



ASIC

Australian Securities & Investments Commission

REGULATION IMPACT STATEMENT

Mandatory central clearing of OTC interest rate derivative transactions

Issue date

About this Regulation Impact Statement

This Regulation Impact Statement addresses ASIC's proposals to implement mandatory central clearing under Pt 7.5A of the *Corporations Act 2001*.

What this Regulation Impact Statement is about

- 1 This Regulation Impact Statement (RIS) addresses ASIC's proposals to implement mandatory central clearing under Pt 7.5A of the *Corporations Act 2001* (Corporations Act).
- 2 In developing our final position, we have considered the regulatory and financial impact of our proposals. We are aiming to strike an appropriate balance between:
 - (a) ensuring fair and efficient capital markets, in-line with ASIC's key priorities;
 - (b) maintaining, facilitating and improving the performance of the financial system and entities in it;
 - (c) promoting confident and informed participation by investors and consumers in the financial system;
 - (d) administering the law effectively and with minimal procedural requirements;
 - (e) improving risk management and reducing systemic risk in the financial industry to promote financial stability;
 - (f) supporting the detection and prevention of market abuse and promoting market integrity;
 - (g) facilitating market participants and market infrastructures to obtain equivalence and substituted compliance determinations from overseas regulators—to reduce the compliance burden associated with duplicative or conflicting regulation; and
 - (h) reinforcing international cooperation.
- 3 This RIS sets out our assessment of the regulatory and financial impacts of our proposed policy and our achievement of this balance. It deals with:
 - (a) the likely compliance costs and savings;
 - (b) our consideration of industry feedback on our proposals;
 - (c) the likely effect on competition; and
 - (d) other impacts, costs and benefits.

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Executive summary

What is the problem ASIC is trying to solve?

- 4 The proposal to implement mandatory central clearing of certain interest rate derivatives seeks to address two significant problems:
- (a) the need for Australian participants in foreign over-the-counter (OTC) derivatives markets to comply with multiple clearing requirements, which increases their compliance costs; and
 - (b) financial stability concerns around the lack of transparency in OTC derivatives markets.

Increased compliance costs

- 5 As a result of international regulatory developments to implement mandatory central clearing, Australian entities that participate in foreign OTC derivatives markets need to comply with foreign clearing requirements, which is costly.
- 6 The central clearing regulatory frameworks of the United States and European Union provide a mechanism for substituted compliance assessments—allowing entities subject to jurisdictions with positive assessments based on substantially-equivalent regulatory requirements to meet the requirements in the United States and European Union for central clearing by complying with their local laws.
- 7 Allowing equivalence minimises costs for market participants by reducing the need to comply with duplicate and potentially conflicting regulations.

Financial stability concerns

- 8 There is a lack of transparency in OTC derivatives markets without central clearing. These markets operate on a bilateral basis outside of organised exchanges or trading platforms. While each participant holds complete information about their own exposures, no one knows the creditworthiness of their counterparty, or that counterparty's obligations to other participants.
- 9 During the global financial crisis (GFC) this lack of transparency made it difficult for market participants to assess the impact of institutional collapses or near-collapses. By reducing their ability to assess real-time counterparty risk there was an increase in mutual distrust, which was reflected in a sharp increase in the cost of funding.
- 10 In such opaque and uncertain environments, withdrawing from the market is rational. This is the mechanism that froze lending capacities in capital markets in a number of developed countries, the flow-on effects of which

served to significantly exacerbate the effect of the GFC. Had markets, regulators and governments been better able to assess the effect of institutional collapses or near-collapses, the broader consequences for the financial system could have been better anticipated and safeguarded against.

- 11 Requiring central clearing of OTC derivatives will enable regulators to better manage systemic risk in the system by facilitating a reduction in counterparty credit exposures among participants and allowing regulators to focus their supervisory efforts on central counterparty (CCPs). The introduction of a mandatory clearing requirement will also help to address concerns around a lack of transparency in OTC derivatives markets by providing regulators and participants with a better understanding of counterparty risk exposure and creditworthiness.

Why is ASIC action needed?

- 12 The Minister has made a decision to implement a mandatory central clearing requirement in Australia to help address the problems of increased compliance costs for Australian participants in foreign OTC derivatives markets, and financial stability concerns surrounding a lack of transparency in OTC derivatives markets.
- 13 In order for Australian participants in foreign OTC derivatives markets to qualify for substituted compliance arrangements for central clearing (and thereby reduce their overall compliance costs) they will need to be subject to similar legally-binding central clearing obligations in Australia.
- 14 Previous market assessment reports published by the Council of Financial Regulators (CFR) have shown that the OTC derivatives markets in Australia are largely dominated by the banks, especially the major Australian banks, as well as a small number of global financial institutions. It is our view that requiring these entities to centrally clear their OTC derivatives transactions would help to substantially address the lack of transparency in OTC derivatives markets and ensure financial system stability.

Note 1: The CFR comprises ASIC, the Reserve Bank of Australia (RBA), Treasury and the Australian Prudential Regulation Authority (APRA) (together, 'the regulators').

Note 2: CFR, *Report on the Australian OTC derivatives market*, July 2013, p.23.

- 15 To realise the deregulatory benefit of a mandatory requirement and to help achieve the financial system stability benefits of central clearing it is necessary for ASIC to make ASIC Derivative Transactions Rules (Clearing) 2015 (derivative transaction rules (clearing)) to give effect to the Government's mandate.

What policy options is ASIC considering?

16 To address the issues that we identified in our engagement with industry we have considered three regulatory options to implement the derivative transaction rules (clearing) in Australia.

Option 1

17 Under Option 1 we proposed to implement a rule framework that has been drafted in accordance with the Corporations Amendment (Central Clearing and Single-Sided Reporting) Regulation 2015 (Central Clearing Regulation). The rule framework proposed under this option does not provide for exemptions from the requirements.

18 We do not recommend Option 1 because it imposes high compliance costs on industry stakeholders.

Option 2

19 Under Option 2 we proposed to implement a rule framework in accordance with the Central Clearing Regulation (set out in Option 1, see paragraph 17) with additional allowances and exemptions. These allowances and exemptions aim to reduce the compliance burden on industry while achieving the targeted substituted compliance and systemic risk benefits.

20 We recommend Option 2 because it imposes minimal costs on market participants while preserving the substituted compliance benefits granted to Australian entities and possibly leading to further relief.

Option 3

21 Under Option 3 we proposed not to impose any direct regulatory requirements on stakeholders.

22 We do not recommend Option 3 because it does not address increased costs to Australian participants in foreign markets as a result of compliance with foreign clearing requirements.

23 Under Option 3, it is likely the United States would withdraw the substituted compliance benefits already provided to Australian businesses active in OTC derivatives markets in the United States. It would also not be helpful to obtaining substituted compliance benefits in other important overseas jurisdictions such as the European Union.

What is the likely net benefit of each option?

- 24 Option 1 proposes to implement a rules framework drafted in accordance with the parameters established by the Central Clearing Regulation. We have calculated the cost savings to industry of implementing Option 1 as \$5,000,000.
- 25 Option 2 proposes to implement a rule framework in accordance with the Central Clearing Regulation (set out in Option 1), with some additional allowances and exemptions. We have calculated the cost savings to industry of implementing Option 2 as \$8,200,000. We believe that Option 2 minimises the compliance burden on clearing entities, while also realising the improved system stability benefits of central clearing.
- 26 Option 3 proposes to maintain the status quo (i.e. not impose a central clearing mandate for any class of persons). This approach would address the financial stability concerns around transparency because the rates of voluntary central clearing would rise given the existing prudential obligations and foreign central clearing requirements. However, a decision to not implement a domestic mandatory clearing regime means Australian participants in foreign markets would not benefit from substituted compliance benefits under this option, and the estimated \$5 million cost savings (based on our updated analysis of Treasury's initial RIS) would not be realised. We therefore believe that Option 3 would result in an overall cost increase to industry.

Consultation process

- 27 On 28 May 2015, we released Consultation Paper 231 *Mandatory central clearing of OTC interest rate derivative transactions* (CP 231) which outlined the proposed scope of the new derivatives transaction rules (clearing). CP 231 was open for submissions from 28 May 2015 to 10 July 2015. We received 11 submissions in response to CP 231 (including three confidential submissions).
- 28 We have engaged with stakeholders following the formal consultation period, particularly in relation to the types of Australian dollar (AUD)-denominated interest rate derivatives subject to the proposed mandate— and we took on board industry concern about the current lack of CCP's offering central clearing for a number of these products.
- 29 We also held meetings with stakeholders to discuss a range of issues, including the proposed requirement for foreign clearing entities (as defined in the Central Clearing Regulation) to clear 'nexus' and 'entered into' trades, and a proposed exemption for 'offset' trades that are created during multilateral compression exercises.

- 30 After the final rules were made, we continued our discussions with industry to identifying any outstanding implementation issues. The discussions focused on the proposed relief from the mandate for swaps resulting from the exercise a swaption, where the swaption was entered into before the commencement of the mandate.

Recommendation

- 31 We recommend Option 2 because it provides a substantial deregulatory benefit to industry while addressing the issues of increased compliance costs to Australian participants in OTC derivatives markets and financial stability concerns surrounding a lack of transparency in OTC derivatives markets.
- 32 The changes introduced under Option 2 will also provide certainty to industry as to their obligations under the derivatives transaction rules (clearing) on an ongoing basis.

Implementation and evaluation

- 33 We will seek the Minister's consent to make the derivative transaction rules (clearing). Should we obtain the Minister's consent to make the rules, we will do so. We will then communicate the rules to stakeholders by publishing the derivative transaction rules (clearing) and organising events with stakeholders to inform them of the impact of the rules.
- 34 We will keep the derivative transaction rules (clearing) under review and evaluate their effectiveness on an ongoing basis through constant communications and dialogue with stakeholders in the market.
- 35 The CFR also periodically examines trends in OTC derivative markets and publishes their assessments of market developments in a market assessment report.
- 36 As part of our ongoing review, and following the derivative transaction rules (clearing) being made in December 2015, industry participants identified one aspect the derivative transaction rules (clearing) that is currently not fully consistent with overseas regimes, leading to potential transitional difficulties in implementation. This is the lack of a grandfathering or transitional arrangement where clearing entities exercise the embedded option in a swaption, and as a result enter into a swap that may be subject to the mandate.
- 37 Industry participants identified the need for relief in order to provide such a grandfathering or transitional arrangement. The proposed relief would help minimise compliance costs by ensuring full alignment with overseas

regimes, and may also improve the likelihood of obtaining substituted compliance benefits under our derivative transaction rules (clearing).

A Introduction

Background

- 38 Over the past decade, rapid growth in OTC derivatives markets has been accompanied by an increasing awareness of both the systemic importance of, and risks inherent in, these markets.
- 39 The magnitude of these risks was demonstrated during the GFC in 2008, particularly at the time of the collapse of Lehman Brothers investment banking group and the threatened collapse of AIG insurance group.
- 40 This episode highlighted a number of structural deficiencies in OTC derivatives markets and the associated systemic risks they posed for both financial markets and the real economy.
- 41 These structural deficiencies stemmed largely from the way that OTC derivatives transactions were concluded. At the time, OTC derivatives contracts were mainly executed directly between two parties over the telephone (i.e. not through an organised exchange or trading platform). This had two important consequences:
- (a) the market was not transparent for both participants and regulators because transactions, prices and exposures were not reported or published; and
 - (b) participants were not only exposed to the direct risk of default by their counterparty, but also to the indirect risk of default by every other market participant due to the potential effect of a default on the solvency of other participants (the contagion effect).
- 42 The inherent lack of transparency, and the interconnectedness among participants in OTC derivatives markets, meant that when the GFC occurred in the second half of 2008 participants were unable to understand and assess the effect of the defaults or potential defaults of major market participants such as Lehman Brothers, AIG and Bear Stearns, as transmitted through OTC derivatives markets.
- 43 This led to an unprecedented freeze in financial markets where major market participants stopped most trading activities involving credit risk, even with the most highly-rated counterparties. The inability to assess counterparty risk during the height of the GFC contributed to the rise of mutual distrust, reflected in a sharp increase in the cost of funding, and led to a halt in most trading and lending activities—which had devastating consequences for both global financial markets and the real economy.
- 44 As a result of issues identified during the GFC, the Leaders of the Group of 20 (G20) nations (including Australia) agreed at the 2009 Pittsburgh

Summit to commit to substantial reforms to practices in OTC derivatives markets. These commitments aim to bring transparency to OTC derivatives markets and improve risk management practices. Specifically, the Leaders of the G20 committed to three key mandates:

- (a) *Transaction reporting*: All OTC derivatives transactions should be reported to trade repositories.

Note: Trade repositories are facilities to which information about derivative transactions, or about positions relating to derivative transactions, can be reported. A derivative trade repository acts as a centralised registry that maintains a database of records of transactions and disseminates the information, including to regulators and the public.

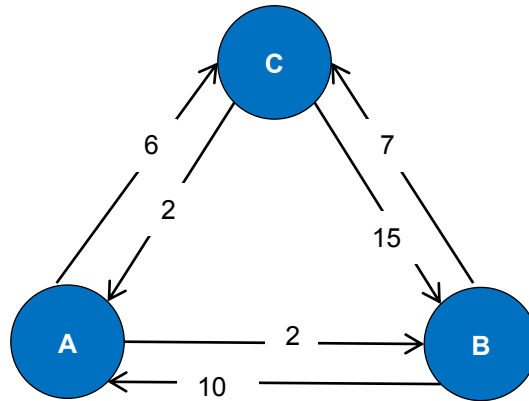
- (b) *Clearing*: All standardised OTC derivatives transactions should be centrally cleared.
- (c) *Trading*: All standardised OTC derivatives transactions should be traded on exchanges or trading platforms, where appropriate.

- 45 This RIS relates to the making of derivative transaction rules (clearing) by ASIC to prescribe central clearing of certain OTC derivatives and implement the mandate in paragraph 44(b) in Australia. The classes of OTC derivatives covered by the rules are proposed to include interest rate derivatives denominated in Australian dollars (AUD interest rate derivatives) and US dollars, euros, Japanese yen and British pounds (G4 interest derivatives).

Central clearing

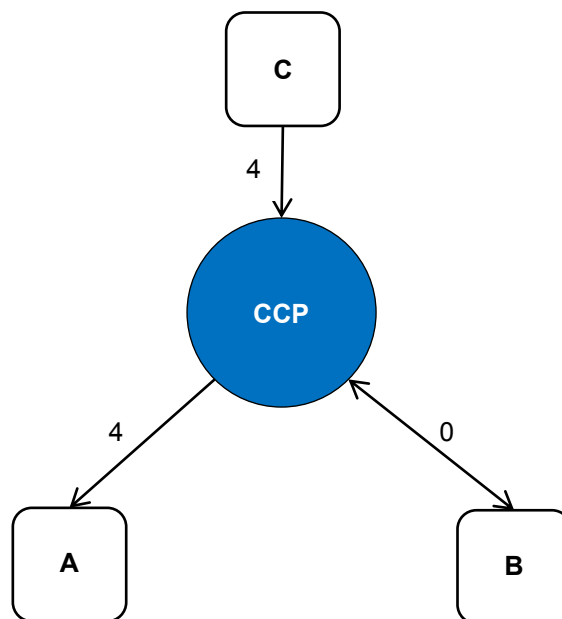
- 46 In an OTC derivatives market without central clearing, when two parties enter into an OTC contract they commit to make a series of payments to each other over the life of the contract. Under this bilateral arrangement each counterparty is exposed to the risk that the other party may default.
- 47 In a centrally-cleared market, the contract between the two counterparties is replaced by two back-to-back contracts with a CCP through a legal process known as novation—with the CCP becoming the buyer to every seller and the seller to every buyer.
- 48 Figure 1 provides an illustration of the payment obligations between counterparties in a non-centrally cleared market. The numbers in the figure represent the hypothetical payments due between counterparties. The total payments due at any point in time may be seen as a measure of total counterparty risk in the system. In this example the total amount of payments due among the three counterparties is 42.

Figure 1: Payment obligations between counterparties in a non-centrally market



- 49 Figure 2 shows how the total amount of payments due among counterparties can be reduced in a market where trades are centrally cleared. After two counterparties agree to enter into a derivative transaction, their bilateral contract is replaced by two mirror-image contracts novated through the CCP.
- 50 The CCP assumes responsibility for making the payments that each party would have received from their counterparty under the bilateral arrangement. The CCP should theoretically have a net risk of zero, because the total payments it needs to make on contracts should be equal to the total payments it is owed.
- 51 With all of the contracts running through a CCP, the CCP can net out the payments owed to each counterparty, reducing the total payments owed to counterparties to eight, down from 42 in Figure 1.

Figure 2: Payment obligations between counterparties in a centrally cleared market



- 52 A central clearing mandate has the effect of making CCP's the focal points of all transactions in centrally-cleared markets which, in turn, would:
- (a) reduce overall risk in the system by minimising counterparty credit risk exposures—because each counterparty would only deal with the CCP rather than multiple counterparties with hidden exposures;
 - (b) concentrate default risk management in the hands of the CCP, in order to limit the contagion effect of the default or potential default of a market participant;
 - (c) minimise total bilateral exposures by netting offsetting positions, creating efficiencies in risk management processes such as holding collateral against potential losses from derivatives contracts;
 - (d) increase transparency, with regulators and participants alike having knowledge of the CCPs overall exposure; and
 - (e) allow regulators to focus supervisory efforts on CCPs—who are already subject to extensive regulatory requirements—rather than having to monitor widely-dispersed default risks across a large range of participants.

International developments

- 53 Australia is implementing the G20 commitments to OTC derivative reforms in close coordination with peer jurisdictions. Similar rules are concurrently being put in place in other G20 jurisdictions in-line with G20 commitments—reflecting the fact that OTC derivative transactions often occur between counterparties in different jurisdictions and the underlying reference asset may be in a third jurisdiction.
- 54 The cross-border nature of OTC derivative trading means that it is possible for clearing requirements to overlap in different jurisdictions. To address this, jurisdictions may allow for a system of recognition, or substituted compliance. ASIC is in discussions with a number of foreign regulators assessing whether the Australian clearing regime is comparable to their own.
- 55 If it is, Australian clearing entities will be able to clear their trades under the Australian requirements and be deemed to satisfy the requirements of the overseas regimes—reducing the compliance burden on Australian clearing entities.

Australian legislative framework

- 56 The Minister has the power to prescribe certain classes of derivatives as being subject to ASIC's rule-making power for each of the G20 mandates: see paragraph 44. This should be based on advice from ASIC, APRA and the RBA.
- 57 In July 2013, the CFR released the *Report on the Australian OTC derivatives market* (the 2013 Report) which recommended Government mandate central

clearing of OTC transactions among dealers with significant cross-border activity in G4 interest rate derivatives.

- 58 In April 2014, the CFR released the *Report on the Australian OTC derivatives market* (the 2014 Report) which recommended implementing a mandatory clearing obligation for OTC transactions in AUD interest rate derivatives for internationally-active dealers.
- 59 On 8 July 2014, in-line with a recommendation made by the CFR, Treasury published a consultation paper which proposed to combine the recommended mandatory central clearing of AUD and G4 interest rate derivatives into a single determination to be issued by the Minister.
- 60 In May 2015, Treasury released consultation on a draft determination which mandates the clearing of AUD and G4 interest rate derivatives and draft regulations setting out the scope of the clearing mandate.
- 61 On 2 September 2015, a Ministerial determination was made setting out the product scope of the Mandatory clearing regime. On 8 September 2015, the Corporations Regulations 2001 were amended to implement central clearing of prescribed classes of OTC interest rate derivatives among a small number of major domestic and foreign banks that act as dealers in the Australian OTC derivatives market—thereby setting ASIC’s rulemaking power.

The derivative transaction rules (clearing)

- 62 While the Minister's determination sets out the high level features of the mandatory clearing regime, ASIC must issue derivative transaction rules (clearing) that set out the remaining details, such as:
- (a) the types of entities that must comply with the clearing mandate;
 - (b) what entities must do to comply with the mandate; and
 - (c) whether there are any exemptions from the requirement to comply with the mandate.
- 63 Derivative transaction rules (clearing) do not need to be made for all derivatives covered by a determination. The rules may also provide exceptions to the application of any requirement. Subject to urgency provisions, ASIC is required to engage in public consultation and consult with both APRA and the RBA before issuing any derivative transaction rules (clearing).

Complementary regulatory impact statements

- 64 The subject of this RIS is the regulatory impact of the derivative transaction rules (clearing) on industry participants, and the associated costs and benefits.
- 65 The Ministerial determination specifies that AUD and G4 interest rate derivatives will be within scope of the mandate and the derivative transaction

rules (clearing). This RIS assesses whether all these derivatives, or only certain sub-sets of such derivatives, should be covered by the mandate. In doing so, this RIS looks at whether the options would realise the cost savings quantified in the Treasury RIS.

- 66 Treasury separately submitted a RIS in relation to the Ministerial determination and draft a Central Clearing Regulation to the Office of Best Practice Regulation (OBPR). The draft Ministerial determination and draft regulation, and ASIC's rule-making, are two necessary and complementary measures. For this reason, a certain degree of overlap exists between the Treasury RIS and this RIS.

Assessing the problem

- 67 The proposal to implement mandatory central clearing of certain interest rate derivatives seeks to address two significant problems:
- (a) increased costs for Australian participants in foreign OTC derivative markets as a result of compliance with foreign clearing requirements; and
 - (b) financial stability concerns around the lack of transparency in OTC derivatives markets.

Increased compliance costs for Australian participants in foreign OTC derivatives markets

Substituted compliance

- 68 International consistency was a key consideration when assessing the case for a domestic clearing mandate for interest rate derivatives.
- 69 Since the G20 commitments to reform OTC markets were announced, a number of key jurisdictions have made significant progress with respect to mandated central clearing.
- 70 As a result of these international regulatory developments to implement mandatory central clearing, Australian entities that participate in these foreign OTC derivatives markets need to comply with those clearing requirements.
- 71 Relevantly, the regulatory frameworks in the United States and the European Union provide a mechanism for substituted compliance assessments that will allow entities subject to jurisdictions with positive assessments based on substantially equivalent regulatory requirements to meet their central clearing requirements in the United States and the European Union by complying with local laws.

Table 1: Progress in overseas jurisdictions towards mandated central clearing

Country	Date	Steps taken towards implementing central clearing
United States	2012	The Commodity Futures Trading Commission (CFTC) and Securities Exchange Commission (SEC) were given powers to write rules and regulations for central clearing. The CFTC guidance on the cross-border application of OTC derivatives provisions establishes that Australian entities provisionally registered with the CFTC as swap dealers are currently subject to US clearing requirements.
European Union	6 August 2015	The European Commission adopted a delegated regulation that will make it mandatory for interest rate derivative contracts to be cleared through central counterparties from early-2016 for interest rate derivatives denominated in US dollars, euros, and British pounds, as well as credit index derivatives that reference European indices. This is broadly in-line with the clearing mandate set by the CFTC.
Japan	2012	The Japan Financial Services Agency imposed a central clearing mandate on yen-denominated interest rate swaps and Japan-referenced credit derivatives.
Singapore	July 2015	Consulted on draft regulations mandating the central clearing of interest rate swaps denominated in Singapore dollars and US dollars.
China	2014	The People's Bank of China imposed a central clearing mandate on yuan-denominated interest rate derivatives from 1 July 2014.
Korea	2014	The Korean government introduced a clearing mandate on Korean won-denominated interest rate derivatives from 1 July 2014.
India	2014	The Indian Implementation Group on OTC Derivatives Market Reforms introduced a clearing mandate on Indian rupee–US dollar foreign exchange forwards from March 2014.

72 Positive assessments will therefore, under certain conditions, allow the European Securities and Markets Authority (ESMA) and the CFTC to place reliance on Australian regulation and regulators. This should minimise costs for Australian market participants and infrastructures arising from duplicate and potentially conflicting regulations.

73 In the United States, foreign participants can apply for the CFTC to assess whether their home regime is comparable. If it is, the CFTC's cross-border guidance permits them to rely on meeting certain requirements of their home jurisdiction to fulfil the CFTC requirements. Under CFTC guidance, Australian entities that are captured by US clearing requirements may comply with comparable Australian regulation instead of CFTC regulation.

Note: The CFTC guidance on the cross-border application of swap provisions establishes that Australian entities provisionally registered with the CFTC as swap dealers are currently subject to US clearing requirements.

74 Currently, with no comparable domestic mandate, the CFTC requires Australian participants to comply with US mandatory clearing requirements when trading with US persons or guaranteed affiliates of US firms.

- 75 Australian market participants currently benefit from relief granted by the CFTC from a number of its so-called 'entity-level' requirements. This relief is time limited and subject to renewal. Failure on the part of Australia to implement a central clearing mandate is likely to put the renewal of such existing relief at risk. It will also make it unlikely that the United States will agree to extend other kinds of substituted compliance relief to Australian entities.
- 76 Similarly to the US, the EU regime allows transactions that are subject to both the EU and Australian mandate to qualify for substituted compliance recognition where:
- (a) the clearing obligations in the European Union and Australia both apply to the product; and
 - (b) the counterparty in Australia is a non-exempted entity or, if exempted, would get an equivalent exemption if established in the European Union.
- 77 While the European Union has yet to implement mandatory clearing requirements, ESMA has advised the European Commission to only recognise the equivalence of Australian mandatory clearing obligations if a trade that will be subject to the EU's clearing obligation is also subject to a clearing obligation in Australia. Otherwise, the EU rules will apply to trades with EU entities.
- 78 The compliance cost of duplicate, or in the majority of cases multiple, foreign jurisdiction requirements affects an increasing number of Australian participants. Introducing an Australian central clearing mandate equivalent to the clearing requirements in the United States and the European Union would relieve Australian entities of this compliance burden.

Regulatory arbitrage

- 79 International consistency considerations are also an issue. In the absence of broadly-harmonised requirements, regulatory arbitrage or other distortions can occur where market participants choose where to conduct business or book trades depending on which regulatory framework they prefer.
- 80 Even where Australian participants will not be directly subject to overseas mandates, if they wish to continue trading with many of their international counterparties the only option will be to centrally clear such trades.

Unintended consequences of overseas requirements

- 81 Unintended consequences could arise due to differences in market structure and market practices. A domestic mandate could permit the CFR to take account of such differences in the derivative transaction rules (clearing).
- 82 There is a lack of transparency in OTC derivatives markets without central clearing. These markets operate on a bilateral basis outside of organised

exchanges or trading platforms. While each participant holds full information about their own exposures, no one knows the creditworthiness of their counterparty, or that counterparty's obligations to other participants.

83 As such, each participant is not only directly exposed to the default risk of its counterparty, but also indirectly to the default risk of all other market participants. This lack of mandated understanding means it is impossible to know which counterparties will be affected by the failure of a significant participant.

84 This lack of transparency during the GFC made it difficult for market participants to assess the impact of institutional collapses or near-collapses, affecting their ability to assess real-time counterparty risk. Consequently, markets, regulators and governments did not have a clear picture of which institutions were exposed (and the extent of that exposure) to troubled financial firms such as Lehman Brothers and AIG.

85 By reducing the ability to assess real-time counterparty risk, mutual distrust rose and was reflected in a sharp increase in the cost of funding. In such opaque and uncertain environments, withdrawing from the market is rational. This is the mechanism that froze lending capacities in capital markets in a number of developed countries, the flow-on effects of which served to significantly exacerbate the impact of the GFC.

86 Had markets, regulators and governments been better able to assess the impact of institutional collapses or near-collapses, the broader consequences for the financial system could have been better anticipated and safeguarded against. Efforts to improve transparency in OTC markets by requiring participants to centrally clear their transactions would serve to better enable such assessments by:

- (a) enhancing systemic risk management by regulators and counterparties; and
- (b) improving market participant understanding of counterparty creditworthiness.

Why is ASIC action needed?

87 The Minister has decided to implement a mandatory central clearing requirement in Australia. This should help address the problems of increased compliance costs for Australian participants in foreign OTC markets, and financial stability concerns surrounding a lack of transparency in OTC markets. The Minister has also set some key parameters of the mandate under the Ministerial determination and regulations.

88 For Australian participants to qualify for substituted compliance arrangements in foreign OTC markets with regard to central clearing, Australia will need

similar legally-binding clearing obligations. Foreign regulators will not consider it material that most OTC derivatives transactions in the Australian market are already being centrally cleared on a voluntary basis.

- 89 For example, ESMA found that while the Australian legal framework provides for the imposition of a clearing mandate, actual equivalence with the EU framework would only be achieved through a Ministerial determination mandating central clearing. ESMA also noted that equivalence would be limited to the specific types of OTC derivatives covered by the Ministerial determination, and to transactions involving counterparties covered by the clearing obligation as set out in the Central Clearing Regulation and derivative transaction rules (clearing).

Note: ESMA, Technical Advice on third country regulatory equivalence under EMIR Australia, final report, September 2013.

- 90 Previous market assessment reports published by the CFR have shown that OTC derivatives markets in Australia are largely dominated by the banks, especially the major Australian banks as well as a small number of global financial institutions. It is ASIC's view that mandating central clearing for these entities with their OTC derivatives transactions would help improve the level of transparency in OTC markets, and achieve the financial system stability benefits inherent in central clearing.

Note: CFR, *Report on the Australian OTC Derivatives Market*, July 2013, p.23

- 91 Foreign regulatory developments, capital requirements and liquidity concerns have driven the uptake of voluntary central clearing of OTC derivatives in Australia. In light of these developments, we consider that a mandatory central clearing requirement is the most appropriate way to help ensure that there is certainty for industry as to their obligations on an ongoing basis.
- 92 Importantly, to realise the expected overall deregulatory benefit of a mandatory requirement, ASIC must make derivative transactions rules (clearing) to give effect to the mandate.
- 93 Lastly, to provide the proposed grandfathering arrangement for swaps resulting from the exercise of a swaption, it is necessary for ASIC to issue a relief instrument that would give effect to this proposed grandfathering arrangement.

B Options and impact analysis

- 94 We have considered three regulatory options to implement the derivative transaction rules (clearing) in Australia:
- (a) *Option 1*: Implement central clearing mandate;
 - (b) *Option 2*: Implement central clearing mandate with additional allowances and exemptions (preferred option); or
 - (c) *Option 3*: Maintain the status quo (i.e. do not impose a central clearing mandate for any class of persons).

Option 1: Implement central clearing mandate

- 95 Under Option 1 the derivative transaction rules (clearing) will be drafted in accordance with the parameters established by the Central Clearing Regulation. The rules proposed under this option do not provide for exemptions from the requirements.

Entity scope

Background

- 96 The government has implemented a regulation which specifies that clearing requirements in relation to derivative transactions can only be imposed on a person who is either an Australian clearing entity or foreign clearing entity in relation to the transaction.

Note 1: The term Australian clearing entity means any Australian financial entity, defined as any Australian authorised deposit-taking institution (ADI) or Australian financial services (AFS) licence holder that is incorporated in Australia and whose derivative activities meet or exceed a mandatory clearing threshold of \$100 billion.

Note 2: The term foreign clearing entity means a foreign financial entity that is an ADI or AFS licence holder that is incorporated outside of Australia whose derivatives activities meet or exceed a mandatory clearing threshold of \$100 billion.

- 97 The Central Clearing Regulation imposes a clearing obligation on trades where one party to the transaction is either an Australian clearing entity or foreign clearing entity and the other party is either an Australian clearing entity, foreign clearing entity or a foreign internationally-active dealer.

Note: The term foreign internationally-active dealer means a foreign entity, other than a foreign clearing entity, that is registered or provisionally registered with the CFTC as a derivatives trader (known in the United States as a swaps dealer).

- 98 Under s901A(3)(e) ASIC may make rules that deal with matters incidental or related to requirements referred to in s901A(2), including specifying the persons who are required to comply with requirements imposed by the rules.

ASIC's proposal

99 Under this option, ASIC would impose clearing obligations on trades involving Australian clearing entities, foreign clearing entities and foreign internationally-active dealers within the scope set out by the Central Clearing Regulation.

100 This would see clearing requirements apply to derivative transactions entered into between:

- (a) two Australian clearing entities;
- (b) an Australian clearing entity and a foreign clearing entity;
- (c) an Australian clearing entity and a foreign internationally-active dealer;
- (d) two foreign clearing entities, where a branch of a foreign clearing entity has booked the trade to the profit-and-loss account of a branch in Australia ('booked-in trades'), entered into the trade under contract law in Australia ('entered-into trades') or, if it has opted-in to the nexus test, conducted a nexus derivative ('nexus trades'); and

Note: A 'nexus derivative' is an OTC derivative to which a clearing entity is a counterparty that meets the nexus test. The 'nexus test' is the test in ASIC Instrument [15/0067] *ASIC Derivative Transaction Rules (Nexus Derivatives) Class Exemption 2015*, and is based on the location of salespersons or traders performing particular functions in relation to an OTC derivative.

- (e) a foreign clearing entity and a foreign internationally-active dealer, where the foreign clearing entity has booked the trade in Australia, entered into the trade in Australia or, if it has opted-in to the nexus test, conducted a nexus derivative.

101 Based on our analysis, this option would bring 15 Australian financial institutions (including the local operations of major overseas banks) within the scope of ASIC's derivative transaction rules (clearing). As the majority of these institutions have already established the infrastructure required for central clearing (i.e. technology systems to facilitate clearing, compliance and monitoring systems, associated compliance staff) and are already clearing most of their new OTC interest rate derivative transactions, the additional compliance costs associated with the mandate would be minimal.

102 The derivative transaction rules (clearing) would also allow other entities to 'opt-in' to clearing obligations (becoming 'opt-in Australian clearing entities' or 'opt-in foreign clearing entities') if they could gain substituted compliance benefits from being subject to a mandatory central clearing requirement in Australia.

Product classes

Background

103 Treasury has issued a Ministerial determination that specifies that AUD and G4 interest rate derivatives would be covered by the clearing mandate. Under s901A(3), ASIC may make rules that further limit the classes of AUD and G4 interest rate derivatives that are subject to the clearing requirement.

ASIC's proposal

104 Under this option, ASIC would mandate clearing requirements for AUD and G4 interest rate derivative product classes that are broadly consistent with overseas mandates. These are:

- (a) fixed-to-floating swaps (where one counterparty swaps its fixed interest rate for the other's 'floating' or variable rate);
- (b) basis swaps (where two parties swap variable interest rates that are based on different money markets);
- (c) forward rate agreements (contracts between parties to determine the interest rate of a future obligation); and
- (d) overnight index swaps (where parties swap the overnight rate for a fixed interest rate).

105 This approach would harmonise Australia's clearing mandate with overseas clearing requirements for G4 interest rate derivatives.

Approved CCPs

Background

106 Under s901A(7) of the Corporations Act, where a mandatory clearing requirement is in place, the clearing entity subject to the requirements must ensure that the derivative transaction is cleared through either a:

- (a) licensed clearing and settlement (CS) facility (licensed CCP); or
- (b) CS facility prescribed by the Corporations Regulations (prescribed CCP).

107 Under s901A(3)(d)(i), ASIC may make rules that specify the licensed CCP or prescribed CCP through which derivative transactions in a particular product class must be cleared.

108 The Central Clearing Regulation states that only CS facilities that meet the criteria set out under the regulation would be able to be prescribed. The Central Clearing Regulation also includes an initial list of overseas CS facilities that have been assessed as meeting the stated criteria.

ASIC's proposal

- 109 Under this option, an entity subject to central clearing obligations will be able to use a licensed or prescribed CCP to comply with their obligations.
- 110 This option causes minimal disruption to the current clearing arrangements of Australian participants in OTC derivatives markets. Those Australian participants that already clear OTC derivatives transactions have existing working relationships in place with the majority of the proposed licensed and prescribed CCPs. Entities can continue to clear as they currently do where this is consistent with the existing licensing regime for CS facilities, without imposing additional compliance costs. This option also leaves open the possibility for ASIC and the RBA to prescribe additional CS facilities in the future, where the regulatory requirements are met.

Calculation of the threshold**Background**

- 111 The Central Clearing Regulation specifies that an Australian clearing entity or foreign clearing entity is an entity that has more than \$100 billion in gross total notional outstanding positions (the clearing threshold). The regulation gives ASIC the ability to specify how entities subject to the clearing obligations must calculate this clearing threshold.

ASIC's proposal

- 112 Under this option, the clearing threshold calculation will include all derivatives that are subject to the clearing requirements, and all other derivatives that are not traded on a financial market (as defined under Pt 7.2A of the Corporations Act) or a regulated foreign market.
- 113 An entity will become a clearing entity if it is above the clearing threshold as at the end of the last day of the quarter for two consecutive quarters. For Australian clearing entities the clearing threshold will be based on the gross notional outstanding of OTC derivatives positions as at the last day of the last quarter. For foreign clearing entities, the clearing threshold will be based on the total gross notional outstanding of OTC derivatives positions that are 'entered into' in Australia, or booked to the profit-and-loss account of a branch in Australia as at the last day of the last quarter.

Note: The last day of the quarter, for the purposes of calculating the clearing threshold, is 31 March, 30 June, 30 September and 31 December of each year. The entity will become a clearing entity on the first Monday three months on or after the last day of the second consecutive quarter (second calculation date) (i.e. at least 90 days).

- 114 The derivative transaction rules (clearing) would also require fund managers (both domestic and foreign) that deal in the relevant product classes to calculate the clearing threshold for each fund under their management.

115 This option captures entities that have significant OTC derivatives activities and pose risk from a transparency perspective, without imposing unreasonable compliance burdens on foreign clearing entities. Foreign clearing entities caught by the clearing requirement are anticipated to enjoy substituted compliance benefits, which are expected to offset associated compliance costs. This arrangement would not impose disproportionate compliance requirements or costs on fund managers (including superannuation trustees).

Overall cost savings

Substituted compliance benefits

116 The costs of complying with the requirement to centrally-clear OTC interest rate derivatives are offset by a number of related regulatory measures that already incentivise Australian entities to centrally clear trades voluntarily, including:

- (a) the [International regulatory framework for banks \(Basel III\)](#), a comprehensive set of reform measures to strengthen the regulation, supervision and risk management of the banking sector;
- (b) market forces providing greater liquidity in centrally cleared markets as more participants begin to clear through CCPs; and
- (c) international standards on margin requirements, which make centrally cleared transactions more economically attractive relative to non-centrally cleared transactions.

117 However, the market-based adoption of central clearing is not recognised by foreign regulators under their mandatory central clearing regimes. In the absence of an Australian mandate, Australian entities will incur the cost of clearing without benefiting from equivalence recognitions from foreign regulators. Consequently, government action to introduce a central clearing mandate is required to achieve the costs savings available through equivalence recognitions.

Treasury analysis of costs

118 An analysis of the likely cost savings was undertaken by Treasury in 2014 and was based on the features and elements that are set out in the final regulations released by the Government on 8 September 2015. Based on the available data at the time, the analysis estimated that there would be approximately 20 Australian entities that would fall under the scope of an Australian clearing mandate and benefit from substituted compliance arrangements.

119 The analysis examined the existing entity-level relief measures that were granted by the CFTC in December 2013 in relation to the US central clearing mandate, including costs relating to:

- (a) one support staff member for chief compliance officer (salary costs);

- (b) risk management requirements, including establishment of a comprehensive risk management program and a compliance monitoring system in-line with *Dodd–Frank Wall Street Reform and Consumer Protection Act* (US) and US CFTC requirements (legal, IT and personnel costs); and
- (c) swap data record-keeping and reporting requirements (mainly personnel costs).

120 The calculation per entity is set out in Table 2.

Table 2: Costs of complying with the US CFTC regime*

Item	One-off costs	Annual costs
Support compliance staff	N/A	\$100,000
Risk management set-up costs (legal)	\$50,000	N/A
Risk management set-up costs (IT)	\$50,000	N/A
Compliance monitoring system (set-up and ongoing monitoring)	\$15,000	\$200,000
Record keeping	\$50,000	\$20,000
Total costs per dealer	\$165,000	\$320,000

* Estimates provided by industry stakeholders

121 The Treasury analysis found that if a central clearing mandate were introduced in Australia, the Australian entities covered under the scope of such a mandate would achieve a combined total annual cost saving of approximately \$6.7 million in substituted compliance benefits in relation to the US CFTC regime.

Further ASIC analysis of costs

122 Further analysis of the number of potential entities that would be subject to the proposed Australian clearing mandate was undertaken by ASIC in 2015. Using more recent data, our analysis showed that there were likely to be approximately 15 Australian entities that would be subject to the proposed mandate, rather than 20.

Summary of costs

123 Taking into account the reduced number of entities that would likely be subject to a central clearing mandate, we estimate that these entities would receive a combined total annual cost saving of approximately \$5,000,000 in substituted compliance benefits in relation to the US CFTC regime. This figure is based on Treasury's initial \$6.7 million assessment of annual substituted compliance savings (based on their original estimate of 20 entities),

adjusted for our updated estimate of 15 entities subject to the proposed mandate.

- 124 In addition to the annual cost savings these entities would receive through substituted compliance with the CFTC regime, we believe they are likely to accrue additional substituted compliance savings in the future as other international jurisdictions such as Singapore, the European Union and Hong Kong introduce mandatory central clearing obligations for OTC derivatives transactions.

Impact on industry

- 125 The imposition of a central clearing mandate would provide a number of benefits to industry participants including improving market transparency and reducing counterparty credit risk. In addition to the associated systemic risk benefits, a clearing mandate would also provide substituted compliance benefits for Australian entities that participate in foreign OTC markets.
- 126 The scope of the mandate captures the systemically-significant participants in the Australian market which, in aggregate, hold the majority of total gross notional OTC derivatives outstanding in Australia.
- 127 From a risk mitigation perspective, the imposition of a central clearing mandate will help firms to minimise counterparty credit risk exposures by only having to deal with the CCP rather than multiple counterparties, and also to create efficiencies in risk management processes such as margining and capital provisioning (through the netting of offsetting positions).
- 128 This option will also protect the existing substituted compliance benefits provided by the CFTC to Australian entities and may in time lead to further relief being provided by the CFTC and ESMA. Following the publication of the Ministerial determination and Central Clearing Regulations by the Government in September 2015, once ASIC's derivative transaction rules (clearing) have been made, it will be possible for Australian financial institutions active in US markets to apply to the CFTC for further, clearing-related relief. The European Union has adopted regulations implementing a central clearing regime which is expected to commence in the first half of 2016. It may, therefore, also be possible to apply for substituted compliance relief under the EU regime.

Impact on consumers

- 129 Consumers will not be subject to the clearing obligation. Only entities that hold an ADI or an AFS licence, or are a foreign entity exempt from holding an AFS licence, can be subject to a clearing mandate. Also, because of the substantial threshold of \$100 billion gross notional value of OTC derivatives outstanding, these obligations will only apply to large entities. Because the transactions that

are expected to be subject to the clearing mandate are not directly related to the banks' retail banking businesses, this mandate is not expected to have a direct impact on the cost of retail financial products or services.

Option 2: Implement central clearing mandate with additional allowances and exemptions

- 130 Under Option 2 the derivative transaction rules (clearing) will be drafted in accordance with the Central Clearing Regulation (set out in Option 1, see paragraph 95) with a number of allowances and exemptions. These allowances and exemptions aim to further reduce the compliance burden on industry while still achieving the targeted substituted compliance and systemic risk benefits.
- 131 The proposed allowances include:
- (a) delaying the mandatory clearing requirement for both AUD-denominated forward rate agreements (AUD forward rate agreements) and AUD-denominated overnight index swaps (AUD overnight index swaps);
 - (b) removing the requirement for foreign clearing entities to clear 'entered-into' or 'nexus' trades; and
 - (c) enabling trades to be 'de-cleared' if necessary.
- 132 The proposed exemptions are for trades:
- (a) cleared in accordance with equivalent clearing requirements in a foreign jurisdiction (alternative clearing exemption);
 - (b) conducted for the purposes of reducing or eliminating OTC derivative contracts by way of multilateral trade compression (multilateral compression exemption);
 - (c) conducted between two entities in the same corporate group (intra-group exemption);
 - (d) that are swaps entered into when clearing entities exercise the option embedded in a swaption contract, where the swaption contract itself was entered into prior to the commencement of the mandate.
- 133 This option is the preferred option put forward because it imposes minimal costs on market participants (including by maintaining the status quo in relation to swaption contracts) while preserving the substituted compliance benefits granted to Australian entities—it also best reflects the stakeholder feedback we received during consultation.

Allowances

Delaying clearing obligations for some product classes

- 134 During consultation, we received a number of submissions that noted there are currently no CCPs in Australia that are currently licensed to clear AUD forward rate agreements.
- 135 Without any market infrastructure in place to clear AUD forward rate agreements we proposed in Option 2 to delay the commencement of the mandatory clearing of AUD forward rate agreements for a period of two years from the commencement date.
- 136 Substantial work is required to establish CCP infrastructure that could accommodate the clearing of AUD forward rate agreements. It will also require entities to build new technology systems, develop new compliance and monitoring systems and hire additional staff—because there are no existing practices to clear this product class. However, we do not believe the regulatory burden outweighs the benefit of clearing AUD forward rate agreements.
- 137 We also received submissions during the consultation period, noting that there is only one CCP currently licensed in Australia to clear AUD overnight index swaps.
- 138 Due to the current lack of market competition for the clearing of this product, we proposed in Option 2 to delay the commencement of mandatory clearing of AUD overnight index swaps for a period of six months from the commencement date.
- 139 Should no additional CCPs enter the market to clear forward rate agreements or overnight index swaps, ASIC will consider further delaying the start dates to ensure the preconditions for mandatory clearing expressed by the CFR in a joint policy statement have been met.

Note: CFR, [Australian regulators' statement on assessing the case for mandatory clearing obligations](#), May 2013.

- 140 If these delays are not introduced, we believe that all 15 entities would need to build new IT, compliance and record-keeping systems to begin clearing AUD forward rate agreements from the original commencement date. Option 2 will prevent entities incurring these costs for another two years.

Removing the requirement for foreign clearing entities to clear 'entered-into' or 'nexus' trades

- 141 During consultation, we received a number of submissions that 'entered-into' or 'nexus' trades should be excluded from the clearing mandate because, to comply with this requirement, foreign clearing entities would be required to build additional systems and incur material compliance costs.

142 A number of submissions also noted that a requirement to clear ‘entered-into’ or ‘nexus’ trades would be inconsistent with the clearing requirements in overseas regimes.

143 After further analysis of this issue we believe there is little risk-reduction benefit gained from requiring ‘entered-into’ or ‘nexus’ transactions to be subject to the clearing requirements and that the overall regulatory benefits do not outweigh the compliance cost that would be imposed. The potential reduction in systemic risk in Australia from requiring ‘entered-into’ or ‘nexus’ trades to be cleared would be relatively small because the only trades that would be captured under this requirement would be those between non-Australian entities (of which a large proportion would be picked up by foreign clearing regimes).

144 As a result, under Option 2 we propose to remove the requirement for foreign clearing entities to centrally clear ‘entered-into’ or ‘nexus’ trades.

No express prohibition on de-clearing

145 In CP 231, we sought feedback on whether the derivative transaction rules (clearing) should impose any prohibitions on derivative transactions being de-cleared after they have been centrally cleared.

146 De-clearing (or re-bilateralisation) is the process of removing a trade from clearing so the CCP no longer interposes itself between the two original parties to the trade (as was the case when it was a cleared trade). The requirement to de-clear a trade can arise when CCPs are conducting multilateral compression cycles amongst a number of different counterparties, and need to match-up counterparties with equal and offsetting exposures to carry out the compression. The ability to de-clear a trade and return it to its original bilateral status can help align counterparty exposures.

147 A number of submissions stated that the derivative transaction rules (clearing) should not prohibit derivatives transactions being de-cleared because it may impede the ability of CCPs to run regular compression cycles as part of their risk-mitigation practices. As a result, under Option 2 we would not seek to impose any prohibition on derivatives transactions being de-cleared after they have been centrally cleared.

Exemptions

148 Most overseas jurisdictions that have implemented mandatory central clearing have included an exemption for alternative clearing and intra-group derivative transactions, including the United States, the European Union, Japan and (the proposed rules in) Canada. The United States and the European Union also provide grandfathering arrangements for swaps that are entered into when entities exercise the option embedded in a swaption

contract, where the swaption contract itself was entered into before the commencement of mandatory central clearing.

149 As a result, we proposed under Option 2 to provide an exemption from the central clearing requirement for alternative clearing, intra-group trades and for new or amended derivatives where the transaction occurs as part of a multilateral compression cycle. We also propose to issue relief to provide a grandfathering arrangement for swaps entered into on the exercise of a swaption.

Alternative clearing exemption

150 Alternative clearing is the practice of allowing entities subject to the Australian clearing mandate to comply with their clearing requirements by clearing in accordance with clearing requirements in a foreign jurisdiction.

151 We believe that allowing alternative clearing offers significant cost-reduction benefits to clearing entities with derivative transactions already subject to mandatory central clearing in another jurisdiction. We expect that alternative clearing will be beneficial for both foreign clearing entities that are subject to mandatory central clearing in the jurisdiction in which they are located, as well as to Australian clearing entities that must comply with clearing requirements in another jurisdiction.

152 Industry feedback was strongly supportive of providing access to alternative clearing arrangements.

Multilateral compression exemption

153 Multilateral trade (or portfolio) compression is the practice of reducing or eliminating OTC derivative contracts by simultaneously terminating or replacing them with a smaller, more compact set of contracts, giving rise to economically-equivalent exposures or for a compensating payment.

154 Multilateral compression cycles can result in the amendment of existing OTC derivatives or the creation of new OTC derivatives. If amended or new OTC derivatives fell within scope of the proposed clearing requirements and were required to be cleared, the clearing requirements could reduce the effectiveness of multilateral compression. This is because mandatory central clearing would change the counterparties to the amended or new derivatives, so that the counterparties would face a CCP instead of the original counterparty. This would change the credit risk profile of the new or amended derivatives, and may make multilateral compression less economically attractive or viable.

155 Multilateral portfolio compression is an effective method for dealers with a large number of trades to reduce operational risk. We received industry feedback strongly in support of providing a multilateral compression exemption.

Intra-group exemption

- 156 An intra-group derivative transaction is a derivative transaction that occurs between two clearing entities in the same corporate group at the time the transaction is entered into.
- 157 We believe there is little risk-reduction benefit from requiring intra-day group derivative transactions to be subject to the clearing requirements, and that the overall regulatory benefits do not outweigh the compliance cost that would be imposed. The reduction in systemic risk that occurs when derivative transactions are entered into between different corporate groups does not apply to the same extent where derivative transactions are entered into within the same corporate group.
- 158 As such, under Option 2 we propose to provide an exemption for intra-group derivative transactions.

Grandfathering arrangement for swaps entered into on the exercise of swaption contracts

- 159 Swaption contracts are a type of derivative contract, which grants one counterparty to the swaption an option (that is, the right, but not the obligation) to enter into an underlying interest rate swap contract.
- 160 The terms of the underlying swap is typically negotiated and agreed, when the parties enter into the swaption.
- 161 Where entities enter a swaptions before the commencement of the clearing mandate, the parties would have negotiated the terms of the underlying swap on the assumption that the swap would not have to be centrally cleared. However, if the swaption is exercised after the commencement of the clearing mandate, the underlying swap resulting from the swaption may be subject to the mandate and need to be cleared.
- 162 As such, if these swaption contracts are not grandfathered, by exempting these underlying swaps from the clearing mandate, it may lead entities to decide not to exercise swaptions, which would impose opportunity costs for these entities.
- 163 We believe granting relief to provide a grandfathering arrangement, as described above, would maintain the status quo of the economic terms of the grandfathered swaption contracts. This would avoid imposing costs on industry and would not change the deregulatory benefits that would otherwise be realised under Option 2.
- 164 The relief measure would have further benefits. It would bring the Australian regime into alignment with overseas regimes and therefore improve the likelihood of obtaining substituted compliance for our rules.

165 Industry feedback was very supportive of providing relief to put in place the proposed grandfathering arrangements.

Overall deregulatory benefits

166 In addition to the annual cost savings that the 15 clearing entities would achieve through substituted compliance arrangements (as discussed in Option 1 see paragraphs 95–129) we believe a number of additional deregulatory benefits would be achieved under Option 2: see paragraphs 167–174. The costings for these additional savings were determined by analysing the savings that would be achieved in relation to the initial analysis undertaken by Treasury.

Delaying mandatory clearing of AUD forward rate agreements and AUD overnight index swaps

167 We believe that without a delay in the requirement to centrally clear AUD forward rate agreements and AUD overnight index swaps all 15 clearing entities would be required to incur large one-off costs in order to connect to an additional clearing facility in order to begin clearing these products.

168 Based on the costs of complying with the CFTC regime in the United States, we estimate that delaying the commencement of mandatory clearing of AUD forward rate agreements and AUD overnight index swaps will lead to annual savings of \$20,000 per entity.

Table 3: Cost savings from delaying central clearing of AUD forward rate agreements and AUD overnight index swaps

Cost item	One-off costs	Annual costs
IT system build	\$175,000	\$N/A
IT staff	\$25,000	\$N/A
Legal	\$13,000	\$N/A
Total costs per clearing entity	\$213,000	\$N/A

Allowing alternative clearing

169 We believe that without access to alternative clearing arrangements, all 10 foreign clearing entities would be required to build new compliance and record-keeping systems in order to ensure that they are fully complying with the Australian clearing mandate.

170 We estimate that allowing foreign clearing entities to use alternative clearing arrangements will lead to annual cost savings of \$75,000 per foreign clearing entity.

Table 4: Cost savings from allowing foreign clearing entities to use alternative clearing

Cost item	One-off costs	Annual costs
Compliance monitoring system (set-up and ongoing monitoring)	\$15,000	\$50,000
Record keeping	\$20,000	\$20,000
Total costs per foreign clearing entity	\$35,000	\$70,000

Removing the requirement to clear 'entered-into' and 'nexus' trades

- 171 We believe that without an exemption from clearing 'entered-into' and 'nexus' trades' all 10 foreign clearing entities would be required to build additional IT, compliance and record-keeping systems to identify 'entered into' and 'nexus' trades before the trade has been executed, in order to ensure that they are fully complying with the Australian clearing mandate.
- 172 We estimate that removing the requirement for foreign clearing entities to clear 'entered into' and 'nexus' trades will lead to annual cost savings of \$95,000 per foreign clearing entity

Table 5: Costs savings from removing the requirement for foreign clearing entities to clear 'entered-into' and 'nexus' trades

Item cost	One-off costs	Annual costs
IT	\$200,000	N/A
Compliance monitoring system (set-up and ongoing monitoring)	\$15,000	\$50,000
Record keeping	\$50,000	\$20,000
Total costs per foreign clearing entity	\$265,000	\$70,000

Exempting intra-group trades and multilateral compression exercises

- 173 We believe that without an exemption from clearing intra-group trades and trades conducted as part of multilateral portfolio compression exercises, all 15 clearing entities would be required to build additional compliance and record-keeping systems in order to ensure that they are fully complying with the Australian clearing mandate.
- 174 We estimate that providing exemptions for intra-group trades and trades that form part of multilateral compression exercises will lead to annual cost savings of \$75,000 per clearing entity.

Table 6: Cost savings from exemptions for intra-group trades and multilateral compression

Cost item	One-off costs	Annual costs
Compliance monitoring system (set-up and ongoing monitoring)	\$15,000	\$50,000
Record keeping	\$20,000	\$20,000
Total costs per clearing entity	\$35,000	\$70,000

Impact on industry

- 175 To the extent that the requirements under Option 1 and Option 2 differ, Option 2 would have a smaller cumulative impact on industry. Specifically, the proposals to provide exemptions for intra-group trades and multilateral compression exercises would help to reduce the concentration of operational risk by making it easier for entities to conduct intra-group hedging exercises, and allow dealers with a large number of trades to reduce operational risk through trade compression. The proposal to grant relief to provide grandfathering arrangements for swaptions would also help to avoid imposing opportunity costs on industry and therefore maintain the deregulatory benefits that would otherwise be realised under Option 2.
- 176 Option 2 is the preferred option because it achieves the inherent benefits of central clearing for market participants (by allowing them to minimise counterparty credit risk exposures and to create efficiencies in risk management processes), imposes minimal costs on market participants, and preserves the substituted compliance benefits granted to Australian entities (with the possibility of further future relief).

Impact on consumers

- 177 ASIC does not expect consumers to be caught by central clearing obligations because OTC derivatives are typically only traded by, and accessible to, financial institutions and corporations. It is also extremely unlikely that an individual would hold a portfolio of OTC derivatives in excess of \$100 billion gross notional value to meet the clearing threshold.

Option 3: Maintain the status quo

- 178 Under Option 3, ASIC would not impose any direct regulatory requirements on stakeholders.
- 179 However, the lack of an Australian central clearing mandate would not mean that Australian participants in OTC interest rate derivative markets would be able to avoid having to centrally clear or be subject to clearing mandates in other jurisdictions. Market forces such as prudential requirements and overseas regulations would still ensure that most OTC interest rate derivative

transactions in Australia would be centrally cleared. For example, the majority of G4 interest rate derivative transactions entered by Australian banks have an international bank as the counterparty, many of which are subject to the US clearing requirement.

180 Australian banks would therefore still have to incur the costs to put in place and maintain the necessary arrangements for central clearing if they wished to participate in OTC derivatives markets—without enjoying the substituted compliance benefits that would arise from a central clearing mandate.

181 Pursuing this non-regulatory option, ASIC would not seek to use its rulemaking powers to mandate a central clearing requirement for any class of persons with respect to OTC derivatives. In this instance, the cumulative impact of market forces, prudential obligations arising out of Basel III and foreign central clearing requirements would incentivise Australian entities to move towards central clearing without legislative intervention.

182 This approach would go some way to addressing the financial stability concerns around transparency, given that rates of voluntary central clearing would rise under such incentive structures. However, the decision to not implement a domestic mandatory clearing regime means Australian participants would still have to adhere to foreign central clearing requirements. Participants would not benefit from substituted compliance determinations under this option, and hence the \$5 million cost savings based on our updated assessment of the initial estimate put forward in Treasury's initial RIS would not be realised.

Impact on industry

183 Failure by Australia to put in place a central clearing mandate would mean that Australian participants in OTC derivatives markets would not be able to benefit from substituted compliance rulings and would have to clear in accordance with overseas regulatory frameworks. Relief provided in the past is likely not to be extended or revoked if Australia reneges on its commitment to implement a central clearing mandate.

184 Australian market participants already benefit from relief granted by the CFTC from a number of its so-called 'entity-level' requirements. This relief is time limited and subject to renewal. Failure on the part of Australia to implement central clearing as one of the key agreed reforms of OTC derivatives markets is likely to put the renewal of existing relief at risk. It will also make it very unlikely that the United States will agree to extend other kinds of substituted compliance relief to Australian entities.

Note: See CFTC, [*CFTC's division of market oversight issues time-limited no-action relief from certain requirements of Part 45 and Part 46 of the Commission's Regulations, for certain swap dealers and major swap participants established under the laws of Australia, Canada, the European Union, Japan or Switzerland*](#), press release, 20 December 2013.

- 185 The European Commission is currently conducting an equivalence assessment of the Australian regulatory framework for OTC derivatives, with a view to determining what substituted compliance relief it will provide. Failure to put in place a central clearing mandate would significantly reduce the scope of the relief that would be provided by the European Commission.
- 186 Similar outcomes would result as mandatory central clearing is adopted by further jurisdictions. Australian participants in global OTC derivatives markets would, as a consequence, face an increasing compliance burden in continuing their activities in these markets.
- 187 This option would therefore not address the first issue of providing relief to Australian OTC derivatives market participants from the effect of overseas regulation—resulting in increased costs for Australian banks and other institutions accessing global capital markets, especially in the United States and the European Union. These costs would include direct costs of complying with foreign regulations, but could also give rise to indirect costs such as those caused by having to withdraw from certain markets and, as a result, not being able to hedge certain products or currencies.
- 188 As well as failing to address the main problem, this option does not provide any compensating benefits to Australian participants in OTC derivatives markets because it will not reduce the pressure driving the uptake of central clearing in Australia and globally. Australian banks and businesses will therefore have to maintain the necessary arrangements for central clearing in order to continue participating in OTC derivatives markets.

Impact on consumers

- 189 There would be no impact on consumers under this Option 3 because there is currently no obligation in Australia to clear OTC derivatives.

C Consultation

- 190 The Australian Government released a consultation paper on a proposed central clearing mandate in February 2014. The paper asked for stakeholder feedback on a number of matters, including a central clearing mandate for G4 interest rate derivatives restricted to internationally-active dealers, and the best methodology for defining these dealers. Initial feedback was also requested for a possible future central clearing mandate for AUD interest rate derivatives, and the timing of such a mandate.
- 191 Twenty-three submissions were received, mainly from financial industry bodies and the major banks. Other submissions were received from a smaller financial institution, corporate entities, energy and commodity companies, and financial consultants.
- 192 There was almost universal support for a G4 interest rate derivative mandate limited to transactions between internationally-active domestic and foreign banks. There was also wide support for a similar AUD interest rate derivative mandate, but somewhat less consensus on timing. A number of submissions supported a simultaneous move to impose G4 and AUD interest rate derivative mandates, while others noted that international consistency is a key consideration, and that an AUD interest rate derivative mandate in Australia should be timed to coincide with a similar move in key overseas jurisdictions.
- 193 There was very firm support to restrict any clearing mandate to internationally-active domestic and foreign banks, but no consensus on how to define these entities. Many submissions, especially from the major domestic banks, called for further detailed consultation on this issue.
- 194 Following the release of the 2014 report (which recommended the imposition of a central clearing mandate for AUD interest rate derivatives) the Government released a further consultation paper in July 2014 on:
- (a) a proposal to proceed with an AUD interest rate derivative central clearing mandate (in combination with the G4 interest rate derivative mandate) limited to internationally-active domestic and foreign banks;
 - (b) the timing of the commencement of such a mandate; and
 - (c) an amended definition of internationally-active domestic and foreign banks.
- 195 On the whole, stakeholders supported combining the AUD and G4 interest rate derivative mandates, and limiting the scope of the mandate to internationally-active domestic and foreign banks. Views on the detailed definition of internationally-active domestic and foreign banks continued to diverge.

- 196 Following this consultation, Treasury and the CFR have continued to engage with key stakeholders on this definition. It appears that broad support for a reworked definition of internationally-active domestic and foreign banks has been achieved.
- 197 On 28 May 2015, the Government released a draft of the Ministerial determination and associated regulations for public consultation. Stakeholders were broadly supportive of the Government's approach and agreed with the importance of the commitments being implemented in a globally-coordinated, least-cost manner.
- 198 Following the consultation process, Treasury published a Ministerial determination on 2 September 2015 which set out the mandatory central clearing product scope.
- 199 On 8 September 2015, Treasury published amendments to the Corporations Regulations to implement central clearing of prescribed classes of OTC interest rate derivatives.
- 200 On 28 May 2015, ASIC released CP 231 and draft derivative transaction rules (clearing) for consultation. CP 231 was open for submissions from 28 May 2015 to 10 July 2015, which allowed six weeks for stakeholders to respond. We received 11 written submissions in response to CP 231 (including three confidential submissions) from a broad range of stakeholders.
- 201 We have engaged with stakeholders following the formal consultation period and, in particular, in relation to the types of AUD interest rate derivatives subject to the proposed mandate—where we took on board industry concern about the current lack of CCP's offering central clearing for a number of these products.
- 202 We have also held several meetings with stakeholders to discuss a range of issues, including the proposed requirement for foreign clearing entities to clear 'nexus' and 'entered-into' trades, and a proposed exemption for 'offset' trades that are created during multilateral compression exercises: see paragraphs 204–211.
- 203 Lastly, as part of our ongoing implementation review, we have identified the opportunity to grant further relief, which would avoid imposing opportunity costs on industry and help to maintain the deregulatory benefits that have been identified under Option 2.

Key feedback

Product scope

- 204 A number of submissions raised concerns regarding the proposal to mandate clearing of AUD forward rate agreements because, at present, there are no licensed clearing facilities clearing these products.
- 205 A number of submissions also questioned the decision to mandate the clearing of AUD overnight index swaps, because there is currently only one licensed CCP clearing this product. Industry proposed that AUD overnight index swaps should not be subject to the clearing mandate until there are at least two CCPs that may be used to meet the mandate.

Clearing of 'nexus' and 'entered-into' trades by foreign clearing entities

- 206 During consultation, we received a number of submissions arguing that 'entered-into' or 'nexus' trades should be excluded from the clearing mandate because, to comply with this requirement, foreign clearing entities would be required to build additional systems and incur material compliance costs.
- 207 A number of submissions also noted that a requirement to clear 'entered-into' or 'nexus' trades would be inconsistent with the clearing requirements in overseas regimes.

Multilateral compression exemption

- 208 A number of submissions expressed support for an exemption from the clearing requirement for 'offset' trades that are created during multilateral trade compression exercises. The industry response was that multilateral compression exercises serve an important purpose in helping to reduce both entity and overall systemic risk.
- 209 A number of submissions argued that an exemption should also be applied to 'offset' trades that are created during bilateral compression exercises.

Intra-group exemption

- 210 Industry response was that the derivative transaction rules (clearing) should allow an exemption for intra-group derivative transactions.
- 211 A number of submissions argued that the notification requirement regarding intra-group transactions should be amended to require post-trade notification rather than pre-trade notification in order to provide ASIC with certainty that a transaction has been conducted and to allow entities to retain the flexibility to hedge, as required.

Grandfathering for swaptions

- 212 As part of our ongoing implementation review, industry identified the need for grandfathering arrangements for swaps that are entered into when entities exercise an option embedded in a swaption contract, where the swaption contract was entered into before the commencement of the mandate.

D Conclusion and recommended option

- 213 OTC derivatives are an important segment in global financial markets. For Australian businesses, OTC derivatives are an essential product for hedging their foreign exchange, interest rate and other market exposure risks. This is particularly important for the major Australian banks, because they depend on global capital markets for raising a substantial proportion of their funding needs. Given the central importance of the major banks in providing financing to Australian consumers and businesses, preserving their access to global financial markets (including OTC derivatives markets) at the lowest possible cost is a key concern for the Government.
- 214 The reforms to OTC derivatives markets are an important global initiative to improve the stability of financial markets and minimise the risk of future financial crises. The Government is prepared to play its part in implementing the reforms, including with respect to central clearing of OTC derivatives.
- 215 However, in implementing any reforms the Government is determined to minimise the regulatory impact on Australian banks and businesses operating in OTC derivatives markets. With respect to the OTC derivatives reforms, it is of particular importance to limit the potential impact of extraterritorial regulation. Failure to do so could significantly increase the costs of Australian banks and businesses raising funds and hedging risks in global financial markets.
- 216 The Government has considered the options examined in this RIS to address the issues set out in paragraphs 4–7 (i.e. maximising substituted compliance relief). Option 3 does not address this problem because it would likely cause the United States to withdraw the substituted compliance benefits already provided to Australian businesses active in OTC derivatives markets in the United States. It would also not be helpful in obtaining substituted compliance benefits in other important overseas markets, such as the European Union, because they implement their own OTC derivatives reforms. Option 1 addresses this problem—as does Option 2. However, Option 1 imposes higher compliance costs on industry stakeholders.
- 217 Following consideration of these options and their relative impact on Australian banks and businesses it is our recommendation to proceed with Option 2. Option 2 is the preferred option because it imposes minimal costs on market participants, while preserving the substituted compliance benefits granted to Australian entities and possibly leading to further relief.

E Implementation and review

- 218 The central clearing mandate will be implemented through the derivative transaction rules (clearing) and evaluation of the impact of the central clearing mandate will occur on several levels.
- 219 The CFR regularly survey Australian OTC derivatives markets and report on key developments and issues. Based on the results of their work the CFR have, in the past, provided recommendations to Government on developing regulation to implement global reforms to OTC derivatives markets. It is anticipated that the CFR will continue this series of reports, including on any issues or new developments they may identify in relation to central clearing.
- 220 Regular global surveys of the state of OTC derivatives markets regulation are conducted by the Financial Stability Board (FSB). Nine reports have been produced to date, with the most recent published in July 2015. These reports provide a comparative view of the progress of the reforms to OTC derivatives markets across jurisdictions, including with respect to central clearing. The FSB reports provide a good overview of the state and progress of global reforms to OTC derivatives markets, and a way for individual jurisdictions, including Australia, to benchmark their own progress against that achieved by their peers.

F Regulatory Burden and Cost Offset (RBCO) Estimate Table

Option 1

Table 7: Average annual costs and cost offsets of implementing Option 1

Costs/costs offset (\$m)	Business	Community organisations	Individuals	Total savings
Total by sector (cost)	\$5.0	\$	\$	\$5.0
Agency (cost offset)	\$	\$	\$	\$
Within portfolio (cost offset)	\$	\$	\$	\$
Outside portfolio (cost offset)	\$	\$	\$	\$
Total by sector(cost offset)	\$	\$	\$	\$

Table 8: Average annual compliance savings of implementing Option 1

Proposal is cost neutral?	No
Proposal is deregulatory?	Yes
Balance of cost offsets \$	

Option 2

Table 9: Average annual costs and cost offsets of implementing Option 2

Costs/costs offset (\$m)	Business	Community organisations	Individuals	Total savings
Total by sector (cost)	\$8.2	\$	\$	\$8.2
Agency (cost offset)	\$	\$	\$	\$
Within portfolio (cost offset)	\$	\$	\$	\$
Outside portfolio (cost offset)	\$	\$	\$	\$
Total by sector(cost offset)	\$	\$	\$	\$

Table 10: Average annual compliance savings of implementing Option 2

Proposal is cost neutral?	No
Proposal is deregulatory?	Yes
Balance of cost offsets \$	

Option 3

Table 11: Average annual costs and cost offsets of implementing Option 3

Costs/costs offset (\$m)	Business	Community organisations	Individuals	Total savings
Total by sector (cost)	(\$5.0)	\$	\$	(\$5.0)
Agency (cost offset)	\$	\$	\$	\$
Within portfolio (cost offset)	\$	\$	\$	\$
Outside portfolio (cost offset)	\$	\$	\$	\$
Total by sector(cost offset)	\$	\$	\$	\$

Table 12: Average annual compliance savings of implementing Option 3

Proposal is cost neutral?	No
Proposal is deregulatory?	No
Balance of cost offsets \$	