AFMA

MEMBER NEWS

May 2019

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IBOR Transformation update

- AFMA's IBOR Transformation Work Group is regularly meeting and engaging with the authorities on key strategic issues affecting the Australian market.
- The Reserve Bank of Australia has made statements and held an international panel event to communicate the importance of the transition away from LIBOR and its effects on the market.
- ASIC has written to the CEOs of major Australian financial institutions regarding their preparations for the end of LIBOR.
- Accounting issues arising from IBOR transition are a priority concern and the International Accounting Standards Board has issued a related Exposure Draft.
- ISDA has published two new consultations on benchmark fallbacks – one covering adjustments that would apply to fallback rates in the event certain IBORs are permanently discontinued, and another relating to pre-cessation issues for LIBOR and certain other IBORs.

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Coordination of CPS 234 Implementation

AFMA's submission to APRA's CPG 234 consultation was broadly supportive of the guidance which addressed some issues raised by CPS 234 sensibly and provided a picture of what a comprehensive CPS 234 program might look like for a large institution.

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Changes to the Interest Rate Options Conventions

The Interest Rate Options Committee and the Market Governance Committee have now ratified amendments to the standard transaction size conventions applicable to the interbank market.

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HAVE YOUR SAY

APRA consults on APS 220 Credit Risk Management

APRA is proposing revisions to the credit risk management framework for authorised deposit-taking institutions.

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APRA consults on proposed reporting standard for derivatives activity

APRA released for consultation a draft reporting standard that will be used to collect quarterly data on the derivatives activity of ADIs and registered financial corporations.

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Equity Derivatives - Takeovers Panel consults on Guidance Note 20

The Takeovers Panel is undertaking a consultation on *Guidance Note 20* which outlines the Panel's approach to the disclosure requirements around Equity Derivatives.

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COMMITTEE ROUND-UP

Committee Round-up

A snapshot of the issues considered and initiatives undertaken by AFMA's Market, Operations, Policy and Business Line Committees over the past month.

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AFMA LEARNING

Professionalism: Conduct & Ethics Course Update

AFMA has now launched the *Professionalism: Conduct & Ethics* course and has started taking bookings for public workshop cohorts.

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Growing International Focus on Conduct Standards

Viewpoint

The Chair of the UK's FICC Markets Standards Board (FMSB), Mark Yallop, visited AFMA during May and had constructive meetings with AFMA's Board and with members of the Market Governance and Professionalism Committees. AFMA and the FMSB share a common interest in promoting good practice in the FICC markets, so this provided for many interesting points of discussion.

Australia is comparatively well-advanced in its approach to the setting and management of industry standards for the institutional OTC markets. The principal components are AFMA's Market Conventions, Code of Conduct and Conduct Standards.

The FMSB is an independent body set up by market practitioners in 2015 to improve standards of conduct in wholesale FICC markets in response to the Fair and Effective Markets Review. It has quickly established an influential presence in the UK's wholesale FICC markets and aims to bring transparency to grey areas by identifying emerging vulnerabilities, clarifying and documenting practice and agreeing standards to improve conduct and market behaviour. Ensuring that wholesale FICC markets are transparent, fair and effective is at the heart of the FMSB's mission, which is a shared objective with AFMA.

Setting up the FMSB was one of the main recommendations to emerge from the Fair and Effective Markets Review, which was conducted by HM Treasury, the Bank of England and the Financial Conduct Authority.

FMSB aims to fill the "void" between high level principles and low level operational rules with clearer guidance for market participants. FMSB has 4 key strategic goals to meet in serving its mandate:

1. Analyse and report on emerging FICC market conduct vulnerabilities;
2. Address areas of uncertainty in specific trading practices;
3. Promote adherence to Standards;
4. Contributing to international convergence of Standards.

FMSB has so far published 13 Standards or Statements of Good Practice and original research on historical causes of misconduct.

AFMA has a broader operating framework and scope of activity than FMSB and a longer role in providing guidance on industry practice. However, the FMSB has a specialist capability and draws on the scale and needs of the London market. Hence, FMSB's work serves as a useful reference point for AFMA's work in this area and we proactively reached out to the Board to establish a dialogue with it.

The discussions with Mr Yallop confirmed the great value of industry standards that outline the norms of proper conduct in financial markets. There was an exchange of views on a range of matters of interest to AFMA member firms active in Australia's financial markets including, for example, changing market structures, IT based trading systems and electronification of markets that present new challenges in the design of standard business practices to ensure fair and effective markets. These are matters that both FMSB and AFMA will need to address over time in their respective markets.

My Yallop outlined FMSB's aim to contribute to the global convergence of standards, which from AFMA's perspective is a sound objective though it does face some practical challenges. The FX Global Code provides the best example of a global standard but in practice FICC markets more generally are more heterogeneous in nature than the FX market. While the global convergence process is thus more difficult, it is nonetheless possible to achieve beneficial outcomes for market participants.

For example, AFMA Committees are now routinely asked to consider if FMSB guidance, or similar guidance, that is being developed might be usefully adopted, or adapted, by AFMA for Australia's financial market place. If AFMA substantively incorporates the principles set out in an international standard into an AFMA conduct standard, then the latter should give practical guidance on the application of those principles in the Australian context, such as by including relevant examples drawn from the local market place. This is how the recently issued *AFMA Swaps Reference Price Transactions Guidelines* work. They are consistent with the relevant FMSB standard but they are more market specific, take account of ASIC's views and provide localised practical examples.

Another area where AFMA will observe FMSB's future work is in relation to its development of metrics to demonstrate the practical effectiveness of industry standards in supporting financial markets such that they operate in accordance with stakeholder expectations. AFMA's Professionalism Committee recently amended our conduct standards development policy to include a requirement to include metrics into the management plan for a standard that might be used to determine its effectiveness, where this is feasible.

FMSB also has interest in the development of industry training to support the adoption of good practice in FICC markets internationally. The AFMA Accreditation program for individuals fills this need in the Australian market and the enhanced conduct training competent that we have introduced through the *Professionalism: Conduct & Ethics* course is evidently leading edge training for accreditation in international terms. AFMA's program is being further developed to improve its flexibility in recognising training provided by other bodies, which could be beneficial in the context of FMSB's global objectives in this area.

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BEAR Variable Remuneration Determination

Viewpoint

AFMA made technical comment on the Banking Executive Accountability Regime (BEAR) – Consultation On Determination under Paragraph 37EA(4)(b) of the *Banking Act 1959*. This document defines certain variable remuneration not to be variable remuneration for the purposes of the BEAR, where certain conditions are met. Its purpose is to ensure that application of the deferred remuneration obligations across ADIs is consistent with the intent of the BEAR.

While technical in nature, there were several important points made to ensure that accountable persons in NOHC group and groups where the ADI is not the head of the group are properly taken into account. Comments also sought to address the situation for a foreign ADI's accountable person who is also subject to the rules on remuneration for Material Risk Takers put out by the European Banking Authority.

Please contact David Love if you would like to receive a copy of AFMA's submission.

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Enforceability of Financial Services Industry Codes

Viewpoint

The Hayne Royal Commission Final Report recommended that certain provisions of financial sector codes should be 'enforceable code provisions' (rec 1.15). This would apply to existing consumer codes issued by industry bodies, such as those covering retail banking and insurance and is not directly applicable to the member oriented, voluntary, AFMA Code of Conduct.

The Government for its part agreed to implement this recommendation to provide ASIC with additional powers to approve and enforce code provisions.

The Commissioner also noted the benefits of voluntary codes in harnessing the views and collective will of industry. The Government has stated that it will continue to support and encourage industry to develop voluntary codes that go beyond the requirements in the law.

Given the Government's commitment to implement recommendation 1.15, Treasury launched a consultation process in March to inform the development of legislation to give effect to it. AFMA made a submission to the Treasury consultation on the mandating of voluntary codes. Our key objective is to establish the policy principles and objectives that should underpin industry codes and, thus, avoid wholesale markets codes and similar documents being inadvertently caught by the provisions in the proposed legislation.

Please contact David Love if you would like to receive a copy of AFMA's submission.

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AFMA Comments on NGF Capping Claims Proposals

Viewpoint

AFMA made comment on a draft Corporations Amendment (National Guarantee Fund Payments) Regulations 2019 (Regulations). As outlined in the April edition of the *Newsletter*, the purpose of the Regulations is to replace the existing cap with three new caps on payments out of the National Guarantee Fund (NGF) which cover all of the heads of claim:

- The first caps the amount that a claimant may receive for claims relating to the same event and the same participant at $1 million.
- The second caps the cash component of any such claim at $250,000.
- Third, if the participant becomes insolvent, the NGF Regulations cap the total amount paid out of the NGF in relation to that participant at 15 per cent of the minimum amount in the NGF as at the end of the day on which the participant became insolvent.

Without capping of claims, actuarial assessments cannot provide a definitive response on the minimum required for the fund, making it difficult for the SEGC to make a precise decision with absolute certainty. This leaves open the likelihood that further levies would be placed on equities brokers to increase the amount in the fund as a safeguard.

The NGF is a compensation fund maintained by the Securities Exchanges Guarantee Corporation Limited (SEGC) in accordance with the Corporations Act and related Regulations. The SEGC's purpose is to meet a range of claims that may arise out of conduct in relation to securities by participants on the market in relation to risks solely associated with the conduct of brokers, not any risk arising from the market licensee's conduct or that of any of its employees in conducting that market. The basis of the fund was a proportion of the fidelity funds previously held by the capital city exchanges prior to their consolidation into the Australian Securities Exchange in 1987. To this has been added interest from broker accounts and investment income. Payments have been made from the NGF for claims and administration and securities industry development purposes at the direction of the Government which depleted the fund.

In 2005, the fund stood at around $160 million. In addition to some claim payouts, Government authorised transfers out of the fund through the Financial Industry Development Account (FIDA) to, among other things, subsidise ASIC market surveillance which depleted the fund down to around $95 million several years ago, leading to a levy on brokers to take it back above the minimum amount of $100 million. AFMA strongly supported the SEGC Board telling the Government that no more money should be transferred to FIDA in the future as this is not in the interests of possible claimants.

AFMA supports the making of the Regulations on the basis that they are in the interest of the market and consistent with objectives of the relevant part of the Corporations Act and give the fund certainty with regard to potential liabilities.

Please contact David Love if you would like to receive a copy of AFMA's submission.

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Environmental Products Information on AFMA website

Member Updates

AFMA's Environmental Products Committee has in recent meetings considered various ways in which we can provide more information to market participants to assist them with understanding how the market operates.

AFMA has now prepared a dedicated page on Environmental Products on its website. It provides a list of useful Environmental Products Information for both AFMA members and non-members who deal in Environmental products, including a review of environmental trading schemes, environmental products trading conventions and documentation.

The Committee is currently working on an environmental products settlements guide that will also likely appear on this webpage in coming weeks.

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ATO/AFMA Liaison Meeting

Member Updates

AFMA and the ATO continued their constructive dialogue with a biannual liaison meeting held on 18 April 2019. Topics for discussion included the ATO's administration of the Diverted Profits Tax and the Significant Global Entity penalty regime, the ATO's administration of the Anti-Hybrid rules, including potential areas of engagement with the AFMA member, and the ongoing Top 100/1,000 program. On the latter point, there was considerable discussion regarding the timetable for completion of the reviews and the public messaging that the ATO will make when delivering the outcomes of the program. AFMA is beginning to work with its members and the ATO to ensure that the outcomes and limitations of the program are properly understood within government and the broader community.

AFMA will continue to engage with the ATO regarding matters of importance to its members. Please contact Rob Colquhoun if you require any further information.

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ARRC Encourages the Transition Away from LIBOR to SOFR

Member Updates

The article below is reproduced for member's information.

The white paper mentioned – *A User's Guide to SOFR* – illustrates key differences between *in arrears* compounding conventions vs *in advance* when applied to overnight risk free rates (RFRs), and outlines the use of OIS derivatives in order to create a term product or hedge in the absence of a term SOFR benchmark rate. The fundamentals outlined can be applied to any overnight RFR including the RBA's Cash Rate.

Please contact AFMA's David Love or Murray Regan should you have questions.

The Alternative Reference Rates Committee (ARRC) has released a white paper to help explain how market participants can use its recommended alternative to U.S. dollar LIBOR, the Secured Overnight Financing Rate (SOFR), in cash products. This paper builds on the ARRC's work developing the Paced Transition Plan, which outlines the steps for an effective shift to SOFR.

"We have only a little over two and a half years until LIBOR could become unusable. It's crucial for the safety of the financial system, and for the many firms using LIBOR, that they not wait to begin a transition. By releasing this white paper, the ARRC shows how market participants can use SOFR and transition now," said Tom Wipf chair of the ARRC and Vice Chairman of Institutional Securities at Morgan Stanley. "We encourage market participants to begin writing contracts using SOFR instead of U.S. dollar LIBOR."

The paper makes several points:

- *SOFR is the ARRC's preferred alternative to U.S. dollar LIBOR. It has number of characteristics that LIBOR and other similar rates do not:*
  - *It is produced by the New York Fed for the public good;*
  - *It is derived from an active and well-defined market with sufficient depth to make it extraordinarily difficult to ever manipulate or influence;*
  - *It is produced in a transparent, direct manner and is based on observable transactions rather than being dependent on estimates, like LIBOR, or derived through models; and,*
  - *It is derived from a market that was able to weather the global financial crisis and that the ARRC credibly believes will remain active enough in order that it can reliably be produced in a wide range of market conditions.*

- *Financial products either explicitly or implicitly use some kind of* average *of SOFR, not a single day's reading of the rate, in determining the floating-rate payments that are to be paid or received. An average of SOFR will accurately reflect movements in interest rates over a given period and smooth out any idiosyncratic, day-to-day fluctuations in overnight market rates.*

- *Issuers and lenders will face a technical choice between using a* simple *or a* compound *average of SOFR. In the short-term, using simple interest conventions may be easier since many systems are already set up to accommodate it. However, compounded interest would more accurately reflect the time value of money and allow for more accurate hedging.*

- *Users need to determine the period of time over which the daily SOFRs are averaged. An* in advance *structure would reference an average of SOFR observed before the current interest period begins, while an* in arrears *structure would reference an average of SOFR over the current interest period.*

- *An average of SOFR* in arrears *will reflect what* actually happens *to interest rates over the period and the paper discusses a number of conventions designed to allow for a longer notice of payment within this* in arrears *framework. The note also discusses conventions for* in advance *payment structures and hybrid models that can reduce the basis relative to* in arrears*.*

The paper also explains the interaction between SOFR and the type of forward-looking term rates that the ARRC has set a goal of seeing produced once SOFR derivative markets develop sufficient depth. While these term rates can be a useful tool for some users and an integral part of the new ecosystem, hedging these rates will tend to entail more transaction costs than using SOFR directly and their use must be consistent with the functioning of the overall financial system. For this reason, the ARRC sees some specific productive uses for a forward-looking SOFR term rate, in particular as a fallback for legacy cash products referencing U.S. dollar LIBOR and in loans where the borrowers otherwise have difficulty adapting to the new environment, and believes that those who are able to use SOFR should not wait for the term rates in order to transition.

Additional information

On 30 April the ARRC issued a document to commemorate the one-year anniversary of the publication of the Secured Overnight Financing Rate (SOFR). SOFR is the rate that the ARRC selected as its preferred alternative to U.S. dollar LIBOR.

This two-page document highlights progress made since the Federal Reserve Bank of New York, in collaboration with the Office of Financial Research, began daily publication of the SOFR in 2018. Through charts and other visuals, this document highlights the evolution of liquidity in SOFR-linked markets, the development of fallback contract language, and the breadth of market participant involvement in the ARRC.

About the ARRC

The ARRC is a group of private-market participants convened by the Federal Reserve Board and Federal Reserve Bank of New York in cooperation with the Consumer Financial Protection Bureau, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Office of Financial Research, the Office of the Comptroller of the Currency, the Commodity Futures Trading Commission, the Securities and Exchange Commission and the U.S. Treasury Department. It was initially convened in 2014 to identify risk-free alternative reference rates for U.S. dollar LIBOR, identify best practices for *contract robustness, and create an implementation plan with metrics of success and a timeline to support an orderly adoption. The ARRC accomplished its first set of objectives and identified SOFR as the rate that represents best practice for use in certain new U.S. dollar derivatives and other financial contracts. It also published its Paced Transition Plan, with specific steps and timelines designed to encourage adoption of SOFR. The ARRC was reconstituted in 2018 with an expanded membership to help to ensure the successful implementation of the Paced Transition Plan, address the increased risk that LIBOR may not exist beyond 2021, and serve as a forum to coordinate and track planning across cash and derivatives products and market participants currently using U.S. dollar LIBOR.*

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IBOR Transformation update

Member Updates

AFMA's IBOR Transformation Work Group meets regularly and is engaging with the authorities on key strategic issues affecting the Australian market. The following reports give a sense of the sweep of issues that are being considered and pursued with the official sector.

Official Messages to the Market

Recently, the Reserve Bank of Australia has made statements and held an international panel event to communicate the importance of the transition away from LIBOR and its effects on the market.

International perspectives

In mid-May the RBA held a high level international session about the end of LIBOR and the impact on Australian financial markets, with Andrew Bailey (CEO, UK Financial Conduct Authority (FCA)) and Christopher Giancarlo (Chairman, US Commodity Futures Trading Commission). This provided a first-hand opportunity to hear from Bailey, the man who started the ball rolling on LIBOR transition. After covering the well known reasons for the transition he provided an official view on the current situation. He said that there is substantial consensus that the largest part of the market currently relying on LIBOR – that is the bulk of interest rate derivatives – does not need term rates. This part of the market is focused on hedging the general level of interest rates rather than term bank credit risk. It is already able to operate from a risk management perspective with the overnight risk-free rates, compounded where appropriate.

Because term rates are not needed for the bulk of the derivatives market, and because the overnight, Risk Free Rates (RFRs) are likely to be the most robust interest rate benchmarks available – since they are firmly grounded in transactions – he expects that liquidity in interest rate derivative markets will in future be OIS-based, i.e. directly linked to the overnight RFRs.

Bailey thought it is probable that with future liquidity in swaps and futures centred on these overnight RFRs, so that spreads are tightest and hedges cheapest in these RFR-based derivatives, there will be powerful incentives for other instruments, including bonds and securitisations, also to reference the overnight RFRs. On the other hand, he is also aware of the demand in cash markets for forward-looking term rates, perhaps especially in respect of smaller and medium-sized issuers, and in syndicated loan markets, where parties may decide that knowing coupon or interest payments in advance is more important to them than a few basis points in spread. So he also voiced support for the development of forward-looking term rates derived from the RFRs.

He thinks that it is quite feasible that we will in future see two centres of gravity in interest rate reference rates – the largest one, used in the bulk of interest rate derivatives, will likely be around overnight RFRs. But a segment of cash markets, and perhaps a small part of the derivatives market which directly hedges cash market instruments, may prefer term rates. Where the term rate also has the overnight RFR as its core, this will facilitate hedging with minimal basis risk.

Bailey cautioned that those for whom forward-looking term rates are not necessary or desirable, should not wait for their arrival. But the work to develop new forward-looking RFR-derived term rates could be a useful facilitator of transition in cash markets.

From the US perspective, Chairman Giancarlo pointed out that the authorities have been warning market participants of the high likelihood that LIBOR will no longer be available after 2021 for use as a reference benchmark for the global markets. He noted the growing evidence of a shift in sentiment among market participants from “why are we moving away from LIBOR” to “how do we adopt SOFR”. He believes that in the US they are making good progress as well as in other currency jurisdictions like Sterling and Swiss Franc, where the transition is well under way.

There is broad consensus that development of SOFR swaps markets will follow SOFR futures. His expectation is that in the next 12 months, both these markets – SOFR futures and swaps, as well as related debt markets – will hit critical levels where liquidity begets liquidity. Also due to the work of the ARRC, major legal and operational steps necessary for the switch from LIBOR to SOFR-based rates have been identified that are critical for the switch from LIBOR to SOFR-based rates for derivatives, loan products, mortgages, retail loans and others.

Multiple Rate Approach in Australia

RBA Deputy Governor, Guy Debelle said that in Australia, we have a ‘multiple rate approach’. The credit-based benchmark BBSW has been strengthened and coexists alongside the cash rate, which is the RFR for the Australian dollar. This has been possible since both BBSW and the cash rate are supported by underlying markets with enough transactions to calculate robust benchmarks.

He said BBSW can continue to exist even after LIBOR ends. For many financial products, it will still make sense to reference a credit-based benchmark. But as markets transition from referencing LIBOR to RFRs, there may be some corresponding migration away from BBSW towards the cash rate. This will depend on how international markets for products such as cross-currency basis swaps end up transitioning away from LIBOR. Debelle said good progress is being made on developing new market conventions for trading cross-currency basis swaps, referencing RFRs or combinations of RFRs and IBORs, to give market participants the choice.

Debelle gave three clear messages to the Australian market.

1. The end of LIBOR is approaching. Market participants should continue preparing for this by transitioning to alternative risk-free rates.
2. It is prudent for users of all benchmarks to have robust fall-back provisions in their contracts, not just those referencing LIBOR. ISDA's work on fall-backs is progressing well, and we encourage all users of interest-rate benchmarks to adopt ISDA's fall-backs once they are finalised.
3. Most jurisdictions in the Asia-Pacific region have chosen to strengthen their credit-based benchmarks. This includes Australia, where BBSW remains robust. Credit-based benchmarks can coexist alongside risk-free rates when they are supported by liquid underlying markets. Users can then choose the benchmark that is most appropriate for their circumstances.

RBA comments concerning 1-month BBSW

Member attention is drawn to the comments of RBA Assistant Governor (Financial Markets), Christopher Kent in March 2019. He said that users of 1-month BBSW should be considering alternative benchmarks given the illiquidity in the underlying market. He suggested that participants consider using other robust benchmarks that are already available rather than waiting for the development of a term risk-free rate. He cited as reasons that users of BBSW should be aware that the market underpinning the 1-month tenor is not as liquid as for the 3-month and 6-month tenors. Unlike for these longer tenors, banks have no incentive to issue 1-month bills. This is because under the liquidity standards, they would be required to hold an equivalent amount of high-quality liquid assets. The few transactions that do occur are mainly ones where investors are selling their bills back to the banks.

In subsequent discussion with RBA officials it has been made clear that the RBA is not suggesting 1-month BBSW will end, that they think it should end, or that the authorities here would take action to bring it to an end. This is in sharp contra-distinction to the UK FCA's position with regard to LIBOR. What the authorities want to emphasise to the Australian market is that market participants should continue preparing for a move to alternative risk-free rates and adopting more robust fall-back provisions in their contracts. While BBSW remains robust, it would be prudent for all users to also adopt more robust fall-back provisions for BBSW in their contracts.

Fallback provisions to be required

It is highlighted to members that Kent said that once ISDA has finalised its wording for fallback provisions, the RBA expects all users of BBSW to adopt them where possible. For new securities referencing BBSW, the RBA will make it a requirement that these fall-back provisions be adopted before the securities can be eligible in the RBA's market operations. Currently, this would affect FRNs issued by banks, securitisation trusts and the state governments.

ASIC Inquiry Letter

ASIC has written to the CEOs of major Australian financial institutions regarding their preparations for the end of LIBOR. This letter was prepared in consultation with other member of the Council of Financial Regulators. APRA has also recently written to prudentially regulated entities about their risk assessment work and preparation in relation LIBOR's demise.

The purpose of the letters is to better understand how major Australian financial institutions are preparing to transition away from LIBOR to alternative benchmarks. ASIC, APRA and RBA are seeking assurance that the senior management in these institutions fully appreciates the impact and risks and is taking appropriate action ahead of the end of 2021.

The financial regulators made clear their expectation that all institutions currently relying on LIBOR need to consider the impact of LIBOR transition on their business. In particular, users of LIBOR should:

- be aware of the size and nature of their exposures to LIBOR;
- put in place robust fall-back provisions in contracts referencing LIBOR; and
- be taking action to transition to alternative rates.

This letter was strongly endorsed by the IBOR Transformation WG as it assists communication with financial institutions that have not been engaged to date with the consequences of the transition away from LIBOR and accommodating robust fallback arrangements.

Accounting Issues Consultation

Accounting issues have been identified by the IBOR Transformation WG as a matter of priority importance for attention where benchmark changes are concerned. The International Accounting Standards Board (IASB) in recent months has been looking at these issues and has released an exposure draft for proposed amendments to IFRS 9 and IAS 39. For effect in Australia, the IFRS changes would have to be adopted into AASB 9 and AASB 39 and they have circulated a corresponding exposure draft with the support of the IFRS consultation. This consultation ends on 31 May.

The IASB has identified two groups of issues that could have financial reporting implications for changes in benchmarks. These are:

a) issues affecting financial reporting in the period before the replacement of an existing interest rate benchmark with an alternative interest rate (pre-replacement issues); and

b) issues that might affect financial reporting when an existing interest rate benchmark is replaced with an alternative interest rate (replacement issues).

The proposals set out in the Exposure Draft address only the pre-replacement issues with regard to the implications for specific hedge accounting requirements in IFRS 9 Financial Instruments and IAS 39 Financial Instruments: Recognition and Measurement, which require forward-looking analysis. As a result of the reform, contractual cash flows of hedged items and hedging instruments that are based on an existing interest rate benchmark will likely change when the existing interest rate benchmark is replaced with an alternative interest rate. Until decisions are made with respect to what the alternative interest rate is and when that replacement will occur, uncertainties will exist regarding the timing and the amount of future cash flows of the hedged items and the hedging instruments.

The IASB notes that the hedge accounting requirements in IFRS 9 and IAS 39 provide a clear basis to account for such uncertainties. These uncertainties about the timing and the amount of future cash flows could affect an entity's ability to meet specific forward-looking hedge accounting requirements in the periods before replacement. In some cases, solely due to such uncertainties, entities could be required to discontinue hedge accounting for hedging relationships that would otherwise qualify for hedge accounting. Also, IFRS Standards may prevent entities from designating new hedging relationships that would otherwise qualify for hedge accounting. Discontinuation of hedge accounting would require an entity to recognise gains or losses in profit or loss. In the IASB's view, discontinuation of hedge accounting solely due to such uncertainties before the reform's economic effects are known would not provide useful information to users of financial statements. Therefore, the IASB decided to propose exceptions to specific hedge accounting requirements in IFRS 9 and IAS 39 to provide relief during this period of uncertainty.

It is important to be aware that the IASB has not yet considered whether and, if so, how to address any issues that might affect financial reporting when an existing interest rate benchmark is replaced with an alternative interest rate, i.e. replacement issues. As more information becomes available, the IASB will assess the potential financial reporting implications of the replacement and determine whether it should take any action and, if so, what. Members need to diligently assess what these "replacement issue" financial implications may be.

ISDA Consultations

In mid-May, ISDA published two new consultations on benchmark fallbacks – one covering adjustments that would apply to fallback rates in the event certain interbank offered rates (IBORs) are permanently discontinued, and another relating to pre-cessation issues for LIBOR and certain other IBORs.

The first consultation sets out options for adjustments that will apply to the relevant risk-free rates (RFRs) if fallbacks are triggered for derivatives referencing US dollar LIBOR, Hong Kong's HIBOR and Canada's CDOR.

ISDA previously published a consultation in July 2018 seeking input on the approach for addressing certain technical issues associated with adjustments that will apply to the RFRs if the fallbacks are triggered. This consultation covered GBP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR and BBSW and requested preliminary feedback in respect of USD LIBOR amongst other IBORs. The compounded setting in arrears rate approach and the historical mean/median approach were identified as the preferred approaches for addressing certain technical issues associated with fallbacks for GBP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR and BBSW based on responses to the July 2018 Consultation.

Pre-cessation consultation

From an Australian perspective the second consultation relating to pre-cessation issues is of importance. ISDA is seeking comment on how derivatives contracts should address a regulatory announcement that LIBOR or certain other IBORs categorized as critical benchmarks under the EU Benchmarks Regulation are no longer representative of an underlying market. The pre-cessation language will have general application in ISDA Master Agreements and situations which might give rise to pre-cessation triggers have been discussed at some length by the IBOR Transformation WG. While there are theoretical scenarios which can be envisaged giving rise to a pre-cessation trigger, in practice for Australia we could only foresee event driven triggers, such as announcements by the benchmark administrators that they are ceasing publication of a benchmark and no successor will continue its publication.

AFMA intends to make comment on this second ISDA consultation.

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CPS 234 Implementation Coordination

Member Updates

AFMA finalised its submission to the CPG 234 consultation during the month. The submission was broadly supportive of the guidance which sensibly addressed some issues raised by CPS 234 (particularly the methodology approach to assessing criticality and sensitivity) and provided a picture of what a comprehensive and mature CPS 234 program might look like for a large institution.

AFMA raised concerns with the start date for the standard of 1 July 2019, which as the guidance is only out in draft form at present we viewed as very tight. Instead, it suggested that APRA should consult much earlier in its processes. While the quality APRA has achieved is high on this occasion, earlier participation from the regulated community can assist in ensuring regulations are appropriate to the realities on the ground.

Now that the consultation process is finished AFMA's Information Security Committee is turning its attention to assisting firms with the implementation challenges.

AFMA has confirmed with APRA that it considers infrastructure providers including exchanges to be third parties for the purposes of the guidance. This means that all firms will have to assess the ASX and other providers for their information security. AFMA is investigating what options might be available to pool resources in this regard to ensure an efficient outcome is achieved for the market.

The next meeting of the Information Security Committee is scheduled for 13 June. Members are welcome to send delegates to the meeting. Please contact the Secretariat if you would like to attend.

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Changes to the Interest Rate Options Conventions

Member Updates

The Interest Rate Options Committee and the Market Governance Committee have now ratified amendments to the standard transaction size conventions applicable to the interbank market. The amendments proposed were communicated to members in the February 2019 edition of the newsletter.

Effective 3 June 2019 these amendments will be codified in Section 3.4 of the IRO Conventions, as follows:

AUD millions	1y	2y	3y	4y	5y	7y	10y	15y	20y	30y
1m	200	200	100	50	50	50	25	25	10	10
3m	200	200	100	50	50	50	25	15	10	10
6m	200	100	100	50	50	50	25	15	10	10
1y	100	100	100	50	50	50	25	15	10	10
2y	100	100	75	50	50	25	25	15	10	10
3y	100	75	50	50	50	25	25	15	10	10
4y	75	75	50	50	50	25	25	15	10	10
5y	50	50	50	50	50	25	25	15	10	10
7y	50	50	25	25	25	25	25	15	10	10
10y	50	25	25	25	25	25	25	15	10	10

Members seeking further information on the amendments should contact Murray Regan.

APRA consults on APS 220 Credit Risk Management

Have Your Say

A reminder to ADI members:

APRA is proposing revisions to the credit risk management framework for authorised deposit-taking institutions: Key points from the Executive summary:

- APS 220 was last substantially updated in 2006: Since then, APRA has increased its expectations of credit standards and the ongoing monitoring and management of an ADI's credit portfolios.
- Credit risk relating to residential mortgage lending has been a key area of supervisory focus for APRA in recent years. Specific areas of prudential concern have included credit standards and particular types of higher-risk lending, such as interest-only lending.
- In regard to commercial property lending, competitive pressures have also negatively impacted credit standards.

APRA is proposing to update APS 220 to reflect the outcomes of its reviews in these areas. Of note, the new accounting standard AASB 9 Financial Instruments (AASB 9) provides for an expected loss approach to provisioning for credit losses, and while APRA's existing treatment of provisioning is also forward-looking, the existing APS 220 reflects concepts and terminology commensurate with the prior accounting incurred loss approach.

The revised standard is broader than the existing APS 220, covering credit standards and the on-going monitoring and management of an ADI's credit portfolios in more detail. The proposed requirements also include enhanced Board oversight of credit risk and the need for an ADI to maintain prudent credit risk policies, processes, practices and controls over the full credit life-cycle.

APRA is also reviewing APS 220 to take into account recent guidance issued by the Basel Committee on Banking Supervision (Basel Committee), notably, on asset classification, and sound credit risk practices associated with the implementation and ongoing application of an expected loss accounting approach.

The final report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry also identified a range of areas where the regulation and supervision of financial institutions should be strengthened. The revised APS 220 includes the recommendations relevant to the revision of APS 220 regarding the valuation of collateral taken by ADIs.

APRA intends to implement the proposed reforms to APS 220 from 1 July 2020. Submissions to this consultation are due to be submitted to APRA by **28 June 2019.** Comments to AFMA should be directed to Murray Regan not later than 7 June 2019.

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APRA consults on proposed reporting standard for derivatives activity

Have Your Say

A reminder to ADI and RFC members:

On 18 March, APRA released for consultation a draft Reporting Standard *ARS 722.0 ABS/RBA Derivatives (ARS 722.0).* ARS 722.0 will be used to collect quarterly data on the derivatives activity of authorised deposit-taking institutions (ADIs) and registered financial corporations (RFCs). This follows up on comments received in response to APRA's 2017 consultation, and addresses what the agencies see as required additional data to that collected by ASIC on derivative positions and counterparty information.

As proposed, ARS 722.0 will apply only to ADIs and RFCs whose gross derivatives positions exceed $1.5 billion. Data reported will not be subject to audit requirements as ARS 722.0 reporting does not align with statutory reporting requirements.

Submissions to APRA are due by 18 June 2019. To date we have not received feedback from member ADIs and RFCs on what may be issues arising from these proposals.

If you have comments please direct these to Murray Regan not later than 7 June 2019.

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Equity Derivatives – Takeovers Panel consults on Guidance Note 20

Have Your Say

The Takeovers Panel is undertaking a consultation on Guidance Note 20 which outlines the Panel's approach to the disclosure requirements around Equity Derivatives.

The previous version of the guidance had quite difficult drafting and the proposed revision does have some increased clarity. AFMA is preparing a submission that seeks greater clarity around the obligations of banks as writers of equity derivatives.

Submissions to the consultations are due on 31 May, members interested in contributing to the consultation should contact Damian Jeffree.

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AFMA

MEMBER NEWS

May 2019

Committee Round-up

Member Updates

AFMA's Market and Operations Committees and Working Groups play a vital role in the efficient operation of the OTC markets by developing and managing the conventions, practices and documentation that enable the conduct of OTC transactions on common terms and understandings. Market Committees are elected by their peers and are subject to oversight by the Market Governance Committee. AFMA also has a range of Policy Committees that facilitate industry discussion and action on policy and regulatory issues.

Member firms that do not have a representative on a particular committee may suggest items for inclusion on meeting agendas by contacting the AFMA Secretariat.

The summary below gives a snapshot of the issues considered and initiatives undertaken by AFMA committees over the past month.

Market & Operations Committees

Market Committee calendar Q2 meetings will follow the release of the May newsletter and will be included in June.

Operations Committee *21 May*	• Members discussed with ASX the potential of the market moving to report Repos via the ASX Repo reporting functionality rather than as single legs. Firms were surveyed about any issues following the meeting. • The Committee discussed with ASX the potential to make system changes to address settlement trade-dependency issues in the system by flagging trades as connected, and by other mechanisms. Firms were subsequently sent surveys to assist ASX move quickly in this regard. • The Operations Conventions updates were finalised and approved for publication in the coming weeks. These will replace the previous two conventions for Operations. • The meeting considered amendments to the operations sections of the Repo market conventions that would align the local practices with the recently released ICMA conventions for margining in the Repo market. Members are asked to send their firm's positions in time for a follow up discussion and potentially resolution at the next meeting of the Committee. • Members noted the consultation on Swift messages for payments by the RBA. • The Committee discussed the potential to develop a domestic Operations conference.

Debt Capital Markets Committee *22 May*	• Members noted the intention of ASIC to engage with fixed income market participants as part of their regulatory scrutiny of over-the-counter markets. • The Committee established three working groups to examine market practices and to make recommendations on initiatives to improve market efficiency.

Policy Committees

Futures Steering Committee *29 April*	• Members considered the final draft for submission on Bank Bill futures in light of the feedback received from other committees and members. • Members discussed the desirability of various tags that are being rolled out in other markets for the local market.
Risk Management Committee *30 April*	• Discussed global progress on interest rate benchmark reform and potential impacts ramifications on domestic market operations. • Discussed APRA's recent consultations on non-centrally cleared derivatives and counterparty credit risk, as well as the open consultation on APS 220 Credit Risk Management.
Taxation Committee *2 May*	• Considered the latest updates on the ATO's Justified Trust program and discussed members' experiences. • Noted changes to the ATO's governance structures for Banking & Finance; • Discussed the administration of the Anti-Hybrid rules and the implications for members.
Equity COO Committee *9 May*	• Members discussed the CHESS replacement program. • Members considered the progress of the Equity Give Ups Working Group and the necessary governance steps once a preliminary draft is completed.
ECM Legal Committee *13 May*	• Discussed d raft feedback letter to ASIC on Report 605 Allocations for settlement. • Approved ECM Terms update. • Agreed to DDPM review process. • Considered publication best practice for international selling restrictions.
IBOR Transformation Working Group *16 May*	• Meeting with RBA to discuss fall-backs, pre-cessation triggers, 1 month BBSW and overnight cash rate / AONIA and term rates. • Considered accounting issues and IASB consultation paper.
FICC Markets Compliance *21 May*	• Discussed compliance messaging coming out of the ASIC Annual Forum and looked at the ASIC FICC conduct focus. • Discussed FMSB presentation to Board meeting and the development of conduct standards. • Was briefed in IBOR transition benchmark market issues and ASIC letter to major financial institutions. • Discussed next steps with foreign financial service provider AFS licensing.

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Professionalism: Conduct & Ethics Course Update

Learning

AFMA has now launched the *Professionalism: Conduct & Ethics* course and has started taking bookings for public workshop cohorts. Initial appetite for the public workshop course has been sporadic, as member firms develop their rollout plans and individuals consider their timing options. Public cohorts have begun for Melbourne and Brisbane, and a number of members have made enquiries about delivery of the course in-house. AFMA will be releasing new public cohort dates soon for the various major centres.

A number of eligible experienced accredited individuals have enrolled in the RPL Assessment only version of the course and will be completing the assessments online without a workshop component. While it is encouraging that the RPL (Recognised Prior Learning) version has been attractive to some, we recognise that others are likely to prefer the peer-to-peer learning benefits embedded in the workshop version of the course.

Education Committees

FX Education Advisory Committee *17 April*	Reviewed two draft dealing competencies, covering pricing of transactions and the management of financial risk, for the Diploma of Financial Markets.

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