ISN SUBMISSION

REDUCING SYSTEMIC RISK IN OVER-THE-COUNTER DERIVATIVES

THE CORPORATIONS LEGISLATION AMENDMENT (DERIVATIVE TRANSACTIONS) BILL 2012

20 August 2012

SB1228

Industry Super Network

Industry Super Network undertakes collective projects on behalf of a number of industry super funds, including analysis of public policy in the interest of five million members. Although ISN has historically focused on public policy related to superannuation, the financial turmoil of recent years and the harm it has caused our members – ranging from reduced investment returns to confidence in the superannuation system – compels us to engage on broader issues related to the financial system itself.

We welcome the opportunity to comment on the *Corporations Legislation Amendment (Derivative Transactions) Bill 2012*.

The global financial crisis imposed trillions in losses on pension funds and their members around the world.[1] Public support of the financial system, directly and indirectly, was trillions more.[2] The follow-on effects of the crisis continue to undermine economic growth and investment returns worldwide, and here in Australia, notwithstanding that funds in our network (and, we believe, super funds more generally) avoided the toxic products and practices implicated in the GFC.

In September 2009, G-20 leaders agreed that (1) all standardised OTC derivative contracts should be (a) traded on exchanges or electronic trading platforms, where appropriate, and (b) cleared through central counterparties by 2012 at the latest. (2) OTC derivative contracts should be reported to trade repositories. (3) Non-centrally cleared contracts should be subject to higher capital requirements.

In our view, implementation of the G-20 commitments would reduce systemic risk in the global financial system. However, the draft legislation should adopt a more streamlined and efficient approach. We appreciate that the bill would provide the Minister for Financial Services and regulators with potentially broad powers, but the layers of process, and the potential for wide variation in treatment of different derivatives and market participants, has the potential to produce an unwieldy, and ultimately less effective, regulatory regime.

Some examples of the inefficiencies in the draft legislation include that it:

- Prohibits derivatives rules from imposing any requirements, even reporting and transparency requirements, unless the Minister has made an affirmative determination that rules can be made as to that specific class of derivative.

- Requires the Minister to have regard for the regulatory impact of the determination and to consult with each of the financial regulators prior to making any such determination. This could have the practical effect of meaning only determinations that have the consensus of the regulators and Minister will be promulgated, and thus it is possible that only derivatives where there are clearly established problems might be regulated. Put another way, regulations would only be put in place after there has been harm. (This strikes us as an approach that is exposed to the weaknesses seen in the United States prior to the Commodity Futures Modernization Act, at which time the Chair of the Commodity Futures Trading Commission sought to regulate OTC derivatives and was unable to do so in the face of opposition by other regulators and the Secretary of the Treasury).

- Prohibits application of requirements, even reporting requirements, for transactions that occurred in the past. As a result, it would be virtually impossible for the public to gain an accurate picture of

---

[1] See, e.g., Pension markets in focus, OECD, December 2008 (Observing that "Between January and October this year, private pensions in the OECD area have registered losses of nearly 20% of their assets (equivalent to USD 5 trillion).").

[2] See, e.g., Andrew Haldane, Banking on the state, 25 September 2009 (estimating that public support of US, UK, and European banks as a result of the GFC is greater than US$14 trillion).

current and historical market practices and exposures.

- If the Minister makes a determination, ASIC's rules are subject to various hurdles, including that each decision to make rules for a class of derivatives will require separate public consultation and each set of rules would require the consent of the Minister (in addition to being disallowable by either house of Parliament as is customary). Insofar as mandatory requirements are put in place, the bill contemplates and makes express provision for carve outs and exceptions to any reporting, clearing, or execution requirement.

We also note that the legislation creates for derivatives market participants a special set of alternatives to civil law enforcement proceedings. Specifically, market participants who allegedly violate the law relating to trade repositories can avoid civil proceedings by paying a penalty (apparently not to exceed 200 penalty units, or about $28,000); other alternatives include undertaking remedial measures (including education) and accepting non-financial sanctions. It is not clear why derivatives market participants are entitled to this special treatment, and no rationale is discussed in the explanatory memorandum. We question the deterrence effects of providing market participants with options to avoid civil proceedings. (Where a regulator has determined to accept a settlement for alleged violations in the public interest this may be appropriate). More generally, we recommend remedies consistent with similar breaches as a starting point.

Implementing the G-20 principles in a manner that is in the public interest would benefit from a more simplified and streamlined approach. Some changes that we believe should be made include:

- All derivatives transactions should be required to be reported and publicly available in a data format that facilitates independent analysis. Transparency is a necessary and basic feature of fair and efficient markets, and should happen without the need for any action by the Minister.

- Classes of OTC derivatives that are accepted for clearing by a licensed clearing house should be required to be cleared without the need for a determination by the Minister.

- Alternatively, all classes of derivatives could be required to be cleared and exchange-traded as a default, with the opportunity for a participant to seek an exemption, which exemption would be issued only after public consultation. The draft legislation puts extraordinary burdens on the Minister and regulators just to meet the basic commitments of the G-20; instead, the legislation should affirmatively adopt the G-20 commitments and enable participants to obtain an exemption where there is good cause. The core of the G-20 commitment was a shift from (a) the approach to derivatives regulation enshrined in the United States Commodity Futures Modernisation Act, which generally excluded derivatives from regulation other than anti-fraud, to (b) at least a basic framework of regulation that requires for all swaps significant transparency, and for all standardised swaps, engagement with regulated parts of the financial market infrastructure. Put another way, the G-20 commitments reflect a straightforward decision that the faith in sophisticated market participants to manage their risks was misplaced, and that the bulk of these transactions should move into a regulated environment.[3]
  - Reliance on capital "incentives" to promote central clearing strikes us as misguided. To be effective, the "incentive" must provide a net economic gain to the entity that is determining whether to submit a contract for central clearing. As a result, the capital incentive likely must be

---

[3]For example, the legislative history of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which is part of the United States' response to the G-20 commitments, provides that one of the objectives is "bringing in as much of the OTC market under the centrally cleared and exchange-traded framework as possible." Report of the United States Senate Committee on Banking, Housing, and Urban Affairs regarding The Restoring American Financial Stability Act of 2010, S. Rep. No. 111-176 at 34. See also, e.g., United States Securities and Exchange Commission Release No. 34-63557 (2010).

greater than the reduction in risk arising from central clearing, which could have perverse results. When one considers that the profit potential in the bilateral environment may be greater due to informational asymmetry and other factors, the capital "incentive" needed to overcome the private incentives in favour of the bilateral environment may be quite significant. A straightforward requirement for central clearing of standardised contracts, in conjunction with higher capital charges for bilateral derivatives, is likely to be more efficient.

- The legislation should require rigorous position limits on derivatives, or at a minimum expressly enable position limits to be set. Derivatives positions in excess of a bona fide hedge are intrinsically additional financial system risk. Position limits permit derivatives to facilitate the shifting of risks to parties best positioned to bear those risks (we acknowledge that whether derivatives actually accomplish this is open to doubt). The absence of position limits, however, enables leveraged speculation, which has been economically destructive in credit derivatives.
  - We also note that encouraging excessive leveraged speculation can undermine meaningful price discovery. Liquidity affects the basis on which one enters into transactions and makes valuation decisions (in particular, pricing in a liquid market generally reflects expected resale price in the short-term, not long-term fundamentals).[4] Some might argue that stronger capital requirements and collateral requirements that would arise from the G-20 commitments will reduce the scope of leveraged speculation. We support stronger capital and collateral requirements, but do not believe they substitute for position limits. Capital requirements and collateral requirements can both be procyclical, and collateral can increase contagion risk, especially if it is rehypothecated.

- We recommend deletion of the provisions that would require the Minister, before determining that a class of derivatives may be regulated, to consider the likely effect on the Australian economy, and on the efficiency, integrity and stability of the Australian financial system, of allowing the derivative transaction rules to impose requirements. First, this inquiry is phrased in a one-sided manner (it does not ask what would be the effect if requirements were not allowed to be imposed). Second, it is unnecessary because the Minister, as an elected public official, is already expected to make decisions in the public interest after considering appropriate facts and circumstances. Third, it is under inclusive, as it does not specifically call for the Minister to focus on the public interest, which may include consideration of these economic effects, but should also include other matters. Finally, there is a significant danger that requiring the Minister to consider specific factors will invite legal challenges of a Ministerial determination on procedural grounds (i.e., a party whose commercial interests are adversely affected by the determination or ASIC rules could challenge the Minister's decision claiming the Minister did not consider the specified factors, which could result in the Minister having to produce privileged deliberative materials or undertake a burdensome process of building a paper trail and decision making record to establish a defence). Relatedly, the draft provisions invite judicial scrutiny of a public policy and political judgment.[5] We are concerned this provision could lead to judicial second guessing of Ministerial decisions on matters of policy.

- Access to trade repository data (at least in respect of trades with an Australian nexus) should be free for non-commercial purposes. One reason is that superannuation trustees and their advisors likely

---

[4] See, e.g., Michael Carter, Uncertainty, Liquidity and Speculation: A Keynesian Perspective on Financial Innovation in the Debt Markets, Journal of Post Keynesian Economics (Winter 1991-1992).

[5] A judge hearing an allegation that a Minister did not consider the necessary factors will almost certainly have to determine whether, in the judge's view, the Minister's consideration was "adequate." A judge also may feel compelled to make a determination about whether, in the judge's view, the Minister's consideration of the specified factors resulted in a "reasonable conclusion."

would want to understand the nature of derivatives risks of Australian institutions, and Australia's financial markets infrastructure, but performing the data analysis would generate classic public goods problems. We also note that derivatives already present an externality insofar as superannuation funds likely will have to pay for staff and data analysis, even if the data is made available without cost for non-commercial purposes.

- Because the public disclosure would be for non-commercial purposes, a material delay would not appear to be necessary. Non-commercial use would limit the risk of adverse effect on the commercial interests of derivatives market participants, foster transparency, and enable academics, the press, and long-term capital providers to contribute to the analysis of this market for the protection of their members.
- Relatedly, the special provisions in the legislation that allow for rules to specify as "in confidence" the information provided by a trade repository to ASIC may be in tension with fair and transparent markets, and public accountability. ASIC should be able to make case-by-case decisions to treat information as "in confidence" where there is good reason to do so.
- We would encourage the Government to consider establishing a trade repository as a public institution or utility that recovers costs from markets participants who engage in derivatives trades. In this way, the transaction data has the potential to be a true public good. A private trade repository, however, may effectively subsidise derivatives trading by selling transaction data for trading and non-trading analytical purposes to parties that do little if any such trading.

The above changes should reduce the complexity of the draft legislation and follow-on regulatory efforts, resulting in a more streamlined and efficient approach to implementing the G-20 commitments. This, in turn, would increase the likelihood of effective reform.

General comments

Industry super funds are long-term investors. Our members are better off when there is stable growth and broad prosperity.

The G-20 commitments are built upon important and basic requirements of fair and orderly markets. These commitments, if properly implemented, would significantly improve the regulation of derivatives. We strongly support the Government's efforts to implement them in Australia. A failure to do so invites cross-border regulatory arbitrage that, even if it did result in increased derivatives business based in Australia, would not be of a kind that is conducive to market stability. One of the key lessons arising from the United States' experience of the GFC is that permitting different regulatory treatment of OTC derivatives relative to on-exchange derivatives and cash markets resulted in the rapid growth of risky financial activity in the unregulated market.[6] The business built via regulatory arbitrage rested on weak foundations.

While we strongly support implementation of the G-20 commitments, we note that they are limited in focus. They focus primarily on reducing systemic risk.[7] While reducing systemic risk is critical, the G-20

---

[6] See, e.g., Testimony of Chairman Mary L. Schapiro on behalf of the United States Securities and Exchange Commission, before the Subcommittee on Securities, Insurance, and Investment of the United States Senate Committee on Banking, Housing and Urban Affairs (stating that "The severe financial crisis that has unfolded over the last two years has revealed serious weaknesses in the structure of U.S. financial regulation. One of these is the gap in regulation of OTC derivatives, which under current law are largely excluded or exempted from regulation.")

[7] The G-20 also statement included a number of ambiguous terms that might limit the strength of resulting regulation. In large part, the efficacy of even systemic risk reforms arising out of the G-20 commitment will turn on how a jurisdiction determines what

commitments do not address the issue of allocative efficiency of derivatives markets directly, if at all. As a result, one of the key questions faced by major economies after the GFC would remain after implementation of the G-20 commitments: have financial markets characterised by a significant amount of leveraged speculation done a good job of facilitating efficient capital allocation and, if not, how can they be improved?

Addressing this challenge may involve changes to derivatives markets that are more significant than the G-20 commitments. In broad terms, taking on this challenge will require a fresh, evidence-based assessment of the costs and benefits of derivatives from a public welfare perspective. It also will require consideration of what reforms if any would result in derivative products being net beneficial to productive capital formation with low social costs.

An evidence-based assessment of derivatives and their real economic effects will require setting aside theory for facts, and consideration of the broader costs and benefits of these contracts and the markets in which they trade. In particular, it will require scrutinising the claims that derivatives facilitate "complete markets" (for example, that credit default swaps permit parties to provide debt financing while enabling other parties to take the actual credit risk), which in turn, result in optimal financial and economic performance.

Please consider, as an example of what is meant by setting aside theory for facts, the divide between the theoretical predictions of efficiencies arising from credit default swaps, on the one hand, and the results of empirical analyses of such swaps, on the other hand. The theoretical argument proponents have used to garner political and regulatory support for credit default swaps is principally that they reduce the cost of capital for operating companies, particularly in connection with bond issuances, by providing a market-based assessment of a company's credit risk, and allocating credit risk to parties best suited to bear it.[8] This is an empirical claim. It has been tested. The United States Federal Reserve Bank of New York staff examined whether the credit default swap market has lowered the cost of corporate debt and found:

> Contrary to the claim that the development of the CDS market has lowered interest rates, we do not find evidence that the average firm with a traded CDS has benefited from a reduction in the credit spreads it pays to issue in the bond market or the spreads it pays to borrow from banks. However, we do find evidence that the onset of CDS trading has affected negatively the cost of debt financing in both of these markets for the riskier firms as well as those that are more informationally opaque. These findings are quite robust as they hold for multiple measures of firm risk and multiple proxies of firm opacity. They also hold both when we account for the potential endogeneity of the firms that have traded CDSs through our matched sample and when we limit our analysis to our sample of firms with traded CDSs. Further, we find that this differential effect of CDS trading does not arise from differences in the liquidity of firms' CDSs. On a positive note, we do find evidence, of a small reduction in the spreads that safer firms and more informationally transparent firms pay to borrow in the bond market and from banks after their CDS start to trade. Moreover, we document that CDS market liquidity increases the amount of a loan syndicated by the lead bank and increases the number of participants in the syndicate. Together, our results suggest that the hedging opportunities and information revealed through the CDS market help lower firms' cost of debt. In the case of riskier and more

---

is a "standardised … contract," what structures qualify as an "exchange[] or electronic trading platform," what circumstances are included within the qualifier "where appropriate," and the like. Derivatives market participants have sought liberal interpretations of these terms around the globe.

[8]The arguments in favour of credit default swaps (and other financial derivatives) ultimately must tie back to real economic outcomes as it is generally agreed that, from a social policy perspective, finance is valuable only insofar as it contributes to such outcomes. See, e.g., James Tobin, On the Efficiency of the Financial System, Policies For Prosperity: Essays in a Keynesian Mode (1987).

> informationally opaque firms, these benefits, however, are overwhelmed by the costs resulting from a reduction in bank monitoring which likely arises when banks buy protection for their credit exposures to borrowers.[9]

In short, the NY Fed staff found that the average borrower was not helped by credit default swaps, that risky borrowers (such as SMEs who are most in need of better financial service) were actually harmed, but that high quality borrowers (who probably already are reasonably well served by debt capital markets) were helped.

Not only does the evidence suggest the real economic effects of credit default swaps with respect to capital raising are negative, but credit default swaps actually increase the likelihood that a business will default.[10] This is not surprising given the existing literature regarding the potential for market-based measurements (particularly as to credit risk) where there is a crisis of confidence to result in a default notwithstanding good fundamentals.[11] These real economic effects lie alongside the theoretical[12] and empirical[13] evidence of contagion and systemic risk arising from CDS.

It is emblematic of the GFC for strongly held beliefs based in finance theory to fail to square with the empirical evidence. With respect to credit default swaps, the net benefits of these contracts to public welfare is open to doubt once one considers that (i) the empirical evidence suggests these contracts do not produce real economic benefits in the form of improved funding for businesses (and in fact harm the businesses most in need), (ii) these contracts are zero-sum (except for dealers who profit through the spread, and data sellers) and (iii) the CDS market has drawn many high quality workers, investment capital, and regulatory resources from more productive activities.

End users

With respect to how to treat end users of OTC derivatives, we note that the theoretical arguments in support of end user hedging being facilitated by OTC derivatives have also been questioned by empirical analysis. In particular, operating companies that participate in the OTC derivatives market (1) "have significantly higher leverage and fewer liquid assets," and (2) "have lower capital expenditures, do less research and development …, and have lower market-to-book ratios."[14] We also note that the substantial

---

[9] Adam B. Ashcraft and João A. C. Santos, Has the Credit Default Swap Market Lowered the Cost of Corporate Debt?, Federal Reserve Bank of New York Staff Report no. 290 July 2007 (note, this paper was updated on 25 January 2008, but the findings were substantially unchanged.)

[10] See, Stavros Peristiani and Vanessa Savino, Are Credit Default Swaps Associated with Higher Corporate Defaults?, Federal Reserve Bank of New York Staff Report No. 494 May 2011.

[11] See, e.g., Daniel Cohn and Richard Portes, Dealing with Destabilizing "Market Discipline," Working Paper 10533, National Bureau of Economic Research, May 2004.

[12] See, e.g., Sebastian Heise and Reimer Kühn, Derivatives and Credit Contagion in Interconnected Networks, The European Physical Journal B, April 2012.

[13] See, e.g., Sheri Markose, Simone Giansante, Mateusz Gatkowski, and Ali Rais Shaghagh, Too Interconnected To Fail: Financial Contagion and Systemic Risk In Network Model of CDS and Other Credit Enhancement Obligations of US Banks. Presentation given at the ECB Workshop on Recent Advances in Modelling Systemic Risk Using network, October 2009, COMISEF Working Papers Series WPS-033 21 April 2010.

[14] See Söhnke M. Bartram, Gregory W. Brown, and Frank R. Fehle, International Evidence on Financial Derivatives Usage, Financial Management, Spring 2009. (We note that there are in our view some methodological issues with this paper (e.g. it seems to rely on certain neoclassical theories as the bases for certain inquiries and interpretations), and its conclusions, but the purposes for

majority of OTC derivatives activity is not by end users,[15] and therefore question the degree to which concerns about effects on end users should drive regulation in this area.

With that said, we believe that companies should be able to manage risks related to their businesses, and that derivatives can play a role in this endeavour. However, we recommend that contracts between dealers and end users should be a bona fide hedge[16] or fully collateralised[17] and subject to position limits, and in each case reported to a trade repository.[18] While we support central clearing, we do not take a position at this time regarding mandating central clearing of transactions between end users and financial intermediaries. We note that other transactions on regulated markets between end users and financial intermediaries are not always centrally cleared (but that transactions between the intermediary and its counterparty matched through an exchange are centrally cleared).

---

which we cite it is purely for the referenced empirical relationships, which speak for themselves. We do not necessarily support other inferences, such as why corporations might hedge and whether expanded or limited derivatives markets would be or would not be helpful).

[15] See, e.g., Bank of International Settlements, Semiannual OTC derivatives statistics at end-December 2011 (noting that, of approximately US$63 trillion in total notional amount of OTC foreign exchange derivatives, less than US$10 trillion had a non-financial customer counterparty (approximately 14.9% non-financial). Given the potential utility of a foreign exchange derivative to businesses, it is likely that other categories of OTC derivatives would have even less non-financial participation. BIS statistics confirms this: for OTC equity-linked derivatives, non-financial customers hold US$733 billion relative to a total notional amount of US$5.9 trillion (approximately 12.2% non-financial); with respect to single-currency OTC interest rate swaps, non-financial customers are a counterparty to approximately US$37 trillion notional relative to a total notional amount of nearly US$505 trillion (approximately 7.4% non-financial)).

16 We recognise posting collateral for derivatives that are a bona fide hedge may be inappropriate where the exposure to be hedged arises from an illiquid asset, especially if the exposure is not to be realised for a significant period of time. For example, it may be inappropriate to post cash collateral on a well-designed hedge of currency risk arising from an illiquid asset where the currency risk is a function of the asset being denominated other than in AUD. In such a circumstance, if the hedge is out of the money at the end of its duration, the realisation of the loss on the hedge should be payable through realisation of currency-related gains on the underlying asset. If an exchange of cash collateral akin to variation margin was required during the period of the hedge, it would require allocating resources to cash rather than investment or useful expenditure, resulting in less economic efficiency.

17 Some end users have argued that posting collateral is costly. We note that dealer banks will charge a higher fee/spread for an uncollateralised swap ceteris paribus. Moreover, based on discussions with executives of dealer banks domiciled in the US, we understand that the additional expense of an uncollateralised swap is generally more expensive to an end user than a simple credit facility used to provide cash collateral.

18 We note that a number of energy derivatives market participants here in Australia have sought exemptions from the G-20 commitments. Their argument rest in part on the notion that bespoke contracts are optimal for risk management, and that central clearing will impose collateral requirements that are too burdensome. We are concerned that these market participants are considering the issue solely from their own standpoint. For example, a bespoke contract might be very well tailored to the risk of that business. But if there is no natural counterparty for that bespoke contract, the dealer bank will presumably hedge the position with one or more instruments in a portfolio that is predicted to move inversely to the position. In so doing, the dealer bank would not simply take on, but potentially create, basis risk. It is unclear whether, from a systemic point of view, dealer banks or end users in the business are better positioned to take on these risks. (There are reasons to believe the end user might be better positioned – after all, businesses seem to have done reasonably well with plain vanilla forwards and exchange-traded commodity futures in hedging their risks prior to the spate of innovations in the late 1990s through the late 2000s.)

Conclusion

We support the Government's efforts to implement the G-20 OTC derivatives commitments. We also encourage the Government and regulators to take a more careful look at derivatives and their costs and benefits to the Commonwealth and its people. The provisional evidence about the costs and benefits does not necessarily support continued allocation of resources to derivatives markets and products, which should inform the Government's reaction to claims that implementation of the G-20 commitments will be a burden on OTC derivatives market participants.

An extraordinary amount of human and financial capital is deployed in zero-sum derivatives speculation that, empirically, does not always appear to improve capital formation. Whatever real economic effects derivatives do have, harmful or not, are obtained at a high social cost, including externalities.

The current draft of the legislation would call on the Minister, before determining that a class of derivatives may be regulated, to consider the likely effect on the Australian economy, and on the efficiency, integrity and stability of the Australian financial system, of allowing the derivative transaction rules to impose requirements.

Industry super funds support long-term investment that promotes strong returns for our members built upon stable growth and broad prosperity. And so we would ask a slightly different question. We would ask that the Minister consider what could be accomplished if the capital deployed in speculative derivatives was instead put to use building infrastructure, funding businesses, and constructing physical assets; what if fewer of our talented students were employed trading derivatives and creating new ones? What if the resources put to facilitating speculation in financial commodities was instead put to developing long-term investments? What would Australia look like and what might the future hold? Industry Super Network greatly appreciates the opportunity to comment on the draft legislation and supports the Government's efforts to move forward with the G-20 commitments to OTC derivatives reform.

About Industry Super Network

Industry Super Network (ISN) is an umbrella organisation for the industry super movement. ISN manages collective projects on behalf of a number of industry super funds with the objective of maximising the retirement savings of five million industry super members. Please direct questions and comments to:

Zachary May

Director of Regulatory Policy
Level 30, 2 Lonsdale St,
Casselden Place
Melbourne 3000
03 9657 4369/0488 016 923
zmay@industrysuper.com