Response to feedback received – Concept Paper on Recordkeeping and Reporting Requirements for Over-the-Counter (OTC) Derivatives

1. INTRODUCTION

1.1 Bank Negara Malaysia ("the Bank") and Perbadanan Insurans Deposit Malaysia ("PIDM") jointly issued a Concept Paper on Recordkeeping and Reporting Requirement for OTC Derivatives ("Proposed Requirements") for industry and public consultation on 26 March 2012.

1.2 The objectives of the Proposed Requirements for capturing OTC derivatives data are to allow the Bank to monitor exposures of regulated institutions to OTC derivatives and to facilitate an orderly resolution of problem member institutions by PIDM.

1.3 More than 40 responses were received from the industry participants. Most responses were supportive of the Proposed Requirements to improve data availability of OTC derivatives for facilitating financial markets surveillance and resolution planning. Many constructive suggestions were also received to help further refine the Proposed Requirements, including the state of the current system infrastructures and OTC derivatives market practices. These comments and suggestions were highly useful to inform the Bank and PIDM on the development of appropriate strategies to further advance this joint initiative.

2. INDUSTRY COMMENTS AND JOINT RESPONSES

Potential duplication of efforts and resources

2.1 While respondents were appreciative of the need and urgency to improve availability of OTC derivatives information, many were concerned whether the efforts and resources to enhance their existing systems to meet the Proposed Requirements would also be meeting the expectations under the trade repository initiative to be determined by the Securities Commission Malaysia ("SC").

2.2 In response to this valid concern, the Bank and PIDM have engaged with the SC on the plan moving forward for the implementation of the trade repository. Following the engagements, the Bank and PIDM have agreed not to proceed to finalise the Proposed Requirements. Instead, the three agencies will work

together to define detailed requirements for the trade repository which are expected to be substantially similar to the transaction-level data requirements contained in the Proposed Requirements jointly issued by the Bank and PIDM.

System limitations

2.3 Many respondents highlighted the constraints in the current systems and processes to fully meet all the Proposed Requirements. A common system constraint was the inability to capture a comprehensive set of OTC derivatives data and difficulties to integrate the current systems with multiple data sources and report all the required data set under the Proposed Requirements.

2.4 The Bank and PIDM recognise that time and efforts are necessary to address current system constraints and to build internal capacity to meet the reporting requirements. An appropriate transitional arrangement will be considered under the trade repository framework to facilitate compliance. Pending the implementation of the trade repository, it is important that the planning for system enhancements takes place at sufficiently early stage to ensure readiness in meeting the future requirements under the trade repository.

2.5 It should also be noted that the readiness and ability of reporting institutions to report the required data set is critical to facilitate the prompt determination and transfer of the qualified financial agreements during a resolution process. This will in turn allow the Bank and PIDM to determine a reduced temporary suspension period under the Financial Services Act 2013, Islamic Financial Services Act 2013 and the Malaysia Deposit Insurance Corporation Act 2011.

Portfolio reconciliation practices

2.6 Respondents also highlighted that regular reconciliation of outstanding portfolio with their counterparties is not a common practice although such practices are increasingly being adopted internationally. As portfolio reconciliation is not a regular practice in Malaysia, some respondents were concerned that when a reconciliation exercise is undertaken by a financial institution at the request of the Bank or PIDM, this could potentially signal deterioration of financial strength of the financial institution. Some respondents also requested for a longer turnaround time for the submission of reconciled trade data to facilitate consolidation of derivatives positions, particularly for institutions with branches operating overseas, as well as to allow counterparties to agree and resolve differences in the valuations of their derivatives positions.

2.7 The Bank and PIDM are currently considering the option of requiring regular portfolio reconciliation separately from the reporting requirements. While this may not be a mandatory requirement as part of trade reporting requirements, financial institutions should endeavour to regularly reconcile their derivatives portfolio with their counterparties as a sound risk management practice to enable prompt identification of trade discrepancies and risks.

Scope of reporting requirements

2.8 Several respondents sought clarification on whether the following transactions are reportable under the Proposed Requirements, specifically:

- Structured products with reference to derivatives instrument;
- Transactions involving counterparties who are individuals;
- Transactions which are originated or arranged by the overseas and Labuan branches or subsidiaries of the reporting institutions; and
- Short dated contracts which would mature before the next reporting date.

2.9 All OTC derivatives transactions across all underlying asset classes (regardless of the length of maturity of the derivatives contract) will be reportable to the trade repository, except for structured investment products with reference to derivatives instrument which do not fall under the scope of reporting. Based on the industry feedback, OTC derivatives transactions rarely involve a natural person as counterparty and that the involvement of a natural person is more relevant in the case of structured investment products as an investor. Since structured investment products do not fall under the scope of reporting, likewise the natural person as an investor in a structured investment product is not subject to the reporting requirements. The scope of the reporting institutions including the legal form of the entity will be further defined under the trade repository framework taking into consideration the need to capture a broader set of reporting entities for systemic risk monitoring.

Objectives of maintaining data requirements under Section 4

2.10 Some respondents also sought clarification of the objective of maintaining internal records on the qualitative information under Section 4 of the Proposed Requirements.

2.11 The main objective of Section 4 of the Proposed Requirements is to gather information such as the overall organisation and group structure, key responsible persons for OTC derivatives operations and any outsourcing arrangements that would facilitate prompt and orderly resolution of OTC

derivatives transactions of problem institutions. The Bank and PIDM are currently reviewing the appropriateness of including the information requirements under Section 4 as part of the trade repository requirement or separately.

Reporting values for certain data fields and proposals on additional data fields

2.12 Clarification was sought by some respondents on the specific data values that should be reported as 'Others', 'Remarks', 'Purpose', 'Notional Amount' and 'Cancellation Date' as different values may be reported depending on the interpretation by individual institutions. For example, which currency should be reported as the 'Notional Amount' under a foreign exchange swap transaction involving two different currencies, and whether certain hybrid products such as swaptions should be reported as 'Others' or 'Swaps'. Respondents also suggested 'Minimum Transfer Amount' and 'Collateral Amount as at Reporting Date' to be added into the reporting template as additional collateral data fields.

2.13 The Bank and PIDM recognise the need to provide greater clarity on the proposed data requirements given the wide diversity of and highly customised OTC derivatives products. A set of revised data and reporting requirements taking into consideration the industry's comments and suggestions on data fields will be defined as part of the trade repository consultation paper.

Classification of hedging and non-hedging transactions

2.14 Most respondents agreed that the use of the accounting definition of hedging under the Malaysian Financial Reporting Standards ("MFRS") 139 would provide a consistent approach in classifying derivatives hedges for regulatory reporting purposes, although some economic and portfolio hedges would not qualify under the accounting standard, thus resulting in only a limited number of OTC derivatives trades being reported as hedging transactions.

2.15 A definition of hedging for purposes of OTC derivatives reporting will be further described in the trade repository consultation paper. This will take into consideration the definition used in the MFRS 139 and the on-going review of hedge accounting standards at the international level.

Standardised counterparty identifier

2.16 Several respondents suggested that the proposed standardised counterparty identifiers should be confined to only the SWIFT Bank Identification Code (BIC) or local Business Registration Number to avoid using other non-standardised identifiers. Some respondents also suggested the adoption of the global Legal Entity Identifiers ("LEI") as a way forward to be consistent with international standards.

2.17 The Bank and PIDM are agreeable with the industry's proposal to use either the SWIFT BIC or the local Business Registration Number as the interim counterparty identifier. These proposals will also be incorporated in the trade repository consultation paper.

2.18 While there are many potential benefits for the adoption of the global LEI system, further assessment is necessary to identify and understand better domestic implementation issues. The Bank, SC and PIDM will further engage the industry on the use of the global LEI system during the trade repository consultation process.

Use of third party reporting services

2.19 The Bank and PIDM, together with the SC will also consider allowing reporting institutions to use third party services as reporting agents as proposed by the industry.

3. GOING FORWARD

3.1 The Bank and PIDM are in the advance stage of discussion with the SC and expect that a joint consultation paper on the specific data and reporting requirements of the trade repository will be issued in second quarter of 2013. This new joint consultation paper will incorporate all relevant requirements that were issued in the earlier concept paper.

3.2 While the end-goal is to leverage on the trade repository as the centralised repository for OTC derivatives data, the Bank may from time to time, during the interim period require financial institutions to provide aggregate-level information on OTC derivatives for monitoring of market activities and systemic risk.

Bank Negara Malaysia
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