

September 2009

ISDA Japan Credit CCP Working Group

Requests for the CCP on Japanese CDS

The global financial crisis and default of Lehman Brothers have led to a public debate on the counterparty credit risk management of OTC derivatives, especially credit default swap (“CDS”) is highly important for the sound development of the financial market as a whole. And the recent events have resulted in a surge in the awareness that the use of a central counterparty (“CCP”) is one of the most effective solutions for the counterparty credit risk management. Clearing of OTC derivatives through CCP is listed in the regulatory proposals in the US and Europe, and some of the CCP have already started clearing CDS on North American and European CDS (“overseas CCP”), which is now becoming an important infrastructure in the US and European CDS market.

Size of Japanese CDS market on Japan referenced names is relatively small compared to the US and European market, but there is no doubt that CDS is an important risk management tool for investment portfolio and banking sector in the sense that it is inextricably linked to Japanese corporate bonds market.

On this background, ISDA Japan Credit Derivatives Committee, in which most of the CDS market participants are members, shared the view that CCP on Japan referenced CDS is a necessary infrastructure for increasing the market liquidity and for further development of Japanese CDS market, and decided to launch the working group (“the WG”) to discuss the necessity of the CCP and the essential functions and issues to be considered for such CCP, independently from any interests of specific CCPs.

In the WG meetings, the members shared the view that CCP on Japanese CDS is necessary for the sound development of Japanese CDS market. There are ongoing initiatives by Japanese exchanges to establish the CCP on Japan referenced CDS in Japan (“Japanese CCP”), but the members are concerned whether it makes any business sense for Japanese CCP to operate independently from overseas CCPs given the small size of Japanese CDS market. In addition, it was questioned whether the proliferation of CCPs by regional reference names across the world is really desirable for our industry.

On the other hand, there is no overseas CCP in operation which has a specific plan to deal with Japan referenced CDS at the moment. Even if overseas CCP decide to deal with Japan referenced CDS, there remain concerns whether the clearing member can receive the sufficient support in Japanese language to

ensure large population of Japanese local participants, or whether Japan referenced CDS can be cleared without any operational problems. However, overseas CCP have already gone through the considerations on possible problems, and these experiences should be leveraged when considering the establishment and operations of the CCP on Japanese credit as the best practice.

Based on these recognitions, the members of the WG have discussed what are requirements and functions for the CCP on Japanese CDS for the development of Japanese credit market. Here below are our wishes targeted toward overseas CCPs who may think about covering Japanese credits in the future and Japanese CCPs to be launched, in light of the WG's discussions.

I. Participation in CCPs and the linkage between CCPs

The members of the WG agreed that the CCP on Japan referenced CDS are necessary for the market developments in Japan although most of the members indicated that it is not necessarily easily achievable.

It depends on each firm that which CCP they use to clear Japan referenced CDS, or how they participate in the CCP i.e. to become a clearing member or to use client clearing services. In either case, however, there is a concern that the cost to use those CCP will become comparatively high because of the limited trade volume of the Japanese CDS market. In particular, for those firms which use global booking for Japanese CDS or which are clearing members of the CCP in operation already, it is economically difficult to make a decision to participate in Japanese CCP directly. Instead, these firms strongly wish to participate indirectly through a linkage (i.e. cross margining between Japanese CCP and overseas CCP, or clearing through Japanese CCP on behalf of netting and clearing with overseas CCP).

The linkage between CCPs, such as cross margining or cross participation, would require considerations on settlement methods, valuation rules, the contractual relationships between CCPs, the liquidation methods at default of the clearing members, as well as the capital treatment of the cleared transactions. The reality, though, is that there are no concrete plans to make the link happen among the existing CCPs at the moment, and it would require a reasonable time to set up the link between CCPs.

There was an opinion to set up and launch the standalone CCP to clear Japanese CDS first and then to consider the linkage with overseas CCP. On another front, there is also an opinion to consider the linkage first because of the reasons stated above. As previously discussed, it would require a reasonable time to set up the link between CCPs, and therefore, the WG would strongly request CCPs to start concrete and detailed discussion among relevant parties as soon as possible.

II. Participants of CCPs

It is important to ensure that there be as many as market participants as possible in order to enhance the netting effect and reduce the systemic risk. Without regard to the way of participation, whether it's direct or indirect, following participants at four categories of participants in the market are considered to be eligible participants in the CCP.

1. major dealers (market makers)
2. banks and securities companies (non-major dealers)
3. buy-side firms (life Insurance companies, non life Insurance companies, hedge fund, investment advisory companies, etc.)
4. end-users

On the other hand, to avoid that the amount of the margin requirements becomes too high, it is crucial to set the strict criteria based on the financial credibility such as a credit rating. In order that all these participants are able to clear their CDS through CCP, it is necessary to prevent any probable risks and to ensure the credibility of the CCP itself by allowing indirect participation, i.e. client clearing. There are some legal issues which could be obstacles to have a wide variety of participants participate in the CCP; how to block the risk between the CCP and an end-user who is not a clearing member, segregation of customer's initial margin, portability of customers' contracts, etc. To review and solve these issues is a shortcut to secure desirable number of CCP participants. The WG members consider these are important issues to be solved as expeditiously as practicable, and the WG members are ready to work together on this point with CCPs to cover Japan referenced CDS.

There are many global dealer firms which book the CDS at their non-Japanese legal entities (offshore booking). Since the proportion of overseas investors or market participants with offshore booking are relatively high in Japanese CDS market. This point is critical when considering the establishment and operation of Japanese CCP. Most of these firms have already started using CCP for North American and European CDS, and it would be economically difficult to participate in Japanese CCP in addition to overseas CCP in operation. Accordingly, it is necessary to consider how to have these firms use Japanese CCP and how to actualize the linkage as described before, as well as where to set the qualification criteria for clearing members. Japanese exchanges carrying out the studies setting up the CCP will be required to discuss the concrete solutions such as client clearing for these issues.

III. Cost-benefit analysis

It is crucial to ensure the firm financial basis and sound management of CCP. At the same time, it is also necessary to try to increase the number of participants by setting a reasonable cost on back of the

existing system infrastructure. As previously stated, there were concerns that the cost will be so high to use Japanese CCP because of the limited size of Japanese CDS market. To promote the discussions on actual participations or possible membership status, it is strongly requested to conduct cost-benefit analysis and estimate the participation cost of the CCP at early stage. The WG members are ready to work together to provide necessary data to support those analysis and calculation.

IV. Japanese language support during Japanese business hours

It is necessary for the CCP on Japan referenced CDS to provide the supports in English language as most of the market participants in Japanese CDS market are global dealer firms. At the same time, most of Japanese CDS are traded during Japanese business hours and the traders are mostly Japanese, so it is also requested to provide a support in Japanese language during Japanese business hour. Especially, at the early stage of launching CCP, on-site full support may be indispensable. It will not be necessary, however, for on-site support once the smooth operation is confirmed, while it is required to ensure the timely support system available to cope well with any problems during Japanese business hours.

V. Product scope

It is necessary for the market to be populated by a large number of participants in order for it to enjoy the benefit of multilateral netting. On the other hand, it is also required to consider the operational risk and the load on the system incurred by the wide product scope in order for it to operate stably. It is practical to take a phase approach, i.e. to start with the narrow scope and expand it gradually with confirming the stable operation of the system. The following is the proposed approach.

Phase 1: iTraxx Japan (Index CDS)

Phase 2: single names (Constituents of iTraxx Japan)

Phase 3: highly liquid single names (non constituents of iTraxx Japan)

In addition to the above mentioned, it is desirable to take a phased approach for both outstanding transactions and new transactions;

Phase 1: backloading of existing transactions

Phase 2: new transactions

With regards to the currency, Japanese and US dollars are recognized as the currency of denomination. For operational efficiency, all transactions subject to clearing should be standardized and confirmed electronically.

Index CDS are standardized transactions, and single name CDS are being discussed among dealers and the agreed standardization is expected to be implemented by December 2009.

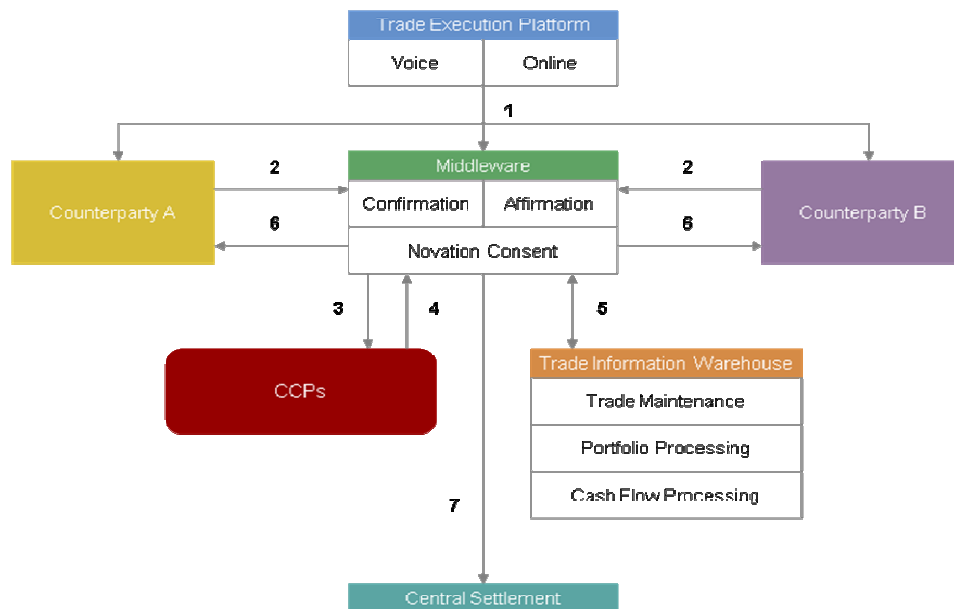
VI. Regulatory issues

It is essential to comply with all regulatory requirements to clear Japan referenced CDS. For example, to set up a CCP in Japan, it is required to be approved as “Financial Instruments Obligation Assumption Service” (Financial Instruments and Exchange Act 156-2). It is also necessary to confirm the regulatory requirements for segregation of margin used for customer clearing.

Regulatory capital reduction is an important benefit for using CCP. Under the Basel II, on the trade with central clearing houses certified by jurisdictional authorizations, risk assets are reduced to zero. For the Japanese underlying CDS, as a merit of the capital requirements, the same treatment or extremely favorable treatment is desirable for centrally cleared transactions.

VII. Work flow

It is important to leverage the existing business processes currently in use by the industry. More specifically, it is necessary to ensure the connectivity to existing electronic platforms currently used, and to make the data flow smoothly from the internal system to the trade information warehouse.



1. Executed trade data should feed in to risk management system at counterparties as well as Middleware
2. Counterparty A and B immediately electronically affirm each other

3. CCP receives real time feed of bilaterally agreed eligible activity for clearing
4. CCP performs its appropriate checks and responds to Middleware with acceptance of the cleared trade
5. Middleware updates the original Counterparty trades to a Cleared trade between Counterparty A and CCP, CCP and Counterparty A, CCP and Counterparty B and Counterparty B v CCP. Middleware passes these to the TIW and obtains back TIW trade Id's
6. Counterparty A and B receive a message advising that the trade has been cleared and update their books and records accordingly with the TIW ID
7. TIW advises Central Cash Settlement of certain cashflows for settlement

VIII. Targeted live date

Considering the US and European market where some CCPs have already started operations, it is desirable to launch the CCP on Japan referenced CDS as early as possible. As a feasible target date, operational framework should be finalized and obtain the regulatory approval by March 2010. Starting operations by June 2010 would be ideal.

Although the decision regarding whether to join the CCP, which CCP to join, or on what membership status should be made by market participants, the above represents the summary of opinions and requests through the discussions in the WG. The members of the WG intend to review and work actively with the CCP which plans to clear Japan referenced CDS on the issues described in the letter.



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(in Alphabetical order)