

Review on the Loss Compensation Framework, etc. Pertaining to CDS Clearing

11th June, 2012

Japan Securities Clearing Corporation

I. General Purpose

In the Clearing System for CDS Transaction, the Loss Compensation Framework is in place where any loss has been incurred due to a Clearing Participant's default, compensation is not only made by JSCC but also, within the set framework, requested to other Clearing Participants, should there be any deficit, with the basic principle of self-responsibility that the loss must be compensated by collateral, etc. deposited by Defaulting Clearing Participants.

Whilst, in this Loss Compensation Framework, CCP's stable operation is ensured even in case heavy losses were incurred, it has been pointed out by Securities Companies, etc. currently considering obtaining the Clearing Qualification that other Clearing Participants will have to bear the heavy burden under the situation where chain-reaction default has occurred, which could lead to an incident of systemic risk and hence, the framework needs to be improved.

Under these circumstances, through review on the Loss Compensation Framework and the handling of renunciation of the Clearing Qualification in the event of a Participant's default, necessary changes shall be made to the framework accordingly, maintaining the stability of CCP as well as consistency with the IRS Loss Compensation Framework.

II. Outline

Item	Description	Remark
1. Introduction of the Period with a Cap Pertaining to the Non-Defaulting Clearing Participant's Contribution in the Event of Default	<ul style="list-style-type: none">• In the event of a Participant's default, "a period with a cap" shall be put in place.• "a period with a cap" shall be the period until the 30th day from the initial default (in case another default has occurred during the period, the 30th day from the relevant default; the same shall apply hereinafter to subsequent defaults).	<ul style="list-style-type: none">• The same handling as IRS (the same in this item of 1).
(1) Handling of the Non-Defaulting Clearing Participant's Contribution	<ul style="list-style-type: none">• Compensation using each Non-Defaulting Clearing Participant's Clearing Fund shall be capped at the required amount of Clearing Fund for the initial default occurring during the period with a cap.	<ul style="list-style-type: none">• The following are the order of compensation by loss compensation resources: (1st Tier) Defaulting Clearing Participant's

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<p>by Special Clearing Charge in the Period with a Cap</p> <p>(2) Introduction of the Period with a Cap Pertaining to the Non-Defaulting Clearing Participant's Contribution by Special Clearing Charge</p>	<ul style="list-style-type: none"> • During the period with a cap, the required amount of Clearing Fund will not be calculated on a weekly basis but the required amount of Clearing Fund for the initial default (the relevant amount will be excluded, in case there is any amount of money that was used as the 3rd-tier compensation resources due to chain-reaction defaults) will be applied. • In case the loss has been borne by Clearing Fund, each Non-Defaulting Clearing Participant shall replenish the deposit amount up to the required amount of Clearing Fund at the end of the period with a cap. • Compensation using Special Clearing Charge shall be capped at each Non-Defaulting Clearing Participant's required amount of Clearing Fund for the initial default occurring during the period with a cap. 	<p>Margin and Clearing Fund</p> <p>(2nd Tier) Compensation by JSCC</p> <p>(3rd Tier) Non-Defaulting Clearing Participant's Clearing Fund as well as Compensation by JSCC</p> <p>(4th Tier) Non-Defaulting Clearing Participant's Special Clearing Charge</p> <p>(5th Tier) Compensation by Recipient Clearing Participant's Variation Margin, etc.</p>
<p>2. Introduction of Default Contingent Margin</p> <p>(1) Method for Calculating Default Contingent Margin</p>	<ul style="list-style-type: none"> • In the period with a cap, the deposit of Default Contingent Margin shall be requested, aside from Clearing Fund, as collateral calculated based on the change in each Non-Defaulting Clearing Participant's required amount of Clearing Fund. • In the period with a cap, the amount corresponding to each Non-Defaulting Clearing Participant's required amount of Clearing Fund will be calculated on a daily basis. • In case, as a result of the day's calculation, there was any increase in the required 	<ul style="list-style-type: none"> • The same handling as IRS (the same in this item of 2) • The amount corresponding to the Required Amount of Clearing Fund as a result of the daily calculation shall be the "Calculatory Required Amount," and the amount actually used to calculate the Required Amount of Default Contingent Margin shall be the "Applicable Required Amount."

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(2) Procedure, etc. for Depositing Default Contingent Margin	<p>amount versus the applicable required amount for the previous business day, the increase shall be the required amount of Default Contingent Margin, with the calculatory required amount for the day as the applicable required amount for the day.</p> <ul style="list-style-type: none"> • In case the calculatory required amount for the day decreased versus the applicable required amount for the previous business day, the applicable required amount for the previous business day shall be the applicable required amount for the day. • The required amount of Default Contingent Margin shall be zero at the end of the period with a cap. • In case of any shortfall in the deposit of Default Contingent Margin, each Non-Defaulting Clearing Participant will deposit the amount of such shortfall by the noon on the business day following the day on which such shortfall has occurred. • Handling of the deposit of Default Contingent Margin (deposit by cash, deposit by Substitute Securities) shall be the same as Initial Margin. 	
3. Style of Auction to Be Implemented	<ul style="list-style-type: none"> • The implementation style of Auction pertaining to positions possessed by Non-Defaulting Clearing Participants and JSCC's hedge trade positions shall be changed as follows: <ul style="list-style-type: none"> I. The Default Management Committee will execute the Primary Auction, and according to the situation of bidding, decide whether to make a winning bid for all eligible positions at the Primary Auction or for the 80% or more portion of such positions and conduct either Secondary Position or Additional Position for the remaining positions. 	<ul style="list-style-type: none"> • The method of the Primary Auction is the same as the Primary Auction in the current framework. • The Default Management Committee shall judge totally in view of potential for improvement in the amount of loss, market fluctuation risk, the status of funding by Clearing Participant, etc., in order to decide whether the Secondary Auction, etc. is required, and JSCC shall comply with the

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	<p>II. Secondary Auction can be executed on the date of the Primary Auction or the following business day.</p> <p>III. Additional Auction shall be executed during the same day after the bidding process for the Primary Auction has been implemented, in a situation where a bid for all positions subject to bidding can be accepted, on the assumption that the bid for 80% or more of those positions has been accepted, in order to improve the bid price in bidding for the remaining positions.</p> <p>IV. In the Additional Auction, the contents of a bid for the remaining positions shall be maintained, and upward revision of the price and additional bidding shall only be allowed.</p> <p>V. The price decided at the Additional Auction will be applied only to the remaining portion of the positions.</p> <p>VI. At either Auction, the results of bids shall be finalized as soon as the required collateral deposit by Non-Defaulting Participants for the loss incurred at the Auction.</p>	<p>advice given by the Default Management Committee</p> <ul style="list-style-type: none"> • The method of Auction is the same as the Secondary Auction in the current framework. • Contract Price for the portion exceeding 80% shall be finalized at the Primary Auction. • Whether to make an additional bid is optional. • For the handling of collateral deposit by Non-Defaulting Clearing Participant, see “5. Method for Depositing the 4th-Tier Loss Compensation Resources” and “6. Deposit of the 5th-Tier Loss Compensation Resources.”
<p>4. Introduction of the Scheme to Increase the Possibility of Successful Auction</p> <p>(1) The Order of Loss Compensation Pertaining to Clearing Participant that Did Not Make Any</p>	<ul style="list-style-type: none"> • With regard to the Clearing Participants who did not make a bid at the auction, the sum of the relevant Clearing Participant’s Clearing Fund shall be used in advance of other Clearing Participants’ Clearing Fund in the consumption of financial resources of the 3rd-tier loss compensation. 	<ul style="list-style-type: none"> • Cases where the number of bids made does not reach the required number of bids shall be handled as Clearing Participants who did not make a bid at the auction.

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Bid at Auction		<ul style="list-style-type: none"> • In the case where several Clearing Participants did not make any bids, their financial resources will be calculated on a pro-rata basis among the relevant Clearing Participants for use in the compensation. • Clearing funds paid by Clearing Participant(s) who did not make bid for reasons JSCC deemed unavoidable shall not be used on a preferential basis. • Even in the case of conducting the Secondary Auction (or Additional Auction), the Tier of Participant(s)' financial resources for loss compensation will be determined only according to the result of the initial Auction. • The same shall apply to the order of use of Special Clearing Fee in the consumption of financial resources of the 4th-tier loss compensation.
(2) Determination of the Order of Contribution According to the Bid Price	<ul style="list-style-type: none"> • For the Clearing Funds of Clearing Participant(s) that made a bid, the amount calculated using the formula of “the number of bids at the relevant price / the total of the required number of bids made by the Clearing Participant that made the relevant bid x the required amount of Clearing Funds of the Clearing Participant that made the relevant bid” will be used, in the descending order of bid price for each bid (Excluding the portion of bids that exceeds the required number of bids per Clearing Participant. • The sum of Clearing Funds of the Clearing Participant that made a bid at a price lower than the fixed range of divergence from the Contract Price will be used next in order to 	<ul style="list-style-type: none"> • “The fixed range of divergence” shall be the level deemed by the Default Management

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	<p>the Clearing Funds of the Clearing Participant that did not make any bid.</p>	<p>Committee to be significantly diverged from the market weighing the composition and scale of positions subject to bid and market condition, etc., and JSCC shall determine the level on a case-by-case basis following the advice given by the Committee.</p> <ul style="list-style-type: none"> • The relevant range of divergence will be notified to each Clearing Participant prior to the implementation of Auction. • The same shall apply to the order of use of Special Clearing Charge in the compensation by means of the 4th-tier financial resources for loss compensation. • In case this applies to several Clearing Participants, their financial resources will be calculated on a pro-rata basis among the relevant Clearing Participants for use in the compensation.
<p>5. Method for Depositing the 4th-Tier Loss Compensation Resources</p>	<ul style="list-style-type: none"> • In cases where the loss of Defaulting Clearing Participant's Variation Margin, etc. after such default exceeds the sum of the 1st- to 3rd-tier loss compensation resources, and in the case where the amount to be borne by the relevant Clearing Participant in the 4th-tier loss compensation resources exceeds the 'sum of the House Initial Margin deposited with JSCC by the relevant Clearing Participant, Default Contingent Margin, and the amount already deposited as the 4th-tier collateral,' the Clearing Participant shall deposit with JSCC cash equivalent to the relevant excess by the business day following the day on which such excess has resulted, as the 4th-tier collateral. 	<ul style="list-style-type: none"> • The same handling as IRS.

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	<ul style="list-style-type: none"> • Deposit of the 4th-tier loss compensation resources in consequence of the Auction shall be handled as follows: <ul style="list-style-type: none"> I. In the case where all positions subject to Auction are sold at the Primary Auction: <p>In cases where the loss resulting from the tentative result of bids at the Primary Auction exceeds the 1st- to 3rd-tier loss compensation resources, and in the case where the amount to be borne by the Clearing Participant in the 4th-tier loss compensation resources exceeds the ‘House Initial Margin, etc.’ the relevant Clearing Participant shall deposit with JSCC cash equivalent to the relevant excess by the deadline specified by JSCC on the date of the Primary Auction, as the 4th-teir collateral. JSCC will finalize the result of bids, as soon as all Clearing Participants completed depositing the relevant collateral.</p> II. In the case where some positions subject to Auction are sold at the Primary Auction and the Secondary Auction will be executed for the remaining positions on the business day following the day of the Primary Auction: <ul style="list-style-type: none"> - In cases where the loss resulting from the tentative result of bids at the Primary Auction exceeds the 1st- to 3rd-tier loss compensation resources, and in the case where the amount to be borne by the Clearing Participant in the 4th-tier loss compensation resources exceeds the ‘House Initial Margin, etc.’ the relevant Clearing Participant shall deposit with JSCC cash equivalent to the relevant excess by the deadline specified by JSCC on the date of Primary Auction, as the 4th-teir collateral. JSCC will finalize the result of bids, as soon as all Clearing Participants completed depositing the relevant collateral. - In cases where the loss resulting from the tentative result of bids at the Secondary Auction exceeds the 1st- to 3rd-tier loss compensation resources, and in the case where the amount to be borne by the Clearing Participant in the 4th-tier loss compensation resources exceeds the ‘House Initial Margin, etc.’ the relevant Clearing Participant shall deposit with JSCC cash equivalent to the 	<ul style="list-style-type: none"> • The “House Initial Margin, etc.” refers to the total amount of the in-house IM the relevant Clearing Participant deposited with JSCC, Default Contingent Margin, and the amount deposited as the 4th-tier collateral. (the same in this item of 5)

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	<p>relevant excess by the deadline specified by JSCC on the date of the Secondary Auction, as the 4th-teir collateral. JSCC will finalize the result of bids, as soon as all Clearing Participants completed depositing the relevant collateral.</p> <p>III. In the case where some positions subject to Auction are sold at the Primary Auction and the Additional Auction will be executed for the remaining positions during the day:</p> <p>In cases where the loss resulting from the tentative result of bids at the Primary Auction as well as the Additional Auction exceeds the 1st- to 3rd-tier loss compensation resources, and in the case where the amount to be borne by the Clearing Participant in the 4th-tier loss compensation resources exceeds the 'House Initial Margin, etc.' the relevant Clearing Participant shall deposit with JSCC cash equivalent to the relevant excess by the deadline specified by JSCC on the date of the Primary Auction, as the 4th-teir collateral. JSCC will finalize the result of bids, as soon as all Clearing Participants completed depositing the relevant collateral.</p> <ul style="list-style-type: none"> • The Clearing Participant shall deposit by cash with JSCC the difference between the money already deposited as the 4th-tier collateral and the 4th-tier loss compensation, until the deadline specified by JSCC on the business day following the date of Auction. • In case the loss incurred by JSCC resulting from the default settlement exceeds the sum of the 1st- to 3rd-tier loss compensation resources, the loss shall be compensated using the 4th-tier collateral. 	<ul style="list-style-type: none"> • The same handling as IRS. • The same handling as IRS.
6. Deposit of the 5 th -Tier Loss Compensation Resources	<ul style="list-style-type: none"> • In cases where the loss of defaulting Clearing Participant's Variation Margin, etc. after such default exceeds the sum of the 1st- to 4th-tier loss compensation resources, and in the case where the amount to be borne by the relevant Clearing Participant from the 4th- 	<ul style="list-style-type: none"> • The same handling as IRS.

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	<p>and 5th-tier loss compensation resources exceeds 'the sum of House Initial Margin deposited with JSCC by the relevant Clearing Participant, Default Contingent Margin, the amount already deposited as the 4th-tier collateral, and the amount already deposited as the 4th-tier collateral,' the Recipient Clearing Participant shall deposit with JSCC cash equivalent to the relevant excess on the day following the business day on which such excess has resulted, as the 5th-tier collateral.</p> <ul style="list-style-type: none"> • Deposit of the 5th-tier loss compensation resources in consequence of the Auction shall be handled as follows: <ul style="list-style-type: none"> I. In the case where all positions subject to Auction are closed at the Primary Auction: <p>In cases where the loss resulting from the tentative result of bids at the Primary Auction exceeds the 1st- to 4th-tier loss compensation resources, and in the case where the amount to be borne by the Clearing Participant in the 5th-tier loss compensation resources exceeds the 'House Initial Margin, etc.' the relevant Clearing Participant shall deposit with JSCC cash equivalent to the relevant excess by the deadline specified by JSCC on the date of the Primary Auction, as the 5th-tier collateral. JSCC will finalize the result of bids, as soon as all Clearing Participants completed depositing the relevant collateral.</p> II. In the case where some positions subject to Auction are sold at the Primary Auction and the Secondary Auction will be executed for the remaining positions on the business day following the day of the Primary Auction: <ul style="list-style-type: none"> - In cases where the loss resulting from the tentative result of bids at the Primary Auction exceeds the 1st- to 4th-tier loss compensation resources, and in the case where the amount to be borne by the Clearing Participant in the 5th-tier loss compensation resources exceeds the 'House Initial Margin, etc.' the relevant Clearing Participant shall deposit with JSCC cash equivalent to the relevant excess by the deadline specified by JSCC on the date of Primary 	<ul style="list-style-type: none"> • The "House Initial Margin, etc." refers to the total amount of the in-house IM the relevant Clearing Participant deposited to JSCC, Default Contingent Margin, the amount already deposited as the 4th-tier collateral, and the amount already deposited as the 5th-tier collateral. (the same in this item of 6)

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	<p>Auction, as the 5th-teir collateral. JSCC will finalize the result of bids, as soon as all Clearing Participants completed depositing the relevant collateral.</p> <ul style="list-style-type: none"> - In cases where the loss resulting from the tentative result of bids at the Secondary Auction exceeds the 1st- to 4th-tier loss compensation resources, and in the case where the amount to be borne by the Clearing Participant in the 5th-tier loss compensation resources exceeds the ‘House Initial Margin, etc.’ the relevant Clearing Participant shall deposit with JSCC cash equivalent to the relevant excess by the deadline specified by JSCC on the date of the Secondary Auction, as the 5th-teir collateral. JSCC will finalize the result of bids, as soon as all Clearing Participants completed depositing the relevant collateral. <p>III. In the case where some positions subject to Auction are sold at the Primary Auction and the Additional Auction will be executed for the remaining positions during the day:</p> <p>In cases where the loss resulting from the tentative result of bids at the Primary Auction as well as the Additional Auction exceeds the 1st- to 4th-tier loss compensation resources, and in the case where the amount to be borne by the Clearing Participant in the 5th-tier loss compensation resources exceeds the ‘House Initial Margin, etc.’ the relevant Clearing Participant shall deposit with JSCC cash equivalent to the relevant excess by the deadline specified by JSCC on the date of the Primary Auction, as the 5th-teir collateral. JSCC will finalize the result of bids, as soon as all Clearing Participants completed depositing the relevant collateral.</p> <ul style="list-style-type: none"> • The Clearing Participant shall deposit by cash with JSCC the difference between the money already deposited as the 5th-tier collateral and the 5th-tier loss compensation, until the deadline specified by JSCC on the business day following the date of Auction. 	<ul style="list-style-type: none"> • The same handling as IRS.

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	<ul style="list-style-type: none"> In case the loss incurred by JSCC resulting from the default settlement exceeds the 1st- to 4th-tier loss compensation resources, the loss shall be compensated using the 5th-tier collateral. 	<ul style="list-style-type: none"> The same handling as IRS.
<p>7. Handling of Clearing Participant that Requested for Renunciation of the Clearing Qualification</p>	<ul style="list-style-type: none"> A Clearing Participant that requested for renunciation of Clearing Qualification shall have its Clearing Qualification renounced either on the day when the period of 30 days has elapsed after the renunciation of the qualification or upon closing of its positions, whichever occurred later. In the case where its qualification has been renounced during the period with a cap or another Clearing Participant has defaulted either on the day when the period of 30 days has elapsed after the renunciation of the qualification or upon closing of its positions, whichever occurred later, its Clearing Qualification shall be renounced either as of the end of the period with a cap or upon closing of its positions, whichever occurred later. A Clearing Participant that requested for renunciation of Clearing Qualification shall be requested to bear the loss pertaining to another Clearing Participant's default occurring before the renunciation of its Clearing Qualification. A Clearing Participant whose Clearing Qualification has been renounced shall not be requested to bear the loss pertaining to another Clearing Participant's default occurring after its Clearing Qualification has been renounced. A Clearing Participant that requested for renunciation of Clearing Qualification shall be obligated to participate in Auction until the renunciation of its Clearing Qualification. In the case where the relevant Clearing Participant's positions have been closed, however, the Clearing Participant shall be released from its obligation to participate in Auction, on condition of the preferential use of its Clearing Fund in the Loss Compensation Framework and the bearing of the loss pertaining to the 4th-tier loss 	<ul style="list-style-type: none"> The same handling as IRS (the same in this item of 7).

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	compensation resource on a preferential basis. • A Clearing Participant that requested for renunciation of Clearing Qualification shall not be requested to participate in the Auction pursuant to another Clearing Participant's default occurring after its Clearing Qualification has been renounced.	
8. Others	• Other necessary amendments shall be made accordingly in order to conform to the IRS Clearing System.	• Restrictions, etc. on the purpose of use of Clearing Deposit to preserve collateral

III. Timeline for the Implementation

The framework will be implemented from the 23rd of July, 2012 (under the condition of the required permission from the Financial Services Agency).

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