

August 12, 2014

**Comments on the Consultative Document “Foreign Exchange Benchmarks”
published by the Financial Stability Board**

Japanese Bankers Association

We, the Japanese Bankers Association, would like to express our gratitude for this opportunity to comment on the Consultative Document *Foreign Exchange Benchmarks* published by the Financial Stability Board (the “FSB”) on July 15, 2014.

We respectfully expect that the following comments will contribute to your further discussion on this issue for finalizing the recommendations.

<Overall Comment>

To our understanding, the main causes of the manipulation of foreign exchange benchmarks, such as WMR, were the inappropriate sharing of information and collusion between dealers belonging to financial institutions, as indicated in the Consultative Document.

Given this, the most important and essential ways to address this issue are, as incorporated in the draft recommendations, the establishment of appropriate internal processes and procedures to manage end user information as well as the improvement of codes of conduct in financial institutions. Some measures, in addition, could be taken for the calculation method of benchmarks to reduce the incentive for manipulation. For example, WMR may be reviewed to adopt Time Mean which appropriately reflects bid-offer rather than referencing the median rate as under current practice. Further, the calculation window of benchmarks may be extended to an appropriate extent. These measures are expected to have a certain effects in disincentivising malpractice.

With regard to the development of a “global/central utility” referred in the market infrastructure subsection, we are concerned that a concentration of the order flow to a single utility may place the utility in the position to execute large one side trade (buy side or sell side) in a short window (e.g. the time of the global/central utility’s netting settlement). Since there are few market makers who trade against such large orders, the

liquidity of the market in the window might significantly decrease and it is highly likely that the utility is forced to make a deal, if any, at an unfavorable price and expose end users to the risk of disadvantages. We recognize current market infrastructure works smoothly. Therefore, we believe it is premature to recommend the development of a single utility, and the Foreign Exchange Benchmark Group (FXBG) should give a careful consideration on its risks.

We strongly support the FXBG's encouragement for industry-led initiatives to develop market infrastructure. Given that a framework where multiple private-sector brokers, etc. provide netting arrangements is already in place, it is appropriate to solicit market participants to utilize such a framework at their discretion.

Even if any kind of FX benchmarks and global/central utility is developed in the future in response to the FXBG's recommendations, market participants should be allowed to use their own discretion in whether to use such a benchmark and utility instead of being mandated by, for example, regulations.

The FX market is widely used to facilitate export and import trades, cross-border capital transactions and other transactions. Therefore, ensuring sound liquidity in the FX market and maintaining its function of best execution for end users would contribute to appropriate and fair development of global economy. From this viewpoint, we would like to comment on each recommendation hereinafter.

<Specific Comments>

1. Appropriate Width of the Fixing Window (Recommendation 1)

It is generally considered that the wider the window, the more difficult for malicious persons to influence the benchmark calculation; and as a result, chance of manipulation may decrease. On the other hand, there is a disadvantage of widening a fixing window. The wider the window, the more the rate could be affected by emerging news, undermining its function as a benchmark rate at a specific point in time. While there is no obvious problem in the current width of one minute, it could be effective to extend it to around five minutes in order to minimize the opportunity for rate manipulation.

2. Alternative Benchmarks and their Calculations (Recommendation 2)

Assuming that the fixing window described in the Comments 1. is extended to five minutes, we recommend that FX benchmarks should be calculated as the time mean of bid-offer per second over a 5-minute period. Given the width of five minutes, it would be reasonable to extract samples to calculate benchmarks every second.

As investors and other benchmark users want to avoid tracking errors, there is a need to execute transactions at the rate as close as possible to the benchmark rate. Therefore, it is important for financial institutions receiving FX transaction orders to be able to “replicate”⁽¹⁾ the benchmark rate.

However, as the current median rate is not fixed until the fixing period finishes, it is difficult in practice to hedge a non-fixed median rate during the fixing period. In the case of the time mean rate, on the other hand, a certain amount can be hedged based on a replicated benchmark in every sampling cycle during the fixing period. Reducing the risk of incurring loss from tracking error would prevent dealers from manipulating markets for their own benefits in order to avoid such loss.

Further, the execution of transactions based on a mid-rate is in itself loss-making business for market makers in many cases. Therefore, the FXBG’s recommendation to set appropriate bid-offer and use them as a threshold when executing a transaction with end users would reduce incentives to manipulate benchmarks to cover loss making.

To our understanding, there is no demand for a benchmark with a long fixing period (up to 24 hours) at present.

3. Timing of the Fixing Window (Recommendation 3)

We support the recommendation to continue to center the fixing windows exactly on the hour.

The three options for the timing of the fixing windows proposed in the recommendation do not vary much in terms of advantages and disadvantages. Further, centering the fixing window exactly on the hour would be more suitable than

⁽¹⁾ In this context, the ability to replicate means that third parties are able to assess the benchmark based on price movements in the market, and that market participants are able to hedge based on a replicated benchmark in accordance with the rate determination method publicly available.

closing/starting it on the hour as a definition of benchmark rate.

As not many market participants are questioning the timing of the fixing windows (i.e. being centered exactly on the hour or close or start on the hour), it is unnecessary to change the existing common practice.

From the perspective of avoiding event risks related to benchmark determination, due consideration should be given in determining what times of day the fixing window should be set at by keeping in mind not to overlap it with such times when major other economic indicators are published. For example, hardly any major economic indicators and other relevant data are released at 4pm London time, and other times are not referenced in transactions in most cases. Therefore, impact is minimal in these cases.

4. Data Sources (Recommendation 4)

While broadening the range of data sources to expand the coverage of price information would enhance the confidence in benchmarks, the data sources should be reliable for benchmark users.

5. Foreign Exchange Reference Rates set by Central Banks (Recommendation 5)

Central bank reference rates are widely used. Central bank's initiative to comply with the relevant IOSCO principles would lead to raising market participants' awareness.

6. Development of Market Infrastructure (Recommendation 6)

(1) Multiple brokers (including an electronic broker) and ECN have been addressing the establishment of market infrastructure in relation to WMR order voluntarily. We fully endorse that FXBG supports such industry-led initiatives. However, with regard to the market infrastructure operated by multiple private brokers, the following should be considered:

(i) Collection of orders

While currently orders are collected by financial institutions, there is a discussion about how end users can directly place orders with brokers. Such effort for the

collection of orders should not be impeded because providing an option to an end user how to place orders may reduce the room for collusion between particular dealers. Further, brokers and etc. should specify the scheme which should be required to charge an appropriate execution fee (this fee may also be included in the execution rate).

(ii) Netting

The treatment of the unexecuted orders after netting should be explicitly defined (e.g. mechanism of netting, participants of non-end users to netting (auction) process, returning the unnetted orders or separately setting up a particular executor).

(iii) Execution

Where a particular executor (including such utility itself) carries out execution, the executor has to have stricter internal rules and governing process. The operation of the executor should be appropriately recorded with time stamps.

- (2) The development of a “global/central utility” by consolidating such facilities to one single utility should be deliberately considered for the following reasons:

(i) Decrease in liquidity

By concentrating end user’s orders using a benchmark in one single utility, market makers may refrain from trading actively during the benchmark setting time, which gives rise to a concern over a significant decrease in liquidity and an increase in volatility.⁽²⁾

⁽²⁾ The reason why the appearance of a “global/central utility” gives rise to a decrease in liquidity is because transactions executed in the fixing window of WMR, etc. are concentrated in one single utility, which results in increasing the possibility that financial institutions may refrain from active trading during this window and end users also may refrain from actual transactions during this window. The decrease in liquidity possibly may enlarge market fluctuation risk needlessly. To date, a market maker has carried out dynamic hedge and risk-taking to give best execution for an end user in the sense of the best possible price. However, a decrease in liquidity during the fixing window of WMR, etc. means that a transactional price is determined under the situation where the market fluctuation risk is higher.

(ii) Discrepancy in execution rate

Under such a situation that liquidity declines and market fluctuation risk is higher than the intrinsic one, the execution of unnetted orders may cause the execution rate to significantly differ from the to-be market prevailing rate.

Where the execution of unnetted orders is entrusted to one single bank or market participant, other market participants can estimate discrepancy in the position of unnetted orders from the deals by such bank and market participant to estimate discrepancy in the position of dealing through a central utility. As a result, unnetted orders are likely to be forced to be executed at an unfavorable price for end users.

Form the above two reasons, a probability that end users and their customers may suffer from material disadvantages will increase.

(iii) Challenge in effectiveness

If the market participants and its end users avoid using the central utility due to the economical disadvantages as described above, the operating cost of the utility may be elevated a high level. Further, operational and litigation risks are not small, and the occurrence of systemic risk arising from concentration of the risk imposed on one single utility is of concern.

7. Pricing Reflecting Risk for a Transaction (Recommendation 7)

In light of minimizing the manipulation intended to cover loss-making as mentioned in the Comment 2., bid-offer price, rather than mid-rate, should be used for end user pricing with regard to the benchmarks such as WMR.

Application of imposing proper fee to end user is very critical to maintain the soundness and liquidity of the FX market.

8. Code of Conduct for Market Participants (Recommendations 8 -10)

We agree with these recommendations.

9. Enhancement of Banks' Internal Systems (Recommendation 11)

In OTC market such as the FX market, a market maker must retain the inventory positions (assumes risk), thereby covering end user's risk in a flexible manner and establishing a highly liquid market. Thus, we definitely disagree with the differentiation of organizations intended to prohibit the holding of the inventory positions.

It is impracticable to differentiate the inventory positions, in a uniform and rigorous manner, held by a market maker and the positions in proprietary book. On the other hand, each financial institution confines the products in which each market maker can deal and sets position and loss limits appropriately, thereby enabling excessive risk-taking that does not reflect the inventory positions to be minimized.

By strengthening the internal code of conduct for order execution and communications with which we agree with regard to Recommendation 8, it is believed to enhance the aforementioned management of the conflict interest.

10. Code of Conduct for Market Participants (Recommendations 12 and 13)

We support these recommendations.

11. Rates used in calculation of indexes (Recommendation 14)

In light of minimizing the manipulation intended to cover loss-making as mentioned in the Comment 2., it is preferable to use bid or offer of FX benchmarks in calculating indexes.

12. Recommendations for Asset Managers (Recommendation 15)

Conducting due diligence and demonstrating it to end users are expected to lead to much deeper understanding of the FX market.