

CHAIRMAN'S COMMENTS

Dear Members,

Reviewing the activities since the last newsletter I continue to be astounded by the achievement of the Executive representing the industry. In June we heard from the FCA on the subject of promotion of currency transfer services and from PwC on the referendum ... which was swiftly followed with Ian Benson, Jude Bahnan, Laura Hanna and myself holding a Brexit panel to garner opinion and start the debate on what the future holds. Ian has followed up with some analysis in this newsletter.

Richard Creed has completed the second consultation on the technical requirements for security under PSD2. Millie Richardson and Jude Bahnan have attended several forums with HMT & FCA through the consultation process for MiFID2. Jude has provided a summary in this newsletter. Mike Southgate and I ran the Fraud Round Table in April and the notes from that were circulated by EI. Jamie Cooke provided a Fraud Best Practice presentation at the June member meet which is also available via the website. Strong authentication as a tool to prevent fraud was once again focussed on by Mike Southgate at the September member meet alongside Andrew Barnett from Barclays Fraud Risk Management team. AFEP is forming a partnership with the Metropolitan Police Cyber Intelligence Sharing Partnership (CISP) and we'll be hearing more from this team in December but in the meantime cyber crime bulletins are being circulated monthly.

Last week Mike Southgate hosted a Risk Round Table and the presentation and notes will be circulated. The newsletter contains a short piece on Counter-party Risk.

EI has circulated:

- New NCA glossary codes;
- Briefing of changes in requesting a defence under POCA or TACT; and
- FATF Guide on Counter Terrorist Financing.

The Executive is currently co-ordinating consultations for PSD2, MiFID2 with FCA, AMLD4 with HMT and Bulk Data Gathering with HMRC and is maintaining a watch on the Payment Strategy Forum consultation. As a result we took the decision to run with the same team instead of holding elections. We are pleased to welcome Kam Biring, Joanna Jenkins, Dipesh Patel, AJ Penniston and Munish Trehan as future Executive Members who will be working alongside the Executive to ensure consultations are responded to on time and to provide consistency across the range of activities and regulators.

Francesca Maritan

Chairman

FX Forwards and MiFID II

Jude Bahnan

Earlier this year, we reported that the European Commission had finally issued its long-awaited delegated regulation relating to the scope of FX instruments, which outlined the classification of financial instruments relating to a currency and clarified the definition of spot contracts under MiFID II. As we had hoped, the regulation contained a carve-out for OTC FX forwards entered into with a non-financial counterparty as a means of payment for identifiable goods and services.

FX Forwards and MiFID II

Jude Bahnan

In July of this year, AFEP was invited to attend a meeting with a number of representatives from different areas within FCA together with other interested parties such as HM Treasury. The purpose of the meeting was to discuss the implications of the delegated regulation, and how this might affect our industry, with particular reference to what is meant by “identifiable goods and services”, and also how more sophisticated products such as “window” forwards, should be treated under the new legislation.

We were happy to find that FCA were both knowledgeable and supportive of our industry, and had a practical view on the interpretation of the delegated regulation. They sought input from AFEP on a number of areas, and through the work of our FX Forwards working party, we were able to present FCA with a number of potential scenarios to obtain their view on. FCA also indicated at that meeting that they intended to publish a Consultation Paper on this area.

At the end of last month, FCA released CP16/29, the third Consultation Paper on MiFID II. In this paper FCA has set out its view on the definition of spot contracts, and the treatment of FX forwards entered into as a means of payment. The FCA has chosen to significantly expand sections of its Perimeter Guidance manual (PERG) to set out its interpretation of the delegated regulation. The guidance is very helpful in that it includes some specific scenarios, some of which are clearly based on those presented by AFEP for consideration.

The detailed guidance of relevance to AFEP members is contained in Questions 31A to 31O of the draft amendments to the PERG MiFID Q&A Guidance (pages 312-329).

Rather than copy out sections of the proposed guidance, we would encourage members to read the source document itself which is available for download from the FCA website. We regard the following sections of particular interest to AFEP members who may wish to avail themselves of the exclusions available and thereby avoid their contracts falling to be regulated as MiFID financial instruments:

- Q31E: sets out in more detail FCA’s view of what constitutes identifiable goods or services
- Q31G: explains how a PI might satisfy itself that the conditions in the “means of payment” exclusion are met, and indicates some scenarios under which a PI may rely on assurances given by its client.
- Q31H: explains FCA’s view of the difference between a flexible forward (which might benefit from the exclusion), and an option (which is always a MiFID instrument).
- Q31I: sets out specific real-life examples and scenarios, and includes substantial input from our own working party
- Q31K: describes the interaction between MiFID II and PSD in respect of the delegated regulation
- Q31L: sets out FCA’s view that NDFs do not fall within the spot or “means of payment” exclusion and are always therefore to be treated as MiFID Instruments

Please note that the proposed guidance is still in its consultative stages with the consultation period ending on 4th January 2017, and AFEP still has the opportunity to provide further input to FCA before publication of the finalized version of the guidance.

At our meeting with FCA in July, it was also clear that whilst they had provided significant input at EU level in framing the exclusions, there remained the possibility that other member states may not interpret them in the same practical manner as FCA. There is also the possibility that ESMA or the EC could release its own guidance that may be more restrictive in application than that proposed by FCA.

For those firms that decide they may need to seek MiFID permissions as a result of the new guidance, FCA is intending to run workshops from October to December 2016. The gateway for applications will open during Q1 2017, with the aim of authorising all firms that require authorisation prior to 2018.

AFEP will be seeking input from members on the proposed amendments to PERG and their impact before the consultation closes. We also intend to run some workshops/roundtables on the practical implementation of this draft guidance for our membership.

Brexit – repercussions in our industry?

Ian Benson

Public remarks made by world leaders at the recent G20 summit in China reaffirmed the prevailing view that the road to Brexit will be a long and uncertain one. It is now more than two months since the people of the United Kingdom voted to leave the EU, and still very little detail has emerged on the shape of the UK's future relationship with the EU. Whilst not featuring prominently in the debate amongst the electorate as a whole, the decision may have significant consequences for the financial services sector, including participants in the payments market. A few of the most significant consequences are highlighted below.

Payment Services Directive

The provisions of the Payment Services Directive (PSD), as implemented in the UK by the Payment Services Regulations 2009, mean that UK authorised payment service providers have the right to carry on business in another EU member states via "passporting" arrangements. Brexit could lead to restricted market access for UK providers, depending on the outcome of negotiations between the EU and the UK. Providers may need to consider establishing a payment institution within the EU in order to passport services across the EU via that institution. Payment service providers are also faced with the added complication of the introduction of the successor Directive PSD2. However, some commentators have highlighted that quite apart from being a legal obligation, compliance with PSD2 represents sounds commercial and technological sense in its own right. Compliance with the new regime may therefore be prudent irrespective of the future legal status of the PSD regime.

SEPA membership

By virtue of its current EU membership the UK is a member of SEPA, the Single Euro Payments Area. SEPA is a payment-integration initiative of the European Union for simplification of bank transfers denominated in euro. Interestingly, while SEPA membership includes, it is not limited to, EU Member States. There may therefore be scope for the UK be a member of SEPA on an independent basis and not as a corollary of EU membership.

MiFID

The existing MiFID regime, which governs firms who provide services to clients linked to financial instruments, does not include a passporting regime that would allow a non-EU business to passport its products or services across the EU. However, the MiFID II regime, due to come into effect in January 2018, may allow third country passporting. The passporting options available will depend on the category of clients to which services would be provided. In relation to professional clients, a firm must be registered with the European Securities and Markets Authority (ESMA), which must have given a positive equivalence determination with regard to the relevant third country. In the retail client scenario, MiFID II can require the establishment of a branch, with corresponding obligations regarding minimum capital, senior management and access to a suitable investor compensation scheme. There may be scope to consider the establishment of a new subsidiary within the EEA for the purpose of accessing an EU-MiFID client base.

Brexit – repercussions in our industry?

Ian Benson

FCA Guidance

In response to the referendum decision, the FCA published a press release on 24 June 2016 confirming that EU regulation will remain applicable to UK firms until any changes are made, which will be a matter for government and parliament. The FCA has instructed firms to continue to abide by their obligations under UK law, including those derived from EU law, and to continue with implementation plans for legislation that is still to come into effect. While that may seem futile in light of the exit process, this approach has value in at least two respects. Firstly, the exit date is likely to be some time off, and secondly, the possibility of UK businesses making use of any passporting regime applicable to non-EU countries will likely rest on the appropriate equivalence determination being made by European authorities. This should, in theory, be more straightforward if UK businesses are abiding by the rules that are in place within the EU.

Credit Risk Management

Francesca Maritan

Risk Management

SYSC 4.1.1 requires a firm has effective processes to identify, manage, monitor and report the risks it is or might be exposed to. Typically this rule does not directly apply to Authorised Payment Institutions or Authorised E-Money Issuers (who do not also have Part 4a permissions). However the FCA does expect all firms to be able to demonstrate risk-centric policies and processes against the 'proportionate' and 'effective' test.

In the literature for Payment Institutions, the FCA categorises risk into 5 key areas:

- Settlement (a settlement of a payment transaction does not take place as expected)
- Operational (loss from inadequate or failed internal processes, people or systems)
- Counterparty (that the other party to a transaction does not fulfil its obligations)
- Liquidity (inadequate cash flow to meet financial obligations)
- Market (risk resulting from the behaviour of the entire market)

AFEP believes that robust risk management is simply good management practice and to support firms looking to implement more formal risk management arrangements we will shortly be hosting a round table on the subject. In this newsletter we look at the management of counterparty risk.

The risk of a client or a counterparty failing to honour its side of a contract is a very real threat to firms but one which can be managed with some very simple policies and processes. The first principle being to ensure the Board of Directors has established its appetite for risk, thresholds and limits and the process by which exceptions are to be managed and breaches contained. These 'rules' within which dealers can operate should be clear and documented. Larger firms will have established a credit committee whose role is to monitor compliance with the rules and to approve exceptions and to manage any breaches.

When writing policy consider:

Limits:

- The maximum single deal size
- The maximum length of forward contract
- Number and / or value of open contracts permitted (including linked persons e.g. parent / sister companies)

Before, which, further financial due diligence such as credit checking or past company accounts obtained. How frequently is this reviewed and / or what triggers a refresh?

Thresholds:

- The threshold above which senior management approval is required, this should be expressed in value and contract length
- The mix of risk and commercial decision making

Risk Management:

- Implement different margin / deposit size based on client risk
- Restrict contract lengths for very risky situations
- Vary both during volatile periods
- Ensure the client is clear at the outset on the firm's policy on both initial and variation margin and for all contracts how the firm manages its risk with its counterparty when a client fails to settle
- Ensure the terms and conditions contain relevant clauses which allow the firm to take necessary steps to manage such risks

Upcoming Member Meeting

Wednesday 7th December

Venue: Barclays, 5 N Colonnade, London, E14 4BB

Time: 5.00pm

Agenda: Francois Rogers from PSR, Chris Young from the MET, Cyber Intelligence Sharing Partnership, an update from the Executive Committee followed by drinks, nibbles and networking.