Report on the Australian OTC Derivatives Market

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Australian Prudential Regulation Authority
Australian Securities and Investments Commission
Reserve Bank of Australia

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Contents

1. Introduction and Executive Summary

In response to the global financial crisis, the G20 leaders agreed a range of key reforms to financial markets: building resilient financial institutions; ending 'too big to fail'; addressing shadow banking risks; and making over-the-counter (OTC) derivatives markets safer. On OTC derivatives, the G20 leaders made the following commitments at the Pittsburgh summit in September 2009:

> All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements.[1]

In November 2011, G20 leaders added to these commitments, agreeing that international standards on margining of non-centrally cleared OTC derivatives should be developed.[2] Consistent with these commitments, the Australian Prudential Regulation Authority (APRA), the Australian Securities and Investments Commission (ASIC) and the Reserve Bank of Australia (RBA) (together, the Regulators), recognise that the efficiency, integrity and stability of the Australian OTC derivatives market may be enhanced through greater use of centralised infrastructure: trade repositories (TRs); central counterparties (CCPs); and trading platforms.

The Regulators have recommended imposing mandatory requirements where appropriate, supplementing an incentives-led transition to greater use of centralised infrastructure. Under the *Corporations Act 2001*, the responsible Minister is required to take into account advice from the Regulators before issuing a determination that mandatory obligations with respect to trade reporting, central clearing or platform trading should apply. In order to inform their advice, the Regulators are actively monitoring developments in the Australian and overseas OTC derivatives markets. As part of this process, the Regulators carry out periodic surveys of the Australian OTC derivatives market and produce assessment reports based on the results. The most recent previous report was published by the Regulators in July 2013.[3] In accordance with the main recommendation of that report, the government is currently consulting on a proposal that trades between internationally active dealers (generally referred to as dealers in this report) in US dollar-, euro-, British pound- and Japanese yen-denominated interest rate derivatives should be subject to mandatory clearing requirements.[4]

This report constitutes the latest advice from the Regulators to the Minister. Based on an assessment of current activity and practices in the Australian OTC derivatives market, in this report the Regulators make the following recommendations.

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1 G20 (2009), 'Leaders' Statement, Pittsburgh Summit', 24–25 September. Available at <https://www.g20.org/sites/default/files/g20_resources/library/Pittsburgh_Declaration.pdf>.

2 G20 (2011), 'Building Our Common Future: Renewed Collective Action for the Benefit of All', Cannes Summit Final Declaration, 4 November. Available at <https://www.g20.org/sites/default/files/g20_resources/library/Declaration_eng_Cannes_0.pdf>.

3 APRA, ASIC and RBA (2013), *Report on the Australian OTC Derivatives Market*, July. Available at <http://www.cfr.gov.au/publications/cfr-publications/2013/report-on-the-australian-otc-derivatives-market-july/index.html>.

4 The term 'dealer' as used in this report is not intended to refer to an entity that is required to hold an Australian Financial Services Licence because it deals in financial products. Instead, in the context of this report, a dealer is an entity that makes a market in OTC derivatives by buying and selling on its own behalf.

1.1 Central Clearing

There is evidence that regulatory and commercial incentives are proving effective in encouraging the Australian OTC derivatives industry towards central clearing, at least in the interdealer market. The Regulators nevertheless consider that there would be benefits to the Australian financial system from adopting an approach that is consistent with that of overseas regulators, who are proceeding with mandatory clearing across a range of interest rate and credit derivatives. Accordingly, in addition to considering the case to mandate central clearing of Australian dollar-denominated interest rate derivatives, the largest and most systemically important OTC derivatives market in Australia, the Regulators have also specifically considered the case for mandatory clearing of products that are already subject to a clearing obligation in another jurisdiction.

In line with the Regulators' July 2013 recommendations, the government has proposed a central clearing mandate for US dollar-, euro-, British pound- and Japanese yen-denominated interest rate derivatives for trades between dealers with significant cross-border activity in these products. While to date the Regulators have not recommended mandatory clearing of North American and European referenced credit index derivatives, they undertook to revisit this recommendation to assess whether there was evidence of regulatory arbitrage in the Australian market and whether this recommendation was likely to affect the outcome of equivalence or comparability assessments. Given the Japanese mandatory clearing requirements for Japanese referenced credit index derivatives, the Regulators have also analysed Australian activity in these products. Finally, the Regulators have also undertaken further work to understand the incremental costs and benefits of extending a central clearing mandate to non-dealers.

Australian dollar-denominated interest rate derivatives

The Regulators have repeatedly noted that there would be a substantial financial stability benefit from increased central clearing of Australian dollar-denominated interest rate derivatives. To date the Regulators have not recommended imposing a mandatory clearing obligation, being of the view that regulatory and commercial incentives would eventually be effective in encouraging the industry to transition to central clearing. They nevertheless acknowledged in their July 2013 Report the benefit of adopting an approach that was consistent with that of overseas regulators, who are proceeding with mandatory clearing across a range of instrument classes. Accordingly, the Regulators signalled that they would consider recommending a mandate in the current market assessment.

In July 2013, the Regulators did not recommend mandatory clearing of these products, so as not to interfere with Australian-headquartered dealers' commercial negotiations with CCPs or otherwise disrupt the ongoing transition to central clearing.[5] Instead, the Regulators took the decision to allow Australian-headquartered dealers further time to establish operational arrangements with CCPs before making any such recommendation. Since July, as anticipated, good progress has been made by Australian-headquartered dealers in establishing direct clearing arrangements with ASX Clear (Futures) Pty Limited (ASX Clear (Futures)) and LCH.Clearnet Limited (LCH.C Ltd).

> **Having monitored Australian-headquartered dealers' progress in implementing appropriate clearing arrangements, the Regulators are satisfied that the incremental cost of mandatory central clearing of Australian dollar-denominated interest rate derivatives would be very low for trades between internationally active dealers in the Australian market. Consequently, it is recommended that the government consider a central clearing mandate for trades between internationally active dealers in Australian dollar-denominated interest rate derivatives.**

5 At the time of the last Report, two CCPs clearing these products had only recently received regulatory approval to provide these services directly to Australian participants. In contrast, overseas-headquartered dealers had already had the opportunity to establish direct clearing arrangements for these products with offshore CCPs.

Should the government accept this recommendation, the government and ASIC would determine the timing and other aspects of implementing such a mandate in consultation with market participants and other stakeholders.

North American, European and Japanese referenced credit index derivatives

In considering the case for imposing a clearing mandate for North American, European and Japanese referenced credit index derivatives, the Regulators have observed a relatively low level of activity in these products among Australian-headquartered dealers.

> **The Regulators do not see a case for implementing a central clearing mandate for North American, European and Japanese referenced credit index derivatives at this time, particularly since most Australian market activity in these products involves at least one EU- or US-headquartered counterparty.**

Consequently, the Regulators believe that, even in the absence of a domestic mandate for these products, the likelihood of regulatory arbitrage is limited. Furthermore, few domestic participants have arrangements in place to clear such products, so the cost of complying with a mandatory clearing requirement for these products could be high in the short term. However, the Regulators will continue to monitor activity and the extent of central clearing in these products. Should this reveal evidence of regulatory arbitrage in the Australian market, the Regulators would revisit this recommendation.

Non-dealers

In the July 2013 Report, the Regulators committed to doing further work to better understand the incremental costs and benefits of extending any central clearing mandate to smaller participants in the Australian OTC derivatives market that were not covered in the dealer survey (referred to as non-dealers in this report). To facilitate this work, in late 2013, the Regulators issued a survey to a wide range of non-dealers and conducted a large number of follow-up meetings. Based on insights from the survey, at the current time, the Regulators are not convinced of the public policy case for introducing mandatory central clearing of OTC derivatives for non-dealers. Instead, the Regulators propose to keep under review the case for extending mandatory central clearing to non-dealers in light of ongoing market and international regulatory developments.

With few exceptions, non-dealers' activity in OTC derivatives is relatively limited and motivated primarily by hedging of underlying cash flows and exposures. Accordingly, even though there may be some systemic risk reduction benefit from central clearing by non-dealers, it is likely to be limited. Indeed, where small financial institutions and especially non-financial entities have restricted access to liquid assets to meet CCPs' initial and variation margin obligations, new sources of risk could emerge.

In the long term, commercial incentives – from the pricing of centrally cleared and non-centrally cleared trades – are expected to encourage a range of non-dealers to adopt central clearing, especially those with the scale and liquidity to support it. When internationally accepted margining principles for non-centrally cleared OTC derivatives are implemented, the relative cost of central clearing is likely to decrease, further incentivising such non-dealers to centrally clear. Indeed, some large non-dealers, especially those affected by mandatory obligations in overseas jurisdictions, are already establishing such arrangements in anticipation of such incentives emerging. Further, industry liaison suggests a high level of awareness and understanding among a broader range of non-dealers of what would be required in order to centrally clear.

The Regulators acknowledge, however, that for some non-dealers it is unclear whether either the private or public policy benefits will ever be sufficient to offset the costs. Given this, on the basis of currently available information, the Regulators would expect to give close consideration to a specific exclusion from any mandatory clearing obligation for certain non-dealers. In particular, consideration would be given to exclusions for certain non-dealer financial institutions and non-financial entities, where these have limited OTC derivatives activity, as well as certain categories of public entities.

The incentives-led transition to central clearing among larger non-dealers could accelerate when ASX Clear (Futures) launches its client clearing service and LCH.C Ltd makes its international client clearing offering available to Australian clearing participants.

> **Accordingly, the Regulators do not believe it is appropriate to mandate central clearing for non-dealers at this time. The Regulators will nevertheless continue to monitor the availability of client clearing for OTC interest rate derivatives and the incentives-led migration to central clearing, particularly by non-dealers with access to sufficient liquidity. In addition, the Regulators will review the impact of international regulatory developments.**

The Regulators would nevertheless be concerned if the absence of mandatory clearing requirements for non-dealers encouraged regulatory arbitrage in the Australian market, and would respond accordingly. The Regulators would also review the case for extending mandatory clearing requirements if this was likely to materially affect the outcome of equivalence or comparability assessments carried out by overseas jurisdictions, and to have material implications for Australian market participants' business costs and international market access.

1.2 Platform Trading

The Regulators are of the view that it is not yet appropriate to recommend a mandatory platform trading obligation, for three key reasons:

- Before making any recommendation on mandatory platform trading, the Regulators would prefer to see further consensus emerge across key jurisdictions on the characteristics of relevant trading platforms for such purposes.
- Survey data on market liquidity, and the extent to which Australian participants are using non-fully electronic execution channels, suggest that liquidity in the local market is not high by international standards in many asset classes. They also suggest that market participants continue to predominantly use other execution channels, presumably for a range of commercial reasons.
- Treasury is undertaking a review of the Australian Market Licence (AML) regime, and the Regulators would prefer to await the outcome of that review prior to recommending any mandatory trading obligations.

The Regulators will nevertheless continue to monitor developments to gauge the implications of overseas regimes for methods of execution and liquidity in the Australian OTC derivatives market, and more generally monitor evolving trends in the utilisation of electronic trading platforms. It is noted that international consistency may become a higher priority if overseas jurisdictions were to implement mandatory platform trading obligations for products or asset classes widely traded in Australia, including asset classes that may be subject to mandatory clearing obligations. Consequently, the Regulators may consider it necessary to reassess the case for mandatory trading obligations for such products, primarily on international consistency grounds, and potentially make recommendations to the government ahead of the next market assessment.

1.3 Risk Management Practices

The Regulators understand that market participants, especially dealers, generally conform to accepted good market practice and published Australian market conventions. Prudential capital requirements provide a strong incentive to exchange variation margin for non-centrally cleared trades and the Regulators expect that forthcoming regulatory changes will also promote the exchange of initial margin and increased use of trade compression. The Regulators observe that participation in trade compression has already increased, and will continue to encourage further improvements. While the Regulators understand the current impediment to compressing certain Australian dollar-denominated interest rate swaps, they encourage market participants to explore ways to overcome this.

The Regulators have consistently focused on market participants' collateralisation of OTC derivatives transactions, including the legal and operational arrangements that underpin these arrangements. These issues will also be relevant as the Regulators consider the implementation of the BCBS-IOSCO margin requirements for non-centrally cleared OTC derivatives. The Regulators are also aware of the need for international consistency in the implementation of the BCBS-IOSCO margin requirements for non-centrally cleared OTC derivatives, and will monitor closely the implementation of this framework in key jurisdictions.

More broadly, the Regulators recognise the growing international focus on risk management practices for OTC derivatives and expect to actively engage in any future international initiatives in this area.

The remainder of this report is structured as follows. Chapters 2 and 3, respectively, provide updates on relevant domestic and overseas regulatory developments. Chapter 4 sets out the Regulators' assessment of the Australian OTC derivatives market and discusses the basis of the Regulators' recommendations. Chapter 5 describes the next steps.

2. Domestic Regulatory Developments

2.1 Introduction

Australia's regulatory framework continues to evolve and substantial progress has been made towards implementing Australia's G20 OTC derivatives reform commitments. Following the Regulators' recommendations in October 2012 and a subsequent determination by the government and rulemaking by ASIC, the first phase of Australia's mandatory trade reporting regime commenced in October 2013, and the second phase commenced on 1 April this year. And, further to the Regulators' recommendations in July 2013, the Australian Government is consulting on mandatory clearing requirements for US dollar-, euro-, British pound- and Japanese yen-denominated interest rate derivatives. In addition, overseas regulators have made progress in assessing the extent to which they are prepared to rely on Australia's regulation of OTC derivatives markets where their own rules have cross-border application.

2.2 July 2013 Report on the Australian OTC Derivatives Market

In July 2013, the Regulators published their periodic *Report on the Australian OTC Derivatives Market* (the Report).[6] The Report drew on information collected through a survey of major market participants conducted in early 2013. The Report reviewed major regulatory and industry developments and assessed in detail the case for mandatory clearing obligations for US dollar-, euro-, British pound- and Japanese yen-denominated interest rate derivatives, North American and European referenced credit index derivatives and Australian dollar-denominated interest rate derivatives.

The key recommendations arising from the Regulators' assessment were that:

- The government should consider a central clearing mandate for US dollar-, euro-, British pound- and Japanese yen-denominated interest rate derivatives, primarily on international consistency grounds. The Regulators recommended that the initial focus of such a mandate should be dealers with significant cross-border activity in these products.
- The Regulators would monitor for a further period Australian banks' progress in implementing appropriate clearing arrangements for Australian dollar-denominated interest rate derivatives, before recommending mandatory central clearing. The Report stated that the initial scope of any mandate would be likely to be the interdealer market.
- The Regulators did not see a case for a central clearing mandate for North American and European referenced credit index derivatives at that time. However, the Regulators undertook in their next market assessment to seek further information about Australian market participants' counterparty exposures and the breadth of central clearing.

The Regulators considered a number of other areas relevant to Australia's G20 commitments and the stability of derivatives markets. In particular, the Regulators noted that platform trading was progressing in major jurisdictions. The Regulators committed to monitoring international developments and their effects on Australian participants but were not in a position to make a recommendation at that time. The Regulators also committed to continuing to monitor market participants' risk management of non-centrally cleared trades, including through portfolio compression, portfolio reconciliation and collateralisation.

[6] APRA, ASIC and RBA (2013), *Report on the Australian OTC Derivatives Market*, July. Available at <http://www.cfr.gov.au/publications/cfr-publications/2013/report-on-the-australian-otc-derivatives-market-july/index.html>.

2.3 Mandatory Central Clearing

The Australian Government published a paper in February 2014 proposing that the responsible Minister determine, in accordance with section 901B of the Corporations Act, that US dollar-, euro-, British pound- and Japanese yen-denominated interest rate derivatives should be subject to mandatory clearing requirements.[7] In line with the Regulators' recommendation that the initial focus of such a mandate should be dealers with significant cross-border activity in these products, the government proposed restricting the scope to financial entities that had reached a certain threshold level of activity. The government is seeking feedback on how to define such a threshold, suggesting that it could be set with respect to an entity's notional principal outstanding in OTC derivatives or in OTC interest rate derivatives. It was proposed that this threshold be calculated on a legal entity basis. The consultation period closes on 10 April 2014.

If, after considering stakeholder feedback, the government chooses to pursue this proposal, it would expect to expose a draft Ministerial Determination, and relevant accompanying regulations, for comment in the second quarter of 2014. ASIC would also consult on and make Derivative Transaction Rules (DTRs) to give effect to the clearing obligation and to provide some period for implementation after finalising the rules. Accordingly, clearing obligations would not be expected to commence before the end of 2014.

2.4 Trade Reporting

As noted in the July 2013 Report, ASIC has finalised DTRs setting out the requirements for OTC derivatives market participants to report derivative transaction and position information to trade repositories (TRs). ASIC also published a regulatory guide to assist market participants in complying with their reporting obligations.[8] The first phase of the regime began on 1 October 2013 and phase two reporting entities commenced reporting credit and interest rate derivatives in accordance with the regime on 1 April (Table 1). To facilitate orderly implementation of the reporting regime, ASIC has worked with phase one and phase two entities and with relevant industry groups, and has granted transitional relief in a number of areas.

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7 Australian Government (2014), *Implementation of Australia's G-20 Over-The-Counter Derivatives Commitments – Proposals Paper – G4-IRD Central Clearing Mandate*, February. Available at <http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2014/G20-over-the-counter-derivatives-commitments>.

8 ASIC (2013), *Regulatory Guide 251 – Derivative Transaction Reporting*, August. Available at <http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg251-published-29-August-2013.pdf/$file/rg251-published-29-August-2013.pdf>.

Table 1: Phasing of ASIC's Trade Reporting Regime

Phase	Reporting entities	Effective date[(a)] Credit and interest rate derivatives	Effective date[(a)] Commodity,[(b)] equity and foreign exchange derivatives
1	Australian 'Swap Dealers'[(c)]	1 October 2013	1 October 2013
2	Financial entities[(d)] with $50 billion or more notional principal outstanding[(e)]	1 April 2014	1 October 2014
3	Financial entities[(d)] with less than $50 billion notional principal outstanding[(e)]	1 October 2014	1 April 2015

(a) Effective date of the transaction reporting obligation; position reporting obligations are delayed relative to these dates

(b) Excluding electricity derivatives

(c) A Swap Dealer is a category of entities required to register with the US Commodities and Futures Trading Commission (CFTC)

(d) Financial entities refers to Authorised Deposit-taking Institutions (ADIs), Australian Financial Services Licence (AFSL) holders, Clearing and Settlement (CS) Facility Licence holders and exempt foreign licensees

(e) Measured as at 31 December 2013

In July 2013, the government made the Corporations Regulation 2001 7.5A.50, which limits the ability of ASIC to apply trade reporting obligations to end users until 31 December 2014.[9] In its February 2014 proposals paper, the government has sought feedback on a permanent exemption from trade reporting obligations for end users. The intent is to give certainty to stakeholders and to focus trade reporting requirements on major market participants. The government has, however, noted that any such exemption may need to be narrowed to ensure that information on any systemically important OTC derivatives trading by end users would be available to regulators.

2.5 Financial Market Infrastructures

Trade repositories

The July 2013 Report also noted that ASIC had recently finalised its Derivative Trade Repository Rules and associated guidance for entities seeking an Australian Derivative Trade Repository Licence.[10] No TRs are yet licensed to operate in Australia. However, the Depository Trust & Clearing Corporation (DTCC) has recently submitted a draft licence application in relation to its Singaporean subsidiary, DTCC Data Repository (Singapore) Pte Ltd to ASIC. In the interim, the government has prescribed by regulation eight overseas TRs that can be used to fulfil Australian trade reporting obligations.[11] This regulation is due to expire on 30 June 2014.

Central counterparties

Since the Regulators' last Report in July 2013, no further OTC derivatives CCPs have been licensed in Australia. Currently, two domestic CCPs – ASX Clear Pty Limited and ASX Clear (Futures) – and one overseas CCP – LCH.C Ltd – that clear OTC derivatives are licensed in Australia. ASX Clear Pty Limited clears OTC equity options, while ASX Clear (Futures) and LCH.C Ltd are licensed to clear OTC interest rate derivatives.

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9 An end user is an entity that is not a financial entity, as defined in Table 1.

10 ASIC (2013), *Regulatory Guide 249 – Derivative Trade Repositories*, July. Available at <http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg249-published-11-July-2013.pdf/$file/rg249-published-11-July-2013.pdf>.

11 These repositories are: four DTCC facilities; CME; INFX SDR; Ice Trade Vault; and Monetary Authority appointed under s 5A of the Exchange Fund Ordinance of Hong Kong. See Corporations Amendment (Derivative Trade Repositories) Regulation 2013 available at < http://www.comlaw.gov.au/Details/F2013L01279>.

As foreshadowed in the previous Report, ASX Clear (Futures) is seeking to expand its dealer-to-dealer OTC derivatives clearing service to include client clearing for Australian dollar-denominated interest rate derivatives. ASX Clear (Futures) anticipates launching this service in early April 2014. LCH.C Ltd also has a client clearing service, and it intends to permit Australian participants to act as clearing agents for indirect participants in the near future.

On 6 February 2014, the US Commodity and Futures Trading Commission (CFTC) granted ASX Clear (Futures) time-limited relief from the requirement to register as a Derivatives Clearing Organisation (DCO, the CFTC equivalent of a Clearing and Settlement (CS) Facility Licence holder in Australia).[12] This allows US participants of ASX Clear (Futures) to clear the participants' proprietary trades in Australian and New Zealand dollar-denominated interest rate swaps using its service. The relief will expire at the end of 2014, or earlier if ASX Clear (Futures) registers as a DCO or is granted an exemption from DCO registration.

Trading platforms

In October 2013, the CFTC's rules governing the registration and operation of swap execution facilities (SEFs) came into effect. Similar developments in the European Union (EU) are discussed in Section 3.3.3. Under CFTC rules, any multilateral swaps trading platform that is located in the US or used by US persons is required to register as a SEF or Designated Contract Market.[13] On 20 December 2013, after earlier short-term no-action relief, the CFTC granted time-limited no-action relief until 15 May 2014 to the Australian trading platform, Yieldbroker Pty Limited (Yieldbroker), which holds an AML.[14] During this period of relief US persons can continue to use Yieldbroker to execute Australian dollar-denominated interest rate derivatives trades.

At the same time, Treasury is continuing its review of the AML regime. Depending on the results of this review, and subsequent decisions by the government and the Parliament, the scope of the AML regime or the criteria on which exemptions are granted could be changed. Conceivably, new regulatory categories could be established. This is relevant to OTC derivatives reforms since, under the Corporations Act, to fulfil a mandatory trade execution obligation a trade would need to be executed on a trading platform licensed under the AML regime or prescribed by regulation.

2.6 Equivalence of Australian Regulation

The EU and CFTC have made considerable progress in assessing the equivalence of certain aspects of Australia's regulation of OTC derivatives markets. Positive assessments will, under certain conditions, allow the European Securities and Markets Authority (ESMA) and the CFTC to place reliance on Australian regulation and regulators. This would be expected to minimise costs for Australian market participants and infrastructures arising from duplicative and potentially conflicting regulations.

[12] CFTC (2014), 'CFTC's Division of Clearing and Risk Issues No-Action Letter for ASX Clear (Futures) Pty Limited', Press Release PR6852-14, 6 February. Available at <http://www.cftc.gov/PressRoom/PressReleases/pr6852-14>.

[13] The application of this requirement to foreign trading platforms was confirmed by the CFTC in guidance issued in November 2013: see CFTC (2013), 'CFTC's Division of Market Oversight Issues New Guidance on the Application of Certain Commission Regulations to Swap Execution Facilities', Press Release PR6775-13, 15 November. Available at <http://www.cftc.gov/PressRoom/PressReleases/pr6775-13>.

[14] CFTC (2013), 'CFTC's Division of Market Oversight Provides Conditional Time-Limited No-Action Relief to Australian-Based Trading Platform Yieldbroker Pty Limited', Press Release PR6804-13, 20 December. Available at <http://www.cftc.gov/PressRoom/PressReleases/pr6804-13>.

European Union

At the request of the European Commission (EC), ESMA has produced and published advice on the equivalence of nine non-EU regimes: Australia, Canada, India, Hong Kong, Japan, Singapore, South Korea, Switzerland and the US.[15] The advice details ESMA's assessment of the equivalence of non-EU regimes' legal provisions and the level of supervision and enforcement to those under *Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories*, commonly known as the European Market Infrastructure Regulation (EMIR).

In its assessment, ESMA concluded that Australia was:

- *Equivalent with respect to CCPs:* Australian CCPs are subject to effective supervision and enforcement; Australian legislation provides for recognition of foreign CCPs where they are subject to an equivalent regime in a manner consistent with EMIR; and the Australian regulatory framework, including the RBA's Financial Stability Standards, provides legally binding requirements equivalent to those required under EMIR.
- *Equivalent with respect to TRs and mandatory trade reporting:* Australian TRs must comply with legally binding requirements equivalent to those under EMIR; Australian legal, supervisory and enforcement arrangements are equivalent to the TR and trade reporting requirements under EMIR; requirements for professional secrecy attached to TR data are consistent with those under EMIR.
- *Conditionally equivalent with respect to mandatory clearing obligations*. As neither Australia nor the EU had mandatory clearing obligations in place at the time of ESMA's advice, ESMA provided advice conditional on future obligations under the Australian regime. ESMA advised that Australian mandatory clearing obligations should be considered equivalent only if any product subject to the EU's clearing obligation is also subject to a clearing obligation in Australia, and if the Australian regime granted exemptions only to participants that will benefit from equivalent exemptions if established in the EU.
- *Not equivalent with respect to risk mitigation techniques*. ESMA found no specific legally enforceable risk mitigation requirements in Australia equivalent to those under EMIR. This reflects the current lack of international standards covering such techniques. Indeed, the US is the only jurisdiction for which ESMA concluded that equivalent requirements were in force, the US having introduced such requirements in the Dodd Frank Act. The Regulators will give close consideration to international standards should such standards be developed in this area.

The EC is considering ESMA's advice before making equivalence decisions and adopting Implementing Acts to give effect to those decisions. The outcome of the EC's equivalence decisions will affect non-EU CCPs, TRs and OTC market participants in a number of ways:

- *CCPs and TRs*. Recognition under EMIR is required if a non-EU CCP or TR is to be permitted to (continue to) provide services to EU-based financial institutions. If the EC accepts ESMA's positive assessment of Australia's CCP and TR regimes and adopts an Implementing Act, one of the preconditions for Australian CCPs and TRs to obtain EMIR recognition will have been met.

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15 ESMA's advice on Australia is: ESMA (2013), *Final Report: Technical Advice on Third Country Regulatory Equivalence under EMIR – Australia*, September. Available at <http://www.esma.europa.eu/system/files/2013-1159_technical_advice_on_third_country_regulatory_equivalence_under_emir_australia.pdf>. ESMA (2013), *Supplement to the Final Report: Technical Advice on Third Country Regulatory Equivalence under EMIR – Australia*, October. Available at <http://www.esma.europa.eu/system/files/2013-1373_esma_technical_advice_on_equivalence_of_australia_-_otc_and_tr.pdf>.

- *Market participants*. A positive equivalence decision on mandatory trade reporting and clearing obligations or risk mitigation techniques, and the resulting Implementing Act, would permit trades between an EU-based participant and a non-EU-based participant to be regulated under either jurisdiction's regime for the purposes of fulfilling corresponding EMIR requirements. This could lower the regulatory burden on cross-border participants and reduce the risk of conflicting regulatory requirements. If the EC adopts Implementing Acts in accordance with ESMA's advice, Australian market participants (including EU entities) will be able to report under ASIC's trade reporting regime and, under certain conditions, to clear under Australian rules.

US Commodities and Futures Trading Commission

As noted in Section 2.5, subject to applicable no-action relief, the CFTC currently requires non-US CCPs and trading platforms that offer services to US persons to register with the CFTC. In contrast, non-US participants that have provisionally registered as Swap Dealers or Major Swap Participants are able to apply to the CFTC for an assessment of the comparability of their home regime. If the home regime is assessed as comparable, the CFTC's cross-border guidance permits non-US Swap Dealers and non-US Major Swap Participants to comply with certain requirements of their home jurisdictions instead of the comparable CFTC requirements.[16]

The five largest Australian-headquartered dealers have provisionally registered with the CFTC as non-US Swap Dealers. On 22 December 2013, the CFTC approved substituted compliance regarding certain entity-level business conduct requirements for swap dealers located in Australia, Canada, the EU, Hong Kong, Japan and Switzerland.[17] The CFTC also approved substituted compliance for the EU and Japan in relation to certain transaction-level requirements. Where the CFTC did not find comparable requirements, it provided no-action relief until 4 March 2014 for swap dealers from these jurisdictions to comply with its requirements.[18] The CFTC is continuing to review the comparability of transaction reporting requirements, and has therefore extended existing time-limited no-action relief for swap dealers from all six of these jurisdictions.[19]

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[16] CFTC (2013), 'Interpretative Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations', Federal Register, Vol 78, No 144, July. Available at <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-17958a.pdf>.

[17] CFTC (2013), 'CFTC Approves Comparability Determinations for Six Jurisdictions for Substituted Compliance Purposes', Press Release PR6802-1320, 20 December. Available at <http://www.cftc.gov/PressRoom/PressReleases/pr6802-13>.

[18] CFTC (2013), 'Re: Time-Limited No-Action Relief from Certain Entity-Level Internal Business Conduct Requirements for Certain Swap Dealers and Major Swap Participants Established under the Laws of Australia, Canada, the European Union, Japan, and Switzerland', CFTC Letter No 13-78, 20 December. Available at <http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/13-78.pdf>.

[19] CFTC (2013), 'Time-Limited No-Action Relief from Certain Requirements of Part 45 and Part 46 of the Commission's Regulations, for Certain Swap Dealers and Major Swap Participants Established under the Laws of Australia, Canada, the European Union, Japan or Switzerland', CFTC Letter No 13-75, 20 December. Available at <http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/13-75.pdf>.

3. International and Overseas Regulatory Developments

3.1 Introduction

Since the Regulators' last Report, international standards and guidance have been substantially progressed or finalised in a number of areas. International bodies have increasingly focused on jurisdictions' implementation and have emphasised the importance of addressing regulatory conflicts and inconsistencies. Individual jurisdictions are progressing reforms of OTC derivatives markets, and are consulting on and finalising rules, standards and guidance. Major jurisdictions have sought to clarify the cross-border implications of their regimes, and are working with other regulators and international bodies to ensure broadly harmonised approaches.

3.2 International Developments

3.2.1 Implementation monitoring

The Financial Stability Board (FSB) continues to monitor jurisdictions' progress in implementing their G20 commitments. In September 2013, the FSB published its *Sixth Progress Report on OTC Derivatives Reform Implementation*.[20] The FSB publishes these reports periodically, at the request of the G20 leaders, in order to monitor jurisdictions' progress and to encourage consistent and timely implementation of OTC derivatives reforms. The seventh report is expected to be published ahead of the 10 April meeting of G20 Finance Ministers and Central Bank Governors.

In the sixth report, the FSB noted that over half of its member jurisdictions had legislative frameworks in place to support the implementation of all reform commitments. Implementation of trade reporting requirements is the furthest progressed of the G20 reforms; by end 2013 the FSB expected three-quarters of jurisdictions to have adopted the relevant legislation and regulations, with more than half of jurisdictions having requirements in force already. Similarly, half of FSB jurisdictions – including Australia – had implemented Basel III capital requirements by September 2013. In contrast, at the time of the sixth report, mandatory central clearing obligations and requirements for trade execution were only partially in force in a small number of jurisdictions. In this latest progress report, the FSB reiterated its call for clarity on the regulators' approaches to cross-border activity, and for authorities to work together to resolve conflicts, inconsistencies and gaps. Despite the remaining uncertainty regarding cross-border activity, the FSB encouraged jurisdictions to put forward specific regulatory proposals, in part to assist in the identification and resolution of cross-border regulatory issues.

[20] FSB (2013), *OTC Derivatives Market Reforms: Sixth Progress Report on Implementation*, September. Available at <http://www.financialstabilityboard.org/publications/r_130902b.pdf>.

The report also focused on market participants' practical readiness for the implementation of the OTC derivatives reforms, observing that regulatory uncertainty had delayed preparations by some market participants. The FSB found that actual use of centralised infrastructure by market participants was most advanced in trade reporting and central clearing of OTC interest rate and credit derivatives. The FSB noted that while many large market participants were already using centralised infrastructure prior to the reforms, they had modified their operational and legal arrangements in order to meet specific regulatory requirements. Some large market participants had also made changes to facilitate client or third-party access to centralised infrastructure. In contrast, smaller market participants had made less use of centralised infrastructure in the past and this remained the case. The FSB stated that the concentration in intermediaries that facilitate smaller market participants' access to centralised infrastructure was growing. While this was to be expected, the FSB identified that it would be important to monitor this increased reliance on a small group of participants for such access, as well as related ancillary services (e.g. collateral management and transformation).

3.2.2 Cross-border issues

The OTC Derivatives Regulators Group (ODRG) was established to respond to growing concerns among various regulatory authorities and market participants about the cross-border implementation of OTC derivatives reforms. The ODRG comprises 12 market regulators from major jurisdictions, including ASIC. In response to a call from the G20 Finance Ministers and Central Bank Governors to provide the FSB with specific and practical recommendations for resolving remaining cross-border conflicts, the ODRG published a number of understandings in August 2013:

- consultation and communication when equivalence or substituted compliance assessments are being undertaken is essential
- a flexible, outcomes-based approach should form the basis of final assessments regarding equivalence or substituted compliance assessments
- a 'stricter-rule' approach should apply to address gaps in mandatory trading or clearing obligations
- consultation should take place on the implications for other jurisdictions of any mandatory clearing determinations, based on the International Organization of Securities Commissions (IOSCO) recommendations
- jurisdictions should remove barriers to reporting to TRs by market participants and to access to TR data by authorities
- there should be appropriate transitional measures and a reasonable but limited transition period for foreign entities.[21]

The ODRG Principals met again in September 2013 to discuss a number of issues relating to cross-border regulation, including the application of clearing requirements to foreign branches and affiliates; risk mitigation techniques and margin requirements for non-centrally cleared derivatives; cooperation regarding equivalence and substituted compliance assessments; and cooperation in the supervision of foreign entities.[22]

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[21] ODRG (2013), 'Report on Agreed Understandings to Resolving Cross-Border Conflicts, Inconsistencies, Gaps and Duplicative Requirements', August. Available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/odrgreport.pdf>.

[22] ODRG (2013), '20 September 2013 Meeting of the Principals of the OTC Derivative Regulators Group', September. Available at <http://www.esma.europa.eu/system/files/2013-1400.pdf>.

While welcoming the progress that had been made to date, in their September 2013 declaration the G20 Leaders called for further steps to be taken by authorities in resolving these issues:

> We … welcome the recent set of understandings by key regulators on cross-border issues related to OTC derivatives reforms, as a major constructive step forward for resolving remaining conflicts, inconsistencies, gaps and duplicative requirements globally, and look forward to speedy implementation of these understandings once regimes are in force and available for assessment. We agree that jurisdictions and regulators should be able to defer to each other when it is justified by the quality of their respective regulatory and enforcement regimes, based on similar outcomes, in a non-discriminatory way, paying due respect to home country regulation regimes. We call on regulators in cooperation with the FSB and the OTC Derivatives Regulators Group to report on their timeline to settle the remaining issues related to overlapping cross-border regulatory regimes, and regulatory arbitrage.[23]

This message was reiterated by the G20 Financial Ministers and Central Bank Governors following their February 2013 meeting. In the context of the broader post-crisis regulatory reform agenda, including the OTC derivatives commitments, the Communiqué highlighted that the Ministers and Governors aim:

> to promote resilience in the financial system and greater certainty in the regulatory environment to support confidence and growth ... [and] ... will implement these reforms in a way that promotes an integrated global financial system, reduces harmful fragmentation and avoids unintended costs for business.[24]

In response to a request from the Chair of the FSB, the ODRG published a list of remaining cross-border implementation issues on 31 March 2014. [25] The cross-border issues that the ODRG is working on are:

- *Treatment of branches and affiliates.* The ODRG continues to work on identifying possible gaps and duplicative requirements in the treatment of foreign branches and affiliates and continues to explore potential solutions for those cases.

- *Organised trading platforms and the implementation mandatory platform trading obligations.* The ODRG is assessing the circumstances under which registration of foreign organised trading platforms, for purposes of derivatives trading and trading obligations, is required by authorities, and identifying possible approaches to the application of substituted compliance or equivalence for organised trading platforms. In addition, the ODRG is considering differences across jurisdictions the timing and approach to implementing trading obligations.

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23 G20 (2013), 'G20 Leaders' Declaration', September. Available at <https://www.g20.org/sites/default/files/g20_resources/library/Saint_Petersburg_Declaration_ENG.pdf>.

24 G20 (2014), 'Communiqué', Meeting of Finance Ministers and Central Bank Governors, Sydney, 22–23 February. Available at <https://www.g20.org/sites/default/files/g20_resources/library/Communique%20Meeting%20of%20G20%20Finance%20Ministers%20and%20Central%20Bank%20Governors%20Sydney%2022-23%20February%202014_0.pdf>.

25 ODRG (2014), 'Report of the OTC Derivatives Regulators Group on Cross-Border Implementation Issues', March. Available at < http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ODRG-Report-to-the-G20--March-2014.pdf/$file/ODRG-Report-to-the-G20--March-2014.pdf>.

- *Equivalence and substituted compliance.* An equivalence or substituted compliance assessment should be based on an understanding that similar regulatory outcomes may be achieved through the implementation of detailed rules or an applicable supervisory framework, or both. Such assessments may be made on a broad category-by-category basis, rather than on the foreign regime as a whole. An equivalence or substituted compliance assessment should fully take into account international standards (where appropriate), regulatory arbitrage, investor protection, risk importation, prudential and other relevant considerations. ODRG members are continuing to work on implementing these understandings with respect to the use of equivalence and substituted compliance.

- *Clearing determinations.* The ODRG has developed a framework for consultation among authorities on mandatory clearing determinations, which aims to harmonise mandatory clearing determinations across jurisdictions to the extent practicable and, where appropriate, subject to jurisdictions' determination procedures.

- *Margin requirements for non-centrally cleared derivatives transactions.* ODRG members agreed that early consultation should be established in order to seek consistent approaches, to the extent possible, in implementing the international standards.

- *Data in TRs.* ODRG members agreed to explore direct access as the preferred approach to ensuring that regulators have access to relevant data held in trade repositories consistent with their mandates.

The ODRG has also identified a number of cross-border issues that are being addressed in other forums or through bilateral engagement between regulators. The ODRG has committed to producing reports on these issues in September and November 2014. In addition, the Chair of the FSB also committed the FSB to publishing a report in September 2014 on jurisdictions' established processes to enable them to defer to each other's rules in cross-border contexts where these achieve similar outcomes.[26]

3.2.3 Margin requirements for non-centrally cleared derivatives

In September 2013, the Basel Committee on Banking Supervision (BCBS) and IOSCO published a final framework for margin requirements for bilateral derivative exposures.[27] The framework is designed to reduce the potential for contagion from the default of a market participant by ensuring that derivatives exposures are adequately collateralised. In addition, by bringing bilateral risk management practices more into line with those used in central clearing, the framework will enhance transparency, aid risk comparisons and promote central clearing for derivatives that meet the preconditions for safe and reliable clearing.

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[26] FSB Chairman (2014), 'Letter to G20 Finance Ministers and Central Bank Governors: Financial Reforms – Progress and Challenges', 17 February. Available at <http://www.financialstabilityboard.org/publications/r_140222.pdf>.

[27] BCBS-IOSCO (2013), *Margin Requirements for Non-Centrally Cleared Derivatives*, September. Available at <http://www.bis.org/publ/bcbs261.pdf>.

The final framework requires financial firms and systemically important non-financial entities that engage in non-centrally cleared derivatives trades to exchange initial and variation margin. Initial margin is intended to cover potential future price movements, while variation margin recognises observed marked-to-market price movements. The framework envisages that margin obligations will be calculated using appropriate methodologies that ensure risk exposures are covered with a high degree of confidence. Standardised initial margin and haircut rates can be applied by counterparties where an entity does not use an approved margin model. The International Swaps and Derivatives Association (ISDA) has put forward a proposal to develop a standardised initial margin model that, if approved, would allow market participants to better anticipate their margin obligations.[28]

In response to feedback from the second round of consultation conducted in 2013, the BCBS and IOSCO clarified the following aspects of the final framework:

- Physically settled foreign exchange forwards and swaps are exempt from initial margin requirements.
- The foreign exchange transactions associated with the final exchange of principal for cross-currency interest rate swaps are exempt from initial margin requirements; however, the interest rate component of the transaction is not exempt.
- 'One-time' rehypothecation of initial margin is permitted under certain, strict conditions. This is intended to alleviate the liquidity burden of the framework.

The requirement to collect and post initial margin on non-centrally cleared trades will phase in over a four-year period, beginning December 2015. The phasing is based on both counterparties exceeding a threshold level of notional principal outstanding of non-centrally cleared OTC derivatives, measured on a consolidated group basis, with the threshold gradually being lowered to its final level of €8 billion by December 2019. It will also be a requirement to exchange variation margin on all new trades booked after 1 December 2015. Ongoing work to assess jurisdictions' progress in implementing the framework, review industry's progress in implementing the reforms, and review whether the framework remains consistent with other international regulatory initiatives is also planned. The Regulators remain closely engaged with this work.

3.2.4 Exposures to central counterparties

Large exposure limits

In March 2013 the BCBS published a consultation paper on large exposure limits.[29] As part of this consultation, the BCBS sought feedback on whether similar limits should be applied to banks' exposures to CCPs. The consultation acknowledged that limiting exposures to CCPs could:

- conflict with the G20 commitment to centrally clear all standardised OTC derivatives
- give CCPs an incentive to reduce initial margin and default fund requirements, potentially making them less resilient.

The BCBS has been considering industry feedback and is expected to publish a final framework shortly.

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28 ISDA (2013), 'Standard Initial Margin Model for Non-Cleared Derivatives', December. Available at <http://www2.isda.org/attachment/NjE2Ng==/SIMM%20for%20Non-cleared%2020131210.pdf>.

29 BCBS (2013), *Supervisory Framework for Measuring and Controlling Large Exposures*, March. Available at <http://www.bis.org/publ/bcbs246.pdf>.

Capital requirements

A joint taskforce comprising the BCBS, the Committee on Payment and Settlement Systems (CPSS) and IOSCO is currently working on refining the capital framework for bank exposures to CCPs. This framework is designed to ensure banks' exposures to CCPs are adequately capitalised, while maintaining incentives to centrally clear, and will replace the interim rules published in July 2012.[30] The consultation period for the revised framework closed in September 2013.[31] The taskforce has considered the comments received as part of that consultation, as well as the results of a recent quantitative impact study, and is expected to publish a final framework in the near future.

3.2.5 Basel III leverage ratio

On 12 January 2014, the BCBS finalised the Basel III leverage ratio framework.[32] The leverage ratio is a simple, non-risk-based ratio of capital to exposures, which is designed to restrict the build-up of leverage in the banking sector and supplement risk-based capital requirements. Initially, the BCBS has set a minimum leverage ratio of 3 per cent. The framework limits the scope for netting in calculating the derivatives component of a bank's exposures. Consequently, while APRA has yet to consult with the banking industry on implementation in Australia, the leverage ratio is expected to act as an incentive for banks to compress their OTC derivatives portfolios by either bilaterally or multilaterally terminating offsetting trades against counterparties.

3.2.6 Authorities' access to trade repository data

In August 2013, the CPSS and IOSCO published a final report on authorities' access to TR data.[33] The report provides guidance to TRs and authorities on access to OTC derivatives transaction and position data held by TRs. The report examines a broad range of possible uses that authorities may have for TR data, and considers the depth and breadth of the data authorities would typically require to fulfil their mandates.

The report sets out guidelines for authorities when requesting data from TRs, and for TRs when responding to such requests. These guidelines provide that:

- access levels should be consistent with authorities' mandates
- authorities obtaining access to data should have appropriate arrangements in place to keep the data confidential
- an authority should, at a minimum, be able to access any data from a TR that it would be able to obtain directly from the reporting entity under its mandate
- a TR should apply the guidelines in the report to judge whether the data requested by a particular authority are consistent with that authority's mandate. To aid TRs in making such judgements, requesting authorities should provide sufficient supporting information.

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30 BCBS (2012), *Capital Requirements for Bank Exposures to Central Counterparties*, July. Available at <http://www.bis.org/publ/bcbs227.pdf>.

31 BCBS (2013), *Consultative Document: Capital Treatment of Bank Exposures to Central Counterparties*, July. Available at <http://www.bis.org/publ/bcbs253.pdf>.

32 BCBS (2014), *Basel III Leverage Ratio Framework and Disclosure Requirements*, January. Available at <http://www.bis.org/publ/bcbs270.pdf>.

33 CPSS and IOSCO (2013), *Authorities' Access to Trade Repository Data*, August. Available at <http://www.bis.org/publ/cpss110.pdf>.

3.2.7 FSB Aggregation Feasibility Study Group

The FSB is conducting a feasibility study of options for aggregating information from TRs and sharing information among authorities. This study was requested by the G20 Finance Ministers and Central Bank Governors in their April 2013 Communiqué in order to enable 'comprehensive monitoring of risks to financial stability'.[34] In response, the FSB established an ad hoc Aggregation Feasibility Study Group (AFSG), comprising experts from the members of CPSS and IOSCO, as well as other experts from organisations with responsibility for macroprudential and microprudential surveillance and supervision. ASIC is participating in this group. The study builds on previous work by the CPSS and IOSCO.[35]

On 4 February 2014, the AFSG published a consultative report, which describes the three options under consideration: a physically centralised model; physically decentralised data collection and storage, using a logical index to aggregate data from local TR databases; and collection and aggregation by authorities themselves.[36] For each option, the report outlines the:

- *Legal considerations*, including those relating to submission of data to the aggregation mechanism, access to the mechanism and governance of the mechanism.
- *Data and technology considerations*, including those related to data standardisation and harmonisation, data quality, information security and other technological considerations.

In the consultation, which closed on 28 February, the AFSG sought feedback on these considerations and proposed criteria for evaluating the three options. Based on the feedback received, the final report will assess the benefits and costs of each option and form a recommendation for the FSB. The final report is due to be published in May 2014.

3.2.8 Legal Entity Identifiers

To assist in analysing and aggregating data reported to TRs, it is important that counterparties can be uniquely and consistently identified. Accordingly, global authorities have made substantial progress towards developing a system of Legal Entity Identifiers (LEIs). In January, the FSB Plenary endorsed nominees to the initial Board of Directors of the Global LEI Foundation, based on recommendations from the LEI Regulatory Oversight Committee (ROC). The ROC currently has 62 member authorities and 20 observers.[37] ASIC is a member of the ROC. The ROC is developing the statutes for the Global LEI Foundation, which will be the final step in formally establishing the Global LEI Foundation. Once the Global LEI Foundation is established, the Foundation's Board of Directors will take over responsibility for establishing the LEI system under the supervision and oversight of the ROC.

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34 G20 (2013), 'Communiqué', Meeting of Finance Ministers and Central Bank Governors, Washington DC, 19 April. Available at <http://www.g20.utoronto.ca/2013/2013-0419-finance.html>.

35 CPSS and IOSCO (2012), *Report on OTC Derivatives Data Reporting and Aggregation Requirements – Final Report*, January. Available at <http://www.bis.org/publ/cpss100.htm>.

36 FSB (2014), *Consultation Paper: Feasibility Study on Approaches to Aggregate OTC Derivatives Data*, February. Available at <http://www.financialstabilityboard.org/publications/r_140204.htm>.

37 A list of members and observers is available at <http://www.leiroc.org/about/membersandobservers/index.htm>.

To date, 22 institutions have been sponsored by ROC member authorities as pre-Local Operating Units (pre-LOUs); 13 of these institutions have been endorsed by the ROC.[38] These entities issue pre-LEIs, which are interim identifiers used in advance of the formal launch of the final LEI system. ROC members have agreed that pre-LEIs issued by endorsed pre-LOUs will be accepted globally for regulatory reporting purposes in all ROC member jurisdictions. The *ASIC Derivative Transaction Rules (Reporting) 2013* require the use of LEIs where available, but allow reporting entities to use pre-LEIs to meet the Australian reporting obligations where necessary.[39]

3.2.9 Macroeconomic Assessment Group on Derivatives study

In August 2013, the Macroeconomic Assessment Group on Derivatives (MAGD) published its *Macroeconomic Impact Assessment of OTC Derivatives Regulatory Reforms*.[40] The group was established by the OTC Derivatives Coordination Group – comprising the Chairs of the BCBS, the Committee on the Global Financial System, the CPSS, the FSB and IOSCO – in February 2013 to assess the macroeconomic effects of the G20 reforms to OTC derivatives markets. In order to complete the assessment, MAGD seconded a number of financial and economic modelling experts from central banks (including the RBA) and other authorities, and liaised with an advisory panel of academics.

The assessment examined the broad macroeconomic benefits and costs of the G20 OTC derivatives reforms, including mandatory central clearing obligations for standardised OTC derivatives; margin requirements for non-centrally cleared OTC derivatives; and capital requirements for bank's derivatives exposures. The report focused on the long-run implications of the reforms, assuming full implementation in all jurisdictions.

MAGD found that the main benefit of the G20 reforms was in reducing counterparty exposures through netting at CCPs, and reducing contagion risk through collateralisation. The report estimated that these factors would reduce the probability of derivatives-propagated financial crises and, as a result, reduce the expected value of GDP lost due to financial crises.

The assessment also examined the costs of the reforms arising from requiring financial institutions to meet higher capital requirements and to hold more high-quality, low-yielding assets for margin and collateral purposes. These costs could lead to reduced economic activity by increasing the price of financial services and limiting risk transfer activity. MAGD used a number of macroeconomic models to assess the reduction in GDP due to higher prices for financial services.

On balance, the report found a net benefit of 0.12 per cent of global GDP per year, with greater netting efficiencies increasing the estimated benefit by reducing collateral requirements.

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38 A full list of sponsored pre-LOUs is available at <http://www.leiroc.org/publications/gls/lou_20130318.pdf>. A list of endorsed pre-LOUs is available at <http://www.leiroc.org/publications/gls/lou_20131003_2.pdf>.

39 ASIC (2013), *Regulatory Guide 251 – Derivative Transaction Reporting*, August. Available at <http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg251-published-29-August-2013.pdf/$file/rg251-published-29-August-2013.pdf>.

40 MAGD (2013), *Macroeconomic Impact Assessment of OTC Derivatives Regulatory Reforms*, August. Available at <http://www.bis.org/publ/othp20.pdf>.

3.2.10 Principles for Financial Market Infrastructures

In August 2013, CPSS and IOSCO published an initial report on jurisdictions' progress in implementing the CPSS-IOSCO *Principles for Financial Market Infrastructures* (the Principles).[41] The Principles are a set of best-practice global standards for financial market infrastructures (FMIs), including CCPs. The report assessed the progress of 27 jurisdictions' in adopting the necessary legislation, regulation or policies in the year since the Principles were finalised. The report noted that substantial work had been undertaken in most jurisdictions. However, few jurisdictions had fully implemented the Principles for all types of FMIs by April 2013, although many expected to be near completion by the end of 2013. Australia had fully implemented the Principles for CCPs, securities settlement systems and payment systems. At the time of the assessment, Australia was assessed as having not yet fully implemented the Principles for TRs, since ASIC's Derivative Trade Repository Rules were not finalised until July 2013.

An updated report is due to be published shortly. Later reports will assess the consistency of the adopted measures with the Principles and the consistency of outcomes across jurisdictions arising from adoption of the Principles. The RBA is a member of the taskforce responsible for conducting these assessments.

3.2.11 Recovery and resolution

In August 2013, CPSS and IOSCO published a consultative report on recovery of FMIs. The report contains draft guidance on how FMIs can meet the recovery-related requirements in the Principles; it does not establish additional standards. In particular, once finalised, the guidance will help FMIs develop comprehensive and effective plans to recover from threats to their viability so that they can continue to provide critical services to market participants.[42] The RBA is participating in the group responsible for drafting this guidance. Consultation closed on 11 October 2013. Having considered feedback from consultation respondents, the group is finalising the guidance and intends to publish its report in the second quarter of 2014.

In parallel, the FSB has consulted on a draft annex to the *Key Attributes of Effective Resolution Regimes*. The draft annex sets out sector-specific considerations for how the Key Attributes should be applied, including to particular classes of FMI.[43] This consultation was intended to be complementary to the CPSS-IOSCO consultative report on recovery. Consultation closed on 15 October 2013.

The FSB also published a consultative report on the sharing of non-public information among relevant authorities that have a role in resolution.[44] The report proposed guidance which elaborates on standards for information sharing, confidentiality and statutory safeguards. Consultation closed on 15 October 2013.

[41] CPSS-IOSCO (2013), *Implementation Monitoring of PFMIs – Level 1 Assessment Report*, August. Available at <http://www.bis.org/publ/cpss111.htm>.

[42] CPSS-IOSCO (2013), *Recovery of Financial Market Infrastructures – Consultative Report*, August. Available at <http://www.bis.org/publ/cpss109.htm>.

[43] FSB (2013), *Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions*, August. Available at <http://www.financialstabilityboard.org/publications/r_130812a.pdf>.

[44] FSB (2013), *Consultative Document: Information Sharing For Resolution Purposes*, August. Available at <http://www.financialstabilityboard.org/publications/r_130812b.htm>.

3.3 Developments in Other Jurisdictions

3.3.1 United States

US Commodities and Futures Trading Commission

Swap Execution Facilities and 'made available to trade' obligations

As discussed in Section 2.5, the CFTC's SEF regulations came into effect in October 2013. To date, 19 entities have temporarily registered with the CFTC as SEFs and another five entities have applications under consideration.[45] In order to gain and maintain permanent registration, a SEF must demonstrate continued compliance with all relevant regulatory requirements.

On 12 February, the CFTC announced relief for EU-registered Multilateral Trading Facilities (MTFs) from the requirement to register as SEFs.[46] The relief is conditional on an MTF having a central limit order book, a sufficient level of pre-trade and post-trade price transparency, non-discriminatory access for market participants, and an appropriate level of oversight. This relief was foreshadowed in the EC's and CFTC's 'Common Path Forward' agreement in July 2013, and allows US persons to continue to use MTFs. The relief for MTFs will expire once the CFTC implements an exemption regime for trading platforms. This exemption regime will be based on an alternative compliance regime, conditional on the trading platform being subject to, and compliant with, equivalent regulatory requirements in its home jurisdiction. Certain market access requirements and reporting obligations are also likely to apply.

The phase-in of the CFTC's mandatory platform trading regime began on 15 February 2014. The regime requires certain US dollar-, euro- and British pound-denominated fixed-for-floating interest rate swaps and certain North American and European referenced credit index derivatives to be executed on either a registered SEF or a Designated Contract Market.[47] The regime began following the CFTC's approval of five self-certifications of made-available-to-trade (MAT) determinations for Javelin SEF, trueEX, TW SEF and MarketAxess SEF in January 2014, and Bloomberg SEF in March 2014.

Derivatives Clearing Organisations and mandatory clearing

The CFTC's central clearing obligation for US dollar-, euro-, British pound-, and Japanese yen-denominated interest rate swaps and North American and European-referenced credit indices was extended to third-party investment managers and pension funds on 9 September 2013. This is the final group of entities that will be subject to the regime for these instruments.

Cross-border guidance

As discussed in Section 2.6, the CFTC recently approved a number of comparability determinations under its cross-border guidance. On 14 November 2013, it also issued an advisory letter regarding footnote 513 in the CFTC's cross-border guidance.[48] The advisory letter stated that, where a swap between two non-US persons was 'arranged, negotiated, or executed' by personnel or agents of a non-US swap dealer located in the US, no substituted compliance would be available and the CFTC's transaction-level requirements would apply. The CFTC has requested public comments on its cross-border guidance and the advisory letter. Consultation closed on 10 March 2014.

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[45] A list of entities that have applied for registration as a SEF is available at <http://sirt.cftc.gov/SIRT/SIRT.aspx?Topic=SwapExecutionFacilities>.

[46] CFTC (2014), 'Statement by the CFTC and the European Commission on Progress Relating to the Implementation of the 2013 Path Forward Statement', Press Release PR6857-14, 12 February. Available at <http://www.cftc.gov/PressRoom/PressReleases/pr6857-14>.

[47] A complete list of products to which the mandate applies is available at <http://www.cftc.gov/ucm/groups/public/@otherif/documents/file/swapsmadeavailablechart.pdf>.

[48] CFTC (2013), 'Applicability of Transaction-Level Requirements to Activity in the United States', CFTC Staff Advisory No 13-69, 14 November. Available at <http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/13-69.pdf>.

US Securities and Exchange Commission

In March 2014, the US Securities and Exchange Commission (SEC) published a consultation on proposed rules designed to enhance the SEC's oversight and supervision of Clearing Agencies (the SEC equivalent of a CS Facility Licence holder in Australia).[49] The proposed rules would apply to 'Covered Clearing Agencies', which are Clearing Agencies overseen by the SEC that:

- are designated by the US Financial Stability Oversight Council (FSOC) as systemically important;[50]
- clear transactions with a more complex risk profile, such as security-based swaps; or
- are determined by the SEC to be Covered Clearing Agencies.[51]

To date, the FSOC has designated six Clearing Agencies as systemically important, of which the SEC supervises four.[52] The proposed rules set a number of standards for Clearing Agencies, across areas including governance, risk management, operations, and disclosures to the public and regulators. The proposed rules are intended to implement the CPSS-IOSCO Principles within the SEC's regulatory regime.

3.3.2 European Union

CCPs and mandatory clearing

EMIR provides a framework for authorising CCPs and imposing mandatory clearing requirements. European and foreign CCPs were required to apply to ESMA by 15 September 2013 if they intended to provide or continue to provide services to EU-based financial institutions. The first CCP – NASDAQ OMX – was authorised on 18 March 2014.[53] Authorisation of at least one CCP that clears relevant products is a precondition to any European clearing obligation.

In July 2013, ESMA published a paper that proposed and sought feedback on ESMA's framework for determining which classes of OTC derivatives should be subject to a clearing obligation under EMIR.[54] ESMA is required to consider three factors in determining which products should be subject to a clearing obligation:

- the degree of standardisation of the contractual terms and operational processes for the product
- the volume and liquidity of the product
- the availability of fair, reliable and generally accepted pricing information for the product.

49 SEC (2014), *Standards for Covered Clearing Agencies*, March. Available at <http://www.sec.gov/rules/proposed/2014/34-71699.pdf>.

50 The FSOC is a statutory body with responsibility for identifying risks and responding to emerging threats to financial stability. It is chaired by the Secretary of the Treasury, and includes representatives from the federal financial regulators (including the CFTC and SEC), an insurance expert appointed by the President, and state regulators.

51 Under the proposed rules, in determining whether a Clearing Agency should be considered a Covered Clearing Agency, the SEC may have regard to whether the Clearing Agency clears products that are correlated with participant defaults or have discrete jump-to-default price changes, and whether the Clearing Agency is deemed systematically important in jurisdictions other than the US.

52 The CFTC supervises the remaining two Securities Clearing Agencies.

53 A list of CCPs authorised to provide services in the EU is available at <http://www.esma.europa.eu/page/Registries-and-Databases>.

54 ESMA (2013), *Discussion Paper: The Clearing Obligation under EMIR*, July. Available at <https://www.esma.europa.eu/consultation/Discussion-Paper-Clearing-Obligation-under-EMIR>.

Based on preliminary analysis of broad asset classes against these factors, ESMA concluded that it would be likely to focus on interest rate and credit derivatives. This conclusion is supported by the fact that these asset classes are subject to clearing obligations in other jurisdictions.

The discussion paper considered a number of other relevant matters, including: criteria for determining when contracts entered into prior to the effective date of a clearing obligation must be centrally cleared (known as 'frontloading'); counterparty classification; criteria for determining phase-in periods and the minimum time necessary for phase-in; considerations for covered bonds; considerations specific to delivery risk for foreign exchange contracts; and the interaction of portfolio compression and a clearing obligation.

The consultation period for the discussion paper closed on 12 September 2013, and ESMA has published the responses received.[55] Following the authorisation of NASDAQ OMX, ESMA can now draw on responses to the discussion paper to consult on draft Regulatory Technical Standards to support mandatory clearing obligations. Following that consultation, ESMA will submit the Regulatory Technical Standards to the EC, which will have three months to endorse the Standards. The Standards will become effective following a non-objection period by the European Parliament and EC and publication in the Official Journal.

Risk mitigation

As of 15 September 2013, all EU counterparties were required to comply with EMIR requirements regarding portfolio reconciliation, portfolio compression and dispute resolution. This marks the final phase-in date for risk mitigation techniques prescribed by EMIR.

Trade reporting

Mandatory trade reporting began in the EU on 12 February 2014; the obligation was triggered by ESMA's registration of the first TRs under EMIR and came into force 90 days later. Under the EU's mandatory trade reporting obligation, all EU counterparties must report all their derivatives trades – including trades in exchange-traded derivatives – to a recognised TR. To date, ESMA has recognised six TRs: CME Trade Repository, DTCC Derivatives Repository, ICE Trade Vault, Krajowy Depozyt Papierów Wartosciowych, Regis-TR and UnaVista.[56]

Cross-border scope

In February 2014, the EC endorsed ESMA's draft Regulatory Technical Standards that define the cross-border scope of the clearing and risk mitigation obligations under EMIR.[57] The regulatory standards are designed to prevent risks from OTC derivatives contracts entered into by non-EU counterparties being imported into the EU, and prevent evasion of EMIR rules. An important clarification is the definition of transactions that have a 'direct, substantial and foreseeable effect' within the EU.

Broadly, an OTC contract is deemed to have a direct, substantial and foreseeable effect within the EU – and therefore need to comply with clearing and risk mitigation requirements – when at least one of the following conditions is fulfilled:

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55 Responses are available at <http://www.esma.europa.eu/consultation/Discussion-Paper-Clearing-Obligation-under-EMIR#responses>.

56 A list of trade repositories registered with ESMA is available at <http://www.esma.europa.eu/content/List-registered-Trade-Repositories>.

57 EC (2014), *Commission Delegated Regulation No 285/2014 Supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to Regulatory Technical Standards on Direct, Substantial and Foreseeable Effect of Contracts within the Union and to Prevent the Evasion of Rules and Obligations*, February. Available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2014:085:0001:0003:EN:PDF >.

- At least one of the non-EU counterparties is guaranteed by an EU-based financial counterparty. The guarantee must cover at least €8 billion of notional principal outstanding of the non-EU entity and represent more than 5 per cent of the OTC derivatives exposure of the EU-based guarantor entity.
- Two EU branches of non-EU-based financial counterparties enter into an OTC contract, provided that both non-EU-based counterparties, if established in the EU, would be within EMIR's regulatory scope.
- It is deemed that a contract is designed to evade the 'object, spirit or purpose' of EMIR.

Basel III Implementation

The EU's Basel III implementation – the *Capital Requirements Regulation* (CRR) and the *Capital Requirements Directive IV* – entered into force on 28 June 2013 and 17 July 2013, respectively.[58] Entities have had to comply with most parts of the regulation since 1 January 2014 and member states were to implement the directive by 31 December 2013.

One aspect of CRR that has yet to come into effect is capital requirements for bank exposures to CCPs. From 15 June 2014, EU banks will need to hold capital against their exposures to CCPs. If a CCP is recognised under EMIR, it is classified as a qualifying CCP under CRR and receives more favourable capital treatment. As discussed in Section 2.6, for non-EU CCPs an Implementing Act that gives effect to a positive equivalence decision with respect to CCP regulation is a precondition for recognition. If there are delays in either the recognition or equivalence process the EC has some flexibility to delay the introduction of the capital requirements for exposures to CCPs.

Trading

On 14 January 2014, the EC, European Parliament and European Council agreed on a draft for the *Markets in Financial Instruments Regulation* (MiFIR), which will implement the G20 commitment on trade execution. This regulation is accompanied by the *Markets in Financial Instruments Directive* (MiFID II) which sets out the regulatory framework for trading platforms.[59] MiFID II is not expected to be implemented before 2015.

Broadly, MiFID II introduces a new type of trading venue – Organised Trading Facilities (OTFs) – for non-equity financial instruments which will operate alongside existing Regulated Markets and MTFs. Derivatives that are eligible for clearing under EMIR and deemed to be 'sufficiently liquid' will be required to be traded on an OTF, an MTF or a Regulated Market. All three market types will be subject to pre- and post-trade transparency requirements. MiFID II also introduces and builds on a number of other market structure reforms outside of the OTC derivatives market, including the introduction of a European consolidated tape, regulations for dark pools and algorithmic trading, best execution requirements, and position limits and trading bans for commodities.

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58 *Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on Prudential Requirements for Credit Institutions and Investment Firms* and *Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on Access to the Activity of Credit Institutions and the Prudential Supervision of Credit Institutions and Investment Firms*. Available at <http://eur-lex.europa.eu/JOHtml.do?uri=OJ:L:2013:176:SOM:EN:HTML>.

59 A directive must be transposed in to the national law of EU member states before it has effect in that jurisdiction; a regulation has immediate effect across all member states.

3.3.3 Other jurisdictions

Canada

In November 2013, Ontario, Quebec and Manitoba published harmonised, province-specific rules to support trade reporting obligations.

In December 2013, the Canadian Securities Administrators published, for consultation, a proposed framework for mandatory central clearing obligations. Consultation on the rules closed 19 March 2014.[60]

Hong Kong

The Hong Kong authorities published the results of consultations on mandatory clearing obligations for certain non-deliverable foreign exchange forwards and interest rate swaps.[61] The relevant legislation to provide a regulatory framework for mandatory clearing obligations was tabled in July 2013 and the regime is expected to take effect from mid 2014.

The Financial Services and the Treasury Bureau, the Hong Kong Monetary Authority, the Securities and Futures Commission and the Insurance Authority have also consulted on a resolution regime for financial institutions, including FMIs. The consultation runs for three months and closes on 6 April 2014.[62]

Japan

In November 2012, a Japanese Government ordinance took effect requiring the central clearing of yen-denominated interest rate derivatives referencing the Yen London Interbank Offered Rate (LIBOR) and credit derivatives referencing Japanese indices (i.e. the iTraxx Japan Index Series). This mandatory clearing requirement currently applies to transactions between large domestic financial institutions that are members of the Japan Securities Clearing Corporation (JSCC). The Japanese Financial Services Agency is considering whether the central clearing requirements should be applied to a wider group of transactions or entities.

The JSCC plans to launch an OTC client clearing service in 2014.

Singapore

Singapore's licensing regime for TRs and CCPs came into force in August 2013. Following a consultation period, the Monetary Authority of Singapore finalised regulations for mandatory trade reporting in October 2013. During the initial phase of the regime, banks, other financial entities and significant non-financial holders of derivatives will have to report all interest rate and credit derivatives transactions.[63] Reporting begins in April 2014 for banks, in July 2014 for other financial entities and in October 2014 for significant derivative holders.

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60 Canadian Securities Administrators (2013), *CSA Staff Notice 91-303 – Proposed Model Provincial Rule on Mandatory Central Counterparty Clearing of Derivatives*, December. Available at <http://www.osc.gov.on.ca/documents/en/Securities-Category9/csa_20131219_91-303_mandatory-counterparty-clearing-derivatives.pdf>.

61 The Hong Kong Monetary Authority and the Securities and Futures Commission (2013), *Joint Supplemental Consultation Conclusions on the OTC Derivatives Regime in Hong Kong – Proposed Scope of New/Expanded Regulated Activities and Regulatory Oversight of Systemically Important Participants*, September. Available at <https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=12CP2>.

62 The Financial Services and the Treasury Bureau, the Hong Kong Monetary Authority, the Securities and Futures Commission and the Insurance Authority (2014), *Consultation Paper on an Effective Resolution Regime for Financial Institutions in Hong Kong*, January. Available at <http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/doc?refNo=14CP1>.

63 Those with greater than SG$8 billion of gross notional outstanding across interest rate and credit derivatives.

4. Assessment and Recommendations

4.1 Introduction

Under Part 7.5A of the Corporations Act, the responsible Minister may issue a determination that mandatory trade reporting, central clearing or platform trading obligations should apply to a specified class or classes of derivatives. In making the decision to issue a determination, the Minister must take into account the advice of the Regulators. This Chapter contains the Regulators' assessment of the case for further mandatory obligations.

In conducting their assessment, the Regulators have drawn on both quantitative and qualitative information. The Regulators continued to monitor developments through ongoing discussions with market participants and financial market infrastructure providers and, as in previous assessments (in July 2013, October 2012 and May 2009), have also been informed by surveys of market participants' OTC derivatives market activities and practices, in this case administered in late 2013.

4.1.1 Surveys

For this report the Regulators conducted two surveys: a survey of dealers and a non-dealer survey. The survey of dealers active in the Australian market (referred to collectively as 'Australian dealers') focused on Australian dollar-, US dollar-, euro-, British pound- and Japanese yen-denominated interest rate derivatives, as well as certain North American, European and Japanese referenced credit index derivatives. In addition, respondents were asked about their level of engagement with CCPs that clear OTC derivatives, their use of trade execution infrastructure and their risk management practices for non-centrally cleared trades. The non-dealer survey focused on the nature of non-dealers' OTC derivatives activity across all asset classes, as well as their activity in products that are currently subject to overseas mandates. It also sought information on their experience of central clearing and the implications of moving to central clearing for their business, including any costs, risks and operational challenges.

To supplement the surveys, the Regulators held meetings with a representative sample of dealers and non-dealers. In addition to data from the survey, the assessment draws on OTC derivatives market data collected and published by AFMA, the BIS, CME, DTCC, LCH.C Ltd and the RBA.

4.2 Central Clearing

4.2.1 Scope and prioritisation

Consistent with the May 2013 *Statement on Assessing the Case for Mandatory Clearing Obligations* (the Statement), the Regulators have prioritised products for consideration based on the potential benefits from central clearing, taking into account whether the product is already under a clearing obligation in another jurisdiction.[64] Currently, the only clearing mandates in effect are the CFTC's mandate and Japanese requirements. The CFTC's mandate applies to interest rate derivatives denominated in US dollars, euros, British pounds and Japanese yen, as well as North American and European referenced credit index derivatives. The Japanese requirements relate to trades between Japanese financial institutions in Japanese yen-denominated interest rate derivatives and Japanese referenced credit index derivatives. While the product scope of mandatory clearing requirements under EMIR has yet to be determined, ESMA has signalled that the first such obligations are likely to apply to interest rate and credit derivatives (see Section 3.3.2).

In line with the Regulators' July 2013 recommendations, in February 2014 the government launched a consultation on a central clearing mandate for US dollar-, euro-, British pound- and Japanese yen-denominated interest rate derivatives for trades between dealers with significant cross-border activity in these products. The consultation closes on 10 April. In the last Report, the Regulators also committed to continuing to monitor Australian-headquartered dealers' progress in establishing appropriate clearing arrangements for Australian dollar-denominated interest rate derivatives before recommending mandatory central clearing of Australian dollar-denominated interest rate derivatives. While the Regulators did not recommend mandatory clearing of North American and European referenced credit index derivatives, they undertook to revisit this recommendation.

Accordingly, the Regulators have:

- reviewed the case for mandatory clearing of Australian dollar-denominated interest rate derivatives
- assessed whether, in the absence of an Australian mandate for North American and European referenced credit index derivatives, there is evidence of regulatory arbitrage
- analysed Australian activity in Japanese referenced credit index derivatives, given mandatory clearing requirements for these products in Japan
- undertaken further work to understand the incremental costs and benefits of extending a central clearing mandate to non-dealers.

Benefits from central clearing

The potential benefits of central clearing will reflect the level of trading activity in a particular derivatives product, its characteristics and the profile of participation in the market. Activity in the Australian market continues to be concentrated in single-currency interest rate derivatives and foreign exchange derivatives, including cross-currency swaps. This is reflected in the composition of Australian banks' OTC derivatives positions (Table 2).

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[64] APRA, ASIC and RBA (2013), *Australian Regulators' Statement on Assessing the Case for Mandatory Clearing Obligations*, May. Available at <http://www.cfr.gov.au/publications/cfr-publications/australian-auth-statmnt-mandatory-clearing-obligations.html>.

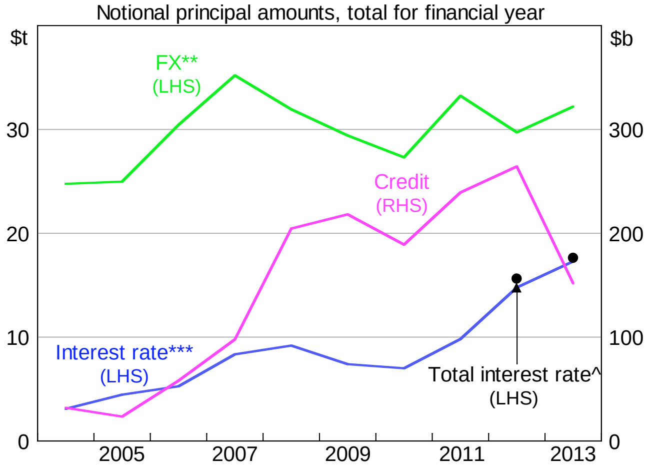
Table 2: Australian Banks' OTC Derivatives Outstanding[(a)]
As at end June 2013

	Notional principal[(b)]		Gross market value[(c)]	
	Value (US$ billion)	Share (per cent)	Value (US$ billion)	Share (per cent)
Single-currency interest rate	7 853	64.5	171	44.7
Foreign exchange[(d)]	4 039	33.2	197	51.4
Credit	150	1.2	2	0.5
Commodities	111	0.9	11	2.8
Equity	26	0.2	3	0.7

(a) Positions reported by Australian banks to the RBA for the BIS semiannual survey; this is a narrower scope than the Regulators' survey and does not exactly align with Australian-headquartered dealers
(b) Notional principal is the reference amounts from which contractual payments are determined in derivatives markets
(c) Gross market value is the sum of the absolute values of all open contracts with either positive or negative replacement values evaluated at market prices prevailing on the reporting date
(d) Includes cross-currency swaps and gold
Sources: BIS; RBA

Turnover across both domestic and foreign participants in the Australian market is also concentrated in interest rate and foreign exchange derivatives (Graph 1). Foreign exchange contracts tend to have a shorter duration, and therefore it is not unexpected that the turnover of these contracts is higher than that of interest rate derivatives. However, while turnover of foreign exchange derivatives has been relatively consistent across the last decade, the turnover of interest rate derivatives has increased over the same period.

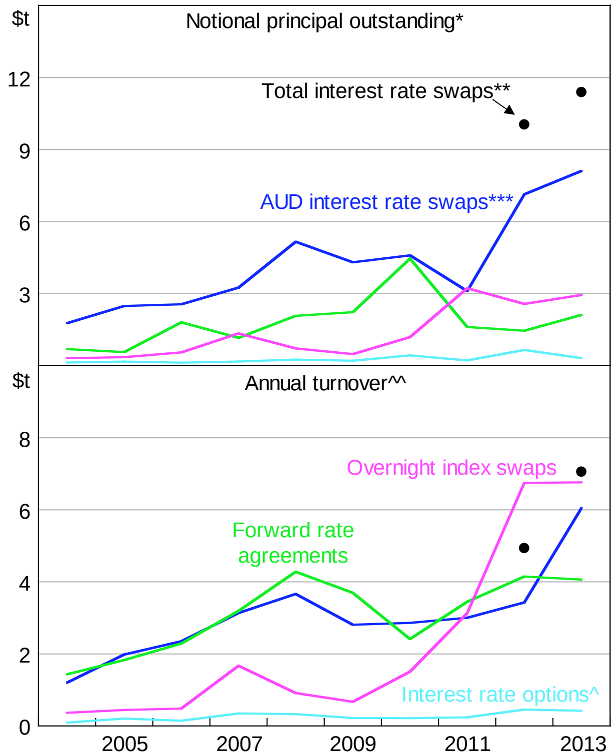
Graph 1
Australian OTC Derivatives Market Turnover*
Notional principal amounts, total for financial year



* Excludes in-house transactions
** FX forwards, swaps and options
*** Includes single- and cross-currency AUD interest rate swaps, forward rate agreements, overnight index swaps and interest rate options
^ Also includes non-AUD single- and cross-currency swaps; not collected before 2011/12
Source: AFMA

Both turnover and the notional principal outstanding of interest rate derivatives continue to increase across most product types (Graph 2). Interest rate swaps continue to be the largest product type among interest rate derivatives and account for just under 70 per cent of the notional principal outstanding of interest rate derivatives in the Australian market, based on AFMA data.

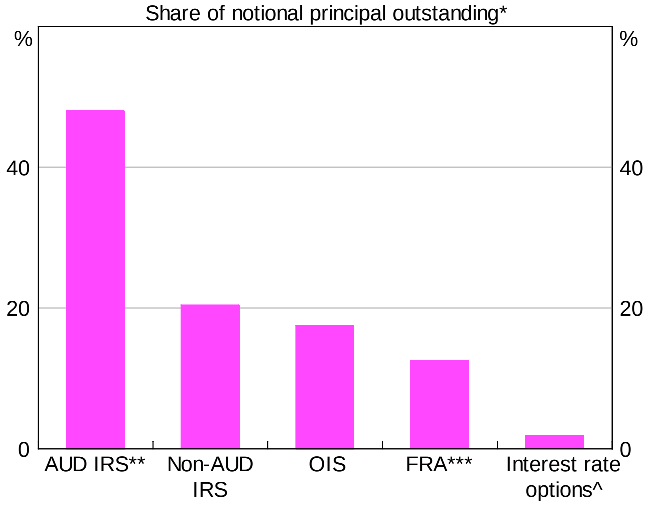
Graph 2
Australian OTC Interest Rate Derivatives Market



* As at end May; excludes in-house transactions; OIS prior to 2012 includes in-house transactions
** Includes non-AUD single- and cross-currency swaps; not collected before 2011/12
*** Includes AUD single- and cross-currency swaps
^ Includes swaptions, bond options and caps/floors
^^ Total for financial year, excludes in-house transactions
Source: AFMA

In terms of the currency breakdown of interest rate derivatives in the Australian market, single-currency Australian dollar-denominated interest rate swaps account for just under half of the notional principal outstanding of interest rate derivatives (including cross-currency swaps) (Graph 3). Cross-currency swaps with an Australian dollar-denominated leg account for a further 10 per cent, and almost 95 per cent of these cross-currency swaps have floating Australian dollar legs, reflecting the widespread use of these derivatives to hedge offshore funding. The remaining third are non-Australian dollar-denominated interest rate swaps; this includes cross-currency swaps without an Australian dollar leg.

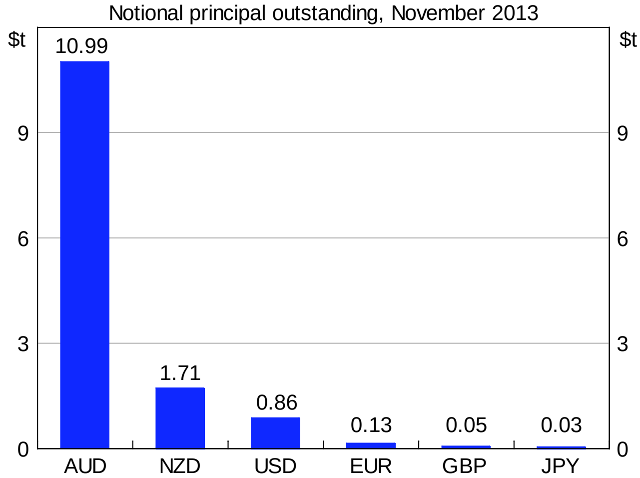
Graph 3
Australian OTC Interest Rate Derivatives Market
Share of notional principal outstanding*



* Of all interest rate derivatives, as at end May; excludes in-house transactions except for FRA
** Includes single- and cross-currency IRS with an AUD-denominated leg
*** Includes AUD and non-AUD denominated FRAs
^ Includes swaptions, bond options and caps/floors
Source: AFMA

Survey data suggest that Australian dollar-denominated interest rate swaps are also the largest category of clearable interest rate swap, by notional principal outstanding, among dealers in the Australian market (Graph 4). This holds for both Australian- and overseas-headquartered dealers in the Australian market, which may reflect foreign participants consolidating trading activity such that the Australian-based entity is primarily responsible for activity in Australian products.

Graph 4
Australian Dealers' Centrally Clearable Interest Rate Derivatives
Notional principal outstanding, November 2013



Source: Regulators' survey

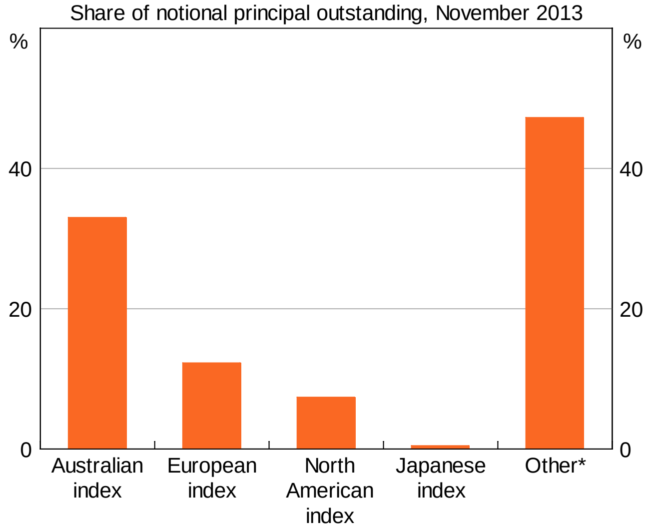
The Australian dollar-denominated interest rate swaps market is largely an interbank market, with trading concentrated among the dealers. The largest eight respondents in the AFMA survey account for around 86 per cent of market activity in interest rate swaps; this share has fluctuated between 86 and 95 per cent across the last decade. The scope of AFMA's survey is broadly the same as the Regulators' dealer survey.

As Table 2 above shows, credit derivatives constitute a much smaller proportion of Australian market activity. Survey responses suggest that there is less than $500 billion in notional principal outstanding of credit derivatives held by dealers active in the Australian market.[65] Around 20 per cent of this relates to derivatives referenced to North American, European or Japanese indices (Graph 5). However, only a very small share of this activity involves Australian-headquartered dealers. Similarly, while around a third of the notional principal outstanding of credit derivatives held by dealers active in the Australian market references the iTraxx Australian index, activity in these products is dominated by overseas-headquartered entities.

Graph 5

Australian Dealers' Credit Derivatives

Share of notional principal outstanding, November 2013



* Includes single-name credit derivatives and other credit index derivatives
Source: Regulators' survey

Assessment

Based on the data presented above, and consistent with the conclusion of the July 2013 Report, the Regulators believe there are strong in-principle benefits from central clearing of Australian dollar-denominated interest rate derivatives, certain foreign exchange derivatives, cross-currency swaps, and potentially Australian referenced credit index derivatives.

Consistent with the May 2013 Statement, the Regulators have also prioritised their assessment of products where an overseas regulator has introduced a mandate and there is material activity in the Australian market. The Regulators have identified material activity in US dollar-, euro-, British pound- and Japanese yen-denominated interest rate derivatives, collectively; and North American and European and Japanese referenced credit index derivatives, collectively.

Preconditions for central clearing

In the Statement, the Regulators identified a number of preconditions that must be satisfied in order for a CCP to clear a product safely and reliably:

- the product must have a robust valuation methodology so that the CCP can confidently determine margin and default fund requirements
- there must be sufficient liquidity in the market to allow for close out and/or hedging of outstanding positions in a default scenarios

[65] The Regulators' survey covered a much wider range of institutions than the BIS data presented in Table 2; the transactions captured by the Regulators' survey that are not reported in Table 2 would have been reported to other central banks for the BIS survey.

- there must be sufficient transaction activity and participation so that the fixed and variable costs of clearing the transaction can be covered
- there must be some standardisation of contracts to facilitate the CCP's trade processing arrangements.

These preconditions are consistent with those agreed internationally. Since the Australian dollar-denominated interest rate derivatives and the North American, European and Japanese referenced credit index derivatives under consideration by the Regulators are currently being cleared safely and reliably by CCPs, the Regulators consider that these products meet the preconditions for central clearing.

As noted in the previous Report, in the case of foreign exchange derivatives and cross-currency swaps, in addition to meeting the preconditions identified above, a central clearing solution must develop a link to an appropriate mechanism for managing the settlement risk associated with the exchange of payments in two currencies.[66] Financial markets have devoted increasing attention to this issue. CLS Bank International – which operates a payment-versus-payment settlement system for foreign exchange transactions – has given priority to working with banks and CCPs to facilitate the settlement of centrally cleared foreign exchange derivatives. In addition, LCH.C Ltd has announced its intention to clear deliverable foreign exchange options. Market participants are also looking to better understand how central clearing of foreign exchange derivatives would be implemented in practice.

In November 2013, the Global Financial Markets Association published a study that provides further insight on size and nature of the same-day liquidity risk if the deliverable foreign exchange options market were centrally cleared.[67] Notwithstanding these developments, it is unlikely that the central clearing of foreign exchange derivatives will be implemented in the near-term. Accordingly, while there would be in-principle benefits to central clearing of these products, these products have not been prioritised in this assessment.

Similarly, while central clearing of Australian-referenced credit index derivatives may be beneficial, no CCP currently offers clearing of these products. The Regulators have nevertheless sought information on market participants' activities in credit derivatives referencing the iTraxx Australian index, focusing on the seven most recent series. Globally, activity in credit derivatives referencing the iTraxx Australia index is very small compared with that in North American and European referenced credit index derivatives (Table 3).

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66 For further discussion of cross-currency swaps in Australia, see Arsov I, G Moran, B Shanahan and K Stacey (2013), 'OTC Derivatives Reforms and the Australian Cross-currency Swap Market', RBA *Bulletin*, June, pp 55–63. Available at <http://www.rba.gov.au/publications/bulletin/2013/jun/7.html>.

67 The GFMA study found that the same-day liquidity shortfall from the default of two participants in the foreign exchange options would be as high as $161 billion across 17 currencies if transactions were settled on a gross basis, and $44 billion if transactions were settled on a net basis. If a CCP cleared all of the transactions in this market, the Principles would require it to have access to liquidity to cover such a shortfall. A slide presentation on the 'OTC FX Options Clearing and Settlement Analysis Results' is available at <http://www.gfma.org/uploadedFiles/Initiatives/Foreign_Exchange_(FX)/GFXDOTCFXOptionsAnalysisResults2013Nov18(1).pdf>.

Table 3: Global Activity in Credit Index Derivatives

As at end February 2014

Index referenced	Notional principal Share (per cent)
iTraxx Europe (untranched)	32.3
CDX North American Investment Grade (untranched)	22.8
iTraxx Europe Senior Financials	5.9
CDX North American High Yield	4.5
iTraxx Japan	0.8
iTraxx Australia	0.9

Source: DTCC

Activity in credit derivatives referencing the iTraxx Australia index is also spread across a number of different series – as the index is recalculated every six months – with each of the seven most recent series accounting for between 9 and 24 per cent of the notional principal outstanding held by dealers active in the Australian market. However, notional principal outstanding of iTraxx Australia credit index derivatives is not a direct measure of liquidity or transaction activity, which are the key considerations when assessing whether this product class meets the preconditions for central clearing. The Regulators understand that the turnover in these products fluctuates significantly depending on underlying market conditions. There is also evidence of some seasonality with turnover increasing every six months when the index is recalculated. Consequently, the Regulators would need to be convinced that there was sufficient liquidity and transaction activity in these products before concluding that it reliably met the preconditions for central clearing.

4.2.2 Australian dollar-denominated interest rate derivatives

In the July 2013 Report, the Regulators decided to monitor for a further period Australian banks' (i.e. Australian-headquartered dealers') progress in implementing appropriate clearing arrangements for Australian dollar-denominated interest rate derivatives, before recommending mandatory central clearing. This Section reassesses the case for recommending a mandatory clearing obligation for Australian dollar-denominated interest rate derivatives. In so doing, it uses the framework articulated in the Statement, examining the implications of a mandated transition to clearing for the Australian financial system and participants, as well as considerations around international consistency.

Implications of mandating for the Australian financial system and participants

Consistent with the Statement, in assessing the implications for the Australian financial system and participants of mandatory clearing of Australian dollar-denominated interest rate derivatives the Regulators have considered:

- The availability or accessibility of central clearing of Australian dollar-denominated interest rate derivatives, whether as direct participants or as clients.
- Whether participants have already established appropriate commercial and operational arrangements with CCPs or whether such arrangements are still under negotiation for particular types of participants.
- The extent to which market participants are already centrally clearing Australian dollar-denominated interest rate derivatives.

- Evidence of commercial pressure or regulatory incentives to centrally clear Australian dollar-denominated interest rate derivatives.

This Section focuses on the implications for dealers in the Australian market, since the Regulators stated in the July 2013 Report that the initial scope of such a mandate would be likely to be the interdealer market. The Regulators' consideration of non-dealer clearing is presented in Section 4.2.4.

Currently, one domestic CCP – ASX Clear (Futures) – and one overseas CCP – LCH.C Ltd – are licensed in Australia to admit Australian-based institutions as direct participants to clear Australian dollar-denominated interest rate derivatives. CME also clears these derivatives, but is not yet licensed in Australia. A number of domestic participants have nevertheless established client clearing arrangements that allow them to clear trades through CME via foreign banks that are participants in this service.

The ASX Clear (Futures) OTC clearing service currently has eight clearing participants, including four Australian-headquartered dealers, and clears dealer-to-dealer Australian dollar-denominated interest rate derivatives. Since it was granted a licence in Australia, two Australian-headquartered dealers have joined LCH.C Ltd as direct clearing participants. The other Australian-headquartered dealers have client clearing arrangements, which allow them to clear trades through LCH.C Ltd.

The establishment of direct clearing arrangements is important because, as discussed in the July 2013 Report, client clearing is an inefficient means for Australian-headquartered dealers to clear Australian dollar-denominated interest rate derivatives. A particular disadvantage of client clearing for Australian-headquartered dealers is the exposure limits some clearing agents place on Australian-headquartered dealers' often directional Australian dollar-denominated interest rate derivatives business.

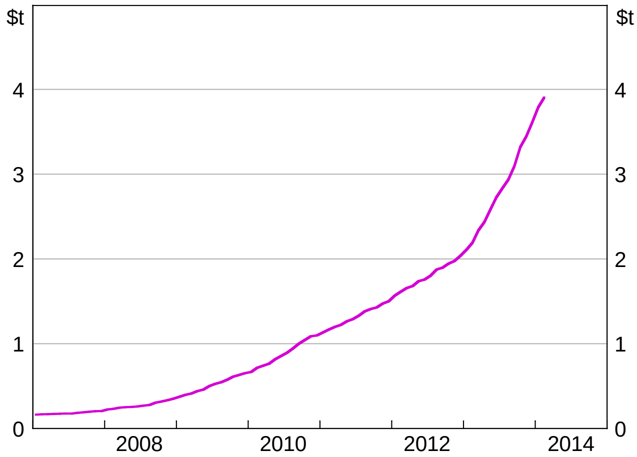
Since the July 2013 Report, the transition to central clearing of Australian dollar-denominated interest rate derivatives has continued to accelerate. While survey data suggest dealers have cleared only 22 per cent of their total notional principal outstanding in these products, the proportion of new transactions submitted to clearing is much higher. Indeed, many dealers in the Australian market are reportedly centrally clearing almost all new interdealer trades that are eligible for clearing.

While new interdealer trades are being centrally cleared, there remains a substantial value of older trades that have not been 'backloaded' into CCPs. Industry liaison suggests that market participants intend to compress these outstanding trades to minimise the capital they are required to hold to meet the Basel III leverage ratio (discussed in Section 3.2.6) before they backload the remaining trades into CCPs. Compression will allow market participants to reduce notional principal outstanding by simultaneously terminating offsetting trades against counterparties while retaining a desired market-facing risk position. As a result, market participants will have fewer trades to backload into CCPs.

By mid January 2014, ASX Clear (Futures) had cleared around $5 billion of Australian dollar-denominated interest rate derivatives. The notional principal outstanding of these derivatives at offshore CCPs had increased to A$3.9 trillion as of end February 2014 (Graph 6).[68] This growth reflects increased clearing by both domestic and foreign bank participants of LCH.C Ltd and CME. Australian-based participants' notional principal outstanding at LCH.C Ltd, across all OTC interest rate derivatives, has almost doubled since July 2013 (Graph 7).

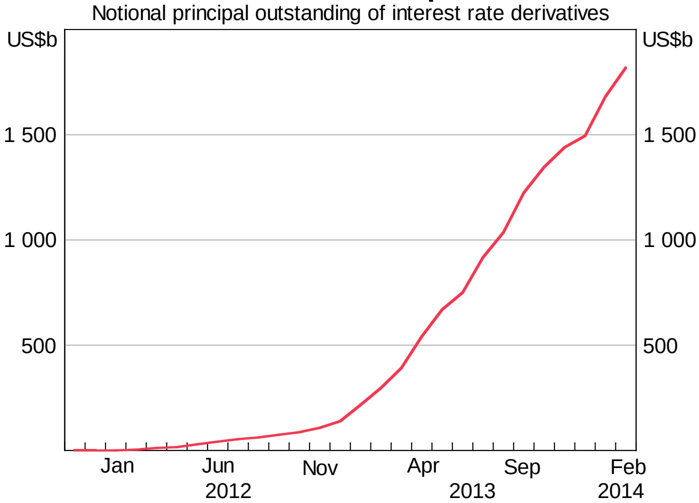
68 The relevant offshore CCPs publish further data on centrally cleared interest rate derivatives on their respective websites, CME <http://www.cmegroup.com/trading/interest-rates/cleared-otc/#data> and LCH.C Ltd <http://www.swapclear.com/what/clearing-volumes.html>.

Graph 6
AUD Interest Rate Derivatives Cleared at Offshore CCPs
Notional principal outstanding*



* CCP figures adjusted for the double counting that occurs when a trade is novated
Sources: CME; LCH.C Ltd/SwapClear

Graph 7
Clearing at LCH.Clearnet Limited by Australian Participants*
Notional principal outstanding of interest rate derivatives



* Total outstanding for Australian entities; to the extent that trades are between these entities, they will be counted twice
Source: LCH.C Ltd/SwapClear

The observed increase in central clearing of Australian dollar-denominated interest rate derivatives is partly in anticipation of mandatory requirements. In addition to the strong signal from the Regulators in their July 2013 Report, many dealers anticipate that Australian dollar-denominated interest rate derivatives will eventually be subject to overseas mandates. While this has encouraged many dealers to establish arrangements to facilitate central clearing, commercial incentives have to date been an even stronger driver of the transition to central clearing. Industry feedback suggests that liquidity in the interdealer market for interest rate derivatives across a range of currencies has moved to central clearing. This move has been driven by dealers seeking to maximise operational and netting efficiencies, and minimise capital requirements, by channelling clearable interest rate derivatives through CCPs. These dealers are either unwilling to trade such interest rate derivatives with other dealers unless they will be centrally cleared, or are demanding a materially higher price for non-centrally cleared interest rate derivatives.

International consistency

In accordance with the Corporations Act, the Regulators have also considered relevant international standards and international commitments. The Statement identified three international consistency considerations: the potential for regulatory arbitrage; equivalence or comparability of the Australian regime; and unintended consequences from overseas requirements.

While Australian dollar-denominated interest rate derivatives are not currently subject to mandatory clearing in any overseas jurisdiction, it is anticipated that overseas jurisdictions will consider such a mandate in the near future. In such an event, the Regulators would expect to be consulted by the relevant agencies from that jurisdiction, and would seek to coordinate the implementation to achieve a smooth transition to mandatory clearing.

Should an overseas jurisdiction consider introducing such a mandate, an equivalent Australian mandate could materially lower the cost of compliance for Australian participants, and possibly allow the Regulators to tailor requirements to the Australian market to avoid unintended consequences (within the scope of the ODRG's agreement on the stricter rules approach, see Section 3.2.2).

Recommendation and further considerations

The Regulators have repeatedly noted that there would be a substantial financial stability benefit from increased central clearing of Australian dollar-denominated interest rate derivatives. To date the Regulators have not recommended imposing a mandatory clearing obligation, being of the view that regulatory and commercial incentives would eventually be effective in encouraging the industry to transition to central clearing. They nevertheless acknowledged in their July 2013 Report the benefit of adopting an approach that was consistent with that of overseas regulators, who are proceeding with mandatory clearing across a range of instrument classes. Accordingly, the Regulators signalled that they would consider recommending a mandate in the current market assessment.

In July 2013, the Regulators did not recommend mandatory clearing of these products, so as not to interfere with Australian-headquartered dealers' commercial negotiations with CCPs or otherwise disrupt the ongoing transition to central clearing. Instead, the Regulators took the decision to allow Australian-headquartered dealers further time to establish operational arrangements with CCPs before making any such recommendation. Since July, as anticipated, good progress has been made by Australian-headquartered dealers in establishing direct clearing arrangements with ASX Clear (Futures) and LCH.C Ltd.

> **Having monitored Australian-headquartered dealers' progress in implementing appropriate clearing arrangements, the Regulators are satisfied that the incremental cost of mandatory central clearing of Australian dollar-denominated interest rate derivatives would be very low for trades between internationally active dealers in the Australian market. Consequently, it is recommended that the government consider a central clearing mandate for trades between internationally active dealers in Australian dollar-denominated interest rate derivatives.**

Should the government accept this recommendation, the government and ASIC would determine the timing and other aspects of implementing such a mandate in consultation with market participants and other stakeholders.

4.2.3 North American, European and Japanese referenced credit index derivatives

Given the CFTC's and Japanese mandates, this assessment again considers the case for mandating central clearing of North American, European and Japanese referenced credit index derivatives.

Implications of mandating for the Australian financial system and participants

North American, European and Japanese referenced credit index derivatives are currently being cleared by CCPs based in the US, Europe and Japan, respectively. However, few dealers that are active in the Australian market have either direct or indirect arrangements with any of these CCPs to clear these products. This reflects that relatively few dealers in the Australian market trade these products. Furthermore, since no CCP that clears these credit derivatives yet has the appropriate regulatory approval to operate in the Australian market, client clearing is currently the only option available for domestic participants. Client clearing is not currently available to access the JSCC, the only CCP that currently clears Japanese referenced credit index derivatives.

The liquidity, price and cost incentives to centrally clear considered in the case of Australian dollar-denominated interest rates derivatives also apply for North American, European and Japanese referenced credit index derivatives. However, given the mandatory obligation to clear Japanese referenced credit index derivatives only applies to trades between Japanese financial institutions, these incentives are expected to have less of an effect on participants in the Australian market.

Despite these commercial incentives and overseas regulatory requirements, to date less than 10 per cent of clearable North American, European and Japanese referenced credit index derivatives traded in the Australian market has been centrally cleared. In part, this reflects that trades in these products that were executed prior to the introduction of overseas mandatory clearing requirements have not yet been backloaded into CCPs. It is likely that a much higher proportion of new trades is centrally cleared. Consequently, this proportion is expected to increase; particularly if these products also become subject to mandatory clearing under EMIR.

International consistency

International consistency is a key consideration in assessing the case to recommend a domestic clearing mandate for North American, European and Japanese referenced credit index derivatives. These products are subject to mandates in both the US and Japan. It is also expected that at least some of these products will be considered for mandatory clearing by ESMA and the EC (see Section 3.3.2).

As previously described, the Regulators have considered three matters relevant to international consistency. Each of these is addressed in turn.

Regulatory arbitrage

One of the international consistency considerations is that in the absence of broadly harmonised requirements, there may be potential for regulatory arbitrage or other distortions in market participants' choice as to where to conduct business or book trades. In part, this risk is expected to be addressed by the cross-border application of overseas mandates, acknowledging that the ODRG is still considering the application of clearing requirements to foreign branches and affiliates.

Even where Australian participants will not be directly subject to overseas mandates, if they wish to continue trading with many of their international counterparties the only option will be to centrally clear such trades. Survey data indicate that most outstanding transactions in these products involve at least one EU- or US-headquartered counterparty. This suggests that there would be limited risk of regulatory arbitrage if a domestic mandate was not introduced. Nevertheless, the Regulators would be concerned if evidence of regulatory arbitrage emerged and recognise that imposing a domestic mandate should entirely remove any scope for such arbitrage.

Equivalence or comparability
Under certain circumstances, the CFTC and European authorities will recognise compliance with Australian rules as equivalent to compliance with their own requirements. This could lower the cost of compliance for Australian participants.

Currently, in the absence of a comparable domestic mandate, the CFTC requires registered Swap Dealers and other participants in the Australian market to comply with its mandatory clearing requirements when trading with US persons or guaranteed affiliates. Also, while the EU has yet to implement mandatory clearing requirements, ESMA has advised the EC to adopt an Implementing Act that recognises the equivalence of Australian mandatory clearing obligations only if a trade that will be subject to the EU's clearing obligation is also subject to a clearing obligation in Australia. Otherwise, EU rules will apply to trades with EU entities or where the trade has a direct, substantial and foreseeable effect within the EU (see Section 3.2.2).

Recent experience with overseas jurisdictions' assessments of the equivalence or comparability of Australian OTC derivatives regulation suggests that requirements for each product class will be assessed separately. While there may be some benefit to Australian participants from a finding of regulatory equivalence, in the case of North American, European and Japanese referenced credit index derivatives this benefit would be limited by these participants' relatively low level of activity in these product classes.

Unintended consequences of overseas requirements
The final international consistency consideration is possible unintended consequences for Australia, where, in the absence of a domestic mandate, Australian participants were required to comply with overseas regulations. Such unintended consequences could arise due to differences in market structure and market practices. Consistent with the foregoing analysis for Australian dollar-denominated interest rate derivatives, a domestic mandate could permit the Regulators to take account of such differences in their rules (within the scope of the ODRG's agreement on the stricter rules approach). However, the benefit from being able to do so for these products would be limited by Australian participants' low level of activity in these products.

Recommendation and further considerations

In considering the case for imposing a clearing mandate for North American, European and Japanese referenced credit index derivatives, the Regulators have observed a relatively low level of activity in these products among Australian-headquartered dealers.

> **The Regulators do not see a case for implementing a central clearing mandate for North American, European and Japanese referenced credit index derivatives at this time, particularly since most Australian market activity in these products involves at least one EU- or US-headquartered counterparty.**

Consequently, the Regulators believe that, even in the absence of a domestic mandate for these products, the likelihood of regulatory arbitrage is limited. Furthermore, few domestic participants have arrangements in place to clear such products, so the cost of complying with a mandatory clearing requirement for these products could be high in the short term. However, the Regulators will continue to monitor activity and the extent of central clearing in these products. Should this reveal evidence of regulatory arbitrage in the Australian market, the Regulators would revisit this recommendation.

4.2.4 Non-dealers

Survey of non-dealers

In the July 2013 Report, the Regulators committed to doing further work to better understand the incremental costs and benefits of extending any central clearing mandate to non-dealers. To support this work, in late 2013, the Regulators issued a survey to a wide range of non-dealers. The survey sought information on the scale and scope of non-dealers' OTC derivatives activity, their motivation for using OTC derivatives, their counterparty relationships, and their arrangements for counterparty risk management. It also sought information on their experience of central clearing, including incentives to clear (whether due to pricing or the cross-border reach of other jurisdictions' regulations), challenges and constraints in establishing clearing arrangements, and the implications of moving to central clearing for business costs and operational arrangements.

In order to reach a broad range of non-dealers, the Regulators sought the assistance of the Australian Bankers' Association, AFMA, the Alternative Investment Management Association, the Association of Superannuation Funds of Australia, the Finance and Treasury Association, the Financial Services Council and the Insurance Council of Australia in distributing the survey to their members.

In total, 33 responses were received, from the following non-dealer types:

Table 4: Non-Dealer Survey Respondents[a]

	Number
Smaller ADIs	5
Insurance companies and superannuation funds	12
Investment managers[b]	5
Non-financial entities	6
Government agencies	5

(a) To supplement the survey, the Regulators held discussions with a range of non-dealers including hedge funds

(b) Excluding superannuation funds

Source: Regulator's survey

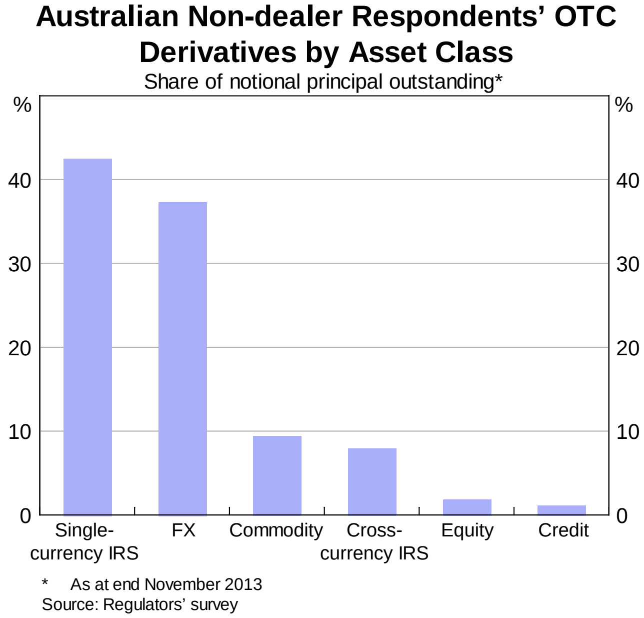
Quantitative survey responses were supplemented with qualitative information obtained in a series of follow-up discussions with a range of non-dealers and industry bodies.

Non-dealer activity

A wide range of non-dealers participate in the Australian OTC derivatives market. Non-dealers include smaller ADIs, insurance companies, superannuation funds, hedge funds, other investment managers, non-financial entities, government debt management agencies and government investment agencies. The latter three categories are generally not required to hold Australian Financial Services Licences.

Non-dealers' OTC derivatives activity is concentrated in foreign exchange and interest rate derivatives, with each accounting for around 40 per cent of total notional principal outstanding across reporting non-dealers (Graph 8). These proportions are reasonably consistent across all types of non-dealer respondents. Smaller ADIs tended to report a larger proportion of interest rate derivatives relative to foreign exchange derivatives, which probably reflects the domestic nature of their assets and liabilities and their relatively limited exposure to foreign markets. The survey suggests that, where used by non-dealers, credit derivatives are predominantly used by investment managers. They nevertheless still account for only a very small proportion of investment managers' OTC derivatives positions. The non-financial entities surveyed tended to be more active in commodity derivatives than other non-dealer respondents.

Graph 8



The above breakdown across asset classes is also consistent with hedging as the primary motivation for non-dealers' usage of OTC derivatives. Non-dealer respondents reported using foreign exchange derivatives to hedge the risks arising from:

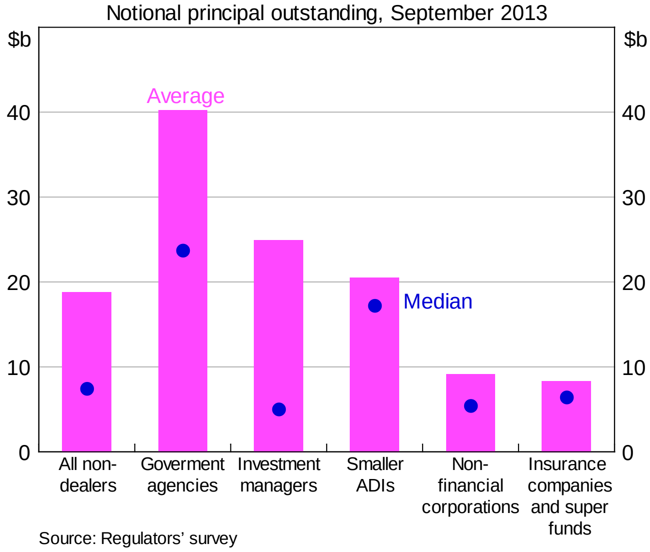
- foreign investments, where the returns need to be repatriated to Australia
- foreign funding, where the repayments are funded from Australian dollar revenue but are denominated in foreign currency
- exports or imports with prices set in foreign currency.

The non-dealers surveyed tend to use interest rate derivatives to manage interest rate risk arising from unmatched assets and liabilities. For example, a non-dealer that issues bonds with a fixed coupon and invests the funds raised in an asset that pays a floating interest rate can use an interest rate derivative to convert the floating rate return into a fixed rate return. This hedges the risk that interest rates fall and the floating rate is insufficient to fund the coupon payments on the bond. There was variation among respondents in the degree to which hedges were tailored; while non-dealers managing a pool of investments or funding often hedged at a portfolio level, others customised OTC derivatives to align with specific dates or reference rates in order to remove price or basis risk. Given the hedging motivation, many non-dealers' OTC derivatives positions are highly 'directional' in nature. That is, unlike dealers who typically engage in offsetting OTC derivatives trades to retain an overall neutral market exposure, or take on smaller net proprietary positions, a non-dealer's OTC derivatives position is generally balanced by the underlying position that it is hedging.

In addition to hedging, some investment managers and hedge funds reported using derivatives to more efficiently gain exposure to an underlying asset or risk. For investment managers, this tends to be a temporary method used to manage cash flows, with these institutions reportedly preferring to invest directly in the underlying asset. An example of using derivatives to manage cash flows is the case of an investment manager that has received a large inflow of funds and uses credit or equity derivatives as an efficient and timely means of gaining the desired exposure before gradually building a position in the underlying securities. In contrast, some hedge funds may use derivatives in preference to investing in the underlying asset. However, industry liaison suggests that only large hedge funds have the scale necessary to make OTC derivatives an efficient method of gaining such exposure. Smaller hedge funds tend to use exchange traded derivatives instead; although it is noted that OTC derivatives could be used to implement more complex strategies.

Based on the survey responses, the average non-dealer respondent's notional principal outstanding across all OTC derivatives is around $20 billion, while the median is approximately $10 billion (Graph 9). The survey responses are expected to have a significant upward bias, as larger non-dealers are more aware of and engaged with the OTC derivatives reforms, and therefore over-represented in the sample. Within this, non-dealer positions in interest rate derivatives average around $9 billion, which is relatively low when compared with the average notional principal outstanding for a dealer in the Australian market, which is around $1.2 trillion. This finding is consistent with AFMA data that suggest activity in the Australian OTC derivatives market is highly concentrated among dealers.

Graph 9
Australian Non-dealer Respondents' OTC Derivatives
Notional principal outstanding, September 2013



Source: Regulators' survey

Non-dealer respondents reported the creditworthiness of their counterparty as one of the most important factors when trading OTC derivatives. All non-dealer respondents managed the credit risk to bilateral counterparties by applying credit limits and diversifying their exposure across counterparties. The median number of counterparties with which survey respondents had documentation was 16, the number of counterparties increasing with the level of a non-dealer's notional principal outstanding of OTC derivatives. Positions were nevertheless often concentrated among a subset of these counterparties.

For those non-dealers with access to sufficient liquid collateral, there are strong price incentives to adopt credit support arrangements that involve the daily exchange of collateral to cover changes in the value of outstanding OTC derivatives positions. While non-financial entities and those simply hedging investments in illiquid assets have generally not adopted such credit support arrangements, other non-dealers have done so.

Implications of mandating for the Australian financial system and participants

Evidence of clearing and incentives to clear

Although central clearing among non-dealers is currently limited, there is evidence that it has increased since the Regulators' July 2013 Report. A small number of large non-dealers have client clearing arrangements in place and are either actively clearing or at least testing these arrangements. Central clearing is most common in products that are subject to the CFTC's mandatory clearing requirements, in part because some non-dealers trade with counterparties that are subject to this mandate.

While industry feedback suggests that currently the majority of non-dealers do not yet face commercial incentives to centrally clear, some have established client clearing arrangements in anticipation either of such commercial incentives eventually emerging, or a clearing mandate being introduced. Indeed, around half of non-dealer respondents expected to be subject to a clearing mandate at some stage. Over three quarters of respondents reported that they were at least currently considering central clearing. As discussed above, since the sample of survey respondents is likely to be biased towards larger non-dealers, this may overstate non-dealers' preparedness for central clearing as a group. It does, nevertheless, indicate a growing awareness of the issues among the non-dealer community.

North American and European referenced credit index derivatives, which are not widely traded by non-dealers in the Australian market, are the only products for which non-dealers reported that significant liquidity had moved to central clearing. This is consistent with the finding in Section 4.2.3 that overseas-headquartered dealers are involved in most trades in these products in the Australian market, and that therefore these trades are likely to be subject to overseas mandates. Nevertheless, the majority of non-dealer respondents were concerned about a migration of liquidity for other OTC derivatives products in the future.

One potential source of a price differential between centrally cleared and non-centrally cleared trades is the higher capital charges applied under Basel III where a bank retains non-centrally cleared derivatives exposures. To date, most dealers have not yet begun to pass on these higher costs to their non-dealer counterparties. Furthermore, with the exception of small ADIs, non-dealers are not typically directly subject to similar capital charges. Over half of non-dealer survey respondents nevertheless expected price differences to emerge over time.

If the majority of dealers were to start passing on the higher costs associated with non-centrally cleared OTC derivatives, there is good reason to expect such price incentives to be effective in encouraging at least the larger non-dealers to central clearing. Similar price differences between collateralised and uncollateralised non-centrally cleared OTC derivatives have already encouraged a large number of financial institutions – both large and small – to exchange collateral to cover daily price movements. In contrast, for some liquidity-constrained non-dealer financial institutions and non-financial entities the price differential between collateralised and uncollateralised trades has not yet been sufficiently high to offset the liquidity cost of posting collateral.

Importantly, even where non-centrally cleared derivatives trades are collateralised, credit support agreements typically continue to specify only the exchange of variation margin. This contrasts with central clearing, which requires both initial margin and variation margin to be posted. Accordingly, until international standards on margining for non-centrally cleared derivatives (discussed in Section 3.2.3) are implemented, there may remain an overall cost advantage for liquidity-constrained non-dealers continuing to trade non-centrally cleared OTC derivatives.

One risk that could emerge in future, in either a centrally cleared or non-centrally cleared environment, is that a non-dealer without access to sufficient liquid assets at a reasonable cost may choose not to use OTC derivatives to hedge its underlying exposures. This could have broader implications for financial stability. Alternatively, if a liquidity constrained non-dealer chose to continue to hedge using OTC derivatives, it would have perhaps three options to ensure that it could meet collateral requirements. The non-dealer could:

- reallocate a portion of its investments to high-quality liquid assets
- attempt to secure a line of credit
- access 'collateral transformation' services, under which the provider accepts lower quality or less liquid assets and, for a fee, post assets that meet a CCP's margin requirements on behalf of the non-dealer.

All three options would involve costs for non-dealers. A reallocation of investments would lower investment returns, while the other two entail potentially high fees. Lines of credit and collateral transformation could also introduce new sources of risk for non-dealers, and since they involve new sources of interconnections between financial institutions possibly to the system more broadly.[69]

Clearing arrangements
The price incentive to centrally clear would also need to offset the fixed cost of establishing central clearing arrangements. Dealers have, of course, had to make similar changes to facilitate central clearing. However, given the relative scale of a dealer's OTC derivatives activity, the cost can be spread over a larger number of trades. Similarly, the relative size of OTC derivatives activity across different non-dealers means that larger non-dealers will generally face a lower average cost of clearing. For non-dealers, the fixed cost of establishing central clearing arrangements typically involves negotiating a client clearing agreement and implementing operational changes.

There are also substantial fixed costs for clearing agents in establishing the systems to facilitate client clearing. Consequently, the provision of such services benefits from economies of scale. Currently, Australian participants of CCPs are unable to offer client clearing services; however, they are expected to have the ability to do so in the near future. As noted in Section 2.5, ASX Clear (Futures) anticipates launching its OTC client clearing service in early April 2014, which will allow Australian participants to act as clearing agents for trades cleared through this service. LCH.C Ltd offers a client clearing service internationally, and has signalled its intention to permit Australian participants to act as clearing agents.

[69] For further discussion of the considerations for non-dealers when choosing to centrally clear, see Clarke A and P Ryan (2014), 'Non-dealer Clearing of Over-the-counter Derivatives', RBA *Bulletin*, March, pp 77–88. Available at <http://www.rba.gov.au/publications/bulletin/2014/mar/bu-0314-9a.html>.

To date, this combination factors has led to a concentrated market structure, with a relatively small number of large international dealers offering client clearing services internationally. At this stage, clearing agents are competing actively for the small number of non-dealers that have opted to centrally clear. Nevertheless, if a large number of non-dealers were required to centrally clear, there could be risks from the currently high level of concentration in the provision of clearing services to clients. The Regulators will monitor the availability of client clearing, which may change once Australian participants are able to offer client clearing.

Segregation and portability

The choice of clearing agent is important for a non-dealer due to the operational dependence on its clearing agent. The non-dealer is also likely to have some financial exposure to its clearing agent, although the extent of this will vary significantly depending on the CCP's account structure. For instance, under a net omnibus account structure, the clearing agent typically retains the difference between the gross margin it collects from its clients and the net margin it pays to the CCP. The clearing agent may also use a 'margin multiplier' such that it collects more margin from its clients than it owes to the CCP. A non-dealer's exposure to its clearing agent is reduced if its margin is held at the CCP, with further protection afforded by individual segregation of client accounts.

Account structure also affects the ease and likelihood with which a non-dealer can 'port' positions should its clearing agent default. Porting refers to the transfer of a client's positions from one clearing agent to another; this is particularly important in the event of a clearing agent default since it allows the client to maintain its portfolio intact rather than have its positions closed out as part of the CCP's default management processes.

Porting of a client's positions under such circumstances would typically require that the client have arrangements in place with an alternative clearing agent. For large non-dealers that are already centrally clearing, best practice appears to be converging on having three active clearing agents. This would be expected to increase the likelihood that one of the two alternative clearing agents was willing to take on the non-dealer's position. However, given the high fixed cost of establishing a clearing arrangement, having multiple active clearing agents may only be feasible for larger non-dealers that conduct a significant volume of OTC derivative business. And even then, there can be no guarantee that one of the alternative clearing agents would have the capacity to take on the positions at the time it was called upon to do so.

Some clearing agents also offer, for a fee, 'back-up' clearing agency services. Under such arrangements, operational connections are established between the non-dealer and the back-up clearing agent, but the service is not used actively on an ongoing basis. Again, however, there can be no guarantee that porting would actually occur at the time a shock arose.

While not strictly necessary for portability, non-dealers with multiple clearing agents tend to actively clear through all of their clearing agents. As previously noted, these tend to be larger non-dealers with sufficient turnover to be able to split their OTC derivatives positions across multiple clearing agents. Actively clearing through multiple clearing agents allows a non-dealer to minimise the consequences of being able to port should one of its clearing agents default. It has also been suggested that a clearing agent may be more likely to prioritise active clients when selecting which, if any, client positions to accept from a defaulted clearing agent. It should be noted that, since non-dealers' OTC derivatives positions tend to be directional, reflecting the underlying exposures that they are hedging, splitting positions across multiple clearing agents may not have significant implications for netting efficiency.

International consistency

As with the assessments of the case for mandatory clearing of interdealer trades, the Regulators have considered each of the three aspects of international consistency below.

Regulatory arbitrage

The institutional scope of clearing mandates differs in the various overseas jurisdictions that have announced or introduced such mandates. While the Japanese mandate only applies to financial institutions, in the US and EU regimes some non-dealers are required to centrally clear OTC derivatives, while others receive an exemption.

- In the US, trades with a small financial institution (with less than US$10 billion in assets) or a non-financial entity are subject to an end-user exemption where they are for hedging purposes or to mitigate commercial risk. This means that the trade does not have to be centrally cleared.
- In the EU, all trades between financial institutions – of any size – in mandated products (which are yet to be determined) will be subject to mandatory clearing obligations. In addition, if a non-financial entity's notional principal outstanding of OTC derivatives exceeds a certain threshold (measured over a rolling 30-day period) it will be subject to mandatory clearing requirements. These thresholds are set by asset class and exclude contracts entered into in order to reduce risks relating to commercial or treasury financing activity; the threshold is set at €1 billion for credit and equity derivatives and €3 billion for interest rate, foreign exchange and commodity derivatives. Any non-financial entity with notional principal outstanding below the relevant threshold is exempt from the clearing obligation, even where it trades with a financial institution. Pension schemes are also exempt from the clearing requirement under EMIR until 15 August 2015. This exemption is designed to give the EC time to consider the progress by CCPs in developing solutions for the transfer by pension schemes of non-cash collateral to meet variation margin obligations.

US, EU and Japanese rules also provide exemptions for a range of public entities, including central banks and government debt management agencies.[70]

Both the EU and US rules therefore provide examples of mandatory clearing exemptions for certain categories of public entity, as well as non-financial entities that use OTC derivatives to hedge. In the case of non-dealer financial institutions, the treatment differs between the EU and the US. The EU will require that all financial entities (with the exception of pension schemes currently) centrally clear mandated products, irrespective of size. The US, by contrast, provides an exemption from clearing for hedging-related OTC derivatives activity by smaller financial institutions.

These overseas examples will be relevant in the Regulators' consideration of the scope of any specific exclusion from mandatory clearing obligations for certain types of non-dealer. In particular, the Regulators would expect to give close consideration to exclusions for both financial and non-financial entities with limited OTC derivatives activity, as well as certain categories of public entity.

[70] In the EU, members of the European System of Central Banks and other EU State bodies performing similar functions, as well as EU public bodies charged with or intervening in the management of the public debt, are exempt from all mandatory clearing obligations. The EC has the ability to extend this to equivalent foreign bodies based on a comparative analysis of the application of reporting and clearing obligations in the foreign jurisdiction. US rules also explicitly exclude OTC derivatives traded with the Federal Reserve Bank, the Federal Government or a Federal agency backed with the full faith and credit of the US. The CFTC has similarly sought to extend the exemption from clearing requirements to foreign governments and foreign central banks. Finally, under a Japanese Cabinet Office Order, central banks and public debt management bodies are exempt from mandatory clearing obligations.

The Regulators would however be concerned if, in the absence of a domestic mandate that included trades by non-dealers, there was evidence of regulatory arbitrage. As with dealers, this risk is mitigated by the cross-border application of overseas mandatory requirements. Further, to the extent that overseas-based non-dealers do not have existing Australian operations, the likelihood of such a non-dealer establishing an Australian-based entity solely to take advantage of the absence of an Australian mandate would seem to be low.

Equivalence or comparability

Unlike Australian-headquartered dealers, to date Australian-based non-dealers have not had to register with the CFTC as Swap Dealers (nor as Major Swap Participants), and therefore are not directly subject to CFTC regulation. Where an Australian-based non-dealer trades with a US person, it is captured indirectly by the CFTC's mandatory clearing requirements and substituted compliance is not available. Substituted compliance could be available if an Australian-based non-dealer traded with a foreign branch of a US person (e.g. the Australian branch of a US bank) or a non-US person guaranteed by a US person.

The EU's requirements also only apply to Australian-based non-dealers to the extent that they trade with EU counterparties, or where the transaction has a direct, substantial and foreseeable effect within the EU according to the criteria described in Section 3.3.2. ESMA's advice on Australian mandatory clearing requirements suggests that equivalence will only apply if the particular trade is subject to mandatory clearing in both the EU and Australia. This implies that if a non-dealer traded with an EU counterparty in a mandated product it would have to centrally clear the trade unless it was a non-financial entity that fell below the EU thresholds. An equivalent domestic mandate could therefore confer some benefit on non-dealers that would otherwise be affected by overseas clearing mandates, to the extent that they would not need to monitor their regulatory status under overseas regimes on an ongoing basis and comply with applicable overseas rules.

Nevertheless, there remains some uncertainty as to whether these assessments of the equivalence Australian mandatory clearing requirements will consider Australian market participants as a whole, or differentiate between entities that are and are not subject to Australian mandatory clearing requirements. If groups of entities were assessed separately, there might be less benefit from a positive assessment for rules applying to non-dealers. However, if the absence of a domestic clearing requirement for these entities affected the overall assessment of Australia's mandatory clearing obligations, potentially lower compliance costs for dealers would therefore also need to be taken into account.

Unintended consequences of overseas requirements

As discussed in the case of Australian dollar-denominated interest rate derivatives and North American, European and Japanese credit index derivatives, a domestic mandate may enable the Regulators to address some unintended consequences (within the scope of the ODRG's agreement on the stricter rules approach). While the benefit to non-dealers remains less certain than that for dealers, the Regulators will continue to engage with overseas regulators as appropriate in order to better understand the implications for non-dealers of overseas rules.

Recommendation and further considerations

In the July 2013 Report, the Regulators committed to doing further work to better understand the incremental costs and benefits of extending any central clearing mandate to smaller participants in the Australian OTC derivatives market that were not covered in the dealer survey (referred to as non-dealers in this report). To facilitate this work, in late 2013, the Regulators issued a survey to a wide range of non-dealers and conducted a large number of follow-up meetings. Based on insights from the survey, at the current time, the Regulators are not convinced of the public policy case for introducing mandatory central clearing of OTC derivatives for non-dealers. Instead, the Regulators propose to keep under review the case for extending mandatory central clearing to non-dealers in light of ongoing market and international regulatory developments.

With few exceptions, non-dealers' activity in OTC derivatives is relatively limited and motivated primarily by hedging of underlying cash flows and exposures. Accordingly, even though there may be some systemic risk reduction benefit from central clearing by non-dealers, it is likely to be limited. Indeed, where small financial institutions and especially non-financial entities have restricted access to liquid assets to meet CCPs' initial and variation margin obligations, new sources of risk could emerge.

In the long term, commercial incentives – from relative pricing of centrally cleared and non-centrally cleared trades – are expected to encourage a range of non-dealers to adopt central clearing, especially those with the scale and liquidity to support it. When internationally accepted margining principles for non-centrally cleared OTC derivatives are implemented, the relative cost of central clearing is likely to decrease, further incentivising such non-dealers to centrally clear. Indeed, several large non-dealers, especially those affected by mandatory obligations in overseas jurisdictions, are already establishing such arrangements in anticipation of such incentives emerging. Further, industry liaison suggests a high level of awareness and understanding among a broader range of non-dealers of what would be required in order to centrally clear.

The Regulators acknowledge, however, that for some non-dealers it is unclear whether either the private or public policy benefits will ever be sufficient to offset the costs. Given this, on the basis of currently available information, the Regulators would expect to give close consideration to a specific exclusion from any mandatory clearing obligation for certain non-dealers. In particular, consideration would be given to exclusions for certain non-dealer financial institutions and non-financial entities, where these have limited OTC derivatives activity, as well as certain categories of public entities.

The incentives-led transition to central clearing among larger non-dealers could accelerate when ASX Clear (Futures) launches its client clearing service and LCH.C Ltd makes its international client clearing offering available to Australian clearing participants.

> **Accordingly, the Regulators do not believe it is appropriate to mandate central clearing for non-dealers at this time. The Regulators will nevertheless continue to monitor the availability of client clearing for OTC interest rate derivatives and the incentives-led migration to central clearing, particularly by non-dealers with access to sufficient liquidity. In addition, the Regulators will review the impact of international regulatory developments.**

The Regulators would nevertheless be concerned if the absence of mandatory clearing requirements for non-dealers encouraged regulatory arbitrage in the Australian market, and would respond accordingly. The Regulators would also review the case for extending mandatory clearing requirements if this was likely to materially affect the outcome of equivalence or comparability assessments carried out by overseas jurisdictions, and to have material implications for Australian market participants' business costs and international market access.

4.3 Platform Trading

The G20 committed that all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate. The Regulators recognise the in-principle benefits from greater use of trading platforms in the Australian OTC derivatives market. Centralised trading venues can promote market efficiency by bringing buyers and sellers together in a single location and facilitating price discovery and price competition through pre- and post-trade transparency. Electronic trading also provides operational benefits, such as straight-through processing to CCPs and TRs. Trading on a platform can also potentially improve market integrity, since increased centralisation facilitates regulatory supervision of market conduct and infrastructures. Furthermore, to the extent that trading platforms improve market liquidity they can enhance the stability of the financial system.

However, it is generally acknowledged that the benefits and costs of platform trading will depend on the characteristics of the trading platform.[71] The international consensus on what constitutes an acceptable trading venue for mandatory trading obligations is still developing. While the CFTC has progressed the implementation of its regime, the EU is still in the process of finalising changes to its regulatory framework for trading platforms. Most other jurisdictions (including the US Securities Exchange Commission, as well as peer jurisdictions in Asia such as Hong Kong, and Singapore and Japan) have yet to introduce mandatory trading rules, having chosen to prioritise other aspects of OTC derivatives reform.

Furthermore, as discussed in Section 2.5, to fulfil a mandatory trade execution obligation under the Corporations Act a trade would need to be executed on a trading platform that was either licensed under the AML regime (which is currently under review) or prescribed by regulation. The Regulators believe it would be preferable, if possible, to make a recommendation on mandatory platform trading obligations once Treasury's review of the AML regime had further progressed.

Products that are traded widely in Australia could, however, become subject to an overseas platform trading mandate in the short or medium term. This might occur, for instance, if overseas regulators were to implement mandatory clearing requirements for asset classes widely traded in Australia (which in turn triggered mandatory trading requirements). In such circumstances, the Regulators may consider it necessary to reassess the case for mandatory trading obligations for such products, primarily on international consistency grounds.

Market liquidity

The G20 acknowledged that trading on exchanges or electronic platforms may not be appropriate for all standardised OTC derivatives contracts. For a product to be effectively traded on a centralised venue there must be sufficient liquidity for buyers and sellers to enter and exit their positions without unduly affecting market prices. If there is insufficient liquidity, the pre-trade transparency from trading on a platform could move market prices in anticipation of the trade, which could act as a disincentive to trade and further reduce market liquidity. Without adequate publication delays for large trades, post-trade transparency provided by trading platforms may also further reduce liquidity in already illiquid asset classes. Market liquidity is affected by:

- trading volume
- product characteristics
- transaction size

[71] See, for example, IOSCO (2011), *Report on Trading of OTC Derivatives*, February, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD345.pdf>, and IOSCO (2012), *Follow-on Analysis to the Report on Trading of OTC Derivatives*, January, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD368.pdf>.

- transaction frequency
- market participant characteristics.

To assess liquidity in the Australian OTC derivatives market, the Regulators sought information from survey respondents on average daily turnover for each instrument class. Data from the Regulators' survey of dealers was supplemented by analysis of trade repository data reported by phase 1 entities.

Within each asset class, these transactions are spread across different product subtypes, currency denominations and tenors. Consequently, the Regulators focused on the most active products in each asset class. Consistent with the results of previous surveys, apart from foreign exchange derivatives, the number of transactions executed by dealers in the Australian market is not high. Based on the Regulators' survey data, the median Australian dealer executes, on average, 62 foreign exchange derivative trades each day, although the range of activity in this asset class is very wide – varying from a single trade executed per day, on average, to well over a thousand.

The average transaction size for foreign exchange derivatives is $10 million compared with $46 million for single-currency interest rate derivatives, based on the Regulators' survey data. Focusing only on Australian-headquartered dealers, trade repository data from DTCC shows larger transaction sizes for single-currency interest rate swaps; the average transaction size for single-currency interest rate derivative transactions reported by phase 1 reporting entities under the ASIC transaction reporting regime is $84 million, with a median of $22 million.[72] However, as the regime is still phasing in, these data are not yet complete.

Use of trading platforms

The Regulators also sought information on dealers' access to and use of trading platforms. Dealer respondents identified a large number of trading platforms used to execute OTC derivative trades, including both single- and multi-dealer platforms. Most platforms tend to specialise in a particular asset class of OTC derivatives; foreign exchange derivative platforms are most common, followed by single- and cross-currency interest rate derivative platforms.

Consistent with this, foreign exchange, single- and cross-currency interest rate derivatives are the products most traded on some form of platform. Dealers reported that, on average, 60 per cent of their notional principal outstanding in these asset classes was transacted on a platform (Table 5). However, the use of fully electronic platforms is fairly consistent across all asset classes, with 20 per cent of notional principal outstanding reportedly executed on such platforms across all asset classes except cross-currency swaps. Indeed, non-platform, bilateral trade execution – such as by phone or email – remains the most common method for executing transactions among dealer respondents.

[72] As of 31 January 2014.

Table 5: Average Australian Dealer's Use of Trade Execution Methods

Year to end November 2013, per cent of notional principal outstanding[(a)]

	Non-platform	Voice broking platform	Hybrid voice/ electronic platform	Fully electronic platform
Equity	60	20	–	20
Credit	60	–	20	20
Commodity	50	30	–	20
Cross-currency swaps	40	50	–	10
Single-currency interest rate	40	30	10	20
Foreign exchange	40	20	20	20

(a) Respondents were asked to report to the nearest 10 per cent; the results have been reported on the same basis

Source: Regulators' survey

Use of SEFs by dealer respondents was relatively limited across asset classes at the time of the survey. For single-currency interest rate derivatives, most respondents reported executing less than 20 per cent of the gross notional principal traded in November 2013 on SEFs; however, this varied among respondents, with a number of dealer respondents reporting no execution of single-currency interest rate derivatives on a SEF. For credit derivatives, the other class of derivatives that is now subject to a CFTC platform trading mandate, virtually no respondent reported using a SEF in November 2013. These results may reflect a number of transitional factors, including the fact that the CFTC's SEF regime only commenced in October 2013 and mandatory trading obligations did not commence until February 2014 – after the survey period.

Recommendation and further considerations

The Regulators are of the view that it is not yet appropriate to recommend a mandatory platform trading obligation, for three key reasons:

- Before making any recommendation on mandatory platform trading, the Regulators would prefer to see further consensus emerge across key jurisdictions on the characteristics of relevant trading platforms for such purposes.
- Survey data on market liquidity, and the extent to which Australian participants are using non-fully electronic execution channels, suggest that liquidity in the local market is not high by international standards in many asset classes. They also suggest that market participants continue to predominantly use other execution channels, presumably for a range of commercial reasons.
- Treasury is undertaking a review of the AML regime, and the Regulators would prefer to await the outcome of that review prior to recommending any mandatory trading obligations.

The Regulators will nevertheless continue to monitor developments to gauge the implications of overseas regimes for methods of execution and liquidity in the Australian OTC derivatives market, and more generally monitor evolving trends in the utilisation of electronic trading platforms. It is noted that international consistency may become a higher priority if overseas jurisdictions were to implement mandatory platform trading obligations for products or asset classes widely traded in Australia, including asset classes that may be subject to mandatory clearing obligations. Consequently, the Regulators may consider it necessary to reassess the case for mandatory trading obligations for such products, primarily on international consistency grounds, and potentially make recommendations to the government ahead of the next market assessment.

4.4 Risk Management Practices

While the G20 commitments do not specifically address risk management practices, the commitments do include capital and margin requirements. Risk management practices more broadly – including trade compression, portfolio reconciliation, trade confirmation, trade valuation and dispute resolution – are a focus for the FSB, which has encouraged regulators to consider whether further regulatory efforts to promote such practices should be undertaken.[73] Risk management practices have also been a focus of EU and US regulators in their comparability and equivalence assessments of foreign regimes, as the EU and US regimes incorporate specific risk management requirements for non-centrally cleared derivatives.

In line with the growing international focus in this area, the Regulators have continued to monitor participants' risk management practices, and have previously made recommendations in areas where they believe further attention by industry is warranted. A particular focus for the Regulators has been the relatively low level of participation in multilateral trade compression cycles for Australian dollar-denominated interest rate swaps. In the July 2013 Report, the Regulators also noted that they would provide advice to the government on implementation of the now-finalised internationally agreed framework on margin requirements for non-centrally cleared trades. The Regulators have also considered other aspects of risk management practices identified by the FSB.

Trade compression

Trade (or portfolio) compression is the practice of reducing or eliminating either bilateral or centrally cleared OTC derivative trades by simultaneously terminating or replacing them with a smaller, more 'economical' set of trades with an equivalent exposure or for a compensating payment. Trade compression can be a particularly effective method for dealers with a large number of trades, but relatively small net exposures, to reduce operational risk.

Compression can occur on either a multilateral or a bilateral basis. Multilateral trade compression involves terminating trades across a number of counterparties and generally requires coordination by a service provider. Where trades have been centrally cleared, the CCP may organise a multilateral compression across all its participants. Bilateral compression or 'tear-ups' generally do not involve a service provider. There would typically be fewer offsetting positions available for termination in a bilateral compression compared with a multilateral compression. However, to the extent that trades do not completely offset, bilateral counterparties may negotiate a compensating payment or new trades designed to allow both counterparties to retain their desired risk position.

Previous reports have identified that domestic participants have not been consistent users of multilateral trade compression services. The Regulators noted that they would consider whether action should be taken to facilitate coordinated participation in such processes. During a recent multilateral trade compression cycle for Australian dollar-denominated interest rate swaps, the Regulators made a concerted effort to encourage wider participation.[74] The Regulators have also monitored the outcome of the cycle, meeting with the service provider and a number of dealers involved in the cycle – both before and after the exercise.

[73] FSB (2013), *OTC Derivatives Market Reforms: Fifth Progress Report on Implementation*, April. Available at <http://www.financialstabilityboard.org/publications/r_130415.pdf>.

[74] The multilateral Australian dollar interest rate swap compression in February 2014 using triReduce, a service offered by TriOptima, an ICAP Group company.

There was increased participation in the most recent cycle, with 20 entities participating compared with 12 in July 2013. This trade compression cycle achieved the best result for several years, with the ratio of trades completely or partially eliminated comparable to that in similar products denominated in other currencies. However, the increase in terminations was relatively modest as many of the entities that participated submitted only a subset of their trades (in around a third of cases only one of the counterparties submitted the trade for compression; these trades were therefore ineligible for compression) or set low tolerances that inhibited compression. Of the approximately 25 000 trades submitted, less than 4 000 were terminated, resulting in a relatively modest $94 billion reduction in notional principal spread across the 20 participants. In comparison, just over 2 000 trades, with a notional principal of over $60 billion were terminated in the July 2013 compression. These results are consistent with the findings from the survey; most respondents reported that they had terminated less than 10 per cent of their notional principal outstanding in the year to end November 2013, and a number reported not achieving any significant reduction.

One reason for the comparatively less successful outcomes for multilateral compression cycles for Australian dollar-denominated interest rate swaps is the way the reference rate is calculated.[75] Australian dollar-denominated interest rate swaps reference AFMA's Bank Bill Swap (BBSW) rate. AFMA divides the maturities of Prime Bank Eligible Securities into two half-month 'buckets', representing distinct maturity pools of securities. The BBSW rate represents the midpoint (the 'fix') of the best bid and offer in the locally traded market for the securities within each maturity pool. Additionally, financial market participants observe that the BBSW rate tends to fix:

- lower in the first three days than on other days of each half-month period (i.e. the 1st to the 3rd and the 16th to the 18th of each month)
- higher in the last three days than on other days of each half-month period (i.e. the 13th to the 15th and the 28th to the 31st).

This results in yields fluctuating around the transition between buckets as liquidity decreases and demand varies for eligible securities. This discontinuity of reference rate used for interest rate derivatives may be reasonably unique to Australia; it is not evident that interest rate derivatives that reference the London Interbank Offered Rate or other similar rates have these maturity-related discontinuities.

The valuation of Australian dollar-denominated interest rate swaps in some dealers' systems may calculate a present value for a trade that differs slightly from the market valuation due to the issues described above. If a trade was compressed using an incorrect valuation it would require recognition of the profit and loss impact. To avoid this, dealers tend to either not submit trades that 'rollover' (i.e. involve a cash flow) around those dates, or set low tolerances around such trades. Due to this issue, in the most recent cycle many dealers excluded all of these trades, which halved the pool of trades available for compression.

Until each compression participant is confident with the tools available to compensate and adjust for differences, it is likely that such trades will continue to be excluded. The issue can be overcome in a bilateral compression by executing a new trade that preserves a dealer's net exposure for trades that rollover around the start or end of maturity buckets. However, this type of negotiation is currently not possible in a multilateral compression cycles. Accordingly, the industry is also pursuing several initiatives designed to systematically adjust for valuation differences in multilateral compression cycles.

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75 Another potential complication is that a participant's internal systems may use a different discount rate to value trades than that used by TriOptima. This can be overcome by setting tolerances to adjust for the difference in discounting, but it adds to the complexity of using triReduce.

Almost all dealers surveyed had participated in at least one compression in the year to end November 2013, with some overseas-headquartered dealers having engaged in as many as 20 during that period. While multilateral compression cycles for a particular product type tend to be run every 6 to 12 months, some dealers reportedly consider bilateral compression as frequently as quarterly. Consistent with the requirements in the EU and US, the majority of dealers have documented policies and procedures around considering compression on a regular basis, and the remainder are considering adopting such policies. Some of these policies and procedures apply to all counterparties while others only apply to major counterparties. As discussed in Section 3.2.5, dealers will in future have a stronger incentive to compress trades so as to minimise the capital they are required to hold under the Basel III leverage ratio.

Collateralisation

Since their 2009 survey of the OTC Derivatives Market in Australia, the Regulators have consistently focused on market participants' collateralisation of OTC derivatives transactions, including the legal and operational arrangements that underpin such collateralisation.[76] These issues will also be relevant as the Regulators consider the implementation of the BCBS-IOSCO margin requirements for non-centrally cleared OTC derivatives (discussed in Section 3.2.3). Implementation of this framework is ongoing in all jurisdictions and, given the cross-border nature of OTC derivatives markets, the need for internationally consistent implementation is well recognised. Consequently, the Regulators will monitor closely the implementation of this framework in key jurisdictions.

The BCBS-IOSCO framework requires financial firms and systemically important non-financial entities that engage in non-centrally cleared derivatives trades to exchange initial and variation margin. With respect to variation margin, the results of the surveys and industry liaison indicate that such market participants generally both pay and receive variation margin on a daily basis, subject only to a minimum transfer amount. In contrast, it is not standard practice in the OTC derivatives markets, including the Australian OTC derivatives market, to exchange initial margin – even for interdealer trades. Consequently, implementing initial margin requirements is expected to involve significant changes to legal and operational arrangements.

Another requirement under the BCBS-IOSCO framework is that collateral provided as initial margin be held in a bankruptcy-remote manner, with very limited rehypothecation. A majority of respondents currently hold collateral on their own books, though a minority also reported using a custodian to hold collateral for some types of transactions. A number of respondents reported that at least some of their collateral documentation permits the rehypothecation of collateral.

The BCBS-IOSCO framework also specifies that the assets used to collateralise non-centrally cleared derivatives should be highly liquid and subject to appropriate haircuts. The results of the Regulators' survey suggest that the collateral currently accepted and posted in the Australian market would meet these requirements. The most commonly posted collateral among respondents was cash, usually denominated in Australian dollars, US dollars or euros. The majority of respondents also accept government debt securities. However, it was noted by a number of market participants that the demand for collateral was likely to increase – in part due to the move to central clearing and the implementation of the BCBS-IOSCO framework – and therefore other types of collateral would need to be considered.

Dealers are already considering making the necessary changes to their operational and legal arrangements in anticipation of the implementation of the BCBS-IOSCO margin requirements in a number of jurisdictions. Some dealers have also expressed interest in doing so, even ahead of the implementation of the BCBS-IOSCO framework, once the capital treatment of collateralised trades is clarified.

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[76] APRA, ASIC and RBA (2009), 'Survey of the OTC Derivatives Market in Australia', May. Available at <http://www.rba.gov.au/payments-system/clearing-settlement/survey-otc-deriv-mkts/>.

Confirmation, valuation, portfolio reconciliation and dispute resolution

Trade confirmation and portfolio reconciliation are designed to ensure that counterparties have the same information about a trade when it is executed and over time as its value fluctuates. Furthermore, in the event of a disagreement it is important to have processes in place to resolve such disputes in a timely manner. The survey results suggest that dealers in the Australian market generally have appropriate policies and procedures in place to monitor and manage information about trades over their lifecycle.

Responses to the Regulators' survey questions on confirmation appear to be broadly consistent with market conventions published by AFMA. Most dealers reported that they confirmed most trades within one or two days of execution. In general, the survey results suggest that OTC equity and commodities trades tend to take longer to confirm, especially if the confirmation is paper based, although the Regulators understand that electronic confirmation is becoming much more widely used, including in these asset classes. Some dealers also reported that transactions with corporates took longer to confirm. If the Regulators considered that some market participants were not meeting market conventions or good market practice in this respect they would engage directly with those participants.

In line with previous Reports, the Regulators have observed increased utilisation of portfolio reconciliation services. A majority of respondents reported revaluing their portfolios on a daily basis, using valuation models that are independently validated and monitored.

The frequency of portfolio reconciliation varies depending on the size of the counterparty. Daily reconciliations are the norm for interdealer trades and trades with other ADIs, but portfolio reconciliation is reportedly less frequent with smaller counterparties. There is also some evidence of dealers in the Australian market aligning their portfolio reconciliation policies with EU and US requirements. Industry liaison also suggests automated reconciliation, typically using an external service provider, is becoming more common among dealers and a small number of the more active non-dealers market participants.

All dealer respondents have written policies and procedures for tracking valuation disputes. Survey results and industry liaison indicate that most trade valuation disputes are resolved in a timely fashion, and often without the need to invoke the formal dispute resolution procedures set out in trade documentation. At the time of the survey, some respondents had valuation disputes that were unresolved for more than 5 days, but only very few had outstanding valuation disputes that were unresolved for more than 10 or 15 days. It is understood that lengthy disputes are uncommon. Non-dealers reported few valuation disputes; this is likely due to the fact that these entities trade largely vanilla instruments with well-established valuation models.

Recommendation and further considerations

The Regulators understand that market participants, especially dealers, generally conform to accepted good market practice and published Australian market conventions. Prudential capital requirements provide a strong incentive to exchange variation margin for non-centrally cleared trades and the Regulators expect that forthcoming regulatory changes will also promote the exchange of initial margin and increased use of trade compression. The Regulators observe that participation in trade compression has already increased, and will continue to encourage further improvements. While the Regulators understand the current impediment to compressing certain Australian dollar-denominated interest rate swaps, they encourage market participants to explore ways to overcome this.

The Regulators have consistently focused on market participants' collateralisation of OTC derivatives transactions, including the legal and operational arrangements that underpin these arrangements. These issues will also be relevant as the Regulators consider the implementation of the BCBS-IOSCO margin requirements for non-centrally cleared OTC derivatives. The Regulators are also aware of the need for international consistency in the implementation of the BCBS-IOSCO margin requirements for non-centrally cleared OTC derivatives, and will monitor closely the implementation of this framework in key jurisdictions.

More broadly, the Regulators recognise the growing international focus on risk management practices for OTC derivatives and expect to actively engage in any future international initiatives in this area.

5. Next Steps

This Report constitutes the Regulators' latest advice to the Minister on the case for mandatory obligations under the Corporations Act. The particular focus of this Report has been the case for introducing a mandate for central clearing of Australian dollar-denominated interest rate derivatives and certain other OTC derivatives products.

As required by the Corporations Act, if the Minister accepts the Regulators' recommendation to consider a central clearing mandate for Australian dollar-denominated interest rate derivatives, it is expected that the government would consult on a proposed determination. Such a proposal would consider:

- the likely effect on the Australian economy, and on the efficiency, integrity and stability of the Australian financial system
- the likely regulatory impact
- any other matters that the Minister considers relevant, such as relevant international standards and international commitments.

These are also the matters the Regulators have considered in preparing their advice. The government may also consider issuing regulations that restrict the product or institutional scope of mandatory requirements, thereby providing temporary or ongoing exemptions in relation to specified products or entities. This would be consistent with the Regulators' recommendation that the initial focus of mandatory central clearing obligations should be interdealer trades.

If the Minister proceeds with a determination, in order to implement the regime ASIC would need to consult publicly on DTRs that establish the details of the requirement, including matters such as the institutional and product scope and how the requirements may be met. In developing these rules, ASIC would also consult with APRA and the RBA.

Looking ahead, the Regulators will continue to actively monitor developments in the Australian and overseas OTC derivatives markets. In particular, the Regulators have committed to monitoring:

- activity and the extent of central clearing in North American, European and Japanese referenced credit index derivatives
- the availability of client clearing for OTC interest rate derivatives and the incentives-led migration to central clearing, particularly by non-dealers with access to sufficient liquidity
- the implications of overseas regimes for methods of execution and liquidity in the Australian OTC derivatives market
- industry participation in trade compression and initiatives designed to overcome the current impediment to compressing certain Australian dollar-denominated interest rate swaps
- the implementation of the BCBS-IOSCO margin requirements for non-centrally cleared OTC derivatives in key jurisdictions.

However, the Regulators do not expect to produce another report of comparable scope until after mandatory clearing obligations are in effect, which is not likely to be until 2015. The Regulators will seek to use data from trade repositories wherever possible, supplemented by special-purpose surveys and liaison meetings where appropriate.