9 September 2011

OTC Derivatives Central Clearing Consultation
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Dear Mr Chambers

Discussion Paper – Clearing for OTC Derivatives

The Australian Financial Markets Association (AFMA) welcomes the opportunity to comment on the Council of Financial Regulators' Discussion Paper – 'Clearing for OTC Derivatives'.

The Australian Financial Markets Association (AFMA) is the leading industry association promoting efficiency, integrity and professionalism in Australia's financial markets and provides leadership in advancing the interests of all market participants. These markets are an integral feature of the economy and perform the vital function of facilitating the efficient use of capital and management of risk. Market participants perform a range of important roles within these markets, including financial intermediation and market making.

AFMA represents over 130 members, including Australian and international banks, leading brokers, securities companies, fund managers, traders in electricity and other specialised markets and industry service providers.

1. General Observations

AFMA welcomes the measured and consultative approach that the RBA and other members of the Council are taking to develop a policy framework for implementing the Government's commitment to have over-the-counter (OTC) derivatives centrally cleared in Australia. Regulation that is sympathetic to market forces and dynamics is important to ensuring that laws support the efficient functioning of the market and the usefulness of important financial tools.

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Derivatives play an important role in our economy. The markets for these products are large and diverse, with rules and conventions governing trading activity that have developed over decades. Swaps and other derivatives are important financial tools used by asset managers, insurance companies, banks, and the vast majority of the largest commercial and industrial companies to manage risk.

The implementation of a new regulatory regime by industry would need adequate time to adapt, prepare infrastructure arrangements, and test systems in order to have effective and rational reporting, clearing, and exchange infrastructure, which supports liquidity, and controls costs, and which does not increase risk in the system.

In accordance with existing Government policy, AFMA supports the principles of regulatory neutrality and market-driven solutions, assuming necessary pre-requisites for a safe and orderly market are established. Competition between private entity service providers will ensure choice for market participants and promote innovation. Market-driven solutions should be considered as the superior means of implementation wherever possible, although we recognise that some mandating of outcomes can be beneficial in certain circumstances for the market place overall.

The core view that emerges from dealing with the questions posed in the Discussion Paper is that Australia is facing a difficult set of circumstances where the problems are easy to articulate but for which there is no obvious and easy optimal solution available. The biggest policy challenge is the need to determine a solution in a dynamic global environment. We need to be cautious about settling on a regulatory framework that makes it impossible for market participants to adopt appropriate risk management and business decisions based on cost and liquidity with regard to choice of central counterparty (CCP). The regulatory approach should be one which allows for flexible implementation in an open competitive environment for market infrastructure within the context of the policy outcome structured to meet the Council's concerns about risk to the Australian financial system.

While OTC derivatives markets in the Asian region are still relatively small and therefore do not have the same level of systemic importance that they have in the US and Europe, the increasing need to manage risk through derivatives is growing in line with the big rise in demand for and trading in related underlying assets in the Asian region. Jurisdictions are all working towards the goal of meeting the G-20 commitment on central clearing. Accordingly, authorities are pushing for derivatives to be cleared centrally. Some jurisdictions, such as Singapore, Japan and Hong Kong are pursuing local solutions by requiring derivatives denominated in local currencies to be cleared through domestic CCPs. Other jurisdictions, such as Australia and Canada are carefully examining the question of how to define and contain systemic risk associated derivatives in their currencies while maintaining global connectivity with the main CCPs serving the globally traded market. At a minimum, standards in forthcoming regulation requiring centralised clearing in the United States, Europe and Asia should ensure CCPs adhere to the same standards wherever they are located and operate in harmony with one another.

2. 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?

In deciding whether a product is eligible for CCP clearing, the sole criterion of whether it is standardised is insufficient. Standardisation alone does not ensure eligibility as it does not guarantee a liquid market. Consideration also needs to be given to:

- regular availability of prices;
- sufficient depth of market liquidity; and
- whether the product contains inherent risk attributes that cannot be mitigated by the CCP.

In looking at clearing eligibility these questions could be considered:

1. Can sufficient liquidity in the market (or related markets) be assured, such that proprietary positions of an insolvent participant can be closed out in the market under all but the most extreme scenarios?
2. Are market prices available and reliable such that they can be relied upon as the basis for calculating market risk and therefore margin and other collateral requirements, under all but the most extreme scenarios?
3. Does the CCP have robust and workable default management procedures to effect closing out in the market?
4. In extreme scenarios, where the market does not function effectively so as to accommodate "normal" closing-out, does the CCP have enforceable powers to allocate losses in a predictable and transparent way to surviving participants and the CCP?
5. Can the clearing service and maintenance of risk management structures to withstand participant default be provided at an economic cost?

These other matters are also important to take into account:

- Legal Uniformity - including standard transaction documentation and definitions
- Process Uniformity (automation) - including straight-through-processing for the matching of confirmations, settlements and event handling
- Product Uniformity - including standard valuation, payment structures, dates and determination of life cycle events

Processes are needed for agreeing which products are 'clearing eligible'. This could include regulators working with the relevant market participants to decide which products are clearing eligible. Conversely, a CCP should not be forced to clear a product if it is unable to manage the risk of doing so. Regulators should have the ability to decide a product is not clearing eligible if they are not comfortable with the risk management processes available in CCPs.

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

See our comments in response to Question 1.

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?

Australian dollar-denominated interest rate derivatives are already being centrally cleared by Swapclear. This indicates that those interest rate derivatives that can be standardised and have the characteristics that allow them to be centrally cleared.

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.

Quantification of the costs of moving to central clearing continues to be a matter of guesstimates and judgment rather than being determined by empirical data for the present. However, there is consensus in the market that the cost of providing OTC derivatives will increase to end-users, for both cleared and uncleared derivatives, as a result of regulatory reform. This may result in changes of behaviour by clients.

It is reasonable to assume that the current regulatory changes in the US and Europe will change the behaviour of derivatives users if the costs of cleared derivatives exceeds the economic value to users. As regulation begins to displace competition, the cost/benefit equation will be affected by mandatory clearing requirements. That may disrupt the market-driven evolution we have seen in the past 15 years. It is too early to tell exactly what the new world of regulation-driven cleared OTC derivatives will look like, but for at least some market participants it may no longer provide economic value. Regulatory reform has a history of spurring innovation as the market finds ways to reduce costs and provide value to clients. The result may be that new financial products come into existence that sit outside the range of current OTC derivatives but serve a similar economic purpose.

3. 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?

The discussion paper criteria are:

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.

An alternative approach that merits consideration is the one taken in the Dodd-Frank Act which sets out 5 factors to be taken into account:

1. The existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data.
2. 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.
3. The effect on the mitigation of systemic risk, taking into account the size of the market for such contract and the resources of the clearing agency available to clear the contract.
4. The effect on competition, including appropriate fees and charges applied to clearing.
5. The existence of reasonable legal certainty in the event of the insolvency of the relevant derivatives clearing organisation or one or more of its clearing participants with regard to the treatment of customer and security-based swap counterparty positions, funds, and property.

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?

The proposed criteria are:

a. the potential contribution to systemic risk of these participants; and

b. harmonisation with international requirements.

The Council further notes that an indication of the expected scope of clearing obligation would cover transactions undertaken or facilitated (as a principal or as broker or agent) by Authorised Deposit-taking Institutions (ADIs) and Australian Financial Services Licence (AFSL) holders (again, subject to any size or class exemptions that might be considered appropriate). Some additional or alternative definitions of entity coverage may be appropriate to ensure the scope of the clearing obligation is applied evenly and to minimise regulatory arbitrage opportunities.

Extending financial regulatory measures to non-financial institution counterparties, whose use of OTC markets is largely in support of their commercial activities, could have serious liquidity implications for end-user firms which could materially affect the competitive position of companies.

The principle set out by CPSS-IOSCO provides an appropriate approach:

> Fair and open access to [financial market infrastructure] services encourages competition among market participants and promotes efficient and low-cost clearing and settlement. . . . participation requirements should therefore encourage broad access, including access by participants, other market infrastructures, and where relevant service providers, in all relevant jurisdictions, based on reasonable risk-related participation requirements.

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

Commercial end-users

Commercial end-users 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.

Non-systemic financial institutions

Requiring non-systemic financial institution end-users to use CCPs would 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 the superannuation industry.

Intra-group transactions

There should be some exemption from the clearing obligation in relation to intra-group transactions. For example, this will be important as in many cases there may be legal requirements that affect which group companies can face counterparties 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.

4. 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?

AFMA considers that the threshold policy question should be around jurisdiction and access arrangements for collateral relevant to Australian based transactions rather than whether there should be clearing through a local CCP.

It may be more relevant to consider arrangements for holding collateral relevant to Australian-based transactions as the more significant question than whether there should be clearing through a local CCP.

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.

The push by multiple jurisdictions to establish a CCP could result in multiple, under-scaled or under-diversified CCPs. Several major jurisdictions have already made it clear that they will require products traded in them, or by firms located in them, to be cleared there. Jurisdictional fragmentation will inhibit the full realisation of scale and scope economies. The existence of multiple CCPs domiciled in various jurisdictions has several adverse consequences, and measures to address them can pose systemic risks and regulatory challenges. If the same product is cleared in CCPs in multiple jurisdictions, position netting opportunities will be foregone, thereby reducing the efficiency of capital utilisation and increasing the costs and risks of position replacement in the event of default.

Careful attention needs to be paid to the impact of the regulatory arrangements being established in the US and Europe. For example, the European Union's proposed 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.

AFMA would like to work closely with Council members 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.

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?

The consultations of the CPSS-IOSCO on principles for financial market infrastructures include new principles on segregation and portability, tiered participation and general business risk. In the consultation the proposed Principle 14 on segregation and portability is applicable. The substantially new principle recommends that CCPs should have segregation and portability arrangements that protect customer positions and collateral, to the extent practicable and where feasible and supported by the legal framework. This qualifying language recognises that there may be market structure or legal impediments to a CCP facilitating segregation and portability in the cash markets.

The principle is designed to offer CCPs flexibility in achieving segregation of customer collateral and identifies the advantages and disadvantages associated with the use of omnibus and individual accounts. The principle also provides expanded guidance on the way that margin is collected (gross or net basis) by the CCP and explains how different levels of customer protection can be achieved. While the principle presents options, the overall objective is to protect customer positions and collateral, particularly in the case of insolvency of a participant.

AFMA agrees that the segregation of indirect participants' positions and collateral plays an important part in the safe and effective holding and transfer of their assets. Effective segregation arrangements can reduce the impact of a clearing participant's insolvency on its customers.

AFMA has not identified a need to change Australian Law or regulation which would impose a particular model for handling margins. There are a number of ways that margin can be segregated depending on how the margin is posted and held and the segregation in place in a given situation. There are variables in margin posting that need to be taken into account, such as whether a CCP collects margin from clearing participants on a gross basis or on a net basis. 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 clearing proprietary assets or segregated from the clearing participant'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 clearing participant's name), with the clearing, 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 clearing participant. The choice of arrangements can be critical in relation to whether customer positions and related margin are likely to be successfully ported. Market participants should have freedom to contract on segregation and portability, as opposed to this being rigidly prescribed through regulation.

It is noted that the Basel Committee in its consultative document on "Capitalization of bank exposures to central counterparties", proposed a favourable treatment for "bankruptcy-remote" collateral for direct participants as well as a favourable qualifying CCP risk weight for non-member banks exposures, provided their assets were segregated and bankruptcy-remote from the direct participants. Accordingly, in respect of a particular CCP the need for rules would depend upon how bankruptcy-remote the CCP is. Consistent with this AFMA considers that under the proposed Principle 14 on segregation and portability, segregation should not be a universal requirement.

The model selected for segregation of assets and margins should be judged from the standpoint of how well it protects the positions of indirect clearing participants on their request, allows an expedite portability, and provides full transparency to the participants on their exposures. It is a common feature of CCPs for the clearing participant to guarantee performance by the client to the clearing house. The clearing participant takes on credit risk towards the client, and for that reason the clearing participant must apply credit limits to manage the extent of their exposure to clients.

Clearing participants do not guarantee performance by the CCP to the client. The rationale for this approach is that the client should look to the legal segregation framework and the financial guarantees package of the CCP rather than to the clearing participant in conducting their counterparty risk assessment. Typically clearing provides clients with the ability to port or transfer positions without consent to transfer being required of the outgoing clearing participant, which will enable a client to address possible concerns with the financial stability of their clearing participant, provided that they are able to find a suitable substitute clearing participant. If a client leaves any residual positions with the outgoing clearing participant they may be required to provide adequate collateral because the outgoing clearing participant continues to be exposed to the CCP for performance by the client for those positions. Ensuring the effectiveness of segregation and portability provisions and mechanisms is a substantial challenge and work in these areas continues in the United States and the European Union. For example, in order to provide further certainty of the effectiveness of segregation and portability provisions in the European Union, recent texts of European Market Infrastructure Regulations (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 this provision (if it survives to the final text) may be more complicated.

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?

Tax

Tax requirements should not frustrate the broader policy objectives surrounding the use of CCPs for clearing OTC derivatives. The interaction of Australian tax law with central clearing, such as it relates to the holding of collateral of onshore and offshore counterparties and withholding tax, will need to be carefully assessed to ensure tax considerations do not interfere with the objectives of containing systemic risk and providing an efficient clearing policy environment. Complex tax law issues may be raised, that include questions such as whether tax treaty arrangements are in place with other jurisdictions where a CCP may be located.

The Council should ensure that it includes its tax policy analysis and consultation with industry tax experts as part of its further work in settling policy with regard to central clearing.

Close out netting

AFMA has provided separate comments to the Treasury on 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 AFMA 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.

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

The Government has announced its intention to review the policy governing financial market infrastructure. AFMA awaits this policy consultation process as the appropriate place to consider in detail the broader regulation of CCPs. The new CPSS-IOSCO principles for financial market infrastructure will need to be considered in this context and the existing thoroughly developed arrangements under Part 7.3 of the Corporations Act dealing with licensing and regulation of clearing and settlement facilities administered by ASIC and financial stability standards set by the Reserve Bank.

In broad terms, regulation should strive to ensure that the risk-management design of a CCP is robust, but should otherwise refrain from determining which CCPs should prevail by imposing geographical criteria, or by policies that would inhibit market forces from determining which CCPs prevail. Competition issues form part of the regulatory concerns to ensure fair and open access and maintenance of appropriate governance arrangements.

Regulation also needs to take account of any potential tendencies for CCPs handling similar products to compete for market share by offering weak requirements for margin or participation in guarantee funds. Clearing participants should only be able introduce risk commensurate with their capital position. Further, entities that become clearing participants of OTC derivatives should have the ability to participate in the CCP default management process including the ability to bid for the portfolios of other clearing participants of the CCP. If a CCP admitted clearing participants that were 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 clearing participants 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 clearing participants, and reduce the likelihood that the CCP's risk management process would be effective.

From a structural point of view a CCP with OTC derivatives clearing activities should be in a separate legal entity from other businesses. This prevents the commingling of default and guarantee funds across products. It is important to ensure that a CCP's OTC

derivatives clearing activities are independently managed and 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.

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

Links between CCPs have the potential to cloud the risk picture in a financial system. Interoperability between CCPs would expose each CCP to the credit risk of those with which it interoperates. Risk to some extent can be addressed by developing strict risk management standards that are applied consistently by international authorities and by requiring CCPs to assess their operations against those benchmarks and reporting progress to their regulators.

The indication that we have at the moment is that CCPs, especially the major global ones, will be very reluctant to trust another's risk management. Interoperability requires close coordination between CCPs, particularly in a crisis. Careful consideration needs to be given to the legal framework governing enforceability of collateral posted by one CCP to another, default management, close-out and bankruptcy. The legal framework needs to support the contractual obligations between the CCPs and between each CCP and its clearing participants to prevent loopholes from being exploited in a default. Coordination by the regulatory authorities at a global level would seem to be a prerequisite but at present this looks extremely difficult to achieve, not least because of substantive differences across legal and regulatory regimes. This means that interoperability is seen as a long term desirable goal.

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?

Without interoperability of CCPs, counterparties to a trade will have to agree on which CCP to use. Some may be unwilling or unable to agree, thereby reducing the potential number of counterparties with which a particular firm can trade and reducing liquidity. This problem can be mitigated to some extent by market participants making arrangements to clear at multiple CCPs, but this increases costs and operational burdens. Maintaining multiple memberships imposes additional costs and operational challenges on the intermediaries. This also means facilitating connection of end users to multiple CCPs needs to be considered.

5. 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?

Clearing is a highly complex undertaking that requires significant adaptation of existing and development of new technology systems, operational infrastructure, and legal arrangements between parties. There are commercial incentives for clearing houses to proliferate and compete in the current environment in a way which could disrupt the market for certain asset classes if regulation forces users to use infrastructure in a manner which is incompatible with market forces. Premature imposition of new regulation which is not in harmony with market dynamics could lead to increased risks for markets and market participants.

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

Part of the September 2009 G-20 commitments was the undertaking to 'take action at the national and international level to raise standards together so that our national authorities implement global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage'. This undertaking is particularly important in relation to financial market infrastructures.

There is increasing apprehension that regulation in different G-20 jurisdictions may be creating conditions which will lead to fragmentation of markets, protectionism, and regulatory arbitrage, ultimately decreasing the ability of global regulators to effectively regulate an increasingly global capital marketplace. Different jurisdictions are enacting changes in a way that creates an uneven playing field and whether differences in approaches to regulation could give rise to competitive imbalances and/or regulatory arbitrage opportunities between different jurisdictions is becoming a real concern. Even differences that may appear relatively minor can in practice give rise to major problems and therefore be a significant hurdle to meeting the G-20 objectives.

This issue is currently especially acute in relation to derivatives market infrastructure. Major jurisdictions are creating rules which are ambiguous and which create problematic extra-territorial challenges and issues of legal uncertainty and misunderstanding which might give rise to material risk. Key jurisdictions seek to have at least some extraterritorial effect in relation to their regulations relating to derivatives. For example, in relation to the regulation of derivatives under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) in the U.S., concerns have been raised as to the extent the potential extraterritorial reach of Dodd-Frank Act in the circumstances specified will have on parties that undertake derivatives activities within the U.S. or outside the U.S. with a counterparty that is the branch or subsidiary of a U.S. bank or financial institution.

Banks and other financial institutions that undertake significant cross-border activities are particularly concerned that they may be subject to overlapping regulatory requirements in different jurisdictions and may need to comply with two or more different regimes. Areas of concern include duplication of registration and licensing requirements, clearing obligations, transaction and position reporting, collateral and margining requirements, and prudential obligations. There is also the possibility that it may be impossible for an institution to comply with conflicting requirements in different

jurisdictions. Even where compliance with two or more overlapping requirements is possible, this is likely to lead to additional administrative and compliance costs.

The effect of such regulation is to cause competitive imbalances in the international derivatives markets with market participants structuring their businesses and making decisions in relation to dealings in particular jurisdictions or with particular counterparties based on regulatory considerations rather than normal commercial grounds. The effect of such imbalances is also likely to have an effect on counterparty and ultimately client choice and lead to increased costs. If differences are material, many firms are likely to gravitate away from an integrated global approach to business and structure their businesses around specific products with local counterparties in the relevant jurisdiction.

Regulation around use of infrastructure needs to be directed at problem-solving and avoidance of conflicts and unnecessary burdens. The G-20's goal of addressing key systemic risk issues cannot be met without effective international coordination on market infrastructure.

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?

The governance of CCPs is an important issue. CCPs should be organised so as to align the control of risks with those who bear the consequences of risk management decisions. Failure to align rights with risks borne will tend to decrease the effectiveness of CCPs in reducing systemic risk.

The capital treatment definition is an important aspect of the changes which is still to be determined. While the authorities at the global level have foreshadowed that the Basel III capital charges are meant to encourage dealers to move OTC derivatives trades into clearing houses, no clarification has been provided yet on what these charges will be.

APRA has not advised yet on how the 2% risk-weight which Basel III assigns to cleared trades will work under Australian prudential standards so it is not possible at present to assess how this may affect banks in practice. While the majority of capital increases under Basel III are intended to be directed at trades with counterparties not governed by credit support annexes - mainly the corporate end-users - the amount of relief that will flow from moving OTC derivatives into central clearing needs to be promulgated before informed comment can be given.

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)?

6. Conclusion

AFMA understands the difficulties facing the members of the Council of Financial Regulators in coming to a definitive view in relation to the questions posed in the Discussion Paper. Centralised clearing is likely to have significant behavioural effects on the allocation of risk, the total amount of risk in the system, and the incentives of firms and individuals to take on, manage, and monitor risk. The cumulative effect of the changes is difficult to predict because of the complex nature of the interactions within the financial system. There is no obvious perfect solution available.

In order to deal with this difficult environment reliance should be placed on adherence to existing fundamental policy principles for the regulation of Australia's financial services. The comments in this paper reflect a belief in open systems, competition and regulatory neutrality, which we believe are in concert with the Government's policy framework. While some other jurisdictions have favoured solutions which favour particular commercial organisations we believe that such an approach is not right for Australia. The Australian national interest is served by having an open and competitive globally connected financial market.

AFMA in line with our long standing position supports the objective of the Government to require all standardised OTC derivative contracts to be cleared through central counterparties. The questions for debate surround scope, timing of transition and location. It is on the latter question of location that the greatest caution needs to be taken with precipitate mandatory rules.

AFMA appreciates that there is a legitimate regulatory concern that if the market was relying on an offshore CCP then in all likelihood its default resources and default resolution processes would be governed by the laws of its home jurisdiction rather than the laws of Australia. It is reasonable for the regulators in Australia to prefer to see a pool of collateral relating to Australian related assets in a CCP to be subject to their jurisdiction in a crisis.

Our proposal is that the Council should at this stage define a policy outcome in relation to identifying and containing systemic risk to the Australian market rather than coming to a settled determination on the means by which to achieve the outcome. The scale, nature and timing of changes going on globally with centralised clearing mean that imposing a rigid regulatory framework within Australia would lead to undesirable outcomes from both regulatory and commercial viewpoints. Flexibility in responding to evolving market structures would best serve the national interest.

Developing the means by which to achieve the policy outcome set by the Council should be conducted through a collaborative effort between the regulators and the stakeholders. AFMA stands willing and able to take leadership in moving the agenda forward on developing a concrete implementation plan that allows the industry to make appropriate risk management and business decisions based on cost and liquidity with regard to choice of CCP in line with the overall regulatory outcome set by the Council. For example, through a working group that brings industry stakeholders and Council members together.

Please contact me at dlove@afma.com.au or (02) 9776 7995 if further clarification or elaboration is required.

Yours sincerely

David Love
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