Malcolm Edey: The transition to central clearing of OTC derivatives in Australia

Speech by Mr Malcolm Edey, Assistant Governor (Financial System) of the Reserve Bank of Australia, at the International Swaps and Derivatives Association's (ISDA) 2015 Annual Australia Conference, Sydney, 22 October 2015.

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I thank Mark Manning for his invaluable assistance in preparing these remarks.

Good morning and thanks to ISDA for the opportunity to speak here today.

When I last addressed this forum three years ago, it was a time of quite significant stress in world financial markets. A particular focus of concern was the unfolding crisis in Greece and the associated risk of spillovers to other parts of Europe.

A lot has happened since then. As a general observation, financial conditions around the world have been gradually recovering, though not without some periodic bouts of nervousness. The concerns about Greece came to a head around the middle of this year, and spillovers from that have turned out so far to be quite limited.

More generally, the world economy has been expanding at a reasonable pace over these three years, and the process of balance sheet repair has continued. These are positive developments.

Nonetheless, in some important respects the situation is still some way from returning to normal. The after-effects of the global financial crisis are still weighing on activity in some of the major economies. And interest rate settings around the world are still at exceptionally low levels to support growth, seven years after the crisis reached its height.

All of this underscores the point that financial crises are costly events. They are costly in terms of lost income and output, lost jobs and damage to institutions. And we've seen again that it takes a lot longer to recover from a financial crisis than it does from other types of economic downturn.

These are good reasons for the global efforts that have been made over the past few years to build resilience in our financial systems. A great deal of work is underway on that front, at both national and international levels. In Australia, we have had a major inquiry into the financial system which, as one of its priorities, made a number of recommendations to strengthen financial resilience. Key recommendations in that area have been endorsed by the government this week. Internationally, there has been an extensive program of regulatory reform initiated by the G20 and coordinated through the international standard setting bodies.

Today I want to focus on just one aspect of that work, namely the move to central clearing of over-the-counter (OTC) derivatives. As you know, this was initiated by the G20 commitments made at the Pittsburgh Summit in 2009[1]. While progress on those commitments has been slower than many would have liked, a lot has been achieved. In my talk this morning, I would like to review what has been achieved so far, highlight some of the key considerations in implementation, and look ahead to some of the work that remains to be done.

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[1] Specifically, G20 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".

What has been achieved?

When I spoke at this conference in October 2012, the Australian Council of Financial Regulators (the Council) had provided its advice to the government following on from the G20 commitments, and the legislative response to that advice was well underway. The resulting amendments to the Corporations Act came into force at the beginning of 2013. These gave the responsible minister the power, on the advice of the regulators, to determine particular products for mandatory trade reporting, central clearing or platform trading. They also gave ASIC the power to elaborate on the details of any such obligations by setting derivative transaction rules.

As I foreshadowed then, the immediate priority once the legislation came into effect was the introduction of a broad-based trade reporting requirement. That regime is now fully in force for all but the smallest derivatives market participants.

Given its mandate for financial stability, the Reserve Bank's primary interest has been in central clearing, and it has worked closely on this with the other council agencies. Initially the agencies favoured an incentives-led transition to central clearing. But for a number of reasons, including considerations of international consistency, the council ultimately turned its attention to a mandated approach. An important initial step was to establish a framework for assessing the case for any mandatory clearing obligations. That framework was applied in the regulators' published reports on the Australian OTC Derivatives Market in July 2013 and April 2014. Together, these reports made recommendations to the government to proceed with clearing obligations for interest rate derivatives in Australian dollars and four major global currencies.[2]

As most here would know, just a few weeks ago, the government issued a determination consistent with those recommendations. The government also released amendments to the Corporations Regulations 2001 restricting the institutional scope of the regime to internationally active dealers. ASIC is now in the process of finalising its derivative transaction rules in response to feedback from the recent consultation. These rules will set out further details of the mandatory clearing requirement including how the mandate will apply to cross-border transactions, the use of overseas CCPs to meet the mandate, and the effective commencement date in 2016.

Key considerations in implementation

The implementation of a mandatory clearing obligation in Australia has involved a number of important considerations. The aim throughout has been to ensure that the financial stability benefits of central clearing are achieved, while supporting effective market functioning and keeping the Australian market globally connected. I would like to discuss in more detail how the regulators have sought to achieve this.

Ensuring that the stability benefits are achieved

Central clearing potentially offers a range of well-known benefits. They include: centralised and standardised risk management; reduced counterparty risk exposures due to multilateral netting; a less complex and more transparent 'hub and spokes' network of exposures; coordinated default management; and operational improvements and efficiencies. CCPs also provide a focal point for regulation and oversight.

These benefits are likely to be greatest for products that are traded widely and which give rise to sizeable counterparty exposures when they are not centrally cleared. In the Australian context, the regulators have identified Australian dollar-denominated interest rate swaps, and

[2] The US dollar, euro, British pound and Japanese yen.

swaps denominated in the major currencies, as having these characteristics. These products were therefore prioritised in the regulators' recommendations.

The trade-off, of course, is that CCP clearing concentrates risk in just one (or a few) systemically important entities that might be critical to the functioning of the financial system as a whole. This has always been recognised in the debate. But, as the share of activity that is centrally cleared has risen, this dependence has attracted increasing attention. It is critical that these entities are highly resilient to shocks, operate on a continuous basis, and maintain the confidence of market participants.

Recognising this, in 2012, the relevant international standard-setting bodies[3] published an enhanced set of standards for CCPs and other critical facilities called the Principles for Financial Market Infrastructures (PFMI). As the title indicates, the standards are principles based, and they have broad coverage. They establish requirements in all areas of CCP design and operation: legal and governance arrangements; credit and liquidity risk management; settlement; default management; general business risk and operational risk management; and access, efficiency and transparency.

The PFMI have been adopted internationally and an extensive peer review process, co-chaired by the Reserve Bank, is underway monitoring the implementation measures that have been taken. In Australia, the Bank has included the stability-related principles in its Financial Stability Standards and has found them to be a sound basis for supervisory dialogue on risk matters. Application of the principles has been a catalyst for a range of enhancements in the risk management practices of the CCPs under the Bank's supervision. ASIC has addressed other aspects of the principles in its supervision and policy setting activities, including by setting out ASIC's expectations of how licensed CCPs should comply with their licence obligations.

Given the particular importance of continuity of service, a key focus of the debate has been on what might be called 'Plan B'; that is, how to ensure that, if a severe stress event threatened the viability of a CCP, it could continue to operate uninterrupted. There are two strands to the work in this area: recovery, which refers to actions taken by the CCP itself in a stress event; and resolution, which refers to actions taken by a resolution authority within the framework of a special regime to restore viability.

The principles require that the tools and powers available to a CCP in recovery allow for any residual losses and liquidity shortfalls to be allocated comprehensively. So in principle, if a CCP in stress was able to implement its recovery plan in full, resolution should never be necessary.

A special resolution regime is nevertheless an important back-stop. Resolution actions might be called into play if a CCP faced challenges in executing its recovery plan without public intervention, or if there were stability grounds for the resolution authority to intervene. It is expected that the starting point for a resolution authority would be the CCP's own recovery plan.

A number of jurisdictions, including Australia, are now developing special resolution regimes for CCPs and other FMIs in accordance with an agreed international framework developed by the Financial Stability Board (FSB).[4] In Australia the government consulted on a proposed regime in the first half of this year. Under the proposal, the Reserve Bank would be the resolution authority for domestically incorporated and domestically licensed CCPs and securities settlement facilities. Its mandate would be to pursue the overarching objective of financial stability and an additional key objective of continuity in the provision of critical services. In this week's response to the Financial System Inquiry, the government agreed to progress additional measures in this area.

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[3] The Committee on Payments and Market Infrastructures (CPMI) and the International Organization of Securities Commissions (IOSCO).

[4] This framework is set out in the *FSB's Key Attributes of Effective Resolution Regimes* (ref).

Supporting market functioning

In implementing all these reforms, the Australian authorities have been careful to intervene only where necessary, so as to preserve appropriate incentives and avoid imposing unnecessary costs on industry participants. This was reflected in the initial preference for industry-led solutions that relied on private incentives. The Bank and the other regulatory agencies took the view that an industry-led approach would allow the transition to occur in a measured way, and would avoid unnecessarily interfering with commercial outcomes.

The decision, ultimately, to recommend a mandated approach, and the government's acceptance of that advice, were driven importantly by considerations of international consistency. In a number of cases, products had already been mandated for clearing in other jurisdictions, notably interest rate derivatives denominated in the major currencies. The regulators took into account the benefits that could arise in such cases from favourable comparability assessments of the Australian regime, and from avoiding opportunities for regulatory arbitrage. These, of course, needed to be balanced against any possible adverse implications that regulatory intervention might have for market functioning.

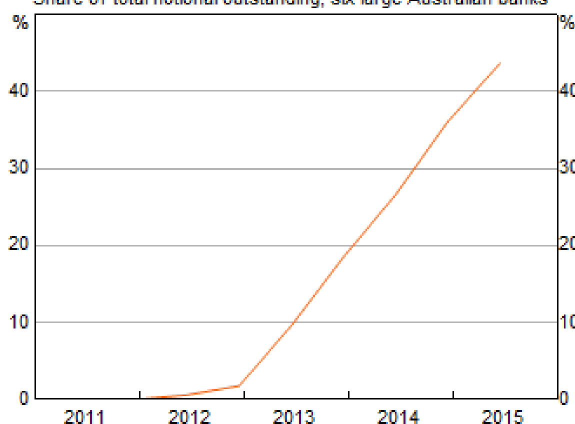
By the time they issued their recommendation in respect of interest rate derivatives in the major currencies, the regulators were confident that the industry had already made considerable progress in the transition to central clearing for these products. The incremental cost of regulatory intervention was therefore expected to be low. By April 2014, when the regulators also recommended that Australian dollar-denominated interest rate derivatives be centrally cleared, the Australian banks were already well advanced in becoming direct participants of the two licensed clearing services, LCH.Clearnet Limited (LCH.C Ltd) and ASX Clear (Futures).

During the period since those recommendations were made, the transition to clearing among Australian banks has continued to accelerate, even though the clearing mandate has only recently been confirmed and has yet to take effect. Our liaison with Australian banks reveals that they are now centrally clearing almost all new trades that are eligible for clearing, and have also made considerable progress in backloading legacy trades into CCPs. All four major Australian banks are now active participants of both LCH.C Ltd and ASX Clear (Futures) and more than 40 per cent of Australian banks' outstanding OTC interest rate derivatives across currencies has been centrally cleared via LCH.C Ltd (Graph 1).

Graph 1

Centrally Cleared OTC Interest Rate Derivatives

Share of total notional outstanding, six large Australian banks*



* Principal notional outstanding with LCH.C Ltd as a percentage of all AUD and non-AUD OTC interest rate derivative positions reported by Australian banks in the BIS semiannual derivatives survey; observation for June 2015 is provisional and is subject to revision

Sources: BIS; LCH.C Ltd; RBA

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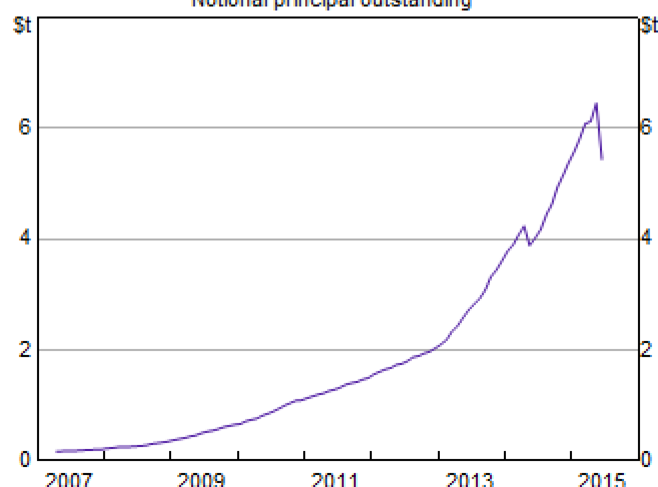
Both pricing and regulatory factors have contributed to this. Of course, the anticipation of a mandate being introduced has been an important factor. But more generally over time, a material pricing differential has emerged between cleared and non-cleared transactions, which has reinforced this trend. In the case of Australian dollar-denominated interest rate derivatives, the acceleration of Australian banks' transition to clearing has contributed to an increase in total notional cleared to more than $5 trillion (Graph 2).[5]

Since the regulators issued their recommendation, CME Clearing (CME) has also become licensed in Australia, although it currently has no direct Australian participants. It is not yet clear how the competitive dynamics in this area will evolve.

Graph 2

A$ Interest Rate Derivatives Cleared at CCPs

Notional principal outstanding*



* CCP figures adjusted for the double counting that occurs when a trade is novated. ASX Clear (Futures) data not available before December 2014

Sources: ASX Clear (Futures); CME; LCH.C Ltd

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Another important consideration for the regulators was the institutional scope of any clearing mandate. The government ultimately followed the regulators' advice that the clearing mandates should apply only to internationally active dealers. This followed a survey, completed in early 2014, of non-dealers' use of OTC derivatives. Overall, the regulators were not convinced of the public policy case to extend clearing mandates to non-dealers. They took the view that the contribution to systemic risk reduction might be limited, given the relatively small scale of non-dealers' activity and their typical hedging motivation. There remained questions over access to appropriate clearing arrangements. And the international consistency motivation was also weaker. Reinforcing this conclusion, subsequent evidence suggests that non-dealers' access to clearing agency services may be becoming more limited, with a number of instances of clearing agents stepping back from this business.

Dealing with cross-border issues

The third area I'd like to touch on is the cross-border dimension. Given the global nature of the OTC derivatives market, this has been a prominent part of the international policy debate. A

[5] The recent decline in cleared notional observed in Graph 2 represents compression activity. Compression is the practice of terminating offsetting trades in participants' portfolios.

particular focus has been the cross-border application of some jurisdictions' rules, and arrangements for deference and cooperation among regulators. For a jurisdiction such as Australia, with a relatively small but highly globally connected financial sector, these things are particularly important. A key consideration has been to ensure that regulatory settings allow Australian institutions to remain globally connected. Another is to ensure that the desired outcomes are achieved without duplicating regulatory costs for market participants. ASIC has given considerable thought to these questions as part of its rulemaking on mandatory clearing. The Australian agencies have also worked closely with overseas regulators on the cross-border dimension.

Let me give you a concrete example.

In recent years, equivalence assessments of the Australian regimes in this area were undertaken by the European Securities and Markets Authority (ESMA). These assessments were used to determine whether the European authorities would allow Australian rules to apply, or would impose their own requirements on Australian institutions. In the case of CCPs, the Australian regime was given an unconditional positive assessment of equivalence by ESMA in late 2013. This ultimately led to recognition for the two CCPs in the ASX Group under the European Market Infrastructure Regulation.

Similarly, in the United States, ASX Clear (Futures) recently became the first foreign CCP to obtain an exemption from registration as a Derivatives Clearing Organisation by the US Commodity Futures Trading Commission (CFTC). This was, effectively, recognition of the equivalence of the Australian regulatory regime, and it avoided a potentially costly duplication of requirements for that business.

Of course, the mutual recognition process needs to work in both directions, and the Australian regulators have conducted similar equivalence assessments in cases where foreign CCPs have sought to offer their services here. In recent years, both LCH.C Ltd and CME have been licensed to offer services in Australia. In both cases, this occurred under provisions requiring the overseas regulatory regime to be deemed 'sufficiently equivalent' to that in Australia and supervisory cooperation arrangements to be concluded with the relevant overseas regulators. The resulting oversight regime maintains a broad equivalence of standards, avoids regulatory overlap and provides for deference to the home regulator.

One other important aspect to be considered was the framework for domestic location requirements for systemically important facilities. Early in the policy process, a key question was the extent to which we should allow our domestic market to be cleared by an overseas-based CCP. After careful consideration, it was decided not to insist on domestic incorporation. Although a financial stability argument might be made for such a requirement, the regulators took the view that it could risk market fragmentation and might not be sustainable in a rapidly changing global market.

Instead, the council has developed a graduated framework for imposing additional regulatory requirements depending on the importance of a cross-border CCP to the domestic economy and financial system. In 2013, LCH.C Ltd became the first CCP to be granted an overseas licence and to fall within the scope of this framework. LCH.C Ltd has since established operational and governance arrangements commensurate with the scale of its services to Australian participants. It has also established Australian dollar liquidity arrangements consistent with the requirements for a systemically important CCP, including opening an Exchange Settlement Account with the Reserve Bank. As part of the supervisory arrangements, the Bank is also represented on a global college for LCH.C Ltd, led by the Bank of England, as well as a newly established crisis management group.

Since CME's operations in Australia are currently limited, additional requirements under the regulatory influence framework have not been triggered. The Bank and ASIC nevertheless have a joint memorandum of understanding with the CFTC to support deference arrangements, both in respect of CME and in respect of the CFTC's interest in ASX Clear (Futures).

What remains to be done?

Of course, the work is not yet done. While the reporting regime has been almost fully implemented and the transition to clearing is well advanced, some elements of the agreed international package of derivatives reform have yet to be completed. For instance, the international margining regime for non-centrally cleared derivatives is not due to come into force until next September; APRA is leading domestic work on the local implementation of that regime. At the same time, ASIC has been working on a framework for assessing the case for mandatory platform trading. This is one of the topics that will be considered in the regulators' latest OTC derivatives market assessment report, due to published early next month.

Internationally, work is continuing on CCP resilience, recovery and resolution. Regulatory arrangements supporting cross-border provision of CCP services will continue to be refined over time, with a particularly important area of focus being cross-border crisis management and resolution arrangements. The Australian regulators will continue to engage in these debates.

Conclusion

Let me draw all this together with a few concluding remarks.

As I said at the outset, the work on derivatives reform is just one part of a wider effort to build resilience in our financial systems. Given the global nature of these markets, the regulatory work has necessarily had a strong international dimension.

In engaging with this, the Australian regulators have sought to keep several objectives in mind. Of course, there is the overarching objective of financial stability. But there are a number of other important aims to be taken into account: supporting market functioning; the need for our institutions to maintain connectedness with the rest of the world; avoiding costly duplication or inconsistency of requirements with other jurisdictions; and ensuring that regulatory settings are proportionate to the risks that need to be managed.

In balancing these aims, we recognise that it is important to consult thoroughly with market participants at each stage of the process. We take that very seriously. So I take the opportunity today to thank market participants, and to thank ISDA, for the constructive way that you've engaged with us on all these reforms.

Thanks for your attention today.