ASX OTC Interest Rate Derivatives Clearing

Consultation on OTC Rule and Handbook amendments

CONSULTATION PAPER AUGUST 2016

Invitation to comment

ASX is seeking submissions on the matters canvassed in this paper by 16 September 2016. Submissions should be sent to:

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Office of General Counsel ASX Limited
20 Bridge Street Sydney NSW 2000

Attention: Catherine Eakin

ASX prefers to receive submissions in electronic form Submissions not marked as 'confidential' will be made publicly available on ASX's website.

If you would like your submission, or any part of it, to be treated as 'confidential', please indicate this clearly in your submission. ASX is available to meet with interested parties for bilateral discussions on the matters under consultation.

Contacts

For general enquiries, please contact:

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Introduction

ASX seeks feedback from OTC Participants on:

- ASX's proposal to expand the product coverage of the OTC Clearing Service to include:
  - new OTC Interest Rate Derivatives products – Asset Swaps and BBSW vs AONIA Basis Swaps; and
  - extended maturities for existing OTC Interest Rate Derivatives products (outlined below);
- whether ASX should amend its OTC Rules to confirm that OTC Open Contracts are 'settled to market' rather than 'collateralised to market' by variation margin payments.

ASX also proposes to make a number of miscellaneous OTC Rule and Handbook amendments.

ASX's proposed amendments to the OTC Rules and Handbook outlined in this Consultation Paper are available at http://www.asx.com.au/documents/public-consultations/Consultation-OTC-Rule-and-Handbook-amendments.pdf.

OTC Participant responses to this Consultation Paper should be submitted to ASX by Friday 16 September 2016.

OTC Rule and Handbook Amendments

Expansion of OTC Product coverage

The ASX Rates Product Advisory Committee has recommended that the product coverage of the OTC Clearing Service be expanded to cover the new and extended OTC Interest Rate Derivatives products outlined below. ASX seeks to respond to market demand and enhance its range of Australian dollar clearable products in accordance with market developments and liquidity by modifying its eligibility criteria for OTC Transactions to include these new and extended OTC Interest Rate Derivatives products.

BBSW vs AONIA Basis Swaps (new product)

ASX proposes to accept Basis Swaps BBSW 1m, 3m and 6m vs OIS with a maximum maturity of 10 years.

Asset Swaps (new product)

ASX proposes to accept Asset Swaps, with the maximum maturity profile dependent on the Floating Rate. Asset Swaps with BBSW 1m will be limited to 10 years and BBSW 3m and BBSW 6m will be limited to 30 years.

The key features of the proposed Asset Swaps are as follows:

- Different Start Dates for the Fixed and Floating Legs will be allowed.
- The Fixed Leg Start Date can be up to 1 year prior to the Floating Leg Start Date.

- Front and Back Stubs will be allowed.
- Different Day Count Conventions will be allowed on each leg.

BBSW 3m (extension of existing product)

ASX proposes to extend the maximum maturity on BBSW 3m vs Fixed and BBSW 3m vs BBSW 6m Basis Swaps from 10 years to 30 years.

OIS (extension of existing product)

ASX proposes to extend the maximum maturity on Zero Coupon OIS Trades from 1 year to 3 years.

However, ASX seeks OTC Participant feedback on whether the maximum maturity on:

- Zero Coupon OIS Trades; and
- Outright OIS (that currently have a maximum maturity of 3 years),

should be extended to 10 Years.

Forward Starting Swaps (extension of existing products)

ASX proposes to provide additional flexibility for Forward Starting Swaps to align with the maximum maturities identified above.

ASX proposes that the expansion of product coverage outlined above should take effect from 3 October 2016 (indicative).

Key Operating Rules:

OTC Handbook, Schedule 1 – OTC Eligibility Criteria

Consultation Questions:

(1) Do you support ASX expanding the product coverage of the OTC Clearing Service to cover the new and extended OTC Interest Rate Derivatives products outlined above?

(2) Should the maximum maturity on (i) Zero Coupon OIS Trades and (ii) Outright OIS Trades, be extended to 10 years?

(3) Do you have any comments on ASX's proposed amendments to the OTC Eligibility Criteria (available at http://www.asx.com.au/documents/public-consultations/Consultation-OTC-Rule-and-Handbook-amendments.pdf)?

(4) Do you have any comments on the proposed timing for introduction of these changes?

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Characterisation of variation margin payments

Under the *Basel III leverage ratio framework and disclosure requirements - January 2014*[1], a bank's derivatives exposure is calculated as the replacement cost for current exposure plus an add-on for potential future exposure. The add-on is calculated by applying an add-on factor to the notional principal amount of the derivative contract. Add-on factors vary according to the 'residual maturity' of the contract. The framework states that:

> *For contracts that are structured to settle outstanding exposures following specified payment dates and where the terms are reset such that the market value of the contract is zero on these specified dates, the residual maturity would be set equal to the time until the next reset date. In the case of interest rate contracts with remaining maturities of more than one year that meet the above criteria, the add-on is subject to a floor of 0.5%*.

The intent of this statement appears to be that, when determining potential future exposure, the 'residual maturity' of a contract can be the period between 'specified payment dates' if the terms of the contract require the full amount of mark to market exposure accruing from one payment date to the next to be settled on each such date, with the result that the value of the contract is reset to zero with each such payment (commonly referred to as 'settled to market'). A contract that requires collateralisation of the mark to market exposure as it fluctuates over the life of the contract, such that amounts of collateral received by a party may become repayable by the party in future, apparently would not fit within the above statement (commonly referred to as 'collateralised to market').

The emergent industry view appears to be that cleared OTC interest rate swaps for which mark to market exposures are settled daily, rather than collateralised, can take advantage of the lowest available add on factor (0.5%), translating into lower derivatives exposures. A number of OTC interest rate swap clearing services have amended their operating rules either to align with the 'settled to market' contract structure outlined above,[2] or to give their members the choice of 'opting into' this contract structure on a contract by contract basis.[3] ASX is not aware that any bank prudential regulatory authority has publicly endorsed or raised issues concerning this application of the leverage ratio framework.

ASX's operating rules already support the characterisation of OTC variation margin payments to ASX as daily settlement, rather than collateralisation, of mark to market exposures. OTC Rule 5.8 provides that payments of variation margin are made absolutely and are not repayable by the recipient. However, in response to feedback and queries by a number of OTC Participants, ASX is seeking input through this consultation process on amendments which would give enhanced legal certainty that settlement to market, rather than collateralisation to market, is intended by all parties. Price alignment interest would remain in place and would not derogate from the intended 'settled to market' contract structure.

ASX has commissioned an external Australian law legal opinion to confirm that the effect of the draft amendments to ASX's OTC Rules would be that the payment of variation margin is made as a settlement

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[1] Adopted in Australia for Authorised Deposit Taking Institutions under APRA's *Prudential Standard APS 112, Capital Adequacy: Standardised Approach to Credit Risk, January 2013*

[2] For example, CME Clearing Rule 814 (Settlement Variation and Option Value).

[3] For example, LCH Clearnet General Regulations 57 (Collateralisation of SwapClear CTM Contracts) and 57A (Settlement of SwapClear STM Contracts and Conversion to SwapClear STM Contracts).

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and not as security or collateral for the OTC Participant's obligations under OTC Open Contracts. ASX will make this legal opinion available to OTC Participants on request.

Key Operating Rules:

OTC Rules 5.8, 5.9 and 5.11 and OTC Handbook 5.8, 5.9

Consultation Questions:

(1) Do you support amendment of the OTC Rules to confirm that variation margin payments are made to settle, rather than collateralise, mark to market exposures? Why?

(2) Has your institution considered whether different tax and accounting outcomes may result from 'settled to market' and 'collateralised to market' contract structures for cleared interest rate swaps? If so, please outline the differences (if any).

(3) Has your institution obtained any formal or informal guidance from your home prudential regulator on matters concerning 'settled to market' versus 'collateralised to market' contract structures?

Miscellaneous changes

ASX also proposes to make several miscellaneous amendments to the OTC Rules and Handbook as follows:

- **Addition of a new condition for acceptance of OTC Transactions for registration (OTC Handbook 4.5(b)(i))**. An OTC Transaction that has been reported to a data repository can be accepted by ASX for registration only if ASX is capable of reporting to the data repository. This is because ASX has a regulatory obligation to report the termination of OTC Transactions accepted for clearing, to the data repository to which the OTC Transaction was originally reported.[4] Currently ASX has reporting capability to DTCC. However, ASX will consider expanding its reporting capability to include other data repositories on request by OTC Participants.

- **Remove the requirement for an Australian Bank to lodge a quarterly capital statement with ASX (OTC Rule 3.3(b)(i))**. This amendment acknowledges the public disclosures required of Australian Banks under Basel III and is intended to avoid unnecessary reporting obligations for OTC Participants.

- **Confirm that OTC Intraday Margin must be met by an OTC Participant within one hour of ASX making a call or such other period of time as notified by ASX (OTC Handbook 5.6)**. This approach to the settlement of intraday margin calls has been endorsed by the ASX Clear (Futures) Risk Consultative Committee.

Consultation Questions:

(1) Data Repository reporting: Are there data repositories (other than DTCC) that ASX should consider in expanding its reporting capability?

[4] Refer http://www.cftc.gov/idc/groups/public/@otherif/documents/ifdocs/asxclearamdorderdcoexemption.pdf see para 10.

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Next Steps

ASX seeks OTC Participants views on the draft amendments to the OTC Rules and Handbook. Submissions should be made by Friday 16 September 2016.

ASX welcomes the opportunity to discuss the draft amendments with interested parties (refer to the contact details on page 2).