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Secretariat
The Financial Stability Board
Bank of International Settlements
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Submitted by email: fsb@bis.org

7 September 2018

Dear Secretariat,

Subject: Response to the FSB DAT report
Incentives to centrally clear over-the-counter (OTC) derivatives
A post-implementation evaluation of the effects of the G20 financial regulatory reforms

Nomura holdings, Inc. (Nomura) is pleased to have an opportunity to respond to the Financial Stability Board consultative document, "Incentives to centrally clear over-the-counter (OTC) derivatives" (DAT report) published on 7 August 2018.
Nomura believes that it is very important to evaluate comprehensive impact of multiple reforms for the derivative markets and so highly appreciate the DAT initiative to provide this valuable analysis. We strongly sympathize with remarks in this consultative document, such as the standard setting body should consider the cost and benefit of particular reform(s) and their impact on financial stability.

Generally speaking, we found many observations consistent with our views in this report such as:

- There is a general increase of centrally cleared transactions in the market;
- For dealers and large clients, sets of regulations provide positive incentives for central clearing; and
- If products are clearable and there is sufficient economic benefits (e.g. risk management, market liquidity), these products are likely to be centrally cleared without mandatory clearing requirement.

Nomura would also like to emphasize the following issues:

- Incentives for client clearing service providers are significantly damaged by the regulation (e.g. leverage ratio); and

- It may not be necessarily sensible to apply mandatory clearing for clients with a small volume of transactions.

For the purpose of promoting centrally cleared trades and effective reduction of systemic risk, Nomura recommends considering the following points:

- Reflection of collected margin amounts for derivative exposures in leverage ratio calculation;
- Methodology change for SA-CCR over-collateralization multiplier, in order to align with realistic amount of risk mitigation;
- Performing analysis for the degree of financial stability threat by exempting products which are not suitable to clear or those by small clients; and
- We suggest regulators to reconsider the clearing requirements applying to the intra group transactions in light of the reduction of counterparty credit risk.

The following are our answers for fourteen questions categorized as incentive, market, reform and access, accompanied with findings and characterization in the original report.

<u>Questions, Findings and Comments</u>

Incentives

Q1. Do you agree or disagree with the finding that, in general, there are strong incentives for dealers and larger (in terms of level of derivatives activity) clients to centrally clear OTC derivatives? Do you agree or disagree with the finding that some categories of clients have less strong incentives to use central clearing?

Findings: Mandatory clearing requirements and margin requirements have led to increased central clearing, notably interest rate and credit derivatives. But some small and less active clients have less strong incentives to clear because of fixed cost, which CCPs require and likely passed on to clients through minimum fees and other charges.

A1. In general, dealers and large clients have incentives to centrally clear in order to reduce costs. However, counterparties with directional portfolios and those that are exempted from clearing mandates have few incentives to clear.

Q2. Do you agree or disagree with the finding that relevant post-crisis reforms have, overall, contributed to the incentives to centrally clear? Is the consultative report's characterisation of distinctions in how the reforms have affected incentives for different types of clients consistent or inconsistent with your experience?

Findings: Dealers who responded to the survey pointed out the clearing mandate, margin requirements and regulatory capital costs for centrally cleared and uncleared derivatives as the most important factors incentivizing the clearing of OTC derivatives. Clients who responded pointed out counterparty risk management considerations, differences in bid-offer spreads between and the regulatory capital costs of cleared and uncleared derivatives as the most important factors.

A2. As the post-crisis reforms progress, a number of dealers and clearing service users have chosen to centrally clear in order to reduce the size of exposure and the amount of required regulatory capital.

The effects of the reforms have brought about differences in pricing and liquidity between cleared and uncleared derivatives, which acts as an incentive to clear for clients

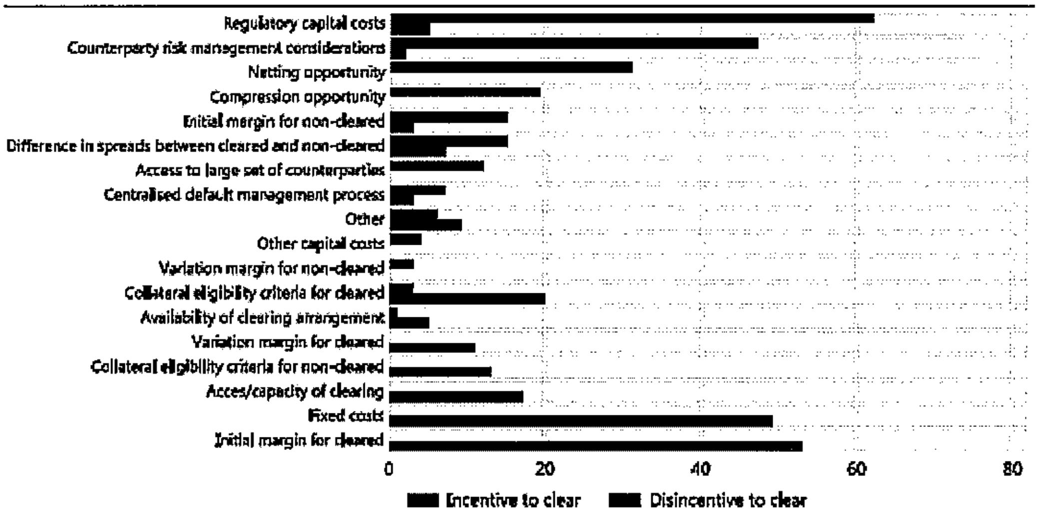
Q3. Do the margin requirements for uncleared derivatives give a sufficient incentive to clear? How do these requirements interact with mandatory clearing obligations to incentivise clearing? Are there particular instruments, and specific types of entities where the incentive to clear is not adequate? In such cases, are there specific aspects of the requirements that diminish incentives to clear?

A3. As findings in this report show, many dealers clear non-mandated, but clearable products such as non deliverable forwards (NDFs) on a voluntary basis after the margin requirements were implemented. We think clearing and margin requirements give incentives of clearing derivatives to market participants.

However, it is not necessary to apply clearing requirements and to give incentives of clearing derivatives such as NDFs, which are used for risk hedges by end-users and which could not be threats against financial stability. In addition, bespoke derivatives, which are structured to meet clients' complicated risk hedge needs, cannot be cleared in most cases, and market participants would have few incentives to clear.

Q4. The consultative report seeks to identify the most important regulatory and non-regulatory factors which affect incentives to centrally clear OTC derivatives for dealers, other financial intermediaries, large clients and small clients. Please identify any significant missing factors and comment on the relative strength of regulatory and non-regulatory factors discussed in the consultative report.

Figure D.2 The weighted rank of the top factors incentivising/disincentivising dealers from centrally clearing non-mandated products



A4. Since different dealers and clients have different positions and trading styles, it is difficult to identify or comment regarding factors of incentives of centrally clearing in whole.

However, we can point out some problems relating to CCP authorization/ registration status, clearing mandates in each jurisdiction and equivalence between jurisdictions when markets choose a CCP to clear derivatives in light of cost associated with central clearing. This fragmentation of the market place and cost associated drives the CCP Basis (price differential) and regulators should consider the wider implications.

Markets

Q5. Is the consultative report's characterisation of the shift of activity and trading liquidity towards centrally cleared products, and the consequent impact on uncleared products, consistent or inconsistent with your experience?

Characterization: As findings in this report show, many dealers and active clients clear non-mandated, but clearable products on a voluntary basis, if centrally clearing reduces the size of their exposure. Whilst 43% of the 44 client survey respondents state that they voluntarily centrally clear nonmandated OTC derivatives products, the percentage of their portfolio which is voluntarily centrally cleared is lower.

A5. Although a number of transactions of certain products such as NDFs and inflation swaps are centrally cleared on a voluntary basis, there are many derivatives which are not clearable. Therefore the impact of the shift of activity towards centrally cleared products does not seem to be significant.

Q6. There are various industry efforts underway to reduce the cost of clearing, including portfolio compression and direct clearing membership models. Based on your experience are these proposals, or other forthcoming changes to clearing infrastructure and models, likely to affect incentives to provide or use clearing services?

A6. Dealers have incentives to clear derivatives to use netting and compression opportunities in order to reduce the notional size of their portfolio.
The cost and resources to the clearing providers are still high and in general this will disincentivize provision of client clearing services.

Reforms

Q7. Do you agree or disagree with the report's characterisation of the effects of the following reforms on incentives to centrally clear?

a. central clearing mandates (both in terms of product scope and entity scope);
b. minimum standards for margin requirements for uncleared derivatives;
c. capital requirements for credit valuation adjustment (CVA) risk;
d. capital requirements for jump-to-default risk (including where applicable the Standardised approach for counterparty credit risk (SA-CCR) and the Current exposure method (CEM));
e. G-SIB requirements; and
f. The leverage ratio.

Characterization: Market participants have strong incentives to centrally clear, when post-crisis reforms increase the costs of OTC derivatives transactions.

A7:

a) Clearable products which are not mandated to be cleared are decided to be cleared based on costs and benefits by each market participant. On the aspects of entity scope, dealers and large clients which have most of the share in the market are incentivized strongly to clear their transactions.

b) Clearing members have incentives to centrally clear products on a voluntary even those which are non-mandated. The main incentive is the cost of the Initial Margin for non-cleared derivatives. But client clearing service providers have few incentives of clearing, because the required regulatory capital associated with providing client clearing service might be a great burden for them.

c) The CVA risk capital charge increases the cost of uncleared transactions and therefore increased the incentive for market participants to centrally clear.

d) In general, market participants have incentives to centrally clear in order to reduce burden of capital charge when risk-sensitive methodology, SA-CCR, is adopted. In addition please see comment in Q9.

e) Since G-SIBs methodology includes items of total exposure and OTC derivatives notional amount, large dealers have strong incentives to centrally clear in order to use compression service and to reduce the size of those exposure and notional amount. The incentive would further increase if centrally cleared notional was excluded from the GSIB calculation.

f) If revised SA-CCR is implemented in leverage ratio calculation, dealers would have further incentive to clear as the increased more accurate reflection of netting reduces the size of leverage. Currently under CEM, dealers also have incentive to centrally clear in order to use compression service and to reduce the size of their exposure.

   On the other hand, client clearing service providers' incentive is depend on cost and benefit of providing client clearing services.

Q8. Do you agree or disagree with the consultative report's characterisation of the impact of these reforms on the incentives to provide client clearing services?

Characterization: If costs of providing client clearing service increase, providers have less incentive to provide the services.

A8. We agree that client clearing service providers have negative incentive to provide the services because the services increase the size of providers' leverage exposure.

This paper mentions the impact on leverage exposure from client clearing service at the consolidated level. But those providers decide whether to provide those services in light of marginal cost and benefit of client clearing service. Therefore we think that the problem that leverage ratio regulation is disincentive for client clearing service should be solved.

Q9. Are there any areas where potential policy adjustments should be considered which would enhance the incentives for or access to central clearing of OTC derivatives, or the incentives to provide client clearing services?

A9. The current leverage ratio regulation has a negative incentive on the provision of client clearing service. In order to enhance the incentives for or access to central clearing of OTC derivatives, the current leverage ratio regulation needs potential policy adjustments.

We understand that BCBS will monitor the impact and will take appropriate actions including a change in the treatment of initial margin received from clients. From the perspective of the incentives to provide client clearing service, at least the exposure mitigation effect of received initial margin should appropriately considered in exposure calculation.

Moreover, we agree with the consultative report that, current Multiplier formula in SA-CCR is calibrated based on excessively conservative assumption. We believe that additional considerations, including revision of Multiplier formula and/or exceptional treatment of client IM outside Multiplier calculation, would be needed.

Access

Q10. Do you agree or disagree with the report's characterisation of the difficulties some clients, especially clients with smaller or more directional derivatives activity, face in:

a. accessing clearing arrangements; and

b. conducting trading and/or hedging activity given the restrictions imposed by their client clearing service providers?

Characterization: Client clearing service providers charge minimum clearing fees and set restrictions on clients clearing activity in order to cover providers' clearing cost. Those increase the per trade cost of small clients. Some clients with directional portfolios are also most affected by restrictions set by service providers. Those clients have less incentive to centrally clear.

Q10. We agree this characterization that small clients and those with directional portfolios might have less incentive to centrally clear.

a) As for accessing clearing arrangements, each client should decide in light of cost and benefit of clearing. It is unclear that some clients feel difficulties to access in whole.
b) It is also unclear that some clients face difficulties in conducting trading and/or hedging activity.

Q11. Do you agree or disagree with the finding that the provision of client clearing services is concentrated in a relatively small number of banks? Does the current level of concentration raise any concerns about incentives to centrally clear, or risks to the continuity of provision of critical economic functions, including during periods of stress?

Findings: Many market participants access CCPs as clients via a clearing member

A11. Some clearing members stop providing client clearing service, and the service is concentrated in a small group of clearing firms.

This situation has less impact on incentives of central clearing, but might be potential risk under stress environment in light of portability of clients cleared portfolios.

Q12. Do you agree or disagree with the report's characterisation of the incentive effects created by up-front and ongoing fixed costs of:

a. using clearing services?

b. providing client clearing services?

Characterization: Clients who responded to the survey ranked the high fixed costs associated with participation in clearing as the most important factor to disincentivize to participate central clearing.

A12.

A, The fixed cost associated with participation in clearing is a problem especially for small clients. The regulator should carefully consider in the light of systemic risk if this kind of client should be mandated to clear.

B. Client clearing service providers covers its cost relating to the service via the fees, this does not appear to have an effect on the incentive to provide the services. The regulatory capital requirement under Leverage Ratio has the largest impact on the incentive to provide client clearing services.

Q13. In light of the finding in this report that economic factors generally incentivize central clearing for certain market participants but perhaps not for others, please describe your views regarding the costs and benefits of the scope of the clearing mandates, both in terms of the products and entities covered.

Q13. Clearing requirements on standardized products with high liquidity and large trading volume are effective to reduce systemic risk. On the other hand, the additional benefit of expanding the scope to small clients will be small. In addition, we suggest regulators to reconsider the clearing requirements applying to the intra group transactions in light of the reduction of counterparty credit risk.

Q14. Should regulation seek to create incentives to centrally clear OTC derivatives for all financial firms, including the smallest and least active? If so, what would that imply for the costs of uncleared trades? If not, for which types of firm and product is it most important to have incentives for central clearing? Conversely for which types of firm and product would it be acceptable not to have incentives for central clearing? Please elaborate.

A14. The defaults of dealers and large clients who trade standardized products with high liquidity could be a great threat to financial stability. Therefore it is important to apply clearing and margin requirements, and to give incentives to centrally clear in order to reduce systemic risk by downsizing counterparty credit risk exposure.
However, it is not necessary to apply those mandates to transactions of products which are not suitable for clearing or for them to apply to small clients.

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We appreciate the opportunity to share our view on this Consultative Document issued by Financial Stability Board. Should you wish to discuss any of the above, we would be glad to provide any further information. We hope the Financial Stability Board find our comments useful in establishing a sensible framework for the derivatives market.

Yours sincerely,

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