January 15, 2016

Comments on the Consultation Paper: *Non-centrally Cleared OTC Derivatives Transactions-Margin and Other Risk Mitigation Standards,* issued by the Hong Kong Monetary Authority

Japanese Bankers Association

1. Preamble

(1) We, the Japanese Bankers Association ("JBA"), would like to express our gratitude for this opportunity to comment on the consultation paper (the "CP"): *Non-centrally Cleared OTC Derivatives Transactions-Margin and Other Risk Mitigation Standards,* published by the Hong Kong Monetary Authority ("HKMA") on December 2, 2015.

(2) Many financial institutions, particularly those in Asia, are expected to submit their views on the CP. As the standards will be applied to cross-border transactions, such as between entities in Asia and those in the U.S. and Europe, our comments especially focus on issues and effects associated with the cross-border application. We hope that our comments below will be of assistance and offer an additional point of reference as you work towards finalising the standards and forming an international consensus.

2. Specific comments

(1) Scope of application

(i) Products to be excluded from the covered products

Footnote 10 under paragraph 2.1.1 in the draft SPM module (SPM 2.1.1) states that "the provisions relating to VM apply to physically settled FX forwards and swaps and to all components of cross-currency swaps."

To our understanding, FX transactions (i.e. FX forwards and FX swaps) should be addressed systematically according to the BCBS/CPMI's *Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions*. They are however not covered by the BCBS/IOSCO's Final Report on margin requirements.

While we agree that the standards should ultimately be applied to those counterparties with which a covered entity solely engages in FX transactions, they should be excluded from the standards for the moment, similarly to proposed rules of Japan and the U.S.

rules, given a limited period of time up to the regulatory implementation and in order to ensure global consistency.

(ii) Non-financial counterparties

Currently, the (proposed) rules of Japan, the U.S. and Singapore do not apply to a non-financial counterparty. Although the threshold set to define a covered non-financial counterparty is relatively high, the approach to subject large foreign derivative end users to the standards would not be accepted by non-financial counterparties. Also given the actual level of prevalence of CSA and consistency with rules of other jurisdictions (excluding the EU), this approach is considered to be premature. Therefore, the HKMA is requested to reconsider the definition of the covered entity to exclude the non-financial entities from that definition.

With regard to the threshold of the transaction volume to define a covered non-financial counterparty, we would like to ask whether an inquiry needs to be directly made to individual counterparties to check whether they meet the definition or the HKMA takes a necessary action, such as disclosing relevant information obtained from such counterparties before trades. We would also like to ask which authorities hold jurisdiction over non-financial counterparties, etc. in this respect.

(iii) Transactions with a special purpose entity, a collective investment scheme and a private equity fund

We understand that the standards apply to those special purpose entities, collective investment schemes and private equity funds (collectively, "SPEs, etc.") which engage in a number of derivative transactions. However, as they do not necessarily hold enough liquidity to cover the exchange of margin, requiring such entities to exchange variable margin ("VM") or initial margin ("IM") would undermine the sustainability of their business models. A prudent approach should be taken to this matter.

Further, in general, SPEs, etc. do not necessarily engage in many derivative transactions due to their nature. Therefore, it is requested that the similar regulatory treatment as that of a non-financial entity will be applicable to these entities.

(iv) Treatment of counterparties in jurisdictions where close-out netting or netting of collateral is not legally enforceable

In paragraph 21 of section 2.1, the CP proposes that VM should be posted and collected and IM should be collected, both on a gross basis for transactions with counterparties in non-netting jurisdictions. This proposed approach may increase collateral cost while at the same time give rise to additional exposures, which may eventually lead to heightened systemic risk. Therefore, it would be very difficult to convince counterparties

to accept this condition. While it is considered reasonable to a certain extent to take this approach to non-netting jurisdictions from the perspective of promoting the legislation of netting arrangements, it may make it difficult for financial institutions in such jurisdictions to engage in derivative transactions. From this viewpoint, it would be realistic to provide a certain implementation period to promote non-netting jurisdictions to work on the legislation.

Further, the CP also indicates that an AI should have, and should endeavor to ensure that its counterparty has rigorous and robust dispute resolution procedures in place, as outlined in Sub-section 4.6, before the initiation of a transaction of non-centrally cleared derivatives. We would like to request to clarify whether this means that AIs cannot enter into a transaction without confirming such condition.

(v) Treatment of AIs incorporated outside Hong Kong

According to the CP, AIs incorporated outside Hong Kong would be allowed to follow foreign margin standards. We would like to confirm that this also applies to overseas branches of Japanese financial institutions (i.e. the "substituted compliance" approach described in the table set out in SPM 2.1.11 is applicable to them).

Further, with regard to the two provisions below, we would like to know whether a prior application will be required from respective parties to a transaction. If such an application is necessary, the HKMA is requested to provide a specific timeframe, including the application deadline, as well as to clarify whether it is allowed to make a prior application from national authorities collectively for all transactions. Also, consideration should be given to disclosing those jurisdictions to which margin standards are applicable.

- ✓ As a principle, substituted and partial compliance would only be available if the HKMA has issued a comparability determination in relation to a foreign jurisdiction's margin standards. (II-1-11)
- ✓ An AI or a supervisory authority may submit to the HKMA a formal request for a comparability assessment of a jurisdiction's margin standards, or risk mitigation standards. (SPM 2.3.2 and 2.3.3)

(vi) Aggregate notional amount

SPM 2.4.6 and SPM 2.4.7 define the aggregate notional amount. Some guidance should be provided concerning how to mutually check whether exposures exceed the thresholds with counterparties prior to entering into a transaction, including for the case specified in paragraph 2.4.6 (iii) where the calculation is based on the aggregate notional amounts of group companies. In doing so, the HKMA is also requested to consider collecting,

aggregating and updating information and providing entities with a tool that gives access to such information.

(2) Collateral administration and calculation of collateral requirements

(i) Obligation related to exchange of margin

Given that other major jurisdictions like the U.S., the EU and Japan are working towards implementing their margin requirements, requiring only the receipt of margin is considered to be appropriate in order to ensure effectiveness of the exchange of margin in cross-border transactions. It would be ideal to address conflicting requirements between jurisdictions (e.g. differences in legal enforceability of collateral) and afterwards require both the receipt and posting of margin. However, to require only the receipt of margin first should be regarded highly as an approach that focuses more on time limits.

To avoid any misunderstanding, we would like to mention that our comment here is based on our expectation that after the application of at least the receipt-only requirement is expanded to multiple countries at the level of WGMR (Working Group on Margin Requirements), both the receipt and posting of margin will be ultimately required.

(ii) Obligation to collect the full amount of VM

SPM 3.1.1 requires that the full amount of VM necessary to fully collateralise the mark-to-market exposure of the non-centrally cleared derivatives be exchanged. Under the current CSA practice, however, parties to CSA rarely agree to the exchange of VM at such an amount. Therefore, it is likely that they will fail to reach an agreement even if they negotiate to meet this requirement. Given this, and in order to prioritise the receipt of the minimum required amount, the framework should be modified to allow collateral to be exchanged at the amount agreed upon between the parties.

(iii) Concept of the business day

While the term “Hong Kong business day” is used in SPM 3.7.6 and other parts of the CP, it is often the case under cross-border transactions that a Hong Kong business day falls under a holiday in foreign jurisdictions. The definition of a “business day” needs to be changed according to the location of collateral and the operation function. Therefore, the framework should be modified to enable the parties to a transaction to agree upon the definition of a business day.

(iv) Additive 8% haircut upon currency mismatch

In Pages 12 and 29 of the CP, it is indicated that an additive haircut of 8% (“FX-haircut”), which applies in the case of a currency mismatch, does not apply if cash is

posted for VM purposes. On the other hand, the haircut schedule in page 47 shows that a 0% haircut applies to "cash funds in same currency" (which implies that the FX-haircut is applied to cash collateral in the case of a currency mismatch). Please clarify that the FX-haircut does not apply to cash VM collateral. (Given that the U.S. final rule has determined not to apply the FX-haircut in this case, the HKMA should take the same approach.)

If it is determined that the FX-haircut should be applied to cash VM collateral, respective parties to a contract should be allowed to designate one currency of the margin collateral that can be exempted from the haircut requirement, similarly to the treatment applied in the case of IM. Otherwise, it would be difficult to conclude a contract by the due date because interest of both parties under cross-border transactions would conflict outright.

(v) Valuation

The valuation process and parameters, etc. used for valuation purposes are internal information of each financial institution and should not be disclosed to, or agreed with, counterparties as described in SPM 4.3.

(vi) Portfolio compression

Unlike compression by clearing houses, portfolio compression related to non-centrally cleared transactions should be carried out by the private sector on a voluntary basis. Therefore, it should not be made mandatory but instead should be regarded as a recommendation from the HKMA.

(3) Others

(i) Supervisory approach

- ✓ Provisions pertaining to margin could be determined by the bilateral CSA. (SPM 5.1)
- ✓ In light of regulatory compliance burden of financial institutions, an approach to integrated documentation of various regulations and practices should be considered by taking into account its effectiveness and practical burden. (SPM 5.2)

(ii) Inconsistency with the BCBS/IOSCO's Final Report and (draft) rules of Japan and the EU

The BCBS/IOSCO's Final Report and the margin rules of Japan and the EU (the latest consultation document) provide for a haircut of 15% to be applied to debt securities collateral with a probability of default of over 1% up to 7.5%. The CP, including Appendix C, does not refer to such a haircut.