Malcolm Edey: OTC derivatives regulation

Keynote address by Mr Malcolm Edey, Assistant Governor (Financial System) of the Reserve Bank of Australia, to the International Swaps and Derivatives Association (ISDA) Conference, Sydney, 18 October 2012.

* * *

I would like to thank Mark Manning for his assistance in preparing this speech.

Good morning, and thank you once again for the opportunity to speak to you today.

A great deal has happened since I last addressed this gathering a year ago. Markets around the world remain under pressure, with the sovereign debt crisis and fears over the future of the Euro continuing to weigh on confidence. Australia has been somewhat sheltered from these developments. As reported in the Bank's recent *Financial Stability Review*, Australian banks' asset quality has held firm, their usage of wholesale funding has been wound back, and overall bank funding costs have fallen over the past year.

While Australia's financial sector and the condition of the real economy remain favourable by international comparison, many of the lessons of the global financial crisis remain as relevant in Australia as elsewhere. The Australian authorities have continued to be involved in both domestic and international debates over refinements to regulatory settings. The aim of course is to reduce the likelihood of further distress, and to ensure that in the event that problems do emerge the authorities have the appropriate tools to deal with them effectively.

Over the past year, the agencies that comprise the Council of Financial Regulators have progressed a number of regulatory initiatives, consulting extensively with industry participants on matters such as the implementation of Basel III in Australia, enhancements to the resolution regime for banks, and reforms to the regulation of financial market infrastructure. But today I'd like to focus again on the area of reform I discussed here a year ago: the regulation of OTC derivatives markets.

As everyone in this room is aware, at the Pittsburgh Summit three years ago the G-20 leaders agreed that, 'all standardised OTC derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivatives contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements'.

When I spoke to this group last October, the Council of Financial Regulators was engaged in a consultation on central clearing of OTC derivatives. I talked about a number of policy challenges that the Council agencies were grappling with, including whether central clearing of Australia's most systemic OTC derivatives markets should be mandatory, and whether such clearing should be required to take place through a domestic central counterparty.

Consultation on these matters continued through the remainder of 2011 and the early part of this year. At the same time, arrangements in other international jurisdictions, most notably in the United States and Europe, were becoming clearer and domestic financial institutions were beginning to examine and adapt to the third-country reach of the prospective new rules. Also, in part reflecting strong views expressed by the Australian authorities, the Financial Stability Board developed the notion of 'four safeguards' for a resilient global framework for central counterparties. This work recognised that, in meeting the G-20 commitments, market participants in some jurisdictions may be reliant on offshore-based central counterparties. Authorities and market participants alike therefore needed to have confidence that such arrangements would protect their interests, both for domestic financial stability and for the effective functioning of markets.

Specifically, the four safeguards comprise: ensuring effective international cooperative oversight of global CCPs; fair and open access criteria; appropriate liquidity arrangements in all relevant currencies; and procedures for effective resolution. The *Principles for financial market infrastructures*, released in April by the Committee on Payment and Settlement Systems and the International Organization of Securities Commissions (IOSCO) this year, embed some elements of the four safeguards; other elements are left to domestic authorities to implement in their own regulatory frameworks and approaches.

Having considered the views of stakeholders and assessed the implications of developments internationally, the Council delivered a policy recommendation to the Deputy Prime Minister and Treasurer in March this year. The recommendation had three main elements:

1. Don't mandate immediately, but establish the power to do so

The Council agencies recommended that, where possible, industry-led solutions – in part reflecting appropriate regulatory incentives – should be relied upon to steer the market towards the desired outcome. Nevertheless, they also recommended that the authorities should be granted a legislated power to mandate outcomes in the event that the incentives prove insufficient to drive the necessary change on an acceptable time frame. One concern would be if there were perceived to be an opportunity for regulatory arbitrage between the Australian regime and those of other jurisdictions. Another would be if, in assessing the sufficient equivalence of the Australian regime, other jurisdictions took into account whether or not a regulatory mandate was in place.

Reliance in the first instance on market incentives is particularly relevant in the case of central clearing. Premature regulatory intervention could interfere with the competitive and commercial responses of central counterparties, clearing participants and other service providers. A flexible approach should allow for the transition to occur with maximum choice available to participants on issues such as the commercial terms of agreements, the choice of counterparties and central counterparties, and operational changes that might be needed.

The Council's assessment was that higher capital requirements for non-centrally cleared transactions, as well as the implementation of emerging international standards for margin requirements on non-centrally cleared OTC derivatives, should create a sufficiently strong economic incentive to channel trades through a central counterparty. Once a critical mass of market participants have begun to clear centrally, it is likely that other market participants will follow, so as to be able to trade with counterparties who have already shifted to central clearing. The policy responses of other jurisdictions are also important in this regard. To the extent that financial institutions headquartered in other jurisdictions are required to centrally clear by their local regulators, they are likely to – or, in some cases, may have to – also centrally clear transactions executed in the Australian market.

2. A qualifying central counterparty may be either domestic or overseas-based

A central counterparty operating in Australia must have either an Australian Clearing and Settlement Facility Licence or a valid exemption. The regulatory regime in Australia specifically permits an overseas-based central counterparty to operate in this jurisdiction, as long as its home regulatory regime is deemed to be sufficiently equivalent to that in Australia. The consultation last year sought views on whether it should be mandated that any central counterparty clearing OTC derivatives markets of systemic importance to Australia be located in Australia. Having given this further consideration during the consultation process, the Council agencies concluded that to do so would unduly constrain market participants' choices, reduce the effectiveness of economic incentives in driving outcomes, and potentially have other unintended consequences.

In the Council's view, any additional risks associated with reliance on an overseas-based central counterparty may be managed through implementation of the Financial Stability Board's four safeguards. In the spirit of these safeguards, the Council has developed a framework for regulatory influence over cross-border clearing and settlement facilities.

Specific requirements would be expected to be applied in a graduated and proportional manner and would include the following:

- all licensed CCPs must demonstrate legal compatibility of the facility's rules with Australian regulatory objectives, and have adequate mechanisms to demonstrate compliance with all licence obligations;
- where licensed CCPs have material Australian-based participation and/or provide services in Australian-related products, they must have governance and operational arrangements that promote stability in the Australian financial system;
- where a CCP is deemed to be systemically important by the Reserve Bank, it must hold an Exchange Settlement Account (ESA) at the Bank to better manage liquidity and settlement risks around Australian dollar obligations.

The Australian regulators are also closely engaged with ongoing international work on the recovery and resolution of financial market infrastructure. This work will be a key input into the development of a fully articulated recovery and resolution regime for financial market infrastructure in Australia. It will also establish a benchmark for assessment of the recovery and resolution regimes applicable to overseas-based facilities seeking to operate in Australia.

3. Establish a licensing regime for trade repositories

The Council recommended that a licensing regime for trade repositories be established, largely modelled on the existing licensing regimes for market operators and clearing and settlement facilities under the Corporations Act. ASIC will have primary responsibility for administering this regime and overseeing any trade repositories licensed under the regime.

These elements have since been reflected in draft legislation issued by Treasury for consultation in July and introduced to Parliament in September. It is anticipated that the framework will be in place by year-end. Under the proposed framework, the Minister for Financial Services and Superannuation will have the power to prescribe certain classes of derivatives as subject to mandatory reporting to a trade repository, mandatory clearing by a central counterparty, or mandatory execution on a trading platform. To give effect to any mandate, ASIC will be tasked with developing "derivative transaction rules". These rules will clarify matters such as the institutional and product scope of the obligation.

Among the regulators, therefore, ASIC will have the primary role in implementing the new framework and in doing so will work closely with the Bank and APRA. The Bank, in particular, will have three main functions in the new regime:

- *A market-monitoring function*. In carrying out its market operations and in its financial stability role, the Bank will need to understand the implications of market developments in response to the new rules; and in particular the evolution of participant behaviour and the participation structure of the market. This will include the analysis of data sourced from trade repositories, monitoring the interaction between the centrally cleared and non-centrally cleared segments of the market, and observing changes in collateral demand and usage.
- *An advisory function*. Before prescribing a class of derivatives under the framework, the Minister must seek the advice of the Bank, as well as APRA and ASIC. ASIC must also consult with both the Bank and APRA before issuing any derivative transaction rules.
- *An oversight function*. In its role in overseeing clearing and settlement facilities operating in Australia, the Bank will, with ASIC, advise the Minister on any licence applications from central counterparties seeking to provide OTC derivatives clearing services in Australia. And, once a licence has been granted, the Bank will oversee any newly licensed central counterparty against the Financial Stability Standards.

In parallel with the passage of the legislation through Parliament, the Council agencies are monitoring developments in the Australian OTC derivatives market to establish whether economic incentives are already beginning to work. A comprehensive survey was circulated to market participants in July, and an analysis of the results is expected to be published towards the end of this month. The results of this assessment will be an important input into possible recommendations to the government around mandatory obligations. The Australian agencies currently anticipate that additional assessments will be undertaken over the next year or so, in order to monitor the Australian market's progress in making the transition to central clearing, along with the other G-20 commitments around OTC derivatives reforms.

Even if these assessments conclude that the industry is making adequate progress, the Australian agencies will also continue to examine whether the existence of mandatory obligations could deliver other benefits. For instance, there could potentially be a case to impose a mandatory obligation for central clearing if to do so would make it more likely that other relevant jurisdictions considered the Australian regime to be sufficiently equivalent, and therefore reduced the compliance burden for domestic market participants when trading with overseas-based counterparties.

The current assessment is likely to confirm the previous position that Australian dollar interest rate swaps, cross-currency swaps and other foreign exchange derivatives are likely to be the priority asset classes for the purposes of meeting the G-20 commitments. Developments in these asset classes are likely to be monitored most closely in future assessments.

In the near term, the priority for any recommendations around mandatory obligations is likely to be trade reporting. As noted elsewhere, the Council agencies regard trade reporting to be not only good practice, but also a means of ensuring the availability of good data to monitor market developments in support of regulators' financial stability and market conduct objectives. However, given the time-frames required to consult on and pass the relevant legislation, it could be some months before a definite move towards mandatory reporting obligations could be made. ASIC would then have to develop the associated derivative transaction rules, which would be subject to a regulatory impact study and further industry consultation. It would also be necessary to license at least one trade repository to operate in this jurisdiction. As a result, it could be well into next year before any mandate is actually in force.

The effectiveness of the regime will also require a range of responses from market participants. If the transition to new arrangements, whether or not triggered by the issuance of a mandate, is to occur on an acceptable time-frame, institutions should already be making the operational and organisational changes needed to move towards greater use of centralised infrastructure. Based on the Council agencies' market assessment and ongoing dialogue with stakeholders, I'd like to identify five areas in which more work will need to be done.

First, international banks and the large domestic banks have already had to begin making the transition, in part in response to regulatory reforms already underway in some jurisdictions. In the case of central clearing, efforts to date also reflect the economic incentive of an emerging price differential between cleared and non-cleared transactions. This work is ongoing. International banks active in the Australian market are generally already actively clearing Australian dollar-denominated interest rate swaps via offshore entities that participate in LCH.Clearnet's London-based SwapClear service or CME Clearing in the United States. In most cases, the large domestic banks have taken the initial step of concluding client-clearing agreements for some of their OTC derivatives business. For several of these institutions, the transition to central clearing for this segment of their business is having profound implications for the organisation of their operations. Indeed, these institutions have been confronted with a number of legal and operational issues, such as clearing agreements that often contain more restrictive contractual terms than in their existing ISDA Master Agreements with bilateral counterparties. They have also had to adjust to new operational dependencies on the clearing participants through which they channel their business. For the Council agencies, the experience of these institutions has illuminated a number of issues that may warrant further consideration, and which may shape the design of derivative transaction rules should mandatory clearing be imposed.

Second, it is evident that in the absence of similar pressures, smaller and more domestically focused institutions are generally at an earlier stage in this process. Given the complexity of the required adjustment, these institutions are encouraged to accelerate their transition plans. In the case of central clearing, it is likely that these institutions will be reliant on a relatively limited number of large, probably international, providers of client-clearing services. Recognising these dependencies, the Council agencies continue to examine matters such as client monies rules, so as to ensure adequate protections for Australian institutions. Client monies remain an important area of focus for regulators around the world, with international work under way under the auspices of IOSCO.

Third, the scope for Australian-domiciled institutions to access central counterparties directly to clear Australian-dollar denominated derivatives is limited by the fact that no central counterparty is yet licensed to provide these services in Australia. Similarly, no trade repository is yet licensed to operate in Australia. ASIC and the Bank acknowledge their responsibility for dealing with any licence applications received from central counterparties or, once the new regime is in place, trade repositories seeking to provide services in Australia. The large Australian banks continue to discuss operational, legal and commercial terms of access with both domestic and overseas-based central counterparties that are interested in providing services in this area. An important consideration is how any international services would be adapted to the Australian market and time zone, including in relation to the provision of operational support, valuation methodology, margin collection and collateral eligibility criteria. The tax treatment of payments to an overseas-based central counterparty has also been identified as a potential issue. Ultimately, any central counterparty offering services to Australian-domiciled institutions will need to meet the needs of the Australian market place, the requirements for cross-border regulatory influence articulated by the Council, and possible future requirements that might be set out in derivative transaction rules in support of any mandatory clearing obligations.

Fourth, at the November 2011 Summit in Cannes, the G-20 leaders called for international standards for the margining of non-centrally cleared OTC derivatives. In accordance with this request, an international working group led by the Basel Committee on Banking Supervision and IOSCO released, in July, a set of draft principles for consultation. The principles propose harmonised margining arrangements, consistent with those in place for central counterparties. While variation margin is already typically exchanged in respect of non-centrally cleared trades, the application of initial margin is less widespread. Implementation of the principles is therefore likely to lead to a substantial increase in demand for collateral assets that are eligible to meet initial margin requirements. The working group has conducted a quantitative impact study to assess the possible magnitude of the increase globally, the results of which will inform the group's final proposal. The Council agencies have been considering how the new arrangements might be implemented in the Australian context, a key area of concern being the increase in demand for high-quality collateral.

Finally, the Council agencies will continue to assess how best to enhance transparency in OTC derivatives markets, within the parameters of the new regulatory framework. This work will consider the role platform-based execution might play in enhancing pre- and post-trade transparency. It will also examine any legal and confidentiality constraints to making aggregated trade-repository data on OTC derivatives market activity publicly available.

So, clearly, there has been a lot of progress over the past year. But our work is far from done. While the Council's direction is clear and the legislative process underpinning the framework is well underway, there remains a fair amount of work ahead to complete the transition; for market participants, infrastructure providers, and regulators alike. I hope that when this group meets in a year’s time, many of these outstanding issues will have been resolved.

Once again, thank you very much for the opportunity to speak today, and for your attention.