June 2, 2016

Comments on the *Discussion Paper on Margin Requirements for non-Centrally Cleared Derivatives*, issued by the Reserve Bank of India

Japanese Bankers Association

We, the Japanese Bankers Association ("JBA"), would like to express our gratitude for this opportunity to comment on the Discussion Paper on Margin Requirements for non-Centrally Cleared Derivatives, published by the Reserve Bank of India ("RBI") on May 2, 2016. We would also like to appreciate RBI for efforts to address major issues concerning margin requirements in light of characteristics of the Indian market.

Given the importance of the Indian financial market and its potentiality of further growth, many financial institutions, particularly those in India and other Asia countries, are expected to submit their views on the Discussion Paper ("DP"). As the standards will be applied to cross-border transactions conducted by foreign financial institutions operating in India or Indian financial institutions and their overseas branches, 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 requirements and forming an international consensus.

Specific comments

(1) Scope of application

(i) Products to be excluded from the covered products

Paragraphs 4 and 5 (page 3-4) of the DP set out that variation margin requirements will be applicable to foreign exchange forward, foreign currency swaps and cross currency swaps which are physically settled. 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.

We understand that in India, FX transactions between financial institutions in India are cleared through the Clearing Corporation of India Limited ("CCIL"). Considering cross-border transactions, FX transactions should be excluded from the standards, similarly to the rules of Japan and the U.S., given a limited period of preparation for market participants before the regulatory implementation and in order to ensure global consistency, instead of including such transactions into the scope.

(ii) Transactions with financial institutions

Paragraph 30 (page 13-14) of the DP stipulates that the margin requirements thereunder are applicable to branches of foreign banks/entities in India. 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. If branches in India are required to comply with rules which are different from those in other jurisdictions, foreign financial institutions will need to separate transactions executed by Indian branches from other transactions. That would be difficult in practice. As a result, such rules may decrease the financial transactions in India, giving rise to a risk of decline in market liquidity. Also from the perspective of avoiding unnecessary confusion, RBI is requested to introduce a framework which is consistent with that of other jurisdictions as much as practical.

To our understanding, India's foreign currency regulation requires collateral to be exchanged within India for derivative transactions, etc. executed inside India with Indian financial institutions. Due to such regulation, when an Indian financial institution executes transactions at its domestic branch as well as its overseas branch, it needs to enter into two CSAs for domestic and overseas collateral arrangements (four CSAs, if adding initial margin ("IM")) and to engage in collateral operations twice (four or more times, if adding IM). Given that overall economic effects are the same, such requirements will increase operational risk and settlement risk in connection with exchange of collateral. Further, such burden as the above-mentioned agreements and operations will be an obstacle for Indian financial institutions to expand their business overseas or for foreign financial institutions to enter into the Indian financial market, which may have adverse effects on market liquidity. In this view, RBI is requested to consider exempting the above foreign currency regulation from covered transactions under margin requirements to enable smooth implementation of the margin requirements in the Indian market.

(iii) Transactions with non-financial entities

Currently, the rules of Japan, the U.S., Singapore and Canada do not apply to a non-financial entity. Although the proposed margin requirements set a relatively high threshold to define a covered non-financial entity, such requirements to include non-financial entities into the scope of application would not be accepted by them.

Further, since non-financial entities will no longer be able to engage in new transactions unless they develop necessary operational processes and procedures, it will be impossible for them to hedge market risks associated with their business, which may increase the impact on the real economy. Also given the actual degree of prevalence of CSA and consistency with rules of other jurisdictions, the inclusion of non-financial entities within the scope of application is considered to be premature. Therefore, RBI is requested to reconsider the scope of application to exempt transactions with the non-financial entities from the scope of margin requirements.

(iv) Intra-group transactions

We are deeply grateful for RBI's decision to exempt intra-group transactions from the scope of margin requirements in consideration of efficiency for market participants to execute transaction, risk management framework within a group and other relevant factors. Having said that, it is requested that a part of the description in paragraph 29 (page 13) of the DP be deleted; more specifically, the part where it is stated as "if these transactions do not transfer risks in or out of a banking group". Considering that external risk transfer to/from an outside party assumes a transaction with a party outside the group, adding such a description to the provision exempting intra-group transactions from the scope may raise confusion among market participants as to, for example, the type of transactions and methods how to identify them. If it is difficult to delete the said description, RBI is requested to clarify types of transactions and how to identify such transactions.

(v) Clarification of exemption of jurisdictions where margin requirements are not introduced and jurisdictions where legal enforceability of netting is not assessed, from the scope of margin requirements

From a realistic point of view, it is substantially impossible to enter into the CSA and initiate the exchange of collateral in line with the effective date of those margin rules in Europe, the U.S. and Japan for the following reasons: (a) there is no legal enforceability in the request of CSA conclusion by private-sector financial institutions; (b) it is a long-term project to establish operational processes and procedures; and (c) it takes time to amend the bankruptcy law to ensure the legal enforceability of netting.

Further, financial institutions in those jurisdictions that are subject to margin requirements would have no choice but to simultaneously suspend new transactions with those counterparties which CSA is not entered into in order to avoid violations against the margin requirements. This may lead to significantly affect market liquidity of applicable regions because, among other things, covered transactions will not be executed in the derivatives market.

Given the above, it should be clarified that jurisdictions where margin requirements are not introduced and jurisdictions where legal enforceability of netting is not assessed will be exempted from the scope of margin requirements.

(2) Collateral administration and calculation of margin requirements

(i) Availability of exchange of collateral on a net basis

We would like to ask whether the following description in paragraph 14 (page 7) of the DP, "Due to lack of legal unambiguity on reckoning exposures based on net basis, the requirement of variation and initial margins have to be applied on a contract by contract basis," indicates that the legal enforceability of close-out netting is not ensured in India. In addition, please let us know whether RBI requires the computation of both IM and variation margin ("VM") on a gross basis and on a contract-by-contract basis under this requirement.

If our understanding in the above is correct, requiring collection/posting of VM even though the legal enforceability of close-out netting is not ensured will increase risks and will go against original regulatory objectives. Further, as indicated in our comment in (1)(v), for cross-border transactions, the treatment discussed above will differ from treatment under the margin rules of other jurisdictions that assume netting. This gap may undermine smooth regulatory implementation.

(ii) Additive 8% haircut upon currency mismatch

Similarly to margin rules of other jurisdictions, VM collected/posted in cash should be exempted from the additive haircut of 8% applicable upon currency mismatch. As the table presented in paragraph 24 (page 11) of the DP is not clear in this respect, please amend the DP to clarify this point.

(3) Model-related issues

- Requirement of the schedule-based IM calculation, and establishment of a floor for model-based calculation

Mandating the schedule-based IM calculation (the standardised method) and establishing a floor of 80% of the amount computed based on the schedule for banks using model-based approach will undermine effects of the model-based approach that computes IM by appropriately reflecting risk characteristics and diversification effects of portfolios. This contradicts the intention of the BCBS and IOSCO which permit the use of two types of calculation methods (i.e. the standardised approach and the model-based approach). In this view, the proposed floor should be withdrawn.

(4) Others

(i) Timing of implementation

The margin requirements are not finalised yet although the requirements will take effect in less than three months, on September 1, 2016. Given that it takes time to enter into contracts, establish operational frameworks and take other necessary actions, the implementation date of September 1 is considered to be unrealistic as there is not enough time for preparation. Therefore, RBI is requested to reconsider the implementation timeline.

(ii) Cross-border transactions

The DP stipulates in paragraph 30 (page 13-14) that “RBI will cooperate with other regulators/supervisors of other jurisdictions with respect to appropriate treatment of cross border derivative transactions”. However, it would be extremely difficult to clarify the treatment of cross-border transactions by the implementation date for the following reasons:

(a) The margin requirements in India are not finalised yet even though there are less than three months left until the implementation date.

(b) Some of the aspects in India’s proposed margin requirements, such as exchange of margins on a gross basis and the establishment of a floor for IM computed using models, differ significantly from the margin rules published by other jurisdictions.

(c) RBI will need to cooperate with regulators/supervisors of multiple jurisdictions, including Japan, the U.S. and Europe.

Taking these into consideration, and to avoid unnecessary confusion in the market, RBI is requested to reconsider the treatment of cross-border transactions; for example, to exempt them from the proposed margin requirements at the initial implementation and apply them in due course.

(5) Comments on each question

(i) Issue for feedback/comments (p.4)

What are the views on the proposal of excluding physically settled forex forward and swap contracts from initial margin requirements? Are there any other products which may be considered for exclusion from margin requirements?

(Our comment)

Please see our comments in section (1) (i) “Products to be excluded from the covered products”.

(ii) Issue for feedback/comments (p.4)

What are the views on the proposal of including large non-financial entities within the scope of margin requirements?

(Our comment)

Please see our comments in section (1) (iii) “Transactions with non-financial entities”.

(iii) Issue for feedback/comments (p.6)

Are there any procedural or operational problems in requirement of exchange of variation margin on a daily basis?

(Our comment)

Computing VM on a daily basis will not give rise to any problems as the requirement is consistent with margin rules in other jurisdictions. Nonetheless, as we have requested to supervisors of the U.S. and Europe, RBI should avoid impractical rules that impose heavy operational burden with respect to the timing of settlement of margins (e.g. on the following business day of the transaction) and should ensure practicability by, for example, requiring entities to settle margin “without delay”, similarly to Japan’s margin rules.

(iv) Issue for feedback/comments (p.7)

Is the threshold for application of initial margin and minimum transfer amount appropriate for Indian conditions?

(Our comment)

The threshold for application of IM and minimum transfer amount are considered to be appropriate. However, the DP should clarify that a minimum transfer amount can be established for VM and IM, respectively (e.g. to set the minimum transfer amount at INR 2.0 crore for VM and INR 1.5 crore for IM).

(v) Issue for feedback/comments (p.9)

What are the views on the proposed floor on initial margin requirements computed based on approved risk models?

(Our comment)

In the context of international financial regulation, the issue of establishing a floor based on the standardised approach has been discussed together with the initiative to revise the standardised approach in an effort to increase its risk sensitivity.

However, the proposed standardised method for computing IM is a very simple approach in which required IM is calculated based on the notional amount of the derivative transaction multiplied by the given factors, and is not risk sensitive as it does not reflect any effects of risk diversification and netting. In order to ensure the benefit of models as a risk management tool and at the same time the role of the standardised approach as a reliable fallback, the revision of the standardised approach needs to be further discussed before setting a floor.

Please also refer to our comments in section (3) “Model-related issues”.

(vi) Issue for feedback/comments (p.10)

Should certain other assets also be considered for inclusion in the list of eligible collaterals for margining purpose?

(Our comment)

While we think the proposed list of eligible collateral includes sufficient assets, we would like to ask whether the list includes assets outside India. Further, please clarify whether the rating specified in the list represents a rating in India or a rating granted by any global rating agencies.

(vii) Issue for feedback/comments (p.12)

What are the views on the proposed legal arrangement for treatment of assets received as initial margin? Would Indian laws be able to provide mechanism to ensure legally enforceable arrangement which satisfy requirements of paragraph 25 and 26? Is there a need for third party custodial service provider in India? If the answer is yes, then in what form should the third party custodial service provider be set up?

(Our comment)

It is reasonable to prohibit re-hypothecation, etc. so as to protect the IM posting party in the event that the collecting party enters bankruptcy. We are not certain whether schemes that satisfy requirements of paragraph 25 and 26 can be initiated under the applicable Indian laws, and whether a third party custodial service provider needs to be used.

(viii) Issue for feedback/comments (p.13)

What are the views on the proposal of not allowing re-hypothecation, re-pledge or re-use of assets received as initial margin?

(Our comment)

If re-hypothecation, re-pledge and re-use of assets received as IM are completely prohibited, entities may not substantially be able to use cash as IM, although this would rely on schemes of custodians used. Therefore, RBI is requested to carefully determine the rules by taking into consideration the nature of schemes provided by custodians or other service providers. From this perspective, the final margin rules of Europe sets out provisions as excerpted below.

Article 34([1])

Treatment of collected initial margins

1. The collecting counterparty shall not re-hypothecate, re-pledge nor otherwise re-use the collateral collected as initial margin.
2. The requirement laid down in paragraph 1 shall be deemed to be met where a third party holder or custodian reinvests the initial margin received in cash.

[1] The European Supervisory Authorities (ESAs)"Final 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"(Page51)