Australia - Public Consultation on the Central Clearing of Bonds and Repos in Australia

Euroclear response - September 2024

Please find hereafter, Euroclear Bank's response to RBA Public Consultation on the Central Clearing of Bonds and Repos in Australia.

Costs and benefits	**Euroclear response**
1. Have the potential benefits of central clearing the Australian bond and repo markets increased in recent years? What costs/benefits do you view as being the most relevant for consideration of central clearing in the Australian bond and repo markets?	We consider the benefits of central clearing are: counterparty risk reduction, trading anonymity, fewer settlements, operational efficiency and balance sheet netting, whereas we see the costs and challenges are default fund contributions, initial margins and clearing fees and membership arrangements. The trade-offs between the benefits and costs / challenges of central clearing are frequently finely balanced meaning that in our experience there needs to be one compelling driver in order for a move to central clearing to gain market support, capture market share and achieve economies of scale to offset the additional market costs of adoption. For example, the need in Europe to net repo on bank balance sheets in the late 1990s was compelling as repo markets developed. In the 2000s the counterparty risk associated with long dated swap trades was the catalyst for central clearing as swaps volumes grew, and in the early 2000s the explosion in trading volumes following the introduction of electronic trading in cash equity markets was the decisive driver to introduce central clearing and reduce settlement volumes via netting. In our view the most compelling driver for introducing central clearing for bond and repo markets is balance sheet netting. We note this is a harder justification in repo markets where a handful of market participants have significant market share, or where there are limited bidirectional flows for banks. The experience of the Bank of Canada and CDDC in introducing central clearing in Canada might be insightful, given there are some similarities between the markets.
Participation and viability	
2. What do you consider to be the **minimum product scope** and participation necessary to support effective central clearing in Australian bond and repo markets? Do you envisage any issues arising if a prospective CCP was to clear for a single segment of the market (e.g. bonds only or repos only)?	As noted in our response to question 1, we see balance sheet netting of repo as the key central clearing benefit for fixed income markets. This means central clearing of open repo is of limited value, as it is not eligible for balance sheet netting. There may be value in including cash market bond trades too if that facilitates netting of a bond purchase and a repo trade to finance the purchase. There may be a risk in defining a minimum product scope that does not deliver sufficient benefits to justify the investment or scale to make the unit cost economic
3. Under what conditions would you **participate in a bond and repo CCP** if there was one servicing the Australian market?	EB Treasury, for the purpose of reinvesting participant AUD balances, participates to Australian Bond and repo markets, however, the extent of this is very limited and hence, there would be very limited expected benefits from central clearing. These conditions are unlikely to change in the near to mid-term.

4. In your experience, including with bond and repo CCPs in other jurisdictions, are there likely to be **material challenges** faced by the Australian market in transitioning to a centrally cleared environment and how might these be overcome?	We see several challenges: - Market structure – it is important to ensure that there are sufficient clearing members in any cleared market to ensure effective competition. This is a growing problem even in very large markets, such as US Exchange Traded Derivative markets where there are concerns about clearing volumes being concentrated with a handful of market participants. - Cost – there are material legal, technology, operational and change costs associated with implementing central clearing. This is a major market wide transformation which requires scheduling alongside other market transformation initiatives, as they typically use the same scarce resources at market participants. - Market adoption – in our experience a handful of committed anchor clients are essential for the success of this type of project alongside the active support of the public authorities. - A phased introduction of the product is often a good way to manage the implementation risk. For example, when introducing central clearing to the cash equity market in 2001-2002, the London Stock Exchange in a first phase introduced a centrally clearing market structure followed by settlement netting in a second phase 15 months later to limit the scale of the operational changes in the first phase.
Efficiency and resilience	
5. What do you view as being material impediments, if any, to the safe and efficient operation of a bond and repo CCP in Australia? Please consider the effects of an extended disruption on your business (such as liquidity and risk management), as well as broader effects such as those related to financial stability and market confidence.	- CCPs issue margin calls that must typically be met within very strict deadlines. Given the time difference between Australia and Europe, European entities could find it challenging to respond to margin calls issued by an Australian CCP. - Since central clearing typically transforms counter-party credit risk into liquidity risk, European entities may have to beef up their liquidity in Australia and/or manage liquidity differently in the Asia-Pacific region once Australia becomes a larger liquidity consumer. - The central clearing of repo trades may enhance financial stability by ensuring players can keep funding themselves in the market during stress episodes, which is particularly valuable for players that cannot obtain short-term funding directly from the RBA. - The case for the central clearing of bond cash trades is less obvious as neither counter-party credit risk nor market volatility is particularly present in the bond market. As a result, leveraging a strong group of primary dealers may be more efficient than imposing central clearing for bond cash trades. - The business case for non-residential players to set aside capital for a potential replenishment of the default fund will have to be carefully assessed as time-zone differences create operational challenges that may not be offset by the benefit brought about in terms of risk reduction. - The liquidity risks faced by CCPs are accentuated when clearing repo markets due to their size. This is illustrated by the size of the Capped Contingency Liquidity Facility in the US, which according to recent FICC statistic has varied between USD 71 bio and USD 128 bio since 2021 and is considered by US repo market participants as a material cost. The liquidity arrangements for a repo CCP in Australia including potential access to the RBA window will require careful analysis and design.

6.	How material are issues with settlement chains on the safety and efficiency of the Australian bond and repo markets? In your experience, what are the factors behind these issues? What steps, if any, should a prospective bond and repo CCP or its participants take to mitigate the risk of issues associated with settlement chains?	The Euroclear Bank Network team has not received any feedback on issues related to settlement chains. Neither from our provider HSBC nor from the CSD ASX. The topic was not raised at the market association meetings Euroclear attended either. The Euroclear Product team has some experience of settlement chains and loops, including in relation both to repo and centrally cleared markets. We are not aware of the issues noted but would be happy to schedule a call on the subject if that would be helpful.
7.	Are there any aspects of the bond and repo markets that in your view are not functioning efficiently? For example, would **enhanced transparency** in bond and repo markets improve the efficiency of these markets?	We have not received any particular comments from participants on the efficiency of the functioning of the Australian bond market and, as indicated above, we are not aware of issues either on settlement.
8.	What actions could regulators or industry take to improve the efficiency and/or resilience of the bond and repo markets, including to reduce information asymmetry and improve price and liquidity discovery?	Regulation shall allow for direct access/participation in Australian domestic CSDs for foreign clients including foreign FMIs without requiring local entity/presence.
Location		
9.	Some other major jurisdictions have CCPs operating bond and repo clearing services in their domestic markets. What are your views on an overseas operator providing clearing services for the Australian bond and repo markets	The advantages of using an overseas operator include include economies of scale, the potential to calculate and collect margin and default fund contributions, across asset classes and geography. There are benefits of leveraging experiences & knowhow across a large eco system and potentially safety benefits of scale. Equally there are systemic risk and regulatory oversight considerations in an overseas operator as well as governance, control and oversight challenges. There are also of course geopolitical considerations.
10.	Based on your experience, including in other jurisdictions and markets, what features of an overseas-based CCP could present difficulties or introduce risks in the Australian context? How are these challenges managed in other jurisdictions and are they managed successfully?	In our experience the most challenging question when looking at leveraging overseas FMI in a domestic market is establishing a governance and control model that is acceptable to all stakeholders including domestic and overseas regulators. We do not see any one model as being a suitable template as in our experience each scenario is unique when dealing with G20 markets.
11.	With the increasing internationalisation of Australian bond and repo markets, do you consider it desirable for a potential bond and repo service to have effective links to trading and settlement services, including international central securities depositories?	In our experience it is important to have efficient cross-border settlement links between domestic CSDs and ICSDs so that liquidity can easily move between onshore and offshore liquidity pools. However we don’t see any situations where central clearing in one domestic market also requires the CCP to central clear the same bonds in the international market. More concretely FICC clear US Treasuries at the Fed and LCH clear gilts at CREST. Euroclear Bank has significant liquidity pools in US Treasuries and gilts and neither CCP offers central clearing for the liquidity pool at the ICSD.