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

Dear Sir

Central Clearing of OTC Derivatives in Australia

Thank you for the opportunity to respond to the discussion paper "Central Clearing of OTC Derivatives in Australia". National Australia Bank Ltd, as a major participant in Australian OTC Derivative markets and a participant in similar markets offshore is keen to ensure an appropriate response to the G20 commitments. We believe this discussion is a good start to this process.

General Comments

In general, we support the broad conclusion that some form of central clearing of OTC Interest Rate Derivatives could have benefits for the Australian market. As the discussion paper points out, there are substantial benefits and risk associated with a single point of control (and therefore failure) for many OTC derivatives.

In particular, trades entered into a CCP (Centralised Clearing Platform) could benefit from:

1. Efficiencies in the settlement and maintenance of the trades arising from a single point of booking
2. Ease of confirmation of the trade at inception
3. Existence of initial margins to minimise risks in the case of default of a counterparty
4. Probable reduction of the capital currently deployed against counterparty credit

But we need also consider some of the potential risks:

1. Concentration (systemic) risk is possibly greater when the trades are in a CCP given a major default

2. Regulatory intervention would be complex if the CCP was under different oversight to the defaulting party
3. Too many CCPs would compound regulatory complexity and therefore costs for participants

On balance we believe the benefits could overcome the risks in a properly constructed CCP environment. But this is the central issue: what constitutes an efficient and well-regulated system for Australian purposes. The four considerations in the executive summary have guided our thoughts on how such a system may be created.

1. Firstly, NAB has operations in many countries and appreciable interest in UK. As such we will have to engage offshore CCPs as the market for many currencies is shifting liquidity to "cleared only" markets that we need to access. This need will necessarily affect our position for clearing AUD derivatives. As yet this is uncertain.
2. Second, we rely on non-domestic counterparties for a considerable part of our liquidity in AUD OTC derivatives. LCH Clearnet has recently claimed it already clears 25% of AUD Interest Rate Derivatives. Any changes to the local requirements would have to consider the (sometimes conflicting) regulatory requirements of non-domestic participants, and the existence of an incumbent CCP. This is clearly a complex issue that will require some degree of global regulatory harmony.
3. Third, the integrity of the CCP could be protected through appropriate margining and guarantees but should the extent of default overwhelm the CCP the results would be disastrous for the financial system. If, say, there was one global CCP there would be single point of failure; but a very identifiable one. Should there be many regional CCPs an individual failure would be smaller but the contamination of other CCPs could still force a major catastrophe. So a major event could have a similar outcome regardless of the regional or global nature of the CCPs.
4. Fourth, the possibility of market fragmentation should be avoided as a very high priority. A fractured market would become significantly less liquid and costs would increase for all participants in both spread and CCP charges. And in the case of a default the cross-CCP close outs would become complex and disruptive.

The Executive Summary of the discussion paper refers to four key considerations:

1. Offshore CCPs are configured predominately to service their current clients. But the two leaders in this service have both expressed willingness to adapt their operating models to accommodate Australian counterparties. However the timing for such changes is not clear.
2. We agree that the global market for CCPs will need to address the issue of cross-border linkages to cover a wider range of product (e.g. cross currency swaps). Some harmonisation of the global regulatory environment is a critical for this to occur.
3. The systemic risk in CCPs is a major consideration for all participants in the OTC derivatives market; CCPs, derivative users and regulators. Any CCP catering for Australian participants will need to provide for a default and the potential effects on the Australian financial markets.
4. Clearly a fragmented market for clearing would create changes in the liquidity pools for AUD derivatives along with additional costs for collateral. Given our current book and trading composition this would potentially have significant implications.

In considering the specific questions posed however, we have a different view of some of the discussion included in the paper:

1. On page 14, the discussion around capital treatment of indirect clearing is not complete without consideration of the rules which will apply to such exposures and the ability to claim the equivalent risk weighting to a directly cleared transaction. This is an area where clarity is urgently required to assist in decision-making.

2. On page 17 the possibility of market participants leaving the market rather than dealing via a small CCP should not be treated lightly, given the large volumes of AUD IRDs traded by international banks
3. On page 20 there is a discussion of possible regulatory risks which may arise from co-operation (and presumably inter-operability) between CCPs must be balanced against the risk posed by a small, isolated CCP and its potential to fail and pose a risk to the particular financial system it serves. Our view is very much that the downside to an isolated CCP is continuous and ongoing (given the additional margin and potential to split the market into domestic and offshore), whereas the risks to an integrated CCP are tail risks, and within the capacity of regulators to resolve.
4. On page 25 the data on the IR Swap market doesn't split the volume between local and foreign banks. This would be useful data as it would make clear the extent to which AUD IR derivatives could be traded offshore. We have specific commentary on the need to ensure open trading in AUD IR derivatives for efficiency purposes, and at the top of page 27, the important role of foreign banks is noted.
5. On page 31, the point is made that it can be difficult to clearly define the jurisdiction of a transaction, yet doesn't address how this can be dealt with. If the preferred model is a domestic CCP, then this would be difficult. On page 32 it is proposed that transactions between Australian ADIs and foreign non-ADIs would be captured – it is not clear how this could be achieved.
6. With respect to jurisdictional issues, we note such issues are not unique to CCPs, and indeed most ISDA documentation executed results in those transactions being subject to English law. These could be overcome with regulatory co-operation to ensure support, where needed, is provided.

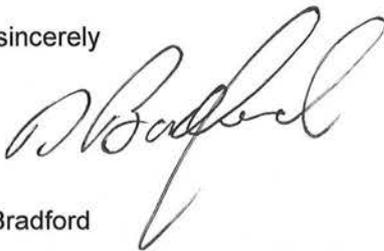
As requested, we have provided specific answers to the questions included in the discussion paper, included as Section A.

In summary, we support the premise that a CCP would enhance aspects of the OTC Derivatives market but that significant risks exist that an inappropriate version may create a "two-tiered" market for AUD derivatives.

In addition to this individual submission, we have also taken part in a number of industry roundtables, and contributed to the submissions from AFMA and the ABA. We would be pleased to continue to discuss this issue directly and via such industry associations.

We would welcome an opportunity to discuss this response. Please feel free to call me on (02) 8220 5462

Yours sincerely



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Section A: Responses to specific 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?

Vanilla IRS and OIS on reasonably standard terms (non-amortising) are suitable. There are deep and liquid markets in standard parcel sizes, such that the only risk would be re-pricing on settlement dates. Option products in general are not, due to the bespoke nature and illiquid markets in Australia. FX products should remain outside, as terms are generally short, interbank FX is settled via CLS and US Treasury has exempted most FX products from the key provisions of Title VII of the Dodd-Frank Act.

Cross currency swaps account for a significant proportion of trades for which bilateral collateral is posted. Including these swaps in clearing would help resolve some of the large collateral flows but we recognise the inherent difficulty of clearing cross currency transactions.

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

Vanilla IRS and OIS

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, for the reasons state din our answer to Q1.

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.

There will be additional clearing costs (processing etc), plus initial and variation margin costs, for clearing via CCP. We estimate that additional costs from funding initial margin on eligible derivatives would be less than AUD5 million, provided all trades are cleared via one CCP. Should multiple CCPs be required, this cost could increase by a multiple of 3 or more depending on the trades cleared due to the inability to net transactions at one CCP. There is also a capital cost for membership, contributions to guarantee funds as members, and any potential additional liability. Some systems development may be required to accommodate the clearer in our systems.

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)

Yes, however the cost of the arrangement to the Banks and dealers should also be considered.

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, however consideration must be given to the purpose for which those participants are accessing the market, and their capacity to support the CCP and margin requirements. In some cases, participants (such as corporate) may "collateralise" their OTC derivative transactions with "other collateral" such as claims over hard assets (land etc).

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

As noted above, where the costs outweigh the benefits and clearing is not considered appropriate for a participant they should be exempt.

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?

To the extent any domestic CCP has interoperability with offshore CCPs, this objective could be achievable. As the AUD and associated interest rate derivatives have operated in a free and open market for many years, and a significant proportion of AUD IRDs are traded offshore (at least 25% according to LCH Clearnet), a purely domestic CCP with no interoperability with large offshore CCPs would not be efficient. In many ways the market is traded offshore as most ISDAs and CSAs are executed under English law. It could be argued that much of the AUD IRD market is effectively already outside Australian domicile.

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.

If clearing via a domestic CCP was mandatory, there is a very real risk of a two tier market emerging where international banks clear in London and the US using LIBOR as the benchmark, while Australian banks clear domestically using BBSW. There would be little incentive for international banks to clear domestically as it would prevent them from netting exposures at the one CCP. Clearing at offshore CCPs enables netting to take place in one place, minimising the liquidity drain of supporting multiple CCPs and preventing margin being fragmented across a number of CCPs. There is also a broader jurisdictional dilemma: what if a US bank had to clear in USA and in Australia for AUD swaps? Is this achievable? Is it efficient?

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?

A significant level of protection from the operation of Australian insolvency laws is afforded to the closing out of arrangements under the CCP's rules if the CCP obtains the protection given to market netting contracts under Australia's netting legislation. However, an extension of this protection to additional activities conducted in accordance with the CCP rules (including in relation to registration of positions, segregation of accounts and portability of positions and collateral) should be considered.

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?

It is possible that Australian market participants will suffer some disadvantage if the clearing of positions through an offshore CCP is not protected from the operation of Australian insolvency laws in the same manner as it is from the insolvency laws of foreign market participants. Accordingly, consideration should be given to recognition of offshore CCPs for the purpose of the insolvency protection described in relation 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?

Due to the nature of the transactions which are to be cleared, some consideration should be given to the creation of a transparent regulatory mechanism to deal with a failure of the CCP (and not just the failure of a participant). Related to this is the consideration of the capital regulation of the CCP.

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

Yes, it is the only way multiple CCPs can succeed and avoid the burden of posting margin at multiple CCPs

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?

In so far as only one CCP is available in the jurisdiction, there would be no competition and no opportunity to achieve lower transaction costs.

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?

We would expect legal impediments to be limited if mandating is to be conducted through the operation of the Australian Financial Services Licence regime and the ADI authorisation regime. However, as a practical matter, we note that it may be difficult to develop a legislative definition of the derivatives which are required to be cleared. In relation to mandating the use of an offshore CCP, some care should be taken so that this does not require Australian market participants to comply with offshore legal obligations which are inconsistent with Australian law or public policy. Also, the possibility that mandating the use of a foreign CCP would cause unintended taxation consequences should also be considered.

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

Yes, numerous jurisdictions are proposing clearing regimes where the domestic players will be forced to clear via domestic infrastructure. Unless there is some agreement on how to allow CCPs to effectively operate across borders, there will be inefficient outcomes (See response to Q9. above). It is critical to obtaining an efficient international outcome that any Australian domestic clearing system is recognised by the US, European and other relevant foreign regulation. Even with this, it is possible that aspects of foreign regulation (such as the "swap execution facility" requirement under Dodd-Frank) could cause complications in the development or implementation of an Australian domestic clearing solution.

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?

We will require clarity on the capital treatment to be applied for trades cleared with a CCP whether direct or indirect. Clear and efficient treatment of capital treatment of CCP memberships and contributions is also required to enable assessment of the merits. Further, clarification as to the interaction between Australia's netting legislation and banking and insurance legislation needs to be provided in relation to the clearing arrangements (the current changes being considered seem only to apply to close-out netting contracts). In addition, the application of Australian Personal Property Securities Act to the new

arrangements should be clarified. Finally, the operation of the client money rules contained in Australia's Corporations Act should be clarified in the context of these arrangements.

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)?

Use if CCPs will increase due to cleared swap markets being more liquid (and therefore efficient) than uncleared, and the capital treatment. Domestic banks would use CCPs in foreign jurisdictions to achieve this.

We note that the nature of the responses above can change depending on the structure of which is proposed for an Australian clearing house. Accordingly, the answers to the questions that are posed depend on the model Australia adopts.