

8<sup>th</sup> December, 2015

Mr. William Coen  
Secretary General  
Basel Committee on Banking Supervision  
Bank for International Settlements  
Centralbahnplatz 2, CH-4002 Basel, SWITZERLAND  
Sent by email to: [William.Coen@bis.org](mailto:William.Coen@bis.org)

Mr. David Wright  
Secretary General  
International Organization of Securities Commissions  
C/ Oquendo 12, 28006 Madrid, SPAIN  
Sent by email to: [info@iosco.org](mailto:info@iosco.org)

cc: Mr. Zohng Li, Policy Advisor, International Organization of Securities Commissions  
Mr. Steven Maijor, Chair, European Securities and Markets Authority  
Mr. Andrea Enria, Chairperson, European Banking Authority  
Mr. Gabriel Bernardino, Chairman, European Insurance and Occupational Pensions Authority

**Margin requirements for uncleared derivatives: important changes to settlement issues required so that Japanese and other Asian markets are not unfairly disadvantaged**

Dear Mr. Coen and Mr. Wright,

The International Swaps and Derivatives Association (**ISDA**) and the Japan Financial Markets Council (**JFMC**) are grateful to the BCBS/IOSCO WGMR for the framework that has been agreed for the margin requirements for uncleared derivatives including considering and taking into account some of the requests from market participants. But there is a significant issue which remains unaltered which we believe unfairly disadvantages Japanese and other Asian markets: the proposed settlement cycle i.e. the timing of calculation, call and delivery of Initial Margin (IM) and Variation Margin (VM).

We are writing to you now because we understand the European Supervisory Authorities (ESA) are imminently about to set out to EU national regulators the approach to adopt for this framework. We would like you to consider and take into account the issues outlined below and alter your guidance on the timing of settlements.

**Summary of the comments**

We believe the total time for margin transfers (i.e. the timing of calculation, call and delivery of initial margin and variation margin) should be two business days following the execution date of derivatives transactions (or three business days in case of cross border transactions).

This is because the current T+1 proposal does not take account of time zone issues for the Asia-Pacific region. It also does not take into account market specific issues in Japan and other Asian markets: the availability of local custodian services and operational challenges. To not make this change would unfairly disadvantage Japanese and other Asian markets and impact their economies.

**Time zone issues for the Asia-Pacific region**

We believe the new margin rules may impose a disproportionate burden for counterparties based on their location, especially those located in the Asia-Pacific region. This will affect their selection of collateral products and may result in higher overall funding costs.

The following example illustrates the issue. A European or US party (Party A) makes a margin call to a Japanese party (Party B) on the business day following the execution date of the derivatives transactions, i.e. T+1 (T being the execution date of the derivatives transactions or when the portfolio changes). The EU or US party will make their margin call on T+1 in their local time, because it will only be able to calculate the margin overnight after the closing of the books at the end of the business day for all trades in the portfolio.

When dealing with a cross border trade, if Party A makes a call during T+1 when Party A is open (for example, at 8 am New York time on T+1), then Party B will only be able to revert on the following day (T+2) in Asia time. As banks prefer to choose their own domestic market products as collateral, Party B will consider posting Japanese Government Bonds (JGBs)<sup>1</sup>. In this scenario, Party B would need to post on the same day as it is already T+2, so it would be impossible to source this collateral from the market because the standard settlement cycle for JGBs is Trade Date (øTDö) +2<sup>2</sup> for both outright transactions and repos transactions.

This situation is applicable not only for Japan, but also to other countries in the Asia-Pacific region. This means Asian parties will be forced to either: 1) pre-fund and excess-fund their collateral-to-post (JGBs or their domestic government securities) resulting in extra costs in addition to the funding costs for required IM and VM collateral; or 2) post cash or other collateral available on the same day such as US Treasuries, which would be available at a later time in the day, due to the time difference.

The same issue was recently recognised by the HKMA consultation (released on December 4, 2015)<sup>3</sup> which proposes that:

- Margin should be called at the earliest time possible after the trade date (for VM) or after either execution of a transaction or a set of predefined events (for IM) but no later than the end of the following Hong Kong business day (øT+1ö);
- Margin should be collected within the standard settlement cycle for the relevant collateral type but no later than two Hong Kong business days after margin has been called (øT+2ö).
- In total, the longest time an authorised institution (AI) would have available for the collection of margin is three Hong Kong business days (øT+3ö).

If unresolved, the situation outlined above would create a number of problems. Pre-funding will result in extra costs, and will be against the overall principle to refine the IM models. Posting cash or other collateral narrows the choice of collateral products or currencies. The use of the Japanese Yen (JPY) will not be possible, in most cases, under ESAø regulatory technical standards (RTS) for IM and U.S. Prudential Regulatorø rule (T+1 settlement), because of time zone differences (the JPY market is closed by the time the EU/US party makes a margin call). The 8% FX haircut will also become applicable as it is likely that an Asian party would have to post US Treasuries temporarily, even though its home currency would serve as its termination currency. We are concerned that these issues would be caused solely by settlement timing requirements and will be specific only to parties in certain locations i.e. mainly in the Asia-Pacific region.

### **The availability of local custodian services**

Some custodians plan to offer an automated collateral allocation service, which is a potential solution to shortening the settlement cycle. But given the limited number of custodians currently offering such a

<sup>1</sup> Please refer to Appendix A for a survey of current allocation of collateral posted/held in Japan.

<sup>2</sup> TD+2 is the current standard settlement cycle for a cash JGB transaction. Please refer to Appendix B for a typical example of a cross border settlement process.

<sup>3</sup> HKMA Consultation paper | CP 15.02 December 2015 øDerivatives Transactions ø Margin and Other Risk Mitigation Standardsö, Page 10

service, a shorter settlement cycle will narrow down the options for custodian selection. This could potentially lead to a concern about credit and the concentration risk amongst custodians. We therefore believe this service should not be a required factor to comply with the regulations. Regulations rather should be based on more traditional custody service models. Within Japan this would allow for the Japanese local trust bank scheme. Because no one service can offer a comprehensive solution for the range of products, locations or regulations, the regulations should therefore permit a wider scope of solutions. To do so would contribute to the long-term benefit of global markets.

The automated collateral allocation service also includes some unresolved issues and challenges.

- Cash is generally not acceptable as part of the asset pool for such service. While cash can be an important option to cover required margin within a short settlement cycle, it will also most likely require additional processing when it is posted as well as being re-invested afterwards.
- JGBs need to be managed separately under segregated accounts (e.g. when JGBs and US Treasuries are posted). The allocation needs to be calculated and instructed separately instead of simply providing a net required IM value. As a result of this allocation processing will not be fully automated but will require additional processing and instructions.

### **Operational challenges**

The industry in Japan, like other countries, faces major challenges in implementing the new operational processes required for the new regime. But this is being compounded in Japan by the challenges outlined above and unique to the Asian region.

- Regulatory differences have drastically been reduced because of some helpful harmonization measures. But there remain some key differences which increase the number of control and monitoring processes that need to be included to the operational workflow.
- As all the national rules are not yet finalised, the time remaining for preparation to firms' systems is limited. We need to be aware that because of the additional issues being dealt with by Japanese market players, the processes may not be as robust as they might be from the outset and could increase the likelihood of risks materialising.

The proposed T+1 settlement cycle and the associated margin rules pose the most significant operational challenge. The increase of IM and VM flows is expected to be substantial with current volumes at least tripling<sup>4</sup>. This timing presents a host of operational challenges and one misstep could have a cascading effect given the short timescale and could significantly increase the operational risks to a firm in Japan (and of course in other jurisdictions).

### **Conclusion**

We recognise that a shorter settlement cycle would be the ideal outcome. But the framework needs to acknowledge immovable time zone differences; the impact on collateral; funding costs and markets; the current state of the infrastructure; and the impact on the wider Japanese and Asian economies.<sup>5</sup>

In light of all the challenges, issues and uncertainties outlined above, a T+1 settlement cycle would add significant operational challenges, and in case of cross border business, a T+2 settlement cycle could only work if the ideal circumstances were in place which we think unlikely.<sup>6</sup>

<sup>4</sup> Please refer to Appendix C for a typical margin call workflow.

<sup>5</sup> The project to change the standard settlement cycle of JGBs from TD+2 to TD+1 has begun, targeting its implementation in 2018, and the plan is then to continue to improve the market infrastructure.

<sup>6</sup> This has also been proposed by the Japanese Bankers Association in response to the second consultation paper "*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*" issued by the European Supervisory Authorities. Please refer to the link below for the letter, "Comments on Second Consultation Paper" sent by the JBA.  
<http://www.zenginkyo.or.jp/fileadmin/res/abstract/opinion/opinion270740.pdf>

If you have any questions or queries about any of the above we would be pleased to answer them.

Yours sincerely,



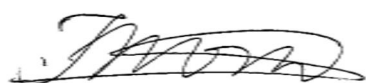
Jonathan B. Kindred

**Co-chairs of the Japan Financial Markets Council**

Contact for JFMC: Paul Hunter, [paul.hunter@ibajapan.org](mailto:paul.hunter@ibajapan.org) +81 (0)3-6205-7531



Shigesuke Kashiwagi



Tomoko Morita

Senior Director and Head of Tokyo Office

**International Swaps and Derivatives Association, Inc. (ISDA)**

[tmorita@isda.org](mailto:tmorita@isda.org), + 81 (0)3-5200-3301

## Appendix A: ISDA Margin Survey (Tokyo) – end of 2014

### Actual Collateral Movement (Delivered) (unit:0.1bil/oku)

Collateral Assets		Independent Amount	%	Variation Margin	%	Collateral (Delivered)	%
Cash	USD	5,344	95.98%	6,067	13.41%	12,351	15.11%
	JPY	224	4.02%	26,142	57.79%	50,844	62.18%
	EUR/GBP	0	0.00%	9	0.02%	8.6	0.01%
	<b>Sub total</b>	<b>5,568</b>	<b>100.00%</b>	<b>32,218</b>	<b>71.22%</b>	<b>63,204</b>	<b>77.30%</b>
Bond	US Treasury	0	0.00%	70	0.15%	1,194	1.46%
	Agency bond	0	0.00%	0	0.00%	0	0.00%
	JGB	0	0.00%	12,950	28.63%	17,304	21.16%
	Corporate bond	0	0.00%	0	0.00%	0	0.00%
	<b>Sub total</b>	<b>0</b>	<b>0.00%</b>	<b>13,020</b>	<b>28.78%</b>	<b>18,498</b>	<b>22.62%</b>
Equity		0	0.00%	0	0.00%	0	0.00%
	<b>Sub total</b>	<b>0</b>	<b>0.00%</b>	<b>0</b>	<b>0.00%</b>	<b>0</b>	<b>0.00%</b>
Others		0	0.00%	0	0.00%	63	0.08%
	<b>Sub total</b>	<b>0</b>	<b>0.00%</b>	<b>0</b>	<b>0.00%</b>	<b>63</b>	<b>0.08%</b>
<b>Total</b>		<b>5,568</b>	<b>100.00%</b>	<b>45,237</b>	<b>100.00%</b>	<b>81,765</b>	<b>100.00%</b>

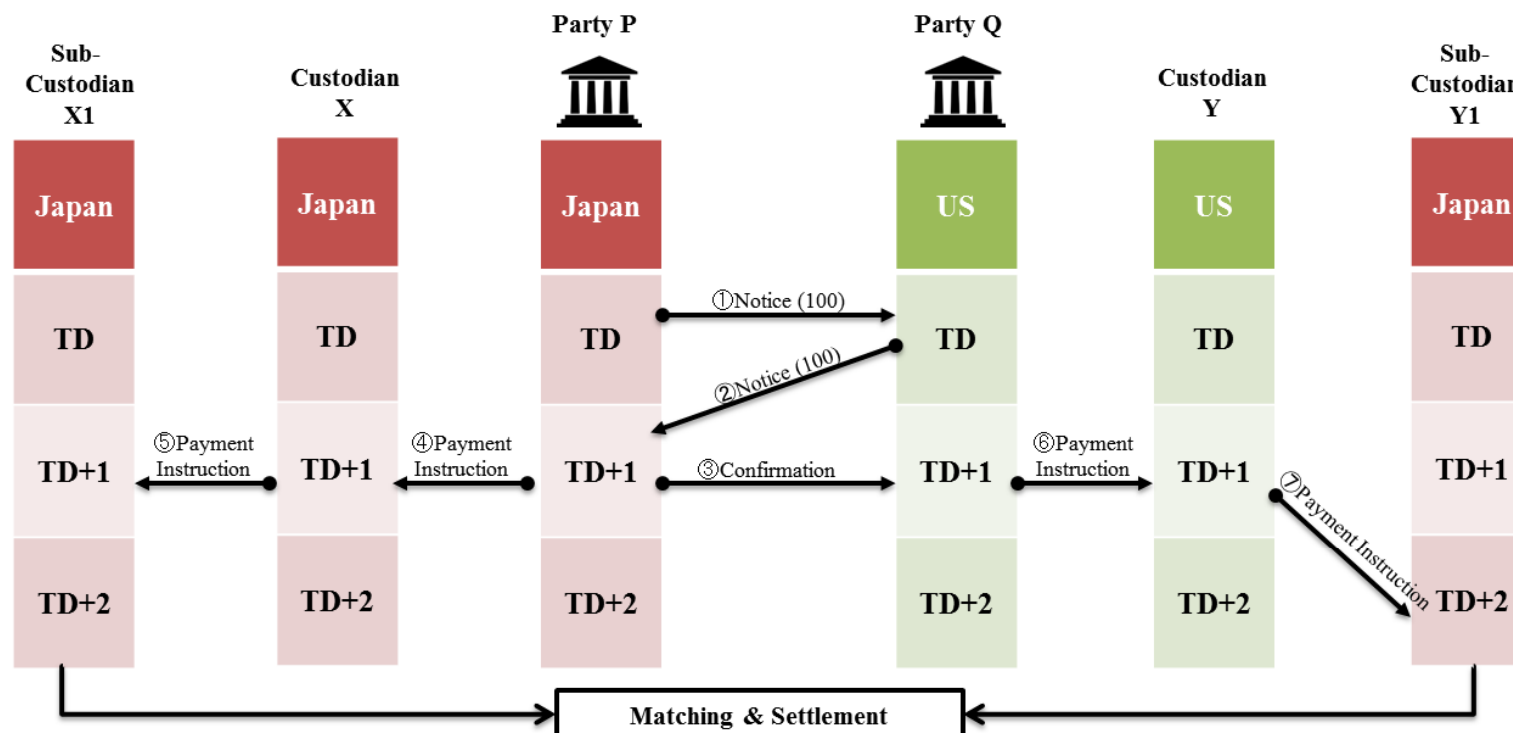
\*Totals may not sum up to 100% as some parties only provided their Collateral (Delivered) amounts. Therefore, sum of Independent Amount and Variation Margin does not equal to Collateral (Delivered).

### Actual Collateral Movement (Received) (unit:0.1bil/oku)

Collateral Assets		Independent Amount	%	Variation Margin	%	Collateral (Received)	%
Cash	USD	12	0.62%	6,067	18.73%	7,190	12.52%
	JPY	49	2.51%	26,142	30.96%	20,574	35.83%
	EUR/GBP	0.03	0.00%	9	0.18%	39.0	0.10%
	<b>Sub total</b>	<b>61</b>	<b>3.13%</b>	<b>32,218</b>	<b>49.87%</b>	<b>27,822</b>	<b>48.46%</b>
Bond	US Treasury	4	0.23%	70	0.70%	311	0.54%
	Agency bond	0	0.00%	0	0.00%	1	0.00%
	JGB	87	4.48%	12,950	40.37%	24,376	42.45%
	Corporate bond	806	41.34%	0	6.04%	2,829	4.93%
	<b>Sub total</b>	<b>898</b>	<b>46.05%</b>	<b>13,020</b>	<b>47.12%</b>	<b>27,517</b>	<b>47.92%</b>
Equity		242	12.39%	0	1.59%	862	1.50%
	<b>Sub total</b>	<b>242</b>	<b>12.39%</b>	<b>0</b>	<b>1.59%</b>	<b>862</b>	<b>1.50%</b>
Others		749	38.42%	0	1.42%	1,216	2.12%
	<b>Sub total</b>	<b>749</b>	<b>38.42%</b>	<b>0</b>	<b>1.42%</b>	<b>1,216</b>	<b>2.12%</b>
<b>Total</b>		<b>1,949</b>	<b>100.00%</b>	<b>45,237</b>	<b>100.00%</b>	<b>57,418</b>	<b>100.00%</b>

\*Totals may not sum up to 100% as some parties only provided their Collateral (Received) amounts. Therefore, sum of Independent Amount and Variation Margin does not equal to Collateral (Received).

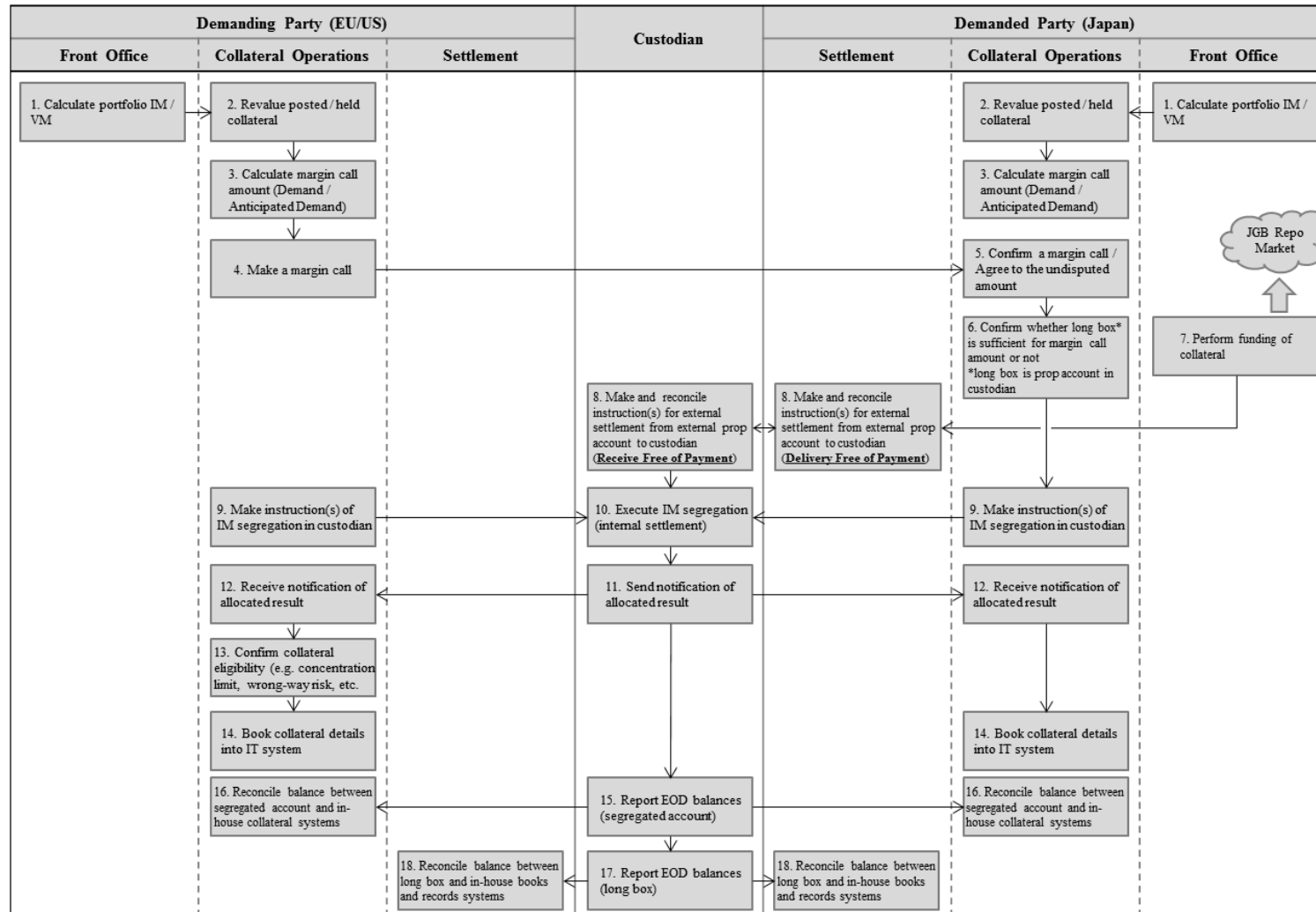
**Appendix B: A typical example of a cross border settlement process (cash JGB transaction)**



- ① Notice of Transaction from Party P located in Japan to Party Q located in U.S.
- ② Notice of Transaction from Q to P
- ③ Confirmation of Transaction from P to Q
- ④ Payment Instruction from P to P's Custodian X located in Japan
- ⑤ Payment Instruction from X to X's Sub-Custodian X1 located in Japan
- ⑥ Payment Instruction from Q to Q's Custodian Y located in U.S.
- ⑦ Payment Instruction from Y to Y's Sub-Custodian Y1 located in Japan

Note: In case payment instructions are unmatched, the settlement shall be delayed by one more day.

## Appendix C: Sample Margin Call Workflow



This sample workflow is assuming integration with an automated collateral allocation service.

In case of straight / classic custody, additional communication with the counterparty is required for confirming collateral details.