



# INTERNATIONAL BANKERS ASSOCIATION OF JAPAN

February 27, 2020

Mr. Christopher Kirkpatrick  
Secretary  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21<sup>st</sup> St, N.W.  
Washington, DC 20581

**Re: Capital Requirements of Swap Dealers and Major Swap Participants (RIN  
3038-AD54)**

Dear Mr. Kirkpatrick:

## **I. Introduction**

The International Bankers Association of Japan (“IBAJ”)<sup>1</sup> is grateful for the opportunity to provide our comments to the re-proposed rulemaking of the Capital Requirements of Swap Dealers and Major Swap Participants (“Proposal”)<sup>2</sup> released by the Commodity Futures Trading Commission (“Commission” or “CFTC”) in connection with the re-opening of the comment period and request for additional comments.<sup>3</sup> The IBAJ supports the Commission’s efforts in establishing capital requirements for swap dealers (“SDs”) not subject to the capital requirements of the Prudential Regulators (“Non-Bank SDs”).<sup>4</sup> In particular, the IBAJ greatly

---

<sup>1</sup> IBAJ is an association for foreign banks, securities companies and associate members based in Japan. It carries out a range of services and activities to promote a strong and efficient financial sector and support members’ business interests. <http://www.ibajapan.org/>

<sup>2</sup> 81 Fed. Reg. 91,252 (December 16, 2016); *see also* 76 Fed. Reg. 27,802 (May 12, 2011)

<sup>3</sup> Capital Requirements of Swap Dealers and Major Swap Participants; Proposed Rule, 84 Fed. Reg. 69,664 (December 19, 2019), available at <https://www.cftc.gov/sites/default/files/2019/12/2019-27116a.pdf>

<sup>4</sup> The “**Prudential Regulators**” are the Board of Governors of the Federal Reserve System (“**FRB**”), the Federal Deposit Insurance Corporation (“**FDIC**”), the Federal Housing Finance Agency

appreciates the Commission's efforts in proposing multiple approaches by which a Non-Bank SD can opt to calculate and comply with the capital requirements.

The IBAJ member firms operating business in Japan impacted by the Proposal are each subject to comprehensive Japanese regulatory capital standards. In addition, while the impacted IBAJ member firms are provisionally registered with the CFTC as SDs, their primary client relationships and business activities are conducted in the Japanese, not U.S., financial markets. Accordingly, we strongly recommend that the Commission adopt clear substituted compliance standards that permit non-U.S. SDs to comply with regulatory capital standards in Japan and avoid potential confusion and duplication resulting from application of U.S. capital standards to non-U.S. SDs.

## **II. Substituted Compliance**

The IBAJ support the Commission's approach to allow substituted compliance with comparable foreign capital, liquidity and financial reporting requirements. It is essential that non-U.S. SDs, including SD subsidiaries of U.S. bank holding companies, be permitted to operate under a regime of full substituted compliance.

Similar to the U.S. capital regime, the Japanese capital regime is structured in a multi-tiered framework where different rules apply to regulated entities depending on various factors including the international activeness of the business, consolidated asset size and other factors. Specifically, the Japanese capital rules based on Basel III standards are required for internationally active banks and for two large broker-dealers as group level requirements. Other domestic banks are subject to domestic rules that, while overall similar to the Basel III standards, use a different minimum capital adequacy ratio. The broker-dealer standalone capital requirement is a "net capital" rule approach to determine the capital adequacy whereby a regulated entity is required to hold sufficient net capital to cover the "risk-equivalent amount" of its market, counterparty and operational risk.

Under the "net capital" rule approach, the capital adequacy ratio, which equals "net capital" (non-fixed regulatory capital) divided by "risk equivalent amount,"

---

("FHFA"), the Farm Credit Administration ("FCA") and the Office of the Comptroller of the Currency ("OCC").

must not fall below 120% as a minimum requirement and 140% as an early warning level, and it is closely monitored even if the ratio is above the levels. In addition, the Bank of Japan requires 200% as a minimum to primary dealers of Japanese Government Bond. The “net capital” (non-fixed regulatory capital) is determined in accordance with Japanese generally accepted accounting principles (“GAAP”) where the net asset amount is deducted by the amount of illiquid assets including non-current assets and certain current assets that cannot be liquidated in a short time period and added with tier 2 capital including eligible subordinated debt, if any. The “risk equivalent amount” is the sum of the market risk equivalent amount, counterparty risk equivalent amount, and operational risk equivalent amount. For this purpose, (a) market risk is risks due to price fluctuations of asset holdings, where the risk equivalent amount is calculated using a standard method or internal model based method similar to Basel 2.5 subject to model approval by the Financial Services Agency of Japan (“JFSA”), (b) counterparty risk is the risk of losses arising from the other party to a transaction not performing its obligations (*i.e.*, a credit equivalent amount multiplied by risk weighting) similar to Basel standards, (c) operational risk is the risk in daily operations (*e.g.*, clerical errors) the value of which is determined simply as three months of operating expenses.

The strong need for substituted compliance is emphasized by the practical challenges the non-U.S. SDs will encounter due to both the CFTC and Japanese capital requirements applying simultaneously. The duplicative application of the two jurisdictions’ requirements will impose a heavy compliance burden that will be extremely costly while lacking any countervailing policy benefit of materially enhancing the safety, soundness and prudence of regulated entities. To avoid such overlaps, conflicts and inconsistencies in the application of two jurisdictions’ capital requirements, we strongly urge the Commission to permit non-U.S. SDs in Japan to operate under a regime of full substituted compliance including the use of internal models approved by the JFSA.

To this end, we strongly urge the Commission to comprehensively observe the capital framework of a foreign jurisdiction in a holistic manner, as opposed to narrowly focusing on a line by line comparison, when analyzing the various elements pertaining to the comparability determination. Of particular note, we commend the

Commission's comprehensive and holistic approach adopted in the comparability determination for the Japanese margin rules applicable to non-cleared inter-affiliate swaps.<sup>5</sup> In this determination, the Commission considered the outcomes of the JFSA's margin requirement to those of the CFTC's requirements "in the broader context of the JFSA's prudential oversight of risk management and capital requirements" and found that the treatment of inter-affiliate transactions under the CFTC margin rule and the treatment of those transactions under the JFSA's margin rules are comparable in outcome for purposes of CFTC Rule § 23.160. We strongly support the Commission's comprehensive and holistic approach of taking into consideration the capital requirements under Japanese law, as opposed to narrowly focusing on only the JFSA's margin rules, in the comparability determination for the margin requirements for inter-affiliate swaps. In addition, we strongly agree with the Commission's approach of recognizing the interconnected nature inherent between the margin requirements and capital requirements as both are prudential regulations sharing a policy goal of securing the safety, soundness and prudence of regulated institutions. As the Commission has determined the Japanese margin requirements applicable to non-cleared swaps as being comparable to the CFTC's margin requirements, we believe determining the Japanese capital requirements also as being comparable to the CFTC's capital requirements is in line with the recognition of the interconnected nature of the margin and capital requirements and principles of international comity.

Furthermore, we request the Commission to allow substituted compliance not only with respect to the capital, liquidity and reporting requirements imposed under the Japanese regulations on non-U.S. SDs in Japan, but also (a) accept other local accounting regimes such as International Financial Reporting Standards and Japanese GAAP and (b) provide automatic approval to internal models that have been approved by the JFSA. We are concerned that reluctance or unwillingness to accept foreign requirements and approvals of foreign regulators will fragment the global swaps markets, lead to smaller and disconnected unstable liquidity pools and

---

<sup>5</sup> Amendment to Comparability Determination for Japan: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, CFTC Release No. 7899-19 (Mar. 26, 2019).

ultimately exacerbate systemic risk.

In this connection, we note the market fragmentation concerns addressed by Ryozo Himino, Vice Minister for International Affairs of the JFSA, at the 2018 ISDA Annual Japan Conference.<sup>6</sup>

In addition, for substituted compliance to be meaningful, we request the Commission to issue a substituted compliance determination for Japan as part of the issuance of the final capital rule. If the Commission does not issue a substituted compliance determination as part of the final capital rule, we further request the Commission to extend the effective date of the CFTC's capital rules until 18 months after the Commission has made a comparability determination with respect to the Japanese capital rules. In light of the significant time and effort necessary to build the required technology and implement the CFTC's capital framework, the Commission should not compel non-U.S. SDs to comply with the CFTC's capital rules before, or immediately after, the conclusion of a comparability determination.

In furtherance of the significant efforts that the Commission has devoted to strike the right balance in protecting the integrity, safety and soundness of the U.S. financial system while promoting global harmonization and recognizing principles of international comity, we strongly encourage the Commission to establish a comprehensive and holistic approach to substituted compliance.

### **III. Automatic Model Approval Process**

Under the Proposal, the Commission allows the use of internal models for credit risk and market risk. In the event the Japanese regulations are not determined to be full comparable under the substituted compliance framework, the IBAJ urges the Commission to provide automatic recognition and approval for internal models, which have been previously approved by the JFSA, which approval requires the model to meet both qualitative and quantitative criteria (*e.g.*, criteria in internal model approach for market risk under Basel 2.5).

The Proposal anticipates that the model approval process will be delegated to

---

<sup>6</sup> "Market Fragmentation," Speech by Ryozo Himino, Vice Minister for International Affairs, Financial Services Agency, Japan, at the 2018 ISDA Annual Japan Conference, October 26, 2018, Tokyo, available at <https://www.fsa.go.jp/common/conference/damwa/20181026.pdf>

the National Futures Association (“NFA”). We are concerned that the complexity and sheer volume of the internal models requiring approval will place a significant strain on NFA resource and, as a result, there arising a risk of a non-U.S. SD not being able to obtain internal model approvals sufficiently in advance of the compliance date.

If a non-U.S. SD is not able to obtain internal model approval sufficiently in advance of the compliance date, it will have no other choice than to calculate and comply with the capital requirements based on the non-model based approach solely for CFTC capital requirements. This duplicative compliance burden will result in the CFTC capital requirement being a huge constraint on the non-US SD’s business. In such case, a non-U.S. SD will confront practical challenges of striving to compete in the foreign market while bearing the punitive capital costs imposed under the non-model based approach.

Furthermore, it may have a detrimental effect to a non-U.S. SD’s ability to provide liquidity in the foreign swaps market. Non-U.S. SDs are an important source of liquidity in foreign markets thus a non-U.S. SD’s inability to provide liquidity will potentially have a negative impact widely across foreign swap markets including the Japanese market. Non-U.S. SDs are critical liquidity providers in the local Japan market and Japanese market participants heavily rely on their liquidity provision, particularly with respect to U.S.-dollar denominated swaps to hedge exposure incurred in connection with U.S. investments. In addition, reluctance by Japanese market participants to trade swaps with non-U.S. SDs due to higher cost or other factors may diminish the ability of U.S.-headquartered firms to compete or access liquidity in the Japanese swaps market. For instance, such reluctance may impede a U.S.-headquartered firm’s ability to hedge or risk manage exposures denominated in foreign currencies, which in turn could diminish their ability to offer products and liquidity to non-U.S. clients. This could result in fragmented global swaps markets comprised of small and disconnected liquidity pools leading to exacerbation of systemic risk.

Generally, non-U.S. SDs operating business in Japan are locally registered or licensed by the JFSA and subject to local regulation and supervision in Japan. If an internal model has been approved by the JFSA, we see no countervailing policy benefit in requiring a separate and duplicative model approval from the CFTC or the

NFA. We strongly believe automatic approvals for internal models, which have been approved by the JFSA will have the benefits of avoiding meritless duplicative model approvals that will alleviate the NFA's model approval burden and facilitate liquidity provision in the swaps market by non-U.S. SDs. In addition, we believe automatic model acceptance is a critical element for a non-U.S. SD seeking to rely on substituted compliance in line with the principles of international comity.

#### **IV. Reporting Requirements**

The Proposal is, in numerous material respects, more onerous than, and inconsistent with, existing reporting requirements under the regulations in Japan.

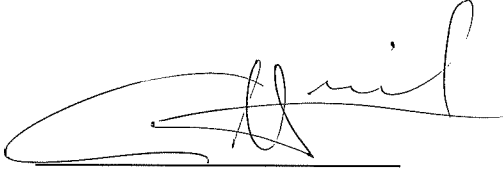
Specifically, the timing, content and public disclosure requirement of the reports should substantially match the existing regulatory requirements, unless there is a compelling policy rationale or considerable policy benefit to require otherwise. While financial reporting may appear to not have the same level of significance relative to the minimum capital or liquidity requirements, financial reporting has its own unique compliance complexities. Due to the disparities from the existing regulations, depending on how the current infrastructure is set up at each firm, certain Non-Bank SDs' may need to build new technology solutions and create new report preparation and validation procedures in order to meet the reporting requirements.

We urge the Commission to conform its reporting requirements to those required under existing reporting requirements under the existing regulations adopted by the JFSA or permit non-U.S. SDs in Japan to operate under a regime of full substituted compliance with respect to the reporting requirements.

#### **V. Conclusion**

We appreciate the opportunity to comment on the Proposal and look forward to working with the CFTC as it continues to consider appropriate capital requirements for covered entities. We are available to discuss these comments in further detail with you if required.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'Avril', written over a horizontal line.

Philippe Avril

Chairman of the IBA Japan

Date: 26 FEB 2020