of EU regulations such as MiFID and EMIR since they do not have the characteristics of those instruments at the heart of these rules.

In FFI's opinion, the market would work best with a single, yet timely flexible cut-off settlement period. In order to tackle differences in market practises and to avoid any unintended causes from accidental settlement delays due to, for example, different local holidays, we see T+7 cut-off period regardless of the currency as an excellent starting point. Contracts beyond this cut-off can be considered as a financial instrument.

A consistent cut-off period is crucial to ensure a simple framework that will ease the administrative burden at many financial and non-financial counterparties engaging in FX spot market. Further, such an approach will best ensure harmonized approach across Member States and will not need to be adjusted continuously.

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

A unified approach would in our opinion simplify the framework considerable. Therefore we agree that non-deliverable forwards should be considered financial instruments or at least they should fall under the scope of the reporting obligation.

Different treatment is justified based on the nature of the settlement of NDFs which is completely different from the settlement of FX spot contracts.

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

Electronification of the FX market has been rapid. The main driver has been technological development and increasing number of end users providing more liquidity, not MiFID as such. Electronification has taken place especially among the large corporates and institutions, but also the smaller ones have already partly adapted. The trend is expected to continue. One should bear in mind however, that this applies mostly to vanilla products.

Many of the more complex products are still mainly traded over the phone, especially with the SME segment. This is due to the relative complexity of the product which makes it safer to agree the terms over the phone. One could argue the electronification has in a way moved the operational risk away from banks to the end user. More FX volume is handled via e.g. algorithmic platforms which can 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?

As mentioned in Q5, FX transactions contain operational risk and the more we have straight thought processing, electrification and algorithms, the more of the operational risk will move to the end user to carry.

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

A transition period is absolutely necessary as market participants will need sufficient time to adapt their systems in order to comply with the harmonised standards. The effect of the harmonized standards needs to be carefully considered as it might pose a change of market practise for the industry and their clients. For example, if new instruments are considered as financial instruments, they will need to be reported according to EMIR requirements. This might mean that some totally new non-financial counterparties will need to start reporting and for example, apply for a legal entity identifier. Setting up these procedures takes time.

Finally, the implementation period should be harmonised within the EU as well as outside the EU to prevent arbitrage and ensure the competitiveness of EU firms operating globally.

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

It would be advisable that the European Commission makes a comparable study of the most relevant non-European Union regimes before finalising the European Union regime. In general the FFI has seen that the more significant differences are across jurisdictions, the higher is the risk that transaction flows move to those jurisdictions that have more flexible regulations. Already since the entry in force of EMIR, some flows have moved to Asia.

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

No comments.

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

No comments.

FEDERATION OF FINNISH FINANCIAL SERVICES

Contact details:

Ms Elina Kirvelä
Phone number: +358207934208
Email: elina.kirvela@fkl.fi