THE 31ST ANNUAL CONFERENCE OF THE BANKING & FINANCIAL SERVICES LAW ASSOCIATION

G20 REFORMS - HOW FAR HAVE WE COME, HOW FAR YET TO GO?

MR DANIEL MCAULIFFE, MANAGER, BANKING AND CAPITAL MARKETS REGULATION UNIT, AUSTRALIAN TREASURY

COMMITMENTS AND OBJECTIVES

The Global Financial Crisis (GFC) highlighted, amongst other things, the opacity and risks in over-the-counter (OTC) derivatives markets. This has led many jurisdictions to implement a range of reforms.

With most derivatives markets being global in scope, effective reform has required an international coordinated response.

Post-GFC, G20 leaders agreed to a range of key reforms to financial markets: building resilient financial institutions; ending 'too big to fail'; addressing shadow banking risks; and making OTC derivatives markets safer.

On OTC derivatives, the G20 at the Pittsburgh summit in September 2009 committed that:

> *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 at Cannes, this was supplemented with an agreement that international standards on margining of non-centrally cleared OTC derivatives should be developed.[2]

The OTC reforms are quite often referred to as the G20 OTC reforms; but, commentators can often lose sight of the fact that the G20 commitments themselves are not the reason for the reforms; the underlying reasons for reforms are why we made the commitments.

The reforms are directed at improving transparency in OTC markets – for regulators and market participants; and at improving risk management practices.

They are directed primarily at protecting the stability of the financial system, including through protecting prudentially regulated entities. They also play a secondary role in disclosing and addressing improper conduct in derivatives markets.

Major jurisdictions such as the United States of America and the European Union were already taking action prior to the G20 deciding to take collective action. Action by other jurisdictions, including Australia, has therefore also been directed at maintaining access to those markets, avoiding the fragmentation of global liquidity pools, and with an eye to the risks that may arise to our markets if we create opportunities for regulatory arbitrage.

The G20 reforms should also be seen in light of the broader benefits of promoting international standards and responses to global problems; and the adoption of those by our trading partners. We are also mindful of the broader value of G20 itself to Australia, as a source of influence and a venue to promote our interests.

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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

GLOBAL[3]

As at December 2013, the amount of global gross notional outstanding OTC derivatives contracts stood at US$710 trillion. This represents a 20% increase over the last six years (US$596 trillion, December 2007) (see Figure 1), with a 13% increase over the last year alone (US$633 trillion, December 2012).

However, this apparent growth can be deceiving: if you take out double counting due to increasing central clearing, the figure declined by about 10% from the end of 2007. This is not just a product of changing numbers of trades – trade compression alone has eliminated some US$170 trillion of transactions over that period.

The gross notional outstanding contracts figure is the one commonly focussed on in the media when describing the size of derivatives markets. However, if you are considering risk and exposures, market value and the credit exposure figures may be the more relevant figures.

The gross market value of outstanding OTC contracts was US$19 trillion at December 2013, down from US$25 trillion at December 2012 (see Figure 2). The market value figure is relevant as it represents the replacement costs of the contracts and therefore the loss incurred if a counterparty fully fails to meet their obligations under the contract. The market value at end-2013 was only 3.5% of the total notional amounts of the contracts.

However, there are arrangements in place so that the full value of contracts is not lost upon counterparty default or failure. Notably, counterparty credit risk is mitigated through netting agreements and the posting of collateral. Gross credit exposures in December 2013 were US$3.0 trillion, down from US$3.8 trillion the year before. This was only 16% of the gross market values or 0.4% of the total notional outstanding at December 2013. In comparison, the year before gross credit exposure in December 2012 was 14.5% and 0.5%, of the gross market values and total notional outstanding respectively (see Figure 3).

Figure 1

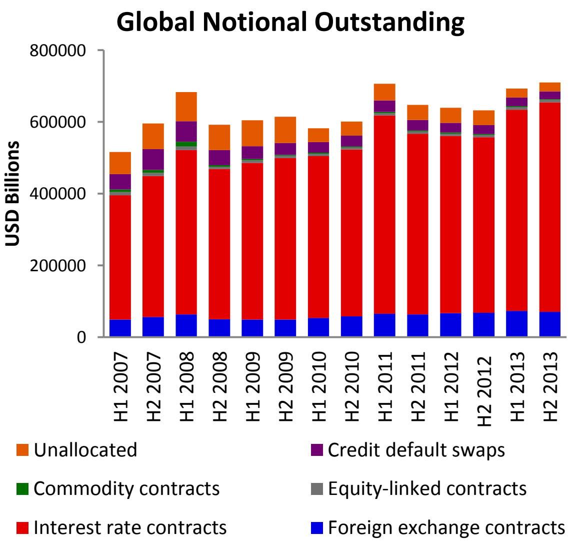
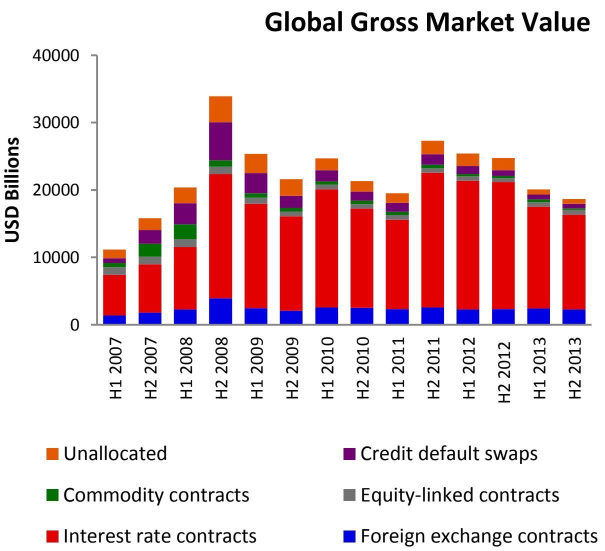
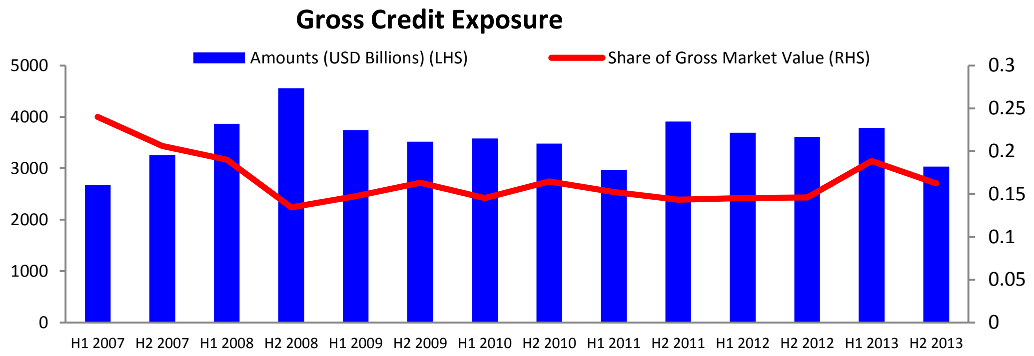


Figure 2



[3] All statistics are sourced from Bank for International Settlements, Monetary and Economic Department, Semi-annual statistical releases, OTC derivatives Statistics, for May 2008, December 2013 & May 2014. Figures 1 -3 are derived from that data, mirroring graphs contained in those releases. Available at: http://www.bis.org/publ/otc_hy1405.htm, See also: http://www.bis.org/statistics/dt1920a.pdf

Figure 3



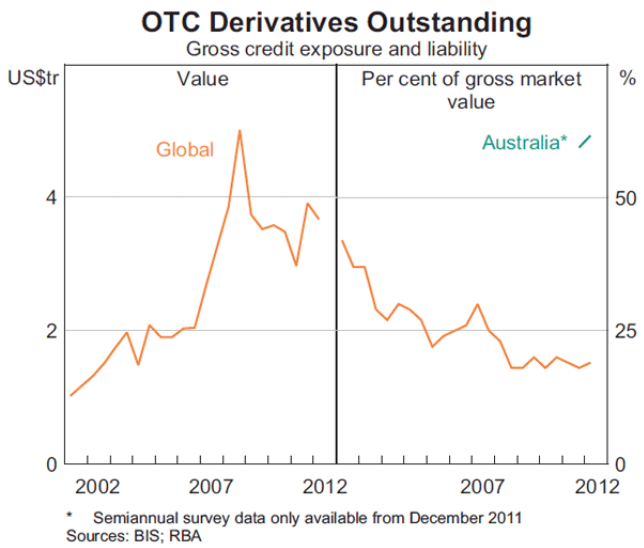
Derivatives reforms are directed at understanding and managing risks – the more relevant figures to focus on are therefore the US$19 trillion (gross market value of outstanding OTC contracts) or US$3 trillion (gross credit exposures) figures, rather than the US$710 trillion figure.

However, you can lose perspective when taking about dollar figures in the hundreds of trillions; US$3 trillion is still a very large number.   Australia's 2012-13 GDP was about AUD$1.5 trillion.

AUSTRALIA[4]

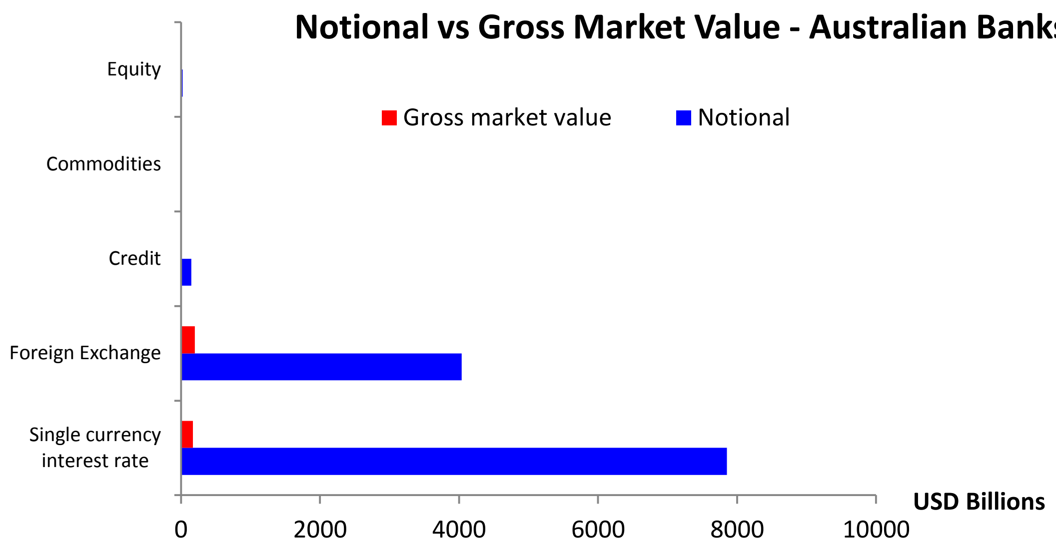
In comparison, at June 2013 total notional outstanding derivatives with Australian banks were about US$12.2 trillion, with a gross market value of US$384billion – about 1% of the global figures. Australian gross credit exposures are over twice the global average as a share of gross market values (Figure 4). This largely reflects the fact that the reporting Australian banks tend to be on one side of cross-currency swap positions, which they use to hedge their offshore funding, and so are unable to net exposures with counterparties.

Figure 4

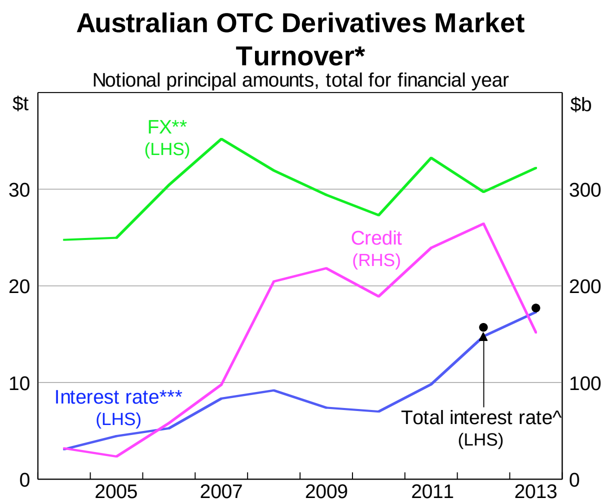


4 Tables and data for graphs are sourced from: Report on the Australian OTC Derivatives Market; Australian Prudential Regulation Authority, Australian Securities and Investments Commission, Reserve Bank of Australia, April 2014. Available at: http://www.cfr.gov.au/publications/cfr-publications/2014/report-on-the-australian-otc-derivatives-market-april/pdf/report.pdf

For comparison with the global total notional and gross market value figures (above), the following graphs for derivatives activity with Australian banks is provided below:



Australia has also seen growth in total notional OTC derivatives transactions; initially reasonably flat from 2007, with growth then picking up from mid-2010. As is the case globally, a significant portion of the increase arises from the rise of central clearing, rather than growth in underlying activity.



* 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
^ Includes non-AUD single- and cross-currency swaps; not collected before 2011/12
Source: AFMA

OTC DERIVATIVES REFORMS IMPLEMENTATION

Australia has sought to rely on market and other regulatory incentives, as the primary drivers for the adoption of improved OTC derivatives risk management arrangements; with a legislative framework as backup where adoption is not occurring on a timetable consistent with our G20 commitments or where mandating is necessary (due to incentives not working or in order to obtain mutual recognition with foreign jurisdictions).

LEGISLATIVE FRAMEWORK

In December 2012 legislation was passed establishing a regime for the imposition of mandatory requirements in respect of trade reporting, central clearing and platform trading of OTC derivatives.

The regime allows the responsible Minister to issue a determination allowing the imposition of specific requirements. ASIC may then make Derivative Transaction Rules (DTRs) setting out the details of how the requirements will be implemented.

The legislation requires the Minister to consult the Regulators (ASIC, APRA and the Reserve Bank) before making a determination, and allows the Regulators to provide advice to the Minister in relation to Ministerial determinations on OTC derivatives.

The Regulators conduct detailed assessments of the OTC derivatives markets at regular intervals. The resulting findings together with any recommendations to the Government for regulatory action are summarised in a continuing series of Reports on the Australian OTC Derivatives Market. The most recent report was issued in April 2014 (see below for the recommendations made with respect to central clearing).

TRADE REPORTING

Following a recommendation made by the Regulators, a Ministerial determination was made in May 2013 imposing a trade reporting obligation for OTC derivatives transactions. ASIC's detailed DTRs were subsequently finalised and trade reporting began for the 4 major Australian banks plus Macquarie on 1 October 2013.

The phased implementation of the reporting obligation commenced is detailed as follows:

Phasing of ASIC's Trade Reporting Regime[5]

Phase	Reporting entities	Effective Date	
		Credit and interest rate derivatives	Commodity[(a)], equity and foreign exchange derivatives
1	Australian Swap Dealers	1 October 2013	1 October 2013
2	Financials with greater than $50 billion notional principal outstanding	1 April 2014	1 October 2014
3A	Financials with less than $50 billion but more than $5 billion notional principal outstanding	13 April 2015	12 October 2015
3B	Financials with less than $5 billion notional principal outstanding[(c)]	12 October 2015	12 October 2015

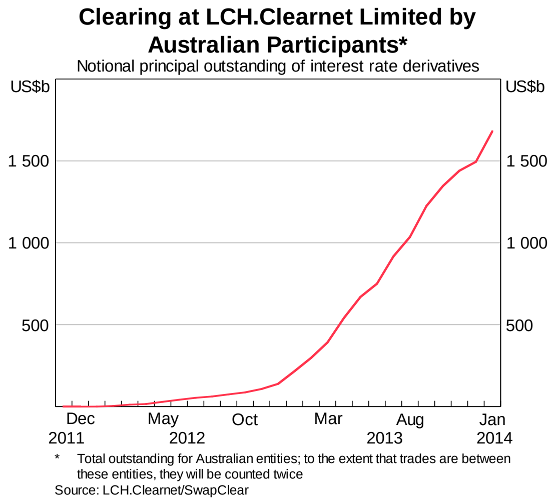
(a) Excluding electricity derivatives

5 Table sourced (with modifications to reflect changes to Phase 3) from www.asic.gov.au

ASIC had recently finalised its Derivative Trade Repository Rules (DTRRs) and associated guidance for entities seeking an Australian Derivative Trade Repository (ADTR) Licence. No trade repositories are yet licensed to operate in Australia. In the interim, the Government has prescribed by regulation a number of trade repositories that can be used to fulfil Australian trade reporting obligations.

CENTRAL CLEARING

There has been a dramatic increase in the central clearing of derivatives transactions. The graph below shows clearing through LCH of AUD interest rate swaps (IRS). The overwhelming majority of AUD IRS is still cleared through LCH, although ASX launched its own clearing service in Q3 2013.



The April 2014 market assessment by Australian regulators found that almost all new AUD IRS are being cleared. Although only 22% of outstanding contracts were cleared as at July 2013, it is expected that existing trades will be cleared in due course.

The uptake of clearing is being driven by institutions acting in anticipation of mandatory clearing (under domestic or foreign rules); the more favourable capital treatment of cleared trades under Basel II and III capital requirements; and commercial incentives – such as responding to the shift of liquidity to cleared derivatives, dealers seeking operational and netting efficiencies, minimising capital requirements by moving to cleared transactions, and emerging pricing differences on cleared trades.

Incentives to clear – Prudential regulation treatment of derivatives exposures

Cleared and non-cleared transactions are subject to different prudential requirements. These requirements incentivise banks to clear standardised OTC derivatives trades through central counterparties (CCPs), while also seeking to ensure that credit exposures to CCPs are sufficiently capitalised.

Banks are required under Basel II to meet a default risk capital requirement in respect of their counterparty credit risk exposures. The Basel III reforms introduce an additional capital charge for non-cleared transactions (the Credit Value Adjustment (CVA) risk capital charge). The Basel III reforms also introduced capital charges for exposures to central counterparties (CCPs). In respect of the latter, a distinction is made between exposures to qualifying CCPs and non-qualifying CCPs.

A joint taskforce comprising the Basel Committee on Banking Supervision (BCBS), the Committee on Payment and Settlement Systems (CPSS) and the International Organisation of Securities Commissions (IOSCO) is working on refining the capital framework for bank exposures to CCPs.[6]

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

In July 2013, the Regulators carried out their second market assessment. The principal recommendation arising from that assessment was that the Government should consider a central clearing mandate for US dollar-, euro-, British pound- and yen-denominated (G4) interest rate derivatives (IRD), and that the initial focus of such a mandate should be dealers with significant cross-border activity in these products. The recommendation was primarily made on international consistency grounds, with the Regulators considering that there would be a benefit to the Australian financial system from adopting an approach that was consistent with that of overseas regulators, who are proceeding with mandatory clearing across a range of instrument classes. Since the publication of this report two central counterparties have been licensed in Australia – ASX Clear and LCH. Both offer clearing of Australian dollar (AUD) denominated IRD for participants, with LCH also offering clearing of G4 IRD.

In February 2014, the Australian Government launched a public consultation on a clearing determination in line with the Regulators' recommendation.

In April 2014, the Regulators released a new Report on the OTC derivatives market. The key recommendation in this Report was for the Australian Government to mandate central clearing for AUD-IRD transactions conducted between internationally active dealers. The Regulators noted that there would be a substantial benefit from increased central clearing of AUD IRD, and that the incremental cost of imposing the mandate would be very low for internationally active dealers, given the progress they had made in implementing clearing arrangements.

In July 2014, the Australian Government released a supplementary proposals paper seeking stakeholder views on a potential mandatory requirement for central clearing of IRD denominated in Australian dollars, as part of the ongoing implementation of global reforms to OTC derivatives markets in Australia.

DEALERS V NON-DEALERS

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

In the long term, commercial incentives – such as 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.

It is unclear, for non-dealers, whether central clearing is appropriate and whether the private benefits will ever be sufficient to offset the costs. For instance, if a liquidity constrained non-dealer, such as a superannuation fund, were required to centrally clear it would either have to re-allocate a portion of its investments to high-quality liquid assets or secure a costly line of credit. In either case, there would be an adverse impact on its investment return to fund holders.

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.

OTHER DERIVATIVES CLASSES

In considering the case for imposing a clearing mandate for North American, European and Japanese referenced credit derivatives, the regulators have observed a relatively low level of activity in these products on the part of the large Australian banks. In contrast to the case of AUD IRD, almost all Australian market activity in these products involves at least one overseas-headquartered counterparty. Consequently, the regulators believe that, even in the absence of a domestic mandate for these products, the likelihood of regulatory arbitrage is minimal. Furthermore, very few domestic participants have arrangements in place to clear North American, European or Japanese referenced credit derivatives, and therefore the cost of complying with a mandatory clearing requirement for these products could be high in the short term.

Accordingly, the Regulators do not see a case for implementing a domestic clearing mandate for North American, European and Japanese referenced credit derivatives at this time.

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.

TRADING

At this point in time, no mandate for mandatory trade execution has been implemented. Advice from the regulators indicates that it is not yet appropriate to recommend a mandatory platform trading obligation.

The Regulators consider that prior to recommending mandatory platform trading, there should be greater consensus emerging across key jurisdictions on the characteristics of relevant trading platforms for such purposes and there should be further examination of the impact of a mandate on the already relatively low market liquidity in key asset classes.

SWAP EXECUTION FACILITIES

US regulations regarding the registration and operation of swap execution facilities (SEFs) came into effect in October 2013. Under the rules, multilateral swaps trading platforms located in the US or used by US persons are required to register as a SEF or Designated Contract Market.[7]

On 20 December 2013, short term CFTC no-action relief was granted to Yieldbroker Pty Limited (Yieldbroker), which is a trading platform licensed in Australia. As a longer term measure the CFTC indicated that it was considering an arrangement whereby Yieldbroker would register as a SEF with the CFTC while maintaining its Australian Market Licence. In the interim US persons will be able to continue to use Yieldbroker to execute Australian dollar-denominated interest rate derivatives trades.

Simultaneously, Treasury in collaboration with ASIC is undertaking a review of the Australian market licensing regime. The outcome of which and subsequent decisions by the Government and the Parliament, could have implications on the scope of the AML regime or the criteria on which exemptions are granted.

Potentially, new regulatory categories could be established – e.g. a licence class that mirrors a US SEF to facilitate mutual recognition.

MARGINING OF NON-CENTRALLY CLEARED TRANSACTIONS

A fourth 'pillar' of the G20 OTC derivative reforms is the commitment to develop global standards on margining of non-centrally cleared OTC derivatives. In September 2013, a framework was published for the implementation of margin requirements for bilateral derivatives exposures (available at http://www.bis.org/publ/bcbs261.pdf). This framework, developed by the Basel Committee on Banking Supervision (BCBS) and IOSCO, seeks to reduce contagion that could result from the default of a market participant, through appropriate collateralisation of derivative exposures. Furthermore, the framework improves transparency and promotes central clearing of appropriate derivatives.

In terms of implementation timing, the international standard provides that the requirement to collect and post initial margin on non-centrally cleared trades should 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.

The regulators in their regular assessment reports have found that there is widespread use of margining in Australia in accordance with market practice and the market conventions promoted by the Australian Financial Markets Association (AFMA).

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7 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>.

The Government is considering the implementation of the BCBS/IOSCO margining standards.

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 the implementation of the BCBS-IOSCO margin requirements for non-centrally cleared OTC derivatives in key jurisdictions.

RISK MANAGEMENT PRACTICES

IOSCO has established a Working Group to set standards by end of 2014 on risk mitigation techniques for non-cleared trades, including documentation, confirmation, portfolio reconciliation, compression, valuation and dispute resolution. ASIC is participating in the IOSCO working group.

Under EMIR and Dodd-Frank, there are requirements for financial counterparties and some non-financial counterparties in relation to risk management practices.

While Australia does not have explicit requirements in law, AFMA issues 'market conventions', which we understand are widely followed by Australian participants. At a market level the regulators have advised that participation in trade compression has already increased. Moreover, prudential regulatory requirements including the Basel III reforms will also promote increased use of trade compression.

The absence of explicit requirements, however, has posed issues in relation to equivalence assessments with the US and EU, who require legal obligations when granting mutual recognition to our arrangements. In 2013, the European Securities and Markets Authority (ESMA) advised that the Australian regime with respect to the risk management obligations applying to non-centrally cleared OTC derivatives was not fully equivalent to that of the EU.

The Government will consider implementation of the standards formulated by the IOSCO working group once they are finalised.

INTERNATIONAL

It is important for the G20 OTC derivative reforms to be implemented across jurisdictions in a coordinated and consistent manner. This requires extensive cooperation among regulators and authorities. Cooperation and synchronisation in implementing standards is needed and where these have been lacking, concerns have surfaced about undesirable market fragmentation, and increased costs and uncertainty for business.

Australia is seeking to implement the G20 reforms in accordance with a globally coordinated approach that keeps foreign markets open to Australian businesses. This is particularly important for Australia as a medium-sized open economy that relies on the large global capital markets for funding and risk management through the use of derivatives.

Australia has been heavily engaged in international efforts to address conflicting and inconsistent implementation of G20 commitments across jurisdictions. Australia has worked with international regulators to facilitate substituted compliance arrangements. Some notable outcomes have already been achieved in this respect:

- ESMA has provided advice to the European Commission that the Australian regulatory framework is equivalent to the European framework in most important areas, including trade reporting and mandatory clearing of OTC derivatives. The Commission is preparing corresponding legislation based on this advice.

- The CFTC has provided substantial relief from a range of onerous requirements for Australian banks active in US financial markets based on a positive outcome of its equivalence assessment of the Australian OTC derivatives regulatory regime. The CFTC determinations are expected to be of significant assistance for Australian banks in continuing to raise funds and hedge risks in the US markets.

As further pieces of the OTC reforms are put in place, the Government and the Regulators will continue to work with international regulators such as ESMA and the CFTC to gain additional concessions facilitating the activities of Australian business in the global financial markets, including through the development of Memoranda of Understanding (MOUs) with foreign jurisdictions.

On a global level, the Financial Stability Board (FSB) continues to monitor jurisdictions' progress in implementing their G20 commitments through regular progress reports (see latest report[8]). These reports encourage consistent and timely implementation of OTC derivatives reforms.

The OTC Derivatives Regulators Group (ODRG) has also been established to find mutually agreed solutions to the problems created by inconsistent cross border implementation of reforms of OTC derivative markets. It consists of regulators from Brazil, the European Union (EU), Hong Kong, Japan, Ontario, Quebec, Singapore, Switzerland, the US and Australia. In September 2013 G20 Finance Ministers and Central Bank Governors urged the ODRG to intensify its efforts to address and resolve remaining cross border conflicts, inconsistencies, gaps and duplicative requirements and to report on its progress in responding to this request. ODRG issued a first report in March 2014 and intends to report again in November 2014 in the context of the G20 Leaders Summit.

[7] http://www.financialstabilityboard.org/publications/r_140408.htm