

Oversight of Clearing and Settlement Facilities

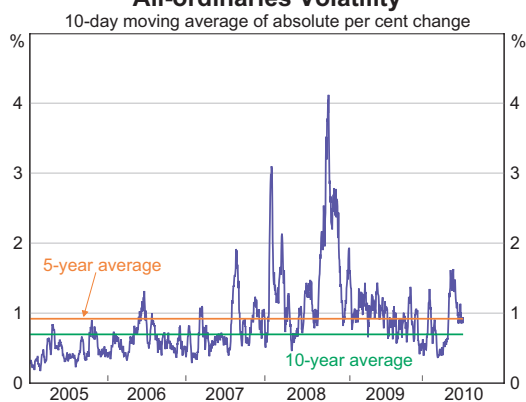
The Reserve Bank Act assigns responsibility to the Payments System Board for ensuring that the powers and functions of the Reserve Bank relating to the oversight of clearing and settlement (CS) facilities under the Corporations Act are exercised in a way that ‘will best contribute to the overall stability of the financial system’.

Under the Corporations Act, CS facilities licensed to operate in Australia are required to comply with financial stability standards set by the Reserve Bank.⁷ Four licensed CS facilities, all owned by the Australian Securities Exchange (ASX), are currently required to meet the Reserve Bank’s *Financial Stability Standards*.⁸

- ASX Clear (formerly Australian Clearing House) – the central counterparty (CCP) for cash equities, pooled investment products, warrants, certain interest rate products and equity- and commodity-related derivatives traded on the ASX market;
- ASX Clear (Futures) (formerly SFE Clearing Corporation) – the CCP for derivatives traded on the ASX 24 market (formerly the SFE market);
- ASX Settlement (formerly ASX Settlement and Transfer Corporation) – the settlement facility for cash equities and warrants traded on the ASX market; and
- Austraclear – the settlement facility for fixed-income securities traded in OTC markets.

While assessment is ongoing throughout the year, the Board conducts a formal assessment of each facility’s compliance with the Financial Stability Standards once a year. The assessments covering the 2008/09 financial year were published in September 2009.

Graph 16
All-ordinaries Volatility



Source: Bloomberg

Developments in Clearing and Settlement over 2009/10

Volatility in financial markets declined over most of 2009/10 as the global financial system recovered from the severe dislocation experienced in late 2008 and early 2009. Average volatility, as measured by the absolute per cent change in the S&P ASX All-ordinaries index, almost halved from 1.5 per cent in 2008/09 to 0.8 per cent in 2009/10, although there was an increase in volatility towards the middle of 2010 associated with concerns about sovereign credit risk in Europe (Graph 16). Concomitant with the reduction in volatility, both the value and volume of trades in

⁷ These standards, along with minimum measures relevant to meeting the standards and guidance on their interpretation, are available at: <http://www.rba.gov.au/payments-system/clearing-settlement/standards/index.html>.

⁸ An additional licensed facility, IMB Limited, falls outside the scope of the Financial Stability Standard for Securities Settlement Facilities due to its small size and the limited nature of its operations. The licensed ASX entities (other than Austraclear) were renamed with effect from August 2010.

the cash equity market increased significantly in 2009/10. The average daily value of turnover in the cash equities market increased by 21 per cent in the year – although part of this increase reflected higher share prices.

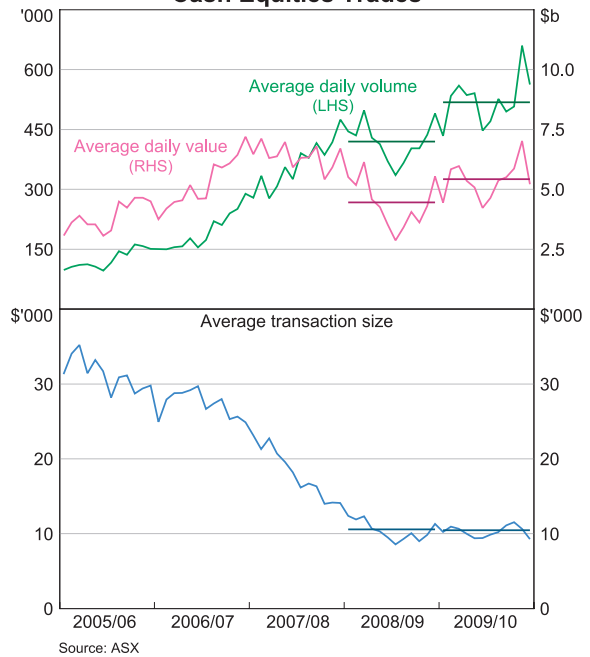
In the main, however, the strong growth in trading activity in 2009/10 reflected the reduction in perceived risk as the recovery in global financial markets progressed. Growth in the average daily number of trades was slightly stronger than in the value of trades, at 24 per cent in 2009/10, so that the average trade size fell slightly (Graph 17). The average trade size fell by only 3 per cent in 2009/10, compared with substantial falls in earlier years reflecting the long-term trend towards breaking up large orders for gradual release into the market and the share price falls over 2007 and 2008. Higher share prices since early 2009 have helped contribute to the stabilisation in average trade size over that period.

Activity in the ASX and ASX 24 derivatives markets also increased in 2009/10 in line with the recovery in global financial markets. Volumes traded on the ASX 24 market grew by 19 per cent. Volumes traded on the smaller ASX derivatives market grew by 14 per cent.

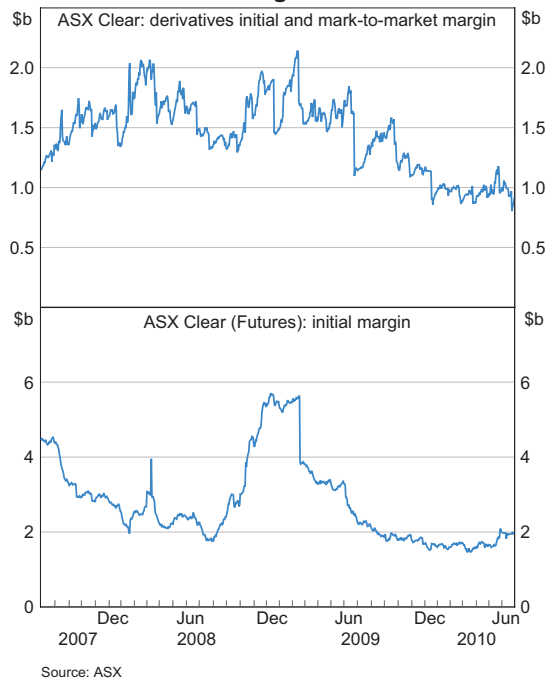
The net effect of the offsetting influences of reduced volatility and increased volume was that the risks faced by the CCPs decreased during 2009/10. ASX Clear's average daily exposure to participants' settlement obligations arising from cash equities trades on the ASX market decreased by 10 per cent to \$889 million.⁹ Risks faced by the CCPs in the derivatives market also fell in 2009/10. Both ASX Clear and ASX Clear (Futures) generally reduced initial margin rates for derivatives over 2009/10. As a result the daily average initial and mark-to-market margin collected by ASX Clear fell by 31 per cent to \$1.1 billion (Graph 18). Initial margin collected in respect of trades on the ASX 24 market fell by 51 per cent to \$1.8 billion.

The value of securities transactions settled by ASX Settlement increased by 6 per cent in 2009/10 to an average daily value of \$8.5 billion. (The growth in the

Graph 17
Cash Equities Trades



Graph 18
Margins



⁹ The daily exposure faced by ASX Clear arises from unsettled trades through the three-day settlement cycle. ASX Clear's average total settlement exposure from a single day's trades was \$421 million in 2009/10, down by 10 per cent from the previous year.

value of transactions settled differs from the growth in the value of securities traded because it includes settlement of non-market transactions and multilateral netting of clearing participants' obligations.) In contrast, the average daily value of debt securities settled through Austraclear edged downwards by 1 per cent to \$41.8 billion. (This includes outright purchases and sales of securities, and securities transferred to effect a repurchase agreement.)

Another major development this year was the prospect of competition between operators of equity market trading platforms. In response to the prospect of approved market operators (AMOs) entering the Australian market, ASX has announced the creation of a Trade Acceptance Service (TAS), which will allow trades executed on AMOs' platforms to be cleared and settled through ASX Clear and ASX Settlement respectively.¹⁰ In late March 2010, the Minister for Financial Services, Superannuation and Corporate Law gave in-principle approval to an application for a market licence by Chi-X, which plans to offer a platform to conduct secondary trading in ASX-listed shares. Final approval of Chi-X's licence is dependent on Chi-X meeting all of the necessary legislative requirements and the finalisation of the regulatory framework for competition in trading services. The Reserve Bank cannot see any reason why the TAS, as currently proposed, would affect the compliance of ASX Clear and ASX Settlement with the relevant Financial Stability Standards.

2008/09 Assessment

In September 2009, the Reserve Bank published its Assessment of the four licensed CS facilities against the relevant Financial Stability Standards, covering the year to end June 2009. The Reserve Bank concluded that all four facilities met the relevant standards over this period.

The assessment period was characterised by heightened volatility in financial markets in late 2008, following the failure of the US investment bank, Lehman Brothers. In light of these events, the Reserve Bank closely examined the facilities' response to the challenges posed by this volatility. Both ASX Clear and ASX Clear (Futures) responded to the changing risk environment by intensifying their participant monitoring, increasing margin requirements, and pro-actively adjusting other risk-control parameters as necessary. All four licensed CS facilities were resilient to the turbulent market conditions during the period.

The Assessment also included a detailed assessment of the licensed CS facilities against the measure of the standards relating to operational risk management. The Reserve Bank concluded that ASX's arrangements are consistent with these measures. Nevertheless, the Reserve Bank noted that best practice in respect of operational risk continues to evolve and the licensed CS facilities should respond both to this evolution and to specific issues identified by unfolding events.

Other developments examined included:

- *Increase in participation requirements:* In January 2009, ASX Clear increased minimum capital requirements for its clearing participants to \$2 million. ASX Clear also announced its intention to further increase participation requirements to \$10 million with effect from 1 January 2010. Following a joint review of this policy by the Reserve Bank and the Australian Securities and Investments Commission (ASIC), at the request of the Minister for Financial Services, Superannuation and Corporate Law, the time-line for implementation of this further increase was revised, with requirements to increase to \$5 million, effective 1 July 2010 and then to \$10 million at a later date, subject to sufficient depth and competition in the third-party clearing market.

¹⁰ Details of ASX's TAS are available at: http://www.asx.com.au/professionals/trade_acceptance_service/index.htm.

- *Exit from default-insurance arrangements:* Late in the assessment period, both CCPs announced their intention to exit from the default-insurance arrangements that formed part of their risk resources available to meet losses arising in the event of a participant default. This followed ratings downgrades of their insurer. These insurance arrangements were replaced with a commercial bank loan facility in June 2009 for ASX Clear, while ASX Clear (Futures) reduced its reliance on the insurance component of risk resources from July 2009. In late 2009, these arrangements were replaced for both CCPs with intragroup subordinated loans from ASX Clearing Corporation, which are in turn funded by a commercial bank loan facility.
- *Enhancements to equities settlement arrangements:* Following the Reserve Bank's *Review of Settlement Practices for Australian Equities* (published in May 2008), ASX took steps to enhance its settlement arrangements. The planned enhancements included the removal of ASX Clear derivatives margins from the CHESS (Clearing House Electronic Sub-register System) settlement batch to ensure that ASX Clear's risk-management arrangements are not dependent on the completion of settlement in the cash equity market (this subsequently occurred in February 2010), and the implementation of an earlier deadline for the back out of settlement obligations, which would mitigate uncertainty and any spill-over to the market at large if a settlement participant failed to meet its payment obligations.

ASX also initiated two reviews concerning risk management and operational processes during the assessment period:

- *Review of participant-monitoring arrangements:* ASX Compliance (ASX Markets Supervision prior to August 2010) undertook a review of participant-monitoring activities and launched a range of projects to enhance capital- and liquidity-monitoring arrangements.
- *Review of default-management processes:* Again, in light of some issues raised by the broker failures of early 2008, ASX embarked on a thorough review of default-management processes. In the first stage of this work, ASX drew up a comprehensive list of 'default intentions', setting out the factors to be taken into consideration at each key decision point, and reviewing capabilities.

ASX continued work in these areas throughout 2009/10. Progress on these matters will be considered in the 2009/10 Assessment.

The Reserve Bank also identified a number of areas where further consideration by ASX was encouraged. These included:

- *Routine margining of cash equities:* Notwithstanding that the size and duration of replacement-cost risk associated with cash equities is low relative to that in derivatives contracts, high volatility in the cash equity market during 2008/09 argued in favour of ASX Clear routinely collecting initial and variation margins over the three-day pre-settlement period. ASX subsequently consulted on this issue (as part of a broader consultation on ASX Clear's risk management controls) in late 2009 and engaged both ASIC and the Reserve Bank of Australia on the issue. In June 2010, ASX released a further consultation document setting out a proposed margining model.
- *Account segregation:* During the assessment period, ASX Clear consulted on a proposal to require that clearing participants maintain house and client accounts for cash equities. While acknowledging the cost of such a move, the Reserve Bank noted that segregation would be consistent with international best practice in this area and particularly relevant in the context of routine margining of cash equities. Account segregation was accordingly included in the consultation on margining of cash equities discussed above, but based on participant feedback was not considered further.

- *Triggers for an increase in fixed risk resources:* ASX was encouraged to develop clear guidance on the circumstances in which it would consider increasing the CCPs' fixed risk resources, rather than relying on additional collateral. As noted in the 2007/08 Assessment, there are shortcomings to relying too heavily on variable calls for additional collateral, particularly given lags in the calculation and settlement of such calls.
- *Intraday margining capabilities:* Due to changes in project priorities, ASX Clear had delayed the implementation of system enhancements to improve intraday margining capabilities. While accepting the reasons for the delay, in the Assessment the Reserve Bank reiterated its interest in delivery of these capabilities.
- *Treasury investment policy:* The Reserve Bank had previously observed that the CCPs' treasury investment policy could give rise to sizeable, concentrated exposures with the large domestic banks. While the Reserve Bank acknowledged that it would be difficult for the CCPs to reduce the concentration of investments among the largest domestic banks without compromising credit quality or liquidity, it encouraged ASX to keep under review the various options for reducing concentration in the treasury investment portfolio.
- *Participant-monitoring arrangements:* In light of the government announcement of reforms to market supervision in Australia, ASX was encouraged to consider any implications for the CCPs' arrangements for monitoring clearing participants.

Dialogue with ASX on several of these matters continued throughout 2009/10, with further developments to be addressed in the Bank's 2009/10 Assessment.

