EMEAP

Executives' Meeting of East Asia-Pacific Central Banks

31 August 2016

Mr. Thomas J. Curry
Comptroller of the Currency
Department of the Treasury
Office of the Comptroller of the Currency

Mr. Daniel K. Tarullo
Governor
Board of Governors of the Federal Reserve System

Mr. Martin J. Gruenberg
Chairman
Federal Deposit Insurance Corporation

Mr. Kenneth A. Spearman
Chairman
Farm Credit Administration

Mr. Melvin L. Watt
Director
Federal Housing Finance Agency

Ms. Mary Jo White
Chair
U.S. Securities and Exchange Commission

Mr. Timothy G. Massad
Chairman
U.S. Commodity Futures Trading Commission

Subject: US T+1 Margin Settlement Requirement

Dear Sirs/Madam:

I am writing on behalf of the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP) which comprises central banks and monetary authorities from 11 jurisdictions in Asia and the Western Pacific, namely: Australia, China, Hong Kong SAR, Indonesia, Japan, Korea, Malaysia, New Zealand, Philippines, Singapore and Thailand. Let me convey the issues identified by EMEAP on the final US margin rules for non-centrally cleared derivatives, particularly on the T+1 settlement requirement ("the Requirement").

We request your kind consideration of our concern that the Requirement might have the perverse effect of undermining financial stability among EMEAP jurisdictions. We urge US regulators to review the Requirement to ensure that its potential risks do not outweigh its incremental benefits.

We appreciate the policy intent of the Requirement to mitigate potential losses arising from counterparty defaults that may lead to contagion. However, we believe it would have an adverse impact on the financial stability considering its unintended consequences on the smooth functioning of most financial markets in the EMEAP region, as detailed below. In this context, we would like to stress the importance of taking due account of the cross-border impact of regulatory reform measures and the need for cross-border collaboration and coordination.

<u>The Requirement heightens counterparty/concentration risks and leads to market fragmentation.</u>

We are particularly concerned that the Requirement would pose higher counterparty/concentration risks and lead to market fragmentation. While an advanced tri-party collateral management system shortens the settlement cycle, and appears to be the only way in which participants can meet the Requirement, there are a limited number of custodians offering this service. Currently, only large EMEAP financial institutions have access to the needed collateral management systems. Hence, the use of automated collateral allocation service would increase interconnectedness and counterparty/concentration risks in view of the limited number of custodians to serve a large number of market participants.

Participants who are not able to access such services will not be able to meet the Requirements, and will be driven to restrict their OTC derivative activities to a smaller non-US group of counterparties resulting in fragmentation of market liquidity. This would unfavorably affect the smooth functioning of financial markets and give rise to financial stability concerns, inadvertently negating the benefits of introducing margin requirements to promote financial stability.

<u>Time-zone differences pose operational challenges.</u>

The time-zone differences between the US and EMEAP jurisdictions bring about major operational challenges. The short time period to implement the settlement process, if not supported by adequate infrastructure, may lead to delayed payments, disputes, and broadly greater operational risk. The operational burden on the smaller EMEAP participants would be disproportionately large.

The following steps need to be completed within the T+1 timeframe: (i) calculation and call of margin; (ii) agreement on the margin amount; and (iii) settlement.

The calculation of margin amounts can be done only after the close of trading in the US (all trading books globally must be closed for portfolio valuations to be completed). As a result, margin will typically be calculated and called one day after the trade date (T+1). Considering that the margin call will likely reach one party after office hours due to time zone differences, additional time is needed to agree on the margin amount. As for settlement, the period depends on the type of collateral to be posted. The standard settlement cycles in EMEAP jurisdictions typically range from T+2 up to T+5. While the use of custodians with advanced tri-party collateral management systems can shorten the settlement cycle, it requires the pre-funding of margins.

We are aware that the length of settlement period available for transactions between counterparties located in different time zones is effectively extended by how the "day of execution" is defined under US standards: (i) the day of execution (T) for a cross-border trade completed after 4pm in the time zone of either counterparty is deemed to be the following business day; and (ii) a trade executed on different calendar days in the respective time zones of both counterparties is deemed to be executed on the latter calendar day. However, we find that this mechanism is applicable only at the level of a single trade and not when a new derivative is added to a portfolio of existing trades. Given that margin is typically calculated based on a portfolio of derivatives, the amount of settlement time available for cross-border transactions may not increase in the majority of cases. Overall, there is a need to clarify what timeline would apply for margin/collateral valuation and settlement where a party located in the US trades derivatives with a counterparty in Asia.

Higher cost can discourage hedging activities

Faced with the above operational constraints, EMEAP market participants may have no option but to pre-fund margins in order to comply with the US requirement. Alternatively, they may opt to post US Treasuries and similar types of collateral held offshore and available on the same day in US time. This may mean posting collaterals denominated in foreign currencies, noting that collaterals in a currency that is different from the settlement currency would likely be subject to an additive 8% cross-currency haircut[1] when posted as initial margins. It is notable that in both instances, EMEAP parties may have to bear additional cost for pre-funding or posting readily available collaterals to comply with the US rules on margin settlement. Increased cost on the part of EMEAP parties is clearly a critical issue not only because it causes an uneven playing field but also because it becomes a barrier to engaging in derivatives.

The possible cessation of the hedging transactions with US parties by EMEAP institutions is a risk to financial stability. The resulting open exposures in the EMEAP region would be subject to market volatilities that may bring about unforeseen financial losses. To ensure that risk management activities among EMEAP firms continue to be undertaken, as they should, a longer than T+1 margin settlement requirement is needed to alleviate costs and operational burden for EMEAP institutions without undermining the general objectives of US's margin rules.

Our request

We request that a firm decision on the timeframe for compliance with the Requirement by EMEAP institutions be deferred until the issues raised in this letter are fully assessed and appropriately addressed. We look forward to working on this matter with our fellow regulators in the US.

We are sending this letter to relevant regulators in the EU as the same issues arise from the EU T+1 margin settlement requirement. Should you have any questions concerning this letter, please do not hesitate to contact the Secretariat of the EMEAP Working Group on Banking Supervision (WGBS) at [redacted].

Yours sincerely,

Mr. Agus D.W. Martowardojo
Governor of Bank Indonesia and
Chairman of the 2016 EMEAP Governors' Meeting

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[1]In line with the BCBS-IOSCO margin requirements for non-centrally cleared derivatives, the cross-currency haircut applies whenever the eligible collateral posted is denominated in a currency other than the currency of settlement.