

# Update on Japanese Margin Requirements for Non-Centrally Cleared Derivatives

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## Japanese regulator issued 2<sup>nd</sup> consultative documents on margin requirements

### What are the key changes?

On 11 December 2015, Financial Services Agency (FSA) as Japanese financial regulator released the 2<sup>nd</sup> consultative documents on margin requirements for non-centrally cleared derivatives with one month comment period.

New margin requirements are expected to come into force in **September, 2016** with phased-in arrangements which are in accordance with BCBS/IOSCO announcement on March, 2015.

### Closing gaps among peers albeit partially

Comparing to the first proposal published on July 2014 which was very much in line with BCBS/IOSCO final report published on September, 2013, this second proposal has modified some parts of requirements which were different from jurisdictions such as US and EU.

The modifications contain “**exchange**” approach on margin instead of collection-only, **no FX haircut** to currency mismatch on cash collateral for variation margin, combined calculation with initial and variation margin for **minimum transfer amount** when there is still difference in treatment between jurisdictions for instance in the case of a trade with counterparties in the jurisdiction having **insufficient legally netting arrangement**.

In other words, the modifications include both eased areas such as the FX haircut and strengthened areas such as the exchange of margin.

Meanwhile, in a case of cross-border transaction, we still see some uncertainty that needs to be addressed.

### Who should pay attention to this regulation?

This report should be of interest to the following parties;



**Financial entities in Japan** whose notional amount of OTC derivative have exceeded ¥300 billion (covered entities) and wish the counterparty to understand Japan’s rules



**Global financial entities** that have or plan to have bilateral derivative transactions with Japanese financial entities (includes Japan branch)



**Professionals** who seek understanding of margin requirements in Japan

### Overview

Compared with the first proposal, we believe the new proposal contains the following key changes.

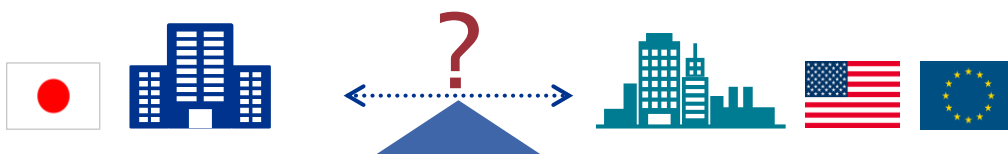
- (1) “**exchange**” (i.e. collect and post ) requirement from collect only
- (2) Eased FX haircut on cash collateral for variation margin
- (3) Combined calculation of minimum transfer amount on IM and VM
- (4) new exception in cross-border transactions regarding netting rule

## Key changes at a glance

The below table summarizes key changes made in the new proposal. As shown, most changes are to align with requirements in other countries though some still see differences.

	Japan 2 <sup>nd</sup> Consultation Paper		US Final by Prudential Regulators	EU 2 <sup>nd</sup> Consultation Paper
Margin Posting	Old	Collection of margin is required	Exchange of margin is required	Exchange of margin is required
	New	Exchange of margin is required		
FX Haircut	Old	FX haircut (8%) applies even to cash collateral	FX haircut (8%) to currency mismatch does not apply to a certain cash collateral for VM	FX haircut (8%) to currency mismatch applies even to cash collateral
	New	A certain cash collateral for VM is exempted from FX haircut		
MTA	Old	Calculate the amount respectively for IM and VM	Combined amount of IM and VM	Combined amount of IM and VM
	New	Combined amount of IM and VM		
Effective Netting	Old	No special treatment on a trade under insufficient netting rules	Require to collect margin on a gross basis	Alternative process to post collateral
	New	Transactions with counterparties in a jurisdiction lacking effective netting arrangement are exempted		

## Do you understand the rules properly that your counterparty is subject to?



### Factors leading to uncertainty

Different scope of products	No or late mandatory clearing	Different scope of entities	No legally effective netting arrangement
Different eligible collateral assets	No qualified CCPs	Insufficient equivalency assessment	Different treatment of inter-affiliate trades
Different quantitative model for IM	Concentration limits on collateral assets	Difficult to resolve dispute	

Despite of these modifications in second proposal, there are still factors as the above to lead uncertainty in cross-border transactions. The first step to address the uncertainty is to understand the rules that your counterparty is subject to. Global financial institutions who have trades with Japanese entity must **take actions now** to analyze, prepare, and respond to the impact of this regulation through the understanding.

## Which counterparty in Japan will ask you to post margin under Japan's rules?

The following two tables show (1) the latest list of covered entities on the mandatory clearing in Japan which will be same in the legal margin requirements and (2) the articles regarding cross-border transactions in the requirement. The entity in the list will ask foreign entity to

post margin under the requirements based on the assessment whether their counterparty fall in the scope of the covered entity if they are established in Japan, while all financial entities in Japan will be required to exchange VM appropriately based on the supervisory guidance.

### List of covered entities as of the end of June 2015 (published by FSA)

Aozora Bank	Shinsei Bank	Nippon Life Insurance Company	Mizuho Securities
Iyo Bank	Standard Chartered Bank	Nourinchukin Bank	Mizuho Trust & Banking
SMBC Nikko Securities	Sumishin Net Bank	Nomura Securities	Mitsui Sumitomo Insurance Company
Ogaki Kyoritsu Bank	Sumitomo Life Insurance Company	Barclays Bank	Sumitomo Mitsui Banking
Australia and New Zealand Banking Group Limited	Sony Bank	Hachijuni Bank	Sumitomo Mitsui Trust Bank
Kansai Urban Banking Corporation	Dai-ichi Life Insurance Company	Bank of America, N.A.	Bank of Tokyo Mitsubishi UFJ
Credit Agricole Bank	Daishi Bank	BNP Paribas Tokyo Branch	Mitsubishi UFJ Trust and Banking Corporation
Credit Suisse Securities	Daiwa Securities	Higo Bank	Mitsubishi UFJ Morgan Stanley Securities
Goldman Sachs	Chiba Bank	Hyakugo Bank	Meiji Yasuda Life Insurance Company
Saitama Resona Bank	Chugoku Bank	Hyakujushi Bank	Met Life
JP Morgan Securities	Deutsche Bank Tokyo Branch	Hiroshima Bank	Merrill Lynch Japan Securities
JP Morgan Chase Bank N.A.	Deutsche Securities	Bank of Fukuoka	Morgan Stanley MUFG
Shizuoka Bank	Tokai Tokyo Securities	Fukoku Mutual Life Insurance Company	Yamaguchi Bank
Citigroup Global Markets	Tokio Marine & Nichido Fire Insurance	North Pacific Bank	Japan Post bank
Citibank	Tokyo Star Bank	Hokuriku Bank	UBS AG Tokyo Branch
Juroku Bank	Tokyo Tomin Bank	Hokkaido Bank	Bank of Yokohama
Shoko Chukin Bank	Nanto Bank	Hongkong and Shanghai Banking Corporation Tokyo Branch	Resona Bank
Joyo Bank	Nishi-Nippon City Bank	Mie Bank	Royal Bank of Scotland Tokyo Branch
Shinkin Central Bank	Development Bank of Japan	Mizuho Bank	

### Articles regarding Cross-Border Transaction (excerpt from the FSA regulation)

Article 123(10) The provision of Article 123(1)(xxi-v) shall not apply to transactions falling under any of the following items at the day of execution.

- (i) A transaction where either of the counterparties is not Financial Instruments Business Operators except for those who meets the following conditions.
  - (a) An entity who conducts OTC derivatives business in foreign country where an effectiveness of close-out netting or equivalent mechanism is appropriately verified in accordance with the legal framework other than foreign government, foreign central bank, multilateral development banks and Bank for International Settlement ("Foreign Governments")
  - (b) An entity whose aggregated notional amount of OTC derivatives is deemed to exceed 300 billion yen which is calculated on average at the end of every month from April of two years before to March of preceding year, if the day of execution is in December, April of the preceding years and March of the year at the day of execution, based on the consideration on the transaction activities and other related circumstances with the counterparty.

※The above translated articles are prepared by KPMG for your reference.

## Proposals from other jurisdictions such as Singapore, Switzerland, Canada, Hong Kong...

Unlike traditional banking regulation (e.g. Basel rules), financial entities must understand not only rules they are subject to but also **other rules their counterparties are subject to** in order to seek a trade that has the most benefit. We believe, therefore, the financial institutions must take professional advices in the areas such as on the right, in order to facilitate your understanding in the most efficient and effective way possible.

Enhance trade capture systems

Revise counterparty setup/client on-boarding process

Set up system/ process for margin calculations

Enhance collateral management

Prepare for segregation of initial margin amounts

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KPMG Japan has an extensive background in providing regulatory advisory and financial risk management consulting services to the major financial institutions. We are able to help clients assess the impact of the new margin requirement on their operations, business and risks and advise on the implementation of new processes and controls.

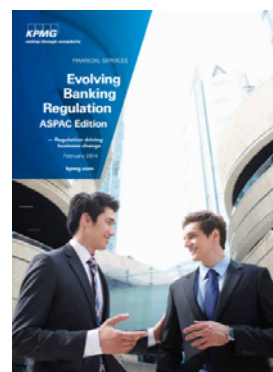
We also have in-depth specialization is:

- ✓ Advising clients on the impact of regulatory reforms including mandatory clearing and new margin requirements
- ✓ Performing independent reviews over risk management and operations related internal controls, models, processes and systems
- ✓ Supporting clients in their implementation of new processes and system for the measurements and management of market risk, credit risk, operational risk and the valuation of complex derivatives
- ✓ Supporting clients with applications to regulators for new licenses and approvals

If you would like to arrange a discussion, please contact one of our KPMG Regulatory Centre of Excellence of Financial Risk Management Consulting team members or your regular KPMG contact.

## Financial Services Thought Leadership

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