Stockbrokers
Association of Australia
Incorporating SDIA

ACH CCP Risk Management Controls
- *Consultation Paper* 30 October 2009

Submission

Executive Summary

At the industry level, The Stockbrokers Association is concerned that the ACH risk management proposals, particularly in relation to the margining of cash equities trading.

While international comparisons appear to be persuasive, questions have been raised as to whether we are comparing like-for-like.

The proposals may lead to other markets in the region gaining a competitive advantage over Australia.

Australia already has a world standard settlement and clearing system, with one of the lowest rates of trade defaults in the world. This comes from existing robust ACH risk management measures, via core capital and T+5 close out requirements, together the power to make further calls for contributions.

As flagged by RBA, there are concerns at the negative effects the measures may have on market liquidity and trading activity.

Additional costs to Members are a real concern, both in terms of cash margining, and in terms of funding a new default fund.

The justification for the creation of a new default fund was not properly made out.

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Introduction
After consulting its Members, the Stockbrokers Association would like to make the following comments in relation to the ACH Consultation Paper on *Central Counterparty Risk Management Controls* dated 30 October 2009.

It would appear that ACH will be proceeding with the main changes outlined in the *Consultation Paper*, particularly the margining of cash equities. The consultation therefore covers a limited number of finer details (for example the 'futures' v. 'lookback' margining method for equities).

We note that ACH has sought specific data from Clearing Participants regarding the likely impact of the changes. Our comments therefore will not give such a level of specificity, but will concentrate on **industry-level issues** and implications for the changes, including their impact upon:

- Market liquidity
- Market volatility
- Market making activities, and
- Australia's role as a financial centre.

International comparisons
The 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, and whether margining applies to all equities trading, or just to the less liquid stocks.

Australia as a Regional Financial Centre
We note, however, that the 2 of 15 exchanges that do <u>not</u> 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 alternative trading platforms[1].

[1] For example, Chi-X and Singapore's SGX move to create a dark-pool trading facility announced in August 2009: http://www.chi-x.com/apac/releases/FINAL_2Pages__Project%20Mariana%20Press%20Release_12%20Aug%202009--3rd-version.pdf

The Federal Government, through its Australian Financial Centre Forum[2], is pursuing its election promise of promoting Australia as the key financial centre of the region. The Stockbrokers Association sits on the Advisory Panel to the Forum.

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 outlined in the *Consultation Paper* (see **Market Volatility and Liquidity** below).

Australia already robust

As noted last year in the consultation regarding changes to Core Liquid Capital, 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 Liquid 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, the Reserve Bank of Australia released its *2008/9 Assessment of Clearing and Settlement Facilities in Australia*[3]*.* 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, 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

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[2] For further information on the Forum, see: http://www.treasury.gov.au/afcf

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

options market, it may also lead to a reduction in **market making** activity, resulting in lower liquidity and increased spreads.

Increased Costs
On ACH figures, some $330m of new daily margins will be required, spread over around 50 Clearing Participants depending on their trading. 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. Inevitably, these costs would have to be passed onto clients, 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. In this environment, inevitably 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.

Settlement security not relevant
It is somewhat frustrating to Members that margining obligations on equities trading will arise, even where settlement is assured through CHESS sponsored holdings or institutional DvP settlement. This is because margining addresses systemic risk for the CCP, not counterparty risk for the participant. **Our Members would therefore welcome the development of a system solution in CHESS that would, for example, 'lock' stock on trade date (T) ahead of settlement on T+3, so that the need for any pre-settlement margining as proposed would be removed.**

Tier 3 Risk Controls (Default Fund)
On ACH figures, a Default Fund as outlined in the *Consultation Paper* would need to hold around $3bn.

We note that in March 2005 on separation of the National Guarantee Fund between trading and clearing, ACH received $71.5m for the purpose of clearing guarantee. This amount of $71.5m ('Restricted Capital Reserve') forms part of the $150m **ACH Clearing Default Fund** (see ASX 2009 Annual Report p.24), which in turn (with subordinated debt and uncalled contributions from participants) amounted to $550m as at 30 June 09. We would therefore submit that an adequate default fund already exists, and there is no evidence that it is insufficient.

Funding for a Default Fund in excess of daily margining will inevitably lead to higher costs to Participants.

Account structures
ACH states in the *Consultation Paper* (at p.21 point 2) that it is reconsidering house/client account segregation. This was previously consulted upon and rejected in the ASX

September 09 Information Document, which was consistent with then SDIA's submission of 6 March 09 that it ought not happen. We reiterate that it ought to be rejected, since it would reduce netting benefits for brokers.

Thank-you 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.

Yours sincerely

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Managing Director & CEO
The Stockbrokers Association of Australia
23 December 2009