JFMC Japan Financial Markets Council

14 March, 2013

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

International Organization of Securities Commissions
C/ Oquendo 12
28006 Madrid
Spain

Submitted by e-mail: baselcommittee@bis.org and wgmr@iosco.org

Dear Secretariats,

Second Consultative Document: Margin Requirements for Non-Centrally Cleared Derivatives

The Japan Financial Markets Council (JFMC)[1] is grateful for the opportunity to comment on the Second Consultative Document on "*Margin requirements for non-centrally cleared derivatives*" published in February 2013 by the Working Group on Margining Requirements (the "WGMR") of the Basel Committee on Banking Supervision (BCBS) and International Organization of Securities Commissions (IOSCO) (hereinafter referred to as the 'Second Consultative Document').

This is the third time the JFMC has participated in this important dialogue. In September 2012 we replied to the first consultation paper and followed this up with a letter in December 2012 to Mr. Stefan Ingves (Chairman of BCBS) and Mr. Masamichi Kono (Chairman of the IOSCO Board) on the same subject. [2]

Overall position

The JFMC is supportive of the G20 commitment to reforming the global over-the-counter (OTC) derivatives market in order to reduce risk and enhance resiliency of international financial markets. We note the further work in this Second Consultative Document including the proposals that initial margin would only apply to entities with an aggregate notional amount of EUR8 billion of non-cleared derivatives or more; an allowance of a EUR50 million threshold between consolidated groups; and a phase in schedule for implementation. This would have some benefits within the context of an Initial Margin (IM) regime, which under the current proposal would require

[1] The JFMC is an association which includes representatives from five Japan-based institutions and five international firms active in Japanese capital markets. Its aim is to ensure that authorities deciding on regulatory initiatives that have a global impact are aware of and take into account the effect of new regulations on Japanese capital markets. The current JFMC members are: Bank of Tokyo-Mitsubishi UFJ, Daiwa Securities Group, Mizuho Securities, Nomura Holdings, SMBC Nikko Securities Inc, Bank of America Merrill Lynch, BNP Paribas, Deutsche Bank Group, JPMorgan Securities Japan Co., Ltd. and Morgan Stanley Japan Holdings. The co-chairs of the JFMC are the representatives from Morgan Stanley and Nomura.

[2] For more information on our previous comments please refer to www.ibajapan.org

mandatory two-way exchanges on a gross basis. But the JFMC continues to have major concerns about the overall proposals and the risks attached to them, and is disappointed that some of these concerns don't appear to have been addressed in the Second Consultative Document.

To recap briefly: the JFMC believes that central counterparties and other clearing facilities provide a valuable service for some swap contracts but not all business fits this model. Non-cleared derivatives will continue to play an important role in meeting the needs of businesses and the management of their risks, particularly in countries that are heavily dependent on trade.

In the Financial Stability Board's 8 February, 2013 report to G20 Finance Ministers and Central Bank Governors, entitled "*Financial Regulatory Factors Affecting the Availability of Long-Term Investment Finance*," the authors underscored the need for vigilance in avoiding unintended consequences when introducing new regulations, including those concerning OTC derivatives. The JFMC remains concerned that the proposed mandatory IM requirements on a gross basis, on top of the impact of capital and liquidity requirements, will in aggregate have such unintended consequences, and result in a detrimental impact on the availability of liquidity which could cause damage to the real economy and constrain international money flows.

In addition, we continue to be concerned that mandatory IM requirements on a gross basis may cause systemic risks, including having a pro-cyclical effect and cause constraints on hedging activities and efficient market mechanisms.

The JFMC therefore is still of the view that a combination of locally monitored variation margin practices, suitable capital requirements and clearing facilities where appropriate, will achieve the G20 goals of reducing risk in the international financial system and is a sensible framework to mitigate the risks from non-cleared swaps.

The Second Consultative Document sets out four broad questions and we set out our responses below. The comments should not however be interpreted as support for an IM regime that the Second Consultative Document treats as a given.

Q1 Given the particular characteristics of physically-settled FX forwards and swaps, should they be exempted from initial margin requirements with variation margin required as a result of either supervisory guidance or national regulation? Should physically-settled FX forwards and swaps with different maturities be subject to different treatments?

The JFMC believes that physically-settled FX forwards and swaps should be exempted from strict IM and VM requirements. The posting and receiving of margin - whether it is initial or variation margin - is commonly used to manage foreign exchange business, but by making such instruments subject to a mandatory margin regime both collateral and administrative costs would rise significantly. This could have a detrimental effect on capital flows and hedging activities, and we are not clear that there would be any corresponding reduction in risk.

The JFMC notes that the BCBS has issued detailed guidelines[3] on how such margin requirements should be managed taking into consideration the replacement cost risk, liquidity risk, operational risk and legal risk. National regulators are given discretion to implement the Guidance and to take into account the size, nature, complexity and risk profile of bank's FX activities.

The JFMC believes that physically-settled FX forward and swaps should be governed by this FX Guidance and not by the proposed margin requirements.

Q2 Should re-hypothecation be allowed to finance/hedge customer positions if re-hypothecated customer assets are protected in a manner consistent with the key principle? Specifically, should re-hypothecation be allowed under strict conditions such as (i) collateral can only be re-hypothecated to finance/hedge customer, non-proprietary position; (ii) the pledgee treats re-hypothecated collateral as customer assets; and (iii) the applicable insolvency regime allows customer first priority claim over the pledged collateral.

Question 2 implies that re-hypothecation of collected IM may only be permitted under certain specified conditions. While the JFMC supports the spirit of the exception proposed in Question 2 as a means to mitigate the liquidity impact of any IM requirements, the JFMC is concerned that the imposition of Key Principle 5 requirements, as a condition of this exception, will minimise the effectiveness of this exception. This is because of the uncertainties associated with implementing the seemingly contradictory conditions imposed by Key Principle 5—i.e., that (i) the margin collected is immediately available to the collecting party in the event of the counterparty's default, and (ii) the collected margin must be subject to arrangements that protect the posting party in the event that the collecting party enters bankruptcy to the extent possible under applicable law.

The JFMC believes it is important to begin with an examination of the legal infrastructure of each given jurisdiction, so as to understand the feasibility of complying with the Principle 5 requirement for immediate access to collected collateral in the case of a default. This would include an examination of how insolvency laws apply across borders. The study will need to establish that different jurisdictions have in place laws that would protect the posting party in the event of the collecting party's bankruptcy. The absence of such arrangements, or a lack of confidence that the IM would be secure, would make it difficult to introduce re-hypothecation of the complexity described in Q2 and could undermine effective counterparty risk management practices and overall financial system stability. It would therefore be premature to consider detailed re-hypothecation rules until coming to a conclusion on this matter. And any phasing-in timetable for a new regime would be dependent on ensuring that a legal framework is in place to meet these concerns.

Q3 Are proposed phase-in arrangements appropriate?

The JFMC believes there are major feasibility concerns regarding the introduction of the proposals, including the significant jurisdictional and legal issues outlined above. There are also practical concerns over the introduction of a mandatory IM regime (and some aspects of a mandatory VM regime).

---

[3] *'Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions'* BCBS, (February 2013)

The JFMC believes that the practical considerations outlined below will be exacerbated by the analytical and logistical coordination challenges attempting to harmonise different countries' legal bankruptcy regimes. It may therefore be premature to address concrete phase-in periods at this stage, but any new regime would need to allow time for:

- participants to work with regulators and with counterparties to develop and gain approval and acceptance of specific valuation models;
- the development of dispute resolution procedures;
- the wide-spread adoption of globally standardised trade documents (e.g. ISDA Credit Support Annex);
- negotiating a CSA, taking account of factors such as the collateral management and the frequency of the variation margin requirement;
- the development of procedures to manage the exchange of margins on a consolidated basis threshold; and
- the preparation of collateral management operations.

Q4 The BCBS and IOSCO seek comment on the accuracy and applicability of the QIS results.

The JFMC believes the QIS data underpinning some of the analytical conclusions has a number of methodological problems. The instructions for those participating in the QIS lacked the clarity required to provide consistent and robust data. For example because of vague instructions, respondents are likely to have answered questions on modeling, thresholds and collateral availability in a number of ways.

We also believe that some of the concepts implicit to the QIS are flawed. For example, the estimates do not give sufficient weighting to periods of stress which would significantly drive up the numbers. The assumptions of how many derivative transactions will migrate to central counterparties are also too optimistic. It is assumed for equity derivatives that 56% of the trade volume will be migrated to central counterparty's eligible transactions.

The Second Consultative Document also implies that there are nearly EUR7 trillion of high quality liquid assets available.[4] But this does not appear to take account of other regulatory demands on liquidity such as the liquidity coverage ratio (LCR) required under BaselIII and the potential outcome of current discussions of the banking business structure which may preclude the use of retail deposits for derivatives trading. Last year Mr. Stefan Ingves (BCBS Chairman) noted that the LCR weighted average for the world's largest 200 banks was at slightly over 100% of the original LCR calibration (based on data from June 2012). This indicates that the banks have little or no scope to meet further liquidity demands. This figure has since been revised but we believe this does not change the underlying position.[5]

---

[4] This figure is calculated from Table 8 (EUR558 billion -Total initial Margin model based on the EUR50 million threshold and no netting) and Table 9 (8% - Ratio of estimated IM to the total amount of unencumbered assets, model based with €50 mil threshold). If EUR558 billion is 8% of unencumbered assets, this suggests the total figure is about EUR7 trillion

[5] Mr. Ingves noted the figure improved to 125% under the revised LCR standards announced in January and some of the assumed inflow and outflow rates were changed. The revised LCR takes into account the increased liquidity needs related to market valuation changes on derivative transactions (i.e. VM), but not the effect of the IM requirement for non-centrally cleared derivatives.

The JFMC is concerned that the nearly EUR7 trillion of unencumbered assets in the QIS may include the high quality liquid assets that the respondents were also counting to meet the LCR requirement. If this is the case the double counting of assets will have distorted the outcome of the QIS and therefore limit its usefulness as a tool in examining the impact of the proposal for mandatory IM.

We are in favour of empirically based policy making and believe that all the issues should be considered in a cost benefit analysis to evaluate whether the suggested advantages of the proposed mandatory IM regime outweigh the risks including the impact on liquidity, economic growth and a well functioning market. We have doubts about the reliability of the current QIS and suggest the WGMR re-evaluate the evidence including how the outcomes of a revised study would be impacted if:

- other regulatory requirements for high quality liquidity assets were taken into account;
- the assets outlined are not acceptable by counterparties for cross-border transactions; and/or
- a pan-national legal framework is not feasible.

Conclusion

In summary, the JFMC acknowledges the further detailed work of the WGMR. But the JFMC would like to underscore that it believes that IM is not the most effective tool to address the issues the G20 were concerned about and that there are a number of risks to the introduction of such a regime including the impact on long-term financing and the real economy. The JFMC would be happy, if required, to provide the WGMR with further information on any of the comments set out in this letter.

Yours faithfully,

Jonathan B. Kindred Shigesuke Kashiwagi
Co-chairs of the Japan Financial Markets Council

Contact: International Bankers Association (IBA Japan): Paul Hunter
Telephone +81 (0)3-6225-2211 E-mail g-info@ibajapan.org