November 27, 2015

Comments on the Draft Guideline: *Margin Requirements for non-centrally cleared derivatives* issued by the Office of the Superintendent of Financial Institutions Canada

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 draft guideline "Margin Requirements for non-centrally cleared derivatives" (the "Draft Guideline") issued on October 19, 2015 by the Office of the Superintendent of Financial Institutions Canada ("OSFI").

(2) Given that the proposed margin requirements cover cross-border transactions, they need to be consistent with other jurisdictions' rules. While other G20 member countries are expected to publish their proposed rules going forward, OSFI is requested to make harmonisation efforts in order to prevent a single financial institution from being subjected to double standards, or even triple standards.

(3) When reading our comments provided herein, please refer to our comments of July 10, 2015 submitted to the European Supervisory Authorities ("the ESAs") (entitled "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")[1]. We presume that the consultation paper issued by the ESAs reflects harmonisation efforts made among main supervisors, such as the U.S., the EU and Japan, and would like to ask OSFI to recognise our comments to such a consultation paper as our most recent views and gain full understanding of it.

2. Specific comments

(1) Matters related to the scope of applicability

<u>(i) Transactions with financial entities</u>

The Draft Guideline is consistent with other jurisdictions' rules in limiting the scope of application to major financial entities and hence we generally agree with the proposed scope. We however are concerned about some inconsistencies, such as the inclusion of

[1] http://www.zenginkyo.or.jp/fileadmin/res/abstract/opinion/opinion270740.pdf

foreign bank branches within the scope. Given that, under the current CSA practice, the amount of margin is calculated by offsetting the mark-to-market ("MTM") exposures arising from transactions booked by the head office and branches, and exchanged accordingly; it would be unreasonable and impractical for each branch to be forced to exchange margin based on different rules. To avoid undue confusion, OSFI is requested not to apply the margin requirements at the branch level and instead to adopt a framework similar to other jurisdictions' rules as much as possible.

(ii) Transactions with non-financial entities

Non-financial entities are not currently subjected to the margin requirements in Japan, the U.S. or Singapore. Although a relatively high threshold is set, non-financial-entity counterparties would not easily accept the idea of including the major overseas end users of derivatives into the scope of margin requirement application. Also from the viewpoints of (i) the actual condition of CSA prevalence and (ii) consistency with rules of other jurisdictions (except for the EU); this idea is considered to be too early to be implemented and thus OSFI is requested to reconsider it.

(iii) Transactions with trust accounts and SPCs

In Japan, assets in trust accounts are legally segregated from credit risk of a trust bank (bankruptcy remoteness). In the Draft Guideline, we understand special purpose companies ("SPCs") and other similar entities engaging in a number of derivatives transactions will be subject to the margin requirements. However, as they do not necessarily hold enough liquidity to enable exchange of margin, requiring such entities to exchange variable margin ("VM") or initial margin ("IM") would undermine the sustainability of their business models. Therefore, a prudent approach should be taken in this respect. Further, given that generally SPCs and other similar entities do not always execute a number of derivatives transactions due to their nature, it is requested that the similar regulatory treatment as that of a non-financial entity will be applicable to these entities.

(iv) Treatment of transactions with counterparties established in a jurisdiction where the legal enforceability of the close-out netting and collateral netting is not assessed

It should be clarified that the margin requirement in the Draft Guideline is not applied to those transactions with counterparties established in a jurisdiction where the legal enforceability of netting is not assessed. Paragraph 15 in pages 5 to 6 of the Draft Guideline requires that a single, legally enforceable netting agreement be concluded. However, in some cases, it is impossible to conclude such an agreement in the first place due to attributes of the counterparty. If the VM or IM requirements are applied to transactions with such a counterparty, it may be necessary to post collateral to those counterparties which are supposed to be managed as a counterparty with positive exposures, which could rather increase risks(*). This is inconsistent with the primary policy objective. In this view, transactions with such counterparties should be exempted from the VM and IM requirements.

(*)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.

(2) Collateral administration and calculation of margin requirements

(i) <u>Obligation related to exchange of margin</u>

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) Frequency of valuation

Paragraph 16 in page 6 refers to the valuation frequency of VM, stipulating that "Variation margin **must** be calculated and called on a daily basis." On the other hand, paragraph 22 in page 6 refers to the valuation frequency of IM, stipulating that "Initial margin **should** be calculated and called on a daily basis." Please confirm that the difference in the terms used here means that IM may be evaluated less frequently than "on a daily basis" if it is deemed as truly reasonable to do so provided that it is agreed between the parties to the transaction.

(iii) Additional haircut of 8% upon foreign exchange mismatch

According to paragraph 46 in page 12, it literally means that the additional haircut of 8% for a currency mismatch is not applicable to VM. We would like to confirm that this interpretation is correct, and request that the final guideline will clarify this point with more explicit descriptions. OSFI is requested to modify the draft guideline to additionally specify that the additional haircut of 8% for a currency mismatch, described in the table in page 14, will be applied only to IM.

Further, OSFI should also take into account a view[2] arguing that the 8% haircut is unnecessary because a currency mismatch is already captured in the IM calculation.

For your further reference, we would like to propose an alternative approach assuming that the treatment of cash collateral and that of other collateral assets will be the same, and provide below excerpts from our comment letter of July 10, 2015 submitted to the ESAs ("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").

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[2] http://www2.isda.org/functional-areas/wgmr-implementation/

[August 17, 2014] ISDA letter to the ESAs on Proposed Margin Requirements: Analysis of Currency Mismatch Haircut

<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).

(iv) Harmonisation of haircuts

Paragraph 57 in page 14 sets forth haircuts for certain asset classes of eligible collateral. While the frameworks of Japan and the EU apply haircuts according to the probability that obligations for debt securities will not be fulfilled (i.e. the probability of default), the Draft Guideline applies haircuts according to the external rating of debt securities. OSFI is requested to conform the Guideline to the rules of Japan and the EU in this respect and to make harmonisation efforts to prevent financial institutions from being subjected to double and triple standards.

(v) A period during which margin needs to be exchanged ("margin exchange period")

To discuss this issue, OSFI should first clarify the "calculation date" as the Draft Guideline seems to lack an explicit definition. The comments below are based on the assumption that the "calculation date" is synonymous with the "deal date".

If both parties to the transaction are located within the same jurisdiction, it would be possible to settle collateral within a relatively short period. However, under cross-border transactions where parties to the transaction are located in a very different time zone, it would take time to negotiate the amount of margin requirements and also the margin exchange period will be affected by the standard settlement cycle of government bonds which are frequently used as collateral. Therefore, the margin exchange period for VM and IM that reflects the existing market practice should be considered in light of various combinations of bilateral transactions, including the case that operations will be carried out often on a cross-border basis and the earliest possible period to settle collateral will vary depending on the location of parties and types of collateral. Further, by setting a margin exchange period that reflects the existing market practice, regulatory burdens on some regional banks in Japan engaging in cross-border transactions would be mitigated because in such a case they will not need to alter their operational flow.

➢ Specific proposal

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 Canada)	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 Canada and the other in the Asian region)	T+3 business days for both VM and IM

The maximum days refer to the market practice 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.

(vi) Re-hypothecation of IM

Paragraph 27 in page 7 prohibits re-hypothecation of IM but OSFI is requested to allow flexible operations. Conforming the Guidelines to relevant ongoing discussions on cash IM such as in the second consultation paper of the ESAs, it is requested that OSFI will retain accommodativeness for treatment of re-hypothecation, re-pledge and re-use of cash IM.

(3) IM model

・Frequency of model parameter review

The frequency to review that model parameters include stress data should be eased to “at least annually”, conforming the Guidelines to the final rules of the U.S. Prudential Regulators. The financial industry is considering a framework to update parameters annually also in light of the second consultation paper of the ESAs which requires that model parameters be recalibrated at least on an annual basis. In this view, we request that the Canadian rules will be aligned with such rules of U.S. and the EU.