ASIC

Australian Securities & Investments Commission

Derivatives 2013: The future comes into focus

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ISDA Annual Australia Conference

17 October 2013

Good morning ladies and gentlemen. Thank you to Stephen O'Connor, the International Swaps and Derivatives Association (ISDA) Chairman, for that kind introduction and for giving me the opportunity to speak to this important conference.

This conference is timely as it comes just two weeks after the commencement of the first of Australia's G20 commitments to over-the counter (OTC) derivatives reform – the obligation for some Australian banks to begin reporting their OTC derivatives transactions to trade repositories.

It also comes at a time when the Australian Government and Australian regulators are gearing up to begin consultation and implementation of other key reforms – namely the mandatory clearing obligation and the international principles in relation to the margining of non-centrally cleared transactions.

This morning I'd like to cover four areas that are at the forefront of ASIC's and the Australian regulators' minds:

- first, I'll talk briefly about the recently agreed international principles on margin requirements for non-centrally cleared trades
- second, I'll give an update on implementation of trade reporting in Australia
- then I'd like to take a forward look on mandatory clearing requirements and requirements for the mandatory execution of trades on organised trading platforms
- finally, I'd like to provide an update on ASIC's cross-border discussions and our perspective on how these are progressing.

Margin requirements

As you are aware, international requirements on margin for non-centrally cleared OTC derivatives were published by a joint working group of the International Organization of Securities Commissions (IOSCO) and the Basel Committee on 2 September. The margin requirements seek to help to reduce systemic risk in the OTC derivatives markets, and to provide incentives for central clearing.

Work on the international requirements benefited from two rounds of public consultation in July 2012 and June 2013, and a quantitative impact study. It also benefited from the contributions of other international bodies.

ASIC was a member of the working group, and we have worked closely with the Australian Prudential Regulation Authority (APRA) and the Reserve Bank of Australia (RBA) during this process.

From Australia's perspective, this ambitious piece of reform is just getting started. Globally, governments and regulators have a lot of work to do to ensure the international requirements are adopted into domestic law in a way that is appropriate for individual markets and which also minimises inconsistencies between national regimes.

I won't go through every aspect of the international margin requirements today. Instead, I will highlight a couple of areas of the international requirements and talk about how the Australian regulators are thinking about implementation.

First, under the international requirements, initial margin and variation margin should be exchanged between entities in financial groups that have significant OTC derivatives portfolios, and any non-financial entities that are identified as systemically important.

However, initial margin does not have to be exchanged for physically settled foreign exchange swaps and foreign exchange forwards. Initial margin also does not have to be exchanged for the physically settled payments of principal under cross-currency swaps. As our financial institutions rely on offshore funding, the Australian regulators were very supportive of the exception for cross-currency swaps.

Second, under the international requirements, initial margin should be calculated based on a standard table or using quantitative models that have been approved by the relevant regulators. This is an area where the Australian regulators would like to engage with industry on developing approved quantitative models. We would also welcome industry initiatives – including any initiatives by ISDA – that may help to ensure initial margin can be calculated on a consistent basis, including for cross-border transactions.

Lastly, I would like to talk about the timetable for implementation. The international requirements are intended to be phased in between December 2015 and December 2019. From December 2015, the requirements will apply to groups with more than 3 trillion euros in notional value of non-centrally cleared derivatives. By 2019, the requirements will extend to groups with more than 8 billion euros in notional value of non-centrally cleared derivatives.

The IOSCO and Basel Committee working group will undertake monitoring work in 2014, to track and assess the likely impact of the margin requirements as other related reforms come into force, and consider whether changes to margin requirements are warranted.

How this timetable will play out in the Australian market and for our participants is something that the Government and regulators are considering. We are also looking at the likely impact on liquidity and

transaction costs in the Australian OTC derivatives market and macroeconomic impact more broadly. In terms of process, a question for the Government is whether ASIC will have a role in applying the requirements to some of our market participants. A related question is whether APRA will apply margin requirements under its prudential framework.

As we consider these questions, we will seek to continue our open engagement with industry as we have done in OTC derivatives reforms so far. We will also engage with the international monitoring work and with colleagues from foreign regulators. It is our hope that this approach will contribute to a smooth implementation and transition in the Australian OTC derivatives market and for our participants.

Trade reporting

I'd like to spend some time now discussing the trade reporting requirements, which came into effect for the five major Australian banks that are registered with the US Commodity Futures Trading Commission (CFTC) as swap dealers on 1 October.

In framing the trade reporting and trade repositories regimes for Australia, and in line with some jurisdictions overseas, ASIC was very conscious of the desirability of a phased approach to trade reporting. Asking the largest institutions already trade reporting under the CFTC's regime to lead the way made sense, in terms of minimising the overall impact of this important shift. Hopefully, over time, the lessons learnt in this first phase of implementation of the trade reporting requirements can be reused to benefit the smaller Phase 2 and Phase 3 entities.

We are also conscious of the implementation challenges that something as seemingly simple as trade reporting can throw up, particularly as financial institutions are so dependent on infrastructures and middleware providers to meet their obligations in this area.

In the lead-up to 1 October, therefore, we had regular meetings with the five reporting entities, facilitated by the Australian Bankers Association, and this has led to transitional exemptive relief being granted to the banks in a few key areas.

We are pleased that reporting started on time, and the Australian regulators now have access to a set of information about the trading activities of these banks that was never available on a routine basis before.

We have heard reports from the Depository Trust and Clearing Corporation (DTCC) and the banks that the implementation of the reporting obligation has gone very smoothly.

As of last Monday, the five reporting entities were reporting around 90,000 open positions across the five asset classes, a figure that will go up over time as the transitional relief tails off.

This early indication of reporting demonstrates just how much valuable information is now available for the first time to the Australian regulators as a result of the implementation of these rules.

The next phase of the reporting obligation commences on 1 April next year for those entities with $50 billion or more notional outstanding in OTC derivatives as at the end of calendar year 2013.

As this will impact many of you in the room, I'm sure you are advancing well in your planning for 1 April. I'm glad to say that, as we did with the first phase, ASIC will be engaging in an ongoing dialogue with the candidate Phase 2 reporting entities, facilitated by ISDA and the Australian Financial Markets Association (AFMA), to ensure, as far as possible, a smooth and efficient commencement of their reporting obligation.

However, we do encourage the entities potentially covered in Phase 2 to work together, and to the extent any relief may be sought, to do so on a coordinated basis and well in advance of 1 April. Beyond Phase 2, ASIC also has work to do to reach out to the remaining authorised deposit-taking institutions and Australian financial services (AFS) licensees, including in the funds management space, well ahead of 1 October next year, when OTC derivatives reporting (of rates and credit derivatives) will start for them.

I'd also like to briefly mention the follow-on consultation on trade reporting ASIC plans to undertake early next year.

End users were not included in the initial phases of the reporting obligation, and so we need to consult on what, if any, reporting obligation should be applied to them, including the important issue of reporting by foreign subsidiaries.

The content of our proposals will reflect a range of considerations, including whether we can rely on banks' reporting of bank-to-end-user transactions and when end-user-to-end-user transactions could be systemically significant. We also expect to consult on technical issues that have arisen in the implementation of the reporting obligation. We look forward to receiving your feedback on this consultation in due course.

Mandatory clearing and mandatory platform trading

I'd now like to touch on the implementation of the other two key G20 reform commitments, being mandatory clearing and mandatory platform trading.

Many of you would be aware that in July, ASIC, APRA and the RBA recommended to Government that it consider a central clearing mandate for US dollar-, euro-, British pound- and yen-denominated OTC interest rate derivatives. The regulators made this recommendation on the basis that the incremental regulatory cost of a mandate for these products is likely to be low, and that there would be international consistency benefits to issuing 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.

These recommendations are with the Government and ASIC stands ready to move quickly to develop rules if the Government accepts the recommendations.

As we did for trade reporting, if the Government were to consult on a draft mandate we would be in a position, within a reasonably short time, to consult on draft implementing rules in the interests of timely introduction and giving the market as much early certainty as possible.

Another G20 OTC reform commitment relates to mandatory platform trading of OTC derivatives. While this commitment has generally received less focus, it has come to the fore in recent weeks with the finalisation of the CFTC's rules for swap execution facilities and the possibility of the first mandatory trading determinations being made in the United States in the coming months.

Consistent with the Australian regulators' approach on mandatory reporting and clearing, the regulators will continue to closely observe developments in other jurisdictions and consider whether the implementation of any mandatory obligation would provide a benefit to the Australian marketplace, especially where doing so will help to maintain liquidity in the Australian market by maintaining consistency with overseas developments.

Cross-border aspects

I'd like to end with some perspectives on the ongoing challenges around the cross-border implementation of OTC derivatives reform.

We have all been working hard to find the appropriate set of regulatory tools to ensure the G20 commitments are implemented effectively, without creating duplicating or conflicting rules. The G20 leaders agreed on the rapid implementation of OTC reforms by national regulators; at that time, the content of those reforms was agreed in broad outline.

In the time available, standard-setting bodies have filled in some detail, but inevitably national parliaments and national regulators have had to fill in the rest.

The result is some mismatch in the content and scope of national rules, in this most global of marketplaces. We see it as the regulators' job to reduce those mismatches, as far as possible, and to facilitate sensible outcomes, where it is not possible to change existing rules.

To the extent possible, the Australian regulators have sought to implement the G20 commitments in a way that both reduces risk, and increases transparency, in the OTC derivatives markets and at the same time, where possible, avoiding market disruption and reducing costs to the industry.

For this reason, our trade reporting and trade repositories rules, for instance, have been closely modelled on regimes overseas and international standards such as the CPSS–IOSCO *Principles for financial market infrastructures* in order to minimise incremental regulatory costs and maximise trading opportunities across borders.

However, as no two regulatory regimes are exactly alike, this has been a matter of minimising the overall disparity, rather than modelling our Australian regime too closely on any one overseas ruleset – and then working hard to ensure effective and efficient implementation here in Australia, particularly for those entities also subject to overseas regulation as part of their international business.

Given some extraterritorial regulation of OTC derivatives markets is inevitable, we believe that the appropriate level of regulation of these markets can also reduce costs for Australian participants.

Developing appropriate regulation that achieves equivalence or substituted compliance will have the effect of putting Australian participants and markets under the Australian regulatory framework, rather than needing to comply with the requirements in foreign jurisdictions.

This will allow the Australian regulators to most appropriately tailor the regime to the needs of the Australian market.

There have been a number of important recent developments that we believe demonstrate that this approach is beginning to bring these benefits to the Australian market.

The European Securities and Markets Authority (ESMA) recently published its advice to the European Commission on the Australian regulatory regime in comparison to the European Market Infrastructure Regulation (EMIR), which is the European Union regulation on OTC derivatives, central counterparties and trade repositories.

There were three key elements of this advice that, if implemented by the European Commission, would reduce compliance costs and increase market access for Australian market participants:

- First, ESMA found the Australian regime for central counterparties to be fully equivalent to that under EMIR, with Australia being one of only two jurisdictions (along with Switzerland) to get this finding. This is the first and most important step for ASX Clear (Futures) and any other domestic central counterparties to be able to gain recognition in the European Union and continue to provide its full services to European Union market participants.
- Second, ESMA found the Australian regime for trade reporting and trade repositories to be fully equivalent to that under EMIR – Australia is the only jurisdiction so far to achieve this finding in both these areas. This should mean that any market participants subject to reporting requirements in the European Union and Australia will be able to comply with their European Union reporting obligation by complying with their Australian obligation. It also means that any trade repositories established in Australia will be able to gain recognition in the European Union.
- Finally, ESMA recommended that the Australian rules for mandatory clearing be found equivalent to those under EMIR, if the product is subject to a mandatory clearing obligation in both jurisdictions and the counterparties are not exempt from a clearing obligation in Australia. This is a finding only the United States and Japan have also received. This means that, if we apply a clearing obligation in Australia on a product and the counterparty in Australia is not exempt from the obligation, then they can comply with future Australian mandatory clearing rules rather than European Union rules.

We believe the outcome of the ESMA process is a very good result for Australian market participants and will see the Australian regulators continue to set the rules in these areas in the Australian market. This technical advice on equivalence if adopted by the European Commission will ensure that Australian market participants complying with Australian rules for trade reporting and mandatory clearing should not have to also comply with requirements in this area under European Union law, as long as they comply with the Australian rules.

Australian regulators continue to consider what if any response is necessary to make to the other aspects of the assessment, particularly around bilateral risk mitigation. It is possible that further regulatory guidance for internationally active institutions will be forthcoming in this space, from APRA and/or ASIC.

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As far as the CFTC's substituted compliance process is concerned, we are in continuing discussions in relation to its consideration of whether to grant the Australian regime substituted compliance, and we remain hopeful of positive outcomes here as well. A finding of substituted compliance by the CFTC would significantly reduce the compliance costs of the Australian banks, as in relevant areas they would be able to continue to comply with Australian requirements and not need to comply with an additional set of CFTC requirements.

Another important set of developments has been around the effective date of the CFTC's requirements for swap execution facilities, or SEFs, and I'm sure this will be a big point of discussion today. From ASIC's perspective, our overarching goal has been to avoid market disruption and to ensure Australian platforms can continue to serve the vital Australian-to-US bank OTC derivatives market. There were two key actions taken that we believed helped to avoid undue market disruption in Australia.

First, we were pleased that an Australian market licensee, Yieldbroker, received interim no-action relief from the CFTC that will allow it to continue providing trading services in interest-rate derivatives to US persons until at least the end of this month. ASIC and Yieldbroker have been working with the CFTC on a supervisory framework for Yieldbroker that would see Yieldbroker register as a SEF while continuing to be primarily supervised by ASIC. We are hopeful that we will be able to agree to a framework along these lines shortly.

We were also keen to ensure that Australian market participants could commence trading on SEFs from 2 October, to ensure any market disruption was limited.

Following a range of conversations with existing licensed or exempt markets in Australia, we understood that the compliance deadline created a risk that Australian participants may not be able to access all market liquidity at the point where these markets split into a SEF and a so-called 'non-SEF'.

To ensure Australian participants could continue to access these markets, we granted six-month no-action relief to a number of SEFs. This ensured that Australian participants could continue to access these markets without short-term disruption.

Conclusion

In conclusion, thank you again for giving me the opportunity to speak at a time when OTC derivatives markets are facing more change and challenges than probably ever before.

I hope I've been able to provide some useful insight into ASIC's thinking on OTC derivatives regulation, and I hope you enjoy the conference and we look forward to continuing our work with you all.