COLLATERAL SETTLEMENT TIMING PROTOCOL

- Outline of the Protocol
 - The Protocol is a protocol to shorten the transfer timing in CSAs (NY CSA, UK Annex, Japanese Annex (1995 and 2008 versions)) from T+3* to T+2 following the reform to shorten the settlement timing for Japanese government bonds.
 - Eligible collateral whose transfer timing is shortened under the Protocol constitutes Japanese government bonds, US Treasury, and cash (all currencies). Therefore, except for Japanese government bonds and US Treasury, transfer timing of other collateral assets i.e., securities (including L/C) will not be shortened and remain unchanged.
 - If the existing transfer timing is shorter than T+2, namely T+0 or T+1, the transfer timing will remain as T+0 or T+1.
 - Unless otherwise agreed, the transfer timing will be shortened not only for transfers of collateral in connection with ordinary margin calls but also for transfers for the purpose of the substitution or exchange of collateral and transfers of collateral after a dispute has been resolved.

* T+4 and longer is also included.

- Background of the Protocol
 - There have been many cases where the transfer timing in a CSA in which Japanese government bonds are specified as eligible collateral was T+3 regardless of whether the collateral was bonds or cash, partly because the settlement timing for Japanese government bonds in the Tokyo market was T+3.
 - With the global trend for shorter settlement timing, there have recently been increasing calls among market participants in Japan for shorter transfer timing for collateral in CSAs to T+2 since the settlement timing for outright transactions was changed to T+2 with respect to Japanese government bonds starting from those with an agreement date of 23 April 2012.
 - It is possible to shorten transfer timing by entering into bilateral agreement with each counterparty, but considering that many felt that "the change to T+2 should be realized as soon as possible," "we do not have enough capacity to enter into negotiated agreements with each counterparty," "if some financial institutions adopt T+2 and others adopt T+3 in the market, collateral

management and operation will be hindered, so there should be some mechanism (ie. protocol) to help market participants move from T+3 to T+2 in a coordinated fashion", a decision was made to prepare a protocol. Also, In order to maximize the number of adhering parties, eligible collateral subject to the Protocol are Japanese government bonds, US Treasury and cash that are largest common type of collateral in light of current market practices in Tokyo.

* This is a matter of market practices rather than an obligation, but according to the Japan Securities Dealers Association and other institutions, "basically, it is desirable to shorten settlement timing for the widest scope of transactions possible." However, retail transactions and non-resident transactions are not subject to the "blanket" change to T+2.

Important Notes

- The Protocol is a means to shorten transfer timing under existing agreements to T+2. Regardless of whether the amendment is made using the protocol or through a negotiated agreement, it is necessary to be able to operate at T+2 based on respective operational capacities.
- 2) From the perspective of avoiding any problem arising from the other party's failure to confirm your adherence to the Protocol, it is highly recommended that each Adhering party reaches out to the Operations contact of its CSA counterparties that might be affected by its adherence to this Protocol.

Explanation of the Main Text (Annex I) of the Protocol

The first paragraph provides that prescribed changes will be made with respect to each Covered CSA (meaning the CSAs subject to change in the Protocol, please see the definitions in Section 6 of the Protocol). Further, since the Protocol is to collectively change multiple versions of CSAs, in some parts there are references to definitions that are not used in other CSAs. The second sentence is included to provide that, of these definitions, for example, the definitions that are only used in the UK Transfer Annex ("Equivalent Credit Support" and "New Credit Support") should be read as not being included if a CSA executed between the parties is a NY Law CSA.

The second paragraph constitutes the main body of the Protocol. The section up to the sentence starting with "provided that if" provides that the timing for transfer of collateral to be made under relevant CSAs will be changed to T+2. In practice, since the timing from which the obligation to transfer collateral that is set out based on the agreement by each party varies depending on the CSA, the structure set out in existing agreements is to be

maintained without change by setting out new definitions rather than using the definitions in the CSA. However, it is explicitly provided that that change will not apply to any CSA that sets outs a transfer timing that is shorter than T+2, namely T+0 or T+1. Further, for operational reasons, it is common that the structure in which actual transfer timing is adjusted depending on the timing for a request to transfer collateral (for example, Paragraph 4(b) of the NY Law CSA) will be adopted, and the sentence starting with "provided that if" is provided in order to maintain that structure without change.

The remaining part defines terms that are not defined in the second paragraph. Only Japanese government bonds, US Treasury, and cash (all currencies) are subject to the shortening transfer timing under the Protocol, so these assets are defined as "Relevant Credit Support". Further, the Protocol changes the transfer timing to T+2 not only in the case of ordinal transfers of collateral but also transfers of collateral in connection with substitution, exchange and dispute resolution (also including any transfer of collateral as determined between the parties). Hence, the term "Transfer Event" is defined to include all of those.

- Frequently Asked Questions on the Protocol
 - Q1. We are non-Japanese resident but can we participate in the Protocol?
 - A1. According to the Final Report on Shortening of JGB Settlement Cycle published by Working Group of Japan Securities Dealers Association, inc. version is available (summary here. http://market.jsda.or.jp/shiraberu/saiken/kessai/jgb_kentou/files/youyaku-e2. <u>pdf</u> Please see page 3, (III, 1. (1) Scope of shortening settlement cycle). Non-Japanese residents are not subject to the "blanket" change in settlement timing for Japanese government bonds to T+2, but they will still be able to participate in the Protocol. However, as stated in (1) of the Important Notes, it is necessary to be able to operate T+2 (including cash and U.S. Treasury) based on its operational capacity. In particular, if your CMU (collateral management unit) is not in Asia and if you don't run your operation around the clock, is not on a 24-hour schedule, it would be expected that you would have some operational difficulties in shortening the settlement cycle of JGB., so you are recommend to consult with the counterparty and make a careful judgment on whether to participate in the Protocol.
 - Q2. Transfer of cash and US Treasury is already operated on T+0 or T+1 basis,

but if we adhere to the Protocol, will the transfer timing be extended to T+2?

- A2. No. The aim of the Protocol is to shorten transfer periods that are longer than T+2 to T+2, and it will not affect existing operations with a transfer timing of T+0 or T+1. For example, if the transfer of US Treasury is operated on T+1 based on the definition of Settlement Day in UK Annex, it continues to be operated on T+1 after the adherence to the Protocol.
- Q3. Some of our counterparties adopt a transfer timing of T+4 for Japanese government bonds. What will happen if both sides adhere to the Protocol?
- A3. Any transfer timing that is currently T+4 or longer will be shortened to T+2.
- Q4. We have UK Annex incorporating Recommended Amendment Provisions for Japanese Collateral, which include the modification of the transfer timing to be made "not later than the close of business on the <u>third</u> Settlement Day". According to this provision, can we operate on T+2 without adhering to the Protocol?
- A4. Yes. You can operate on T+2 although there is no enforceability to require the operation at T+2. If counterparty requests to operate on T+3 for their own reasons, you cannot dissent to such request.
- Q5. In a CSA with certain counterparty, there is some bespoke arrangement which would be inconsistent with the terms of the protocol. What should we do?
- A5. You are recommended that amendment be made only to that counterparty bilaterally as necessary.
- Q6. By when does the Protocol need to be adhered to?
- A6. Since the evergreen method is used, in principle, you can adhere to the Protocol any time. However, a deadline to an adherence to the Protocol may be established at the discretion of ISDA by giving 60 days prior notice.
- Q7. Will the Protocol apply to CSAs that may be signed on or after the date on which the both parties to such potential CSA adhered to the Protocol?
- A7. No. Those CSAs are exempt from the Protocol because, for example, (1) a new CSA will mostly likely be negotiated based on T+2 or shorter transfer timing, and (2) it would be better to allow for the scope to enter into a CSA at T+3 or longer through negotiation on or after the ratification of the Protocol.

- Q8. If, for example, Company A adheres to the Protocol on 29 June and Company B adheres to the Protocol on 28 September, from when will the Protocol apply to CSA between Company A and Company B?
- A8. The Protocol will apply from 5 October for the above case. If ISDA receives Adhering Letter by the last Business Day of the month from the later of parties to the CSA to adhere, the Protocol will be effective between those parties on the fifth day of the following calendar month.
- Q9. Is it acceptable to implement a transfer timing of T+2 through bilateral negotiation? If so, what kind of agreement should be executed?
- A9. Yes. The Protocol has been established as a means to amend a large number of agreements in a short period of time, but if the parties are able to agree bilaterally, it is fine to make a change based on negotiations with individual counterparties. There are two possible ways to amend agreements: (1) incorporate the Annex to the protocol in a bilateral amendment agreement, or (2) amend the relevant provisions in the existing CSA by an ordinary amendment.
- Q10. Why was a word-for-word amendment to relevant sections of the existing agreement using the terms in the existing agreement not made?
- A10. CSAs that are widely used when Japanese government bonds are eligible collateral are roughly classified into four versions: Japanese Annex (1995 and 2008 versions), NY CSA, and UK Annex, but the terms and agreement terms and conditions vary in each version. Further, definitions of transfer timing and the numbering of provisions, etc. are significantly different depending on the form of individual companies. Therefore, word-for-word amendments according to the line of relevant provisions will create inconsistencies in agreement terms and conditions peculiar to each company, or unintended overwriting and discrepancies in the numbering of provision, etc. Accordingly, the Protocol was made simple and clear and did not amend the agreed matters in existing agreements to the extent possible but instead kept the amendments to the minimum necessary.
- Q11. It appears that a further shortening of the settlement timing for Japanese government bonds to T+1 is being considered. If the settlement timing of T+1 is implemented, what will happen to the Protocol?
- A11. Implementation of a transfer timing of T+1 will not affect the validity of the

Protocol. According to the website of the Japan Securities Dealers Association (see "Working Group on Shortening of JGB Settlement Cycle Final Report"*), those considerations are targeting 2017 at the soonest, but if there are many requests from members, the preparation of a protocol for T+1 will be separately considered.

* An English summary version is available in the Japan Securities Dealers Association's website (<u>http://market.jsda.or.jp/shiraberu/saiken/kessai/jgb_kentou/files/youyaku-e2.pdf</u>).

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