Malcolm Edey: The challenge of central clearing in OTC derivatives markets[1]

Address by Mr Malcolm Edey, Assistant Governor (Financial System) of the Reserve Bank of Australia, to the ISDA Annual Australia Conference, Sydney, 20 October 2011.

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Good morning, and thank you to ISDA for the opportunity to speak here today.

This conference is taking place at an interesting and challenging time for the global financial system. Obviously a good deal of attention right now is focused on Europe, particularly on the problem of sovereign debt sustainability and its interaction with the condition of the European banking system. This is a source of significant uncertainty for the rest of the world. Policymakers are working hard to find solutions that will rebuild confidence, but the situation is still fluid and it remains an area that will need to be closely watched.

In Australia meanwhile the financial system is continuing to perform relatively well. The broad outlines of that story are, I think, well known. During the GFC Australia avoided a recession and a banking crisis. Our banks are profitable and well capitalised, and their overall asset quality remains good.

We can't of course expect the Australian system to be entirely immune from the unfolding events in Europe, but a couple of points are worth emphasising. The first is that the Australian banks have only limited direct exposures to sovereign debt in the countries that are most at risk. So potential effects on Australian banks' overall asset quality are not an issue. The second point is that, since the height of the GFC, the Australian banks have done a lot to strengthen their funding positions. They have increased their use of domestic deposits as a funding source, lengthened the average term of their wholesale funding, and correspondingly reduced their reliance on short-term wholesale debt. These things will help to make them more resilient to the uncertainties that are now affecting international credit markets.

As important as these current challenges are, financial regulators around the world have been focusing not just on those, but also on longer-term regulatory reforms. The reform effort is proceeding on a number of fronts, aimed at building more robust financial systems for the longer term and thereby reducing the risk of future crises. Many of these efforts are being coordinated internationally through the G20 process, through the Financial Stability Board, and through standard-setting bodies like the Basel Committee. In all of these bodies Australia is actively represented.

In broad terms, the various reforms draw on the lessons that emerged from the GFC, and they seek to remedy the weaknesses that became apparent during that period. Hence, among other things, there is a significant effort through the Basel process to increase the amount and quality of capital in the global banking system, and to strengthen liquidity management by banks. Although, as I said, we didn't have a banking crisis here during the GFC period, the Australian regulators recognise the importance of improving standards, and we are working on implementation of the various international initiatives in all these areas, and others.

One particular piece of the picture that has absorbed a lot of our attention at the Reserve Bank has been the work on financial market infrastructure, particularly in relation to OTC

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[1] For a more detailed treatment of the issues discussed in this speech, readers are referred to the Council of Financial Regulators Discussion Paper, *Central Clearing of OTC Derivatives in Australia*, June 2011 http://www.rba.gov.au/publications/consultations/201106-otc-derivatives/pdf/201106-otc-derivatives.pdf.

derivatives clearing. I know this is very relevant to ISDA members here today, and it's on this topic that I want to focus my main remarks.

At the Pittsburgh Summit in September 2009, G20 leaders agreed, among other things, to a common commitment to central clearing in key derivatives markets. The commitment states that "all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest". Australia was part of that agreement, and the Australian regulatory agencies, like those in other G20 jurisdictions, are working through the issues associated with its implementation.

In focusing on that today, I want to look at three questions:

- why is there a general case for promoting central clearing?
- what are the complexities involved?; and
- where does the process stand in Australia?

First, *why central clearing*?

The general case for promoting central clearing in derivatives markets is based on the aim of reducing systemic risk by managing interconnectedness. In markets without central clearing, counterparty exposures build up bilaterally and, in certain kinds of products, they can accumulate to very large notional amounts over time. In many cases this might not be a problem, but where the interconnections are extensive enough they can be a source of systemic risk. The risks from those exposures might be managed well by individual institutions, but an institution can't be sure that its dealings with others don't expose it to a lower standard of risk control practiced by a counterparty, or anyone else in the market that is linked through bilateral trades.

The clearing process, by novating positions to a central counterparty (CCP), allows risks to be centrally managed to a standard acceptable to the market and its regulators. Moreover, with legally enforceable multilateral netting, gross exposures can be drastically reduced. As long as the CCP is itself robust, the effect should be to reduce the scope for contagion and thereby limit the impact on the market if one or more of the participants fail. The experience with resolving the Lehman failure in 2008 testifies to the effectiveness of this mechanism in a crisis. We might also expect that confidence in this mechanism will help to underpin market liquidity during periods of financial stress.

All of this presupposes that the CCP is itself robust. Of course, CCPs themselves have a strong incentive to control their risks, since they are after all in the risk-reduction business. But it also points to the need for appropriate regulatory standards to ensure that the risk controls in a CCP are commensurate with its significance for the wider system.

Subject to that proviso, central clearing reduces aggregate counterparty risk by replacing a web of bilateral exposures with a set of potentially much smaller net exposures of each participant to a CCP with robust risk management. Individual participants benefit from the reduction in risk but, importantly, so does the stability of the system as a whole. In a nutshell, that is the basic case for promoting central clearing as a policy objective in systemically important derivatives markets.

Which brings me to my second question: *what about the complexities*?

When talking about these things in the abstract, it's easy to talk as though a central counterparty is truly "central". But in fact, as we all know, it's not that simple. There is a huge array of markets in financial instruments around the world and there are multiple CCPs for different instruments. Some instruments are centrally cleared already, many are not. Not all instruments are good candidates for central clearing, because they are not sufficiently standardised and can't easily be made so.

It's also important to recognise that not all market participants are alike, and not all can be expected to have direct access to the major CCPs even when the new structures are fully in place. So the abstract model in which all participants are connected to the central clearer won't be realised in practice.

For all these reasons, the optimal configuration of clearing arrangements in the real world is far from obvious, and the way global markets will evolve in response to a mandatory clearing environment across multiple jurisdictions is hard to predict.

Another complication is the question of interconnectivity *between* clearers. A central clearer should, in some sense, be central. In theory, netting benefits might be maximised by a single global CCP clearing all the major instruments, with all active traders as members and all positions included in the scope of multilateral netting. It's not clear that such an outcome would be desirable even if it were possible. It would amount to a massive concentration of risk at a single point and would give rise to complex operational issues and questions of jurisdictional oversight.

But in any case, even if such an outcome were desirable, it won't be achieved. The closest alternative might be to provide links that allow trades to be cleared between participants in different CCPs. The question of how this might eventually occur, or even of whether it is achievable at all, then becomes very important. The weight of expert opinion is that the capacity to develop these links is still a good way off. Links between CCPs also raise complex questions about the transmission of risks from one CCP to another, and these will need to be carefully studied.

For the foreseeable future, then, we will be in a world in which there is a collection of CCPs, each of which has some source of competitive advantage in its own location or its own area of specialisation. That advantage might derive from historical legacy, or it might arise because the market that a CCP is servicing has some sort of natural home in its own location. But these markets will remain contestable and so the configuration of CCPs around the world is likely to stay fluid, not least because the market will be rapidly evolving in response to changing regulatory requirements.

It is in this very unpredictable environment that the domestic regulators are considering the policy framework for central clearing in Australia.

Before I come to that, it's worth reviewing a few general facts about the Australian OTC derivatives market. Its largest component, in terms of the amounts outstanding, is the market for single-currency interest rate swaps – the bulk of which are Australian dollar denominated. Australian banks (both locally incorporated and foreign bank branches) have aggregate notional principal amounts outstanding in this market of around $8 trillion.[2]

But banks operating in Australia are not the only entities to transact in this market. From a jurisdictional point of view, we can (in principle) divide transactions in the global market for Australian dollar derivatives into three types, namely local-to-local, local-to-offshore, and entirely offshore. In fact the distinction between a local and an offshore market participant is not entirely straightforward, since many local participants are affiliated with offshore entities. That said, the available data suggest that all three of those transaction types form a significant share of the market. Most of the activity that involves the large foreign banks as the two counterparties is already cleared through LCH SwapClear, while the remainder of the market is currently uncleared.

It is of course misleading in another way to talk of these three market segments as if they were separable. They are in fact closely interdependent, and liquidity in each of the three parts benefits from the liquidity of the others. As a related point, the Australian dollar market

2 APRA data on banks' off-balance sheet business as at end June 2011. Note that this figure double counts amounts outstanding between reporting banks.

is itself interdependent with other global markets, and specifically with derivatives markets in other currencies.

The regulatory agencies in Australia have indicated that they view the Australian dollar IR swap market as being systemically important to the domestic financial system. This reflects a number of considerations, including:

- the size of the market
- its fundamental role in hedging domestic interest rate risk, and
- the long duration of counterparty risk in these instruments.

It is important to note, however, that although this market is large in relation to the Australian financial system, it is not large in global terms.

The next largest OTC derivatives market in Australia[3] is for FX-related derivatives[4], in which the Australian banking system has a notional principal outstanding of around $4 trillion. Other OTC markets, such as those for commodity derivatives, are much smaller, though that is not to say that they don't have the potential to grow over time.

For various reasons, international regulators are at this stage giving priority in their regulatory strategies to single-currency interest rate swaps. Among the reasons for that is that these instruments are often of relatively long duration and have very large volumes outstanding, as well as the fact that cross-currency instruments (the next biggest market) give rise to more complex jurisdictional issues. In Australia, for similar reasons, any mandatory clearing policy is likely to focus initially on the Australian-dollar interest rate swaps market.

At the heart of the policy challenge are two inter-related questions: should there be a mandatory clearing requirement in this market and, if so, should it include a locational requirement, to the effect that trades be cleared by a locally incorporated and locally regulated CCP? Since there is no domestic CCP offering such a service currently, that would involve requiring industry to come up with a solution that meets the regulatory objectives.

There are many factors that will have a bearing on this decision, but I think they boil down to finding a balance between the two objectives of stability and efficiency. The stability consideration comes from the point that I made at the outset. The purpose of promoting central clearing is to reduce systemic risk. CCPs reduce risk in one important respect, but they also concentrate it in a specific location. Where a market is systemically important to the Australian economy and financial system, this points to a case for the CCP that clears it to be subject to appropriate safeguards that control the propagation of risks to domestic participants. This *might* be best achieved where the CCP is locally incorporated and subject to domestic regulation. At the least, it argues that the CCP should be subject to safeguards that take into account its systemic significance for the Australian market.

The second set of considerations are those related to efficiency. We have to recognise that, even for instruments that are denominated solely in Australian dollars, the market is a global one. The cost-effectiveness of a local CCP will thus depend to a significant degree on global forces. I've tried to highlight the uncertainties involved in predicting how the global market will evolve. On that front, a number of submissions to our consultation process have emphasised the risk of splitting the Australian dollar market if any local clearing mandate turns out to be not sufficiently effective.

The cost-effectiveness and viability of a local CCP for this market will also depend on aspects of the international regulatory environment that are not yet determined, including the

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[3] As measured by the amount outstanding.

[4] That is, FX swaps, forwards and options.

extent of eventual mutual recognition of CCPs across borders by their respective regulators. We need to avoid an outcome where internationally active banks find themselves subject to inconsistent mandating requirements among the jurisdictions in which they operate. On that issue, I note that the Financial Stability Board has recently begun discussions on the challenges of mutual recognition, though these are still at an early stage.

Adding further to the complexity is that the environment is already being shaped by regulatory developments in the major jurisdictions, especially the US and Europe. Australian entities that are active in those markets will need to meet the clearing requirements that soon come into force there, and they will also be affected indirectly to the extent that they deal with counterparties that are subject to those jurisdictions.

In the United States, the Dodd-Frank regulations on OTC clearing are likely to start taking effect around the second quarter of next year, and in Europe the corresponding regulations under EMIR[5] are likely to take effect by around 2013. Even before then, market behaviour, and hence the environment for the Australian banks, will be influenced by the anticipation of those requirements.

In broad outline, then, these are some of the key considerations that will need to be taken into account in determining the way forward in Australia.

This brings me to my third question: *where does the policy process in Australia now stand*?

In June, as you know, the Council of Financial Regulators[6] released a discussion paper setting out these issues in detail and calling for submissions from interested parties.

To help focus discussion, the Council paper put forward four propositions. In summary, these were:

- that in the absence of Australian regulatory action, domestic CCP solutions may not emerge;
- that where a market is of systemic importance to Australia, a move to offshore central clearing might introduce risks to the Australian financial system that do not currently exist;
- that the Council agencies considered the market for Australian dollar interest rate swaps to be systemically important within Australia; and
- that in light of this, the Council agencies were considering the case for a requirement that those instruments be centrally cleared, and as part of that were considering whether such clearing should take place domestically.

I stress that these were not conclusions. They were preliminary propositions that the Council agencies were seeking to test.

In response to the paper, we have received around 30 submissions, including one from ISDA and a good number from ISDA members who are no doubt represented here today, along with others from a range of other market participants and interested parties. Most of the submissions are available on the Bank's website. Council agencies have also engaged in a series of follow-up meetings with those who made submissions. I've participated in a number of those myself, and I've appreciated the spirit in which the industry has provided its input.

If I've conveyed anything today, it's that these are difficult and complex issues. Most of the submissions have stressed that point, and there was a strong view from industry that it's

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5 European Markets Infrastructure Regulation.

6 Comprising the Reserve Bank of Australia, ASIC, APRA and the Australian Treasury.

important to take the time to get it right.[7] We take the complexities seriously, and we need to continue engaging with industry in the process of determining the best way forward.

That said, the Council's advice on these matters, when it's made, will be determined by the public policy considerations of stability and efficiency that I've just outlined. Not all industry participants will have the same commercial interests and not all will be of the same view as to their preferred outcome. But where the industry contributions will be valuable is in helping to make clearer what are the costs and benefits, and the risks, of the alternative approaches.

We hope to be in a position to put forward some conclusions from the consultation process soon, but I can't foreshadow those today. In the meantime, I take the opportunity to thank all those in the industry who have made constructive contributions, and we look forward to continued engagement.

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7 But not too long. Others have pointed to the need to respond in a timely way to the rapidly changing international environment. Again, it's a question of balance.