

For information

Legislative Council Panel on Financial Affairs

**Phase 2 Clearing under the
Over-the-counter Derivatives Regulatory Regime in Hong Kong**

PURPOSE

This paper briefs Members on the proposed details of Phase 2 implementation of the clearing obligation under the over-the-counter (“OTC”) derivatives regulatory regime in Hong Kong (“Phase 2 clearing”). Such Phase 2 clearing will require amendments to the **Securities and Futures (OTC Derivative Transactions – Clearing and Record Keeping Obligations and Designation of Central Counterparties) Rules** (“Clearing Rules”) (Cap. 571AN) through making subsidiary legislation pursuant to sections 101N and 101P of the Securities and Futures Ordinance (“SFO”) (Cap. 571).

BACKGROUND

2. The Legislative Council enacted the Securities and Futures (Amendment) Ordinance 2014 to provide for a regulatory framework for the OTC derivatives market in Hong Kong to ensure our regulatory regime is compatible with market development and to meet the relevant commitments of the Group of Twenty. Among other things, the framework introduces mandatory obligations that require the reporting, clearing and trading of OTC derivative transactions. In line with other major jurisdictions, the mandatory obligations are being implemented in phases. Under Hong Kong’s OTC derivatives regulatory regime, Phase 1 and Phase 2 reporting were implemented in July 2015 and July 2017 respectively, while Phase 1 clearing was implemented in September 2016.

3. In March 2018, the Hong Kong Monetary Authority (“HKMA”) and the Securities and Futures Commission (“SFC”) jointly consulted the market on further enhancements to the OTC derivatives regulatory regime, including, among other things, the implementation of Phase 2 clearing. The proposed Phase 2 clearing mainly includes the addition of new Calculation Periods (see paragraphs 5 – 8 below) and the expansion of

product scope to include certain Australian Dollar (“AUD”) interest rate swaps (“IRS”) for mandatory clearing obligation (see paragraphs 9 – 11 below).

4. In response to the positive feedback received from the consultation conducted between March and April 2018, the HKMA and the SFC propose making amendments to the Clearing Rules as set out in the ensuing paragraphs in order to implement Phase 2 clearing under the OTC derivatives regulatory regime.

PROPOSALS

(1) Additional Calculation Periods

5. Pursuant to Rule 6 of the Clearing Rules, the clearing obligation in respect of a prescribed person¹ arises when its average total position in relevant OTC derivatives transactions in a specified period of time reaches the set clearing threshold. The specified periods of time for calculation are stipulated in the Clearing Rules as “Calculation Periods”. Currently, each Calculation Period is set at three-month intervals and the clearing threshold is set at US\$20 billion for all Calculation Periods. There were four Calculation Periods under Phase 1 clearing as stipulated in Schedule 2 to the Clearing Rules and the last Calculation Period ended on 31 May 2018.

6. If a prescribed person’s average total position during any Calculation Period reaches the clearing threshold, it must clear the relevant OTC derivatives transactions with a designated central counterparty (“CCP”) from the corresponding “Prescribed Day” onward. The Prescribed Day is set on the day that is seven months after the end of a Calculation Period, to allow preparation time for the prescribed persons to meet the new clearing obligation.

7. The proposed eight Calculation Periods to be added to the Clearing Rules, their corresponding Clearing Threshold and Prescribed Day are set out in the table below –

¹ A Prescribed Person is an authorized financial institution under the Banking Ordinance, an approved money broker under the Banking Ordinance or a licensed corporation under the Securities and Futures Ordinance.

Calculation Period	Clearing Threshold	Prescribed Day
1 March 2019 to 31 May 2019	US\$20 billion	1 January 2020
1 September 2019 to 30 November 2019	US\$20 billion	1 July 2020
1 March 2020 to 31 May 2020	US\$20 billion	1 January 2021
1 September 2020 to 30 November 2020	US\$20 billion	1 July 2021
1 March 2021 to 31 May 2021	US\$20 billion	1 January 2022
1 September 2021 to 30 November 2021	US\$20 billion	1 July 2022
1 March 2022 to 31 May 2022	US\$20 billion	1 January 2023
1 September 2022 to 30 November 2022	US\$20 billion	1 July 2023

8. We propose that the amendments effecting the additional Calculation Periods should commence on 1 March 2019 to dovetail with the commencement of the first new Calculation Period.

(2) Proposal to expand product scope to include certain AUD IRS

9. Since the implementation of Phase 1 clearing², we have reviewed data reported to the Hong Kong Trade Repository (“HKTR”) under Phase 2 reporting and kept in view the development of international practices and characteristics of our market in order to determine whether the current scope of products mandated to be cleared with designated CCPs should be suitably expanded. We note that AUD plain vanilla IRS are generally considered to be standardised contracts with fair, reliable and generally acceptable pricing sources. Also, data from HKTR show depth and liquidity for plain vanilla AUD IRS in the market with a relatively high percentage of outstanding transactions. We are also aware that imposing clearing obligation for plain vanilla AUD IRS is unlikely to cause significant negative impact on the

² Phase 1 clearing requires the clearing of certain plain vanilla IRS via designated CCPs, subject to certain conditions being met. The product scope of IRS covered under Phase 1 clearing includes (a) certain fixed-to-floating swaps denominated in HKD, USD, EUR, JPY and GBP; (b) certain basis swaps denominated in HKD, USD, EUR, JPY and GBP; and (c) certain overnight index swaps denominated in USD, EUR and GBP.

market, and that major overseas jurisdictions (including the United States and Australia) have mandated AUD IRS for clearing and designated CCPs offering such services are available. Based on the above considerations and with reference to our clearing determination process³, we consider AUD IRS a suitable product to be included in the product scope of the clearing obligation.

10. The tables below reflect the AUD IRS that will be added to the scope of products subject to clearing requirements –

Basis Swaps

Currency	Floating Rate Index	Tenor	Optionality	Constant Notional
AUD	BBSW ⁴	28 days to 10 years	No	Yes

Fixed-to-Floating Swaps (except overnight index swaps)

Currency	Floating Rate Index	Tenor	Optionality	Constant Notional
AUD	BBSW	28 days to 10 years	No	Yes

³ Under the clearing determination process, we look at the following factors when deciding whether a product should be subject to the clearing obligation – (a) whether the product is sufficiently standardised for central clearing; (b) whether there are fair, reliable and generally acceptable pricing sources for the product; (c) the nature, depth and liquidity of the market for the product; (d) the level of systemic risk posed by the product; (e) the impact to the market and market participants of imposing a clearing obligation in respect of the product; (f) whether regulators in other jurisdictions consider such product to be suitable for clearing obligation, and (g) whether any CCP authorized by the SFC offers, or is proposing to offer, services for clearing such product.

⁴ BBSW stands for the bank bill swap rate, which is a major interest rate benchmark for Australian Dollar.

Overnight Index Swaps

Currency	Floating Rate Index	Tenor	Optionality	Constant Notional
AUD	IBOC ⁵	7 days to 2 years	No	Yes

11. The HKMA and the SFC are monitoring developments in the market and factors which may affect the clearing landscape before confirming the effective day of expanding the product scope to include certain AUD IRS for clearing obligation. Market participants and CCPs will be given adequate time (say, 12 months after gazettal) to get ready before the implementation of the requirement.

PUBLIC CONSULTATION

12. The SFC and HKMA jointly conducted a public consultation from March to April 2018 on, among other things, the proposed amendments to the Clearing Rules, and issued a consultation conclusions paper in June 2018. We received positive support from the respondents with regard to the above proposals, and will take into account their responses when finalizing the amendments to the Clearing Rules.

WAY FORWARD

13. We aim to table the necessary subsidiary legislation for effecting the additional Calculation Periods before the Legislative Council for negative vetting in Q4 2018. Pending the confirmation of the effective day of expanding the product scope to include certain AUD IRS for clearing obligation, we will table the necessary subsidiary legislation before the Legislative Council separately in due course.

14. Members are invited to note the content of this paper.

**Hong Kong Monetary Authority
Securities and Futures Commission
31 October 2018**

⁵ IBOC is the RBA's Interbank Overnight Cash reference rate (also known as RBA30). It is sometimes being referred to as AONIA-OIS outside of Australia.