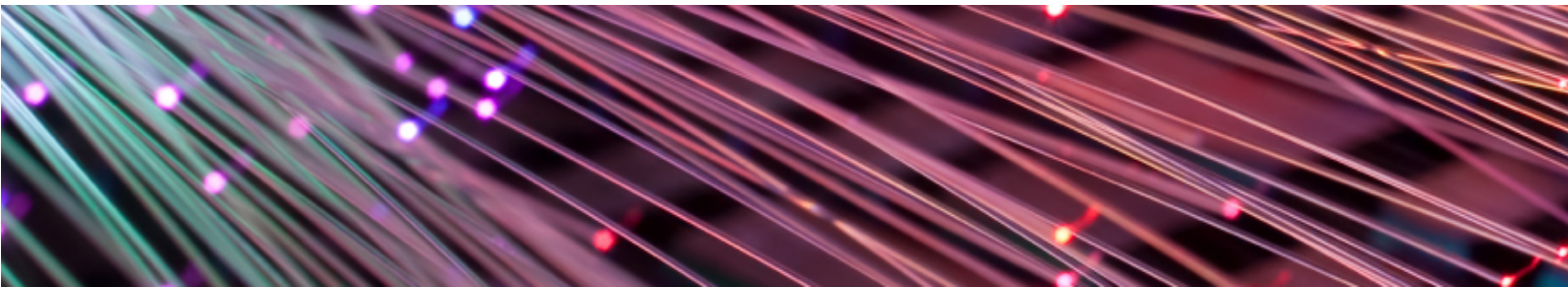




# Central Clearing of OTC Derivatives in Australia

(Discussion Paper issued by the Council of Financial Regulators (CFR) - June 2011)



## ASX Clearing Corporation Response

1 September 2011

---

# T A B L E O F C O N T E N T S

1.	Executive Summary.....	3
2.	Introduction.....	3
3.	ASX Responses to CFR Discussion Paper Questions.....	7

---

## 1. Executive Summary

- Following the Global Financial Crisis, the G20 and underlying national regulatory bodies have been working towards a stated goal of having all standardised OTC derivative products centrally cleared by end 2012.
- The rapidly developing regulatory structure for OTC Derivatives in the US in particular will result in central clearing requirements for Australian market participants and domestic market OTC derivatives activity.
- To date, uncertainty regarding Australian regulatory requirements has meant that Australian OTC derivatives market participants have not been able to commit to an appropriate solution (domestic or offshore) to meet expected central clearing requirements for standardised OTC derivative products traded in the domestic market.
- Further delays in providing clarity on the Australian regulatory framework within which domestic centralised OTC derivative clearing requirements need to operate is likely to result in a larger and perhaps even dominant share of domestically transacted Australian dollar-denominated OTC derivatives activity being centrally cleared offshore. This could significantly limit the ability of domestic regulators to manage systemic risk in the Australian financial system.
- The ASX Group includes existing licensed providers of central clearing services to the Australian market, and has been engaging with stakeholders and technology providers on developing a domestic solution for OTC derivatives clearing. The ASX Group is confident that it can provide a cost effective and timely solution, subject to near term domestic regulatory clarity, for the Australian market.

## 2. Introduction

The Council of Financial Regulators discussion paper on central clearing of over the counter (OTC) derivatives in Australia provides a comprehensive description of the current OTC derivatives landscape and the challenges and opportunities facing global and domestic regulators, market participants and central counterparties (CCPs). The discussion paper provides for further discussion of these issues by a broad range of stakeholders. ASX Clearing Corporation Limited (ASX), as the intermediate holding company within the ASX Group of two domestically licensed clearing facilities, welcomes the opportunity to provide its perspective on the issue of Australian OTC derivatives central clearing requirements. This perspective is based on ASX's extensive experience in central clearing in the Australian regulatory and market environment and also on wide ranging stakeholder discussions on this topic held by ASX over the last 18 months.

### The Changing Global Regulatory Environment for OTC Derivatives

Since the market events of 2008 that led to the global financial crisis, the approach to regulation of OTC derivatives markets has changed substantially. This has been signified by the commitment by the members of G20, including the Australian government, to work collaboratively to facilitate the central clearing of standardised OTC derivatives transactions by the end of 2012. This shift in regulatory approach recognises that there is likely to be a significant change to global and domestic OTC derivative market structures associated with the widespread move to the use of central counterparty clearing. However, it appears that regulators see this potential market impact as reasonable and warranted on the basis that centrally cleared markets working in conjunction with more stringent prudential capital requirements and enhanced standards for market infrastructures will significantly reduce systemic risk. From an industry perspective, many market participants were slow to adjust to this new landscape but are now actively preparing themselves to meet these new regulatory requirements. Regulatory clarity on mandate requirements in offshore jurisdictions has been helpful in creating a more concrete basis for investment in

---

technology and operations capabilities, and in engagement with service providers (CCPs and third party clearers) to facilitate central clearing.

Outside Australia, significant movement has already occurred towards the development of these new market structures. The US, in particular, is well advanced in its regulatory efforts to encourage the emergence of a central clearing infrastructure to support OTC derivatives. The Commodity Futures Trading Commission currently anticipates that it will conclude the drafting of rules covering OTC derivatives markets and participants by the end of 2011, with the prospect that these regulations will come into effect in the first half of 2012. It has also recently become clear, that the US regulations will reach beyond the USA and require central clearing for designated instruments (regardless of the currency of denomination of those instruments) at clearing houses recognised by the US authorities. Europe is also moving ahead with its regulatory change, though not at the same pace as the US. However, it seems highly likely that by the end of 2012 at the latest, mandatory clearing will impact participants both offshore and in Australia, including domestic Australian institutions and their counterparties.

### **Impact on OTC Derivatives Market Participants**

Though Australian dollar-denominated OTC derivatives activity (interest rate activity in particular) is primarily transacted locally on the back of domestic commercial and economic activity, Australia's market is composed of a significant number of international banks. In addition, major domestic financial institutions have, to varying degrees, offshore funding, portfolio management and trading requirements which result in their participation in the US, European and in some cases Asian OTC derivatives markets. Some domestic banks have indicated that they are already taking steps to facilitate their participation in centrally cleared markets offshore that have mandated OTC derivatives clearing. Domestic financial institutions are also waiting for clarity on Australian regulatory requirements for OTC derivatives clearing before engaging in further exploration of their domestic solution requirements.

Major international banks already have significant association or familiarity with central clearing structures through their participation in CCPs in other jurisdictions and through their global exchange-traded derivatives businesses. However, the proposed regulatory changes in the US are having a significant impact and seem likely to result in a requirement to support their global trading activity through multiple clearing houses across numerous regulatory jurisdictions. This is a somewhat unpalatable prospect for such entities due to the additional costs (operational, legal, collateral inefficiencies, etc) and complications resulting from a fragmented market structure. A number of these larger institutions have promoted an alternative vision of a single global central clearing house to mitigate the costs of fragmentation and to deliver the benefits of standardisation across a range of markets. However, regulators, CCPs and many market participants currently acknowledge that this is a highly unlikely outcome given that it would tend to increase concentration risk, require a single regulatory structure extending across national boundaries and would be unlikely to fully meet the needs of regional markets and their participants. Accordingly, many international banks together with exchanges and CCPs are increasingly focussing on more pragmatic solutions to avoid these issues through, for example, the creation of domestic services that combine central clearing coverage of exchange-traded and OTC derivatives.

Realistically, it is more likely that a number of domestic clearing houses will emerge to service OTC derivatives markets. In some cases there is likely to be sufficient market scale (e.g. the US and Europe) for competition amongst multiple clearing houses in the same national or regional market, while in others (e.g. some Asia-Pacific markets) there is more likely to be only one viable clearing house in the medium term given the volume and value of OTC derivatives activity.

ASX has had discussions with regulators, market participants, and other clearing houses on the feasibility of direct CCP linkages to facilitate a reduction in OTC derivatives market fragmentation. However, the broadly accepted conclusion at this stage is that such linkages between CCPs will be difficult to establish in

---

the near to medium-term given the cross-border systemic risk and regulatory issues that they raise. Indeed to date, there have not been any announcements of intended cross-border linkages for OTC derivatives between separate CCP service providers.

ASX is continuing to engage with potential partners and regulators on developing models that could facilitate cross border CCP linkages to mitigate the fragmentation of collateral pools. In advance of resolving these CCP linkage issues, CCPs should still work to ensure that service models across different regulatory jurisdictions are aligned to the greatest possible extent in terms of risk (margining and collateral), default management and legal (e.g. novation documentation) considerations. Clearing model standardisation can still benefit the globally interconnected OTC derivatives markets in the near term by reducing operational process disparities and by laying a foundation for cross-border CCP linkages in the future.

## **Developments in Central Clearing Service Competition and Technology**

The prospect of a larger volume of OTC derivatives activity being centrally cleared is creating heightened competition amongst CCPs. In the US a number of providers (CME, IDCG, NYPC, SwapClear, ICE) are positioning themselves to provide domestic market services. In Europe, SwapClear as an incumbent provider has a strong position, but is already being challenged in this role by Eurex and now by CME. CME is exploring the development of a cross Atlantic link to provide services across both the US and European markets through related corporate entities. However, there are still questions on whether related CCPs operating in different regulatory jurisdictions and markets will be allowed to interoperate or whether this would be commercially viable given CCP cross collateral needs. Issues of national regulatory control, the responsible central bank for CCP liquidity provision and cross-border contagion still apply and remain difficult to resolve. For the moment, it seems likely that stand-alone CCPs will need to operate within their separate domestic regulatory jurisdictions.

For Australia, this current industry trend towards greater competition means that local users are likely to have a choice of potential service providers (in addition to the ASX) even in the case of a requirement to have a domestically located CCP solution.

For offshore-based central clearing solutions some domestic financial institutions may have difficulty in directly accessing such services as they are currently structured, and even if they could participate, would potentially open themselves to unwanted contagion risk from non A\$ related activity. In addition, default fund capital, risk collateral and regulation of these offshore CCPs would reside outside Australia, complicating any attempts to extend Australian legal jurisdiction or regulatory authority over their operations; which is likely to be problematic for Australian regulators especially at times of crisis. It would be possible for an offshore CCP to seek to develop a stand-alone CCP operation in Australia to meet domestic regulatory and market service requirements. However, this structure would most likely require the creation of a new Australian domiciled default fund structure which is likely to be less cost and capital efficient as ASX's solution approach which would seek to leverage its existing ASX Clear (Futures) default fund structure which takes advantage of an existing A\$250 million ASX capital commitment

The prospect of significant growth in the volume of centrally cleared activity globally has encouraged the development of a number of OTC derivatives-related technology solutions for CCPs. Over the past several years new OTC clearing solutions have been developed and implemented at a number of major CCPs globally. These central clearing platforms have incorporated derivatives industry standards such as direct connectivity with market affirmation engines for trade capture, the ability to incorporate third party trade compression services, configurable risk management modules (e.g. VaR) that facilitate CCP risk modelling and scenario testing capabilities, as well as timely novation functionality for OTC market transactions. Some of these systems can also be easily extended to cover new currency and OTC product types, have

---

flexible participant and account structure models, and can connect with a variety of collateral management systems.

In short, the complexity in developing OTC derivatives central clearing technical solutions has reduced substantially over the last several years. These virtually off-the-shelf solutions have incorporated many global market standards in their structure and have significantly reduced the cost and start-up time frame for new service providers. In addition, there is also a broad availability of service implementation partners that bring additional expertise and knowledge captured from recent work on implementing these new systems at major global CCPs across a range of regulatory jurisdictions. ASX has been actively engaging with a number of potential technology solution providers and implementation partners since the beginning of 2011 to assess system functionality and implementation timeframes for the development of its solution should an Australian domestic OTC derivatives central clearing service be required.

## Conclusion

The Council of Financial Regulators discussion paper provides not just an opportunity to capture broad stakeholder views on the subject of central clearing for OTC derivative markets in Australia, but also the prospect of much needed clarity on the regulatory framework within which such central clearing will be required to operate. As discussed above, the diverse drivers of each individual financial institution's derivatives business (whether domestic or international) has made a commercial resolution on an Australian market central clearing solution unachievable to date. The ASX's own experience in exploring service opportunities with potential users has been constructive but has been limited by the uncertainty about the regulatory requirements for clearing of Australian market OTC derivatives activity. This, to some extent, has been influenced by the initial uncertainty about the regulatory approach being taken in the US and Europe. However, even as financial institutions have increasingly begun to accept that Australian market activity will need to be cleared given the greater clarity on US and European regulatory requirements and a more widespread acceptance of the G20 goals, there is continuing uncertainty on the threshold issue of whether domestic regulators will accept an offshore based solution for the Australian markets.

Given the current developments in clearing regulation in the US in particular, it seems increasingly likely that if no decision on the Australian regulatory approach is taken soon, then by default a greater and perhaps dominant share of Australian market activity may need to be cleared by offshore based CCPs to facilitate domestic market participant transactions with US and potentially European entities, that are subject to mandatory clearing requirements imposed by those jurisdictions. The consequences of this would be significant for the domestic market including a loss of domestic regulatory oversight over a systemically important market in Australia, the potential offshoring of the Australian dollar OTC derivatives market and the significant undermining of Australia's role as a regional financial centre.

ASX agrees with the regulators' proposals on the scope (in terms of products and coverage of market participants) for the Australian OTC derivatives market and will be able to offer a cost effective and competitive solution that would be directly under Australian regulatory control and would ensure that collateral and capital supporting the service remained onshore. An ASX offering would also support the direct involvement of domestic market users in the solution design and offer them value through the development of appropriate governance and commercial arrangements to balance user cost containment requirements and service provider return objectives. The use of an ASX service could also provide for domestic market efficiencies from margin offset arrangements between OTC interest rate derivatives products and ASX listed exchange traded interest rate derivatives contracts.

In addition, ASX is also actively exploring the development of bilateral collateral management services for the Australian market that could introduce significant efficiencies and risk reductions in relation to non-



---

centrally cleared OTC derivatives activity. This service could help mitigate the effects of splitting existing bilateral OTC derivatives portfolios through the central clearing of viable product classes.

On this basis, ASX believes that there is a cost effective OTC derivatives central clearing solution available for the domestic market. However, to achieve the G20 timeframes it is important that domestic regulatory direction is established, and that market participants have an opportunity to engage with prospective service providers (including ASX) to determine their preferred solution.

### **3. ASX Responses to CFR Discussion Paper Questions**

#### *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?*

#### **Products Amenable to Central Clearing**

A number of Australian dollar denominated OTC derivative product classes meet the main requirements for central clearing. These requirements include a high degree of product standardisation, good levels of market liquidity and a broad range of end users participating in the market for these products. The availability of other liquid exchange traded products to potentially hedge such portfolios is also beneficial by adding a further layer of risk management capability for the clearing house and its participants. For such products central clearing will result in multi-lateral netting benefits and potential cross-margining benefits, especially if cleared by the same CCP that clears related exchange traded products. In addition, these product characteristics and market conditions will provide the CCP with a capability to manage participant default events through the potential auction of defaulted positions to other clearing house participants.

Based on existing market activity information and on discussions with market participants and technology vendors, ASX considers the following products to be amenable to central clearing:

- A\$ denominated Interest Rate Swaps
- A\$ denominated Overnight Index Swaps
- A\$ denominated Forward Rate Agreements

#### **Products Less Amenable to Central Clearing**

A number of classes of Australian OTC derivatives products (e.g. FX related OTC derivatives, OTC interest rate options and credit default swaps) are potentially less amenable to central clearing.

Foreign exchange related OTC derivative products pose several challenges to their cost effective inclusion in a central clearing structure. These arise from characteristics related to the exchange of principal inherent in foreign exchange derivatives transactions and result in:

- a) Increased counterparty risk throughout the life of the transaction arising from the FX risk on the final exchange of principal
- b) Increased liquidity and settlement risks associated with the FX component of the transactions

Whilst it is possible to create a centrally cleared solution to manage these risks, the potential additional margin and default fund requirements would impose a higher cost increase to users of the products as compared with the more standardised or more liquid interest rate derivatives products. In contrast, banks will generally accept a degree of unhedged FX settlement risk with their counterparties. Clearing houses

---

are also disadvantaged at present, relative to banks, by their inability to participate directly in the Continuous Linked Settlement (CLS) process where large banks in particular can achieve FX settlement risk management and netting efficiencies through their participation.

In the case of cross currency swaps the Australian market is in a somewhat unique position. The substantial offshore fund raising activity of the major domestic banks and the requirement to swap the proceeds of these debt raisings in US\$, Euro or Yen into Australian dollars results in substantial one sided cross currency swap positions for these institutions with the international banks that operate in the domestic market generally standing on the other side of these transactions.

It is likely that the inclusion of such transactions in a portfolio of centrally cleared OTC derivatives would provide multilateral risk and payment netting benefits on the A\$ legs against other cleared A\$ swap activity. In addition, the CCP process of centralised margining, would create a more robust system wide process of managing risk. However, as outlined above, it is also likely that the CCP margin requirements for these transactions would raise the risk management costs faced by clearing participants. CCP default management for this activity may also be challenging, given the relatively narrow range of counterparties, the one-sided nature of the market and the scale of existing positions.

On the other hand, central clearing would likely provide increased transparency on cross currency swap positions to the regulators, allow a central focal point for default management and through the mechanism of mutualisation of risk through the CCP, encourage a collaborative approach to the management of default situations. ASX is continuing to explore cost effective methods of centrally clearing cross currency swaps and would note that no standard international approach to clearing cross currency swaps, nor for that matter an actual cross currency swap central clearing service, has yet been developed.

For A\$ denominated interest rate options and credit default swaps, though there is a reasonable degree of product standardisation, there are a limited number of participants in this market and liquidity and activity levels are generally low. ASX is of the view that these products could be cleared, but given the relatively small size of this market it may be that the costs of central clearing may outweigh the benefits to users unless some users obtain significant portfolio benefits from inclusion of these products in the overall portfolio of products that they clear with one CCP. ASX suggests that before a centralised clearing requirement for these products is given further consideration, the viability should be tested with market participants; ASX's current view is that given the scale of activity, and the fact that this activity does not currently appear to be systemically important, a central clearing requirement should not apply to such products.

Less amenable to Central Clearing:

- Foreign exchange Swaps
- Foreign currency options
- Cross-Currency Swaps
- Interest rate options
- Credit default swaps

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

ASX has an existing robust risk mitigation framework for centrally clearing products. Providing the underlying products have sufficient demand and liquidity, OTC products would be brought within the ASX clearing and default management processes which are currently in place.

Specifically ASX considers that the following characteristics are required in order to ensure a CCP does not face excessive risks clearing OTC derivatives.

- There must be sufficient liquidity



- 
- The derivative product or the underlying instrument must be liquid, the exposure must be able to be closed out in a timely fashion and the derivative product must be able to be accurately priced and margined.
  - The derivative product must have a high level of integrity
    - The derivative product must be a clearly defined financial instrument with satisfactory legal integrity and the markets in this product should not be subject to manipulation.
  - Positions must not be highly concentrated especially among low credit quality participants,

By extending this framework to OTC markets ASX considers that the following list of instruments appear to be feasible for mandatory clearing.

- Interest Rate Swaps
- Overnight Index Swaps
- Forward Rate Agreements

The above list is not exhaustive and there may be other OTC instruments which could be subject to a central clearing requirement in Australia.

*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?*

ASX supports the position put in the Council of Financial Regulators' paper that a number of A\$ denominated interest rate derivative products (specifically interest rate swaps, overnight index swaps and forward rate agreements) have sufficient volume of activity to be viable as centrally cleared products. This is on the basis that approximately 90% of A\$ interest rate derivatives activity is transacted in Australia and on the assumption that a domestic central clearing mandate, preferably including client clearing requirements, would result in this activity being cleared onshore. ASX's assessment is that a CCP that captured this scale of activity would be able to provide a commercially viable clearing service based on a domestic operational and default fund structure.

*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.*

ASX has adopted broad interpretation of this question in its response below. It has assumed that the regulators are interested in information or views not just on the cost implications of transitioning from bilaterally managed to central clearing of certain classes of OTC derivatives products but also on the ongoing costs relating to use of a central clearing service. ASX is not in a position to provide data on such costs, however ASX has sought to outline some of the elements of these costs and potential offsetting benefits, that could be used to guide an assessment of the economic implications of a regulatory decision to require central clearing for certain classes of OTC derivative products.

Although comparisons of the cost between bilateral and central clearing are not readily available, ASX considers that domestically based CCPs will be able to provide cost efficiencies for OTC derivatives clearing. It is important to note that commercial rather than regulatory drivers led to the development of OTC clearing in the first instance. The actual impact on users of such products would depend on a number of factors, such as:

- the relative size and risk of centrally and bilaterally cleared activity in a participant's overall portfolio of OTC derivatives;
- the relative size of prudential capital requirements for bilaterally cleared activity (higher) as compared with centrally cleared activity (lower);

- 
- the degree of sophistication and operational efficiency of a participant's bilateral collateralisation activity; and
  - the ongoing technology costs for a participant associated with managing bilateral activity relative to those faced by it as a direct clearer, or indirect user of a CCP service.

### **Additional Costs from Central Clearing**

In terms of additional costs, market participants would be subject to CCP transaction and risk management fees for cleared OTC activity. The related use of initial margin might also increase the collateralisation requirement for some market participants, but only if they don't obtain offsetting multilateral netting or prudential capital benefits from using a CCP service. There is also a risk that separating out some transaction classes from a bilateral portfolio of OTC derivatives may increase the collateral requirements for that portfolio (from a reduction in the portfolio effect for bilateral activity). In addition, there may be a requirement for risk capital contributions towards a CCP default fund supporting the OTC service.

Any fragmentation of central clearing of different product classes may have an adverse impact on global market participants through an inability to manage multi-product and multicurrency portfolios with either a single or limited number of CCPs. This may increase collateral requirements and potentially technology and operational requirements for such entities.

### **Netting, Operational and Prudential Capital Benefits**

Multi-lateral netting of risk positions and netted cash settlements can provide substantial savings for market participants in terms of risk capital and settlement related operational costs and fees. In addition, a streamlined mark to market and margining process underlying a centrally cleared service is likely to have significant risk reduction benefits for all users by avoiding mark to market dispute resolution issues in the bilateral exposure management process and speeding up the collateralisation of open risk positions. There is also the prospect of additional margining efficiencies arising from the cross-margining benefits between OTC and relevant exchange traded derivatives activity. This could be particularly helpful in the Australian market context as a relatively large proportion of A\$ OTC interest rate derivatives activity is hedged with exchange traded futures due to the relatively small size of Australian Government bond issuance. The use of a central clearing service would also result in a significant reduction in prudential capital required to manage an OTC derivatives portfolio as compared with bilaterally managed transactions.

### **ASX Default Fund Capital Benefit**

ASX Clear (Futures) is well positioned to provide an OTC derivatives service given that it currently has a \$400 million default fund to support multilateral clearing of exchange traded derivatives. The size of this fund is scalable in line with the risks associated with centrally clearing OTC derivatives. OTC derivative users are also able to benefit from the established, liquid trading in exchange traded debt instruments on ASX Clear (Futures) which could in the future generate margin offsets for market users. In addition ASX Clear (Futures) has established operational processes and connectivity to the majority of users of these products which would further increase efficiencies to users.

Overall, ASX is of the view that the domestically managed central clearing of viable products, which together account for a significant share of the volume and value of A\$ OTC derivatives transactions, could generate net benefits to a broad range of product users. This would occur through risk capital and operational efficiencies and for regulators, through a significant reduction in systemic risk and greater transparency of market activity. The use of CCP services globally for exchange traded activity, and in some markets for OTC derivatives activity even in the absence of a regulatory mandate, underscores the efficiency and net market benefits from this approach.

---

## **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? 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.*

ASX agrees with the proposed criteria and would add that there are some additional considerations underlying these criteria for determining the suitability of a central clearing mandate. In the first instance, any assessment of potential systemic risk reduction should include an analysis on the relative effectiveness of a proposed central clearing structure in meeting domestic systemic risk management objectives. As an example, a central clearing service for the Australian market operated from offshore (based on capital held offshore and with offshore operational activity), under a foreign regulatory jurisdiction and with Australian activity making up only a small share of overall cleared activity, may not significantly improve the systemic risk position of the Australian market. It could be argued that such a structure would actually detract from this position by increasing the risk of default contagion from unrelated offshore market activity.

In addition, while the international harmonisation of clearing requirements across product classes is an important consideration for a domestic central clearing requirement, there may be local market conditions that suggest different solution requirements specific to Australia for certain product classes. A case in point is cross currency swap activity originating in Australia. This product class would initially appear to benefit from inclusion in a central clearing requirement, given the systemically important nature of offshore funding and related swap hedging for the domestic financial system. However, in this particular case, these products may not currently be viable for central clearing (see the response to Question 1). Another example is the credit default swap (CDS) product class. Although there has been a strong focus on requiring central clearing for CDS activity offshore, the current low levels of trading in CDS within Australia suggest that there is no need for a central clearing requirement at this time. In summary, the structure of a mandatory central clearing requirement should be flexible enough to allow consideration of additional product classes over time, and alignment of the domestic centrally cleared market with the standardised offshore clearing approach, while also providing the domestic market with a materially improved systemic risk position.

*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?*

*Similarly, the determination of the market participants to whom a mandatory clearing requirement would apply should reflect:*

- a. the potential contribution to systemic risk of these participants; and*
- b. harmonisation with international requirements.*

ASX agrees with these criteria and would rank “the potential contribution to systemic risk of these participants” well ahead of a “harmonisation with international requirements”. This approach would ensure a greater emphasis being placed on domestic market risk management requirements which can vary significantly from those in offshore jurisdictions – i.e. some product classes or participant types may have a greater importance in a domestic market. However, at the current time, it does appear that the bulk of Australian domestic OTC derivatives activity is concentrated amongst Authorised Deposit-Taking Institutions (ADIs), Australian Financial Services License (AFSL) holders and the representative institutions of foreign banks. It is likely that a mandatory clearing requirement that extended to this group of entities would optimise systemic risk reduction for the Australian financial system.

---

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

ASX would recommend that at this time, a central clearing mandate should exempt the following product classes for reasons detailed in the responses to the questions above:

- FX forwards
- FX swaps
- Cross currency swaps
- Interest rate options
- Credit Default Swaps

However, any mandatory clearing requirement should be flexible to consider inclusion of these products at a future date subject to the viability of their clearing and the importance of their inclusion to improve the systemic risk position for the Australian financial system. This could be managed through a regular annual review process of product class coverage of a central clearing mandate undertaken by either the RBA or the Council of Financial Regulators and a clear statement of the criteria that would be used as the basis for a product class being brought within a mandatory requirement for central clearing.

In terms of exemptions for particular participants, the ASX would suggest that at most, only non-financial corporates should be exempted from a mandatory central clearing requirement, in consideration of their relatively low levels of participation in the Australian interest rate derivatives market. However, it may be worthwhile considering value of activity based criteria for such entities inclusion in a mandatory clearing requirement. From a systemic risk perspective it would be most effective to capture all activity undertaken in the product class that is required to be centrally cleared.

With regard to Australian government entities, ASX would recommend that such entities are also included in a mandatory clearing requirement to broaden the systemic risk benefits of a central clearing solution. Though the inclusion of Government entities would result in a requirement to cover their positions with the clearing house with initial and variation margin, they would benefit from multilateral netting of positions, streamlined risk and operational processes and the potential to transact with a larger range of OTC market counterparties.

### ***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?*

ASX agrees with this proposition on the basis that Australian dollar denominated interest rate derivatives transactions are systemically important for the domestic financial system. A counterparty default relating to these instruments could cause a significant dislocation across financial institutions, corporates and retail users of financial services in Australia. Given the scale of OTC interest rate derivatives transactions and their critical nature in managing, for example, term interest rate risk for bank balance sheets and mortgage lending portfolios, significant price movements in these OTC derivative products or a failure in the operation of these markets caused by a major derivative market participant default would have substantial economic consequences in Australia.

Whether a CCP service for the Australian market, including related default management processes, should be allowed to be subject to regulation by an offshore regulator is a policy matter for Australian regulatory authorities.

---

One area of complication which would need to be considered if such an approach were allowed by policy makers is that differences in insolvency regimes between various countries/regulatory jurisdictions could also impact on the effectiveness of default management processes relating to Australian market activity with domestic market participants potentially facing gaps between domestic and offshore rights and obligations relating to risk collateral. This issue would also impact on the ability of an offshore based CCP to align its client clearing functionality with Australian legal and regulatory requirements.

Finally, by definition, the use of an offshore clearing house that clears activity in foreign markets would increase contagion risk from those markets to the domestic market. The Global Financial Crisis highlighted the relative strength of the Australian approach to the regulation of financial institutions, critical market infrastructure and of systemic risk. Looking forward, it will be no less important for Australian regulators to exert influence over the resolution of crises for systemically important domestic activity and to limit the contagion from offshore market failures to the Australian financial system. Given the inherent inter-connectivity of global financial markets, this is not an easy task; however, the impact of any decision which enables systemically important domestic financial activity to be managed in an offshore based and regulated risk management system (an offshore based CCP service) needs to be carefully considered by Australian regulators.

*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.*

### **Domestic CCP Benefits and Drawbacks**

ASX is not in a position to provide quantitative data on the relative costs and benefits relating to the use of either a domestic or offshore based solution to service a mandatory clearing requirement. However, ASX has sought to provide its views on the benefits and drawbacks of either solution below.

The use of a domestic CCP for mandatory clearing of Australian OTC derivatives activity would generally have a number of positive implications for domestic users (as the domestic CCP should be able to efficiently deliver its service in terms of upfront technology, human resource and risk capital costs). ASX's proposed approach would allow the design and ongoing evolution of the CCP service to align with domestic market requirements through direct involvement of domestic market stakeholders in commercial discussions and through a CCP advisory council (with clearing participant and regulator participation) to provide a forum for consultation on such matters as the determination of clearing house participation requirements, client clearing and account portability functionality, revaluation curve construction, new product timetables etc.

As a result of this proposed approach, CCP membership requirements would likely suit a broader range of local market participants as compared with offshore CCP structures – i.e. medium sized financial institutions and entities with a primarily domestic market focus could also potentially directly participate in the domestic CCP. For domestic financial institutions direct participation would reduce prudential capital requirements to support their OTC derivatives activity and hence provide them with a continuing ability to compete on costs (in relation to risk capital) for the provision of OTC derivatives services in the domestic market. Use of a domestic CCP would also provide domestic market participants with assurance that contractual structures, default management and collateral are covered by domestic regulations and domestic laws and aligned with domestic financial market practice.



---

An ASX solution would also provide the benefit of margin offset with ASX listed exchange traded products that correlate with cleared OTC derivative products.

A potential drawback from a domestic CCP structure is that for international bank participants in the domestic market and to some extent for domestic banks that are active in offshore markets, there could be a fragmentation of collateral applied to cover their centrally cleared derivative positions and the additional operational and connectivity costs of linking to multiple CCPs. However, even if a domestic market service was provided by an offshore CCP, it is likely that these financial institutions would be required to use multiple CCPs offshore; the domestic CCP would simply add another required connection within this network. These costs of central clearing fragmentation can be mitigated by aligning the domestic CCPs model and processes with globally accepted standards and through use of existing infrastructure and default fund capital to reduce the set up costs for domestic users (including international bank participants) in the domestic market.

### **Offshore CCP Benefits and Drawbacks**

The benefits of using an offshore based CCP for centrally clearing domestic market activity primarily accrue to globally active international banks. This benefit would potentially be in the form of less risk collateral and default fund capital fragmentation, potentially lower transaction costs given the scale created through aggregation of market activity from multiple jurisdictions and the ability to streamline operational processes (including default management processes) into fewer central clearing platforms.

More moderately sized domestic financial institutions are unlikely to obtain any of these benefits due to the size barriers to obtaining direct access to large offshore based CCPs for OTC clearing services. This would potentially put them at a competitive disadvantage to larger financial institutions that could access the CCP – in effect smaller entities would need to use third party clearing services from international bank clearing arms to allow them to trade in both domestic and offshore OTC derivatives markets. This would raise their prudential capital costs relating to OTC derivatives activity and also from a systemic risk perspective, concentrate OTC derivatives activity across multiple markets with a small number of third party clearers.

From an operational perspective, for financial institutions that operate primarily out of the Australian time zone, use of an offshore clearing house would create challenges in terms of dealing with Australian market operating hours and related settlement and collateral management cycles.

The offshore CCP model would generally prioritise the requirements of offshore markets given the relative scale of US\$ or Euro denominated OTC derivatives activity relative to Australian dollar activity. Consequently, the innovation for and evolution of the Australian market is likely to be significantly constrained by offshore market priorities. From a systemic risk perspective, dislocation or defaults in the offshore market are also far more likely to directly feed into domestic market conditions if an offshore based CCP is covering both.

*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?*

Part 5 of the Payment Systems and Netting Act 1998 (Cth) gives express recognition to market netting contracts, allows obligations under those contracts to be terminated, termination values to be calculated and for net amounts to become payable in accordance with such contracts even if a clearing participant enters external administration. The Payment Systems and Netting Act removes any basis for arguing that such termination or netting is void or voidable under the Corporations Act or is contrary to public policy. The Payment Systems and Netting Act does not, however, provide legal protection for the operator of a



---

netting market which seeks to effect, in accordance with its operating rules, the transfer of a defaulting clearing participant's open positions and cover to another (non-defaulting) clearing participant.

On one view, where a clearing participant is under administration, sections 437D and 468 of the Corporations Act require the central counterparty to seek the written consent of the administrator or liquidator, or approval of the Court, before seeking to effect the transfer of the clearing participant's open positions and cover to another (non-defaulting) clearing participant. In these circumstances, unless the administrator or liquidator's consent to a transfer can be sought and obtained in a timely fashion, transfer of positions is not considered to be a practical solution for the management of a defaulting participant's open positions. At a minimum, these provisions of the Corporations Act create legal uncertainty in relation to the central counterparty's power to transfer positions and cover.

It is, in ASX's view, a regulatory gap that the Australian legislative framework does not provide a mechanism free of legal uncertainty by which a central counterparty may effect the transfer of open positions and cover of a defaulting participant to a non-defaulting participant without the need to obtain the administrator or liquidator's consent.

*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?*

ASX considers that the minimum thresholds needed for the effective risk management of domestic market centrally cleared OTC transactions are: 1) CCP operations to be licensed subject to the oversight of Australian regulatory agencies and located in Australia with 2) default fund monies and 3) collateral both being held domestically. This should be a requirement regardless of a CCP's place of incorporation.

ASX believes that requiring these three elements to be located in Australia will provide the regulatory clarity needed to efficiently manage the default of a clearing participant; and recognising that a CCP's ability to manage the impact of such a circumstance and restore calm to the financial markets and prevent the spread of further instability is a key part of the policy rationale for a mandatory central clearing requirement.

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

In the interest of ensuring that there is a "level playing field" for the provision of domestic central clearing services for OTC derivatives and to avoid any uncertainty about systemic risk management standards, ASX strongly recommends that the existing domestic regulatory framework should be changed to ensure that an overseas CCP that seeks to provide a clearing solution in Australia for systemically important markets (like OTC interest rate swaps) must submit to regulation by the RBA and ASIC against the Financial Stability Standards (on the same basis as for Australian domiciled CS facility licensees). In these matters ASX does not agree that there is a place for "equivalence" of the CCP's home regulatory regime with the Australian regulatory regime – Australian regulatory standards should be consistently applied and enforced.

Globally many CCP regulators are considering whether to impose a mandatory clearing requirement for OTC derivatives. ASX strongly urges the Council of Financial Regulators to attempt to achieve consistency in OTC derivative regulation across jurisdictions, wherever possible.

CPSS and IOSCO are currently reviewing comments on their Consultative report – *Principles for Financial Market Infrastructures*. Although CPSS and IOSCO are considering wide ranging changes to CCPs, ASX considers that the credit risk, liquidity risk, settlement finality and the segregation and portability proposals will have a significant impact on the clearing of OTC derivatives.

---

The Bank for International Settlements (BIS) proposal on the *Capitalisation of bank exposures to CCPs* will also need to be considered in any OTC derivatives clearing regulation. The current BIS proposal, if implemented, will see OTC derivatives clearing impacting on the capital requirements for bank clearing participants.

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

In order to answer this question ASX believes that it is important to define the term "interoperability". ASX considers interoperability as a peer to peer relationship which allows a user of one CCP to execute a trade with a firm which has elected to use another CCP.

Interoperability among CCPs in respect of a given product class should be encouraged where the benefits to participants and other stakeholders (in terms of increased netting efficiency and lower participation costs) outweigh any incremental systemic risks to the market (in terms of CCP interdependencies and default management complexity). Balancing benefits against risks will not necessarily favour interoperability for all product classes in all markets: this is an empirical question which depends on the characteristics of the product class and the market.

Interoperability between CCPs presents a new business opportunity for Australian (currently non-interoperating) clearing houses and is likely to require facilitation by new arrangements for cooperation between regulators in Australia and those in countries where interoperating CCPs are domiciled. ASX agrees that careful consideration and regulatory oversight of interoperability arrangements is required to manage associated systemic risks.

Interoperability will deliver benefits to some market users as it can lead to operational efficiencies as Clearing Members will be able to maintain connectivity with fewer CCPs, incurring less operational and system costs. Multi-lateral netting would also be facilitated by CCP interoperability and enhanced product coverage could be achieved where CCPs can utilise the capabilities of each other's services to provide a service to end-users.

Further mutualisation of risk would be possible with CCP interoperability. The creation of risk management and operational standards amongst CCPs will go some way to reducing the costs of market fragmentation. However, some of the benefits from interoperability can be obtained through other approaches such as greater standardisation of OTC central clearing services.

It is important to note that interoperability will be difficult to achieve for foreign exchange OTC derivative products given the lack of standard CCP approaches or models for such products and the level of volatility present in the FX market.

*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?*

It should be acknowledged that any regulation is going to have a commercial impact on:

- who is willing to provide the service;
- whether the service is commercially viable.

Any regulatory response should be properly designed to address in a proportionate way any actual threat to economically efficient outcomes in the market.

---

Price regulation, if adopted, must be transparent and must not operate as a disincentive to investment by incumbent providers of CCP clearing services or potential new entrants to the market.

However, it should not be assumed that price regulation is an appropriate, or the most efficient or effective or only available, regulatory response. There are a range of other models from no regulatory intervention to industry specific regulation. The regulatory mechanisms adopted by government in opening up the Australian market for trade execution to competition provide one model which has been judged appropriate by policy makers for ensuring that economic efficiency is promoted in a newly competitive marketplace; for example, under the ASIC Market Integrity Rules (Competition in Exchange Markets) 2011, where a person seeks access to pre or post trade information for a market, the market operator must make available the requested information on reasonable commercial terms and on a non-discriminatory basis.

For its part, ASX would provide CCP clearing services in respect of OTC derivatives markets that are systemically important to Australia on reasonable commercial terms and on a non-discriminatory basis.

*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?*

ASX considers that, in order to meet the regulatory objectives of systemic stability at a minimum, all Australian trading in eligible Australian dollar denominated OTC products between Australian based entities, should be subject to mandatory domestic clearing. Conceptually this requirement could be extended to a broader range of trades and entities, although ASX recognises that extending this scope could result in a trade being caught under two or more regulatory regimes. We would encourage the RBA to engage with other regulators to develop a global solution which ensures that the OTC markets outlined in Question 2 are subject to mandatory clearing without being subject to overlapping regulatory regimes. Should there be regulatory overlap ASX is committed to exploring the regulatory status required by overseas regulators to meet both counterparty's regulatory needs.

Specifically ASX has identified several legal impediments to a mandatory clearing requirement that relates to the use of a CCP where that CCP is domiciled in a foreign jurisdiction. Firstly there will be problems with the enforceability of a particular clearing requirement as local regulations and local regulatory supervision will determine the success of the clearing requirement. In addition, a mismatch between offshore and domestic regulations is likely to lead to regulatory arbitrage and fragmentation in the OTC derivative markets which are global in nature.

Other important potential impediments include the choice of jurisdiction where a contract is entered into, differences in insolvency law as well as different protocols for collateral management.

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

ASX recognises that national mandatory clearing requirements are expected to be commonplace for OTC derivatives. We consider that the extraterritorial effects of product range, recognition of Australian CCPs and institutional scope of the mandatory clearing requirement should be considered in developing a regulatory regime for Australia. We are also concerned that there may be potential issues from the offshore booking of transactions by domestic branches of offshore participants in order to avoid jurisdictional central clearing requirements.

ASX believes that the centrally cleared OTC derivatives should, wherever possible, be the same across jurisdictions although at a minimum we consider the OTC derivatives outlined in Question 2 should be

---

centrally cleared. In order to avoid regulatory arbitrage it will also be important for the same types of end users of OTC derivative products to be covered globally under national mandatory clearing requirements.

The recognition of national CCPs by the US and European markets for clearing activity in non US\$ or non-Euro denominated instruments is a key issue for OTC derivatives clearing. At the moment it is uncertain whether a US bank's transaction in an A\$ interest rate swap (IRS), cleared by an Australian CCP would be designated as a cleared transaction for US regulatory purposes especially if the US regulator identifies that all IRS (regardless of currency type) needs to be cleared by a US Derivatives Clearing Organisation (DCO). The definitions of a DCO by the CFTC and Securities Clearing Agency (SCA) by the SEC have already created de-facto standards for extra-territorial evaluation of CCPs by US regulatory bodies.

*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?*

OTC derivatives clearing could be primarily accommodated through APRA implementing the Basel 3 risk weighting proposals for bilateral and central clearing of OTC derivatives as soon as possible.

ASX has recently made a submission to Treasury's consultation on the Financial Sector Legislation Amendment (Close-out Netting Contracts) Bill 2011. A copy of ASX's submission can be found at:

<http://www.treasury.gov.au/contentitem.asp?NavId=066&ContentID=2105>

In summary, ASX outlines that the Bill should comprehensively address the inconsistency between the Payment Systems and Netting Act 1998 and the Banking Act 1959 in relation to market netting contracts as well as close-out netting contracts. Specifically, ASX submits that Treasury should clarify, by appropriate amendments to Part 5 of the Payment Systems and Netting Act, that market netting contracts to which an ADI is party can be immediately closed out by the operator of a netting market despite section 15C of the Banking Act.

*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)?*

Higher capital charges for bilateral OTC derivatives exposures may foster an eventual move to central clearing of those transactions. This, however, is unlikely to occur within the G20 timeframes and the path to achieving a central clearing solution may be difficult given the lack of consensus and differing priorities amongst domestic and international financial institutions.

Moving to a central clearing solution will reduce market fragmentation and reduce collateral requirements through multilateral netting. The uncertainty in relation to the design of the global regulatory framework is preventing some market participants from centrally clearing certain OTC derivatives.

Central clearing already occurs for futures transactions and will also occur soon for OTC equity options in Australia. There are strong economic and risk management benefits from clearing this activity, and technology and risk management developments are moving in the direction of making central clearing of standardised instruments more cost effective. ASX considers that an Australian mandatory central clearing requirement will be needed to facilitate domestic OTC derivatives market participants' agreement on a solution structure and solution provider that are consistent with Australia's G20 commitments.