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September 28, 2012

Via E-mail

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Re: CLS Bank International Response to the Consultative Document on Margin Requirements for Non-Centrally Cleared Derivatives (the "Margin Paper")

Ladies and Gentlemen:

I am writing in response to the Margin Paper. Thank you for the opportunity to submit these comments in support of this important work.

CLS Bank International ("CLS") is an Edge Act corporation located in New York, with an affiliate, CLS Services Ltd., located in London. CLS's payment-versus-payment settlement service (the "CLS System") is the predominant multi-currency settlement system for foreign exchange ("FX") transactions globally. CLS was created as the result of the collaborative efforts of foreign exchange market participants and various central banks, including the Board of Governors of the Federal Reserve System in the United States, the European Central Bank, and the Bank of England, in response to regulatory concerns regarding systemic risk arising from the arrangements then used to settle FX transactions. CLS has a demonstrated history of reducing settlement risk in foreign exchange markets, including during the 2008 financial crisis, when the CLS System and the foreign exchange markets functioned effectively.

Our comments relate to Q2 in the Margin Paper[1]. As discussed below, settlement risk (loss of principal) is generally understood to be the primary risk associated with the settlement of payments relating to FX transactions and that effective mitigation of settlement risk already largely occurs through the use of the CLS System[2]. CLS is committed to extending coverage of its settlement system through the addition of new currencies and new settlement sessions in order to achieve our key strategic objective of providing further settlement risk mitigation in the global FX market. CLS believes that the imposition of mandatory margin requirements on FX swaps and forwards—whether based on transaction tenor or otherwise—would not be appropriate and, in fact, could lead to the unintended consequence of increasing settlement risk in this market. We share this view with the members of the GFMA Global FX Division, and we find the arguments supporting the position that margin requirements are not appropriate for FX swaps and forwards as compelling and persuasive.

The key distinguishing feature of FX transactions is that they require the exchange of the full principal amount of two currencies, rather than, in the case of payment obligations for most other types of derivatives, the net gain or loss of the transaction in a single currency[3]. As a result, the primary risk associated with payments relating to FX transactions is settlement risk, which is the risk that one party delivers the full principal amount in one currency but the other party fails to deliver the full principal amount of the other currency. In contrast, margin is generally understood to address replacement cost risk, which represents the market risk that a non-defaulting party is exposed to during the period that the non-defaulting party replaces its original FX transaction. Given the high levels of liquidity in the FX market, which reduce the period during which a position is exposed to an adverse price movement, replacement cost risk is generally considered low relative to settlement risk.

As noted above, settlement risk is predominantly addressed in the FX market through the CLS System, which was specifically designed by the international financial and regulatory community to address this risk. CLS notes, however, that participation in the CLS System is not mandatory, albeit prudent from a risk management perspective. Imposing mandatory margin requirements on FX swaps and forwards could have a significant financial impact on the deep, liquid, and highly competitive FX market. If market participants were required to post margin in respect of their FX swaps and forwards, the sum of the additional cost of that requirement and the cost of settling payments relating to those transactions through the CLS System could exceed the currency risk mitigation benefit of entering into those transactions. Given a choice between compliance with a mandatory margin requirement to reduce replacement cost risk, and the reduction of settlement risk on a voluntary basis using the CLS System, market participants likely may choose to reduce their usage of the CLS System. If that were the result, mandatory margin requirements would have the unintended effect of prioritizing a lower risk category (i.e., replacement cost risk) over the more significant, well recognized settlement risk. This would undermine CLS' continued efforts to

[1] Q2 poses the following questions: "Should foreign exchange swaps and forwards with a maturity of less than a specified tenor such as one month or one year be exempted from margining requirements due to their risk profile, market infrastructure, or other factors? Are there any other arguments to support an exemption for foreign exchange swaps and forwards?"
[2] Other forms of settlement risk mitigation include internally settled affiliate FX swaps and forwards, and transactions settled via book-entry by a bank for its clients.
[3] Another distinguishing characteristic is that parties' payment obligations for most FX transactions are fixed at the initiation of the transaction and are thus known to the parties from the outset.

achieve further systemic risk mitigation, and seems inconsistent with, and even in direct conflict with, the strategy agreed and implemented by central banks, with supervisors, in addressing and reducing risk in the FX market -- efforts which began in the mid-1990s and continue today.

Please do not hesitate to contact me if you have any questions regarding this submission.

Sincerely,

David Puth