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**AUSTRALIAN BANKERS' ASSOCIATION INC.**

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Dear Mr Kent,

### **Central Clearing of OTC Derivatives in Australia**

The Australian Bankers' Association (ABA) welcomes the opportunity to provide comments to the Council of Financial Regulators discussion paper *Central Clearing of OTC Derivatives in Australia*.

In light of the G-20 and Australian Government's commitment to implement central clearing for OTC derivatives in Australia and the rapidly changing international response and dynamic global environment, it is appreciated that the Council is giving careful consideration to the development of a policy framework for Australia.

## **1. Background**

### **1.1 International developments**

In September 2009, at the G-20 meeting in Pittsburgh, the Leaders agreed that: "All standardised OTC derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest."<sup>1</sup>

The ABA recognises that following the G-20 meeting, the Financial Stability Forum (predecessor to the Financial Stability Board (FSB)) published a report containing recommendations addressing the legal and operational infrastructure underpinning OTC derivatives markets. The international regulatory community is now variously requiring certain OTC transactions to be cleared by a central counterparty (CCP) to reduce counterparty exposure<sup>2</sup>.

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<sup>1</sup> [http://www.g20.org/Documents/pittsburgh\\_summit\\_leaders\\_statement\\_250909.pdf](http://www.g20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf)

<sup>2</sup> For example, in the United States the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), in Japan legislation to amend the Financial Instruments and Exchange Law ("Amendment Act"), and in the European Union the proposed European Market Infrastructure Regulation (EMIR).  
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Additionally, the ABA recognises that there are various international supervisory authorities implementing standards relevant to CCP, including:

- Basel Committee on Banking Supervision (BCBS) has been working on revisions to capital standards that should encourage banks to clear their OTC derivatives positions through CCPs. (We note that non-prudentially regulated entities will not be subject to the same capital standards.)
- Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO) has consulted on revised standards for financial market infrastructures. The policy objectives of the principles are to enhance the safety and efficiency of financial market infrastructures, limit systemic risk, and foster transparency and financial stability. (We note that new principles for financial market infrastructures are expected to be finalised in early 2012.)
- FSB has also issued recommendations focusing on areas of standardisation of products and practices, central clearing, exchange or electronic platform trading, and reporting to trade repositories. (We note that the latest FSB progress report on implementation of OTC derivatives market reforms was published in April 2011.)

## 1.2 Australian developments

The ABA recognises that the Council of Financial Regulators (RBA, APRA, ASIC) undertook a survey of risk management and other practices in the Australian OTC derivatives markets<sup>3</sup>. The survey found that the overall level of activity in Australia, while large in the domestic context, was low relative to major offshore markets. Within the local market, trading was dominated by interest rate and FX derivatives, with only small amounts of activity in equity, commodity and credit derivatives.

Moreover, the types of products and the nature of participants and their use of derivatives were fairly straightforward compared to some offshore markets. Although no immediate concerns were identified, the Australian regulators noted that there was some scope for improvements in market practices. The regulators made a number of recommendations, encouraging market participants to:

- Promote market transparency;
- Ensure continued progress in the timely negotiation of industry standard legal documentation;
- Expand the use of collateral to manage counterparty credit risks;
- Expand the use of automated facilities for confirmations processing; and
- Expand the use of multilateral portfolio compression and reconciliation tools.

The Australian regulators also recommended that market participants should promote access to CCPs for OTC derivative products. It was noted that while a capacity to centrally clear positions transacted within the Australian market did not appear likely within the near future, the benefits of central clearing could be substantial, and therefore participants were encouraged to explore the potential for this as the local market grew and the range of CCP services expanded globally.

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<sup>3</sup> <http://www.rba.gov.au/media-releases/2009/jmr-09-rba-apra-asic.html>

The ABA recognises that the Council of Financial Regulators discussion paper *Central Clearing of OTC Derivatives in Australia* is intended to outline some considerations with regards to the Australian OTC derivatives markets and the range of issues that need to be balanced if central clearing is to be established in Australia.

## **2. Introductory comments**

### **2.1 OTC derivatives**

The ABA notes the following points:

- OTC derivatives exist to serve the risk management and investment needs of parties to the contract.
- OTC derivatives play an important role in Australia's economy and are an important tool used by banks, insurance companies, asset managers, corporations and companies to manage their business, operational and financial risks, including movements in interest rates, currencies (foreign exchange) and commodities.
- OTC derivatives primary benefit is to reduce market risk. Derivatives are often bespoke contracts or bilateral instruments designed to be tailored to the specific needs and hedging requirements of parties – that is, OTC derivatives are arranged to hedge exposures in adverse movements in price. Around 90% of derivatives are contracts traded over-the-counter.
- OTC derivatives may not readily be able to be standardised. Contractual terms and parameters (e.g. notional amounts, payment dates, maturities, etc) under a standardised contract are unlikely to match the exposure to be hedged, which would result in the parties being exposed to risk (contrary to the intention of a hedging transaction).
- OTC derivatives help to provide liquidity and depth to financial markets, which facilitates capital mobilisation, promotes risk diversification and enhances risk management, underpinning global economic growth. Derivatives generate conditions favourable to risk diversification and management at a reasonable cost. Additionally, derivatives spread risks among the various market agents, contributing to global business growth.

The ABA believes that it is crucial for regulators to ensure coherence and proportion between prudential regulation (capital requirements) and markets regulation (structure of market) with regards to OTC derivatives markets. Regulation of OTC derivatives and financial markets infrastructures is important. However, strengthening regulation needs to be assessed in combination with the ongoing recalibration of current capital requirements and risk weightings associated with OTC derivatives and the impact on the way contracts are traded and cleared. Regulation should seek to improve the robustness of OTC derivatives markets.

### **2.2 OTC derivatives central counterparties**

The ABA notes that with the financial backing of clearing members, CCPs provide clearing of all trades (risk management) and position management of all open contracts (trade management). The CCP becomes a counterparty to each market participant – through the clearing members – and nets all offsetting open derivatives positions of each trading party across all other trading parties (multilateral netting).

The advantages of CCP clearing are certainly well-known by the international banking industry. It should be noted that the international banking industry has already instigated a number of initiatives which have resulted in implementation of uniform settlement terms, development of data repositories, improvement in collateral management processes, and a noticeable increase in the proportion of transactions cleared by CCPs. The ABA broadly supports effective measures to extend CCP clearing of standardised OTC derivatives across global markets and regulation to improve the robustness and efficiency of Australia's OTC derivatives markets.

However, the disadvantages of CCP clearing is that it can expose banks and market participants – as clearing members – to the creditworthiness of other clearing members. CCPs are likely to require counterparties to provide collateral and meet margin calls which can expose end-users to liquidity risk where cash resources are being diverted from other business activities and probably at a time that does not match cash flows. Additionally, CCP clearing may not be possible for some types of OTC derivative products.

The ABA believes that central clearing has made, and will continue to make, prudential and commercial sense for the most liquid and 'commoditised' types of OTC derivatives (e.g. interest rate derivatives (IRD) market). In practice, as these contracts are liquid it is easier for CCPs to assess and value these transactions correctly and to prospectively manage the inherent risks involved, in particular in the event of a default of one or more clearing members. However, the same cannot be said for less liquid OTC derivatives where a CCP would encounter significant difficulties in correctly evaluating and assessing the transactions and the risks involved, and therefore may not be sufficiently able to confidentially provide the requisite risk management. In these cases, it would not be sensible to centrally clear these transactions. It should be noted that central clearing may not be always be possible for other practical and technical reasons<sup>4</sup>.

Furthermore, the ABA notes that the Basel Committee has proposed new rules that would require banks to set aside more capital against bilateral exposures, thereby creating an incentive to move bilateral instruments to central clearing. Any capital recalibration for bilaterally-cleared contracts needs to take into account risk mitigation achieved through bilateral collateralisation techniques – that is, where risk mitigation achieved is comparable with central clearing, this should be reflected in the capital treatment of bilateral exposures. Differences in the capital treatment for OTC derivatives cleared and settled bilaterally as opposed to those cleared through a CCP should be based upon relative risk and counterparty exposure.

The ABA notes that central clearing can only exist if the CCP is able to safely assume the counterparty credit risk of all trading parties (i.e. mutualising this risk) through efficient risk monitoring tools and for assets having adequate liquidity only. Notwithstanding our concerns with CCP, the international banking industry is determined to extend the use of CCPs, in particular to clear the 'eligible contracts' which make up (in general) the most highly liquid and highest volume transactions and contracts in the OTC derivatives markets.

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<sup>4</sup> For example, a counterparty may not have access to a clearing house either directly (not a clearing member) or indirectly (a certain number of CCPs clearing OTC derivatives do not allow for the time for their clearing members to clear transactions of their clients). Access to CCPs may also be hindered by administrative (e.g. admission rules) or economic barriers (e.g. CCP connecting costs). In certain cases, central clearing may be impeded as a result of a CCP's unwillingness to accept certain products (because of associated risks and the cost of upgrading risk management systems).

The ABA believes that:

- Regulation of financial markets infrastructures (including CCP) should strike a balance between preserving financial markets' stability, ensuring a fair competition, and allowing access to participants and their clients.
- Capital relief should be retained and extended to indirect members provided that appropriate frameworks and standards are established, such as where clients of clearing members do not have credit exposure to their general clearing member in case of default. (We note that it is likely that many banks and other ADIs will be accessing a CCP as a client of a clearing member).
- Standardisation of contracts (where possible and appropriate) should be encouraged. CPSS-IOSCO should establish a working group to examine the development of principles for promoting the greater use of standardised OTC derivatives.
- Default arrangements should be identified. CPSS-IOSCO should establish a working group to examine the development of principles for handling the default of CCPs (such as loss-sharing rule, CCP re-capitalisation mechanism, onshore collateral pools).

### 2.3 Systemic risk

While the Australian regulators have generally acknowledged that the Australian OTC derivatives markets remained robust during the global financial crisis and have been encouraged by the steps that have been taken by industry to date to improve bilateral risk management, the regulators recognise there is a limit to the improvements to systemic risk management that can be accomplished by unilateral and bilateral tools.

The ABA notes that central clearing could result in a significant advance in risk management as well as provide other benefits to the Australian markets, for example, central clearing provides a focal point for market oversight and participant default management, which can enhance the resilience of financial markets. A well-designed CCP can reduce the risks faced by banks and other market participants and contribute to the goal of financial stability. However, central clearing can bring a new set of risks.

The ABA is concerned that the implementation of mandatory clearing in Australia raises significant concerns regarding systemic risk, risk concentration within the Australian financial system, and supervision of systemically important financial institutions and payment systems, especially if Australian banks rely on global banks' interface with global systems and this overseas-based system subsequently fails. Requiring OTC derivatives to be cleared through a CCP could increase systemic risk because it centralises and concentrates risk into a CCP which is systemically important to the overall financial wellbeing of the system.

The ABA believes that it is sensible for careful consideration to be given to how to define and contain systemic risk associated with AUD derivatives, yet maintain global connectivity with the main international CCPs that serve the global markets. Additionally, careful consideration will need to be given to implementation in terms of adequate resources to build infrastructure arrangements and test systems (trading, clearing, reporting) as well as adequate time to adapt to any new regulatory requirements.

The ABA believes that:

- Risk management standards related to CCPs for OTC derivatives should be established based on global standards to ensure the robustness of financial markets infrastructures.
- Regulation of CCPs should be established to ensure prudential supervision and oversight and effective systemic risk management.
- A 'one-size-fits-all' approach to OTC derivatives is likely to disregard the inherent nature of OTC derivatives markets and stifle the evolution of market-based transparency provisions that would otherwise arise in response to real market demands.
- Any mandatory requirement to establish a local CCP should be cognisant of the technological, cost and legal implications as well as interconnectivity with international CCPs.
- Regulators should support a move to mandatory clearing for only certain product classes where the CCP is domiciled in Australia. In this instance, oversight responsibilities should be retained by the Australian regulators, and the CCP is governed by Australian laws. Mandatory clearing should not be implemented for products that can only be cleared outside Australian jurisdiction.
- Regulators should continue to monitor overseas developments and examine the implications for central clearing in Australia, in particular the impact of reforms in the United States and European Union markets. Cross-jurisdictional arrangements in terms of standards and interoperability will be essential.

## **2.4 Central clearing of OTC derivatives—overarching principles and policy design considerations**

### **2.4.1 Banks operating in Australia**

The ABA notes that the implementation of CCP in Australia raises significant issues and challenges for Australian banks in terms of different operational risks and additional transaction and operational costs.

Therefore, we consider there are a number of overarching principles and policy design considerations with regards to the implementation of CCP, including:

- *Global OTC derivatives markets are a main pillar of the international financial system and the economy as a whole:* Derivatives exist to serve the risk management and investment needs of end-users. Importantly, derivatives help to provide liquidity and depth to financial markets, which facilitates capital mobilisation, promotes risk diversification and enhances risk management, and supports global economic growth.
- *No 'one-size-fits-all' approach should be promoted across OTC derivatives markets:* Even though risk management standards related to CCPs should be established on a global basis to ensure that all CCPs have robust risk management infrastructures and to facilitate linkages between CCPs, the implementation of CCP needs to be based on a number of considerations specific to the particular market in terms of whether regulatory or market driven responses will enhance transparency and promote trading efficiencies without imposing undue and prohibitive costs on transactions. Specifically, central clearing must take into account the underlying economic nature of OTC derivatives and their importance to the Australian financial system. Establishment of central clearing obligations must take into account the functioning of the markets, especially in the context of smaller markets, such as Australia.

- *Central clearing may not be possible for some types of OTC derivatives:* Even though central clearing has made, and will continue to make, prudential and commercial sense for the most liquid, standardised and 'commoditised' types of OTC derivatives, the implementation of CCP needs to recognise the bespoke nature of OTC derivatives. In order to manage the inherent risks and to clear a certain product class reliably, there must be a well established market and robust valuation methodology for the OTC derivative product (so that the CCP can confidently determine margin and default fund requirements and appropriately manage a default scenario) and efficient risk monitoring tools for the CCP (so that the CCP can assess contracts and safely assume the counterparty credit risk of all trading parties).
- *Bilateral counterparty risk management should also be enhanced:* Widespread use of central clearing needs to be complemented by existing counterparty credit risk reduction tools for contracts that cannot prudently be centrally cleared, including mark-to-market of exposures, close-out netting, collateralisation of derivative contracts, and portfolio reconciliations. In situations where CCP clearing is not prudentially advisable (when a transaction or contract is not an 'eligible contract') or possible (e.g. when a counterparty does not have access to a clearing house), these tools play an important risk mitigation role<sup>5</sup>.
- *Central clearing should be globally coordinated:* The implementation of CCP needs to recognise the importance of global coordination, harmonisation of standards and interoperability arrangements (as far as practicable). Alignment of implementation of legislation/ regulation is essential in order to minimise system complexity and inconsistent requirements, unnecessary transaction and operational costs, and unnecessary market disruption. In order to manage (and minimise the possible negative impacts) on market efficiency and market competition, especially for smaller markets, such as Australia, there must be clearly defined regulatory objectives which industry is able to implement.

The ABA recognises there are a number of possible competitive advantages for Australian banks' ability to participate in a CCP as a direct clearing member, including:

- Cost advantages either through greater netting opportunities (reducing capital and liquidity needs) or through avoiding an additional layer of fees for clearing through another participant;
- Capital advantages in circumstances where indirect clearing through a CCP does not qualify for a lower risk weighting under the revised Basel standards;
- Ability to offer clients a more comprehensive service by combining both trading and clearing services; and
- As a signal of creditworthiness or market standing for the institution.

However, there are also a number of competitive considerations for Australian banks, including:

- *Transaction costs:* Margin will likely increase many market participants' collateral needs above levels that characterised bilateral arrangements; initial and variation margin will likely see a net increase in the quantity of collateral held across the market; direct clearing members will typically be obliged to make a contribution to

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<sup>5</sup> For example, close-out netting arrangements reduce bilateral credit risk to the true economic mark-to-market of outstanding transactions traded under such contracts at any time, taking into account the significant offsets that in practice exist, with relevance in situations of insolvency or bankruptcy. Collateralisation arrangements further offset counterparty exposures, where collateralisation levels run close to 100%, in particular for contracts such as credit derivatives where the counterparty exposure can increase significantly over the life of the instrument.

pooled risk resources, as well as hold capital against their trades and any contingent obligations to the CCP; and ongoing fees might need to be paid to the CCP.

- *Operational costs:* Market participants are expected to make adjustments to aspects of their operations, such as trading strategies, organisational structures, market presences, and counterparties; direct clearing members will likely need to adapt existing technology systems and operational infrastructure and develop connectivity solutions (“middle-ware”) between their systems and the CCP.

#### **2.4.2 Australian corporate entities and non-financial organisations**

The ABA notes that the discussion paper proposes to impose a clearing obligation on financial institutions (banks, other authorised deposit taking institutions, and other Australian Financial Services Licensees). The application of a clearing obligation to corporate entities and non-financial organisations would present some specificities and challenges that should be carefully considered.

While subjecting corporate entities and non-financial organisations to central clearing can in certain cases reduce the risk in the financial system, if corporate entities and non-financial organisations were forced to clear products through CCPs, the requirements to post both initial and variation margin to the clearing house or their clearing member would increase risks and introduce an unpredictable liquidity burden. This could have a severe economic impact on corporate entities and non-financial organisations as they will be forced to either divert significant financial resources (liquidity) to enable them to participate in CCP clearing or forego effective long-term risk management through OTC derivatives.

The ABA believes that a balanced and sensible approach is to exempt corporate entities and non-financial organisations based on their systemic relevance, looking at the sum of their net positions. Where there is systemic relevance, we consider that these corporate entities and non-financial organisations should be subject to comparable clearing obligations as financial institutions. Importantly, any exemption should be subject to global coordination in order to avoid any regulatory arbitrage.

The ABA notes that the capital rules will probably result in non-cleared trades becoming more expensive for corporate and non-clearing counterparties.

#### **2.5 Central clearing of OTC derivatives—issues and challenges**

The ABA notes that the discussion paper proposes to implement central clearing for Australian dollar-denominated interest rate derivatives via a CCP domiciled in Australia. In practice, Australian banks will be required to clear other OTC derivatives products via other CCPs due to the participation of their counterparties in overseas markets and the participation of offshore counterparties in the Australian IRD market.

The ABA believes that the implementation of CCP in the Australian market will have a fundamental impact on the capital and financial markets. We consider that careful consideration must be given to the possible impact on banks operating in Australia and more broadly the likely impact across Australia's financial markets.

Therefore, we identify some specific issues and challenges associated with the implementation of CCP in Australia, including:

- Mandatory clearing requirement and designation of a systemically important market and/or product class, including process for determining which OTC derivatives should be subject to a mandatory clearing requirement. (We note that the discussion paper states that criteria must be satisfied: central clearing of a

class of derivatives which would reduce systemic risk, be viable, and be harmonious with international clearing requirements. In addition to standardisation and uniformity (legal, process, product), eligibility should also be measured against the availability of adequate pricing data; sufficient market size and liquidity; the availability of capabilities; the risk attributes of the instrument (where the product risk cannot be mitigated by the CCP); and the effect on competition (where the fees and charges applied to clearing cannot be absorbed). Processes for identifying scope and definitions of the markets, transactions, trades, entities and rule-making powers will be needed);

- Extra-territorial impact of overseas developments and new market rules in other jurisdictions, including practical and cost impacts of requirements to clear the same product classes through different CCPs and interactions between Australian banks and global banks;
- Harmonisation with international requirements and CCP participation criteria, including economies of scale, network effects, risk exposures and concentrations, cross-margining and interoperability arrangements. (We note that the introduction of a local CCP should be done only in a manner that avoids adverse impacts for the contestability of the Australian financial services industry and Australia's financial markets. A rule framework that is consistent with trading rules and conventions that provides operational expertise, capacity and resources and credit support infrastructure will be needed);
- CCP efficiency and viability impacts, including transaction processes, netting opportunities, and client clearing arrangements providing equivalent protections, as far as possible, for both direct and indirect participants;
- Market efficiency impacts of the CCP model adopted, such as volume of activity in a given product class, nature and range of market participants, liquidity in Australia's financial markets. (We note that the overall impact of the implementation of regulatory proposals on financial markets infrastructures (including CCP) and on the levels of market liquidity should be closely considered. While tying up liquidity in certain financial market infrastructures may be positive for prudential supervision and financial stability, it may have adverse consequences for market supervision, market making activities and/or efficient collateral management. The introduction of a local CCP should be done only in a manner that avoids market disruption and liquidity fragmentation);
- Regulatory oversight, including flexibility for supervisory authorities to determine the application of mandatory clearing based on the extent and nature of the OTC derivatives markets in their jurisdictions and capacity for authorities to intervene in crisis management;
- Capital impacts, including retaining capital relief for CCP clearing;
- Risk mitigating techniques for bilaterally-cleared contracts, including enhancement of existing techniques and tools; and
- Competition impacts, including exemptions for certain end-users and/or transaction types (i.e. corporates, smaller market participants and non-systemically important financial institutions, intra-group transactions). (It should be noted that in order to continue to support the demand for effective hedging instruments, non-financial organisation derivatives, intended to manage risk of an underlying asset or liability or the client's business activities, should be excluded from mandatory clearing proposals.)

### 3. Discussion paper—summary of ABA position

The ABA supports:

- The principles of open competitive markets and regulatory neutrality. Mandating of policy outcomes and regulatory objectives should enable the development and implementation of market driven solutions.
- The introduction of a clearing obligation for Australian-denominated interest rate derivatives as the only class of derivatives currently meeting the criteria:
  - *Systemic risk*: Interest rate swaps are fundamental to domestic funding markets and the hedging of interest rate risk by Australian borrowers and lenders (sell-side and buy-side domestic counterparties), and therefore the stability and efficiency of the Australian financial system.
  - *Viable*: The main products, such as forward rate agreements, overnight indexed swaps, and interest rate swaps are relatively standardised and there is some scope to net down large outstandings.
  - *Harmonised*: Interest rate swaps are likely to be subject to mandatory clearing obligations in overseas markets.
- The exemption of FX derivatives (forwards and swaps) from a clearing obligation due to the practical difficulties associated with settlement and in order to harmonise with global standards.
- The introduction of a local CCP in Australia for central clearing of Australian-denominated interest rate derivatives provided this local CCP is sufficiently connected with other international CCPs to enable the Australian IRD market to continue to function efficiently<sup>6</sup>. Regulators should have responsibility for ensuring comprehensive analysis and consultation on the design of financial market infrastructures (including CCP) and the implications for financial stability. Industry representatives should work with regulators on a solution. Regulators should have oversight with supervision retained by the Reserve Bank of Australia, in particular the capacity to intervene in crisis management situations. Industry should have responsibility for developing and delivering a solution (local CCP) within the stated requirements and regulatory objectives. It will be important for an open model to be developed that reflects the fluid nature of the financial markets, but also provides appropriate controls (i.e. risk management/margin requirements) and accommodates an operational platform which addresses the specific needs of local participants (i.e. valuation methodologies, trading/time zone factors, etc) and global counterparties (i.e. strategic alliances, collateral pools, margin offset capabilities, etc).
- The introduction of a local CCP that is based around internationally recognised principles and standards. The ABA, via the International Banking Federation (IBFed), has provided comments to the CPSS-IOSCO review of standards for financial market infrastructures. It will be important for these standards to provide

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<sup>6</sup> The ABA notes that there is not a consensus view across the ABA membership regarding the implementation of a local CCP in Australia. Therefore, we consider that it is important for the Council to engage directly with industry representatives to ensure the significant factors regarding establishment of a local CCP for clearing of Australian-denominated interest rate derivatives as opposed to an alternative approach (i.e. existing/overseas solution with appropriate arrangements to jurisdiction and access for collateral relevant to Australian based transactions) are carefully considered.

a global framework. However, equally it will be important to ensure that the standards do not impose inappropriate demands on the local market, such as an undue cost burden (i.e. collateral, margins, etc) or inappropriate legal ambiguities (i.e. governance, default rules, etc).

- The introduction of a local CCP which considers the global nature of markets and CCP regulation which does not restrict the ability of Australian banks and other financial institutions from continuing to participate and be competitive in the global markets. It will be important for clearing obligations to avoid overlapping requirements and/or infrastructure where viable and sufficient alternatives exist. Additionally, due to the nature, scale and timing of changes internationally, it will be important for CCP to be coordinated with other jurisdictions and overseas regulators to avoid market fragmentation and regulatory arbitrage.

#### 4. Concluding comments

The ABA broadly supports effective measures to introduce central clearing of standardised OTC derivatives contracts in Australia. However, implementation must be based on careful consideration of the specificities of the particular market in terms of whether regulatory or market driven responses will restore investor confidence in OTC derivatives markets, enhance transparency, and promote trading efficiencies without imposing undue and prohibitive costs on transactions. It will be important for regulation should ensure that laws support the usefulness of derivatives as important financial instruments and risk management tools as well as the efficient functioning of Australia's markets.

Ultimately, costs will need to be passed on to end-users via higher prices and premiums. If central clearing is not well-designed or additional costs are material, end-users will either decide not to enter into hedging arrangements (which would increase business, operational and financial risks) or seek alternative products and markets (which would be significantly adverse for the Australian banking and finance industry) – both outcomes would significantly damage the contestability of Australia's markets and the performance of Australia's economy.

The ABA believes that central clearing is likely to have significant impacts on the allocation of risk, incentives to manage and monitor risk, and ultimately, risk within the financial system. We consider that due to the significance of the potential impact of central clearing for banks operating in Australia and Australia's financial markets, the Council of Financial Regulators should continue to engage with industry representatives to thoroughly discuss the particulars of a possible local CCP, the associated technology, cost, legal and commercial considerations, and the implications for banks and other market participants.

Therefore, the ABA recommends that the Council establish a working group comprising all appropriate stakeholders, such as industry representatives (banks and market participants) and end-users. It will be important for the various views to be taken into account in terms of the regulatory outcome being sought by the Council and the particulars of implementation of central clearing in Australia.

Yours sincerely



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Diane Tate