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VIA ELECTRONIC TRANSMISSION

Michele Bullock
CS Submissions
Payments Policy Department
Reserve Bank of Australia
GPO Box 3947
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Re: Reassessing the Case for Central Clearing of Bonds and Repos in Australia, A Consultation Paper by the Council of Financial Regulators

Dear Ms. Bullock:

The Depository Trust & Clearing Corporation ("DTCC") appreciates the opportunity to comment on the above captioned consultation ("Consultation") published by the Council of Financial Regulators ("Council") to reassess the case for central clearing of Australian government and semi-government bonds and repos in Australia.

DTCC is the parent company of Fixed Income Clearing Corporation ("FICC"), which is currently the only covered clearing agency for U.S Treasury security transactions regulated and supervised by the U.S. Securities and Exchange Commission ("SEC"). Through its Government Securities Division ("GSD"), FICC provides real-time trade matching, clearing, risk management, and netting for cash purchases and sales of U.S. Treasury securities as well as repurchase and reverse repurchase transactions involving U.S. Treasury securities. Market participants created and continue to own DTCC and FICC both to reduce the risk of clearing and settling U.S. Treasury transactions and to manage the remaining risk in a way that protects participants and the wider market. FICC is also currently in the process of implementing recent amendments[1] adopted by the SEC to Securities Exchange Act Rules 17Ad-22 and 15c3-3a (such amendments, the "Treasury Clearing Amendments"). The Treasury Clearing Amendments have the effect of requiring that covered clearing agencies in the U.S. Treasury market adopt policies and procedures designed to require their members to submit for clearing certain specified secondary market transactions. These transactions include: all repurchase and reverse repurchase agreements collateralized by U.S. Treasury securities entered into by a member of the covered clearing agency, unless the counterparty is a state or local government or another clearing organization or the repurchase agreement is an inter-affiliate transaction; all purchase and sale transactions entered into by a member of the clearing agency that is an interdealer broker; and all purchase and sale transactions entered into between a clearing agency member and either a registered broker dealer, a government securities broker, a government securities dealer. Compliance by the direct participants of a U.S. Treasury securities central clearing agencies with the requirement to clear eligible secondary market transactions would not be required until December 31, 2025, and June 30, 2026, respectively, for cash and repurchase transactions.[2]

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[1] See Standards for Covered Clearing Agencies for U.S. Treasury Securities and Application of the Broker-Dealer Customer Protection Rule With Respect to U.S. Treasury Securities, 89 Fed. Reg. 2714 (Jan. 16, 2024).

[2] U.S. Securities and Exchange Commission, *SEC Adopts Rules to Improve Risk Management in Clearance and Settlement and Facilitate Additional Central Clearing for the U.S. Treasury Market* (Dec. 13, 2023), https://www.sec.gov/newsroom/press-releases/2023-247.

Executive Summary

Because of the Treasury Clearing Amendments, DTCC and FICC have an appreciation for the Council's considerations when contemplating increasing central clearing of Australian bonds. In particular, in reference to question one posed in the Consultation, DTCC and FICC have spent significant resources analyzing the costs, both tangible and intangible, in relation to the benefits resulting from increased central clearing. As numerous policymakers, academics, and market participants have recognized, greater central clearing of sovereign debt transactions can improve the safety, soundness, and efficiency of markets, promote competition, enhance transparency, and facilitate all-to-all trading. Increased central clearing can also reduce clearing costs and credit risk by incentivizing participants to submit more balanced portfolios that have a lower risk profile and thus carry lower margin requirements. Furthermore, through balance sheet netting and possible favorable regulatory capital treatment, central clearing has the power to increase dealers' capacity to transact and thereby ameliorate constraints on market liquidity. Indeed, FICC has found that during times of market stress, such as in March 2020, market participants submit a *greater* volume of transactions for clearing, presumably to benefit from multilateral netting, increase their trading capacity and limit their credit risk.

Analysis

Central Clearing's Role in Strengthening Markets

DTCC and FICC agree with the diverse array of market participants, regulators, and scholars that have concluded that greater adoption of clearing would improve the resilience and strength of the U.S. Treasury market, and that these same benefits would likely accrue if implemented in other markets, such as the Australian bond market. While expanded central clearing is not a cure-all for all market structure issues, as these commentators have identified[3] central clearing can provide numerous interrelated benefits to the market that not only reduce risk but also improve the efficiency and stability of the market. Increased central clearing augments these benefits, reduces costs, and limits the instances and severity of market disruptions. In addition, greater central clearing can address some of the constraints on market liquidity and facilitate all-to-all trading.

1. *Risk Reduction from Multilateral Netting*

One of the core benefits of central clearing is multilateral netting. Specifically, for each security, each participant's delivery obligations and entitlements in a given security are netted down into a single delivery obligation or entitlement for that security. This netting is generally not possible to a similar degree in bilaterally cleared transactions, since parties are practically and legally only able to net amounts they owe and are owed by the same counterparty and running a matched book necessarily involves trading with multiple counterparties. Multilateral netting substantially reduces the buildup of credit exposure and the knock-on effects such risk can have on the market. This reduction substantially limits the possibility for a cascade of losses and the market disruption that could result from multiple market participants selling

[3] *See* Treasury Markets Practice Group, *White Paper on Clearing and Settlement in the Market for U.S. Treasury Secured Financing Transactions*, Federal Reserve Bank of New York (Nov. 9, 2022), https://www.newyorkfed.org/medialibrary/Microsites/tmpg/files/CS_SFT_2022.pdf; Group of 30 Working Group on Treasury Market Liquidity, *U.S. Treasury Markets: Steps Toward Increased Resilience*, G-30 (July 2021), https://group30.org/images/uploads/publications/G30_U.S_._Treasury_Markets-_Steps_Toward_Increased_Resilience__1.pdf; Nellie Liang & Pat Parkinson, *Enhancing Liquidity of the U.S. Treasury Market Under Stress*, Hutchins Center on Fiscal & Monetary Policy at Brookings (Dec. 16, 2020), https://www.brookings.edu/wp-content/uploads/2020/12/WP72_Liang-Parkinson.pdf; Michael Fleming & Frank Keane, *The Netting Efficiencies of Marketwide Central Clearing*, Federal Reserve Bank of New York (Staff Reports No. 964) (Apr. 2021), https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr964.pdf; FIA Principal Traders Group, *Clearing a Path to a More Resilient Treasury Market*, FIA (July 2021), https://www.fia.org/sites/default/files/2021-07/FIA-PTG_Paper_Resilient%20Treasury%20Market_FINAL.pdf; Basel Committee on Banking Supervision *et al.*, *Review of Margining Practices*, Bank for International Settlements (Sept. 2022), https://www.bis.org/bcbs/publ/d537.pdf.

securities and buying the same securities. It also reduces settlement risk because it converts a party's delivery obligations into a single securities delivery obligation. Accordingly, central clearing serves to *reduce* risk.

2. Creating Market Capacity Through Multilateral Clearing

Multilateral netting can also ameliorate one of the principal constraints on market liquidity, bank capital restraints. Depending on a jurisdiction's bank capital requirements, higher capital requirements and balance sheet impacts can make it more expensive for bank-affiliated dealers to engage in certain transactions, such as sovereign debt. These expenses, in turn, limit the capacity of dealers to participate in the market to the same extent as would otherwise be feasible based on economic fundamentals alone. This results in fewer intermediaries standing ready to execute transactions and thus less market liquidity. Multilateral netting mitigates these constraints by often allowing participant dealers to calculate their exposures under cleared transactions on a net basis for both balance sheet and regulatory capital purposes. Through multilateral netting, a dealer can net virtually offsetting exposures against each other. The resulting exposure amount is less impactful on the dealer's balance sheet and could carry much smaller capital requirements.

If the capital and balance sheet implications of cleared transactions are less impactful, the costs the dealer incurs in entering into such transactions will be much lower and the dealer can use the savings to engage in additional transactions. Indeed, this is arguably one of the reasons why participant dealers have historically submitted a substantially greater volume of transactions to FICC during market dislocations and liquidity crunches. Through multilateral netting, central clearing can help free up market liquidity to the extent the constraints on such liquidity arise from participants' capital or balance sheet limitations.

3. Centralized, Standardized, and Transparent Risk Management

Well-managed central clearing further reduces and manages risk through comprehensive risk management programs that are centralized, standardized, transparent, and subject to extensive regulatory oversight. First, dynamic and evolving risk analysis tools produce outcomes whereby short-term volatility does not result in sudden increases in clearing fund requirements. This stability helps mitigate the risk of procyclical effects of margin. Second, central clearing risk management procedures aim to ensure that a central counterparty will have sufficient resources and capabilities to handle a default scenario under extreme but plausible market conditions. They also aim to make sure that those participants whose portfolios give rise to credit and liquidity risk cover those risks *ex ante* instead of externalizing them to market participants or the official sector in the context of a default or market stress. This internalization not only appropriately allocates costs, reduces risk, and preserves market stability, but it also promotes an alignment of interests, as it incentivizes participants with directional portfolios to flatten out their positions. Additionally, central clearing does not entail separately or confidentially negotiating individualized credit, market, or liquidity risk requirements with participants based on "relationship" considerations, as may occur in the bilateral space.[4] Instead, each participant's financial risk requirements are based on rules available to all participants and are generally publicly available. This standardization and transparency ensures that all of participants, regulators, and the public at large understand the central counterparty's risk management rules. Lastly, central counterparties generally assess standardized fees based in part on the risk embedded in each participant's portfolio. This further incentivizes responsible risk management.

4. Preserving Market Stability and Limiting Fire Sale Risk Through Centralized Default Management

In the event of a default in the bilateral space, each of the bilateral counterparties to the defaulted market participant must separately take market action to close out the defaulter's positions. This can often result in fire sales or price surges as market participants must race against one another to sell or buy the

[4] Basel Committee on Banking Supervision *et al.*, *Review of Margining Practices*, Bank for International Settlements (Oct. 2021), https://www.bis.org/bcbs/publ/d526.pdf.

relevant securities.[5] This is particularly the case when bilateral market participants have not collected sufficient margin or have failed to pre-position enough liquidity to address a default scenario. These fire sales and surges can create substantial market dislocation, with a variety of knock-on effects, including increased margin calls, liquidity stresses, and potential defaults for market participants that have no connection with the defaulter.

By contrast, a central counterparty centrally manages any default. It can therefore take market action in a more orderly manner and, in certain instances, in coordination with other market utilities that are transparent to market participants and mitigate the uncertainty caused by bespoke risk management practices. This centralized management may limit losses to a central counterparty and its participants and reduce the likelihood of overall market disruption.

5. Transparency and Accountability

Central clearing promotes transparency and accountability, and thereby furthers predictability, enhances deliberation, and limits the likelihood of systemic issues arising from hidden concentrations of risk. As noted above, unlike bilateral contracts, a central counterparty's rules, including the terms of margin, default management processes, operational testing requirements, and membership criteria, are generally available to the public for both transparency as well as consultation and accountability purposes.

Furthermore, central clearing gives regulators enhanced visibility into market activity, including around the potential for systemic causes of disruption. Through such enhanced visibility, the Reserve Bank of Australia can identify the types of transactions cleared and whether the data for those transactions, combined with other information available, indicate problematic instances of systemic risk concentration, as well as other problematic forms of activity. This transparency limits the likelihood of unforeseen market risk disruptions and preserves market stability.

6. Facilitating All-to-All Trading Through Comparison and Novation

Central counterparties "novate" transactions that they clear, meaning they will become the buyer to the seller and the seller to the buyer. As many commentators have recognized, this novation can reduce risk and facilitate all-to-all trading by allowing market participants to execute transactions with one another without concern for counterparty credit risk of their trading counterparties.[6]

<u>Increased Clearing May Lead to Decreased Costs</u>

DTCC and FICC believe that increased clearing of sovereign debt has the potential to augment the above-mentioned benefits and will promote the prompt and accurate clearance and settlement in these markets. More clearing would lead to greater multilateral netting and thus lower credit and settlement risk and more trading capacity for dealers. Increased clearing would also ensure that liquidity and credit risks are responsibly managed and that the costs of such risks are borne *ex ante* by those market participants that give rise to them. Further, increased clearing would improve transparency, limit disruptive market action in a default context, and expand the ability of participants to trade with one another.

While some costs, such as fees charged for clearing, are easily recognizable, other costs are harder to quantify. As the Consultation contemplates, one must weigh the benefits of central clearing

[5] *See* Michael S. Gibson, *SR 21-19: The Federal Reserve Reminds Firms of Safe and Sound Practices for Counterparty Credit Risk Management in Light of the Archegos Capital Management Default*, Federal Reserve Board of Governors (Dec. 10, 2021), https://www.federalreserve.gov/supervisionreg/srletters/SR2119.htm. *See also* Matt Scuffham *et al.*, *In Archegos Fire Sale, Credit Suisse, Nomura Burned by Slow Exit*, Reuters (Mar. 30, 2021), https://www.reuters.com/world/asia-pacific/archegos-fire-sale-credit-suisse-nomura-burned-by-slow-exit-2021-03-31/; Eric Platt *et al.*, *Banks Face Regulators' Scrutiny on Handling of Archegos Fire Sale*, Financial Times (Mar. 30, 2021), https://www.ft.com/content/c771ad24-24ca-4002-ab8f-17719e4c32da.

[6] TMPG (2019), *supra* note 18, at 17; TMPG (2022), *supra* note 15, at 4 n.4.

against any costs that could arise from central clearing. In that regard, some may argue that more central clearing may increase a central counterparty's risks and thereby increase the amount of margin required to have available to address a default scenario. It is suggested that these increased commitments and resources would increase the costs of the central clearing to market participants, relative to the costs that participants currently incur in entering into bilateral transactions. As discussed above, central counterparties require participants to post margin and have liquidity available to support the transactions they submit for clearing. This is a notable departure from the bilateral space. The fact that bilateral clearing arrangements do not generally impose some kind of liquidity costs generally means that those costs, when they come to fruition in a default scenario, are externalized to the broader market or the official sector, often during a period of market disruption.

Accordingly, DTCC and FICC caution against viewing the absence of liquidity pre-positioning or comprehensive margining in the bilateral space as suggesting that bilateral transactions do not present liquidity and credit risks and attendant costs. Rather, bilateral transactions have the potential to present the same, and in many cases greater, liquidity and credit risks as compared to centrally cleared transactions. In conducting any cost-benefit analysis, the Council must consider these risks and the costs of not addressing them and how these costs compare to the costs of a central counterparty's risk management in light of the broad systemic benefits discussed above.

Further, more central clearing may cause participants that currently engage in hybrid clearing to submit more balanced portfolios that present lower market and liquidity risks and thereby give rise to lower margin. Some participants run a matched book, but only clear one side of the book. Since uncleared transactions are not eligible for multilateral netting with cleared transactions, a participant engaging in this kind of "hybrid clearing" will have a directional portfolio vis-à-vis a central counterparty. Directional portfolios present greater credit and liquidity risk and thereby can lead to higher margin requirements. Were increased clearing to lead participants to submit their full portfolios, and not single legs, that may result in participants having more balanced cleared portfolios and thus lower margin requirements.

Closing

As the United States continues to move towards implementation of the Treasury Clearing Amendments and expanded central clearing for U.S. Treasury securities and repos, DTCC and FICC continue to believe in the benefits that central clearing can bring across a wide variety of markets and asset classes. We applaud the Council for pursuing these benefits in the Australian sovereign debt market given the various above-discussed benefits that central clearing has brought and will continue to bring to U.S. market structure.

We appreciate the opportunity to submit this viewpoint and welcome any further engagement with the Council to discuss our views on this Consultation.

Very Truly Yours,

Signed by:
Laura Klimpel
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Laura Klimpel