AUSTRALIAN BANKERS' ASSOCIATION INC.

Nicholas Hossack
Policy Director

AUSTRALIAN BANKERS' ASSOCIATION INC.
Level 3, 56 Pitt Street, Sydney NSW 2000
p. +61 (0)2 8298 0408 **f.** +61 (0)2 8298 0402

www.bankers.asn.au

22 June 2012

Manager
Financial Markets Unit
Corporations and Capital Markets Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: financialmarkets@treasury.gov.au

Dear Sir/Madam,

IMPLEMENTATION OF A FRAMEWORK FOR AUSTRALIA'S G20 OVER-THE-COUNTER (OTC) DERIVATIVES COMMITMENTS

The Australian Bankers' Association (ABA) is pleased to make a submission to Treasury's review of the proposed OTC legislative framework. In general, we are pleased with the Government's proposed regulatory framework. We think the proposal will enable the Government to meet the obligations made at the 2009 Pittsburgh G20 meeting.

The ABA broadly supports the submission made by the Australian Financial Markets Association (AFMA). Our purpose with this submission is to encourage the Government to move more quickly to licence central counterparty clearers.

Background

In 2009, Australia (as part of the G20) announced it would move to regulate OTC derivatives, requiring greater use of trade information repositories, clearing through central counterparties, and greater use of trading platforms. This represented a major commitment for Australia as the vast bulk of OTC derivatives are agreed and cleared bilaterally.

As a consequence of this G20 agreement, the Council of Financial Regulators (COFR) began work to better understand Australia's OTC markets and to recommend a way forward, in order to meet the G20 undertakings. This work has culminated in a recommended regulatory approach which is characterised as (a) establishing a legal framework to regulate participation and transaction activities in OTC markets, and (b) waiting to see how the market responds to various forces before developing specific regulatory rules.

The COFR has rightly identified AUD interest rate swaps (AUD IRS) as the key systemically important OTC market in Australia, but has stopped short of giving clear direction on how these agreements should be cleared. While this is consistent with the idea of allowing 'market forces' to drive outcomes, it is potentially costly in terms of efficiency.

After discussions with ABA member banks, it is apparent that there are differences of opinion on how the AUD IRS market should be structured, particularly relating to central counterparty clearing. Some member banks essentially want the AUD IRS market to be cleared through the existing international clearing infrastructure, LCH ClearNet and the Chicago Mercantile Exchange (CME).

Many ABA member banks are already members of these international clearers and this membership gives them an incentive to encourage a greater volume of business through them.

Other banks have indicated that, even though they are not direct members of LCH and CME, by pushing the AUD IRS to these clearers, real liquidity and efficiency benefits can be derived. The argument is that the wider the umbrella, covering various types interest rate derivatives and participants, the greater potential for margining benefits.

However, other ABA members, particularly those domestically owned, have greater reservations over changing their current bilateral clearing practices. Some banks have indicated that they have significant investments in their current bilateral systems and do not see a case for central counterparty clearing.

In addition, some banks have expressed concerns about the operational capability of London and Chicago based clearers to operate effectively in Australia's time zone and the capacity of Australian banks to influence operating rules and default arrangements.

Clearing AUD IRS through international clearers raises risk considerations, including exposure to foreign insolvency laws, and also cost considerations. The advice to the ABA is that it would probably be too costly for an Australian-owned bank to become a direct member of an international clearer, particularly given the higher costs for banks with concentrated portfolios, such as AUD-dominated portfolios. Yet, there are also costs associated with clearing indirectly through an existing clearing member.

Compounding the uncertainty is what Australia's regulation will ultimately require.. Will Australian regulators ultimately allow banks to clear through LCH ClearNet and CME? The obvious answer to that is 'yes', so long as these international clearers meet the licensing requirements. The problem is that the licensing requirements have not been written and/or published, so the banks are having to make decisions with key pieces of the puzzle missing.

'Wait and see' is not benign

Deliberately, the Government has said it is taking a 'wait and see' approach before moving to licence and set rules for clearing AUD IRS agreements, relying on market forces to shape the outcome. Of course, the risk here is that the market moves in a certain direction which is later found by regulators to be inadequate.

The 'wait and see' approach, therefore, is not benign for banks; it has consequences. We understand that the US Commodity Futures Trading Commission (CFTC) which has responsibility for implementing the G20 OTC derivatives policy and relevant Dodd Frank requirements will release in June 2012 its Cross-Border Convergence Guidance Paper.

For Australian banks to continue trading in derivative products with US counterparties, our regulatory regime must be deemed as a *'comparable and comprehensive foreign regulatory regime'.* Without clear rules on how Australia's OTC derivatives are to be cleared, it is hard to see how our regulatory regime will be seen as comparable.

Therefore, in order to avoid disrupting their overseas derivative operations, banks are likely to clear their agreements through LCH ClearNet or CME via an existing member. Another driver of the migration to clearing through LCH ClearNet and CME is the higher capital charges imposed by Basel III for interest rate swaps cleared bilaterally. This new capital charge commences in January next year.

Recommended way forward

In discussions with banks, the view is that by January 2013, banks will have moved to clear their AUD IRS through LCH and CME. It is critical therefore that the Australian regulators are comfortable with this outcome and, if not, they take quick action to intervene in this process.

The ABA floated the idea of forming a group of banks to agree a set of basic requirements of any central counterparty and then using a tender process or some other device to secure a commonly agreed central counterparty clearer for AUD IRS. The idea here is that a collective process to find a central clearing solution would have efficiency advantages.

There was little support for this approach. By far, the strongest advice to the ABA is that it will require the Government to clearly set out a path forward for the central clearing of OTC derivatives, especially AUD IRS. In practical terms, this will require legislation to be passed through Parliament within the next two or three months, and for ASIC to outline its specific licensing requirements[1] for central counterparty clearing well before January 2013.

[1] Location of critical functions (such as risk management, support etc); Location of initial and variation margin; Membership criteria; Default management process; Size and composition of the default fund; Segregation of margin and default funds; Regulatory oversight; Governance and representation

Given that the commercial interests of banks are not aligned on this issue, coupled with the reality that this market is now a regulated market, the ABA sees little alternative than for the Government through its rule making and licensing powers to determine how AUD IRS should be cleared.

If you would like further information, please don't hesitate to contact me.

Yours sincerely,

_____

Nicholas Hossack