

9 September 2011

Mr Chris Kent  
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Reserve Bank of Australia  
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Dear Mr Kent

**Central Clearing of OTC Derivatives in Australia**

This letter refers, and is in response to, the Council of Financial Regulators (the "Council") discussion paper on Central Clearing of OTC Derivatives in Australia, issued in June 2011 (the "Discussion Paper").

Colonial First State Global Asset Management ("CFSGAM") appreciates the opportunity to comment on the Discussion Paper and the extension of time to lodge our submission. CFSGAM is Australia's largest manager of Australian sourced funds, with more than A\$152 billion in funds under management across a diverse range of asset classes including Australian and global shares, short term investments, fixed interest and credit, property securities, direct property, global resources, and infrastructure. **The core principles guiding our response are that we understand the need to protect the Australian financial system and we support that aim.**

Our detailed response to specific questions from the Discussion Paper is enclosed. CFSGAM also participated in the development of the joint banking industry response of 1 September 2011.

We would be happy to meet with the Council and provide further information on our submission. Should you have any questions, please do not hesitate to contact Mr. Tony Adams, Co-Head of Global Fixed Interest & Credit, on 02 9303 6398 or at [tony.adams@colonialfirststate.com.au](mailto:tony.adams@colonialfirststate.com.au).

Yours sincerely



David Dixon

Chief Investment Officer

## CFSGAM RESPONSE ON THE DISCUSSION PAPER

### 6.2.1. The potential clearability of OTC derivatives

Q1. Do you consider the product characteristics of any OTC derivatives classes traded by Australian market participants make them amenable to central clearing in general? If so, what classes would you include, and for what reasons? For which classes do you think central clearing is inappropriate, and for what reasons?

The characteristics of derivative products which are amenable to central clearing are primarily standardisation, a lack of complexity (in terms of valuation), broad usage, liquidity and to a certain extent fungibility. These are, of course, characteristics which have seen the development of the futures industry where clearing is central to the way of business. These products enable a CCP to efficiently manage its risk and exposure to the portfolios of CCP members. The most obvious OTC candidates within any jurisdiction are domestic interest rate derivatives.

Regarding exclusion for certain classes or products, as noted in the Discussion Paper, at a minimum we should harmonise with exclusions generally applying globally. Given the proposed US Treasury exemption, and indications from other jurisdictions in particular the EU on harmonisation in this regard, we support the position adopted in the discussion paper that *"Council agencies would expect that Australian requirements would be harmonised with this"*

Q2. What OTC derivatives traded in Australia would you consider as feasible to be centrally cleared?

As noted in Q1, the most likely feasible products to be centrally cleared in Australia are AUD interest rate derivatives, and within that class AUD interest rate swaps.

Those products that have multi-currency risk and therefore are cross-jurisdictional in nature (including FX Options) are unlikely to lend themselves to clearing until linkages between CCPs to manage multi-currency products are established.

The volume of credit derivatives traded in Australia is very low and it is our position that it would not currently either meet the test of a "clearable" OTC product or provide sufficient turnover to cover the costs of establishing clearing capabilities.

Q3. Do you agree with this paper's suggestion that Australian dollar-denominated interest rate derivatives traded in Australia have the volume and characteristics to be viably centrally cleared?

We agree that it would appear likely that Australian interest rate derivatives, and within that more specifically interest rate swaps, demonstrate the attributes that would make them suitable for central clearing.

Q4. What would be the costs of moving certain OTC derivatives transactions to central clearing? Please provide as much data or information as possible to illustrate this.

Without outlining costs that might apply across the financial markets, the potential costs (and risks) specific to investment managers include:

- Investment managers have limited ability to borrow in their clients' name, which restricts their ability to fund collateral calls. Unlike a financial institution which can issue debt or



potentially access the RBA, investment managers are required to retain excess cash or sell financial assets.

- Unlike a financial institution, the quality and type of assets are determined by the client, with the investment manager responsible for complying with the fund or client risk parameters. These assets are normally long term in nature with derivatives used to meet specific risk requirements. Changing collateral or liquidity requirements part way through the investment life could cause added risk to the client.
- Costs relating to margin call requirements: For a fund to meet margin requirements, it may be required to convert its primary investments, such as bonds, equities or physical assets into lower yielding eligible collateral assets. This would have tax and transactional cost impacts for the client and potentially reduce returns to investors.
- A potential flow-on implication of this is that the establishment of a CCP adds to the risk within an investment manager's portfolio. This can occur by investment managers choosing not to hedge risks due to the potential requirement to hold excess cash in the fund to provide for collateral.
- Investment managers are required to re-balance portfolios during times of both equity and interest rate volatility. An increase in collateral requirement for an interest rate event could be occurring at the same time that liquidity is required from a non-interest rate sensitive sector. These collateral requirements then place additional liquidity requirements on funds simultaneously exposed to diversified market events.

More broadly, the move to centrally cleared derivatives imposes significant liquidity risks on a section of the financial markets where a significant portion of investment managers' funds are open ended with daily liquidity. Collateral posting would add an additional mismatch between the investment horizon of the investor and assets that would be purchased in the fund under client instructions.

#### 6.2.2. Mandatory clearing requirements

Q5. Do you agree or disagree with the proposed criteria for deciding whether a class of OTC derivatives should be mandatorily cleared? (See point 1 under Section 5.1)

Agree.

Q6. Do you agree or disagree with the proposed criteria for deciding whether a class of market participants should be subject to a mandatory clearing requirement? (See point 2 under Section 5.1)

Disagree. The criteria for deciding whether a class of market participants should be subject to a mandatory clearing requirement is not sufficiently broad. We would add:

*c. the potential for significant increase of idiosyncratic risks that may occur as a result of enforced participation in centralised clearing*

CFSGAM is concerned that efforts to minimise the systemic risk within the industry by way of central clearing may have a significant detrimental impact on the risks faced by individual participants. Specifically it may be seen that central clearing concentrates credit risk into a central clearer rather

than allowing the current situation where individual participants are able to manage their own credit risk by diversifying across a range of counterparties.

Further mandatory clearing requirement that would expose cash-flow constrained but otherwise creditworthy end-users to post cash margins today against sensibly hedged future exposures has the potential to cause stress within these organisations and should be discouraged.

We therefore support the position of the discussion paper that it may be that in Australia an appropriate 'line' to be drawn can occur with the exclusion from any mandatory requirements being granted to participants who are not holders of an Australian Financial Services Licence (AFSL) or who are not ADIs. In addition, certain AFSL holders and small ADIs who are sporadic users of derivatives in low volume should also be able to retain bilateral relationships due to the high cost of accessing CCPs and their very limited systemic risk potential.

**Q7. What, if any, exemptions for either products or participants do you think the Council agencies should be considering, and for what reasons?**

Broadly, any derivatives user which does not pose a threat to the stability of the Australian financial market should be exempt.

Affordable access to appropriate methods of hedging, including OTC derivatives, is vital to investment managers as they seek to mitigate risks and meet clients' objectives for long term investments.

Investment managers should be exempt from clearing and margin requirements as the increased collateral and operational requirements are likely to be costly, and the reduction in systemic risk is insufficient to justify.

We do not consider Australian investment managers are a risk to the Australian financial system due to their derivative activities. For example, CFSGAM is Australia's largest investment manager by Australian-sourced funds under management. We are an extensive user of a range of interest rate, currency and credit derivative swaps to hedge our clients' investment portfolios.

Our combined swap turnover for FYE2011 was \$4.84bn or just 0.12% of total turnover according to Australian Financial Markets Association (AFMA) data. Further underlying the weak linkage to systemic risk, our total government bond turnover of \$14.84bn for FYE 2011 is just 1.7% of market turnover according to AFMA data.

Investment managers should benefit from a presumption of hedging and should only have to make an affirmative declaration as to the non-hedging or speculative nature of the transaction when entering into it.

Smaller participants should be exempted from the requirements of mandatory clearing. Cost of clearing for these participants would establish significant barriers to entry and result in overly onerous complex processes for such participants.



### 6.2.3. OTC derivatives central counterparties

Q8. Do you agree or disagree with the agencies' proposition that CCPs clearing OTC derivatives markets that are systemically important to Australia should be domiciled in Australia, particularly for instruments denominated in Australian dollars?

Agree. The ability for local regulators to manage systemic risk in Australia is a desirable if not essential outcome of any regulatory change. CFSGAM has confidence in the transparency of the Australian regulatory regime, and confidence in the domestic market. Offshore regulation is varied and from a risk perspective we do not have the same confidence in other regulated markets as to the transparency, efficiency and overall veracity of those jurisdictions as that of the domestic environment.

There are existing clearance facilities (such as APCA, RBA, ASX/ASX 24 and similar) for operations including the international payments system, domestic payments system, exchange settlement systems for equity, futures and debt markets. One option, in the establishment phase would be for the central clearing to be operated by a government body. This would remove the potential conflict of interest for a corporate provider of such a service (or a related bank-owned service provider). We would also support the use of the well-established and understood clearance systems providers currently available in the domestic market.

In general, the move to central clearing, whilst designed to address counterparty credit risk issues, creates of itself other systemic risks tied to member defaults and potentially the failure of the CCP itself. These risks are present in all CCPs, and the global community is seeking a harmonised approach through the CPSS-IOSCO work on Financial Market Infrastructures.

Q9. What would be the impact on the local market of mandatory clearing through a domestic CCP? What might be the advantages or disadvantages of clearing through an offshore-domiciled CCP? Please discuss all points where you agree or disagree, in as much detail as possible. Where available, please provide quantitative data to illustrate the impact of various CCP configurations on the costs and risks of individual market participants or the Australian market as a whole.

CFSGAM concurs with the joint Discussion Paper response provided here by ANZ Global Markets, Institutional Division; Commonwealth Bank of Australia Markets; Macquarie Bank Limited and Westpac Institutional Bank Financial Markets

Q10. Do you consider any changes need to be made to Australian law or regulation to improve a CCP's arrangements for the segregation and portability of client accounts?

We expect Australian laws may need to be reviewed and modified if required, most possibly in the areas of insolvency law and the rights and obligations of the CCP with respect to its treatment of margin, however this submission does not intend to provide responses that may be construed as legal advice.

Q11. Do you consider any other changes need to be made to Australian law or regulation to improve the handling of collateral posted by market participants for positions cleared offshore?

Refer to Q10 above.

Q12. Are there any other changes to the regulation of CCPs that should be considered that are particular to the clearing of OTC derivatives?

Refer to Q10 above.

Q13. Do you agree that interoperability among OTC derivatives CCPs should be encouraged?

Agree.

Q14. Do you agree that a mandatory clearing requirement might have consequences for efficient outcomes in the market for clearing services? How should Council agencies and market participants look to manage any adverse effects in this area?

CFSGAM concurs with the joint Discussion Paper response provided here by ANZ Global Markets, Institutional Division; Commonwealth Bank of Australia Markets; Macquarie Bank Limited and Westpac Institutional Bank Financial Markets.

#### 6.2.4. Jurisdictional and other matters

Q15. Are there any legal impediments to mandating the clearing of OTC derivatives and the use of CCPs? Are there any legal impediments to mandating the use of a CCP where that CCP is domiciled in a foreign jurisdiction?

Refer to Q10 above.

Q16. Are there any extraterritorial effects of regulatory reform underway in foreign jurisdictions that should be considered in developing a clearing regime for Australia?

CFSGAM has no specific comments to make in this regard.

Q17. Are there any other changes to the existing regulatory framework for the Australian financial system that would be desirable to accommodate a move to central clearing of OTC derivatives?

Refer to Q10 above.

Q18. In the absence of a domestic mandatory clearing requirement, how would Australian participants respond to changes in capital treatment of non-cleared OTC derivatives and global market developments (including the increasing use of CCPs by global dealers)? Do Australian participants expect to centrally clear transactions in products which Australian law does not require them to clear? If so, what is the motivation for centrally clearing these products (e.g. to avoid higher capital charges, offshore jurisdictional requirements, commercial pressure)?

As an investment manager rather than a bank CFSGAM has no specific comments to make in this regard.