



29 September 2016

Office of the General Counsel
ASX Limited
20 Bridge St
Sydney NSW 2000

Attention: Ms Catherine Eakin

By e-mail: catherine.eakin@asx.com.au

Dear Ms Eakin

ASX OTC Interest Derivatives Clearing

This letter provides comments from the Australian Financial Market's Association (AFMA) on the ASX Consultation Paper: *ASX Interest Rate Derivatives Clearing*. The comments are focused on the proposal to recharacterise variation margin payments which will affect OTC Rules 5.8, 5.9 and 5.9 and the OTC handbook 5.8, 5.9.

In summary member feedback indicates support for the change but transitional arrangements need to provide sufficient time for a wide range of market participants to adapt to the change. Broader market communication about this change is also needed as feedback to us indicates that only a limited number of clearing participants have a good understanding of the meaning and impact of this change on internal accounting and tax arrangements.

Characterisation of variation margin payments

In the past variation margin (VM) for bilateral derivatives transactions has been treated as collateral, while in the futures market it has been accounted for as settlement. Conceptually, characterising VM as collateral, means there is a short term holding VM by one party to another as security against default, while if it is characterised as a payment to settle it goes to the profit-and-loss (P&L) when paid over. It has been the practice for cleared OTC derivatives clearing parties in a central counterparty clearing house (CCP) arrangement to exchange periodic payments on a daily basis of Variation Margin (VM) collateral. These VM payments provide a collateral mark-to-market exposure on a given day with the derivative exposure between counterparties being carried forward through the life of the

derivative contract, with its value moving over time and being collateralised by consequent VM payments.

The Basel III leverage ratio implementation has led to the need for a change in approach. The Basel Committee on Banking Supervision has answered in relation to the question¹ -

Q: What is meant by credit risk mitigation? Any collateral pledged to us should be available, however, any hedges with counterparty risk will be hard to identify. A: This requirement asks for delivery of gross positions for on-balance sheet exposures, i.e. guarantees, financial collateral or other risk mitigants are not allowed to reduce the on-balance sheet exposures. However, cash variation margin received associated with derivative transactions and fulfilling the criteria in paragraph 25 of the Basel III leverage ratio framework may be viewed as a form of pre-settlement and hence not considered as a credit risk mitigant for the purpose of the Basel III leverage ratio.

Under the settled to market approach VM payments settle outstanding exposure of the counterparties. The outstanding exposures on succeeding days are in turn covered by further VM payments and there is no net return of previous payments to the counterparty. This means outstanding exposures are settled daily and the terms of the derivatives contracts are reset to make the fair value of the contract zero. As there is a reset to zero at each settlement date the remaining maturity of the derivative then only lasts to the next settlement date which in practice means daily settlement. Accordingly, the applicable capital ratio conversion factor for less than 1 year maturities² under the present Current Exposure Method would apply to bring it down to 0% down from 0.5% or 1.5% for interest rate derivatives contracts with a more than a 1 or 5 year maturities.

The change will require market participants to work with internal and independent accountants to determine the appropriate accounting treatment for relevant exposures and payments and coordinate with impacted internal functions (e.g., tax, operations, financial reporting, risk, etc.) to reflect derivative contracts as settled to market. The ASX is therefore requested to work with participants to provide sufficient time for them to prepare for the change. In addition, broader market communication about this change is also needed as feedback to us indicates that only a limited number of clearing participants have a good understanding of the meaning and impact of this change on internal accounting and tax arrangements.

If you have any queries with regard to these comments I can be contacted on 02 9776 7995 or at dlove@afma.com.au.

Yours sincerely



David Love
General Counsel & International Adviser

¹ Basel Committee on Banking Supervision Frequently asked questions on Basel III monitoring, 22 September 2014, Part 4 Leverage Ratio Question 6 page 2.

² APRA Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk, Credit Exposure Method, Attachment C Table 1