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2 January 2009

Ms Michele Bullock
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By email: pysubmissions@rba.gov.au

Mr Mark Adams
Senior Executive Leader, Exchange Market Operators
Australian Securities and Investments Commission
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Dear Ms Bullock & Mr Adams,

Review of Participation Requirements of Central Counterparties - Australian Clearing House (ACH) Core Liquid Capital changes

In reference to the review requested by Senator the Hon Nick Sherry, Minister for Superannuation and Corporate Law, in December 2008, the Securities & Derivatives Industry Association would like assist by presenting the concerns of a number of its retail, self-clearing Members with the recent changes announced in a Market Information Document in relation to Minimum Capital Requirements for Clearing Participants[1], particularly to increase Core Liquid Capital from $100,000 to:
a. $2m by the end of 2008, and
b. $10m by the end of 2009.

We have already raised these concerns with ACH directly, and with the Minister. We also understand that a number of our Members will be responding to you directly.

A number of our larger Members already have Core Liquid Capital in excess of $10 million or have already transitioned from self-clearing to Third-Party Clearing, and are therefore unaffected by the Market Information Document.

However, while views vary across the whole industry, there are still a number of retail, self-clearing participants who are impacted significantly and will be forced to either raise additional capital or outsource to a third party clearer. Those Members' main points of concern can be summarised as follows:

[1] ASX Market Information Document *Overview of Risk Management Changes to ASX's Central Counterparty Services* 7 July 2008 (particularly Section 4)

a. **Consultation:** the lack of consultation with Clearing Participants other than Third-Party Clearers. The changes were presented as a *'fait accompli'* – the Market Information Document was not a Consultation Paper. Failure to consult on such significant changes carries the risk that issues will be missed, unintended consequences may follow, and those affected may not readily accept what is proposed;

b. **Lack of Explanation of the Basis of the Changes**: this significant change was the subject of less than one page in the Market Information Document. The detail presented was very limited, which begs more questions. Apart from statements such as that the changes will *"…better align these requirements with ACH's risk appetite by dis-intermediating itself from the risk of lowly capitalised market participants…"*[2], and passing references to international best practice, there was no objective analysis provided as justification for the changes. This is in contrast to the review which led to the introduction of the current risk-based requirements in the 1990's[3];

c. **Move away from Risk-Based Approach**: the arbitrary nature and lack of detailed information about the approach taken to re-balance ACH's risk appetite is a path which is very much at odds with the logic and sophistication of our current risk-weighted regime for Liquid Capital, which was revolutionary when implemented around a decade ago and which has served the stockbroking industry well ever since[4]. There are two components to the current capital requirements: **Core Liquid Capital** (which is the subject of the current changes) and **Total Risk Requirement** (which is unchanged). The Total Risk Requirement provisions better consider the risk profile of the business and require capital to be allocated against those risks. However, this requirement does not appear to have come into consideration;

d. **Excess Capital**: these changes increase the levels of Core Liquid Capital, where the size, type and risk profile of the business may not warrant it. Having excess capital on the balance sheet in excess of the needs of the business can lead to 'lazy balance sheets', where proprietor's capital could be better used elsewhere;

e. **Capital Raising difficulties**: a lack of recognition of how difficult raising equity capital can be in such a negative market/economic environment, against such a short deadline;

f. **Commercial and Service implications**: a lack of recognition of the likely level of structural change, in commercial and client-service terms, which would follow as a consequence;

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[2] ASX *Market Information Document* page 8 of 15, paragraph 4.3.1.

[3] In 1995, ASX commenced a review of its capital requirements for participants against its international counterparts. This led to the introduction of the new Rule 1A in May 1999, which *'…replace[d] the old balance sheet based approach to risk assessment with a capital framework that identifies risks within the operations of a stock broking business and requires capital to be held directly against those risks'*: ASX *Capital Liquidity Handbook* June 1999, p.10. Rule 1A is the basis of the current requirements.

[4] See Note 3 above. We also note that none of the high profile failures in 2008 resulted from liquid capital deficiencies, but from other causes.

g. **Issues with transition to Third Party Clearing**: a lack of recognition of what is involved in transitioning from self-clearing to third-party-clearing, the 'penalty' costs associated with breaking existing long-term back-office service contracts, the time necessary to facilitate a transfer, and the need to verify the identity of all existing clients, not just new clients, as the benefit of grandfathering under AML would be lost. Estimates of the time required for the transition are around 6 months from start to finish. The prospect of even a few self-clearers making the transition to third-party clearing significantly erodes the period to the January 2010 deadline, and makes it practically impossible to meet such a tight time-frame. At the very least, a longer transition time ought to have been allowed;

h. **Failure to Differentiate between Third Party and Self Clearers**: The new capital requirements for ACH participants apply across the board, with no distinction between self-clearers and third party clearers. This is not the case with futures (SFECC) clearers, where the NTA requirements for self-clearers are to rise from $5m to $10m and to $20m for third party clearers. The rationale for higher requirements for third party clearers is obvious: if you are clearing for more than one firm, it is to be expected that your capital requirements should be higher. It should therefore be possible to have lower requirements for self-clearers in equities;

i. **Concentration of Clearers**: the changes may result in a concentration of clearing services with a small number of players, which could represent a heightened risk in one area that could offset the reduction of risk elsewhere that is the objective of the exercise;

SDIA Surveys

Forty-nine of our 69 member organisations are ACH Clearing Participants. In order to gauge their reaction to the changes, in August 2008 we undertook a brief survey. Around half the members that are ACH Clearers took part in the Survey.

Key Survey Results

Some of the key results of our Survey are summarised as follows:

Survey Question	Response
1. Effect of the changes a. $2m by 1 Jan 2009, or b. $10m by 1 Jan 2010.	50% of respondents would be significantly affected. Of those, a. 25% would be significantly affected by the move to $2m, and b. 100% would be significantly affected by the move to $10m
2. Whether the member was considering: a. increasing capital to meet the new requirements? or b. outsourcing clearing and settlement functions?	a. 50% said they were considering increasing capital; b. 50% said they were considering outsourcing

3.	Whether outsourcing was a feasible option?	50% said it was feasible 50% said it was not feasible or they were not sure at this early stage
4.	Whether the costs of outsourcing clearing would be prohibitive?	50% said costs would be prohibitive 50% said costs would not be prohibitive, or they were not sure at this early stage
5.	Whether jobs would be lost after transition is completed?	Up to 10 positions per firm would be lost, which would translate to 100-200 job losses
6.	Whether outsourcing would present any particular concerns, e.g. a. loss of control of your business b. lower service levels to clients c. change of back-office system d. contractual breaches with current service provider e. retraining of staff f. other	The main concerns expressed were: - loss of control of the process (90%) - lowering of client service levels (90%) - damages claims for the early termination of service contracts from current providers (30%) One firm made the comment that, *'…outsourcing adds another layer of complexity to our service, and this combined with [other] requirements imposed by the ASX will just further confuse the end clients on who is providing what service.'*
7.	Whether the member would have capital in excess of your needs or the desirable levels for proper returns to investors (i.e. 'lazy balance sheets')	90% said they would have excess capital 10% were unsure at this point One firm made the comment that, *'…the requirement would be dramatically out of proportion to the exposure risk.'*
8.	We then sought data on the Firm's liquid capital ratio (i.e. Liquid Capital to Total Risk Requirement[5]) on some key dates: a. 30 June 2008 (being the last ACH monthly return) b. the ad hoc returns as at: i. 22 January 2008; and ii. 4 April 2008	Average ratios across the respondents were: a. 6.815 b. i. 3.740 ii. 5.153
9.	Effect of changing ratio at 8a. if the member: a. increased core liquid capital to $10m, or b. doubled the Counterparty Risk portion of Total Risk Requirement (without any increased capital).	Average ratios across the respondents were: a. 24.993 b. 4.236

[5] Under the rules, this ratio must be greater than 1. As a prudential measure, participants must report to ACH if the ratio falls to 1.2 or below.

Analysis

From the above figures:

- Numbers likely to transition to third party clearing confirm that logistical problems are likely (especially if they all move to the one clearing participant) (see 2b.)
- Moving to third party clearing may not be feasible to a significant number of self-clearers, and may be more costly (see 3&4);
- Significant job losses on transition to third party clearing are likely (see 5)
- There is a strong level of unwillingness to transition on the basis of loss of control of their businesses and lower service levels to clients (see 6)
- The risk of significant damages claims on termination of contracts with existing service providers is real (see 6)
- Capital levels will be excessive (see 7&9a.)
- Existing capital levels already provide a sufficient buffer for trading risks (see 8&9b.)
- Participants need more time to consider their options than the timetabled changes permit, which may lead to unsuitable outcomes.

We trust this information is useful in your advice to the Minister. If we can be of any further assistance in the review please contact me or Doug Clark, Policy Executive by email to dclark@sdia.org.au.

Yours sincerely,

David W Horsfield
Managing Director/CEO