

# Regulatory Developments in Financial Market Infrastructures

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## Regulatory Framework for Financial Market Infrastructures (FMIs)

The Reserve Bank continues to work with other Council of Financial Regulator (CFR) agencies on the development of proposals arising from a 2011 review of the regulatory framework for FMIs. During 2013/14, work continued in two areas in which the CFR had made recommendations:<sup>25</sup>

- streamlining and clarifying the application of 'location requirements' for FMIs operating across borders
- providing regulators with powers to deal with a distressed FMI and ensure the continuity of critical services.

In its submission to the Financial System Inquiry, the Bank encouraged the government to progress legislative proposals in these areas.

### Location requirements and regulatory influence

The CFR published a paper in July 2012 setting out additional safeguards to ensure that the Australian Securities and Investments Commission (ASIC) and the Bank retain sufficient regulatory influence over cross-border clearing and settlement (CS) facilities operating in Australia. The paper develops a graduated framework (the regulatory influence framework) for imposing additional requirements on cross-border CS facilities proportional to the materiality of domestic participation, their systemic importance to Australia, and the strength of their connection to the domestic financial system or real economy. This framework was, in part, implemented via the new Financial Stability Standards (FSS) that came into effect in March 2013.

In response to requests for further clarity from existing and prospective CS facility licensees, in March 2014 the CFR released a further paper setting out how the Bank and ASIC would expect to apply the framework in various alternative scenarios.<sup>26</sup> In particular, stakeholders had sought clarity as to the circumstances in which a cross-border central counterparty (CCP) would be expected to incorporate domestically and apply for a domestic CS facility licence. The CFR's March 2014 paper clarifies the intention to implement measures under the regulatory influence framework in such a way as to 'support efficiency and innovation in the provision of financial market infrastructure services and accommodate competition where consistent with financial stability'.

On the basis of the analysis in the paper, it is expected that domestic incorporation and licensing requirements would be imposed at a relatively low market share threshold in each of the following product classes: ASX-listed cash equities; ASX-listed equity options; Australian dollar-denominated (AUD) interest rate futures; and AUD equity index futures.

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<sup>25</sup> The February 2012 letter to the then Deputy Prime Minister and Treasurer setting out the CFR's recommendations is available at <<http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2012/CFR-Financial-Market-Infrastructure-Regulation>>.

<sup>26</sup> The paper is available at <<http://www.cfr.gov.au/publications/cfr-publications/2014/pdf/app-reg-influence-framework-cross-border-central-counterparties.pdf>>.

Importantly, there is at present no specific legal provision for imposing a requirement that a CS facility licensee incorporate locally and transition from an overseas licence to a domestic licence. Further to the CFR's recommendations from its 2011 review, a working group of the CFR has developed legislative proposals to remove this impediment.

### Dealing with FMI distress

During the period, the Bank participated in a Treasury-led working group of the CFR that is developing proposals for a special resolution regime for FMIs consistent with international standards. Resolution (and the related concept of recovery) addresses situations in which an FMI is in financial distress (and may become insolvent). If an FMI is unable to restore itself to financial soundness through implementation of an effective recovery plan, a resolution authority may need to intervene with the aim of maintaining continuity of critical services. In conjunction with this work, proposals for enhanced directions and enforcement powers for regulators are also being developed.

Implementation of the CFR's recommendations is being considered in the context of broader international work on the recovery and resolution of financial institutions. The Financial Stability Board's (FSB) *Key Attributes of Effective Resolution Regimes for Financial Institutions* (Key Attributes) set out a number of potential tools to be applied as part of a broad resolution plan, including the power to appoint a statutory manager. The FSB has consulted on an extension of its work to FMIs, and is expected to publish a final report later in 2014.<sup>27</sup> Working to a similar timetable, the Committee on Payments and Market Infrastructures (CPMI) and the International Organization of Securities Commissions (IOSCO) are expected to finalise guidance on recovery planning for FMIs. This expands upon a high level requirement in the Principles that FMIs have recovery plans. The Bank has contributed to this work.

The Bank's submission to the Financial System Inquiry (FSI) noted the importance of a clear articulation to market participants of what actions would be taken in the case of a threat to the continued viability of FMI services. It suggested that this work should be progressed as a matter of priority. The FSI's interim report, released in July 2014, further noted the importance of progressing this work.

### CPSS-IOSCO Principles for Financial Market Infrastructures (PFMIs)

The Bank continues to contribute to a CPSS-IOSCO task force monitoring the implementation of the PFMIs internationally. The task force is examining implementation at three increasing levels: implementation of the PFMIs within the regulatory framework; consistency of implementation measures with the PFMIs; and finally, consistency of outcomes both with the PFMIs and across jurisdictions.

An initial assessment report, published in August 2013, provided a preliminary view of the steps taken by 27 jurisdictions to implement the PFMIs within their respective regulatory frameworks. The task force published an updated assessment in late May. This report revealed that implementation was well advanced for CCPs, trade repositories (TRs) and payment systems. Several jurisdictions (including Australia) had completed their implementation measures.

The task force has also commenced its first assessments of the consistency of implementation measures with the Principles. This work has focused initially on CCPs and TRs in the three largest jurisdictions: the US, Europe and Japan. The Bank has led the subgroup assessing implementation measures in the US. The task force aims to publish the assessments of all three jurisdictions ahead of the G20 Summit in November 2014.

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<sup>27</sup> See FSB (2013), 'Application of the Key Attributes of Effective Resolution Regimes to Non-bank Financial Institutions: Consultative Document', August. Available at <[https://www.financialstabilityboard.org/publications/r\\_130812a.pdf](https://www.financialstabilityboard.org/publications/r_130812a.pdf)>.

Consistent with the implementation of the PFMLs in Australia, the Bank has undertaken annually to assess the Reserve Bank Information and Transfer System against the Principles, and periodically to carry out self-assessments of its oversight of systemically important payment systems against the associated Responsibilities of Central Banks, Market Regulators, and other Relevant Authorities for Financial Market Infrastructures (the Responsibilities). The first of each of these assessments was published in December 2013 (see 'Oversight of High-value Payment Systems').

Similarly, the Bank has undertaken to carry out and publish, jointly with ASIC, assessments of domestic CS facility licensees against the Principles, and self-assessments of ASIC's and the Bank's regulation and oversight of CS facilities against the Responsibilities. The first of each of these reports was published alongside the Bank's 2013/14 Assessment of the ASX CS facilities. These are principally targeted at an international audience, in anticipation of future peer reviews, either by the CPSS-IOSCO task force or international organisations such as the International Monetary Fund. Since the FSS are aligned with all stability-related Principles, the joint assessment against the Principles is similar to the 2013/14 Assessment of the ASX CS facilities, but with the addition of material relevant to ASIC's responsibilities.<sup>28</sup>

## OTC Derivatives

Since the global financial crisis, international policymakers have also sought to strengthen practices in over-the-counter (OTC) derivatives markets. To this end, in 2009, the G20 leaders committed that all OTC derivatives transactions would be reported to TRs, that all standardised OTC derivatives would be executed on electronic trading platforms, as appropriate, and cleared through CCPs, and that higher capital requirements would apply to non-centrally cleared OTC derivatives. In November 2011, G20 leaders added to these, agreeing that international standards on margining of non-centrally cleared OTC derivatives should be developed.

Consistent with these commitments, in January 2013 amendments to the *Corporations Act 2001* took effect that provide for the imposition of mandatory requirements in respect of trade reporting, central clearing and platform trading of OTC derivatives. Under the framework, the responsible Minister, after considering the advice of the Australian Prudential Regulation Authority (APRA), ASIC and the Bank (jointly 'the regulators'), may issue a determination that mandatory obligations should apply to a specified class of derivatives. A determination gives ASIC the power to set Derivative Transaction Rules (DTRs). These set out the details of any requirements. In writing DTRs, ASIC must consult with APRA and the Bank. While providing advice on OTC derivatives reform is a broader responsibility of the Bank, the Board's views have been sought, particularly with respect to mandatory clearing, given the potential implications for the Bank's FMI oversight role.

In order to inform their advice, the regulators actively monitor developments in the Australian and overseas OTC derivatives markets. As part of this process, the regulators carry out periodic surveys and produce assessment reports based on the results of these surveys. In 2013/14, the regulators produced two such reports; one in July 2013 and the other April 2014.<sup>29</sup> The main focus of the two reports was the incremental costs and benefits of imposing mandatory clearing requirements.

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<sup>28</sup> These assessment reports are available at <<http://www.rba.gov.au/payments-system/index.html>>.

<sup>29</sup> APRA, ASIC and RBA (2013), *Report on the Australian OTC Derivatives Market*, July, available at <<http://www.cfr.gov.au/publications/cfr-publications/2013/report-on-the-australian-otc-derivatives-market-july/pdf/report.pdf>>; and APRA, ASIC and RBA (2014), *Report on the Australian OTC Derivatives Market*, April, available at <<http://www.cfr.gov.au/publications/cfr-publications/2014/report-on-the-australian-otc-derivatives-market-april/index.html>>.

## Mandatory clearing requirements

To date, Australia's regulators have favoured allowing private incentives to set the pace of the transition to central clearing. However, given that other jurisdictions are relying on mandatory requirements, the regulators have acknowledged that there could be international consistency benefits to taking a similar approach – especially for products that are subject to mandatory clearing requirements overseas.

- In their July 2013 report, the regulators recommended introducing mandatory central clearing requirements for US dollar-, euro-, British pound- and Japanese yen-denominated interest rate derivatives trades between internationally active dealers. These products are already subject to US Commodity Futures Trading Commission (CFTC) – and in some cases Japanese – mandatory clearing requirements, and it is anticipated that mandatory clearing requirements for these products will also be introduced in the European Union (EU). While the regulators have also considered the case for mandatory clearing requirements for credit derivatives that are subject to overseas clearing mandates, to date they have concluded that they do not see the case for such a recommendation given the low levels of activity involving Australian-headquartered dealers.
- In the April 2014 report, the regulators recommended introducing similar mandatory clearing requirements for AUD interest rate derivatives. AUD interest rate derivatives comprise the largest and most systemically important component of the OTC derivatives market in Australia and could also be subject to mandatory clearing requirements in other jurisdictions in the future. Consequently, the regulators prioritised their assessment of the case for introducing mandatory clearing requirements for this product class. At the time of the July 2013 Report, ASX Clear (Futures) Pty Ltd (ASX Clear (Futures)) and LCH.Clearnet Limited (LCH.C Ltd) had only recently received regulatory approval to provide clearing of OTC interest rate derivatives directly to Australian participants. The regulators were of the view that it was important to give Australian banks time to establish direct clearing arrangements based on private commercial incentives, before recommending introducing mandatory clearing requirements for AUD interest rate derivatives. By April 2014, Australian banks had made substantial progress in implementing appropriate clearing arrangements. Accordingly, the regulators were satisfied that the incremental cost of mandatory central clearing of Australian dollar-denominated interest rate derivatives would be very low for trades between internationally active dealers in the Australian market.

Consistent with these recommendations, the government has released two consultation papers, in February and July 2014, proposing to impose a clearing mandate for interest rate derivatives denominated in the five currencies mentioned above.

Another focus of the April 2014 report was the incremental costs and benefits of extending any central clearing mandate to smaller non-dealer participants in the Australian OTC derivatives market. Based on insights from the survey, the regulators recommended that there was no public policy case for introducing mandatory central clearing of OTC derivatives for non-dealers. Instead, the regulators proposed to keep under review the case for extending mandatory central clearing to non-dealers in light of ongoing market and international regulatory developments.

## Equivalence of Australian Regulation

International consistency benefits were a key reason for the regulators' recommendation that mandatory clearing requirements be introduced in Australia. One such benefit is a lower cost of compliance arising from duplicative and potentially conflicting regulations imposed on the same trade or participant by regulators

in different jurisdictions. If other jurisdictions assess that a particular aspect of Australia's regulation of OTC derivatives markets or related infrastructure is equivalent, they may, under certain conditions, place reliance on Australian regulation and regulators. This could materially lower compliance costs for Australian participants because they would not need to also monitor or demonstrate their compliance with the relevant overseas rules.

During 2013/14, the Board was kept updated on the regulators' ongoing dialogue with the relevant EU authorities and the CFTC on their assessments of the equivalence of certain aspects of Australia's regulation of FMs and OTC derivatives markets. In late 2013, the European Securities and Markets Authority (ESMA) published its advice on the equivalence of Australia's regime with respect to all aspects of the European Market Infrastructure Regulation.

- ESMA concluded that Australia was equivalent with respect to the regulation of CCPs, TRs and mandatory trade reporting.
- Since neither Australia nor the EU had mandatory clearing obligations in place at the time of ESMA's advice, ESMA provided only conditional advice on this aspect of the Australian regime. ESMA advised that Australian mandatory clearing obligations should be considered equivalent only if the product and institutional scope of such requirements aligned with those in the EU's prospective regime.
- ESMA concluded that Australia's regime was not equivalent in relation to risk mitigation requirements for non-centrally cleared trades. This reflected the absence of international standards covering such requirements, which are currently being developed by IOSCO.

In December 2013, the CFTC announced that 'substituted compliance' for a range of entity-level requirements would be available to Australian market participants that had provisionally registered with the CFTC as swap dealers. The CFTC did not grant substituted compliance for transaction-level requirements, such as mandatory clearing. This decision could be revisited once Australian mandatory clearing requirements are in force. The CFTC is continuing to review the comparability of transaction reporting requirements, and has therefore extended existing time-limited no-action relief for Australian swap dealers.

## Cross-border Regulation of Australian CCPs

ASX Clear (Futures), and more recently ASX Clear Pty Ltd (ASX Clear), have submitted applications for recognition by ESMA. This recognition is required for ASX Clear (Futures) to be permitted to admit or retain EU entities as direct participants. Recognition by ESMA is also linked to a CCP's status as a Qualifying CCP in the EU. Under the European implementation of the Basel III bank capital reforms, from December 2014 EU banks will have to hold more capital against exposures to a CCP that is not deemed to be Qualifying. If ASX Clear chooses to pursue its application and achieves EU recognition, then participants that are subsidiaries of EU banks would be able to apply lower capital charges for exposures to ASX Clear.

One of the preconditions for recognition in the EU is that the Australian regime for regulation of CCPs is assessed as equivalent to EU regulation. The Bank's FSS are designed to deliver outcomes equivalent to EU standards, since both are based on the Principles. However, since the EU standards are drafted at a more detailed level, the Bank issued supplementary interpretation of a subset of standards to provide additional clarity in some areas. Currently, the supplementary interpretation applies only to domestically licensed derivatives CCPs in Australia that provide services to clearing participants established in the EU. The Bank has applied this interpretation of the relevant standards in its assessment of ASX Clear (Futures) for 2013/14.

As noted above, ESMA published its conclusions on the equivalence of the Australian regime for CCPs in late 2013. On the basis of ESMA's conclusion that the Australian regulatory framework for CCPs was equivalent to that in the EU, the European Commission is proposing to adopt an Implementing Act that will give legal effect to this decision. Prior to any recognition decision, ASIC and the Bank will also need to execute an MoU with ESMA.

In the case of the US, the CFTC currently requires non-US derivatives CCPs that offer swap clearing services to US persons to register as Derivatives Clearing Organisations (DCOs) with the CFTC. However, on 6 February 2014 the CFTC granted ASX Clear (Futures) time-limited relief from the requirement to register as a DCO. This allows US participants of ASX Clear (Futures) to clear proprietary trades in Australian and New Zealand dollar-denominated interest rate swaps using its service. The relief will expire at the end of 2014, or earlier if ASX Clear (Futures) registers as a DCO or is granted an exemption from DCO registration. The CFTC has indicated that it is considering an exemption regime that will place reliance on a CCP's home regulatory regime.

Separately, the Bank has entered into an MoU with the Reserve Bank of New Zealand governing cooperation and information sharing in the oversight of certain CCPs in which both jurisdictions have an interest.