ISDA® Safe, Efficient Markets

By E-mail

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Dear Sir,

Discussion paper on margin requirements for non-centrally cleared derivatives

Introduction

The International Swaps and Derivatives Association ("**ISDA**")[1] is grateful for the opportunity to provide comments 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. Individual members of ISDA may have their own views on the Discussion Paper, and may therefore provide their comments to the RBI directly.

ISDA strongly support the goals of strengthening resilience in the non-centrally cleared derivatives market by establishing margin requirements. While the Discussion Paper represents an important step forward for establishing a detailed set of requirements for the collection and protection of margin in the OTC derivatives market in India, we submit that it is important for the RBI to continue to focus on the practical issues relating to the implementation of any rules and the overall purpose of reducing systemic risk. This submission is intended to continue the constructive ongoing dialogue between the RBI and derivatives market participants and to focus on the practical concerns and risks surrounding the implementation of the margin rules, including the harmonisation of such rules with those of foreign regulators. We hope that our comments in this submission will assist the RBI with its preparation of the new margin rules for non-centrally cleared OTC derivatives in India ("**Margin Rules**").

[1] Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 850 member institutions from 67 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

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We will address the questions raised in the Discussion Paper below, but wish first to make some overarching comments about what groundwork needs to be done to prepare for an effective margining regime for non-cleared derivatives.

Objectives of margin requirements and central clearing

As stated in the final policy framework in the paper issued by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions in March 2015 ("**BCBS-IOSCO Framework**"), the objectives of margin requirements for non-centrally cleared derivatives are to reduce systemic risks and promote central clearing of standardised derivatives, and central clearing is one of the four elements of the G20's original 2009 reform programme. To promote central clearing, however, there needs to be a clearing service that is internationally recognized as a qualified central counterparty (QCCP), allows international firms to become direct clearing members, offers clearing in a wide breadth of products that are frequently traded so as to offer an alternative to OTC derivative margining, and offers client clearing services so that financial market end users can also opt into clearing instead of margining OTC derivatives. In this regard, we note that availability and use of The Clearing Corporation of India Ltd. ("**CCIL**") is currently limited, largely due to the absence of client clearing options, narrow product scope for clearing and lack of recognition/exemption/equivalence decisions by the regulators of the international banks who account for a significant percentage of OTC derivatives market share.

Local market and infrastructure readiness

Currently, almost no OTC derivatives transactions are margined in India and local custodial infrastructure is underdeveloped (if not non-existent). Most derivatives market participants, especially local entities, lack understanding of how margining requirements would apply and the operational infrastructure to process collateral transfers. We also think that the existing legal framework presents obstacles that are significantly difficult for, if not detrimental to, the implementation of the proposed margin requirements. Such obstacles include:

- lack of legal unambiguity on the enforceability of netting (see "*Lack of legal unambiguity relating to netting*" on P.14 below for detailed discussion);

- prohibition on onshore entities to post collateral offshore (see "*Offshore posting of collateral should be allowed*" on P.22 below for detailed discussion);

- absence or inadequacy of local custodial infrastructure that would satisfy initial margin (IM) segregation requirements (see our answer to question 7 on P.19-20 below for detailed discussion); and

- imposition of stamp duty and other statutory charges on collateral arrangements (see "*Exemption of stamp duty*" and "*Exemptions relating to perfection requirements of IM arrangements*" on P.23 below for detailed discussion).

Until the above obstacles are removed, market participants face challenges in complying with the margining requirements in India, with market liquidity the likely casualty. The 20 or so largest (so called "**Phase 1**") banks must mandatorily begin exchanging initial margin ("**IM**") from 1 September 2016.

Most of these institutions have branches and subsidiaries in India that will be subject to these margining requirements. It is almost impossible that the above mentioned impediments could be resolved before this date if the margining requirements were to be implemented in their current form and timeframe, meaning that these entities will not be able to continue trading OTC derivatives in the Indian market. It is possible that there may be some substitution into offshore transactions in order to allow efficient and regulatory compliant exchanges of collateral, take advantage of netting sets and avoid onerous stamp duty costs, but we believe offshoring of the market would undermine RBI's policy objective and thus reiterate our concern that margin rules should not be implemented before the underlying support infrastructure is ready.

Excessively conservative margining requirements

We have several concerns with the margin calculation methods that the RBI proposes in its effort to be prudent and conservative. Foremost among them is a concern with the proposed 80% floor on IM amounts based upon the Basel standard tables. The standard tables are an excessively blunt calculation tool that has no risk sensitivity facility. The collateral numbers they generate, even at the 80% level, will render the economics of almost all OTC derivative trades unattractive, and combined with the lack of facility to clear these trades, activity in many useful hedging products will substantially cease. The RBI should recognize that IM models (especially the ISDA SIMM™ Model) are designed to be conservative in order to meet the 10-day 99% confidence interval requirement and on average generate collateral requirements double those of what a central counterparty (CCP) would generate for the same portfolio. Mandating higher collateral requirements and the use of standard tables, which produce results that are 8-15 times higher than the ISDA SIMM™ Model, would render derivatives pricing in India at a level that would discourage hedging for legitimate purposes (see "*Proposed 80% floor on IM*" on P.12 and "*Proposed 80% floor on haircut*" on P.19 below).

International harmonisation

In order to ensure the efficient functioning of the global derivatives market and to eliminate operational risks, we strongly support India adopting rules that are harmonised and consistent with other jurisdictions, and are broadly comparable to the BCBS-IOSCO Framework. Without this harmonisation, the market will become increasingly fragmented and its liquidity impaired as counterparties struggle to meet inconsistent margin requirements of various international regulators. Moreover, for margin requirements, inconsistent rules will potentially be incompatible in practice. International consistency will also prevent regulatory arbitrage and lead to a more level playing field between competitors in different jurisdictions.

The inherent legal and infrastructural impediments in the local market, coupled with the inconsistency with international norms, make it almost impossible for market participants to meet the implementation timeline from 1 September 2016. If implemented as proposed, we expect the Indian market would experience immediate adverse impacts from the margining requirements – the prohibitively high cost associated with doing derivatives business in India would likely result in a severe liquidity squeeze, unavailability of hedging options for end users and market fragmentation.

We therefore strongly urge the RBI to postpone the implementation schedule until the impediments mentioned above are removed (see also discussion in Part 7 on P.27). As a practical matter, we would

also note that Phase 1 banks will in any case be subject to IM requirements beginning in September 2016. We would not expect any Indian banks to be in scope for IM requirements before September 2019 or September 2020. Rather than rushing to put in place IM requirements now, the RBI has time to address the structural issues we have identified below prior to finalizing its IM rules. For variation margin ("**VM**"), however, Indian financial entities are expected to begin mandatory exchange of collateral under the BCBS-IOSCO Framework in March 2017. We therefore recommend that the RBI address first with some urgency the structural impediments to the efficient exchange of VM between market participants in India.

Outline of submission

We have divided this submission into the following seven sections in which we set out our responses to the specific questions raised by RBI in the Discussion Paper.

- Part 1 Scope of coverage (questions 1 and 2)
- Part 2 Types of margins required to be exchanged (questions 3, 4 and 5)
- Part 3 Eligible collateral (question 6)
- Part 4 Treatment of collected margin (questions 7 and 8)
- Part 5 Intragroup transactions
- Part 6 Cross-border transactions
- Part 7 Implementation schedule

Part 1: Scope of coverage

Covered transactions

Question 1: 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?

Physically-settled forex (FX) forwards and swaps

ISDA welcomes the proposed exemption of physically-settled FX forwards and swaps from the IM requirements in the Discussion Paper and notes that physically-settled FX swaps and forwards are within scope of the VM requirements under the Discussion Paper. Physically-settled FX forwards and swaps are exempted from both the IM and VM requirements set out in the BCBS-IOSCO Framework and the final US, Japanese and Canadian margin rules, as well as the margin proposals in Singapore. Accordingly, ISDA requests that the RBI take an approach which is consistent with these other jurisdictions and exempt physically-settled FX forwards and swaps from both the IM and VM requirements.[2]

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[2] We note that the BCBS-IOSCO Framework states that, in developing variation margin standards for physically-settled FX forwards and swaps, national supervisors should consider the recommendations in the 2013 BCBS Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions (the "**BCBS Supervisory Guidance**") which requires VM for physically-settled FX swaps and

Notwithstanding the above view, we note that a few members have a preference for the Margin Rules to be aligned with the final draft regulatory technical standards on margin requirements for non-centrally cleared derivatives in the EU (the "**final draft EU RTS**"). If the RBI were to impose VM requirements on physically-settled FX forwards and swaps, we would request the RBI to align the compliance date in respect of those instruments with that stated in the final draft EU RTS.

We would also ask the RBI to ensure that there are clear definitions of "physically settled foreign exchange/forex forwards and swaps" and a clear indication of the distinction between spot and forward transactions. We would welcome consistency between the RBI definitions and those in other jurisdictions[3], to the extent possible, to minimize regulatory conflicts. Cross-referring to the ISDA product taxonomy[4] would also achieve such objective.

We would also welcome clarification on the derivative transactions to be excluded from IM requirements in paragraph 5 of the Discussion Paper and, in particular, the reference to "fixed physically settled foreign exchange transactions associated with the exchange of principal of cross currency swaps". We would welcome consistency between the RBI definitions and those in other jurisdictions or the ISDA product taxonomy[4], to the extent possible.

FX spot and FX contracts linked to securities settlement

We request that the RBI expressly exclude FX spot transactions from both IM and VM requirements in the Margin Rules. We note that such transactions are not subject to margining under the EU, US and Japan regimes.

We also request that the RBI expressly exclude FX contracts which are entered into for the purpose of settling a sale or purchase of securities denominated in a foreign currency and have a settlement period of no more than 7 business days from the Margin Rules.

Equity options

We note that equity options can only be traded on exchange in India and such class of products thus do not fall within the definition of non-centrally cleared derivatives. Accordingly, such products will not be subject to the Margin Rules. We also note that such class of products also fall outside the US margining regimes and are exempted for an initial three-year period under the EU margining regime.

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forwards. We do not oppose VM for physically-settled FX swaps and forwards. Rather, we intend to ask the RBI to better align with the majority of jurisdictions to exclude physically-settled FX forwards and swaps from the scope of the full set of VM requirements in the Draft CPS, and instead address VM for these products via adoption of the BCBS Supervisory Guidance.

[3] By way of reference, article 7 of the final draft EU RTS set out the definitions of "foreign exchange forwards", and "foreign exchange swaps".

[4] Please refer to the two documents under the entry dated March 25, 2015 on http://www2.isda.org/functional-areas/technology-infrastructure/data-and-reporting/identifiers/upi-and-taxonomies/.

Commodity derivatives

We note that banks in India (including branches of foreign banks in India) are not permitted to invest or trade in commodities (other than bullion). We also note that most commodity derivatives are traded by local corporates directly with overseas entities. To the extent that any non-financial entities enter into derivatives as end users, we request that hedging transactions be excluded from the scope of the Margin Rules (see "*Hedging transactions to be excluded form calculation of aggregate notional amount*" below) as imposing margin requirements could disincentivize such entities from using derivatives to hedge and manage their risks. We also note that physically-settled commodity forwards are not subject to the final margin rules in the US and Japan, and thus request that such transactions be excluded from the Margin Rules.

Definition of "non-centrally cleared derivative"

ISDA would welcome a clear definition of "non-centrally cleared derivative" and submits that the definition need not distinguish between whether a derivative is cleared with a QCCP or a CCP which is not a QCCP. If a derivative is cleared (and therefore margin is provided in accordance with the rules of the relevant CCP) in India or outside of India, the derivative should be outside the scope of the Margin Rules and the status of the relevant CCP should not be relevant.

ISDA requests that, when one or both covered entities are subject to foreign margin rules (in addition to the Margin Rules), the parties be permitted to use the definition of "non-centrally cleared derivative" (or its equivalent) under any of the regimes to which they are subject for the purposes of their margining calculations. This would eliminate the need for counterparties to make multiple different calculations to take into account different definitions or different product scopes in each different jurisdiction, and would therefore also likely reduce the risk of errors and disputes. Furthermore, allowing the use of a broader set of products in cross-border netting sets would facilitate the process of margin collection and reduce systemic risk. This approach would align with the final draft EU RTS.[5] See further the discussion in "*Broad product set should be permitted for margin calculation*" below.

Amended trades and new trades resulting from multilateral portfolio compressions should be exempt from margin requirements

The IM and VM requirements should only apply to new contracts entered into after the relevant phase-in dates, so that derivatives entered into prior to the relevant phase-in dates ("**Legacy Derivatives**") are excluded. Making an amendment to an existing derivatives contract should not qualify as entry into a new derivatives contract. We seek the RBI's confirmation that the following will not be subject to the Margin Rules:

(i) *trades amended in a non-material manner (or arising from life-cycle events)*: so long as an amendment does not create any new significant exposure under the Legacy Derivatives, the act

[5] See recital 11 and article 5(1) of the final draft EU RTS, available at https://www.esma.europa.eu/press-news/esma-news/esas-publish-final-draft-technical-standards-margin-requirements-non-centrally

of amending the derivative (or the occurrence of a life-cycle event) should not bring it within the scope of the Margin Rules; and

(ii) *new derivatives that result from multilateral portfolio compression*: portfolio compression is designed to reduce complexity in the derivatives market and has been generally encouraged by regulators. However, if the result of multilateral portfolio compression of Legacy Derivatives would cause the resulting trades to be subject to margin requirements, it would severely reduce the incentives of market participants to conduct multilateral portfolio compression.

(iii) *Wholesale novations completed for the sake of a group restructuring*: Wholesale novation in the case of a group restructuring should not be considered as "new" trades.

Only transactions between two covered entities should be subject to margin requirements

We note that paragraph 4 of the Discussion Paper refers to the margin requirements being applicable where at least one of the parties to the transaction is an entity regulated by the RBI (an "**RBI Regulated Entity**"). Paragraph 6 of the Discussion Paper refers to the margin requirements being applicable to all financial entities (including RBI Regulated Entities) and certain large non-financial entities (collectively, the "**covered entities**"). We submit that the Margin Rules should apply to covered transactions between an RBI Regulated Entity and a covered entity only and would welcome more clarity in the Margin Rules. Subjecting an entity that is not a covered entity to margin requirements is inconsistent with the BCBS-IOSCO Framework and the approach in other jurisdictions. Further, imposing the Margin Rules on a foreign non-covered entity would be extra-territorial and would also likely give rise to potential regulatory conflicts.

Covered entities

Question 2: What are the views on the proposal of including large non-financial entities within the scope of margin requirements?

We agree that only financial entities and systemically important non-financial entities should be in scope for the Margin Rules. This is consistent with the approach taken in the BCBS-IOSCO Framework and under the margin rules of other jurisdictions. However, we note that under paragraph 6 of the Discussion Paper, the RBI may review the scope of covered entities periodically and impose margin requirements on any category of related entities if it is considered desirable to do so. We would welcome confirmation from the RBI that if it intends to change the scope of application of the Margin Rules, it will subject any proposed changes to meaningful and sufficient industry consultation, and provide sufficient notice before any changes become effective.

We would also welcome clarification of the definitions of "financial entity" and "large non-financial entity", and would like to raise some other issues as detailed below.

Definition of "financial entity"

Paragraph 6 of the Discussion Paper indicates that the definition of "financial entity" would cover entities including banks, insurance companies and mutual funds. We would welcome clarification of the definition of "financial entity". For example, would this definition only cover scheduled banks and

other entities falling under the regulatory purview of the RBI (as indicated in paragraph 4 of the Discussion Paper), or would it also cover financial institutions falling outside the regulatory purview of the RBI? In particular, mutual funds and insurance companies are regulated by the Securities and Exchange Board of India (SEBI) and Insurance and Regulatory Development Authority (IRDA) respectively and may be subject to regulatory restrictions relating to the posting of collateral. If other regulators do not require identical margin requirements, or develop conflicting regulation, RBI Regulated Entities would face an inordinate challenge in complying with the Margin Rules. Entities not regulated by the RBI would then have to be excluded from being treated as financial entities in order for trading between the counterparties to continue. If financial entities that are not subject to RBI's purview were to be brought within scope, we request that the RBI work with the relevant regulators to resolve any legal impediments before the implementation of the Margin Rules.

Mutual funds

We would welcome clarification from the RBI that treatment of mutual funds is aligned with other global regulators. In particular, we request clear guidance on when different schemes of a mutual fund could be considered separately so as not to improperly capture those schemes as a single group for the purpose of applying the Margin Rules (e.g. for the application of thresholds or minimum transfer amount).

Definition of "large non-financial entity"

The Discussion Paper states that a large non-financial entity will be an entity having an aggregate notional amount of outstanding non-centrally cleared derivatives at or more than INR 1,000 billion ("**NFE VM Threshold**") on a consolidated group-wide basis. We would welcome clarification of the following points in relation to this definition:

- *Non-banking financial companies*

  Certain non-banking financial companies ("**NBFC**") in India are regulated by SEBI, e.g. venture capital fund, merchant banking companies or stock broking companies. We request that the RBI clarify whether such NBFCs would be subject to the Margin Rules. Similar to our request under "*Definition of "financial entity"*", if NBFCs that are subject to other regulators' purview were to be brought within scope, we request that the RBI work with the relevant regulators to resolve any legal impediments before the implementation of the Margin Rules.

- *Hedging transactions to be excluded from calculation of aggregate notional amount*

  We request that, for the purpose of determining whether a non-financial entity has reached the NFE VM Threshold, the RBI confirm that hedging transactions would be excluded from the calculation of the aggregate notional amount. ISDA believes that non-financial entities would not pose a systemic risk to the market and imposing margin requirements could disincentivize such entities using derivatives to hedge their risks. For reference, the EU Regulation on OTC Derivatives, Central Counterparties and Trade Repositories (commonly known as "EMIR") provides for the exclusion of OTC derivative contracts entered into in order to reduce risks relating to the

commercial or treasury financing activity of the relevant non-financial entity or other nonfinancial entities within the same group[6].

- *Definition of "group"*

  For the purpose of determining whether a non-financial entity has reached the NFE VM Threshold, please see Part 5 below for discussion on the definition of "group".

- *Calculation of aggregate notional amount*

  We request that the formula for calculating the aggregate notional amount be brought in line with global standards. In particular, we request clarification on the calculation periods and the compliance periods with respect to such calculation periods for the purpose of calculating the aggregate notional amount.

Due diligence in respect of covered entities and harmonisation of definitions

A covered entity will not have any relevant knowledge relating to the derivatives business of its counterparty and, in particular, it will not be possible to obtain reliable information about the aggregate notional amount of a counterparty's derivatives positions at any time (other than by way of representations provided by that party). Accordingly, to align with the requirement in the US, ISDA requests that the 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.

ISDA also understands that institutions in Asia face a practical difficulty in obtaining representations from their counterparties as to their status (whether by adhering to protocols or by returning representation letters). Very often, counterparties are slow to confirm their status or fail to respond, leading to a potential tradability issue. Further, the timeline for meeting the VM implementation date will be very compressed and ISDA's members are concerned as to whether an appropriate level of due diligence can be achieved in time. In order to comply with the requirements, RBI Regulated Entities will need to classify and/or obtain self-declarations from each of their counterparties as to whether their portfolios exceed the relevant thresholds and then to negotiate or update documentation, all prior to the applicable VM implementation date. As no equivalent classification exercise has previously been completed within India, it is likely to be time-consuming and challenging to explain the relevant background and requirements to counterparties, and then to carry out the negotiation and re-documentation exercise. ISDA would strongly encourage the RBI to harmonise the applicable definitions as far as possible with other jurisdictions and define the terms by reference to objectively available sources or an existing foreign definition (e.g. globally significantly important bank, swap dealer and financial end user under the US regulations, or FC and NFC+ under the EU rules) such that existing outreaches can be leveraged upon.

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[6] See article 10(3) of EMIR (Regulation (EU) No 648/2012).

Definition of "sovereign"

We request the RBI to provide a definition of entities that would be considered a "sovereign" for the purposes of paragraph 7 of the Discussion Paper. In particular, we would welcome clarification of whether or which state-owned entities would be considered a sovereign for the purpose of the Margin Rules. We would also welcome confirmation from the RBI that non-Indian sovereigns are also subject to exemption.

Part 2: Types of margins required to be exchanged

Question 3: Are there any procedural or operational problems in requirement of exchange of variation margin on a daily basis?

Timing for exchange of variation margin

We agree with the RBI's proposals for VM to be computed and exchanged on a daily basis. However, we would welcome clarification of the timing for settlement of VM following computation or call. We recommend a principle-based approach rather than on the basis of specific deadlines (e.g. proposed rules in Australia make reference to margin being settled "promptly" and final rules in Japan refers to settlement without delay). A principle-based approach would allow for flexibility for the variety of factors impacting the call and settlement timelines, especially time zone differences and cross-border issues. We note that there are ongoing global discussions regarding settlement timing and would urge the RBI to actively participate in such discussions.

Timing for exchange of initial margin

With regards to IM, we note that paragraph 12 refers to IM being exchanged at the inception of the transaction. This wording implies that IM has to be settled as soon as a trade is entered into. Such a requirement would not be aligned with foreign margin regimes or market practice (whereby, once a trade is entered into, IM is then computed based on a portfolio calculation and is subsequently posted). We would welcome confirmation as to the definition of "inception" and the timing for computation after the inception. We would also welcome clarification of timing for settlement of IM following the computation or call. As noted in our comment on timing for exchange of VM, we would urge the RBI to actively participate in global discussions on settlement timing.

We also note that paragraph 12 refers to IM being "reassessed periodically by the bank based on the internal risk management policy and depending on the evolving macro-economic conditions" and would welcome confirmation of the frequency of IM computation.

Satisfying the obligation to post margin

We note that a posting party cannot deliver margin unless the counterparty is ready to receive it and has given appropriate instructions to its custodian or bank. Therefore, a posting party should be permitted to satisfy its posting obligation to its counterparty by delivering a notice in accordance with the required timeframe, assuming that the counterparty has the right to call for margin. A posting party should not be in violation of its posting obligations if the counterparty fails to accept the margin and the posting party delivers the notice in accordance with this paragraph.

Computation of margin requirements

Question 4: Is the threshold for application of initial margin and minimum transfer amount appropriate for Indian conditions?

We would welcome clarification from the RBI that covered entities may mutually agree to exchange collateral based on IM threshold and/or minimum transfer amount that are lower than those stipulated.

Thresholds should be harmonized

We understand that the IM and VM thresholds set out in paragraphs 33 and 35 respectively are intended to be consistent with the thresholds specified in the BCBS-IOSCO Framework and the numbers proposed in other jurisdictions. Global consistency is needed to keep India market participants on an even footing with their peers and competitors. In particular, we note that the INR200 trillion threshold for September 2016 is below the EUR3 trillion threshold set out in the BCBS-IOSCO Framework. Given that entities globally are preparing for implementation based on the EUR3 trillion threshold, some entities would be caught unprepared for the September 2016 implementation date if a lower threshold were to be applied in India. We strongly suggest that the RBI adjust the thresholds when the Margin Rules are finalized by reference to the then prevailing EUR/INR exchange rate and we further seek confirmation from the RBI that it would adjust the thresholds if there is a material change in the EUR/INR exchange rate after the Margin Rules are implemented.

Calculation of thresholds

We understand that the VM and IM thresholds set out in paragraphs 33 and 35 respectively will be based on a group's worldwide derivatives positions, rather than just transactions booked in India, but we would welcome confirmation of this.

We also request the RBI to confirm 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. ISDA believes that intragroup transactions do not pose the same systemic risks as other transactions and do not transfer risks in or out of a corporate group.

Thresholds with respect to large non-financial entities

We note that the permanent IM threshold applicable from 1 September 2020 is INR 550 billion whereas the NFE VM Threshold is INR 1000 billion. For the purpose of determining whether IM is required, it is unclear whether the two thresholds are to be applied to non-financial entities cumulatively or separately. As noted in "*Calculation of aggregate notional amount*" above, it is also unclear how a covered entity should determine whether it has reached the NFE VM Threshold.

If the thresholds were to be applied separately, a non-financial entity (having an aggregate notional amount falling between INR 550 billion and INR 1000 billion, assuming the calculation methods for the two thresholds were the same) would be subject to IM but not VM. If the thresholds were to be applied cumulatively, a large non-financial entity (having reached the NFE VM Threshold of INR 1000 billion) would only be subject to IM if it were also subject to VM. We request clarification from RBI on how the thresholds are to be calculated and applied.

Minimum transfer amount

Paragraph 10 of the Discussion Paper proposes that all margin transfers between counterparties should be subject to a minimum transfer amount of INR 3.5 crore. We request clarification whether such minimum transfer amount is based on the combined amount of VM and IM, or whether it would apply to VM and IM separately.

Question 5: What are the views on the proposed floor on initial margin requirements computed based on approved risk models?

Proposed 80% floor on IM

We strongly disagree with the proposal of subjecting the IM amount to a floor of 80% of the amount computed under the standardised approach and the mandatory use of the standardised approach. This proposal is inconsistent with the BCBS-IOSCO Framework and the margin regimes in all other jurisdictions.

The use of the standardised approach would yield IM amounts that are excessively conservative and disproportionate to the risks involved. Based on internal assessments done by our members, for a diversified portfolio, the IM amount computed using the standardised approach could be up to 15 times higher than that computed under the ISDA SIMM™ Model, a model developed by the industry for use by market participants. Setting a floor for the IM amount at 80% of the amount computed under the standardised approach thus would entail a significant increase in the funding requirements of covered entities, and would exacerbate changes in bank trading behaviours and market liquidity fragmentation, disincentivize hedging activities and have the unintended consequence of impeding economic growth.

We also note that the ISDA SIMM™ Model has been designed to meet certain prescribed criteria and is based on first order sensitivities. The ISDA SIMM™ Model is an open source code model that will be made available to all market participants. It is a simple model derived from Sensitivity Based Analysis under the Basel FRTB Framework. It is easy to use and is designed to produce conservative results. The IM calculated under such model would still provide a prudent buffer against the risks incurred without subjecting parties to inordinately high level of margin. Based on backtesting results, the margin calculated under the ISDA SIMM™ model is around 2 times greater than the sum of all historical VaR measures, and is 1.4 times to 7.7 times greater than the margin required by central counterparty clearing houses and exchanges for similar products with corresponding risk profiles. These backtesting results are attached as Appendix 1[7] to this submission. Use of the ISDA SIMM™ Model thus provides a conservative yet good approximation of the risks incurred, without the disadvantage of reducing liquidity.

As a matter of principle, a covered entity should be able to rely solely on a quantitative risk model or an IM model without the need to run simultaneous calculations under both an IM model and the standardised approach. Making simultaneous computations is onerous and operationally burdensome, and is also inconsistent with the approach taken by regulators in other jurisdictions. When international

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7 Extracted from the ISDA presentation to the RBI on 30 May 2016.

regulators are continuing to work towards harmonising margin requirements, we strongly request the RBI to remove the proposed floor to minimize any regulatory conflicts.

Requirement for RBI approval for IM models

Paragraphs 13, 14 and 16 indicate that the use of any quantitative risk models or IM models must be approved or validated by the RBI. We query whether this requirement for pre-approval by the RBI is necessary, particularly when bearing in mind the short period prior to implementation of the Margin Rules. The choice of model is far less important than model governance. What matters is whether or not the model meets the test of 10-day 99% one-tail confidence interval and the governance mechanisms in place to address, on an ongoing basis at the counterparty portfolio level, actual profit and loss vectors that exceed the IM levels produced by the model. In the event that the use of an IM model is also subject to approval of another regulator, this could give rise to the situation where one regulator (such as the home regulator of a market participant) has approved the model but another regulator (such as the RBI) has not. We thus request the RBI to align with the EU approach, which does not require pre-approval of the IM model (including any models developed by the industry), and permit firms to self-attest that the model meets the criteria, and then use the model from the compliance date onwards. RBI could reserve the right to monitor that the model is subject to certain ongoing monitoring requirements and meets certain governance standards. Under the final draft EU RTS, firms are subject to ongoing requirements in relation to their use and management of the IM models, such as periodic reviews, validation and audit processes, and remediation measures. In the case of the ISDA SIMM™ Model, the model is also subject to a governance framework at the industry level where ISDA is the administrator responsible for calibration, backtesting and benchmarking at an industry level.

Insofar as the RBI intends to retain the approval requirement, we request that the RBI confirm that if an IM model is approved by another regulator or follows the ISDA SIMM™ Model, market participants that intend to use that model only need to notify the RBI and need not seek further approval. We further request that the RBI confirm that such notification by a market participant need only be performed on a one-off basis in respect of all transactions that will use that model.

If, notwithstanding the above, the RBI intends to retain an independent approval requirement in respect of IM models that have been approved by another regulator or which follow the ISDA SIMM™ Model, we request that covered entities be expressly permitted to use a model on an interim "deemed approval" basis (i.e. approval is deemed until such time as RBI reviews the relevant model). This should alleviate some of the timing pressure in light of the first IM phase-in date of 1 September 2016.

To the extent that the RBI requires that market participants make such approval applications, we request that the RBI provide further information and clarification on the procedural aspects of how this would be done and the timeframe anticipated for the approval process. ISDA requests the RBI to clarify how long in advance covered entities should submit models to the RBI for approval if the covered entity wishes to use the model on 1 September 2016.

Margin exchanged on a "contract by contract" or "transaction by transaction" basis

We would like to seek clarification on what exchanging margin on a “contract by contract” basis, a “portfolio” basis and a “transaction by transaction” basis mean under paragraphs 14 and 21 of the Discussion Paper.

As a general point, calculation and exchange of VM are done on a net basis (and not on a gross basis) under margin regulations globally, and netting is the premise for achieving the policy or regulatory objectives to mitigate counterparty credit risks and systemic risks. Inability to exchange VM on a net or portfolio basis would result in a greater number of payment flows and increase operational complexity. Posting VM on a gross basis also exposes counterparties to greater settlement risk and daylight (or Herstatt) risk when posting multiple currencies, which runs contrary to existing risk management practices of market participants. In addition, exchanging margin on a gross basis is inconsistent with the approach taken in relation to the cleared derivatives market in India where exchange of margin with CCIL is done on a net basis.

For IM, calculation of IM is done on a net basis within the same asset class. If IM were to be calculated on a transaction by transaction basis, this would result in a very high IM, which significantly increases the costs of doing businesses in India. It also increases the risk of “cherry picking” in the event of the bankruptcy of the counterparty.

Lack of legal unambiguity relating to netting

We note that the RBI has referred to “lack of legal unambiguity” as the reason for applying margin on a “contract by contract” basis in paragraph 14 of the Discussion Paper. The RBI has previously used similar language in expressing its view with respect to bilateral netting of counterparty credit exposures. ISDA has previously sent a letter dated 12 October 2012 to the RBI (a copy of which is attached as Appendix 2 to this submission) to set out our view of the netting position in India. As noted in the letter, in an ISDA-commissioned netting opinion, ISDA’s Indian counsel, Juris Corp, opined that close-out netting would be enforceable against all banking entities and corporates established in India (and such opinion has since been affirmed in subsequent annual updates and remains valid as of the date of this submission). Such opinion has been, and continues to be, relied upon by our members to make their own individual assessments on their exposures, margining arrangements and regulatory capital treatments when trading with their Indian counterparts. We would thus welcome confirmation from the RBI that institutions could make their own individual assessment on the validity or enforceability of netting when facing Indian counterparties based on valid legal opinions, and in accordance with the method they use to determine netting for regulatory capital purposes.

Further, our members are concerned about the inconsistent outcomes arising from the insolvency proceedings to which nationalized banks, the State Bank of India and its subsidiaries are subject, and those insolvency proceedings to which entities incorporated under the Indian Companies Act (or previous laws relating to companies) are subject. As mentioned above, requiring margin on a gross (and not net) basis would result in significantly higher cost and is out of step with global moves towards incentivizing bilateral margining of non-centrally cleared derivatives. We would strongly urge the RBI to move towards achieving greater consistency in the application of netting in India and aligning the Margin Rules with global standards in fulfilment of its G20 commitments. In this regard, we would

very much welcome the RBI, together with the other relevant authorities in India, to provide clarity to the market by issuing a written statement on the enforceability of close-out netting with respect to different types of entities incorporated in India, with the goal of introducing legislative changes to remove any residual uncertainty in enforceability in close-out netting in India in the long run.

Please refer to our previous submission for our detailed discussions on our view of the netting position in India.

IM model requirements

We would also like to raise the following clarifications or confirmations with respect to the IM model:

- Paragraph 15 refers to the use of historical data that incorporates a period of significant financial stress. We request that the RBI remove the requirement for calibrating the model based on data for bespoke or recently introduced derivatives as such data would not be available during a period of significant financial stress. We would also welcome clarification of the start date and length of the period for the purpose of collecting the historical data. In this regard, we note that under the BCBS-IOSCO Framework, the IM amount must be calibrated to a historical period that does not exceed five years and that includes a period of financial stress for each broad asset class. The calibrations under the ISDA SIMM™ Model are based on three years of contiguous historical data and one year of extreme stress data for each asset class as required by the US and EU regulators. The year for extreme stress data is 2008 for FX, rates, credit and equity, and 2007 for commodities. We strongly recommend the RBI to adopt such guidelines.

- Paragraph 16 refers to the IM model being subject to continuous assessment. We would welcome clarification of the frequency with which IM model has to be assessed under an internal governance process. For example, the final draft EU RTS require IM models to be recalibrated at least every 12 months, although counterparties should have written policies which set out the circumstances that would trigger an earlier recalibration.

- We also request confirmation that MIFOR swaps should be categorized as "interest rate derivatives" under the IM model.

Broad product set should be permitted for margin calculation

ISDA has written to BCBS, IOSCO and the regulators in the US, the EU and Japan (the "**Product Set Letter**") addressing the need for ISDA members to have the flexibility to use a product set that is broader than the minimum product set required by applicable regulations (a copy of which is attached as Appendix 3 to this submission).

The scope of products subject to proposed margin requirements is not consistent across jurisdictions. For cross-border OTC derivative transactions, if two parties have to use two different regulatory product sets to calculate margin, there will be two different margin determinations using the two sets of rules. Dealers would need to develop systems that could simultaneously run two sets of margin calculations based on two different product sets. These same issues also arise within one jurisdiction if two different sets of margin rules apply.

ISDA would like to request that its members have the option of using the broad product set in their implementation of applicable margin rules, including development of models and supporting systems. To the extent that substituted compliance does not apply to trades, ISDA and its members need the

flexibility to adopt broad product sets that include the various definitions of derivatives that apply to each of their counterparties in their respective jurisdictions. This is necessary because it is very challenging, in the available time frame, to build systems that can determine margin based on a different product set for each party to a swap. In this respect, we note that the margin requirements in Japan allow out-of-scope OTC derivative transactions to be included in the in-scope portfolio for the purpose of calculating the regulated VM and IM, as long as the covered entities consistently take such approach on a per counterparty ongoing basis.

Under our proposal, for any counterparty pair, the parties may choose to use a broader product set than the set required by either party's applicable regulation. Netting within this broad product set will be permitted to the same extent, and under the same conditions, that would apply to netting of products subject to the Margin Rules. The broad product set will be used for VM and/or IM and will include derivatives as defined by the rules applicable to each counterparty in its respective jurisdiction.

Please refer to the Product Set Letter for our detailed discussions on this point.

Collateral treatment requirements should not apply to margin that is not required to be collected under the Margin Rules

To the extent counterparties voluntarily exchange collateral greater than the minimum applicable requirements (or where the Margin Rules do not apply at all), we request that parties retain the discretion to determine the eligibility and other requirements associated with such exchange. Imposing eligibility criteria and other requirements on voluntarily posted collateral would have significant consequences for all collateral arrangements. Credit support arrangements with persons that are otherwise exempt from the Margin Rules, for example, would have to be extensively re-negotiated. In many cases, it may not be feasible to maintain voluntary collateral in accordance with the Margin Rules, thereby restricting the ability of parties to negotiate additional protections where necessary to address credit risk in an appropriate way. We request that the RBI clarify this point in the Margin Rules.

Possibility of having multiple netting sets under a single master agreement

Covered entities often enter into bilateral netting master agreements (e.g. the ISDA Master Agreement) to document their derivatives transactions. We request the RBI to confirm that covered entities may enter into two or more credit support documents under the same master agreement and create different netting sets thereunder. As detailed in the next two paragraphs, covered entities should be entitled to create different netting sets for Legacy Derivatives and covered transactions, or for products that are subject to different approaches/models.

Right to include Legacy Derivatives in margin calculations and models

We request that RBI confirm that covered entities would have the discretion to include Legacy Derivatives in their margin calculations and models for the purposes of the Margin Rules, provided that they do so in a consistent manner. Parties should have the option to document their Legacy Derivatives under the same credit support document as new transactions entered into after the relevant phase-in dates, so that all of the transactions entered into under the credit support document will be subject to the same margin requirements.

Flexibility to be permitted in the use of standardised approach and IM model

ISDA members request the flexibility to use both the standardised approach and IM models within the same asset class or netting set, provided that they do not do so on an arbitrary basis. This flexibility will be helpful in many circumstances, for example:

(i) where certain transactions are booked into a new or smaller foreign branch (where it may be difficult or very costly to implement full margin infrastructure); or

(ii) where a standardised approach needs to be used because the valuation of a particularly exotic product is difficult to determine for modelling purposes.

The use of a standardised approach in the above circumstances should not mean that the standardised approach must be used for all other transactions entered into in the relevant asset class.

Dispute resolution procedures

We would welcome clarification regarding the processes that would satisfy the requirement for "rigorous and robust dispute resolution procedures" under paragraph 19, and in particular the timeframe within which the RBI would expect disputes to be resolved. We would also like to seek clarification that the RBI would only expect the parties to commence dispute resolution procedures in the event of a material dispute and if so, we welcome confirmation on what the materiality threshold is. We would also welcome confirmation from the RBI that covered entities could engage third party service providers for the purpose of performing portfolio reconciliation and resolving disputes.

Derivative transactions that do not attract counterparty risk capital charge

Paragraph 20 of the Discussion Paper states that "derivative transactions which do not attract counterparty risk capital charge based on the capital framework for banks will be excluded from IM requirements". We would welcome clarification on the types of derivative transactions that would fall under this exclusion. For example, would this cover prepaid or upfront premium options?

Part 3: Eligible collateral

Question 6: Should certain other assets also be considered for inclusion in the list of eligible collateral for margining purposes?

We submit that, in alignment with margin requirements in other jurisdictions, and in addition to those stated in paragraph 23, the following assets be included in the list of eligible collateral:

- debt securities issued by multilateral development banks;
- mutual fund units with other classes of eligible collateral as underlying assets; and
- gold.

We would also like the RBI to confirm that:

- cash includes cash in INR or any other currency; and

- “Central Government” and “State Governments” include central government and regional or state governments of foreign jurisdictions as well as the Indian central government and Indian state governments.

Haircuts

Cash VM should not be subject to 8% FX haircut

The Discussion Paper provides that cash VM should be subject to an 8% FX haircut. This is likely to give rise to risks and inefficiencies. Cash funds denominated in all major currencies are liquid at the point of counterparty default. There are robust markets in the major currencies that allow conversion to, or hedging, the currency of settlement of the derivative transaction, or transfer at a relatively low cost, thus making the imposition of an FX haircut unnecessary. The imposition of FX haircut on cash VM would also not be consistent with the final draft EU RTS, the US rules[8] and the proposed rules in Australia and Hong Kong, and could skew competition in favour of other such jurisdictions that do not mandate such a requirement.

FX haircut on cash IM and non-cash collateral

We would also welcome clarification of what “currency of settlement of the derivative transaction” (in relation to cash IM) and "currency of the derivatives obligation" (in relation to non-cash IM and VM) mean in the table in paragraph 24 of the Discussion Paper.

For non-cash VM, we recommend alignment with the final draft EU RTS under which the FX haircut applies if the currency of the collateral asset differs from that “agreed in an individual derivative contract, the relevant governing master netting agreement or the relevant credit support annex”.

For cash and non-cash IM, we note that under the final draft EU RTS, FX haircut would apply if the currency of the collateral is not “the currency in which the payments in case of early termination or default have to be made in accordance with the single derivative contract, the relevant governing master netting agreement or the relevant credit support annex”, and each counterparty may choose a different termination currency. We further note that under the US rules, FX haircut would apply if the currency of the collateral asset is not “the currency of settlement for the uncleared swap, except for eligible types of collateral denominated in a single termination currency designated as payable to the non-posting counterparty as part of the eligible master netting agreement”. Similarly, the US rules also allow for each counterparty to choose its termination currency and thus it is possible to have two termination currencies for the purpose of determining the application of FX haircut. For IM, we recommend the RBI to include termination currency, and make clear that FX haircut would not apply to currencies agreed by the counterparties in the relevant contract (including individual derivative contract, the relevant governing master netting agreement or the relevant credit support annex). This is because, with respect to trades between the Indian branches of two foreign banks: (i) the termination currency specified in the relevant master netting agreement would not be INR (as it will likely reference a major

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[8] Under the US margin rules, cash VM in the currency of settlement or any major currencies is not subject to FX haircut.

currency or a currency of the jurisdiction where the foreign bank is based); (ii) the currency of settlement of the derivative transactions may not be INR (even if the transactions reference INR, e.g. INR/USD currency swaps); and (iii) the parties may enter into a credit support annex/deed with respect to onshore trades only in which INR may be specified as the "base currency" or the "eligible currency". We note that Hong Kong has adopted a broad interpretation of the "currency of settlement" to capture case (iii) above. Such broad interpretation would allow Indian branches of foreign banks to exchange collateral in INR with each other for IM without being subject to 8% FX haircut.

Proposed 80% floor on haircut

Similar to our comments under "*Proposed 80% floor on IM*" above, we strongly disagree with the proposal of subjecting haircuts to a floor of 80% of the haircuts set out in the table in paragraph 24 of the Discussion Paper. Such proposed floor would result in a lower valuation of collateral exchanged and thus a greater amount of collateral posted, thereby increasing costs to the counterparty. Imposing such floor is likely to have a very real and serious impact on how covered entities continue to do their businesses in India. As noted before, for reasons of principle, disproportionately high costs and inconsistency with global standards, we request RBI to remove such proposed floor on haircut.

Standardised haircuts are minimum haircuts

We would welcome the RBI's confirmation that the haircuts set out in the table in paragraph 24 of the Discussion Paper are minimum haircuts and that covered entities may mutually agree to impose higher haircuts on eligible collateral.

Part 4: Treatment of collected margin

Question 7: What are the views on the proposed legal arrangement for treatment of assets received as initial margin? Would Indian laws be able to provide a mechanism to ensure a legally enforceable arrangement which satisfies the requirements of paragraphs 25 and 26? Is there a need for a third party custodial service provider in India? If the answer is yes, then in what form should the third party custodian service provider be set up?

In our view, Indian laws would be able to provide a mechanism to ensure that legally enforceable arrangements would satisfy the requirements of paragraphs 25 and 26. We support RBI's proposal that IM collected should be subject to arrangements that protect the posting party in the event of bankruptcy of the collecting party, and that legal arrangements should authorise the use of IM only for the specific purpose of meeting losses arising from the default of the posting party. Such proposal entails segregation of IM and IM being held by third party custodians, which is consistent with what foreign regimes require. In respect of the collateral arrangement applicable to cash IM, we are of the view that cash IM held by a third party custodian should be viewed as being adequately safeguarded so long as the cash IM is held in an account that is not the property of the collecting party. Please refer to "*Re-investment of IM cash*" below for further discussion on the market practice with respect to treatment of cash collateral.

ISDA supports the outcome-based approach set out in paragraphs 25 and 26 of the Discussion Paper in favour of mandating specific types of IM segregation structures. Flexibility should be permitted as long as the collateral arrangements sufficiently mitigate counterparty risk. For example, title transfer and

charge back of margin is a structure that is commonly used in the market and provides protection to counterparties. In association with this, ISDA is currently developing standard form documentation (e.g. 2016 Credit Support Deed for IM under English law and 2016 Credit Support Annex for IM under New York law) to be used by market participants. In order to satisfy the IM segregation requirements under global standards, counterparties also have to enter into a tripartite or other appropriate arrangements with a third party custodian to establish the conditions under which a collateral giver or taker could access the collateral. It is to be noted that the development of such documentation takes a substantive amount of time and industry coordination. Such documentation only takes into account the margining requirements of those jurisdictions that have finalized their rules, and thus does not take into account the margining requirements of India. This means that covered entities would not be able to leverage on such documentation if the Indian requirements were to be substantively different from global standards.

Given the foregoing, we consider that there is a need for one or more third party custodial service provider(s) in India prior to the effective date of the Margin Rules. There should be at least one third party custodial service provider for each type of eligible collateral[9] in the Margin Rules. Any third party custodial infrastructure established in India will also need to enable Indian branches of foreign financial entities to comply with the IM segregation and other requirements under the margin rules of their home jurisdictions (e.g., requirements in relation to credit quality of the custodian and account structures).

Based on the understanding of our members, collateral exchange with respect to OTC derivatives transactions is not a common practice in India. The current custodial infrastructure is underdeveloped, especially for the purpose of meeting the IM segregation requirements from September 2016. There is a real concern as to whether existing or new custodial infrastructures could be developed in time for collateral exchange and management, and provide support to the market, by the implementation date. Even if third party custodial infrastructures that are compliant with the Margin Rules were developed in time, there would not be sufficient time for market participants to negotiate and enter into new custodial agreements, and obtain the relevant legal opinions, by September 2016. Few onshore entities will have collateral management systems or be familiar with the documentation required.

Assuming that regulatory compliant custodial arrangements in India are not put in place by September 2016, in addition to not being able to comply with the IM segregation requirements in India, Indian branches of foreign banks would also not be able to comply with the standards of IM segregation and custodian under their home jurisdictions.

We therefore consider it almost impossible for covered entities to comply with the IM requirements under the Margin Rules by the proposed implementation date.

Access to, and availability of, IM

With reference to the requirement that there are no legal challenges in accessing the assets held by custodians when required under paragraph 26, we would welcome more clarity from the RBI on its

[9] We note that some jurisdictions may prescribe concentration limits with respect to risk exposures arising from third party holders or custodians holding IM. For example, articles 28(4)(b) and 28(5) of the EU RTS provide for a concentration limit on cash IM held by a single third party custodian.

scope. In particular, we would welcome that the RBI makes clear that the IM should be made available in a "timely manner" to the collecting party in the event of the posting party's default.

Certain aspects of custodial arrangements may affect when IM will be available and it is submitted that such factors should not affect the ability of covered entities to enter into arrangements with third party custodians. Where IM is held with an independent third party custodian, IM will only be available to the collecting party after the custodian goes through its required procedures. These procedures include the necessary operational steps for transferring the IM and may include verification of the legitimacy of the collecting party's claim for IM. Custodians may also insist on payment of their fees before releasing collateral from custodial liens. The parties may also agree that the posting party has a right to object to release of the collateral by the custodian if the posting party can claim that the demand is not appropriate. Further, the bulk of collateral collected as IM is likely to be intermediated securities held in a clearing system, which will require the collateral provider (or the custodian on its behalf) to deliver appropriate instructions and wait for delivery of the relevant securities in accordance with standard settlement cycles.

For the reasons stated above, we submit that "timely manner" is a more appropriate standard than "immediately available" under the BCBS-IOSCO Framework.

Periodically updated legal opinions with respect to IM

Paragraph 26 of the Discussion Paper proposes that the collateral arrangements be supported by periodically updated legal opinions in order to verify that the collateral arrangements are "effective". While we support the requirement for obtaining proper legal advice with respect to collateral arrangements, we have the following comments and requests:

(i) We would welcome alignment of the Margin Rules with the final draft EU RTS that require an "independent legal review" to be performed. Such review may be conducted either by an independent internal unit or by an external independent third party.

(ii) We submit that, in assessing whether an IM arrangement complies with the requirements of the Margin Rules, covered entities be entitled to rely on standard industry-wide legal advice developed by market participants. Covered entities should not be required to obtain bespoke legal advice with respect to each new segregation arrangement, which could prove time-consuming and expensive. If industry-wide legal guidance is available with respect to certain standard segregation arrangements, such arrangements will be faster to implement and easier for both covered entities and regulators to analyse. In addition, covered entities should be able to rely on suitable opinions obtained by service providers such as custodians.

(iii) We would welcome confirmation from the RBI on the frequency with which covered entities must update their legal opinions or reviews to support that the collateral arrangements in place are effective under the relevant laws.

(iv) We would also welcome confirmation that the legal opinion or review should only address segregation and that collateral arrangements are "effective" if the relevant collateral is legally segregated from the proprietary assets of the collecting party.

Offshore posting of collateral should be allowed

We understand that according to a circular issued by the Foreign Exchange Derivatives Association of India ("**FEDAI**") on 24 September 2012 ("**FEDAI Circular**"), the RBI provided a clarification to certain specific questions posed by FEDAI members that "providing collaterals/margins for onshore transactions at an off-shore centre is not permissible under the Foreign Exchange Management Act, 1999". In an ISDA-commissioned collateral opinion, Juris Corp opined that the FEDAI Circular would only apply if an onshore branch of a foreign bank or an Indian bank were involved in the actual posting or collection of the collateral. The FEDAI Circular would not apply if offshore entities exchange collateral offshore and their Indian branches were not involved or did not participate in the collateral exchange in any manner.

We would welcome the RBI's confirmation that after the introduction of the Margin Rules, a foreign covered entity would be able to exchange collateral offshore if its Indian branch were not involved or did not participate in the collateral exchange in any manner for onshore trades entered into with an Indian branch of another foreign covered entity. We would also welcome the RBI's confirmation that commodity derivatives transactions booked with market makers located offshore will not be treated as onshore transactions.

Requiring foreign covered entities to post collateral onshore for onshore transactions means they will have to "ring-fence" the trades entered into by their Indian branches, negotiate new credit support documents with their Indian counterparts to provide for onshore collateral arrangements for such Indian exposures. They will also have to set up new or expand existing onshore collateral management departments to handle settlement and other operational issues for a great number of OTC derivatives transactions. All of the above entail increased costs and risks to foreign financial entities, which would likely pass the costs to their Indian counterparties or end users. Such a requirement would also be inconsistent with the BCBS-IOSCO Framework and the way foreign covered entities operate in other jurisdictions.

Similar concerns also apply to cross-border trades when Indian financial entities face foreign covered entities. Currently, OTC derivatives transactions between Indian banks and foreign covered entities that have no presence in India are not collateralised in part because of the prohibition under the FEDAI Circular as well as foreign exchange regulations. If the Margin Rules were to require onshore collateralisation, such foreign covered entities would not have established local collateral management system in time to receive collateral posted by Indian banks in India. Further, due to the prohibition on posting collateral offshore, Indian banks currently have less choice in counterparties and are not able to benefit from a more competitive pricing that would otherwise be available for collateralised trades.

The concerns are exacerbated by the fact that no custodial infrastructure that meets the IM segregation requirements will likely be in place by September 2016. It is our view that substantive legal and infrastructural obstacles have to be removed before any covered entity could comply with the IM segregation requirements from the implementation date. In order to avoid disruption of established trading relationships and severe limitation in hedging and financial flows, we strongly suggest that the RBI permits offshore collateral posting for cross-border trades and expressly confirms that Indian branches of foreign financial entities can post collateral offshore for onshore trades between themselves if they are not involved in the actual collateral exchange.

Exemption of stamp duty

In India, execution of credit support documents and transfer of collateral may attract stamp duty (with the latter attracting ad valorem stamp duty) at both the federal level and at the state level in India. In the case of transfer of collateral, stamp duty may be payable if: (i) a written notice calling for collateral is issued; and (ii) an acknowledgement of, or an agreement with, such notice is required by the collateral provider. Given the frequency (daily) of VM exchange, large amount of IM to be posted and the serious consequences of non-payment or inadequate payment of stamp duty, we request that the RBI work with the relevant authorities to introduce an exemption relating to transfer of IM and VM in relevant stamp duty legislations. Any additional costs incurred in connection with complying with the Margin Rules would have a serious impact on how businesses conduct their trades.

Exemptions relating to perfection requirements of IM arrangements

Collateral segregation requirements relating to IM may be subject to certain registration, filing or other perfection requirements. For example, posting of Indian Government Securities as IM may be subject to the approval of the RBI. Accordingly, we request the RBI to work with the relevant authorities to waive any perfection requirements to ensure the IM settlement timeframe could be met. For example, we are aware that there is a proposal to amend section 77 of the Companies Act, 2013 (Duty to register charges, etc.). We would request RBI to exempt the registration of IM from the requirements of Companies Act, 2013 without affecting the validity and priority of the relevant security interests.

Regulatory or capital treatment of IM and VM

We would welcome confirmation from the RBI that:

- regulatory capital relief would be provided to local covered entities to account for the IM and VM they exchange in compliance with the Margin Rules;
- VM posted and received would not be treated as loan or deposit for regulatory purposes;
- cash received as VM would not be subject to cash reserve ratio or statutory liquidity ratio as such treatment is inconsistent with global norms; and
- securities received as VM would be counted towards the receiving bank's statutory liquidity ratio.

Substitution of IM

We note that collateral substitution is a common practice and is provided in standard credit support documentation (e.g. the 1994 ISDA Credit Support Annex under New York law). We would welcome confirmation from the RBI that parties could agree contractually to substitute IM and that the Margin Rules would not impose any restrictions on collateral substitution. Any such restrictions would be inconsistent with global standards.

Question 8: What are the views on the proposal of not allowing re-hypothecation, re-pledge or re-use of assets received as initial margin?

One time rehypothecation should be permitted

For consistency with the BCBS-IOSCO Framework, we ask the RBI to permit one time rehypothecation of IM. While ISDA recognises that there are many conditions around the one-time rehypothecation of

IM, and hence that a one-time right to re-hypothecate collateral would be of very limited use, ISDA members would nevertheless like to have this option.

Re-investment of cash IM

ISDA requests that the Margin Rules clarify that cash collateral may be invested in other eligible assets upon agreement of the counterparties. This would be consistent with current market practice, and would allow counterparties to minimise their credit risk to the custodian or collecting counterparty whilst potentially earning higher returns than on a deposit account. We note that a custodian would only do so at the direction of, and subject to the control of, the counterparties, and not at its own discretion.

Part 5: Intragroup transactions

Exemption of certain intragroup transactions from the margin requirements

We welcome the exemption of intragroup transactions from the margining requirement. However, ISDA requests that the RBI clarify the basis upon which intragroup transactions are exempted, and confirm whether the RBI intends to issue further guidance, or any class exemptions. For example, we note that both the US and EU rules refer to additional criteria such as centralised risk management.

Definitions of "group" and "banking group"

Paragraph 29 of the Discussion Paper refers to risks being transferred in or out of a "banking group" and consolidation of group entities upon preparation of the "group consolidated financial statements". We would welcome clarifications that "group consolidated financial statements" refers to consolidated financial statements under any relevant accounting rules (including foreign accounting rules). We would also welcome confirmation that "banking group" and "group" have the same meaning and that the terms include foreign entities as well as Indian entities.

Part 6: Cross-border transactions

Treatment of cross-border transactions

Paragraph 30 refers to the Margin Rules being applicable to Indian entities, Indian subsidiaries of foreign entities and Indian branches of foreign banks/entities, and that RBI will cooperate with other regulators with respect to appropriate treatment of cross-border transactions where they are subject to margin requirements of two jurisdictions. We request clarification on what such "appropriate treatment" would be and how it differs from the substituted compliance framework in paragraph 31.

Paragraph 31 indicates that substituted compliance would be available to foreign branches or subsidiaries of India-incorporated covered entities where the transactions are booked overseas. We request the RBI to clarify whether foreign subsidiaries of Indian covered entities would be subject to the Margin Rules even if such subsidiaries are not covered entities.

Please also see our comments in "*Outcome-based approach to comparability assessment*" below with respect to the interpretation of global standards in paragraph 31.

Automatic deference and substituted compliance

We note that paragraph 7(b) of the BCBS-IOSCO Framework states that where a transaction is "*subject to two sets of rules (duplicative requirements), the home and the host regulators should endeavour to (1) harmonise the rules to the extent possible or (2) apply only one set of rules, by recognising the equivalence and comparability of their respective rules*". Accordingly, we urge the RBI to adopt rules that are sufficiently consistent and non-duplicative with other foreign regimes. Rules that are not harmonised would result in fragmentation of the market and a reduction of liquidity. Inconsistent rules would also make it more likely for foreign regulators to determine that the Indian margin regime is incomparable with global standards, thus making substituted compliance unavailable for Indian entities when they conduct cross-border trades.

For transactions entered into by Indian branches/subsidiaries of foreign-incorporated covered entities, the Discussion Paper is silent on the distinction between transactions booked in India and those booked outside of India. We request clarification from RBI on whether only those trades that are booked in India by Indian branches/subsidiaries of foreign-incorporated covered entities are subject to the Margin Rules. We also request clarification on whether Indian subsidiaries of foreign-incorporated covered entities are subject to Margin Rules if such subsidiaries are not covered entities.

It is submitted that transactions entered into by Indian branches of foreign-incorporated covered entities be subject to a framework of automatic deference. Under such framework, where a foreign-incorporated covered entity is directly subject to foreign margin requirements that are substantially similar to the BCBS-IOSCO Framework, it may comply with the margin requirements of its home regulator. This approach has been proposed by the relevant Australian regulator in order to assist achieving a workable cross-border framework.

If automatic deference were not adopted by the RBI, we request the RBI to extend paragraph 31 to such transactions so that substituted compliance can be relied upon by foreign-incorporated covered entities, regardless of the booking location of the trades. We note that such trades will likely be subject to margin requirements of the relevant booking location or the home jurisdiction of the foreign covered entity. Subjecting such trades also to the Margin Rules would give rise to potential regulatory conflicts and we submit that foreign-incorporated covered entities should be allowed to comply with the margin requirements of the relevant foreign jurisdictions in lieu of the Margin Rules.

We set out below an example to demonstrate how substituted compliance should operate:

An Indian branch of a foreign bank (a covered entity) with its head office in Country XYZ (referred to as "**X**" herein) is required to follow the margin rules of its home jurisdiction and the RBI has determined that such margin rules are consistent with global standards. X books its transactions in India and, through its Indian branch, transacts with a covered entity that is also a non-financial entity that falls below the threshold for mandatory margining under Country XYZ rules. The relevant transaction falls within scope of the Margin Rules. Under Country XYZ margin rules, all trades with such non-financial entities are out of scope and X is not required to exchange margin in respect of such transaction. Accordingly, based on substituted compliance under the Indian regime, X or its Indian branch may follow the margin rules of its home jurisdiction (instead of those of India) and need not exchange margin with such covered entity.

The above example would apply in a similar manner where the counterparty to X is an Indian or foreign non-financial entity, an Indian bank or an Indian branch of another foreign bank. Under the substituted compliance framework, if RBI has determined that the margin rules of Country XYZ are comparable, then X is allowed to apply the rules of Country XYZ in determining whether and how the transactions it enters into would be margined.

Outcome-based approach to comparability assessments

We welcome the RBI's statement that foreign margin rules may apply to cross-border transactions where the relevant foreign jurisdiction has adopted margin rules which are consistent with global standards. We would ask the RBI to clarify that the global standards for comparability assessments are those set out in the BCBS-IOSCO Framework. It is important to recognise that foreign margin standards may be compliant with the BCBS-IOSCO Framework and yet may have different product and entity coverage which are not comparable to the Margin Rules. Given the different approaches of national regulators in implementing their margin frameworks, we consider that the comparability assessment should be based on comparability with the BCBS-IOSCO Framework alone, and not with the Margin Rules.

Comparability assessments should be made available to all covered entities and with sufficient notice prior to the implementation date of the Margin Rules

We note that the regulators in the US, Japan, Canada and Switzerland have issued final margin rules, the EU has published the final draft RTS, and the regulators in Australia, Hong Kong and Singapore have proposed margin requirements based on the BCBS-IOSCO Framework.

We recommend that, with respect to jurisdictions that adopt margin requirements that are based on the BCBS-IOSCO Framework, the RBI performs a comparability assessment on its own initiative (rather than requiring each covered entity to make a separate request for comparability assessment) and confirms that substituted compliance will be available to the applicable covered entities in respect of those jurisdictions. Such treatment would be a fitting recognition of the extensive consultative process by which the BCBS-IOSCO Framework was developed. In addition, we suggest that such comparability assessments be made as soon as possible after the Margin Rules are finalised and before the phase-in dates of the Margin Rules. Finally, we suggest that the RBI publishes in advance a clear timeline for the projected comparability assessments that will be made. This will greatly facilitate the implementation of the Margin Rules.

In the event that the RBI retains an approval requirement for IM models, we note that market participants will need time to build, test and receive approvals for IM models that are very new to the market and to re-paper credit support documents (including negotiating new documentation, such as custodial arrangements). Regulators will also need time to formalise the regulatory approval processes for IM models across multiple jurisdictions. To the extent that market participants are proposing to outsource certain functions in relation to the margin requirements, such as the calculation of IM and the calling of IM, market participants would need time to complete such applications or filings, and the regulators would need time to consider them. Moreover, the ability of the market to make the necessary enhancements will depend on the outcome of the comparability assessments, and this could further slow the implementation process. In light of the above, if the RBI is not able to make a comparability assessment as soon as a jurisdiction issues final rules based on the BCBS-IOSCO Framework, and in

any event before 1 September 2016, then we ask the RBI to make a two-year transitional comparability determination during which the Margin Rules will not apply to covered transactions where either or both of the covered entities is subject to the margin requirements of the relevant foreign regime.

We propose that the RBI makes its comparability determinations and the considerations it takes into account in coming to such determinations publicly available so that they can be relied upon by all in-scope entities, and that the RBI maintains an updated list of comparable jurisdictions.

Jurisdictions where netting and/or collateral is not enforceable

ISDA would welcome an exemption for covered entities from the VM and IM 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. A covered entity would be exposed to 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. In addition, we note that such counterparties (in particular smaller banks and non-bank financial institutions in Asian emerging markets) often do not have infrastructure in place to calculate, exchange and manage VM and IM. Imposing margin requirements on non-centrally cleared derivatives transactions with these categories of counterparty would therefore not only expose covered entities to additional risk but would also disrupt established trading relationships and severely limit hedging and financial flows between India and those jurisdictions.

We note that institutions may have different views as to whether netting is enforceable in a particular jurisdiction or not. The validity and enforceability of netting may also vary according to the different counterparty types in a given jurisdiction (for example, the legal analysis may vary according to whether the counterparty is a private bank, a public bank, or some other type of entity). Accordingly, ISDA requests that the RBI allows institutions to make their own individual assessment on whether a jurisdiction is "netting-friendly" in accordance with the method that they use to determine this for capital adequacy purposes. In the event that an institution is uncertain on the legal netting analysis, it should be open to that firm (in its discretion) to approach the RBI to discuss the most appropriate treatment of transactions with entities in the relevant jurisdiction, bearing in mind that in most cases there will be a capital benefit to firms in treating a jurisdiction as netting-friendly notwithstanding the potential advantage of falling outside the margin rules if the jurisdiction is determined to be one where netting is not enforceable, and also that margin rules in other jurisdictions may have a different approach for non-netting jurisdictions.

Part 7: Implementation schedule

As detailed above, given the very low rate of collateralization of OTC derivatives transactions in India currently, the inherent legal and infrastructural impediments in the local market, coupled with the inconsistency with international norms, it is almost impossible for market participants to comply with the IM requirements in the timeframes proposed by the RBI.

As a practical matter, Phase 1 banks will have to comply with the margin requirements in their home jurisdictions from September 2016. This means that the Indian branches or subsidiaries of such banks will have to exchange margin when trading with each other, regardless of Indian margining requirements. Based upon current outstanding notional numbers, we would not expect any India-

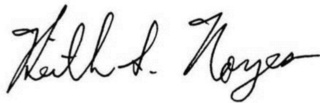
incorporated banks to come in scope for IM requirements before September 2019 or September 2020, based on the thresholds under the BCBS-IOSCO Framework. Accordingly, rushing to implement mandatory IM requirements in India would not further the policy objective to reduce systemic risks in the global derivatives market, but would most likely result in adverse consequences to the market and end users. Given the foregoing, we strongly recommend that the RBI first address the structural obstacles elaborated above prior to finalizing the IM requirements. This would also give CCIL and other Indian central counterparty time to gain recognition by CFTC/ESMA and expand their clearing offering to cover INR interest rate swaps.

For VM, Indian banks are expected under the BCBS-IOSCO Framework to begin mandatory exchange of VM in March 2017. We therefore recommend that the RBI addresses first with some urgency the legal and infrastructural impediments discussed in this submission to ensure the efficient exchange of VM between market participants in India**.**

We look forward to continuing our dialogue with you. Please do not hesitate to contact Keith Noyes, Regional Director, Asia Pacific (knoyes@isda.org, +852 2200 5909) and Rahul Advani, Assistant Director, Policy, Asia Pacific (radvani@isda.org, +65 6653 4171) for questions related to this response.

Yours faithfully,

For the International Swaps and Derivatives Association, Inc.



Keith Noyes

Regional Director, Asia-Pacific

Appendix 1

October 12, 2012

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Dear Sirs

Consistency of netting application to spur financial market growth

1. **Introduction**: The International Swaps and Derivatives Association, Inc. ("**ISDA**")[1] is writing to you in the context of achieving greater consistency in the application of netting directives with regard to financial derivatives transactions in India. With such consistency, our members believe that India's CDS market will grow, the move of OTC derivatives to central counterparty ("**CCP**") clearing, which is one of

[1] ISDA's mission is to foster safe and efficient derivatives markets to facilitate effective risk management for all users of derivative products. ISDA has more than 800 members from 58 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers. For more information, visit www.isda.org.

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India's G20 commitments, will be incentivized and take-up rates for margining of INR derivative transactions will receive a boost in line with global moves towards incentivizing bilateral margining of uncleared OTC derivative transactions[2]. The higher capital charges that will result from the implementation of Basel III will also mean that the cost of trading OTC derivatives on a gross exposure basis will increase significantly. Achieving greater consistency on netting in line with the recognition granted to netting under the Basel accords will we believe have a positive effect on the future growth of the INR derivatives markets by reducing costs to the benefit of real economy companies' looking to manage their business risks, banks and other financial institutions as well as the broader financial market in India. We have set out below a summary of our view of the netting position in India and the regulatory capital incentives for netting under the Basel framework and current Indian regulations. This is followed by a number of suggestions where directives and regulatory initiatives in India could benefit from a consistent recognition of netting.

2. **OTC derivatives and the ISDA Master Agreement**: As you know, in India as well as globally, the practice is for OTC derivatives to be traded under the ISDA Master Agreement. The point to note is that transactions entered into under the ISDA Master Agreement are **not** separate, but rather form a single whole: that is, the effect of the ISDA Master Agreement is to treat **all** transactions between two parties which are governed by the agreement as a single legal whole with a single net value upon early termination of such transactions. This is achieved by the close-out netting provisions under the ISDA Master Agreement which consist of three principal elements: early termination; valuation of the terminated transactions; and an accounting of those values, together with amounts previously due but unpaid, to arrive at a single net sum owing by one party to the other.

3. **Enforceability of close-out netting under the ISDA Master Agreement**: Of course, the key issue is whether each of these three elements is enforceable. "Enforceability" in this context comprises two key components: first, enforceability as a matter of contract law under the governing law of the contract (typically English law or New York law); and second, consistency with and enforceability under the bankruptcy laws of the jurisdiction where the counterparty is located. The latter is critical since, regardless of the law selected to govern the contract, local insolvency law in an insolvent party's jurisdiction will always override in the event of an insolvency. Note that "enforceability" relates to the fact of net payments, not to their amount. Parties may from time to time have commercial disagreements concerning the valuation of derivatives, as they can for other financial instruments, but these do not tend to take issue with the enforceability of netting. Note also that the issue of the enforceability of close-out netting is separate from the issue of the legal capacity of a party to enter into derivatives transactions.

4. **Enforceability under Indian law**: As a contractual matter, outside of bankruptcy, all three of these elements contained in the close out netting provisions of the ISDA Master Agreement are effective as a matter of both English and New York law and also under some other laws, including we believe Indian law. With regard to India, we understand that legal experts in India generally concur that enforceability in insolvency is not an issue with regard to entities incorporated under the Indian Companies Act (or previous laws relating to companies) which would include private sector banks – and we believe that this is a view shared by the Reserve Bank of India ("**RBI**")[3]. However, we understand that there may be some doubt as regards enforceability in insolvency insofar as nationalized banks and the State Bank of India and its subsidiaries are concerned. This stems from the fact that the Indian government banks acts[4] provide that no provisions relating to the winding-up of companies shall apply to such banks and that they can only be liquidated by order of, and in such manner as, the Indian Government directs. In any event, ISDA's Indian counsel, Juris Corp, has confirmed that close-out netting

[2] BCBS-IOSCO Consultation Paper on Margin Requirements for non-centrally-cleared derivatives dated July 6, 2012.
[3] Please refer to paragraph 15 below.
[4] Namely the State Bank of India Act, 1955, the State Bank of India (Subsidiary Banks) Act, 1959 and the Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970 and 1980.

will ultimately be enforceable even in respect of nationalized banks and the State Bank of India and its subsidiaries.

5. **Netting of exposures for regulatory capital purposes**: Basel requires banks to set aside a prescribed minimum percentage of capital (that will increase significantly with Basel III) against their risk-weighted assets (counterparty credit exposure multiplied by a risk-weight percentage). If close-out netting is enforceable, under the Basel framework, counterparty credit exposure is treated as the sum of positive and negative replacement costs[5] of all the outstanding transactions between the bank and that counterparty. If close-out netting is not enforceable, counterparty credit exposure is treated as the sum of positive replacement costs (with negative replacement costs deemed to be zero). Thus, the ability of banks to net their exposures has a significant impact on their regulatory capital requirements and in turn, the price that they will have to charge the counterparty for entering into a transaction.

6. **Position of Reserve Bank of India on netting exposures for regulatory capital purposes**: RBI in its Master Circulars on Prudential Guidelines on Capital Adequacy and Market Discipline – New Capital Adequacy Framework ("**Prudential Guidelines Master Circular**") requires banks to **not** net their exposures for regulatory capital purposes. Thus, in India, Indian-incorporated banks and Indian branches of foreign banks cannot net their exposures for regulatory capital purposes.

7. **RBI's Circulars on Prudential Norms for Off-Balance Sheet Exposures of Banks ("Prudential Norms Circulars")**: In its Circular on Prudential Norms for Off-Balance Sheet Exposures of Banks – Bilateral netting of counterparty credit exposures dated October 1, 2010, RBI stated as follows: *"On receipt of requests from banks, the issue of allowing bilateral netting of counterparty credit exposures, in such derivative contracts, has been examined within the existing legal framework. Since the legal position regarding bilateral netting is not unambiguously clear, it has been decided that bilateral netting of mark-to-market (MTM) values arising on account of such derivative contracts cannot be permitted. Accordingly, banks should count their gross positive MTM value of such contracts for the purposes of capital adequacy as well as for exposure norms."* This position was reiterated in RBI's Circular on Prudential Norms for Off-balance Sheet Exposures of Banks dated August 11, 2011: *"Since the legal position regarding bilateral netting is not unambiguously clear, receivables and payables from/to the same counterparty including that relating to a single derivative contract should not be netted."*

8. **Concerns caused by the Prudential Norms Circulars**: In the Prudential Norms Circulars, RBI, a regulator, has expressed the view that the *"legal position regarding bilateral netting is not unambiguously clear"*. In order to net exposures for regulatory capital purposes in any particular jurisdiction, Basel requires a bank to satisfy its national supervisor that the legal basis for netting is clear and that it has inter alia *"written and reasoned legal opinions"* that confirm the enforceability of netting under the relevant agreement. Basel states further that: *"The national supervisor, after consultation when necessary with other relevant supervisors, must be satisfied that the netting is enforceable"*. We understand that various ISDA member banks had, in reliance upon the ISDA-commissioned legal opinion for India[6], taken the position that close-out netting is enforceable against all banking entities and corporates established in India and the potential adverse impact of RBI's expressed view, particularly given the reference in Basel to consultation with the national supervisor and with other relevant supervisors, is a concern for all banks trying to comply with the Basel framework.

[5] When a transaction is in-the-money for the bank, it has a positive replacement cost and when a transaction is out-of-the-money for the bank, it has a negative replacement cost.

[6] We understand that a number of banks have separately obtained additional advice from ISDA's opinion counsel (Juris Corp) on specific points. In their update opinion of February 17, 2011, ISDA's opinion counsel (Juris Corp) confirmed that their view on enforceability remained unchanged notwithstanding RBI's Circular of October 1, 2010.

9. **Impact on onshore margining**: We understand that currently the bulk of INR derivatives transactions are traded on an uncollateralized basis in India. While there are a number of issues associated with margining (or collateralization) arrangements for OTC derivative transactions in India, one key factor that disincentivizes the use of margining arrangements is non-availability of bilateral netting of exposures for regulatory capital purposes under RBI's Prudential Guidelines Master Circular. While RBI's Prudential Guidelines Master Circular implements Basel and allows banks to offset the adjusted collateral value against the adjusted exposure using the comprehensive approach where the collateral arrangements meet *inter alia* the general requirements for legal certainty, there are the following aspects:

(a) The collateral agreement best suited to India's legal system and regulatory regime that is generally used when margining arrangements are put in place in connection with OTC derivatives transactions is the ISDA English law Credit Support Annex ("**English law CSA**"). It is relevant to note here that RBI has, in the context of the Indian CDS market, permitted the use of the English law CSA for either: (i) onshore INR CDS transactions only, or (ii) all onshore transactions including INR CDS transactions. From a legal standpoint, the English law CSA constitutes a confirmation of a transaction under the ISDA Master Agreement and is not a separate or security document as that term is commonly understood. The effectiveness and enforceability of the English law CSA therefore hinges upon close-out netting under the ISDA Master Agreement. There is now a concern that courts in India, in light of RBI's expressed view in its Prudential Norms Circulars that *"the legal position regarding bilateral netting is not unambiguously clear"*, may take the position that the English law CSA does not meet the requisite level of legal certainty to allow for collateral received under the English law CSA to be recognized as risk reducing under the Basel framework. Further, as the English law CSA is deemed to be a transaction under the ISDA Master Agreement and as RBI's Prudential Guidelines Master Circular directs banks to **not** net their exposures for regulatory capital purposes, the "exposure" under the English law CSA cannot be netted against the other exposures under the ISDA Master Agreement. Without associated regulatory capital savings, entry into margining arrangements will involve banks incurring costs in implementing and maintaining such arrangements and in funding the cost of collateral to be posted and the risk reducing activity of taking and posting collateral will not be incentivized.

(b) Given RBI's position that exposures cannot be netted for regulatory capital purposes, there is concern that RBI will require margining of gross and not net exposures. Assuming bilateral margining and that close-out netting is not enforceable, margining on a gross exposure basis leaves a party worse off than margining on a net exposure basis. We refer you to Annex I for examples. Thus, parties that enter into margining arrangements would wish to margin exposures on a net basis.

(c) Even if RBI permits bilateral margining on the basis of net exposures, and parties enter into bilateral margining based on net exposures, parties are required by RBI's Prudential Guidelines Master Circular to monitor exposures on a gross basis and set aside regulatory capital against their gross exposures. This leads to an anomalous situation where a party's gross exposures and regulatory capital requirements increases when it posts collateral with the counterparty (and the party may be required to post collateral where it is out-of-the-money on the transactions or as initial margin). If close-out netting is recognized as enforceable, exposures and regulatory capital requirements will be reduced when a margining arrangement is put in place. Contrary to this, implementation of margining arrangements in India in the current framework as it stands makes the party face the cost of funding collateral that it is required to post to its counterparty and a higher regulatory capital charge due to its increased gross exposures when it posts collateral with the counterparty.

(d) Given that banks in India cannot net exposures for regulatory capital purposes, banks are currently monitoring their exposures on a gross exposure basis. This means that banks that wish to put in place margining arrangements will have to implement parallel exposure monitoring systems - on a gross basis (for regulatory capital purposes) and a net basis (for margining purposes) which for the banks, and therefore the system as a whole, is inefficient and costly.

10. **Impact on India's CDS market**: RBI's Guidelines on Introduction of CDS for Corporate Bonds dated May 24, 2011 requires margining of CDS transactions and allows margining to be done on a net basis. We believe that permitting bilateral netting of exposures for regulatory capital purposes under RBI's Prudential Guidelines Master Circular and resolution of the other aspects as described elsewhere in this letter including paragraph 9 will help incrementally in the development of the CDS market as banks will perceive a real benefit in exchanging collateral in an efficient way.

11. **Impact on central clearing**: RBI's Prudential Guidelines Master Circular prohibiting netting of exposures for regulatory capital purposes currently applies to exposures to the Clearing Corporation of India Limited ("**CCIL**"). However, CCIL's forex forward segment is margined based on net exposure calculations. Currently, this inconsistent approach to netting is not particularly problematic because RBI's Prudential Guidelines Master Circular provides for a zero risk weight for trade exposures to CCPs including CCIL. It also provides for a risk weight for collateral posted with the CCP that varies depending on the credit rating of the CCP – the risk weight is 20% for collateral posted with CCIL. However, given that the RBI has committed to implementing Basel III when finalized[7], once exposures to CCIL are no longer given a zero risk weight (we refer you to paragraph 12 below), the fact that exposures to CCIL cannot be netted under RBI's Prudential Guidelines Master Circular will be a significant issue for all bank members of CCIL and may have a material impact on the performance and growth of the portion of India's derivatives market that is required to be cleared through CCIL.

12. **Impact of Basel III on CCPs**: Basel III proposes a risk weight of 2% for trade exposures to a CCP where the CCP is a qualifying CCP ("**QCCP**"), viz., a licensed CCP that is compliant with CPSS-IOSCO's Principles for Financial Market Infrastructures ("**FMI Principles**")[8]. For QCCPs, Basel III also proposes a risk weight of 0% for collateral posted by a clearing member with the QCCP, provided the collateral has been segregated and is bankruptcy-remote. If the qualifying proviso is not met, collateral posted with the QCCP will bear a risk weight of 2% or 4%, depending on the degree of segregation and bankruptcy-remoteness. For a non-qualifying CCP ("**non-QCCP**"), risk weights for both trade exposures and collateral posted with the non-QCCP will range from 20% to 150%. We understand that market participants are concerned that CCIL currently does not meet all the FMI Principles and will thus have to be treated as a non-QCCP. Under Basel III, banks will be at a disadvantage when clearing their trades through CCIL if it is a non-QCCP as trade exposures will not qualify for the risk weight of 2% for QCCPs.

13. **Concerns stemming from absence of close-out netting rights upon default or insolvency of CCIL**: Another major problem with the netting of exposures to CCIL is that CCIL's rules currently do not contemplate the possibility of a default by, or the insolvency of, CCIL and thus do not include a mechanism that will allow clearing members to terminate their transactions with CCIL in the event of a CCIL default or insolvency and to crystallize a net sum payable by or to CCIL as a result of such termination. This is out of line with international developments on the key features of OTC derivatives CCPs given that all major CCPs including LCH, ICE, CME and SGX now have express rules granting

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[7] RBI has stated on May 2, 2012 in regard to its Guidelines on Implementation of Basel III Capital Regulations in India that: *"'Capitalisation of Bank Exposures to Central Counterparties' etc., are also engaging the attention of the Basel Committee at present. Therefore, the final proposals of the Basel Committee on these aspects will be considered for implementation, to the extent applicable, in future."*

[8] http://www.bis.org/publ/cpss101a.pdf.

their members close-out netting rights in the event of the CCP's default or insolvency. Regardless of any changes made to the RBI's Prudential Guidelines Master Circular, if CCIL's rules remain in their current form, under the Basel framework, banks may need to treat their exposures to CCIL as gross because it would not be clear that members would have enforceable close-out netting rights upon the default or insolvency of CCIL. Again, this may have a material impact on the performance and growth of the portion of India's derivatives market that is required to be cleared through CCIL.

14. **Central clearing and exposure norms**: In addition, RBI's Master Circulars on Exposure Norms also prohibits the netting of exposures for exposure norms purposes. There is no carve-out for CCIL exposures from the application of the exposure norms. Thus, when clearing of INR/USD FX forwards through CCIL becomes mandatory from early next year and with mandatory clearing of INR interest rate derivatives also expected in due course, banks will hit the single borrower exposure limit of 15% of capital funds for CCIL sooner rather than later given that exposures cannot be netted. Thus, while mandating clearing through CCIL fulfills India's G20 commitments to promote central clearing of OTC derivatives, the RBI's current approach to exposure norms creates an issue for bank clearing members of CCIL that needs to be addressed. Given that banks are required under the rules of the Foreign Exchange Dealers' Association of India to clear INR/USD FX forwards through CCIL, the RBI's current approach to exposure norms can lead to only one outcome – banks will have to stop entering into transactions that must be cleared once they hit the single borrower limit for CCIL. As the RBI's current approach does not recognize the fact that the transactions already cleared with CCIL carry very little counterparty risk due to CCIL's margining and loss mutualization mechanisms, this threshold will be reached far more quickly than is necessary. In our view, this limitation will affect the continued performance and growth of India's FX and interest rate derivatives markets, which are together crucial sources of business risk management for real economy companies.

15. **Need for netting legislation**: RBI has noted[9]:

"There is a strong case for reviewing these legislations and recasting them for a number of reasons. First, prudential regulations are ownership neutral. However, the fact that different banks are governed by different laws has resulted in an uneven playing field which needs to be addressed. For example, while amendments were carried out to enable SBI, SBI subsidiary banks and nationalised banks to issue preference shares, though at different points of time, banks in private sector cannot issue preference shares as the amendments to the BR Act is still to be carried out. Similarly, while bilateral netting in the event of liquidation is admissible for private sector banks governed by the Companies Act and the normal bankruptcy laws, the position in this regard for public sector banks, SBI and its subsidiaries, is not clear in law, as liquidation, if at all, of such banks would be as per the Notification to be issued by the Government in this regard. Second, a single, harmonized and uniform legislation applicable to all banks will provide transparency, comprehensiveness and clarity and provide ease of regulation and supervision to the Reserve Bank. Third, there is also a need to sort out the conflicts and overlaps between the primary laws governing the banking sector and other applicable laws. For example, the Competition Act, 2002 (as amended by the Competition (Amendment) Act, 2007) is in conflict with the provisions of the Banking Regulation Act, SBI Act and other statutes dealing with the amalgamation of banks. Consolidation of banking sector laws and laying down of common regulatory framework for commercial banks are issues requiring serious consideration."

16. ISDA and its members believe that introduction of netting legislation offers the most effective holistic solution to the current issues facing the markets and would enthusiastically offer up any support that would help assist this process. ISDA has published a Model Netting Act together with a

[9] Legislative Reforms- Strengthening Banking Sector (Address by Shri Anand Sinha, Deputy Governor, Reserve Bank of India at Financial Planning Congress '11 organized by Financial Planning Standards Board of India at Mumbai on December 18, 2011).

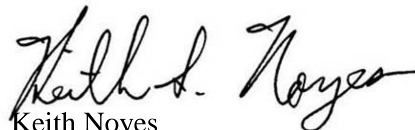
memorandum on its implementation[10] and would be pleased to discuss this further. UNIDROIT's project to develop a set of draft principles regarding the enforceability of close-out netting provisions is also fairly well-advanced[11]. ISDA could also provide an analysis of netting legislation in other relevant jurisdictions.

17. **Interim measures**: ISDA and its members recognize that the introduction of netting legislation is not something that "can be done overnight". Thus, ISDA requests the taking of certain interim measures that could be of assistance to the regulators and market participants. ISDA understands that the Prudential Norms Circulars resulted from RBI's desire to maintain a level playing field between public sector banks and private sector banks. Thus, we presume that RBI may consider allowing the netting of exposures both for regulatory capital and exposure norms purposes if the enforceability of bilateral netting of exposures with government banks is made clearer. As the doubt in regard to government banks stems, in our assessment, from the position that they can only be liquidated by order of, and in such manner as, the Indian Government directs, we believe that significant comfort would be provided if the Ministry of Finance (or other appropriate ministries of the Government of India) were to issue a written statement to the effect that in the liquidation of any government bank, the right to close-out transactions under the ISDA Master Agreement would be recognized and enforced. In addition and in the interim, we believe that a statement from RBI as regards the enforceability of close-out netting in the case of private sector banks, branches of foreign banks in India and corporates would be of tremendous assistance.

18. We would also request RBI to permit banks to net their exposures against corporates for regulatory capital purposes as the enforceability of close-out netting against corporates is not in doubt.

We would be most pleased to assist in any way. Please contact Jacqueline Low (jlow@isda.org, +65 6538 3879) or Keith Noyes (knoyes@isda.org, +852 2200 5909) at your convenience.

Yours faithfully,
For the International Swaps and Derivatives Association, Inc.



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[10] http://www2.isda.org/functional-areas/legal-and-documentation/opinions/.
[11] http://www.unidroit.org/english/studies/study78c/main.htm.

ISDA® Safe, Efficient Markets

ANNEX I
Impact on margined transactions if close-out netting is not enforceable

Assumes no change in replacement cost or collateral value at different points in time.

Party A's Replacement Cost on Transaction 1	Party A's Replacement Cost on Transaction 2	Party A's Collateral Position (collateral received)	Party B's Collateral Position (collateral received)	Party A must pay to Party B's insolvency trustee	Party A claims in Party B's insolvency	Party A must pay to Party B's insolvency trustee	Party A claims in Party B's insolvency
		No margining		Party B insolvent, close-out netting enforceable		Party B insolvent, close-out netting not enforceable	
-13	+10	0	0	3	0	13	10
+13	-10	0	0	0	3	10	13
		Margining on net MTM basis		Party B insolvent, close-out netting enforceable		Party B insolvent, close-out netting not enforceable	
-13	+10		3	0	0	13	10 + 3
+13	-10	3		0	0	10 + 3	13
		Margining on gross MTM basis		Party B insolvent, close-out netting enforceable		Party B insolvent, close-out netting not enforceable	
-13	+10	10	13	0	0	13 + 10	10 + 13
+13	-10	13	10	0	0	10 + 13	13 + 10
		Party A margining on net MTM basis, Party B on gross MTM basis		Party B insolvent, close-out netting enforceable		Party B insolvent, close-out netting not enforceable	
-13	+10	10	3	10	0	13 + 10	10 + 3
+13	-10	13	0	10	0	10 + 13	13 + 0

Where Party A owes the net MTM:

- Margining on a net MTM basis compared with not margining leaves Party A worst off – write off 13 instead of 10.
- Margining on a gross MTM basis results in the worst off outcome –write off 23 instead of 10 (paying 23 instead of 13 could be viewed as neutral since Party A had received the extra 10 as collateral).
- Party A margining on a net MTM basis while Party B margins on a gross MTM basis leaves Party A in the same position as both margining on a net MTM basis – write off 13 instead of 10 (paying 23 instead of 13 could be viewed as neutral since Party A had received the extra 10 as collateral).

Where Party A is owed the net MTM:

- Margining on a net MTM basis compared with not margining could be viewed as neutral – write off 13 in each case (paying 13 instead of 10 could be viewed as neutral since Party A had received the extra 3 as collateral).
- Margining on a gross MTM basis results in a worst off outcome – write off 23 instead of 13 (paying 23 instead of 10 could be viewed as neutral since Party A had received the extra 13 as collateral).
- Party A margining on a net MTM basis while Party B margins on a gross MTM basis leaves Party A in the same position as not margining or both margining on a net MTM basis – write off 13 in each case (paying 23 instead of 10 could be viewed as neutral since Party A had received the extra 13 as collateral).

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Impact on margined transactions if close-out netting is not enforceable

	Party A owes net MTM of 3	Party A is owed net MTM of 3
Both parties do not margin	1	2
Both parties margin on net MTM basis	2	2
Both parties margin on gross MTM basis	3	3
Party A margins on net MTM basis, Party B margins on gross MTM basis	2	2
Value scale: 1 is best, 3 is worst from Party A's perspective.		

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Counterparty Credit Exposure

Assumes no change in replacement cost or collateral value at different points in time.

Party A"s Replacement Cost on Transaction 1	Party A's Replacement Cost on Transaction 2	Party A's Collateral Position (collateral received)	Party B's Collateral Position (collateral received)	Party A must pay to Party B's insolvency trustee	Party A claims in Party B's insolvency	Party A must pay to Party B's insolvency trustee	Party A claims in Party B's insolvency
		No margining		Party B insolvent, close-out netting enforceable		Party B insolvent, close-out netting not enforceable	
-13	+10	0	0	3	0	13	10
+13	-10	0	0	0	3	10	13
		Margining on net MTM basis		Party B insolvent, close-out netting enforceable		Party B insolvent, close-out netting not enforceable	
-13	+10		3	0	0	13	10 + 3
+13	-10	3		0	0	10 + 3	13
		Margining on gross MTM basis		Party B insolvent, close-out netting enforceable		Party B insolvent, close-out netting not enforceable	
-13	+10	10	13	0	0	13 + 10	10 + 13
+13	-10	13	10	0	0	10 + 13	13 + 10
		Party A margining on net MTM basis, Party B on gross MTM basis		Party B insolvent, close-out netting enforceable		Party B insolvent, close-out netting not enforceable	
-13	+10	10	3	10	0	13 + 10	10 + 3
+13	-10	13	0	10	0	10 + 13	13 + 0

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Counterparty Credit Exposure

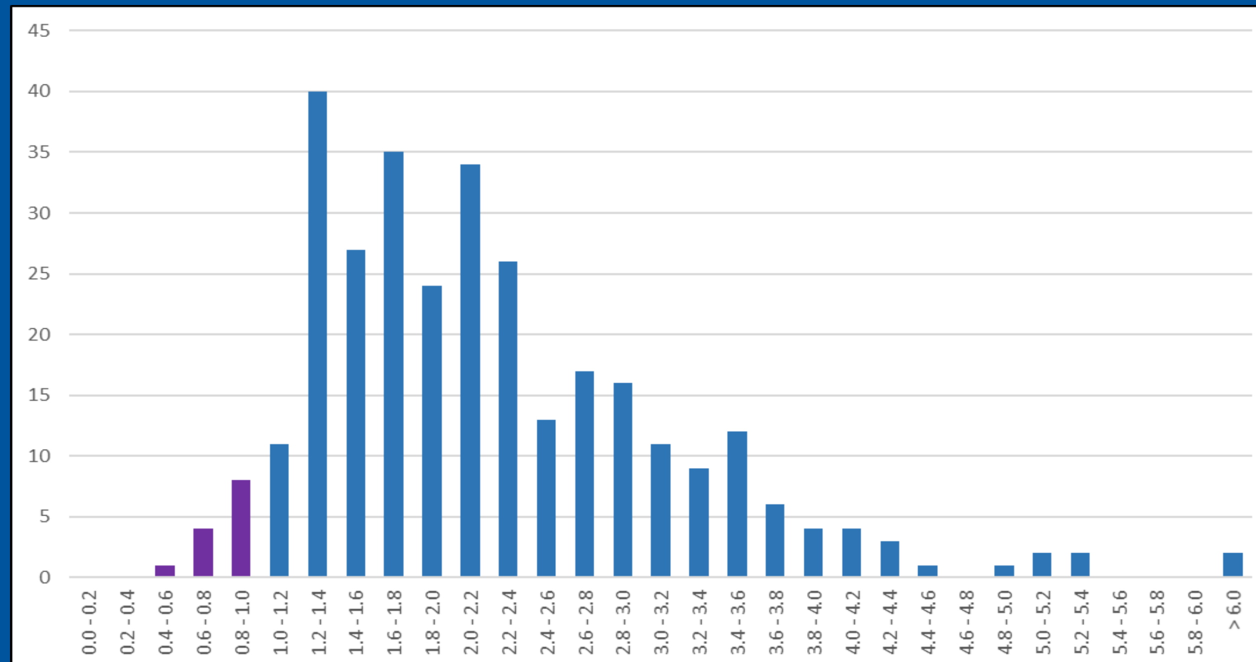
	Party A owes net MTM of 3		Party A is owed net MTM of 3	
	Close-out netting is		Close-out netting is:	
	Enforceable	Not enforceable	Enforceable	Not enforceable
Both parties do not margin	0	10	3	13
Both parties margin on net MTM basis	0	13	0	13
Both parties margin on gross MTM basis	0	23	0	23
Party A margins on net MTM basis, Party B margins on gross MTM basis	0	13	0	13
From Party A's perspective If close-out netting is not enforceable, better off not margining at all.				

Appendix 2

Benchmarking: SIMM™ vs. Historical VaR

For the actual portfolios the calculated IM is likely to be conservative and pass backtesting

- The ratio of the calculated IM to the 99% and 1% percentile of the historical 10-day P&L distribution gave the first indication of the validity of the SIMM
- The sum of all SIMM values is around 2x larger than the sum of all historical VaR measures.
- This indicates that for the actual portfolios the calculated IM is likely to be conservative and pass backtesting



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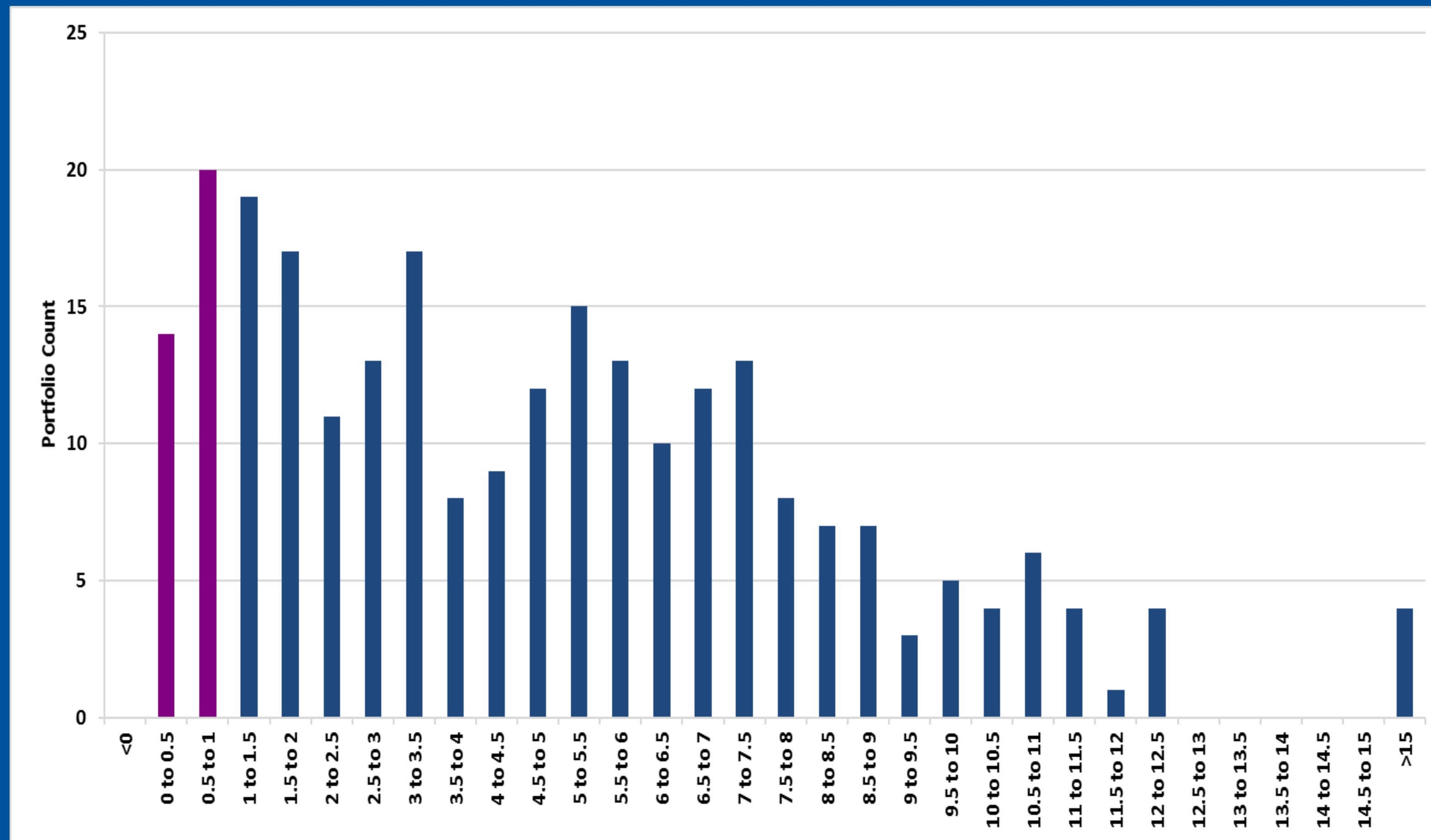
Benchmarking: SIMM™ vs. Standard Grid Calculation

The total Standard Approach (Look-up table) margin is circa x5 the total SIMM margin, for the portfolios included in the backtesting exercise.



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Benchmarking: SIMM™ vs. Cleared Margin Requirements

US Final Rules

When applicable, validation shall include benchmarking against observable margin standards to ensure that the initial margin required is not less than what a derivatives clearing organization or a clearing agency would require for similar cleared transactions.

Credit Qualifying

Region	Grade	Tenor	Index	ICE Margin	ICE Spread	SIMM	SIMM/CCP
Europe	IG	1Y	iTraxx Europe S20 V1	221	**175**	**391**	2.2
Europe	IG	5Y	iTraxx Europe S24 V1	1,322	**1,185**	**2,187**	1.9
Europe	HY	1Y	iTraxx Crossover S20 V1	1,037	**797**	**1,249**	1.6
Europe	HY	5Y	iTraxx Crossover S24 V1	3,555	**3,252**	**8,234**	2.5
N. A.	IG	1Y	CDX.NA.IG.21	273	**216**	**476**	2.2
N. A.	IG	5Y	CDX.NA.IG.25	1,628	**1,460**	**2,250**	1.5
N. A.	HY	1Y	CDX.NA.HY.17	1,278	**982**	**1,343**	1.4
N. A.	HY	5Y	CDX.NA.HY.25	4,380	**4,006**	**7,535**	1.9

Benchmarking: SIMM™ vs. Cleared Margin Requirements

Equities and Commodities

Underlier	Exchange	Future	Exchange Margin	SIMM	SIMM/CCP
S&P 500	CME	3 month	5,116	15,000	2.9
NASDAQ COMPOSITE	CME	3 month	5,184	15,000	2.9
EURO STOXX 50	EUREX	3 month	10,377	15,000	1.4
NIKKEI 225	JSCC	3 month	4,906	15,000	3.1

Commodity Type	Underlying	Future	Exchange	Exchange Margin	SIMM	SIMM/CCP
Coal	Central Appalachian Coal	1 Month	NYMEX	5,937	9,000	1.5
Crude	Brent Crude	1 Month	NYMEX	9,279	19,000	2.0
Light Ends	RBOB Gasoline	1 Month	NYMEX	7,449	18,000	2.4
Middle Distillates	Singapore Jet Kerosene	1 Month	ICE	8,311	13,000	1.6
Heavy Distillates	Singapore Fuel Oil 380 Cst	1 Month	NYMEX	13,331	24,000	1.8
N.A. Natural Gas	Henry Hub Natural Gas	1 Month	NYMEX	9,667	17,000	1.8
Europe Natural Gas	UK Natural Gas	1 Month	ICE	11,757	21,000	1.8
N.A. Power	PJM WH RT Off-Peak Daily	1 Month	ICE	10,513	35,000	3.3
European Power	German Power Base	1 Month	NASDAQ	13,615	20,000	1.5
Freight	Freight Route TC12 Baltic	1 Month	NYMEX	6,515	50,000	7.7
Base Metals	Copper	1 Month	LME	11,236	21,000	1.9
Precious Metals	Gold	1 Month	COMEX	3,512	19,000	5.4
Grains	Chicago SRW Wheat	1 Month	CBOT	5,189	17,000	3.3
Softs	Cotton	1 Month	NYMEX	4,798	15,000	3.1
Livestock	Live Cattle	1 Month	CBOT	3,209	8,000	2.5

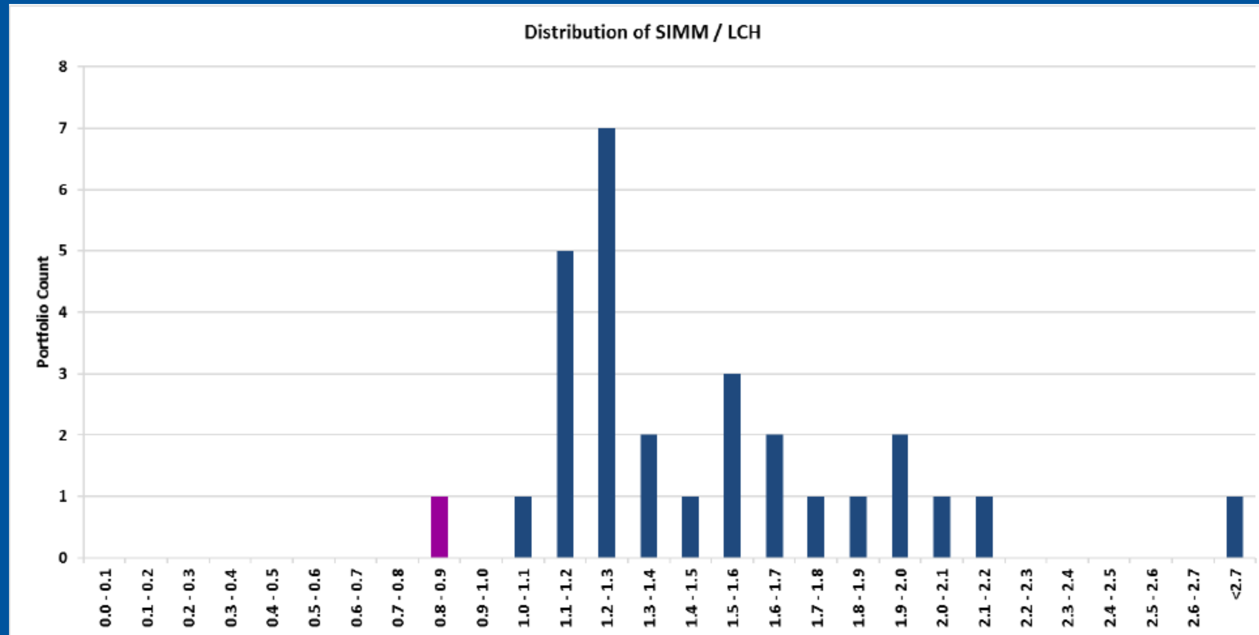
Benchmarking: SIMM™ vs. Cleared Margin Requirements

FX

Underlying	Future	Exchange	SIMM	Exchange Margin	SIMM/CCP
NOK/USD	1 month	CME	7,900	3,368	2.3
SEK/USD	1 month	CME	7,900	2,919	2.7
CAD/USD	1 month	CME	7,900	2,049	3.9
NZD/USD	1 month	CME	7,900	2,815	2.8
CHF/USD	1 month	ICE	7,900	2,984	2.6
JPY/USD	1 month	CME	7,900	2,456	3.2
GBP/USD	1 month	ICE	7,900	2,002	3.9
EUR/USD	1 month	ICE	7,900	2,581	3.1
AUD/USD	1 month	CME	7,900	2,377	3.3

Benchmarking: SIMM™ vs. Cleared Margin Requirements

Interest Rate (SIMM™ vs. LCH)



Total Observations		29
Total SIMM	$	1,083,865,996
Total LCH	$	772,028,803
Overall Comparison		1.40
Average		1.47
Median		1.35

Appendix 3

May 15, 2015

Addressees listed in Annex I attached

Basel Committee on Banking Supervision Bank for International Settlements

Department of the Treasury/Office of the Comptroller of the Currency: **Docket No. OCC-2011-0008/RIN 1557-AD43**

International Organization of Securities Commissions

Board of Governors of The Federal Reserve System: **Docket No. R-1415/RIN 7100 AD74**

The European Securities and Markets Authority

Federal Deposit Insurance Corporation: **RIN 3064-AE21**

The European Banking Authority

Federal Housing Finance Agency: **RIN 2590-AA45**

The European Insurance and the Occupational Pensions Authority

Farm Credit Administration: **RIN 3052-AC69**

Commodity Futures Trading Commission: **RIN 3038-AC97**

Securities and Exchange Commission: **RIN 3235-AL12**

Financial Services Agency

Re: Broad product set for swap margin calculation

Ladies and Gentlemen,

The International Swaps and Derivatives Association[1] ("**ISDA**") hereby writes to apprise you that, in making swap margin calculations, ISDA's members may choose to use a

[1] Since 1985, ISDA has worked to make the global over-the-counter ("**OTC**") derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 64 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law

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product set that is broader than the minimum product set required by regulation. ISDA and its members are using the broad product set as part of their implementation of the margin rules, including for purposes of developing models and supporting systems. Absent substituted compliance, we will apply the new margin rules to a set of trades that includes the various definitions of derivatives that apply to each counterparty in its respective jurisdiction.

We will use a broad product set because it is not possible, in the time frames available, to build systems that can determine margin based on a different product set for each party to a swap.

Discussion:

The authorizing statutes for the margin requirements, in both the US and the EU, do not prohibit the use of a broad product set. In the US, the provisions under the Dodd–Frank Wall Street Reform and Consumer Protection Act [2] require the regulators to adopt initial margin ("**IM**") and variation margin ("**VM**") requirements for uncleared swaps and security-based swaps. In the EU, the EMIR provision[3] states that financial counterparties and certain non-financial counterparties must have risk management procedures that require exchange of collateral with respect to OTC derivatives. These provisions are consistent with a product set that includes all products subject to the applicable margin rules and also includes other products as well.

Having a broad product set as an option will allow parties to reduce risk while simplifying the margin process. For example, supervisory guidance encourages US banks to collect and post VM for physically settled foreign exchange ("**FX**") forwards and swaps.[4] For US swap dealers, including such FX swaps and forwards in a broad product set will allow for a single calculation of VM.

Flexibility in choosing a broader product set will greatly facilitate the process of margin collection by allowing each counterparty pair to choose the set that is best suited to the calculation of margin and management of risk for the portfolio of trades between that counterparty pair. This flexibility is completely consistent with the risk-reduction goals of the margin rules because all regulated products would remain subject to the margin requirements. The broad product set available to the parties will therefore potentially include a wide set of bilaterally traded products, even if such products are not swaps or derivatives under the applicable margin rules.

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firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

[2] §4s(e) of the Commodity Exchange Act; and §15F(e) of the Securities Exchange Act.

[3] Art. 11(3) of Regulation (EU) No 648/12 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories ("**EMIR**").

[4] Basel Committee on Banking Supervision, Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions, Feb. 2013.

Differences in Scope. The scope of products subject to the proposed margin requirements is not consistent across the EU, Japan and the US. Among other differences, equity options are outside the scope of the US swap margin rules entirely, although they are subject to both IM and VM requirements under the EU and Japanese proposals. Physically-settled FX swaps and forwards are subject to VM under the EU proposal but not under the US or Japanese proposal. Annex II, attached, shows the product scope of proposed margin rules in the EU, Japan and the US.

For cross border swaps, using different regulatory product sets for the same swap will not be possible as a practical matter. For example, consider a US swap dealer (located in the US) entering into a swap with an EU financial counterparty (that is not a US-registered swap dealer). The US swap dealer will be required to post and collect VM and IM (assuming the relevant thresholds are met) under the US rules.[5] The EU financial counterparty will be required to collect VM and IM from the US counterparty (again assuming the thresholds are met).

For VM, the calculation by the US counterparty will differ from the VM calculation by the EU party because the product set is different. The US counterparty may determine that it is owed VM and the European counterparty may determine that it is also owed VM. Because VM is a single net number based on the overall exposure, and because the two parties are using different product sets, these two determinations cannot be reconciled.

For IM, both the EU and US parties will be required to collect IM and the US party will be required to post IM as well. Because the product sets are different, the IM that must be posted to the EU party will differ under the US and EU parties' respective determinations. Given the complexity and scale of IM calculations for dealers with a significant volume of swaps, it is not feasible, in the time frames available for implementation, for dealers to develop systems that could simultaneously run two sets of IM calculations based on two different product sets. The practical problems are exacerbated by the need to calculate IM on a daily basis.

The inconsistency in the margin product set raises problems in other cross-border situations. For example, if the same dealer is subject to both EU and US margin requirements, then the dealer would need to calculate IM and VM for two different sets of products. (Such dual requirements could arise, for example, for a US branch of an EU bank that is registered as a US swap dealer.) Such dual calculations would encounter the same inconsistency and operational issues discussed above.

These same issues also arise within one jurisdiction if two different sets of margin rules regulations apply. For example, a US entity that is dual registered as a swap dealer and a security-based swap dealer will be subject to the swap margin rules of the CFTC and the

[5] The US dealer would be required to post and collect margin in this situation under the cross-border approach proposed by the Prudential Regulators and two of the three approaches proposed by the Commodity Futures Trading Commission ("**CFTC**"). One of the three of the CFTC's proposed cross-border approaches, the entity-level approach, would give relief from posting IM in this situation if a substituted compliance determination is made.

Securities and Exchange Commission ("**SEC**").[6] Unless such an entity can use a broad product set, it must run two different sets of margin calculations with its counterparties.

If the parties to a swap elect to use a broad product set, then netting will occur within the broad product set to the same extent as permitted for swaps/security-based swaps/OTC derivatives under the swap margin rules. This netting treatment will be similar to the treatment of legacy swaps under the EU and US proposals.

The Broad Product Set Option:

We therefore respectfully advise you that ISDA members will follow the following procedure to determine the product set for margin calculations for a counterparty pair under the applicable margin rules.

For any counterparty pair, the parties may choose to use a broader product set than the set required by either party's applicable regulation. Netting within this broad product set will be permitted to the same extent, and under the same conditions, that would apply to netting of products subject to the margin rules. The broad product set will be used for VM and/or IM and will include derivatives as defined by the rules applicable to each counterparty in its respective jurisdiction.

* * *

ISDA would welcome a chance to discuss this further. Please feel free to contact me at your convenience.

Sincerely,

Mary P. Johannes

Senior Director and Head of ISDA WGMR Initiative

ISDA

[6] The SEC and CFTC recognized the issues of dual-registration in the rule on mixed swaps (CFTC Rule 1.9(b) and Exchange Act Rule 3a68-4.)

Annex I

ADDRESSEES

Secretariat Basel Committee on Banking Supervision Bank for International Settlements Centralbahnplatz 2, CH-4002 Basel, SWITZERLAND	Legislative and Regulatory Activities Division Office of the Comptroller of the Currency 400 7th St, SW, Suite 3E-218 Mail Stop 9W-11 Washington, D.C. 20219
Secretariat International Organization of Securities Commissions C/ Oquendo 12, 28006 Madrid, SPAIN	Robert deV. Frierson, Secretary Board of Governors of the Federal Reserve System 20th Street and Constitution Avenue, NW Washington, DC 20551
The European Securities and Markets Authority CS 60747 103 rue de Grenelle 75345 Paris Cedex 07, France Attention: Steven Maijoor, Chair	Robert E. Feldman, Executive Secretary Federal Deposit Insurance Corporation 550 17th Street, NW Washington, DC 20429
The European Banking Authority Tower 42 (level 18) 25 Old Broad Street London EC2N 1HQ[UK Attention: Andrea Enria, Chairperson	Alfred M. Pollard, General Counsel Federal Housing Finance Agency Constitution Center (OGC Eighth Floor) 400 7th St, SW Washington, DC 20024
The European Insurance and the Occupational Pensions Authority Westhafenplatz 1 60327 Frankfurt am Main Germany Attention: Gabriel Bernardino, Chairman	Barry F. Mardock, Deputy Director Office of Regulatory Policy Farm Credit Administration 1501 Farm Credit Drive McLean, VA 22102-5090
Christopher Kirkpatrick Secretary of the Commission Commodity Futures Trading Commission Three Lafayette Centre, 1155 21st Street NW. Washington, DC 20581	Elizabeth M. Murphy Secretary Securities and Exchange Commission 100 F Street, NE Washington, D.C. 20549-1090
Financial Services Agency 3-2-1 Kasumigaseki Chiyodaku Tokyo, 100-8967 Japan	

Annex II

DERIVATIVES SUBJECT TO PROPOSED MARGIN RULES

(INITIAL AND VARIATION MARGIN)

Instrument Type	CFTC	Prudential Regulators	EMIR	Japan
Interest Rate	Yes	Yes	Yes	Yes
Foreign Exchange ("FX"), except:	Yes	Yes	Yes	Yes
- FX spot[7]	No	No	No	No
- physically settled FX swaps	No [8]	No [9]	VM, not IM	No [10]
- physically settled FX forwards	No [11]	No [12]	VM, not IM	No [13]
- principal payments on cross-currency swaps	No	No[14]	VM, not IM	VM, not IM
Equity				
- swap based on securities [15]	N/A[16]	Yes	Yes	Yes
- swap based on broad index [17]	Yes	Yes	Yes	Yes
- option based on securities	No	No	Yes	Yes
- option based on broad index	No	No	Yes	Yes
- forward based on securities	No	No	Yes	Yes
- forward based on broad index	No[18]	No[19]	Yes	Yes
Commodities, except:	Yes	Yes	Yes	Yes (not JFSA)[20]

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7 US and EU definitions of "spot" are not identical.

8 Supervisory guidelines provide that banks should exchange variation margin for physically settled swaps and forwards.

9 See footnote 8.

10 Currently out of scope from the definition of "OTC Derivatives" under the Financial Instruments and Exchange Act (FIEA).

11 See footnote 8.

12 See footnote 8.

13 See footnote 10.

14 It is not clear under the Prudential Regulators' release whether VM requirements apply to these principal payments.

15 "Securities" for this purpose excludes a broad index. Also, (1) a swap linked to an exempted security (other than a municipal security) is a CFTC-regulated swap; (2) a swap based on a single security with a composite FX feature is a mixed swap and will be subject to CFTC margin rules only to the extent that SEC regulation does not apply.

16 A swap based on securities is a security-based swap and therefore subject to the SEC's jurisdiction rather than the CFTC's jurisdiction.

17 Broad index refers to a product with more than 9 components that satisfies certain other conditions, including weighting requirements (only relevant for US rules).

18 The classification of forwards based on broad indexes is not explicitly addressed in the regulations.

19 The classification of forwards based on broad indexes is not explicitly addressed in the regulations.

20 Currently, commodity derivatives are not subject to the margin rules of the JFSA but may be subject to the margin rules of other regulators.

Instrument Type	CFTC	Prudential Regulators	EMIR	Japan
- physically settled forwards	No	No	Some[21]	**No**
- trade options	Yes	Yes	Some	**No**
Credit				Yes
- based on single name	N/A[22]	Yes	Yes	Yes
- based on index	Yes	Yes	Yes	Yes
Other (e.g. weather)	Yes	Yes	Certain classes only	Yes [23]
Security linked to any asset	No	No	No	**No**

In addition, the following exclusions also apply:

Cleared and Exchanged Traded	CFTC	Prudential Regulators	EMIR [24]	Japan
Derivatives traded on a futures exchange[25]	No	No	No	No
Derivatives cleared on a recognized CCP	No	No	No	No
Derivatives cleared on a unrecognized CCP	Subject to margin [26]	Subject to margin	No	Subject to margin [27]

21 The margin obligation under EMIR will only apply to physically settled commodity contracts if additional conditions are met e.g. that it is traded on a regulated market or MTF.

22 A credit swap based on a single name is a security-based swap and therefore subject to the SEC's jurisdiction rather than the CFTC's.

23 To the extent that the products fall into the definition of "OTC Derivatives" under the FIEA.

24 Even though Article 11(3) EMIR only refers to OTC derivatives, it is expected that the EMIR margin rules will only apply to OTC derivatives not cleared by a CCP (in line with the heading to Article 11) and, on this basis, the margin rules should not apply to OTC derivatives cleared by a CCP even if that CCP is not recognized under EMIR (see ESMA OTC Question 11(j)). However, the margin rules may apply to uncleared derivatives traded on a non-EU futures exchange if that exchange has not been found to be "equivalent" by the European Commission".

25 The definition of swap excludes "any contract of sale of a commodity for future delivery ... [or] securities future product" Commodity Exchange Act §1a(47)(B)(i).

26 Unless the foreign CCP is exempted by the CFTC.

27 Unless the unrecognized CCP is licensed by the JFSA.