Looking beyond the margins of OTC derivatives reform: Keynote address

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2016 ISDA Annual Australia Conference (Sydney, Australia)
20 October 2016

CHECK AGAINST DELIVERY

Introduction

Good morning. Thank you for having me here today.

As Scott O'Malia has mentioned, we in Australia – and around the world – again stand on the precipice of another piece of significant structural reform emerging from the response to the global financial crisis (GFC) – the implementation of margin requirements for non-cleared derivatives.

Today's conference is very much focused on this specific topic and, over the course of the day, the sessions will cover a range of issues that industry and regulators are working through and are having to solve.

Issues like the model for calculating initial margin, and solutions for managing collateral.

It is also a very timely conference.

On Monday, the Australian Prudential Regulation Authority (APRA) published the final Prudential Standard CPS 226 (CPS 226), on margin and risk mitigation requirements.

While APRA is yet to publish an implementation timetable, CPS 226 is a signal for Australian participants to really ramp up their margin implementation efforts.

In speaking to you today, rather than jump ahead to these more detailed discussions, I would like to give you a perspective on the regulators' role in this.

In many respects it mirrors the role and challenges that regulators have faced in initiating and implementing each piece of structural reform over the last several years since the GFC, namely figuring out how the domestic rules from different national regimes will work together to support confidence and efficiency in an international and borderless market.

In talking about this, I will also try and demystify for you – what I am sure at times appears like – the mystifying world of regulatory decision making.

In doing so, I'll aim to provide some insight into the principles that sit behind some of the decisions we recognise have significant impacts on the markets we oversee, and the lives of many of you.

On a more forward-looking note, I will also talk about:

- improving efficiency and standardisation in the uncleared derivatives market; and
- the role technology and, in particular, the much talked about financial technology (fintech) revolution, can play.

Working Group on Margin Requirements (WGMR) implementation in the context of the Group of Twenty (G20) reforms

G20 reform context

At the risk of raking over old coals, eight years ago now the world experienced the most significant market failure of our time. Well… hopefully of our time.

And this crisis was viewed – at least in part – as being caused by complex derivative contracts traded in the 'opaque' over-the-counter (OTC) market.

Many of the activities or products contributing to the crisis were unevenly regulated across the various global market places. And, by uneven, I mean somewhere between lightly regulated and not at all.

Many regulators, including the superpowers (the United States and European Union), took the view that the gaps created by this 'patchwork' of regulation allowed risk to build up unnoticed by most.

Many also took the view that this build-up of risk occurred under the watch of offshore regulators, but had profound cross border impacts at home.

However we debate the root cause, the consequences were colossal with:

- estimated losses of around $22 trillion, $700 billion in bank bailouts in the US alone
- millions of job losses for ordinary people around the world, and
- profound disruption to the social fabric.

And, as history has almost always shown, where the market fails – particularly on the industrial scale of 2007–08 – the pendulum of political and social focus shifts, and there is an expectation that government and regulators will seize control of the wheel and steer society through and out of the troubled waters.

That is precisely what happened following the GFC.

With that as a backdrop, and as I look back over the past five or so years, governments and regulators have collectively grappled with how we should best go about implementing an agreed set of reforms to the global financial market.

These challenges of implementing global market reforms are not new. For example, we had:

- the Basel capital standards adopted by the banking regulators since the 1980s, and
- IOSCO (International Organization of Securities Commissions), which was first established in 1983 with a broad remit to determine principles for global markets and to have them adopted by its members.

But the G20 Leaders' commitments to reform the OTC derivatives markets were perhaps more ambitious and intended to have immediate impact than at any previous time.

Given the magnitude of the GFC, the G20 leaders wanted to present a strong, united voice, and instil confidence in our economies and the financial markets that support them.

To do so, they committed to making deep, sweeping changes to this 'opaque' OTC market.

At the time, the stated ambitions of these changes were to:

- enhance transparency
- promote financial stability, and
- support the detection and prevention of market abuse.

As you know, in an effort to achieve this, these changes focused on:

- reporting of derivative transactions to trade repositories
- clearing standardised derivatives by central counterparties (CCPs), and
- trading derivatives on exchanges or trading platforms as appropriate.

The G20 leaders also agreed to introduce margin requirements for non-centrally cleared derivatives.

International principles, national regimes

Once the political commitment had been made, the next set of questions focused on:

- how do we work out the details of the reforms
- how do we implement the changes in a broadly consistent manner, and
- how do we make these changes work across global markets?

Starting point

A critical starting point for globally harmonised reform is the international principles and standards adopted by the standard-setting bodies – IOSCO, the Basel Committee on Banking Supervision (BCBS) and the Committee for Payment and Market Infrastructure (CPMI).

Australia has had a strong presence in every one of these standard setting bodies.

In margining, IOSCO and the BCBS formed the WGMR. The WGMR published its final framework in 2013. This was the start of an intensive global implementation program.

But the WGMR framework was just part of the puzzle. International standards and principles are just that – standards and principles – they are not designed to be full and complete rulebooks.

The WGMR framework – like the CPMI–IOSCO *Principles for Financial Market Infrastructure*, or the IOSCO risk mitigation standards – are intended to be a set of principles about what the new requirements are and who should be covered.

Some issues can be resolved within the international standards. For those of you that were following this in 2013, the WGMR debated the treatment of cross-currency swaps – whether the fixed, physically settled foreign exchange (FX) transactions associated with the exchange of principal would be subject to initial margin.

On that issue, ASIC and other regulators were able to take part in the debate to achieve a good outcome for our markets.

Other questions are not answered in the WGMR framework, arguably for the simple reason that they cannot be answered at the abstract level of international principles.

One example is the definition of ‘derivatives’. It is obviously a key reference point of the reforms of the ‘derivatives market’ but, at the same time, this term is often tied to existing national laws, each with their own quirks.

Getting this definition right is crucial to multiple sets of national rules working together.

APRA has addressed these tensions in CPS 226 by adopting the functional definition of ‘derivative’ in the *Corporations Act 2001*, with some specific inclusions and exclusions.

APRA also intends to address some of the cross-border questions through its substituted compliance framework – more on that later.

Another example is whether to apply margin requirements in jurisdictions where netting agreements may not be enforceable. This comes down to a trade-off between competing policy objectives.

APRA has taken a principles-based approach here. It will not require APRA-covered entities to post or collect margin with counterparties in these jurisdictions. Instead, APRA covered entities will need to monitor their exposures and set appropriate internal limits.

Australia's experience

From an Australian regulator's perspective, a number of themes in margin requirements are similar to those in other areas of OTC reforms.

An iterative, consultative style of rulemaking

The starting point for Australian regulators has been a demonstrable commitment to the implementation of the OTC reforms – and the G20 commitments, more broadly.

We have pursued this commitment over the years through the lens of seeking to implement these changes in a way that both:

- supports the resilience and efficiency of our market; and
- continues to support Australian entities accessing global markets with the passport of their Australian regulatory authorisation.

We have done this in full recognition that – depending on how you measure it – the Australian OTC market constitutes about only 2% of the global market. To put it a little bluntly, there seems a strong argument that we may just need international markets more than those international markets need us.

In this context, it makes almost no sense for us to blaze the regulatory trail – if that would result in us potentially developing bespoke Australian rules – with the hope that major jurisdictions will follow suit.

Instead, we believe the more effective approach is for Australian regulators to be proactively collaborating with other regulators. And then, once those other regulatory frameworks are largely articulated, to be a 'fast follower' in our implementation.

Now this task can be challenging, particularly where major jurisdictions do not always agree on the uniformity of their own approaches.

We can also contrast this approach with others we have taken in more domestically orientated markets like the exchange-traded equities market – where we have taken a global lead on topics such as dark pools and high-frequency trading.

Nevertheless, in this complex global market environment, we continue to strongly hold the view that the collaboration and fast follower approach makes sense. This means that we take an active role in international and overseas forums in an effort to influence the international standards. This gives us a voice when the international community is seeking to agree on common approaches.

Then, we aim to take a consultative approach with other regulators as well as industry on rule making. We make an effort to take into account a range of perspectives and make policy decisions supported by evidence, where possible. We also promote harmonised implementation, globally and within the Asia–Pacific region.

Challenges

That said, in taking a 'fast follower' approach, we fully recognise that, while it solves some issues, it potentially also gives rise to others.

There is a clear and understandable industry appetite to know:

- the precise and detailed elements of each feature of these reforms, and
- the precise commencement date, well in advance of the detail of these reforms needing to be implemented.

We get that. We particularly get that a number of the reforms – including those flowing from the margining rules – require changes in behaviour, governance, capital expenditure, systems, and internal and external third-party arrangements.

That is precisely why we try to introduce these changes once as a fast follower – and where possible – in coordination with other jurisdictions.

If we only focused on providing certainty in our domestic environment, then – yes, we could do that by setting our own domestic timetable, start dates and models. But it may result in repeated re-builds of rules frameworks and industry infrastructure to meet unfolding international expectations.

At the same time, market participants may end up having to comply with multiple sets of requirements, if our regime deviates from developing overseas consensus. After all, these are global markets and global reforms.

In short, we recognise our current approach doesn't always work perfectly, but we do think it is the right starting point and one that has worked, and continues to work, in our favour.

For example, when ASIC was implementing trade reporting, we used the flexibility in our legal framework to adopt reporting rules that followed key elements of US and EU requirements. We also provided guidance to industry that took into account how systems and conventions were developing globally.

Similarly for mandatory clearing, the Australian regulators agreed on an approach that harmonised with the US Commodity Futures Trading Commission (CFTC) mandate, and ensured entities subject to our mandate had a choice of CCPs.

APRA has taken a broadly similar approach in writing its margin standards.

Cross-border implementation

Looking beyond our domestic environment, I see familiar themes when we really focus on the cross-border aspects of OTC reforms.

Issue 1: Standard Initial Margin Model (SIMM) and market infrastructure

A key topic for this conference is the use of the ISDA SIMM. This model is intended to meet the regulatory requirements of a number of regulators globally, with obvious risk management and operational benefits and efficiencies.

To me, the case for using a common initial margin model can be compared to important considerations we have undertaken in the world of market infrastructure regulation.

In central clearing for example, participants need to be able to use the same CCP, even though they may be subject to rules across two jurisdictions.

In trade reporting, it can be more efficient to use a global trade repository to meet reporting obligations under multiple national mandates.

On market infrastructure regulation, the fact that Australian market participants need access to global market infrastructure helped to sharpen our policy approach.

A great example is our trade repositories regulation. This regime was intentionally designed to allow us to licence offshore trade repositories and – to the extent appropriate – defer to the home regulator with a view to removing duplicative regulatory obligations.

In fact, we did defer to the Singapore Monetary Authority in large part, when we licensed DTCC Data Repository (Singapore) Pte Ltd. We remain the first and to date only, jurisdiction to exercise our deference powers in this way.

In implementing margin requirements, APRA has taken a similar approach. CPS 226 allows APRA to approve an industry initial margin model.

In fact, APRA's response to consultation draws out APRA's expectation that entities will primarily use the ISDA SIMM. To facilitate this, APRA will conduct a simplified approval process for entities using the ISDA model.

Issue 2: Other elements of rule harmonisation

A related question in margin implementation is whether participants can adopt a consistent set of changes for all of their counterparties, even though these counterparties are subject to rules from other jurisdictions.

These changes can include amendments to ISDA agreements, collateral management systems, and custodian arrangements.

For all OTC reforms, cross-border harmonisation helps to reduce transaction costs from jurisdiction-specific requirements. For Australia, this can also avoid putting up barriers to foreign participation in our market.

For margin implementation, harmonisation can be even more important given the deadlines that industry is facing. We recognise that the more consistent national rules are, the easier it can be for an entity to comply.

The regulators may not have harmonised our rulebooks as much as industry would like us to – and at times there have been understandable frustrations – but there continues to be a concerted effort to work out and minimise differences.

Again, reflecting on Australia's experience, we have aimed for harmonisation with key overseas regimes and consistency with international standards. I have already talked about our approach to licensing market infrastructure and in writing trade reporting rules.

Similarly, APRA's final prudential standards set out in CPS 226 are designed to stick closely to the WGMR principles. And, in important areas, take a principles-based and substituted-compliance approach rather than an Australia-specific, prescriptive one.

Substituted compliance

With all that said, the reality is that national rules written within their own legal and regulatory context – and their own political environment – are unlikely to be 100% harmonised with other sets of national rules.

There will always be some differences in the legal requirements embedded in domestic law. I've already mentioned the definition of derivatives and the treatment of non-netting jurisdictions.

Examples from other areas of OTC reform also come to mind, such as:

- the entity scope of clearing mandates
- different exemptions being hard-wired into primary legislation, and
- really practical issues like time zone differences.

This brings me to regulators' ability to recognise or defer to overseas regimes.

For a small open market like Australia, this tool has proved to be critically important and enormously beneficial, both for foreign participants or infrastructure operators coming into Australia, and for Australian participants accessing the global markets.

Let me throw out a few examples which many of you would already be familiar with:

We worked tirelessly with the CFTC to obtain substituted compliance determinations for Australian swap dealers. This was a really important outcome because it recognised the quality of Australia's regulation, early in the international 'journey' to implement OTC derivative reforms. And, in practical terms, it did (and continues to) realise significant cost savings for the Australian swap dealers.

Second, together with the Reserve Bank of Australia, we put in an enormous amount of work to obtain exemptions or equivalence recognition for our domestic CCPs. In the case of ASX Clear (Futures), these decisions have allowed a CCP to continue to service its futures clearing participants and expand its services to OTC clearing. Again, a tremendously important commercial outcome.

Most recently, the CFTC announced that Yieldbroker Pty Limited (Yieldbroker) has qualified for long-term relief from swap execution facility (SEF) registration under a regime specifically created for Australia (i.e. the qualifying Australian licensed market regime).

Quoting from the CFTC's media release, this makes Yieldbroker 'the first foreign-regulated, multilateral swap trading facility that permits direct access to US persons to qualify for long-term no-action relief' from SEF registration.

We expect the Australian government and regulators' focus on harmonisation and coordination to continue. In this spirit, many of you would have seen the Treasurer's recent announcement about introducing financial benchmarks reforms in Australia.

The Treasurer and the Council of Financial Regulators both emphasised the importance of international harmonisation, which can be important to ensure that the bank bill swap rate can still be used in cross-border transactions with European counterparties after the European Benchmarks Regulation commences.

In recent years, regulators have gained more experience in making substituted compliance or equivalence determinations, and firming up how regulatory deference works in practice. We expect these experiences will be applied in the margin context – and can help to provide smoother implementation.

Going back to CPS 226, APRA has included a substituted compliance regime in its final prudential standards. Domestic covered entities would be able to comply with the requirements of an equivalent foreign jurisdiction in their entirety, in lieu of APRA's requirements, if:

- the foreign regime has been approved by APRA as comparable in outcome, and
- the regime is directly applicable.

In addition, Australian branches of foreign entities may comply with an overseas margin regime where:

- the institution has assessed that the overseas regime is comparable and directly applicable to the entity, and
- the institution is fully compliant.

APRA will have the power to review these assessments. APRA is also engaging in substituted compliance discussions with other regulators including in the Asia–Pacific region.

Looking beyond WGMR: Standardisation of non-cleared derivatives

Now, I also want to look beyond the next 12 months of margin implementation to potential developments in the OTC derivatives markets.

Margin, like capital requirements, appear to be starting to have one intended effect – driving dealers and non-dealers to centrally clear transactions more regularly.

However, there will always be a portion of the market that is not cleared. For example, because a client requires a bespoke contract, or the cost of establishing clearing arrangements still outweigh the economic or risk management benefits of clearing.

Industry is seeing additional benefits come from the move to clearing. In particular, operational efficiencies from straight-through processing, standardisation of names and messaging systems.

At the same time, the cost structure for existing fixed income businesses are changing.

For the non-cleared market and OTC market more broadly, the question is ‘where to from here’?

The changes are creating differing – even conflicting – responses and opinions about the right policy settings.

Take platform trading as an example. Some believe technology improvements in straight-through processing and algorithmic trading make it highly efficient to trade on platforms. Others are still attached to the relationships with their voice brokers, and the perceived execution and other value that they believe come with the relationships.

Some caution against mandating the use of platforms because it may reduce liquidity or cause liquidity fragmentation. Others, including the Bank of England, have interpreted trade repository data as showing that platform trading in the US-dollar market helped to reduce transaction costs. And then there are the debates about businesses restructuring to access global or regional liquidity pools.

Similarly, you can find proponents and critics of other regulatory mandates such as central clearing and margining.

We recognise these tensions. That’s why we have not been having debates about regulatory mandates in isolation. Instead, we are also asking more holistic questions. For example, do we have the right regulatory environment and incentives to promote fair and efficient capital markets in Australia and to facilitate cross-border flow of capital (both financial and human), technology and other innovation?

Documentation, data and process

A question that we have heard from some industry leaders, including ISDA, is how to make the non-cleared market more efficient.

ISDA’s recent white paper (published in September) picks up this question and proposes some ambitious industry initiatives in response. The paper highlighted how ISDA and members can increase standardisation and automation in documentation, systems and process. Doing so can help to:

- reduce costs and errors from manual processing;
- cut time and costs incurred to reconcile different internal identifiers, and
- retire or reduce the use of legacy systems, or imperfect ‘tactical’ solutions adopted to meet regulatory deadlines.

These ideas struck a chord. It seems to me they may also support more effective trade monitoring and risk management – and potentially reduce vulnerabilities in other areas like cyber risk.

These ideas should be sounding familiar to those of you that have a futures background. As ISDA’s white paper points out; a lot of this is about capturing the efficiencies of the cleared segment and bringing it into the non-centrally cleared market.

Two other thoughts occurred to me when reading the white paper.

- The first is the scale of the initiative. It seems we are talking about refreshing the IT plumbing of some of our biggest financial institutions, which is not a job for the faint hearted. In fact, dealing with legacy IT systems is generally an important challenge that the market is increasingly grappling with. But, I might save that discussion for another day.
- The second is that these initiatives can represent opportunities for regulators and industry to work together. For example, maybe regulatory reporting rules can be reviewed to build-in industry standard product identifiers and to ensure they are not entrenching an outdated reporting arrangement.

Technology

The ISDA white paper highlighted technology as a key area for improvement. The ideas range from ‘smart contracts’ to using artificial intelligence and, of course, big data.

This is really important and really exciting.

Standing here as a regulator, I see our role as facilitating new offerings – such as through ASIC’s Innovation Hub – and, at the same time, approaching the fintech revolution through our lens of promoting resilient, efficient financial markets.

This means, while we are as interested in distributed ledger or artificial intelligence as the next person, our role is to work with industry to find the right solutions for articulated problems. This may involve some pretty thorough questions about the efficiency, safety, fairness and system stability implications of a new piece of technology. Particularly, if it’s being adopted by critical market infrastructure or is pushing the boundaries of existing laws.

The future

Bringing the themes of standardisation and technology together – the combination of regulatory reform and technology brings its own brand of complexity, especially when we are (still) in the midst of introducing more change.

Regulators can have a role to play to address or reduce complexity. This takes me back to harmonisation and regulatory cooperation. It’s certainly not the whole solution or the only solution, but I think it is an important part of what regulators can do – especially in a small open market like Australia.

We are fostering innovations coming from Australian companies in the current start-up environment. As fintech offerings mature, and perhaps congregate around a few common industry solutions, we would love to see Australian firms being in the lead group of those solution providers.

This is not just in margining – a significant bulk of the innovative offerings we are dealing with at the moment are technologies and platforms that are bringing in alternative liquidity providers and bringing buy-side participants together.

In the context of other, potentially long-term structural changes, it is another piece of the puzzle that will help shape the derivatives and fixed income markets.

If we are to encourage Australian innovators, it makes it even more important for Australian regulation of fintech and regulatory technology (regtech) to be consistent with (and recognised as being equivalent to) overseas regulation – so that anything created here can be easily exported overseas.

To me, if anything, these are more reasons to keep up our collaboration on global standard setting and regulation – and our efforts at regulatory harmonisation in our domestic regimes.

Conclusion

There is a huge amount of work still to be done in margin implementation. The release of APRA's final standards on Monday makes it clear that the pace is ramping up on this reform.

If you have technical questions about the details of APRA's prudential standard, I will do my best to answer them – as will APRA staff present today.

Looking beyond this implementation project, industry has identified scope to introduce efficiencies and use fintech and regtech solutions.

We are encouraged by these initiatives. And will continue to work with you to realise their potential – to contribute to our overarching objective of fair and efficient capital markets.