Head of Secretariat
Financial System Inquiry
The Treasury
Langton Crescent
PARKES ACT 2600

March 31 2014

Dear sirs,

FINANCIAL SYSTEM INQUIRY – INITIAL SUBMISSION

This letter provides the initial submission of LCH.Clearnet Ltd ("LCH.Clearnet") to the Government's Financial System Inquiry.

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 a range of OTC 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 central clearing counterparties ("CCPs") have over 190 clearing members and over 600 clients across 22 countries.

LCH.Clearnet is the only non-Australian CCP to have been granted an Australian Clearing and Settlement Facility Licence and is currently providing clearing services for over-the-counter ("OTC") interest rate swaps ("IRS") to a number of major Authorised Deposit-taking Institutions through its SwapClear service. LCH.Clearnet is also licenced in Australia to clear for the FEX commodities and energy exchange. LCH.Clearnet is supervised directly by both ASIC and the RBA.

In addition to its Australian licence, LCH.Clearnet is regulated in the UK, US, Singapore, Quebec and Ontario. LCH.Clearnet SA is regulated in France, the Netherlands, Belgium, Portugal, the UK and the US. LCH.Clearnet LLC is registered in the US. LCH.Clearnet and LCH.Clearnet SA have applied for authorisation under EMIR to provide services throughout the EU, and LCH.Clearnet LLC has applied for recognition in the EU.

Access to CCPs such as LCH.Clearnet is important and integral to the implementation of Australia's G20 commitments, and LCH.Clearnet is delighted to be given the opportunity to provide its submissions to assist the Inquiry in its deliberations.

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LCH.Clearnet in Australia and the region

In 2014, LCH.Clearnet will add Sydney as its third global operational centre and the first in the Asia-Pacific region. This will support its plans to extend the SwapClear service and collateral operations into this timezone. Australian institutions are, or have in the past been, clearing members of LCH.Clearnet for other services and have been clearing swaps as clients of SwapClear clearing members for a number of years. Now LCH.Clearnet is able to help Australian financial institutions integrate as fully as possible in international financial markets, thereby contributing to their and Australia's global competitiveness and supporting economic growth in Australia. It is our belief that open markets lead to greater prosperity, and that as Australia competes with other financial centres in the Asia-Pacific region and globally, such openness will serve to strengthen Australian institutions as a whole.

As part of the expansion into Australia, during 2014, LCH.Clearnet will extend its presence in Australia, establishing direct connectivity with the Reserve Bank of Australia via the RITS system, and also with Austraclear.

LCH.Clearnet's decision to enter the Australian market was made possible through the significant developments in regulation and policy which recognised the importance of the role that CCPs play in the financial system. The regulatory structure described by the Council of Financial Regulators ("COFR") in their July 2012 publication "*Ensuring Appropriate Influence for Australian Regulators over Cross-border Clearing and Settlement Facilities*" which envisaged the introduction of competition in the area of financial market infrastructure was long awaited and welcomed. The graduated approach laid out in that paper serves as an example that other jurisdictions – those that welcome competition – could usefully follow. As we develop our activities in the region we will leverage our Australian capabilities in support of our services in other jurisdictions to the highest degree possible.

Recent Regulatory Developments

While the Global Financial Crisis ("GFC") signified a step-change in the evolution and development of international financial markets and their regulation, it is important to note that many of the key reference points had already been present for some years. LCH.Clearnet launched its SwapClear service in 1999. The first global set of CCP regulatory recommendations were issued by CPSS-IOSCO in 2004. The DTCC's trade repository service commenced operations in 2007. The GFC however shocked and devastated institutions and systems globally, and focused policymakers' and business leaders' minds on the need to ensure that economic development can rely on safe, efficient and competitive institutions and infrastructures.

The GFC also brought to light just how inter-connected today's financial markets are, and demonstrated the importance of international regulatory co-operation and open access, enabling market participants to exercise greater choice of supplier when selecting their counterparties. Australia is already well connected into the global stage: many foreign banks have a presence in Australia, and many Australian institutions are accessing the domestic clearing systems through clearing members that are a branch or entity of an international bank. All the major Australian banks have presences in Europe, the US and elsewhere in the Asia-Pacific region – for example, all major institutional broking market participants are, or are likely to become, members of LCH.Clearnet. However there is room for these international links to be strengthened and deepened while retaining appropriate Australian supervisory control.

Competition

When conducting an analysis of competition in the market for providing financial infrastructure, it is important to differentiate between execution and clearing (and other functions such as reporting, settlement and securities issuance). Execution venues compete primarily in terms of being able to offer the deepest liquidity and best execution (in terms of speed and price) to participants. By contrast, when CCPs compete, they focus on delivering the most effective risk management; the strongest protections of clearing members and, increasingly, clearing members' clients; and operational efficiency, including in collateral management.

Assessments of the robustness of the CCPs' risk management policies, processes and procedures are key to enabling market users to make an informed assessment of the effectiveness of competing CCPs. It is vital, for the good of the international and the Australian financial systems, that this competitive pressure between CCPs – to ensure the highest possible degree of safety – is preserved (where it exists) or enabled (where it does not).

While respecting international standards, CCPs can enable their users to realise processing and capital efficiencies. These are greater where the scope of the CCP's coverage is greater (e.g. in terms of currencies), enabling the CCP to realise economies of scale in processing; and also, where fully supported by prudent risk management, for users to be able to align their collateral requirements more closely to the risk that is actually inherent in their portfolio. In turn, participants will then be able to apply greater resources to improving their own services to clients.

LCH.Clearnet has not encountered barriers to market entry in Australia, apart from the moratorium currently in place in the clearing of ASX-listed cash equities following the December 2012 recommendation of COFR. The moratorium is due to end in February 2015. We consider that in the future, interoperability arrangements – where multiple CCPs serve the same trading venue, enabling trading participants to select their clearing venue *independently of their trading venue* – could be introduced in Australia in respect of clearing of cash equities.[1]

[1] We recognise that interoperability may not work in certain markets, such as the OTC derivatives market, as the RBA noted in its paper of June 2012 entitled Central Counterparty Interoperability (http://www.rba.gov.au/publications/bulletin/2012/jun/pdf/bu-0612-7.pdf). The duration of exposures

LCH.Clearnet has significant experience of clearing competition both with and without interoperability, primarily in Europe and for cash equities; but also in exchange-traded derivatives where we also see room for competition in Australia. In equities, LCH.Clearnet and x-clear of Switzerland pioneered the current interoperable structures of CCP clearing for the virt-x market in 2003. More recently LCH.Clearnet launched interoperability on Oslo Børs on 19th March 2014, an equity market significantly smaller than Australia where market participants have welcomed the presence of an alternative CCP. Where it can be delivered cost-effectively, and where incumbents have an incentive to permit it, competition in clearing through interoperability ultimately benefits the participant by:

- Enabling independent choice – a participant can make their own choice of CCP provider regardless of the choices made by their counterparty;
- Fostering innovation – a competitive environment requires CCPs to differentiate in terms of products, processes and service: e.g. reporting, choice of collateral, compression services, client segregation, protection and portability;
- Driving down costs – to offer cheaper pricing than others;
- Incentivising efficiencies – particularly margining efficiencies, i.e. enabling margin requirements to be more closely aligned with actual net exposures by offsetting margins across multiple trading venues and potentially other asset classes.

To an extent, some of these effects have been observed where there are competing trading venues, each using a separate CCP. Competition through interoperability stimulates innovation, and market entry by a new CCP is facilitated as not all clearing members have to join the new CCP in order to be able to clear business with all other members.

LCH.Clearnet's position

It is our view that public policy in the area of financial market structure should set as a priority the facilitation of competition, not only between intermediaries but also between market infrastructures, subject to appropriate prudential safeguards.

We recognise that this may well lead to higher overall costs in the short run as firms seek to maintain multiple clearing relationships, and CCPs will have to bear the costs of additional operational and risk-management processes. Regulators also will have to supervise more CCPs.

However, without this competitive pressure, there is no incentive for a monopoly provider to innovate, seek efficiencies and provide a better service to its customers.

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in OTC markets can be substantially longer than those in exchange-traded markets, making the costs even greater.

Australia has established a framework to enable such competition without placing unnecessary burdens on new providers and should be able to reap the benefits.

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We hope that the Inquiry finds this submission useful and we look forward to engaging further as policies are developed. Please do not hesitate to contact me at rory.cunningham@lchclearnet.com regarding any questions raised by this letter or to discuss these comments in greater detail.

Yours faithfully

Rory Cunningham
Director, Australian Compliance & Asia-Pacific Regulatory Affairs