JFMC | Japan Financial Markets Council

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Dear Agencies

Margin and Capital Requirements for Covered Swap Entities
OCC: [Docket No. OCC-2011-0008] Board: [Docket No. R-1415] (RIN 7100 AD74)
FDIC: (RIN 3064-AE21) FCA: (RIN 3052-AC69) FHFA: (RIN 2590-AA45)

Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants
CFTC: (RIN 3038-AC97)

1. Introduction

The Japan Financial Markets Council (JFMC)[1] is grateful for the opportunity to comment on the U.S. Prudential Regulators'[2] and the Commodity Futures Trading Commission's (collectively, 'the Agencies') proposals to establish capital requirements and initial and variation margin requirements for swap dealers and their counterparties on all non-cleared swaps and non-cleared security-based swaps. Non-centrally cleared bilateral swaps provide an important mechanism to support a range of legitimate financial activities including hedging risks, credit extensions to business, corporate fund raising, international note issuances by a wide variety of issuers and investment activities by investors throughout the world. They play a significant role in facilitating international trade and it is

[1] The JFMC is an association which includes representatives from five Japan-based institutions and five international firms active in Japanese capital markets. Its aim is to ensure that authorities deciding on regulatory initiatives that have a global impact are aware of and take into account the effect of new regulations on Japanese capital markets. The current JFMC members are: Bank of Tokyo-Mitsubishi UFJ, Daiwa Securities Group, Mizuho Securities, Nomura Holdings, SMBC Nikko Securities Inc, BNP Paribas, Citigroup Japan Holdings Corp, Deutsche Bank Group, JPMorgan Securities Japan Co., Ltd. and Morgan Stanley Japan Holdings. The co-chairs of the JFMC are the representatives from Morgan Stanley and Nomura.

[2] U.S. Prudential Regulators: the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Farm Credit Administration and the Federal Housing Finance Agency.

therefore important that a framework is in place that helps support the appropriate global use of these instruments and puts in place appropriate risk safeguards.

We note that after the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) published their proposal on an international framework for margin requirements the Agencies re-opened their own comment period on their 2011 proposal. The JFMC responded both to this consultation and the BCBS/IOSCO consultation.[3]

The swaps market is global and the regulations that are put in place in one country can have an impact on global operations of an international financial institution. National regulators of course need to implement rules to meet the conditions of home markets but also need to have a regard for the impact they may have internationally, including an awareness that different circumstances and business operations may exist. We note the Agencies have, in a number of important respects, set out proposals that are consistent with the BCBS/IOSCO framework, which we welcome as we believe consistency of a framework through harmonization is desirable to a well-functioning global market. But we also note with concern that the Agencies' regulations differ from the international framework in some significant ways (including the threshold for initial margins and definition of affiliates) and these variations are likely to have a detrimental impact on cross-border transactions. To help sustain a well-functioning global derivative market we therefore strongly believe that harmonization, using the BCBS/IOSCO framework, is the best way forward and would urge the Agencies to adopt such an approach.

This letter covers some specific issues that are particularly important to players in the Japanese market and, although we have an interest in other areas of the consultation, these are largely covered by responses from other trade associations. We would like to highlight:

- The desirability of harmonization with other regimes including the treatment of inter-affiliate trades;
- Frequency and timing of the collecting and posting of margins, including the logistical impacts on Asian markets; and
- We are particularly concerned about the implementation and phase-in timetable. Changes to this are particularly important for JFMC members.

2. **Inter-affiliate trades**
The Agencies propose that margin requirements should be applied to inter-affiliate trades but we believe there would be no clear benefits for risk management purposes as they are required to manage risks on a consolidated basis. The proposed rules are not consistent with what regulators in Japan and the EU have proposed and we believe a more consistent approach would be appropriate.

If initial margin is required for inter-affiliate trades then it must be segregated and posted with a third party custodian. This therefore creates a credit exposure which would otherwise not exist, as firms manage credit risk on a group wide basis. Initial margin requirements for the inter-affiliate trade would create a new and unnecessary layer of both credit and operational risk and appears to be counter intuitive.

Cross-border inter-affiliate swaps also need to take into account the business conditions in other countries. We believe there is likely to be some operational constraints in collateralizing inter-affiliate trades at subsidiaries in emerging countries due to the lack of an internal operating infrastructure.

[3] http://www.japanfmc.org/activities/consultation-responses

The proposal would also clearly constrain the overall liquidity available for financial institutions and have detrimental effects on the financial system.

We note that the Agencies' proposal is not consistent with the rationale that was employed by the CFTC when considering the treatment of inter-affiliate swaps for central clearing purposes. In that context CFTC exempted certain inter-affiliate swaps, without conditioning it on exchanging initial or variation margin, noting the "*…risk mitigating characteristics of inter-affiliate swaps…*" and that it "*…was guided by comments expressing concern that a variation margin requirement will limit the ability of U.S. companies to efficiently allocate risk among affiliates and manage risk centrally*"[4]. The JFMC believes that inter-affiliate swaps should not be subject to initial margin and variation margin requirements, or at the very most only variation margin should be required; there would be a greater adverse impact on liquidity if initial margin were imposed on inter-affiliate trades.

3. **Frequency and timing of the collecting and posting of margins**

The JFMC would like to clarify that the proposed T+1 timeframe is a requirement for a margin call rather than for a collateral settlement. Requirements for collateral settlement need to take into account the usual settlement cycle that applies in the relevant jurisdiction as the settlement infrastructures and the settlement cycles vary from jurisdiction to jurisdiction.

Initial margins should, in particular, be given more time to be calculated; for example either weekly or less frequently. This will allow time to reconcile the entire portfolio and examine all the relevant factors before making the margin call. The resolution of any initial margin dispute is likely also to be more difficult and technical than that for a variation margin, and as a result requires more time.

T+1 settlement (and in some cases a T+1 margin call) for initial and variation margins, would cause logistical problems for counterparties located in the U.S. and Asia because of the time zone differences and potentially affect the capacity of swap dealers to service client hedging requirements.

The proposals should take into account business practices in other jurisdictions. In Asia, counterparties and especially corporates, are not familiar with daily operations to post and receive collateral, as Credit Support Annexes (CSA) and daily collateral management practices are not as widely employed with the financial end user counterparties (except by a small number of Tier 1 banks and dealers) compared with the U.S. or EU. This is partly because other risk mitigating procedures are in place, which require the less frequent posting and receiving of collateral. For example, in Japan a comprehensive agreement between a client and a particular bank ('*ginko-torihiki yakujosho*') is common and covers credit contracts in a single collateral agreement.

The JFMC believes there should be more flexibility to the T+1 requirement for posting and collecting margins and a useful model is the Japanese proposed regulations: that margins should be collected "*promptly in the absence of justifiable causes for delay*". This flexibility would help to accommodate important cross-border transactions.

4. **Implementation schedule and phasing-in the new regime**

The JFMC believes that both initial and variation margin requirements need sufficient preparation time (such as two years) after the major markets (especially U.S., EU and Japan) have finalized their regulations. The time taken to finalize national regulations has been delayed, and as a result the time allowed for negotiating collateral agreements is much shorter than was expected when the international framework was published in September 2013. Depending on when local regulations are finalized the lead-in time could be as short as six months.

[4] Federal Register, vol 78. No 70 (April 11, 2013) CFTC 17 CFR 50 Clearing Exemption for Swaps between Certain Affiliated Entities

It will not be possible to negotiate a CSA within such a contracted time frame; negotiating new CSAs with counterparties that require cross-border collateral arrangements are likely to involve complex legal considerations and will need adequate time. This is particularly true within Asia where CSAs, for the reasons described above, are often much less commonly used and it will be necessary for market participants to be allowed to have sufficient time to meet documentation and operational requirements.

We also believe the new regime should be implemented in phases. This will help alleviate the impact on available liquidity, which as a result of a number of regulatory requirements will be in high demand. It will also allow market participants more time to put in place appropriate systems.

5. **Conclusion**

We are grateful that the Agencies are consulting on the national implementation of margins for uncleared swaps. We welcome the progress that has been made but would urge the Agencies to reconsider their position on inter-affiliate trades, the frequency of collecting and posting margins, the implementation and phase-in timetable and the issues raised in the annex to this letter.

If you have any queries about any of the comments outlined in this letter, please do not hesitate to contact us for more information.

Yours faithfully,

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Annex

Below are some additional issues that the JFMC would like to bring to the attention of the Agencies for their consideration.

1. **Application of the U.S. regime to trades with a non-netting jurisdiction**
   There are a number of jurisdictions, especially those in emerging markets, in which close-out netting agreements using standard derivatives documentation are not legally enforceable. If a party in a nettable jurisdiction is dealing with counterparty from a non-nettable jurisdiction, they may have to post or pay a larger amount of collateral than would be justified by the actual risk profile because of this asymmetry. But the risks to the counterparty in the nettable jurisdiction are likely to increase because they would not be able to net off their position and the possible posting of higher initial margins would affect liquidity in the markets.

2. **Treatment of Special Purpose Vehicles (SPVs)**
   The JFMC believes that SPVs should be exempt from both initial and variation margin requirements because they do not a pose systemic risk to the financial system. Also, if margin requirements are applied to SPVs, most, if not all, SPVs will be forced to exit the derivatives hedging market because they don't have ready access to assets that could be used as collateral.

   Even if margin requirements were to be applied to SPVs, JFMC believes that the Aggregate Average Notional Amount (AANA) calculation for SPVs should be conducted at the level of the fund sub-accounts (i.e. individually segregated as 'bankruptcy remote') for the purpose of determining whether it exceeds the threshold for a material swap exposure.

   An SPV may act as a securitization vehicle and issue bonds in a mutually independent series. The underlying assets are segregated and have no recourse to others in the same SPV. Derivative documentation including the netting agreement is also executed, or deemed to be entered into, for each series. The counterparty risk for such an SPV should therefore be recognized for each series rather than on the whole legal entity basis.

3. **Use of government debt as eligible collateral for variation margin**
   The JFMC believes liquid government debt, such as U.S. Treasuries and Japanese Government Bonds (JGBs), should be permitted to be used as eligible collateral for paying variation margins. If an institution was unable to call on this liquid asset, perhaps during a time when there was a short-term squeeze on cash liquidity, then potentially an institution could be in financial difficulties and ultimately fail for short-term market liquidity issues rather than for solvency reasons. This might therefore have a pro-cyclical and damaging effect on markets.

4. **Use of trust accounts**
   The JFMC believes that initial margin should be allowed to be left for safe keeping not only with a third-party custodian but also with a trust account. A trust account is a segregated account with a trust company or a trust bank ring-fenced from insolvency of the trust company or trust bank which is overseen by an applicable law (for example the Trust Business Act of Japan).