Stockbrokers Association of Australia
Incorporating SDIA

ACH CCP Risk Management Controls
- ***Market Consultation Paper*** **30 June 2010**

Submission

Executive Summary

As noted in our earlier submission, The Stockbrokers Association has concerns that the margining of cash equities trading may –

- adversely impact liquidity and trading activity
- lead to increased costs and impediments to our Member's businesses, particularly at a time when other capital requirements are likely to change, and
- put Australia at a competitive disadvantage and impede Australia's efforts to become a Regional Financial Centre.

We commend the ASX for changing some of its proposals in light of industry submissions, particularly –

- not proceeding with the creation of a new default fund
- changing the margin calculation methods, and
- not proceeding with the splitting of house accounts and aggregated client accounts.

Introduction

After consulting its Members, the Stockbrokers Association of Australia would like to make the following comments in relation to the ACH *Consultation Paper* on *Central Counterparty Risk Management Controls* dated 30 June 2010.

As was apparent with the initial consultation on these proposals last year[1], it would appear that ACH will be proceeding with the main changes outlined in the *Consultation Paper*, particularly the margining of cash equities. Once again therefore, this consultation is very limited.

[1] ACH Consultation Paper on *Central Counterparty Risk Management Controls* dated 30 October 2009

International comparisons

Earlier research conducted by ACH found that 13 out of 15 international CCP's imposed cash margining requirements on their participants. While we have been assured that all of the 13 exchanges impose margining for cash equities, Members have raised queries as to whether the comparison is 'like-for-like', for instance whether the capital requirements, settlement rules and failure rates are comparable with Australia's impressive record, and whether margining applies to all equities trading, or just to the less liquid stocks.

Australia as a Regional Financial Centre

We note that the 2 of the 15 exchanges surveyed that do not impose cash equities margining are Hong Kong and Singapore. These are two key exchanges in our region, and compete with Australia for listings and liquidity and innovative trading solutions. The Singapore Exchange, with the support of the Monetary Authority of Singapore, have done much in recent years to encourage offshore investment and offshore participation in its markets, for example, through support for hedge funds and fostering the introduction of alternative trading platforms[2].

The level of foreign participation in ASX trading is thought to be around 40% of trading. In imposing risk management measures in excess of those imposed by our major competitors, ACH may be providing a competitive advantage to other exchanges in the region, by hindering the level of offshore participation in our markets. The Reserve Bank has flagged this as a possible consequence of the ACH changes (see below).

The Australian Government, through the *Australian Financial Centre Forum* has pursued policies to promote and facilitate Australia's role as a financial centre[3]. **The introduction of cash equities margining may run counter to these efforts, by giving others in our region a competitive advantage.**

[2] For example, Chi-X and Singapore's SGX move to create a dark-pool trading facility announced in August 2009: Please click here

3 *Australia as a Financial Centre - Building on our Strengths* Report by the Australian Financial Centre Forum November 2009

Australia already robust

As we have stressed previously[4] Australian has a proud record of market stability. Our low rate of settlement default has for some time been world leading, and this will only have been strengthened by the T+5 compulsory close out rule which became effective in May 2009, and the increased Core Capital requirements currently in the process of phased introduction.

In addition to the above measures (which in the terminology of the *Consultation Paper* may be classified as Tier 1 or 2 Controls) there are also existing powers in ACH to call for contributions and additional cover (CAC).

Market Volatility and Liquidity

In September 2009, the Reserve Bank of Australia released its *2008/9 Assessment of Clearing and Settlement Facilities in Australia*[5]. While assessing ACH's risk management procedures to have been appropriate through the market turbulence of 2008, it suggests that –

> *'…further enhancement to ACH's risk-management framework should be considered, and in particular the routine margining of cash equities.'* (p.21)

This has clearly been a major driver for the current ACH proposals. However, RBA acknowledges in the Report that imposing cash equities margin requirements may create **liquidity problems** for participants, and lead to a **reduction in trading activity**. (p.23) While it is difficult now to predict any adverse effects on liquidity and trading activity from the measures, and acknowledging that changes to the calculation method may reduce costs, much of it will be due to additional costs of participants in doing business.

In particular, the margining requirement could possibly limit high value trading like **index arbitrage**, which would affect overall market liquidity, and increase volatility. On the options market, it may also lead to a reduction in **market making** activity, resulting in lower liquidity and increased spreads.

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[4] Stockbrokers Association of Australia *Submission to ACH on CCP Risk Management Controls-Consultation Paper 30 June 2009* dated 23 December 2009

[5] The RBA Report is available at: http://www.rba.gov.au/payments-system/clearing-settlement/pdf/report-2008-2009.pdf

Increased Costs

On ACH figures, estimates for the last 3 years are that on average, $306 million of daily margins across the industry would have been required, ranging from $1 billion to $92 million per day. This average daily estimate has been reduced from around $330 million in previous estimates[6]. This would be spread over around 50 Clearing Participants depending on their trading. The average forecast margin for a Clearing Participant with over $200 million of liquid capital is $15.7 million compared to around $650,000 for a Clearing Participant with less than $5 million liquid capital[7]. This new impost will have to be funded by Clearing Participants from capital, funding or other bank facilities like guarantees. These increased funding requirements will increase the costs of doing business. Even though ASX has excluded making a rule to make it compulsory to pass these margins on to clients[8], inevitably, these costs will have to be passed on, or businesses may become uneconomic. However, in this environment, it will be difficult to pass such additional costs on to clients, thus putting more financial strain on participants. Accordingly, more self clearers will look at third party clearing to reduce their capital costs, even if this does not suit their business model. Increased third party clearing by a limited number of general clearers may introduce its own risks to the clearing house, in terms of concentration risk.

As well as resulting in additional costs, the requirements may also impede business by reducing a Broker's capacity to accept new orders. For example, say a Broker has a margin of $5m on average. If the Broker is offered a major order they may be unable to accept it if the trade would significantly increase the margin payable to ASX. Even if the Broker has a Bank Guarantee in place they may not cover multiples over and above their usual margin level – cost would be an issue. This would have the greatest impact on smaller Brokers. If a Broker was standing in the market for a Bidder in a takeover would ASX accept a bank guarantee from the bidder in favour of the Participant in relation to the trades resulting from the takeover?

We **commend** the ASX for measures in the latest *Consultation Paper* which may lead to a reduction in the margining requirements. These include:

- adopting the Value-at-Risk (**VaR**) calculation method rather than the 'Look-Back' method (p.6)
- removal of the Settlement Day from the calculation of margin (p.5), and
- no routine required contributions to a default fund (p.6).

[6] *Consultation Paper* page 8
[7] *Consultation Paper* page 9
[8] *Consultation Paper* page 6

We also **welcome** the statement that any margin funds paid to ASX will be able to be included as an asset in capital adequacy calculations – they will **not** be treated as **excluded assets**. We trust that this will be specifically provided for in the rules.

We note that ASX has reduced its estimate of total average daily margins from $330 million to $306 million. Last year ASX gave Members specific estimates of the likely effect of the margin requirements on their firm. In order that Members can better assess the likely impact on their capital and funding requirements (which may necessitate changes to their business structure), it would assist if the **effect of these latest changes** on previous figures given could be **made known to Members**.

'CHESS Locks'

In our previous submission, we proposed introducing a system of 'locking' client monies and stock in CHESS for settlement on Trade Date (T), so that settlement was assured and those scheduled settlements could be excluded from the participant's margin obligations. ACH has now determined that is not proceeding with this proposal, since -

> *'...it is expected to generate significant operational challenges and legal complexities, particularly in the event of a default, and may indeed not attain the goal of margin reduction'* (p.6)

It is frustrating to Members that margin obligations on equities trading will arise, even where settlement is assured through CHESS sponsored holdings or institutional DvP settlement. This will result in excess capital requirements. We submit that this project should be **further considered**. If cost and operational issues are a problem for ASX, this would be an appropriate industry development project for funding by the **National Guarantee Fund**, under the Financial Industry Development Account arrangements.

Use of Margin Funds

There is some concern as to how the margin funds lodged might be used by ASX. There should be rules in place that set out strict limitations on the use of the funds i.e. that they can be used solely against a default by the Broker lodging the funds. On this basis they should be held in trust and not as part of the general funds of ASX. Otherwise our Members may become creditors of ASX should it default.

Similarly, ASX states that it will seek to amend the ASX Clear Rules to replace the mutualised CAC-related Contributions with additional margin requirements based on the same stress test calculation. Margin, unlike Contributions, should not be used by the CCP to offset losses arising from another Clearing Participant's default. This should be specifically provided for in the new provisions.

Account structures

We commend ASX for reconsidering its position and deciding to exclude from its plans the earlier proposal to split the participant's equity market clearing account into a house account and an aggregated client account.

Timing

The *Consultation Paper* states that these measures will not be introduced before Q4 2011 (p.11). We note that if that means the end of 2011, this will be just before the further increase in Core Capital which has been flagged to apply from 1 January 2012. While we await further detail of that increase in Core Capital, the imposition of new margining and higher capital requirements at the same time would be burdensome. There should therefore be a more staggered introduction of one or both requirements so that they **do not both hit Brokers at once**.

Thank-you once again for the opportunity to present industry-level comments in response to the *Consultation Paper*, and for your time and willingness to discuss issues with the Association.

The Stockbrokers Association of Australia

12 August 2010