# Japan publishes final regulations on margin requirements for non-centrally cleared OTC derivatives

On 31 March 2016, the Financial Services Agency of Japan (the "JFSA") finalised a set of regulations on margin requirements for non-centrally cleared OTC derivatives together with its responses to public comments. The margin requirements will be phased in from 1 September 2016. This briefing provides an overview of the final margin requirements and the JSFA's responses to public comments.

## Background

In response to the first Policy Framework on margin requirements published by BCBS-IOSCO on 2 September 2013 (the "**BCBS-IOSCO report**"), the JFSA released a first consultation draft on the margin requirements on 3 July 2014, (the "**First Consultation Draft**"). The margin requirements were expected to take effect on 1 December 2015, but the implementation date was delayed to 1 September 2016 due to the amendment to the BCBS-IOSCO report.

On 11 December 2015, the JFSA released a second consultation draft (the "**Second Consultation Draft**") and its responses to the public comments on the First Consultation Draft. On 31 March 2016, the JFSA published a set of final regulations on margin requirements (including the Cabinet Office Ordinance, the JSFA's Public Notices and the Supervisory Guidelines for Financial Institutions of the JFSA) and its responses to the public comments on the Second Consultation Draft.

## Covered Entities

The following entities with exposures above the *de minimis* threshold set out below (collectively, the "**Covered Entities**") are required to collect and post variation margin ("**VM**") and initial margin ("**IM**") in accordance with the Cabinet Office Ordinance:

(i) Type 1 Financial Instruments Business Operators ("**Type 1 FIBOs**") (these are typically securities houses licensed in Japan to deal in Type 1 securities); and

(ii) Banks, insurance companies, Shoko Chukin Bank, Development Bank of Japan, Shinkin Central Bank and the Norinchukin Bank, which are Registered Financial Institutions ("**RFIs**").

### ■ *De minimis* threshold for VM

The *de minimis* threshold for VM is an average aggregate outstanding notional amount[1] of OTC derivatives (which are subject to mandatory clearing or reporting and excluding transactions booked in trust accounts) of JPY300 billion or more.

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1 An average aggregate outstanding notional amount is calculated as of the end of each of the following months:
- from April of the second preceding year to March of the first preceding year if the calculation is required in January to November; or
- from April of the first preceding year to March of the year if the calculation is required in December.

### *De minimis* threshold for IM

The *de minimis* threshold for IM is higher than the one for VM given the complexity of the IM requirements and their impact on market liquidity. The threshold is (i) an average aggregate outstanding notional amount[2] of OTC derivatives (which are subject to mandatory clearing or reporting and excluding transactions booked in trust accounts) of JPY300 billion or more and (ii) an average aggregate outstanding notional amount[3] of non-centrally cleared OTC derivatives, non-centrally cleared OTC commodity derivatives and physically-settled FX forward and swaps between Type 1 FIBOs, RFIs or Foreign Derivatives Dealers (as defined below) (calculated on a group basis[4]) of more than JPY1.1 trillion[5]. For this purpose, the "group" means (i) the relevant party, (ii) its Parents (*oyagaisha-tou*) and Subsidiaries (*kogaisha-tou*), and (iii) Subsidiaries of its Parents (each as defined in the Financial Instruments and Exchange Act of Japan (the "**FIEA**")).

While Type 1 FIBOs and RFIs with exposures below the *de minimis* threshold are not subject to the VM and IM requirement under the Cabinet Office Ordinance, the Supervisory Guidelines for Financial Institutions of the JFSA still require such entities to establish internal systems which appropriately manage VM (not IM) taking into account the BCBS-IOSCO report and the Cabinet Office Ordinance.

## In-Scope Products

The margin requirements apply to all non-centrally cleared OTC derivatives except that the IM requirements do not apply to the exchange of principal under cross-currency swaps. Since physically-settled FX forwards and swaps as well as OTC commodity derivatives do not fall within the definition of the OTC derivatives under the FIEA, the VM and IM requirements do not apply to such derivatives transactions.

However, Covered Entities may include any of the following out-of-scope products for the purpose of calculating IM and VM provided that such inclusion is made on a continuous basis so as to avoid arbitrary inclusion:

(i) non-centrally cleared OTC commodity derivatives;

(ii) physically-settled FX forwards and swaps;

(iii) exempted non-centrally cleared OTC derivatives;

(iv) trades within the same netting set under a master netting agreement; and

(v) in respect of IM, the exchange of principal under currency swaps.

Further, although the VM and IM requirements do not apply to transactions entered into before the applicable compliance dates set out in the phase-in timetable below ("**Legacy Trades**"), Covered Entities may include Legacy Trades of in-scope products, and the trades of the above out-of-scope products entered into before 1 September 2016 for the purpose of calculating IM and VM provided that such inclusion is made on a continuous basis so as to avoid arbitrary inclusion. Covered Entities may treat each of their counterparties and include different trades for the purpose of calculating IM and VM in respect of each counterparty.[6]

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2 See footnote 1.
3 An average aggregate outstanding notional amount is calculated as of the end of each of the following months:
- from March to May of the first preceding year if the calculation is required in January to August; or
- from March to May of the year if the calculation is required in September to December.

4 Excluding notional amount of transactions within such group.
5 This threshold amount is subject to the phase-in timetable (see Implementation Schedule below).
6 JFSA's response to public comments on 31 March 2016.

# Exempted Transaction

There are several exemptions from the margin requirements including the following:

## 1. Counterparty Exemptions

If the counterparty is not (a) a Covered Entity or (b) an entity which conducts derivatives as business in a foreign country (a "**Foreign Derivatives Dealer**") with exposure above the *de minimis* threshold, the margin requirements will not apply.

### *Foreign Derivatives Dealers*

To determine whether a counterparty is in scope, a Covered Entity may rely on representations from the Foreign Derivatives Dealer to determine whether the exposure of the Foreign Derivatives Dealer is above the *de minimis* threshold or not (unless there are other factors to the contrary that are reasonably available to the Covered Entity)[7].

#### ■ *De minimis* threshold for VM in respect of a Foreign Derivatives Dealer

The *de minimis* threshold for VM in respect of a Foreign Derivatives Dealer is an average aggregate outstanding notional amount[8] of OTC derivatives of JPY300 billion or more.

#### ■ *De minimis* threshold for IM in respect of a Foreign Derivatives Dealer

The *de minimis* threshold for IM in respect of a Foreign Derivatives Dealer is (i) an average aggregate outstanding notional amount[9] of OTC derivatives of JPY300 billion or more and (ii) an average aggregate outstanding notional amount[10] of non-centrally cleared OTC derivatives, non-centrally cleared OTC commodity derivatives and physically-settled FX forward and swaps between Type 1 FIBOs, RFIs or Foreign Derivatives Dealers (calculated on a group basis[11]) of more than JPY1.1 trillion[12]. Notwithstanding the meaning of the "group" above, a Covered Entity may include in this calculation any entities which are treated as group companies under the laws of the jurisdiction of the Foreign Derivatives Dealer.[13]

### *Excluded Foreign Counterparties*

The margin requirements will not apply to transactions with the following foreign entities because such entities are expressly excluded from the definition of Foreign Derivatives Dealer:

(i) counterparties located in a foreign country where agreements on close-out netting and similar agreements are not recognised as valid in light of the laws and regulation of that foreign country (although still subject to the appropriate risk management standard under the Supervisory Guidelines for Financial Institutions of the JFSA); and

(ii) foreign governments, central banks of foreign states, multilateral development banks and the Bank for International Settlements.

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7 JFSA's response to public comments on 11 December 2015.
8 See as footnote 1.
9 See as footnote 1.
10 See as footnote 3.
11 Excluding notional amount of transactions within such group.
12 This threshold amount is subject to the phase-in timetable (see Implementation Schedule below).
13 JFSA's response to public comments on 31 March 2016.

## 2. Trust Account Exemption

If the transaction is booked in a trust account and relates to trust property with an average aggregate outstanding notional amount[14] of OTC derivatives (which are subject to mandatory clearing or reporting) of less than JPY300 billion (in relation to the IM requirement, there is an additional threshold of JPY1.1 trillion[15]), the margin requirements do not apply to such transaction.

## 3. Intragroup Transactions Exemption

The VM and IM margin requirements do not apply to intragroup transactions. For this purpose, the group means (i) the relevant party, (ii) its Parents (*oyagaisha-tou*) and Subsidiaries (*kogaisha-tou*) and (iii) the Subsidiaries of its Parents (each as defined in the FIEA).

## 4. Equivalent Compliance Exemption

If the counterparty is subject to margin requirements in a foreign jurisdiction (to be specified in the JSFA's Notice) which are equivalent to those of Japan, the Covered Entity will be exempt from the Japanese margin requirements by complying with the margin requirements of such foreign jurisdiction. As of 22 April 2016, the JSFA has not issued its Notice on which jurisdictions will be deemed to have margin requirements equivalent to Japanese margin requirements and discussions are still under way in co-operation with the relevant foreign regulators.

# Regulations on Variation Margin

VM is defined as a margin transferred by loan or deposit (the "**Deposit**") to the counterparty corresponding to the mark-to-market exposure of the non-centrally cleared OTC derivatives. Set out below are the key features of the regulations on VM:

## ■ Timing of calculation and collection

VM must be calculated on a daily basis and be collected or posted "without delay" after each margin call (ie, as soon as practically possible[16]). To prevent disputes in relation to the margin call amount, the amount of VM must be an amount calculated based on a pre-agreed method.

## ■ Minimum Transfer Amount

The parties may agree bilaterally to introduce a minimum transfer amount for VM and IM provided that such amount does not exceed JPY70 million. A minimum transfer amount does not have to be allocated separately for VM and IM and can be one total amount used for both VM and IM.[17] A minimum transfer amount may be denominated in a foreign currency.[18]

## ■ Re-hypothecation and re-use of VM

There is no restriction on re-hypothecation or re-use of VM as opposed to IM.

## ■ Outsourcing of VM calculation

The calculation of VM can be outsourced but the Covered Entity must establish and maintain internal systems to check the exposure calculated by the third party.[19]

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14 See as footnote 1.
15 This threshold amount is also subject to the phase-in timetable (see Implementation Schedule below).
16 JFSA's response to public comments on 11 December 2015.
17 JFSA's response to public comments on 31 March 2016.
18 JFSA's response to public comments on 11 December 2015.
19 JFSA's response to public comments on 31 March 2016.

# Regulations on Initial Margin

IM is defined as a margin transferred by a Deposit that corresponds to a reasonable estimate amount of expenses or losses that might arise in the future with respect to non-centrally cleared OTC derivatives (the "**Potential Loss Estimate Amount**").

## 1. Calculation and methodologies

The amount of IM to be collected or posted by a Covered Entity is calculated based on the following formula:

**IM = Potential Loss Estimate Amount – Margin collected from the counterparty – IM Threshold***

* The parties may agree bilaterally to introduce an IM threshold not exceeding JPY 7 billion on a group basis.

For the purpose of calculating the Potential Loss Estimate Amount, a Covered Entity may select (i) the Standardized Model or (ii) a Quantitative Model, each as described below:

### (i) Standardized Model

The Potential Loss Estimate Amount for the Standardized Model is calculated by the following formula on a master netting agreement basis:

**Potential Loss Estimate Amount = 0.4×Gross IM+0.6×Net-to-Gross Ratio (NGR*) × Gross IM**

* NGR = Net Replacement Cost / Gross Replacement Cost (If Gross Replacement Cost is zero, NGR equals to 1).

The Gross IM is the amount of the notional principal amount multiplied by the following ratio:

| Type of derivatives | Residual Period | Initial margin requirement (% of notional exposure) |
|---|---|---|
| Credit derivatives | 2 years or less | 2% |
| | More than 2 years and 5 years or less | 5% |
| | More than 5 years | 10% |
| Commodity derivatives | | 15% |
| Equity derivatives | | 15% |
| FX derivatives | | 6% |
| Interest rate derivatives | 2 years or less | 1% |
| | More than 2 years and 5 years or less | 2% |
| | More than 5 years | 4% |
| Other derivatives | | 15% |

### (ii) Quantitative Model

Where the Quantitative Model is used, the model must meet certain standards and the Covered Entity must establish and maintain a certain level of internal governance. In addition, the Quantitative Model must be notified in advance to the Commissioner of the JFSA.

## 2. Treatment of IM

The key features of the regulations on IM are as follows:

### Timing of calculation and collection

IM must be calculated upon the occurrence of any of the following events and be collected or posted "without delay" after each margin call on a gross basis (ie, as soon as practically possible[20]):

(i) entry into, termination or amendment of a non-centrally cleared OTC derivatives transaction;

(ii) one month has passed since IM is calculated last time; or

(iii) where it is deemed necessary to require IM due to market fluctuations or other reasons.

### Minimum Transfer Amount

The parties may agree bilaterally to introduce a minimum transfer amount for VM and IM provided that such amount does not exceed JPY70 million.

### Re-hypothecation and re-use of IM

Re-hypothecation, re-pledging and re-use of IM are prohibited, provided, however, cash can be re-used if it is conducted as a part of its management in a safe manner.

### Methods for holding IM

IM must be held in a trust or other similar structure to ensure that (i) it will immediately be available to the collecting party in the event of the counterparty's default and (ii) the posted collateral will be returned to the posting party in the event that the collecting party enters bankruptcy.

### Outsourcing of IM calculation

The calculation of IM can be outsourced but the Covered Entity must establish and maintain internal systems to check the exposure calculated by the third party.[21]

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20 JFSA's response to public comments on 11 December 2015.
21 JFSA's response to public comments on 31 March 2016.

# Eligible collateral and haircuts

The following assets listed in the table below can be posted as IM and VM after the application of the haircuts specified below:

| Asset Class* | Class of credit risk** | Residual Period | Haircut (% of market value) |
|---|---|---|---|
| Cash | | | 0% |
| Equities included in major stock indices | | | 15% |
| Government and central bank debt | 1-1 or the case which falls under Article 89, Item 3 of Bank Capital Adequacy Notice | 1 year or less | 0.5% |
| | | More than 1 year and 5 years or less | 2% |
| | | More than 5 years | 4% |
| | 1-2 or 1-3 | 1 year or less | 1% |
| | | More than 1 year and 5 years or less | 3% |
| | | More than 5 years | 6% |
| | 1-4 | | 15% |
| Corporate bonds | 2-1, 4-1 or 5-1 | 1 year or less | 1% |
| | | More than 1 year and 5 years or less | 4% |
| | | More than 5 years | 8% |
| | 2-2, 4-2, 4-3, 5-2 or 5-3 | 1 year or less | 2% |
| | | More than 1 year and 5 years or less | 6% |
| | | More than 5 years | 12% |
| Investment trust (including foreign investment trusts) | | | The highest of the ratios in this column applicable to investment targets |

* Gold is not treated as eligible collateral because the collateral permitted under the Netting Act of Japan is limited to the cash or securities.

** The reference number indicates the class of credit risk for securities with a credit rating assigned by eligible credit rating firms under the Bank Capital Adequacy Notice (JSFA Notice No.19 of 2006, as amended).

### FX haircut

If the currency of the collateral asset is not the same as a currency specified in respect of the transactions, an additional 8% haircut will be applied, provided, however, that such haircut will not apply to cash VM. Each party to the trade can specify a currency for each transaction for the purpose of the FX haircut, and each party is permitted to specify a different currency for IM and VM.[22]

### Concentration limit

The Supervisory Guidelines for Financial Institutions of the JFSA require that the collateral assets should be appropriately diversified (for example, illiquid securities should be used within the certain level of concentration limit).

## Implementation Schedule

Margin requirements will apply in phases from 1 September 2016 depending on the size of the party's average aggregate notional amount of non-centrally cleared OTC derivatives on a group basis as set out in the table below:

<table>
<tr><th rowspan="2">Phase-in timetable</th><th>VM</th><th>IM</th></tr>
<tr><th colspan="2">Average aggregate notional amount of uncleared OTC derivatives on a group basis</th></tr>
<tr><td>1 September 2016</td><td>More than JPY420 trillion</td><td rowspan="2">More than JPY420 trillion</td></tr>
<tr><td>1 March 2017</td><td rowspan="5">No threshold</td></tr>
<tr><td>1 September 2017</td><td>More than JPY315 trillion</td></tr>
<tr><td>1 September 2018</td><td>More than JPY210 trillion</td></tr>
<tr><td>1 September 2019</td><td>More than JPY105 trillion</td></tr>
<tr><td>1 September 2020</td><td>More than JPY1.1 trillion</td></tr>
</table>

## Conclusion and going forward

The final Japan margin regulations are in most respects in harmony with the US and EU rules. Some differences remain, such as timing of collection of margin, method of segregation of IM and comparability determination for purposes of substituted compliance. These, together with the documentation impact of the regulations and the challenges of implementation, will no doubt continue to be the focus of discussions and developments over the next few months as September 2016 approaches.

*Where Japanese legal concepts have been expressed in the English language, the concepts concerned may not be identical to the concepts described by the equivalent English terminology as they may be interpreted under the laws of other jurisdictions.*

22 JFSA's response to public comments on 31 March 2016.

# Contacts

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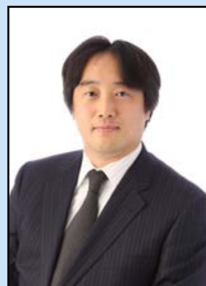

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