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TO:

The Principal Chief General Manager
Department of Banking Regulation
Reserve Bank of India, Central Office
Mumbai 400 001
Via email: otcmargin@rbi.org.in

3 June, 2016

Re: Discussion Paper on Margin Requirements for non-Centrally Cleared Derivatives

Dear Principal Chief General Manager,

The Global Foreign Exchange Division (GFXD) of the Global Financial Markets Association (GFMA) welcomes the opportunity to comment on behalf of its members on the *Discussion Paper on Margin Requirements for non-Centrally Cleared Derivatives* (the Discussion Paper) issued by the Reserve Bank of India (RBI) on 2 May, 2016.

The GFXD was formed in co-operation with the Association for Financial Markets in Europe (AFME), the Securities Industry and Financial Markets Association (SIFMA) and the Asia Securities Industry and Financial Markets Association (ASIFMA). Its members comprise 24 global foreign exchange (FX) market participants,[1] collectively representing more than 90% of the foreign exchange inter-dealer market.[2] Both the GFXD and its members are committed to ensuring a robust, open and fair marketplace and welcome the opportunity for continued dialogue with global regulators.

The FX market is the world's largest financial market. Effective and efficient exchange of currencies underpins the world's entire financial system. Many of the current legislative and regulatory reforms have had, and will continue to have, a significant impact upon the operation of the global FX market, and the GFXD wishes to emphasise the desire of our members for globally coordinated regulation which we believe will be of benefit to both regulators and market participants alike.

[1] Bank of America Merrill Lynch, Bank of New York Mellon, Bank of Tokyo Mitsubishi, Barclays Capital, BNP Paribas, Citi, Credit Agricole, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan, Lloyds, Mizuho, Morgan Stanley, Nomura, RBC, RBS, Société Générale, Standard Chartered Bank, State Street, UBS, Wells Fargo and Westpac.

[2] According to Euromoney league tables.

The FX market is also the basis of the global payments system. The volume of transactions is therefore very high and these transactions are often executed by market participants across geographical borders. As reported by the Bank for International Settlements (BIS) in their Triennial Central Bank Survey: Foreign Exchange Turnover in April 2013, over 75% of FX activity was executed by market participants across five global jurisdictions,[3] hence the view from the GFXD that regulations should be harmonised at the global level. Cross border markets cannot operate in conflicting regulatory landscapes and the natural outcome, should this be the case, is unwanted fragmentation of what is an already highly automated and transparent FX market.

EXECUTIVE SUMMARY

We fully support the RBI taking initiatives to implement the G20 commitments to reform the OTC derivative markets. Whilst we do not specifically address every aspect of the Discussion Paper, or every one of the questions raised in the Discussion Paper, we highlight below some key points that are of particular importance to our members from an FX perspective, and that we ask be taken into account by the RBI in order to preserve market liquidity and avoid causing a bifurcation of the FX market. With respect to a number of the proposals, we have indicated our support for comments made by ISDA in its letter[4] to the RBI on the Discussion Paper.

To summarise five key points from our letter:

1. A preferable and more globally consistent approach to variation margin for physically-settled FX forwards and swaps would be to establish any variation margin requirement for such FX swaps and forwards via reference to the BCBS FX Supervisory Guidance.
2. We urge the RBI to exclude from any margin requirements, FX security conversion transactions entered into in connection with the funding of a purchase or sale of a foreign security.
3. Subjecting initial margin amounts to a floor of 80% of the amount computed under the standardised approach would be inconsistent with foreign margin regimes. We also disagree with the proposal to impose an 80% floor on haircuts.
4. We would welcome an exemption for covered entities from margin requirements in respect of transactions where either netting of derivatives is not enforceable upon insolvency or bankruptcy of the counterparty or collateral arrangements are questionable or not legally enforceable upon default of the counterparty.
5. We are concerned that the implementation timeline proposed does not provide sufficient lead time, due to final rules still being required, and certain legal and infrastructure challenges that exist.

[3] BIS 2013 Triennial Survey, available at http://www.bis.org/publ/rpfx13fx.pdf

[4] To be dated on or about 7 June, 2016

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We set out below in more detail comments on those elements of the Discussion Paper that are of particular concern to our members. We have organised our comments by reference to the enumerated paragraphs in the Discussion Paper and have indicated, where relevant, the applicable RBI issue for feedback/comments.

Paragraph 4 – Transactions within scope of margin requirements

RBI issue for feedback/comments: What are the views on the proposal of excluding physically settled forex forward and swap contracts from initial margin requirements? Are there any other products which may be considered for exclusion from margin requirements?

Margin requirements for deliverable FX transactions

The GFXD welcomes and supports the RBI's exemption of physically-settled FX forwards and swaps from the initial margin requirements in the Discussion Paper. As indicated in the March 2015 *Margin requirements for non-centrally cleared derivatives* by the Basel Committee on Banking Supervision and International Organization of Securities Commissions (the International Margin Framework),[5] these products merit exclusion from the scope of the margin requirements due to their unique characteristics.

However, in order to avoid inconsistency with the treatment of physically-settled FX forwards and swaps in other jurisdictions, potentially creating an uneven playing field and incentivizing regulatory arbitrage, we urge the RBI to exclude physically-settled FX forwards and swaps from the scope of the variation margin provisions as well.

The International Margin Framework excepts physically-settled FX forwards and swaps from its margin requirements entirely, although stating that standards apply for variation margin for physically-settled FX forwards and swaps[6] and citing the 2013 *BCBS Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions* (BCBS FX Supervisory Guidance, see Guideline 3 – Replacement cost risk).[7]

The RBI's application of the variation margin requirements to physically-settled FX forwards and swaps would contrast with the treatment of these deliverable FX products in the US, Japan, Singapore and Canada. Physically-settled FX forwards and swaps are excluded from both initial and variation margin requirements under the final US Prudential Regulators' Rules, US CFTC Rules and

[5] Available at http://www.bis.org/bcbs/publ/d317.htm

[6] See http://www.bis.org/bcbs/publ/d317.htm (see p.7)

[7] Available at http://www.bis.org/publ/bcbs241.pdf

Canadian and Japanese rules. The uncleared margin proposals in Singapore also exclude physically-settled FX forwards and swaps from both initial margin and variation margin requirements.

An important element of the International Margin Framework is the goal of promoting global consistency and reducing regulatory arbitrage opportunities with respect to the treatment of physically-settled FX forwards and swaps. If jurisdictions were to differ in their approach to physically-settled FX forwards and swaps, this may well result in different requirements applying across borders. If this were to result, we would have significant concerns about potential impacts on pricing and liquidity.

In light of the above, in our view a preferable and more globally consistent approach to variation margin for physically-settled FX forwards and swaps would be to establish any variation margin requirement for such FX swaps and forwards via reference to the BCBS FX Supervisory Guidance, rather than include these FX products within scope of the RBI's variation margin requirements for OTC derivatives.

For example, in Singapore the Monetary Authority of Singapore (MAS) in its October 2015 Policy Consultation on Margin Requirements for Non-Centrally Cleared OTC Derivatives states that physically-settled FX forwards and swaps are exempted from the margin requirements, but that entities are expected to appropriately manage the risks associated with such FX transactions, referencing the BCBS FX Supervisory Guidance.[8] In Canada, physically-settled FX forwards and swaps are excluded from the entirety of the uncleared margin requirements,[9] however the Office of the Superintendent of Financial Institutions Canada (OSFI) has separately issued an Advisory which establishes OSFI's expectations regarding the management of FX settlement risk by banks, on the basis of the BCBS FX Supervisory Guidance.[10] In the US, the BCBS FX Supervisory Guidance is adopted by way of a Federal Reserve System Supervisory Letter.[11]

In order to achieve better global consistency across jurisdictions, both to maintain the competitiveness of entities subject to the RBI's margin requirements and to avoid potential jurisdictional conflicts, we recommend that physically-settled FX forwards and swaps be excluded from within scope of both initial margin as well as variation margin, and that any variation margin obligations for physically-settled FX forwards and swaps be addressed instead via the RBI's adoption of the variation margin guidelines in the BCBS FX Supervisory Guidance.

[8] See http://www.mas.gov.sg/~/media/MAS/News%20and%20Publications/Consultation%20Papers/Policy%20Consultation%20on%20Margin%20Requirements%20for%20NonCentrally%20Cleared%20OTC%20Derivatives%201Oct.pdf (Footnote 7)

[9] See http://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/e22.aspx#01 (see para. 20)

[10] See http://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/adv-prv/Pages/FXSR.aspx

[11] See http://www.federalreserve.gov/bankinforeg/srletters/sr1324.htm

Exclusion of FX spot and FX transactions linked to securities settlements from the margin requirements

We also would like to see the RBI establish clear and internationally consistent definitions for terms used in any margin regulation, such as "physically settled forex forward and swaps", and make a clear distinction between FX spot and FX forward transactions. In this regard, we additionally wish to draw the RBI's attention to a specific point regarding FX security conversion transactions (defined below).

First, we would appreciate the RBI clarifying that FX spot transactions, not being derivatives, are excluded from proposed margin requirements. In general, an FX transaction is considered a bona fide spot transaction if it settles via an actual delivery of the relevant currencies within two business days (T+2) or the period generally accepted in the market for that currency pair as the standard delivery period.

We also urge the RBI to classify as spot, or at the least exclude from any margin requirements, FX transactions entered into in connection with the funding of a purchase or sale of a foreign security, even where the settlement period for the securities transaction, and thus the accompanying FX transaction, is greater than T+2. This would be consistent with the classification of these types of FX "security conversion" transactions in other jurisdictions.[12]

Many of our members act as custodian for their customers who are asset managers. Due to increased access to and investor interest in foreign financial markets, growing numbers of these customers are invested in foreign securities. To facilitate the purchase or sale of these foreign securities, custodians, as part of their service offering, often enter into an FX transaction that is incidental to and for the purpose of effecting their customer's foreign security transaction. For example, when a non-US customer wishes to purchase a US dollar-denominated security, its broker-dealer or bank custodian will enter into a corresponding FX transaction so that the customer has US dollars available to meet the cash currency requirements necessary to complete purchase or sale of the security. These FX transactions are integral to the settlement of the security.

Typically, the settlement cycle for most non-EUR denominated securities is trade date plus three days (T+3). Accordingly, the bank custodian or broker-dealer would enter into a FX transaction with its customer on a T+3 basis as well. In some securities markets, for example in South Africa, the settlement cycle can take up to seven days (T+7).

Subjecting FX transactions that are incidental to related securities transactions to OTC derivatives regulation would expose bank custodians, broker-dealers and their customers to needless operational, price, credit and other risks. As a result, participants may restrict FX security conversion transactions to T+2 FX spot contracts, even when the related securities settlement takes longer, thereby exposing

[12] Regulatory authorities in the United States and the EU, for example, have included transactions used in connection with funding the purchase or sale of a foreign security where the settlement period is greater than T+2 days as FX spot (and thus outside the scope of OTC derivatives regulation within those jurisdictions).

the customer to misalignment and FX risk while exposing the bank to certain operational risks and changing, and disrupting, the long-standing and well-functioning settlement processing for the systemically relevant securities markets that exists today.

Applying margin requirements to the types of incidental transactions so described will not provide any meaningful protection to participants. As the RBI recognises in the Discussion Paper, physically-settled FX forwards and swaps are mostly used for hedging underlying exposures and do not give rise to a very high amount of potential future exposure. Inconsistent treatment of these transactions globally should be avoided in order to ensure that the lack of an exclusion for FX security conversion transactions from OTC derivatives/margin requirements regulation in some jurisdictions, such as India, doesn't create unnecessary disincentives from transacting in securities in those jurisdictions by raising their transactional costs relative to other jurisdictions which have excluded FX security conversion transactions, such as the United States and EU.

Paragraph 6 – Entities which would be covered by the margin requirements

RBI issue for feedback/comments: What are the views on the proposal of including large non-financial entities within the scope of margin requirements?

We recommend that the RBI carefully consider harmonizing definitions and thresholds it uses for in-scope entities as far as possible with those used in similar regulations in other jurisdictions, and to define terms by reference to objectively available sources, or existing foreign definitions. For example, "financial entity" and "large non-financial entity" being defined too generally could lead to difficulty and confusion in determining entity status.

We agree with the RBI that it is sensible for small- and medium-sized enterprises to be excluded from the margin requirements, for the reasons set forth in the Discussion Paper and to achieve international consistency. We support ISDA's request that the RBI consult with the industry before meaningfully expanding or changing the scope or content of any margin rules resulting from the proposals. We also agree with ISDA that any such margin rules should make clear that they apply to covered transactions between an RBI regulated entity and a covered entity only, to be consistent with the approach in other jurisdictions and to avoid potential regulatory conflicts.

Furthermore, we also ask that any margin rules provide that covered entities are entitled to rely in good faith on representations given to them by their counterparties, including in industry standard disclosure documents. An RBI regulated entity will not have the full, reliable, relevant knowledge of its counterparties' derivatives activities to be able to conduct reasonable due diligence on their business such as to be able to assess whether or not its counterparties have exceeded relevant notional amount thresholds.

Paragraph 7 - Entities which would be covered by the margin requirements

We agree with the carve-out for transactions with sovereigns, central banks and multilateral development banks and the Bank for International Settlements, for consistency with the approach taken in the International Margin Framework.

Paragraphs 12 and 21 – Computation of margin requirements

RBI issue for feedback/comments: Are there any procedural or operational problems in requirement of exchange of variation margin on a daily basis?

We agree with the comments ISDA makes with respect to the timing of variation margin and initial margin, and with respect to satisfying the obligation to post margin. In particular, with regard to the RBI's proposals for variation margin to be computed and exchanged on a daily basis, clarification of the timing for settlement of variation margin following computation or call would be beneficial.

We also recommend that the RBI take a principles-based approach to timing, rather than mandate specific deadlines. Proposed rules in Australia make reference to margin being settled "promptly" and final rules in Japan refer to settlement "without delay". We urge the RBI to stay involved in ongoing global discussions regarding the timing for posting of collateral.

Operational challenges – stamp duty and security interests

In addition, we understand that other operational challenges exist with respect to the requirement to exchange initial and variation margin exchange. The potential for execution of credit support documents to attract stamp duty, and collateral segregation requirements incurring security interest registration and filing obligations raise practical and cost concerns for our members.

Paragraphs 13, 14 and 16 – Computation of margin requirements

We agree with ISDA that, with regard to the requirement for the RBI to approve initial margin models, the RBI should align with the EU approach, which does not require pre-approval of the initial margin model (including any models developed by the industry), and permit firms to self-attest that a model meets the criteria.

Paragraphs 14 and 21 – Exchange of margin

We are concerned about the RBI's reference to exchange of margin on a "contract by contract" basis and "transaction by transaction basis", and agree with the issues and raised by ISDA with regard to the lack of legal unambiguity relating to netting.

Standardised margin schedules and models able to be relied upon in other jurisdictions, such as the US and EU, contemplate certain limited netting and offsetting of exposures[13] in computing margin amounts to be posted and collected. As ISDA highlights in its letter, requiring margin on a gross (and not net) basis would result in significantly higher cost and would be misaligned with global moves towards incentivizing bilateral margining of non-centrally cleared derivatives.

From a practical standpoint, the RBI's reference to a "lack of legal unambiguity on reckoning exposures based on net basis," meaning that "variation and initial margins have to be applied on a contract by contract basis" is a significant concern for our members. Legally enforceable close-out netting is a key pillar upon which margin requirements rely. Without this, computation of initial margin by parties on a gross, contract-by-contract, basis is unworkable. We too urge the RBI to move towards achieving greater consistency in the application of netting in India and ensuring alignment of any margin rules it establishes with global standards.

Multiple netting sets under a single master agreement

We also agree with ISDA's comment regarding the possibility of having multiple netting sets under a single master agreement. This is consistent with what is permitted under the US uncleared margin rules.

Paragraph 18 – Computation of margin requirements

RBI issue for feedback/comments: What are the views on the proposed floor on initial margin requirements computed based on approved risk models?

Subjecting initial margin amounts to a floor of 80% of the amount computed under the standardised approach would be inconsistent with foreign margin regimes and may lead to global regulators not recognizing equivalency of RBI margin rules.

There should be no need to run bilateral calculations of initial margin based on a standardised schedule verses a risk-based model. We agree with ISDA that making simultaneous computations is overly burdensome and could lead to regulatory conflicts. We reiterate the importance of global consistency for our members, and are concerned that the RBI's proposals in this regard may potentially be counter-productive to international harmonization efforts.

Additionally, the mandatory use of the standardised approach would be inconsistent with the International Margin Framework. The RBI should allow initial margin to be calculated using either

[13] For example, in the EU, initial margin models may account for diversification, hedging and risk offsets arising from the risks of OTC derivative contracts that are in the same netting set, provided that the diversification, hedging or risk offset is carried out within the same underlying asset class referred to in the regulations and not across such classes. See https://www.eba.europa.eu/documents/10180/1398349/RTS+on+Risk+Mitigation+Techniques+for+OTC+contracts+%28JC-2016-+18%29.pdf/fb0b3387-3366-4c56-9e25-74b2a4997e1d (page 39).

an approved risk-based model or a standardised schedule, for consistency with the International Margin Framework as well as regulations proposed or finalised in other jurisdictions, such as the US, EU, Japan, Singapore, Hong Kong, Australia and Canada.

Paragraph 24 – Haircuts for collateral

To achieve better global consistency, cash variation margin should not require an 8% haircut. The RBI should also consider alignment with existing rules in its treatment of non-cash variation margin and initial margin. We disagree with the proposal to impose an 80% floor on haircuts due to the potential harmful impact this may have on business, and global inconsistency.

Paragraph 26 – Treatment of collateral provided

RBI issue for feedback/comments: What are the views on the proposed legal arrangement for treatment of assets received as initial margin?

RBI issue for feedback/comments: Would Indian laws be able to provide mechanism to ensure legally enforceable arrangement which satisfy requirements of paragraph 25 and 26?

RBI issue for feedback/comments: Is there a need for third party custodial service provider in India? If the answer is yes, then in what form should the third party custodial service provider be set up?

We understand that requiring foreign covered entities to post collateral onshore for onshore transactions will require significant new arrangements to be put in place (such as new agreements being negotiated, and new/expanded functions being established to handle settlement and other operational issues), meaning a significant cost outlay. Similar concerns exist with cross-border trades, where foreign covered entities would be required to receive collateral onshore in India.

Furthermore, the lack of a suitable third party custodial service provider in India prior to the effective date of any margin rules is an infrastructure obstacle that will need to be addressed before compliance with margin segregation requirements can be expected. This is because the lack of a developed third party custodian infrastructure in India would create a significant barrier for complying with initial margin requirements within the specified timeline. In addition, given the nascent stage of the third party custodian industry in India and the lack of legal certainty around custody arrangements, there is significant risk for foreign bank branches in India that any onshore collateral posting in India would not be compliant with standards of initial margin segregation required by their home regulators (for example in the EU, US, Hong Kong, etc.). We are therefore in favour of offshore collateral posting being permitted in these circumstances.

Legality of collateral arrangements

Obtaining bespoke legal advice with respect to individual segregation agreements could prove time consuming and expensive. We ask that, in assessing whether margin arrangements comply with the requirements of the RBI's rules, in-scope entities be able to rely on industry-wide legal advice developed by market participants.

Paragraph 29 – Treatment of transactions with group entities

We support the proposed exclusion of intra-group derivatives transactions from the scope of the margin requirements. Intra-group transactions do not raise the same systemic and counterparty risk issues that are raised by derivatives with third parties. The financial health of any group member is very closely linked to that of other group members, and as a result the critical issue for mitigating systemic and counterparty risk is protection against potential exposure to the group overall.

We would be supportive of the RBI further clarifying its expectations in respect of this exemption.

Implementation of initial margin requirements

Separately, for purposes of Paragraph 36, we agree with ISDA that intragroup transactions should only be taken into account once in the calculation of the average aggregate notional amount for the purpose of determining whether a covered entity has reached the thresholds.

Paragraph 30 – Treatment of cross-border transactions

Substituted compliance

We support the comments made by ISDA regarding the treatment of cross-border transactions and urge the RBI to implement a regime, for transactions that are subject to two sets of rules, that is aligned with the goals of the International Margin Framework: harmonisation, equivalence and comparability. We agree with ISDA that rules that are not harmonised would lead to fragmentation of the market and a reduction of liquidity, and that inconsistent rules would make it more likely that foreign regulators determine that the Indian margin regime is incomparable with global standards.

If foreign covered entities are subject to local rules consistent with global standards, and also to margin rules in India, we recommend that the RBI establish the ability for such foreign entities to comply instead with their local rules.

Non-netting jurisdictions

We also refer to the comments made by ISDA regarding the treatment of transactions with "non-netting jurisdictions".

Various concerns have been raised with global regulators as to the treatment of transactions with jurisdictions where netting and/or collateral is not enforceable. For example, the additional risk if close-out netting is not enforceable and/or if it cannot be assured that posted collateral is sufficiently protected against the default of its counterparty. Also, certain counterparties in emerging markets jurisdictions often do not have infrastructure in place to calculate, exchange and manage margin so imposing margin requirements could disrupt established trading relationships and limit hedging and financial flows between India and counterparties in those jurisdictions.

Collateral issues when transacting with non-netting jurisdictions are particularly important to our members because FX forms the basis of the global payments system and, as such, both the number of global market participants and volume of transactions are very high. In emerging market economies, which includes the majority of the non-netting jurisdictions, FX accounts for over 50% (US$535 billion) of the turnover of OTC derivatives,[14] reflecting the greater relevance of exchange rate risk in these economies. We would welcome an exemption for covered entities from margin requirements in respect of transactions where either: (i) netting of derivatives is not enforceable upon insolvency or bankruptcy of the counterparty; or (ii) collateral arrangements are questionable or not legally enforceable upon default of the counterparty.[15]

Paragraph 32 - Implementation schedule

The RBI correctly points out that the margin requirements to be introduced in India will be a significant policy change for most market participants, and that the new requirements will call for operational enhancements and additional amounts of collateral for which liquidity planning will have to be undertaken by entities within scope of margin rules.

Although the RBI contemplates a phasing-in of margin requirements, we are concerned that the implementation timeline proposed does not provide sufficient lead time. Final rules are required before firms will be able to begin necessary work, including legal, documentary, technology systems, operational and risk management work.

Given this, and the issues and concerns we have raised in response to the Discussion Paper, to avoid what could be significant disruption to the market we would be supportive of the RBI delaying finalization and implementation of margin rules until such time as legal and infrastructure challenges have been adequately addressed.

[14] BIS Quarterly Review: International banking and financial market developments, December 2013.

[15] We refer the RBI to the approach taken in, for example, Australia's proposed uncleared margin rules where a covered entity is not required to post or collect variation margin or initial margin where netting of derivatives is not enforceable upon insolvency or bankruptcy of the counterparty. See http://www.apra.gov.au/CrossIndustry/Documents/160225-DRAFT-CPS-226-FINAL.pdf

International harmonization is crucial for our members. With the FX market being the basis of the global payments system, our continued view is that, in order for this market to continue to function effectively and in order to avoid unwanted fragmentation of what is an already highly automated, transparent and well-functioning market, regulations must be carefully considered and harmonised at the global level before they are implemented.

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We appreciate the opportunity to share our views on the Discussion Paper. Please do not hesitate to contact John Ball on +852 2531 6512, email jball@gfma.org should you wish to discuss any of the above.

Yours sincerely,

James Kemp
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