



RESERVE BANK OF AUSTRALIA

65 Martin Place  
Sydney NSW 2000

GPO Box 3947  
Sydney NSW 2001

T: +61 2 9551 8500  
F: +61 2 9551 8054  
edeym@rba.gov.au  
www.rba.gov.au

27 October 2014

ASX  
Elmer Funke Kupper  
Managing Director and CEO  
Exchange Centre  
20 Bridge Street  
Sydney NSW 2000

**By Email – [elmer.funkekupper@asx.com.au](mailto:elmer.funkekupper@asx.com.au)**

Dear Mr Funke Kupper

## **SUPPLEMENTARY INTERPRETATION OF THE FINANCIAL STABILITY STANDARDS FOR CENTRAL COUNTERPARTIES**

As you are aware, in 2013 the European Securities and Markets Authority (ESMA) prepared advice for the European Commission on the equivalence of the Australian regime for regulation of central counterparties with that established in the European Union (EU). A positive determination of equivalence by the European Commission is one of the necessary conditions for recognition of a foreign central counterparty in the EU. Recognition allows a foreign central counterparty to provide clearing services to clearing members established in the EU and is required if a foreign central counterparty is to be regarded as a 'qualifying central counterparty' under EU bank capital regulations.

In the context of ESMA's assessment and ASX's plans to apply for recognition in the EU for ASX Clear (Futures), the Bank set out in a letter to ASX on 16 August 2013 how the Bank proposed to interpret certain of the Financial Stability Standards for Central Counterparties (CCP Standards) in the case of domestically licensed derivatives central counterparties in Australia that provide services to clearing members established in the EU.

ASX has since advised that it is also seeking recognition in the EU for ASX Clear. Accordingly, this letter amends the supplementary interpretation issued on 16 August 2013 to expand its scope to cover all domestically licensed central counterparties in Australia that provide services to clearing members that are either established in the EU or subject to EU bank capital regulations.

### **Interpretation of CCP Standards**

In accordance with the Australian authorities' preference for principles-based regulation, and consistent with the relevant international standards (the *CPSS-IOSCO Principles for Financial Market Infrastructures*), the Bank's CCP Standards and associated guidance are drafted sufficiently flexibly to accommodate different central counterparty profiles and operating environments. Additional, complementary guidance may therefore be required to clarify how certain CCP Standards would in practice be interpreted in specific cases.

Table 1, below, sets out a number of CCP Standards in respect of which ESMA has sought clarification of the Bank’s interpretation and presents supplementary interpretation relevant to all domestically licensed central counterparties in Australia that provide services to clearing members that are either established in the EU or subject to EU bank capital regulations. This supplementary interpretation supersedes that communicated to ASX on 16 August 2013 and will apply in the cases of both ASX Clear (Futures) and ASX Clear.

CCP Standard	Additional Interpretation
<p><b>Governance</b></p> <p><u>CCP Standard 2.6.</u> The board should establish a clear, documented risk management framework that includes the central counterparty’s risk tolerance policy, assigns responsibilities and accountability for risk decisions, and addresses decision-making in crises and emergencies. Governance arrangements should ensure that risk management and internal control functions have sufficient authority, independence, resources and access to the board, including through the maintenance of a separate and independent internal audit function.</p>	<p>The guidance to this CCP Standard, in 2.6.3, states that ‘...a central counterparty should have a risk committee responsible for advising the board on the central counterparty’s overall current and future risk tolerance and strategy, or equivalent...’</p> <p>It is the Bank’s judgement that, in accordance with the guidance, establishment of an independent risk committee is the most appropriate way to help the board discharge its risk-related responsibilities. The risk committee should comprise representatives of participants, and depending on the scale and nature of client clearing activity, also indirect participants. The Bank will interpret CCP Standard 2.6 accordingly in the case of ASX Clear (Futures) and ASX Clear.</p>
<p><b>Credit Risk</b></p> <p><u>CCP Standard 4.2.</u> A central counterparty should identify sources of credit risk, routinely measure and monitor credit exposures, and use appropriate risk management tools to control these risks. To assist in this process, a central counterparty should ensure it has the capacity to calculate exposures to participants on a timely basis as required, and to receive and review timely and accurate information on participants’ credit standing.</p> <p><u>CCP Standard 4.4.</u> A central counterparty should cover its current and potential future</p>	<p>The guidance in 4.2.4 discusses the role of prefunded financial resources in managing losses caused by participant defaults. The guidance recognises that the default waterfall may include ‘...a defaulter’s initial margin, the defaulter’s contribution to a prefunded default arrangement, a specified portion of the central counterparty’s own funds, and other participants’ contributions to a prefunded default arrangement.’ The guidance does not prescribe a particular composition of prefunded financial resources, nor does it prescribe the order in which such funds should be drawn.</p> <p>Nevertheless, the Bank would expect that a material proportion of pooled financial resources comprised a central counterparty’s own resources, and further, that a sufficient proportion of such resources would be drawn first in the event that a defaulting participant’s margin and other contributions were exhausted, so as to ensure that the central counterparty faced appropriate incentives to set robust risk management standards. The Bank will interpret CCP Standard 4.2 accordingly in the case of ASX Clear (Futures) and ASX</p>

CCP Standard	Additional Interpretation
<p>exposures to each participant fully with a high degree of confidence using margin and other prefunded financial resources. In addition a central counterparty that is involved in activities with a more complex risk profile or that is systemically important in multiple jurisdictions should maintain additional financial resources to cover a wide range of potential stress scenarios that should include, but not be limited to, the default of the two participants and their affiliates that would potentially cause the largest aggregate credit exposure for the central counterparty in extreme but plausible market conditions...</p>	<p>Clear.</p> <p>Separately, the guidance in 4.4.2, states that ‘...determinations of whether a central counterparty is systemically important in multiple jurisdictions should include consideration of, among other factors: the location of the central counterparty’s participants; the aggregate volume and value of transactions that originate in each jurisdiction in which it operates; the proportion of its total volume and value of transactions that originate in each jurisdiction in which it operates; the range of currencies in which the instruments it clears and cleared or settled; any links it has with FMIs located in other jurisdictions; and the extent to which it clears instruments that are subject to mandatory clearing obligations in multiple jurisdictions...’</p> <p>In forming a judgement on systemic importance with reference to these factors, the Bank will take into account the (implicit or explicit) views of the relevant overseas regulatory authorities. The need to obtain recognition under EMIR – in order either to continue to provide services to clearing members established in the EU, or to be considered a ‘qualifying CCP’ under EU bank capital regulations – may be regarded as evidence that the EU authorities consider an Australian domestic central counterparty to be a possible vehicle for the transmission of risks to the EU. This may therefore be evidence of systemic importance in multiple jurisdictions.</p> <p>If a systemically important domestic central counterparty in Australia not only required recognition in the EU, but also had material participation of clearing members established in the EU and cleared a range of products, including derivatives with different characteristics (including levels of liquidity), the Bank would expect to conclude that such a central counterparty was systemically important in multiple jurisdictions.</p> <p>The Bank will interpret CCP Standard 4.4 accordingly in the case of ASX Clear (Futures) and ASX Clear and hold these central counterparties to the higher standard that they should maintain additional financial resources to cover the default of the largest two participants and their affiliates (by credit exposure).</p>
<p><b>Margin</b></p> <p><u>CCP Standard 6.3.</u> ...Initial margin should meet an established single-tailed confidence interval of at least 99 per cent with</p>	<p>The guidance to this CCP Standard elaborates further. In particular, the guidance in paragraphs 6.3.1 – 6.3.3 requires that:</p> <ul style="list-style-type: none"> <li>• ‘...the method selected by the central counterparty to estimate its potential future exposure should be</li> </ul>

CCP Standard	Additional Interpretation
<p>respect to the estimated distribution of future exposure...  “...The model should: use a conservative estimate of the time horizons for the effective hedging or close out of the particular types of product cleared by the central counterparty...”</p>	<p>capable of measuring and incorporating the effects of price volatility and other relevant product factors and portfolio effects over a close out period that reflects the market size and dynamics for each product cleared by the central counterparty...’</p> <ul style="list-style-type: none"> <li>• ‘...close out periods should be set on a product-specific basis because less liquid products might require significantly longer close out periods...’</li> <li>• ‘...a central counterparty should select an appropriate sample period for its margin model to calculate required margin for each product that it clears...’</li> <li>• ‘...selection of the period should be carefully examined based on the theoretical properties of the margin model and empirical tests on these properties using historical data...’</li> </ul> <p>In interpreting CCP Standard 6.3 with reference to the guidance summarised above, a domestically licensed central counterparty that clears a range of products with varying degrees of liquidity and provides services to systemically important financial institutions headquartered in multiple jurisdictions would typically be expected to:</p> <ul style="list-style-type: none"> <li>• apply a higher confidence interval, of at least 99.5 per cent, in relation to less liquid products, such as OTC derivatives, to reflect increased uncertainty around potential future exposure for products with such characteristics</li> <li>• use a close out assumption of at least five days for less liquid products, such as OTC derivatives, and the higher of a one or two day close out period for more liquid exchange-traded products</li> <li>• consider a range of sample periods to inform the calibration of margin requirements.</li> </ul>
<p><b>Liquidity Risk</b></p> <p><u>CCP Standard 7.3.</u> A central counterparty should maintain sufficient liquid resources in all relevant currencies to settle securities-related payments, make required variation margin payments and meet other payment obligations on time with</p>	<p>Consistent with the equivalent requirement in relation to credit risk, the Bank will, in determining whether a central counterparty is systemically important in multiple jurisdictions, take into account the (implicit or explicit) views of the relevant overseas regulatory authorities. The need to obtain recognition under EMIR – in order either to continue to provide services to clearing members established in the EU, or to be considered a ‘qualifying CCP’ under EU bank capital regulations – may be regarded as evidence that the EU authorities consider an Australian domestic central</p>

CCP Standard	Additional Interpretation
<p>a high degree of confidence under a wide range of potential stress scenarios... In addition, a central counterparty that is involved in activities with a more complex risk profile or that is systemically important in multiple jurisdictions should consider maintaining additional liquidity resources to cover a wider range of potential stress scenarios that should include, but not be limited to, the default of the two participants and their affiliates that would generate the largest aggregate payment obligation to the central counterparty in extreme but plausible market conditions.</p>	<p>counterparty to be a possible vehicle for the transmission of risks to the EU. This may therefore be evidence of systemic importance in multiple jurisdictions. If a systemically important domestic central counterparty in Australia not only required recognition in the EU, but also had material participation of clearing members established in the EU and cleared a range of products, including derivatives with different characteristics (including levels of liquidity), the Bank would expect to conclude that such a central counterparty was systemically important in multiple jurisdictions.</p> <p>The Bank will interpret CCP Standard 7.3 accordingly in the case of ASX Clear (Futures) and ASX Clear, and hold these central counterparties to the higher standard that they should maintain additional liquid resources to cover liquidity needs in the event of the default of the two participants and their affiliates that would generate the largest aggregate payment obligation to the central counterparty in extreme but plausible market conditions.</p>
<p><b>Segregation and Portability</b></p> <p><u>CCP Standard 13.2.</u> A central counterparty should employ an account structure that enables it readily to identify positions of a participant's customers and to segregate related collateral. A central counterparty should maintain customer positions and collateral in individual customer accounts or in omnibus customer accounts, or equivalent.</p> <p><u>CCP Standard 13.3.</u> To the extent reasonably practicable under prevailing law, a central counterparty should structure its portability arrangements in a way that makes it highly likely that the positions and collateral of a defaulting participant's customers will be transferred to one or more other participants.</p>	<p>CCP Standards 13.2 and 13.3 do not explicitly require that a central counterparty offer the choice between individual and omnibus account structures. However, associated guidance (particularly 13.2.2-13.2.9) draws out the relevant considerations for a central counterparty in determining appropriate account structures. The guidance in 13.3.1 observes that 'in order to achieve a high likelihood of portability, a central counterparty will need to: have the ability to identify positions that belong to customers; identify and assert rights to related collateral held by or through the central counterparty; transfer positions and related collateral to one or more other participants...'</p> <p>Where a central counterparty clears derivatives products for a variety of participant and underlying customer types, the Bank will interpret CCP Standards 13.2 and 13.3 as requiring that the central counterparty employ an account structure that enables its participants to offer their customers individual segregation.</p> <p>Accordingly, in relation to their clearing of derivatives products, ASX Clear (Futures) and ASX Clear will each be expected to make available to its participants an account structure that enables its participants to offer their customers an option that allows for separate identification and protection of individual customers' gross positions and collateral (or collateral value). To further protect derivatives customers, ASX Clear (Futures) and ASX Clear will each be expected to make available an account structure that enables excess customer collateral to be held directly with the central</p>

CCP Standard	Additional Interpretation
	counterparty.
<p><b>Custody and Investment Risks</b></p> <p><u>CCP Standard 15.4.</u> A central counterparty's investment strategy should be consistent with its overall risk management strategy and fully disclosed to its participants, and investments should be secured by, or be claims on, high-quality obligors. These investments should allow for quick liquidation with little, if any, adverse price effect.</p>	<p>Although not explicitly stated in CCP Standard 15.4 or associated guidance (15.4.1), the Bank will interpret this requirement as applying in all market conditions, including in periods of market stress. Furthermore, since CCP Standard 15.4 also requires that a central counterparty's investment strategy should be 'consistent with its overall risk management strategy' and that 'investments should be secured by, or be claims on, high-quality obligors', and since the guidance (15.4.1) notes that investments should be subject to appropriate controls for wrong-way risk, the Bank would not consider investments in a central counterparty's own, or an affiliated entity's, securities, to be consistent with these requirements.</p> <p>The Bank will interpret CCP Standard 15.4 accordingly in the case of ASX Clear (Futures) and ASX Clear.</p>
<p><b>Regulatory Reporting</b></p> <p><u>CCP Standard 21.</u> A central counterparty should inform the Reserve Bank in a timely manner of any events or changes to its operations or circumstances that may materially impact its management of risks or ability to continue operations. A central counterparty should also regularly provide information to the Reserve Bank regarding its financial position and risk controls on a timely basis.</p>	<p>CCP Standard 21 sets out a range of reporting requirements for central counterparties. The Bank is currently reviewing its regular information requirements and will inform ASX Clear (Futures) and ASX Clear accordingly.</p> <p>In the meantime, that Bank would like to clarify that in accordance with CCP Standard 21.1(i), which requires notification to the Bank if '...any internal audits or independent external reviews are undertaken of its operations, risk management processes or internal control mechanisms, including providing the conclusions of such audits or reviews', domestically licensed central counterparties such as ASX Clear (Futures) and ASX Clear will be expected to provide the Bank with copies of any reviews of their margin methodologies.</p>

### Application to ASX Clear (Futures) and ASX Clear

In accordance with Section 821A (aa) of the *Corporations Act 2001*, ASX Clear (Futures) and ASX Clear must '... to the extent that it is reasonably practicable to do so, comply with standards determined under section 827D...'. Under Section 823CA of the *Corporations Act* the Bank assesses how well each of ASX Clear (Futures) and ASX Clear complies with that obligation. Such assessment is carried out by reference to the facts and circumstances at the relevant time. Given current facts and circumstances, the Bank believes that, in order to be assessed as compliant in relation to a CCP Standard specified in column 1 of the table above, ASX Clear (Futures) and ASX Clear need to meet the requirements specified in the corresponding row of the second column of Table 1. Further to the Bank's letter to ASX on 16 August 2013, the Bank already applies this interpretation of the relevant CCP Standards in the case of ASX Clear (Futures). The Bank intends also to apply this interpretation of the relevant CCP Standards in the case of ASX Clear with immediate effect and will formally assess both ASX Clear (Futures) and ASX Clear with reference to this interpretation in its

published annual assessments for the period 2014/15. This interpretation will hold unless and until the Bank notifies ASX Clear (Futures) or ASX Clear in writing to the contrary, which the Bank reserves the right to do at any time.

In light of the above, I seek your written confirmation that ASX Clear (Futures) and ASX Clear understands how the Bank intends to interpret the CCP Standards set out in Table 1, and also request that ASX provide evidence of ASX Clear (Futures)' and ASX Clear's observance of the relevant CCP Standards on this interpretation.

Since this interpretation will apply to all domestically licensed central counterparties in Australia that provide services to clearing participants either established in the EU or subject to EU bank capital regulations, the Bank will make this letter available on its website.

Yours sincerely

A handwritten signature in black ink, appearing to read 'M Edey', written in a cursive style.

Malcolm Edey  
Assistant Governor (Financial System)  
Financial System Group

cc: Alan.Bardwell@asx.com.au  
Amanda.Harkness@asx.com.au  
Nicholas.Wiley@asx.com.au