



27 October 2014

Dr Malcolm Edey
Assistant Governor (Financial System)
Reserve Bank of Australia
65 Martin Place
SYDNEY NSW 2000

Dear Dr Edey,

Interpretation of Financial Stability Standards for Central Counterparties (CCP Standards)

Thank you for your letter dated 27 October 2014 which amends the supplementary interpretation of the CCP Standards issued by the Bank on 16 August 2013 to expand its scope to cover all domestically licensed central counterparties in Australia that provide services to clearing participants that are either established in the EU or subject to EU bank capital regulations.

The Bank already applies this interpretation of the CCP Standards in the case of ASX Clear (Futures). I confirm that ASX understands that the Bank also intends to apply this interpretation of the CCP Standards to ASX Clear in the manner set out in Table 1 of your letter with immediate effect. The supplementary interpretation of the CCP Standards set out in your letter therefore supersedes that communicated by the Bank on 16 August 2013 and applies to both ASX Clear and ASX Clear (Futures).

At your request I set out in the schedule to this letter (using the same references in Table 1 of your letter) the actions that ASX Clear and ASX Clear (Futures) are taking to address the CCP Standards and timeframe within which those actions will be implemented.

I understand that the Bank will now publish this interpretation of the CCP Standards on its website and that this interpretation of the CCP Standards will be applied to any domestically licensed CCP which provides services to clearing participants that are either established in the EU or subject to EU bank capital regulations.

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'Elmer Funke Kupper', with a large, sweeping flourish extending to the left.

Elmer Funke Kupper
Managing Director and CEO

Schedule

Table 1. Supplementary Interpretation of CCP Standards

CCP Standard	Additional Interpretation	ASX Clear and ASX Clear (Futures) actions and timing to address Standard
<p>Governance</p> <p><u>CCP Standard 2.6.</u> The board should establish a clear, documented risk management framework that includes the central counterparty's risk tolerance policy, assigns responsibilities and accountability for risk decisions, and addresses decision-making in crises and emergencies.</p> <p>Governance arrangements should ensure that risk management and internal control functions have sufficient authority, independence, resources and access to the board, including through the maintenance of a separate and independent internal audit function.</p>	<p>The guidance to this CCP Standard, in 2.6.3, states that '...a central counterparty should have a risk committee responsible for advising the board on the central counterparty's overall current and future risk tolerance and strategy, or equivalent...'</p> <p>It is the Bank's judgement that, in accordance with the guidance, establishment of an independent risk committee is the most appropriate way to help the board discharge its risk-related responsibilities. The risk committee should comprise representatives of participants, and depending on the scale and nature of client clearing activity, also indirect participants. The Bank will interpret CCP Standard 2.6 accordingly in the case of ASX Clear (Futures) and ASX Clear.</p>	<p>ASX intends to establish an independent Risk Consultative Committee for ASX Clear. The Committee is to initially comprise representatives of Clearing Participants and will have an independent, member-elected Chairperson. ASX envisages that the Risk Consultative Committee will have a broad mandate to consider and make recommendations to the Board of ASX Clear on matters related to the risk management of the clearing facility.</p> <p>ASX Clear intends to call for nominations to the Risk Consultative Committee in Q4 2014, with a view to the first meeting of the committee occurring in Q1 2015. ASX intends to review the case for including client representatives on the Risk Consultative Committee subsequent to establishment of the Committee.</p> <p>ASX Clear (Futures) already has a Risk Consultative Committee. This Committee has recently recommended criteria for client representation on the Committee. ASX Clear (Futures) will consider that recommendation in formalising criteria for client representation on the Committee in its Operating Rule Procedures.</p>

CCP Standard	Additional Interpretation	ASX Clear and ASX Clear (Futures) actions and timing to address Standard
<p>Credit Risk</p> <p><u>CCP Standard 4.2.</u> A central counterparty should identify sources of credit risk, routinely measure and monitor credit exposures, and use appropriate risk management tools to control these risks. To assist in this process, a central counterparty should ensure it has the capacity to calculate exposures to participants on a timely basis as required, and to receive and review timely and accurate information on participants' credit standing.</p>	<p>The guidance in 4.2.4 discusses the role of prefunded financial resources in managing losses caused by participant defaults. The guidance recognises that the default waterfall may include '...a defaulter's initial margin, the defaulter's contribution to a prefunded default arrangement, a specified portion of the central counterparty's own funds, and other participants' contributions to a prefunded default arrangement.' The guidance does not prescribe a particular composition of prefunded financial resources, nor does it prescribe the order in which such funds should be drawn.</p> <p>Nevertheless, the Bank would expect that a material proportion of pooled financial resources comprised a central counterparty's own resources, and further, that a sufficient proportion of such resources would be drawn first in the event that a defaulting participant's margin and other contributions were exhausted, so as to ensure that the central counterparty faced appropriate incentives to set robust risk management standards. The Bank will interpret CCP Standard 4.2 accordingly in the case of ASX Clear (Futures) and ASX Clear.</p>	<p>Effective 27 October 2014 the total prefunded default resources of ASX Clear are \$250 million. This comprises Restricted Capital Reserve (\$71.5 million), equity capital (\$103.5) and subordinated debt (\$75 million) provided by ASX Group.</p> <p>In the event of a default once the defaulter's margins have been applied ASX Clear would meet any further shortfalls by drawing first upon the Restricted Capital Reserve. If these funds were exhausted ASX Clear would then draw upon equity capital and subordinated debt.</p> <p>ASX Clear (Futures) already meets the standard.</p>
<p><u>CCP Standard 4.4.</u> A central counterparty should cover its current and potential future exposures to each participant fully with a high degree of confidence using margin and other prefunded financial resources. In addition a central counterparty that is involved in activities with a more complex risk profile or that is systemically important in multiple jurisdictions should maintain additional financial resources to</p>	<p>Separately, the guidance in 4.4.2, states that '...determinations of whether a central counterparty is systemically important in multiple jurisdictions should include consideration of, among other factors: the location of the central counterparty's participants; the aggregate volume and value of transactions that originate in each jurisdiction in which it operates; the proportion of its total volume and value of transactions that originate in each jurisdiction in which it operates; the range of currencies in which the instruments it clears and cleared or settled; any links it has with FMI's located in other jurisdictions; and the extent to which it clears instruments that are subject to mandatory clearing obligations in multiple jurisdictions...'</p> <p>In forming a judgement on systemic importance with reference to</p>	<p>At 27 October 2014 ASX Clear's financial resources already meet the higher standard, namely that financial resources would cover the default of the largest two participants and their affiliates (by credit exposure). ASX Clear will formally move to adopt the higher standard for financial resources at the same time as doing so for liquidity (end 1Q2015).</p> <p>ASX Clear (Futures) already meets the higher standard.</p>

CCP Standard	Additional Interpretation	ASX Clear and ASX Clear (Futures) actions and timing to address Standard
<p>cover a wide range of potential stress scenarios that should include, but not be limited to, the default of the two participants and their affiliates that would potentially cause the largest aggregate credit exposure for the central counterparty in extreme but plausible market conditions...</p>	<p>these factors, the Bank will take into account the (implicit or explicit) views of the relevant overseas regulatory authorities. The need to obtain recognition under EMIR – in order either to continue to provide services to clearing members established in the EU, or to be considered a ‘qualifying CCP’ under EU bank capital regulations – may be regarded as evidence that the EU authorities consider an Australian domestic central counterparty to be a possible vehicle for the transmission of risks to the EU. This may therefore be evidence of systemic importance in multiple jurisdictions.</p> <p>If a systemically important domestic central counterparty in Australia not only required recognition in the EU, but also had material participation of clearing members established in the EU and cleared a range of products, including derivatives with different characteristics (including levels of liquidity), the Bank would expect to conclude that such a central counterparty was systemically important in multiple jurisdictions.</p> <p>The Bank will interpret CCP Standard 4.4 accordingly in the case of ASX Clear (Futures) and ASX Clear and hold these central counterparties to the higher standard that they should maintain additional financial resources to cover the default of the largest two participants and their affiliates (by credit exposure).</p>	<p>ASX Clear and ASX Clear (Futures) already meet CCP Standards 6.3 on margin requirements as interpreted by the Bank. Specifically;</p> <ul style="list-style-type: none"> • Confidence Interval: OTC derivatives and any other less liquid products at least 99.5%; all other liquid products in excess of 99%. • Close out period: OTC derivatives and less liquid products 5 days and all other liquid products at the higher of 1 or 2 days.
<p>Margin CCP Standard 6.3. ... Initial margin should meet an established single-tailed confidence interval of at least 99 per cent with respect to the estimated distribution of future exposure... “ The model should: use a conservative estimate of the</p>	<p>The guidance to this CCP Standard elaborates further. In particular, the guidance in paragraphs 6.3.1 – 6.3.3 requires that:</p> <ul style="list-style-type: none"> • ‘...the method selected by the central counterparty to estimate its potential future exposure should be capable of measuring and incorporating the effects of price volatility and other relevant product factors and portfolio effects over a close out period that reflects the market size and dynamics for each product cleared by 	<p>ASX Clear and ASX Clear (Futures) already meet CCP Standards 6.3 on margin requirements as interpreted by the Bank. Specifically;</p> <ul style="list-style-type: none"> • Confidence Interval: OTC derivatives and any other less liquid products at least 99.5%; all other liquid products in excess of 99%. • Close out period: OTC derivatives and less liquid products 5 days and all other liquid products at the higher of 1 or 2 days.

CCP Standard

time horizons for the effective hedging or close out of the particular types of product cleared by the central counterparty...

CCP Standard 6.5. In calculating margin requirements, a central counterparty may allow offsets or reductions in required margin across products that it clears or between products that it and another central counterparty clear, if the risk of one product is significantly and reliably correlated with the risk of the other product...

Additional Interpretation

the central counterparty...

- '...close out periods should be set on a product-specific basis because less liquid products might require significantly longer close out periods...'

- '...a central counterparty should select an appropriate sample period for its margin model to calculate required margin for each product that it clears...'

- '...selection of the period should be carefully examined based on the theoretical properties of the margin model and empirical tests on these properties using historical data...'

In interpreting CCP Standard 6.3 with reference to the guidance summarised above, a domestically licensed central counterparty that clears a range of products with varying degrees of liquidity and provides services to systemically important financial institutions headquartered in multiple jurisdictions would typically be expected to:

- apply a higher confidence interval, of at least 99.5 per cent, in relation to less liquid products, such as OTC derivatives, to reflect increased uncertainty around potential future exposure for products with such characteristics
- use a close out assumption of at least five days for less liquid products, such as OTC derivatives, and the higher of a one or two day close out period for more liquid exchange-traded products
- consider a range of sample periods to inform the calibration of margin requirements.

ASX Clear and ASX Clear (Futures) actions and timing to address Standard

- Sample periods for margin model: margins are set by reference to multiple periods being 60 days, 120 days, and 12 months, for cash market 2 years and for OTC Derivatives, 5 years.

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<p>Liquidity Risk</p> <p>CCP Standard 7.3. A central counterparty should maintain sufficient liquid resources in all relevant currencies to settle securities-related payments, make required variation margin payments and meet other payment obligations on time with a high degree of confidence under a wide range of potential stress scenarios... In addition, a central counterparty that is involved in activities with a more complex risk profile or that is systemically important in multiple jurisdictions should consider maintaining additional liquidity resources to cover a wider range of potential stress scenarios that should include, but not be limited to, the default of the two participants and their affiliates that would generate the largest aggregate payment obligation to the central counterparty in extreme but plausible market conditions.</p>	<p>Consistent with the equivalent requirement in relation to credit risk, the Bank will, in determining whether a central counterparty is systemically important in multiple jurisdictions, take into account the (implicit or explicit) views of the relevant overseas regulatory authorities. The need to obtain recognition under EMIR – in order either to continue to provide services to clearing members established in the EU, or to be considered a ‘qualifying CCP’ under EU bank capital regulations – may be regarded as evidence that the EU authorities consider an Australian domestic central counterparty to be a possible vehicle for the transmission of risks to the EU. This may therefore be evidence of systemic importance in multiple jurisdictions. If a systemically important domestic central counterparty in Australia not only required recognition in the EU, but also had material participation of clearing members established in the EU and cleared a range of products, including derivatives with different characteristics (including levels of liquidity), the Bank would expect to conclude that such a central counterparty was systemically important in multiple jurisdictions.</p> <p>The Bank will interpret CCP Standard 7.3 accordingly in the case of ASX Clear (Futures) and ASX Clear, and hold these central counterparties to the higher standard that they should maintain additional liquid resources to cover liquidity needs in the event of the default of the two participants and their affiliates that would generate the largest aggregate payment obligation to the central counterparty in extreme but plausible market conditions.</p>	<p>ASX Clear intends by the end of 1Q2015 to move to the higher standard and maintain additional liquid resources to cover liquidity needs in the event of the default of the two participants and their affiliates that would generate the largest aggregate payment obligation to the central counterparty in extreme but plausible market conditions.</p> <p>ASX Clear (Futures) already meets the higher standard.</p>

CCP Standard	Additional Interpretation	ASX Clear and ASX Clear (Futures) actions and timing to address Standard
<p>Segregation and Portability</p> <p>CCP Standard 13.2. A central counterparty should employ an account structure that enables it readily to identify positions of a participant's customers and to segregate related collateral. A central counterparty should maintain customer positions and collateral in individual customer accounts or in omnibus customer accounts, or equivalent.</p> <p>CCP Standard 13.3. To the extent reasonably practicable under prevailing law, a central counterparty should structure its portability arrangements in a way that makes it highly likely that the positions and collateral of a defaulting participant's customers will be transferred to one or more other participants.</p>	<p>CCP Standards 13.2 and 13.3 do not explicitly require that a central counterparty offer the choice between individual and omnibus account structures. However, associated guidance (particularly 13.2.2-13.2.9) draws out the relevant considerations for a central counterparty in determining appropriate account structures. The guidance in 13.3.1 observes that 'in order to achieve a high likelihood of portability, a central counterparty will need to: have the ability to identify positions that belong to customers; identify and assert rights to related collateral held by or through the central counterparty; transfer positions and related collateral to one or more other participants...'</p> <p>Where a central counterparty clears derivatives products for a variety of participant and underlying customer types, the Bank will interpret CCP Standards 13.2 and 13.3 as requiring that the central counterparty employ an account structure that enables its participants to offer their customers individual segregation.</p> <p>Accordingly, in relation to their clearing of derivatives products ASX Clear (Futures) and ASX Clear will each be expected to make available to its participants an account structure that enables its participants to offer their customers an option that allows for separate identification and protection of individual customers' gross positions and collateral (or collateral value). To further protect derivatives customers, ASX Clear (Futures) and ASX Clear will each be expected to make available an account structure that enables excess customer collateral to be held directly with the central counterparty.</p>	<p>ASX Clear already makes available to its participants an account structure that enables its participants to offer their exchange traded options (ETO) customers an account option that allows for separate identification and protection of individual customers' gross positions and collateral (or collateral value).</p> <p>ASX Clear (Futures) has already established during 2014 an account structure that enables its participants to offer their futures and OTC derivative customers an account option that allows for separate identification and protection of individual customers' gross positions and collateral (or collateral value).</p> <p>ASX Clear and ASX Clear (Futures) will consult on rule amendments that will enable excess customer collateral for derivatives to be held directly with ASX Clear and ASX Clear (Futures). A service offering that makes this choice available is scheduled for the first half of 2015 following regulatory clearance.</p>

CCP Standard	Additional Interpretation	ASX Clear and ASX Clear (Futures) actions and timing to address Standard
<p>Custody and Investment Risks</p> <p>CCP Standard 15.4. A central counterparty's investment strategy should be consistent with its overall risk management strategy and fully disclosed to its participants, and investments should be secured by, or be claims on, high-quality obligors. These investments should allow for quick liquidation with little, if any, adverse price effect.</p>	<p>Although not explicitly stated in CCP Standard 15.4 or associated guidance (15.4.1), the Bank will interpret this requirement as applying in all market conditions, including in periods of market stress. Furthermore, since CCP Standard 15.4 also requires that a central counterparty's investment strategy should be 'consistent with its overall risk management strategy' and that 'investments should be secured by, or be claims on, high-quality obligors', and since the guidance (15.4.1) notes that investments should be subject to appropriate controls for wrong-way risk, the Bank would not consider investments in a central counterparty's own, or an affiliated entity's, securities, to be consistent with these requirements.</p> <p>The Bank will interpret CCP Standard 15.4 accordingly in the case of ASX Clear (Futures) and ASX Clear.</p>	<p>ASX Clear's and ASX Clear (Futures)'s investments are all either secured by, or claims on, high quality obligors consistent with an overall conservative risk management strategy designed to support the CCP in meeting its obligations in extreme but plausible market conditions. Investments are not permitted in ASX Clear's or ASX Clear (Futures)'s own or any affiliated entity's securities.</p> <p>In keeping with conservative risk management strategy, the investment portfolio historically had a significant weighting (80 to 90%) to short term money market instruments issued by the four domestic major banks. ASX Clear and ASX Clear (Futures) are transitioning the portfolio progressively over the next few years to a lower weighting of direct exposure to the four domestic major banks as well as providing for portfolio growth through investment in government securities or investments secured by high quality obligors.</p>
<p>Regulatory Reporting</p> <p>CCP Standard 21. A central counterparty should inform the Reserve Bank in a timely manner of any events or changes to its operations or circumstances that may materially impact its management of risks or ability to continue operations. A central counterparty should also regularly provide information to the Reserve Bank regarding its financial position and risk controls on a timely basis.</p>	<p>CCP Standard 21 sets out a range of reporting requirements for central counterparties. The Bank is currently reviewing its regular information requirements and will inform ASX Clear (Futures) and ASX Clear accordingly.</p> <p>In the meantime, that Bank would like to clarify that in accordance with CCP Standard 21.1(i), which requires notification to the Bank if '...any internal audits or independent external reviews are undertaken of its operations, risk management processes or internal control mechanisms, including providing the conclusions of such audits or reviews', domestically licensed central counterparties such as ASX Clear (Futures) and ASX Clear will be expected to provide the Bank with copies of any reviews of their margin methodologies.</p>	<p>ASX Clear and ASX Clear (Futures) already provide, and will continue to provide, relevant internal or external audit reports and any reviews of margin methodology to the Reserve Bank.</p>