July 10, 2015

Comments on Second Consultation Paper: *Draft Regulatory Technical Standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012* issued by the European Supervisory Authorities

Japanese Bankers Association

1. Introduction

(1) We acknowledge that considerable improvements have been made to the first consultation paper (the "1st CP"), addressing our comments on those requirements that are difficult to implement or entail some issues (for example, the treatment of additional haircut of 8% or limitation on collateral concentration). We therefore respectfully express our gratitude to all relevant staff at authorities for their due considerations on these issues.

(2) It is expected that a number of financial institutions, primarily those in Europe, will provide comments on this second consultation paper (the "2nd CP"). We would like to make our comments in broader standpoints encompassing the Asia region and regions where the collateral agreement (the Credit Support Annex) is less commonly used, not only from a viewpoint of Japan. It is understood that the EMIR does not only set forth requirements that are applied to cross-border transactions executed by Japanese or Asian financial institutions or corporates with European financial institutions or corporates, but also serve as guidance for which other authorities would develop their own regulation. It is therefore respectfully requested to fully reflect views of other regions including Asia, in addition to those of European financial institutions.

2. General Comments

(1) Setting a practical settlement period

- If the time difference is large, such as between Sydney and London, the settlement in T+1 or T+2 may be physically impossible or very difficult.
- On the other hand, if both counterparties are domiciled in the EU, collateral can be settled within a relatively short period of time. However, many regional financial institutions in Europe are executing a considerable amount of cross-border transactions.

Given the above and taking into account the combination of negotiated transactions, more physically feasible settlement period should be considered as follows:

(i) If a transaction is executed between counterparties within the same jurisdiction or within a predetermined region, both variation margin (VM) and initial margin (IM) shall be settled on a T+2 basis, at a maximum.

(ii) In cases other than the above (e.g., one counterparty is in the EU and the other is in Asia), on a T+3 basis, at a maximum.
(iii) If the settlement is executed within the above maximum period, the adjustment to margin period of risk (MPOR) is not necessary.

(2) Exemption for jurisdictions where the regulation is not implemented and those where the legal enforceability is not assessed

- In practice, it is substantially impracticable to enter into a CSA agreement and initiate the exchange of collateral by no later than the date of application of respective regulation in Europe, U.S. and Japan, with those counterparties domiciled in the jurisdictions where the regulation is not implemented, for the following reasons: (i) financial institutions have no binding power even if they request those counterparties domiciled in such jurisdictions to enter into a CSA; (ii) considerable time is required to establish an operational framework; and (iii) the revision of the insolvency law regime requires a longer period of time to ensure the legal enforceability of netting.
- Financial institutions subject to the regulation may be forced to concurrently cease entering into a new transaction with those counterparties with which the CSA agreement is not entered into, in order to avoid the violation of the regulation. Such situation is expected to result in a major disruption in the market of the relevant regions; for example, a cover transaction could not be executed in the derivatives market.

Given the above, it is requested to consider the following alternatives:

(i) The application of EMIR should be extended until relevant authorities implement the margin requirements, or a certain transition period (about one to two years) should be set after the date of application as lead time for entering into the CSA agreement.
(ii) The BCBS and IOSCO will issue a written recommendation to encourage entering into the CSA agreement to the jurisdictions where the regulation is not implemented.
(iii) Transactions with the counterparties domiciled in the jurisdictions where the legal enforceability of close-out netting is not assessed should be exempted from the regulation.

(3) Easing the conditions for applying the additional haircut of 8%

- To avoid the 8% haircut that results in an increase in collateral cost, the transfer currency needs to be the same as the currency in which VM is denominated, or the termination currency needs to be the same as the currency in which IM is denominated.
- However, since counterparties' interests would completely conflict in cross-border transactions for the former case, it is difficult to enter into a contract by the designated deadline. For the latter case, if counterparties set a single currency without considering their intent in executing a cross border transaction, this might give rise to confusion at the time of bankruptcy.

- Given that the most of financial institutions are required to exchange IM in addition to VM, the need for setting the additional haircut of 8% is considered to be low in the first place.
- It is considered necessary to ensure consistency with the treatment of not applying haircut for cash collateral in VM.

Given the above, it is requested to consider the following alternative:

While a single termination currency or transfer currency should be set for a contract within the same jurisdiction, it should be permitted to set multiple currencies in a cross-border contract (that is, each counterparty may set a different single currency).

3. Our responses to the questions

(Responses in (1) to (8) below are for the questions provided in the 2nd CP)

(1) Scope of regulation

(i) [Question 1 (P.27)] Under the 1st CP, there was a concern that transactions with a non-financial counterparty (NFC) domiciled outside the EU would uniformly be subject to the regulation. However, the 2nd CP clarified that NFCs outside the EU are treated in the same manner as NFCs in the EU (that is, NFCs outside the EU (i.e., non-EU NFCs) is exempted from the regulation as is the case with NFCs in the EU (i.e., EU NFCs-)). We would like to appreciate this reasonable change.

(ii) On the other hand, as noted in [Article 3 GEN in P.27, (8) in P.18～19, the fifth and sixth paragraphs in Background and rationale in P.8], the 2nd CP may be interpreted as requiring counterparties domiciled in the jurisdictions where the regulation has not been implemented (i.e., the jurisdictions which will not implement the regulation) or those where the legal enforceability is not assessed (i.e., the jurisdictions where there is a doubt about the legal enforceability of close-out netting and the feasibility of constructing an asset segregation scheme that meets the regulatory requirements) to collect and post IM and VM. This would imply that the transactions with counterparties domiciled in non-EU jurisdictions which are either jurisdictions where the regulation is not implemented or jurisdictions where the legal enforceability is not assessed are executed without an appropriate exchange of collaterals. Such transactions may immediately be deemed as violating the regulation. If such rule would be determined, it is difficult to eliminate the possibility of inviting unintended consequences.

Given the above and our concerns below, we would like to propose the following alternatives in connection with the scope of the regulation:

➢ Our concerns requested to be taken into account in rule making ✓ In practice, private financial institutions have no binding power to require counterparties domiciled in the jurisdictions where the regulation is not implemented to enter into the CSA agreement.

- ✓ Conclusion of the CSA agreement is not often established as practice in such jurisdictions. Therefore, there are a number of cases where the operational framework is not established. It is therefore unrealistic to conclude the CSA agreement and initiate the posting and collecting collateral by no later than the application date of the regulation in Europe, U.S. and Japan.
- ✓ The negotiation process for entering into the CSA agreement cannot start immediately after the regulation is finalised. In practice, it is difficult to engage in a detailed negotiation with counterparties until equivalence assessment across authorities is completed.
- ✓ Financial institutions subject to the EMIR might be forced to concurrently cease entering into a new transaction with those counterparties with which the CSA agreement is not entered into, in order to avoid the violation of the regulation. Such situation is expected to result in a major disruption in the market of the relevant regions; for example a cover transaction could not be executed in the derivatives market.
- ✓ Some local laws and regulations restrict the facilitation of smooth conclusion of the CSA agreement. For example, in India, the local foreign exchange act does not permit entering into the Global Standard CSA agreement (which is an agreement that permits posting and collection of collateral on a cross-border basis). To comply with the margin requirements, a new operational flow for posting and collecting collateral needs to be established in India, and the legal system that impedes the facilitation of a centralized and efficient process for entering into a CSA agreement at the head office, etc. needs to be reviewed. (See Attachment 1 "IMPROVEMENT OF CSA AGREEMENT" which is an excerpt from the request submitted by the Embassy of Japan in India to the Indian Chamber of Commerce.)
- ✓ As stated in [the sixth paragraph in P.8, and (8) of (Recitals) in P.18-19], with regard to IM being posted to counterparties in a disputable jurisdiction, European financial institutions are required to segregate IM outside the EU, by using third-party banks (custodians). However, in the above-mentioned case of India, as collateral posting and collection is not permitted on a cross-border basis in the first place, it is impossible to physically segregate IM being posted. Given that the cross-border scheme would not function, there may be cases where the requirements in the 2nd CP would not be satisfied.
- ✓ If the exchange of VM is required with a counterparty in a jurisdiction where the legal enforceability of close-out netting is not assessed, this may lead to an increase in risks, as well as to cause difficulty in reaching an

agreement in the amount of VM to be exchanged. (*)

(*)For the counterparty domiciled in such a jurisdiction, since the entity (Japanese financial institution) is a counterparty for which the close-out netting is assessed as legally enforceable, exposures based on which VM is calculated will be calculated assuming the close-out netting. Whereas, for the entity, since the legal enforceability of the close-out netting is not assessed in the counterparty's jurisdiction, exposures will be calculated on a gross basis. (That is, exposures will be calculated by aggregating only positive exposures, treating negative exposures as nil.) Inevitably, there is a difference in the exposure calculation of the both counterparties, and the amount of VM to be exchanged could not be determined. To ensure consistency of the calculation between the counterparties, if the entity calculates its exposures assuming that the counterparty's close-out netting is legally enforceable (that is, negative exposures from losing positions are deducted for calculation purposes), resultant exposures will be smaller than actual exposures held. Therefore, even if the entity has a positive exposure, there may be cases where the entity has to post collateral. In such a case, risks of the entity would rather increase, which would be against the primary policy objective of risk mitigation.

- Proposed alternatives:

  On the assumption that private financial institutions will facilitate the process of entering into the CSA agreement with counterparties in the jurisdictions where the regulation is not implemented, we propose the following alternatives:

  (i) The application of EMIR should be postponed until relevant authorities in the jurisdictions where the regulation is not implemented implement the margin regulation, or a certain transition period (about one to two years) should be set after the application date as lead time for entering into the CSA agreement.

  (ii) Coordination across relevant authorities should be promoted in order to establish a framework for discussing measures. For example, the BCBS and IOSCO may issue a letter to relevant authorities in the jurisdictions where the regulation is not implemented to encourage financial institutions under supervision to enter into the CSA agreement (namely, promote efforts to reduce barriers that impede the facilitation of the CSA agreement).

  (iii) Transactions with counterparties domiciled in the jurisdictions where the legal enforceability of close-out netting is not assessed should be exempted from the margin requirements.

(2) Settlement period for collateral

Firstly, since the "calculation date" specified in [the third paragraph of Article 1 VM in P.31-32, etc.] is not defined, it is requested to clarify the definition. The comment below is provided assuming that the "calculation date" is equivalent to the "deal date".

The physically shortest period for VM and IM should be considered, by taking into account the combination of negotiated transactions, instead of setting the settlement period from angles of VM (with IM posting and collection) or VM (with no IM posting and collection), etc.:

➢ Specific proposal (See Attachment 2 for details)

Location of the head office	Maximum days from the calculation date
i) Within the same jurisdiction, or in a predetermined region (for example, between counterparties in the EU)	T+2 business days for both VM and IM (In case of cash, T+1 business day)
ii) Other than the above (for example, one counterparty is in the EU and the other in the Asian region)	T+3 business days for both VM and IM

The maximum days refer to the shortest period and no amendments to margin period of risk (MPOR) is necessary.

Note: ii) is the case where operations will occur on a cross-border basis.

The following discusses our specific concerns and rationale of our proposed alternatives. Understandably, a shorter settlement period is better from a risk mitigation perspective. Nonetheless, various risks, costs and inconvenience arising from requiring a short settlement period should not be disregarded.

(i) VM

a. Where IM is collected and posted

- The first diagram in Attachment 2 of this comment letter shows the settlement timeline when VM is paid/received between the counterparties in Asia and Europe. Since the shortest settlement period is determined for the cross-border transactions on the assumption that "the counterparties should in a first stage collect at least the undisputed amount" as set out in the 2nd CP, the shortest settlement period would still be T+3, even eliminating the "agreement" and "reconciliation" processes from respective VM and IM processes.(*) However, under this "T+3" settlement period, the dispute between the counterparties would not be resolve, and hence counterparties would have no choice but to accept the amount that is smaller than the amount calculated based on its own calculation. This may result in under-collateralization in terms of credit protection. In order to execute the current level of operational procedures, additional time is required for the settlement period.

(*) However, the period can be shorten by one day if collateral is limited to cash that does not require confirmation of the security.

- We understand that the MPOR should take into account the typical settlement cycle applied to exchange of the margins in order to create an incentive for settlement risk mitigation. This however is considered to be a sort of penalty, and it is not reasonable to set such penalty for transactions where the settlement is executed at the shortest period practicable for counterparties. Such penalty should only be imposed on the portion exceeding the shortest number of days practicable for counterparties, as this may disincentivise entities from engaging in cross border transactions.

b. Where no IM is required

- The 2nd CP requires that the collection shall not exceed one business day from the calculation date. As discussed above, however, the period of T+3 needs to be ensured for cross-border transactions.
- For non-cross-border transactions, if both the CSA operation function are domiciled in the EU, some transactions may be settled in T+1. If the CSA operation function of either counterparty is domiciled in other jurisdiction, the same period as cross-border transactions is required since it may take time for notification to the head office, reaching an agreement, settlement and other processes.
- If the settlement cycle of T+1 became mandatory, similarly to Asian financial institutions, European financial institutions engaging in cross-border transactions need to (a) establish locations globally for negotiating a CSA agreement with respective counterparties; and (b) establish risk and liquidity management frameworks that enable to immediately post and collect collateral at the discretion of each location. However, European financial institutions capable of establishing such locations and frameworks are very limited, and hence cross-border transactions may be extremely difficult to engage in. (*)

  (*) Specific examples are as illustrated below:

  (a) Where an European financial institution which has reached the IM threshold transacts with an Asian regional financial institution which has not reached the IM threshold

  (b) Where an European financial institution which has not reached the IM threshold transacts with an Asian leading financial institution which has reached the IM threshold

(ii) IM

- The second diagram in Attachment 2 of this comment letter shows the settlement timeline when IM is paid/received between the counterparties in

Asia and Europe. The settlement cycle is dependent on whether there is an auto allocation function for the custodian service, but if there is no auto allocation function, the settlement cycle would be T+3 in the shortest period.

- If the auto allocation function is used, the required settlement cycle would shorten by about one day. However, custodians, including trust banks in Japan, that provide such function are limited.
- If the head office or operation department of both counterparties is located in the same jurisdiction, and the auto allocation function is used, margins may be settled in T+1. However, establishing regulatory requirements assuming the use of services provided only by certain vendors would substantially lead to driving out custodians with no auto-allocation function from the market.
- These would likely to give rise to the following issues and risks:

(i) Increased oligopoly in the custodian business and hence more concentration of various risks to certain vendors

(ii) Decline in the quality of service and an increase in fee due to oligopoly

(iii) Adverse impact on the business continuity

(iv) Difficulty to secure an alternative service vendor

Given the above, the rules, that could not be complied without using service offered by certain vendors, should not be established. The rules, if implemented, should not be a mandatory, but be a recommendation. In other words, the rule that requires IM to be calculated and collected within one business day (T+1) should be revised.

(3) IM model

- Derivative transactions generally have risk factors related to multiple asset classes. Therefore, if individual derivative transactions within a netting set are all allocated to a single asset class, and the amount of IM by asset class is calculated and aggregated, the resultant aggregated IM may be over-calculated.
- Taking into account that the original objective of this regulation is to clearly define the asset classes, and recognise risk hedging and diversification effects within the same asset class, while not allowing recognition of such effects across different asset classes, the approach to assign the same risk factor (e.g. interest rate risk factor) to multiple different asset classes, and simply aggregate these may produce an outcome that may deviate from the intention of this regulation.
- To enter into a derivative contract which is in the asset class different from the class which the derivative contract to be hedged is categorised into with the same counterparty for the purpose of hedging some of risk factors inherent in the derivative contract being hedged (for example, to enter into an interest rate derivative transaction with the same counterparty for hedging interest rate risk inherent in an equity derivative transaction) would originally mitigate counterparty risk between the

counterparties, eventually reducing systemic risk. Hence, such type of transaction should be greatly encouraged. Nonetheless, the amount of IM would increase if such transaction is entered into, which might have a negative consequence of disincentivising counterparties.

- To avoid such unintended consequence and construct a framework that aligns with the intention of this regulation, an approach to first disaggregate all derivative contracts by sensitivities and allocate these into each asset class would be recommended.

(4) Concentration Limits

We support the proposed approach to apply concentration limits to limited entities. This requirement however still has the following issues:

The introduction of the concentration limits would (i) in the case of posting the collateral, increase the type of collateral to be posted, and therefore the collateral sourcing cost is expected to be increased; and (ii) in the case of receiving the collateral, increase the collateral management cost for the same reasons. Either (i) or (ii) would lead to an increase in the operational burden for collateral management purposes.

Accordingly, securities with a certain level of high liquidity even under the period of stress should be exempted from the concentration limit. This is because, since positions of securities with high liquidity could be liquidated in a short time, the negative impact of collateral concentration to certain securities on converting collateral assets to cash would be reduced.

If such concentration limits would be introduced, counterparties subject to this regulation in the EU would impose concentration limits also to non-EU counterparties that are not subject to the concentration limits, thereby increasing the operational workloads of non-EU counterparties. Further, there is a risk that non-EU counterparties that are unwilling to be subjected to the concentration limits might cease transactions with EU counterparties.

Given the above discussions, the following unclear points are requested to be clarified:

(i) Whether “each of the counterparties belong to one of the categories listed in paragraph 3” stated in [the second paragraph of Article 7 LEC in P. 43] intends to require the concentration limits applied only to counterparties both in the EU.

(ii) Whether “the collateral” in [the second paragraph of Article 7 LEC in P.43] refers only to IM, or both IM and VM.

(iii) Whether (a), (b) and (c) in [the third paragraph of Article 7 LEC in P.43] include financial institutions whose head office is domiciled outside the EU. Additionally, whether (a) is applied to all group entities.

(iv) Whether the concentration limits are applied only to the portion exceeding EUR

1billion (for example, if a EUR 1.2billion of collateral is exchanged, the concentration limits are applied only to the EUR 0.2 billion), or to the entire amount of collateral, with regard to “the collateral collected in excess of EUR 1 billion” in the second paragraph of Article 7 LEC in P.43],

(v) We understand that the concentration limits are applied to the aggregate of IM and VM when both IM and VM are collected and received by means of securities. We would like to ask whether this understanding is correct.

(vi) Additionally, to clarify our understanding, we would like to confirm whether entities should assess the concentration limits based on the aggregated amount of collateral received from all counterparties if the same securities are posted as collateral from multiple counterparties; or to assess the concentration limits based on the amount on a counterparty-by-counterparty basis. (In practice, if the concentration limits are set on the multiple-counterparties basis, it is difficult to manage the limits on a real time basis or comply with the regulation. Therefore, management based on an individual-counterparty basis is considered to be a realistic approach.)

(5) Requirements on establishing various documentation and policies and procedures

We support the revision made to 1st CP, which addresses undue requirements to have even a written agreement that would not exchange the margins with NFC counterparties.

(6) Perform an independent legal review at least on an annual basis in order to verify whether the requirements are met for each jurisdiction

The independent legal review requirement set out in [the second paragraph 2 of Article OPD in P.48] to be performed at least on an annual basis in order to verify the legal enforceability of the bilateral netting arrangements is a stricter requirement than that under the current capital regulation, and therefore such legal review is considered to lack reasonableness. The independent legal review requirement to be performed at least annually to verify that the segregation arrangements meet the requirements has a similar concern.

Additionally, it is requested to clarify that the independent review, if implemented, should only be required for EU financial institutions.

(7) De-facto banning of treating cash as eligible collateral for IM

- As set out in the paragraph 1 of Article 1 SEG in P.48, a framework is required to be in place to protect IM from the default or insolvency of the custodian. In practice, however, it is difficult to segregate cash, and therefore such requirement may result in de-facto banning of using cash as collateral for IM.
- If the volume of other high-quality collateral assets to be used for IM is insufficient in the markets, counterparties could not fulfill its obligation to post IM due to this

requirement.

- Given that counterparties are required to post collateral in a very tight timeline (i.e. T+1) for IM (which could be regarded as unrealistic taking into account practical conditions such as time required for the IM calculation and reconciliation), there are cases that counterparties would need to post cash as collateral to shorten time required for collateral posting.
- In view of this, the condition that may make counterparties impossible to use cash as collateral for IM should not be added. Even if cash is not eligible for IM as IM cannot be in principle re-invested, some cash will need to be used for IM. Therefore, we would like to suggest that the final rule to include a threshold amount, such as EUR 500K, under which the posting party's exposure to custodian risk for return of cash is deemed to be acceptable, as well as the grace period of 3 days, when the IM cash exceeds such threshold.
- The definitions related to the use of collateral assets (prohibited re-hypothecation, re-pledge and re-use; and re-investment which is allowed as long as the agreement is reached) could be determined at the discretion of respective jurisdictions. (It is understood that, basically, the definitions shall be in line with the agreement under relevant governing law of ISDA -CSA.) We would like to confirm if the "re-invested collateral" [in P.49] in the rule includes "collateralized short-term loan contract (so-called "Yutan call")" which is currently considered as an option of IM cash reinvestment in Japan.
- Additionally, in the context of Basel III leverage and other requirements, the impact of various Basel requirements could not be disregarded since cash may be piled up at hand of each entity. Thus, custodians and trust banks that offer a segregation function may become more careful in accepting cash. Given such consequence, the competent authorities are requested to continue considering relaxing this requirement, by fully taking into account the relevance between the margin requirements and the Basel III including the leverage requirements so as to facilitate the provision of function by custodian banks/trust banks that contribute to mitigating systematic risk through the segregation of IM.

(8) Treatment of additional 8% haircut

➢ Request for clarification and confirmation of the objective

(i) Definition of termination and transfer currencies

Please provide more specific definition for termination and transfer currencies. Under the 2nd CP, if the currency is different from the termination and transfer currencies defined under the agreement, the haircut of 8% needs to be applied. In this regard, we would like to confirm whether such termination and transfer currencies should be defined using the same definition for both counterparties, or these currencies are

separately defined by respective counterparties, taking into account that, under documentation practice of ISDA Master and CSA Agreements, termination and transfer currencies are often separately defined by respective parties to the agreement.

(ii) Please clarify whether a haircut shall be applied to assets purchased through re-investment as defined in [the second paragraph of Article 1 REU in P.49], using examples. (For example, in the case where the termination currency is USD, and JPY cash is posted for IM, and US Treasury Securities are purchased through re-investment.)

(iii) Whether a haircut is applied to cash posted for IM

(iv) Details of [seventh paragraph of Annex II in P.58]. In particular, it is requested to clarify the intention of requiring the application of an 8% haircut only to the “unsettled variation margin”.

(For example, in the case where the transfer currency is USD and JPY cash is posted, the haircut of 8% is applied only to unsettled collateral until the settlement is completed, and after the settlement, the haircut of 8% will not be applied. In other words, whether this requirement intends that VM equivalent to 8% additionally posted portion will be returned. To avoid unnecessary confusion, it is requested to apply the same calculation method as IM.)

(v) If, under the agreement, the termination currency is specified as USD for IM, or the transfer currency is defined as USD for VM, and the exchange of collateral is executed in USD (e.g., $1,000,000), we would like to confirm whether the haircut of 8% needs not be applied.

Assuming the same agreement as above, the haircut of 8% needs to be applied if the collateral is exchanged in JPY, and the collateral amount is calculated as $1,000,000 x JPY120 (the conversion rate for $/¥) / (1-0.08) = JPY130,434,783. We would like to ask whether this is correct.

(vi) If the termination and transfer currencies are not agreed with the counterparty, it may be interpreted that the haircut is applied to collateral assets for both VM and IM. It is therefore requested to clarify this. If the haircut is applied to both VM and IM, there is a concern that the haircut will be applied in a duplicated manner to VM and IM for the same Trade Population.

- Easing the conditions for applying the haircut of 8%
  - The termination currency under the ISDA Master Agreement is set forth as a termination currency used for close-out netting. In the case of contracts between counterparties in the same jurisdiction, a specific single currency is generally set, whereas for cross-border transactions, a specific single currency is often not defined, for example by setting forth as “either USD, JPY or EUR”, or “non-defaulting party or non-affected party shall determine”. This is due to the fact that:

a) “Termination currency for close-out netting” shall be a currency used for liquidation which does not cause difficulty in the close-out netting proceedings by a non-default party. (Under current default practice, the currency used at a jurisdiction where the head office of a defaulting party is domiciled is mostly used to determine the amount of receivables.)

b) Under the cross-border contract, the termination currency may differ, depending on jurisdictions where both counterparties domicile.

- In light of the above practice, a same single currency should not be applied to both counterparties. Instead, multiple termination currencies should be permitted to be set in line with the practice.
- Practically, there may be a financial institution that sets a single termination currency, with a view to avoiding additional haircut. In such a case, it is necessary to take into account difficulty that may be caused when executing close-out netting. In the first place, it is not considered necessary to attach importance to the relevance between the termination currency under the ISDA Master Agreement and collateral currency under the CSA Agreement.
- It is apparent that it would be favourable for an entity if the termination and transfer currencies are set as denominated in home currency, whereas if those currencies are denominated in the counterparty’s currency, it would be unfavourable for the entity. As such, in the practice for negotiating a cross-border agreement, both parties would not compromise and insist to use their home currency. Consequently, not only the negotiation process for entering into an agreement would be prolonged, but in the end, financial institutions with a weaker power would be forced to compromise. As a result, there would be many transactions where large Euro-American financial institutions set the termination and transfer currencies in its home currency, whereas relatively small financial institutions in Asia and/or Africa need to accept those currencies to be denominated in the non-home currency, and are required to apply the additional haircut. Such situation may impede smooth transactions in markets.
- We recognise that the objective of the margin requirements is to prevent and reduce the impact of counterparty bankruptcy risk. In the context of VM, however, there is a concern that the introduction of the haircut would result in an increase in credit risk since the collateral poster would assume credit risk equivalent to the haircut portion of collateral against the collateral taker. Such situation would be contrary to the objective of this regulation.

Consequently, further review of the requirement on the additional haircut is strongly proposed for the following reasons: (i) since, in addition to VM, the exchange of IM will become mandatory for most of financial institutions in the future, it is not necessary in the first place to set the additional haircut of 8%; (ii) it is necessary to ensure consistency

of the treatment for VM cash to which the haircut is not applied; and (iii) it is necessary to smoothly implement the requirement in a short lead time, without having an adverse impact on financial practice.

Given the considerations above, we propose the following:

Termination and transfer currencies of a contract entered into between the counterparties in the same jurisdiction shall be a single currency, whereas for the cross-border contract, setting multiple currencies (for example, both counterparties designate their own single currency separately) should be permitted.

4. Comments other than those related to questions

(1) Scope

(i) Obligation for collecting and posting initial and variation margins

As set out in the above 3(1), it is proposed not to impose the obligation to post collateral. It is requested to revisit this issue as it is important that the same concern may arise in cases where the same rules are introduced at respective jurisdictions, and the harmonization with the regulations of other jurisdictions should be ensured. In this comment letter, the issue associated with this rule is discussed from the following four patterns of transactions:

a. Transactions between entities in the EU

In transactions between entities in the EU, generally, if one counterparty requests the other counterparty to post collateral, the other counterparty is expected to accept this request, and therefore it would not be an issue for those entities in the EU to be imposed the collateral obligation. Nonetheless, if the rule would be finalised as "the collateral taker must collect the amount it calculated" or "the collateral poster can only post the amount it calculated", both parties could not reach an agreement. In order to avoid such situation, it is requested to clarify the definition of "undisputed amount" in [sixth paragraph of Article 1 VM in P.32 and fifth paragraph of Article 1EIM in P.33].

b. Transactions between entities in the EU and outside the EU

Except for transactions discussed in c. and d. below, similarly to the transactions in a., basically there is no issue in this transaction, provided however that the condition that the both counterparties may agree to exchange collateral at the "undisputed amount" is also permitted for entities outside the EU. For smooth introduction of the regulation, it is requested to achieve harmonization as much as possible.

c. Transactions between entities in the EU and non-EU entities in the jurisdictions where the regulation is not implemented

The issue is as stated in 3(1) above.

d. Transactions between entities in the EU and non-EU entities in the jurisdiction where the legal enforceability of the netting is not assessed

The issue is as discussed in 3(1) above.

(2) IM model

(i) Not taking into account any correlations between the unsecured exposure and the collateral [the second paragraph of Article 5 MRM in P.36]

The final policy framework established by the BCBS and IOSCO provides the option of model-based haircuts. Because, in general, interest rate, FX and other risks are commonly inherent in the derivative portfolio and collateral assets, risks that are covered by applying haircuts include the correlation risk between the derivatives portfolio and collateral assets, in addition to price fluctuation risk (volatility) unique to individual collateral assets.

In light of the objective of the regulation to reduce systemic risk, it is difficult to understand the rationale behind the prohibition of taking into account such correlation. Rather, it is considered to unduly restrict the latitude of entities in modeling (this relates also with Question 3).

(ii) Posting of the additional margin in response to changing market conditions [eighth paragraph of Article 3 MRM in P.34]

Firstly, we would like to confirm which phrase does the “over a period that ranges between one and thirty business days” relates to; “to post the additional initial margin” or “the recalibration of the model”.

If the “over a period that ranges between one and thirty business days” relates to the former (i.e., where this period refers to the deadline for posting additional margin arising from recalibration of the model”), it is expected that, in particular, the amount of required collateral would increase across the financial industry in a time of financial crisis. Consequently, depending on the liquidity of High Quality Liquid Assets, setting the 30-business day deadline uniformly for all transactions might result in increasing systemic risk. It is therefore requested to clarify a rationale for setting the 30 business-day criterion, and to defer a decision on applying the same deadline, if possible, to avoid any unintended adverse consequence on market liquidity.

(iii) The 1st CP required notifying the relevant competent authorities if they are intending to use an internal model for IM calculation and be prepared to supply relevant documentation. This requirement is eliminated from the 2nd CP. We would like to confirm whether this implies that the use of internal model will not require any procedures including the notification to relevant competent authorities.

(3) Intragroup transactions

The 2nd paper requires exchanging margins for intragroup transactions unless the relevant competent authorities grant the exemption. The objective of this requirement is to prevent systemic risk that arises from a failure of one financial group to have a chain reaction on other financial groups. However, the exchange of margins between the entities would not be an effective measure for preventing the chain of failure across the group, and would not contribute to the prevention of systemic risk. Nonetheless, if this is mandated, a considerable number of collateral securities would be piled up within the group without being disposed of, because, apart from VM, collateral assets could not be repledged in the case of IM, and major sovereign bonds are expected to account for the majority of collateral assets in order to avoid an adverse impact on the leverage ratio of custodians accepting IM. If the volume of major sovereign bonds traded in the market would be reduced, there is a concern that the volatility of interest rate would further increase in the future to normalize the monetary policy (lifting of quantitative easing and zero-interest-rate policy), thereby leading to market turmoil. Additionally, it is requested to clarify from which relevant competent authorities approval should be obtained for the exemption for the intra-group transactions. For example, the clarification is requested for the following cases: If more than 2 entities exist in the EU in the group company, whether it is necessary to obtain approval from all relevant competent authorities in which those group entities are domiciled or from either one of the competent authorities. Or, if the exemption for the intragroup transaction is set forth in the jurisdiction where a non-EU group entity is domiciled similarly to the cases in the EU, whether the requirement to obtain approval should be satisfied for such non-EU jurisdiction.

(4) Equivalence assessment

The completion of equivalence assessment after the finalisation of respective regulations is indispensable for entering into a CSA agreement on a cross-border basis. Therefore, to complete the conclusion of a huge number of CSA agreements across jurisdictions by no later than the application date of the regulation, it is requested to complete the equivalence assessment by early 2016 (January 2016). If equivalence assessment could only be completed after this timing, it is impracticable for private financial institutions to accelerate their CSA agreement process through its own efforts. Therefore, with regard to jurisdictions for which the equivalence assessment is not completed at early next year, including those jurisdictions where the regulation is not implemented, it is requested to allow more flexibility in the timing of implementation; for example, setting a certain lead time.

(Attachment 1)

Suggestion xx-xx

IMPROVEMENT OF CSA AGREEMENT

■ New ☐ Ongoing

1. SUGGESTION

- In order to facilitate the introduction of Global Standard Credit Support Annex ("Global CSA") against Indian banks, regulations on transfer of securities for collateral posting outside in India must be eased.
- Or, if such deregulation is not possible in the near future, then settlement and clearing of Indian Securities has to evolve for Indian National Debt to be used as eligible collateral for Local Credit Support Annex ("Local CSA").

2. ISSUE / PROBLEM

- Aftermath of the Great Financial Crisis, executing collateralized OTC derivatives has become a sound global practice as agreed at G20 in 2009. Foreign banks in India are finding it difficult to expand derivative transactions with Indian banks and Financial Institutions because of severe restrictions on collateral posting, both locally as well as globally.
- Consequently, this limits the overall growth of derivative markets in India.
- Practice in India doesn't conform to the standards of "The 2009 G20 agreement to reform the global OTC derivatives market" which stipulates the introduction of collateralization of derivative transactions worldwide.

3. BENEFIT / MERIT FOR INDIA

- With the enabling of transfer of security outside India under Foreign Exchange Management (FEMA) Act, derivative transactions between the Indian banks and foreign banks under global CSA will be activated and this will lead to development of local derivatives markets as well as debt capital markets. An active derivatives market is a key proponent to attract more foreign investment which is in line with the long-term vision of the Indian Government to develop local Infrastructure.
- Introducing global CSA will mitigate credit risk between Indian and Foreign banks, and contribute to activation of financial markets in India. It will also contribute to development of overseas business of the Indian banks.
- Acceptability of India national debt by foreign banks will increase if it is accepted as an eligible security (in case of Local CSA). It will also help for the expansion of Indian Bond markets and demand for Indian bonds.

4. (IF ANY)INTERNATIONAL STANDARD / BEST PRACTICE

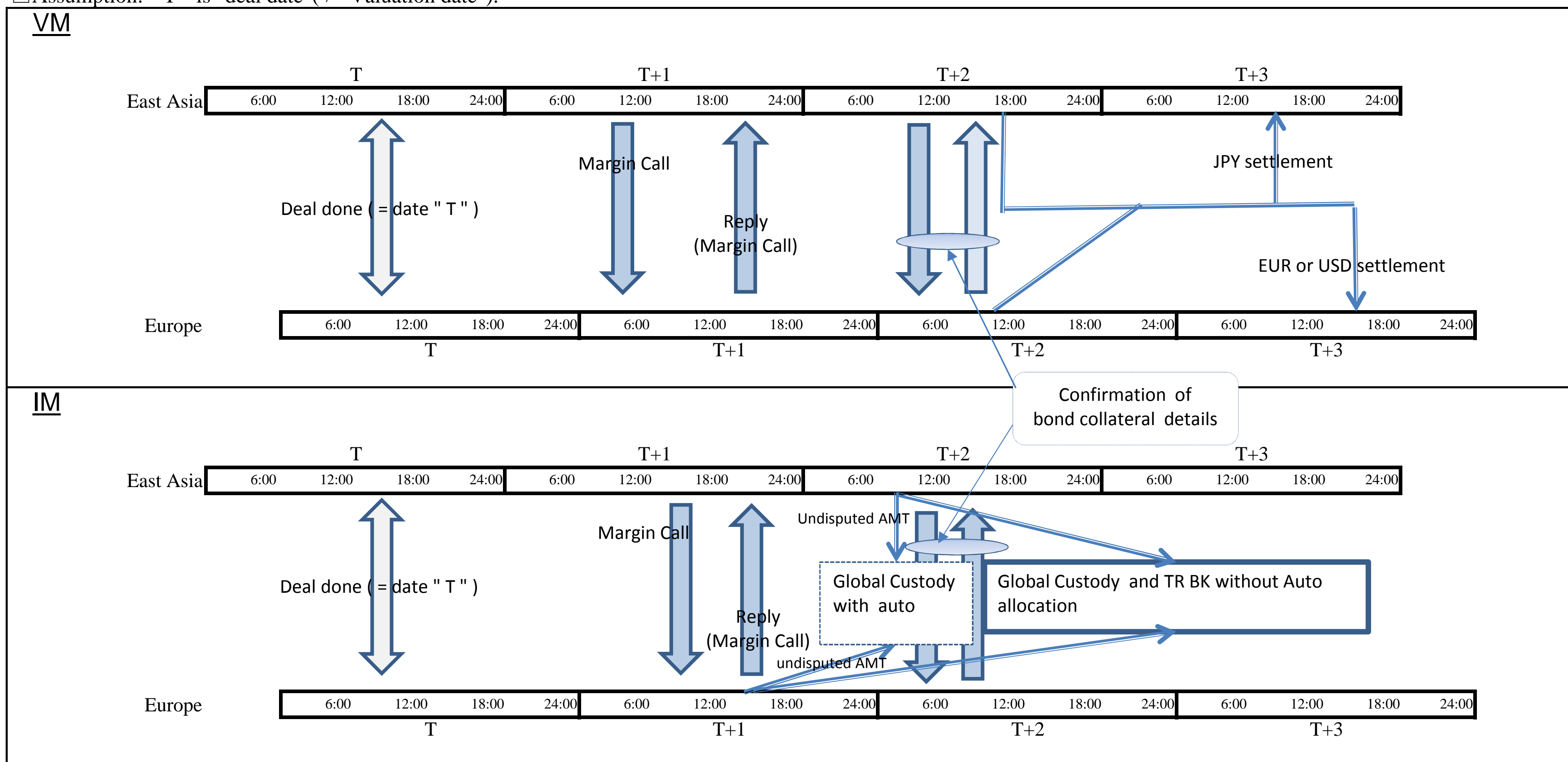
- Each country is advancing standardization and introducing legislation on derivative transactions for conforming to the international agreement of G20 in September, 2009 (example: Malaysia).
- The Global CSA has been introduced among major Asian countries except for Indonesia, Vietnam, and India. Especially, The Global CSA is commonly used in the market of Thailand as compared to other ASEAN countries.

5. (IF ANY) RESPONSE OF FEDAI AND/OR OUR COMMENTS THEREON

- 24th September2012 FEDAI Circular / SPL-62/ISDA-CSA/2012
  "On the issue, it is observed that providing collaterals / margins for onshore transactions at an off-shore centre is not permissible under FEMA"

Shortest Settlement Period for Margins in Cross-border Transactions

☐Assumption: " T " is "deal date"(≠"Valuation date").



○ If collateral is limited to cash which does not require confirmation of bond collateral details, the settlement period can be shorten by one day
This assumes that the "counterparties shall collect at least the undisputed amount" under the proposed EU Regulation

○ If the dealing hours are late in the East Asia time zone, deals executed in this time zone may be treated as deals done in the following day, depending on the system o each firm.
In such a case, the following date of the actual deal date is recognised as "T".