

Senate Standing Committee on Economics

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Budget Estimates, 2 June – 4 June 2009

Question: bet 173

Topic: Regulations for ‘Over-the-counter’ Derivatives

Hansard Page: E103

Senator Bushby asked:

Senator BUSHBY—Yes. But I understand in the last week that ASIC together with the RBA and APRA have indicated they would like to see more regulation around the way that is run, or maybe a central clearing house I think was one of the suggestions for a better way of approaching that to make sure that it is done in a way that protects consumers.

Mr D’Aloisio—Over-the-counter markets in Australia, according to the joint RBA and APRA report, compared with what has happened overseas have operated well, but there is room to improve. There is a consultation report that has been put into the market and we are working with the RBA on that.

Senator BUSHBY—What sorts of timelines are you looking at?

Mr D’Aloisio—I am not sure. I might come back to you on that. The next stage is an extensive industry consultation. It is probably just a few months I think, but I can check that.

Senator BUSHBY—The turnover of over-the-counter derivatives is actually quite large, is it not?

Mr D’Aloisio—It is about \$90 trillion or something. It was a very big number.

Senator BUSHBY—Yes, that is in Australia. It is a very large—

Senator Sherry—I have read it, but I do not believe it does call on the government to legislate for some sort of regulatory supervision.

Senator BUSHBY—I may have overstated that. When I used the term ‘regulation’ I was not necessarily referring to government regulations as such. It was more as a framework around the market and the way it operates. I am interested to hear about that. It is a significant activity, as we have heard. It is trillions of dollars. Obviously in an unregulated situation or a situation where there is not a framework there is certainly a potential for individuals and entities to suffer large losses. I am interested to hear about that and how that is going. You said you would take it on notice in terms of timelines.

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Answer:

APRA, ASIC and the RBA have formed a working group to promote safe, efficient and robust practices in the Australian OTC derivatives market.

The result will be new regulation which:

- a) enables regulators to receive important derivative information so it can monitor the market;
- b) ensures suitable risk management systems are utilised; and
- c) implements changes to improve the derivative market infrastructure (such as access to central clearing).

The first derivative markets in which these new regulations will be employed are the interest rate derivative and credit derivative markets, the markets the joint OTC working group considered most important.

These new regulations will take into account international initiatives, such as G20 recommendations and regulatory initiatives in the US and Europe.

The expected timeframe has been set as follows:

DATE	TASK
12 June 2009	Industry roundtable
5 August 2009	Working Group and Industry Roundtable to finalise work programmes, process and timetable (where possible).
30 September 2009	Gap analysis to determine what additional derivative information should be disclosed to regulators
[subject to international timetable]	The new regulation should be implemented the timing of international initiatives (e.g. those of the OTC Regulators Forum lead by the NY Federal Reserve and IOSCO Task Force for Unregulated Financial Markets and Products (TFUMP)).

It is important that any new Australian regulation is consistent with new international regulation, as these markets are international. The OTC working group timetable must therefore follow international timetables, which have not yet been formally set.

Failure to be consistent can mean, among other things:

- (a) international markets become concerned about dealing with Australia, limiting the ability for Australians to do business; or
- (b) international markets export worst practices to Australia, if the Australian regulation is too weak.

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AFMA has indicated it will submit an industry letter of commitment to the Council of Financial Regulators in the next month supporting the recommendations of the Survey Report.

Please note: AFMA estimate the turnover in the OTC derivatives market to be \$60 trillion, as at 30 June 2008.

Other derivatives related regulatory initiatives include the international recommendations being developed by TFUMP. Australia is taking a lead role in developing these recommendations, but they are more focused on securitisation and credit derivatives, rather than central clearing.

Further background:

In May 2009, the working group released the *Survey of the OTC Derivatives Market in Australia*. Following an industry forum held on 12 June, the working group has been in bilateral discussions with industry groups, key service providers and international regulators.

On 5 August, the working group held an industry roundtable to:

- Finalise the work programmes;
- Agree a process for ongoing engagement with industry; and
- Establish timelines for concrete measurable deliverables, where possible.

Three core work programmes have been finalised:

- Market transparency;
- Risk management: documentation and collateral; and
- Automation and use of infrastructure.

Market transparency work programme

This work programme will be lead by ASIC and will focus on prudential and market integrity objectives such as:

- Optimising the level of OTC derivative transaction transparency to regulators (with initial focus on credit default swaps and interest rate swaps) for prudential/systemic risk and market conduct monitoring purposes;
- Promoting the use of data warehouses, central counterparties and electronic trading venues; and
- Standardisation of OTC derivative contracts.

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This will involve:

- Undertaking a gap analysis to determine what additional information should be disclosed to regulators;
- Continuing to engage with international developments in this area with respect to the coordination of data requirements and sources and the sharing of information between regulators.
- Maintaining industry dialogue to further develop data sources, standardisation of derivative contracts and to determine whether institutions are prepared to sign waivers allowing the release of data by the DTCC's Trade Information Warehouse and other data providers.

The working group will complete the gap analysis by 30 September, consulting with market participants via AFMA in the process.

The working group is currently in dialogue with international regulators via an OTC Derivatives Regulators' Forum chaired by the Federal Reserve Bank of New York. This Forum is actively examining which data could usefully be sourced from DTCC's Trade Information Warehouse for credit derivatives (and in the future from warehouses for other products), and how these might be shared among regulators. As part of this work, the Forum is developing reporting templates.

Risk management: documentation and collateral work programme

This work programme is lead by APRA and will focus on:

- Good management of legal and counterparty risks including timely completion of industry-standard documentation and promoting more extensive of Credit Support Annexes in ISDA agreements; and
- Establishing, promoting and monitoring best practice guidelines.

This will involve:

- Gathering more information on current practices;
- Conducting targeted prudential reviews; and
- Working with AFMA to develop best practice guidelines

APRA's targeted visits to regulated entities are already underway. These will continue and a dialogue will be opened with AFMA on best practice guidelines. ASIC will then look to apply APRA's best practice guidelines to the broader non-APRA regulated sector.

Automation and use of infrastructure work programme

This work programme is lead by the RBA and will focus on:

- Platforms for confirmations processing, portfolio reconciliation and compression to minimise operation risks, feed internal risk management systems and connect to central counterparties and other straight-through-processing systems; and
- Central counterparties for counterparty and operational risk management, transparency and centralised default management.

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This will involve:

- Identifying and addressing any regulatory barriers;
- Facilitating access to infrastructure (whether domestic or overseas) as it becomes available for Australian products and participants; and
- Engaging with industry participants on Australia specific challenges such as access arrangements, time zone frictions, portfolio impacts and buy-side challenges.

Working sub-groups are being established by the AFMA OTC Committee to engage with ASIC, APRA and RBA on each of the three workstreams.

Treasury have been present at both the industry roundtables.

The RBA recently varied its *Financial Stability Standard for Central Counterparties* to place due reliance on (sufficiently equivalent) overseas regulators.

ASIC is developing regulatory guides for licensing professional markets (such as electronic trading platforms) and clearing and settlement facilities, which will clarify licensing requirements for overseas facilities.

ASIC will also recommend licensing exemptions, where appropriate, to facilitate Australian institutions' access to other relevant infrastructure, such as delta neutral auction and portfolio compression services which reduce outstanding notional value of OTC derivative transactions.