ISDA Safe, Efficient Markets

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

Dear Secretariats

This letter contains the response of the International Swaps and Derivatives Association, Inc. ("ISDA") to the Council of Financial Regulators ("Council") discussion paper on central clearing over-the-counter ("OTC") derivatives in Australia of June 2011.

Since 1985, ISDA has worked to make the OTC derivatives markets safer and more efficient. Today, ISDA is one of the world's largest global financial trade associations, with over 800 member institutions from 56 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, central counterparties ("CCPs") and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

As the Council is likely aware, ISDA is actively engaged with providing input on regulatory proposals in the United States, Canada, European Union and Asia. Our responses to the questions posed in the discussion paper are derived from these efforts and from consultation with ISDA members operating in Australia. Accordingly, our response draws on this international experience and dialogue and is not focused on technical aspects of Australian law relating to the implementation of reform.

ISDA commends the Council for its careful consideration of these issues and welcomes further dialogue with the Council on this letter.

Given the efforts being made to increase the use of CCPs, which will profoundly affect the role of the CCP in the broader financial infrastructure, effective CCP regulation, prudential supervision and oversight is critically important. If this is not achieved, CCPs will themselves become a major source of systemic risk. Thus, it is highly important that comprehensive analysis and consultation occurs on the design of the market structure and the implications for financial stability.

Before we address the questions posed in the discussion paper, we would like to make a few general observations.

Global Markets, Regulatory Coordination and Timing

The Council recognises in the discussion paper that OTC derivatives are traded on global markets, the proposed reforms to the functioning of these markets are "significant" and that "to a large extent" the proposed reforms are more relevant for Europe and the United States than for "smaller" markets such as Australia. Given that context, we strongly urge the Council to gather the necessary information on the impact of the reforms in the US and EU markets prior to embarking on comparable and substantial reforms in Australia. Without this information, we consider it is too early to determine what Australian derivative or market is viably subject to a clearing mandate. In that regard, it should be acknowledged that the implementation of key financial market reforms, due to their scale and complexity, is facing delay. The implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") has been put back by approximately about six months, after the Commodity Futures Trading Commission and the Securities and Exchange Commission agreed to delay implementation from a deadline set by the U.S. Congress of July 15 to the end of the year. Similarly, the European Parliament, in early July 2011, postponed finalisation of the European Market Infrastructure Regulation ("EMIR"), which contains similar provisions on clearing of OTC derivatives to the Dodd-Frank Act.

In addition, we urge that regulators consider the global nature of the markets when creating regulations for OTC derivatives so that the regulation does not restrict the ability of Australian entities from continuing to participate and be competitive in the global derivatives markets. To this end, it is vital that regulators seek to avoid mandating duplicative, overlapping requirements and/or infrastructure where sufficient alternatives exist. For example, regulators should consider whether it is appropriate to establish an Australia-based CCP solution if an already existing CCP based abroad can adequately service Australian market participants.

Scope

It is unclear what would be an "Australian" derivative or market. We understand the Council is considering regulation for derivatives with Australian counterparties and counterparties holding Authorised Deposit-taking Institution authorizations or licences under the Australian Financial Services Licence regime. However, will the regulations only cover trades where both parties are acting in the domestic Australian market or is it sufficient for one party to be acting through an office in Australia in order to come under the regulatory regime? If the Council decides to regulate cross border trades, how does it intend to coordinate with foreign regulators to ensure consistency of regulations? Given the global nature of the OTC derivatives market, such coordination is essential to effectively establish international minimum risk management standards, avoid regulatory arbitrage, and mitigate systemic risk and adverse spill-over across countries. Diverse and inconsistent requirements between different supervisors will increase costs and make it less likely that robust international standards can be developed. Close international cooperation between various supervisory bodies including banks, CCPs, and systemic risk supervisors would mitigate these risks.

The Council will need to clearly define the scope of the transactions, entities, trades and markets that are intended to be covered by the regulations in order for the industry to give meaningful comments on proposed rules. The Council will also have to outline which of its member agencies have jurisdiction and rule-making authority over the various issues outlined in the discussion paper.

Comments on the questions in the discussion paper

The remainder of this letter our comments in relation to the specific questions posed in the discussion paper. Our response is set out underneath each question.

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?

As noted in our comments on Question 5 below, we consider that the "sufficient liquidity" requirement ought to be applied very conservatively. We repeat the importance of this, as a CCP must calculate net margin each day and price availability is required to do this. In addition, since this requirement applies for the whole life of the trade price availability must be guaranteed in all market conditions, including stressed markets.

Further study is necessary to determine if there is sufficient liquidity with respect to each derivative asset class. Certain parameters for liquidity for each product are a minimum number of market makers, frequency of trading (daily) and depth of market (daily trading must be in sizes that are not insignificant). Some products may meet these requirements, or not, depending on tenor. For example, 5 year fixed income swaps may be traded daily in significant sizes but the same swap with a 30 year term may not trade frequently enough to be considered liquid. In addition to having multiple market makers for each cleared product, it is important for an Australian CCP to be able to manage the risk and collateral around those products in a way that accurately reflects the Australian markets, and that those market makers who are members of the CCP be required to provide daily valuations to the CCP.

When considering clearability, it is also practical to recognise that the margin model of leading OTC derivatives CCPs employs historical market data to compute initial margin[1]. Where historical data is not available, it will be necessary to perform analysis to verify that the proxies adopted provide a conservative representation of the underlying risk including adverse market conditions.

As stated, the Council should also consider the costs of establishing regionally-based CCPs, which may or may not be further bifurcated by asset class, as well as the availability of international CCPs to adequately meet the needs of Australian market participants. In this regard, it should be noted that if clearing of Australian dollar-denominated interest rate derivatives increases at international CCPs, this is likely to reduce the viability of centrally clearing in Australia.

[1]There should also be minimum standards set for the period of data used and that these calculations are validated with respect to stressed market conditions.

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

Refer to response to question 1 above.

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?

Please note our response to question 1 above. In addition, ISDA understands from talking to market participants that over 50% of clearing- eligible Australian dollar-denominated interest rate derivatives that are traded in Australia or elsewhere around the globe are cleared at the London Clearing House ("LCH").

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.

The implementation costs of building an Australian OTC derivatives CCP including its technological and regulatory infrastructure are substantial[2]. For example, the Hong Kong Exchanges and Clearing ("HKEx") is initially investing HK$180 million on an information technology system and hiring staff for its new CCP clearing division, which will be run independently of HKEx's other CCPs for derivatives and equities[3].There are also substantial on-going costs of operating an OTC CCP. It is has been estimated that the running cost at the Japanese OTC CPP alone are over US$40 million though this figure is still under debate among the industry.

However, the more sizable and on-going cost of moving contracts to CCPs relates to the initial margin plus guarantee fund contributions that depend on the amount of contracts cleared. Globally, the direct incremental initial margin and guarantee fund contributions are expected to be large – up to about US$150 billion according to the analysis provided by the IMF[4]. A 2010 JP Morgan report estimated that the total capital cost of all the recently introduced regulatory measures across 16 global banks would amount to about $221 billion[5].

In addition, the fragmentation of multiple CCPs on product and geographic lines means a Clearing Member ("CM") will have to manage their OTC derivatives books on a CCP-by-CCP basis. Such management would be necessary in order to control the amount of collateral the CM will have to provide to each CCP, and their consequent

[2] By way of comparison, on March 30, 2011 U.S. Congressman Barney Frank, Ranking Member of the Full Committee, released the following statement regarding "…a yet-to-be-released study by the Government Accountability Office stating that it will cost up to USD$2.9 billion over five years to implement the Wall Street Reform and Consumer Protection Act." Refer: http://democrats.financialservices.house.gov/press/PRArticle.aspx?NewsID=1410

[3] FX Week 05 Jan 2011. Refer: http://www.fxweek.com/fx-week/news/1935100/hong-kong-lawmakers-enforce-mandatory-ccp-2012

[4] International Monetary Fund (2010) Global Financial Stability Report, available at http://www.imf.org/external/pubs/ft/gfsr/2010/01/pdf/chap3.pdf

[5] JP Morgan (2010) "Global Banks—Too Big to Fail?" Morgan Europe Equity Research, February 17.

exposure to each CCP. For example, given that the US is characterised by fixed rate mortgages and Europe by pension plan asset-liability management, it is possible that swap dealer participants will be receiving fixed in rates at a US CCP, and paying fixed at an EU CCP. In which case, what was before a balanced rate book becomes very directional at each CCP, motivating collateral and exposure management, and the provision of higher rate markets for US cleared swaps relative to EU cleared swaps, thus fragmenting the liquidity of the market as it is today.

Further, an additional cost for some market participants is the loss of the netting benefits they already obtain on their bilateral contracts within their own derivatives books. For example, a dealer may be getting substantial netting benefits from standardized contracts that are CCP-eligible and nonstandard contracts that cannot be centrally cleared, but that are all transacted under the same master agreement. Some dealers argue that the multilateral netting benefits within the CCPs will not be large enough to offset these potential increased collateral needs.

Finally, in terms of the implementation timing of any approach, ISDA notes that a transition period from ‘clearable’ to ‘mandatory’ sensibly reflects the work required and risks involved in moving a product to central clearing. Accordingly, we recommend an extended period between a CCP being given permission to clear a product and clearing becoming mandatory on that product. Further, ISDA would recommend transparency during any such period. This will provide important notice and information for affected parties on what the relevant margin and default fund calculations will be, what pricing requirements will be set by the CCP, and how default management will operate.

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)

At the outset, we note that the review of OTC derivatives in order to determine whether to impose a mandatory clearing requirement is, of course, extremely consequential. If the relevant clearing solution fails to establish an operationally sound and robust risk management framework, or captures an inappropriate category of OTC derivatives, the consequences for the CCP and for the market could be significant.

In terms of the factors that should be taken into consideration by regulators in identifying contracts appropriate for mandatory clearing in order to best achieve the goals of mandatory clearing and to mitigate adverse effects, we consider that the five factors outlined in Section 723 of the Dodd-Frank Act are a preferable starting point to the three factors noted in the discussion paper as the five factors in the Dodd-Frank Act are more elaborate than the three concepts provided in the discussion paper. The five factors follow:

<u>(I) The existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data.</u>

Some types of OTC derivatives (for example CDS contracts in standard tenors and coupons referencing the on-the-run major traded indices) have a ready market of buyers and sellers, as evidenced by bids and offers that change throughout a trading day. By contrast, more complex products are frequently tailored to a counterparty's risk management needs and thus may be less liquid. A good example here would be a CDS on a bespoke portfolio of credits: it may be difficult to obtain daily market prices for this product. Further, the tailored nature of products like these means that reliable pricing data may not be available, and this can lead to significant model and parameter risks in a models-based valuation.

It is critical that a CCP has the capacity and expertise needed to manage all of the risks associated with the products that it clears. These risks include potential valuation error, which can in turn lead to errors in estimates of initial or variation margin requirements and/or guaranty fund obligations. Since margin must be calculated at least daily, and since daily (or more frequent) market prices form the best basis for valuation, the availability of daily market prices for cleared products must be assured in all market conditions, including stressed markets. This is key since, if the amount held as margin turns out to be inadequate to cover the liquidation of a portfolio, then the CCP itself may be endangered.

Based on the foregoing, it is clear that the size of the relevant OTC derivative market and its depth are crucial properties in the determination of the scope of mandatory clearing, and a conservative interpretation is required here. ISDA would be happy to provide expertise to assist in the definition of appropriate measures of the liquidity required for clearing, for mandatory clearing, and for contract market execution.

(II) The availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is then traded.

This addresses two important and related points. First, it reinforces the importance of assessing the financial integrity and operational competence of a CCP. In this context, the determination must also take into account, in assessing the enumerated factors, whether these factors can be satisfied by the CCP given the potential volumes which it would clear under a mandatory clearing requirement.

Second, the evaluation should be premised on the determination that the terms and conditions of the cleared OTC derivatives and the terms and conditions on which they are cleared are consistent with the material terms and trading conventions on which the relevant OTC derivatives are then traded.

These determinations are essential to ensure that the imposition of a mandatory clearing obligation for OTC derivatives will, in practice, actually achieve the objectives of increasing market liquidity and reducing risk in the financial system rather than increasing it.

(III) The effect on the mitigation of systemic risk, taking into account the size of the market for such contract and the resources of the CCP available to clear the contract.

Like the preceding factors, this factor is intended to examine whether a mandatory clearing requirement with respect to the relevant OTC derivative would decrease systemic risk. This, in turn, requires an assessment of the size of the market for the relevant OTC derivative, the risk attributes of the OTC derivative, the scope and risk profile of other products cleared by the CCP, and the aggregate amount (and terms of availability) of the CCP's financial and credit support resources. Other risks, such as settlement and operational risks that can contribute to a clearing failure must, of course, also be considered.

Finally, the current and likely future importance of a CCP to the market it serves must be considered together with the extent to which the failure of a CCP will itself contribute meaningfully to systemic risk.

(IV) The effect on competition, including appropriate fees and charges applied to clearing.

This issue is important as while competition is desirable in principle, it also exposes CCPs to new risks. Thus an assessment of a clearing application should address the potential conflict of interests between owners and management of CCPs and the wider financial system with particular sensitivity to risk management standards.

Here, regulation has an important role in correcting the effect whereby low margin and guarantee fund levels may win a CCP business in the short term at the expense of wider financial stability. Lower margin and guarantee fund requirements should only be allowed where a CCP possesses sufficient alternative resources to support itself to a robust standard and where such a reduction does not materially increase systemic risk.

(V) The existence of reasonable legal certainty in the event of the insolvency of the relevant CCP or one or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds, and property.

Financial stability requires legal certainty of outcome in insolvency. This is essential to ensuring, that, upon insolvency, the assumptions on which credit support levels and default management procedures were structured are well founded and reliable. It is also essential in order to mitigate concerns that may deter participation in the market or in available clearing solutions. In particular, confidence in the portability of customer accounts upon the insolvency of a clearing member is extremely important to market participants.

These five criteria, if taken together and conservatively applied, make it highly likely that a CCP will be able to value, call for margin on, and risk manage all cleared products. Therefore we submit that these criteria should be interpreted strictly, and only to mandate clearing for a particular product where they are clearly met at the time of the relevant application, and are highly likely to continue to be met in the future, including during future stressed periods. Such an approach will ensure adequate clarity and decrease the risk of inconsistent impositions of the clearing obligation.

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)

ISDA agrees with the Council that not all participants in the Australian OTC derivatives market should be subject to mandatory clearing. Market participants, and in particular end-users that rely on OTC derivatives to manage efficiently the risks inherent in their core economic activities, should maintain the ability to bilaterally transact tailored hedging and other risk-management products. Exceptions for certain classes of end-users should be publically disclosed and coordinated on an international basis to avoid regulatory arbitrage.

We believe that affordable access to appropriate methods of hedging, including the use of OTC derivatives, is vital to end-users as they seek to mitigate risks and maintain their economic viability. We caution against implementing regulation that would make access to these critical risk management tools either too difficult or too expensive to attain. We also understand that the construction of an end-user exemption is likely to be complex, given the need to ensure that there is no regulatory arbitrage but also provide that regulation is applied to non-systemically significant end-users in a proportionate manner.

We agree with the general approach that certain firms should be exempt from clearing and margin requirements, as the increased collateral and operational requirements would be too burdensome and the reduction in systemic risk is insufficient to justify the imposition of these costs on the economy as a whole. We are not aware of any study that has shown these firms to present risk to the financial system by virtue of their derivatives activities. Thus, any such requirements will result in increased costs to such commercial end users without any resulting benefit to derivatives markets. These requirements would also affect end-users' ability to use derivatives for risk management purposes as many of these firms, especially non-financial end-users, need their most liquid assets for working capital and investment purposes.

Such firms should also be permitted to choose the venue for execution that best suits their hedging needs – whether on exchange, electronic or bilateral.

Dealers facing end-users that do not pose a threat to financial stability should be permitted to evaluate and underwrite the credit risk of such end-users and negotiate bilateral collateral or credit support arrangements as they deem necessary.

End-users should be allowed to make representations in bilateral contracts which allow those end-users to avail themselves of the relevant exemptions. Rather than requiring regulatory certification, end-users should be presumed to be hedging and should only have to make an affirmative declaration as to the character of a transaction when or if they are entering into a speculative transaction.

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

Exemptions for commercial end-users: Such parties often have risk-management needs that are unique to their individual situations. For example, the location (basis), volume, timing and duration of derivatives required may vary from party to party, depending on individual hedging needs. Standardised offerings alone, therefore, are rarely adequate. Requiring such standardisation could expose participants to additional market risk, while potentially limiting the speculative liquidity needed to help spread and absorb these risks.

Limited, proportionate exemptions for non-systemic financials: We are concerned that requiring non-systemic end-users to use CCPs will have liquidity effects which are insufficiently understood at present, and, given the way that derivatives are used to manage overall portfolio risk, may artificially and inefficiently isolate derivatives components from the rest of these portfolios, requiring posting of high levels of margin on derivatives and not net exposures. This could, for example, have significant effects on savings and pensions.

Exemptions for intra-group transactions: We would propose that there should be allowance for an exemption from the clearing obligation (and possibly the reporting obligation) in relation to transactions with affiliates. For example, this will be important as in many cases there may be legal requirements that affect which group companies can face counterparties through but the risks may be hedged or managed in another group company, so that it will need to be possible to transfer risk intra-group.

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?

We strongly urge the Council to gather the necessary information on the impact of the reforms in the US and EU markets prior to embarking on comparable and substantial reforms in Australia. Without the benefit of this information, we consider it is too early to determine what Australian derivative or market is viably centrally cleared. Further, and as noted above, it should be acknowledged that the implementation of key financial market reforms in the US and the EU faces delay.

Also, the European Union's envisaged standards for accrediting third-country CCPs are stringent. Regulatory powers have been given to the European Securities and Markets Authority ("ESMA"). ESMA may recognise a third country CCP if the European Commission has determined that:

(a) the third country's legal and supervisory arrangements ensure that its CCPs comply with legally binding requirements that are equivalent to the EU's;

(b) these CCPs are subject to effective supervision and enforcement in the third country on an on-going basis; and

(c) the third country's legal framework provides for effective reciprocal access of EU CCPs.

This could potentially lead to regulatory conflict. If it were to be mandated that Australian dollar trades must be cleared in Australia and a European-domiciled CCP also offers Australian dollar clearing (which is currently the case), then not providing reciprocal access to that European clearing solution could result in ESMA deciding not to recognise Australia's CCP for the purpose of clearing by European banks. In the extreme case, all of the liquidity that European banks provide to Australian OTC markets could disappear as a result.

We would reiterate our suggestion that the Council work closely with the Australian industry on this issue and also take into account whether Australian market participants will be adequately serviced by already existing CCPs based abroad with demonstrable capacity and experience in clearing OTC derivatives.

Below we highlight a few of the key considerations that may inform the optimal solution for accessing CCPs and allowing for the most efficient use of capital.

Multiple CCPs:

The CCP industry typically exhibits network externalities, in that the value of the services offered depends on the number of participants and contracts cleared. In other words, an increase in the number of CMs will have benefits that accrue to existing CMs, as they will be able to clear with more counterparties. In addition, the CCP industry exhibits important economies of scale, which means that the average cost per transaction declines with an increase in the number of transactions. Staffing, premises,

> and information technology infrastructure, such as a database engine, the clearing platform, networks, and interfaces have high fixed costs. Also, CCP multilateral netting efficiencies diminish as the number of CCPs clearing the same product type increases. In sum, a single CCP has potentially the lowest costs.

It is worth noting, in this context, that some of the benefits of a single CCP can be achieved by connecting several CCPs through links (where CCPs cooperate with each other) and cross-margining (where a CM uses its positions at both CCPs to lower collateral requirements overall). The regulatory, operational and legal demands of this interoperability are, however, substantial.

Interoperability:

Interoperability presents formidable challenge for OTC derivatives CCPs. Senior executives from major OTC derivatives central counterparties have said as recently as June 2011 that interoperability between CCPs for OTC derivatives "…will not happen in our lifetime"[6]. Currently, OTC derivatives clearing is not fragmented along national lines but centralised and international, and the tailored nature of the product compared to more standardised cash asset classes makes it less suitable for interoperability. However, we would be supportive of proposals to give CCPs the right to interoperate and right of access to relevant data and systems – and believe this could help to bring clearing costs down for end-users – providing the additional risks arising from interoperability are properly managed.

Membership Criteria and Operational Standards:

Best practice CCP risk management starts with stringent requirements to become a CM in terms of sufficient financial resources, robust operational capacity, and business expertise. We suggest that any CCP solution adopt CM requirements that are clear, publicly disclosed, objectively determined, and commensurate with risks inherent in the cleared products and the obligations of CMs to the CCP.

CCPs typically seek to ensure that their CMs are creditworthy by establishing a set of financial requirements for membership. Usually CMs are required to meet, both initially and on an ongoing basis, minimum capital requirements, often stated as the larger of a fixed amount and a variable amount that depends on some measure of the scale and riskiness of the CM's positions with the CCP and in other financial markets. In most cases, membership is restricted to regulated entities that meet regulatory minimum capital requirements. CMs that carry client accounts are often required to meet capital standards that are more stringent than regulatory minimum requirements.

In addition to financial requirements, leading CCPs establish standards of operational reliability for CMs. CCPs typically impose tight deadlines for the submission of trade data and for completing various settlement obligations. The failure of a CM to meet these tight deadlines could significantly increase the CCP's risk exposures to that CM and possibly to other CMs as well. Compliance with operational deadlines is closely monitored on a day-to-

[6] "No CCP interoperability in our lifetime – clearing houses", International Financing Review, 12 July 2011, available at http://www.ifre.com/derivatives-no-ccp-interoperability-in-our-lifetime-%E2%80%93-clearing-houses/639106.article

day basis. Furthermore, in recent years many CCPs have been paying greater attention to the backup systems that CMs would have available if their primary operating systems were disrupted.

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*.

As above, we consider it is too early to undertake this extremely consequential work at a time when the settings in the large international markets are in flux as frameworks are being implemented. Consequently, for the moment, we can only broadly agree with the proposition that should clearing of Australian dollar-denominated interest rate derivatives increase at international CCPs, it will impact volumes and potentially reduce the viability of centrally clearing in Australia. In the future, useful data from will become available from trade repositories to inform analysis and ultimately decisions on the regulatory settings for the Australian market.

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?*

First, we do not consider that the Council should set a particular model as a minimum requirement. There is a strong argument to be made for permitting market participants to contract on segregation and portability, as opposed to prescribing a method via regulation. One possibility would be to establish omnibus segregation as a default standard, but permit clearing members and their clients to negotiate to create individually segregated accounts to contract around the standard. This would permit those who value segregation more highly than it costs CMs to segregate to negotiate mutually beneficial arrangements with CMs. Such contracts would reflect information available only to the contracting parties, but which regulators could not know when setting a one-size-fits-all standard. That said, end-users should be aware of the trade off between highly segregated collateral and less segregation.

Second, ensuring the effectiveness of segregation and portability provisions and mechanisms is a substantial challenge and work in these areas continues in the US and the EU. For example, in order to provide further certainty of the effectiveness of segregation and portability provisions in the EU, recent texts of EMIR contain the provision that "The [segregation and portability] requirements set out in paragraphs… shall prevail over any conflicting laws, regulations and administrative provisions of the Member States that prevent the parties from fulfilling them". However, the enforceability of such a provision (if it survives to the final text) may be complicated.

In addition, as the Council may know, there are many different ways that margin can be segregated depending on how the margin is posted and held and the segregation in place in a given situation. This is critical in relation to whether customer positions and related margin are likely to be successfully ported.

One variable in margin posting is whether a CCP collects margin from CMs on a gross basis (i.e. the CCP collects from each CM all margin posted by the CM's customers on account of CCP-imposed margin requirements) or on a net basis (i.e. the CCP collects from each CM a level of margin sufficient to account for the net risk to the CCP of the combined customers' positions, with offsetting customer positions resulting in a corresponding reduction in the aggregate margin requirement).

An important consideration in how margin is held is the degree to which the margin is commingled with other assets and where the margin is held. Customer assets may be comingled with the CM's proprietary assets or segregated from the CM's proprietary assets in an omnibus or on an individual client basis. Margin may be held at the CCP (in the client's name or in the CM's name), at the CM, or at a third-party custodian. In a situation where margin is posted by the client on a gross basis, but collected by the CCP on a net basis, it is possible that client margin is held at both the CCP and the CM.

As an additional matter, we note the proposed changes to Australia's netting legislation as set out in the Financial Sector Legislation Amendment (Close-out Netting Contracts) Bill 2011. The matters raised by ISDA in its submission to the Bill are as important to contracts which are centrally cleared as they are to those which are not. Moreover, to the extent that Australia's netting legislation is to form the basis of the statutory protection of the operation of a CCP, it is critical that the issues in relation to netting and the operation of Australian banking and insurance legislation be resolved in a manner consistent with the certainty required for a CCP to function.

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?

Refer to Question 10 above.

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

Australian regulation should require that a CCP legally separates its OTC derivative clearing activities from its other businesses. This prevents the commingling of default and guarantee funds across products. This will ensure that a CCP's OTC derivatives clearing activities are independently managed, there is no conflict of interest or exposure to these activities from its other businesses and that the CCP has dedicated resources to manage its OTC clearing activities, which is particularly important in the event of a default.

Second, CMs should only be able introduce risk commensurate with their capital position. Further, entities that become CMs of OTC derivatives CCPs must have the ability to participate in the CCP default management process including the ability to bid for the portfolios of other CMs of the CCP. If a CCP admitted a CM (or a group of CMs) that was unable to participate fully in default management of the product it clears, there could be significant negative repercussions for the CCP and for the market. In particular, the unexpected failure of one or more CMs to participate in default management at a moment of severe stress for the CCP would reduce available resources and liquidity, place heightened burdens on other CMs, and reduce the likelihood that the CCP's risk management process would be effective. Moreover, for there to be the right level of incentives for active participation in default management, there needs to be enough 'skin in the game', which suggests not only that that the default fund needs to be allocated proportionally to risk introduced; but also that the default fund to initial margin ratio should reflect the estimated percentage of market risk remaining following the completion of the default management hedging phase.

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

As we have stated above, interoperability presents formidable sets of challenges for OTC derivatives CCPs. Indeed, a convincing case has not yet been made for interoperability between CCPs clearing OTC derivatives instruments given the formidable hurdles to overcome before interoperability can be implemented safely. For example, interoperability for cash equities requires additional collateral being posted by CMs to the interoperating CCPs. However, given that the risk profile and settlement periods of OTC derivatives are substantially different to the risk profile and settlement periods for cash equities, the required additional collateral would appear to be much higher and could be prohibitively large. There are also many concerns in relation to how default management and resolution would work in a world where CCPs are connected.

As a minimum first step, CMs must be able to carry out proper due diligence on the risks to which they are exposed through their CCP(s)' proposed interoperability arrangements. To this end, we believe that CM should be given access to the data necessary to carry out a full assessment of their CCP(s)' proposals for measuring, monitoring and managing the risks arising from interoperability well in advance of the launch of an interoperability arrangement.

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?

An effective Australian CCP solution needs to (at a minimum):

(a) comply with international minimum risk management standards and financial resources requirements appropriate for OTC derivatives CCPs as defined by the global standard setters such as the Committee on Payment and Settlement Systems ("CPSS") and the Technical Committee of the International Organization of Securities Commissions ("IOSCO") (collectively "CPSS-IOSCO"); and

(b) be economically viable and so offer a reasonable limit on the implementation and on-going costs for the affected Australian industry. The reasonableness of the costs would assessed in comparison with the costs of accessing international CCPs.

If either of these conditions cannot be satisfied, then am Australian OTC derivatives CCP solution would not produce efficient or effective outcomes for Australia.

Jurisdictional and other matters

Q15. Are there any legal impediments to mandating the clearing of OTC derivatives and the use of CCPs? Are there any legal impediments to mandating the use of a CCP where that CCP is domiciled in a foreign jurisdiction?

We do not comment on specific Australian laws but we recommend that the Council consider the importance of limiting any clearing mandate to appropriate products and participants as discussed above.

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

Yes, as above, if the Council decides it wishes to regulate cross border trades there are extraterritorial issues to consider and the Council should consider how it intends to coordinate with foreign regulators to ensure consistency of regulations.

The Council should be mindful of the fact that OTC derivative reforms that are consistent and coherent within a single jurisdiction can have adverse market impact when they apply to cross-border transactions, even where the different jurisdictions involved have (apparently) similar rules.

Particular concerns arise as a result of:

(a) The possibility that two parties to a transaction are required to trade in different venues, clear on different CCPs or report to different trade repositories.

(b) Requirements for non-US entities to register as swaps dealers and become subject to full US entity and transactional rules, in addition to the rules applicable in the entity's home state, including applying the US transactional rules to business with non-US counterparties.

(c) The uncertain treatment of foreign branches.

(d) The absence of (or limits) on exemptions for intra-group transactions (discussed above) which restrict the ability to move risk by back-to-back transactions within a group of companies.

(e) EMIR’s mutual recognition constraint for third country CCPs was discussed in question 8. It is worth noting that concerns also arise from the Dodd Frank Act. A potential Australian CCP might possibly gain blanket recognition from US regulators, though the criteria for that recognition is not clear at present. This means that an Australian CCP may be required to register as a DCO in the US, subjecting the Australian CCP to potentially conflicting regulation between US and Australian regulators. Failure to register as a DCO may result in US banks not being able to clear through the Australian CCP. Instead, US banks could be required under the Dodd Frank Act to treat the CCP as a bilateral trading counterparty and require the Australian CCP to post margin to the US bank. Otherwise, US banks may not be permitted to trade with this counterparty.

These issues can be addressed by convergence/alignment of rules, limited exemptions for cross-border business and (mutual) recognition arrangements, while still achieving the objectives of the reforms. However, while solutions for these issues remain unresolved as between the United States, the European Union and other jurisdictions, we reiterate our recommendation to the Council to refrain from hasty decision making.

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?

A plan for the mitigation of CCP stress and the procedure for resolving a failing CCP do not yet exist in the regulatory frameworks in the US or EU. This area is also not addressed in the proposed international standards for "financial market infrastructures" recently promulgated by CPSS-IOSCO[7]. However, ISDA wishes to emphasize that it is imperative that a comprehensive plan to address CCP stress is agreed ex ante. A credible CCP resolution plan is vital for financial stability, particularly given that a CCP may be the principal venue for clearing a product. In the absence of adequate continuity planning, CCP stress might preclude the functioning of the market for that product or the functioning of the entire financial system.

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)?

Yes, provided it is correctly implemented, Basel III will create a regulatory capital incentive for central clearing as trade exposures to "Qualifying CCPs" attract a 2% risk weight for trade exposures, while trade exposures to other entities attract a 20% risk weight.

The incentive to clear is also driven by commercial pricing in the specific OTC derivatives product market independent of regulation.

Conclusion

ISDA would like to emphasize the considerable costs of building a CCP should not be ignored. Though the Singapore Exchange (" SGX") has not disclosed any number, market cost estimates for the build out of SGX's clearing house are SGD40 – 50 million excluding on-going running costs. As noted, HKEx has budgeted HK$180 million on an information technology system and hiring staff for its new CCP clearing division to build out their clearing house, though it is too early to say whether actual costs will be greater or lower than this budget. An additional source of costs would be the inefficiency associated with a bifurcated market. This could arise because, as mentioned in question 3, over 50% of the eligible Australian dollar denominated interest rate derivative trades are already cleared in LCH.

[7] CPSS-IOSCO consultative report, 'Principles for Financial Market Infrastructures' March 2011

Before mandating that such significant investments be made, Australian regulators may find it preferable to first obtain more information on the size of the Australian OTC derivatives market that is potentially suitable for clearing. One way in which this might be achieved is through the participation of Australian financial institutions and global banks in a global trade data repository such as the one being established by DTCC for interest rate derivative products. After a period of collecting and analysing the data, Australian regulators would have a far better understanding of which products are most liquid and where the largest risk concentrations exist. This knowledge could inform a decision about the merits and costs of establishing an onshore CCP.

Whilst this data is being collected and analysed, an interim solution could be implemented which would allow Australia to meet its 2012 G20 commitments on clearing without requiring significant initial investment or potentially causing market fragmentation. One example might be to develop a framework for 'accrediting' third country CCPs to clear the trades of Australian financial institutions.

There are many ways to go about the accreditation process for third country CCPs. The most straightforward would be to require that the CCP's home country regulator affirms that the CCP meets the highest risk management standards defined by CPSS-IOSCO before granting accreditation. An alternate, but somewhat more complex, method would be to require the third country CCP to register with Australian regulators before allowing Australian financial institutions to make use of its clearing services.

The suggested approach would ensure that on a timely basis that eligible products are cleared, but only at CCPs approved by Australian regulators. After a period of time, Australian regulators would be able to study the results and in conjunction with trade repository data make an informed decision whether an Australian CCP would, 1) help to reduce systemic risk build ups, 2) not cause the market to become fragmented, and 3) be able to capture sufficient volume to be economically viable.

ISDA appreciates the opportunity to provide comments on the discussion document and looks forward to working with the Council as it continues the regulatory process. Should you require further information, please do not hesitate to contact the undersigned.

Yours sincerely,

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