Regulatory Developments in Financial Market Infrastructures

Throughout the year, the Board has remained engaged with a number of important domestic and international regulatory initiatives relevant to its responsibilities in relation to payments and clearing and settlement facilities. These include three ongoing initiatives of the Council of Financial Regulators (CFR), namely a review of the regulatory framework for financial market infrastructures (FMIs) in Australia; work on competition issues in the clearing and settlement of Australian cash equities; and the development of a framework for over-the-counter (OTC) derivatives regulation. The Bank also introduced new Financial Stability Standards (FSS) that align with new international standards for FMIs, and has also assisted overseas regulators in cross-border comparability assessments of regulatory regimes for central counterparties (CCPs) and OTC derivatives markets.

Review of the Regulatory Framework for Financial Market Infrastructures

In April 2011, the CFR was asked by the then Deputy Prime Minister and Treasurer to consider possible changes to the regulation of FMIs to strengthen regulators' ability to provide effective oversight and manage risks to both stability and market integrity. The CFR's advice was released by the then Deputy Prime Minister and Treasurer in March 2012, inviting further consultation with stakeholders on the final framework for implementation of the CFR's proposals.[37] Further to this consultation, Treasury has led work to develop legislative proposals consistent with the proposed framework, with input from the Reserve Bank and other CFR agencies. The Bank and the Australian Securities and Investments Commission (ASIC) have also taken steps to incorporate elements of the package that do not require legislative change into their respective frameworks for oversight of FMIs. Developments in three main areas of the reform of FMI regulation are particularly worthy of note.

Regulatory influence over cross-border financial market infrastructures

The CFR released a supplementary paper in July 2012 describing the approach to be taken by the Bank and ASIC to ensure adequate influence – and continuity of service – where a clearing and settlement (CS) facility has cross-border operations.[38] The paper builds on the CFR's recommendation that regulators be given explicit powers to support a 'proportional and graduated' location policy for licensed CS facilities. It describes a framework within which incremental requirements could be imposed on cross-border CS facilities that are systemically important in Australia, or that have a strong connection to the Australian financial system and real economy.

37 The Council of Financial Regulators' letter to the Deputy Prime Minister and Treasurer is available at <http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/2012/CFRWG%20on%20Financial%20Market%20Infrastructure%20Regulation/Key%20Documents/CoFR_Letter_to_Deputy_PM.ashx>.

38 See Council of Financial Regulators (2012), *Ensuring Appropriate Influence for Australian Regulators over Cross-border Clearing and Settlement Facilities*, July. Available at <http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2012/cross-border-clearing>.

Most of the specific measures envisaged under the framework have been incorporated into the Bank's revised FSS, as discussed below, and ASIC's *Regulatory Guide 211* (RG 211) on CS facilities, revised in December 2012.

Corporations and financial sector legislation

In June 2013, Parliament passed legislation containing several provisions that support the regulation of clearing and settlement (the *Corporations and Financial Sector Legislation Amendment Act 2013*). The relevant provisions of the legislation:

- support the capacity of CCPs to transfer client positions from a potentially insolvent clearing participant to another clearing participant, in line with requirements under the new FSS
- remove the requirement for the Bank and ASIC to conduct annual assessments of licensed CS facilities, except as determined by regulation
- enable more effective information sharing arrangements with other regulators.

The Bank provided a submission to the Parliamentary Joint Committee on Corporations and Financial Services in support of the changes.[39] The Committee's report was published in May 2013. Notwithstanding the changes, the Bank may, at its discretion, continue to assess licensees on an annual basis, even where this is not prescribed. Accordingly, the Bank has issued a statement setting out criteria to be considered in determining which CS facilities should continue to be subject to annual assessments, in addition to any for which annual assessment has been prescribed by regulation.[40]

Resolution of financial market infrastructures

In accordance with the CFR's recommendation for legislative change to provide for the appointment of a statutory manager to a distressed FMI, the Bank and other CFR agencies are supporting Treasury work to develop a proposal for a comprehensive FMI resolution regime consistent with international principles. 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.

Implementation of the CFR's recommendation is being considered in the context of broader international work on the recovery and resolution of FMIs and other 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.[41] The FSB is consulting on an extension of its work to FMIs, with a view to publishing a final report in late 2013. Working to a similar timetable, the Committee on Payment and Settlement Systems (CPSS) and International Organization of Securities Commissions (IOSCO) have also released for consultation draft guidance on recovery planning for FMIs. The Bank has contributed to this work.[42]

39 See *Submission to the Inquiry into the Corporations and Financial Sector Legislation Amendment Bill 2013*, available at <http://www.rba.gov.au/publications/submissions/inquiry-corp-legis-amend-0413.html>.

40 See Reserve Bank of Australia (2013), *Frequency of Regulatory Assessments of Licensed Clearing and Settlement Facilities*, August. Available at <http://www.rba.gov.au/payments-system/policy-framework/frequency-of-assessments.html>.

41 See FSB (2011), *Key Attributes of Effective Resolution Regimes for Financial Institutions*, October. Available at <http://www.financialstabilityboard.org/publications/r_111104cc.pdf>.

42 See CPSS-IOSCO (2013), *Recovery of Financial Market Infrastructures – Consultative Report*, August, available at <http://www.bis.org/publ/cpss109.htm>. See also FSB (2013), *Application of the Key Attributes of Effective Resolution Regimes to Non-bank Financial Institutions*, August, available at <http://www.financialstabilityboard.org/publications/r_130812a.pdf>.

Also of relevance is a September 2012 Treasury consultation paper setting out proposals for strengthening a range of the Australian Prudential Regulation Authority's (APRA's) crisis management powers, including those related to resolution of a distressed authorised deposit-taking institution (ADI).[43] The paper discussed how aspects of the proposed ADI resolution regime could be extended to FMIs, including by the establishment of a statutory management power.

In conjunction with further development of policy on FMI resolution, the Bank will continue to work with the other CFR agencies to consider the implementation of enhancements to directions powers and sanctions under the *Corporations Act 2001*. These enhancements were also recommended in the CFR's advice to the Treasurer and discussed in Treasury's consultation on APRA's crisis management powers.

Competition in clearing and settlement/Code of Practice

Over the past year, the CFR, together with the Australian Competition and Consumer Commission, has undertaken detailed work on competition issues in the clearing and settlement of the Australian cash equity market. The CFR's conclusions were published and endorsed by the government in February 2013.[44] Those conclusions included a set of preconditions for competition in clearing and settlement. However, reflecting views from industry on the costs of adjusting to a competitive environment for clearing in difficult market conditions, the CFR concluded that a decision on any licence application from a CCP seeking to compete in the Australian cash equity market should be deferred for two years. In the meantime, ASX should work with industry stakeholders to develop a *Code of Practice for Clearing and Settlement of Cash Equities in Australia* (Code), based on a set of principles around user input to governance, transparent and non-discriminatory pricing, and access to clearing and settlement services. ASX consulted extensively and released the final Code in July.[45]

At the end of the two years, the CFR intends to carry out a public review of the Code's implementation and effectiveness. At the same time, the CFR will review the prospect of granting a licence to a competing CCP, or of pursuing other regulatory outcomes. If competition were to be ruled out indefinitely, a regulatory response might be appropriate.

New Financial Stability Standards

On 29 March 2013, the Reserve Bank's new FSS came into force.[46] The new FSS are aligned with the requirements in the CPSS-IOSCO *Principles for Financial Market Infrastructures* (the Principles) that address matters relevant to financial stability. They also:

- mirror the structure of the Principles and associated key considerations, with some amendments to reflect the type of CS facility, the Australian regulatory and institutional context, and other relevant factors
- comprise 21 standards for CCPs and 19 standards for securities settlement facilities, each with one or more accompanying sub-standards
- are supported by guidance, based on the explanatory notes to the Principles.

43 Treasury (2012), *Strengthening APRA's Crisis Management Powers*, September. Available at <http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2012/APRA>.

44 The government's response to the CFR's recommendations is available at <http://www.treasury.gov.au/PublicationsAndMedia/Publications/2013/competition-of-the-cash-equity-market>.

45 The final Code is available at <http://www.asx.com.au/cs/documents/ASX_finalises_Code_of_Practice_and_membership_of_Forum.pdf>. The CFR's media release on the introduction of the Code is available at <http://www.cfr.gov.au/media-releases/2013/mr-13-04.html>.

46 The new FSS are available at <http://www.rba.gov.au/payments-system/clearing-settlement/standards/index.html>. For a summary of the feedback received during consultation and the Bank's response, see RBA (2012), *New Financial Stability Standards: Final Standards and Regulation Impact Statement*, December, available at <http://www.rba.gov.au/payments-system/clearing-settlement/standards/201212-new-fss-ris/index.html>.

ASIC has also implemented the requirements in the Principles that are relevant to its regulatory remit by revising its regulatory guidance on oversight of CS facility licensees.[47] Monitoring of the Principles' global implementation is ongoing through the CPSS and IOSCO. An initial progress report was published in August 2013.[48]

The Bank's consultation with stakeholders during the development of the new FSS identified the need for transitional relief to be granted in respect of certain sub-standards. Acknowledging that international guidance had yet to be finalised in respect of matters related to recovery and resolution of FMIs, and that certain changes necessary to meet account segregation and portability and liquidity risk requirements could involve significant industry-wide or legislative change, the Bank granted transitional relief for 12 months in respect of a small number of sub-standards. The Bank has, however, made it clear that it is unwilling to extend the period of transitional relief for these sub-standards, except in exceptional circumstances. It is therefore anticipated that the sub-standards for which relief is currently available will become effective from 31 March 2014.

The Bank has also articulated its approach to assessing CS facility licensees against the new FSS.[49] The Bank has set out its information requirements and expectations, drawing a distinction between the approach that it will take in respect of domestic facilities licensed under section 824B(1) of the Act, and that in respect of overseas facilities licensed under section 824B(2). Notably, in the case of overseas facilities, the Bank intends to place appropriate reliance on information provided by an overseas facility's home regulator when assessing against any standard for which there is a materially equivalent standard in the facility's home regime.

OTC Derivatives

There is an international policy consensus that increasing the use of centralised infrastructure – trade repositories (TRs), CCPs and trading platforms – in OTC derivatives markets will be an effective way to address many of the concerns around the functioning of these markets that emerged during the global financial crisis. Accordingly, in 2009, the G20 leaders committed that all OTC derivatives transactions would be reported to TRs, that all standardised OTC derivatives would be cleared through CCPs and, where appropriate, traded on exchanges or electronic trading platforms, and that higher capital requirements would apply to non-centrally cleared OTC derivatives. International standard setters have also been developing standards for initial and variation margin requirements where OTC derivatives remain non-centrally cleared.[50]

Consistent with these commitments, in January 2013 amendments to the Corporations Act took effect that provide for the imposition of mandatory requirements in respect of trade reporting, central clearing and platform trading of OTC derivatives. Under this regime, the responsible Minister – after considering the advice of the regulators – may issue a determination that mandatory obligations should apply to a specified class of derivatives. Once the Minister has made a determination, ASIC may make Derivative Transaction Rules (DTRs), setting out the details of any requirements, including the institutional scope, product scope, transitional arrangements and the manner and form in which persons must comply with the requirements. In making

47 See ASIC (2012), *Regulatory Guide 211: Clearing and Settlement Facilities: Australian and Overseas Operators,* December. Available at <http://www.asic.gov.au/rg>.

48 See CPSS-IOSCO (2013), *Implementation monitoring of PFMIs – Level 1 assessment report,* August. Available at <http://www.bis.org/publ/cpss111.htm>.

49 Details of the Bank's oversight approach are available at <http://www.rba.gov.au/payments-system/clearing-settlement/standards/201212-new-fss-ris/attachment-6.html>.

50 See G20 (2009), *Leaders' Statement*, Pittsburgh Summit, 24–25 September, available at <http://g20.org/load/780988012>. also See G20 (2011), *Building Our Common Future: Renewed Collective Action for the Benefit of All,* Cannes Summit Final Declaration, 4 November, available at <http://g20.org/load/780986775>.

these rules, ASIC must also consult with APRA and the Bank. 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. Over the past year the regulators have produced two such reports, in October 2012 and July 2013.[51]

Mandatory trade reporting

The key recommendation from the October 2012 report was that the government should consider a broad-based mandatory trade reporting obligation for OTC derivatives. Following the regulators' recommendations and the passage of the legislation described above, in December 2012, the Treasury consulted on a proposal that a broad-ranging determination be made requiring the reporting of OTC derivatives to a licensed trade repository, where one is available. Consistent with this proposal, in May 2013 the Minister made a determination covering interest rate, foreign exchange, credit, equity and commodity (excluding electricity) derivatives.

In anticipation of this determination, ASIC consulted in March 2013 on draft DTRs that set out proposed requirements for the reporting of OTC derivative transactions to licensed TRs, including the details of transactions that would need to be reported. These DTRs were finalised in July 2013, with a phased implementation. The reporting obligation for internationally active banks is due to commence in October 2013.[52]

The January 2013 changes to the Corporations Act also introduced a licensing regime for TRs. ASIC has responsibility for administering this regime, and in July the Derivative Trade Repository Rules also came into force, with which licensed TRs must comply.[53] ASIC expects the first TR to be licensed under the new regime by early 2014.

Mandatory central clearing

To give market participants and international regulatory peers more clarity around how the regulators will assess the case for introducing clearing mandates, in May 2013 the regulators published a statement on assessing the case for mandatory clearing obligations.[54] The framework set out in the statement was applied in the July 2013 report, which concluded the following:

- The Minister should consider a central clearing mandate for US dollar-, euro-, British pound- and yen-denominated interest rate derivatives, primarily on international consistency grounds. The initial focus of such a mandate should be dealers with significant cross-border activity in these products.
- The regulators do not see a case for mandating North American- and European-referenced credit derivatives at this time.
- The regulators will monitor for a further period Australian dealers' progress in implementing appropriate clearing arrangements before recommending mandatory central clearing of Australian dollar-denominated interest rate derivatives. The initial scope of any mandate would likely be the interdealer market.

With both ASX Clear (Futures) and LCH.C having received regulatory approval in July to clear Australian dollar-denominated interest rate derivatives, the regulators expect banks' operational arrangements for these derivatives to be largely in place by the end of 2013. The regulators will therefore review the case for mandatory

51 APRA, ASIC and RBA (2012), *Report on the Australian OTC Derivatives Market*, October, available at <http://www.rba.gov.au/payments-system/clearing-settlement/otc-derivatives/201210-otc-der-mkt-rep-au/index.html> and 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>.

52 *ASIC Derivative Transaction Rules (Reporting) 2013*. Available at <http://www.comlaw.gov.au/Details/F2013L01345>.

53 *ASIC Derivative Trade Repository Rules 2013*. Available at <http://www.comlaw.gov.au/Details/F2013L01344>.

54 APRA, ASIC and RBA (2013), *Australian Regulators' Statement on Assessing the Case for Mandatory Clearing Obligations*, May. Available at <http://www.cfr.gov.au/publications/cfr-publications/australian-auth-statmnt-mandatory-clearing-obligations.html>.

central clearing of Australian dollar-denominated interest rate derivatives in their next report in early 2014. The regulators also plan further work to understand the incremental costs and benefits of extending a central clearing mandate to non-dealers.

Mandatory platform trading

In their July 2013 report, the regulators reiterated that they see in-principle benefits in a greater utilisation of trading platforms in the Australian OTC derivatives market. However, at this stage the regulators have not made a specific recommendation regarding a mandatory platform trading obligation. The regulators continue to monitor developments in other jurisdictions and will seek more detailed information on activity in the Australian market, with a view to more clearly defining the characteristics of suitable trading platforms in the context of ongoing discussions about possible reform of the markets licensing regime.

Capital requirements for OTC derivatives

Consistent with the G20 commitment, the Basel III capital framework for banks includes rules designed to ensure that banks' exposures to CCPs will be adequately capitalised, while also preserving incentives for banks to centrally clear their trades. The rules also promote robust risk management by CCPs and recognise the role of the Principles. In June 2013, the Basel Committee on Banking Supervision (BCBS), in cooperation with CPSS and IOSCO, released a consultation paper on the capital treatment of banks' exposures to CCPs, which contained proposed rules that fine tune the interim rules for capital exposures to CCPs published in July 2012.[55]

As of January 2013, APRA has adopted the interim rules on ADIs' exposures to CCPs. Under Basel III, banks' exposures to 'qualifying' CCPs are subject to much lower risk-weights than bilateral counterparty exposures. Through an exchange of letters, in April 2013, the regulators confirmed that APRA considers ASX Clear and ASX Clear (Futures) – the only Australian-licensed domestic CCPs – to be qualifying CCPs.[56]

Margin requirements for non-centrally cleared derivatives

In September 2013, the BCBS and IOSCO finalised principles on margining for non-centrally cleared OTC derivatives (i.e. transactions that remain bilateral between counterparties), to be phased in between 2015 and 2019. The purpose of these principles is to reduce contagion and spillover effects that could result from the default of an OTC derivatives counterparty by ensuring that collateral is available to offset losses arising. By introducing margining requirements that align with CCP practices, the international principles are also expected to provide greater incentives to move to central clearing. The regulators are now in the process of developing advice to the government in relation to the implementation of these principles in Australia.

Cross-border issues

The international dimension of OTC derivatives regulation and the cross-border application of some jurisdictions' rules have become more prominent in recent months. In its April 2013 Communiqué, the G20 Finance Ministers and Central Bank Governors called upon regulators to resolve 'remaining cross-border conflicts, inconsistencies, gaps and duplicative requirements'.[57] Consistent with this, the Australian authorities

55 BCBS (2013), *Capital Treatment of Bank Exposures to Central Counterparties*, June. Available at <http://www.bis.org/publ/bcbs253.pdf>.

56 See ASIC and RBA letter to APRA, *Qualifying Central Counterparties – ASX Clear and ASX Clear (Futures)*, available at <http://www.cfr.gov.au/publications/member-publications/pdf/letter-qccp-status-asic-rba-to-apra.pdf> and APRA's response, available at <http://www.cfr.gov.au/publications/member-publications/pdf/letter-qccp-status-apra-response.pdf>.

57 G20 (2013), *Communiqué*, Meeting of Finance Ministers and Central Bank Governors, Washington, 18–19 April. Available at <http://g20.org/load/781302507>.

have been working with the relevant authorities in the US and the European Union (EU) to assist in these authorities' comparability assessments of the Australian regime for regulation of CCPs and OTC derivatives markets. These assessments will determine the extent to which the US and EU authorities will allow Australian rules to apply, rather than imposing their requirements directly on Australian institutions (so-called 'substituted compliance' or 'equivalence').

The Board has considered particularly closely the work undertaken by the European Securities and Markets Authority (ESMA) to compare the Australian and EU regimes for regulation of CCPs. ASX Clear (Futures) is seeking regulatory recognition in the EU and a positive assessment is one prerequisite for such recognition. In addition, ASIC and the Bank will need to execute memoranda of understanding with ESMA.

While the FSS are designed to deliver outcomes equivalent to ESMA's standards, they are less detailed. The Bank has therefore issued supplementary interpretation of a subset of standards, by way of an exchange of letters with ASX.[58] In early September, ESMA published its advice to the European Commission on regulatory equivalence in a number of regimes, including Australia's regime for regulation of CCPs. The Australian regime was considered to be equivalent to that in the EU.[59]

58 The Bank's letter to ASX is available at <http://www.rba.gov.au/payments-system/clearing-settlement/pdf/supplementary-guidance-domestic-derivatives-ccps.pdf>.

59 ESMA's advice to the European Commission is available at <http://www.esma.europa.eu/system/files/2013-1159_technical_advice_on_third_country_regulatory_equivalence_under_emir_australia.pdf>.