

28 September, 2012

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

International Organization of Securities Commissions
C/ Oquendo 12
28006 Madrid
Spain

Submitted by e-mail: baselcommittee@bis.org and wgmr@iosco.org

Dear Secretariats,

Consultative Document: Margin Requirements for Non-Centrally Cleared Derivatives

The Japan Financial Markets Council (JFMC) is a new industry association which was founded in June 2012 and 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 new global regulatory initiatives are aware of and take into account the impact of new regulations on Japanese capital markets.¹

The JFMC is grateful for an opportunity to comment on the Basel Committee on Banking Supervision (BCBS)/International Organization of Securities Commissions (IOSCO) joint consultation on 'Margin requirements for non-centrally-cleared derivatives' published in July 2012 (hereinafter referred to as the 'Consultative Document'). We understand and welcome that in deciding on the final standards you will also take account of the results of the quantitative impact study (QIS) and seek to avoid any unintended consequences. We hope our observations below prove helpful in this decision making process.

1. Introduction

The JFMC is fully supportive of the G20 commitment to reforming the global OTC derivatives market in order to reduce systemic risk and enhance the resiliency of international financial markets. The JFMC, however, has concerns about the proposals for introducing margin requirements for non-centrally cleared derivatives transactions as set out in the Consultative Document.

The JFMC believes that Initial Margin (IM) requirements as currently proposed are not the optimal tool to address systemic risk concerns emanating from non-cleared swaps. We need to be aware of the possible detrimental affects it may have on: liquidity levels, the extension of credit to business, capital market activities and international money flows. Together these may have a negative impact on the Japanese real economy and this may also be true of other markets.

¹ The JFMC membership consists of Bank of Tokyo-Mitsubishi UFJ, Daiwa Securities Group, Mizuho Securities, Nomura Holdings, SMBC Nikko Securities Inc, Bank of America Merrill Lynch, BNP Paribas, 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. The continuing need for non-cleared swaps

The JFMC fully agrees with the policy objective to introduce central counterparties (CCPs) and the standardisation of more derivatives trades so that they can be centrally cleared. We believe this is likely to mitigate global systemic risks affecting wider financial markets. But the JFMC also believes that, while there are factors encouraging the ability of CCP clearing to reduce counterparty risk, there continues to be an important role for non-CCP cleared bilateral swaps to support legitimate financial activities. These include: 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.

Business sectors in Japan rely heavily on hedging as part of their business strategy. As outlined below, this activity is an important contributor to the success of the Japanese real economy and any threat to the viability of the non-centrally cleared swaps market would have possible wider knock on effects.

- Japan's economic growth, like a number of countries, is very dependent on international trade. Japanese manufacturers export goods all over the world and need to apply a sophisticated risk mitigation policy to control for volatility in the foreign exchange markets including the effects of the strengthening Yen. These firms rely to a large extent on derivative transactions including longer-term foreign exchange related transactions as well as currency swaps, which are typically uncleared transactions.
- Japan has few natural resources and is reliant on imports of oil, gas and other commodities. Japanese general trading companies deal in a diverse range of products including energy and commodities and use uncleared derivative transactions to hedge their positions.

3. Macro effects

The G20 in setting their mandate on this issue made clear that macro-level considerations need to be taken into account. We note the Consultative Document states that any potential benefits of introducing margin requirements must be weighed against the impact on aggregate liquidity levels as there will be an increased demand from derivative counterparties for liquid and high-quality collateral.

New Basel III liquidity rules will require banks to have in place liquid assets and the credit valuation adjustment (CVA) capital charge will be required on uncollateralised exposures (including sovereigns) as an incentive to use CCPs. Increased liquidity requirements are likely to come at an increased cost and together with the proposed initial margins, banks will need to pass on these higher collateral and capital costs to clients through the pricing of bilateral over the counter (OTC) derivatives trades. This may act as a disincentive to businesses taking out appropriate hedging.

Liquidity pressures may ultimately affect the extension of credit to business, wider market activities, international money flows, and also financial system stability. Below are a number of ways in which IM could therefore affect the real economy.

- ***Constraint on international capital market activities***

Many issuers enter into cross-currency swaps for the purpose of hedging and converting domestic currency. Margin requirements for such cross-currency swaps might substantially discourage these important capital markets activities, and affect the economics of bond issuance. End-user exemptions would not mitigate this situation because a swap provider bank has to reflect the increased collateral price into cross-currency swaps with the issuer.

- ***Constraint on international money flows***

As a result of the proposals, overall funding costs are likely to increase and this may damage cross-border money flows. For example, if more cross-currency swaps were difficult to trade, it would affect international money flows from surplus countries to countries which need funding. This may cause a negative impact on the global economy in both the medium and long term by affecting the level of global imbalances.

One example of this is the Japanese 'Samurai-bond' market. Japanese capital markets are supported by the large capital surplus in the domestic household sector, and these savers have played an important role in providing finances to overseas borrowers. At the end of 2011 the 'Samurai-bond' market had an outstanding balance of approximately US\$125 billion (equivalent). Euro-yen debenture issuance in 2011 by non-Japanese issuers was US\$ 76 billion (equivalent). In addition, domestic offering of debentures by non-Japanese issuers was US\$ 36 billion (equivalent).

Most of these proceeds were swapped out of Japanese yen – the issuing currency - to the home currency of the bond issuers, using OTC cross-currency swaps and often with structured features embedded. Many of these cross currency swaps will not easily be cleared through CCPs, and therefore the introduction of more stringent margin requirements could prevent these borrowers from taking advantage of the Japanese capital surplus, either because of an increase in costs or a shortage of eligible assets. Eventually this could undermine global optimal capital flows essential for global economic growth.

Imposing IM would have a major impact on the real economy including in Japan. At the end of 2011 the notional amount of outstanding OTC foreign exchange derivatives including currency swaps, of which one side is Japanese Yen, was US\$13,661 billion and its gross market value was US\$590 billion.² The Yen is the third largest traded currency in the global OTC foreign exchange derivatives market after the US dollar and the Euro.

Various institutions - including the International Monetary Fund (IMF), the Office of the Comptroller of the Currency (OCC), the Bank of England and the International Swaps and Derivatives Association (ISDA) - all indicate that the global costs involved in putting in place clearing and various margin requirements are likely to be large. There is therefore likely to be a shortage of high quality collateral. There is already a heavy demand for high-quality liquid assets due to new banking prudential requirements and OTC derivative market reforms (especially the transfer to CCPs). In addition there is also an increased presence of central bank operations and there are also limits on the supply from the private sector because of changes in the securitisation market.

- ***Tying up funds that might otherwise be used to support the real economy***

If the end-user corporate is required to post initial margin and variation margin (VM), they will have either to borrow money to purchase the eligible collateral or acquire the eligible collateral directly through security transactions such as a repo. If this business has to borrow, banks are likely to have to extend credit at some point in the process. If a certain part of the credit line is used in extending loans to purchase eligible collaterals, there will be less credit available to help encourage business and economic growth.

For prudentially regulated financial institutions the proposals for mandatory two-way IM on a 'gross' basis, mandatory segregation of IM with prohibition on re-hypothecation or re-use and limitations on the eligible collateral, would all tie up a large amount of resources. This would limit lending into the real economy.

² Bank for International Settlements Statistical Release (May, 2012)

- **The quantitative impact study (QIS)** will be an important indicator of the macro impact of this project and we welcome the commitment in the Consultative Document to consider and examine the results of this study in order to avoid any unintended consequences. We also believe that it is important that the review should take account of other regulatory changes – such as the new Basel III liquidity standards, the new margin requirements for CCPs for derivatives, and the fundamental review of the trading book - and examine whether the cumulative effect is likely to result in unintended outcomes.

4. Systemic risks to the financial system

We believe there are a number of systemic risks that IM requirements might generate, which we highlight below:

- **Procyclical Effect:** IM is an effective risk mitigation tool during normal conditions. But during times of stress, rather than mitigating problems, IM may exacerbate the situation and thereby have a procyclical effect. For example, trades between prudentially sound banks would be required to have additional IM for their non-centrally cleared derivatives but this in itself could potentially lead to a buildup of stress in these institutions where none existed beforehand. For trades cleared through central counterparties, it is possible to ease the adverse effects by creating counter positions through the netting effect but this is not the case for non-centrally cleared derivatives. There are other ways to mitigate the impact on non-cleared swaps. For example, in Japan banks generally secure their derivatives exposures to their borrowing clients through open-end general collateral (a '*ne-tanpo*' agreement) as a market neutral risk mitigation tool. (This is described further in section 6). If existing and effective risk mitigation tools are not recognised and expensive mandatory IM are required, the overall risk control mechanism in the market may become inefficient or ineffective.
- Another example of a procyclical effect would be if a large institution collapses. This event would negatively affect the functioning of financial markets because counterparties would be forced to liquidate large amounts of collateral assets in addition to covering emerging risks after 'closing out' non-centrally cleared swaps. Also, as a result of the VaR model approach to IM, the requirements for initial margins will be simultaneously and sharply increased among market participants. In order to fulfil margin requirements for high-quality assets, a significant number of market participants would be likely to fund their purchase by exchanging large amounts of other risky assets in the markets. This would have systemic implications.
- **Constraint on Hedging Activities:** We are concerned that if IM was introduced, the cost of hedging activities through uncleared swaps would become prohibitively expensive, and as a result of this many market participants (e.g. asset managers, investors and other end-users) would be unable to enter into necessary hedging arrangements and this potentially would leave them exposed to a number of risks. In aggregate, the loss to the market of this important hedging tool would create a new source of systemic risk.
- **Constraint on Efficient Market Mechanism:** We are concerned that the introduction of IM might reduce overall turnover of cross-currency swaps or other foreign exchange related transactions. A decline in foreign exchange transactions might then constrain the efficient functioning of markets, including an effective market arbitrage mechanism between the US dollar market and other currency markets. This may result in destabilising effects to the financial system.
- **More concentration by custody institutions:** It is possible there may be a major build up of collateral assets in some custody banks who are able to provide sophisticated

international collateral management services. This might lead to a number of systemic concerns: i) market participants' overreliance on the safety of collateral assets including the process for orderly liquidation of collateral assets when a counterparty defaults ii) a potential surge in required margin amounts due to the procyclical nature of VaR models during a period of stress and iii) the possible absence of an effective and transparent process for custody arrangement.

- **Threatening Liquidity and Banks' Prudential Control:** We are concerned that over-collateralisation may become a destabilising factor on the financial system because of liquidity pressures and the inefficient nature of banks' loss absorbency arrangements. For example, because of an increase in demand for high-quality liquid assets the price of them may become so expensive that funding markets would be forced to accept lower-quality assets as collateral. Tying up high-quality assets in initial margin requirements for uncleared swaps may reduce liquidity in the markets. Adding this to the CCPs guarantee funds and initial margin posting for solvency protection for CCPs may result in short-term market volatility which may destabilise the financial system.

5. Implementation – firm related risks

In addition to the systemic issues outlined above, there may also be a number of firm-related risks in effectively implementing the proposals.

- **Application of thresholds:** The proposed introduction of thresholds, including how to set levels, may cause implementation problems. A top down, one-size-fits-all approach that does not account for differences in creditworthiness, legal jurisdictions or IM calculation methods between parties may discourage legitimate transactions or encourage regulatory arbitrage. Threshold applications may result in a situation where one party to a trade is required to post collateral while the other is not. There is also the question of how thresholds should be harmonised with netting practices or open-end general collateral agreements used in Japan.
- **Segregation of IM and prohibition on re-hypo/re-use:** Any IM standards will need to include proper arrangements for the investment management of IM collateral assets even after segregation.

6. Taking account of other mitigants

Any new regulation needs to take into account local conditions which may counterbalance the risks outlined in the Consultative Document.

For example, in Japan the ISDA's Credit Support Annex (CSA) is not usually exchanged between banks and business corporations. One reason for this is that banks in Japan secure exposure to business corporations through more comprehensive arrangements. Whole banking transaction agreements (which are called '*ginko-torihiki yakujosho*') are an important part of Japanese banking practice. Japanese banks and their corporate customers have a master credit arrangement supported by an open-end general collateral agreement (called a '*Ne-tanpo*' agreement). This means that all the credit contracts between the client and a particular bank are covered by a single collateral agreement and it would therefore be duplicative to require separate IM and VM for derivative transactions.

CSA practices are rare for trades between business corporations across Asia. The historical development and current business practices are quite different to western markets where CSA was originally introduced. It is highly likely that banks would face difficulties requesting business corporations to post collateral under the CSA. Business corporations are not

accustomed to exchanging margins and onerous collateral requirements may hinder the use of derivative transactions for legitimate business risk hedging purposes.

In some jurisdictions, lawmakers have allowed an end user clearing exemption that will allow many swap market participants not to clear swaps (that are otherwise required to be cleared) . For example, in Japan, for the first phase of transition, only plain vanilla type Japanese Yen interest rate swaps and index-based credit default swap (CDS) transactions between major swaps dealers, (which satisfy the relevant CCPs' membership qualification) are required to be centrally cleared. This is to ensure the smooth and orderly transition in the market while limiting any destabilising factors in the financial system.

We therefore request that regulators take into account the unique features of individual countries and regions when introducing any regulatory reforms including margin requirements, particularly in the context of end-user exemptions.

7. The way forward - How to mitigate the risks from uncleared swaps

The JFMC believes a mix of capital (as the primary mitigant which has been strengthened by new Basel III standards) and variation margin (as a supplemental risk mitigation tool) is a sensible framework to mitigate the risks from uncleared swaps. This approach also supports effective risk management practices. The JFMC believes this would strike a balance between addressing the risks set out in the Consultative Document and maintaining financial stability and ensuring efficiency in the market.

The JFMC believes the risks of uncleared swaps might also be mitigated by a variety of other measures including, but not limited to: well-designed capital charges, product standardisation, and mandatory clearing requirements. We believe that a mandatory two-way initial margin practice based on the 'gross' is problematic. A more workable alternative would be a variation margin without a mandatory two-way initial margin.

8. Exemptions and thresholds

If IM requirements are introduced regulators will need to clarify various exemptions from the rules and how this will be applied to cross-border transactions. In particular:

- ***Clear exemption for FX trades:***

We believe one or more categories of foreign exchange related transactions should be exempted as the settlement risks are controlled by the operational arrangements. Detailed definitions of how exceptions will work should be determined by each national regulator taking account of local circumstances.

- ***Clear exemption for end-users:***

The Consultative Document explains that there was broad consensus within the BCBS and IOSCO that the margin requirements need not apply to non-centrally-cleared derivatives with non-financial entities who are not systemically important. We agree with this position. We believe the rule should clearly exempt end-users who are not financial entities and who enter into uncleared swaps with the legitimate purpose of risk hedging for commercial or financial purposes.

We also believe the exemption should apply to both initial and variation margin practices. Initial and variation margins may fit with the business model of financial counterparties that are trading derivatives or are otherwise in the business of selling derivatives and laying off the risk. Non-financial entities are, in contrast, generally using derivatives to hedge a future cash flow risk so until that future date arrives they do not want the derivative to generate any cash flow.

- **Clear exemption for Inter-affiliate trades:**
Inter-affiliate trades should be exempted and this exemption should apply both to initial and variation margins. Recent policy discussions have been examining international regulatory coordination of consolidated group operations in order to avoid the disorderly resolution of banks. We are therefore not clear why margin exchanges should be necessary within group entities to protect each against a stand-alone default by any of the group's entities.
- **Thresholds:**
If set at appropriately high levels, thresholds may act to mitigate the drain of liquidity from the marketplace that would follow the introduction of IM. But such thresholds will be successful only if they are introduced as a flexible, commercial decision of the counterparties, rather than by a top down approach. This is because the contracting parties themselves are best positioned to determine their own risk appetite as well as the credit quality of counterparties. When left to the commercial judgement of each institution, thresholds can be applied with enough flexibility to account for different calculation methods, different legal jurisdictions or the specific terms of any given transaction. Such an approach would also limit the risk of creating opportunities for regulatory arbitrage that might result in a top-down approach that does not recognise variations in the creditworthiness of individual institutions or other conditions unique to each transaction. Since the role of thresholds is similar to that of credit extended to a counterparty, the introduction of thresholds would need to be harmonised with widely used netting practices or, in Japan's case, the open-end general collateral agreements common in its commercial banking system. Such harmonisation would be best facilitated by leaving thresholds to be set by the commercial judgement of participants.

Finally, regardless of the format of margin that is adopted, appropriate phase-in arrangements will be necessary in order to avoid potential problems which might affect the real economy.

The JFMC are supportive of the overall aim to enhance financial stability whilst at the same time also supporting economic growth. We hope the information set out in this letter will be useful in the BCBS/IOSCO deliberations, and we would be happy to provide further information if required.

Yours faithfully,



Jonathan B. Kindred
Co-chairs of the Japan Financial Markets Council



Shigesuke Kashiwagi

Contact: International Bankers Association (IBA Japan): Paul Hunter, Iwao Toriumi or Takaaki Fujimoto.
Telephone +81 (0)3-6225-2211 E-mail g-info@ibajapan.org