

Implementation of a framework for Australia's G20 over-the-counter derivatives commitments

Response to July 2014 Proposals Paper – AUD IRD central clearing mandate

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From:

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This submission is prepared in response to the Proposals Paper referred to above. It is made on behalf of those banks named above (the "Group" or "We") in our role as market participants and liquidity providers and reflects a common view on the proposals contained in the Consultation Paper as they relate to our derivatives-trading/ markets businesses. Other submissions may be presented by any or all of the Group reflecting particular issues that require an individual response.

The Group has formed the following common views on the feedback sought in the paper.

Responses to Feedback Questions

1. Do you have any comments on the specific benefits and costs of complying with a mandatory central clearing obligation for AUD IRD, from the point of view of your business and/or that of your customers?
 - In particular, do you agree that the additional compliance costs of complying with a central clearing mandate for AUD IRD would be low for internationally active dealers? We request that, in commenting, you quantify compliance costs as far as possible, including whether costs are likely to change over time, are transitional or projected ongoing costs. For example, costs may include:
 - legal costs;
 - staff costs — for example number of staff hours and training costs;
 - IT costs; and/or
 - increased costs of managing risks or funding projects.

The Group does not feel that there would be a significant cost of compliance and in fact the mandate is consistent with the current market practice for interbank dealing in single currency AUD IRD. We concur that it would be a low impact to internationally active dealers as the market standard has already moved to a clearing basis.

2. *With respect to benefits, do you have views on whether the imposition of a central clearing mandate for AUD IRD would be likely to lead to substituted compliance benefits for dealers? If so, what would these benefits be, and would you be able to provide an estimate of the savings to your firm?*
 - *If possible, please provide the same details as requested above with respect to the detailed breakdown of savings estimates.*

As market standard practice is already to clear clearable inter-dealer AUD IRD any threat to substituted compliance would be more acutely felt than costs or obligations that the mandate would impose. In the international OTC market, substituted compliance presents potential for reduction of the regulatory burden while still achieving regulatory goals.

We think it is helpful to provide perspectives on the two major offshore OTC regimes, vis-à-vis equivalence / substituted compliance.

In the case of CFTC regime, the equivalence concept (“substituted compliance”), unfortunately fails to fully bridge gaps between national regimes, and this lessens the value of it to us. Two observations about substituted compliance regarding clearing under the US regime that Treasury should be aware of:

- (a) **It is hard to get.** We have a concern that the level of equivalence between the Australian regime and the US regime would need to be quite high to obtain a positive substituted compliance determination. Although the CFTC has stated that it is not applying a line-by-line approach to rule comparison, their approach last December was something other than a consideration of the whole of a regime. For example, Japan’s bid to obtain an equivalence assessment for its clearing regime was unsuccessful, on the grounds that in surveying the Japanese regime, the CFTC encountered:

“differences in the scope of entities and products between [the Japanese and the CFTC clearing requirements] due to differences in market structures and conditions”.^[1]

(b) **It does not assist as greatly as it might.** Even if Australia did obtain a substituted compliance determination in relation to its clearing rules, based on the CFTC’s cross-border guidance from last July, it may not assist us greatly. Any trading in mandatorily-clearable swaps that we would do with a US person (other than potentially certain foreign branches of US banks) would always need to be cleared under US rules. Any trading with non-US persons (with the exception of entities guaranteed by or conduited to US persons) could not be impacted by US rules. A positive determination in relation to Australian clearing rules would most likely only present a potential benefit when we are trading with Australian branches of US banks, or Australian incorporated entities in the “guaranteed by or conduited to” category. This is a small benefit, but a definite one.

A genuine benefit of substituted compliance under the CFTC regime is that it may potentially shield us from some adverse CFTC actions in relation to other areas of rulemaking. For example, the CFTC rule, finalised in April 2013 and which provided an exemption from interaffiliate clearing, denied a large benefit of the rule to US entities trading with affiliates incorporated outside of Singapore, Japan and the EU. This small group of jurisdictions was considered by the CFTC to be the only other jurisdictions in the world progressing clearing rules sufficiently at that time.¹ Australia being left off such a list caused some of us some harm regarding risk management of United States-incorporated subsidiaries. When an Australian mandate is implemented, we are hopeful that Australian agencies may be able to assist us in rectifying this situation.

In terms of European (EMIR) equivalence, a positive determination on equivalence is likely to do more to assist Australian dealers. Under the EU equivalence regime, if one of our institutions is trading with a European Bank (i.e. each of us are caught by our respective regimes), and the product is subject to a mandate under both regimes, the parties are able to decide which regime to comply with. An AUD IRS mandate therefore presents a benefit to us in terms of EMIR equivalence.

3. Could you please comment on the incremental costs and benefits of merging the timing and the determinations for G4 and AUD IRD?

There are few incremental costs to merging the rule making dates but potentially significant issues relating to practical implementation. As noted in the paper Australia is at a particularly disadvantage with regard to opening hours of the key CCPs. Neither LCH SwapClear nor the ASX OTC IRD Clearing Service are open 24 hours causing operational issues if transactions struck many hours before they are submitted to clearing fail to do so out of hours to the traders who executed the deal. A mandated requirement to clear in that example would serve to increase systematic risk in all

^[1] <http://www.gpo.gov/fdsys/pkg/FR-2013-12-27/pdf/2013-30977.pdf>

¹ 11 April 2013, see <http://www.cftc.gov/ucm/groups/public/@Irfederalregister/documents/file/2013-07970a.pdf>

currencies including the G4 but is absolutely critical for AUD. LCH Swapclear is also currently unable to accept initial margins in AUD.

We request that the implementation of the AUD mandate does not occur at the same time as the mandate of G4 currencies IRD to permit resolution of some of these problems. Market impact would be further limited by ensuring the mandate coincided with or closely followed AUD IRD mandates imposed by foreign regulators.

The Group notes that critical FMI must be in place and active for the mandate to become live.

4. Do you agree with the proposal to restrict ASIC rulemaking to entities that are considered to be dealers?

Yes. Given the dominance of the Group in terms of turnover amongst Australian entities, there is limited advantage to extending mandatory clearing to a wider range of entities in the initial phase. In the short-term non-dealers, are likely to face significant compliance, IT and liquidity costs. However, Australian agencies may consider extending the scope of mandatory clearing at a later time in order to take into account the meaningful levels of risk brought to the system by certain non-dealer participants and the availability of client clearing and related services to them.

Uncleared OTC derivatives are an important component of many non-dealers' risk management programmes, and use of such derivatives can be both prudent and productive.² A clearing mandate within a short timeframe applying to non-dealers could discourage or in some cases effectively prohibit non-dealers from recourse to an important form of risk management.

5. What are your views on the two options presented above to define internationally active dealers? Do you have views on additional criteria that should be used, or do you think that one or more of the suggested criteria should not be used? Or would you prefer a different methodology and if so, which one and why?

The key question is one of regulator intent and implementation should match that intent. The two options use the terms "financial entity" which could cover active market making participants but also hedge funds and other non-bank counterparts. We would recommend that the obligation should be as symmetrical with foreign standards to ensure minimising of regulatory arbitrage.

There are also definitional details that need to be clarified:

"OTC Derivative". It would be helpful if Treasury or ASIC could consider creating a sounder definition of "OTC derivative" before any more regulations or rules under part 7.5A are put in place. The objective to be pursued in a consultation could be that OTC Derivative is basically comprised of "A" minus "B" minus "C", where:

² Please see for background the ISDA-commission Research Paper entitled: The Value of OTC Derivatives: Case Study Analyses of Hedges by Publicly Traded Non-Financial Firms, March 2014, by Ivilina Popova and Betty Simkins (at <http://www2.isda.org/functional-areas/research/studies/>).

- “A” is the s761D derivative definition;
- “B” represents futures and options on futures, globally;
- “C” is the set of products that the s761D definition picks up, which are not “derivatives” to the ordinary derivatives industry participant or generally considered derivatives across foreign jurisdictions (for example, loan sub-participations and sales of businesses involving intellectual property).

Such a definition should be applied by amendment to the transaction reporting regime and provide some benefit there.

Option A and B item 2: “Entered into in Australia”.

This is a concept that it is not possible to accommodate operationally for historic transactions. Additionally, the strict application of legal concepts of “entered into in Australia” create some impracticalities for future transactions. This lack of practicality is having an adverse impact for foreign dealers in the context of transaction reporting and we suggest deletion of those words.

Option A item 3: Notionals and counterparty static. The proposed definitions place heavy reliance on counterparty attributes that will need to be collected, stored and maintained / updated. For example, each of us would need to know some or all of the following about each of our counterparties, anywhere in the world. We will need to know whether or not the specific counterparty:

- Has \$100 bn or more in gross notional OTC derivatives (defined under the Australian Corps Act) outstanding / outstanding booked or entered into in Australia;
- Is a “financial entity”. It is not clear how this would be defined, particularly for non-Australian financial entities.
- Whether or not it had used up its trading limit with Australian dealers (referring here to option A point 3). This requires some complex counterparty attribute work, which would ideally be addressed by a global real-time-running utility that existed just to address this point. Such utility would need to:
 - i. continuously monitor what entities were in scope under items 1 and 2 in Option A.
 - ii. monitor, on an continuous / real time basis, for each foreign financial institution in the world, the total notional of derivatives between such foreign financial institution and the entities in scope under items 1 and 2. It would flag each foreign financial institution whose total notional with entities in scope under items 1 and 2 exceeded AUD 100 billion. Note that

such flag might be “on”, in relation to a specific foreign financial institution, at 10 am on the morning of the day of a TriOptima compression run, and “off” at the end of that day.

- iii. when an entity in scope under items 1 and 2 wanted to trade on an uncleared basis with any of the world’s foreign financial institutions, it would need to confer with the utility as to whether or not such prospective counterparty was flagged or not.

Our view is that Option B is better than Option A, because of the problems noted above in relation to point 3 in Option A.

- i. In Option B:the words “booked or entered into” (for reasons raised in the ASIC reporting rules where they have caused problems) should be deleted deleted in determining whether an entity is in scope, and a less problematic concept of nexus is used to determine which of its transactions are in scope (for example, merely “booked in”); and
- ii. replacement of “any foreign financial entity” with the following: “ any Foreign ADI (as defined in the Banking Act), any foreign entity that is an AFSL holder and additionally any Exempt Foreign Licensee (as defined in the ASIC reporting rules)” in each case with the suggested threshold of gross notional OTC outstanding (regardless of whether the derivatives making up such amount were booked or entered into here).

6. Do you have comments on a possible coordination of the AUD-IRD mandate with similar overseas requirements? If so, to which key overseas jurisdictions should an Australian mandate be linked?

As per the answer to question 5 we believe this is the best approach. They key jurisdictions are those regulated by EMIR or Dodd-Frank. It may be sufficient to institute the mandate in concert with the first of those jurisdictions to mandate.

As noted above, ideally problems presented in clearing AUD IRS on LCH SwapClear, as the dominant CCP clearing trading in that product between dealers, should be resolved before a mandate is activated. Additionally, interest withholding tax should not apply to margin flows into and out of Australia, and this problem needs to be rectified before a mandate is imposed..

7. Do you have comments on the proposed timetable for implementing the central clearing obligation?

Once the problems noted above have been resolved, as the mandate as presented is intended to reinforce current market practice and is intended to only apply to dealings between significant market participants the timing ought not bring any incremental costs.

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