

# OTC IRS Client Clearing in Japan

An overview of the current global regulatory landscape and the key issues relevant to Japan-based clearing brokers and clients

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## Where do we start?

Following the global financial crisis, the 2009 G20 Pittsburgh Summit leaders issued this statement:

### **G20 Leaders' Statement at the Pittsburgh Summit, 24-25 September 2009**

*[...] Building on their Declaration on Further Steps to Strengthen the International Financial System, we call on our Finance Ministers and Central Bank Governors to reach agreement on an international framework of reform in the following critical areas:*

*[...] Improving over-the-counter derivatives markets: All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse.*

From this simple beginning came a raft of complex regulation that has kept the financial services industry busy ever since.

The key items that impact the OTC IRS markets in Japan are:

	OTC IRS Clearing	Basel 3
US	Dodd-Frank Act <sup>1</sup>	Draft rules published June 2012, pending public comments
EU <sup>2</sup>	EMIR	CRD1V
Japan	Amendments to FIEA: the Financial Instruments and Exchange Act	Phase implementation, one of the first movers
Other G20 <sup>3</sup>		Various

On top of this complex regulation is a great deal of uncertainty. It is difficult to predict exactly how the rules are going to be implemented and what the impact will be on each organisation. Although some softening was widely anticipated, the CFTC have recently made their position clear:

“I believe it is critical that Dodd-Frank reform applies to transactions entered into by branches of US institutions offshore.” Chairman Gensler (CFTC)

## The Global Landscape

In the US the CFTC rules are being phased in. Category 1<sup>4</sup> organisations are now subject to the CFTC clearing mandate and an expansion to include Category 2 organisations is imminent. The CFTC are requiring all Derivatives Clearing Organisations (DCOs) to provide client clearing as part of their service. CFTC rules stipulate that if one counter party is a Swap Dealer (SD), a Major Swap Participant (MSP) or the client of a Futures Commission Merchant (FCM), then the trade can only be cleared through a DCO. So far, 153 of the 398 total required rulemakings have been finalised, while 129 rulemaking requirements have not yet been proposed<sup>5</sup>.

In Europe, ESMA’s EMIR and resulting Draft Technical Standards were adopted by the European Commission this year (2013). These

rules allow third-country CCPs to be recognised through regulatory equivalence<sup>6</sup>.

Outside Europe, only recognised CCPs will be able to clear for European counterparties. A decision on the mandatory clearing of OTC derivatives is expected in early 2014, based on recognised CCP capabilities. However, CRD IV is being seen as a major incentive to clear early<sup>7</sup>.

Looking at the main CCPs across the APAC region, SGX has been live with OTC IRS clearing for some time but is not providing client clearing yet; HKEx has an imminent dealer-to-dealer launch planned; ASX has announced a 1 July 2013 launch, with client clearing to follow in late 2013; Korea has announced a clearing mandate but KRX has not yet launched its service; Shanghai has announced their intention to clear in 2014; and there have been no announcements from India as yet.

Japan currently leads the APAC region in JPY OTC IRS clearing, thanks to its progressive regulatory regime and the size of its economy. JSCC<sup>8</sup> began clearing JPY OTC IRS in October 2012 and the Japan Financial Services Agency (JFSA) mandated clearing of domestic LIBOR-based IRS that can be cleared by JSCC a month later. JSCC expanded their service to include TIBOR<sup>9</sup>-based IRS (not yet mandated for clearing) earlier this year.

JSCC currently benefits from “no action relief” from the CFTC, allowing it to in effect act as a DCO for specified categories of counterparty until its successful registration as a DCO<sup>10</sup>. JSCC has further announced its intention to

1 Dodd-Frank Wall Street Reform and Consumer Protection Act 2009

2 Including G20 member countries: Germany, France, Italy, UK

3 Australia, Argentina, Brazil, Canada, China, India, Indonesia, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey

4 See CFTC fact sheet: [http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/90111tcl\\_factsheet.pdf](http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/90111tcl_factsheet.pdf)

5 Source: Dodd-Frank Progress Report ,1 May 2013, Davis Polk & Wardwell LLP

6 See <http://www.esma.europa.eu/page/European-Market-Infrastructure-Regulation-EMIR>

7 Catalyst white paper at: <http://www.catalyst.co.uk/149-CRD4.html>

8 Japan Securities Clearing Corporation

9 Euroyen TIBOR or ZTIBOR

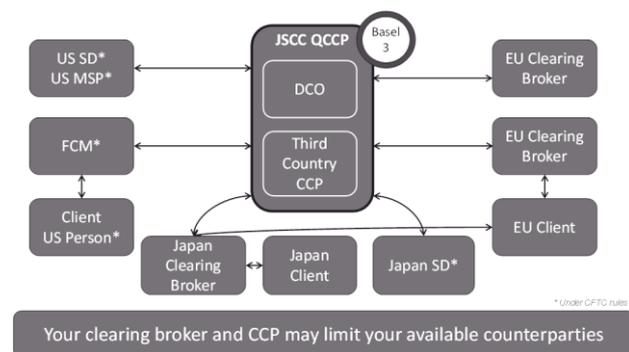
10 For details of time constraints and full text, see <http://www.cftc.gov/ucm/groups/public/@Irllettergen/eral/documents/letter/12-56.pdf>

become an ESMA recognised third-country CCP.

The JFSA have also announced their intention to mandate client clearing and consider mandating the clearing of cross-border trades. While JPX has highlighted the expansion of JSCC's clearing services as part of its long term strategy.

## Clearing in Japan

With the clearing mandate in force in Japan and the potential for both US and EU regulation to impact the available clearing venue, the compliance burden is constantly increasing. Add to the clearing mandates and other rules, the capital requirements for uncleared trades of Basel 3 and it is easy to see how an organisation's choice of counterparty can be limited.



By clearing through a CCP that is a DCO, a recognised third-country CCP and a QCCP many of those restrictions are lifted, whether as a member, an affiliate or a client.

Within Japan, the global brokers are well positioned to service global clients with global needs. They have already competed to sign up the largest buy-side firms, providing access to multiple CCPs in multiple jurisdictions. However, with the new regulations come a new class of client: both international and potential new domestic brokers are considering a regional focus; a streamlined service with standardised on-boarding, documentation and operational procedures.

Of particular concern is the cost of inaction. Opportunities for revenue generation will change: as OTC derivatives become increasingly commoditised, spreads are likely to fall. While mandatory clearing and other regulation may force existing clients elsewhere.

**Regional Banks can succeed in establishing successful and profitable clearing business, leading to expansion in other business areas**

## What should clients be looking for in Japan?

- A clearing broker and at least one backup broker
- OTC Trade management
- Independent valuation
- Operational efficiency and STP
- Collateral management
- Operations
- Transformation and financing
- Segregation
- Custody
- Reporting
- Comprehensive on-boarding and on-going assistance

With additional clearing mandates on the way, global regulators are making clearing inevitable. It will take time for a broker to set up a new client clearing service. Clients need to ensure that they have a clearing broker and a backup broker. Not being able to clear will limit the available counterparties and impact regulatory capital. In Catalyst's experience, the automation and design of key processes will be the drivers behind the financial success for brokers and their clients.<sup>1</sup>

**JSCC are uniquely positioned in terms of regulation and preparedness**

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## Meet our author



### Michael Steinbeck-Reeves

Based in Japan, Michael is an expert in OTC clearing with experience going back to the original designs of SwapClear and RepoClear.

He has an excellent understanding of CCP clearing, including global regulation, risk methods and operational workflows.

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**Disclaimer:** Comments in this presentation on are based on Catalyst's understanding of the global regulatory landscape as of May 2013. This document is neither intended to be comprehensive, nor to provide legal or accounting advice.