JFMC Japan Financial Markets Council

13 December, 2012

Mr. Stefan Ingves
Governor of Sveriges Riksbank and
Chairman, Basel Committee on Banking Supervision
Basel Committee on Banking Supervision
Bank for International Settlements,
Centralbahnplatz 2, CH-4002
Basel, Switzerland

Mr. Masamichi Kono
Vice Commissioner for International Affairs, JFSA and
Chair of the IOSCO Board
International Organization Of Securities Commissions (IOSCO)
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Dear Sirs,

BCBS-IOSCO Proposal on Margin Requirements for Non-Centrally Cleared Derivatives

The Japan Financial Markets Council (JFMC)[1] is writing to you ahead of the forthcoming Basel Committee to update you on our views about the margin requirements for non-centrally cleared derivatives. We continue to support the robust reform of the OTC market. However, we believe that the Initial Margin (IM) proposals that were set out in the consultation paper will have a major impact on liquidity, and as our original response indicated, may not only have a detrimental effect on the real economy but could actually contribute to systemic risk, rather than mitigate it.

The public responses to the joint BCBS-IOSCO consultation have revealed a wide range of concerns in different markets, and we hope that you will take these views on board when putting together a robust and clear regime to address the risks that the G20 set forth in its original outline at the 2009 Pittsburgh Summit. Furthermore, we would request that any revision to the joint consultation be

[1] The JFMC is an association which includes representatives from five Japan-based institutions and five international firms active in Japanese capital markets. Its aim is to ensure that authorities deciding on regulatory initiatives that have a global impact are aware of and take into account the effect of new regulations on Japanese capital markets. The JFMC members are: Bank of Tokyo-Mitsubishi UFJ, Daiwa Securities Group, Mizuho Securities, Nomura Holdings, SMBC Nikko Securities Inc, Bank of America Merrill Lynch, BNP Paribas, Deutsche Bank Group, JPMorgan Securities Japan Co., Ltd. and Morgan Stanley Japan Holdings. The co-chairs of the JFMC are the representatives from Morgan Stanley and Nomura.

followed by a Quantitative Impact Study (QIS) to assess any changes to the proposals.

As BCBS and IOSCO consider the recommendations from the Working Group on Margining Requirements (WGMR), we would request that any revisions address some of the misperceptions (which have also been identified by others including in a letter to you from ISDA, IIF and AFME) regarding how best to achieve the original goals of the G20.

First, we would note that, while central counterparties (CCPs) are an important tool to reduce counterparty risk, **there is also an important role for non-cleared swaps**, which are not by their nature inherently risky. Cleared swaps are not able to meet all the varied needs of corporations and other end users, who must rely on bespoke derivatives to hedge legitimate business and trading activity such as international bond issuance. Such tailor-made contracts, for example, are a crucial tool used by Japan's exporters in mitigating the risks of currency fluctuation. As such, regulation that might encumber the legitimate use or economic viability of non-cleared swaps poses a threat to Japan's economy.

Second, the proposed new proposals should reflect the fact that **non-cleared derivatives have significantly higher capital requirements than cleared derivatives.** This therefore captures the increased counterparty risk when trading with a bilateral partner as opposed to trading through a clearing house. Any move to add significant initial margin requirements on top of these capital charges will in many cases make hedging a non-economically viable activity, thus increasing risks while negatively impacting liquidity.

Third, **the drain on liquidity posed by an unreasonably stringent initial margin regime will not be mitigated by a delayed implementation process**. An effort to phase in initial margin requirements, as a potential effort to mitigate the negative impact, would only delay the deleterious impact on liquidity and is not a solution. The goal may well be to ease market participants toward other alternatives, but this would fail because, as stated above, alternatives to many non-cleared swaps simply do not exist.

Fourth, for certain types of transactions, notably those commonly used in Japan such as export finance hedging, **initial margin, no matter how high it is set, will not drive the market to central counterparties.** If a transaction is not clearable, then no amount of initial margin can incentivise a participant to clear a transaction through a CCP. This will only result in reduced liquidity in non-cleared markets and end users will rely on unsuitable hedging instruments, if at all.

Finally, given the unique situation of individual jurisdictions and the various mitigants that might already exist in different markets, we trust that any new regime will allow for the competent local regulator to decide many of the details of implementation. We believe that the proposed new regime should take account of other risk mitigants that are already built into the system and for this reason we believe FX trades should be excluded. Moreover, as the JFMC has stated earlier, many international borrowers who tap into Japan's excess savings enter into cross-currency swaps either to hedge or convert into a domestic currency. A failure to accommodate this would mean that initial margins could have a major impact on crucial capital markets activity and international money flows. This would significantly hamper 'Samurai' bond issuance or other markets that similarly channel capital from surplus nations to those that need such funding.

In summary, we believe a mix of capital (as the primary mitigant which has been strengthened by new Basel III standards) and variation margin (as supplemental risk mitigation tool), will provide a robust framework to mitigate the risks that might arise from non-cleared swaps. This process will address the risks that concern the G20, while alleviate the negative impact that the original margin proposals threaten to pose to the real economy by creating a build up of pro-cyclical risks during times of financial stress; and putting in place a barrier to business.

We would be happy to work with BCBS/IOSCO in putting together a robust and appropriate regime.

Yours faithfully,

Shigesuke Kashiwagi

Jonathan B. Kindred Shigesuke Kashiwagi
Co-chairs of the Japan Financial Markets Council

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