

OVERSIGHT OF OVERSEAS FACILITIES

Submission by Australian Clearing House Pty Limited (ACH) and SFE Clearing Corporation Pty Limited (SFECC) in response to the Reserve Bank of Australia's consultation on variation of the Financial Stability Standard for Central Counterparties

21 November 2008

1 EXECUTIVE SUMMARY: THE ACH AND SFECC POSITION

ACH and SFECC welcome the opportunity to comment on the RBA's consultation paper and regard the consultation on the regulatory framework for overseas CCPs as timely given, as the consultation paper correctly notes, the "increasing evidence of cross-border provision of clearing and settlement services".

We also find ourselves in agreement with several of the themes in the consultation paper, notably the need for a competitively neutral, level (regulatory) playing field, free of regulatory arbitrage; and the need for information-sharing among CCPs and their regulators.

However, we feel that the proposed variation – for overseas CCPs – to the Financial Stability Standard for Central Counterparties ("the Standard") may unfortunately be impractical and may not meet its stated objectives. Our suggested alternative is therefore that:

- The regulatory framework to ensure competitive neutrality must be based on a mutual recognition approach, because "competitive neutrality in the Australian regulatory environment" is not, in our opinion, a meaningful concept in financial markets that are, by their very nature, global;
- Within that mutual recognition approach, any work to "map the requirements of the overseas regime to the measures underpinning the Standard" should explicitly be formal, public and subject to consultation (in part so that the analysis of the legal framework of the foreign jurisdiction is transparent to users);
- Any "assessment of whether the [overseas CCP] applicant would meet the Standard at the time of its application" should similarly be formal and published (the latter so that the systemic risk associated with the CCP is transparent);
- As per the current drafting of the Standard, the RBA should, notwithstanding mutual recognition, assess an overseas facility annually. ACH and SFECC do not feel that such an assessment is "unnecessary", nor indeed a large regulatory burden for overseas CCPs or a significant regulatory overhead for the RBA; such an assessment would also have the benefits of allowing the RBA to consider a CCP's risk protections holistically and of explicitly emphasising the high standard of regulation applied in Australia; and,
- The consideration of the regulatory framework for overseas CCPs and its competitive neutrality should include amending section 822E of the Corporations Act to ensure competitive neutrality.

In contrast the proposed variation would, we believe, suffer from the following issues:

- The fact that even major jurisdictions may not be "sufficiently equivalent, in relation to the degree of protection from systemic risk" (e.g. in considering stress test outcomes relative to financial resources); and,
- In any case, determining whether "measures underpinning the Standard" are "explicitly covered by the overseas regime" will be problematic since overseas regimes are mainly principle- rather than rule-based meaning that coverage is definitionally not explicit (e.g. again in terms of whether stress test outcomes are considered relative to financial resources).

We would welcome the opportunity to discuss our views with RBA staff. In the first instance please contact Anne Brown, Chief Risk Officer on (02) 9227 0223 / anne.brown@asx.com.au or Andrew White, Senior Manager, Clearing Risk Policy on (02) 9227 0596 / andrew.white@asx.com.au.

2 THE THEMES OF THE ACH AND SFECC SUBMISSION

ACH and SFECC have identified two key themes in our submission, both of which – the robustness of CCPs and their regulation, and the importance of competitive neutrality – mirror themes in the consultation paper itself.

The rest of Section 2 of the submission describes these themes in detail; Section 3 of the submission then summarises the key points from that detail to address our views on the key issues for respondents outlined in the consultation paper.

A The robustness of CCPs and their regulation

- A1 Central Counterparties are a key element of financial infrastructure
- A2 Central Counterparties need to be robust
- A3 The RBA's Financial Stability Standard for Central Counterparties ensures that Australia's current Central Counterparties are robust
- A4 Regulation elsewhere may not provide the same level of comfort

B The importance of competitive neutrality

- B1 Competitive neutrality is good
- B2 Competitive neutrality is a two-way street
- B3 Competitive neutrality is difficult to establish in the wider context through the variation of one jurisdiction's regulatory standards or the application of international standards; instead it needs to be based on mutual recognition supported by an annual assessment
- B4 Overseas facilities already benefit from one competitive advantage under the Corporations Act; this advantage needs to be addressed to ensure competitive neutrality
- B5 There should also be no competition between Central Counterparties on risk management

A The robustness of CCPs and their regulation

A1 Central Counterparties are a key element of financial infrastructure

CCPs are a key element of financial infrastructure, and are a key defence against the realisation of systemic risk. This has been acknowledged by regulators for some time, and increasingly so in the light of recent market volatility, as highlighted below:

- “There are good reasons to suppose that a central counterparty can insulate a market against crisis” (Bank of England, Financial Stability Review, June 1999);
- “Post-trade clearing and settlement are ... the central nervous system of the financial system ... [and] ... are critical for the performance of the economy.” (Federal Reserve Bank of Chicago, Economic Perspectives, Q4 2006); and,
- “Market participants and regulators agreed on the following ... improvements in the OTC derivatives market infrastructure: developing a central counterparty for credit default swaps that, with a robust risk management regime, can help reduce systemic risk” (Federal Reserve Bank of New York, June 2008).

In risk terms, CCPs provide the following benefits:

- Standardising and automating trade capture and post-trade processing, and providing a “golden record” of each trade, thus reducing processing errors and operational risk;
- Providing, in the form of their rulebooks, a standard set of conditions of business, thereby minimising legal risk;
- Providing, or interfacing with, robust payment systems, thus reducing payment and settlement risks;
- Performing, or enable Securities Settlement Facilities (SSFs) to perform, netting of payments and settlements, thereby reducing settlement obligations and systemic and liquidity risks;
- Mitigating against counterparty credit risk and facilitating multilateral netting of exposures through the substitution of one high quality counterparty (the CCP) for many, potentially lower quality, bilateral counterparties;
- Reducing systemic counterparty credit risk by netting exposures to that single (central) counterparty;
- Where such techniques are applied, improving the management of replacement cost risk within a market through the marking-to-market of unsettled trades and the use of margin;
- Reducing the potential systemic impact of a default by undertaking to maintain adequate capital and liquidity, substantially in excess of other types of financial institutions, to deal with such an event without impacting other participants.

The value of CCPs has been proven over recent history, in terms of a set of market-wide events including extreme price volatility and participant defaults.

In terms of extreme price volatility, this has included historic events such as the 1987 stock market crash as well as more recent events such as the sub-prime credit crash. In terms of participant defaults, major global CCPs have survived defaults of clearing participants such as Drexel Burnham Lambert (1990), Barings (1995), Griffin (1998), Enron (2001), Refco (2005) and Lehman (2008). In all cases, major global CCPs coped with these default events by closing-out or transferring the positions of the defaulters, without impacting other participants, and within the margin and other financial resources available to them. Anecdotally, the certainty about counterparty creditworthiness provided by CCPs also helped market activity to continue despite, and recover from, these events.

The value of CCPs has also recently been reiterated by overseas central banks, notably the Federal Reserve Bank of New York and the European Central Bank, as well as by Counterparty Risk Management Policy Group III (“the Corrigan Report”), in their proposal for extending central clearing to OTC derivatives including credit default swaps.

Conclusion: CCPs are critical in financial stability terms and provide significant benefits to the financial system.

A2 Central Counterparties need to be robust

The risk and crisis management highlighted above is predicated on CCPs being prudent and robust in terms of their financial resources, both variable (margin) and fixed (capital, be that own funds or funds provided by clearing participants).

A longer history of CCPs suggests that this is not always the case, for example:

- In 1974 the Caisse de Liquidation – the CCP for the Paris White Sugar market – became insolvent;
- In 1983 the Kuala Lumpur Commodity Clearing House in Malaysia had to be “re-established” following the defaults of six Palm Oil brokers;
- In 1987 a government and market participant “lifeboat” was formed to save the Hong Kong Futures Guarantee Corporation – then separate from ICCH (HK) the CCP – following the stock market crash, and the fund was re-established as part of the CCP;
- In 1989 a sole market maker member on the OMX Derivatives Markets experienced liquidity problems due to trading losses. After all positions had been closed, the market maker had an unpaid settlement amount for options of SEK 736,000, which was covered by OMX Derivatives Markets’ own funds.

It should also be noted that at the time of writing, the residual impact of the Lehmans’ default on one international CCP remains uncertain, while another (bank-owned) international CCP has received a third party capital injection since the credit crisis.

Conclusion: notwithstanding isolated incidents highlighted above, it is clear that both a CCP’s own standards with regard to the adequacy of their financial resources and the regulation of that adequacy are critical to the maintenance of systemic financial stability.

A3 The RBA’s Financial Stability Standard for Central Counterparties ensures that Australia’s current Central Counterparties are robust

The RBA’s Financial Stability Standard for Central Counterparties (“the Standard”) ensures that Australia’s current CCPs (ACH and SFECC) are robust. This – as it relates to fixed financial resources – is embodied specifically in Measure 7(b) of the Standard:

“The operator of a central counterparty must ensure, through the use of stress testing, that in all but the most extreme circumstances, it will be able to meet its obligations to participants in the event that the participant with the largest obligations is unable to meet them.”

This Measure has been interpreted by ACH and SFECC, in consultation with the RBA, as meaning that:

- ACH and SFECC should each have significant fixed financial resources beyond the variable margins collateralised by Clearing Participants (since the latter cover normal, rather than more extreme, conditions);

- Those financial resources should have a variety of layers both paid-in (equity, debt, and, ideally, funds from Clearing Participants) and promissory (insurance and contingent funds from Clearing Participants);
- Where those fixed financial resources are theoretically insufficient on the basis of ACH or SFECC's stress testing, then ACH or SFECC should call for additional margin (contributions and additional cover) as a variable top-up to those fixed financial resources;
- While such calls for additional margin can be discounted based on the credit standing of Clearing Participants in normal market conditions, they should be called dollar for dollar based on the theoretical stress testing results in extreme market conditions;
- Similarly, while the fixed financial resources of the CCPs can be allocated against stress testing results for high credit quality Clearing Participants, only a proportion of those resources should be allocated against lower credit quality Clearing Participants, with calls for additional margin then being based on that lower proportion; and,
- Stress testing should be daily and based on scenarios that are calibrated to be broadly equivalent to the largest single price move in the last twenty years for single asset scenarios and the largest single price move in the last 100 years for multi-asset scenarios.

In our view this approach ensures that both ACH and SFECC are extremely robust.

Conclusion: were the Standard similarly applied to overseas CCPs, such regulation would ensure that those CCPs were comparatively robust. Any variance of the application of the Standard for overseas CCPs introduces a risk that overseas CCPs are not as robust as domestic ones (i.e. that regulatory arbitrage could exist).

A4 Regulation elsewhere is unlikely to provide the same level of comfort

CCP regulation world-wide¹ is principle- rather than rules-based. However, it is not based on a consistent set of principles which intuitively means that there is a risk in assuming that oversight of different CCPs by different regulators applying different sets of principles provides the same level of comfort in terms of the robustness of the CCPs.

The fact that regulation is principle-based and the principles are not consistent in different jurisdictions will, in practice, lead to a difficulty in assessing whether different regulatory regimes are "sufficiently equivalent", as defined under the Corporations Act, to the requirements and supervision to which domestic CCPs are subject. Similarly it makes assessing whether "measures underpinning the Standard" are "explicitly covered by the overseas regime" problematic. This is particularly the case if the objective of so doing is to establish competitive neutrality (i.e. ensure no regulatory arbitrage): even where principles are similar, the competitive impact may be very different – as the case studies below show – meaning that equivalence of coverage is debatable and competitive neutrality is, in any case, not achieved.

It is unclear from the consultation document whether such formality is envisaged, but one implication of this is that, in ACH and SFECC's view, any work to "map the requirements of the overseas regime to the measures underpinning the Standard" should therefore be formal, be made public and be subject to consultation (in part so that the analysis of the legal framework of the foreign jurisdiction is transparent to users).

Given the above, there is a real risk that any variance of the application of the Standard for overseas CCPs could mean that an overseas CCP would not be as robust as a domestic one. Moreover, this risk would not be addressed by an informal assessment of the overseas CCP against the Standard at the time of application. Firstly, it is unclear why this one-off assessment would be informal when assessments of domestic CCPs are formal as well as ongoing (annual);

¹ Notwithstanding that – to ACH's and SFECC's knowledge – one OECD country (New Zealand) does not currently apply regulatory standards to CCPs.

such an informal assessment would also not be helpful to market participants in terms of the transparency of the systemic risk associated with the CCP. Secondly, both that CCP's arrangements and its regulation could change over time, meaning that – notwithstanding the proposed information flows between the overseas CCP, its regulator and the RBA – there is also a risk that an overseas CCP found to meet the Standard at the time of application and therefore licensed, subsequently fails to meet the Standard. The proposed framework involves an annual statement – presumably in an attempt to address this risk. However, ACH and SFECCE would regard such an annual statement as inadequate given the difficulties in assessing whether a regime is “sufficiently equivalent” and whether “measures underpinning the Standard” are “explicitly covered”.

An alternative solution to this would simply be to perform an annual (and formal) assessment of overseas CCPs against the Standard, as per the current drafting of the Standard and the approach taken on domestic CCPs. This – the annual assessment itself, as distinct from ongoing regulatory liaison (which would logically be the purview of the home regulator of the CCP) – would not *prima facie* seem to be a large regulatory burden for overseas CCPs; for the reasons outlined above, it is certainly not “unnecessary”. It would also not, on an annual basis and given appropriate information-sharing arrangements, in ACH and SFECCE's view be a significant regulatory overhead for the RBA. It would however have the benefits of explicitly emphasising the high standard of regulation applied in Australia and of allowing the RBA to consider a CCP's risk protections holistically.

Case study 1: the UK

CCPs in the UK are regulated as Recognised Clearing Houses (RCHs) by the Financial Services Authority (the FSA). There are a number of criteria to become recognised as an RCH. In terms of financial resources, the FSA requires that:

The UK RCH must have financial resources sufficient for the proper performance of its relevant functions as a UK RCH. In determining whether a UK recognised body has financial resources sufficient for the proper performance of its relevant functions, the FSA may have regard to:

- (1) the operational and other risks to which the UK recognised body is exposed;*
- (2) if the UK recognised body acts as a central counterparty or otherwise guarantees the performance of transactions in specified investments, the counterparty and market risks to which it is exposed in that capacity;*
- (3) the amount and composition of the UK recognised body's capital; (among other things)...*

[And] In assessing whether a UK recognised body has sufficient financial resources in relation to counterparty and market risks, the FSA may have regard to:

- (1) the amount and liquidity of its financial assets and the likely availability of liquid financial resources to the UK recognised body during periods of major market turbulence or other periods of major stress for the financial system; and*
- (2) the nature and scale of the UK recognised body's exposures to counterparty and market risks and, where relevant, the counterparties to which it is exposed.*

However, the recognition requirements do not specify that an RCH must use stress testing, nor do they specify a link between stress testing and financial resources in terms of the number or scale of Clearing Participants which should be used as a standard.

Anecdotally, UK RCHs – or at least those whose arrangements are transparent – do use stress testing and do attempt to maintain financial resources in excess of their largest Clearing Participant's stress testing losses. However, none of those CCPs call additional margin based on stress testing results. Consequently, stress testing results can be in excess of fixed financial resources for some time, prior to those fixed financial resources being increased. Finally, stress testing may not be conducted daily and the severity of the scenarios may not be calibrated and/or may be subject to qualitative override.

Case Study 2: the US

Derivatives Clearing Organizations (DCOs) in the US are regulated by the Commodity Futures Trading Commission (CFTC). The relevant Core Principle (B) relating to financial resources states that:

The applicant shall demonstrate that the applicant has adequate financial, operational, and managerial resources to discharge the responsibilities of a derivatives clearing organization.

In addressing Core Principle B, applicants and registered derivatives clearing organizations may describe or otherwise document:

1. The resources dedicated to supporting the clearing function:

a. The level of resources available to the clearing organization and the sufficiency of those resources to assure that no material adverse break in clearing operations will occur in a variety of market conditions; and

b. The level of member/participant default such resources could support as demonstrated through use of hypothetical default scenarios that explain assumptions and variables factored into the illustrations.

However, the principle does not specify that a DCO must use stress testing, nor does it specify a link between stress testing and financial resources in terms of the number or scale of Clearing Participants which should be used as a standard.

Anecdotally, US DCOs – or at least those whose arrangements are transparent – do use stress testing. However, they use it largely for management information rather than to determine the adequacy of their financial resources. As a result, stress testing results can routinely be in excess of fixed financial resources. Partly as a result, none of these CCPs call additional margin based on stress testing results. Finally, stress testing is normally not conducted daily.

It is worth noting that DCOs have been used in the US case study because the regulation and risk management practices of equities CCPs in the US are less transparent.

Implications:

(a) Even major jurisdictions may not be “sufficiently equivalent, in relation to the degree of protection from systemic risk etc.”;

(b) Determining whether “measures underpinning the Standard” are “explicitly covered by the overseas regime” will be problematic since overseas regimes are mainly principle- rather than rule-based so coverage is definitionally not explicit;

(c) Any work to “map the requirements of the overseas regime to the measures underpinning the Standard” should therefore be formal, be made public and be subject to consultation (in part so that the analysis of the legal framework of the foreign jurisdiction is transparent to users);

(d) Any “assessment of whether the [overseas CCP] applicant would meet the Standard at the time of its application” should similarly be formal and published (the latter so that the systemic risk associated with the CCP is transparent);

(e) And, given the risks inherent in the above (specifically, the risk that an overseas CCP found to meet the Standard at the time of application and therefore licensed, subsequently fails to meet the Standard), ACH and SFEC’s view is that, as per the current drafting of the Standard, the RBA should assess an overseas facility annually (in part to order allow the RBA to consider a CCP’s risk protections holistically as well as to emphasise the high standard of regulation applied in Australia) . ACH and SFEC do not regard this as an unnecessary, or indeed large, regulatory burden for overseas CCPs or a significant regulatory overhead for the RBA.

B The importance of competitive neutrality

B1 Competitive neutrality is good

ACH and SFECC agree with the RBA that the framework for regulation should not impose an unnecessary regulatory burden on any facility, including overseas facilities, and that it should ensure competitive neutrality (see section B2 for a caveat with regards to competitive neutrality).

ACH and SFECC see the benefits of competitive neutrality as being that:

- Competition is fostered on business grounds rather than risk management ones (see section B5 for more detail on this); and,
- A level (regulatory) playing field is established and regulatory arbitrage is avoided (see sections B3 and B4).

B2 Competitive neutrality is a two-way street

While ACH and SFECC agree that competitive neutrality is a suitable objective of an appropriate regulatory framework, it does not believe that competitive neutrality “in the Australian regulatory environment” is a meaningful concept in financial markets that are, by their very nature, global.

ACH and SFECC’s view is that, given “the increasing incidence of cross-border provision of clearing and settlement services”, the objective of the regulatory framework should be competitive neutrality full stop. This therefore suggests that any regulatory framework to support competitive neutrality should be based around mutual recognition arrangements rather than the variation of one country’s regulatory standards.

B3 Competitive neutrality is difficult to establish in the wider context through the variation of one jurisdiction’s regulatory standards or the application of international standards; instead it needs to be based on mutual recognition supported by an annual assessment

ACH and SFECC’s view is that competitive neutrality cannot be achieved by varying regulatory standards which are super-equivalent to those applied elsewhere. Unfortunately, at present, it also cannot be achieved by relying on international standards (see below). Instead it needs to be achieved through mutual recognition arrangements, supported, as noted in section A4, by an annual assessment.

The variation of one jurisdiction’s regulatory standards

In ACH and SFECC’s view, given the difficulties in assessing whether, firstly, different regulatory regimes are “sufficiently equivalent” and, secondly, “measures underpinning the Standard” are “explicitly covered by the overseas regime, the variation of Australia’s domestic standards cannot:

- Ensure equivalence of protection from systemic risk (per section 4);
- Ensure competitive neutrality even in Australia (since protection from systemic risk comes at a cost, borne by the CCP subject to the higher – presumably non-varied – regulatory standard);
- Reflect the changing nature of the international landscape, since it offers domestic CCPs nothing in terms of their ability to compete internationally;
- Promote the stability and efficiency of the Australian financial system:
 - Stability, since domestic CCPs could be destabilised by international competition – potentially based on risk management or regulatory arbitrage, with potential associated “race to the bottom” type problems – while unable to respond by diversifying internationally themselves;

- Efficiency, since the risk benefits highlighted in section 1, as well as the more operational benefits of a CCP, depend on economies of scale which would be reduced by competition; moreover, the investment by domestic CCPs in their operational efficiency could theoretically be threatened as they are forced to concentrate instead on maintaining market share.

As an aside, the RBA is no doubt aware of the work in Europe around the so-called McCreevy code (the *European Code of Conduct for Clearing and Settlement*, 7 November 2006) and the idea that financial market infrastructure providers, including CCPs, should be able to “passport” in to, and thus compete in, different jurisdictions. It will also be aware that different regulatory approaches have been a barrier to such passporting, suggesting that a framework that does not either use consistent international standards or a mutual recognition arrangement may not achieve effective competition.

The application of international standards

Our view is that competitive neutrality could potentially be achieved through the consistent application of international standards. In the world of CCPs, international standards do exist: the CPSS-IOSCO Recommendations for Central Counterparties (November 2004), recently endorsed by the CESR-ESCB Draft Recommendations for Central Counterparties (October 2008).

However, these international standards are not applied consistently. Most CCPs performing self-assessments against the standards would regard themselves as observing the majority of them. In cases where central banks assess CCPs against the standards, they too would regard those CCPs as observing the majority of the standards. However, again focusing on the stress testing of the adequacy of financial resources, most of the assessments – of both types – concentrate on whether stress testing is done, not on whether it is then used to ensure the adequacy of financial resources. Moreover, in some cases, stress testing that is done “quarterly” or “frequently” – in major, well regulated jurisdictions – is said to observe the standard, even though the standard is that stress testing should be done at least monthly.

As a reminder, this contrasts with the stress testing conducted by ACH and SFECF which is done daily, compared with ACH and SFECF’s financial resources, and results in a call for additional margin (contributions/additional cover) where those financial resources are theoretically insufficient.

Mutual recognition

ACH and SFECF’s view is that, when supported, as noted in section A4, by an annual assessment, mutual recognition arrangements – such as the SEC-ASIC/Australian government mutual recognition agreement referenced in the RBA consultation paper² – provide an appropriate mechanism for ensuring competitive neutrality more broadly and are aligned with “the increasing incidence of cross-border provision of clearing and settlement services”.

Conclusion: if an objective of the regulatory framework is to ensure competitive neutrality, this cannot be achieved through a variation to Australian standards or through the used of international standards; it needs to be achieved through a mutual recognition approach, supported by an annual assessment.

² Which ACH notes already applies to “Markets” (including exchanges) and which could therefore logically – with additional signatories (CFTC, the RBA) and building on existing arrangements for overseas facilities (in Australia) and DCOs (in the US) – be extended to CCPs. NB it is worth noting that such mutual recognition for CCPs would have a driver (market efficiency through lower clearing costs created by competition) different from the drivers for mutual recognition for markets (investor access, increased liquidity and improved price formation).

B4 Overseas facilities already benefit from one competitive advantage under the Corporations Act; this advantage needs to be addressed to ensure competitive neutrality

Under section 822D of the Corporations Act, all licensed clearing and settlement facilities (including overseas clearing and settlement facilities) must lodge with ASIC written notice of a change to their operating rules. Such a notice must set out the text of the change, specify the date on which the change was (or will be) made and explain the purpose of the change.

However, section 822E of the Corporations Act – disallowance of such changes – does not apply to overseas clearing and settlement facilities. It does however apply to ACH and SFECC. Moreover, while the formal disallowance process under section 822E takes 28 days, ACH and SFECC have agreed with ASIC that prior to formal submission of a notice of a change in its operating rules, ACH and SFECC will engage ASIC in an informal process to explain and review the proposed rule change in draft. This informal process involves an iterative process based on queries and comments from ASIC. On previous rule changes, this informal process has taken up to 18 months.

The fact that overseas clearing and settlement facilities are not subject to such a disallowance process – formal and informal – clearly gives them a competitive advantage: they would – assuming that their domestic rule disallowance process is less onerous and/or less time-consuming – be able to move with greater speed than ACH and SFECC in, for example, listing new products and in making changes to their risk management approach. ACH and SFECC are aware of one overseas CCP which has plans to start operations in Australia, which has a proven track record of fast track product development, has a less onerous and less time-consuming domestic rule disallowance process, and which would therefore likely seek to take advantage of this differential.

Conclusion: any consideration of the regulatory framework for overseas CCPs and its competitive neutrality needs to be widened to include amending section 822E of the Corporations Act to ensure competitive neutrality.

B5 There should also be no competition between Central Counterparties on risk management

ACH and SFECC's starting point is that as well as the regulatory framework ensuring competitive neutrality (i.e. no regulatory arbitrage) it should also ensure that – notwithstanding CCPs' innovation of their risk management capabilities – there should be no scope for arbitrage or competition on standard risk management practices: margining, minimum capital requirements, or stress testing and the adequacy of financial resources.

Previous commentary has already shown that there are significant differences in CCPs' stress testing of the adequacy of financial resources. While such differences are not necessarily motivated by the CCP attempting to be competitive, there is no doubt that they do lead to a competitive advantage since a CCP which has a lower standard in terms of the adequacy of financial resources will also have lower costs because of the cost of (lower) capital. Interestingly, while theoretically a CCP with higher capital has a competitive advantage because it is seen by clearing participants as lower risk, anecdotally this would be negated and overturned by its higher costs: generally, clearing participants are more cost-driven than they are risk-driven. This could hypothetically – in the absence of appropriate governance and/or regulation – lead to a "race to the bottom" type problem regarding the comparison of stress testing to financial resources.

In terms of margin, CCPs also have divergent standards since even those CCPs which use the same margin model (e.g. SPAN) may adapt that model in terms of how it is technically

implemented and/or may set their parameters in different ways, especially given that such parameters rely on assumptions around confidence intervals and holding periods. With regard to holding periods (or, more accurately, close-out periods), for example, many CCPs use a one-day horizon, whereas ACH and SFECC choose to be more conservative and use a two-day horizon. Such differences potentially give those CCPs applying a one-day horizon a competitive edge since margin can be seen as a cost and lower margin may therefore be seen as more attractive by market participants.

Similarly, on minimum capital requirements CCPs will – in the absence of competition – inevitably set minimum standards at different levels and on different bases. However, in a competitive environment, any difference between CCPs would give one CCP a competitive advantage and could theoretically – in the absence of appropriate governance and/or regulation – lead to a “race to the bottom” type problem.

The European precedent

Many of these issues have been explored as part of the work done by the European Association of Central Counterparty Clearing Houses (EACH) as part of its work in response to the McCreevy Code, for example in documenting the *Access and Interoperability Guideline* (28 June 2007, published with the equivalent associations for stock exchanges and settlement facilities, FESE and ECSDA) and the *Inter-CCP Risk Management Standards* (July 2008). Whilst acknowledging that the focus of this work has been on the inter-operability of CCPs rather than competition between CCPs *per se*, given that ultimately the McCreevy Code “aims at enhancing transparency and increasing competition in the post-trading sector”, ACH and SFECC’s view is that the lessons learnt by EACH are relevant when considering how to ensure that CCPs do not compete on risk grounds.

In particular, EACH’s *Inter-CCP Risk Management Standard 2* states that there should be “no competition on risk grounds”. That standard also makes several points similar to those above, notably:

- “There should be no purposeful competition on the level of risk coverage (for example the relaxing of risk management standards and controls in select new markets);
- “Initial margin levels must not be set at imprudently low levels ... with the aim of using these margin levels as a competitive tool to appear more attractive to market participants”;
- “In the event that CCPs compete on the level of margin requirements it is clear that the market would see a downward spiral of risk protections which would be to the detriment of all the CCPs concerned and the financial system as a whole. This must be avoided at all costs”;
- “CCPs should not be altering (specifically relaxing) its [*sic*] risk management policies as a means of seeking competitive advantage in select markets”.

The *Access and Interoperability Guideline* also clearly states that, “Competition between CCPs must not have a significantly detrimental effect on risk management standards in place.”

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| <p>Conclusion: as well as the regulatory framework ensuring competitive neutrality (i.e. no regulatory arbitrage) it should also ensure that there is no scope for arbitrage or competition on standard risk management practices.</p> |
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3 ACH AND SFECC'S SUBMISSION ON KEY ISSUES FOR RESPONDENTS

i) The general approach proposed for regulation of overseas facilities in respect of matters related to stability

ACH and SFECC fear that the approach may unfortunately not meet its stated objectives and may be impractical since:

- Even major jurisdictions may not be “sufficiently equivalent, in relation to the degree of protection from systemic risk etc.”; and,
- Determining whether “measures underpinning the Standard” are “explicitly covered by the overseas regime” will be problematic since overseas regimes are mainly principle- rather than rule-based meaning that coverage is definitionally not explicit;

ACH and SFECC therefore propose that instead:

- If an objective of the regulatory framework is to ensure competitive neutrality – and given that “competitive neutrality in the Australian regulatory environment” is not a meaningful concept in financial markets that are, by their very nature, global – this needs to be achieved through a mutual recognition approach;
- Any work to “map the requirements of the overseas regime to the measures underpinning the Standard” should explicitly be formal, be made public and be subject to consultation (in part so that the analysis of the legal framework of the foreign jurisdiction is transparent to users);
- Any “assessment of whether the [overseas CCP] applicant would meet the Standard at the time of its application” should similarly be formal and published (the latter so that the systemic risk associated with the CCP is transparent);
- As per the currently drafting of the Standard, the RBA should assess an overseas facility annually; and,
- Any consideration of the regulatory framework for overseas CCPs and its competitive neutrality needs to be widened to include amending section 822E of the Corporations Act to ensure competitive neutrality.

Please refer to Sections A3, A4, B3, B4, C1 and C2 for more detail on the above.

ii) The proposed wording of the variation to the Standard and the nature of the proposed conditionality

As noted in our response to issue (i), ACH and SFECC do not regard such variation and conditionality as an appropriate way forward, and instead propose an alternative based on a mutual recognition approach, supported by an annual assessment.

We would also note the following more detailed point on the proposed wording of the variation:

- An annual statement is not an appropriate substitute for an annual and public assessment by the RBA (see section A4 for more detail).

And with regard to the nature of the proposed conditionality, we would make the following points:

- The statement “the inclusion of such conditionality in the Standard would be consistent with competitive neutrality vis-à-vis domestic facilities” is not meaningful in the context of financial markets which are, by their very nature, global: competitive neutrality needs to be seen in the round and therefore needs to be achieved through a mutual recognition approach (see sections B2 and B3 for more detail).
- Our view is therefore that “cooperative oversight” – or rather, mutual recognition – should be the starting point rather than a potential further development, for the competitive neutrality reasons outlined above.

- We disagree with the premise that an overseas facility would need to (our emphasis) “provide sufficient information to enable the Reserve Bank to assess compliance with any measures underpinning the Standard that are **not considered** under the overseas regime”. This should instead be “**not equivalent**”, hence our view that annual assessment by the RBA against the Standard is a more practical approach, especially given the need – acknowledge by the RBA – to understand CCPs’ risk protections holistically.
- We do not regard an annual (and formal) assessment of overseas CCPs against the Standard as a large regulatory burden for overseas CCPs or as a significant overhead for the RBA; it is certainly not “unnecessary” (see section A4 for more detail).
- Moreover, as noted previously, ACH and SF ECC see clear, transparent, public assessment against the Standard as the appropriate approach rather than as a “fall-back” (see section A4 for more detail), in part because it emphasises the high standard of regulation applied in Australia.
- The idea that an annual statement should “include sufficient information to satisfy the Reserve Bank that the overseas facility was in compliance with the overseas regime” is presumably based on the assumption that the overseas regime is “sufficiently equivalent” to the Standard. We believe that this assumption is unfortunately not valid (see sections A3 and A4 for more detail) meaning that the assessment should be against the Standard not the overseas regime. This view extends to the proposed information exchange with overseas regulators to monitor continued “sufficient equivalence”.

iii) The form of the annual statement of compliance and, in particular, whether the facility should be exempt only if it is able to provide a statement from its overseas regulator

Again, ACH and SF ECC do not regard an annual statement as an appropriate substitute for an annual and public assessment by the RBA (see section A4 for more detail). We would also note that self-certification would not be appropriate under any circumstances.

iv) The proposed wording of guidance for Section 824B(2) licensees and, in particular, the additional information requirements proposed

As noted in our response to issue (i), ACH and SF ECC do not regard such variation as an appropriate way forward, and instead propose an alternative based on a mutual recognition approach, supported by an annual assessment.

We would also note the following more detailed points on the proposed wording of the variation and on the additional information requirements proposed:

- As previously stated, we would suggest that rather than concluding Memoranda of Understanding with overseas regulators, the RBA should instead seek to conclude mutual recognition agreements.
- We are fully supportive of the value of information-sharing; however, we do not feel that it should be limited to “material changes”, “annual accounts” and “stress-test outcomes relative to... risk resources”; our view is that it should be sufficient to enable the RBA to complete an annual and public assessment against the Standard.
- With regard to “measures underpinning the Standard [that] are **not considered** under the overseas regime”, please see our response to issue (ii).
- Again, we do not regard an annual statement as an appropriate substitute for an annual and public assessment by the RBA (see section A4 for more detail).
- The wording “prior to the commencement of operations under the licence” suggests that the RBA might place reliance on the facility’s initial annual statement rather than on its “assessment of whether the applicant would meet the Standard at the time of its application”; our view is that it should place reliance on the latter (which should also be formal and published; see section A4 for more detail).
- As noted in our response to issue (iii), we would not regard self-certification – or indeed, “indirect provision of the regulator’s assessment of compliance via the licensee – as appropriate. With regard to such proposed “indirect provision” we would query how that

equates with the information exchange between regulators implied in the conditionality covered under issue (ii).

v) The nature of the proposed information-sharing arrangements between the Reserve Bank, the overseas facility and the overseas regulator

Please refer to our response to issue (iv).