The European Association of Co-operative Banks comments on

COMMISSION CONSULTATION DOCUMENT on FX FINANCIAL INSTRUMENTS

9 May 2014

The European Association of Co-operative Banks (EACB) is the voice of the co-operative banks in Europe. It represents, promotes and defends the common interests of its 28 member institutions and of co-operative banks in general. Co-operative banks form decentralised networks which are subject to banking as well as co-operative legislation. Democracy, transparency and proximity are the three key characteristics of the co-operative banks' business model. With 3.700 locally operating banks and 71.000 outlets co-operative banks are widely represented throughout the enlarged European Union, playing a major role in the financial and economic system. They have a long tradition in serving 215 million customers, mainly consumers, retailers and communities. The co-operative banks in Europe represent 56 million members and 850.000 employees and have a total average market share of about 20%.

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I. General Comments

The European Association of Co-operative Banks (EACB) welcomes the opportunity to respond to the Commission Consultation paper on FX Financial Instruments.

As a general remark, the members of EACB consider that the most important issue is not to delineate FX spots, but to clarify which FX contracts qualify as financial instrument and fall in the scope of MiFID and EMIR.

Moreover, the members of EACB note that definition of financial instruments in MiFID is the only legal definition of financial instruments or financial products and is used as a basis in a variety of legal instruments. However, it appears that this general definition may not be suitable for all regulated areas and if necessary, exceptions or additional requirements for individual products should be considered. A clarification for foreign exchange business in connection with Regulation 648/2012 ("EMIR") should not be automatically transferred to other regulatory areas, as forex markets have significantly different characteristics than other financial products.

Furthermore, taking into account the high volumes of cross-border transactions in the FX markets, the EU rules should be compatible with the corresponding regulations in the U.S. and in Asia particularly in foreign exchange products.

The EACB presents below its considerations on the basis of the specific consultation questions:

II. Background

EU legal framework and definitions

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

The members of EACB agree that a clarification of what constitutes an FX spot contract would be useful in order to ensure legal certainty. In particular with regard to EMIR we would like to stress the importance of establishing a uniform treatment of FX transactions on the European level, i.e. which FX instruments fall under the EMIR requirements and which not.

Moreover, a global harmonisation is also essential in order to avoid regulatory arbitrage by choosing a certain region depending on the relevant legal and regulatory environment (e.g. Asia at this moment). We note that a global harmonisation is essential also in view of equivalence of rules and substituted compliance (for example in respect of Dodd Frank Act and EMIR). A high degree of harmonisation with third countries would also limit the technical and administrative effort.

III. Issues for discussion

Foreign exchange market

Question (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?

Many banks and end users use spot contracts for cash management and payments activities. It can be safely assumed that foreign exchange transactions of non-financial counterparties (NFC) usually serve the payment purposes as indicated in the consultation paper (even though forward contracts). In fact, the intermediaries (especially cooperative banks) allow transfers in foreign exchange, with physical settlement, to NFC (as small-medium enterprises) as a means of payment to facilitate the payment for goods and services. In business dealings, these payments are usually set in 90 days. SMEs need these payment facilities to accommodate their activity on foreign markets. In this case, it is unquestionable that the purpose of the counterparties in not an investment, but the "object" of the contract (i.e. the currency). This approach is also reflected in the legislation of some members states (e.g. Italy). In such cases the law does not consider FX contracts concluded for commercial purposes and/or which are physically settled as financial instruments[1]. In this context it is important to note the Commission itself in the relevant Consultation Paper acknowledges that *"payment instruments are not typically considered financial instruments"*, and that *"MiFID, therefore, generally uses activities and counterparties to define exemptions and classifies a contract as a financial instrument by looking at the type or characteristics of instruments"*.[2] In its Q&A on MiFID[3], the Commission states that commercial FX forward transactions are not covered by MiFID. We consider that the Commission should continue with the same approach.

Moreover, numerous foreign exchange transactions among financial institutions often concern "payment" operations. For example, the high volumes of banks in FX swaps result to a significant extent from the fact that banks offset the daily fluctuating foreign currency balances with each other. These fluctuations result from the movements on the foreign currency accounts of customers, from foreign currency loans (payment, interest payments, repayment) from exchange and hedging transactions by customers for current or future payments in foreign currencies or from payments related to investments in foreign currency by customers (purchase, sales, interest and dividend payments). To that extent, foreign exchange transactions between banks often have a real economic background or fulfil the purpose referred to as "payment" in the consultation paper. However, a clear-cut distinction would be very difficult to achieve in practice and such a distinction could not follow a standardised procedure.

In any case, we deem that the Forex spot should always fall outside MiFID.

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[1] As an example, please refer to the Italian Consolidated Law on Finance (Legislative Decree No. 58/1998) whereas the MiFID Annex 1 is transposed and implemented. Article 1 (4) of this law states also that "the means of payment are not financial instruments. Financial instruments, and specifically financial contracts for difference, are foreign currency sale and purchase contracts, extraneous to commercial transactions and settled on the difference (…)". Accordingly, in Italy only those purchases and sales of foreign currencies which are concluded for "non-commercial" purposes and are "cash- settled", are currently considered as financial instruments. Therefore, only if both of the mentioned conditions are met (i.e. non- commercial purpose and cash-settled transaction), the relevant contracts are to be classified as financial instruments falling within MiFID. On the contrary, if at least one of the said conditions is not satisfied, the contracts are considered as payment instruments (i.e. not as financial instruments).

[2] Please refer to page 3 of the Consultation Paper,

[3] The relevant Commission document can be found here: http://ec.europa.eu/internal_market/securities/docs/isd/questions/questions_en.pdf

Settlement and delivery

Question (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?

In defining the settlement period to delineate FX spots, we understand that two or three business days after transaction date (T+2 or T+3) could be considered as an international market practice in many cases. However, a 3-day settlement period as a criterion to differentiate between spot and forward, for example, does not take into account the fact that eurozone public holiday calendars on which a deal is based differ from actual bank holidays observed by banks. In cross-border transactions a 3-day period can easily be exceeded because of differing public holidays. Because of the overrun caused thereby the transaction would then be classified as a financial instrument.

Against this background, the EACB would recommend seeking orientation in Art. 272 para 2 of the Capital Requirements Regulation ("CRR"). This clause defines "long settlement transactions" transactions "where a counterparty undertakes to deliver a security, a commodity, or a foreign exchange amount against cash, other financial instruments, or commodities, or vice versa, at a settlement or delivery date specified by contract that is later than the market standard for this particular type of transaction or five business days after the date on which the institution enters into the transaction, whichever is earlier".

Alternatively, if the term "market standard" is considered rather vague, the following definition of a spot contract could be used: "Transactions, where a counterparty undertakes to deliver a foreign exchange amount against cash, other financial instruments, or commodities, or vice versa, at a settlement or delivery date specified by contract that is later than a minimum of three business days in each jurisdiction involved after the date on which the institution enters into the transaction."

In principle we would advise not to complicate matters (operational/ monitoring burden) by using different cut-off periods for each currency. Moreover, it is important that the same definition of a spot contract is used in all markets.

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

Without prejudice to the distinctions between means of payment and financial instruments under question 2, in principle, we would suggest that the limits are set without discrimination of all foreign exchange products, i.e. also on non-deliverable forwards. We consider that if further distinctions were made, it would lead to an unnecessary complication and would make monitoring more burdensome and difficult.

FX Market Developments

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

The International Financial Reporting Standards (IFRs) hedge accounting requirements have lead to less FX options, while the number of plain vanilla contracts traded through electronic platforms has increased. Moreover, it seems that more smaller specialised firms have entered the FX market. Many of these firms often do not hold license because they state to only perform spot transactions.

FX Risks

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

As already stated above under question (5) more smaller firms are active in the FX market performing without licence, not only spot contracts but also transactions with a longer duration. We wonder whether their potential impact on the market has been analysed and assessed by the regulators and whether duty of care is preserved by these firms.

Transition Periods and International Aspects

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

Yes. It is extremely important to provide an adequate transitional period for the necessary technical and procedural system adjustments. It should also be taken into account that possibly the alignment of different EU legislations will be necessary in that regard.

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

In Hong Kong spot transactions are defined as T+2 transactions with an actual delivery of the currency (deliverable or physically-settled transactions). These transactions are not considered as derivatives/financial instruments. In the U.S. the norm is T+2 transactions with an actual delivery of the currency (deliverable or physically-settled transactions), with however the possibility to extend the number of days if a longer settlement is concerned depending on the customary timeline in the relevant market. These instruments are not considered as derivatives/financial instruments. As for Australia and New Zealand, the norm is T+2, irrespective of whether these transactions are cash-settled (no actual delivery of the currency) or physically-settled (actual delivery of the currency). These instruments are not considered as derivatives/financial instruments.

However, we would advise the European Commission to further investigate on the differences of treatment between the most relevant jurisdictions. A global level playing field is needed for European banks/ investment firms: On the one hand, European regulations should at least have the same flexibility with regard to FX contracts as the other relevant jurisdictions. We should prevent a competitive disadvantage for European banks/ investment firms by imposing more obligations to European parties than outside Europe. On the other hand, having more flexibility in the European Union than in the U.S. and other relevant jurisdictions would also not be desirable and could pose problems in respect of equivalence of rules or substituted compliance (for example between Dodd Frank Act and EMIR). A fragmentation of the market, as the one evidenced the last years in interest rate derivatives in USD, would reduce the liquidity of markets, and significantly increase transaction costs and technical complexity for banks and consumers.

Regulatory Implications of Classification as a Financial Instrument

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

The EACB reverts to its comments under title "I. General Comments" and "Question 2" with regard to the distinction between payment instruments and financial instruments.

With regard to the applicability of the EMIR rules on FX transactions, the EACB would also like to add the following:

- Foreign exchange transactions related to the real economy (see our comments under (2) above), generally characterized by limited volume and duration (e.g. 3 months) should be exempt by EMIR requirements, as the associated expenses of small and medium size companies would be disproportionate.

- In addition, we consider that foreign exchange transactions with central banks, due to their purpose and low risk for the counterparty, should equally be exempted from of the EMIR requirements.

- As the Commission acknowledges in the consultation paper, the main risk of short term FX transactions – either spot or short term derivatives transactions such as FX forwards, FX swaps, FX options – is the settlement risk. In order to limit the settlement risk the techniques of "Continuous Linked Settlement" ("CLS") or "payment for payment" (PvP) are used with respect to spot transactions but also FX forwards and FX swaps. Therefore, the settlement risk with regard to many of these transactions is rather limited. Taking this into account and in line with our argumentation above in question, we consider that also short term FX derivatives transactions - in particular FX swaps but also FX options or non-deliverable forwards - with a settlement period of less than three days – should be exempted from the EMIR requirements (even if these instruments qualify as FX derivatives).

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

No further comments.

Contact:

The EACB trusts that its comments will be taken into account.

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