December 2, 2014

Comments on "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants" issued by the Commodity Futures Trading Commission

Japanese Bankers Association

1. Preamble

(1) We, the Japanese Bankers Association ("JBA"), would like to express our gratitude for this opportunity to comment on a proposed joint rule "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants" (the "proposed rule") (RIN 3038–AC97) issued on October 3, 2014 by the Commodity Futures Trading Commission (the "CFTC").

(2) To our understanding, the primary impact of the proposed rule on Japanese financial institutions arises when they transact with a covered swap entity. In September 2013, the Basel Committee on Banking Supervision ("BCBS") and the Board of the International Organization of Securities Commissions ("IOSCO") released their final report on "Margin requirements for non-centrally cleared derivatives" ("BCBS/IOSCO Final Report"), and national supervisors are to establish detailed margin requirements based on that international minimum standards. The proposed rule published accordingly by the CFTC, which supervise the U.S. market (i.e. the world's largest derivative market), is considered important because it is deemed as a model or guidance for other jurisdictions to follow.

(3) We would like to comment particularly from the perspectives of Asian regions, including Japan, and jurisdictions where collateral agreements ("CSA") are not widely used. We hope that our comments below will be of assistance and offer an additional point of reference as you work towards finalizing the rule so that it will become a most reasonable and fair rule from global perspectives and will promote the implementation of the international standards.

2. Overall comment

(1) Issues and concerns arising from the existence of many different rules

Our concern about the proposed rule from the perspectives of non-U.S. financial institutions is that it lays out some conditions favorable to U.S. financial institutions. For example, eligible collateral for variation margin ("VM") is limited to cash denominated in U.S. dollars or in the currency in which payment obligations under the swap are to be settled. In addition, it can be interpreted that cash collateral denominated in U.S. dollars is only exempted from the application of a haircut of 8%. First of all, it would be appreciated if the CFTC would clarify whether this interpretation is correct; and if not, how to interpret it. The following comment is based on the assumption that our interpretation is correct. It is our concern that such conditions will drive other jurisdictions to follow suit, giving rise to various different rules across the jurisdictions. Further, the proposed rule requires an initial margin ("IM") threshold amount (for the final phase) that differs from the requirement under the BCBS/IOSCO Final Report, and uses a definition of the term "affiliate" that is different from the general definition (i.e. more than 50% of voting power). Given the above, if the proposed rule is implemented as it is, banks engaging in cross-border transactions with many financial institutions will have to abide by different rules depending on their counterparties. This would not only make it more difficult for banks to implement regulations but, in effect, would also result in failure of internationally-agreed framework. Or, if other jurisdictions do not follow the U.S.'s approach, it may give rise to a movement in the market where non-U.S. entities avoid transactions with U.S. financial institutions. The CFTC is requested to take this into account and take the initiative, as U.S. regulators, in realizing smooth introduction of reasonable and fair international regulations.

(2) T+1 IM settlement is not practical (particularly in cross-border cases)

A particular concern for financial institutions located in Asia and the Far East region is that the proposed rule may be interpreted as requiring the timing of IM and VM settlement on the day a covered swap entity enters into the transaction or the following business day ("T+1"). Given administrative procedures necessary for the calculation of IM (e.g. pre-reconciliation), this timing requirement would be difficult to meet even in the case of transactions between entities located within the U.S. In the case where the time difference is large between the locations of respective parties to the transaction (e.g. between Sydney and New York), this requirement would create severe disadvantage for Asian financial institutions with a large time difference and is not practical to comply with. The CFTC is requested to consider that the rule should be practical to implement not only for transactions in the U.S. but also for cross-border transactions with Asia, etc.

(3) Level of requirements

(Even assuming that the proposed rule will be further refined to some extent,) satisfying the requirements related to timing and deadlines under the proposed rule is considered to be difficult and thus many jurisdictions and financial institutions may fail to comply with the rule. This may give rise to an unfair playing field between jurisdictions and financial institutions complying with the rule and those that are not in compliance with the rule. In the first place, this regulatory initiative has been initiated as part of internationally-agreed G20's program. If only some jurisdictions and financial institutions are capable of complying with the rule, it would undermine the meaningfulness of implementing the rule as an international agreement. Given that margin requirements are a rule established based on the international agreement by G20 leaders and a rule which should be comply with by a larger number of financial institutions, the level and content of the requirements should be achieved with a reasonable effort even by those financial institutions in jurisdictions which have not yet developed a sufficient framework related to operation, systems, documentation and other relevant areas.

(4) Necessity of integrating swap margin rules

National regulators of all major regions, i.e. EU, Japan and the U.S., as well as the U.S. prudential regulators (Board, FCA, FDIC, FHFA and OCC), have issued their national draft rules. Given that there are significant differences across these draft rules, it is crucial to explore how extraterritorial application of these swap margin requirements can be implemented in a realistic and effective manner. Basically, banks should be deemed as achieving regulatory compliance if they comply with the rules of the home jurisdiction of their head office. However, even if approaches for cross-border application are designed in a refined manner, financial institutions engaging in cross-border transactions would need to manage their transactions pursuant to multiple standards corresponding to the number of their counterparty's home jurisdictions, and as a result will virtually be unable to function. (Further, if rules pertaining to extraterritorial application differ across jurisdictions, it would be more difficult for them to implement swap margin requirements.) Ultimately, therefore, the only essential solution for this issue is to promote the integration of swap margin rules. To this end, the issue should be returned to the BCBS and IOSCO for discussion, instead of being discussed and adjusted bilaterally or among multiple national regulators, as it is considered to be the most efficient and quickest way. If it is determined that swap margin rules will not be integrated, regulators are expected to perform the comparability assessment upon finalization of national rules. Since it would be difficult to initiate preparing for implementation (e.g. documentation) until the comparability assessment is completed, some banks may fail to meet the deadline to implement the rules, giving rise to a number of counterparties unable to transact with. Therefore, if swap margin rules will not be integrated, it is critical to complete the comparability assessment as soon as practical.

(5) Timing of implementation

As a compliance date, a transition period of at least two years after the finalization of the rules and completion of the comparability assessment should be provided to implement VM requirements, and a longer transition period to implement IM requirements; given (a) the proposed rule is not finalized yet, (b) details of many areas need to be discussed and adjusted between the public and private sectors, (c) a great deal of efforts and resource is necessary to prepare for implementation and (d) specific actions cannot be initiated until the comparability assessment is completed. Additionally, there are opinions and idea that protocol, if developed, would enable financial institutions to implement the proposed rule in a short span of time. The use of protocol, however, is limited to the cases where uniformed terms and conditions of agreements are applied, and hence not available to the cases where cut-off time and the

<u>settlement period are separately defined (in particular, cross-border transactions between such as U.S. and Japan.) For example, almost 100% of Japanese financial institutions modify the template for the use of actual transactions, and therefore, protocol is rarely available for Japanese financial institutions. It is therefore requested to consider this in setting the timing of implementation. When legacy trade is excluded from the IM calculation, a separate ISDA master agreement needs to be entered into. Entering into a new separate ISDA master agreement with a counterparty may reduce the effect of close-out netting discussed in 5. (3) (iii) below, and would urge firms to conclude a number of new agreements, which usually require a long time to conclude, in a short period of time. Consequently, it is requested to revisit the current proposed rule that eventually force firms to enter into more than one ISDA master agreement. If this reconsideration would not be made, the CFTC is requested to set considerable lead time for implementation of the proposed rule.</u>

3. Scope of application

(1) Covered entities

i) The proposed rule refers to entities that are subject to the rule as “covered swap entities.” “Financial end users,” on the other hand, are not directly subject to the rule but need to exchange VM (and IM, if necessary) when transacting with a covered swap entity. (It is understood that the “financial entity” is used interchangeably with the “financial end user.” The following comments uniformly use the term the “financial end user.”) The financial end users include entities which are engaged in derivatives transactions but do not necessarily assume the exchange of VM or IM, such as securities investment funds and securitization vehicles (see SUPPLEMENTRARY INFORMATION: II. C.2.a).

ii) Securities investment funds and securitization vehicles are merely entities that engage in minimum derivatives activities needed for business purposes, and due to such characteristics do not always maintain the liquidity to enable the exchange of VM. Indirectly mandating these entities to exchange VM may undermine the sustainability of their business model, and thus the CFTC is requested to address this matter carefully. Further, these entities, due to their characteristics, are not necessarily engaged in many derivatives transactions. It is therefore requested that these entities are treated in a manner similarly to non-financial entities.

iii) The scope of entities directly or indirectly subject to exchange of VM is not consistent across jurisdictions. To avoid undue confusion, national regulators are requested to unify the criteria of covered entities as much as possible. In addition to the above-mentioned securities investment funds and securitization vehicles, the treatment of SPCs and SPVs should be consistent across jurisdictions.

iv) As stated above, it is understood that the proposed rule uses the “financial entity” interchangeably with the “financial end user.” If however the “financial entity” has a different definition, it is requested to align with the definition under the proposed rule issued by the U.S. prudential regulators (Board, FCA, FDIC, FHFA and OCC), since the different definition would lead to a lack of consistency with the proposed rule issued by the U.S. prudential regulators, thereby causing unnecessary confusion.

v) The proposed rule issued by the U.S. prudential regulators (Board, FCA, FDIC, FHFA and OCC） and this proposed rule have a different definition of the financial end user". Specifically, under the proposed rule released by the U.S. prudential regulators (Board, FCA, FDIC, FHFA and OCC), the "financial end user" is included in the definition "a company that has elected to be regulated as a business development company pursuant to section 54(a) of the Investment Company (15 U.S.C. 80a‑53(a))" (57390; 2nd Column; 1st Paragraph); however this proposed rule does not include such a company in the definition of "financial end user" (§23.151). It is hence requested to align the definition and contents of the both proposed rules.

(2) Phase-in of IM requirements

i) The proposed rule adopts a phase-in approach to introduce IM requirements similarly to the BCBS/IOSCO Final Report, EU's draft rules and Japan's draft rules, however the IM threshold amount for the final compliance date (i.e. the threshold applicable from December 1, 2019) is inconsistent with other proposed rules. Specifically, while other rules sets a threshold of €8 billion for the final compliance date, the proposed rule sets a threshold of zero in the case of transactions between covered swap entities (see§23.159, SUPPLEMENTARY INFORMATION: II.J) and substantially a threshold of US$3 billion in the case of transactions between a covered swap entity and financial end user (see§23.151 and §23.152).

ii) Given the above, the proposed rule results in an inconsistency with the BCBS/IOSCO Final Report, EU's draft rules and Japan's draft rules, which may cause unnecessary confusion among market participants. It is understood that due consideration have been given in setting a threshold of US$3 billion, which is referred to as a "material swaps exposure" in the proposed rule (see SUPPLEMENTARY INFORMATION: II. C.2.e). Nonetheless, the CFTC is requested to develop requirements in a manner to ensure international consistency and avoid unnecessary confusion because the proposed rule has an impact not only on entities within the U.S. but also on those outside the U.S. In addition, such inconsistency will obviously drive regulatory arbitrage. Specifically, financial institutions whose amount of transactions is in between two different thresholds would inevitably avoid transactions with U.S. financial institutions if the terms and conditions are the same. The CFTC is requested to also take this into account and carefully consider the necessity of setting a threshold specific to the U.S. rules. In terms of the criteria for assessing whether thresholds are exceeded, the BCBS/IOSCO Final Report, EU's draft rules and Japan's draft rules use month-end average notional amount of transactions over three months (i.e. June, July and August) whereas the proposed rule uses average daily aggregate notional amount of transactions over the same periods. Aggregating these daily amounts on a group basis and retaining such data after aggregation as evidence would be a burdensome task. As the nature of both data does not differ, it is requested that the CFTC reconsiders adopting month-end average notional amount from perspectives of reducing unnecessary burden and ensuring consistency between international rules.

4. Collateral operation

(1) Content of requirements (§23.152 and §23.153)

<u>The proposed rule requires not only the collection of VM or IM but also the posting of these margins.</u> We understand that the CFTC attaches importance to requiring a covered swap entity to post margin to other financial entities in order to forestall a build-up of potentially destabilizing exposures in the financial system (see 55907; 2nd Column; 2nd Paragraph). Nonetheless, requiring the posting, as well as the collection, of minimum IM and VM amounts is likely to further increase practical burdens or confusion of market participants because, in the absence of explicit rule concerning dispute resolution, a judgment on to what extent negotiation with counterparties needs to be made will differ on a case-by-case basis. <u>In light of the fact that the BCBS/IOSCO Final Report, EU's draft rules and Japan's draft rules do not require the posting of margins, the CFTC is requested to avoid incorporating an inconsistent requirement in the U.S. rule.</u>

(2) T+1 settlement and daily operation (§23.152 and §23.153)

The proposed rule requires a covered swap entity to valuate margin requirements "each business day." Further, IM needs to be posted or collected in response to execution of new transactions, changes in a portfolio composition or changes in the required IM amounts resulting from calculations per internal margin models or the standardized look-up table. If our interpretation is correct, margin must be posted or collected on the business day following the day a transaction is entered into ("T+1") or on the day the transaction is entered into ("T+0") (see 59907; D.1) It is understood that this would also be applied to VM. (Or if the proposed rule does not necessarily intend to designate the timing of exchanging margin, please advise whether it only intends to require a margin calculation from the business day following the date on which a transaction is entered into. Our comment below is made assuming that our interpretation is correct.)

Given that the BCBS/IOSCO Final Report does not refer to the timing of posting or collecting margin and does not require daily calculation of margin requirements, it is considered that the proposed rule provides a tighter rule for both points.

i) T+1 posting/collection requirements

Under the existing margin posting/collection process implemented on a bilateral basis, it would be difficult to calculate margin requirements reflecting information as of the close of the NYSE on the previous business day and then to issue margin calls during the business hours in Asia (i.e. actually a few hours later). Many globally-active financial institutions operating on the Asian time often use data as of two previous business days. Further, given a standard settlement cycle of government bonds, which are frequently used as collateral, it would be difficult to post/collect margin on the business day following the day of notifying margin calls. Currently, a standard settlement cycle of the U.S. government bonds is the trade date + 1 business day ("T+1") while many other governments bonds that are pledged as collateral are shifting to a settlement cycle of T+2. (For example, Europe has adopted the "T+2" settlement cycle from the fourth quarter of this year and Japanese government bonds (JGBs) shifted to the "T+2" settlement cycle from the "T+3" cycle in April 2012. They are unlikely to shift to the "T+1" cycle in the near future.) Under such circumstances, it would be difficult to implement the "T+1" margin posting/collection cycle in all cases. This is particularly the case when transactions are executed across borders. If both parties to the transaction are located within the U.S., the "T+1" margin posting/collection requirements should be relatively easy to satisfy because there is no or only a small time difference and an established settlement system or framework is already in place. On the other hand, where there is a large time difference between the parties to the transaction (e.g. between Sydney and New York), it would be difficult to establish a process adaptable to the "T+1" margin posting/collection because of the time required for negotiating the required amount of margin and the difference of holidays, as well as given the current practice which is taking about "T+4" for margin settlement (see the diagram in Appendix 1 for details). It would be a possible option to establish a new collateral management process/procedure within the U.S. and make a settlement in USD. This however would require additional costs and resources that are only affordable by a very limited number of financial institutions. Additionally, such option would increase the difficulty of pledging collateral denominated in a currency other than the currency of the home jurisdiction, incentivizing entities to enter into derivative transactions with those counterparties within the same territory and thus undermining global, cross-border transactions. Moreover, in the case of IM, it should be noted that additional time is required to give instructions on margin settlement to global custodians, Japan's trust banks and other entities assuming asset segregation functions (which requires about two days in the case of JPY cash/JGB settlement under current practices). Therefore, instead of designating a uniform timing of posting/collecting margin by specifying "within XX day(s)," the CFTC should take into consideration that collateral operations will be performed under cross-border transactions as well and that the shortest possible time to meet the posting/collection requirement differs depending on locations and types of collateral; and therefore are requested to make a feasible rule by, for example, deeming entities as satisfying the requirement provided that they are adopting the market's best practice. It should also be noted that the

"Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions" published by the BCBS/Committee on Payment and Settlement Systems (CPSS) in February 2013 recommends the use of CLS and that, if such use is made obligatory, settlement periods will become longer.

ii) Frequency of margin calculation

Under current market practices, regional banks with a low operational capacity still calculate margin on a weekly or monthly basis in many cases. Requiring daily operation, in addition to mandatory conclusion of a number of CSAs, will significantly increase administrative burden. Although daily operation is preferable for the purpose of settlement risk and credit risk management, given current situations, the requirement should not be tightened relative to the BCBS/IOSCO Final Report. Even if the requirement is decided to be enhanced in some way, the CFTC is requested to give flexibility to some extent by, for example, providing a transition period.

(3) Eligible collateral and haircuts (§23.156)

i) The proposed rule limits eligible collateral for VM to cash only. (According to our interpretation) cash collateral should be denominated either in U.S. dollars or in the settlement currency (of the swap transaction). The issue here is that under the swap where payment obligations are settled in the currency other than U.S. dollars (e.g. euro interest rate swap), cash collateral denominated in the currency other than that settlement currency (e.g. JPY cash collateral) will not be permitted to be used as VM. This would not only undermine the discretion of financial institutions but also would create a considerably unfair playing field for non-U.S. financial institutions relative to U.S. financial institutions because the former will need to obtain foreign currency to pledge collateral, which will increase collateral cost and the liquidity risk of foreign funds. Further, the unavailability of securities (e.g. government bonds) as VM would prompt pressure to sell those securities, aggravate liquidity risk and give rise to other problems. According to a survey conducted by the ISDA Japan in 2014 and a similar survey conducted by the ISDA on a global basis, the percentage of cash collateral received was only 43.3% and 74.9%, respectively. Given this, limiting VM to cash may trigger various risks and side effects. The proposed rule explains that the CFTC has determined to limit eligible collateral for VM to cash by taking into account the 2013 Standard Credit Support Annex ("SCSA") and general market practices by central counterparties ("CCP"), and also for the purpose of applying a zero haircut (see 59913; 3rd Column.). We understand the rationale but recommend that the CFTC should expand the list of eligible collateral similarly to IM given that the SCSA has been used only by a limited number of entities and its use is not likely to prevail in the near future and that the use of CCP is developing but has not widely spread yet on a G20-global scale.

ii) Under the proposed rule, an additional haircut (8%) to be applied when the currency of collateral and settlement (of the swap transaction) is different is limited to IM. In addition, (similarly to VM) for the purpose of the IM requirements, only cash collateral denominated in U.S. dollars is not subject to an additional haircut (8%) (see 59913; 2nd Column). (The table presented in pages 59931 and 59932 does not provide a special treatment for USD cash, and hence it is requested to confirm which treatment the CFTC intends to propose. The following discusses under the assumption that the CFTC intends to propose treatment specified in page 59913.) This may be an approach to give preferential treatment to USD cash. However, neither the BCBS/IOSCO Final Report, EU draft rules nor Japan's draft rules provide for a treatment that gives advantage to the home currency. The above treatment is understandable if the proposed rule is a regulation solely governing the U.S. and only applies to transactions within the U.S., but would cause a number of issues because the proposed rule is a regulation drafted based on the international agreement and applies globally across borders. In the event that countries in Europe or Asia take the same approach, covered entities engaging in cross-border transactions would have to manage and operate collateral in accordance with the number of standards corresponding to the number of counterparty's jurisdictions, giving rise to a concern that the proposed rule would not, in practice, function as an internationally-agreed rule. The CFTC therefore is requested to consult on an international basis whether to adopt a preferential treatment to the U.S. currency, and make a careful judgment.

iii) As mentioned above, under the proposed rule, an additional haircut (8%) is applied when the currency of collateral and settlement (of the swap transaction) is different. It is unclear whether this settlement currency represents the currency used to calculate margin on a portfolio-by-portfolio basis or the currency in which each transaction within the portfolio is settled. Therefore, the CFTC is requested to provide a clear guidance on when the currency of collateral and the currency of settlement is deemed as different. For example, please clarify whether currency swap between U.S. dollars and Japanese yen with cash collateral denominated in Japanese yen is included in such a case.

(4) Minimum Transfer Amount (§23.154 and other provisions)

The proposed rule indicates that a minimum transfer amount ("MTA") of US$650,000 is applied to the required cumulative amount of VM and IM (see 59904; 2nd Column; 4th Paragraph). It is considered that this intends to clarify how MTA should be operated, which was not explicitly stipulated in the BCBS/IOSCO Final Report. However, requiring the application of MTA to a cumulative amount of VM and IM will be difficult to implement in practice and will cause undue burden on market participants because: (a) VM is exchanged directly with a counterparty whereas IM is exchanged via a custodian, etc. and (b) posting/collection of VM and IM may be implemented in a different timeframe and by different divisions/entities in some cases under existing collateral management practices. For example, if a division in Tokyo undertakes the responsibility of IM management and a division in New York undertakes the responsibility of VM management, they will have to operate MTA individually. The proposed rule should delete the descriptions that might deny such a collateral management framework and allow application of MTA separately to VM and IM. In this respect, Japan's draft rule can be referred to as it allows application of MTA separately to VM and IM by including the provision regarding MTA separately for both VM and IM.

5. Internal IM models

(1) Calculation requirements: Asset class classification (59909; E.2.c)

i) Under the proposed rule, the CFTC is aware that classifying swaps into asset classes on a transaction-by-transaction basis is problematic, and seek comment for alternative approaches. More specifically, the CFTC expects that the covered swap entity would make a determination as to which asset class best represents the swap based on a holistic view of the underlying swap. Further, they propose that if it is difficult to determine the asset class, a swap be classified into the "unclassified swaps" category and those swaps under this category be aggregated to calculate the gross IM amount.

ii) However, taking into consideration that risk characteristics of hybrid transactions vary depending on market conditions, it would not be appropriate to classify a swap into a specific asset class over the entire transaction period based on type of transactions. Further, to avoid disputes arising from a difference in the asset class classification, all market participants would need to consent to classification methods for all types of various OTC derivatives before the implementation of the proposed rule, which is deemed to be difficult given a limited timeframe. Moreover, calculating the gross IM amount based on aggregated value of swaps for which classification is difficult would considerably undermine incentive to use internal models that take into account the effect of offsets.

iii) As an alternative approach, we would like to propose asset class classification based on sensitivities, which is an approach recommended in the letter of July 14, 2014 submitted by the ISDA and the Securities Industry and Financial Markets Association ("SIFMA") to the European Supervisory Authorities ("ESA")[1]. This approach will:

- enable the IM calculation that appropriately reflects the effect of offsets/correlations between risk factors;
- more clarify the relationship between linear risk factors and asset class classification;
- enable the calculation without setting assumptions regarding correlations between risk factors belonging to different asset classes; and
- enable avoidance of overlapped investments in systems modification and other areas

[1] http://www.sifma.org/issues/item.aspx?id=8589949919

because the calculation of risk sensitivities is required for all financial institutions upon implementation of a new standardised approach (so-called the sensitivity-based approach) proposed under the Fundamental Review of the Trading Book ("FRTB"). In addition, this approach will prevent a significant gap in the amount of IM requirements between banks using internal models and banks using the standardised approach, which is a concern inherent in the IM calculation, and the resulting segmentation of the market.

Further, as mentioned in the ISDA's supplementary proposal[2] on the FX haircut dated August 17, 2014 and submitted to the ESA, this approach is able to reflect, in an economically reasonable manner, an additional haircut arising from a currency mismatch between the IM calculation (of which currency is different from the currency of each swap in the portfolio) and the collateral asset.

(2) Calculation requirements: Risks to be captured (59909; E.2.c, 59929; §23.154(b)(3))

i) The proposed rule requires covered swap entities to capture all of the material risks that affect the valuation of the transaction, specifically requiring capturing of basis risk, risk of changes in the volatility and nonlinear risks.

ii) Instruments that are covered by the proposed rule are primarily non-centrally cleared exotic instruments. As the market price and sensitivity of exotic instruments relies heavily on the pricing model of each company, a difference in the required amount of IM calculated between market participants will increase if vega (the first order sensitivity to changes in the volatility), as well as delta (the first order sensitivity to changes in underlying assets), is incorporated in the IM calculation. This would make dispute resolution difficult and may ultimately reduce the liquidity of transactions.

iii) If capturing of nonlinear risks is required, the workload to calculate forward margin requirements will extremely increase; making it difficult to appropriately reflect funding cost of margin into the price. If, as a result, the pricing becomes conservative, the liquidity of the derivatives market may decrease and, in times of stress, may further aggravate. This might undermine the regulatory objective of preventing systemic risks. Given that most risks can be captured by delta, the CFTC needs to carry out a cost-benefit analysis of additionally imposing a requirement to capture nonlinear risks and the resulting impact on the market liquidity.

iv) To implement the proposed rule, there are a number of issues to be addressed across the entire operational processes related to the exchange of VM and IM and credit monitoring, etc., as well as the development of IM calculation systems. To have in place processes and procedure capable of implementing the proposed rule within a limited timeframe, financial institutions should establish each operational process under the assumption that

[2] See "ISDA letter to the ESAs on Proposed Margin Requirements: Analysis of Currency Mismatch Haircut" (August 17, 2014) from ISDA website. (http://www2.isda.org/functional-areas/risk-management/)

IM models that reduce potential dispute as much as possible will be used. Therefore, at least at an early stage after the enforcement of the proposed rule in December 2015, the CFTC is requested not to require capturing of above-mentioned risks.

(3) Calculation requirements: Netting sets (59929; §23.154(b)(2))

i) Under the proposed rule, if swaps entered into before and after the applicable compliance date ("legacy trade" and "new trade," respectively) are covered by the same ISDA master agreement, both legacy trade and new trade are required to be included in the aggregate in the IM calculation.

ii) Compared to the case where IM is calculated solely for new trade, if IM is calculated for legacy trade and new trade in the aggregate, the required amount of IM may become excessive. This contradicts with the objective of the BCBS/IOSCO Final Report to avoid a rapid dry up of liquidity and market turmoil by phasing in the regulation.

iii) If, on the other hand, financial institutions seek to exclude legacy trade from the IM calculation, they need to cover legacy trade and new trade under separate ISDA master agreements. In such cases, the effect of close-out netting upon default decreases and thus credit risks of the overall financial system increases; thereby undermining the objective of introducing the proposed rule. The proposed rule therefore should delete this requirement; or if it is difficult to do so, should be amended to require legacy trade to be included in the IM calculation only when legacy trade and new trade are covered under the same CSA. (See Appendix 2 for detail.)

(4) Operational requirements: Model validation (59909; E.2.c.d, 59929; §23.154(b)(3),(4),(5))

i) First of all, we would like to express our disagreement to the proposed requirement setting forth the internal management standards for IM models at the same level as those required for internal regulatory capital models.

ii) As stated in the BCBS/IOSCO Final Report, capital and margin requirements are the two core regulatory tools to protect the financial system from the default of derivatives market participants. The balance between survivor-pay and defaulter-pay should always be carefully considered from the perspectives of micro risks of individual financial institutions and ensuring the stability and efficiency of the derivatives market.

iii) Unlike internal regulatory capital models, IM models are used to calculate the amount of margin to be exchanged with the counterparty. The IM models therefore have the following preconditions and characteristics:

- The appropriateness of models cannot be assessed based on the conservativeness of values (i.e. values calculated are large);
- Discontinuous changes in values by model calibration, etc. should be avoided in order to mitigate the impact on funding plans of the counterparty, and ultimately of the overall markets; and

- Consistency should be maintained across all market participants in terms of, among other things, the standards and methodologies of validating models so as to enable a novation which is a risk mitigation technique in times of financial crisis.

Further, with regard to loss absorption, it should also be noted that unlike margins to CCP, capital serves as a buffer for IM required under the proposed rule.

iv) Given above, unlike internal regulatory capital models, IM models need to be implemented based on interaction between all market participants and national supervisors instead of one-on-one interaction between each market participant and the CFTC. The proposed rule should take this point into account and the requirement be amended to align with such practice. Assuming that a robust capital buffer is secured under internal regulatory capital models, the IM model governance should focus more on the stability, transparency and efficiency of the derivatives market. It is not considered reasonable to require both models to establish an equally-robust governance framework.

(5) Operational requirements: Counterparties subject to calculation (59929; §23.154(a)(6), 59931; §23.155(a)(3))

i) The proposed rule requires an entity to calculate IM and VM on a daily basis for each swap for which the counterparty is a non-financial end user that has material swaps exposure.

ii) The reason for setting forth this requirement is merely specified as "for risk management purposes", which does not provide compelling grounds that address an increase in calculation burdens. We suppose this provision intends to first require firms to identify the size of exposures to counterparties for risk management purposes, and to encourage the conclusion of CSA with counterparties with large exposure. If this is the objective of this provision, this requirement could be replaced by monitoring of the risk exposure to counterparties. Imposing the VM and IM calculation to those counterparties for which the CSA operation is not carried out as if the counterparty were a counterparty with which CSA is entered into is not considered to be so useful and lacks reasonableness to cover an increase in operational burdens.

(6) Operational requirements: Control mechanisms for the VM calculation (59931; §23.155(b))

i) The proposed rule requires each covered swap entity to create and maintain documentation setting forth the valuation methodology with sufficient specificity to allow the counterparty and regulators to calculate a reasonable approximation of the margin requirement independently. It also requires, based on the request from the CFTC, to provide further data or analysis concerning the methodology or a data source, including an explanation of the manner in which the methodology meets the requirements, the theoretical basis of the methodology, the empirical support for the methodology, and the empirical support for the assessment of the data sources.

ii) To ensure the appropriateness of VM calculation, it is necessary to create and maintain documentation setting forth the methodology. In some cases, however, the description of such documentation may be simplified, for example, by quoting a number of other related documents or omitting to include assumptions that are commonly accepted across the firm. If the requirement "to allow the counterparty and regulators to calculate a reasonable approximation of the margin requirement independently" is strictly interpreted literally, some firms might breach this requirement. It is therefore requested to clarify that the level of documentation to be developed is considered to be sufficient if periodic verification is carried out within the firm. In particular, since it is not expected to disclose these specified documents without any changes to counterparties, the CFTC is requested to clarify this as well.

(7) Others: Standardized initial margins (SUPPLEMENTARY INFORMATION: Ⅱ. E.3. b)

i) The proposed rule seeks comment on whether the CFTC should adopt an alternative method to the net-to-gross ratio approach to recognize risk offsets under the standardized initial margin requirement.

ii) For the purpose of counterparty credit risk ("CCR") exposure calculation, it has been decided that the current exposure method ("CEM"), which uses the NGR, will be replaced by the SA-CCR (i.e. a standardized approach for measuring CCR). It is requested that the effect of offsets will be recognized, in the same way as in SA-CCR, for the purpose of the standardized initial margin requirements under the proposed rule.

(8) Others: Request for early announcement regarding model application procedures

i) The CFTC is requested to inform, at the earliest possible stage, those financial institutions to which the proposed rule will be applied from December 2015 of information on documents and data necessary for IM model application and the timeline to submit such data.

6. Others

(1) Treatment of counterparties in jurisdictions where the legal enforceability of close-out and collateral netting is not confirmed

The proposed rule could be construed as not explicitly excluding from the scope of its application those counterparties in jurisdictions where the legal enforceability of close-out is not confirmed. If a financial institution enters into a collateral agreement with such a counterparty and collects/posts collateral thereunder, but subsequently such agreement is denied of its enforceability of close-out and collateral netting; the financial institutions may incur a significant loss.

Ex1. Assume an entity which engages in two transactions with a counterparty in a jurisdiction where the legal enforceability of close-out is unconfirmed. The entity's exposure to the counterparty is +30 under one transaction and -40 for the other transaction, and that these transactions are netted against each other. In this case, net exposure of the entity will be -10. The calculation of VM to be posted is based on the assumption that an effective close-out is legally enforceable (because if a different assumption is applied, it is impossible to agree on the amount of VM to be exchanged (unless all transactions are in the same direction)). In this case, therefore, the entity will post 10 VM. In practice, however, exposure to the counterparty to be recognized should be +30 (=30 + 0, assuming that -40 is 0) taking into account actual risks because these are transactions with counterparties in a jurisdiction where the legal enforceability of close-out is not confirmed. More specifically, in this case, the entity takes an additional risk of 10 for the counterparty to which it already has exposure of +30, upon entering into a collateral agreement with that counterparty. The reason for assuming an additional risk is that a collateral agreement is required even for a transaction with those counterparties for which the enforceability of close-out cannot be confirmed.

Ex2. Assume an entity which engages in a transaction with a counterparty in a jurisdiction where the legal enforceability of collateral netting is not confirmed. The entity has a total exposure of -30 to the counterparty and pledges collateral of 30. In this case, the entity will incur zero loss upon default of the counterparty if collateral netting is enforceable, but will be required to fulfill a payment obligation of -30 if it is concluded as not enforceable. In addition, collateral of 30 that has been posted will be treated as general receivables and thus will not be returned, imposing loss of 30 on the entity. Had the entity not entered into a CSA, it would have been required only to fulfill the payment obligation of -30, and thus would have not incurred any loss. This indicates that the entity would suffer more loss because of entering into the CSA.

It is reasonable to allow entities to decide whether to enter into a collateral agreement at their discretion by taking into account the above possible cases and risks. Further, the CFTC should not uniformly require entering into collateral agreements and collection/posting of collateral for all of those jurisdictions where the legal enforceability is not confirmed. Otherwise, entities would have to avoid transactions with counterparties in those jurisdictions, which may deny access of such jurisdictions to the derivatives markets.

Some, on the other hand, may view that it is not preferable to exempt counterparties in such jurisdictions from the proposed rule because that may incentivize entities to transact with counterparties in these jurisdictions and that the CFTC should rather promote the establishment of a framework which ensures the enforceability of close-out by including the counterparties in such jurisdictions in the scope of the proposed rule. However, it is virtually impossible to engage in the excessive volume of unsecured transactions with a counterparty with whom close-out is not enforceable; given that such a transaction requires a higher credit line, as well as higher capital charge for regulatory capital calculation purposes, relative to a similar but secured transaction with a counterparty with whom close-out is enforceable because exposures are managed on a gross basis and the effect of collateral cannot be reflected for risk management purposes. Therefore, even if those jurisdictions in which the legal enforceability of close-out is not confirmed are exempted from the margin rules, transactions are unlikely to flow into those jurisdictions. As a derivatives market participant, we welcome the framework that increases the number of jurisdictions where close-out netting is enforceable. However, applying the margin rules to those jurisdictions where close-out is not enforceable would deny access of entities in such jurisdictions to derivatives markets, depriving them of a market risk management tool, as well as would require additional (and uncontrollable) risk-taking through posting collateral for those transacting with counterparties in such jurisdictions. These consequences would contradict the objective of the margin requirements to mitigate the systemic risk. If the CFTC intends to increase the number of jurisdictions where close-out and collateral netting are enforceable, an appropriate measure should be discussed earnestly because there should be a more direct way having less negative impact, such as a peer review by the Financial Stability Board, rather than an indirect way having more negative impact, such as the margin rules.

If the proposed rule intends to include in the scope of its application those jurisdictions where the legal enforceability of close-out or collateral netting is not confirmed, it should provide exceptions allowing entities to decide at their discretion whether to enter into a collateral agreement until the legal enforceability of close-out/collateral netting is ensured. Even if such legal enforceability is ensured, a sufficient lead time is needed to prepare for the implementation of the margin requirements ---it should be noted that the percentage of the use of collateral agreements in such jurisdictions is considered to be very low--- and the CFTC is requested to set compliance dates by taking this into account.

(2) Confirmation of the enforceability of close-out (§23.151)

Several conditions need to be satisfied to qualify for an eligible master netting agreement. Specifically, in addition to the granting of the right to close out under the master netting agreement, the proposed rule requires that the exercise of the right to terminate will not be hampered other than in the case of “stays” provided for under certain U.S. receivership, conservatorship or resolution regimes (or similar laws of foreign jurisdictions) or in a contractual agreement subject to such laws. Unlike the close-out case (for which the ISDA has summarized and published a legal opinion on behalf of the industry), there is no established way to confirm the latter case and it is not even clear what specific cases are assumed. It is therefore still premature to require this condition and this could be considered when a confirmation method is established.

(3) Cross-border application

<Request for a substituted compliance determination>

The proposed rule excludes from coverage of its margin requirements any foreign non-cleared (security-based) swap (i.e. a non-cleared (security-based) swap in which both parties and any guarantor on either side is not a U.S. entity or its branch and is not controlled directly or indirectly by a U.S. entity). Covered swap entities, on the other hand, have room for substituted compliance under certain circumstances, but is permitted to make a request for substituted compliance determination only if directly supervised by the authorities administering the foreign regulatory framework for non-cleared (security-based) swaps. It is unclear as to why the proposed rule limits the availability of substituted compliance to the case where covered swap entities are directly supervised. It is considered that such a limit is not necessary.

<Scope of cross-border application>

The proposed rule proposes three options for the cross-border rules. All of the proposed options are however complicated, and hence we consider that the only solution is to align the cross-border rules across jurisdictions in collaboration with other jurisdictions. The following explains the complexity of respective options and the necessity of aligning the cross-border rules by illustrating the Prudential Regulator's Approach.

i) To our understanding, if a non-U.S. SD (not guaranteed by a U.S. entity) and a non-U.S. financial end user enters into a transaction, the Prudential Regulators' approach will be applied as shown in the table below (see 59917; 2 Prudential Regulators' Approach).

		Non-U.S. financial end user	
		NY branch	HO and branches other than in NY
Non-U.S. SD (not guaranteed by a U.S. entity)	NY branch	The proposed rule will apply, but substituted compliance may be permitted.	The proposed rule will apply, but substituted compliance may be permitted.
	HO and branches other than in NY	The proposed rule will apply, but substituted compliance may be permitted.	Excluded from the scope of application of the proposed rule

Generally when the CSA is used, the amount of margin is calculated for multiple head offices and branches covered by a single agreement. If substituted compliance is not permitted, the U.S. margin requirements may be applied to transactions outside the U.S. which are not subject to the proposed rule (e.g. a transaction between the head offices outside the U.S.) because a single agreement is entered into. In such circumstances, for example, if transactions between Japanese financial institutions would also be required to use cash denominated in U.S. dollars for VM purposes, such treatment is considered to be the cross-border application beyond the reasonable level. The CFTC is requested to respect the framework of the BCBS/IOSCO Final Report in terms of cross-border application and allow entities in principle to comply with the proposed rule by satisfying the margin rules of the jurisdiction where the head office is located in order to avoid confusion in the markets.

ii) To our understanding, if a non-U.S. SD (guaranteed by a U.S. entity) and a non-U.S. financial end user enter into a transaction, the non-U.S. SD will not be eligible for substituted compliance and will be subjected to the proposed rule.

If a margin framework (regardless of its level of development of the jurisdiction) functions appropriately, an event of default of either party to the transaction would be addressed as a problem between both the parties and should not affect other entities. More specifically, even if the non-U.S. SD is guaranteed by a U.S. parent company, impact within the U.S. arising from such default should be extremely limited. Therefore, in respect of this type of transaction, the CFTC is requested to also respect the framework of the BCBS/IOSCO Final Report in terms of cross-border application and allow entities in principle to comply with the proposed rule by satisfying the margin rules of the jurisdiction where the head office is located.

iii) However, even if approaches for cross-border application are designed in a refined manner, financial institutions engaging in cross-border transactions will need to manage their transactions pursuant to multiple standards corresponding to the number of their counterparty's home jurisdictions, and as a result will virtually be unable to function. (Further, if cross-border application rules differ across jurisdictions, it will be more difficult to implement swap margin requirements.) Ultimately, therefore, <u>the best essential solution for this issue is to integrate swap margin rules.</u> To this end, the issue should be returned to the BCBS and IOSCO for discussion and adjustment, instead of being discussed and adjusted bilaterally or among multiple national regulators, as it is considered to be the most efficient and quickest way.

If it is determined that swap margin rules will not be integrated, regulators are expected to perform the comparability assessment upon finalization of national rules. Since it would be difficult to start preparing for implementation on a full scale (e.g. documentation) until the comparability assessment is completed, some banks may fail to meet the deadline to implement the rules, giving rise to a number of counterparties unable to transact with. Therefore, if swap margin rules will not be integrated, it is critical to complete the comparability assessment as soon as practical.

(4) Interaffiliate transactions (59904; 2nd Column)

The proposed rule imposes margin requirements also on interaffiliate transactions (including the case where the counterparty is non-financial entity). Although we understand that the proposed rule intends to mitigate the systemic risk by applying the margin requirements without exception, the necessity for imposing the proposed rule on interaffiliate transactions is not considered to be high, and at least, it is not necessary to apply the proposed rule from the date of its enforcement. This is because; (a) risks arising from interaffiliate transactions are generally much lower than external transactions, (b) although organized as a locally-incorporated company in accordance with local authorities' intention, etc., many affiliates are substantially managed integrally with the bank similarly to the structure of the head office and branches and thus transactions with the affiliates do not differ in substance from transactions with the head office and branches, (c) imposing the margin rules on interaffiliate transactions may undermine the establishment of an efficient booking system and (d) it is practically difficult to enter into the CSA with all covered counterparties, including affiliates, within a considerably limited timeframe by no later than the compliance date. Given above, it is recommended that the CFTC addresses this issue carefully by also taking into account international regulatory developments.

Further, an entity is deemed as an affiliate even when only 25% of its voting power is owned. This definition may raise the following concerns: (a) an entity over which the firm does not have strong control may be treated as an affiliate, giving rise to problems in, for example, allocating the initial margin thresholds; (b) where engaged in a number of cross-border transactions with financial institutions, the firm may have to take different approaches depending on the home jurisdiction of its counterparties, increasing the difficulty to comply with the requirements and also undermining the internationally-agreed framework; (c) unlike where the definition of "more than 50%" is applied, an affiliate may belong to multiple groups if the definition of "more than 25%" is applied, making it complicated and difficult to adjust thresholds among those groups.

(5) Documentation of margin matters (§23.158)

Covered swap entities are required to execute necessary trading documentation that specifies IM models validation and other matters. While the documentation requirements are integral part of model governance, it is not practical to require all covered entities to establish and maintain the documentation processes/procedures at an equivalent level of robustness. Instead, it is recommended that the level of documentation requirement should take into account the composition and size of derivatives portfolios of covered entities. Particularly when the application of a certain standardized model is permitted as proposed by the ISDA and other organizations, the standardization and unification of documentation requirements should also be permitted.

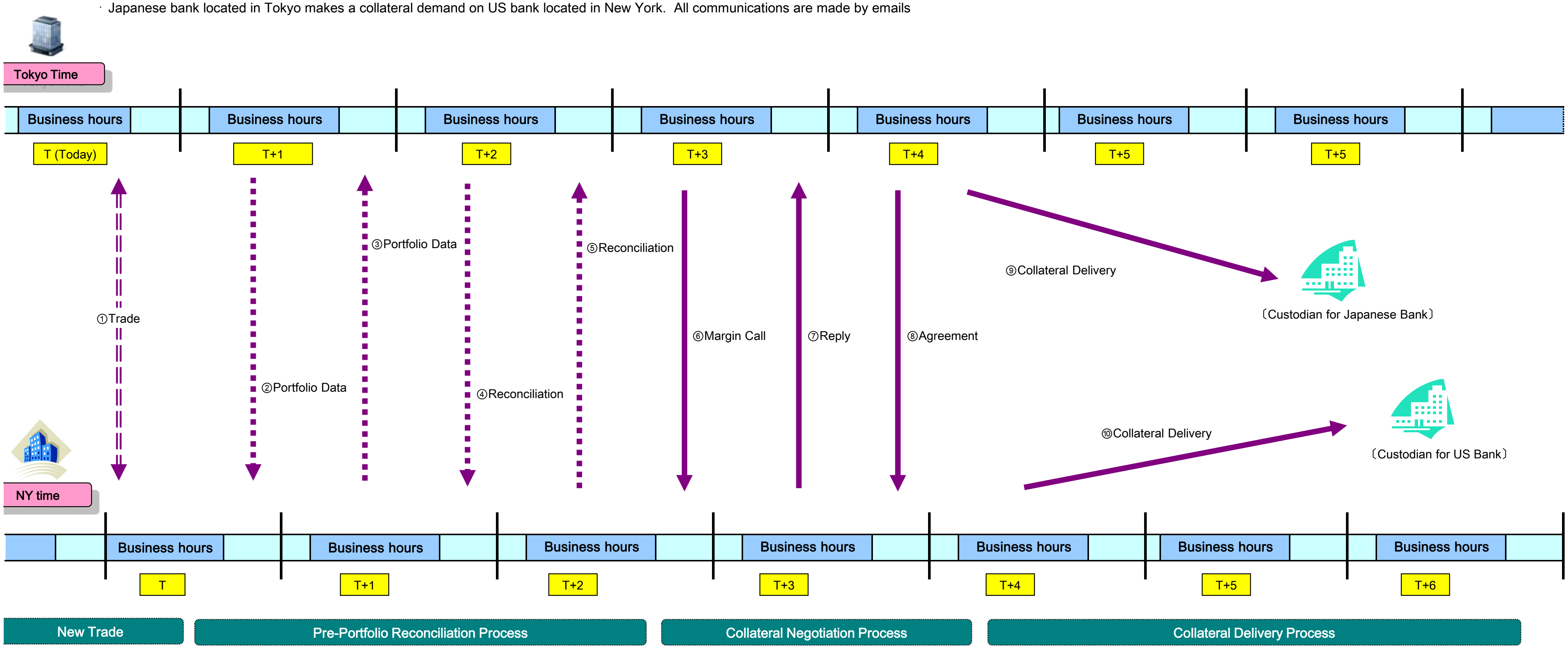
(6) Mandatory use of "third-party custodian" (§23.157)

The proposed rule requires covered swap entities to use custodians that are not affiliates. However, the necessity of this requirement is considered to be low for the following reasons: (a) custodians are required by law to ensure bankruptcy remote, and thus decline in the creditworthiness of their (derivatives) counterparties will not directly affect the creditworthiness of their assets trusted to custodians, (b) custodians are highly rated in general and due to the nature of their business strive to maintain stable creditworthiness and (c) in practice, custodians to be used are not unilaterally determined by either of the parties but are decided through consultation between both the parties. If requiring the use of third-party custodians, it is recommended to take more realistic approach; for example, requiring a covered entity to prepare more than one options for custodians and give the counterparty latitude to select a third-party custodian.

[IM operation] Why T+1 as transfer timing doesn't work for Asian banks ?

[Assumption]

・ Japanese bank located in Tokyo makes a collateral demand on US bank located in New York. All communications are made by emails



< Note >

Pre-Reconciliation

・ This is a new process which is required to fix the portfolio subject to IM calculation between the parties. It will take at least two days if the parties exchange the trade data by email due to the time zone difference between Tokyo and New York.
・ It is assumed that the portfolio as of T-1 will be used. There is a possibility, however, that some parties cannot gather the trade data on a group basis globally and finish the IM calculation on the day T. In that case, the portfolio as of T-2 is supposed to be used inevitably.

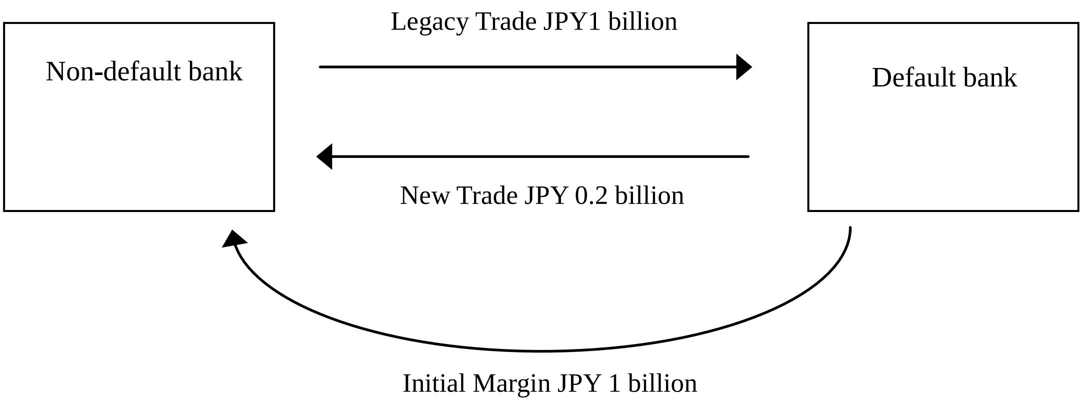
Collateral Negotiation

・ This process is normally made via emails. Due to the time zone difference between Tokyo and New York, the collateral details to be delivered cannot be agreed during the business hours of the day on which the margin call is issued.
・ The above case is the best case where no dispute occur. In case any dispute arises, it may possibly take more few days to agree on any collateral delivery until the dispute is solved.

Collateral Delivery

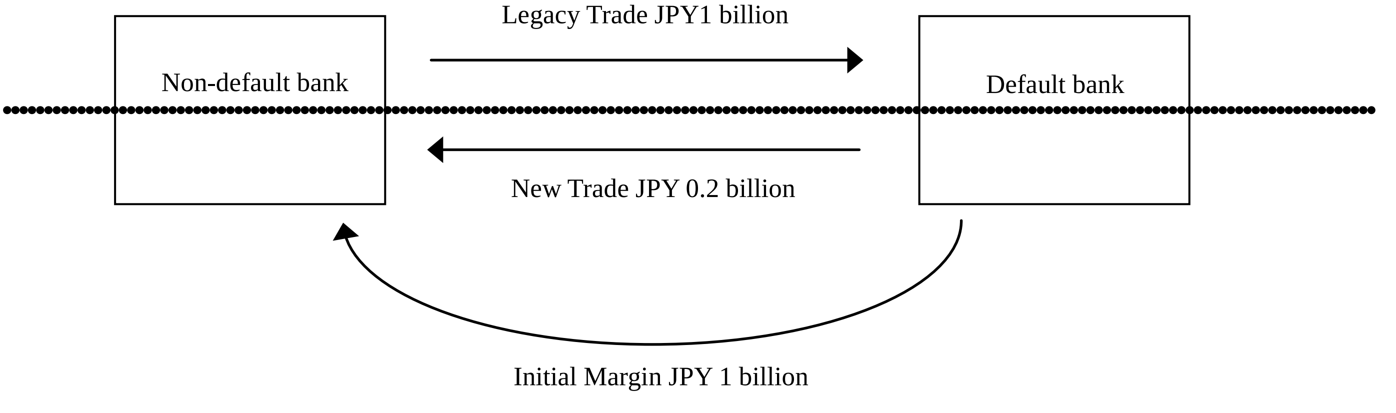
・ Delivery timing may differ depending on the collateral type(Cash, Security, etc), In case of JGB, which is most likely to be mainly used for IM by Japanese banks, it will be delivered in two days after the agreement according to the market practice as illustrated above. As for other type of collaterals such as cash, it may be able to be delivered on the following day after the agreement.

A. Claims and debts upon default - Single master agreement



JPY1 billion of claim arising from Legacy Trade and JPY0.2 billion of debt arising from New Trade are offset under the close-out netting. As a result, the non-default bank has JPY0.8 billion of claim, and receives payment of its claim from JPY1 billion of Initial Margin, and return the remaining JPY0.2billion to the default bank. (The non-default bank incurs no loss.)

B. Claims and debts upon default - Multiple master agreements



JPY1 billion of claim arising from Legacy Trade and JPY0.2 billion of debt arising from New Trade will not be subject to close-out netting. As a result, the non-default bank has JPY1 billion of claims, while owes JPY0.2 billion debts to be repaid and needs to return JPY1 billion of Initial Margin.
JPY1 billion claims will be notified as a defaulted claim (The non-default bank incurs JPY1 billion of loss if there is no dividend.)