

October 11, 2013

Comments on the Consultative Document from the Committee on Payment and Settlement Systems and the International Organization of Securities Commissions: Recovery of Financial Market Infrastructures

Japanese Bankers Association

We, the Japanese Bankers Association (“JBA”), would like to express our gratitude for this opportunity to comment on the consultative document: Recovery of Financial Market Infrastructures, released on August 12, 2013 by the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO).

We highly appreciate this guidance, which is designed to ensure that the present Financial Market Infrastructures would be more robust and better placed to withstand financial shocks. Nonetheless, JBA would like to add some comments from the viewpoint of FMI participants.

We hope that our comments below will be of assistance and may offer an additional point of reference as you work towards finalizing rules proposed in the consultative document by CPSS and IOSCO.

1. Recovery tools (in the Consultative report “3. Recovery tools”)

We think that the recovery tools proposed in the Consultative report are considered to be comprehensive in general. However, there would be a concern over the effectiveness of these tools, and in this regard, we respectfully provide the following comments.

Considering the objective of this Consultative report that financial market infrastructures (FMIs) should not assume public financial support and minimise the negative impact on direct and indirect participants, shareholders, financial markets and the financial system as a whole, “variation margin haircutting by CCPs (VM haircutting)” is, among the proposed “recovery tools”, considered to be more acceptable than “cash call” and “initial margin haircutting by CCPs (IM haircutting).”

VM haircutting, however, could give rise to the following issues, which should be taken into account in finalising this Consultative report:

- Each central counterparty (CCP) has a different legal basis so the default waterfall could be different.

- VM haircutting may cause funding problems to some clearing members because while only the CCPs can receive VM, the clearing members who are entitled to receive the VM may not be able to receive it from CCPs.
- In related to these funding problems mentioned above, if the size of VM haircutting is large and its duration is prolonged, there is a concern that such a situation may lead to a liquidity squeeze in the market.
- VM haircutting may disincentivise the clearing members to implement a better risk portfolio management as they may not focus on maintaining positive MTM.
- Tax issues, for example, waiver of the margin claims may be treated as taxable as treated for other loan receivables under applicable tax laws.

“Cash call” could be one of the recovery tools provided that anti-moral hazard measures for FMIs risk management are sufficiently introduced. Such measures could include, for example, (i) FMI should ask “cash call” only after the FMI’s capital is used and VM haircutting is executed, and there is still a cash shortfall, (ii) FMI should give the additional loss bearers the proportionate FMI’s shares in return, and (iii) If “cash call” is executed for the purpose of meeting “equity call” or “capital call,” non-core capital such as preference shares rather than core capital should be used .

With regard to IM haircutting, this tool is fundamentally reserved for use when IM contributors default themselves, and therefore it is not considered reasonable to be used for covering losses created by other members’ default.

## 2. “Recovery tools” which are not acceptable from the perspective of direct and indirect participants and proposed alternative

The recovery tool proposed in this Consultative report which, among other things, is not considered acceptable is the waiver of the initial margin associated with “IM haircutting” (See Consultative report P.20 “3. Initial margin haircutting by CCPs” 3.5.19.)

This is because, as noted in above 1., IM haircutting is fundamentally reserved for use when IM contributors default themselves, and therefore it is not considered reasonable to be used for covering the loss created by other members’ default.

We are of the view that the most important alternative option is the auction, which is the default management process, to be executed successfully so as to avoid any situations requiring “IM haircutting” or “VM haircutting.”

In light of this option, incentives for auction bidders to make competitive bids should also be considered; for example, any gains arising from the auctioned portfolio could be treated as non-taxable.

## 3. Tools to allocate uncovered losses caused by participant default and replenish financial

resources of the FMIs

The Consultative report proposes, as one means to address remaining losses, rules requiring direct participants to commit to provide additional resources. Given the possibility of jeopardising the stability of the financial system, however, options should not necessarily be limited to requiring certain parties such as clearing members to bear such losses. Rather, on that premise, it is necessary to consider, to the extent feasible within the legal system, options such as collaboration with central counterparties in other jurisdictions and enhance the liquidity in the FMIs.

If options such as the above are not feasible, and the overarching objective of this Consultative report is to minimise the negative impact on the financial system as a whole, it is proposed that such losses should eventually be shared by all the participants.

Additionally, in the case of “the default of a clearing member engaged in client clearing,” the use of VM haircutting to its clients should be considered, whereas in the case of “the default of a client,” the clearing broker of such defaulting client should bear the loss in the first place. Other clearing members should bear the loss resulting from this situation only if the clearing broker of this client could not cover the loss.

Lastly, where clearing members are unduly required to additionally cover losses or replenish funds in times of extreme stress, it is requested to introduce a rule enabling clearing members to timely capture any participant with an extraordinarily large one-sided position as well as the financial position of CCPs.