

Central clearing of OTC Derivatives in Australia

LCH.Clearnet Group Limited response to questions listed in the Discussion paper issued by the Council of Financial Regulators, dated June 2011

Responses to specific questions raised in discussion paper

6.2.1 The Potential 'Clearability' of OTC derivatives

- Q1. Generally, LCH.Clearnet concurs with the considerations set out in section 2.3.3 of the discussion paper, which are themselves broadly consistent with the factors set out in the Financial Stability Board' OTC Derivative Market Reforms Working Group paper (October 2010).

In order to clear a new product or market, the key factor a CCP must consider is its ability to manage the risks the product or market presents - including the risk of default. This would normally require: the CCP has access to accurate pricing and valuation data; a degree of contract standardisation; and sufficiently deep liquidity in the market (or in sufficiently close hedges) to facilitate default management.

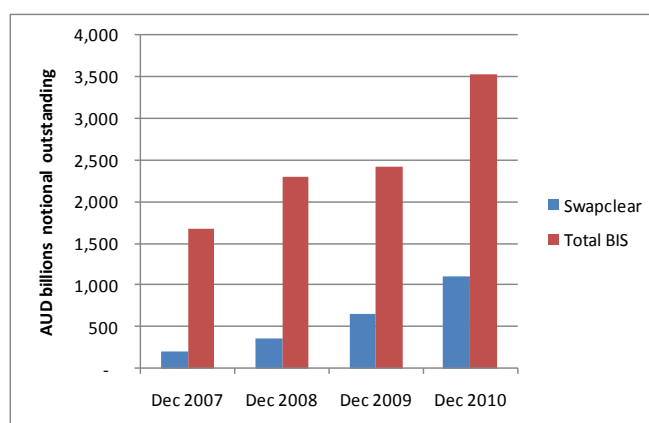
Other features of the product, including the potential for step changes (eg jump-to-default risk in CDS) and nonlinearities (eg option prices) are also relevant to the ability of a CCP to manage the risk appropriately. More generally, it is essential that the legal framework in the relevant jurisdiction(s) adequately protects and supports default management under a CCP's rules.

LCH.Clearnet's CCPs clear a broad range of asset classes encompassing cash securities, exchange-traded derivatives and several types of OTC derivatives. The Group has significant experience in analysis of the appropriateness of products for clearing. In particular, we have experience in setting up and managing operational and risk management structures to deal with specific features of the OTC derivatives market. Our experience has shown that, compared to exchange-traded derivatives, OTC products can need additional specialised default management processes. This can include the need to draw on member institutions' expertise in the design and operation of such processes.

The feasibility of implementing effective default management arrangements is a crucial element of deciding whether a class of OTC derivatives can be cleared.

- Q2. LCH.Clearnet is not currently active in clearing for Australian domestic participants. However, LCH.Clearnet has been clearing AUD-denominated interest rate swaps for international banks since 2003; and in general, it considers that it should be possible to clear the same classes of instruments in Australia.

The chart below shows outstanding AUD interest rate swap transactions in SwapClear (notional) alongside overall amounts reported to the BIS in its regular survey. Based on its experience of running the SwapClear service, LCH.Clearnet considers that the risk and default management challenges presented by clearing OTC interest rate swaps can be met and that they are therefore an entirely suitable product class for clearing, provided that the market for such swaps is sufficiently liquid. These figures demonstrate clearly the substantial proportion of Swapclear-managed AUD swaps activity within the overall BIS number, and it is evident that the increased use of a CCP in this market would be highly beneficial both from a liquidity and from a risk management perspective.



- Q3. Further and very significant netting and risk reduction benefits will accrue to Australian IRS market participants if they are also able to use clearing to reduce risks associated with transactions with offshore counterparties and in currencies other than AUD (including, in due course, cross-currency swaps). For instance, at the time of writing, participants in SwapClear have contributed £160mn in initial margin in relation to AUD interest rate swaps, compared to aggregate individual members' worst-case losses of £485mn on those swaps without netting. This suggests that overall exposures are 67% less as a result of netting in SwapClear, with clear capital benefit.
- Q4. To split IRS clearing into domestic and offshore components makes little sense, and would be directly disadvantageous for market participants in terms of margin costs, capital efficiency and operational complexity.

LCH.Clearnet considers that the costs of moving to central counterparty clearing are mainly a question for participants in the market to consider. Nevertheless, LCH.Clearnet suggests that whatever costs are incurred, there are significant benefits in the form of reduced regulatory capital charges for the relevant business, where permitted, as well as a reduced operational and credit risk profile compared to bilateral settlement.

6.2.2 Mandatory clearing requirements

- Q5. The Council's proposed criteria in 5.1.1 for setting a clearing obligation seem broadly sensible, namely that such an obligation should reduce

systemic risks, should be viable to implement, and should be aligned with other jurisdictions where possible. On the last point, the G-20 Leaders agreed that all “standardised” derivatives should be subject to mandatory clearing.¹ LCH.Clearnet supports consistent international approaches, wherever possible, to minimise the effects of regulatory arbitrage.

- Q6. Other jurisdictions are also considering criteria for possible exemptions and again, LCH.Clearnet supports alignment where possible.
- Q7. LCH.Clearnet has no comment to make on exemptions for particular products or participants beyond the general remarks set out above about the avoidance of regulatory arbitrage.

6.2.3 OTC derivatives central counterparties

- Q8. The discussion paper identifies arguments for and against allowing Australian entities to clear their transactions through global CCPs. There are strong advantages that would accrue to Australian market participants from access to global CCPs, both in order to clear markets that are systemically important for Australia and for other international markets. Australian institutions would be able to access deep and liquid global markets for OTC derivatives which would also generate benefits for end-users – financial institutions and corporates seeking to hedge risks – in terms of pricing, liquidity and the range of products available.

Use of a global CCP to clear OTC derivatives would give Australian institutions (i) access to a wide range of counterparties;² (ii) the benefits of netting and fungibility with existing cleared “offshore” AUD IRS contracts; (iii) assurance that the contractual framework was recognised under the law of other major jurisdictions; (iv) access to a multicurrency platform to clear both IRS and other products.

On the other hand, the Council’s paper also considers arguments for restricting the clearing of systemically-important OTC markets to clearing houses located in Australia. Whilst there may be legitimate concerns about offshore entities offering services to local institutions, LCH.Clearnet, as a global CCP, ensures that it complies with local regulatory requirements, and engages proactively with regulators in each jurisdiction where it is active. It would therefore expect to maintain a close relationship with the Australian authorities in relation to business carried out in Australia, including OTC clearing. It would also expect information-sharing arrangements to be put in place between the UK and Australian authorities to facilitate access to information and assessments carried out by the FSA and Bank of England.

Another concern expressed in the discussion paper is that the Australian

¹ G20 Leaders’ Statement, the Pittsburgh Summit, September 2009

² Of the 13 entities listed on page 26 of the consultation document as being large active dealers in interest rate swaps, all 8 non Australian entities have at least an affiliate that is a member of SwapClear. A total of 34 members of SwapClear have outstanding AUD denominated interest rate swaps at the time of writing.

authorities might be remote from decision-making about the activity of an offshore CCP in the event of a crisis involving Australian participants, and that therefore decisions about default and the management of the defaulting entity's transactions might be made without reference to their impact in Australia. In practice, and as seen during the Lehman default, LCH.Clearnet would fully anticipate detailed interaction with the appropriate authorities, by telephone, video conference calls, and even in person if needed to discuss the situation and share concerns of this nature. Even a domestic Australian OTC CCP could not expect to remain isolated from a financial crisis, because globally systemically important institutions might still be members of the domestic clearing house. Developments in Australia could have global implications for stability and confidence, particularly if the domestic CCP cleared contracts denominated in foreign currency. We would fully expect that channels of communication with overseas authorities would be needed to facilitate assessment of the domestic and international impacts of any developments.

The discussion paper notes with concern the prospect of Australian participants being forced to submit to the law of a foreign jurisdiction as a result of mandatory clearing. However, this is neither new, nor an issue unique to OTC clearing. Australian entities already participate in systems and frameworks governed by foreign jurisdictions – such as exchanges located overseas – and operate under industry standard master agreements with counterparties that are typically not themselves subject to Australian law. Furthermore, if and when mandatory clearing for OTC derivatives is introduced in other jurisdictions such as the US and EU, this issue could also arise: Australian market participants might be unable to access these international markets except as a client of an overseas entity, under that entity's standard terms and conditions and in a foreign jurisdiction.

Nevertheless, LCH.Clearnet recognises that a mandatory clearing requirement for interest rate swaps might also capture smaller, more domestically-focused participants, who may not otherwise need to enter into contracts under overseas legal systems. In establishing a Swapclear clearing service in Australia, a key task would be to ensure that there is a choice of participating as a direct member or, for example, through a client clearing framework. The latter could allow such local participants to access a global range of counterparties via a Swapclear clearing member whilst benefiting from specific protections.

Q9. No comments

Q10. No comments

Q11. No comments

Q12. No comments

Q13. LCH.Clearnet has extensive experience in seeking to establish interoperability arrangements in respect of exchange-traded cash equities. There are very significant contractual, regulatory and risk management

obstacles to overcome in making such arrangements successful. Much of this has revolved around the issue of peer-to-peer CCP credit risk in respect of what are short term risk contracts. We believe that interoperability between CCPs clearing interest rate swaps (or other OTC instruments) is unlikely to be practicable given their additional complexity (relative to cash equities business), and their substantially longer tenors.

More generally, the effect of introducing interoperability arrangements between OTC CCPs on systemic risk is not clear. The risk management structure of a CCP depends to some extent on the fact that clearing members are subordinate to the CCP, replacing multiple bilateral peer-to-peer relationships. Reintroducing peer-to-peer elements to the structure in the form of bilateral links between CCPs reintroduces complexity and potentially systemic risks. This is particularly the case where the two CCPs have differing risk management frameworks or where there are asymmetries in the types or size of business conducted, each of which could lead to very large bilateral margin obligations between the multiple CCPs. Where the membership of the two CCPs is heterogeneous there can also be divergence between the interests of different groups of market participants, particularly in a default situation, and this could lead to misaligned or uncooperative behaviour across the market.

LCH.Clearnet therefore considers that there remain disadvantages and uncertainties around the interoperable approach when applied to OTC derivatives clearing, relative to an approach in which the lower-tier banks and end-users are able to participate in a single global CCP via a client clearing arrangement. Using two different clearing houses adds to complexity, risk and overall operational and capital costs.

- Q14. The Council is right to recognise a danger of inefficient outcomes in the market for clearing services under mandatory clearing requirements. Inefficient outcomes could result from coordination failure (for example, if no viable clearing mechanism could be implemented by the market, or where the solution implemented was not recognised by other jurisdictions as meeting appropriate standards), or from competition between rival providers based on a “race to the bottom” for risk standards. Some of these market failures can be addressed by appropriate regulation, which can monitor risk standards, and encourage appropriate governance with representation for users (which can also help to ensure equitable treatment in terms of fees and charges).

In the global market for clearing OTC interest rate swaps, several solutions have been implemented besides SwapClear. The clearing houses that operate such solutions are in competition, but are subject to minimum risk standards imposed by their local regulators in line with international standards established by CPSS-IOSCO. However, the choice of whether to clear through a particular CCP is driven strongly by the network effects of the existing membership.

6.2.4 Jurisdictional and other matters

Q15. No comment

Q16. Given the international character of the OTC derivatives market, LCH.Clearnet considers it beneficial for regulatory regimes to be aligned as far as is practicable to avoid the risks of regulatory arbitrage. For this reason the agreement of the G20 nations on broad objectives for enhanced regulation was welcome. LCH.Clearnet notes that the implementation of those objectives necessarily takes different forms in different jurisdictions.

To the extent that Australian-domiciled global banks wish to deal in OTC derivatives with counterparties in other jurisdictions, the form and coverage of mandatory clearing in those jurisdictions will have an impact. Australian banks that are not members of a relevant CCP will not be able to trade with counterparties that are subject to mandatory clearing, unless exemptions are in place under the foreign jurisdiction's laws. Instead they may need to carry out any such business as a client of a (foreign) global bank, which may involve greater risks and costs, including the risk of over-dependence and/or concentration of exposures with a single agent, and regulatory capital costs.

Q17. We have not identified any specific changes needed to the regulatory system in Australia.

Q18. This is chiefly a question for Australian participants in OTC derivatives markets. LCH.Clearnet notes however that G20 countries have agreed to implement mandatory clearing for standardised derivatives (such as IRS), and so it is likely that a majority of non-Australian counterparties will be required to clear transactions. Where permitted, it is therefore likely that Australian participants that needed to deal with those counterparties, and access liquid markets directly, would seek to participate in CCPs in order to and avoid additional costs and risks that might arise from participating as customers of non-Australian global banks.