



# Delivering Efficiencies to the Marketplace through the Harmonisation and Linking of CCP Activities The Way Forward

Market Information Document

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## A. Executive Summary

In the first quarter of 2009, ASX received responses to its Consultation Paper, *Delivering Efficiencies to the Marketplace through the Harmonisation and Linking of CCP Activities*. The paper outlined a number of potential enhancements to the current operation and structure of ASX's two central counterparties (CCPs), ACH and SFECC, and also the interaction between them. In addition, the Consultation Paper requested feedback from stakeholders on additional market needs and their expectations of ASX's CCP services. Following the consultation process, in the second quarter of 2009, ASX released a high-level summary of responses received from stakeholders, *Summary of Responses to Key Initiatives*.

ASX has since reviewed the proposed initiatives in light of these responses, together with the risk appetites of the relevant CCP and of ASX Group. Each initiative has been assessed, in broad terms, against the following criteria, with stakeholder feedback proving particularly relevant for the last three criteria:

- **Regulatory Compliance:** including ensuring that each of the CCPs continue to meet the obligations relating to their Clearing and Settlement Facility Licences (CSFLs) and to the Financial Stability Standard for Central Counterparties;
- **Risk Management Impact:** including the ability to enhance risk measurement and/or improve risk mitigation, especially in order to minimise wider systemic risks;
- **Market Enhancement:** including the ability to encourage market development and/or meet demand from stakeholders; and
- **Operational Effort:** including the anticipated effort and costs required from industry participants to implement and maintain changes relative to market-wide benefits.

Following this assessment, ASX has reviewed each proposal and determined the initiatives to be progressed to the next stage and the relevant priority with other ASX projects. These initiatives include, in the currently anticipated order of execution:

- Margin Offsets (SPI vs XJO);
- Migration of TIMS to CME SPAN;
- Migration of RIVA SPAN to CME SPAN;
- Margin Offsets (between all other appropriate contracts);
- Widen Definition of House Business on ACH;

In contrast, while the ASX is of the view that they represent enhancements, given stakeholder feedback and its own analysis, the following initiatives will not be progressed at this stage:

- Omnibus Client Account in the ACH Cash Market;
- Single Point of Collateral Lodgement;
- Integration of ACH and SFECC.

This Paper addresses each of the proposals in turn, outlining ASX's analysis following the feedback from Clearing Participants and the rationale for the proposed way forward. Enquiries on this document should be directed to Paul Jones ([paul.jones@asx.com.au](mailto:paul.jones@asx.com.au)) or Andrew White ([andrew.white@asx.com.au](mailto:andrew.white@asx.com.au)).

## B. Introduction

In the first quarter of 2009, ASX received responses to its Consultation Paper, *Delivering Efficiencies to the Marketplace through the Harmonisation and Linking of CCP Activities*. The paper outlined a number of potential enhancements to the current operation and structure of ASX's two central counterparties (CCPs), ACH and SFECC, and also the interaction between them. In addition, the Consultation Paper requested feedback from stakeholders on additional market needs and their expectations of ASX's CCP services. Following the consultation process, in the second quarter of 2009, ASX released a high-level summary of responses received from stakeholders, *Summary of Responses to Key Initiatives*.

This paper reassesses the initiatives outlined in the ASX Consultation Document *Delivering Efficiencies to the Marketplace through the Harmonisation and Linking of CCP Activities* in light of the feedback received from Clearing Participants in mid 2009 and further ASX analysis. The assessment process has reviewed the proposals against four broad criteria:

### 1. Regulatory Compliance

ACH and SFECC are required to comply with obligations relating to their respective Clearing and Settlement Facility Licences (CSFLs). Such obligations include providing services that are fair and effective and reasonably practical to reduce systemic risk; compliance is overseen and annually reviewed and assessed by the Australian Securities and Investment Commission (ASIC). In addition, both CCPs must meet stability and risk requirements, including compliance with the Financial Stability Standard for Central Counterparties (FSS), overseen and annually assessed by the Reserve Bank of Australia (RBA).

### 2. Risk Management

ACH and SFECC are responsible for managing and mitigating the risk associated with the provision of clearing and CCP services in line with the risk appetite of the ASX Group. Such risk management functions include accurate estimation and apportionment of risk reflected in risk mitigation activities including appropriate margining and market structures. Risk mitigation includes efforts to reduce or ameliorate risk in excess of the risk appetite of the ASX Group to ensure the stability of the CCP. In addition to the ASX's own risk appetite, the FSS also imposes measures on the management of risk, which are subject to an annual compliance assessment by the RBA. A further important component of risk management is the ability of such arrangements to facilitate the successful management of a Clearing Participant default.

### 3. Market Enhancement

As a service provider, ACH may initiate changes to meet demonstrable market demand where appropriate. This may include an expansion of services to other markets or participants, or modification of the existing service to better meet the needs of users or enhance the efficiency and effectiveness of the market.

### 4. Operational Effort

The ASX Group has considered the likely effort required from stakeholders in implementing the various proposals. For those initiatives that reduce risk or that are regulatory-driven, such operational concerns are of secondary consideration. This is consistent with recognition that the benefits, rights and advantages afforded by Clearing Participant status in a CCP are necessarily accompanied by certain obligations and related cost/resource impacts. In contrast, for initiatives that support market enhancement or market demand, the operational impact of both implementation and maintenance may be of greater importance in determining their progress.

Each initiative has been assessed in broad terms against these criteria; a summary of the analysis and outcomes is outlined below in the order presented in the consultation document, followed by the ASX conclusion and proposed next steps. Full details on the proposals are available in the initial consultation document.<sup>1</sup>

<sup>1</sup> [http://www.asx.com.au/about/pdf/consultation\\_paper\\_harmonisation\\_linking\\_ccp\\_activities.doc](http://www.asx.com.au/about/pdf/consultation_paper_harmonisation_linking_ccp_activities.doc)

## Account Structures

### Proposal 1: Each Clearing Participant to maintain a separate house account and (omnibus) client account for the ASX cash equity market

ASX is of the view that the proposal to separate house and client accounts would assist position and account management following a default of a Clearing Participant and in some circumstances could strengthen existing client segregation arrangements. However, such separation does not unambiguously improve risk measurement or mitigation. Indeed, several respondents argued that the gross funding of two separate obligations increases operational risk and may also increase settlement risk in some circumstances; a position that ASX acknowledges. The consultation process also raised the issue of the potentially significant market impact, as the proposal requires market-wide implementation of separated Cash Market accounts. This is despite only a small number of Clearing Participants with proprietary trading, signifying that the implementation and maintenance requirements may be disproportionate to the benefits received given the current market structure.

While ASX supports the potential additional protection that would be afforded to underlying clients resulting from the separation of settlement of house and client transactions in the ACH equity cash market, ASX concluded that on balance the benefits in a default of such account separation do not, at this stage, outweigh the potentially significant costs of such a change. In reaching this conclusion, ASX also recognised the importance of:

- the client segregation protections already in place (in both the HIN stock holding rules and cash trust account arrangements) that are demonstrably more powerful than the proposed separation of house and client accounts; and
- the client compensation arrangements provided by the SEGC's National Guarantee Fund.

Nevertheless, in light of the potential benefits that account separation could produce, client/house segregation remains a longer term objective for ACH. ASX will revisit the proposal in the future should any significant systems development or changes to market structure present the opportunity for its introduction. Any future introduction of margining (or similar) to the equity cash market would undoubtedly require this topic to be re-visited: it will be included in the forthcoming consultation document on CCP risk controls later this year.

### Proposal 2: Introduction of a voluntary omnibus client account to the ASX Options market

The proposed omnibus client account structure would introduce alternative margin lodgement arrangements and facilitate future margin offsets for Clearing Participants and their underlying clients. Furthermore, the voluntary nature of the proposal would allow those Clearing Participants that see benefit for themselves, or their clients, to enhance their product offering, while not impacting on other Clearing Participants or the CCP. Nevertheless, feedback received via the consultation process indicated that there was unlikely to be widespread demand for an omnibus account arrangement. Major hurdles noted were the complexity of explaining potential default obligations and the impact of pooling client funds on the risk profile, especially for retail users, such that many would be unlikely to take up the offer. In addition, legal constraints under the Corporations Act would need to be investigated. Operationally, the proposal would require a moderate investment by any Clearing Participants who offer the account, particularly in the area of back-office margin apportionment and reconciliation. ACH would be required to establish omnibus accounts for relevant Clearing Participants, and implement appropriate netting and settlement arrangements.

ASX is not convinced that there is sufficient market demand to introduce an omnibus account on the ACH Options Market at this time. While the current business case does not support implementation now, this proposal will be reviewed in future and the implications of the different account structures across SFEC and ACH will be re-visited once more detailed consideration is given to the introduction of cross-CCP margin offsets. It should be noted that without such an omnibus client arrangement, it is difficult to envisage any effective implementation of margin offsets for client positions.

### Proposal 3: Widen the definition of house business on ACH in line with that used by SFECC

The widening of the definition of house account (proprietary) business on ACH will improve risk attribution by more accurately assigning such risk to the relevant counterparties. Further, it will provide full segregation of client business from house business during events of default. Notwithstanding these benefits, a wider definition may require a once-off alteration to Clearing Participants' internal processes and procedures to ensure transaction classification complies with the updated broader definition.

ASX has concluded that there is a reasonable business case for implementing this initiative. The improved accuracy of risk attribution for related entity transactions to the House account, harmonisation with SFECC definitions that would in part assist future margin offsets, broad support from respondents, and relatively low operational complexity suggests the marketplace would, on balance, benefit from this initiative.

ASX will review the current definition of House business with a view to harmonisation with that of SFECC. It is anticipated that this will be implemented over the medium to long term, with its timing likely to be determined by progress on margin offset arrangements.

## Margining Algorithms

### Proposal 4: Harmonisation of ACH and SFECC margining methodology

The consultation process supported the contention that the introduction of a more advanced, common margining methodology across CCPs would improve risk estimation, better reflect trading strategies, create easier opportunities for margin offsets between the two CCPs and bring ASX's CCPs in line with international best practice. A number of respondents were very supportive of the initiative to replace TIMS, with significant recognition of CME SPAN as the current global benchmark for risk management. The replacement of RIVA SPAN was also welcomed by SFECC respondents. A number of respondents held the view that CME SPAN would potentially increase the number of viable trading strategies and contract liquidity.

The migration of TIMS to CME SPAN is not without operational complexity; however ASX is not convinced that such complexity is a barrier to implementation. Indeed many Clearing Participants active on overseas exchanges in the region already use CME SPAN. Given almost all CCPs around the world have since moved from TIMS to an alternate margining algorithm (including SPAN), precedence suggests that the process is achievable. It is anticipated that the upgrade of RIVA SPAN to CME SPAN will, in comparison, be operationally simpler.

The ASX position is that a sufficient business case has been established for the migration and harmonisation of margin algorithms across ACH and SFECC to CME SPAN. The anticipated improved risk estimation and attribution, Clearing Participant demand and anticipated market liquidity benefits, balanced against manageable operational issues, suggest significant benefits for stakeholders from this initiative. ASX will review the CME SPAN program for more detailed feasibility study and will revert to the industry in due course regarding an implementation timeline as appropriate.

## Margin Offsets

### Proposal 5: Introduction of margin offsets across CCPs

This proposal aims to improve risk measurement by calculating margins on the total portfolio held by a Clearing Participant across both clearing houses. In doing so, margin offsets allow a more accurate estimation of the exposure of the CCP to a Clearing Participant, and margin efficiencies for the Clearing Participant by reducing unnecessary over-margining. These benefits are achieved at no increase in risk to the CCPs and in some cases, the risk diversity benefit could provide an additional tier of risk protection. Several respondents anticipated margin offsets would encourage market growth, free up liquidity and make viable trading opportunities that are currently unprofitable. In particular, several respondents agreed with ASX's suggestion that the key area of benefit lay in the cross margining of equity futures in particular the SFE's SPI future and ASX equity options.

Nevertheless, such benefits rest on an assessment of the eligibility of securities/products for offset, and the suitability of accounts for offset. The introduction of margin offsets, while a relatively simple concept mathematically, has a number of practical issues to overcome. For example, legacy technology systems and the historical differentiation of the legal entity acting as a Clearing Participant on each market may represent barriers to implementation and therefore require more detailed analysis.

ASX has concluded that this work should proceed to the next stage due to the improved capital efficiency for Clearing Participants and potential for increased market liquidity in cross-margined contracts, achievable at no resulting increase in CCP risk. Despite the advantages, ASX notes the substantial legal, risk management, and operational issues that must be overcome.

Given that the stakeholder responses focussed primarily on the potential benefits of XJO and SPI margin offsets, ASX will firstly undertake analysis on the feasibility of a bespoke solution to cater for this specific combination ahead of any change in margin algorithms to CME SPAN. The conclusions of this review will form the basis of the feasibility of margin offsets under the current market structure and guide subsequent development of more widespread offset arrangements. This will include liaison with relevant Clearing Participants, and ASX will revert to the industry in due course.

## Single Point of Collateral Lodgement

### Proposal 6: Introduction of a single point of collateral lodgement

ASX anticipates that a single point of collateral lodgement (SPL) would benefit Clearing Participants by creating more flexible and efficient collateral usage across both CCPs. Benefits could result from operational efficiencies and reduced fees associated with collateral movements and banking payments and lower liquidity risk, by limiting the size or frequency of margin calls. However, a SPL would require revised operational procedures for Clearing Participants and the CCP to submit collateral to the new entity. Further work by the CCP would be required in establishing the appropriate legal basis for such consolidation for both ASX and the users of the service.

While ASX is still of the view that a SPL would deliver benefits for both Clearing Participants and the CCP, a number of concerns were raised during the consultation process, specifically around the implementation of the proposal. While the ASX is confident that such concerns can be overcome, the lower level of demand does not support the independent implementation of this proposal at this time. This proposal may be reviewed in the future.

## Initiatives Related to Potential Integration of the Two CCPs

### Proposal 7: Full integration of the ACH and SFECC

It is likely that full integration would, in the absence of any other initiatives, improve market depth and improve efficiencies. Further, the majority of respondents were in agreement with ASX's view that such benefits could instead be achieved by a number of the other initiatives outlined above without the need to undertake complex, lengthy and potentially costly work. The integration of clearing houses would involve a significant amount of resources from the industry and ASX, encompassing legal work on the consolidation of two rulebooks into one, clearing systems integration and changes to internal processes and procedures of both the ASX and Clearing Participants. Moreover, in some cases a single solution is not appropriate for the two markets supported by the CCPs.

ASX has concluded that the integration of both CCPs, given their current differences, is not desirable in the short to medium term but may be revisited as part of future strategic initiatives. The majority of the market benefits are otherwise achievable as a result of gradual harmonisation and linking of CCP processes and procedures over the medium term.