Implementation of a framework for Australia's G20 OTC derivative commitments

RVS response to the OTC consultation paper

Date:	June 2012
Version number:	V2
Status:	Final

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1 Response

1.1 Introduction

This document is RVS's response to the consultation paper issued by Treasury in April 2012 and supplements RVS' face to face presentation held on 1 June 2012.

RVS's position is that standardised data, such as our EOD Benchmarks and Industry Curves, are a key ingredient for ensuring comparability of capital calculations, risk, P&L and regulatory returns across firms.

This is particularly true in a global OTC derivatives framework where interoperability and valuation issues will be critical to ensure that Australia is not at a competitive disadvantage when compared to larger offshore markets and jurisdictions.

Our vision has been that RVS will become an industry owned utility and we are gratified that globally significant firms are now beginning to engage in this industry wide approach to consistent underlying data.

Commonality of underlying data will enhance the proposed OTC and reporting framework.

1.2 Commentary

RVS's perspective on centralised clearing of OTC derivatives is that valuation of both the transactions and associated collateral should be based as closely as possible on a consistent set of data and models. This consistency should apply across multiple clearing organisations.

Interoperability of CCP's is a key outcome, without which some jurisdictions, possibly including Australia, would be at a relative disadvantage which would result in the longer term weakening of their financial sectors.

In other words two parties to any given transaction should be able to nominate their preferred CCP in their local jurisdiction and then deal exclusively with that organisation – by paying and receiving margins or posting eligible collateral as required.

In this example a US and Australian bank would be able to manage their OTC derivatives commitments in their home jurisdictions and would be able to do so under the governance of their home regulator(s).

RVS sees commonality of data at all levels, such as LEI's, transaction descriptions and associated UPI's, clearing interoperability and validated benchmark end of day prices as being critical to the on-going evolution of robust, systemically secure and profitable financial markets. Valuation of financial markets instruments should be based upon globally consistent, industry governed, independent and transparent data.

To this end, RVS has been working with AFMA over the past two years to develop a standard set of conventions for describing all transaction types used by the Australian financial markets.

These conventions are in an advanced stage of development and we anticipate that they will be available in July or August 2012.

The establishment of industry benchmarks for end of day data was the reason that RVS was created. This perspective and background leads us to make the following observations.

1.3 The nature of independent CCP's

The central premise of creating an environment for local CCP's is that Australia wants to both comply with the G20 directives AND protect its own Sovereignty in terms of a strong and functional financial markets industry.

RVS believes that there should be an explicit recognition that moving to a CCP framework does not negate risk – it is a risk transfer mechanism to a new, single counterparty. The creditworthiness and resilience of the intermediary – the CCP – should be beyond question.

Andy Haldane, Executive Director Financial Stability Bank of England in a recent speech at the University of Edinburgh said that *"catastrophe risk has been totally mis-priced." "That was a key fault-line during the crisis and, as recent experience attests, remains a key fault-line today".*

One view would be that CCP's should be constructed in a way which eliminates the risk of a failed financial institution impacting on the public purse but this would involve a capital and margining regime at the extreme end of the cost and risk spectrum and flow on effects into the broader global economy.

Additionally as not all transactions will or can be standardised sufficiently to fit into a CCP framework and those which do not fit are likely to be highly customised and possibly structured, the highest risk transactions will be managed, valued and settled in a bi-lateral manner outside the CCP framework.

1.4 Offshore CCP's

What guarantee do the Australian regulators have that offshore CCP's will be managed in accordance with the strict standards likely to be imposed on Australian domiciled CCP's and therefore that positions cleared and margined offshore will be secure?

It is likely that CCP's will operate well under normal circumstances but how will Australia protect its interests in the event of severe disruption (natural disasters, armed conflict, massive political shifts and such like)? Are CCP's the new "too big to fail" institutions and if so what pressures will they face and will there be a misalignment between their objectives and those of the broader economy? Who will the CCP's be owned by? Will they represent shareholders' interests and will those be aligned with Australia's national interests? Should these institutions be owned and run by Governments and how does the implicit "lender of last resort" position play to the operational model CCP's will be expected to maintain.

1.5 Bank or CCP user considerations

Banks will have positions which are with other domestic banking entities but will also have positions with offshore banking groups.

Banks would therefore have positions with counterparts which are broadly, in inverse order of riskiness:

- OTC centrally cleared onshore in Australia
- OTC centrally cleared offshore
- OTC not centrally cleared subject to bi-lateral netting and or collateral agreements
- OTC not centrally cleared not netted or collateralised

1.6 Settlement and inter-operability issues

CCP's in different jurisdictions have different underlying market data, timing, pricing algorithms, margin agreements, membership conditions, contract terms and threshold agreements.

This means that a negative position on one CCP, which in theory should be offset by an equal and opposite position on another CCP would not be assessed equally by the different CCP's and so would leave the banks / counterparties to the transaction subject to pay and receive margins calculated using different methods at potentially different times of day and in vastly different markets with differing dynamics.

If dealing with say a large American bank, where would the transaction be settled?

Assume the American bank has an Australian presence and deals with one of the major Australian banks. This transaction would be settled in Sydney which is advantageous for the Australian bank (timing, market dynamics) but potentially a disincentive for the offshore bank (management issues dealing with small markets and smaller amounts in a non-core financial market hub).

If the position were to be reversed then the Australian bank would be at a relative disadvantage.

1.7 Collateral

There are a number of issues regarding collateral.

Bi-lateral collateral contracts (usually ISDA /CSA's) are a good risk mitigation method but can result in significant disputes if the counterparts do not use substantially the same pricing models and data.

Australian banks trading with New York based entities are often engaged in payment disputes because of timing, data and model issues. Some banks deal with these issues by imposing unreasonably high threshold levels or by simply relying on the prices and calculations given by the NY counterpart. Both approaches water down the risk mitigation characteristics of bi-lateral collateral agreements.

Collateral valuation issues are not removed by inclusion in a CCP framework because the CCP's will face the same timing, model and data issues. Collateral valued by a CCP in New York will almost certainly have a different value from that calculated by an Australian bank.

1.8 Possible solution

RVS believes that one solution is to create a global network of inter-operable CCP's so that each party can transact freely with any counterpart in any jurisdiction but can novate the transaction to a CCP in its HOME jurisdiction.

The keys to interoperability and collateral are standard contracts, pricing and consensus market data, including industry standard curves.

If two geographically separate CCPs were to agree to use the same market data, curves and pricing methods to arrive at a valuation and therefore margin call, the banks would be free to place their entire OTC/CCP portfolio with one exchange in one jurisdiction.

This approach assumes that the exchanges would agree a method of dealing with timing issues. In discussion with some overseas bodies it has been suggested that a simple approach such as using market data and valuation as at the receiving parties end of day would work. There would of course be threshold issues to be dealt with.

In other words there would be no relative disadvantage for either an Australian or offshore entity. Each could place their portfolio with the CCP of choice in their nominated jurisdiction and would be able to manage positions accordingly.

An Australian entity operating on an Australian CCP would therefore net it's positive and negative positions so would pay a single margin call to the Australian CCP – as opposed to making and receiving payments from and to multiple CCP's in many jurisdictions.

This is particularly important for Australian institutions given the wide range of jurisdictions our banks trade in.

Bi-lateral CSA's could also be dealt with in this manner – standardised curves, data and models would reduce disputes, lower threshold levels and therefore make collateral a more effective risk mitigation tool.

RVS has been working with AFMA to create a set of conventions and descriptions for all products traded in financial markets in Australia (including local banks and offshore entities). This set of conventions is expected to be largely completed in August 2012 and could form the basis of standardised contracts for some OTC products.

Additionally, industry standard curves could be made available to CCP's on a rolling 24 hour EoD basis so that they are performing their valuations off the same underlying data and meaning that any variations would be minimised and be mostly model based. Alignment of models and stringent audit or model validation procedures would further serve to minimise discrepancies.

2 The RVS service

For the benefit of any readers who are not familiar with the RVS service and to put our comments in context, we have included a short description of the service and independent governance framework.

RVS has created a global industry Benchmark service for independently and transparently validating End of Day (EoD) rates and curves – it has been designed to be the single industry source for EoD rates for all time zones and centres and operated as a commercial utility. The service has been incubated in Australia, in conjunction with AFMA, prior to a global roll out in 2012.

The service will be available to all players in the financial markets; banks, brokers, exchanges, clearing houses and regulators.

2.1 Capital, operational costs and EOD rates

Basel III regulations will see a significant rise in capital requirements (BCBS estimate a doubling of overall capital and have released additional capital requirements for G-SIFI banks). For Tier 1 & 2 banks the challenge will be to minimise the capital impost and retain profitability in their financial markets business. Additionally, the introduction of compulsory centralised clearing for some OTC derivatives products will create major operational challenges as banks substitute direct counterparty dealings with novated CCP contracts.

The ability for banks to reduce operational costs will be as important as capital optimisation. The focus should be in areas that are repetitive and industry collective outsourcing will become a cornerstone to cost savings.

Banks should seek wherever possible to combine non-competitive operational activities to realise both industry-wide and individual firm efficiencies and take cost and risk out of their businesses. RVS is an opportunity for banks to do so.

EoD rate collection and validation is carried out by every individual bank each day. Each bank is collecting essentially the same data set as every other bank, meaning that they are all performing the same task but with different business processes. The cost of these duplicated processes in each bank is substantial.

Different data inevitably leads to inconsistent valuation practices and reporting. Practical issues such as different collateral valuations lead to disputes which require more capital to be allocated as well as time and money to resolve. From a regulatory viewpoint there is no consistency of reporting meaning that a unit of risk reported by one bank cannot be compared to the same unit of risk reported by another bank. This will also be true of the proposed CCP framework unless a consistent approach on data, models and product definitions can be agreed.

New regulations require greater arm's length independence and transparency, without which it will be harder to substantiate results in a manner which satisfies regulators, auditors and analysts. New banking and accounting standards are targeting the data, not models, with the implications of significant capital increases above current levels.

2.2 RVS provides IFRS, valuation uncertainty and industry curves

The RVS service will provide Level 1, 2 and 3 rates, identified daily by centre, calculated according to industry agreed rule sets (whether jurisdiction SRO, IFRS, GAAP, a local regulator, or a blend of rules).

The service will also provide a set of industry agreed benchmark curves, based off validated data, agreed construction points and approved methodologies.

Examples of metrics awaiting industry approval are:

Mark-to-market, Fair Value (sometimes called Mark-to-worst), Prudential valuation and adjustment metrics, Exit valuation (incorporating time to exit in a declining market and having regard to relative size of the disposal in the overall market), Liquidity Indicators and Confidence Indicators.

2.3 Firm resolution

Firm resolution (or wind up) is an important issue and banks are required to have plans that would allow them to be wound up in a controlled manner in the event of a failure. Recent firm failures have highlighted the difficulty of arriving at agreed valuations for portfolios and individual transactions meaning that the time for resolution is potentially significantly extended (*e.g.*, the Lehman resolution is expected to continue for a considerable length of time).

An industry benchmark is not a panacea to all potential problems and issues in the resolution of a large, complex institution, but would provide a reference point against which many transaction valuations could be agreed. An industry standard and approved set of valuation adjustments will further clarify and enhance the ability to arrive at a speedy resolution.

This aspect of the service is likely to be critical for the efficient operation of a CCP under stressed market conditions. Efficient resolution of a failed institution means that the period of stress for the CCP would be minimised which in turn means a stronger and less fragile financial system.

2.4 Industry owned

RVS will operate an industry owned outsourced service to collect, validate, and deliver a complete data set for each time zone and centre. The data set will be based on the local EoD covering a rolling 24 hours in all active markets.

The service provides significant benefits across all areas of the industry which are discussed in other RVS documents (available on request).

RVS has introduced new concepts only possible through this outsourced collective service approach, such as weighting bank contributions to assist in making each rate point as accurate as possible. RVS has applied for patents to protect its IP.

2.5 Governance model

A key design principle of the RVS service is the self-governance model that allows the industry to clearly demonstrate to each centre's regulators that they are providing effective self-governance.

This self-governance model combined with an industry ownership model is one aspect which separates RVS from any existing consensus based quote vendor services. There are two aspects to this self-governance:

- Local Industry body/SRO engagement in each country ensuring all local rules and market nuances are captured in the service
- A global Advisory Board which will provide RVS and local industry bodies/SRO's guidance on the global interpretation/implementation of rules and governance requirements ensuring robustness of the industry self-governance.

As an example, AFMA, the Australian industry association, has been engaged to run industry committees and working groups who have defined the Conventions, Policies and Governance Processes for each asset class or instrument group for trading activity in the Australian jurisdiction. Included in these sets of Conventions is a governance framework for RVS to report out of market prices independently from the contributing source.

- Industry - prices submitted by any contributor are reported should the price fall outside of predetermined and agreed parameters
  Subscribers - compare their internal prices to that of the industry Benchmark.

The Conventions are available to all other jurisdictions so that it will not be necessary to start with a blank sheet of paper in each country. Each jurisdiction's SRO (or industry association) will be able to define its own changes to the Rules allowing quicker adoption of the RVS service. SRO's in each jurisdiction need to be

engaged in order to lead the local industry in the creation of the governance model and locality specific Conventions. Key SRO's in major trading centres are engaged in this process.

The outcome is that the EoD benchmark rate will be as accurate as possible reflecting the true price from each centre and time zone at their end of day. RVS' objective is to be the ultimate "trusted source".

3 Definitions

Acronym	Description
Level 1	The fair value hierarchy introduced 3 levels of inputs based on the lowest level of input significant to the overall fair value (IFRS 7.27A-27B): Level 1 - quoted prices for similar instruments
Level 2	Level 2 - directly observable market inputs other than Level 1 inputs
Level 3	Level 3 - inputs not based on observable market data
EoD	End of Day
AFMA	Australian Financial Markets Association
RAVA	RAte VAlidation
AFMA RAVA	Refers to the committee/s structure established by AFMA for the purpose of agreeing and approving Australian Conventions, Rules and Governance Protocols
IFRS	International Financial Reporting Standards
RWA	Risk Weighted Assets
Dark pools	Dark pools are areas in the financial markets where rates are not accessed under either the level 1 or level 2 definitions Conventionally “dark pools” have referred to stock transactions not carried out on visible markets (so called “upstairs trading”) but in the context of this document it is used to refer to any opaque data at any maturity for any instrument.
CCP	Central Clearing Party (sometimes called a Clearing House)
ISDA CSA	International Swaps & Derivatives Association Credit Support Annex
GFC	Global Financial Crisis – also called the Credit Crunch in some countries
RVS	Rate Validation Services P/L
IPV	Independent Price Verification
SRO	Self-Regulatory Organisation
SIFI	Systemically Important Financial Institution
SAM	Statistical Analysis Module
MTM / MTW	Mark-to-market and mark-to-worst. Mark to worst values the transaction on the disadvantageous side of the bid/offer spread.
CoCo	A form of “bail-in” or contingent capital instrument

4 Document control

If you have any queries regarding the information in this document, please contact:

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4.1 Distribution

Date	Version	Recipient(s)
June 2012	V2 Final	Council of Australian Regulators