Regulation Impact Statement – Implementation of Reforms to Australia's Over-the-counter Derivatives Markets – Central Clearing Mandate for G4 and AUD Interest Rate Derivatives

1. Problem Definition

This final stage Regulation Impact Statement (RIS) follows an early assessment RIS supporting the Government's in-principle decision to make a Ministerial determination and accompanying regulations allowing the Australian Securities and Investment Commission (ASIC) to issue derivative transaction rules (DTRs) mandating central clearing of prescribed classes of over-the-counter (OTC) derivatives. This decision was announced by the Acting Assistant Treasurer in December 2014.[1]

In May 2015 the Government released for public consultation a draft Ministerial determination and regulations imposing a central clearing mandate for prescribed classes of OTC derivatives. ASIC simultaneously released its draft central clearing DTRs for public consultation. The Government intends to finalise and make the determination and regulations taking into account the outcomes of the public consultation.

Central clearing is one of the reforms being implemented globally in OTC derivatives markets. Clearing mandates in overseas jurisdictions are impacting on Australian banks and businesses active in global financial markets. The implementation of a clearing mandate in Australia is intended, as explained in detail below, to mitigate the negative effects of this impact. This RIS accordingly does not focus on issues associated with Australia's OTC derivatives central clearing framework, but is primarily concerned with mitigating the impact of foreign OTC derivatives regulations on Australian banks and businesses.

This RIS only relates to the making of the Ministerial determination and related regulations. ASIC's central clearing DTRs are subject to a separate regulatory impact assessment.

Background - global OTC derivatives reforms

The OTC derivatives market is one of the largest global financial markets, with total volume of over US$ 700 trillion[2]. OTC derivatives are used by a wide range of market participants to hedge numerous types of financial and other risks, as well as for speculative purposes.

The global financial crisis (GFC) of 2008 highlighted structural deficiencies in the OTC derivatives market, in particular with respect to transparency and default risk management.

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[1] http://mhc.ministers.treasury.gov.au/media-release/058-2014/

[2] Bank for International Settlements, as of end 2013. This figure is however acknowledged to exaggerate the size of the market because it double-counts a large number of cleared transactions.

G20 leaders at the 2009 Pittsburgh Summit in response agreed to a number of reforms designed to address these deficiencies.

- Transparency was to be improved by requiring OTC derivatives contracts to be reported to specialised data warehouses known as trade repositories, which would make this information available to regulators. Also, standardised OTC derivatives should be traded on public exchanges or electronic trading platforms, with public access to prices and transaction information as appropriate; and

- Default risk management was to be improved by requiring standardised OTC derivatives to be centrally cleared through central counterparties (CCPs) which would assume the responsibility of managing and containing the consequences of a default by a market participant.

G20 jurisdictions have started implementing these agreed reforms. Australia in late 2012 established a general framework in its legislation for the regulation of its OTC derivatives markets. In 2013 specific requirements in relation to reporting of OTC derivatives contracts to trade repositories were introduced. Mandating central clearing is the next step in the implementation of the global OTC derivatives reforms in Australia.

Background – central clearing

Central clearing seeks to streamline and simplify the management of default risk in markets, including in OTC derivatives markets. It does this by interposing a CCP into every transaction concluded on a market through the legal process of novation, resulting in two transactions in which the CCP has become the counterparty to each of the two original parties.

This has the effect of making CCPs the focal points of all transactions in centrally cleared markets, with the following main benefits:

- Concentration of default risk management in the hands of the CCP, in order to contain the contagion effect of the default or potential default of a market participant;

- Minimisation of total bilateral exposures through netting of offsetting positions, creating significant efficiencies in risk management processes such as margining and capital provisioning; and

- Ability of regulators to focus supervisory efforts on CCPs, rather than having to deal with widely dispersed default risks.

Many important financial markets use central clearing to obtain these benefits. For example, all share trading on the ASX is centrally cleared.

Context – financial system stability

Ensuring adequate default risk management in OTC derivatives markets is a major challenge in maintaining financial system stability in crisis situations. Central clearing is one of the key measures intended to address this issue, by concentrating default risk management in the hands of CCPs. CCPs employ a variety of means to manage default risk, including through careful selection of members, initial margin and collateral requirements, and the establishment of default funds that can be drawn upon to mitigate the consequences of a member default.

Central clearing is a key tool for safeguarding financial system stability. Because they are focal points of risk in the financial system, CCPs are subject to extensive regulatory requirements. In Australia, the Reserve Bank of Australia (the RBA) is the main supervisory agency for CCPs.

Nevertheless, the uptake of central clearing as such is not the key problem addressed in this RIS. This is because, as will be explained in detail below, a range of regulatory and commercial factors have already led to the widespread uptake by dealers of central clearing in Australian OTC derivatives markets.

Background – the Australian OTC derivatives market

Information compiled by ASIC, the RBA and the Australian Prudential Regulation Authority ((APRA) – collectively the Regulators) in a series of reports on the Australian OTC derivatives markets indicates a number of key factors about these markets, including the following:

- the market is dominated by two product classes, single-currency IRD and foreign exchange derivatives;
- AUD-denominated IRD (AUD-IRD) are the biggest product category among single-currency IRD; and
- the market is dominated by dealers, which consist of the major domestic and foreign banks. Smaller banks and corporate entities do not play a systemically significant role.

The two latest reports by the Regulators were issued in July 2013[3] (the 2013 Report) and April 2014[4] (the 2014 Report), in both of which recommendations were made with respect to central clearing. The Reports were compiled following surveys of market participants' OTC derivatives market activities and practices, covering institutions such as large domestic and international banking groups, smaller authorised deposit-taking institutions, fund managers, government borrowing authorities and corporate treasuries.

Central clearing in Australian OTC derivatives markets

As set out above, G20 jurisdictions have committed to mandatory central clearing as an important method to address inadequate default risk management in OTC derivatives markets. The first jurisdiction to mandate central clearing was the US, where central clearing of IRD denominated in G4 currencies (G4-IRD) and certain classes of credit derivatives has been mandatory since March 2013. Since then a small number of further jurisdictions, for example Japan, have introduced clearing mandates. In the near future central clearing mandates will come into force in more G20 jurisdictions, including in globally important markets such as the European Union (EU).

Central clearing obligations in foreign jurisdictions may impact on Australian businesses that want to enter into OTC derivatives transactions in those jurisdictions or with counterparties that are subject to those obligations, even if they are not subject to a central clearing mandate in Australia. An Australian bank concluding an OTC derivative transaction with a US bank will have to centrally clear the transaction if the US bank is subject to a clearing mandate in the US. It will have to do so under US rules which will require, for example, that the CCP must be licensed by the US regulator, the Commodity Futures Trading Commission (CFTC). This may be the case even if the transaction is concluded in Australia with the local branch of the US bank, because bank branches are generally subject to the regulatory framework applying to their parent entities[5].

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[3] Report on the Australian OTC Derivatives Market, July 2013.

[4] Report on the Australian OTC Derivatives Market, April 2014, available on the same website of the Council of Financial Regulators (CFR).

[5] An unguaranteed Australian subsidiary of a US bank would not, but global banks have in the past generally structured their overseas operations as branches and not subsidiaries wherever possible.

Australian banks are particularly exposed to this type of extraterritorial regulation, because they raise large amounts of wholesale funding in overseas financial markets and use OTC derivatives transactions in those markets to hedge various types of risks. In such circumstances, the banks may have little choice other than to comply with local regulations if they wish or need to continue doing business in that jurisdiction or with entities subject to its regulatory regime.

The impact of foreign clearing requirements, especially coming out of the US, is one of the main forces driving the uptake of central clearing in Australia. However, there are also other factors that are reinforcing this trend. For example, new international prudential standards known as the Basel III rules have provided further incentives for central clearing due to reduced capital charges imposed on centrally cleared transactions.[6] Commercial factors, such as better liquidity in cleared markets, and more efficient management of margin and collateral requirements by CCPs, have also played an important role.

The 2013 Report accordingly concluded that a substantial proportion of new transactions in G4-IRD between dealers was already being cleared (p.33). The 2014 Report found that the trend towards central clearing had accelerated further, and that even in AUD-IRD dealers were centrally clearing almost all new transactions (p.34). It therefore appears safe to conclude that, as far as AUD and G4-IRD transactions between dealers is concerned, almost all new transactions that can be cleared are now being centrally cleared.

Problem definition – mitigation of impact of foreign regulation through substituted compliance

The extraterritorial impact of local regulations on businesses from other jurisdictions has become a key problem in the implementation of the OTC derivatives reforms. Complying with the regulatory framework of another jurisdiction imposes significant legal and compliance costs. For businesses with wide-ranging international activities such as the major Australian banks there may be a need to comply with more than one country's regulatory framework simultaneously – for example, this may be the case for Australian banks operating in the US and the EU. Costs may be multiplied if these regulatory frameworks are inconsistent, imposing duplicative or even conflicting requirements.

Globally regulators are addressing this problem through an approach known as substituted compliance, under which regulators grant relief from their own regulatory requirements if a foreign entity is subject to equivalent requirements in their home jurisdiction.[7] An Australian bank concluding an OTC derivative transaction in the US would under this approach be exempt from complying with the relevant US regulations if the CFTC had made a formal determination granting substituted compliance to Australian-regulated entities, following an equivalence assessment by the CFTC of the Australian regulatory framework.

The impact of foreign OTC derivatives regulations on Australian banks and businesses is the key problem addressed in this RIS. Market assessments by Australian regulators show that the Australian OTC derivatives market is dominated by the big banks, including the major Australian banks as well as the local operations of global financial institutions. According to the 2013 Report, the majority of G4-IRD transactions are concluded between Australian banks and global financial institutions (2013 Report, p.30). A similar conclusion holds for AUD-IRD (2014 Report, p.24). These global banks are or will soon become subject to clearing mandates imposed by their home regulators, especially in the US

[6] See discussion in Council of Financial Regulators, OTC Derivatives Market Reform Considerations, March 2012, p.18 for a discussion of the effect of prudential standards.

[7] The equivalence or not of regulatory requirements in foreign jurisdictions is determined by the local regulator through a formal assessment. Where equivalent obligations are identified relief from local requirements is then granted to foreign entities subject to those requirements in the overseas jurisdiction.

and the EU. In turn, Australian banks entering transactions with these global banks will be captured by US and EU regulations, and will have to bear the associated compliance costs, unless relief can be obtained through substituted compliance determinations in these jurisdictions.

Failure to assist Australian banks and businesses in obtaining substituted compliance relief in important jurisdictions would impose significant costs on these entities in doing business in global financial markets. The main costs in this respect include direct compliance costs arising from specific foreign regulatory requirements as well as indirect costs attributable to problems in the implementation of the global OTC derivatives reforms. An example of the former would be the CFTC requirement to establish a comprehensive risk management program and a compliance monitoring system, which would impose significant legal, IT and personnel costs[8]. An example of the latter would be the obligation to use different CCPs in different regional markets due to a lack of coordination and agreement among important global regulators[9]. This would impose additional membership fees and related costs on Australian banks and businesses, but also lead to significant indirect costs such as reduced netting efficiencies in margin and collateral management.

Increased costs and reduced efficiencies in accessing global financial markets, especially for the major Australian banks, would have significant implications for the Australian economy and consumers, given the importance of global financial markets as funding sources for the banks. The impact would occur through increased costs passed on to business and individual customers of the banks, but also through increased risks borne by the banks due to difficulties in implementing appropriate hedging strategies.

In practical terms, addressing this problem means minimising the impact of US and EU regulation on the major Australian banks by maximising the scope of substituted compliance determinations granted by the CFTC and the EU authorities[10] to Australian banks and businesses. Protecting the access of the major Australian banks to global financial markets is a priority for the Australian Government, given their importance as sources of funding to the banks and the potential impact (as explained above) of any funding and hedging problems on the wider Australian economy. Finding a solution to this problem is therefore a key consideration in deciding how to implement the global OTC derivatives reforms in Australia.

Australia's CCP framework

There are currently three CCPs clearing OTC derivatives licensed in Australia: ASX Clear (Futures) Pty Ltd (ASX Clear), owned and operated by the ASX; LCH.Clearnet Limited (LCH), based in the UK;

[8] An assessment of the cost impact of this item is provided in Section 4 below.

[9] This is an outcome that may arise out of a current dispute between European and US regulators with respect to the mutual recognition of CCPs.

[10] The main regulator in the EU is the European Securities and Markets Authority (ESMA). Substituted compliance determinations are formally made by the European Commission, after technical advice is provided by ESMA.

and Chicago Mercantile Exchange Inc. (CME), based in the US. ASX Clear started operating in July 2013. Previously all OTC derivatives in Australia were cleared offshore. For interest rate derivatives denominated in Australian dollars LCH has in the past been the largest CCP. LCH and CME offer clearing for a wide range of OTC derivatives, whereas ASX Clear is focusing on Australian dollar interest rate derivatives at this stage.

Becoming a participant in a CCP is expensive, due to costs such as membership fees, default fund contributions, clearing fees and margin payments. Businesses therefore minimise the number of CCPs they deal with. Choice of CCP may be determined by a number of factors, including:

- Cost – this includes direct costs such as fees and default fund contributions, but also indirect costs. Netting efficiencies, which are largely driven by the scale and scope of a CCP's operations, are critical in this context, because they can significantly reduce capital costs and margin payments;

- Product range – it may be more attractive for a business to join a CCP which can cover all of its product needs; and

- Other factors – for example, a domestic CCP may offer operating times consistent with local business practice, whereas an overseas CCP may face some difficulties in this regard.

No single factor is decisive in all situations. The final choice will depend on the circumstances of each possible CCP and how they match the specific needs of the business.

Because OTC derivatives transactions are frequently concluded across borders, it is critical for CCPs to be formally recognised in foreign jurisdictions. CCPs are critical elements of each jurisdiction's financial infrastructure, and all jurisdictions only allow clearing to occur through authorised CCPs. Recognition and authorisation of foreign CCPs occurs through the formal equivalence assessment process described above. For an Australian CCP such as ASX Clear it is critical to obtain overseas authorisation based on the Australian regulatory framework being accepted as equivalent by foreign jurisdictions. ASX Clear has been authorised in the US and the EU, allowing it in principle to clear transactions involving businesses subject to clearing mandates in those jurisdictions.

2. Why Is Government Action Required?

Current legislative framework

As noted above, the Australian legislative framework for OTC derivatives was passed in December 2012.

Under this legislation, the relevant Minister has the power to prescribe certain classes of derivatives as being subject to an ASIC rule making power in relation to mandatory clearing by a central counterparty, mandatory reporting to a trade repository, or mandatory execution on a trading platform. The legislation also provides a power to set boundaries for ASIC's DTRs by regulation with regard (among others) to the types of derivatives and the classes of persons they may cover.

To give effect to a particular mandate, a Ministerial determination is required giving ASIC powers to develop DTRs clarifying matters such as who is subject to the rules, which specific products are covered and when the mandate comes into force.

Why is Government action required?

The market assessment reports undertaken by the Regulators have shown, as mentioned, 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 active in Australia. Ensuring that these entities centrally clear their OTC derivatives transactions would therefore substantially achieve the financial system stability benefits inherent in central clearing (2013 Report, p.23). For this reason, the 2013 and 2014 Reports recommend that central clearing mandates for AUD and G4-IRD should be restricted to these major financial institutions (called 'dealers' in the reports).[11]

However, the 2013 and 2014 Reports also conclude that the majority of new AUD and G4-IRD transactions entered into by dealers are already being centrally cleared.[12] The main reasons for this development are:

- Many of the foreign financial institutions active in the Australian OTC derivatives market are already subject to an overseas obligation to centrally clear (2013 Report p.30). This would notably apply to the Australian branches of US banks; and

- Prudential standards under the Basel III reforms are imposing higher capital charges on non-centrally cleared OTC derivatives transactions, thereby providing a strong incentive to centrally clear (2013 Report p.10).

- As more and more transactions are centrally cleared, market forces such as the search for better liquidity and netting efficiencies are reinforcing the uptake of central clearing.

This means that international developments, other regulatory requirements and market forces are already driving market participants towards central clearing. A central clearing mandate imposed by the Government is not required to achieve this outcome and the associated financial stability benefits.

The main reason why Government intervention is being proposed is to minimise the impact of extraterritorial regulation on Australian businesses through substituted compliance determinations by overseas regulators.

Equivalence assessments by overseas regulators of the Australian regulatory framework for OTC derivatives will only consider legally binding requirements. The fact that most OTC derivatives transactions in the Australian market are already being centrally cleared will not be considered as a material factor in an equivalence assessment of Australia's regulatory framework for OTC derivatives.

A clear demonstration of this can be seen in the advice provided by the EU regulator, the European Securities and Markets Authority (ESMA), to the European Commission with respect to its assessment of the Australian regulatory framework.[13] With respect to central clearing, ESMA found that while the Australian legal framework made provision for the imposition of a clearing mandate, actual equivalence with the European framework would only be achieved once a Ministerial determination was made mandating central clearing. Equivalence would also be limited to the specific types of OTC derivatives covered by the determination, and to transactions involving counterparties covered by the clearing obligation as specified in regulations and/or DTRs made by ASIC.

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[11] 2013 Report p.33, and 2014 Report p.36.

[12] 2013 Report p.30, and 2014 Report p. 34.

[13] As noted above ESMA provides relevant technical advice to the European Commission following a detailed equivalence assessment. The formal granting of substituted compliance relief is done by the Commission through implementing acts.

This example shows clearly that substituted compliance will only be granted by overseas regulators on the basis of legally binding obligations. Government action through a Ministerial determination, regulations and ASIC DTRs is consequently essential to achieve the desired outcome.

3. Options

The focus of governments and regulators in implementing the global central clearing reforms for OTC derivatives is at this stage limited to central clearing for OTC IRD. One reason is that IRD constitute the largest class of OTC derivatives, both globally and in Australia. The central clearing mandate in the US is limited to certain types of IRD denominated in a range of global currencies. Recommendations by the Regulators in the 2013 and 2014 Reports in Australia have focused on central clearing requirements with respect to G4 and AUD-IRD.

As noted above, foreign exchange derivatives are a second important OTC derivatives product class in Australia and globally. However, there are structural problems that have to date prevented CCPs from offering central clearing for foreign exchange OTC derivatives. The lack of practical clearing opportunities will have to be overcome before central clearing requirements can be applied to this product class.

The options set out below are therefore limited to central clearing requirements for OTC IRD denominated in G4 currencies and Australian dollars.

Option 1: Status quo option

Under this option the Government would not use its legislative powers to impose a central clearing requirement for OTC IRD in Australia. This does not mean that there would not be any central clearing of OTC IRD transactions. Because of the combined impact of market forces, other regulatory requirements such as prudential standards, and through the extraterritorial reach of foreign central clearing requirements, central clearing of OTC IRD would continue to expand in Australia. This would however occur without the backing of a formal Government mandate.

Option 2: Light touch option

Under this option the Minister would make a determination providing ASIC with rule making power to prescribe G4 and AUD-IRD to be centrally cleared by a limited number of internationally active financial institutions. It is envisaged that this would mainly be achieved through an activity threshold calculated on the basis of the total notional volume of OTC derivatives entered into by an entity.

It is envisaged that the threshold would be set at $100 billion, calculated on the basis of an entity's total gross notional outstanding positions across all OTC derivatives.[14] Currently available information suggests that at this level approximately 20 entities would be subject to ASIC's rules. They would include the 5 largest Australian banks and a number of major foreign financial institutions, especially the global investment banks.

The available information also suggests that the entities captured under this threshold would account in aggregate for the majority of transactions and would include the systemically significant entities active in the market.

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[14] It is likely that this calculation would have to be done at the end of each quarter, and an entity would be deemed to have exceeded the threshold if it remained above it for two consecutive quarters. The details of the proposed calculation method are set out in ASIC's central clearing DTRs.

The Ministerial determination would be accompanied by regulations setting high-level parameters for ASIC's central clearing DTRs and addressing a small number of other issues related to central clearing as well as the wider OTC derivatives markets reforms. The regulations would mainly address the following matters:

- The key elements of the activity threshold defining the entities that are subject to the clearing mandate: This would include for example the level of the threshold (anticipated to be $100 billion) and how offshore dealers are to be treated for purposes of the mandate;

- An exemption for public entities such as central banks from the central clearing requirement: Such a provision is standard internationally and is necessary to obtain reciprocal treatment for our public institutions; and

- A provision allowing the use of prescribed in addition to domestically licensed CCPs, subject to a number of conditions. This ensures that market participants can continue to access a small number of widely used global and regional CCPs that do not wish to apply for a licence in Australia, to avoid restricting the scope of clearing opportunities currently available.

In addition, it is proposed to make a minor amendment to the regulations clarifying that for AFSL holders that only have authorisation for specific types of derivatives rather than having a general derivatives authorisation, the DTRs can only impose requirements with respect to those types of derivatives covered by their licence authorisation.

Option 3: Wider scope option

Under this option the Minister would make a determination providing ASIC with rule making powers to mandate central clearing of G4 and AUD-IRD for a wider class of financial entities. This would mainly be achieved by lowering the threshold to a level that would capture a number of smaller Australian and overseas banks, as well as a number of large fund managers.

It is anticipated that under this option the threshold would be lowered to about $10 billion. According to currently available information this would mean that about 40 entities would become subject to the clearing mandate. This group of entities is estimated to account for almost all of the activity in this segment of the market.

The same regulations as outlined under Option 2 would be made under this option.

4. Net Benefit Analysis

Option 1: Status quo

Under this option the Government would not impose any direct regulatory costs on stakeholders.

However, the absence of an Australian central clearing mandate would not relieve Australian participants in OTC IRD markets from the need to centrally clear. As mentioned above, forces such as prudential requirements and overseas regulations would still ensure that most OTC IRD transactions in Australia would be centrally cleared. For example, the majority of G4-IRD transactions entered into by Australian banks have an international bank as the counterparty, many of which are subject to the US clearing requirement.[15]. Australian banks would therefore still have to incur the costs to put in

[15] See the 2013 Report, p.30.

place and maintain the necessary arrangements for central clearing if they wished to participate in OTC IRD markets.

Failure by Australia to put in place a central clearing mandate would mean that Australian participants in OTC IRD 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 would be likely not to be extended or revoked if Australia reneged on its commitment to implement a central clearing mandate.

Australian market participants already benefit from relief granted by the CFTC from a number of its so-called 'entity-level' requirements.[16] 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 to OTC derivatives markets is likely to put the renewal of existing relief at risk. It will also make it very unlikely that the US will agree to extend other kinds of substituted compliance relief to Australian entities.

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 Commission.

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.

This option would in sum not address the key problem of providing relief to Australian OTC derivatives market participants from the impact of overseas regulation, resulting in increased costs for Australian banks and other institutions accessing global capital markets. This would include the direct costs of complying with foreign regulations, but also 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. Markets most likely to be impacted in this manner are in the US and EU, and products that are likely to be affected include in particular interest rate derivatives denominated in Australian dollars and global currencies such as the US dollar and the euro. These markets and derivatives play a critical role in the funding activities of the Australian banks, and any increased costs incurred would ultimately be borne by Australian businesses, consumers and investors.

While it does not address the main problem, this option also would not provide any compensating benefits to Australian participants in OTC derivatives markets since it would not reduce the pressure driving the uptake of central clearing in Australia and globally. Australian banks and businesses would therefore have to maintain the necessary arrangements for central clearing in order to continue participating in OTC derivatives markets.

Option 2: Light touch regulation

The light touch option would, as noted above, bring about 20 Australian financial institutions (including the local operations of major overseas banks) within the scope of ASIC's central clearing DTRs. As these institutions have established the infrastructure required for central clearing and are already clearing most of their new OTC IRD transactions, the additional compliance costs associated with the mandate would be minimal.

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[16] See CFTC press release of 20 December 2013, available at: http://www.cftc.gov/PressRoom/PressReleases/pr6803-13

The imposition of this mandate may provide some marginal financial stability benefits by reinforcing the existing strong trend towards central clearing in OTC IRD markets. While the scope of the mandate may appear relatively narrow, it would nevertheless capture the systemically significant participants in the market as shown by the fact that these institutions in aggregate hold the majority of total gross notional OTC derivatives outstanding in Australia.

This option would 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 the EU. Once the Ministerial determination, associated regulations and ASIC's DTRs have been made, it will be possible for Australian financial institutions active in the US markets to apply to the CFTC for further, clearing-related relief. As it is expected that the EU will have a central clearing regime in place starting in 2016, it may also be possible to apply for substituted compliance relief under that regime.

The light touch option is the preferred option put forward in this RIS, as it imposes minimal costs on market participants while preserving the substituted compliance benefits granted to Australian entities and possibly leading to further relief.

For purposes of quantifying the expected benefits of the proposed mandate, the approach taken has been to focus on those benefits that are confirmed and are actually available to Australian market participants. These are the existing entity-level relief measures granted by the CFTC in December 2013. The assumption applied is that this relief will be extended by the CFTC, as compared to the do-nothing option, where it may be expected that the CFTC would revoke the measures. The additional potential benefits accruing from additional substituted compliance grants provided by the CFTC and the EU have not been quantified, as it is impossible to forecast the type and extent of relief that may be provided.

The detailed calculation is based on a number of specific types of relief provided by the CFTC, in particular requirements relating to risk management and swap data recordkeeping. The cost of complying with these requirements is calculated for the 20 Australian entities subject to the proposed mandate. This cost is assumed to be the savings achieved under this option because it would have to be incurred under the do-nothing option which assumes that the relief will be withdrawn. The following relief provided by the CFTC is quantified:

- 1 support staff for chief compliance officer (salary costs)[17];
- Risk management requirements, including establishment of a comprehensive risk management program and a compliance monitoring system in line with Dodd-Frank and CFTC requirements (legal, IT and personnel costs); and
- Swap data record-keeping and reporting requirements (mainly personnel costs).

The calculation per dealer is set out in the table below[18]:

Item	*One-off costs*	*Annual costs*

[17] Many dealers already have a chief compliance officer. Some may not, but this potential saving is ignored.

[18] Estimates based on industry input and publicly available information, for example with respect to average salaries in the US.

Item	*One-off costs*	*Annual costs*
Support compliance staff		$100,000
Risk management set-up:		
• Legal • IT	• $50,000 • $50,000	
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**

The estimated total annual benefit of this option calculated based on 20 dealers is $6.73 million, as set out in the below table.

Average annual regulatory costs (from business as usual)				
Change in costs ($ million)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	($6,730,000)	$ -	$ -	($6.73)
Cost offset ($ million)	Business	Community organisations	Individuals	Total, by source
Agency	$	$	$	$
Are all new costs offset? □ **Yes, costs are offset** □ **No, costs are not offset** ☒ **Deregulatory — no offsets required**				
Total (Change in costs – Cost offset) ($ million) = ($6.73)				

Option 3: Wider scope of regulation

This option would impose a central clearing mandate on a wider class of financial entities. It is estimated that 20 additional entities would be captured under this option. This would be likely to include entities such as smaller banks and fund managers that are currently not centrally clearing their OTC derivatives transactions. These entities would therefore have to incur the costs of establishing the infrastructure and arrangements necessary for central clearing.

The benefits of this option are in general similar to those of the light touch option. The financial stability benefits are considered to be similar because the additional entities captured are not systemically significant market participants. This option would also be highly likely to ensure that the relief currently granted by the CFTC would be extended.

For purposes of quantifying the estimated benefit of this option the underlying approach is the same as for the previous option, i.e. it is based on estimating the cost savings resulting from the CFTC substituted compliance relief granted in December 2013. As with the previous option no further savings have been estimated due to the impossibility of forecasting what further relief may be provided. There are however significant costs associated with this option, as the additional 20 entities captured would have to incur the expenses of establishing central clearing infrastructure and arrangements.

These costs relate mainly to legal, IT and training expenses required to establish such arrangements and instruct staff in how to operate them. As the 20 major dealers have already established clearing arrangements and are clearing the majority of their new transactions, no further costs are created in this respect for them. The additional costs therefore affect the 20 non-dealers captured under this option on top of the 20 dealers.

These set-up costs include internal and external costs, the latter arising mainly in relation to legal advice, tax advice and IT systems changes. Internal costs relate to these matters and to putting in place changes in operational processes. These are all personnel costs. It is expected that the new central clearing arrangements will replace the current uncleared derivatives operations of the 20 non-dealers and can be handled by existing staff working on the latter, i.e. no additional ongoing costs will arise under this option.

The calculation per non-dealer is set out in the table below[19]:

Item	*One-off costs*	*Annual costs*
External costs		
Set-up costs:		
• Legal • IT	• $200,000 • $500,000	
Internal costs		
Staff costs	$435,000	
Total costs per dealer	**$1,135,000**	**NA**

The estimated annual benefit for this option is $4.46 million, as set out in the table below. It is noted that for this option the costs are entirely borne by the 20 non-dealers, whereas the benefits mainly accrue to the 20 dealers (because the non-dealers are not active in overseas markets and therefore do not profit from substituted compliance relief).

Average annual regulatory costs (from business as usual)

[19] Estimates based on industry input.

Average annual regulatory costs (from business as usual)				
Change in costs ($ million)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	($4,460,000)	$ -	$ -	($4.46)
Cost offset ($ million)	Business	Community organisations	Individuals	Total, by source
Agency	$	$	$	$
Are all new costs offset? ☐ **Yes, costs are offset** ☐ **No, costs are not offset** ☒ **Deregulatory—no offsets required**				
Total (Change in costs – Cost offset) ($ million) = ($4.46)				

5. Consultation

The Australian Government released a consultation paper on a proposed central clearing mandate in February 2014. The paper asked for stakeholder views on a number of matters, including a central clearing mandate for G4-IRD restricted to internationally active dealers, and the best methodology for defining these dealers. Initial views were also requested for a possible future central clearing mandate for AUD-IRD, and the timing of such a mandate.

23 submissions were received, mainly from financial peak bodies and the major banks. Other submissions were received from one smaller financial institution, corporate entities, energy and commodity companies, and financial consultants.

There was almost universal support for a G4-IRD mandate limited to transactions between internationally active dealers. There was wide in principle support for a similar AUD-IRD mandate, but somewhat less of a consensus on timing. A number of submissions supported a simultaneous move to impose G4 and AUD-IRD mandates, while others noted that international consistency is a key consideration, and that an AUD-IRD mandate in Australia should be timed to coincide with a similar move in key overseas jurisdictions.

There was very firm support to restrict any clearing mandate to internationally active dealers, but no consensus on how to define these entities. Many submissions, especially from the major domestic banks, called for further detailed consultation on this question.

Following the release of the 2014 Report (which recommended the imposition of a central clearing mandate for AUD-IRD) the Government decided to release a further consultation paper requesting stakeholder views on:

- a proposal to proceed with an AUD-IRD central clearing mandate (in combination with the G4-IRD mandate) limited to internationally active dealers;
- the timing of the commencement of such a mandate; and

- an amended definition of internationally active dealers.

This paper was released in July 2014, with consultation closing in early August.

Stakeholders on the whole supported combining the AUD-IRD and G4-IRD mandates, and limiting the scope of the mandate to internationally active dealers. Views on the detailed definition of internationally active dealers continued to diverge.

Following this consultation Treasury and the regulators continued to engage with key stakeholders on this definition. A reworked definition of internationally active dealers was subsequently developed and incorporated in the draft legislation.

On 28 May 2015 the Government released a draft Ministerial determination and draft regulations imposing a central clearing mandate for certain classes of OTC derivatives. The main features of the proposed mandate are:

- Limited to interest rate derivatives denominated in Australian dollars and four global currencies, with the detailed scope of products to be set out in ASIC DTRs;

- Limited to a small number of internationally active dealers, by means of a definition that captures the major domestic banks as well as large foreign financial institutions active in Australia and subject to Australian regulation; and

- Clearing allowed through all CCPs licensed in Australia as well as at least four prescribed overseas CCPs, with a power provided to ASIC to prescribe additional CCPs, subject to a number of conditions.

17 submissions were received in response. There was strong support for the proposed mandate, including for the proposed product and entity scope. The $100 billion threshold was supported as appropriate for Australian market conditions by almost all submissions.

A comment was received relating to the drafting of the definition of a 'foreign clearing entity' in the regulations which could result in a wider scope of entities being captured than intended. A recommendation will be made to the Government to amend the definition as proposed in the final regulations.

A number of specific concerns and comments were made in relation to matters addressed in the ASIC DTRs. As noted elsewhere ASIC is consulting separately on its central clearing DTRs. The issues raised in the submissions have been brought to ASIC's attention.

6. Conclusion and Recommendation

OTC derivatives are an important segment in global financial markets. For Australian businesses they provide an essential service for hedging their foreign exchange, interest rate and other 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 unhindered access to global financial markets, including OTC derivatives markets, at the lowest possible cost is a key concern for the Government.

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.

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.

In considering the options examined in this RIS the central issue is whether the main problem set out in Section 1 (i.e. maximising substituted compliance relief) is successfully addressed. Option 1 fails this test because it would likely cause the US to withdraw the substituted compliance benefits already provided to Australian businesses active in the US OTC derivatives market. It would also not be helpful in obtaining substituted compliance benefits in other important overseas markets such as the EU as they implement their own OTC derivatives reforms. Option 2 addresses this problem, which is also the case for Option 3. Option 3 however imposes higher compliance costs on industry stakeholders.

Following consideration of these options and their relative impact on Australian banks and businesses it is recommended that the Government proceed with Option 2, i.e. the light touch regulatory option.

7. Implementation and Evaluation

The central clearing mandate will be implemented in detail through ASIC's central clearing DTRs. These are being drafted and developed in a separate process by ASIC, including through consultation with industry stakeholders. ASIC will produce a separate RIS for its DTRs.

ASIC released its draft DTRs for consultation in May 2015. Under the DTRs, actual implementation of the central clearing mandate will occur in April 2016. Responsibility for overseeing the smooth implementation of the mandate rests with ASIC.

Evaluation of the impact of the central clearing mandate will occur on several levels.

As mentioned above, the Regulators regularly survey the Australian OTC derivatives markets and report on key developments and issues. Based on the results of their work the Regulators have in the past provided recommendations to the Government for regulatory action in implementing the global reforms to OTC derivatives markets. It is anticipated that the regulators will continue this series of reports, including with respect to any issues or new developments they may identify in relation to central clearing.

Regular global surveys of the state of OTC derivatives markets regulation are conducted by the Financial Stability Board (FSB). Seven such reports have been produced to date, with the next one due in late 2014. 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 the 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.

GLOSSARY

2013 Report	Report on the Australian OTC Derivatives Market, July 2013
2014 Report	Report on the Australian OTC Derivatives Market, April 2014
AFSL	Australian Financial Services Licence
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
AUD	Australian dollar(s)
AUD-IRD	Australian dollar-denominated interest rate derivatives
CCP	Central counterparty
CFTC	U.S. Commodity Futures Trading Commission
DTRs	Derivative transaction rules
ESMA	European Securities and Markets Authority
EU	European Union
FSB	Financial Stability Board
G20	Group of Twenty
G4-IRD	US dollar-, euro-, British pound- and yen-denominated interest rate derivatives
GFC	Global financial crisis
IRD	Interest rate derivative(s)
OTC	Over-the-counter
Proposals Paper	Implementation of Australia's G20 over-the-counter derivatives commitments, G4-IRD central clearing mandate, February 2014
Regulators	APRA, ASIC and the RBA
Report	Report on the Australian OTC Derivatives Market, April 2014
RBA	Reserve Bank of Australia
Supplementary Paper	Implementation of Australia's G20 over-the-counter derivatives commitments, AUD-IRD central clearing mandate, July 2014
US	United States of America