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**RESPONSE TO THE CONSULTATION PAPER BY THE COUNCIL OF FINANCIAL REGULATORS
“REASSESSING THE CASE FOR CENTRAL CLEARING OF BONDS AND REPO IN AUSTRALIA”**

Thank you for the opportunity to provide feedback on the benefits and contingencies associated with clearing repos and bonds in Australia. We appreciate the comprehensive approach taken in assessing the implications of clearing activities and wish to highlight several key considerations.

Introduction

Clearing repos and bonds through a domestic Central Clearing Party (CCP) would significantly enhance market efficiency and transparency in Australia. By establishing a local CCP, the market would benefit from real-time trade confirmations, which ensure that transactions are promptly and accurately recorded, thus reducing the potential for errors and disputes. This immediate processing helps to mitigate settlement risks and standardise clearing processes, leading to greater market liquidity and stability.

Currently, the Australian repo market faces limitations due to a lack of term markets, which impedes the development of a robust, long-term funding structure. The introduction of a domestic CCP would address this gap by facilitating more extensive and varied repo transactions, including longer-term repos, thereby deepening the market and enhancing its functionality.

Additionally, as global markets increasingly shift towards risk-free rates, price transparency becomes crucial. A domestic CCP would support this transition by providing comprehensive securities financing transaction (SFT) reporting, which enhances price discovery and transparency. This is vital for the effective implementation of risk-free rates and helps market participants make informed decisions. By ensuring

transparent and standardised reporting, the CCP would contribute to a more reliable and efficient pricing mechanism, aligning with global trends and improving the overall market infrastructure.

Central clearing significantly mitigates counterparty risk by serving as an intermediary between buyers and sellers, a crucial function in repo markets where counterparty default risk is a persistent concern. This intermediary role is especially beneficial in the Australian market, which has historically shown sensitivity to settlement fails and operational disruptions. In the repo market, where transactions are typically short-term and involve high-frequency trading, the risk of settlement failures can lead to liquidity shortages and broader market instability.

A domestic CCP would be well-positioned to address these risks effectively, leveraging its deep understanding of local market dynamics and regulatory frameworks to provide tailored risk management solutions. By centralising the clearing process, a domestic CCP can implement robust risk controls, such as rigorous margin requirements and default fund arrangements, to safeguard against counterparty defaults and ensure smooth transaction settlements.

Furthermore, the integration of the RBA's open market operations and Bond Lending Facility with the CCP would be essential to support its functionality and stability. The RBA's involvement would help facilitate liquidity provision, manage monetary policy impacts, and ensure that the CCP's operations align with broader financial stability goals. By collaborating with the RBA, the CCP can leverage the central bank's expertise and resources to enhance market stability, address liquidity needs, and reinforce confidence in the clearing system, ultimately supporting a more resilient and efficient repo market in Australia.

Establishing a domestic clearing house for repos and bonds would strengthen Australia's financial infrastructure. It would align with global best practices and potentially reduce systemic risk by ensuring that clearing functions are managed under local regulatory oversight.

Contingencies and Key Considerations

Under APS 221, CCPs are required to maintain a default fund to cover potential defaults. The establishment of a robust default fund is crucial for managing systemic risk. However, building and maintaining this fund involves significant capital requirements, which can be challenging. The ability to meet this requirement would be essential to ensure the CCP's resilience and credibility. A domestic CCP would need to carefully manage exposures to other Australian banks to avoid potential contagion effects. This requires effective risk management practices and robust stress testing to ensure that the CCP can handle multiple default scenarios without significant disruptions. As a Group our concern in the creation of the default fund in any CCP is what the overall exposure would look like if one major player, in this case another Australian Bank, were to step out. We believe in its current form; this scenario wouldn't align to the intention of the application of APS221, and therefore a key requirement of the CCP implementation in Australia.

Offshore Participation

Despite the significant increase in offshore central banks' trading volumes of ACGB's over the past four years, their involvement in the cleared space remains critical for the successful development of a CCP in Australia's repo and bond markets. Historically, offshore central banks have not been members of offshore CCPs, as their primary needs—such as capital efficiency or netting benefits—are often less pressing given their unique positions and objectives. However, their participation is vital for ensuring comprehensive liquidity and market stability within any new domestic CCP framework. Their engagement would not only validate the CCP's infrastructure but also enhance its credibility and attractiveness to other market participants. Thus, integrating offshore central banks into the clearing ecosystem could significantly bolster the efficacy and robustness of clearing operations for ACGBs and repo transactions in Australia. While such integration can

facilitate cross-border transactions, it necessitates complex arrangements and coordination to align with international standards and ensure operational consistency.

Sponsorship model, cost considerations and benefits

The introduction of a CCP in Australia necessitates the adoption of a sponsorship model, particularly due to the presence of numerous smaller market participants who may struggle with the high costs and capital requirements associated with direct membership. Implementing this model would allow smaller players to access CCP services through larger, more capitalised entities, alleviating the financial burden on individual firms. However, the complexity of establishing and managing such a model poses significant challenges, including the need for robust risk management frameworks and clear regulatory guidelines. The sponsorship model, where Local clearing members sponsor international participants, poses several difficulties. These include potential conflicts of interest, limited control over clearing operations, and complexities in aligning with global regulatory standards. Additionally, the sponsorship model may not fully address the need for a fully integrated domestic clearing solution.

Australian banks benefit from a robust capital standing, underpinned by a well-diversified customer deposit base, with over 70% of their funding sourced from customer deposits. This strong financial position reduces their immediate need for the risk mitigation and capital efficiency advantages provided by clearing bonds and repos, which are more critical in markets with less stable funding structures, such as those in Europe and the US. The substantial reliance on customer deposits affords Australian banks a more stable and resilient funding environment, diminishing the urgency for adopting clearing mechanisms to the same extent as seen in more volatile markets. Consequently, while clearing bonds and repos offer significant benefits, the immediate pressure to integrate such systems is less pronounced in Australia compared to regions with higher dependency on more volatile wholesale funding sources. While Australian banks maintain a strong capital position, this does not necessarily translate into immediate benefits from clearing. The capital required for a default fund and other clearing-related costs may still present a financial burden, particularly for smaller institutions. Moreover, the benefits of clearing may be gradual and require significant time for the market to fully realise.

The implementation of a sponsorship model for clearing bonds and repos in Australia is crucial due to the substantial number of smaller market participants who would struggle with the direct costs and capital requirements of CCP membership. However, a significant limitation of this model is the current lack of comprehensive prime banking services provided by local Australian players. The absence of a robust prime brokerage ecosystem restricts the ability of smaller entities to effectively engage in clearing activities and hinders their participation in global markets. Without the support of local prime brokers who can offer essential services such as collateral management, credit lines, and access to global liquidity, the sponsorship model may fall short in facilitating efficient clearing and may limit the broader market's ability to fully benefit from an integrated clearing system. Addressing this gap in prime banking services is essential for ensuring that the sponsorship model can operate effectively and that Australian market participants can compete on a global scale.

Efficiency, settlement system

For the efficient clearing of repos and bonds in Australia, a significant uplift and centralisation of the cash and settlement systems are essential. Currently, Australia's cash and settlement infrastructure is fragmented among different entities, including Austraclear, Euroclear, and ClearStream, each operating within their own systems and time zones. To streamline operations, it is crucial to integrate these systems into a cohesive framework that can operate efficiently across global time zones. This would involve extending cash settlement windows to accommodate the three major settlement systems, ensuring that all transactions can be processed seamlessly. Moreover, bridging these systems presents challenges that need to be addressed to

avoid operational bottlenecks and ensure robust connectivity. By centralising and modernising the cash and settlement infrastructure, Australia can enhance its clearing efficiency, reduce operational risks, and align more closely with global practices, thereby supporting smoother repo and bond transactions in a synchronised, global financial landscape.

Central Clearing Counterparties

Using a domestic CCP like ASX for clearing bonds and repos in Australia offers several notable advantages over an established offshore CCP such as LCH. ASX's deep understanding of the Australian market and its regulatory environment allows for tailored services and smoother compliance, which can streamline the clearing process. Local CCPs typically present fewer barriers to entry and faster implementation due to reduced regulatory and operational hurdles compared to offshore CCPs, which often face complex integration challenges and time zone differences. Additionally, ASX's alignment with local regulations simplifies compliance and reduces the risk of non-compliance, whereas offshore CCPs require navigating multiple regulatory frameworks and additional registration requirements. From a systemic risk perspective, a domestic CCP can better contribute to market stability and offer more responsive support during local disruptions. Moreover, operating with ASX may lower transaction costs due to reduced cross-border fees and leverage local economies of scale, while offshore CCPs often involve higher costs associated with cross-border transactions and currency conversions. Overall, while offshore CCPs offer global reach, the benefits of a domestic CCP in terms of market familiarity, efficiency, and cost-effectiveness make it a compelling choice for the Australian market. Although the underlying advantage of an offshore provider is simply the lower barrier of entry, speed of entry for existing participants, in addition to the proven ability to deliver a market integrated solution; something no domestic provider had been able to prove historically.

In summary, while the benefits of clearing repos and bonds in Australia are substantial, including enhanced market efficiency and risk mitigation, several contingencies must be addressed. These include ensuring compliance with APS 221 default fund requirements, managing exposures to domestic banks, overcoming integration challenges with offshore central banks, and addressing the limitations of the sponsorship model. Furthermore, the strong capital position of Australian banks and the lack of prime banking services add additional layers of complexity to the immediate realisation of these benefits.

Yours sincerely



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