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Capital Markets Unit
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Dear Mr Lim

PROPOSALS PAPER G4-IRD CENTRAL CLEARING MANDATE

The Australian Financial Markets Association (AFMA) welcomes the opportunity to comment on the G4-IRD Central Clearing Mandate Proposals Paper. These comments build on the long standing dialogue which AFMA has with the Treasury and the other members of the Council of Financial Regulators (Council) on the ongoing implementation of the OTC derivatives reforms. The response takes account of the Council's latest assessment report of April 2014.

Comments are organised as responses to the questions posed in the Proposals Paper and which in a couple of instances go beyond the scope of the questions to related points of policy. On the core question of whether there should be a mandate to centrally clear US Dollar-, Euro-, British Pound-, and Yen denominated interest rate derivatives (G4-IRD) by covering relevant dealers, AFMA is supportive. In line with the Council's recent recommendation it is also sensible to extend this mandate to include AUD-IRD.

Comments on the mandate go to timing taking into account of the regulatory changes and need to avoid duplicated clearing obligations with other jurisdictions. The primary reason for supporting these mandates comes from the assistance it gives to cross-border recognition and comparability assessments of the Australian OTC derivatives regime in a context where the Australian market has voluntarily embraced central clearing of appropriate derivatives.

Question 1 - Costs

Do you have comments on the benefits and costs of complying with a mandatory central clearing obligation, from the point of view of your business and/or that of your customers? We request that, in commenting, you quantify compliance costs as far as possible, including whether costs are likely to change over time, are transitional or projected ongoing costs.

Cost impact of reforms

Answering this question from an industry wide perspective continues to present a real challenge. AFMA has noted in previous submissions on this topic that accurate quantification of the costs of the OTC derivatives reforms was difficult to predict before the reforms came into effect and continues to be difficult as the reforms are implemented. Building up costings from component elements does not give the full picture as there are now a complex combination of factors which have to be taken into pricing a derivative for customers. Information and data at the firm level and the desired granularity is highly commercially sensitive and is not disseminated.

The work done by the Macroeconomic Assessment Group on Derivatives (MAGD) which developed and employed models that provide an estimate of the benefits and costs of the proposed reforms in its report of August 2013[1] provides a top down view on how to conduct a macroeconomic cost analysis. This identified three main streams of costs – those from holding more capital, posting additional margin and facing additional clearing fees – to give a total cost of the planned regulatory changes. What this study underestimates are the rise in operational costs that not only flow from infrastructure connectivity but internal compliance and verification costs along with the more intangible factors of uncertainty and disruptions to existing business models and relationships that flow from rapid implementation of imperfect rules.

Deloitte[2] has recently taken the MAGD analytical framework and applied it to the EMIR regulatory regime and estimated costs on a typical transaction for cleared interest rate derivatives as €13.50 for each €1 million of notional value of a derivative transaction, which means on an average sized transaction of €105 million notional as €1,428 in additional costs. Of this reporting and other compliance costs represent €63. The report then provides its estimate for an uncleared interest rate derivative which produces a figure of €170.50 in additional costs for each €1 million notional. Reporting and compliance costs are estimated at €0.50 compared to €0.63 for a cleared transaction for each €1 million notional.

The Deloitte estimate is still only partial. The report notes that additional compliance and operational costs are likely to be incurred by all market participants and infrastructure providers and these are not quantified as part of the simple equation presented in the report. The report also does not take into account in the estimate two important additional factors which present serious analytical challenges that are the subject of considerable current academic discourse. The first is variation margin. The need to post variation margin at short notice means that market participants need to hold additional precautionary collateral available for posting. These additional collateral costs are substantial. The second come from costs associated with liquidity management and

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[1] The MAGD report can be found at http://www.bis.org/publ/othp20.htm

[2] Deloitte – EMEA Centre for Regulatory Strategy, OTC Derivatives - The new cost of trading, April 2014, page 6 http://www.deloitte.com/assets/DcomUnitedKingdom/Local%20Assets/Documents/Industries/Financial%20Services/uk-fs-OTC-Derivatives.pdf

collateral optimisation. Such costs are highly dependent on the nature of each firm's business and again can be quite significant. In summary the Deloitte report provides a conservative estimate of reporting and other compliance costs.

Overall, while the question posed is entirely sound in its objective the feedback received will be in all likelihood be very limited and imperfect. Accurate and granular costings are only likely to emerge when the suite of OTC derivatives reforms are implemented and bedded down.

Tax – Interest Withholding Tax

There is a further additional cost factor that arises out of tax law that we would like to also highlight in answer to this question.

In February 2013, AFMA, together with the Australian Bankers' Association and the Financial Services Council, lodged a submission with Treasury seeking a withholding tax exemption for interest paid to or from Central Counterparties (CCPs) arising in respect of centrally cleared derivative transactions. The submission focussed on what AFMA perceives is an inappropriate taxation outcome arising from Australia's implementation of the G-20's commitment to ensure that systemically important OTC derivatives (such as AUD interest rate swaps) are cleared through an appropriately structured CCP. The concern expressed in the submission was that where the CCP was located outside of Australia, interest paid on the collateral could result in Australian interest withholding tax. This consequence is viewed as being an unintended consequence of the implementation of the G-20 commitments and had a significantly adverse impact on the Australian derivatives market, vastly in excess of any revenue arising to the Government.

The bases for the concerns articulated in the submission are twofold. Firstly, in order to meet the G-20 commitment to have systemically important derivative transactions cleared through a CCP, any interest flows to offshore CCPs will, prima facie, give rise to an interest withholding tax obligation for the payer. This will be regardless as to where the CCP is located. Secondly, the increased collateral obligations arising through the central clearing of systemically important derivatives results in increased interest flows. The issue would not be solved through the establishment of a local CCP, as this CCP would be obliged to withhold and remit interest withholding tax on any payments to offshore counterparties.

Developed industry practice with respect to the imposition of interest withholding tax is that the payee will be "grossed up" such that the payer (i.e. the Australian party) will economically bear the burden of the withholding tax. This cost will be effectively factored into the price offered by the Australian party in any derivatives market and will render the Australian party as uncompetitive relative to its global counterparts. In this regard, it is noted that market participants located in key financial centres, including the United States, United Kingdom, Hong Kong and Singapore, will not impose interest withholding tax on interest paid to or from a CCP.

The submission estimated that due to the imposition of Australian withholding tax on interest paid to/from CCPs, the percentage of Australian derivatives transactions that could be lost to overseas jurisdictions could be in the magnitude of 20-25%. Such a reduction would be enduring.

Question 2 – G4 Mandate

Do you have comments on the proposal to mandate central clearing in respect to G4 IRD? Please also consider the costs and benefits of a wider or narrower scope. Could you

comment on the incremental costs and benefits of a broader or narrower scope of coverage? For example, including only USD IRDs or alternately including all IRDs.

The policy logic behind the mandate is to enhance comparability for recognition purposes by other jurisdictions. As part of this there is a need to address and reconcile the cross border mandatory clearing obligation so that equivalence or substituted compliance for a non-Australian G4 Dealer that is already clearing elsewhere is recognised as compliant alternative clearing. This would allow a non-Australian based G4 Dealer to meet its clearing obligation in Australia by clearing under the regulations of its home jurisdiction. Substituted compliance should look at the equivalence of the clearing regime in the non-Australian jurisdiction and, in accordance with the approach adopted under the foreign entity exemption provided for in the Australian trade reporting rules. This recognises any exemptions provided for under the rules of the non-Australian regime as also exempt under the Australian regime.

Question 3 – G4 Dealers

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

Precise scope for mandate

The proposal indicates the mandate is to be limited in scope to transactions between two G4 dealers. This premise should be expressly set out in any drafting of the rules under a mandate. Vague drafting which could give rise to questions about any broadening of this premise would create uncertainty and lead to significant additional market impacts. It should therefore be the subject of further policy consideration by the Government so that the task of adding entities and / or phasing in of timelines is not a matter of administrative discretion for ASIC to determine.

The clearing mandate should also only apply to transactions that are booked in Australia as the aim of the mandatory clearing mandate is to reduce systemic risk in the Australian market. Transactions that are executed in Australia but booked to another jurisdiction, such as the US or the EU, are subject to clearing mandates in those jurisdictions.

As a caution on drafting, the terminology of "entered into" used in respect of the trade reporting mandate has proved to be problematic in practice and is quite expansive in scope. While duplicated reporting obligations are a costly and unnecessary regulatory burden that can be met, the problems that would arise with duplicated clearing obligations are insurmountable.

Intra-Group

AFMA agrees with the proposition that there should be an exemption for intra-group trades. Both the US CFTC and European EMIR rules grant exemptions from their respective clearing obligations for inter-affiliate or intragroup transactions as such transactions may be necessary for aggregating risks within a group structure. Such intragroup risks are idiosyncratic and not systemic in nature.

Under Article 11 of EMIR, financial counterparties are granted an intra-group exemption under certain conditions. The EMIR exemption from the clearing obligation is available for transactions between a counterparty established in the EU and a counterparty

established in a non-EU jurisdiction if the European Commission has made a determination that the non-EU jurisdiction has an equivalent regime. The exemption is not available where both counterparties are established outside the EU, even though the clearing obligation can apply to such counterparties.

Under Regulation 50.52 of the CFTC, there are certain exemptions from the clearing obligation for certain inter-affiliate swaps. Where an affiliated entity relies on the exemption, the CFTC rules impose conditions on swaps between the affiliate and a non-affiliate ("outward-facing swaps"). Where the affiliates relying on the exemption are located in the U.S. or a jurisdiction determined by the CFTC to have a comprehensive and comparable clearing requirement, it is sufficient if they comply with the clearing requirements (or an exception or exemption) under their local regime.

It is recommended that both the European and US regimes be taken into account and an intra-group exemption be made available.

Question 4 – Threshold

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

The use of simple thresholds, while easy to define and set has proved from experience as not leading to sensible and desirable outcomes. This is an area where further specific consultation on the detail of metrics for covering an organisation in a clearing mandate to appropriately capture entities that should be mandated to clear needs to be carried out.

It is understood that the intention behind the mandate is to cover those firms currently clearing on a voluntary inter-dealer basis along with additional participants who would generally be regarded, as active price makers. The indicia of who those additional participants are and how they are defined will require classification beyond a threshold calculation and would include descriptors such as the above, as well as consideration of:

- risk profiles in the market, including frequency of product type dealt and tenor;
- metrics to include net and gross thresholds; and
- some form of qualitative measure, akin to the definitions used in foreign regimes, such as swap dealer and / or major swap participant (under CFTC rules).

The rules need to be workable across the range of dealers in the Australian market. Definitions would need to be clear and efficient, so that thresholds or licensing parameters are not serious disincentives to foreign market participants.

In addition, any definition of "G4 Dealer" should not:

- require continuous monitoring;
- set outstanding notional thresholds; and
- provide for differential calculations between firms.

This is a question on which further industry consultation is needed. AFMA would be pleased to assist with such consultation.

Question 5 – Implementation timetable

Do you have comments on the proposed timetable for implementing the central clearing obligation? Could you comment on the incremental costs and benefits of an earlier or later start date than what is proposed?

This question raises transitional concerns. Practical problems with the readiness of infrastructure and lack of adequate lead time due to hasty setting of rules to allow for proper understanding of their impact and shortcomings has to date made implementation of OTC derivatives reforms a difficult process for industry. It has already been noted that dealers have voluntarily adopted central clearing so that the regulatory value in adopting premature deadlines to encourage industry attention and engagement in the reform process is not present in this case.

It is noted that mandatory clearing under EMIR is expected to come into effect at the end of the 2014 or early 2015. As has been raised in previous consultations cross-border implementation timings are an important consideration. It is important to avoid close timing of implementation in multiple jurisdictions as firms do not have the resources to prepare and implement two clearing mandates in two different jurisdictions at the same time.

Consultation on precise timing of implementation is best suited to discussion with industry at roundtables. We would look forward to engaging with the Treasury and the regulators on this matter.

Capital rules finalisation

A factor to be taken into account in such discussions would be the imperative for introduction of mandate which is strongly influenced by the need to provide comparability with other jurisdictions. Australia should move at a speed which is commensurate with other major jurisdictions such as the European Union and not get out ahead. Implementation should also take account of closely related reforms with regard to capital requirements.

Recognition would need to be given to the capital requirements imposed on mandated dealers pursuant to Basel III principles and APRA related regulations. Determinations for calculating capital risk and clearance requirements are still unclear, both locally and off-shore, and the differentials in such calculations can have major impacts on how business is to be conducted. There should be a logical progression in the imposition of obligations so that affected firms can accurately understand the capital costs and valuation impacts of entering in derivatives transactions before another layer of rules associated with the mandate come into effect. This means that applicable Australian Prudential Standards and APRA implementation issues would need to be resolved before mandated clearing is implemented.

Client Money

A policy issue that has been previously raised in consultations on rule changes that should also be taken into account concerns potential conflicts between existing client money regulations in Australia and client clearing of OTC derivatives. AFMA believes that further consultation between Treasury and industry would be prudent to address concerns with complexity and imprecision, with the introduction of a clearing mandate. Current inconsistencies exist between the Corporations Act and the ASIC Market Integrity Rules and any operating rules of a mandated clearing house would need to be not only consistent, but in harmony with existing regulatory obligations.

Question 6 - CCP Prescription

Do you have comments on the proposal that some CCPs may be prescribed in order to ensure Australian market participants have appropriate access to CCPs? Or is there another option you prefer? If so, why?

The timing of the mandate should take account of cross-border operational issues associated with entering trades into CCP infrastructure. This is particularly important in relation to G4-IRD where cross-border operational issues are of foremost importance. This means that access to CCPs that are prescribed or licensed in Australia for the purposes of the mandate should be available during normal Australian business hours.

Question 7 – Costs and Benefits

From the point of view of your business and/or that of your customers, what is your preliminary view on the costs and benefits of mandatory central clearing of:

- *a) AUD IRD?*
- *b) North American and European referenced CDS?*
- *c) Any other derivatives?*

The general comments made in response to Question 1 on costs are cross referenced in relation to this question.

The mandated clearing of AUD-IRD is supported consistent with the reasoning supporting the G4-IRD mandate and the recent recommendations of the Council.

No further extension of mandatory clearing of other derivatives is warranted. This is because the transactions conducted in the Australian market in these other derivatives are not systemically important at present.

Question 8 – Platform Trading Mandate

Do you have views on the appropriate timing of the introduction of such mandatory requirements? Are there any preconditions that should be met before such mandatory requirements are introduced?

A platform trading mandate for Australia continues to lack justification at this time given the scale, liquidity and nature of derivatives transactions conducted in this market. The swaps market is dependent on dealers to provide liquidity. While there are a number of standardised and liquid swaps that are likely to migrate to a trading platform, it is possible that there will be insufficient liquidity to support the type of order book models common to the cash equity and futures markets. It is important to allow sufficient flexibility in trading methods that reflect the differing levels of liquidity that exist across the derivatives market and the differing needs of market participants.

The more important issue around platform trading arises from the influence of the CFTC Swap Execution Facility (SEF) rules. This is an area which is currently under a lot of industry scrutiny to understand how liquidity is being affected and to what extent it is being fragmented. The market is in experimentation stage and it is speculative to predict with any sort of precision how it will evolve. Significant Australian market participants are subject to the US CFTC trading rules and therefore are adapting their businesses to these cross border rules. This is having an important influence on the global trading of derivatives and it is important that market participants are given flexibility in transitioning

to these evolving systems and given time to bed down before further obligations are imposed.

Question 9 – Trading Platform Characteristics

What do you view as the characteristics that make a trading platform suitable for mandatory trading of derivatives?

The following factors are suggested in looking at policy around trading platforms:

1. Any new trading platform rules should follow on from completion of the market licensing review and be properly integrated into any revision of market operator regulation and the timetables for any possible changes.
2. The importance of industry consultation with and advice to the Treasury. This follows on from the process surrounding the market licensing review. Trading deals with real world day to day practical issues where disruptions can have very serious consequences for dealers and their clients. It is important to gather information into topics such as the logistics of having separate rules for each platform, and the degree of complexity and additional layer of regulation that it brings. AFMA members would like to share their experience with what does and does not work with current trading platforms.
3. The accessibility to offshore SEFs. Any pre-requisite to set up or use domestic facilities would require licensing requirements for offshore market operators to be first fully settled.
4. The need for connectivity technology to reach a degree of maturity. Platforms and middleware provider infrastructure is in a rapid stage of development and practical issues problems are still common with interfacing and connecting up existing and new systems. This technology needs more time to mature.

Question 10 – Trade Reporting Scope

Do you have comments on the proposals relating to:

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

While the policy purpose of derivatives trade reporting has broad industry support the implementation of reporting is proving to be a challenging and costly exercise. In its original comment to ASIC on trade reporting AFMA questioned the feasibility of two-sided reporting when extended to a broad class of end-users. Experience with implementation of two-sided in the European Union has demonstrated serious compliance problems for buy-side end users.

The development of a coherent OTC derivatives reporting regime which can assist authorities across the globe in identifying potential build ups of systemic risk is a major project of long term benefit. It is key to the success of the regime that the requirements should be feasible and sustainable for firms to implement. Recently in support of a relief application on behalf of Phase 2 trade reporting entities AFMA made comment in response to a request from ASIC to quantify costs and the value of the relief. It is generally recognised that there is no precise methodology for such quantification and it involves making subjective assessments and assumptions in order to arrive at an estimate. After

surveying affected members AFMA estimated that the value of granting the relief was $3.5 million per Phase 2 Reporting Entity. This was the beneficial value for the Australian jurisdiction only six month delay in implementing some measures. In other words this just shows the tip of the cost iceberg. The purpose of noting this estimate is to illustrate the very high costs that are being encountered by large, sophisticated financial institutions in implementing trade reporting which requires extensive use of IT and compliance resources. Extending reporting to buy-side end-users who are generally doing fairly small numbers of derivatives transactions will be a disproportionately costly exercise for them.

The main objective of two-sided reporting is to allow for a comprehensive overview of the derivatives market and to enable the identification, monitoring and assessment of systemic risk. The collation of transaction reports submitted by sell-side institutions with whom buy-side end-users generally transact will meet that policy goal. For each transaction with a buy-side participant, there will also be a sell-side participant, so sell-side transaction reports on their own will already provide a comprehensive overview of the market. In addition, the identification of systemic risk is achieved through the requirement for sell-side reporting parties to identify their counterparty in respect of each transaction. This allows the regulators to monitor the positions and portfolios of buy-side users of derivative transactions as effectively as if those buy-side end users submitted transaction reports independently. The further requirement for end-users to submit transaction reports is, in practical terms, not strictly necessary and actually merely replicates the information available from sell-side reports for data integrity purposes. Planned enhancement to trade reporting infrastructure through improved identifiers such as Legal Entity Identifiers will increase the integrity of the data over time.

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

The comments about the value of two-sided reporting being applied to end-users applies equally to buy-side AFSL holders who are doing small numbers of derivatives transactions as part of the normal hedging risk management. The spot light of concerns in this area has recently fallen onto this issue now that consultations with ASIC have started on Phase 3 reporting entities. The scope and practical connectivity challenges of requiring every firm with an AFSL to report even if they only do one derivative transaction a year is now starting to be realised, particularly by buy-side market participants.

Our members who use commodity derivatives have asked AFMA in particular to highlight their concerns to Treasury, as an illustration of why the policy on the Phase 3 reporting entity scope should be reconsidered. Special consideration was given to the special nature of the National Electricity Market at the policy stage to allow for further and detailed consideration of electricity derivatives reporting before the imposition of any reporting obligation. A decision which was entirely appropriate in the view of AFMA. Beyond electricity market participants, energy producers and suppliers more broadly may use oil and gas commodity derivatives to hedge their physical market risk. Such transactions are characterised by their bespoke character often between peers rather than with dealers and only a small numbers of transactions. For example, with gas commodity derivatives there are only a handful of transactions conducted a year.

The market for energy commodity derivatives is small and illiquid in Australia. It is very different to the large commodity derivatives markets that are seen in centres such as Chicago and London. The Australian commodity transactions themselves are not systemically important to the financial system nor are the energy companies engaging in them.

Participants in the energy market need to hold an AFSL if they deal in any derivatives. We are advised by affected members that their AFSL's commonly refer generically to "derivatives" as the scope of their authorised activity rather than specifying sub-categories such as oil/gas derivatives or commodity derivatives. Accordingly, a simple limitation on reporting obligations by linking it to the scope of products authorised under an AFSL would not address the problem. So while they use derivatives like buy-side end-users, the fact that they have an AFSL makes them subject to the Phase 3 reporting requirements. The law would apply an uneven reporting burden for similar activities if the end-user exemption alone was extended.

Another way needs to be found to create a de minimis reporting threshold.

c) Or is there another option you prefer? If so, why?

In the last response the need to require all AFSL holders to report any derivatives transaction is questioned as required under the current Phase 3 Derivatives Transactions Rules.

It is proposed that a de minimis reporting threshold related to the existing respective classes of derivatives be introduced for Phase 3 reporting entities. It is recognised that setting thresholds at an appropriate level can give rise to considerable debate. At this stage AFMA does not have a consensus position on what the threshold should be. Further discussion and consultation on this point is required. If Treasury is receptive to consideration of this proposal AFMA would be please to facilitate dialogue with our members on this option.

Thank you for your consideration of this submission. Please contact me at dlove@afma.com.au on (02) 9776 7995 if further clarification or elaboration is desired.

Yours sincerely

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