Council of Financial Regulators Discussion Paper 'Central Clearing of OTC Derivatives in Australia'

To Council of Financial Regulators

This letter contains the response of J.P.Morgan to the Council of Financial Regulators ("Council") discussion paper on central clearing over-the-counter derivatives in Australia issued in June 2011. We welcome the opportunity to provide this response and contribute the following feedback.

J.P.Morgan notes that the International Swaps and Derivatives Association, Inc. ("ISDA") and the Australian Financial Markets Association ("AMFA") have submitted detailed responses addressing the eighteen questions in the discussion paper. J.P.Morgan has worked closely with ISDA and AFMA in drafting their responses to the Council's paper. The ISDA and AFMA responses are based on industry feedback through their respective forums of which J.P.Morgan has been a part. J.P.Morgan has reviewed the draft ISDA and AFMA responses and we are of the opinion that they broadly reflect our position; and on that basis, J.P.Morgan has not submitted a comprehensive, independent response into the Council.

However, we identify in this letter some specific points of consideration with respect to the proposed establishment of a local Central Clearing Party for OTC Derivatives ("CCP"). J.P.Morgan believes that further examination and analysis of these points would be prudent before any local CCP is mandated in Australia. We set out our considerations below:

- Several CCPs operating in other jurisdictions are already operational and provide open access to clearing for a variety of (a) clearing members clearing directly; and (b) clients clearing indirectly through clearing members. These structures are open to Australian participants wishing to clear directly (provided that the membership criteria are satisfied) or indirectly through pre-existing clearing members.
- These CCPs have in place systems and processes to provide detailed information to Australian authorities, both for business as usual and in crisis situations.
- These CCPs also have in place client clearing models that are currently in use.
- The establishment costs of any new local CCP on a mandatory basis, and with "top down" deadlines, would be likely to represent a significant burden on local market participants.
- Any new local CCP would be likely to require significant time and capital to establish, and ongoing operational effort to support.
- A client clearing model is expensive and complex to set up. The lead time from inception to launch is significant, and moving forward in a potentially rushed manner may give rise to additional, unforseen risks/problems given that legal, operational and risk management certainty are key if the local CCP is to improve systemic stability rather than reduce it.
- A local CCP raises the risk that liquidity in locally cleared currencies becomes fragmented, causing price differentials between globally cleared versus local clearing cleared currencies.
- The introduction of a requirement to use a local CCP would be likely to result in increased costs for participants in the form of more margin and more capital for default funding.
- One of the desired outcomes from the establishment of a local CCP is the disbursement of credit risks arising from OTC Derivative activity. Given the nature of

the Australian marketplace, the likely pool of participants in any local CCP would appear to be constrained and could be correlated in times of stress. Therefore, the effectiveness of the local CCP to reduce those risks arising through OTC Derivative transactions would also appear to be constrained. It will be necessary, in our minds, to have a critical mass of participants of the local CCP to ensure an effective diminishment of risk, and to ensure ongoing stability and viability of any local CCP.

- There are concerns that eligible collateral categories will differ between CCPs resulting in cost disparities in margin funding.
- If mandatory clearing of AUD/NZD products is introduced, there is a potential to split market activity resulting in AUD/NZD products being segregated from the other products cleared by existing CCPs located outside of Australia.
- A pool of AUD products already exist in CCPs located outside of Australia. The introduction of a local CCP may result in a split in the books of Australian market participants who are already clearing on existing CCPs.
- Irrespective of whether a local CCP is mandated in Australia, Australian market participants are likely to still require access to CCPs located outside Australia to support the clearing of other currencies. As a result, the establishment of a local CCP in Australia is unlikely to resolve all issues that have been identified with respect to access to information for Australian regulators.

In our view further investigation of the key considerations referred to in the Council's discussion paper may result in the determination that alternative approaches may be more suitable to the Australian market. The four key considerations are: (i) availability of central clearing services to Australian-based market participants; (ii) the significance of cross border linkages; (iii) the implications of central clearing for financial stability; and (iv) the effect CCPs have on the efficiency and functioning of the markets.

One possible approach would be to provide for the development of clearing in the Australian markets on a voluntary basis, together with the requirement for CCPs providing services to Australian market participants to have in place clear rules requiring the CCP to provide access to data to Australian regulators on a timely basis.

These points should be read in conjunction with the other industry submissions J.P. Morgan has participated in. It is noted that the Council has proposed individual meetings with market participants, and should the Council be so inclined J.P. Morgan would welcome the opportunity to discuss this proposal.

J.P.MORGAN

By: ______________________

Name: Jeff Herbert-Smith

Title: Managing Director – Head of Aust and NZ Fixed Income

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