CONSULTATION ON ASSESSING SUFFICIENT EQUIVALENCE

MAY 2009

CONTENTS

Reserve Bank

ISBN: 978-0-9805857-3-5 (ONLINE)

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1. Introduction

In February 2009, the Reserve Bank announced a variation to the *Financial Stability Standard for Central Counterparties* to give effect to an oversight regime for overseas central counterparties. Under this regime, any central counterparty licensed under the alternate licensing regime for overseas facilities will be exempt from full assessment against the Standard, on the condition that it is able to provide documentary evidence from its overseas regulator that it meets all relevant requirements. A licence may be granted under this alternate regime where the applicant is deemed to operate under a 'sufficiently equivalent' regulatory regime in its home jurisdiction.

The Reserve Bank commited to working with the Australian Securities and Investments Commission (ASIC) to establish guidance on how 'sufficient equivalence' would be assessed, noting that this process would involve consultation with the industry.[1] This Consultation Document sets out the Reserve Bank's preliminary views on this matter, covering only the aspects of sufficient equivalence that relate to the Reserve Bank's regulatory responsibilities; that is, sufficient equivalence in relation to the degree of protection from systemic risk.

The document is structured as follows. Section 2 provides some background to the relevant legislation and related regulatory guidance produced by ASIC. Section 3 then articulates the key elements of the Reserve Bank's proposed approach to assessing sufficient equivalence. Section 4 closes with some key issues for respondents.

Interested parties are invited to make submissions by 19 June 2009. Submissions will be placed on the Reserve Bank's website and those making submissions will be offered the opportunity to discuss their views with Reserve Bank staff. Submissions should be sent to:

Head of Payments Policy Department or pysubmissions@rba.gov.au
Reserve Bank of Australia
GPO Box 3947
Sydney NSW 2001

2. Background

Under Section 820A of the *Corporations Act 2001* (the Act), a person operating a clearing and settlement (CS) facility in Australia is required either to hold an Australian CS facility licence or be granted an exemption from the licensing requirement.

A licence may be granted under Section 824B(1) of the Act if, among other things, the Minister for Superannuation and Corporate Law is satisfied that 'the applicant has adequate operating rules, and procedures, for the facility to ensure, as far as is reasonably practicable,

1 *See http://www.rba.gov.au/MediaReleases/2009/mr_09_03.html*

that systemic risk is reduced and the facility is operated in a fair and effective way.' If, however, the applicant is authorised to operate a CS facility in the foreign country in which its principal place of business is located, it can apply for a licence under Section 824B(2) of the Act. A licence may be granted under this alternate regime at the Minister's discretion, and only if the applicant satisfies certain requirements, including that it is subject to a regulatory regime in its principal place of business that is sufficiently equivalent to that in Australia 'in relation to the degree of protection from systemic risk and the level of effectiveness and fairness of services' it achieves.[2]

The term 'sufficient equivalence' is not defined in the legislation. In 2002, ASIC published Regulatory Guide 54 (RG 54), *Principles for cross border financial services regulation*, which articulates a general approach to regulating foreign providers and foreign facilities, services and products. Among the ten principles set out in RG 54, four (Principles 7-10) relate specifically to establishing whether an overseas regulatory regime is equivalent to that in Australia. In particular, according to RG 54, an overseas regime is sufficiently equivalent where it:

- is clear, transparent and certain (Principle 7);
- is consistent with the relevant international principles (Principle 8);
- is adequately enforced in the home jurisdiction (Principle 9); and
- achieves the outcomes that are achieved by the Australian regulatory regime for comparable domestic markets (Principle 10).

RG 54 (Section 4.13) suggests that the 'outcomes' achieved by an overseas regime for CS facilities will be deemed equivalent to those achieved by the Australian regime, if:

- the clearing and settlement process operates reliably and is not at risk of failing;
- users of CS facilities are confident that the facility operates fairly and that settlement obligations will be met;
- the facility and its participants are properly supervised so that breaches of the law or the facility's rules are likely to be detected and disciplined; and
- systemic and other risks relating to default are anticipated and appropriately dealt with.

Under the Act, the Reserve Bank has responsibility for oversight of licensed CS facilities in respect of matters relating to financial stability. In particular, the Reserve Bank has determined *Financial Stability Standards* with which CS facility licensees must comply on an ongoing basis, and against which a formal assessment is carried out at least once a year.

RG 54 predates the *Financial Stability Standards*, which were determined by the Reserve Bank in 2003. There is, therefore, a case for establishing specific regulatory guidance as to how, in practice, the Reserve Bank would assess sufficient equivalence with the protections afforded

2 *Section 827A of the Act specifies a number of matters that the Minister must consider in deciding whether to grant a licence. These include any relevant advice received from ASIC or the Reserve Bank. In some circumstances, perhaps where an overseas applicant was seeking a licence under Section 824B(2) to operate a facility to serve a particularly large or systemically important market in Australia, the Reserve Bank could advise the Minister that licensing under the alternate regime for overseas facilities was not appropriate – notwithstanding sufficient equivalence – and that the applicant should apply for a licence under Section 824B(1). Under such circumstances, the exemption under the varied* Financial Stability Standard for Central Counterparties *would not apply and the licensee would be assessed in full against the Standard.*

by the *Financial Stability Standards*. The approach outlined below builds upon the principles established in RG 54.

3. An Approach to Assessing Sufficient Equivalence

In considering the sufficient equivalence of an overseas regulatory regime in relation to protection from systemic risk, the Reserve Bank proposes that the following be taken into account:

- The **clarity and coverage** of stability-related principles applied by the overseas regulator relative to the Standards.
- The nature and intensity of the overseas regulator's **oversight process**, including direct comparison with the regime applied by the Reserve Bank.
- **Observed outcomes** relative to those in Australia, as reflected in an initial assessment of clearing and settlement facilities operating under the relevant overseas regime.

The overseas regime will need to demonstrate sufficient similarity to the Australian regime in all three aspects if it is to be judged sufficiently equivalent in relation to protection from systemic risk.

3.1 Clarity and coverage

The scope and coverage of the Reserve Bank's regime is clearly set out in the *Financial Stability Standard for Central Counterparties* and the *Financial Stability Standard for Securities Settlement Facilities*. In each case the Standard sets out a licensee's obligations, as follows: 'a CS facility licensee must conduct its affairs in a prudent manner, in accordance with the standards of a reasonable CS facility licensee in contributing to the overall stability of the Australian financial system, to the extent that it is reasonably practicable to do so.'

Each Standard is supported by a set of minimum measures which the Reserve Bank considers relevant in determining whether a CS facility licensee has met the Standard. The measures are principles based, but supported by detailed guidance to assist both the licensee and the Reserve Bank in assessing compliance.

Given this approach, in assessing sufficient equivalence in respect of clarity and coverage, the overseas regime would be expected to exhibit the following:

- A clearly articulated and easily understood approach to assessing a licensee in relation to matters affecting stability, perhaps in the form of a set of principles or standards.
- A high degree of overlap in the broad coverage of such principles and the measures underpinning the relevant Standard. Where there are gaps, the Bank would expect to be able to assess equivalence by objective reference to rules and procedures.

This approach is consistent with that developed by ASIC in RG 54 (Principle 8, Section 4.4), under which ASIC deems an overseas regulatory regime to be equivalent where it shares a similar regulatory philosophy and is, at least at a high level, equivalent.

3.2 Oversight process

The Reserve Bank is required by the Act to report to the Minister each year on how each CS facility licensee that it oversees complies with the Standards and whether it is doing all other

things necessary to reduce systemic risk. To that end, the Reserve Bank carries out a formal annual assessment of CS facility licensees against the Standards, publishing its findings. It also conducts formal operational and executive liaison meetings with CS facility licensees, imposes formal quarterly data and business reporting requirements (and risk-management reporting for central counterparties), and maintains a regular ongoing dialogue in respect of material developments.

Given the features of the oversight process in place in Australia, an overseas regulator's oversight process would be judged to be sufficiently equivalent if it demonstrated the following:

- An established framework for ongoing formal assessment against stability-related principles, with reviews undertaken at a reasonable frequency.
- Evidence of regular dialogue with CS facility licensees on matters related to stability.
- A well defined process for communication of material changes and evidence of dialogue and follow up by the overseas regulator.
- Adequate enforcement capability, perhaps underpinned by legislation, with appropriate procedures to ensure that principles and standards are reliably applied.
- Adequate arrangements for information-provision by the licensee, including clearly stated and appropriate data and business reporting requirements.
- In the case of central counterparties, regular and appropriate monitoring of risk-management processes and outcomes.

ASIC's focus has typically been on the outcomes achieved by a foreign regulatory regime rather than the regulatory mechanisms adopted by foreign regimes to achieve those outcomes (RG 54, Section 3.8). Nevertheless, as a practical matter, some assessment of mechanisms and approach is necessary, for instance to gauge the likelihood that a breach of the law or the facility's rules will be detected or that the crystallisation of a systemic risk will be anticipated. The approach articulated here also encompasses the expectation in RG 54 that standards are adequately enforced.

3.3 Observed outcomes

Finally, the Reserve Bank proposes an outcomes test. A similar test is envisaged in RG 54.

The outcomes test proposed in the context of protection from systemic risk would involve an initial assessment by the Reserve Bank of the CS facility licence applicant against the measures underpinning the relevant *Financial Stability Standard*. Such an exercise would draw on publicly available information, including rules and procedures, regulatory compliance reports, and self-assessments, supplemented with information provided by the applicant (and its overseas regulator) in the context of its licence application. Evidence of a high level of compliance with the measures underpinning the Standards would indicate that the overseas regulatory regime was designed to achieve broadly equivalent outcomes to those of the Australian regime in relation to operations, structures and risk-management approaches.

To complement the initial assessment of the licence applicant, a similar exercise would also be conducted (where applicable) for a sample of other CS facilities operating under the same overseas regime. The objective here would be to validate whether the observed outcomes for

the licence applicant were illustrative of those generally achieved under the regime in question. Since the Reserve Bank would have no jurisdiction to request additional information from these facilities, such supplementary assessments would be conducted at a higher level, using only publicly available information.

Should this exercise reveal that CS facilities operating in the relevant overseas regime typically achieve outcomes consistent with the measures underpinning the relevant *Financial Stability Standard*, the overseas regime might, other things being equal, be deemed sufficiently equivalent to the Australian regime.

4. Key Issues for Respondents

The Reserve Bank invites comments on any aspect of this Consultation Document. Interested parties might, however, wish to consider the following issues in particular:

- The general approach proposed for assessing sufficient equivalence in relation to the degree of protection from systemic risk.
- Practical issues in assessing the degree of overlap in the coverage of standards or principles underpinning the Australian and overseas regimes.
- Practical issues in assessing overall sufficient equivalence should a regime appear stronger in some respects (eg, a more intensive oversight process), but weaker in others (eg, a less formal assessment process, lack of legislative backing in enforcement, or more general principles/standards).
- Practical issues in carrying out the outcomes test to gauge the sufficient equivalence of outcomes.