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September 1, 2011

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Dear Sir/Madam:

**Re: Central Clearing of OTC Derivatives in Australia**

The purpose of this letter is to respond to the request for submissions outlined in the Council of Financial Regulators' (Council) discussion paper *Central Clearing of OTC Derivatives in Australia*. We appreciate the opportunity to comment on the regulatory developments outlined by the Council, including the proposal to mandate domestic clearing of Australian dollar-denominated interest rate swaps.

In responding to the request, this submission is broken down into the following components:

1. Background on RBC
2. Factors to Consider in OTC Derivatives Markets Reforms
3. Response to Consultation Paper
4. Further Study

**1. Background on RBC**

RBC is Canada's largest bank as measured by assets and market capitalization. We are one of North America's leading diversified financial services companies and provide personal and commercial banking, wealth management services, insurance, corporate and investment banking and transaction processing services on a global basis. We employ approximately

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79,000 full-time and part-time employees who serve close to 18 million personal, businesses, public sector and institutional clients through offices in Canada, the U.S., Australia and 55 other countries.

RBC Capital Markets, the Corporate & Investment Banking division of RBC, provides a focused set of products and services to institutions, corporations, governments and high net worth clients around the world. With over 6300 professional and support staff, RBC Capital Markets operates out of 75 offices in 15 countries, including Australia. We work with clients in over 100 countries around the world to help them raise capital, access markets, mitigate risk and acquire or dispose of assets. The Australian operations of RBC Capital Markets employs approximately 180 professional and support staff providing products and advisory services to wholesale clients based in Australia, New Zealand and Asia.

In terms of derivatives markets in particular:

- largest in Canada: we are the largest domestic derivatives dealer in the Canadian market;
- trader in major international markets: we have significant derivatives trading operations in Toronto, London and in New York and are active in a number of derivatives markets across the globe, including Australia;
- hedge internal risk: we utilize derivatives in our own business to manage our risk portfolio;
- component of client offering: we provide derivatives products and services to our clients, including buy-side participants such as pension funds and corporate end users, to hedge their risks and to better manage their businesses.

By virtue of the scope of our operations, we bring a number of perspectives to bear on derivatives issues that may be of interest for the Council:

- experience with international regulatory developments: we are active in the global derivatives markets and are therefore involved first-hand with a number of developing international regulatory developments and trends;
- similar regulatory initiatives in Canada: we have had cooperative and ongoing discussions with public authorities in Canada on derivative market reform issues that are similar to those faced in Australia;
- diversified experience: we have insights into the derivatives market not only in the capacity of managing our own book, but also in terms of providing risk management services to a wide range of different clients and end users;
- involvement in Australian market: as a foreign bank, we are active in the Australian markets in serving our clients and therefore have a direct interest in any derivatives reforms that may impact on these markets.



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## 2. Factors to Consider in Guiding OTC Derivatives Regulatory Reforms

Our comments below on the Council's consultation paper are guided by the following factors/considerations that we believe are important in assessing the regulation of OTC derivatives markets more broadly:

- critical risk management tool: derivatives are a fundamentally important tool for both financial institutions and our clients to minimize risks and to help promote financial stability;
- support the need for reforms: while derivatives were not a cause of the financial crisis, we recognize and support the need to find ways to improve the functioning of these markets, including through initiatives such as standardization, transparency, central party clearing and the use of trading venues;
- efficient/effective regulation: any regulatory reforms for the derivatives markets should be designed to achieve specific, well-defined public policy objectives and should be as minimally intrusive and efficient as possible so as to minimize market disruptions for market participants who rely on these products;
- flexible/rely on markets: to the extent possible, regulatory reforms should be principles based – setting out general public policy parameters, while at the same time leaving as much flexibility as possible for market participants to meet these obligations through solutions that reflect commercial and economic realities;
- sound analysis: reforms should be made on the basis of analytical assessment, with consideration given to factors such as the availability of other internationally available venues to achieve public policy goals and an understanding of market implications if domestic options are adopted;
- international harmonization: reforms within individual jurisdictions must be harmonized with international regulatory developments in order to minimize the risks of: regulatory arbitrage; creating unlevel playing fields for market participants; enacting conflicting or inconsistent regulatory requirements; fragmenting or disrupting markets; generating unintended consequences for end users of these products;
- managed transition: implementation periods for the reforms must provide for a reasonable transition period to allow for the complex changes required to market structures, legal documentation and compliance regimes to be made.

## 3. Response to Consultation Paper

### Consultation Paper Proposals

Consistent with a number of the principles outlined above, we commend the Council for the initiative it has undertaken to outline its public policy objectives and proposed regulatory reforms for the purposes of public consultation before taking any final decisions in this area. This measured approach will be important in helping to ensure that the regulatory reforms

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ultimately enacted in Australia are consistent with international developments and minimize market disruptions for market users.

In reviewing the details of the paper, we have elected to provide a general response to the broad direction of the regulatory reform proposals rather than an individualized response to the specific questions that have been identified. Specifically, the focus of our comments will be on the concept of mandating domestic clearing for Australian dollar-denominated interest rate swaps (IRS's) and possibly future rate agreements (FRA's).

In discussing this option, the Council identified the following considerations in its paper:

1. Any mandatory requirement that a class of OTC derivatives be centrally cleared should reflect the following factors:
  - a. the potential reduction of systemic risk that might result from this move;
  - b. the viability of central clearing of that product class; and
  - c. the international harmonisation of clearing requirements across product classes.

As to the benefits of a mandatory requirement, the following factors were noted:

- a. having Australian agencies as the primary regulators of a CCP operating in the domestic market provides superior policy outcomes with respect to regulatory clarity, transparency and accountability;
- b. Australian regulators' capacity to intervene in crisis management scenarios is likely to be more straightforward with regards to a local CCP; and
- c. in enforcing a mandatory clearing requirement, undertaking clearing through Australian-domiciled CCP's avoids the prospect of Australian regulation having an outcome that would require Australian entities to submit to a foreign jurisdiction, if that was a consequence of directly or indirectly participating in a foreign-domiciled CCP.

At the same time, the possible negative consequences were also identified:

The agencies recognize that this may have detrimental effects on some market participants' capacity to net across products that might be cleared through other CCPs....a reduction in cross-currency or cross-product netting opportunities may result in increased costs due to additional collateral requirements. The Council agencies would be concerned if a consequence of this was a serious disruption to the functioning of domestic markets.

In the section immediately below we will expand upon some of the above considerations identified in the Council's paper.



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### Commentary on Mandatory Clearing

We are concerned about the trend towards jurisdictions imposing mandatory regulatory requirements on particular products:

- critical risk mitigation tool: as noted above, OTC derivatives products are an important vehicle for entities such as banks, pension funds and corporate end-users to manage risk;
- market reforms already underway: there are already substantial reforms underway that will dramatically impact the future of OTC derivatives markets. These reforms could increase the cost/pricing and limit access and choice, which could have broader negative implications on risk management, financial stability and broader economic growth over time, e.g.:
  - *higher capital costs/deleveraging of markets*: the imposition of higher capital levels will almost certainly contribute to the deleveraging of OTC derivatives market globally as the Basel III capital rules (in effect January 1, 2013 for international implementation, November 1, 2012 for Canadian banks) impose a significant increase in capital against OTC counterparty derivatives exposures. These capital increases can be expected to have a significant dampening impact on OTC derivatives risk intermediation with some derivatives products classes relatively more affected than others;
  - *deglobalization of the OTC derivatives markets*: historically, OTC derivatives markets have been characterized by a number of efficient features such as flexible bi-lateral relationships, principles-based regulation and global booking points and trading activity. Regulatory developments across a number of jurisdictions, however, including in the United States under Dodd-Frank, will contribute to the fragmentation of OTC derivatives markets as transaction booking moves into regional subsidiaries and away from global booking points. This will present significant organization design challenges for many market participants and introduce extra-territoriality concerns across jurisdictions;
  - *increased legal and compliance complexity and regulatory costs*: the legislative and regulatory initiatives currently underway, including through vehicles such as Dodd-Frank in the US, will trigger the need for widespread multi-party execution, clearing and margin segregation agreements between dealers, clients and CCPs. Existing bilateral OTC derivatives documentation will also need to be renegotiated and/or amended. The possibility of legal and documentation gridlock impacting market participants is a real concern. The costs related to these changes, particularly in areas such as mandated margin segregation in a clearing market as compared to a rehypothecated OTC bilateral market, could be substantial;
  - *global market consolidation*: the consolidation underway globally with exchange and clearing houses likely reflects the anticipation of future revenues migration from the OTC derivatives space into central execution

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and clearing venues. Whatever the motive, the restructuring underway in the market infrastructure space will, at least in the short term, complicate clearing venue risk assessment and decision making around clearing venue selection.

Taken together, the above changes that are already in progress will culminate in dramatic changes to the OTC derivatives markets that will inevitably have consequences for market participants, including both dealers and users of derivatives markets. Our concern is that the move towards mandated domestic clearing across a number of jurisdictions will only serve to exacerbate the negative consequences noted above. Specifically, there is a concern that the national jurisdiction biased approach relating to mandatory OTC clearing obligations will have a number of negative implications:

- market fragmentation: accentuating the pressure towards the fragmentation and de-globalization of OTC derivatives markets as transaction booking moves into regional subsidiaries and away from global booking points;
- legal complexity: creation of significant potential conflicts and organizational design challenges for many market participants arising from the extra-territorial application of laws;
- negative market impacts: loss of significant efficiencies and netting opportunities as markets become increasingly fragmented into narrow mandated product classes; risk that markets for domestic products may be too small/illiquid to warrant/support a domestic CCP, creating disruptions/dislocation in the markets for these products;
- competitiveness concerns for dealers: risk that anti-competitive concerns could arise as players subject to local mandated clearing rules are no longer in a position to compete or participate in global derivatives markets against larger players who may not be subject to the domestic clearing requirements and would have the flexibility to provide OTC derivative clearing and execution services on a global scale for their clients;
- implications for end-users: as markets fragment, costs could increase and access and choice may be more limited. Hedging/risk management could become more costly and complex contributing to reduced stability and negative broader economic consequences.

Positioning these concerns within a broader international context, you may be aware that in a letter dated July 5, 2011, ISDA and a number of other associations highlighted the following issues for regulators considering reforms in this area:

In September 2009, leaders of the G20 undertook to strengthen the international financial regulatory system. Shared G20 commitments included measures to ensure stricter rules on transparency, capital, counterparty risk (through clearing and other operational commitments) and trading of derivatives contracts. Considerable progress has been made on these commitments by G20 members, and it is clear that G20 leaders will successfully deliver them.



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Importantly, understanding the global nature of today's financial markets, the G20 also undertook to "take action at the national and international level to raise standards together so that our national authorities implement global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage."

The associations signing this letter are concerned that regulation in different G20 jurisdictions may be creating conditions which will lead to the above-mentioned harmful outcomes, ultimately decreasing the ability of global regulators to effectively regulate an increasingly global capital marketplace....

Extra-territorial application of one nation's laws to another nation's market and firms is a fundamental concern in a global market like derivatives, where it is common for counterparties based in different parts of the world to transact with each other.

Regulators should seek to agree on the standards for equivalence or recognition for CCPs in each others' jurisdiction – to avoid such ambiguity and to give CCPs and regulators the opportunity to meet the standards (also giving market participants the opportunity to prepare for compliance and to transition to a cleared environment for their trading activities). Equivalence is critical for rules on clearing as conflicting clearing requirements would be impossible to comply with if the rules of each of two different jurisdictions require a trade to be cleared in its jurisdiction.

Based on the above, we are concerned that the proliferation of mandatory domestic clearing requirements in a number of different jurisdictions will create the risk of significant market fragmentation, disruptions in markets and competitive dislocation that will have important negative consequences for not only dealers but for end users such as pension funds and corporations seeking to manage their risk through OTC derivatives products. Prices could increase, choice could decline and the markets could become much more concentrated and complex from a trading perspective.

#### **4. Further Study**

As suggested above, we are concerned that the existing and prospective regulatory developments will have significant negative consequences for market participants and that these will only be exacerbated through the imposition of mandatory domestic clearing requirements. Having said that, however, it is clear that the extent of these concerns will vary by jurisdiction and by product and that further analysis would be required to better understand the specific implications of the proposal to mandate domestic clearing for Australian dollar-denominated interest rate swaps.

In this regard, the Council may want to consider Canadian developments on this issue. In particular, recognizing the potential risks associated with a similar proposal for mandated clearing of Canadian-dollar-denominated interest rate swaps, industry participants are

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working closely with public authorities on a modeling initiative to better understand the possible consequences of a mandatory domestic clearing requirement for these products.

As part of this analysis, detailed scenarios are being developed on the following:

- the consequences of alternative OTC derivative clearing scenarios, assuming:
  - 1) various combinations of mandated vs. exempt Canadian counterparty participations;
  - 2) various combinations of Canadian dollar products inclusion; and
  - 3) alternative levels of foreign participation in the Canadian CCP
- the pricing, funding and capital implications of margin segregation vs. rehypothecation made under alternative scenarios for direct and third party OTC derivatives clearing;
- the potential for the Canadian CCP participants to achieve cross margining benefits with Canada future and repo clearing venues;
- the implications of increased Basel III capital requirements on cleared and non-cleared derivatives products, pricing, transfer of back books, and implications for foreign participation;
- the possible incentives that could be considered to attract foreign market players to participate in a domestic clearing option, with a particular focus on the implications of mandating domestic market participants to use just one clearing venue when other market competitors have access to alternative offshore CCPs.

The objective of this analysis will be to attempt to provide an empirical understanding on the following:

- public policy concerns: what is the extent of the systemic risk posed by the product in question? (i.e. while the notional values could be substantial, once considerations such as netting and the extent of existing clearing is taken into account, the net exposures may be quite low); would the negative market impacts outweigh any of the benefits to be gained in reducing risk?;
- market impacts/disruptions: what would be the impact of imposing a mandated clearing requirement on domestic dollar-denominated interest rate swaps? (e.g. is there sufficient liquidity in the market to sustain a domestic clearing venue?; what would be the impact on pricing/access/structure of the market for these products?; what are the impacts on margin requirements; what are the opportunities/limitations on cross-margining potential; what are the implications for cross-currency swaps?;
- implications for end users: would pricing increase?; would there be restricted access to products/suppliers?; would there be an incentive to use foreign dealers/markets?;
- implications for financial institutions/dealers: if domestic dealers are mandated to use the domestic clearing venue while their competitors could continue to use the venue of their choice, would the domestic dealers be able to compete?



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The overriding goal of this work is to provide a concrete model/data set to verify the implications regarding mandated domestic clearing. We believe that this information will be critically important in helping to inform the policy approach and regulatory options that Canada should consider on a going forward basis.

Given the similarities in the Australian approach to the options under consideration in Canada, the Council may want to consider undertaking a similar scenario modeling exercise. To facilitate this work, we would note that the analytical assessment we have undertaken in Canada is expected to be completed by October at which time we would be pleased to share the results with the Council. This type of analysis could be helpful in informing the specific responses outlined in the Council's paper.

While the above analytical work would take some time to complete, we would note that there seems to be some recognition in a number of jurisdictions, including the US and Europe, that it is better to take the time to get things right rather than to adhere to tight timelines that could create significant market disruptions. A related benefit of a measured approach is that it would allow time for international market and regulatory reforms to progress further which may provide further guidance on the shape of the scope of changes that may ultimately be required in markets such as Canada and Australia. As an example, international precedents could develop on the use of vehicles such as trade repositories and regulatory memoranda of understanding among regulators on issues such as clearing that could respond to domestic public policy concerns while at the same time promoting the consistency and international harmonization needed to ensure the ongoing stable functioning of these markets.

In closing, we would note once again that we appreciate the opportunity to comment on these issues and would be pleased to follow up if you have any questions or comments on the foregoing.

Sincerely,



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