Australian Government
The Treasury

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Mr Tony Simovski
Acting Deputy Executive Director
Regulatory Reform Division
Department of Prime Minister and Cabinet
One National Circuit
BARTON ACT 2600

Email: helpdesk-obpr@pmc.gov.au

Dear Mr Simovski

REGULATION IMPACT STATEMENT - FINAL ASSESSMENT

I am writing in relation to the attached Regulation Impact Statement (RIS) prepared for the Financial System Legislation Amendment (Resilience and Collateral Protection) Bill 2016 (the Bill).

I believe the RIS meets best practice requirements and is consistent with the ten principles for Australian Government policy makers. It also addresses all comments provided by the Office of Best Practice Regulation on the 'first pass' final stage RIS (dated 10 March 2016). I attach a table which provides a summary of the requested changes made in the RIS.

In particular, the RIS addresses the seven RIS questions:

What is the problem?

International margin requirements for OTC derivatives will be phased in from 1September 2016, after which entities operating in Australia will progressively need to be able to provide, and enforce rights in respect of, margin provided by way of security, or face rising costs and other barriers to participation in global OTC derivatives markets.

The new margining requirements are a core component of international efforts to address problems highlighted by the 2007/2008 global financial crisis (GFC).

Market assessments, published by Australian regulators in July 2013,[1] April 2014[2] and November 2015,[3] 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 . These global banks will soon become subject to margining mandates imposed by their home regulators, especially in the US and the EU; as will some of the major Australian banks who are also subject to regulation in the US or EU.

Why is government action needed?

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 (e.g. Australian banks operating in the US and the EU).

[1] Report on the Australian OTC Derivatives Market, July 2013.
[2] Report on the Australian OTC Derivatives Market, April 2014, available on the same website of the Council of Financial Regulators (CFR)
[3] Report on the Australian OTC Derivatives Market, November 2015.

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.[4]

Under rules being implemented by Australia's trading partners and the rules to be implemented by APRA (which were recently released for consultation), the major Australian banks will progressively need to post and receive margin on their non-centrally cleared OTC transactions (including by way of security) to remain competitive and continue to have access to international OTC derivatives markets.

Without legislative change, entities operating under Australian law may not be able to fully comply with margining requirements that are imposed on them, or their counterparties, due to domestic or foreign regulation. This could significantly restrict the ability of Australian entities to participate in certain financial markets or trade with particular counterparties.

What policy options are you considering?

I certify that there are only two feasible options for addressing the policy problem sought to be addressed. No other options have been seriously considered or proposed. We have considered: (1) maintaining the status quo; and (2) creating a facilitative legislative regime, which allows financial institutions to meet international margining requirements and any corresponding prudential standards set by the Australian Prudential Regulation Authority (APRA). Only Option 2 would provide sufficient legal certainty for entities to continue to participate confidently and effectively in global markets, in accordance with international margin requirements.

What is the likely net benefit of each option?

Option 1: there are considerable regulatory and opportunity costs associated with maintaining the status quo once international requirements are phased in from September 2016, and no clear benefit. Entities operating in Australia (such as banks) would likely become less competitive in global markets. We estimate the regulatory cost of Option 1 to be $88 million a year, once international margin requirements are in effect.

Option 2: the cost of compliance with foreign OTC margining regulations would be lower if the legal impediments to posting margin were removed from the Australian law. We estimate that a facilitative regime would bring the total associated costs of margining down to $84.1 million per year   a saving of $3.9 million, compared to Option 1. There are also other non-quantifiable benefits from keeping Australian financial sector regulation consistent with international best practice and enabling Australian entities (or foreign entities subject to Australian law) to participate in international markets free from idiosyncratic regulatory impediments. Such impediments would be inconsistent, for example, with the promotion of Australia as a financial centre.

We believe Option 2 is preferable to Option 1.

Who will you consult and how will you consult them?

We have met with a broad range of industry stakeholders, in one-on-one meetings and by convening a series of roundtables on the proposed reforms. The Government also conducted public consultation on draft legislation (the Financial System Legislative Amendment (Resilience and Collateral Protection) Bill 2016), from 21 December 2015 – 5 February 2016.

What is the best option from those you have considered?

We believe there has been adequate analysis of all options, and that Option 2 (a facilitative regime) will deliver the best outcome. It would ensure that entities operating in Australia are able to comply with international margin requirements, and any corresponding APRA prudential standards.

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[4] 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.

How will you implement and evaluate your chosen option?

The Government will seek to introduce and pass the Bill (and associated Regulation) by mid-2016. The implementation of Option 2 conforms with the Government's policy position as set out in its response to the Financial System Inquiry (FSI). We will evaluate its impact by continuing to consult with industry associations such as the Australian Financial Markets Association and International Swaps and Derivatives Association and financial regulators; and reviewing the next Council of Financial Regulators' report on the Australian OTC derivatives market.

I note that the RIS includes a description of its status at each major decision point during the development of the reform.

I submit the RIS for second pass final assessment.

Yours sincerely

John Lonsdale
Deputy Secretary
Markets Group