Implementation of OTC Derivatives Reforms in Australia

Speech by Oliver Harvey delivered at Risk Australia Conference, Sydney, 13 August 2013.

Thank you Aaron for that introduction, and I appreciate having the opportunity to come and speak to you all about the implementation of a range of OTC derivatives reforms, and ASIC's role in delivering those changes.

Today I'd like to talk through some of these initiatives , both those that are well underway and those that are only just starting, and also provide you with some views on the cross-border discussions that are occupying us as each G20 jurisdiction and others implement reforms of OTC derivatives markets.

Background to these reforms

At the risk of repeating facts you've heard many times, I think it's important to go back and set the scene for why it was considered necessary to initiate regulatory reform in the OTC derivatives marketplace.

Let's not forget that back in 2008, OTC credit derivatives contributed to the global financial crisis. Regulators found that extremely large risks were being built up that were not being appropriately managed, and they found that they (and indeed other market participants) lacked understanding as to the size, directionality and interconnectedness of those risk positions.

This lack of market transparency contributed to financial instability, as institutions became reluctant to lend to one another and to engage each other as counterparties.

These limitations on market transparency were particularly evident when regulators were obliged to make momentous decisions – for example, whether or not to bail out the Lehman Brothers investment bank and the AIG insurance group in 2008 without full knowledge of the risk positions and interlinkages of their counterparties and therefore of the systemic consequences of bailout decisions.

Ultimately, risks being taken in the OTC derivatives markets were to have a real impact on the overall stability of the financial system and consequent flow-on impacts to the real economy and to governments' balance-sheets, and each and every one of us in this room.

As I am sure everyone in the room now knows well, out of the ruins of the global financial crisis, a broad international policy consensus was reached that encouraging greater use of centralised infrastructure in OTC derivatives markets should help to address many of the concerns of regulators and market participants by improving market transparency, reducing systemic risk and better detecting and preventing market abuse in OTC derivatives markets.

This consensus was most prominently articulated in 2009 when the G20 leaders made three key commitments:

- firstly, to require that all OTC derivative transactions be reported to databases known as trade repositories;
- secondly, to require all *standardised* OTC derivatives transactions to be centrally cleared through clearing houses; and
- Thirdly, to require all standardised OTC derivatives transactions to be traded on exchanges or electronic trading platforms, *where appropriate*.

G20 leaders also agreed to higher capital requirements for non-centrally cleared OTC derivatives transactions, and this has now fed through into the Basel III framework administered by APRA.

In 2011 the G20 added to the OTC derivatives reform agenda a commitment to develop standards on margining for non-centrally cleared OTC derivatives.

One might ask why, if Australian financial institutions were able to more prudently trade OTC derivatives and avoid the excesses of financial institutions elsewhere, did Australia sign on to these commitments, and why are we implementing these reforms today?

The fact is that OTC derivatives markets are by their nature global. The subsidiary of AIG that brought it down was based in London, the two hedge funds Bear Stearns bailed out on the eve of the GFC were based in the Cayman Islands, and Lehman Brothers' downfall was caused in part by trades booked through its UK subsidiary.

These observations and examples are very much at the forefront of, for example, the CFTC's thinking on how far it believes its regulations should reach, in order to better manage future risks.

As a consequence of that interconnectedness and the regulations being driven by these considerations, OTC derivatives reform underway globally will have an impact on Australian-based and Australian-located financial institutions.

As global financial centres implement these reforms, many of the institutions in this room will be affected by these changes, if they haven't been already.

Perhaps the most obvious example of this is the four major Australian banks and Macquarie Bank who are all provisionally registered with the CFTC as foreign (non-US) Swap Dealers, and are therefore subject to a range of CFTC rules.

OTC derivatives reform is unavoidable in an open economy with globally active participants.

Against that backdrop, we believe that a phased-in, well-considered, and internationally consistent implementation of OTC derivatives reforms in Australia is in the best interests of the Australian financial system, by ensuring risk is reduced and Australian institutions can continue to access global OTC derivatives markets with as little disruption as possible.

With this in mind, and since the conference last year, the agencies that comprise the Australian Council of Financial Regulators have worked intensively with industry and with overseas regulators.

In approaching this work and the potential consequence it has for you in this room, we have been driven by a number of overarching themes.

In addition to the potential benefits that greater use of centralised infrastructure can offer, we are also conscious of the potential regulatory costs and distortions that these changes can have, and remain firmly committed to ensuring these initiatives are implemented in Australia in a manner that is as cost effective and undisruptive as possible - having regard to the reform objectives.

Those of you who have been directly affected by this reform agenda, and those of you who are keen onlookers, will no doubt have your own view on whether we as Australian regulators, are collectively achieving these objectives, but we remain committed to implementing these changes in a sensible and considered way.

In this context, the regulators have largely sought to support an incentives-led transition where appropriate. At the same time, at the end of last year, Australia introduced legislation that provides for the Minister to impose mandatory requirements for trade reporting, central clearing and platform trading of OTC derivatives, where appropriate and on the regulators' advice.

In order to enable our advice to the Minister on these matters to be as informed as possible, the regulators are actively monitoring developments in the Australian and overseas OTC derivatives markets, and also carry out periodic market surveys to produce assessment reports based on the results.

The most recent of these reports was published last month, and prior to that, in October last year.

Trade Reporting

The regulatory reform that has been progressed the fastest in Australia and globally has been the G20 commitment to require details of OTC derivatives transactions be reported to trade repositories.

Trade repositories are a new type of financial market infrastructure – really just big databases of OTC derivatives transactions that regulators can tap into to better understand these markets and the risks that institutions in these markets are exposed to.

As set out in the Regulators' Report on the Australian OTC Derivatives Market in October last year, the regulators consider that there would be substantial benefits to the efficiency, integrity and stability of the financial system if market participants were to use centralised trade repositories, including increased capacity for market oversight and monitoring of risk concentration and other systemic risk indicators, improved risk management for market participants, enhanced market transparency and greater operational standardisation.

Comprehensive trade reporting would also provide the regulators with detailed information to inform recommendations around potential future product class prescriptions and the design of any future rules.

Alongside these benefits it was also clear in October that the practice of trade reporting by Australian entities was relatively limited, and that it was likely necessary to mandate the practice, in order for the intended benefits to be most effectively realised.

With this in mind and since framework legislation was passed late last year, both Treasury and more particularly ASIC have been busy consulting stakeholders on the implementation of mandatory trade reporting in Australia.

As foreshadowed in a Treasury consultation in December last year, the Treasurer has now formally granted ASIC rulemaking power over five asset classes, namely credit derivatives, equity derivatives, foreign exchange derivatives, interest rate derivatives, and commodity derivatives, other than electricity derivatives.

ASIC consulted stakeholders in March and April of this year on details of the reporting regime, including details such as the fields to be reported, phase-in arrangements, and the like.

In July, we finalised derivative transaction rules about trade reporting, and separate rules for licensed trade repositories. We also published guidance and FAQs on a new dedicated page of our website titled "OTC derivatives reform", along with other explanatory material.

In keeping with the principles I spoke about earlier, in framing the detailed rules to implement the reporting obligation, ASIC has been focused on ensuring as far as possible that our reporting requirements are consistent with those being implemented in other jurisdictions – and discussions with a number of you are ongoing.

The aim is that Australian participants can continue to access global markets and infrastructures and thereby minimise the implementation costs of these reforms.

In fact we are already in discussions with the pan-European securities regulator, ESMA and the CFTC about the potential equivalence of the Australian trade reporting regime with their respective requirements.

Under the rules we have made, the mandatory reporting of derivative transactions will be introduced in a number of phases.

The first phase will require reporting by any Australian entity that is registered as a Swap Dealer with the CFTC, from October 2013.

Other large financial entities with OTC derivatives portfolios amounting to $50 billion or more of gross notional outstanding positions, will be required to report from April 2014, and remaining financial institutions and intermediaries, including both ADIs and AFSLs as well as certain foreign entities, from October 2014.

As far as end users are concerned, for example corporates who are not ADIs or AFSL holders but who enter derivative contracts as counterparties, these are not covered by the three reporting phases we have finalised so far.

We intend to undertake further consultation on requirements for non-financial end users before any reporting obligation is implemented for them, and this consultation is planned for late 2013 or early 2014.

We will be consulting on issues such as whether a *de minimis* reporting threshold is appropriate for end users, whether end user to end user trades should be reported, and whether intragroup trades should be reported for end users.

In line with Treasury regulations, we would expect that whatever the design for end user reporting, it would commence no earlier than January 2015.

We will also wrap into that consultation a technical rule tweak on foreign subsidiaries of Australian ADIs, with the intent of bringing them into the reporting regime starting 1 October 2014.

As we work through the implementation of the reporting obligation, ASIC is committed to working closely with relevant stakeholders on the implementation of these reforms to ensure a smooth and effective introduction of the reporting obligation.

We encourage stakeholders to get in contact with us early as undoubtedly a range of technical considerations will arise as the reporting obligation comes into effect.

One question you might be asking is what are ASIC and the other regulators going to do with all this data? In consulting on the implementation of these requirements, we focused on three key objectives:

- to firstly enhance the transparency of transaction information available to relevant authorities and the public;
- secondly to promote financial stability; and
- finally to support the detection and prevention of market abuse.

We and the other regulators are working hard to ensure this data will help achieve each of these objectives, and during the rulemaking process, we worked closely with the other regulators to ensure the data being reported would support their ability to perform their respective mandates.

Going forward, with Government support we expect to upgrade our existing systems to support a whole-of-market assessment capability.

Mandatory Clearing

The second element of the G20 commitments involves requiring standardised OTC derivatives transactions to be centrally cleared.

In their *Report on the Australian OTC Derivatives Market* published in July 2013, ASIC, APRA and the RBA examined the case for mandatory central clearing of three instrument classes:

- interest rate derivatives denominated in US dollars, euros, British pounds or yen (sometimes called G4 currencies);

- North American and European-referenced credit derivatives; and finally
- Australian dollar denominated interest rate derivatives.

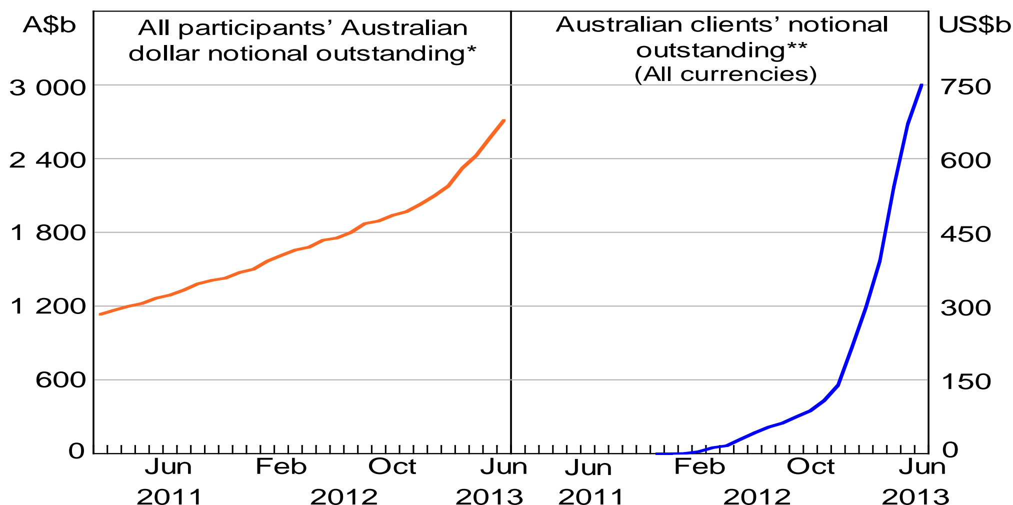
With regards to the first category, the regulators recommended that the Government consider a central clearing mandate for US dollar-, euro-, British pound- and yen-denominated OTC interest rate derivatives.

This reflected a number of factors:

- firstly, the material levels of activity in these markets in Australia – which naturally correlates in part with the benefits that can be derived from central clearing;
- secondly that certain trades in these products are already covered by mandatory clearing requirements in other jurisdictions – which means that there are benefits for Australia in being able to demonstrate an approach that is internationally consistent with other major jurisdictions; and
- thirdly that the largest Australian banks are already centrally clearing a substantial proportion of their new trades in these products via the client-clearing arrangements they have with participants in the global CCPs – which should mean that the cost of any mandate for these types of entities (being those with significant levels of cross-border activity), should be limited.

A couple of graphs show the rapid growth in central clearing of OTC interest rate derivatives, specifically through LCH – the largest provider of interest rate derivatives clearing services.

Notional Principal Outstanding of Interest Rate Derivatives at LCH



* CCP figures halved to adjust for the double counting that occurs when a trade is novated

** Total outstanding for Australian clients; to the extent that trades are between these clients, they will be counted twice

Source: LCH.Clearnet / SwapClear

This is the case, both for Australian clients of LCH clearing participants in all currencies - on the right, and for all LCH clearing participants in Australian-dollar denominated OTC interest rate derivatives - on the left.

As mentioned, the regulators consider that the incremental regulatory cost of a mandate for interest rate derivatives in the G4 currencies is likely to be low, and that there would be international consistency benefits to determining a mandate for these products.

Given the nature of the entities responsible for the bulk of the activity, the regulators recommended that the initial focus of such a mandate should be dealers with significant cross-border activity in these products.

This recommendation has been passed on by the regulators to the Government, and it is now something for it to consider further, and act on if deemed appropriate. If the Government accepts the recommendation of the regulators, then ASIC will need to commence a consultative rulemaking process like we have just undertaken in relation to trade reporting.

During this process, we expect to work closely with stakeholders to ensure the implementation of the clearing obligation proceeds smoothly, with enough time for market participants to arrange appropriate clearing arrangements where necessary.

We will also consult closely with the relevant authorities in the 'home currency' jurisdiction of the relevant products to ensure as far as possible there is a consistent application of these requirements globally.

As activity in the Australian market is most heavily concentrated in Australian dollar-denominated interest rate derivatives, the potential benefits of central clearing of this product class are probably the most significant.

Regulators have said they will monitor for a further period Australian banks' progress in implementing appropriate clearing arrangements before recommending mandatory central clearing of this product class.

In this context and as shown in the slide, the regulators have in any event, observed an acceleration in central clearing of these products in what we see as a response to the various regulatory and commercial incentives in the market place today, such as:

- the Basel III capital requirements that have made bilateral derivatives transactions more costly compared with centrally cleared trades; and
- the shrinking pool of derivatives counterparties that are willing to enter in to non-centrally cleared transactions.

All the same, we continue to watch this space to confirm that incentives are in fact having the desired and intended outcome. The initial scope of any mandate, should we pursue one, would likely be the interdealer market.

Recently and importantly, two CCPs, ASX Clear (Futures) and LCH.Clearnet Limited, received regulatory approval to offer central clearing of OTC interest rate derivatives in Australia.

Despite the acceleration of central clearing of Australian dollar interest rate derivatives shown in the slide, progress by domestic participants has been limited by the lack of opportunities for direct clearing – with those domestic entities currently needing to clear as clients of clearing members, and often at a higher cost, through a participant of an international clearing house – a participant who may themselves be a competitor.

The authorisation of these two CCPs here in Australia, has the potential to better facilitate direct clearing by Australian banks, and avoid some of the concerns with the options currently available.

The regulators will therefore focus on the Australian banks' progress in implementing appropriate clearing arrangements with these CCPs. We expect operational arrangements to be largely in place by the end of 2013.

With regards to North American and European referenced credit derivatives, while there is material activity in these products in the Australian market, the regulators have observed a relatively low level of activity in these products among domestic participants, including the large Australian banks.

Furthermore, domestic participants are currently unable to directly clear North American and European referenced credit derivatives, and are only clearing to a limited extent via existing client clearing arrangements.

Accordingly, the regulators do not see a case for mandating these products at this time. In the next regulators' OTC market assessment report scheduled for next year, the regulators will further consider the case for mandating central clearing of North American and European referenced credit derivatives.

Other G20 Commitments

The third element of the G20 commitments involves requiring standardised OTC derivatives transactions to be traded on exchanges or electronic trading platforms, where appropriate.

At this stage, the Australian regulators have not recommended any mandatory obligations be put in place for the execution of trades on organised trading venues.

In particular further consideration needs to be given to what constitutes an acceptable trading venue for these purposes, which may require changes to the regulatory regime for trading platforms in Australia.

We expect however as other jurisdictions begin to put into place these platform trading requirements, the regulators here will need to consider further if a mandatory trading obligation would be appropriate.

The final area of focus for the G20 in relation to OTC derivatives has been the work by the international Working Group on Margining Requirements, which is close to finalising key principles on the application of minimum margin requirements for non-centrally cleared derivatives.

Once that report is finalised, the Government and the Australian regulators will need to consider next steps, including the most appropriate way to implement the international principles in Australia in line with the timetable to be agreed by the international working group.

Cross-border discussions

I'd like to spend a bit of time now on the cross-border impact of all these new OTC derivatives requirements, and how ASIC is approaching the range of issues that are arising as these G20 reforms are implemented.

These are unusual times for financial regulation, with the broad conclusions from the GFC post-mortem being a general consensus for the need for rapid implementation of a range of reforms that otherwise may have taken place over decades, or potentially not at all.

If you look at the way international financial regulation used to be done – take for example the development of standards for Credit Rating Agencies or the IOSCO Objectives and Principles of Securities Regulation – there were broadly three distinct and neatly sequential stages:

- Firstly a period of international negotiation to come to an agreement on international standards;
- Followed by a period of time for each jurisdiction to implement the agreements in their national laws and regulations; and
- Finally international bodies like the IMF and other international agencies would typically undertake assessments of how effectively these reforms have been implemented in each jurisdiction.

We simply don't have the time to do these three stages sequentially and still keep up with the rapid pace of implementation of OTC derivatives reforms in other jurisdictions, and expectations of major foreign jurisdictions and international agencies that are monitoring and reporting on domestic progress.

For example, as we finalised our trade reporting rules over the first half of the year, international standards such as on regulators' access to data held in trade repositories were still in the process of being developed by bodies such as the International Organization of Securities Commissions (IOSCO), and the CFTC and ESMA had already commenced the process of assessing whether the Australian regime is equivalent to their own.

This has inevitably led to challenges in the cross-border implementation of these reforms.

It goes without saying that each of the G20 jurisdictions has their own unique legal framework, financial industry structure, and regulatory institutional history.

Have made these points, we have however been encouraged by the spirit with which we have engaged with regulatory colleagues around the world.

I would not want to get drawn in to an analysis of the merits of each decision taken by other regulators, but what I would say is that their engagement has always been constructive and with a recognition that we all share the same end goal of reducing risk in the financial system.

This engagement has been facilitated particularly through IOSCO, which is currently chaired by our ASIC Chairman, Greg Medcraft. We expect the role for IOSCO across all areas of securities regulation, and in particular OTC derivatives reform, to increase in the years ahead.

Other groups, like the OTC Derivatives Regulators' Forum – and other less formal groupings of key OTC derivatives regulators - have been useful forums for exploring regulatory cooperation and for reaching agreements in relation to certain areas of cross-border derivatives regulation.

We have also had a substantial amount of constructive engagement bilaterally with other regulatory agencies around the globe, including like-minded and like-positioned regulators in our own region, and we believe this engagement has and will continue to be absolutely vital in resolving problems as they arise and ensuring we implement these reforms without creating undue market instability or undue market disruption.

There also continues to be broad agreement by each jurisdiction that the assessment of the equivalence of another's regime can only be appropriately undertaken via an "outcomes-based", as opposed to line-by-line, approach.

The proof will be in the pudding, but we remain committed to doing what we can to ensure these principles are followed through.

Conclusion

So in conclusion, while we recognise the challenges faced by market participants in implementing these reforms, we remain firm in the belief that these reforms have the potential to reduce risk that can arise through OTC derivatives transactions.

We strongly believe that after these reforms are completed, OTC derivatives markets will have a lower level of risk than they did before the GFC, allowing for the continued development of these markets that are so vital for a wide range of financial institutions and end users seeking to manage their risks and conduct business in a global environment.

This is an extremely important and wide-reaching series of reforms and industry has been actively engaged to date during their development – and we very much appreciate that.

ASIC and more broadly the agencies of the Council of Financial Regulators will continue to work closely with stakeholders to provide guidance and work through implementation issues, and to strive to "think globally and act locally" to ensure that domestic initiatives are as sensitive and as complimentary as possible to regional and international approaches, and are implemented here in the most sensible and considered way possible.

Thank you and enjoy the conference.