March 15, 2013

Comments on the “Second Consultative Document Margin requirements for non-centrally cleared derivatives” by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions

Japanese Bankers Association

We, the Japanese Bankers Association (“JBA”), would like to express our gratitude for this opportunity to comment on the “Second Consultative Document Margin requirements for non-centrally cleared derivatives”, released on February 15, 2013 by the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO).

We hope that our comments below will be of assistance and perhaps offer an additional point of reference as you work towards finalizing the rules proposed by BCBS and IOSCO.

<Introduction>

We believe that the following should be ensured in enforcing the proposed margin requirements as stated in our comments of September 28, 2012 on the Consultative Document from “Margin requirements for non-centrally-cleared derivatives” released on July 6, 2012 by BCBS and IOSCO.

(i) Thorough identification and analysis of the proposed requirement’s impact on the financial market based on which a sufficient preparation period should be provided.

(ii) Factoring in overall regulations of financial and OTC derivative transactions and market practices of OTC derivatives, including ISDA-CSA (Credit Support Annex), and international rules as well as regulations in each jurisdiction already in place, should be taken into account. In particular, the scope and timing of application should be discussed considering differences in business practices of exchanging margins or in the extent of use of ISDA-CSA across jurisdictions at present.

We hereinafter would like to provide our comments to each question raised in the Second Consultative Document, as well as our views with regard to areas that are not explicitly specified in the BCBS/IOSCO’s questions from practical perspectives.
Taking a comprehensive look at physically-settled FX forwards and swaps in light of the objectives of the proposed requirements, in particular, the reduction of systemic risk, we believe that they should be exempted from both initial margin and variation margin requirements on the grounds that they have distinctly different characteristics, maturities, risk diversification, and other elements from other derivative transactions. If any margin requirement is to be imposed, it may be appropriate to only require variation margin on FX forwards and swaps with a maturity of over 1 year.

(i) Characteristics of physically-settled foreign exchange forwards and swaps
- As noted in “I. Summary” of Final Determination of “Determination of the Foreign Exchange Swaps and Foreign Exchange Forwards under the Commodity Exchange Act” issued by the Department of the US Treasury, providing the grounds for exempting both foreign exchange swaps and forwards from the definition of “swap”, foreign exchange swap and forward participants know their own and their counterparties’ payment obligations and the full extent of their exposures at settlement throughout the life of the contract. Thus, while the mark-to-market value of a position in a foreign exchange swap or forward may vary based on changes in the exchange rate or interest rates, the actual settlement amounts do not.
- Due to the above differences in characteristics of foreign exchange swaps and forwards, it is evident that their credit and market risks are limited, and hence a different treatment should be permitted. It is understood that such characteristics are broadly recognized among market participants.

(ii) Maturities of majority of transactions are short-term
- As indicated in Table 6 (page 33) presented in Appendix C of the Second Consultative Document, a majority (i.e. 52.1%) of QIS respondent financial institutions’ FX forwards and swaps are those executed within one year (with the denominator including foreign exchange derivatives other than FX forwards and swaps (e.g. currency options)).
- BIS statistical release: “OTC derivatives statistics at end-June 2012” (issued in November 2012) enables a comparison of maturity characteristics between foreign exchange derivatives and other derivatives. A similar comparison is available from Japan’s statistical data as of June 2012 based on which BIS statistics are generated. Both statistics show a distinct difference in maturity between foreign exchange derivatives including FX forwards and swaps and other derivatives. (See Table 1 and Table 2 below.)
Table 1  BIS statistics ([http://www.bis.org/publ/otec_hy1211.pdf](http://www.bis.org/publ/otec_hy1211.pdf)) (Pages, 13, 14 & 17)

<table>
<thead>
<tr>
<th>Transaction type</th>
<th>One year or less</th>
<th>One year and up to five years</th>
<th>Over five years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign exchange derivatives</td>
<td>72.7%</td>
<td>19.3%</td>
<td>8.0%</td>
</tr>
<tr>
<td>Interest rate derivatives</td>
<td>41.9%</td>
<td>34.4%</td>
<td>23.7%</td>
</tr>
<tr>
<td>Credit default swaps</td>
<td>20.8%</td>
<td>67.8%</td>
<td>11.4%</td>
</tr>
</tbody>
</table>


<table>
<thead>
<tr>
<th>Transaction type</th>
<th>One year or less</th>
<th>One year and up to five years</th>
<th>Over five years</th>
</tr>
</thead>
<tbody>
<tr>
<td>FX forwards/swaps</td>
<td>66.7%</td>
<td>25.7%</td>
<td>7.6%</td>
</tr>
<tr>
<td>Interest rate forwards/swaps</td>
<td>34.2%</td>
<td>42.4%</td>
<td>23.4%</td>
</tr>
<tr>
<td>Equity forwards/swaps</td>
<td>17.2%</td>
<td>42.5%</td>
<td>40.2%</td>
</tr>
</tbody>
</table>

(iii) Risk diversification across a number of entities

- While foreign exchange transactions are widely used as a funding tool, they are diversified across a number of entities in practice.
- In fact, the above-mentioned BIS statistics provide by transaction type the Herfindahl Indices which depict the concentration levels of a transaction. Low Herfindahl indices for foreign exchange derivatives, as shown below, indicates that the concentration in such transactions is relatively low compared to other derivatives and that such transactions are diversified across a number of financial institutions etc. (See Table 3 below.)

Table 3 BIS statistics ([http://www.bis.org/publ/otec_hy1211.pdf](http://www.bis.org/publ/otec_hy1211.pdf)) (Page 20 to 22)

<table>
<thead>
<tr>
<th>Transaction type</th>
<th>Indices</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forwards, forex swaps and currency swaps</td>
<td>487</td>
</tr>
<tr>
<td>Interest rate swaps (US dollar)</td>
<td>764</td>
</tr>
<tr>
<td>Interest rate swaps (Euro)</td>
<td>549</td>
</tr>
<tr>
<td>Equity-linked forwards and swaps (U.S.A.)</td>
<td>736</td>
</tr>
<tr>
<td>Equity-linked forwards and swaps (Europe)</td>
<td>781</td>
</tr>
</tbody>
</table>

- Further, it should be taken into account that risk reduction by PVP settlement arrangements through CLS has been gradually developing as noted in the “Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions” (published by BCBS on February 15, 2013) and are expected to be further promoted as a result of the publication of this Supervisory guidance.
- As stated above, there is a significant difference in systemic risk between FX forwards and swaps, and other derivatives. Therefore, FX forwards and swaps should be subject to a different treatment, exempting them from both initial margin and variation margin requirements. If BCBS
and IOSCO consider applying variation margin requirements, such application should be limited to FX forwards and swaps with a maturity of over 1 year: a transaction that is considered to have a relatively large amount of risk; specifically a transaction of which systemic risk could be reduced relatively effectively through such application. In the case of FX forwards and swaps with a maturity of 1 year or less, on the other hand, each financial institution should discuss and decide with its counterparties whether to require margin by taking into account such factors as the credit quality of counterparties.

<Q2.>

- The conditions specified in Q2, “(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” are not acceptable under Japan’s existing legal framework. If the conditions for permitting re-hypothecation (re-use) are limited to those set forth in Q2, the proposed requirements may result in an unlevel playing field across jurisdictions from regulatory perspectives.

- Further, the conditions for permitting re-hypothecating (re-using) of initial margin should be relaxed in some cases from those currently proposed, giving that customer assets are protected by each jurisdiction’s legal framework in a manner considered reasonable from the viewpoint of consistency with other financial regulations as well as business practices in jurisdictions, and that each jurisdiction has in place effective regulatory regimes for bankruptcy, segregation or other areas.

- The Consultative Document published by the Financial Stability Board (FSB) on November 18, 2012, “A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos,” allows banks subject to prudential regulation to engage in cash collateral reinvestment or the re-hypothecation of client assets, taking into account the application of the Basel III Liquidity Coverage Ratio (“LCR”). (See Recommendations 8 and 9). In view of consistency with other financial regulations, it is requested that the BCBS and IOSCO consider giving local authorities discretion to decide whether to allow the re-hypothecation (re-use) of initial margin (under certain conditions) in accordance with legal framework in its jurisdiction.

<Q3.>

- As stated in the “Introduction”, it is considered that a sufficient period for preparation should be provided and that differences in market practices of exchanging margins or in the extent of use of ISDA-CSA across jurisdictions at present should be taken into account in implementing the proposed margin requirements. Further, margin exchange rules need to be developed in a manner to ensure alignment with regulatory framework across jurisdictions. From these
standpoints, we firmly request that the BCBS and IOSCO amend Key principle 8 and Requirement 8.1 through 8.10 of the proposed requirements as follows:

(i) Implementation of the initial margin requirements from January 1, 2015 (in approximately a two-year period) would only allow a considerably short period to prepare for such implementation. Given this, it is requested that a sufficient period for preparation (e.g. 3 to 4 years) should be provided, implementing such requirements more than 2 years after the finalisation of relevant regulatory frameworks in each jurisdiction such as developing relevant laws, regulations or guidance.

(ii) Variation margin should be subject to a phase-in treatment in accordance with a similar timeline applied in assessing covered entities that should be subject to the initial margin requirements based on the total gross notional exposure of non-centrally cleared derivatives. Further, a threshold of requiring the exchange of variation margin should also be consistent with the one for initial margin.

(iii) All thresholds proposed for covered entities to be subject to the margin requirements should be eased. Especially, on permanent basis (2019 and beyond in this Consultative Document), covered entities subject to the requirements should be limited by raising the proposed threshold to €0.25 trillion (i.e. one-third of the threshold proposed for 2018 in the Consultative Document) for both initial and variation margins.

(iv) It is requested that flexibility be given, allowing national supervisors to reschedule the margin requirements implementation or set their own transitional period even after the finalisation of the proposed margin requirements, taking into account the readiness of jurisdictions where margin exchanging practices and ISDA-CSA are not widely adopted at present as well as the progress of discussions on dispute resolution procedures (especially for initial margin). For example, the margin requirements could be first applied to more systemically-risky instruments and then to FX swaps and forwards in later periods.

• What concerns us most in respect of the proposed phase-in process is as mentioned below:

(i) Developing quantitative models to calculate initial margin and putting in place dispute resolution procedures (DRP) that are necessary to resolve disputes are expected to require considerable time.

• The development of quantitative models and supervisor’s approval process thereof are new issues to be addressed. And financial institutions subject to this requirement need to respond to newly established regulatory frameworks, which determine necessary elements of such models, in each jurisdiction. Given this, the effective date of the proposed initial margin requirements (i.e. January 1, 2015) is not realistic, even though the scope of application is limited to transactions between entities engaged in relatively
large volumes of derivatives trading. Although the standardised initial margin schedule is proposed as an alternative approach to the use of a quantitative model, it imposes a significant liquidity impact on financial institutions as analysed through QIS. Therefore, the BCBS and IOSCO are respectfully requested to assess and determine the expansion of the scope of financial institutions which can apply the quantitative model before implementing the proposed requirements.

• Given that ISDA has been continuously discussing for more than two years but has not been able to finalise DRP, developing DRP in the short term is considered to be significantly difficult. If the initial margin requirements are implemented without having a globally-agreed DRP in place, initial margin disputes may frequently arise among market participants, resulting in the malfunctioning of the initial margin requirement framework. In our opinion, an effective way to avoid disputes is to create DRP and develop basic design and specific calculation methods for a quantitative model* under WGMR (Working Group on Margining Requirements)’s initiative.

(*) Necessary elements in developing basic design and specific calculation procedures for a quantitative model include the following:

• The period of historical data used; weight adjustment on sample PL; combination of VaR in a normal period and stressed VaR; haircuts calculation methods under internal quantitative models; clarification of well-defined asset class; permitting different calculation methods within the same asset class (e.g. in the case of Japanese yen interest rate derivatives allowing quantitative models for vanilla derivatives and the standardised schedule for exotic derivatives) and other elements.

(ii) Similarly to the case of initial margin, implementing the variation margin requirements will increase the burden of documentation-related negotiation between parties and operational workloads in practice in jurisdictions where margin exchanging practices and ISDA-CSA are not widely adopted at present.

• Specifics of the proposed requirements such as the covered entities, scope of application and qualified collateral will not be clarified until the proposed margin requirements are finalised and each jurisdiction develops relevant local frameworks based on such requirements. Therefore, parties to transactions which do not exchange margin under current practice will be able to start full-fledged negotiations/discussions for some matters only when the specifics are clarified.

• Further, in light of the objectives of the proposed margin requirements, i.e. to reduce systemic risk, there is not much significance in uniformly applying the variation margin
requirements to smaller financial institutions with relatively small volumes of derivative trading at the same time as other larger entities. Therefore, the proposed thresholds should be reconsidered by also carefully assessing the extent of impact. In addition, for the purpose of promoting centrally-cleared derivatives, the timing of the implementation of the proposed margin requirements should be discussed in line with mandatory central clearing for smaller financial institutions and development of relevant regulatory frameworks by jurisdictions.

- In relation to Requirements 8.1 through 8.10 of the proposed requirements, we respectfully express our opinions particularly on the thresholds for initial margin as well as methods to calculate the consolidated group’s total notional exposure of non-centrally-cleared derivatives based on which the scope of application of the proposed requirements is assessed.

- The thresholds and notional amounts should be denominated in U.S. dollars in accordance with the current global market practices. Further, the scope of non-centrally-cleared derivative activities to be included in the notional amount computation should be clearly defined (e.g. Non-centrally-cleared derivatives with end-users should be excluded from the computation).

- It is understood that the Second Consultative Document proposes that the thresholds be applied and notional amounts be calculated on a consolidated basis with the intention of preventing regulatory avoidance. However, there may be cases where it is difficult to allocate pre-defined thresholds because of the difference in the scope of consolidation assessment attributable to different accounting standards etc. as well as the difference in legal frameworks in each jurisdiction. In addition, some financial institutions may have difficulty in promptly establishing exposure management procedures for entities operating across different jurisdictions. Taking these into consideration, it is considered reasonable to apply thresholds and compute notional amounts for assessment on an entity-by-entity basis while regulatory avoidance should be prevented by developing a separate framework through collaborative efforts by authorities across jurisdictions.

- Parties to non-centrally cleared derivatives are not able to determine whether the volume of such transactions executed by their counterparties such as financial institutions should be subject to the margin requirements. Relying on the counterparty’s representation in this respect lacks reasonableness and objectivity. Therefore, the BIS or national supervisors should regularly disclose (e.g. on an annual basis) the covered entities that are subject to the margin requirements. Further, instead of applying the proposed aggregate month-end average notional amount of non-centrally-cleared-derivatives for the last three months of each year, it is
recommended to set an appropriate and realistic notional amount which provides related entities with sufficient time to review/prepare before the actual margin exchange after the assessment. For example, we propose to use the month-end average notional amount over a three-month period from October through to December to determine the covered entities in the year after the next year. Without such a sufficient period for preparation, the more the number of entities subject to the margin requirements increases, the more likely it would be practically difficult to immediately start exchanging margin.

<Q4.>
- It is expected that further detailed QIS and analysis will be performed to evaluate the appropriateness of the standardised initial margin from the perspective of their relation with other regulatory initiatives such as changes to standardised approaches for trading book and counterparty credit risk capital requirement, potential minimum haircuts on repurchase and reverse repurchase transactions, and implementation of the LCR, as stipulated in the executive summary of the Second Consultative Document.

- Table 7 of Appendix C shows that model-based initial margin required on non-centrally cleared derivatives as a percentage of the notional amount is higher than the one required on centrally-cleared transactions (i.e. 0.50% for the former and 0.10% for the latter). Taking this estimation into consideration, and for the purpose of reducing concern over liquidity, we respectfully request the BCBS and IOSCO to consider raising the threshold for the exchange of initial margin to the extent that initial margin requirements on non-centrally cleared derivatives as a percentage of the notional amount would not contradict the purposes of promoting central clearing (e.g., the desirable percentage might be approximately 0.20%).

- According to Table 9 of Appendix C, schedule-based initial margin requirements (under the EUR50 million universal threshold) comprise 86% of available liquid assets whereas model-based requirements comprise 8% of available margin eligible assets, resulting in a significant difference. As stated in our comment on Q3, given that it may be difficult to develop a quantitative model as well as to resolve disputes, the more-than-expected number of financial institutions, especially the smaller ones, may use the standardised margin schedule at the earlier stage of applying the proposed margin requirements. Therefore, it is recommended that the proposed requirements should provide practical schedule-based haircuts; e.g., haircuts that would produce initial margin requirements comprising 20% or less of available liquid assets and not exceeding the amount by twice as much as that would be required when calculated by using a quantitative model.
(Requirement 2.1)

- Concerning variation margin requirements, taking into account the current market practice and operational burden, setting different thresholds shall be permitted considering the credit standing of counterparties.

(Requirement 2.2)

- Both the quantitative models and standardised schedule do not consider direct factors, specifically, the probability of default of a covered entity. For some transactions, however, the use of indirect factors only (e.g., confidence interval, holding period and applicable interest rates) may not be sufficient for determining the collateral value. Accordingly, a more practical treatment which takes into account the difference in the credit standing of counterparties should be permitted.

(Requirement 2.3)

- In light of conditions and market practice unique to each jurisdiction, a minimum transfer amount (MTA) should be permitted in USD or in a home currency (e.g., in JPY or AUD). Discretion should also be permitted for setting MTA to some extent taking into account changes in FX rates and the credit standing of counterparties.

(Requirements 3.2 and 3.3)

- In some consolidated groups, models and the risk management framework for derivatives are established separately for each entity including overseas entities. Given this, it is requested to clarify that a different quantitative model may be used for each entity within the same consolidation group.

(Requirement 4)

- The implementation of this margin requirement is expected to facilitate the exchange of collateral between financial institutions across jurisdictions. Whether to impose taxes on interest incurred on cash collateral exchanged needs to be discussed, including the development of a tax treaty and tax-exempt treatment.

- Key.principle 4 states that “Accepted collateral should also be reasonably diversified.” However, the same level of a diversification requirement that will be applied to relatively low-liquid assets should not be applied to relatively high-liquid assets, such as JGBs. Such high-liquid assets should be permitted to be fully used for any margin to be exchanged without restriction.
(Requirement 7.1)

- It should be clarified that this proposed margin requirement is applied only to transactions between jurisdictions which have agreed to the implementation of this requirement and jurisdictions which have established legally enforceable netting agreements. Also, the method for confirming the legal enforceability that would not cause any dispute over the assessment of such enforceability (for example, by requiring a public institution to publicly make a statement thereon). We are afraid that if, a bilateral exchange of margin is required for transactions with an entity in a jurisdiction with no established legally enforceable netting agreements, a covered entity might incur a loss from a transaction with such an entity as netting is not available upon the default of either party.

(Annex B)

- With regard to the statement an “additional (additive) haircut on asset in which the currency of the derivative obligation differs from that of the collateral asset”, if both parties agree to calculate the initial margin using one currency on a negotiation basis, it is understood that the initial margin can be calculated using this agreed currency for all asset classes. We respectfully request to specify that such a treatment is permitted.

- Even in cases where there is difference between the transaction currency of individual transactions and the currency used to calculate the initial margin, foreign exchange risk is reflected by incorporating the FX rate factor in the calculation of the initial margin. Therefore, it is considered reasonable to change the expression to “additional (additive) haircut on asset in which the currency of the initial margin used for settlement differs from that of the collateral asset”. In addition, discretion shall be given in determining haircuts based on the agreement between transaction parties (for example, between 0% and 8%), rather than requiring a fixed haircut.