Finance and Treasury Association

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Re consultation on Implementation of Australia's over-the-counter derivatives commitments - FTA Response to Treasury proposals for a permanent end-user exemption

The Finance and Treasury Association welcomes this opportunity to once again consult with Australia's financial regulators on proposed regulation of OTC derivatives transactions.

This will be FTA's sixth formal submission on OTC derivative regulations starting in September 2011 with a response to the Council of Financial Regulars (via RBA), then June 2012 (Treasury), September (Treasury), October (Parliament of Australia), and February 2013 (Treasury).

Background

FTA recognises that this consultation forms part of the necessary work designed to ensure that Australia meets commitments made at the 2009 G-20 Summit in Pittsburgh with regard to regulation of over-the-counter (OTC) derivatives.

We note that two trade repositories have been licensed, and that the first stage derivative trade reporting under Australia's G20 obligations has commenced.

In prior submissions, FTA has taken comfort that Treasury has acknowledged FTA's key message "some stakeholders argued that their use of derivatives was primarily for the hedging of

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business risk and questioned the systemic importance of their derivatives trading activities". We reiterate that point.

FTA has also previously noted that there may be a negative real economy impact from the direct application of these OTC derivative regulations on the corporate sector. A common experience with regulation is that any extra costs and complications end up being borne by the end user, and so dampen economic activity; policy-makers and regulators need to show caution as to what they impose.

FTA reiterates that non-financial corporations ("corporates") make extensive use of derivatives to manage financial risk positions created through ongoing business operations or funding activities. FTA was particularly concerned to ensure its Australian corporate treasurer members will continue to be able to use flexible OTC instruments such as forward foreign exchange contracts and cross currency swaps and these vital tools not be made prohibitively expensive or administratively unworkable. FTA considers that deals done by non-financials based in Australia are a small part of the derivatives markets, and are not material in their impact on systemic risk and hence should be exempted from the proposed rules.

FTA retains its position that the Australian financial market and economy would be best served by adoption of single-sided reporting i.e. the US reporting hierarchy principle that only one party to each derivative reports the transaction and the reporting party will be the financial institution with the highest level of registration (i.e. Swap Dealer or Major Swap Participant under the Dodd-Frank Act).

And FTA wishes to reiterate its position that the exemption should extend to end user transactions where both parties are part of the same corporate group. Many corporates centralise their market activity in order to reduce risk and better manage the financing requirements of global operations. This can result in internal derivative transactions between legal entities of the same corporate group. We can see no benefit in reporting these internal transactions.

Finally, FTA considers OTC trade repository information on corporate hedging should only become publicly available with a significant lag and on a basis where names could not be determined by the nature of data released. FTA considers that there is a risk of breaching of commercial-in-confidence arrangements.

Australian non-financial corporations use derivatives more intensively than international peers for two reasons, namely (i) the need to access international capital markets and (ii) our high proportion of commodity producers. For this reason, in support of substituted compliance with

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international capital markets jurisdictions it behoves Australian policy-makers and regulators to take a lead in justifying these exemptions to their international peers in the G20 process.

Comments re Specific Questions

1. Do you have comments on the benefits and costs of complying with a mandatory central clearing obligation, from the point of view of your business and/or that of your customers?

FTA members feel strongly that the activities of typical non-financial corporation end-users do not pose a systemic risk to the Australian nor global financial system. As such we maintain that the direct and indirect cost of non-financial corporations being required to clear OTC derivatives centrally would more than offset the benefit. And so we reiterate our practical disagreement with the double-sided reporting principle.

FTA also takes issue with Basel – IOSCO rules which place a capital penalty on banks dealing non-centrally cleared OTC derivatives. Such "exotic" derivatives include risk management products in wide use by corporate treasurers to manage everyday business risks.

And while taking a pragmatic perspective, and recognising Australia's G20 commitments, FTA has also questioned the very rationale for centralised clearing and exchange-trading, in raising concerns that they may in fact exacerbate the concentration risk that is present, but less of a concern, under a traditional diffused over-the-counter regime.

3. Do you agree with the proposal to restrict ASIC rulemaking to entities that are considered to be G4 Dealers, and to exempt intra-group trades? Could you comment on the incremental costs and benefits of including or exempting other types of entities or transactions? For example including all AFSL holders and ADIs or alternately setting a high threshold of activity.

FTA agrees with the proposal to restrict ASIC rulemaking to entities that are considered to be G4 Dealers, and to exempt intra group trades.

FTA believes that it is desirable for Australian entities to be regulated at home under a regime which achieves **substituted compliance** with key capital markets jurisdictions.

It is acknowledged that Australian institutional borrowers will inevitably have higher costs of compliance to access international capital markets. It is also generally considered that to date this has been a favourable trade-off, as the cost of borrowing and diversity of tenor and investor type has been advantageous to Australian institutional borrowers.

Yet FTA remains unconvinced that the application of OTC trade reporting and clearing to derivative end users would have a net benefit to end users of financial products and services.

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FTA considers it appropriate for Government in the form of the Commonwealth Treasury to retain decision-making power over the local application of foreign financial regulations. Policy-makers are better positioned than regulators to take a principles-based, rather than legalistic, view of regulations. Ultimately they can also take a macro-commercial view.

4. Do you have comments on the calculation methodology used for determining the proposed threshold of activity and the appropriate level of the threshold? Do you have views on whether notional OTC derivatives or notional OTC IRDs is the more appropriate basis for calculating the threshold? Or would you prefer a different methodology and if so, why?

At this point, the Financial Regulators appear to be seeking a mandate only for clearing of OTC transactions between G4 dealers. Our understanding is that non-financial corporation OTC derivative end–users are not covered by this mandate, and that regulators would consult more widely and seek a separate mandate from Government should it wish to extend this mandate beyond non-G4 dealers.

Should there be an intention in future to apply the mandate beyond G4 dealers, FTA advocates further consultation in which exemptions based on end-user definitions for non-financial corporations would need to be developed. At that time, commercially sensible calculation methodologies could be investigated.

FTA is concerned that unless thresholds are well above current derivative use levels that an unintended consequence may be to put in place triggers which cause non-financial corporations to curb derivative use out of concern to avoid any reporting (or central clearing) requirements. This would be an example of commercial actions being potentially over-ridden by regulation.

10. Do you have comments on the proposals relating to:

a) Making the exemption of end-users from trade reporting permanent, subject to ensuring that appropriate information on systemically important OTC derivatives trading is available to regulators?

The FTA welcomes the government's proposal to make permanent the end-user exemption for trade reporting. We do not consider there to be any substantial benefit to imposing trade reporting obligations on true end-users (i.e. those that enter into derivatives for hedging purposes).

However, it is concerning that the "exemption may need to be narrowed" to provide "appropriate" information on systemically important OTC derivatives trading to regulators. The additional proviso that "regulators will also consider the impact…on global efforts to coordinate the reporting framework" is also a matter of concern.

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To make the exemption meaningful, it is critical that the definition of an end-user captures all non-financial corporations in Australia, and there is no attempt to narrow what constitutes an enduser.

And even if an end-user's derivatives activities were considered to be systemically important, it is highly likely that information regarding the relevant trades would be reported by the dealer counterparty (under a single-sided reporting regime). In our view, the regulations should place the obligation to report OTC derivatives on those entities that are best placed to comply with them (i.e. the dealers). If the regulations were to place responsibility for reporting on a systemically important end-user (effectively requiring two-sided trade reporting), the potential legal liability would, in our view, outweigh the benefits to be achieved.

b) A more tightly targeted AFSL reference in the regulations?

FTA agrees with an amendment that an AFS Licensee should not be required to report trades that are conducted outside their AFSL.

We also note that trade reporting for holders of an AFS License is due to commence on 1 October 2014. The reporting obligation applies to all AFS Licensees regardless of the purpose for which they enter into the OTC derivatives or the total value of derivatives which they enter into. Some corporates that primarily enter into OTC derivatives for hedging purposes hold AFS Licenses.

At the very least, FTA is in favour of the proposal to refine the reference to AFS Licensees such that it only captures those AFS Licensees that are authorised to deal in derivatives. We suggest that making this refinement would be entirely consistent with the policy intent behind ASIC's Derivative Transaction Rules (Reporting) 2013.

Furthermore, applying the Reporting Rules to entities that are not authorised under an AFS licence to deal in derivatives (whether or not such entities hold an AFS licence which authorises them to conduct other financial services business) imposes a significant compliance burden (in terms of staffing and systems requirements) on these entities. This outweighs any regulatory benefit gained in respect of achieving transparency of those entities' OTC derivatives transactions.

OTC derivatives entered into by such corporates (including those for hedging) would potentially be caught by the requirement for AFS licensees to report despite the fact that the end-user exemption has been made permanent.

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Hence we encourage the Government to also consider extending the end-user exemption so that all non-financial corporations which are AFS license holders do not need to report trades entered into for hedging purposes.

Finally, FTA feels there may be a need for legal clarification. Does breach of current and proposed rules result in civil penalties or is a direct liability imposed on directors/officers of the company that are involved?

Conclusion

- Corporations are signifcant users of financial derivatives in Australia. These transactions are primarily used to manage financial risk positions created through their ongoing business operations or their funding activities.
- FTA's concern is for such prudent corporate risk management tools to not be made prohibitively expensive or administratively unworkable.
- FTA has reiterated concerns with the central clearing (and exchange trading) of OTC derivatives.
- OTC derivatives used for hedging are not already exchange-traded because they are at some level bespoke. They are bilateral contracts where the counterparties agree terms specific to the needs of the end user.
- FTA remains highly concerned about Basel / IOSCO rules which place a capital penalty on banks dealing non-centrally cleared derivatives with non-financial corporations.
- While FTA is gratified that the end-user reporting exemption is likely to be made permanent we note a negative side-effect with banks already seeking additional information and indemnities. It is a reminder (as with the prior point on uncleared derivatives) that any extra costs and complications tend to end up being borne by the end user and dampen economic activity, so regulators need to be show caution in what they impose.
- Non-financial corporation end-users who are also AFSL holders should also be exempted.
- FTA advocates further consultation in which exemptions based on end-user definitions for non-financial corporations could be developed. At that time, if necessary, calculation methodologies for thresholds also could be developed.
- FTA considers OTC trade repository information on corporate hedging should only become publicly available with a significant lag and on a basis where names could not be determined by the nature of data released.

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FTA considers deals done by non-financials are a small part of the derivatives markets here and abroad, and therefore not material in their impact on systemic risk and should be exempted from the proposed reporting (and clearing) rules.

For Australian entities an exemption for corporate risk management provides degree of protection for the non-standardised way corporate entities access OTC derivatives as a primary risk management tool.

Australian non-financial corporations use derivatives more intensively for hedging than international peers due to a common need to access international capital markets, and due to there being a relatively high number of Australian commodity producers. In support of "substituted compliance" for the Australian regulatory environment with international capital markets jurisdictions, Australian policy-makers and regulators need to be in the forefront supporting these exemptions to their international peers.

We look forward to continue working with Government and the financial regulators on the next stages of the consultations.

Yours faithfully,

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About FTA

The Finance & Treasury Association (FTA) is a professional association for executives working across all aspects of treasury and financial risk management. The FTA provides training and skills development and access to current information, facilitates networking and builds a community in this specialised area of business. It seeks to increase recognition of the skills of members and to convey the views of members on key technical issues facing the profession to government, other associations and the wider community.

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