Central Clearing of OTC Derivatives in Australia

Consultation Process and Questions

To The Council of Financial Regulators

From:

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This letter refers and is in response to the Council of Financial Regulators (the "**Council**") discussion paper on Central Clearing of OTC Derivatives in Australia, issued in June 2011 (the "**Discussion Paper**"). It is made on behalf of those banks named above (the "**Group**") in their role as market participants and liquidity providers and reflects a common view on the issues raised in the Discussion Paper as it relates to their markets businesses. Other submissions may be presented by any or all of the Group reflecting particular issues or comments that require an individual response.

At the outset, the Group notes its view that the Discussion Paper provides a very comprehensive overview of the issues at hand. In essence, we recognise that there is an inherent responsibility among both regulators and market participants to follow the commitment of the G20 countries to, among other things, implement the directive that "*all standardised OTC derivative contracts should be…cleared through central counterparties by end 2012 at the latest*." As also noted in the Discussion Paper, there is a balance to be achieved between ensuring the availability and participation in central clearing services to Australian based market participants and creating a structure which recognises the significance of global markets and cross-border linkages.

In regard to the latter consideration, it is important to recognise that a solution to the G20 commitment by any member country which is entirely domestic runs the risk of fragmenting the market for those cleared products. This would occur through an absence of international participation in the local CCP, an undesirable drop in liquidity in the Australian markets, an increase in costs for domestic end-users and an alternative market for Australian derivatives operating outside Australian regulators' purview.

The core principle guiding the Group's response is that we understand the need to protect the Australian financial system and support that aim. We are concerned though that a local solution will raise costs, bifurcate the AUD derivatives market and reduce the competitiveness of Australian banks internationally, sending large portions of business offshore and beyond the judicial reach of the Australian regulators. We therefore suggest that you seek to minimise these risks by working closely with other global regulators and to implement a local solution that can

easily transition to a more global solution should the global clearing climate allow this at some stage.

For any organisation which conducts its business globally, including members of the Group, there is a pressing need for international comity. Again, in the implementation by each of the G20 countries of their commitment to increase the resilience of markets, through regulation, there is an emerging concern about extra-territoriality and the multiplicity of obligations imposed on market participants whose activities touch each relevant jurisdiction. While interoperability is a laudable aim for global financial markets, there is also a perception that different jurisdictional laws, most relevantly bankruptcy laws, will prevent that from happening in the foreseeable future.

In considering regulation of OTC derivatives activity in Australia there is an additional fundamental issue that needs to be recognised. The regulatory agencies that comprise the Council do now, through existing Australian laws, regulate those persons who carry on the business of dealing in financial products. If Australian-based market participants were to use offshore CCPs, that does not in and of itself preclude the regulation of those participants by the Council agencies. In fact, as acknowledged in the Discussion Paper, it is inevitable that Australian-based participants who are active in global markets will use those offshore CCPs for the clearing of derivative products which otherwise have no connection with Australia.

In considering the balance between a domestic and a non-domestic solution, the fundamental issue of cost must be considered. While, as discussed below, the cost is difficult to estimate, the reality is that the creation of an Australian domestic CCP will take both time and a considerable amount of money. Both of those factors should be considered in the context of a global environment where existing central clearers do currently exist and will be used by some Australian based participants who will shortly be impacted by new foreign laws on clearing. Therefore the marginal cost of transacting through a domestic CCP will be greater than that for existing CCPs, and likely higher than that for any future multi-currency CCPs. This point is particularly relevant where some market participants have a choice in clearing venue whilst others may be required to clear locally, placing them at a disadvantage. Lastly the volume transacted through the local CCP needs to be maximised in order to provide a business case to any potential sponsor.

The Discussion Paper suggests up to 80% of swaps that may enter clearing could be included in the mandate, it would be essential to attain this penetration to minimise some of the difficulties outlined above.

Suggested Responses

6.2.1. The potential clearability of OTC derivatives

Q1. Do you consider the product characteristics of any OTC derivatives classes traded by Australian market participants make them amenable to central clearing in general? If so, what classes would you include, and for what reasons? For which classes do you think central clearing is inappropriate, and for what reasons?

The characteristics of derivative products which are amenable to central clearing are primarily standardisation, a lack of complexity (in terms of valuation), broad usage, liquidity and to a certain extent fungibilty. These are, of course, characteristics which have seen the development of the futures industry where clearing is part and parcel of the way of business. These products enable a CCP to efficiently manage its risk and exposure to the portfolios of CCP members. The clearest OTC candidates within any jurisdiction are domestic interest rate derivatives.

Regarding exclusion for certain classes or products, as noted in the Discussion Paper, at a minimum we should harmonise with exclusions generally applying globally. Given the proposed US Treasury exemption, and indications from other jurisdictions, in particular the EU, on harmonisation in this regard, we support the position adopted in the discussion paper that *"Council agencies would expect that Australian requirements would be harmonised with this".*

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

As noted in Q1, the most likely feasible products in Australia are AUD interest rate derivatives, and within that class AUD interest rate swaps present as the most likely candidate. Relevantly, central clearing is likely to promote matching and trade compression which can reduce the gross risk faced by all participants because the underlying products are somewhat homogenous. Those products that have multi-currency risk and therefore are cross-jurisdictional in nature (including FX Options) are unlikely to lend themselves to clearing until linkages between CCPs to manage multi-currency products are established.

The volume of credit derivatives traded in Australia is very low and it is our position that it would not currently either meet the test of a "clearable" OTC product or provide sufficient turnover to cover the costs of establishing clearing.

Q3. Do you agree with this paper's suggestion that Australian dollar-denominated interest rate derivatives traded in Australia have the volume and characteristics to be viably centrally cleared?

We agree that it would appear likely that Australian interest rate derivatives, and within that more specifically interest rate swaps, demonstrate the attributes that would make them suitable for central clearing. However, our fundamental concern is that a model of central clearing which creates a bifurcated market will reduce the market participation and liquidity of Australian dollar-denominated interest rate derivatives, therefore reducing the viability.

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 costs of adopting a central clearing platform include:

- Infrastructure build for CCP and/or broker connectivity
- Adapting MIS to accommodate new reporting and margin management requirements
- The costs incurred in posting collateral
- For direct members, both the proposed capital deduction and funding cost for default fund contributions

- For non-members who are banks, the question of capital relief is currently unresolved, and therefore there is a risk that these entities may not receive capital relief whilst still incurring the costs of clearing
- CCP (and broker if dealing indirect) fees
- Loss of netting benefits and increased counterparty exposure if some parts of a portfolio are cleared whilst others remain bilateral (e.g. risk offsetting structured and standardised derivatives with the same counterparty)

While the financial impact of clearing AUD swaps can be catered for in the pricing of new transactions (i.e. by increasing the cost to the end-user of transacting), this would not be possible if participants were required to rebook legacy transactions into clearing. For this reason, the Group would not advocate mandatory backloading of existing transactions to clearing houses. However it should be noted that if the costs of clearing some or all legacy trades was lower than the capital charge and other costs involved with keeping them outside clearing participants may, on a case by case basis, mutually agree to backfill.

6.2.2. Mandatory clearing requirements

Q5. Do you agree or disagree with the proposed criteria for deciding whether a class of OTC derivatives should be mandatorily cleared? (See point 1 under Section 5.1)

Broadly agree. It is important to note that in determining mandatory clearing suitability there are two questions: the suitability of the product characteristics; and the suitability of a CCP to manage the product. The mandatory requirement should not be made independent of the CCP frameworks available. In other jurisdictions it appears that a two-step bottom-up process is more likely. That is, a CCP will initially be approved to clear a product on a voluntary basis first, and then a decision to make that product mandatory will be made subsequently. There are steps outlined in the Dodd-Frank Act[1] for example that provide a methodology for a product's acceptance to clearing. Therefore questions such as risk management expertise, systems, scalability, access at any CCPs considered for mandatory clearing as well as the effect on competition must be considered and form a key part of the decision to mandate. Australian criteria need to ensure that the CCP will be acceptable to other

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[1]Dodd-Frank Act S.723(D)(ii):

"'(ii) In reviewing a swap, group of swaps, or class of swaps pursuant to subparagraph (A) or a submission made under subparagraph (B), the Commission shall take into account the following factors:

''(I) The existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data.

''(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.

''(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 derivatives clearing organization available to clear the contract.

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

''(V) The existence of reasonable legal certainty in the event of the insolvency of the relevant derivatives clearing organization or 1 or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds, and property."

regulators such as the CTFC who would be required to approve the CCP for their regulated entities to utilise it.

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)

With respect to the harmonisation of international requirements, we note that there is a general regulatory direction toward excluding non-financial (commercial) end-users of derivatives, and potentially certain narrowly defined end-users who are financial institutions from any mandatory clearing requirement. With respect to end-users generally, it is important that regulatory change recognise the importance of derivatives as a financial risk mitigant. A mandatory clearing requirement that would expose cashflow constrained but otherwise creditworthy end-users to post cash margins today against sensibly hedged future exposures has the potential to cause stress within those corporates and should be discouraged. Higher capital charges under Basel III will ensure counterparties manage exposure to this class of participant effectively.

We therefore support the position of the discussion paper that it may be that in Australia an appropriate 'line' to be drawn can occur with the exclusion from any mandatory requirements being granted to participants who are not holders of an AFSL or who are not ADIs. In addition, certain AFSL holders and small ADIs who are sporadic users of derivatives in low volume should also be able to retain bilateral relationships due to the high cost of accessing CCPs and their very limited systemic risk potential.

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

Product exemptions should generally recognise international standards and ensure the Australian market is not penalised relative to international convention or regulation or provides an opportunity for regulatory arbitrage. It is the view of the Group that products that involve any non-AUD currency should be excluded from a mandatory domestic CCP requirement.

Transactions in derivatives among members of a group of affiliated companies should be explicitly excluded from any requirement for central clearing. Intra-group risk management is effected to ensure an appropriate compliance with the regulatory and other legal restrictions imposed on any group, rather than any other reason, and ensuring that the appropriate legal entity has a managed risk position.

Finally, it is arguable that short-dated trades (with a tenor of, say, less than 3months) have less contribution to systemic risk and could be exempted from any mandatory clearing, as there is greater transparency on counterparty credit risk over a short time period and less potential credit exposure.

6.2.3. 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?

Implicit in this question is the notion that having an Australian domiciled CCP clearing OTC derivatives that are systemically important to Australia will provide a key to management of systemic risk in Australia. Certainly, the ability for local regulators to manage systemic risk in Australia is a desirable if not essential outcome of any regulatory change. In general, the move to central clearing, whilst designed to address counterparty credit risk issues, creates of itself other systemic risks tied to member defaults and potentially the failure of the CCP itself. These risks are present in all CCPs, and the global community is seeking a harmonised approach through the CPSS-IOSCO work on Financial Market Infrastructures.

By definition, an Australian domiciled CCP will be able to be controlled, through regulation by the Council's agencies. The question posed however is whether a domestic clearing solution provides a better systemic outcome for markets that are systemically important to Australia. A domestic CCP provides the Australian regulatory community with direct oversight over the governance, rules, operation, monitoring, and enforcement of a CCP and in a crisis the local regulators would have an unfettered ability to make the decisions they deemed necessary to preserve stability in systemically important markets. Collateral is also preserved in the local jurisdiction.

The Council will not be able to direct all market participants, but may seek to maximise the volume of business captured in the domestic CCP as a percentage of the total AUD market. Any regulatory solution promulgated by the Council would need to ensure that market participants whose 'home' regulator is outside of Australia are not restricted through their own laws from participating in the Australian market. It follows that a solution managing systemic risk for Australia must consider:

(a) Regulation of conduct in Australia;

(b) Regulation of conduct outside of Australia by Australian persons who are subject to Australian regulation (for instance, qualifying AFSL holders and ADIs);

(c) Regulation of conduct outside of Australia by persons who are not otherwise subject to Australian regulation but whose behaviour affects systemic risk in Australia (for instance, through dealing in AUD denominated or sited assets).

It is important that a solution be developed in co-operation with overseas regulators to ensure that the benefits which flow from any use of a CCP are available as a tool for the management of Australian systemic risk. That would be achieved by any domestic CCP or non-domestic CCP used by those organisations which are within the regulatory framework of the Council's agencies being required to be of an international standard agreed by global regulators. Such an approach enables a regulatory solution to be achieved without promoting commercial disincentive to participate in any given market. The standard established by the Technical Committee of the International Organisation of Securities Commissions would serve as an appropriate starting point.

It should be noted that a domestic CCP does not necessarily address the systemic risk to which Australian market participants are exposed via their involvement in global markets. We note that there are different models of clearing emerging in global markets, most particularly an agency model (adopted through the US with the clearing role being undertaken by a Futures Commission Merchant) and principal model (adopted generally in Europe). Any regulatory solution promulgated

by the Council would need to ensure that market participants whose 'home' regulator is outside of Australia are not restricted through their own laws from participating in the Australian market

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 most significant impact to the local market of mandated clearing though a domestic CCP would occur if market participants, who are not compulsorily required to clear through that domestic CCP, do not so clear. This could follow from a choice made to clear but through a different (presumably non-Australian) CCP or to otherwise discontinue their involvement in the AUD derivatives market. Either of those outcomes will impact negatively on the liquidity available in the AUD market, potentially leading to a bifurcated market and deterioration in liquidity and access.

The efficiency of the CCP and its ability to provide its service at a low cost will be an integral part of its success. It will also be important to understand how the other regulators will treat the capital position of the entities they regulate for their positions with the local CCP.

The local CCP should comply with global best practice on Risk Management. As noted above, the structure of any CCP, including an Australian domestic CCP, must meet an internationally agreed standard in terms of membership criteria, corporate and governance structure, waterfall and default proposals and submission to regulator direction in times of crisis. Being a DCO under Dodd-Frank would be essential, for example. From both a systemic risk perspective and a desire to attract participants who would otherwise choose not to use the CCP, effectiveness and efficiency of the CCP is critical.

The model of the ownership of an Australian CCP will be of critical concern for its members. Although difficult to quantify, it seems clear that the development cost of a "greenfields" AUD OTC derivative clearer will be substantial. If the model requires or implies that local participants must finance the development (as has occurred in more mature existing CCPs) that could amount to a very large commitment. Market participants have suggested that as little as 30% of the market would be captured by this CCP which would make viability very challenging.

Clearing through an offshore CCP has several positive features. The key risk management process is more likely to be mature and supported by the most significant and substantial participants in each market. The AUD product will be a small proportion of that CCPs business and consequently will benefit from economies of scale. Offshore CCPs are already supported by the most significant global market makers so the AUD product will find the widest possible clearing for those who utilise it.

In summary, we note the following issues relevant to a non-domestic CCP.

(a) Advantages

- Improve pricing and liquidity (by avoiding fragmentation)

- Greater scope for margin netting (liquidity and funding efficiencies). Ideally similar products would be cleared globally at a single CCP to maximise these netting benefits (positive potential margin offset with swaps denominated in other currencies)
- Leverage demonstrated operational capabilities of established offshore CCPs (e.g. LCH Swapclear) with proven track records; and reduced operational complexity of multiple standalone CCPs
- Scale – Reduces financial cost by creating economies of scale through volume aggregation; broader market participation reduces single participant credit concentrations
- Ease of transacting with major international market participants
- Centralised collateral pools will make it easier to manage collateral most efficiently

(b) Disadvantages

- Risk management oversight provided by a non-Australian regulator, with little scope to direct problem resolution if other currencies are also in stress
- Membership terms and conditions, including default waterfall structures, can be onerous for regionally focused businesses as they reward currency and product diversity and large portfolio in terms of default fund contributions and margin multipliers
- Acceptable collateral may be inefficient for Australian users
- Collateral is held offshore and may be difficult to access in times of stress of the CCP
- Systematic interdependence with all derivative markets instead of a ring-fenced AUD market
- Inability to agree commercially viable terms for membership will dilute the ability for Australian members to participate in any default management process and new product approval processes of an International CCP
- Clearing in non-Australian based time zones is operationally more challenging and inefficient in achieving a cleared trade outcome

The cost analysis is difficult to present as the configuration of the CCP is a key point. Until an AUD CCP architecture is known the margin calculations and other terms cannot be effectively compared. It is also clear that the existing business models of the established CCPs will have to evolve in order to meet new hurdles imposed by evolving international laws. Whether a domestic or a non-domestic solution is utilised, cost will become a factor. The extent of the costs would vary dependant on the services the participant was looking to provide to their customers and counterparties. There would be both establishment expenses as well as fixed and variable ongoing costs.

The key costs entities face in order to clear are:

- Technology build for reporting of trades to external stakeholders
    - Affirmation platforms
    - Trade repositories
    - Execution counterparties
    - Organised electronic platforms

    - Clearing Houses
- Technology build to adapt internal reporting systems
    - Deal capture
    - Settlements
    - Collateral management
    - Cleansing and enhancing existing static data
    - System architecture and analysis of new systems
- Legal review
    - Review of CCP structure, ensuring bank capacity to participate
    - Review all existing ISDA and creation of new trading relationship documents to align with CCP needs
    - Amendment and update of CSAs
    - Preparation/review of broker agreements
    - Declearing protocols
- Credit
    - Credit exposure to CCPs
    - Collateral types
    - Clearing members
    - De-cleared or failed pre-settlement risk
- Middle Office review
    - Endorsement of CCP revaluation protocols
- Operations
- Finance

Ongoing costs include

- CCP clearing fee
- Intermediating broker fee (if used)
- Bid/ask on margin from CCP and or broker

At any level, the establishment costs any domestic CCP faces are likely to be very significant. It is likely that an established global clearing business will be able to apply better economies of scale on their establishment and maintenance costs were they to create an Australian entity than a stand-alone domestic entity. Whilst these fees would be applicable to any CCP, the costs to an Australian CCP will not have the benefits of economies of scale and will be higher than offshore CCPs.

Clearly any mandated clearing is likely to have infrastructure costs for all participants. Market makers or relevant participants could expect to bear a large portion of the developmental spend, but end-users would also face many of these costs as they standardise systems and records. It is likely most of those costs will be incurred whether clearing is at a domestic or international CCP.

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?

We expect Australian laws may need to be reviewed and modified if required, most possibly in the areas of insolvency law and the rights and obligations of the CCP with respect to its treatment of

margin, however this submission does not intend to provide responses that may be construed as legal advice.

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 Q10 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?

Refer to Q10 above.

In addition, we note that there are a number of regulatory measures that should be made:

- Portfolio compression should be mandatory through CCPs
- Restrictions should be placed on complexity of products allowed to be cleared in CCPs
- Reporting of risk and stress testing/scenario analysis for CCPs including limits on concentration of one way risk
- Minimum ratio of contribution to default fund by the CCP.
- Minimum margining requirements for CCPs
- Rigorous oversight standards by the Regulator

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

Interoperability should be encouraged as a step toward establishing an efficiency of global clearing, enabling market participants to transact in multiple asset classes through the most appropriate CCP. However, it is important to note that international insolvency and other laws will impact the viability of interoperability and any CCP solution should not necessarily rely on a short term resolution of the conflicts and issues which prevail.

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?

We remain uncertain as to the implications on the Australian market of mandated clearing and in particular the change in volumes and dynamics which that might create. It is therefore our expectation that the AUD interest rate derivatives market would struggle to support multiple clearing venues, even in a mandated environment. The cost of clearing services is likely to be a major expense for derivatives users over time. The ability to influence cost structures and product coverage may be critical for Australian participants.

6.2.4. 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?

Refer to Q10 above, although we do note that the ability of the Council agencies to regulate will be impacted by general jurisdictional constraints.

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

Domestic Australian derivative participants are heavily reliant on international market participants in order to provide risk mitigation. Ensuring any mandated clearing platform complies with international requirements is therefore essential. In addition, the corollary applies in that many Australian AFSL holders and ADIs, directly or through their affiliates, operate in a global market outside of Australia, dealing with non-Australian enterprises. From a participant perspective, therefore, it is vital that the regulatory framework which is established is clearly prescribed. A multiple set of clearing obligations with respect to any one product between two international counterparties will not only create regulatory confusion but be detrimental to the overall objective of systemic risk management.

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?

Refer to Q10 above.

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)?

Australian market participants will make arrangements that maximise their access to market liquidity. This is likely to drive them towards clearing a portion of their business via CCPs to ensure the liquidity provided by those who are mandated to clear can still be accessed. In addition, it is likely that capital efficiencies will drive Australian participants to global CCPs despite Australian law not requiring them to do so. Finally, Australian participants will, directly or indirectly through their affiliates, be regulated by laws emerging in the market outside of Australia. That is to say, they will be, in part, the foreign dealers affected by the regulation of the derivatives industry regardless of the outcome in Australia.

It is relevant to note that AUD interest rate swaps between global banks are already being cleared in large volume at existing CCPs, though no Australian ADI has membership of such a CCP. Whether a domestic CCP or a non-domestic CCP is resolved as the outcome for clearing AUD derivatives, the motivation to clear will be driven by a combination of regulatory direction, accessibility, pricing and liquidity and capital and funding implications. The issues raised in the Discussion Paper are important ones although the Group, like others in the global markets, has some difficulty in determining an optimal path.

If the Council agencies and Government determine on balance that mandating central clearing of OTC derivatives in Australia is preferable to waiting for greater global clarity in both regulations and design, then we believe it is important the industry as a whole quickly moves to a scoping and design phase to support that outcome. That phase would include determining participant classes and exemptions, derivatives product classes and exemptions, permissible categories of clearing outside

of Australia, and other key design conditions such as preserving the competitiveness of the Australian based market and ensuring as level a playing field as possible. The viability of varying solutions also needs to be properly analysed during this phase.

Alternatively if a local CCP is not viable or cannot be mandated without placing local buy side or sell side at an unacceptable competitive disadvantage, the Council needs to determine the terms under which offshore clearing of AUD product is acceptable.

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