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Dear Ms Brown,

# OTC derivative markets

## Opening remarks

The Australian Bankers' Association (ABA) appreciates the opportunity to provide comments on the Treasury proposals paper *Implementation of Australia's G20 over-the-counter derivatives commitments*.

The G20 financial regulation agenda is seeking to improve the transparency and resilience of OTC derivative markets by introducing more centralised financial market infrastructures (FMIs) – trade repositories, central counterparties (CCP) and trading platforms.

The global financial crisis exposed risks in some OTC derivative markets, including insufficient transparency regarding counterparty exposures, inadequate collateralisation practices, and cumbersome operational processes (including default management). In addition to improving transparency and mitigating systemic risk, international regulatory authorities are also concerned about protecting against market abuse.

The ABA notes the following points:

- OTC derivatives exist to serve the risk management and investment needs of parties to the contract.
- OTC derivatives play an important role in Australia's economy and are an important tool used by banks, insurance companies, asset managers, corporations and companies to manage their business, operational and financial risks, including movements in interest rates, currencies (foreign exchange) and commodities.
- OTC derivatives primary benefit is to reduce market risk. Derivatives are often bespoke contracts or bilateral instruments designed to be tailored to the specific needs and hedging requirements of parties – that is, OTC derivatives are arranged to hedge exposures in adverse movements in price. Around 90% of derivatives are contracts traded over-the-counter.
- OTC derivatives may not readily be able to be standardised. Contractual terms and parameters (e.g. notional amounts, payment dates, maturities, etc) under a standarised contract are unlikely to match the exposure to be hedged, which would result in the parties being exposed to risk (contrary to the intention of a hedging transaction).
- OTC derivatives help to provide liquidity and depth to financial markets, which facilitates capital mobilisation, promotes risk diversification and enhances risk management, underpinning global economic growth. Derivatives generate conditions favourable to risk diversification and management at a reasonable cost. Additionally, derivatives spread risks among the various market agents, contributing to global business growth.

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Australia, as a member of the G20 and the OTC Derivatives Regulators Group (ODRG), has committed to implementing enhanced market practices and regulation for OTC derivative markets. We consider that as Australian financial regulators are contemplating how to implement this international commitment, a number of principles should be maintained:

- Improving transparency and financial system stability;
- Encouraging harmonisation and global adoption of new rules so Australian financial institutions and businesses benefit from consistent and equivalent regulation;
- Balancing consistent and equivalent regulation with implementing new rules in a way that minimises disruption to Australian financial markets and for market participants (thereby recognising that smaller markets will be impacted in different ways to larger markets and the importance of the contestability of our markets);
- Supporting access to global markets for Australian financial institutions and efficient and cost-effective local risk management options for Australian businesses; and
- Promoting market-driven and industry-led initiatives that minimise the cost impost of additional regulation on banks and other market participants.

The ABA believes that it is crucial for Australian financial regulators to ensure coherence and proportion between prudential regulation (capital requirements) and markets regulation (structure and operation of markets) with regards to OTC derivative markets. Regulation of OTC derivatives and FMIs is important, however, strengthening regulation needs to be assessed in combination with the ongoing recalibration of current capital requirements and risk weightings associated with OTC derivatives and the impact on the way contracts are traded and cleared. Regulation should seek to improve the robustness of OTC derivative markets.

## International consistency

The ABA believes that international consistency is important to minimise the risk of adverse and unintended consequences for Australian financial institutions from the impost of additional and foreign regulation. For instance, differences in market structure and conditions could result in an Australian bank being directly subject to an overseas regulators' requirements as well as local regulatory requirements resulting in conflicts of law, inconsistencies, complex systems and administration, and legal uncertainty for the bank. Substituted compliance, equivalence or recognition will be important for Australian banks and other market participants.

There are a number of Australian entities directly and indirectly impacted by global regimes.

The US Commodities Futures Trading Commission (CFTC) has determined that Australian swap dealers subject to APRA and ASIC's regulatory regimes can rely on substituted compliance in respect of a number of 'entity level' requirements under the CFTC's regime (however, not 'transaction level' requirements which include mandatory clearing, portfolio reconciliation and compression, and swap relationship documentation). It is hoped that mandatory clearing requirements being introduced in Australia will provide an opportunity for additional substituted compliance determinations to be made by the CFTC.

The European Securities and Markets Authority (ESMA) has published advice to the European Commission (EC) on its comparison of the Australian regulatory regime with the European Market Infrastructure Regulation (EMIR). The EC is currently considering whether to adopt law consistent with ESMA's advice. ESMA recommended that the Australian rules for mandatory central clearing be found equivalent to those under EMIR, if the product is subject to a mandatory central clearing obligation in Australia and the counterparty is not exempt from the obligation. ESMA also advised that the Australian regime with respect to trade reporting were equivalent to that under EMIR. However, ESMA advised that the Australian regime with respect to the risk management obligations applying to non-centrally cleared OTC derivatives was not fully equivalent to that of the EU.

In Australia, under section 901B of the Corporations Act, the Minister may determine the classes of derivatives that may be subject to ASIC rulemaking, specifying whether any rules may relate to requiring either trade reporting, central clearing or use of trading platforms. Furthermore, under section 901A of the Corporations Act, ASIC may, by legislative instrument, make rules imposing requirements for trade reporting, central clearing or use of trading platforms. ASIC is required to consult on any rules, and rules only come into force following consent by the Minister.

The ABA believes there are benefits for the Australian financial system and Australian financial institutions and businesses from adopting an approach which is consistent and equivalent with overseas regulatory authorities, as far as practicable and relevant for this jurisdiction, and with the intent of seeking substituted compliance, equivalence or recognition to avoid regulatory duplication and legal uncertainty.

Implementation of regulation should be contemplative of local infrastructure, equivalence with existing foreign regimes and be drafted with the overarching principle of not only achieving goals consistent with international counterparts, but also consistent with the original objective of the G20 mandate of implementing this reform in a manner which reduces systemic risk, promotes transparency and reduces market abuse.

The ABA's main concern is that a robust and safe system be implemented, which does not disadvantage Australian banks domestically or internationally. We are also concerned that Australian banks and other market participants have sufficient time and resources to make necessary system and process changes, make the necessary commercial decisions and access infrastructures to set up the right arrangements for their new FMI requirements.

## Central clearing of OTC derivatives

Central clearing requirements are requirements for OTC derivative transactions to be cleared through a licensed clearing and settlement (CS) facility or a CS facility that has been prescribed in the regulations.

There are a number of benefits for central clearing, including:

- Improved financial stability and consequent economic benefits to reduce risks;
- Liquidity in OTC derivative markets;
- Capital treatment – lower risk weightings than non-centrally cleared transactions for ADIs subject to Basel III rules;
- Potentially lower initial and variation margining for centrally cleared transactions (compared to non-centrally cleared transactions) – although this cannot be determined as yet; and
- Improved risk management practices.

However, there are also a number of costs associated with central clearing, including:

- Initial and ongoing costs for systems and process changes (noting in particular the costs for smaller ADIs and participants);
- Changed market practices and legal arrangements (i.e. renegotiating contracts due to new arrangements, designing new administrative and legal arrangements to reflect the CCP requirements);
- Collateral – initial margin to CCP, whereas bilateral transactions do not require exposures to be collateralised (noting that collaterisations requirements are being internationally developed for non-centrally cleared transactions);
- Liquidity risk due to the CCP requirements that participants exchange variation margin;
- Lower returns as participants will need to hold additional liquid assets (including against transactions and any contingent obligations);
- Direct participants will be obligated to contribute to the pooled risk resources (collateral) and pay fees and indirect participants will need to employ multiple clearing brokers;
- Capital treatment – potentially higher for exposures to CCP default funds;
- Higher counterparty risk and potentially fragmented portfolio management where a selection of derivatives products are cleared and different products are 'un-netted';

- Taxation – interest may be paid on any collateral held by the CCP and non-residents may be subject to interest withholding tax or other taxes;
- Time zone issues – location of CCPs and their associated practices; and
- Potentially increased risk for certain participants now exposed to system wide and systemic risk rather than a bilateral relationship.

The direct and indirect impact of global regulation is significantly increasing the costs and complexities of managing operational and business risks for Australian financial institutions and businesses. Therefore, it is important that any new rules are implemented in a way that minimises adverse and unintended consequences and allows sufficient time and resources for banks and other market participants to make the necessary changes over a phased implementation approach. Furthermore, it is important that any new rules match the ability for banks and market participants to access direct clearing. We note that two CCPs (ASX Futures Clear and LCH Swapclear) have received regulatory approval to offer clearing of AUD-IRD, however, this does not necessarily mean that the infrastructure is available locally and in the Australian time zone.

The pre-conditions for a CCP to clear a product safely and reliably include:

- Robust valuation methodology so margin and default fund requirements can be determined;
- Sufficient liquidity in the market so close out and/or hedging of outstanding positions in possible in a default scenario;
- Sufficient transaction activity and participation so fixed and variable costs of clearing can be covered; and
- Standardisation of contracts to facilitate trade processing arrangements.

The ABA notes that single currency interest rate derivatives comprise 64.5% of the market in terms of notional principal outstanding and single-currency Australian dollar-denominated interest rate swaps account for just under half of the notional principal outstanding in interest rate derivatives.

Overall, the ABA believes that central clearing has made, and will continue to make, prudential and commercial sense for the most liquid and 'commoditised' types of OTC derivatives (i.e. IDR market). In practice, liquid OTC derivatives are easier for CCPs to assess and value these transactions correctly and to prospectively mange the inherent risks involved, and in particular, in the event of a default of one or more clearing members. However, the same cannot be said for less liquid OTC derivatives where a CCP would encounter significant difficulties in correctly evaluating and assessing the transactions and the risks involved, and therefore, may not be sufficiently able to confidentially provide the requisite risk management. In these cases, it would not be sensible to centrally clear these transactions. It should be noted that central clearing may not be always be possible for other practical and technical reasons.

Therefore, the ABA broadly supports effective measures to extend CCP clearing of standardised OTC derivatives across global markets and regulation to improve the robustness and efficiency of Australia's OTC derivative markets. Importantly, regulation of financial market infrastructures (including CCP) should strike a balance between preserving financial markets' stability, ensuring fair competition, and allowing access to participants and their clients.

Furthermore, the ABA encourages Australian representation in the development of a framework for standardising contracts, mandating clearing determinations globally, and identifying default arrangements with the aim of harmonising mandatory clearing determinations across jurisdictions.

### Definition of G4 dealer

The ABA believes that the case for a mandate for the G4-IRD and AUD-IRD should be based on applying the rules to larger financial institutions conducting significant cross border activity in the designated product classes.

There are several approaches to defining a G4 dealer, including a threshold of $50 billion or more notional OTC derivatives outstanding, or a threshold based on notional IRD outstanding (noting the threshold would be calculated based on a legal entity basis, so only the outstanding OTC derivatives entered into by the legal entity would be counted and would not include outstandings of related entities).

The ABA believes that the Federal Government should not simply adopt a threshold approach because this could capture, or not capture, certain entities. Instead the definition should balance certainty and flexibility for the regime to be applicable to an entity and a product-type. The criteria should focus on 'systemically important' activity to ensure the threshold is not the only criteria so that sophisticated entities that are, or become, 'systemically important' in the market by virtue of the amount of risk they put in the system can also be captured.

It is assumed that the major banks (ANZ, Commonwealth Bank, NAB and Westpac) and Macquarie Bank will be captured, along with additional participants. It is unclear how these additional participants may be defined beyond a threshold calculation, but might include descriptions as follows:

- Metrics to include net and gross thresholds;
- Risk profiles in the market, including frequency of product-type dealt and tenor; and
- Some form of qualitative measure, akin to the definitions used in foreign regimes, such as, swap dealer (under CFTC) and / or major swap participant.

The ABA believes that other currencies and instrument classes (i.e. foreign exchange derivatives, credit derivatives, commodity derivatives, equity derivatives) should not be subject to a mandate, at least at this stage, and subject to further assessment and resolution of technical issues encountered in overseas regimes. The reason for a mandate is international consistency (and avoiding regulatory arbitrage or other market distortions) and the materiality of transaction activity, respectively. Additionally, the initial focus of the mandate should be financial institutions (dealers) with a significant cross border activity in these derivative products and on transactions booked in Australia.

Factors we consider relevant to determining the new regime include:

- A practically workable definition so that Australian participants (outside ANZ, Commonwealth Bank, NAB, Westpac, and Macquarie Bank) which may not currently be able to clear can manage their economic risks;
- The definition is consistent for G4-IRD and AUD-IRD (noting the definition should focus on dealer activity);
- The definition does not capture smaller ADIs and participants;
- The definition is not a deterrent to foreign participants;
- The infrastructure is available locally and in the Australian time zone;
- The associated costs for making new arrangements for clearing and creating system adjustments to enable clearing for other Australian participants is subject to a measured approach (implementation timing, collateral considerations, etc); and
- The resolution of a number of practical issues, such as client clearing, exclusions, compression transactions, treatment of subsidiaries, giving 'prescribed status' for a foreign CCP (to mitigate concentration risk), assessment of capacity of available CCPs, etc.

The ABA also believes that the Federal Government should continue to monitor clearing arrangements for non-dealer financial institutions and other smaller users of OTC derivatives and that the Government and regulatory authorities should continue to monitor overseas developments to ensure that any compliance costs and benefits are managed as part of implementation of the regime in the Australia market.

Overall, the ABA is concerned that the CCP regime is simple and clear, but enables flexibility to capture the entities and product-types that are suitable for the Australian market.

The ABA recommends that the Federal Government:

- Mandate central clearing for G4-IRD (US dollar, Euro, British pound and Japanese yen-denominated interest rate derivatives) and AUD-IRD (Australian dollar denominated interest rate derivatives) only. The Government should mandate both G4-IRD and AUD-IRD concurrently, however, implementation timing will need to be phased to allow sufficient time for all participants to have in place the necessary internal systems and processes and infrastructure to comply.
- Explicitly contain in the determination that the mandate relates to dealer activity only, being transactions between any two G4 dealers (not end-users of the relevant products, non-financial corporate or non-dealer financial institutions). A G4 dealer should relate to a 'price maker' (not a price taker or client).
- Commencement of the mandate, and subsequent rules, should be contingent on the availability of infrastructure and a CCP being locally licensed and operating close to 24 hours. In the instance that this is not available, relief should be granted.

The ABA recommends that further consultation is necessary, and should be conducted with the industry prior to a mandate being introduced. We do not support a definition based on outstanding notional thresholds or a definition which requires continuous monitoring or allows different calculations between financial institutions. Furthermore, we do not support a mandate being introduced until determinations for calculating capital risk and clearance requirements are clearer, both domestically and internationally. APS regulations and APRA implementation requirements need to be resolved.

### Exemption for intragroup trades

The ABA believes that the rules associated with the mandates should exempt intragroup transactions for the central clearing obligation. This approach is consistent with the US and EU. The reason for this rule is to avoid introducing any requirements to centrally clear derivatives transactions that are not transferring any risk into or out of a single corporate group.

### Implementation

The ABA believes that implementation of central clearing obligations in Australia should be done via a phased approach, and contingent on the availability of infrastructure and a CCP being locally licensed and operating close to 24 hours. It is essential that Australian banks and other market participants have sufficient clarity about the obligations and time to conduct due diligence on any new CCP arrangement and to make any necessary changes to internal and external systems, processes and procedures.

The ABA believes that implementation timing should be coordinated with other jurisdictions, market participants, clearing members and service providers with the aim of maintaining stable, competitive and safe derivative markets in Australia. Additionally, overseas experience indicates that entities should be given at least 6-9 months prior notification for mandatory clearing to take effect, starting from the date of having published the final clearing rules. Without finalised rules, Australian banks and other market participants will not be able to make necessary commercial decisions and implement system changes and processes properly. Once final rules are available, it will still take time to coordinate internal and external changes necessary. These domestic and international factors should be taken into account with the implementation timing.

## Platform trading

The ABA believes that the Federal Government should continue to monitor developments in other jurisdictions and give further consideration to trading platforms, and in particular, what constitutes an acceptable trading platform for these purposes and defining the characteristics of suitable trading platforms.

Factors we consider relevant include:

- Characteristics of derivatives – vanilla, standard amount (i.e. notional, start date, roll date, tenor, amortising, accreting, etc), liquidity;
- Infrastructure and licensing requirements for the Australian market as against international standards;

- Access to offshore trading platforms, including Swap Execution Facilities (SEFs), and integration of licensing requirements for any domestic facilities; and
- Integration with other infrastructure, fragmentation and interrelated issues.

The ABA notes there is an international focus on the commitment to increase the use of exchanges and electronic trading platforms. However, we note that principles are still being developed in major derivatives trading jurisdictions and consensus has not yet emerged. We encourage Australian representation in these international developments and consideration of the economic impact and commercial costs for Australian market participants. We also note that Treasury is currently undertaking a review of the Australian market licence regime.

## Trade reporting

The ABA believes that the regulations should be amended to clarify that the obligations would only be imposed on AFS licensees with respect to derivatives authorised under their licence and exempt end-users from trade reporting obligations.

Factors we consider relevant include:

- Appropriateness of a threshold (i.e. trade volume, reasons for trading and nature of the entity itself) to ensure that the reporting obligation does not impose undue costs across the market;
- Definition of 'end-user' and exemptions – for example, we do not believe it is necessary for the reporting of small end users transactions who: (i) are using the IRD purely to hedge the interest rate risk of their business and transacting small notional values and volumes; (ii) are not 'systemically important'; and (iii) will be reported to the trade repository as a counterparty to the reportable transaction (i.e. effectively one sided reporting). The counterparty who is the end user will still be visible as they are reported to the trade repository;
- Codification of aspects (i.e. threshold) into the determination and subsequent regulations;
- Delegated reporting and associated liability and risk issues – noting lack of clarity around expectations across the industry and the impact for Australian banks providing delegated services to smaller counterparties (not receiving end-user exemptions);
- Implementation timing contingent on the availability of infrastructure locally (i.e. DTCC) – noting delays in vendors systems being available for review by banks and other market participants; and
- Confirmation of the Phase 1 obligations being made permanent and available for Australian financial institutions caught under Phase 2 and Phase 3.

The implementation costs could be significant and involve internal systems enhancement, potential connectivity linking required with the CCP, and reliance upon vendor solutions.

The ABA notes that the proposed implementation timing for Phase 3 is unrealistic unless the regime is targeted (i.e. end user exemptions) and/or delayed. It is important to ensure the market has clarity about the manner in which these trade reporting obligations will be implemented so that commercial decisions can be made.

> The ABA recommends that end-of-day snapshot reporting and one sided reporting for smaller financial institutions should be contemplated for Phase 3. This approach would balance the policy intent with the additional compliance costs for all entities. It would also more readily enable larger institutions to facilitate trade reporting across the Australian market without the imposition of confusing legal positions (i.e. liabilities associated with delegated reporting).

## Other issues

### Risk management

The ABA notes that Australian banks and other market participants conform to good market practices and market conventions. Prudential capital treatment and lower risk weightings for centrally cleared transactions for ADIs subject to Basel III rules and forthcoming regulatory changes will incentivise exchange of initial and variation margin and increase use of trade compression.

The ABA also notes that there is an international focus on risk management, such as the ESMA's advice that the Australian regime with respect to the risk management obligations applying to non-centrally cleared OTC derivatives was not fully equivalent to that of the EU. Collateralisation of OTC derivatives transactions, including legal and operational arrangements which underpin these arrangements, will need to be considered as part of the implementation of the BCBS-IOSCO margin requirements for non-centrally cleared OTC derivatives in Australia. We encourage Australian representation in the development of a plan to implement international standards in order to seek consistent approaches and timings.

### Cross border implementation

The ABA believes that the Australian financial regulators will need to give further consideration to a number of issues, and in consultation with the industry, including:

- Establishment of recovery and resolution regimes for FMIs, including CCPs;
- Substituted compliance, equivalence and recognition and regulatory cooperation in the application of regulations in cross-border contexts (primarily, enabling regulatory authorities to defer to each other's rules where these achieve similar outcomes) – mandating a clearing regime is of critical importance so that it will be recognised by overseas regulators;
- Market structure and alignment with international progress with the G20 commitments – ensuring participants' ability to access risk reducing OTC derivative markets;
- Treatment of branches and affiliates (including, Australian recognition of other regimes);
- Data in trade repositories (including, Australian financial regulators' access to relevant data collected by trade repositories).

These cross border implementation issues are important to ensure the efficiency and efficacy of the new rules.

## Concluding comments

The ABA believes further consultation is needed to resolve a number of definition and implementation issues. Importantly, we consider that a mandate for central clearing in Australia must not create market fragmentation or reduced liquidity in the classes of products identified, must fit within the international context of foreign regimes for recognition purposes, and must not unnecessarily increase costs for Australian market participants. Overall, we support a harmonious application of OTC derivatives reform requirements.

Yours sincerely,

**Diane Tate**