

Central Counterparty Recovery

Response to Consultation Feedback on Exposure Draft Rules
for Interim Replenishment of Default Funds

RESPONSE TO CONSULTATION

1 APRIL 2016



Contacts

For general enquiries, please contact:

Janine Ryan – General Manager, Legal
T 02 9227 0497
E janine.ryan@asx.com.au

Media enquiries, please contact:

Mr Matthew Gibbs – General Manager,
Media and Communications
T 02 9227 0218
E matthew.gibbs@asx.com.au

Contents

1. Response to Consultation Feedback	3
1.1. Overview.....	3
1.2. Revised Operating Rules.....	4
1.3. Next Steps.....	4
Schedule 1 – Substantive feedback and ASX responses	5



1. Response to Consultation Feedback

1.1. Overview

On 4 December 2015, ASX released a [Consultation Paper on Exposure Draft Rules for Interim Replenishment of Default Funds](#) seeking comment on proposed amendments to the ASX Recovery Handbook to provide for more rapid replenishment of the default funds of ASX Clear and ASX Clear (Futures) (**ASX CCPs**) if those funds are depleted as a result of a participant default.

ASX thanks all those who shared their views and expertise during the consultation period. ASX received 7 formal submissions in response to the Consultation Paper. ASX has published the non-confidential submissions at <http://www.asx.com.au/regulation/public-consultations.htm>.

The majority of respondents were supportive of the ASX proposals. Some respondents did not support the proposal or sought clarification of various aspects of the proposal. A high level summary of the key questions and comments, and ASX's response, is set out in Schedule 1.

As a result of feedback, ASX does not propose to make material changes to the proposal outlined in the Consultation Paper. ASX's approach to key issues identified is as follows:

- **Modelling of interim default fund size:** A number of respondents requested detail on the modelling undertaken by the ASX CCPs to determine the balance between default fund contributions and use of additional margin prior to full replenishment of the default fund. ASX provided a summary of its modelling to the Risk Consultative Committees of ASX Clear and ASX Clear (Futures). ASX welcomes further bilateral discussions with any interested participants
- **Use of initial margin as a mutualised resource:** A number of respondents expressed concern that, during the interim period, margins of participants would be used as a mutualised resource such that they were available to cover losses of other participants. ASX confirms that margins provided by a participant are only able to be used to cover the exposures of that participant. It is **not** proposed that these amounts would be "mutualised" so that they could be used to cover the losses of other participants
- **Caps on liability:** ASX notes that the liability of participants to make cash payments to the ASX CCPs for Recovery Assessments and interim replenishment contributions remains capped under the proposed amendments
- **Pre-funding of Recovery assessments to fund interim replenishment obligations:** Some respondents suggested that the ASX CCPs should call additional Recovery assessments from participants and hold those funds to cover interim replenishment contributions. Based on previous consultation feedback that was not supportive of pre-funding of assessments, ASX does not propose to introduce pre-funding of Recovery assessments

- **Source of funding for ASX CCP replenishment of the default fund:** ASX has in place a recapitalisation plan which considers the options available to fund its replenishment obligations. Those options include use of existing cash reserves and/or raising additional capital through equity issuance, including through a private placement. ASX does not consider that the cost of setting aside cash or seeking external committed funding (which may in any event not be available in circumstances of extreme stress) is warranted given the low probability of the money being called upon and ASX's ability to raise funding within a short time frame if required.

ASX has also made some minor drafting amendments to clarify the operation of certain rules but those changes do not affect the substance of the proposed amendments.

ASX recognises that industry thinking and regulatory requirements are continuing to evolve in relation to recovery and resolution. ASX will continue its active engagement with regulators, participants and industry and will keep its Recovery Rules under review to address any material developments.

1.2. Revised Operating Rules

The revised ASX Recovery Rulebook incorporating the changes made by ASX in response to consultation feedback is available at: <http://www.asx.com.au/documents/clearing/attachment-D-asx-recovery-rules.pdf>.

A mark-up of the amendments from those contained in the December Consultation Paper is available at: <http://www.asx.com.au/documents/clearing/attachment-e-6-asx-recovery-rules.pdf>.

1.3. Next Steps

ASX intends to formally lodge the amended ASX Recovery Rulebook with ASIC for regulatory clearance in April 2016. Subject to regulatory clearance, the amended ASX Recovery Rulebook are expected to take effect in Q4 FY16. ASX will publish a market notice to confirm the effective date closer to the time.

Schedule 1 – Substantive feedback and ASX responses

Key issue	Comment/question	Response
Mix of mutualised and non-mutualised resources/determination of Minimum Fund Size	Could ASX provide further examples of how DF contributions may compare to use of additional IM?	ASX provided a summary of its modelling to the Risk Consultative Committees of ASX Clear and ASX Clear (Futures). ASX welcomes further bilateral discussions with any interested participants.
Use of initial margin as a mutualised resource	If the interim default fund is fully depleted, clarify whether initial and additional margin called during the interim period could be applied against losses of another participant.	ASX confirms that margins provided by a participant are only able to be used to cover the exposures of that participant. It is not proposed that these amounts would be “mutualised” so that they could be used to cover the losses of other participants.
Use of recovery assessments to fund replenishment	The proposal is not supported because it would defeat the purpose of the (limited number of) cash calls on members. Adding additional default resources should not be required considering that ASX introduced its Recovery Rules late last year and were based on extensive research and analysis as to the required number of assessments, which should capture the potential for further defaults during the 22 business day cooling off period and therefore capture the financial resources needed in circumstances that would stretch beyond extreme but plausible scenarios. ASX should consider a structure whereby at least one assessment will be immediately pre-funded if the DF is used or very likely to be used. If those assessments are not used up, they should automatically convert to a DF replenishment at the end of the 22 business day period. ASX could call for a different size if the DF is below the minimum requirements but this should continue to be subject to the existing cap.	The Recovery Rules introduced in October 2015 provided for participants to: <ul style="list-style-type: none"> • Pay recovery assessments, up to a capped amount, to be applied against losses incurred as a result of participant defaults during the default period • Make further contributions, up to a capped amount, at the end of the default period to replenish the default fund to provide cover to for potential future defaults. As a result, the amounts for the maximum recovery assessments were not calibrated to be sufficient to provide financial cover to address all losses arising from defaults during the default period AND to replenish the default fund following the default period. The caps on liability of participants to meet cash calls to pay recovery assessments and replenishment amounts in respect of a default period remain the same under the proposed amendments. As noted in the Consultation Paper, the main effect of the proposed



Key issue	Comment/question	Response
		<p>amendments is to bring forward the time at which some, but not all, of those replenishment amounts must be paid to satisfy regulatory requirements. The amendments may, however, increase the participant's exposure to loss during the default period, compared to the current Recovery Rules, if the participant has made an interim contribution to the default fund and that contribution is utilised as a result of a further subsequent default during the default period. This could only occur if there was a further default which resulted in loss in excess of both the defaulting party's collateral and ASX's interim contribution to the default fund.</p> <p>ASX received strong opposition from most participants to prefunding of recovery assessments in ASX's prior consultations on recovery tools.</p> <p>As a result, ASX does not propose to make any amendments to the caps on liability or to require prefunding of recovery assessments.</p>
<p>Impact of utilisation of interim contributions on final default fund size</p>	<p>What is the impact on the final default fund if the interim default fund is utilised by a further default? As the interim replenishment could have been used during the cooling off period, deducting any interim replenishment amount from the newly sized default fund may lead to a potential underfunding of the new default fund.</p>	<p>If some or all of the interim replenishment amounts are utilised by a further default during the default period, then the final replenishment amount, and therefore, the final default fund size, will be reduced by the amount utilised. This reflects the intention noted above that the interim replenishment arrangements should primarily affect the timing of replenishment, rather than the amount which is required to ultimately be replenished (and therefore the caps on liability imposed on participants).</p> <p>If the final default fund size is not sufficient to provide full financial cover, the ASX CCPs may utilise their powers to rescale the default fund on a quarterly basis. In the interim, the ASX CCPs would continue to utilise additional initial margin to ensure full financial cover.</p>

Key issue	Comment/question	Response
Basis of calculation of interim participant contribution	Should be based on average stressed exposures/margin utilisation between DMP and the day before the interim contribution is called.	ASX considers that calculation of participant interim contributions based on pre-default positions is appropriate given the potential limited time between completion of the default management process and the payment of interim replenishment contributions.
Basis of calculation of final replenishment contributions	Should be based on average stressed exposures/margin utilisation between when the interim contribution is called and the end of the default period.	<p>ASX considers on balance that calculation of participant final replenishment contributions based on pre-default positions is appropriate because:</p> <ul style="list-style-type: none"> • It provides greater certainty and transparency to both the ASX CCPs and participants on their likely replenishment obligations and minimises the risk that participants will reach their cap on replenishment obligations • It will assist participants in assessing whether they wish to resign from the ASX CCP by reducing the variability in the basis of calculation • It aligns the basis of calculation for interim and final replenishment contributions • Contributions would be recalculated based on post-default positions within the next quarter • The incentive to exit for those whose contributions would be reduced based on post default positions is likely to be minimal given the relatively small amount required to replenish the default fund relative to the amount of collateral required to be held against positions and the short time frame to recalibration of the default fund relative to the decision to cease clearing operations entirely • For participants whose contributions would increase as a result of post default positions, the ASX CCP would remain

Key issue	Comment/question	Response
		adequately protected against the risk associated with their increased exposures through the use of initial margin and potential additional margin calls on their increased portfolio.
Reassessment of Minimum Fund Size	What is the methodology and timing of reassessment of the Minimum Fund Size?	<p>ASX, in conjunction with the Risk Consultative Committees, will review the Minimum Fund Size on an annual basis. It is proposed that this review would also cover the amount participants may be required to replenish on an interim basis.</p> <p>ASX expects that this review would take into account factors such as the changes in the relative size and distribution of participant positions and resulting exposures over the previous 12 months as well as incorporating the impact of any refinements/enhancements in stress testing methodology and scenarios.</p>
Source of funding for ASX CCP replenishment of the default fund	What funding sources are available to ASX to make its contribution? Are these funding sources committed?	<p>ASX has developed a recapitalisation plan, approved by the ASX Board, which considers the options available to fund its replenishment obligations. Those options include use of existing cash reserves and/or raising additional capital through equity issuance, including through a private placement. ASX does not consider that the cost of setting aside cash or seeking external committed funding (which may in any event not be available in circumstances of extreme stress) is warranted given the low probability of the money being called upon and ASX's ability to raise funding within a short time frame if required.</p>

Key issue	Comment/question	Response
Risk Consultative Committee	Consultation of the Risk Consultative Committee may add complexity and delays.	ASX expects that the Risk Consultative Committees can be convened for consultation within a reasonable time to avoid delays. The ASX CCPs also retain the final discretion whether to require participants to make an interim contribution to the default fund.
Maintenance of financial cover during default management process	Request the ASX CCPs to illustrate how full financial cover is provided during the default management process to facilitate continued functioning.	The ASX CCPs will assess and quantify on an ongoing basis throughout the default process the impact (either realised or unrealised) on the ASX CCP's financial resources of actual close-out costs incurred and the mark-to-market (on an appropriately prudent basis) of any positions yet to be closed out. Stress Test Exposure Limits will be reduced in line with any material resulting impact on the ASX CCP's default fund, which may result in additional margin calls on participants. .
Extension of default period for further defaults	ASX should limit the number of times the 22 business day cooling-off period can be restarted following an event of default during such period.	ASX considers that imposing a maximum time limit on the default period may create an arbitrary and potentially adverse outcome given the extreme circumstances that would need to exist to give rise to multiple defaults over an extended period. ASX considers that the current time frames and recovery tools in the Recovery Rules provide an appropriate balance of the risk without unduly increasing the exposure of the ASX CCPs and participants.