ISDA Safe, Efficient Markets

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The Reserve Bank of Australia's Consultation on New Financial Stability Standards

The International Swaps and Derivatives Association, Inc. ("**ISDA**")[1] welcomes the opportunity to provide comments on the Reserve Bank of Australia ("**RBA**") Consultation on New Financial Stability Standards ("**Consultation Paper**") released on 29 August 2012.

ISDA is actively engaged with providing input on regulatory proposals in the United States ("**US**"), Canada, the European Union ("**EU**") and in Asia. Our response to the Consultation Paper is derived from these efforts and from consultation with ISDA members operating in Australia and Asia. Our response is drawn from this experience and dialogue. Individual members will have their own views on different aspects of the Consultation Paper, and may provide their comments to the RBA independently.

ISDA commends RBA for its careful consideration in setting new financial stability standards ("**FSSs**") which would align the Australian regime with the Committee on Payments and Settlement Systems ("**CPSS**") and the Technical Committee of the International Organization of Securities Commission' ("**IOSCO**") Principles for Financial Market Infrastructures ("**FMIs**") ("**the Principles**")[2]. We also appreciate and support the objectives to promote effective risk management, reduce counterparty risk, improve overall transparency and ultimately promoting international harmonization of operational standards for central counterparties ("**CCPs**") in the Over-the-Counter ("**OTC**") derivatives market.

General observations

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

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1 ISDA's mission is to foster safe and efficient derivatives markets to facilitate effective risk management for all users of derivative products. ISDA has more than 800 members from 58 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers. For more information, visit www.isda.org.

2 Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, *Principles for Financial Market Infrastructures*, April 2012.

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Disclosures

As an increasing number of OTC derivatives contracts will be cleared through CCPs, both the buy-side and sell-side participants in the market will increasingly face CCPs as counterparties instead of each other. Historically, OTC market participants used a number of methods to assess their exposure to the credit of their OTC counterparties, such as negotiating collateral agreements and requesting for additional information, to make an informed credit risk assessment of their OTC counterparty. This has enabled OTC market participants to react quickly to changes in the market conditions or to a counterparty's change in credit profile.

However, these tailored practices will not be available for cleared trades. Counterparties will be obligated by law and regulation to clear many of their OTC swaps and, depending on the jurisdiction, may have very limited choices of venues for clearing. Financial institutions that have a clearing mandate would need to assess the risks of their clearing arrangements, including the impact this may have on their regulatory capital requirements. It is therefore important that counterparties are able to obtain sufficient information from CCPs to enable them to make appropriate risk assessments. We commend the steps taken in Standard 20: Disclosure of rules, key policies and procedures, and market data toward promoting transparency and reducing risk. In particular, we believe it is extremely important that before a CCP makes any changes to its operational arrangements, risk controls and default-management rules and procedures, the CCP will engage stakeholders in their consultation and that these decisions be disclosed to the relevant stakeholders.

Harmonization of Standards

A significant percentage of Australian dollar interest rate swaps ("**AUD IRS**") are currently cleared by London Clearing House ("**LCH**") and other foreign CCPs in a well-regulated environment. We cannot over state the importance to market participants of being able to continue to clear their transactions through foreign CCPs that meet the standards set by the Australian regulators to harmonize with the CPSS-IOSCO Principles. This would help prevent fragmentation of trading volume between different CCPs which would, reduce netting benefits and increase margin costs. We commend the RBA for recognizing netting in the calculation of margin requirements across products and CCPs.

Liaison between national regulators is important in ensuring the proposed FSSs will interact positively with other regulatory initiatives impacting FMIs and/or derivatives markets, such as the Dodd-Frank Act ("**DFA**") and the corresponding European regulations. This is a concern as the diverse and inconsistent requirements between different supervisors could increase costs, reduce cross border transaction liquidity, and potentially impede some FMIs from operating in Australia if faced with conflicting regulatory requirements. One area of potential conflict that may arise is if clearing were mandated in Australia. For example, if a US customer were to trade an AUD IRS with an Australian Bank and both the US customer and Australian Bank were subject to a mandatory clearing requirement in their respective home jurisdiction, the AUD IRS trade cannot be cleared as it would be impossible to clear a trade through more than one CCP.

We strongly agree with the standards as set out in the CPSS-IOSCO Principles for Financial Market Infrastructures. We believe a harmonized and single international standard would provide greater consistency in oversight and regulation of FMIs worldwide. In addition, given the global nature of OTC derivatives and the relative size of Australia's OTC derivatives market, we urge you to consider the global nature of the markets when implementing the FSSs so as not to restrict the ability of Australian market participants to continue participating in and be competitive in the global OTC derivatives market.

Potential damage to the real economy

In addition to the potential for conflicting and overlapping national regulations, it is also important to consider the global initiatives such as the Basel III liquidity requirements and the recently released **BCBS** and **IOSCO** consultative document "Margin requirements for non-centrally-cleared derivatives". The assets required to meet the Basel III liquidity requirements and for the proposed margin requirements for non-centrally-cleared derivatives are also high quality liquid assets. These same assets are also required to meet the margin requirements of a CCP. Consequently, there is a possibility of a liquidity drain as all financial institutions would be mandated to meet their margin requirements for cleared and non-centrally-cleared derivatives as well as their Basel III liquidity requirement using the same set of assets. Many global financial market participants utilize this collateral pool for their funding and liquidity needs. A reduction in the size of this collateral pool may result in higher funding costs, which may affect a financial institutions performance in other activities in the real economy. To avoid a reduction in the collateral pool, the assets that are considered eligible as margin for the CCP should be widen, with appropriate haircuts applied.

Response to specific questions

The remainder of this letter sets out our comments in relation to the specific questions posed in the Consultation Paper. Our response is set out underneath each question. The headings used below correspond to the headings used in the Consultation Paper.

4.6 QUESTIONS

Question 1: Are there potential conflicts between the requirement for licensed clearing and settlement (CS) facilities to explicitly support financial system stability and other relevant public policy objectives (proposed CCP and SSF Standard 2.1), and other obligations or duties of facilities and their directors?

No comments.

Question 2: Should the requirement for non-executive members of a CS facility's board (proposed CCP and SSF Standard 2.4) be extended to specify the number of non-executive directors and their degree of independence from management or related entities?

No comments.

Question 3: Are there any potential obstacles to CCP's taking the proposed steps to monitor the credit standing of participants and impose additional risk controls where a participant's credit standing is calling into question (proposed CCP Standard 4.3)?

A CCP would need a robust and dedicated team to constantly assess and determine a counterparty's credit standing. A CCP may not be in the best position to determine a counterparty's credit standing as it may have no access all available information of the counterparty to draw a holistic view of the counterparty's portfolio. As the counterparty would most likely be clearing via a number of CCPs and have dealings on a bilateral level, the CCP would only have access to a portion of the counterparty's risk profile. It would be premature to base the credit standing of a counterparty on this information alone. One of the usual methods used is credit spreads as an indicator of a counterparty's credit standing. However, credit spreads may only exist for well-known names and may not be available for all counterparties.

When a CCP imposes additional risk controls on a participant because of a deterioration of its credit standing, the reasons and procedures for such an act must be clearly stated in the rules of the CCP. Additionally, the CCP should have a grace period to allow the counterparty to question or defend its "alleged" change in credit standing.

We are concerned with certain aspects of FSS 4.2.1[3]as it requires the CCP to monitor the large exposures of its participants' customers. While we support the need to monitor large exposures as a good risk management standard, there may be jurisdictions in which disclosure of trade data may be in contravention of local privacy laws. For example: A Chinese bank may be a clearing client of an Australian bank, clearing AUD dollars via a recognized CCP. The Chinese authorities do not allow trade information to be reported to a repository outside of China. Consequently, it may be impossible for clients in certain jurisdictions to comply with this requirement.

We are concerned with FSS 4.2.2[4] and intraday margin ("**IDM**"). As you may know, most margin systems for central clearing contain three components: initial margin ("**IM**"), variation

[3] RBA's 'Attachment 2, Draft Guidance – Financial Stability Standards for Central Counterparties', page 19, FSS 4.2.1: "A central counterparty should monitor the existence of large exposures to its participants and, where appropriate, their customers."

[4] RBA's 'Attachment 2, Draft Guidance – Financial Stability Standards for Central Counterparties', page 19, FSS 4.2.2: "A central counterparty should mitigate its credit risk to the extent possible. For example, to control the build-up of current exposures, a central counterparty should require that open positions be marked to market and that each participant pays funds, typically in the form of variation margin, to cover any loss in its positions' net value at least daily; such a requirement limits the accumulation of current exposures and therefore mitigates potential future exposures. In addition, a central counterparty should have the authority and operational capacity

margin ("**VM**") and IDM. In relation to VM and IDM, clearing members ("**CM**"), tend to pre-fund their clients' obligations. In relation to IDM, in general, CCPs do not provide physical payment for accounts with net mark-to-market gains[5]. This may produce a liquidity drain at the CM as clearable OTC derivatives are fungible products, which may be cleared at more than one CCP. Clients my have certain preferences for clearing, for example: a client may choose to clear it's receive fixed positions on interest rate swaps ("**IRS**") at one CCP and its pay fixed at a second CCP. This fragmentation of the clearing market may result in unbalanced netting sets in the CM's house and client accounts. As such, the use of IDM calls for OTC derivatives cleared at multiple CCPs creates systemic risk as CMs must make payment of net mark-to-market losses on directional exposures to CCPs without the benefit of payment from CCPs for accounts with net mark-to-market gains. CMs will be exposed to a serious liquidity risk as they risk-intermediate CCPs in distressed market conditions. Ideally, there should be a synchronized margining system between CCPs or interoperability for CCPs clearing the same OTC derivative products. This would allow a single payment from CM as the trade exposures of the CM would be netted and offset against the different CCPS. However, we acknowledge the formidable hurdles that must be overcome before any interoperability can be implemented safely between CCPs. Consequently, we would like to recommend a CCP's IDM calls be "two-way", meaning that IDM calls would pay accounts with net mark-to-market gains and call on accounts with net mark-to-market losses.

Question 4: In balancing the system-wide impact of restricting collateral eligibility to high-quality liquid assets against the risk that lower-quality or less-liquid assets may not hold their value in a stressed market should any other collateral eligibility criteria be considered (proposed CCP and SSF Standard 5)?

We agree that a CCP should consider using collateral that is commonly accepted in the relevant jurisdictions in which it operates. However, as you elude to in the question, members have very grave concerns about the combined liquidity impact of upcoming regulation in Europe, the US and now Asia that mandates central clearing of OTC derivatives as well as regulations in those regions requiring non-centrally cleared trades to be margined and the introduction of the Basel III liquidity requirements that will also require counterparties to post high quality, liquid assets to meet these requirements. There is a possibility of a liquidity drain as all financial institutions would be mandated to meet their margin requirements for cleared and non-centrally-cleared derivatives as well as their Basel III liquidity requirement using the same assets. These assets would no longer be freely available in the market as it would be pledged as collateral for margin and liquidity requirements. As these assets are a fundamental part of the provision of overall funding and liquidity to a large number of market participants, reducing the size of this pool of instruments may lead to a reduction in monetary base available to the economy, thereby impacting the ability of financial institutions to fund themselves and their ability to make loans

to make intraday margin calls, both scheduled and unscheduled, from participants. Further, a central counterparty may in some cases choose to place limits on credit exposures, even where these are collateralized. Limits on concentrations of positions or additional collateral requirements may also be warranted"

[5] At this point, we understand the Chicago Mercantile Exchange does pay out (80% of) gains to members on an IDM.

and perform other activities in the real economy. To give you an idea of the scale of collateral that would be required, ISDA estimates that the combined effects of the proposed BCBS and IOSCO *Margin for non-centrally-cleared derivatives*[6] would cause a liquidity drain in the region of US$15.7 trillion to US$29.9 trillion for IM only[7]. To ease the demand on these high quality liquid assets, a wider set of instruments should be considered as eligible. However, it is important that the appropriate haircut, with industry consultation, be applied to such assets. The haircuts applied to these assets should take into account the potential decrease in value of the assets in a stressed market. It is important to widen the range of eligible instruments as the probability of CMs exceeding the CCP's collateral concentration limits would be easily breached if there are only a few instruments qualifying as high quality, liquid assets. Extremely illiquid assets should not be considered as one of the tenets of a CCP is to continue functioning in the event of a CM default and it is fundamentally important that a CCP be able to liquidate those instruments fairly easily.

In addition, CCPs should avoid unintended and undesirable negative results of wrong-way correlation between a portfolio and collateral assets (namely where the collateral value declines when the counterparty owes more money, thereby indicating that different risk factors are correlated in a negative manner). Accordingly, CCP stress testing should include a scenario for wrong-way collateral risk to discourage CMs from pledging wrong-way correlated (yet eligible) assets to meet collateral requirements. For example, there are wrong-way risk implications of posting a corporate bond as collateral against a Credit Default Swap ("**CDS**") on a highly correlated underlying. Banks are subject to strict supervision to control wrong way risk in the Basel framework and we urge RBA to consider similar restrictions for CCPs.

It is important that there be clear and transparent rules for both the CM and client collateral regarding the reuse of collateral; the details of the operational structure of collateral accounts (e.g. omnibus or segregated accounts); what assets are considered eligible and the corresponding haircuts; the method used to determine the haircuts; when these haircuts may change and how the CCP communicates these changes; how procyclical adjustments are determined; if the client collateral is segregated or commingled with the CCP's own assets; and the legal certainty of segregation of collateral from the assets of settlement banks/ custodians.

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[6] Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions released a Consultation Paper on *Margin requirement for non-centrally-cleared derivatives*, July 2012.

[7] ISDA study was part of ISDA response letter to Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions Consultation Paper on *Margin requirement for non-centrally-cleared derivatives*, July 2012, refer to Appendix 1 and 3.

Question 5: To date, SSFs in Australia have not assumed credit or liquidity risks on principal. Some SSFs may, however, be designed in such a way that they assume credit exposures or liquidity obligations to participants, as contemplated in the proposed SSF Standards 4 and 6. Should SSFs licensed to operate in Australia be permitted to assume these risks as principal?

No comment.

Question 6: Should an SSF always be required to offer intraday or real-time settlement finality, or are there circumstances in which a minimum standard end-of-day settlement finality would be acceptable (proposed SSF Standard 7)?

Yes, an SSF should offer intraday or real-time settlement finality as it pertains to the use of securities as a form of margin by a CM.

If a CCP were to request for an intraday margin ("**IDM**"), the CM may choose to use a security instead of cash as its form of margin. If the CM chooses to use a security, the SSF needs to be flexible enough to accept this on an intraday basis or as agreed bilaterally between the CCP and the CM for settlement of its IDM.

Question 7: Should settlement arrangements utilized by CCPs, or offered by SSFs, be allowed to settle using DvP model 2 where trade values are small and operational requirements dictate its use, or should all facilities be required to settle according to DvP model 1 or 3 (proposed CCP Standard 11, SSF Standard 10)?

A CM may have a portfolio of transactions that contain different currencies and the corresponding collateral or securities. As there may be a number of time zones for settlement across the different currency classes and securities, it may be a challenge using DvP model 1 or DvP model 3, regardless of whether the transactions are settled on a trade-by-trade basis or on a multilateral net basis, as settlement cannot occur contemporaneously due to the different time zones involved. For example, a CM who is receiving AUD Dollar and paying USD Dollar, would need to await the USD Dollars be transferred and receipt acknowledged by the CCP before it may receive the AUD Dollar amount. In the traditional way of remittance, the AUD Dollar payment would be effected during the Australian time zone, while the USD Dollar payment would be effected during the US time zone, consequently, contemporaneous payment transfer would not be possible.

A possible workaround may be to provide onshore settlement across multiple currencies in Australia. However, in order for the non- AUD Dollar payments to be transferred during the Australian time zone, CMs may be required to pre-fund their onshore accounts (or arrange certain settlement facility) with the onshore settlement institution (who provides settlement services). The pre-fund process complicates the funding arrangement of a CM as special arrangements would need to be made to accommodate this advance in payment. For example: an Australian based CM making a variation margin payment to an Australian based CCP on 9 Oct

2012 would need to pre-fund a USD Dollar payment for 8 Oct 2012 for the payment to be transferred within the Australian time zone on 9 Oct 2012. Additional market infrastructure would need to be set-up and possibly regulatory approval from the US regulators to allow real time US settlement during the Australian time zone.

For cash payments, a possible solution is offered by Continuous Linked Settlement ("**CLS**"), which mitigates settlement risk through the provision of its payment versus payment ("**PvP**") settlement services. Currently, CLS only covers foreign exchange spot transactions, foreign exchange forward transactions, foreign exchange swap transactions, non-deliverable forward transactions ("**NDF**") and OTC credit derivatives transactions. At this time, CLS does not cover other OTC derivative transactions, such as interest rate swaps or margin payments arising from the ISDA Credit Support Annex.

We urge the RBA not to mandate the usage of DvP model 1 or DvP model 3. We would like to suggest the CCP and CM be allowed to determine, on an industry level, which settlement arrangement may best suit their processes and needs.

Question 8: Would a change from principal-to-principal model to an agency model for indirect participants of a CCP allow for effective portability arrangements in the case of a clearing participant default (proposed CCP Standard 13)? What would be the costs and consequences of such a change?

Firstly, we do not consider that the RBA should set a particular model as a minimum requirement. There is a strong argument to be made for permitting market participants to contract on segregation and portability, as opposed to prescribing a model via regulation.

Both the principal-to-principal model and the agency model have their benefits and disadvantages. From an effective portability arrangement perspective, ISDA believes there is no difference between the two models. Fundamentally, it will depend on how the client accounts are setup and the level of segregation of the client account and the insolvency and other supporting laws of the jurisdictions involved. These supporting laws are important to the operation of porting in each jurisdiction and it is likely that some legislative change is needed to facilitate the operation of either model. For example, the "agency" model is not easily implemented without a significant level of supporting legislation such as that which exists for it in the United States (and it is not apparent that similar legislation is already in place in Australia).

The MF Global case clearly showed that porting can be problematic under the agency model.

Some favor the agency model over the principal-to-principal model ("**Principal model**") as it allows a wider range of clients to be clearing members ("**CMs**") of the CCP, with the Futures Commission Merchant ("**FCM**") standing as guarantor to the trade. This works well in the US as it has a long established history as well as layers of statutory protection which supports the agency model. A bank cannot register as an FCM, but must register as an FCM subsidiary under current US Commodity Futures Trading Commission ("**CFTC**") regulations. This would mean the FCM may not be as highly capitalized as the bank itself, undermining the benefit of a highly

capitalized bank contributing to the CCP's guaranty fund, absorbing the defaults of other members, accepting client positions from the defaulting member and replenishing default funds of the CCP.

The Principal model, on the other hand, has a much smaller number of CMs and a much higher barrier to entry to qualify as a CM. Hence, most other financial entities would need to be a client of a CM, in order to clear via a Principal model. One of the reasons for the high qualifying requirements is the need for a CM to be highly capitalized, ability to contribute to the CCP's guaranty fund, ability to absorb the losses of another CM, ability to accept a defaulting member's portfolio and ability to replenish the funds of the CCP at a time when market conditions are stressed and volatile.

We support FSS 13.2.2[8], which gives a client the flexibility to decide whether it would favor an individual or omnibus account or whether initial margin is collected on a gross or net basis level to fit its needs. It should be noted, the current general market practice is not to net client collateral. We believe porting should not be mandated but should remain subject to agreements between a non-defaulting CM ("**NDCM**") and the underlying clients. Whether the portfolio is ported as a whole or as a portion of the portfolio, should be left as a bilateral agreement, where possible. For example: a client of a defaulted CM may not wish its portfolio to be ported to a particular NDCM for credit reasons. In such an instance, only partial porting of the defaulted CM would be possible. On the flip side, a NDCM may not take on a defaulted CM's portfolio because it would impose a higher regulatory capital requirement on the NDCM at a time of increased market volatility and stress.

Question 9: Should the required level of segregation for any collateral posted on behalf of participants' customers differ between CCPs clearing securities and derivatives markets, having regard to the much shorter duration of pre-settlement risk exposure in securities transactions and the reduced likelihood that customer positions would be ported in such circumstances (proposed CCP Standard 13)?

As we are a trade organization for OTC derivatives, we are unable to opine on the securities market.

Question 10: Should a CS facility licensee be subject to more prescriptive controls regarding their investment policies than envisaged in the proposed FSSs, such as minimum proportion of funds invested in risk-free assets or limits on the concentration exposures to investment counterparties (proposed CCP Standard 15)?

No comments.

[8] RBA's 'Attachment 2, Draft Guidance – Financial Stability Standards for Central Counterparties', page 57, FSS 13.2.2: "A central counterparty should employ an account structure that enables it readily to identify positions belonging to a participant's customers and to segregate related collateral. Segregation of customer collateral by a central counterparty can be achieved in different ways, including individual or omnibus accounts."

Question 11: It is proposed that CS facility licensees be required to achieve resumption of operations within two hours following a disruption to critical information technology systems (proposed CCP Standard 16.7, SSF Standard 14.7). What would be the benefits and costs of reducing the window for resumption of operations for systemically important CS facility licensees in respect of their critical systems?

No comments.

Question 12: Should the proposed FSSs include specific requirements for licensed CS facilities to manage cyber security risks? If so, what sorts of risk controls would be appropriate?

No comments.

Question 13: Following the release of the CPSS-IOSCO consultative report on Recovery and Resolution of Financial Infrastructures, is there sufficient clarity within the proposed FSSs to capture all necessary measures to ensure an effective recovery regime (including loss allocation arrangements)?

With respect to the proposed Standard 12, generally, it may be helpful to define the nature of the interests that must be taken into account in default management procedures, for example, the legitimate interests of the CCP's direct and indirect participants and other relevant stakeholders.

Question 14: Requirements under proposed CCP Standards 3.5, 16.4 and 16.10, and SSF Standards 3.5, 14.7 and 14.10 have been designed to ensure arrangements are in place to assist any statutory manager when stepping into a CS facility following a shock to the CS facility. Are these standards sufficiently comprehensive to ensure any action would be effective?

No comments.

Question 15: Are there any further requirements placed on CS facilities in other jurisdictions that could be applied in Australia to enhance systemic risk controls of licensed CS facilities, without imposing disproportionate costs?

No comments.

Question 16: Is it appropriate to increase the threshold value below which an SSF would be exempt from the proposed FSSs?

No comments

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Question 17: Is the assessment approach articulated in Attachment 5 consistent with the objective to deliver a framework for regulation of overseas licensees that does not impose an unnecessary regulatory burden, while ensuring competitive neutrality in the Australian regulatory environment?

ISDA commends RBA for recognizing the assessments of an overseas regime as having sufficient equivalence in relation to overseas facilities operating in Australia. As different overseas jurisdictions may need to cater for special characteristics of their local markets, differences in requirements and supervision may arise between the Australia and the foreign regime. It may be useful to benchmark the overseas regime's compliance with applicable global standards set by international bodies such as CPSS, IOSCO and the Basel Committee on Banking Supervision. The assessment of an overseas regime should not be based on a rule-by-rule approach and should look at the substantive regulatory outcome (where appropriate) on a holistic level. This would promote international comity; minimize operational and implementation costs; and harmonization of international standards.

Yours sincerely,

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