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Council of Financial Regulators
GPO Box 3947
SYDNEY NSW 2001
AUSTRALIA

DISCUSSION PAPER: Central Clearing of OTC Derivatives in Australia

Reval.com, Inc. appreciates the opportunity to provide comments and observations on the Discussion Paper issued by the Council of Financial Regulators. Reval provides the leading web-based/Software-as-a-Service (SaaS) solution for derivative risk management and hedging accounting, and also offers a complementary suite of services including outsourcing. Reval offers financial executives front-to-back office capabilities for managing interest rate, foreign exchange, and commodity hedging portfolios, including integrated market data, pricing, risk management and reporting. Reval's client base spans over 500 of the world's largest organisations reporting under both IFRS and US accounting standards.

Reval has also been heavily involved in the Dodd-Frank Act implemented in the United States and the subsequent rules created by the Commodity Futures Trading Commission (CFTC). Our CEO, Jiro Okochi, testified on behalf of corporate end-users before the U.S. Senate Agriculture Committee in 2009. In this capacity he is a member of the Global Markets Advisory Committee to the U.S. Commodity Futures Trading Commission and was named one of the 100 Most Influential People in Finance by Treasury & Risk magazine for a third time since 2003. Our involvement in the US process, alongside our discussions with regulators and major players and clients throughout the world, guides us in our observations outlined in the comments below.

Although Reval does not have any specific observations on the additional queries around Australian domiciled CCPs or the jurisdictional matters, I would like to use this opportunity to stress the importance of ensuring that end-users of derivatives are not forced to clear any trades nor have margin imposed for un-cleared trades. As you are probably aware, the U.S. agencies and the European Commission are proposing an end-user clearing exemption subject to meeting some basic requirements. I would hope that the Council of Financial Regulators will closely mirror this important end-user exemption from mandatory clearing.

An exemption from margining and capital requirements for un-cleared OTC derivative transactions would also be well received by the end-user community and would promote swap business to the Australian markets as currently the Prudential regulators in the U.S. seem to be leaning towards margin requirements for all swaps, albeit a possibility of a threshold amount for non-financial corporations. In our opinion this largely nullifies the benefit and intent of the end-user clearing exemption as companies will either find it too costly to enter into un-cleared trades or unable to find a market for illiquid or customized swap transactions.

Regards,

Jiro Okochi
Chief Executive Office
Reval.com, Inc.

REVAL RESPONSE

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?

Interest rate derivatives typically are the most long-dated of instruments and therefore provide the greatest scope for significant credit risk. The Council should ensure that cross currency interest rate swaps are included within such a definition including the fixed to fixed variety as many would often consider these currency instruments yet the credit risk associated with such instruments is often greater than domestic interest rate derivatives.

There are OTC derivatives in the currency and in particular, commodity asset classes can be long-dated and complex such that the Council should consider for central clearing. This would also be consistent with other jurisdictions such as the US market, where only foreign exchange forwards and swaps have been specifically excluded from central clearing.

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

All OTC derivatives should be eligible for central clearance for major participants with an exclusion provided for end-users of these instruments. We do not see any specific attributes that would make central clearing not feasible although in more complex instruments, there are a number of practical considerations that need to be considered.

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 with the suggestion that interest rate derivatives are of significant volume to be viably centrally cleared for major participants.

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.

From a systems perspective, the costs of moving certain derivatives to central clearing are significant. Banks and CCP's will need to build new interfaces for trades and collateral with sufficient granularity such that the respective valuations of each derivative are aligned (within a given tolerance). This will likely require an upgrade of the banks internal software to meet such requirements.

In spite of this, a lot of time will be spent reconciling fair values between the banks and the CCP – particularly if each entity uses its own bespoke valuation models. Banks may end up supporting two valuation models – the current model for internal use, pricing and risk management, and a second model that is reconciled to the CCP and used for calculating margin requirements.

Another challenge will be matching transactions to deal confirmations. Often, a transaction is booked into the banking system as components, whereas the deal confirmation usually presents the total solution altogether. This will make it very difficult for the CCP to reconcile transactions together.

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 agree with the proposed criteria as they reference back to the underlying goals of central clearing.

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)

We agree as it appears consistent with global approaches to the criteria for clearing. Reval also agrees that end-users would likely be exempt from clearing as a result of these criteria as they will be globally.

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

Limiting the scope to interest rate derivatives opens the door for the creation of derivatives that do not meet the definition of an "Interest Rate Derivative" for central clearing purposes but contains similar cash flows and meets the hedging strategy of an interest rate derivative.

Reval suggests the Council follows the US approach for selecting ALL derivative instruments for clearing and then determining which lower risk instruments that can be opted out such as FX forwards and swap transactions. This represents a more robust methodology in an environment where new instruments are created frequently and often cater for multiple asset classes simultaneously.