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Mr Michael Lim
Financial System and Services Division
The Treasury
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Dear Mr Lim,

OTC derivative markets – AUD IRD

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 – AUD-IRD central clearing mandate*. We note our previous submission made to Treasury on 17 April 2014. We also note the latest report by the Council of Financial Regulators published on 3 April 2014.

Opening comments

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.

The ABA notes that clearing mandates should reflect market practice. Such clearing mandates will assist in gaining cross border recognition and comparability assessments (substituted compliance or equivalence) as well as managing compliance costs. 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 Australian 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. For example, two CCPs (ASX OTC IRD Clearing 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 ABA 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.

Proposal to combine mandates into a single determination and align implementation of G4-IRD and AUD IRD

The ABA believes that the case for a mandate for 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 (significant market participants). Other currencies and instrument classes (i.e. foreign exchange derivatives, credit derivatives, commodity derivatives, equity derivatives) should not be subject to a clearing mandate, at least at this stage, and subject to further assessment and resolution of technical issues encountered in overseas regimes.

A mandate should be determined and formalised for G4-IRD and AUD IRD concurrently, however, this does not mean that implementation of mandatory clearing rules must happen at the same time. We note that the reason for a mandate is cross border coordination and 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 larger financial institutions with a significant cross border activity in these derivative products and on transactions booked in Australia.

A mandate for G4-IRD and AUD IRD merging the rulemaking dates would not present significant issues. For example, building systems for G4-IRD and AUD IRD would be similar, and thus, there may be some operational and compliance benefits for streamlining. However, there may be significant practical and operational implementation issues. For example, the existing CCPs put Australia at a disadvantage as neither ASX OTC IRD Clearing or LCH Swapclear operate for 24 hours, which causes operational issues for transactions and systemic risk for all currencies, but particularly AUD. Furthermore, LCH Swapclear is also unable to accept initial margin in AUD. Therefore, the we suggest that the AUD IRD mandate does not get implemented at the same time as the mandate of G4-IRD to ensure resolution of outstanding problems. We note that the market impact would be limited by aligning implementation to coincide with, or closed followed by, AUD IRD mandates imposed by foreign regulators. Key foreign jurisdictions include Dodd-Frank Act (United States) and European Market Infrastructure Regulation (EMIR) (Europe).

Importantly, the necessary financial market infrastructure must be in place and active for a clearing mandate to be implemented. It is essential for outstanding problems to be resolved prior to implementation. It is also essential to exempt interest withholding tax from margin flows in and out of Australia prior to implementation.

Defining and restricting ASIC rulemaking to "dealers"

The ABA believes that definitions should be aligned with foreign jurisdictions to avoid/minimise regulatory arbitrage.

The ABA assumes that the "dealers" captured will be the major banks (ANZ, Commonwealth Bank, NAB and Westpac) and Macquarie Bank. Given the turnover of these five institutions, we do not believe there is benefit in extending mandatory clearing to other participants, particularly in an initial phase.

Non-dealers are likely to face significant compliance burden and costs, including IT systems and liquidity costs. We consider that extending mandatory clearing to additional participants at a later stage should give consideration to systemic risk and the availability of client clearing and services to these participants. A clearing mandate for non-dealers at this stage could inappropriately inhibit these participants from important risk management programs and/or impose additional operational costs for uncleared OTC derivatives.

Additional participants and significant financial counterparties beyond dealers may present systemic risks. We consider extending mandatory clearing to these participants at a later stage should be given consideration (noting that the US and European regimes go beyond dealers for these types of mandates). The law should allow for ASIC to extend the clearing mandate beyond the class of entities initially captured, and to ensure coverage is harmonised with other jurisdictions as these rules are settled.

The ABA believes that "OTC derivatives" should be the definition in section 761D of the Corporations Act, excluding futures and options on futures globally and products that are not considered by the market or foreign jurisdictions to be derivatives. This approach will capture ordinary derivatives or derivatives generally globally accepted as derivatives. We consider this definition should also be used for trade reporting.

The ABA believes that Option B is preferred (with amendments and clarifications). There are problems with Option A. For example, the definitions of notionals and counterparty static rely on counterparty being collected, stored and maintained/updated which are not readily available.

Specific amendments and clarifications:

- "Entered into in Australia" – this concept is not possible to accommodate for historic transactions. Furthermore, the strict application of legal concepts of "entered into in Australia" create some impracticalities for future transactions. We suggest deletion of those words.
- "Booked or entered into" – for similar reasons as raised with regards to the reporting rules where they have caused problems, we suggest deletion of those words and replace with "booked in". (Transactions that are booked in another jurisdiction should not be caught.)

- "Any foreign financial entity" – this concept is too broad and would have extra-territorial consequences, we suggest deletion of those words and replace with "any Foreign ADI (as defined in the Banking Act), any foreign entity that is an AFSL holder and additionally any Exempt Foreign Licensee (as defined in the ASIC reporting rules)".

The ABA supports the class of entities subject to the clearing mandate to include any Australian ADI with $100 billion or more gross notional outstanding of the relevant mandated derivatives (i.e. G4-IRD and AUD IRD) "booked in Australia" as well as those foreign financial entities (as defined above) or any entity that opts into the clearing mandate. The clearing mandate should also only apply if both parties to the G4-IRD or AUD IRD transaction, which is "booked in Australia", is subject to the clearing mandate, i.e., both parties to the transaction is either a domestic or foreign financial entity above the $100 billion clearing threshold.

Intra-group transactions should be excluded

The ABA believes that the clearing mandate should exempt intra-group transactions (derivatives transactions within a group of an entity covered by the clearing mandate). This approach is consistent with the US and European regimes. 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.

Compliance costs

The ABA believes that where the mandate is applied to G4-IRD and AUD IRD Australian dealers, being the major banks and Macquarie Bank, this will minimise costs on the Australian market and individual participants while still achieving the policy and regulatory intent.

We note that the mandate is consistent with current market practice for interbank dealing in single currency AUD IRD. Additionally, we note that the mandate is envisaged to cover Australian dealers already subject to clearing mandates in other jurisdictions and have voluntarily adopted central clearing where appropriate. Therefore, it would be low impact for Australian dealers internationally active as the standard has already moved to a clearing basis. However, substituted compliance is important and if this is not attained/retained this could have significant compliance costs and obligations. Substituted compliance and equivalence represents the potential to reduce the regulatory burden and compliance costs while still realising the policy and regulatory intent.

Substituted compliance and equivalence

United States – Commodities and Futures Trading Commission (CFTC) regime

Unfortunately, the equivalence concept ("substituted compliance") has not provided cover for Australian dealers across both regimes. For example, the level of equivalence between the Australian regime and the US regime is high in order to obtain a positive substituted compliance determination. Furthermore, even if Australia did obtain a substituted compliance determination in relation to its clearing rules, based on the CFTC's guidance, any trading in mandatorily-clearable swaps conducted with a US person (other than potentially certain foreign branches of US banks) would always need to be cleared under US rules. Any trading with non-US persons (with the exception of entities guaranteed by or conduited to US persons) could not be impacted by US rules. Therefore, a positive determination in relation to Australian clearing rules would most likely only present a potential benefit when we are trading with Australian branches of US banks, or Australian incorporated entities in the "guaranteed by or conduited to" category. This is a small compliance benefit, but a benefit nonetheless. However, a larger compliance benefit of substituted compliance under the CFTC regime is that it may have advantages in relation to CFTC actions in other areas of rulemaking.

When an Australian mandate is implemented, the ABA encourages ASIC to work with the CTFC to have Australia added to the list of jurisdictions.

Europe – European Securities and Markets Authority (ESMA) regime

A positive determination on equivalence is likely to do more to assist Australian dealers. Under the EU regime, if Australian dealers are trading with a European Bank, both participants are captured by their respective regimes, and the product is subject to a mandate under both regimes. In this instance, the participants are able to decide which regime to comply with. Therefore, an AUD IRD mandate presents a compliance benefit for Australian dealers in terms of EMIR equivalence.

That said, the clearing mandate may only cover some USD, GBP, EUR and JPY IRDs, not AUD IRDs. One of the requirements of conditional equivalence is that the products subject to clearing in Australia are also cleared under EMIR so it is possible that equivalence could cover the G4 currencies, but not AUD.

Implementation and timing

The ABA believes that implementation of mandatory central clearing obligations in Australia should be done via a phased approach, and contingent on:

- The availability of infrastructure and the dominant global CCP for IRD being locally licensed and operating close to 24 hours; and
- The major foreign jurisdictions also implementing the clearing mandate for their markets (United States and Europe).

It is essential that Australian banks and other market participants have sufficient clarity about their 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. It is also essential that clearing mandates are based on cross border coordination and implementation.

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 participants 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.

That said, where the mandate is applied to G4-IRD and AUD IRD Australian dealers, being the major banks and Macquarie Bank, and reinforces current market practice for dealings between significant market participants, the implementation timing should not present significant or incremental costs.

The ABA recommends that the Federal Government:

- Mandate central clearing for G4-IRD (USD, GBP, EUR, JPY 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 should apply only to significant market participants (being the major banks and Macquarie Bank), and replicate current market practice.
- The class of entities subject to the clearing mandate should include any Australian ADI with $100 billion or more gross notional outstanding of the relevant mandated derivatives (i.e. G4-IRD and AUD IRD) "booked in Australia" as well as those foreign financial entities (as defined) or any entity that opts into the clearing mandate.
- The clearing mandate should also only apply if both parties to the G4 and AUD-IRD transaction, which is "booked in Australia", is subject to the clearing mandate, i.e., both parties to the transaction is either a domestic or foreign financial entity above the AUD 100 billion clearing threshold.
- Implementation timing for any additional participants will need to be phased to allow sufficient time for 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 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 the dominant global CCP for IRD being locally licensed and operating close to 24 hours and the major foreign jurisdictions also implementing the clearing mandate for their markets (United States and Europe). In the instance that this is not available, relief should be granted.

Yours sincerely,

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