REGULATION IMPACT STATEMENT FOR THE FINANCIAL STABILITY STANDARDS

Background

In 2001, Parliament enacted the *Financial Services Reform Act*, which *inter alia* created a new licensing regime for clearing and settlement (CS) facilities in Australia. The new regime gives certain responsibilities to the Reserve Bank of Australia, consistent with its broad mandate for the smooth functioning of the payments system and for financial system stability.

The Reserve Bank has formal responsibility for ensuring that CS facilities conduct their affairs in a way that is consistent with financial system stability. As part of this role, the Reserve Bank is empowered to set and monitor compliance with financial stability standards for CS facilities. These powers are set out in section 827D of the *Corporations Act* ("the Act"):

> 827D (1) The Reserve Bank of Australia may, in writing, determine standards for the purposes of ensuring that CS facility licensees conduct their affairs in a way that causes or promotes overall stability in the Australian financial system.

This Regulation Impact Statement sets out the issues involved in establishing standards for CS facilities, the options considered by the Reserve Bank in carrying out its responsibilities under the Act, and the analysis and consultation undertaken. It then details the financial stability standards which have been determined by the Reserve Bank, and how they will be implemented.

Issues

Facilities that clear and settle transactions in securities such as bonds and equities, and in derivative instruments such as options and futures, are a critical part of Australia's financial architecture. The efficient and safe operation of these "back office" functions helps to ensure that disturbances, of external or domestic origin, do not spread throughout the financial system.

Clearing and settlement takes place after market participants have entered into a transaction in a financial instrument (e.g., a security or a derivative). *Clearing* is the process of transmitting and reconciling instructions following the transaction, and calculating the obligations to be settled. Clearing may involve the netting of obligations and also the "novation" of the original trade to a central counterparty. *Settlement* is where the obligations of parties to the transaction are discharged. In a securities transaction, this typically involves the delivery of a security in return for payment; in a derivatives transaction, it usually involves only a one-way payment.

Clearing and settlement can be completed on a bilateral basis between the parties to the transaction but, in many circumstances, the process is conducted under the rules of an organised body. In Australia, a "clearing and settlement facility" is an organisation that provides a regular mechanism for parties involved in financial product transactions to meet their obligations to each other, and is required to hold a clearing and settlement facility licence under the Act.

There are currently two major operators of CS facilities in Australia: the Australian Stock Exchange (ASX) and the Sydney Futures Exchange (SFE). Both the ASX and the SFE offer a facility that acts as a central counterparty, and also a facility that acts as a settlement system.

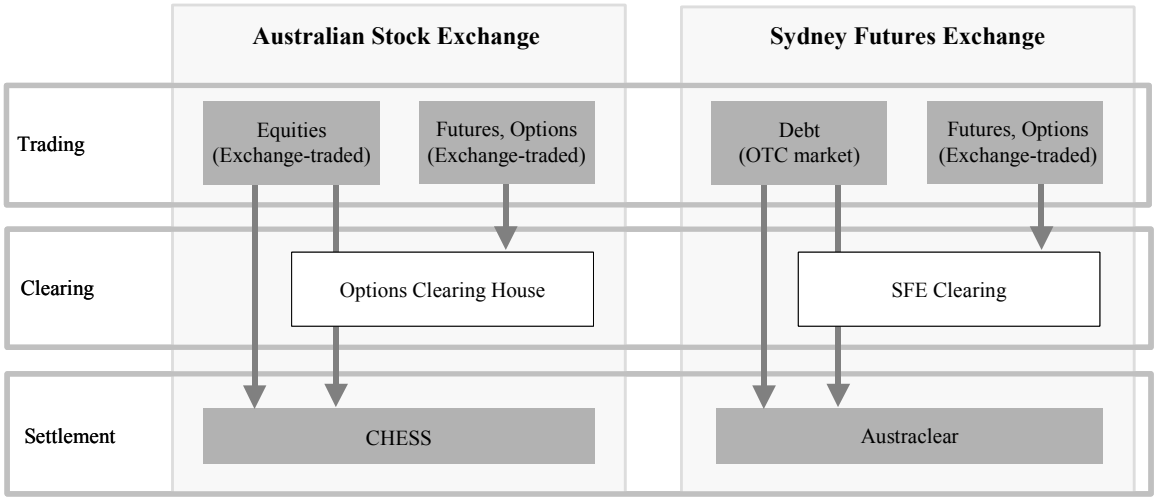
Central counterparties interpose themselves between the two parties to a trade and become the buyer to every seller and the seller to every buyer. As such, they become parties to trades and take on the same risks as any other market participant. This role means that central counterparties have exposures to, or claims on, every other participant in their facility. As a result, their ability to meet

all their obligations is critical to the stability of the financial system. In Australia, the Options Clearing House (OCH) acts as a central counterparty for some transactions undertaken on markets operated by the ASX, as does the SFE Clearing Corporation (SFECC) for futures and options and some debt transactions.

Securities settlement or "scorecard" facilities maintain a record of title to securities and ensure that title changes take place according to instructions from the seller of the securities. Their main purpose is to record changes in ownership; in contrast to central counterparties, the systems do not become a counterparty to the trades they record. In Australia, there are two scorecard facilities – the CHESS system for equities which is owned by the ASX and the Austraclear system for debt securities which is owned by the SFE.

The following diagram illustrates these arrangements, and the table below indicates the volume and value of transactions cleared and settled through these facilities. These values are substantial. If converted to daily averages, the values (albeit notional for derivatives) are equivalent to around 10 per cent of Australia's GDP. As a consequence, a major disruption or participant failure in these facilities is likely to have substantial flow-on effects to the Australian financial system as a whole.

Australia's clearing and settlement facilities



Values and volumes cleared and settled in Australia
2000/01

Facility	Volume per year ('000)	Value per year ($bn)
Austraclear	294	4,540[a]
CHESS	14,797	391
SFECC	31,277	11,159[b]
OCH	9,508	102[b]

Source: EMEAP Red Book Statistical Tables.

a. Austraclear volumes and values include statistics for CGS which were settled in RITS at that time.

b. Figure represents notional turnover rather than actual settlement values.

As noted by the international bodies, the CPSS and IOSCO:

> Weaknesses in securities settlement systems can be a source of systemic disturbances to securities markets and to other payment and settlement systems. A financial or operational problem at any of the institutions that perform critical functions in the settlement process or at a major user of a system could result in significant liquidity pressures or credit losses for other participants. Any disruption of settlements has the potential to spill over to any payment systems used by the system or any payment systems that use the system to transfer collateral. In the securities markets themselves, market liquidity is critically dependent on confidence in the safety and reliability of the settlement arrangements; traders will be reluctant to trade if they have significant doubts as to whether the trade will in fact settle.[1]

Although the likelihood of systemic disturbance is low,[2] the potential cost is very high, should such a disruption occur. For example, the failure of a major financial institution during circumstances of market instability could not only result in losses for investors, but also any depositors of that institution, and indeed investors and depositors of other institutions which had large exposures to the failed institution.

Objective

The objective of the Reserve Bank's financial stability standards is set out in the Act. Under s827D(1), the Reserve Bank may, in writing, determine standards for the purposes of ensuring that CS facility licensees conduct their affairs in a way that causes or promotes overall stability in the Australian financial system.

Options

Three options are available to the Reserve Bank:

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[1] CPSS/IOSCO, *Recommendations for securities settlement systems*, November 2001, Basel, page 1. CPSS refers to the Committee on Payment and Settlement Systems at the Bank for International Settlements and IOSCO to the International Organization of Securities Commissions.

[2] Estimates of the probability of CS facility failure are extremely difficult to make, but some indication of the likelihood can be gleaned from the fact that clearing house failure is rare internationally, but has actually occurred: examples identified by Hills, Rule, Parkinson and Young in "Central counterparty clearing houses and financial stability" in Bank of England, *Financial Stability Review*, June 1999, London are the Caisse de Liquidation in Paris (1974); the Kuala Lumpur Commodity Clearing House (1983); and the Hong Kong Futures Guarantee Corporation (1987).

Option I: No regulatory action

The legislation does not impose an obligation on the Reserve Bank to issue financial stability standards. Under s821A(aa) of the Act, a CS facility licensee must, to the extent that it is reasonably practicable to do so:

i. comply with the Reserve Bank's financial stability standards; and

ii. do all other things necessary to reduce systemic risk.

In the absence of financial stability standards, this obligation is reduced to the second limb ("all other things …"). In order to meet this obligation, licensees would have to:

- identify sources of systemic risk both in their operations and those outside of their operations which they nonetheless have the ability to mitigate;
- form a view on which of those risks it would be reasonably practicable to mitigate; and
- identify the optimum means by which those risks could be mitigated.

Option II: Issue a standard to be met by all clearing and settlement facilities

The Reserve Bank may issue a standard to be complied with by all CS facility licensees under s827D(2)(a) of the Act. The standard would apply to all facility licensees regardless of the function they perform.

Option III: Issue separate standards for central counterparties and securities settlement facilities

The Reserve Bank may issue standards to be complied with by specific classes of CS facility licensees under s827D(2)(b) of the Act. This approach would allow the standards to vary according to the function of the facility. As explained in section 2 above, the clearest distinction in the risks and functions undertaken by clearing and settlement facilities is that between the activities of a central counterparty and of a securities settlement facility.

Impact analysis

The impact of the options considered by the Reserve Bank would fall on the following parties:

- clearing and settlement facility licensees;
- participants of clearing and settlement facilities and, indirectly, investors in financial products; and
- the community as a whole, to the extent that the financial stability standards address systemic risk in the Australian financial system.

Each of the Options considered would involve direct costs to the Reserve Bank as regulator but, irrespective of the Option taken, these will be relatively low and will be met with existing resources.

Option I: No regulatory action

A potential benefit under this option is that CS facility licensees have greater freedom in terms of the measures they take to reduce systemic risk. Nonetheless the steps, as identified in the outline of

Option I, a CS facility licensee would have to take in order to meet the "second limb" obligation in the absence of standards would give rise to a number of costs for CS facility licensees and the Australian financial system more generally:

- meeting the steps would require each licensee to make subjective judgements, with no independent guidance, on which issues it should address and their relative importance. The regulator could challenge these judgements. For example, without the guidance of the standards, a licensee may unwittingly find itself in breach of the Corporations Act because the regulator holds a different view on the appropriateness of its risk controls. Because of the regulator's view on the significance of the breach for financial instability, the regulator could call for immediate rectification of the breach, a change which would come at a considerable cost to both the licensee and its participants. The standards bring a degree of transparency which might not have otherwise been there;

- for this reason, there could be no assurance that the actions of CS licensees would be sufficient to ensure an appropriate reduction in systemic risk and a strengthening of the resilience of the financial system to shocks. Without the guidance of the regulator, it is difficult to see how the licensee could objectively judge how well it had met its legislative obligation to do all things reasonably practicable to reduce systemic risk;

- if the Australian Securities and Investments Commission (ASIC) or the Reserve Bank were to find that a CS facility has not met the "second limb" test, ASIC may issue a direction to the facility to take action. Such a direction may harm the reputation of that CS facility and of the Australian financial system more generally; and

- in the absence of financial stability standards, Australia's clearing and settlement facilities may be viewed internationally as inadequately regulated. An international consensus regarding minimum standards for the reduction of systemic risk in clearing and settlement has been emerging since the November 2001 CPSS/IOSCO publication, "Recommendations for Securities Settlement Systems". In January 2003, the Group of Thirty (G30) published its recommendations on central counterparties.[3] In addition, the CPSS/IOSCO framework is used by the International Monetary Fund (IMF) in its Financial Sector Assessment Program (FSAP). Whilst licensees may gain some useful insights into how they might go about reducing systemic risk, the international minimum standards are generic and do require country specific implementation.

Option II: A single standard for clearing and settlement facilities

The Reserve Bank could set a single financial stability standard that would apply to all CS facility licensees. Compared with Option I, the benefits of this approach are:

- licensees would be aware of the generic sources of systemic risk that the Reserve Bank believes need to be addressed and can be addressed in a reasonably practicable way;

- CS facility licensees would be aware of the specific minimum actions they are required to take to reduce systemic risk; and

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[3] Group of Thirty, *Global Clearing and Settlement: A Plan of Action.* The Group of Thirty is a private, non-profit international body composed of senior representatives of the private and public sectors and academia.

- licensees would have an objective test against which they could measure their efforts to do all things necessary to reduce systemic risk – an approach which reduces uncertainty for the licensees.

CS facility licensees and the economy in general would benefit from the reduction of systemic risk and the improved resilience of the financial system that is likely to result from comprehensive regulation of Australian CS facilities via a standard issued by the Reserve Bank. In addition, the standing of the Australian financial system would benefit, relative to Option I, as an assessment by the IMF that the regulatory regime for CS facilities lacks transparency and is as a matter of practice unworkable for the licensees, would have the potential to harm the standing of the Australian financial system.[4]

The possible costs to licensees of Option II are:

- compliance may require changes in the operations of CS facilities, which may involve investment on behalf of both CS facilities and their participants. However, due to the generic requirement to reduce systemic risk under section 821A(aa)(ii) of the Act, there is a high probability that such costs would have been, or would have to be, incurred anyway; and

- a single standard for all CS facility licensees would need to cover the functions of both central counterparties and securities settlement facilities. In complying with the standard, a central counterparty, for example, would need to determine whether its operations were also required to meet measures directed at securities settlement facilities. This does not appear to be an efficient form of regulation, since as discussed in Section 2, there are substantial differences between central counterparties and securities settlement facilities in the functions they performed and the risks they incur.

Option III: Separate standards for central counterparties and securities settlement facilities

Under this approach, separate standards would be determined that would address the unique risks stemming from the operations of central counterparties on the one hand, and securities settlement facilities on the other. Targetting the standards in this way would address the inefficiencies inherent in a single standard that seeks to cover the very different risks and functions of the two types of CS facilities. Otherwise, the benefits and costs for Option III are the same as Option II: the principal benefit being the certainty provided for the licensees by a structured framework for addressing systemic risk.

Consultation

Under the Act, the Reserve Bank must consult with the CS facility licensees that will be required to comply with the standard, and with ASIC.

The Reserve Bank released draft financial stability standards for public comment on 28 November 2002. Copies of the standards were provided to current and prospective CS facility licensees, as well as to ASIC and Treasury. The standards were also made available on the Reserve Bank's website. Interested parties were requested to provide comments on the draft standards by 31 January 2003.

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[4] See for example the discussion in CPSS/IOSCO, *Assessment methodology for "Recommendations for Securities Settlement Systems"* November 2002, Basel, page 24.

The Reserve Bank received submissions from four parties. Meetings were held to discuss the submissions and to consider suggested changes to the wording of the standards. A range of constructive comments made in the submissions were adopted in the final standards. All submissions were broadly supportive of the standards.

This public consultation process was preceded by informal consultation with interested parties to obtain initial feedback on the Reserve Bank's proposed course of action. This helped the Reserve Bank to refine the draft standards prior to their release for public comment.

Conclusion and Option Chosen

In the light of the impact analysis, the Reserve Bank has decided to adopt Option III to meet its responsibilities under the Act. Option III is judged superior to Options I and II, and will enable Australia to consolidate its reputation as a well-regulated jurisdiction in the area of clearing and settlement. The decision to adopt Option III has been endorsed in principle by the Payments System Board of the Reserve Bank.

The Reserve Bank's financial stability standard for a central counterparty requires that it "… conduct its affairs in a prudent manner, in accordance with the standards of a reasonable clearing and settlement facility licensee in contributing to the overall stability in the Australian financial system, to the extent that it is reasonably practicable to do so". The Reserve Bank has set out a number of minimum requirements, and associated measures to be taken, which it considers are relevant in determining whether a clearing and settlement facility has met the standard. The requirements include:

- a well-founded legal basis;
- participation requirements that promote safety and integrity and ensure fair and open access;
- identification of the impact the facility has on the financial risks incurred by participants;
- settlement arrangements that ensure that exposures are clearly and irrevocably extinguished on settlement;
- appropriate systems, controls and procedures to identify and minimise operational risk; and
- reporting to the Reserve Bank.

There are also measures that are specific to central counterparties because of the risks they assume through novation. These address the nature and scope of novation; the risk-control arrangements of the central counterparty; default procedures when a participant is unable to fulfil its obligations to the central counterparty; and governance arrangements.

The Reserve Bank's financial stability standard for securities settlement facilities has the same objective as that for central counterparties, viz. that the licensee must conduct its affairs in a prudent manner and in a way that contributes to the overall stability of the Australian financial system. The Reserve Bank has also set out a number of minimum requirements that are common for both central counterparties and securities settlement facilities. Other measures, however, are specific to securities settlement facilities because of the "scorecard" nature of their business. These address, for example, the certainty of title to securities for participants and the mechanisms for dealing with the external administration of a participant.

Implementation

Consistent with the Act, the standards will be gazetted. The standards will also be published, along with associated measures and guidance notes intended to assist CS facilities with compliance. The publication will be available on the Reserve Bank's website (www.rba.gov.au) and hard copies will be provided to the CS facilities concerned and to other interested parties.

Since compliance with the standards may require CS facilities to undertake system changes, the Reserve Bank will provide for transitional arrangements as appropriate, and existing licensees were invited to apply for transitional relief. One licensee applied, and the Reserve Bank is in the process of discussing transitional arrangements with it. Once these arrangements have been agreed, they will be made public. Subject to the transitional arrangements being agreed beforehand, the standards will take effect upon gazettal.

The Payments System Board is required to report to the Minister annually on the development of standards, and any changes made to the standards. In addition, the Reserve Bank is required to conduct an assessment, at least once a year, on the extent to which facilities have complied with the standards, and must submit a report on this assessment to the Minister. These two channels of Ministerial reporting will provide regular review of the appropriateness of the standards. In addition, it is open for the Payments System Board to review the standards in the light of experience and developments in clearing and settlement.

Reserve Bank of Australia
SYDNEY
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