The LIAJ's Comments on Second Consultative Document Margin requirements for non-centrally cleared derivatives

15 March 2013

The Life Insurance Association of Japan (LIAJ)

Contents

1. General opinions on the second consultative document

1. The Life Insurance Association of Japan (LIAJ) would like to extend our gratitude to the Basel Committee on Banking Supervision (BCBS) and the Board of the International Organization of Securities Commissions (IOSCO) for providing us with the opportunity to submit our comments on the *Second Consultative Document: Margin requirements for non-centrally cleared derivatives*, published on 15 February 2013.

2. The LIAJ is a trade association comprised of all 43 life insurance companies operating in Japan. Its aim is to promote the sound development of the life insurance industry and maintain its reliability in Japan. We would like to respectfully request that the BCBS and the IOSCO carefully consider the comments submitted from the sole representative body of the life insurance industry in Japan, which holds the second largest life insurance market in the world.

3. We have serious concerns regarding the "administration under foreign exchange (FX) forwards and swaps regulations," "advisability of initial margin re-investment" and "need to amend the ISDA-CSA Agreement" in the consultative proposal. With regard to the "administration under the FX forwards and swaps regulation" in particular, we strongly request the introduction of this regulation be excluded from the regulations because the impact will affect not only the financial industry, but all commercial activities that involve currency transactions as well.

4. We also believe the disadvantages arising from the "administration of FX forwards and swaps" in terms of the reduction or curtailment of commercial activities as a result of introduction of the regulation should be given the same consideration as the advantages in terms of the reduction of systemic risk and improvement of the transparency concerning participants in over-the-counter derivatives transactions, which are the objectives behind the introduction of said regulation. In addition to the investment and loan activities of financial institutions, said transactions are utilized to hedge foreign currency receipts and disbursements and foreign currency-denominated assets in a broad range of businesses in the manufacturing and services sectors. Therefore we are concerned not only about the increase in hedging cost, but also about the negative effect on liquidity when the introduction of margin requirements is imputed in execution prices. Besides, we believe that there is little need to implement initial margin requirements in Japan, as Japanese authorities conduct adequate supervision and monitoring on financial institutions such as life insurance companies regarding to their management of liquidity including pledged collateral.

5. From the viewpoint of diversifying their investments, Japanese life insurance companies in particular normally invest in a broad range of assets, including foreign currency-denominated bonds in addition to yen-denominated securities such as Japanese Government Bonds, in order to underwrite long-term risks and stably perform their insurance obligations. On the other hand, they fundamentally execute an equivalent volume of hedge transactions using FX forwards and swaps because their insurance product obligations are denominated in yen. We are concerned that for users of such "actual demand," the additional capital burden imposed by the gross basis transfer of the initial margin as a result of the introduction of this regulation, in addition to the increase in transaction costs and decrease in liquidity, could become an obstacle to sound business management.

6. Furthermore, we have deep concern that Japanese life insurance companies' funding function as global institutional investors might be forced to impair, as the implementation of this

requirements would lead to the investment restriction on foreign markets, such as those of Europe and U.S., by Japanese life insurance companies.

7. With regard to the “advisability of initial margin re-investment,” and the administration of the cash of the initial margin in particular, we are concerned that specifying the re-investment portfolio will be exceedingly difficult. In addition to the fact they are maintaining sufficient liquidity, and the fact their liquidity including the management of collateral etc. is already being monitored under the supervisory authorities, from the viewpoint of improving investment performance efficiency Japanese life insurance companies invest the cash collateral accepted through various transactions by pooling it together with the cash from the insurance premiums they receive and cash for purposes such as payment of insurance benefits.

8. With regard to the “need to amend ISDA-CSA Agreement,” the ISDA-CSA now exists as a global market convention for over-the-counter (OTC) derivatives transactions and is recognized to fulfill nearly the same role as the variation margins under discussion. When variation margins are exchanged based on the margin requirements presented in the latest proposal, it is assumed that, in practice, covered entities operate those margin using ISDA-CSA Agreement currently under contract entered into with each entities. In order to do so, they might be imposed on complicated operations to individually amend the details of agreements with existing counterparties, and thus we are concerned that this will place a substantial burden on the OTC derivatives trading system.

2. Responses to the questions

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?

9. We strongly request the regulation be excluded because the introduction of said regulation will affect not only the financial industry but also all of the commercial operations that accompany FX transactions, a point we have mentioned in our summary opinion as well.

10. We also believe the disadvantages arising from the “administration of FX forwards and swaps,” in terms of the reduction or curtailment of commercial activities as a result of introduction of the regulation, should be given the same consideration as the advantages in terms of the reduction of systemic risk and improvement of the transparency concerning participants in over-the-counter derivatives transactions, which are the objectives behind the introduction of said regulation. In addition to the investment and loan activities of financial institutions, said transactions are utilized to hedge foreign currency receipts and disbursements and foreign currency-denominated assets in a broad range of businesses in the manufacturing and services sectors. Therefore we are concerned not only about the increase in hedging cost, but also about the negative effect on liquidity when the introduction of margin requirements is imputed in execution prices. Besides,

we believe that there is little need to implement initial margin requirements in Japan, as Japanese authorities conduct adequate supervision and monitoring on financial institutions such as life insurance companies regarding to their management of liquidity including pledged collateral.

11. From the viewpoint of diversifying their investments, Japanese life insurance companies in particular normally invest in a broad range of assets, including foreign currency-denominated bonds in addition to yen-denominated securities such as Japanese Government Bonds, in order to underwrite long-term risks and stably perform their insurance obligations. On the other hand, they fundamentally execute an equivalent volume of hedge transactions using FX forwards and swaps because their insurance product obligations are denominated in yen. We are concerned that for users of such "actual demand," the additional capital burden imposed by the gross basis transfer of the initial margin as a result of the introduction of this regulation, in addition to the increase in transaction costs and decrease in liquidity, could become an obstacle to sound business management.

12. Furthermore, we have deep concern that Japanese life insurance companies' funding function as global institutional investors might be forced to impair, as the implementation of this requirements would lead to the investment restriction on foreign markets, such as those of Europe and U.S., by Japanese life insurance companies.

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.

13. With regard to the regulation of margin deposits and the re-investment of the initial margin in particular, we are concerned that specifying the re-investment portfolio will be exceedingly difficult because Japanese life insurance companies, from the viewpoint of improving investment performance efficiency, invest the cash collateral they have accepted through various transactions by pooling it together with the cash from the insurance premiums they receive and cash for purposes such as payment of insurance benefits. Because Japanese life insurance companies manage and invest the premiums received from policyholders as consideration for insurance as their own assets (equity assets), in order to perform their obligations to pay insurance benefits and pensions in the future, and are receiving sufficient supervision and monitoring of their liquidity from authorities, including the management of collateral etc., the re-investment of margin deposits accepted as part of such management and investment should be permitted.

Q3.

Are the proposed phase-in arrangements appropriate? Do they appropriately trade off the systemic risk reduction and the incentive benefits with the liquidity, operational and transition costs associated with implementing the requirements? Are the proposed triggers and dates that provide for the phase-in of the requirements appropriately calibrated so that (i) the largest and most systemically-risky covered entities would be subject to the margining requirements at an earlier stage so as to reduce the systemic risk of non-centrally cleared derivatives and create incentive for central clearing, and (ii) the smaller and less systemically risky covered entities would be allowed more time to implement the new requirements? Should the phase-in arrangements apply to the exchange of variation margin, in addition to the exchange of initial margin as currently suggested? Or, given that variation margin is already a widely-adopted market practice, should variation margin be required as soon as the margin framework becomes effective (on 1 January 2015 as currently proposed) so as to remove existing gaps and reduce systemic risk? Do differences of market circumstances such as readiness of market participants and relatively small volumes of derivatives trading in emerging markets require flexibility with phase-in treatment, even for variation margin?

14. The current ISDA-CSA exists as a global market convention for over-the-counter (OTC) derivatives transactions and is recognized to fulfill nearly the same role as the variation margins under discussion. When variation margins are exchanged immediately on January 1, 2015 based on the margin requirements presented in the latest proposal, it is assumed that, in practice, covered entities operate those margin using ISDA-CSA Agreement currently under contract entered into with each entities. In order to do so, they might be imposed on complicated operations to individually amend the details of agreements with existing counterparties, and thus we are concerned that this will place a substantial burden on the OTC derivatives trading system. In order to address these concerns, adequate consultations should be held among all of the concerned organizations including the ISDA, and just as for the initial margin regulation, a sufficient run-up period and framework for phase-in implementation of the requirements should be considered.