

Study Committee
on Central Counterparty for OTC Derivatives Transactions

Summary

Reference Translation



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I . Introduction

1 . Background relating to the establishment of the study group

(1) What started as a problem relating to subprime lending has expanded to a global financial crisis. In particular, credit concerns between financial institutions have increased dramatically. Under these circumstances, various problems have been highlighted in relation to counterparty risk in OTC derivative transactions.

(2) Regulators in each country or region have been discussing the need to strengthen regulation relating to OTC derivatives transactions.

In Europe and the United States, the main exchanges are foreseeing a change in regulation, and in order to facilitate a stable and smooth transaction framework with reduced systemic risk, they are starting to implement trading and clearing functions for OTC derivatives.

(3) Tokyo Financial Exchange Inc. (TFX) has been actively investigating the implementation of an OTC clearing business for several years.

This is for the following reasons:

① TFX is the only exchange in Japan that specializes in trading and clearing financial derivatives. TFX has accumulated considerable knowledge and experience in this field.

② The clearing members of TFX are major financial institutions in Japan, the United States, and Europe. A central counterparty (CCP) will require participation from institutions with extremely high credit quality and TFX's clearing members qualify in this regard.

③ Foreseeing the potential for growth and the potential needs of the credit default swaps (CDS) market, TFX started posting CDS prices on its website in March 2004. These prices are assembled with the help of several financial institutions.

(4) Given the above, TFX organized a study committee to discuss the establishment of a CCP for OTC derivatives transactions. Moreover, in order to construct a CCP that fulfills the needs of market participants and the demands of the regulator, TFX has been conducting detailed research into the appropriate system and strategy.

2 . Discussion and summary

- (1) From October 2008, the study committee has met regularly and opinions on the establishment of a CCP for OTC derivatives have been received from a wide variety of market participants and specialists.
- (2) This document is a summary of the discussions held during the study committee sessions. The content of this document will act as a reference for action taken on establishing OTC derivatives clearing solutions.

II . Content of the discussions

1 . Trends and discussions concerning the clearing of OTC derivatives transactions

(1) The topic of strengthening regulation relating to OTC derivatives transactions has been discussed in Europe and the United States.

① The United States

In February 2009, the House Agriculture Committee passed legislation to bring transparency and accountability to derivatives markets. Part of this legislation demands that OTC derivatives be cleared through a central clearing facility. Through this and other measures, the enforcement of stronger regulation is progressing.

② Europe

The European Commission has called for the establishment of a central clearing solution for CDS trades in the EU. Major market participants are committed to complying with this request.

(2) With interest rate swaps, major market participants in Europe and the United States already participate in SwapClear of LCH.Clearnet, which has become a global standard.

The movement of the establishment of a CCP started in Europe and the United States for CDS.

2 . The necessity of a central counterparty

(1) Use of a central counterparty for OTC derivatives transactions provides the following benefits:

① Counterparty risk is reduced, and it becomes possible to decrease the use of credit lines.

② It becomes possible to reduce the risk portion of the capital adequacy ratio.

③ Processing is standardized and operational risk can be reduced.

④ Systemic risk in the market can be reduced.

(2) The study committee members recognized these benefits and acknowledged the significance and necessity of a central counterparty solution for OTC derivatives.

3. Important opinions and points from the discussions

(1) Basic Points

- ① Based on the needs of market participants and the direction of policy discussions by regulators, the study committee decided that central clearing facilities should target Interest Rate Swaps and Credit Default Swaps.
- ② Since participants in the interest rate swap market do not necessarily participate in the CDS market and vice versa, the committee agreed that it would be better for clearing members to be different for each asset class.
- ③ One of the main points under discussion concerned the question of how to manage OTC transactions where the contractual entity is based outside Japan. Many OTC transactions that take place in Japan are recorded in a global book and the contract is held by the foreign entity that controls this book.
- ④ There was an opinion that if the qualifications for clearing membership are set at a high level, then the number of possible clearing members will be reduced and the CCP will be less effective. On the other hand, there was also the opinion that it will be necessary to have high level qualifications in order to achieve a credit risk asset value of zero in BIS's capital adequacy requirements.

(2) Clearing of interest rate swaps

- ① Major market participants in Europe and the U.S.A. are using SwapClear from LCH.Clearnet. To process global book transactions, an in-house system has already been constructed for SwapClear. With this in mind, it was concluded that TFX should cooperate with LCH.Clearnet.
- ② If there is a cooperation between TFX and LCH.Clearnet, there needs to be considerable planning in anticipation of a bankruptcy by a clearing member from either organization. In addition, the settlement scheme between TFX and LCH.Clearnet, bankruptcy processing, risk management, and the details of cooperation between TFX and LCH.Clearnet were identified as future items of discussion.
- ③ The committee decided that the first product to be cleared should be a yen-denominated Plain Vanilla Swap. The addition of other currencies and more exotic swaps were set as future projects.

(3) Clearing of CDS

- ① Some committee members pointed out that the introduction of a CCP was not a pressing issue since the number of the market participants and the trading volume of the CDS market in Japan is small.

There was also the opinion that a CCP for CDS will be necessary in Japan as the proper financial market infrastructure needed for the development of the Japanese CDS market.

- ② A CCP for CDS supported by a large number of market participants, like LCH.Clearent's facility for interest rate swaps, doesn't exist at present. Some committee members thought that once the CCP for CDS was established in Europe and the U.S.A., the establishment of a CCP in Japan would become necessary.

Moreover, in order to use a CCP in Japan, it will be necessary for foreign firms to operate through a clearing member in Japan. However, according to foreign clearing institutions, clearing members say they do not have the resources to implement the back office systems necessary to support such a mechanism.

- ③ However, committee members expressed the opinion that foreign-affiliated financial institutions would participate clearing members in Japan if the use of the CCP was made obligatory through regulation.

- ④ Committee members pointed out that TFX should closely monitor the situation in Europe and the U.S.A. to see what kind of CCP system is successfully adopted and supported by the market place. This should be combined with close attention to the direction that the Japanese regulator takes.

- ⑤ Many committee members expressed that the first contract to be processed by the CCP should be a CDS index composed of Japanese companies. After that, liquid single name CDS that are part of the index may be added.

III. TFX Policy

(1) Regulators in every country are continuing discussions surrounding the establishment of a CCP for OTC derivatives transactions and we are in the middle of policy adjustments by some of the major countries.

The regulators in Europe and the U.S.A. have already clarified the direction that they will take, by making the use of a CCP mandatory and by recommending the establishment of central clearing facilities. However, this is not the case in Japan and it will be necessary to confirm the direction and content of Japanese regulation.

(2) The opinion of the committee members was highly influenced by the stance of the regulators and the content of future regulation. While closely following the intentions of the regulators and examining business viability, it is the intention of TFX to contribute to the development of the OTC derivatives market in Japan.

(3) To be specific, based on the content of this document and the direction taken by the regulators, TFX will establish a CCP for OTC derivatives transactions in Japan. The schedule is as follows:

Within 2009, an outline of the system will be confirmed.

Within fiscal year 2010, the CCP will commence operation.

The priorities of TFX will be to secure appropriate risk management, to improve convenience for market participants and to form an effective alliance with CCP facilities in Europe and the U.S.A.

Additionally, cooperation will be pursued with SwapClear of LCH.Clearnet with regards to clearing interest rate swaps.

<New CCP (TFX idea)>

	Interest rate swap	CDS
1. Eligible Contract	Plain Vanilla Swap (Exotic instruments planned for future)	iTraxx Japan (Single name planned for future)
2. Qualification of Clearing Members	Highly creditable financial institutions whose equity is about one trillion yen and whose rating is A or better	
3. Clearing Member of CCP	TFX Interest Rate Futures Clearing Members who have the above-mentioned qualifications. About 15.	
4. Confirmation Matching	MarkitWire	DTCC Deriv/SERV
5. Linkage	SwapClear of LCH.Clearnet	—
6. Margin	Amount which can cover the assumption loss based on stress tests should be deposited	
7. Other items	OTC derivatives transactions based on the ISDA Agreement are eligible	

**Members of Study Committee
on Central Counterparty for OTC Derivatives Transactions**

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Credit Suisse Securities (Japan) Limited

Daiwa Securities SMBC Co., Ltd.

Deutsche Securities Inc.

Goldman Sachs Japan Co., Ltd.

HSBC Securities (Japan) Ltd.

JPMorgan Securities Japan Co., Ltd.

Merrill Lynch Japan Securities Co.,Ltd.

Mitsubishi UFJ Securities Co., Ltd.

Mizuho Corporate Bank, Ltd.

Mizuho Securities Co., Ltd.

Morgan Stanley Japan Securities Co., Ltd.

Nikko Citigroup Ltd.

Nomura Securities Co., Ltd.

RBS Securities Japan Limited

Societe Generale Securities (North Pacific) Ltd.

Sumitomo Mitsui Banking Corporation

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