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October 17, 2014

Comments on the International Organization of Securities Commissions' Consultative Report: *Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives*

Japanese Bankers Association

We, the Japanese Bankers Association ("JBA"), would like to express our gratitude for this opportunity to comment on the Consultative Report: *Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives,* released on September 17, 2014 by the International Organization of Securities Commissions ("IOSCO").

We respectfully expect that the following comments will contribute to your further discussion on this issue for finalizing the Standards.

<Overall Comment>

1. **<u>Policy on developing the Risk Mitigation Standards (the "Standards")</u>**

In implementing the margin requirements effective from December 2015, details of the requirements and FAQs are expected to be released by national authorities, and an initiative to establish an industry-wide consistent practice will be undertaken. National authorities are therefore requested to develop new requirements to be introduced by fully taking into account the margin requirements and uniform industry practice.

Most of proposed standards provided in the Consultation Report are materialized based on the agreement between the two entities. To address the cases where such requirements fail to be met due to a cause attributable to one counterparty, it is requested to clarify in the Consultation Report that the entity to which the cause is not attributable should not assume any responsibility with regard to non-compliance of the requirements.

Additionally, a mechanism is requested to be established that allow entities to consult the authorities on specifics of the requirements, as necessary.

2. **<u>Scope of the requirements applicable to investors</u>**

Given that transaction volume and risk amount differ between brokers and dealers and investors (funds and trusts), and that investors are subject to other laws and regulations, the scope of the requirements should consider such differences (characteristics and consistency across laws and regulations) in order to increase the effectiveness of overall risk mitigation standards.

In view of this, instead of uniformly applying Standards to all types of covered entities, an alternative approach should be explored. Specifically, covered entities shall be grouped into brokers and dealers conducting the dealing activities with a large volume of transactions and counterparties and Investors (funds and trusts), and requirements shall be applied only to brokers and dealers (by setting a difference in the scope of average). It is considered that such approach would substantially regulate the investors (customers).

3. Phase-in implementation of the Risk Mitigation Techniques

Strict requirements on risk mitigation techniques should not be applied from the onset of the implementation. Rather, it is requested to apply the Standards on a phase-in manner, imposing stricter requirements gradually.

Some risk mitigation techniques, depending on their applicable standards, may take substantial time such as for systems development. Therefore, for serving the purpose of minimising risks as much as practicable, it is considered that a phase-in period shall be set rather than applying strict requirements (e.g., requiring daily trade confirmation) at the onset. Additionally, it is requested to consider relaxing the requirements, for example, the frequency of carrying out the procedures should be set taking into account the size of transactions of counterparties.

<Specific Comments>

1. Scope of Coverage (Standard 1)

We support Standard 1 which is an approach that requires applying the risk mitigation techniques to broad market participants as much as practicable in order to reduce systemic risk to the maximum extent possible. Meantime, risk mitigation techniques are effective when both parties cooperate to mitigate such risks. If risk mitigation techniques are legislated and made mandatory only at a jurisdiction of either entity, they may not effectively function. To avoid such a situation, related regulation should be developed in a manner to mandate both entities to apply the techniques.

The application to covered entities and non-covered entities transactions and related recommendations should be determined at the discretion of respective jurisdictions. In particular, the application to non-financial end user may impose undue burden relative to actual risks, and hence respective jurisdictions should have latitude in determining such application.

To develop more effective standards, the following are also requested to be considered in determining the scope of coverage, taking into account our overarching view discussed above:

(i) Definition and scope of financial entities and systemically important non-financial entities (covered entities)

Given that the concept of financial entities is broad, and there is a difference in the degree

and extent of developing infrastructure for risk mitigation techniques across jurisdictions and corporations, if the Standards are applied to a broad range of entities, practical burden would be significant. Hence, to limit covered entities for the application of the Standards in practice, it is requested that the definition of financial entities and systemically important non-financial entities be clarified, while adopting the basic approach to apply the Standards to a wide range of market participants as much as practicable.

In addition to clarifying the above definitions, it is also requested to allow a certain degree of latitude to each jurisdiction so that the definition of covered entities and scope of coverage be applied by considering applicable laws and regulations, parties to transactions and actual state of transactions.

Additionally, in cases of a scheme in which an entity making a substantial investment decision ("Manager") involves as a party to the transaction, requirements on Managers should be considered. Because, for funds taking a scheme in which the "Administrator", which is a holder of the fund, and the substantial investment making entity (Manager) are different, the effectiveness of applying overall risk mitigation standards is enhanced for complying with the Standards 2 to 9, if applied to the Manager. (Particularly, Standard 6 Portfolio Compression cannot be implemented by the Administrator.)

(ii) Relationship between margin requirements and the Standards

Key consideration 1.2 requires each authority to at a minimum apply the Standards to covered entities in a manner consistent with the authority's application of the margin requirements for non-centrally cleared OTC derivatives. However, currently, proposed margin requirements published by authorities in Japan, the U.S. and Europe differ in terms of criteria of covered entities for the requirements.

Differing criteria of covered entities for the margin requirements across jurisdictions may cause confusion in the cases of cross border transactions since the governing standards of the two parties differ. Consequently, requirements should be carefully considered in determining the application to cross-border transactions.

If the covered entities differ from the margin requirements above, cases (criteria) where the requirements are applied to non-covered entities of the margin requirements should be clarified.

(iii) Use of third-party service

Third-party service is generally used for the reconciliation and other procedures. Given that the market of service providers is currently oligopolistic, and that the efficiency will not be enhanced unless market participants use the same service, it is expected that the same third-party service will be primarily used.

If the effectiveness of the third-party service is undermined, disruption is highly likely to occur at a market wide level as well as individual company level. Accordingly, national authorities shall carry out due diligence to assess the capability and reliability of the third-party service, and instruct the service provider, as necessary.

2. Trading Relationship Documentation (Standard 2)

Explanatory note 2.6 specifies that it may not be appropriate for authorities to prescribe a universal form of documentation for Trading Relationship Documentation. It is however considered that ISDA/CSA is a universal form of Trading Relationship Documentation, and these should be explicitly included as examples in the Standard.

ISDA/CSA is most widely used for swap agreements, and includes the provisions that are in line with each standard set forth in the Consultation Report, although there are some differences in the level of covering the standards. Additionally, ISDA/CSA is developed and used for the purpose of complying with the margin requirements and hence discuss in detail those provisions provided in the standards. It is therefore considered very useful to proactively acknowledge these agreements.

3. Trade Confirmation (Standard 3)

In specifying the deadlines for completion of trade confirmations, such deadlines should be set separately for cross border and domestic transactions.

Trade confirmations for some transactions are carried out via providers other than MarkitWire and SWIFT. When such other providers are used, cross border transactions take more time for completing trade confirmation than domestic transactions since those transactions require substantial time for communication and confirmation, etc. due to time differences.

4. Valuation with Counterparties (Standard 4)

The process and/or methodology proposed in this Consultation Report are meaningful for risk mitigation techniques. However, such process and/or methodology are not legislated in any jurisdiction, and hence implementation of such process and/or methodology needs a careful consideration.

While it is significant to agree on and clearly document the process and/or methodology for making valuation determinations, specific matters to be agreed on should first be discussed and the introduction of such process and/or methodology should be carefully discussed ,considering that currently any jurisdiction has not yet introduced such process and/or methodology,.

It is understood that there is a broad consensus on valuation process and/or methodology of OTC derivative transactions which are frequently traded, but it is a significantly difficult issue to determine how such process and/or methodology should be documented. On the other hand,

transactions not traded frequently may lack a common valuation methodology and/or process. While it is crucial to pre-agree on and document such process and/or methodology, it is considered difficult to employ the uniform valuation process and/or methodology.

In relation to documentation above, the term "methodology" is requested to be deleted from Key consideration 4.3 because valuation logic of derivative transactions generally constitutes intellectual property right of individual banks, and hence should not be disclosed with no restriction.

5. Reconciliation (Standard 5)

(i) Implementation and frequency of portfolio reconciliation

The proposal to reconcile, at regular intervals, the material terms and valuations of non-centrally cleared OTC derivatives transactions should not be mandatory but instead be treated as a recommendation for the following reasons:

Practical burden is unduly heavy if mandating the regular reconciliation with counterparties for which the necessity of reconciliation is low because the calculated amount of collateral requirements agrees through collateral exchange negotiation. On the other hand, the reconciliation will inevitably be carried out for those counterparties with the significant amount of difference in calculated amount of collateral identified in the process of collateral exchange.

If the frequency of reconciliation is defined, regardless of whether being mandatory or recommended, it is requested that the minimum requirement of frequency be set at once a month or so.

If the reconciliation is obliged through regulation, items to be included in, and the definition of, the "material terms" should be unified globally. It is also requested to clarify the definition, and to establish measures to remove any unclear areas (for example, unclear areas can be clarified by FAQs for specific products).

It is expected that industry-wide uniformed practice will be established for the reconciliation over time to comply with the margin requirements. Inconsistent with such industry-wide uniformed practice, however, if reconciliation-related requirements implemented differ across jurisdictions, burden will significantly increase to research requirements of national regulations, cooperate between the entities when the details of requirements to comply with differ from those applied to the counterparty (for example, frequency and material terms differ), as well as to develop internal data and systems. (For example, if material terms are not unified on a global basis, assuming a worst scenario, each entity would need to research material terms of respective jurisdictions across the world, establish an internal database that contains all requirements of all jurisdictions, identify different material terms for each counterparty to perform the reconciliation. To carry out meaningful reconciliation, both entities should perform

the reconciliation using accurate data. Therefore, the definition of such material terms should be clarified to avoid any misunderstanding between the entities.

(ii) Uncollateralized transactions

It is requested to add specific examples to clarify what "uncollateralized" transactions mean.

Key consideration of Standard 1 (Scope of Coverage) states that only non-centrally cleared OTC derivatives transactions between two covered entities are subject to the Standards in the Consultation Report. However, since the margin requirements require securing such transactions through the exchange of collateral, it is unclear what transactions the Consultation Report deems as "uncollateralized".

6. Portfolio Compression (Standard 6)

Portfolio Compression is an effective measure among risk mitigation techniques, and hence it is crucial to promote the implementation of portfolio compression. On the other hand, due consideration should be given in determining whether to mandate the implementation to covered entities.

Portfolio compression has an effect in reducing the amount of initial margin (IM) to be exchanged, and is advantageous for covered entities. Therefore, the implementation of portfolio compression is expected to be promoted to a certain extent through allowing self-initiative of covered entities without mandating the requirements. This will be more effective through cooperation between financial institutions.

For example, it is important to establish a framework whereby financial authorities regularly check the status of implementing portfolio compression to assess whether reasonable actions are taken at respective entities.

On the other hand, there are transactions that may not be terminated for hedging purposes. For such transactions, it is difficult to set quantitative criteria for mandating the portfolio compression. If mandated, performing portfolio compression itself should not be mandated, rather, a requirement to consider performing portfolio compression based on a reasonable judgment should be imposed.

7. Dispute Resolution (Standard 7)

(i) Regulatory reporting of disputes

It is requested to give due consideration for mandating regulatory reporting of disputes that remain unresolved after a reasonable period of time for the following reasons:

Under commonly established practice, risks arising from such disputes are managed under the credit risk management framework between both entities. In this regard, both entities have sufficient incentive to avoid such disputes. Therefore, the regulatory reporting obligation is not

considered to create an incentive for both parties to further make an effort to resolve disputes between the parties.

(ii) Threshold for authorities to determine valuation disputes

If regulatory reporting of disputes is mandated, and the threshold for disputes subject to reporting is set, national authorities are requested to consider setting the same threshold across national regulations.

If the threshold differs across jurisdictions, the strictest threshold will be applied to the exchange of collateral for cross-border transactions substantially, thereby leading to an increase in practical cost for compliance with such threshold.

8. Implementation (Standard 8)

(i) Implementation timing

Implementation of margin requirements should be the highest priority. Accordingly, a certain period of lead time should be ensured after margin requirements for implementation of the risk mitigation standards.

Financial institutions are currently undertaking their initiative to implement the margin requirements by assigning maximum resources as possible. Such initiative for complying with the requirements involves many challenges. Nonetheless, we acknowledge that the margin requirements are the most significant measure to reduce systemic risk to the maximum extent possible. On the other hand, major participants have already implemented the risk mitigation techniques in some form, and hence delay in the legislation of risk mitigation techniques proposed in the Consultation Report for a certain period of time may not have a significant impact.

Implementation of the Standards warrants considerable preparation effort including development of laws, regulations and rules applicable to relevant parties involved in transactions such as a counterparty, manager and administrator (trustor), entering into agreements, establishment of an operational framework and systems development. In particular, concluding an agreement that includes the reconciliation procedures, which we mentioned concerning Standard 5, would require considerable time.

Consequently, the Standards should be implemented with sufficient lead time (e.g. approximately three years) after implementation of the margin requirements.

(ii) Transactions with non-covered entities

Our view is that the risk mitigation techniques should not be mandated to transactions with non-covered entities. If certain standards are imposed on such transactions, sufficient lead time

should be secured before its implementation.

This is because covered entities of the margin requirements are expected to have already been developing processes for concluding ISDA, portfolio reconciliation and dispute resolution, while non-covered entities of the margin requirements have not yet developed such processes.

(iii) Application to Financial End User

Dealers and brokers need to devote considerable time to establish processes and procedures, including operational processes, for financial end users (investment vehicles such as funds and trust accounts) which are also covered entities, since the number of such users is large.

Considering practical burden that may be placed on dealers and brokers, the Standards should be applied to financial end users in a phased manner, avoiding concurrent application to both dealers and brokers and financial end users.

9. Cross-Border Transactions (Standard 9)

(i) International cooperation among national authorities

Development of rules is the responsibility of national authorities. However, for those related to cross-border transactions, it is requested to develop common rules based on sufficient international cooperation.

Lack of common rules across jurisdictions may cause disputes with counterparty, giving rise to considerable effort to resolve such disputes. Additionally, in the absence of common rules, a large amount of cost and effort may incur to comply with rules of counterparty's jurisdiction.

(ii) Equivalence assessment

To avoid extraterritorial application of the regulation enforced before the equivalence assessment, the implementation date of national regulation should be set at the same timing across jurisdictions, and equivalence assessment should be carried out sufficiently before the enforcement.

If the national regulation is not considered to be equivalent and different requirements of multiple jurisdictions are applied to one transaction, a significant impact is expected to be on the swap markets. For example, if multiple times of reconciliation need to be carried out for reconciling the same portfolio using different data formats unique to each jurisdiction, the whole industry may incur unnecessary cost.

Given this, in the absence of consistency across national regulations, implementation timing needs to be delayed.