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MANDATORY CENTRAL CLEARING OF OTC INTEREST RATE DERIVATIVE TRANSACTIONS

This submission responds to issues raised in two recent consultation papers:

- Treasury: OTC Derivatives central clearing and single-sided trade reporting - Draft regulations
- ASIC CP231: Mandatory central clearing of OTC interest rate derivative transactions

Given that the Minister's determination, proposed changes to Corporations Act regulations, and the introduction of ASIC's Derivative Transaction Rules (DTRs) are closely interrelated matters we have consolidated our comments into a single submission that sets out ASX's views on the implementation of the clearing mandate.

ASX supports the introduction of an Australian clearing mandate for OTC interest rate derivatives denominated in Australian dollars (AUD) and G4 currencies (i.e. USD, Euro, Yen, British pound). This ensures Australia complies with its G20 commitments to act to reduce and manage risks associated with OTC derivatives that were exposed during the global financial crisis. Requiring the centralised clearing of these products will, combined with other policy changes, reduce the risk of future financial crises.

The decision to introduce the clearing mandate concurrently over all five currencies helps to avoid the prioritisation of the clearing of G4 currencies over AUD clearing in this jurisdiction.

The group of AUD interest rate products to be cleared are systemically important to the Australian economy and it is appropriate that they be centrally cleared now that the necessary clearing facilities are licensed and operational. These facilities are clearing an increasing flow of interest rate derivative transactions.

ASX notes that the Government has identified that a major benefit of implementing an Australian clearing mandate is that it "may allow Australian-regulated financial institutions to clear their cross-border OTC derivatives transactions under Australian rules, subject to appropriate regulatory recognition (for example 'substituted compliance') being given by overseas regulators".

With this outcome in mind, the design of the Australian arrangements needs to consider the extent to which Australian requirements are consistent with rules applying in other jurisdictions, thereby making the process of regulatory recognition simpler. Importantly, Australian regulatory settings should not put Australia's regulatory recognition with other jurisdictions 'at risk'.

ASX supports the broad design features of the proposed regime for centralised clearing as embodied in the various regulatory instruments:

- the Ministerial determination authorising central clearing of interest rate derivatives denominated in AUD and the G4 currencies;
- the Corporations Act regulations setting the broad criteria to apply to the clearing mandate, in particular the goal of limiting its application to a relative small number of major domestic and foreign banks that act as dealers in the Australian OTC market and which have gross notional amounts outstanding above a threshold of $100 billion;
- ASIC's derivative transaction rules (DTRs) that define, among other matters, which specific products are subject to the clearing mandate, which facilities can be used to fulfil that obligation, and the specifics of how that clearing should be conducted.

ASX's comments are limited to three specific areas of the DTRs where ASX believes that change should be considered.

ASIC DTRs - Deadline for mandatory central clearing (generally T+1)

It is proposed that:

> *a clearing entity must centrally clear a clearing transaction as soon as practicable after entry into the arrangement and by no later than the end of the business day following the day on which the clearing transaction was entered into (commonly known as T+1)*

ASX notes that this deadline does not meet the regulatory standard set in other major jurisdictions (in particular, the US)[1]. For example:

- The US requirement[2] is "as soon as technologically practicable after execution, but in any event by the end of the day of execution". For this purpose the day of execution means the calendar day of the party to the swap that ends latest (i.e. T+0).

It is argued T+1 is necessary as the deadline could expire before a clearing facility located offshore, and outside of the Australian time zone, is open and available to clear the derivative transaction. This is not an appropriate basis for extending the regulatory deadline for AUD denominated swaps given the significant bilateral risk exposure that would remain. If foreign-based clearing houses wish to service the systemically significant clearing market for AUD interest rate swaps, they should be open during Australian business hours, and allow clearing entities to achieve T+0 clearing.

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[1] We understand that details of the European arrangements will be contained in draft regulatory standards which are not expected to be released until July 2015.
[2] See Code of Federal Regulations, Title 17§ 50.2.

As a general proposition Australia should align the main features of its clearing mandate to those applicable in the US and EU given the need for Australia's regulatory regime to achieve regulatory recognition with other major markets.

Failure to align the clearing deadline in Australia with those in the US and EU may undermine the case for Australian banks', ASX and other industry users equivalence or substituted compliance in these foreign jurisdictions. ASX understands that the timing requirement of clearing is a key consideration for US regulators.

ASIC also recognises the importance of timing requirements in determining whether foreign clearing regimes should be considered equivalent to Australia's:

> *In order to minimise cross-border conflicts, inconsistencies and the duplication of requirements in multiple jurisdictions, we have deliberately only proposed that timing requirements of foreign clearing requirements are relevant to determining whether foreign clearing requirements are considered equivalent to the clearing requirements under the derivative transaction rules (clearing).* [3]

The proposed T+1 clearing deadline puts regulatory equivalence and substituted compliance 'at risk'.

ASIC DTRs - Clearing through clearing facilities

It is proposed:

- *to allow a clearing entity to use a licensed CS facility or prescribed CCP to comply with mandatory central clearing, whether clearing directly or indirectly; and*
- *that where there is no licensed CS facility or prescribed CCP that can clear the derivative transaction that is subject to the clearing requirements, then the clearing requirements do not apply.*

ASX believes that Australian clearing entities should only clear swaps through prescribed, as opposed to Australian licensed, facilities where Australian regulators are satisfied that they have appropriate influence over those facilities.

We understand that the US and European regulators require a higher degree of influence over third country CCPs that wish to do business with local participants in their markets than Australian regulators, under the proposed framework.

The Australian Government's exposure draft regulations[4] provide only that adequate arrangements must exist for ASIC and the RBA to have access to information about the level of clearing activity by Australian clearing participants with prescribed facilities.

At a minimum, adequate arrangements for regulatory influence over unlicensed CS facilities should extend to requiring:

- A memorandum of understanding between Australian regulators and the facility's home country regulator, for the exchange of information including information that Australian regulators need to evaluate the facility's compliance with the PFMIs and continued eligibility for exemption from licensing;

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[3] ASIC CP 231: Mandatory central clearing of OTC interest rate derivative transactions, paragraph 88.
[4] Draft Corporations Amendment (Central Clearing and Single-Sided Reporting) Regulation 2015, Reg 7.5A.63.

- Undertakings by the facility to:
  - report to Australian regulators, on an ongoing basis, the exposures (e.g. measured by margin requirements) of Australian clearing participants to the facility;
  - certify every 12 months that it continues to comply with the PFMIs in all material respects;
  - produce every 12 months a certificate of the home country regulator that it remains in good regulatory standing;
  - report promptly to Australian regulators any other matters relevant to its compliance with the PFMIs or whether it should be required to obtain an Australian CS facility licence;
  - submit to the jurisdiction of Australian regulators and appoint an agent in Australia for service of process.

These minimal requirements reflect the undertakings given by ASX in order to petition for exemption from registration as a Derivatives Clearing Organisation (DCO) in the US.

ASIC DTRs - Transactions and asset classes subject to mandatory central clearing

As noted above, ASX agrees with the choice of products to which the clearing mandate should apply as set out in Table 2 on pages 20-21 in CP 231. The consultation paper however also noted two other specific issues with regards to the choice of products to be cleared.

ASX does not have a strong view on whether AUD denominated forward rate agreements (FRAs) should be included within the mandate or whether the duration of overnight index swaps (OIS) to be covered should be extended beyond the proposed two years out to three years. However, we have received some feedback from ASX OTC clearing participants that suggests that there may be demand:

- for central clearing of AUD denominated FRAs, even though such a service does not currently exist; and
- to clear AUD OIS out to a maturity of at least 10 years and possibly even longer. At this stage, ASX's OTC service clears OIS to a maximum maturity of 3 years given there is sufficient liquidity at that duration.

This feedback may support consideration being given to including AUD denominated FRA's and longer maturity OIS (to an initial 3 years, with extension to longer maturities if liquidity develops in the market) within the clearing mandate.

If you have any questions on this matter you could contact Gary Hobourn, Senior Economic Analyst, Regulatory and Public Policy in the first instance.

Yours sincerely

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