At the Pittsburgh G20 Summit of 2009, leaders committed that all standardized over-the-counter derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by the end of 2012 at the latest.

Regulators around the world are working diligently to put the final touches on rules requiring central clearing. Though there has been significant focus on efforts in Europe and the U.S., Japan was the first to actually implement that mandate.

Japan has a rich heritage in market structure innovation. In fact, Japan became one of the first countries to start trading commodity futures with the establishment of the “Dojima Rice Exchange” in Osaka in 1697. Over three centuries later, the Government of Japan became the first country to pass laws requiring central clearing of OTC derivatives by amending the Financial Instruments and Exchange Act in May 2010. Japan’s Financial Services Agency subsequently finalized regulations, setting a November 2012 deadline for certain Japanese entities to begin clearing certain types of interest rate and credit default swaps.

According to data published by the Bank of Japan, Japan’s interest rate swap market had USD $35.69 trillion in notional value outstanding at the end of June 2012. Although Japan accounts for only 7% of the global market for interest rate swaps, it is by far the largest interest rate

While Japan has a relatively small share of the global interest rate swaps market compared to the U.S. and Europe, it has taken the lead in implementing the G20 requirement for central clearing. Since November, large domestic financial institutions have been required to submit certain yen-denominated interest rate swaps to a licensed clearinghouse. More than 30 firms have signed up to clear yen IRS at the Japan Securities Clearing Corp., the only clearinghouse currently licensed for domestic clearing, and the volume of trades cleared at the JSCC has been rising rapidly. In this article, Thomas Treadwell, Citi’s head of OTC clearing in Asia-Pacific, provides an update on the adoption of clearing in the Japanese swaps market.

By Thomas Treadwell

Solid Start for Interest Rate Swaps
Inter-Dealer Solution

Japan’s clearing mandate specifically covers large domestic financial institutions that are registered under FIEA as “Financial Institution Business Operators” or “Registered Financial Institutions” and that are members of licensed clearinghouses such as the JSCC. The clearing requirement applies to these entities when transacting in yen-denominated interest rate swaps and credit derivatives with other institutions in those two categories.

In practical terms, this means that the clearing mandate is limited at present to dealer-to-dealer transactions. The JSCC is in discussion with market participants to have a client clearing platform in place in the future, which will provide an onshore solution for firms that are not clearing members or affiliated with clearing members of JSCC.

The new clearing mandate currently applies to two types of swaps: plain vanilla yen-denominated interest rate swaps that reference the yen Libor rate and credit default swaps based on the iTraxx Japan index. The rules establish that these products must be cleared at the following central clearinghouses:

- iTraxx Japan CDS—a licensed Japanese CCP;
- Yen-denominated interest rate swaps—a licensed Japanese CCP, or a foreign CCP that is licensed by the JFSA, or a foreign CCP which is not licensed by the JFSA but has established a linkage with a licensed Japanese CCP with JFSA approval.

To date, only the JSCC meets these requirements. Although roughly 20% of the yen-denominated interest rate swaps market is cleared today at clearinghouses outside Japan, in the new regulatory regime those CCPs will require further licenses from the JFSA in order to clear OTC derivatives for institutions subject to the JFSA clearing requirements.

JSCC went live with its inter-dealer clearing models for the iTraxx Japan CDS in July 2012 and yen-denominated interest rate swaps in October 2012. As of Dec. 18, the most current data available at the time of publication, more than 6,400 interest rate swaps worth 59.8 trillion yen (USD $712 billion) in gross notional value had been cleared since launch. The volume is likely to continue to increase when the JSCC widens its product offering to include Tibor-based swaps, which is currently scheduled for the first quarter.

Addressing Clearing Member Concerns

Since the launch of interest rate swaps clearing, the service has seen solid participation from both domestic and foreign institutions. Thirty-two entities have signed up to clear IRS, including 21 dealers and 11 “entrustors,” firms that are affiliated with those dealers. A key factor in this success was the many months of negotiations and consultations between market participants and the JSCC on the design of the clearing platform.

One of the most important issues for clearing members was establishing a limit on their liabilities to the clearinghouse in case of a default. To avoid becoming insolvent or stopping service, a CCP needs the ability to call for additional resources from its clearing members in order to cover any losses in a default scenario. Depending on the structure of the CCP’s assessment power, this could be considered an unlimited liability to the CCP. This causes issues for international dealers that may be required by their home regulators to cap all liabilities.

A CCP’s financial safeguards package starts with strict membership requirements to ensure that all members are adequately capitalized and contain the operational and technical expertise to support ongoing business and default management. The CCP mitigates counterparty risk through adequate capital, financial safeguards, and the ability to call for additional resources.}

IRS Clearing Participants

The Bank of Tokyo-Mitsubishi UFJ, Ltd.
Barclays Bank PLC
BNP Paribas
Citigroup Global Markets Japan Inc.
Credit Suisse Securities (Japan) Limited
Daiwa Securities Co. Ltd.
Deutsche Bank AG
Goldman Sachs Japan Co., Ltd.
JPMorgan Securities Japan Co., Ltd.
Merrill Lynch Japan Securities Co., Ltd.
Mitsubishi UFJ Morgan Stanley Securities Co., Ltd.
Mizuho Corporate Bank, Ltd.
Morgan Stanley MUFG Securities Co., Ltd.
Nomura Securities Co., Ltd.
Resona Bank, Limited
The Royal Bank of Scotland plc
SMBC Nikko Securities Inc.
Société Générale
Sumitomo Mitsui Banking Corporation
Sumitomo Mitsui Trust Bank, Limited
UBS AG

Source: Japan Securities Clearing Corp.

IRS Clearing Entrustors*

Bank of America N.A.
Merrill Lynch Capital Services Inc.
Merrill Lynch International
Merrill Lynch International Bank Limited
(Affiliates of Merrill Lynch Japan Securities Co., Ltd.)

Credit Suisse International
(Affiliates of Credit Suisse Securities (Japan) Limited)

JPMorgan Chase Bank N.A.
(Affiliates of JPMorgan Securities Japan Co., Ltd.)

Mizuho Bank, Ltd.
Mizuho Securities Co., Ltd.
Mizuho Trust & Banking Co., Ltd.
(Affiliates of Mizuho Corporate Bank, Ltd.)

Morgan Stanley & Co. International plc
Morgan Stanley Capital Services LLC
(Affiliates of Morgan Stanley MUFG Securities Co., Ltd.)

*Clear through affiliated clearing participant.
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March 12-15, 2013
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FIA International Futures Industry Conference
Boca Raton Resort and Club • Boca Raton, Florida

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**FIA New York Expo**
Hilton New York

May 8-10, 2013
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June 25-26, 2013
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The Brewery • London, United Kingdom

September 25-27, 2013
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credit risk by collecting initial margin, variation margin and default fund contributions. CCP margin models will be held to international standards in order to be considered for the qualified CCP recognition set by global regulators.

In a clearing broker default scenario, the CCP default management team—which is made up of clearing member representatives—will go through a detailed default management process that includes the hedging and liquidation of the defaulted clearing members cleared contracts. The CCP financial safeguards package will be used towards the liquidation in the order prescribed by the CCP default waterfall. As CCPs and clearing members are likely to be systemically important institutions, the efficient liquidation and continuity of market activity is a fundamental principle throughout the default management process. The challenge becomes to design a model that ensures there are always adequate resources available to offset the full portfolio liquidation. Some key areas of focus that the CCP uses to address these possible shortfalls are as follows:

- The ability of the CCP to call for additional assessments from its clearing members once resources have been exhausted.
- The number of times the clearing member is required to replenish its default fund contributions within a specified time period.
- The compulsory termination of all existing cleared transactions between the CCP and members in the case of a failed auction.
- The limitation on the exit of clearing members during default settlement period.

After multiple industry sessions and detailed analysis, the JSCC developed a solution that satisfied most stakeholder requirements. This solution is basically in line with international standards and uses a combination of resources that include the defaulted member’s collateral, CCP contributions, guarantee fund contributions, clearing member assessments and haircutting of variation margin, all in a sequenced order to get a capped liability.

Another key topic was the potential conflict in governing laws. In today’s global OTC market, it is a common occurrence for counterparts from different ends of the earth to transact with each other. CCPs tend to reside in one location, and thus are generally governed by the local law of that jurisdiction. Domestic market participants and clearing members who trade much of their volumes in that jurisdiction would also be governed by that local law. Conversely, international counterparts trading these products would likely have much of their activity governed by overseas laws such as U.S. or U.K. laws.

To address this issue, the JSCC determined to accept U.K. law as a governing law for certain aspects of existing CDS trades. This allows participants to continue to rely on the legal code with which they are most familiar, which is especially important for products such as credit default swaps that are closely linked to local bankruptcy laws.

**Need for Client Clearing Solution**

In Japan today, the only live OTC clearing solution is the JSCC’s inter-dealer clearing offering. Clients that want to centrally clear their trades cannot access this service unless they are affiliated with clearing members. In a global market that is rapidly moving to central clearing and higher capital charges for bilateral trades, this quickly becomes a problem. Market-makers are factoring the cost of capital charges into their pricing for bilateral trades, creating a material incentive for clients to seek out clearing.

The JSCC is now consulting with the industry on the design of a client clearing platform and is tentatively aiming to offer this service in the third quarter of 2013. In the meantime, some market participants want the option to use international clearinghouses that currently offer client clearing solutions for yen-denominated interest rate swaps. This would allow clients to receive more competitive pricing for their cleared trades as well as the additional protections of portability and segregation provided by clearing. Regulatory action will be required for this to happen, however.

The Japanese regulators have been proactively working with global regulators and market participants to understand the challenges and concerns of central clearing and have made great progress in meeting the G20 commitment. The JSCC has been thoughtful in its approach, balancing the need to comply with the very highest global standards with the restrictions placed upon foreign clearing members. From a commercial standpoint, it is still very early days and thus we are likely to see the impacts from liquidity and netting as the models evolve.

**Thomas Treadwell** is Asia-Pacific head of derivatives clearing in the prime finance division of Citi. He is based in Singapore.