MUFG
The Bank of Tokyo-Mitsubishi UFJ, Ltd.

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Committee of European Securities Regulators

Re: CESR Consultation Paper on Standardisation and Exchange Trading of OTC Derivatives

Dear Sirs

Thank you for the opportunity to respond to the above consultation. We would like to begin by making a general point about the short timeframe for responding. Allowing less than a month to respond to the consultation paper is fairly worrying given the importance of OTC derivatives for banks and other financial institutions in the UK and Europe and given the amount of initiatives currently coming from European and national bodies. It would be much more useful going forward if firms were allowed the standard eight to twelve weeks to contribute a meaningful response.

Our general impression of this consultation is that this paper only sets out some conceptual proposals for high-level discussion where the issues that regulators aim to tackle require very practical and tailor-made solutions.

This paper sets out a number of objectives, including to increase market efficiency, transparency and liquidity, to allow better information sharing and counterparty risk and operational risk management, and ultimately to reduce systemic risk rooted from the OTC markets. The paper generally consults on the needs for further standardisation of OTC derivatives, through legal, process and product uniformities, and trading at organised venues including exchanges with links to other issues such as CCP clearing. We would like to make a few comments based on our review of each of the above key elements.

First, the consultation paper recognises that legal uniformity is fundamental to further standardisation and sets out some proposals for further uniformity. We agree with the importance of legal uniformity, however, we consider that one common set of legal documentation is unlikely to fit all products within an asset class. For example, different types of CSA agreements may be needed to enable market participants to manage their counterparty exposure effectively. We do not see any urgent need for further legal uniformity given that a high level of standardisation has already been achieved by the industry through the ISDA documentation system. Having said that, if a case were to be made for greater uniformity leading to improved process efficiency and risk reduction, we would be keen to review it. However we would not like to restrict the flexibility for negotiations in certain technical areas allowed in the current ISDA system.

Second, the paper discusses process uniformity, especially the use of electronic confirmation systems for OTC derivatives. We have seen some clear benefits of process uniformity and strongly agree that the use of electronic confirmation and STPs will increase operational efficiency and transparency, and hence reduce risks associated with OTC transactions. However, we have noticed that electronic confirmations have already been widely used by the majority of market participants in foreign exchange, interest rates and CDS markets through centralised systems, such as CLS, LCH and DTCC. STPs have also been adopted by major market participants on a wide range of OTC products. We would therefore urge regulators to

Head Office: 7-1 Marunouchi 2-Chome,
Chiyoda-Ku, Tokyo 100-8388, Japan
MUFG – Mitsubishi UFJ Financial Group

Bank of Tokyo-Mitsubishi UFJ
12-15 Finsbury Circus
London EC2M 7BT

Tel: +44 (0)20 7588 1111
Fax: +44 (0)20 7628 8241
Telex: 884811

carefully examine the substantial investments made by the industry and progress already achieved across OTC markets, before setting further mandatory requirements in this area.

Third, the consultation explores the possibility of further product uniformity. We can certainly see some benefits as a consequence of that, in terms of improved product and pricing transparency, as well as more efficient operation management and information sharing. On the other hand, we have noted significant limitations of product standardisation as 'one size' is unlikely to fit all market participants. High-level product standardisation might potentially hamper legitimate business needs for bespoke product features, cause additional basis risks for hedging counterparties, affect market liquidity and even impact the volatility of other markets. Please refer to our answers to Q2 and Q3 in the Appendix for a detailed analysis based on the case of foreign exchange derivatives.

CESR advocates moving eligible OTC derivatives to organised trading venues, including exchanges for the benefits of greater pricing transparency, market liquidity and operation efficiency. Here we are particularly concerned with the potential damaging impact of exchange trading on certain asset classes that already have satisfactory liquidity and depth, such as foreign exchange and rates. We consider that only very marginal benefits at best will be gained to foreign exchange and rates markets, if they are moved to exchange. Particular attention should also be paid to the impact of exchange trading on CDS products, in terms of the availability of protection in the event of the issuer's restructuring and the associated capital charge for CDS end users. Please refer to our answer to Q8 in the Appendix for a detailed analysis on the implications for foreign exchange and CDS products.

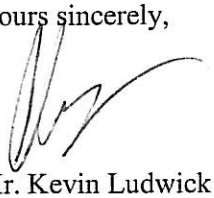
It is essential to strike a proper balance between the benefits at a macro level (i.e. transparency to the regulatory authority) and the benefits at a micro level (i.e. meeting commercial needs of market participants) when taking further regulatory actions. We currently transact with corporate customers in the OTC market principally so that they may hedge the financial risks arising from their business. We recognise that other market participants may enter into OTC markets for investing or speculating. As a consequence, bespoke OTC derivative products which may vary significantly from one to the other were created to cater for a wide variety of business needs. We believe that regulatory actions should respect and differentiate between those various needs appropriately. These varied participants are the key to the depth and liquidity of foreign exchange and rates markets. Amongst different types of market participants, we would like to draw your attention to end users of OTC products for legitimate commercial purposes, which mainly include hedging against risks arising from fluctuations in interest rates and foreign exchange rates as well as credit and market risk exposures of their portfolios. The impact of CESR's proposals on the varied participants described above should be proportionate with the risks posed by them. The effect of CESR's proposals on end users (corporate customers with hedging needs) in terms of basis risks from contract standardisation and earning volatility from imperfect hedging are in our view disproportionate.

In summary, we believe that the goal of greater standardisation and exchange trading should be to promote market efficiency in terms of pricing, processing and liquidity, to reduce risks and to facilitate various types of transactions and trade portability of OTC derivatives. In the mean time, it should not hamper the legitimate commercial needs of end users or create additional basis risks or cause the loss of hedging benefits for hedging counterparties. We also think that further regulatory actions should build on the existing attempts by the markets to create greater standardisation. This would be far preferable to proposals requiring significant expenditure on new infrastructure.

Given that achieving further standardisation and exchange trading for all eligible OTC products is not a target for a short time frame, we trust that it is more appropriate to focus regulatory attention on asset classes posing a higher risk to the financial system. We also hope that the regulatory initiatives on standardisation and exchange trading of OTC derivatives will not distract regulators and banks active in Europe from the other prudential regulatory developments which have more immediate implications for systemic risk and financial stability.

Please find our responses to the specific consultation questions in the attached Appendix.

Yours sincerely,



Mr. Kevin Ludwick
General Manager
European Compliance Division

Appendix Summary of consultation questions

Q1: Do you agree with CESR's assessment of the degree of standardisation of OTC derivatives? Is there any other element that CESR should take into account?

We agree with the assessment in principle.

Q2: Do you agree with the benefits and limitations of standardisation noted above? Please specify. Can you also describe and where possible quantify the potential impact of the limitations to standardisation? Are there any other elements that should be considered?

We agree with the analysis of benefits and limitations in principle but we think the analysis is fairly imbalanced between the three categories of uniformity. The analysis mainly focuses on product standardisation although a more immediate need for process uniformity is suggested in the paper.

We also felt that the analysis of benefits and limitations of product standardisation is not adequate, as benefits and limitations may vary from one asset class to another. For instance, the analysis of limitations captured the negative implication for hedging counterparties who may lose hedge accounting benefits and be exposed to some basis risk due to high level product standardisation. However, the negative impact is not limited to these when an asset-class specific analysis is performed. For example, in FX OTC derivatives markets, the hedging counterparties are usually large corporations with international operations, such as GM and Ford, who enter into OTC FX transactions to hedge their long term cash flow. Highly standardised products may not only cause a loss of hedging benefits for those end users, but also make them exposed to additional basis risks which are unwanted to their shareholders and can no be effectively managed by themselves due to the lack of the required expertise and resources. If these were to materialise, it is likely for us to see an increased volatility in the earnings of those hedging counterparties shown in their income statements. The same impact may be observed from hedging counterparties who use OTC products for fair value hedging. In this way, the fluctuation in volatility may potentially be passed on from OTC markets to equity markets and thus pose risks to the financial system and may also impair the interests of investors to equity markets. Therefore we believe it is more appropriate to differentiate between different asset classes when performing the assessment.

Q3: Do you agree that greater standardisation is desirable? What should the goal of standardisation be?

We can see some benefits as a consequence of greater standardisation, including a better understanding of market positions and increased market transparency, as well as more efficient operation management and information sharing. However, we believe that the goal of greater standardisation should be to promote market efficiency in terms of pricing, processing and liquidity, to reduce risks and to facilitate various types of transactions and trade portability of OTC derivatives. In the mean time it should not hamper the legitimate commercial needs of end users, create additional basis risks, or cause the loss of hedging benefits for hedging counterparties.

As mentioned in the above answer, we believe that the treatment for each asset class should be differentiated. With reference to FX OTC derivatives, it is very unlikely that greater standardisation in terms of product features is desirable for hedging counterparties (please refer to our answer to Q2 for further details). If no effective hedging and hedging accounting benefits can be maintained by hedging counterparties, they may, over the long term, change their hedging approach, such as reducing or avoiding incurring foreign exchange exposure in the manufacturing process. This could substantially undermine the market demand for FX OTC derivatives and result in a fall in market liquidity.

On the other hand, further standardisation to some extent, without hampering the need for bespoke product features, may potentially be welcome by CDS market participants, as seen in the past few years in light of the progress made by the industry in developing standard coupons and big-bang protocols. Although some negative impact of further standardisation has been observed by market participants,

such as the need for funding the payment of difference resulted from standard coupons, we think that further standardisation would bring some benefits to the market as a whole.

Q4: How can the industry and regulators continue to work together to build on existing initiatives and accelerate their impact?

There have already been a number of industry initiatives on the further standardisation of OTC products. For example, we have seen further legal and product standardisation in the CDS market driven by market forces. Electronic confirmation systems have also been widely used in FX, rates and OTC markets through CLS, LCH and DTCC. We would like to urge regulators and the industry to continue to build on the existing attempts by the markets to create a greater standardisation. This would be far preferable to further investment on new infrastructures or to alternative efforts which could in fact have significant cost implications for market participants or have adverse consequences on their ability to manage and hedge their risks.

Q5: Are there any obstacles to standardisation that could be removed by regulatory action? Please elaborate.

No comment.

Q6: Should regulators prioritise focus on a) a certain element of standardisation and/or b) a certain asset class.? Please provide supporting rationale.

We believe that certain asset classes, such as FX and rates, have already developed satisfactory depth and liquidity and we do not see any benefit from regulatory actions in these markets. We believe that regulators should prioritise asset classes of which the market depth and liquidity are fairly limited and would potentially pose material systemic risks to the financial system.

Q7: CESR is exploring recommending to the European Commission the mandatory use of electronic confirmation systems. What are the one-off and ongoing costs of such a proposal? Please quantify your cost estimate.

No comment.

Q8: Do you agree with the assessment done by CESR on the benefits and limitations of exchange trading of OTC derivatives? Should any other parameters be taken into account?

We do not agree with CESR's views on the balance of benefits of exchange trading (e.g. enhanced liquidity) and do not therefore think mandatory use of exchange trading for all OTC derivatives would be desirable. As mentioned above, differentiated treatments will be required for different asset classes, and for example, we see little benefits in particular for FX, rates and CDS markets.

In general, exchange trading will require a common set of documentation for all products of the same type, leaving no room for negotiation and disincentivising innovation. We consider that 'one size' is unlikely to fit all products in an asset class, and will affect the legitimate needs of commercial users for bespoke products features.

As to FX and rates OTC derivatives, exchange trading will inevitably require collateralisation (margining) for many products, for instance FX swaps. We can see some clear benefits of collateralisation, including the removal of counterparty credit risk and the potential drop in initial payment by end users as the CVA margin reflected in the current pricing may be reduced accordingly. However, since the counterparty risk can not be fully mitigated by collateralisation, a charge may still be incurred by end users to cover residual credit risk and wrong way risk. In the mean time, collateral requirements are likely to fluctuate under the mark-to-market valuation mode and this will have to be financed by end users. Currently end users of those transactions with satisfactory credit ratings are not required to fund the fluctuation in value by posting collateral as long as the movement is within the pre-approved risk limit of the market-makers. This means that end users are currently using their market-

makers' balance sheet to fund the fluctuation of the market risk where market-makers take the credit risk arising from funding the MTM movements. If the OTC products are moving to exchanges, end users will have to fund MTM movements by posting more collateral at the expense of additional borrowing costs. In this way, end users might end up with paying more for their FX swaps, should the volatility of FX rates be higher than that of their credit ratings. If this were to materialise, it may cause a higher volatility in end users' earnings.

Exchange trading of CDS will also require some additional attention. CDS written on North American investment grade corporate reference entities and European corporate reference entities generally also include the restructuring of the underlying's issuer as a credit event. Credit events such as restructuring are currently decided by the CDS Determinations Committee (DC) which is made up of 15 dealer and non-dealer investors with ISDA as the Secretary and coordinator. For CDS positions with restructuring as a credit event trigger, a 40% relief is available for end users in relation to the credit risk capital charge under the current Basel II rules (Section192 of the Revised Basel II Framework). To move CDS products to exchanges or organised trading venues in Europe, the exchanges will need to provide an efficient harmonised mechanism to enable restructuring to remain as an eligible credit event, in the absence of a harmonised insolvency mechanism across all jurisdictions.

Q9: Which sectors of the market would benefit from/ be suitable for (more) exchange trading?

No comment.

Q10: In your view, for which sectors of the market will increased transparency associated with exchange trading increase liquidity and for which sectors will it decrease liquidity? Please specify.

In our view, increased transaction costs from exchange or organised venue trading would be an disincentive for market participants in foreign exchange and interest rate trading, where there is no shortage of liquidity.

Q11: Do you identify any other elements that would prevent additional OTC derivatives to be traded on organised platforms?

In our view, mandatory transaction cost may also make exchange trading or organised platform trading less desirable to the industry.

Q12: How should the level of liquidity necessary/relevant to exchange trading be measured?

No comment.

Q13: Do you agree with CESR's assessment of the characteristics and level of standardisation which are needed for a contract to be traded on an organised trading platform?

No comment.

Q14: Is the availability of CCP clearing an essential pre-determining factor for a derivative contract to be traded on an organised trading platform? Please provide supporting rationale.

In our view, CCP clearing is an essential condition for exchange or organised platform trading.

We have noticed that one of the main benefits of CCP is that the cost of counterparty default is spread around the system as a failed member's liability will be covered by its margin, its contribution to Guaranty Fund, and the rest of the Guaranty Fund if necessary. However, we do not believe that it will be a free benefit, and we are concerned that the cost of the insurance benefits may be posed on end users.

Using CCP will definitely require investments on IT systems and resources by market participants over a relatively long term. A cost and benefit analysis will be necessary to justify any regulatory actions.

One of the benefits of using CCP is that regulators would be able to efficiently gather data for trade confirmation directly from CCP. However, this benefit has already been available by using DTCC as a centralised repository system for CDS transactions. It was noted that electronic confirmation has also been widely used for FX and rates OTC products through CLS and DCH system.

Q15: Is contract fungibility necessary in order for a derivative contract to be traded on an organised trading platform? Please provide supporting rationale.

No comment.

Q16: Which derivative contracts which are currently traded OTC could be traded on an organised trading platform? Please provide supporting rationale.

No comment.

Q17: Please identify the derivative contracts which do trade on an organised trading platform but only to a limited degree and could be traded more widely on these types of venues.

No comment.

Q18: In the OTC derivatives context, should any regulatory action expand the concept of "exchange trading" to encompass the requirements set out in paragraph 86 and 87 or only the requirements set out in paragraph 86? Please elaborate.

No comment.

Q19: Do current trading models and/or electronic trading platforms for OTC derivatives have the ability to make pricing information (both pre- and post-trade) available on a multi-lateral basis? Please provide examples, including specific features of these models/platforms.

No comment.

Q20: Do you consider the SI-regime for shares relevant for the trading of OTC derivatives?

No comment.

Q21: If so, do you consider that the current SI-regime provides the benefits described above which 'exchange trading' may offer or are amendments needed to the SI obligations to provide these benefits to the OTC derivatives market?

No comment.

Q22: Which characteristics should a crossing network regime, as envisaged in the review of MiFID, have for a CN to be able to be qualified as a MiFID "organised trading venue"?

No comment.

Q23: In your view does the envisaged legislative approach in the US leave scope for regulatory arbitrage with the current EU legislative framework as provided under MiFID? Would regulatory measures taken in the EU to increase 'exchange trading' of OTC derivatives help to avoid regulatory arbitrage?

No comment.

Q24: The Commission has indicated that multi-laterality, pre- and post-trade transparency and easy access are key aspects of the concept of "on exchange" trading. Do you agree with CESR applying these criteria in its further analysis of what this means in the EU context, in particular in applying MiFID to derivatives trading?

No comment.

Q25: If not, do you consider that MiFID requirements and obligations should be refined to cover deviating characteristics of other electronic trading facilities? Please elaborate.

No comment.

Q26: Are there any market-led initiatives promoting 'exchange trading' that the regulators should be aware of?

No comment.

Q27: Which kind of incentives could, in your view, efficiently promote greater trading of standardised OTC derivatives on organised trading venues? Please elaborate.

No comment.

Q28: Do you believe there would be benefits in a mandatory regulatory action towards greater trading of standardised OTC derivatives on organised venues? Please elaborate.

No comment.