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CS Submission
Payments Policy Department
Reserve Bank of Australia
GPO Box 3947
Sydney NSW 2001

By email: CSubmissions@rba.gov.au

ASX RESPONSE TO CONSULTATION ON REASSESSING THE CASE FOR CENTRAL CLEARING OF BONDS AND REPOS IN AUSTRALIA

ASX welcomes the opportunity to provide a response to the Council of Financial Regulator's (**CFR**) consultation on reassessing the case for central clearing of bonds and repos in Australia. As noted in the consultation paper, there have been considerable changes in the size and structure of the market, and its participants since the 2015 RBA consultation reviewed the costs and benefits of central clearing of repos in Australia.

ASX provided a submission to the RBA's 2015 consultation which observed that while there are significant benefits of repo transactions being centrally cleared, in the short term, the likelihood of such benefits being realised was limited under the structure of the repo market in 2015. With the market changes observed since 2015, ASX considers that these potential benefits remain. However, the extent to which benefits of central clearing would be realised is subject to the product scope covering both bonds and repos, and achieving sufficient participation in the central counterparty (**CCP**).

In addition, given the importance of the Australian bond and repo market and the interconnectedness of a CCP for this market to the Australian financial system, consideration of the location of a CCP should have regard to whether the regulatory agencies have sufficient powers in times of market stress to direct the CCP to do all things necessary in the interests of financial system stability in Australia.

Potential benefits of a CCP in the Australian bond and repo market

ASX considers that the potential benefits outlined in ASX's 2015 submission to the RBA consultation on Central Clearing of Repos continue to be relevant, and also extend, to central clearing of bonds. Key benefits include the following:

- > Multilateral netting (reducing counterparty exposures compared to bilateral trading).
- > Settlement efficiencies (with a single net position for settlement calculated by the CCP).
- > Capital efficiencies (including capital requirements for banks).
- > Enhanced risk and default management.

It is also likely that the introduction of a CCP for bond and repos in Australia would drive:

- > Increased use of electronic trading platforms for repos – which may lead to increased operational efficiency for the market through standardisation, straight through processing (i.e. connectivity between repo electronic platforms and the CCP) and also improved market transparency.
- > Further growth in market participation and liquidity – through reduction of counterparty risk and credit exposures.
- > Greater cross-product efficiencies – it may be possible for a bond and repo CCP in Australia to provide cross-product margin offsets e.g. in the U.S. CME and FICC have entered into an arrangement to provide margin offsets between cash Treasuries cleared by FICC and CME Group cleared Interest Rate futures products.¹

¹ <https://www.cmegroup.com/trading/interest-rates/cleared-otc/faq-cme-ficc-cross-margining-arrangement-expansion.html>.

ASX considers that realising these benefits would be subject to the product scope covering both bonds and repos, and achieving sufficient participation in the central counterparty. These issues are explored further below.

Product scope

Clearing both bonds and repos in a single CCP provides the greatest level of settlement netting efficiency, as bond and repo transactions are often linked. For example, a bank may buy a bond as an outright transaction with one counterparty and immediately lend it to another counterparty via a repo. Settlement risks/inefficiency (i.e. failed transactions) may be introduced or increased if one of these transactions is (or can be) centrally cleared and one is not (or cannot) be centrally cleared.

The greatest of multilateral netting and settlement efficiencies would be driven from central clearing of the most actively traded instruments, in this case Commonwealth Government Securities (**CGS**) and securities issued by the states and territories (semi-government securities). The market may benefit from an initial focus on building critical mass towards the central clearing of outright bond transactions and repos in these securities as an initial product scope.

Participation

ASX considers that major banks and large non-bank dealers in bonds and repos are likely to obtain the greatest benefits from central clearing of bonds and repos in the Australian market due to the nature of their activity (i.e. greatest multilateral netting potential and capital savings under the prudential regulatory regime). Building critical mass in the near to medium term could be quite challenging in the absence of a mandate. Slow and limited take up of the CCP over the medium term could also have the effect of limiting the benefits for those who have signed up. This could lead to some risks for the market such as market bifurcation, where a substantial portion of the market remains bilaterally settled (leading to an increase in settlement failures). It also presents commercial risks for the CCP and some market participants who would need to make substantial investments in building and integrating with the CCP.

Risk of settlement failures

Notwithstanding the benefits highlighted above, a CCP for the bond and repo markets would need to implement appropriate processes to address and resolve the occurrence of 'circles' of settlement fails as described in section 2.2 of the consultation paper. This is required in order to avoid the CCP introducing new settlement inefficiencies into the market.

Considerations for location requirements

The RBA's 2015 consultation observed that a CCP for bonds and repos in which the RBA was a participant would likely be considered both systemically important and strongly connected to the domestic financial system. As the current consultation paper notes, there have been considerable changes in the size and structure of the Australian bond and repo markets in recent years which may be relevant to the assessment of the domestic connection of a prospective bond and repo CCP.

A CCP for the bond and repo market (regardless of participation by the RBA) will have an important role in the functioning of the domestic funding market and liquidity risk management, particularly given the use of such facilities by banks.² It will also have to connect with other critical market infrastructure, including being a participant of Austraclear to facilitate settlement of bonds and repos. A bond and repo CCP will have interdependencies with the broader market which includes having a link to Austraclear, the RBA market operations and to Government and Semi-Government debt issuance. Please refer to **Attachment A** for further details on the expected interdependencies.

Any disruption to, or dysfunction in, the bond and repo CCP is likely to have broader market implications, including:

- > Impacts to market liquidity and activity in bonds and repos.
- > Reliance on the RBA for funding and liquidity.
- > The risk of spillover into other related or unrelated products and asset classes (potentially also systemically important) through inability to obtain appropriate funding and liquidity.

Given the potential role of the CCP, and connection to other critical market infrastructure, it would be appropriate for such a facility to be subject to regulatory controls to ensure that Australian regulators have primary responsibility, and appropriate powers, to respond and directly support continuity of services in an acute crisis at the bond and repo CCP. Regulatory controls should also ensure that the bond and repo CCP has appropriate onshore operations and expertise.

² Approximately half the repo market activity is between banks, with repos often used to manage a bank's short-term cash needs.

Implementing appropriate controls to mitigate risk to the Australian financial system may only be practical if a domestic location requirement is in place.

Whilst the Regulatory Influence Framework contemplates additional safeguards for cross border facilities (such as holding an Exchange Settlement Account with the RBA for settlement of Australian dollar obligations for systematically important CCPs), ASX considers that enabling a provider to supply important financial market infrastructure from offshore, or using offshore resources, is likely to present risks to the Australian bond and repo market than if that service was operated onshore.

For example, the Council of Financial Regulator's 2012 paper '*Ensuring Appropriate Influence for Australian Regulators over Cross-border Clearing and Settlement Facilities*' (CFR 2012 Paper), noted that additional risks could be introduced to the Australian financial system in some circumstances:

*"failure to account for Australian interests in a CCP's governance of risk and default management arrangements could give rise to stability risks by creating disproportionate obligations for surviving Australian-based participants in the event of a default, or generating other spillovers to the Australian financial system via the close-out process. Similarly, failure to provide adequate operational support or money settlement arrangements to Australian-based participants could lead to undue disruption in the event of a crisis or operational incident. Equally, the fair and effective delivery of services to Australian-based participants and their clients could be compromised if governance and operational arrangements did not adequately consider Australian interests."*³

Any offshore interest is likely to be from an overseas CCP operator who would seek to leverage their experience, existing infrastructure and capital resources in providing such an offering to the Australian market. In this regard it is important that a bond and repo CCP is not conflicted, or constrained in any way, in their ability to prioritise their financial and legal obligations owed under an Australian licence and the proper functioning of key financial market infrastructure. For example, an overseas operator offering Australian CCP services may also be licensed overseas. In times of market stress however the overseas operator may find itself subject to conflicting duties or obligations owed under separate licence obligations.

A 2015 paper on *Central clearing: trends and current issues* noted that risks can be correlated across CCPs in several jurisdictions which may have overlapping members across many CCPs, and liquidity problems in one CCP may coincide with similar issues in other CCPs.⁴ If there is a systemic shock in another CCP overseas, this could impact a domestic participant's ability to meet their counterparty obligations in Australia, as a result of their membership, and defaults experienced, in other CCPs. It could also reduce capital reserves supporting the CCP's Australian activities, where the same financial resources underpin the CCP offerings overseas and also in Australia.

The stability of the Australian bond and repo market could be adversely impacted at both the Australian participant and CCP level. Whilst contagion risks to the Australian market may be unavoidable at the participant level, given the overlapping membership of many global CCPs, having a domestic central clearing facility may help limit risks at the CCP level to support domestic stability.

We would welcome the opportunity to discuss the matters raised in this submission in more detail. If you have any questions, please contact Bianca Richardson, Senior Policy Adviser (bianca.richardson@asx.com.au) or myself on the details below.

Kind regards



Diane Lewis
GM, Regulatory Strategy and Executive Adviser
diane.lewis@asx.com.au

³ Page 9, Council of Financial Regulators (2012) *Ensuring Appropriate Influence for Australian Regulators over Cross-border Clearing and Settlement Facilities*.

⁴ Page 68, Domanski D, Gambacorta L & Picillo C (2015) [BIS Quarterly Review: Central clearing: trends and current issues](#).

Attachment A: Interdependencies and related implications

A bond and repo CCP will have interdependencies with the broader market which includes having a link to Austraclear, the RBA market operations and to Government and Semi-Government debt issuance. The following table sets out the interdependencies, risks and potential impacts.

Interdependency	Risks	Potential impacts
<p>Participation of Austraclear Limited to settle bond and repo transactions</p> <p>Austraclear provides DvP settlement for bond and repo transactions for the Australian market. A bond and repo CCP would be a participant of Austraclear, which would hold an RBA exchange settlement account to settle margins, cashflows and securities associated with the bond and repo CCP.</p>	<p>Bond and repo CCP delay or default.</p>	<p>A disruption to the bond and repo CCP's services may directly impact the effective operation of Austraclear, this could include requests for time extensions leading to settlement delays, and/or an increase in failed transactions where bilateral transactions cannot be settled as a result of delays to settling cleared transactions.</p>
<p>Link (directly or indirectly) to RBA Market Operations</p> <p>This link arises from the RBA's direct participation in Australian bond and repo markets (in contrast to the market for Australian Interest Rate Swaps). The RBA directly holds ~25% of the CGS on issue (although this will reduce over the coming years), provides funding through its open market operations and directly facilitates the effective operation of the bond and repo market by lending securities to market participants which is crucial in resolving settlement failures.⁵</p> <p>While the RBA does not anticipate participating in a bond and repo CCP directly in the medium term⁶, it will be indirectly exposed to a bond and repo CCP's activities through the nature of its continuing role in the market.</p>	<p>Bond and repo CCP major default.</p>	<p>Participants of the bond and repo CCP may immediately require bilateral funding / securities lending from the RBA at elevated levels; including borrowing to meet failed settlements or other obligations at the bond and repo CCP.</p>
<p>Funding cost implications for AOFM and Semi-Government debt issuance</p> <p>A bond and repo CCP which has gained critical mass is expected to broaden access and increase liquidity in the Australian bond and repo market. This is likely to contribute to improved conditions for AOFM and Semi-Government primary and secondary market activities.</p>	<p>Bond and repo CCP major participant default, CCP insolvency; or discontinuation of the service.</p>	<p>Impacts to the bond and repo CCP could immediately impact liquidity and activity in the bond and repo market and a second order effect of this could reasonably be expected to be a deterioration in conditions for AOFM and Semi-Government primary and secondary market activity, i.e. an increase in funding costs.</p>

⁵ Section 2.2 paragraph 3, Consultation Paper.

⁶ Section 2.3.2, Consultation Paper.