May 20, 2016

Comments on the “*Margining and risk mitigation for non-centrally cleared derivatives*”, issued by the Australian Prudential Regulation Authority

Japanese Bankers Association

We, the Japanese Bankers Association (“JBA”), would like to express our gratitude for this opportunity to comment on “*Margining and risk mitigation for non-centrally cleared derivatives*”, published by the Australian Prudential Regulation Authority (“APRA”) on February 25, 2016.

Many financial institutions, particularly those in Australia and Asia, are expected to submit their views on the Discussion Paper and Draft Prudential Standard. As the standards will be applied to cross-border transactions, such as between entities in Australia 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.

Specific comments

(1) Scope of application

(i) Products to be excluded from the covered products

We are grateful for APRA’s consideration to establish more granular phase-in dates and qualifying levels for the variation margin (“VM”) requirements. However, such VM requirements apply to physically settled FX forwards and 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 the rules of Japan and the U.S., given a limited period of time up to the regulatory implementation and in order to ensure global consistency.

(ii) Financial institutions

APRA is requested to clarify that overseas branches of foreign banks (i.e. branches in Australia) will not be directly subject to the standards. Under current practices of credit support annex ("CSA"), required margins are calculated after netting of the mark-to-market ("MTM") value arising from transactions booked by the head office and several branches and exchanged based on such calculation. Therefore, it would be unreasonable and impractical to force each branch to exchange margin based on different rules. Also from the perspective of avoiding unnecessary confusion, APRA is requested to introduce a framework which is consistent with that of other jurisdictions as much as practical, instead of imposing a branch-by-branch rule.

(iii) Non-financial counterparties

Currently, the 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, APRA is requested to reconsider the definition of the covered entity and to exclude the non-financial entities from that definition.

(iv) Intra-group transactions

The definition of intra-group transactions should be aligned with the definition under the "ASIC Derivative Transaction Rules (Clearing) 2015" ("2.1.4 Exception to Clearing Requirement") which sets out central clearing rules, and such intra-group transactions should be exempted from the standards. Given that the standards intend to promote central clearing, intra-group transactions should be scoped out of the application of the standards as long as they are exempted from central clearing rules in Australia.

(2) Collateral administration and calculation of margin 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.

If the posting of margin is to be made mandatory, APRA is requested to permit flexible approaches agreed between parties (e.g. preference is given to demand of the party receiving margin) in the event of a dispute between jurisdictions.

(ii) Obligation to collect full amount of VM

Paragraph 16 of the section "Exchange of variation margin for non-centrally cleared derivatives" of the Draft Prudential Standard requires that VM be exchanged so that the MTM exposure of the non-centrally cleared derivative transactions is fully collateralised. 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. The said paragraph also stipulates that "In the event of a dispute, the undisputed amount must be exchanged between the two counterparties until the dispute is resolved," and we do not disagree with the requirement from the perspectives of market practice and credit risk mitigation.

Also, to our understanding, it is required under the standards to continue negotiations so that the full amount of remaining VM which could not exchanged can be collected. However, since VM is exchanged on a daily basis, the next exchange of VM will occur while spending time on such negotiations of the remaining amount. Given this, it would be more effective to allow parties to determine their agreed amount of VM to be exchanged, instead of requiring collection of full amount of VM, in order to avoid unnecessary confusion.

(iii) Additive 8% haircut upon currency mismatch

The Draft Prudential Standard stipulates that for the purposes of both VM and initial margin ("IM"), even non-cash collateral will be exempted from an additional FX haircut of 8%, which is applied in the case of currency mismatch, if it is denominated in the "termination currency". It is requested that respective parties to a contract will be allowed to designate each "termination currency". Otherwise, it would be difficult to enter into a contract before the standard takes effect because interest of both parties under cross-border transactions would conflict outright. Further, there are many cases under the current ISDA Master Agreement that the termination currency is not designated in advance by stipulating, for example, that such currency should be "either USD, EUR or GBP" or "designated by the non-Defaulting Party." Please confirm whether this practice is permitted.

(iv) Valuation processes

Valuation processes are internal information of financial institutions and should not be disclosed to or agreed with counterparties although the paragraph 83 of the Draft Prudential Standard requires to do so.

(v)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 APRA.

(vi) Re-hypothecation, etc.

Although paragraph 28 of the Draft Prudential Standard prohibits re-hypothecation, re-pledge and re-use of IM, APRA is requested to allow such re-hypothecation, re-pledge and re-use, taking account of the actual condition where custodians may receive only limited amount of cash collateral relative to debt securities collateral.

(vii) Coverage of “netting” in the margin calculation

Please confirm that netting should be performed separately for each collateral agreement (e.g. CSA) rather than for each master agreement similarly to the margin calculation practice under “enforceable netting agreement” where margin amounts are usually calculated separately for each collateral agreement, instead of each netting agreement.

(3) IM Model-related issues

(i) Foreign deposit-taking institutions are included in the scope of the “financial institutions” which is defined as a covered counterparty. In accordance with this, those foreign banks operating in Australia by setting up a branch need to apply to Australian authorities for approval to use a model. Under the condition that regulatory harmonisation across jurisdictions will be achieved, it is requested that foreign banks will be exempted from model approval in Australia or be allowed to apply a simplified model approval process so long as their home country authorities have approved the use of the model.

(ii) As part of the internal audit process, covered entities are required to carry out an independent review needed at the time of applying for model approval. However, it is difficult to perform such an audit before the exchange of IM is actually initiated. Therefore, we would like to ensure that a review by the risk management department is permitted as an alternative approach in this respect.

(4) Others

(i) Supervisory approach

APRA's supervisory approaches are deemed reasonable: for example; substituted compliance is broadly granted in consideration of foreign jurisdictions' margin rules which have already been finalised or of which draft has been issued, and intra-group transactions are exempted from the IM requirements. Nevertheless, as discussed above, APRA is requested to reconsider the application of the standards to branches of foreign banks.

(ii) Inconsistency with BCBS/IOSCO's Final Report and foreign jurisdictions' rules

The Prudential Standard is consistent with the EU rule which includes FX transactions within the scope of application but is inconsistent with rules of the U.S. and Japan which exclude such FX transactions from the scope of application. APRA is requested to reconsider in view of this and make harmornisation efforts across jurisdictions as much as practical. Further, such harmonisation efforts are also requested with respect to differences in the level of haircuts as discussed below.

a. With respect to Japanese government bonds ("JGBs") with residual maturity of 5 years, the Japanese rule applies a haircut of 2% whereas the Australian rule assigns a haircut of 4%.
   (This is because that JGBs with residual maturity of 5 years are classified as debt securities with "residual maturity over 1 year up to 5 years" under the Japanese rule but as debt securities with "residual maturity 5 years or longer" under the Australian rule.)

b. The level of haircuts set forth in "Table 4: Standardised schedule of risk-sensitive haircuts" in the Draft Prudential Standard's Attachment B is inconsistent with the one set forth in "Table 2 Haircuts for long term credit quality assessments" in the European Supervisory Authority's Final Draft Regulatory Technical Standards' ANNEX II "Standard haircuts to the market value of collateral for the purposes of Article 29".

(iii) Due diligence

Please confirm that covered entities may rely on representation by the counterparty with respect to confirmation of the counterparty information.

(iv) Independent review of the initial margin

We would like to ask whether approaches of the IM independent review are not limited to a review as part of the internal audit process, and third-party review, such as a review as part of the external audit process and a review by ISDA, are permitted.

(v)Transactions with counterparties in jurisdictions where netting is not enforceable

It is stipulated that covered entities are not required to post or collect margin under transactions with counterparties in jurisdictions where netting is not enforceable. We would like to ask whether covered entities are given discretion to determine such enforceability.