FINANCE & TREASURY ASSOCIATION

Thursday 15 September 2011

OTC Derivatives Central Clearing Consultation
Reserve Bank of Australia
GPO Box 3947
Sydney NSW 2001

Re: Central Clearing of OTC Derivatives in Australia
Response to discussion paper by Finance and Treasury Association.

Overview

In the wake of the global financial crisis, neither regulators nor market participants felt they had a good understanding of some over the counter (OTC) derivatives and their associated linkages and interdependencies within the markets. There was a lack of confidence that the current bilateral risk management tools utilised in all segments of the OTC derivative market would be effective in dealing with the stresses of the market. In particular, there was a fear that a default of one institution could have a significant systemic effect on other institutions. Concerns over the lack of transparency and risk management resulted in regulators initiating reform in the OTC derivative market.

Central clearing provides a central point for market oversight and participant default management, bringing with it a perceived increase in the resilience of financial markets. For this reason it is acknowledged that the Council of Financial Regulators support the move to central clearing, however with central clearing come other negative consequences that potentially affect the way corporations behave and the risks that they are exposed to.

A move to central clearing of OTC derivatives will likely bring additional cost to corporate participants (if not exempt). Mainly the requirement to post initial margins and additionally the obligation of ongoing margin calls where no current collateral requirements exist. The effect to a corporates' cash flow along with the additional fees and interest expenses will discourage the use of these derivatives by corporations to manage unintended risks in business operations, potentially exposing them to increased risk through unhedged adverse market movements as an unintended consequence.

Regulation in relation to OTC derivatives will also lead to two tiered pricing in the market, as financial institutions will likely price rate quotes based on whether the instrument is cleared centrally or not. As many corporate treasuries may have the inability to post initial and ongoing margins, high rating and desired financial institutions may be able to negotiate unfavourable terms, increasing quotes under the disguise of increased collateral requirements.

The key recommendation of this submission is to examine the need for an exemption for corporations that undertake both standard and non-standardised OTC derivatives for hedging and risk management purposes. This appears to be in line with current international reform, however a conscious effort must be made to ensure any exemption to clear centrally should protect a participant's ability to align exposures with OTC contracts and avoid any additional margining, unfavourable two tiered pricing and transaction costs.

Corporations use of Financial Derivatives

Corporations are large users of financial derivatives in Australia. These transactions are primarily used to manage financial risk positions created through their ongoing business operations or their capital market activities (primarily the sourcing of capital). As a result of these types of activities, corporations are primarily 'price takers' of financial derivatives, being either buyers or sellers of positions (based on their underlying business), rarely both, hence their gross financial derivative positions are largely the same as their net financial derivative positions, hence receive little benefit attributed to the large financial institutions from netting.

The manner in which these transactions are used means they are a critical tool for mitigating risk and not creating risk. To date these transactions have been typically made available to corporations on a credit line basis either without direct security being required or when required being able to be provided in a number of different forms. For example, under current collateralisation agreements such as Credit Support Annexes, corporate entities are quite often able to provide bank guarantees, letters of credit or securities as collateral and hence are not required to draw down on either working capital or debt facilities.

The cash outcomes of these hedging financial derivatives do not occur until the maturity of the exposure being managed/hedged occurs, however, if margining is required throughout the transaction's life, this could create a significant impost on corporations and a disincentive to use an effective risk management tool. In contrast to large derivative market participants who trade these instruments the fact, as mentioned above, is that corporations financial risk management transactions are ‘one directional’ and they do not receive any netting relief.

As stated above, corporations utilise financial derivatives as cash flow hedges for their underlying business activities. The requirement to provide margin to a central clearer would place the effectiveness of these hedges at risk and could create significant accounting implications and unnecessary volatility in financial reports.
We understand corporations are likely to be exempted (so long as they are not a swap trader) from the requirement to centrally clear in the United States. We encourage the local regulators to adopt a similar approach in Australia. Additionally, should corporations be forced to use standardised contracts their ability to receive hedge accounting treatment in the accounts would be inhibited.

We understand the imperative in the local market to set regulation for a central clearer to ensure the Australian capital markets remain competitive. However, we do not believe that the establishment of a central clearer will provide any benefit to Australian corporations, and may in fact impose additional costs on the use of financial derivatives, potentially driving a two tier pricing regime, prices for organisations who centrally clear and those that do not. If corporations are exempt, financial institutions would lose netting benefits potentially increasing the cost of providing these transactions, particularly given the lack of netting relief. . Additionally, corporations would be concerned if there were multiple clearing houses that financial institutions may be required to use (say onshore and offshore) as this would also have the impact of diluting the ability to net.

It may be argued that corporations may benefit from reducing their exposure to providers of financial derivatives, typically the local and international banks, by replacing them with a central clearer, however, this would be largely ineffective. The credit relationship corporations have with providers of financial derivatives are typically two way as those same institutions are also often providers of capital, hence netting the risk for the corporations. However, shifting this to a central clearer removes this benefit and replaces it with another credit exposure, that to a central clearer. Additionally we may find the growth of bundled solutions, combining debt capital with derivatives as one structure, while potentially being cost and credit effective will reduce flexibility and transparency, detracting from corporations ability to bifurcate the management of their liquidity and market risk (primarily interest rate risk), as per the currently accepted corporate governance approach.

Based on the balance of implications outlined above, the key recommendation of this submission is to develop an exemption from mandatory clearing requirements for corporate entities using derivative products purely for financial risk management purposes or “Hedging”. In the United States, exemptions are likely to apply to many corporate end users and smaller market participants, in part because of the smaller effect on systemic risk made by these entities.

For Australian entities an appropriate exemption would protect the non-standardised way corporate entities trade OTC derivatives. Eliminating margining and additional transaction costs to ensure that hedging remained an economic way to decrease business risks. To ensure this a conscious effort by regulators should also be made to restrict financial institutions from passing through their additional liquidity costs to corporate entities through unfavourable pricing.

In the discussion paper you also asked if some specific questions could be answered. We have provided a response to those we believe relate to corporations.

6.2. Suggested Questions
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 'vanilla' interest rate derivatives which are traded using common market variables, such as frequency of payment, payment term, term to maturity, principal amount for instance, could be effectively cleared. These transactions are generally traded in the interbank market. However for the corporate hedgers, transactions are typically structured to meet specific hedging requirements (of corporations), and hence would not have consistent features and would be more difficult to clear.
Currency related transactions present more difficulties to clear, particularly as their settlement is often not netted.

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

'Vanilla' interest rate derivatives, as per the description above.

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?
Yes

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.

The FTA is not in a position to respond to this point, however, there is real concern attached to the ongoing cost to corporations from a central clearing regime, either if they are included or excluded.

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)

We do not believe all market participants should be included, we believe, if central clearing is required, it should be restricted to active traders of OTC derivatives for market marking purposes.
Agree with the proposed criteria for classes of OTC derivatives, provided the exemption for certain market participants still applies where they transact a derivative that falls within this asset class (eg where a corporation transacts a vanilla 3 year swap as part of its hedging).

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)

Yes, as it implies user of OTC derivatives that would not contribute to systemic risk would not be required to centrally clear, which would imply that most (or ideally all) corporations would be exempt. It also proposes harmonisation with international requirements (5.1.2(b)), which implies that corporations would be exempt where they might be using products purely for hedging purposes (consistent with the US). It is recommended that the definition "purely for hedging purposes" is not over-emphasised so that it does not place an onerous burden of proof on the corporation.

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

As mentioned above exemptions for users of OTC derivatives for hedging purposes (not active traders) and non-standard transactions.

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?

Neither disagree nor agree, Corporations commonly transact OTC derivatives both in Australia and offshore, the domicile of the counterpart is mostly a function of the OTC derivative providers global structure, location of actual market being accessed and the actual product. There is a concern, as discussed in the opening comments that having multiple clearers on a global basis could increase the cost of dealing by mitigating the ability of financial institutions to net.

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.

Given corporations are typically users of OTC derivative transactions, the impact of clearing through a domestic versus offshore CCP will be a function (unless an exemption is provided) of the ability to effective service any margining requirements. An offshore clearer could require margin in a currency other than Australian dollars which could create currency exposure for a corporation where none existed before.

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?

No comment

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?

No comment

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

No comment

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

No comment

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?

Yes we agree, particularly if corporations who are users of derivatives are included. This could create a disincentive for corporations to manage exposures they have to the financial markets, hence potentially having an adverse impact on their business by removing an effective risk mitigation tool.

6.2.4. Jurisdictional and other matters

Given corporations are typically users of OTC derivatives and believe they should be exempt, they do not have an opinion on the jurisdictional 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?

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

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?

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)?

Yours sincerely

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