

Competition Policy Review Secretariat
The Treasury
Langton Crescent
PARKES ACT 2600

10 June 2014

Dear Sir/Madam,

COMPETITION POLICY REVIEW: LCH.CLEARNET RESPONSE TO ISSUES PAPER (14 APRIL 2014)

LCH.Clearnet Limited (**LCH.Clearnet**) supports the Government's continued efforts to ensure that Australia has a competitive marketplace that drives productivity and growth. We welcome the opportunity to make this submission in response to the Government's Competition Policy Review.

We have focused our response on those issues that are most relevant to our business, namely the matters raised in Chapter 2 of the Issues Paper and how regulation and public policy can help further to promote competition in financial markets.

Background to LCH.Clearnet

LCH.Clearnet is a subsidiary of the LCH.Clearnet Group, the world's leading clearing house group, which services major international exchanges and platforms, as well as over-the-counter markets. It clears a broad range of asset classes including cash equities, exchange traded derivatives, commodities, energy, freight, interest rate swaps, credit default swaps, bonds, repos, and foreign exchange derivatives. The Group's CCPs have over 190 clearing members and over 600 clients across 22 countries.

In 2013 the Treasury granted LCH.Clearnet an Australian clearing and settlement facility licence (**CS facility licence**) under Part 7.3 of the Corporations Act 2000 (Cth), which authorised LCH.Clearnet to offer its global derivative swap clearing service (SwapClear Global) to Australian Clearing Members. LCH.Clearnet has also been authorised to provide clearing services to the proposed futures market to be provided by the Financial and Energy Exchange.

The importance of CCPs

Since the Global Financial Crisis, Governments and regulators around the world have recognised the importance of central clearing. The G20 meeting in Pittsburgh in 2009,

recognising the benefits of central clearing, committed its members to further extend its scope from exchange-traded to OTC derivative markets¹. Australia, as a member of the G20, has committed to enhanced regulation of clearing infrastructure, including the mandating of the clearing of certain derivatives and derivatives transaction reporting.

The importance of CCPs has been recognised by the Australian financial authorities, for example in its *Statement on Assessing the Case for Mandatory Clearing Obligations*, the Council of Financial Regulators (CFR) said:

"...central clearing may be a highly effective way to enhance the efficiency, integrity and stability of financial markets.

- *By substituting the numerous bilateral exposures of a market participant for a single multilateral net exposure to a central counterparty, central clearing simplifies the network of interconnections between financial institutions and can reduce total counterparty credit exposures.*
- *By streamlining the counterparty risk management process, central clearing can also facilitate platform trading.*
- *Centralisation can carry other efficiency benefits. For instance, by acting as a hub for market participants, a central counterparty can improve the effectiveness of default management arrangements and coordinate operational improvements and efficiencies across the system – such as through the standardisation of financial products and associated documentation, the streamlining of the transaction workflow, and the simplification of collateral management.*
- *Central clearing can also provide a focal point for regulation and oversight of market-wide risk management, while reducing information asymmetries in the market more generally."*

Competition in clearing

While competition has emerged in equities trading (for example, Chi-X and APX), the only provider of equities clearing in Australia is ASX. This means new entrants in the equities trading space are obliged to clear through ASX, and can only compete on the cost of trade execution, not clearing.

In derivatives, the Government recently authorised LCH.Clearnet to offer clearing services to Australian clearing members. This has enabled them to become direct members of these services, enabling them to realise cost saving and reduce risks by realising the benefits of counterparty risk mitigation through direct access to Central Counterparty clearing. The

¹ https://www.g20.org/sites/default/files/g20_resources/library/Pittsburgh_Declaration_0.pdf

extension of competition in clearing to financial futures and to equities would enable them to realise further efficiencies and stimulate innovation and competition between CCPs.

LCH.Clearnet continues to explore the expansion of its services in Australia to a number of other asset classes, in which ASX currently provides the only CCP in Australia. Australia has become an important part of our business strategy. We have made significant investment into the Sydney office of LCH.Clearnet with a view to it becoming our key operational centre to support the Asia-Pacific region. This will both help Australia to develop further as a financial centre in its own right and provide Australian participants with a competitive base for their clearing operations to access the wider Asia-Pacific region.

Impact of regulation on competition in clearing

Recently, the CFR published its policy on the regulation of CCPs in Australia². One key aspect of this policy represents a significant barrier to new entrants seeking to offer certain clearing services in Australia – specifically the requirement that a CCP must be an Australian incorporated entity if it provides services which are systemically important and with a strong domestic connection.

This requirement significantly reduces the prospect of introducing competition to the majority of the market segment that is currently exclusive to ASX. In particular it provides a significant barrier to entry for strong globally regulated offshore CCPs such as LCH.Clearnet providing services in Australia.

For example, a significant and important segment of the Australian financial market is interest rate futures. The only market for these futures is the ASX24 market, and the only CCP permitted to clear this market is ASX Clear (Futures). If a new market were to be formed to compete with ASX24, the new market would need to clear through ASX Clear (Futures), unless another CCP were licensed to be able to do so. LCH.Clearnet would be interested in clearing such a new market. However the policy published by the CFR presents a significant barrier to entry for LCH.Clearnet, thereby denying the benefits of choice and competition to clearing participants.

The barrier arises because the CFR policy, in respect of interest rate futures, would require overseas CCPs to establish an Australian incorporated subsidiary; this is because the CFR considers that if a CCP were to have even a relatively small share of the Australian dollar-denominated interest rate futures market (of which ASX currently has 100%), the new entrant would be deemed to have a strong domestic connection and the potential to become systemically important.

Requiring a CCP to provide this service through a local subsidiary is a significant barrier to entry, because many of the potential benefits of global clearing (such as exposure netting with instruments traded on global markets) would be lost, not just for the CCP, but also for

² <http://www.cfr.gov.au/publications/cfr-publications/2014/pdf/app-reg-influence-framework-cross-border-central-counterparties.pdf>

the users of the CCP (i.e. the banks, financial institutions and their customers). The absence of netting with other global exposures increases significantly the cost of users obtaining clearing services as there would be significant duplication of infrastructure and capital. Reduced netting also means increased risk to users and to the financial system generally.

The above example demonstrates how the current policy would apply to Australian interest rate futures. The same position would apply to the clearing of other important market segments such as Australian equities (again where ASX is a monopoly provider of CCP services, through its clearing facility ASX Clear).

We recognise that the policy established by the Council of Financial Regulators is driven by considerations of financial stability, and that that is an essential requirement in the regulatory framework for CCPs under Part 7.3 of the Corporations Act. It is also in LCH.Clearnet's interest that financial stability is central to regulatory policy, as its very business is to manage risk to ensure stable financial markets. LCH.Clearnet is itself regulated by the Bank of England and, by becoming a licensee in Australia, LCH.Clearnet also become subject to the Financial Stability Standards of the Reserve Bank of Australia (RBA).

We consider, however, that there is a balance to be struck between the desire for financial stability, and the desire for competition and efficiency in CCP services. A policy which effectively precludes competition by mandating that the service be provided by an Australian incorporated entity does not strike the right balance.

The need for policy review in this area

In this Competition Policy Review, we would encourage the Panel to consider the implications for competition in Australia's current financial infrastructure policy and regulation, as articulated by the CFR.

Such a review is necessary to ensure that the proper balance is struck between financial stability (on the one hand) and productivity, efficiency, and innovation (on the other).

The requirement that a CCP be incorporated in Australia to provide meaningful CCP services to segments of the market such as financial futures and equities is unreasonable, and goes well beyond what is necessary to achieve the required outcomes of financial stability and protecting the public interest. Such outcomes can be effectively achieved by a foreign incorporated CCP, providing the Australian regulators can be satisfied with the robustness of the local regulatory regime, as LCH.Clearnet has already demonstrated through being subject to the RBA's financial stability standards, and ASIC's requirements as a licensee, in relation to the FEX service and SwapClear.

Failure to revise this requirement means there will be a monopoly in this segment of market infrastructure, and this is particularly relevant where the monopolist is in the form of the vertically integrated trading, clearing and settlement infrastructure of the ASX. The costs

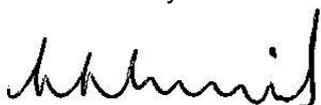
associated with this include higher fees in clearing services, reduced innovation, reduced netting with global exposures (and therefore increased risk and capital costs) and these are ultimately passed to the general public given the high levels of participation in the financial markets in Australia. It is for the benefit of the Australian economy and welfare of Australians to create a competitive and productive financial market infrastructure. Other jurisdictions around the world have embraced competition in this sector without lessening financial stability standards.

One of the "guiding principles" of the *Competition Principles Agreement* in 1993 between the Commonwealth and the States and Territories, following on from the Hilmer review the previous year, was that regulation should not restrict competition unless it can be demonstrated that the benefits of that restriction to the community as a whole outweigh the costs, and that the objectives of the regulation can only be achieved by restricting competition.

This Review will, we expect, receive many submissions which draw upon these principles. They are just as important today, and particularly in the financial services industry, where effective regulatory oversight must always be a priority – but not at the expense of fostering an environment for innovation and competitive developments, in the interests of investors, as well as the broader community.

Please do not hesitate to contact me at rory.cunningham@lchclearnet.com or 02 8226 8824 regarding any questions raised by this letter or to discuss these comments in greater detail.

Yours faithfully



Rory Cunningham
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