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Committee on Payment and Settlement Systems,
Bank for International Settlements,
cpss@bis.org

Technical Committee,
International Organization of Securities Commissions,
fmi@iosco.org

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Dear Sirs,

Comments on the consultative report on *Principles for Financial Market Infrastructures*

1. Introduction

Japan Government Bond Clearing Corporation (JGBCC), a clearing organization licensed under the Japanese Financial Instruments and Exchange Act, has been in the clearing business relating to the OTC trading of Japanese government bonds (outright transactions, repo transactions) since May 2005.

This document contains JGBCC's comments to the consultative report on *Principles for Financial Market Infrastructures* (PFMI) issued on 11 March 2011 by the Committee on Payment and Settlement Systems (CPSS) of the Bank for International Settlements and the Technical Committee of the International Organization of Securities Commissions (IOSCO). JGBCC appreciates the fact that PFMI was submitted for market consultation to provide an opportunity to comment thereon.

JGBCC respects the ongoing efforts of CPSS-IOSCO to stabilize the financial market, beginning with the *Recommendations for securities settlement systems* issued in 2001. JGBCC hopes that the PFMI, which is essentially a culmination of the series of such undertakings, will become more appropriate as a result of the market consultations and that the application thereof will lead to further progress in the stability and efficiency of the financial market.

2. Comments

Principle 2: Governance

It is stated in explanatory note 3.2.12, "A risk committee should be chaired by a sufficiently knowledgeable independent board member and consist of a majority of board members that are independent of management." JGBCC agrees that there is a need to ensure that the deliberations of a risk committee are held from a perspective independent of the management. However, individuals capable of making decisions and stating opinions from a standpoint independent of the management are not necessarily limited to "independent board member(s)", as there also may be knowledgeable individuals from the outside who are capable of serving the purpose. Accordingly, it is believed that the explanatory note on the risk committee should be modified to read, "consist of a majority of board members that are independent of the management or knowledgeable persons external to the entity".

Principle 4: Credit risk, Principle 7: Liquidity risk

It is stated in Principle 4, "A CCP should also maintain additional financial resources to cover a wide range of potential stress scenarios that should include, but not be limited to, the default of the [one/ two] participant[s] and [its/their] affiliates that would potentially cause the largest aggregate credit exposure[s] in extreme but plausible market conditions."
Further, Principle 7 states, "An FMI should maintain sufficient liquid resources to effect same-day and, where appropriate, intraday settlement of payment obligations with a high degree of confidence under a wide range of potential stress scenarios that should include, but not be limited to, the default of [one/two] participant[s] and [its/their] affiliates that would generate the largest aggregate liquidity need in extreme but plausible market conditions."

The probability of default of one or two participants with the largest exposure for each FMI will naturally differ depending mainly on the number and constitution of FMI participants, the initial and ongoing membership requirements of FMI, the details and level of government regulation pertaining to financial institutions and the current credit standing of each FMI participant. It is believed that the establishment of a simplistic numerical requirement to uniformly cover the default of "[one/two] participant[s] ... largest" exposure or liquidity without consideration for the differences in such factors that impact the probability of default is neither fair nor reasonable.

Further, JGBCC has a rule on the allocation of loss to the counterparty of the defaulting participant[Note 1], and the term of contract for repos and other securities financing transactions, which are JGBCC's core clearing instruments, is comparatively short[Note 2]. Given that the foregoing factors are expected to have the effect of reducing transactions with participants with an increasing risk of default, it is believed that there is relatively small possibility of JGBCC being subjected to the largest credit exposure or the largest liquidity need by defaulting participants in such instruments, as compared with those in the instruments of other clearing organizations without a rule on allocation of loss to the counterparty of the relevant participant or in derivatives and other instruments with fairly long contract periods.

Accordingly, it is believed that there is a need for the market regulator and the central bank of each country to design appropriate frameworks for stress scenarios, additional financial resources and funding arrangement, with consideration for the market structure and other characteristics of the corresponding country.

(Notes) 1. The loss incurred by JGBCC upon default of a participant is covered with, in the order of priority, 1) the assets of the defaulting participant, 2) contribution of the counterparty of the defaulting participant, 3) a part of JGBCC's retained earnings, and 4) contributions of other participants.

2. While contracts of various durations, ranging from overnight to open-ended, are possible in the Japanese repo market, 70% to 80% of the transactions are overnight.

Principle 14: Segregation and portability

The draft states that a CCP should have rules and procedures that enable the segregation and portability of positions and collateral belonging to customers of a participant, without any exception, regardless of the type of financial instrument. However, in view of the following circumstances a. through c., the adoption of segregation and portability may be valid for listed derivatives, but may not be appropriate for "cash".

a. In the case of listed derivatives, it is believed that a portability system will be required in order to ensure the opportunity for customers of defaulting participant to lock in some profits or losses by offset transactions or other means in the event a participant defaults prior to maturity, since the details of a transaction (settlement amount, profit/loss) are not locked in until the timing of unwinding or final settlement. Meanwhile, the mechanism for "cash" is such that it is possible to protect customer rights relating to unsettled agreements by means other than portability even if a participant should default (for example, exercise of right of recovery under bankruptcy laws or payment by investor protection fund), since the claims and obligations are fixed at the time of the initial agreement.

b. Portability is expected to be ineffective in many cases, with the exception of long-term repo transactions, since settlement is due within a short period (the settlement cycles for "cash" transactions are mainly T+1 ~ T+3).

c. Since the adoption of segregation leads to a decline in netting efficiency, which in turn results in an increase in collateral, it will be necessary to require collateral from customers in order to establish a portability system. Hence, it will be necessary to compare and balance the higher cost of transaction due to an increase in collateral against the merits of the portability system in adopting segregation and portability. However, given that a system is in place for the protection of customers with regard to unsettled agreements, as described in a. above, it is unlikely that investors and market participants will opt for an increase in collateral.

   Accordingly, it is believed that there is a need to make determinations in accordance with the attributes of an instrument in applying Principle 14, as well as to establish a mechanism for the protection of investors by other means when the adoption of segregation and portability is not appropriate in view of instrument attributes.

Yours sincerely,

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