

Changes to Clearing Participant Minimum Core Capital Requirements Approach

CONSULTATION PAPER

JUNE 2016



Invitation to comment

ASX is seeking submissions on this paper by 11 August 2016. Submissions should be sent to:

E samantha.hettihewa@asx.com.au

20 Bridge Street Sydney NSW 2000

Attention: Ms S Hettihewa

ASX prefers to receive submissions in electronic form. Submissions not marked as 'confidential' will be made publicly available on ASX's website

If you would like your submission, or any part of it, to be treated as 'confidential', please indicate this clearly in your submission. ASX is available to meet with interested parties for bilateral discussions on the Changes to Clearing Participant Minimum Core Capital Requirements Approach.

Contacts

For enquiries, please contact:

C Grace – Senior Manager, Clearing Risk Policy
T 02 9227 0439
E colm.grace@asx.com.au

Samantha Hettihewa – Manager, Clearing Risk Policy
T 02 9227 0939
E samantha.hettihewa@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

Introduction.....	3
ASX Risk Control Framework.....	4
Objectives and timeline of the proposed Change to Schedule 1 in respect of MCCR	5
MCCR and Total Risk Requirement.....	6
Proposed Minimum Capital Requirements for Clearing Participants	6
Impact.....	8
International Benchmarking.....	9
Time-line for compliance.....	9
Meeting Shortfalls in Core Capital	9
Out of Scope	9
Industry Consultation.....	10



Introduction

Executive Summary

ASX Clear (ASXCL) sets minimum core capital requirements (MCCR) on its Clearing Participants (CP) which ensure that only CPs of robust financial standing use its service. The MCCR together with its other risk controls enable ASXCL (the CCP) to promote systemic stability in ASX's markets.

The current methodology used to set the MCCR reflects, to a limited degree, the risk profile of each CP as it only varies according to the number of market participants clearing through the CP. ASX is now looking to enhance the MCCR methodology to reflect that greater complexity inherent within a CP's business increases the probability of unexpected financial, operational or compliance shocks that could result in CP losses, and necessitates higher minimum core capital levels to be able to absorb them. This greater complexity includes the level of own account business activity, the extent of non-ASX business, and the degree of client short option activity applicable to the CP.

The MCCR is designed to be a base level of core capital, and is complemented by a risk based measure of liquid capital (Total Risk Requirement) that uses the actual level of exposure from a CP's activities to set a required risk capital level in response to such exposures. This consultation does not propose making any changes to the Total Risk Requirement.

Under the MCCR changes under consideration, ASXC would retain the current base core capital requirement of \$5m, \$10m, \$15m and \$20m (depending on number of market participants the CP clears for), however introduce additional core capital requirements dependant on whether the CP undertakes any:

- client short ETO activity (cover 2¹);
- Own account business in financial products (irrespective of whether traded and cleared on ASX); and/or
- Non-ASX business.

An additional MCCR of \$2.5m or \$5m would apply for each such activity undertaken by that CP (i.e. up to an additional \$15m in total) depending on the level of such activity.

¹ Relates to all short options other than those specifically covered



The MCCR applicable to a CP would also be reviewed periodically (at least annually) which could mean that its MCCR fluctuates up or down from time to time having regard to changes to activities undertaken by the CP.

A transitional period of up to 12 months following introduction of the changes is proposed to allow CPs to meet any increased Core Capital requirements. A transitional period of up to 6 months is also proposed to allow CPs to meet any subsequent increases to their Core Capital following a review of the MCCR applicable to its activities.

Initial analysis undertaken by ASX indicates that the additional MCCR being considered would lead to increased core capital requirements for 29 out of the 36 CPs (the vast majority being in the range of \$2.5m - \$7.5m). All but 3 of the CPs hold sufficient capital (based on figures as at end January 2016) to meet such increased MCCR.

The proposed requirements are discussed further below.

Consultation Period

Given that the proposal could result in a capital impact to ASXCL CPs, market feedback is actively sought. In order to gain the most beneficial and meaningful feedback, ASX requests that respondents provide comprehensive reasoning and, where possible, quantifiable impacts to support their feedback. Responses are required by 11 August 2016.

Given the complexity of some of these issues, ASX Management will be available to meet one-on-one with interested clearing participants to assist with any queries you may have.

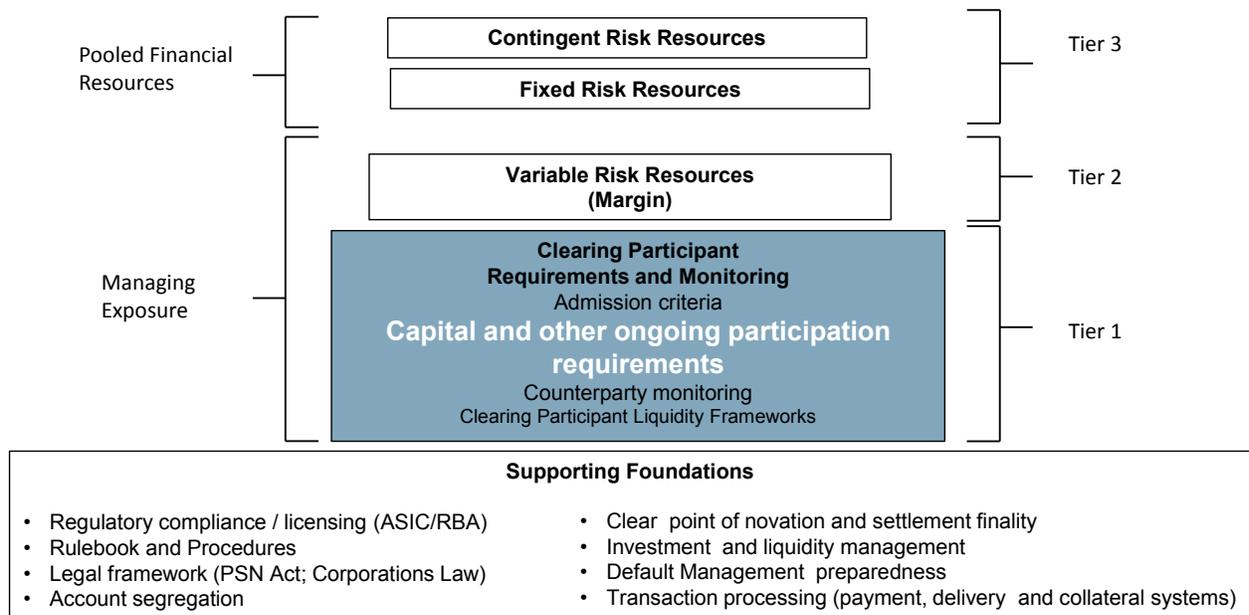
ASX contact details are provided on page 2.

ASX Risk Control Framework

Overview

In acting as a CCP, ASXCL is exposed to the counterparty credit risk of its CPs whereby, in the event of a CP default, ASXCL takes on the cleared open exposures of that CP. ASXCL manages this counterparty credit risk through a framework of tiered risk controls, which are summarised in the diagram below. Tier 1 controls are designed to reduce the likelihood of a CP default while tiers 2 and 3 provide resources to absorb shortfalls arising from managing a default. The MCCR represents a “Tier 1” control alongside the CCP’s other CP requirements and monitoring including admission criteria, CPs’ liquidity risk frameworks (currently being consulted on), counterparty monitoring and existing Risk Capital Requirements.





Objectives and timeline of the proposed Change to Schedule 1 in respect of MCCR

Objectives

The objectives underlying the setting of the MCCR are as follows, with all but (f) already reflected in the current approach:

- ASX seeks to act in the interests of the market as a whole.
- ASX has low risk appetite for credit risk.
- ASX must have a reasonable degree of confidence that its Clearing Participants have sufficient financial capacity to absorb unexpected financial, operational and compliance related losses, including those arising from the activities of their clients.
- The minimum core capital approach is transparent, allowing CPs to understand the relationship between their risk profiles and minimum core capital requirements.
- The MCCR approach is designed such that it is simple and easily understood
- The MCCR is sensitive to the inherent risk profile of the CP.

The new requirement (f) in respect of the risk sensitivity of the MCCR, drives the proposed changes to the approach, as set out in the next sections of this paper.



MCCR and Total Risk Requirement

Under ASXCL's risk based capital framework, in addition to meeting the MCCR, each participant is also required to hold sufficient regulatory capital (liquid capital) to cover a measure of the risk exposures arising from all of the activities it undertakes.

While the MCCR is intended to be the CP's baseline participation capital requirement, set on the basis of the CP's potential future risk profile, the Total Risk Requirement (TRR) is an estimate of capital required based on known CP exposures at a point in time. In other words, the MCCR is a forward looking capital measure, while the TRR is a responsive capital measure and as such, the two measures are complementary.

This consultation does not propose making any changes to the TRR.

Proposed Minimum Capital Requirements for Clearing Participants

ASXCL is seeking to introduce a risk responsive MCCR for all ASXCL CPs which not only recognises, as currently, the additional clearing obligations undertaken by the CP in clearing for other participants, but also recognises a broader set of activities specific to that CP.

Identifying Categories of CP Activity for MCCR Purposes

A CP needs to have sufficient financial capacity to absorb financial, operational or compliance losses that may be suffered by the CP. MCCRs currently set by ASX for its CPs take into consideration the increased possibility for financial, operational or compliance losses arising having regard to the number of market participants that the CP clears for.

It is proposed that those MCCRs also take into consideration other factors that may increase the possibility for financial, operational or compliance losses having regard to specific types of risk activities undertaken by the CP and the materiality of such activities. The risk activities that ASXCL is considering imposing additional core capital requirements for relate to non- ASX business activities (including but not limited to execution and clearing in international stocks and derivatives, corporate finance, stock and margin lending, debt and foreign exchange activities), client short ETO positions and own account business.

Capital Requirements for Identified Categories

The changes under consideration would involve a determination of MCCR as follows:

- a) ASX will apply a low risk base core capital requirement of \$5m, equivalent to the existing Direct Participant requirement, for any participant partaking in ASXCL's clearing service, where that CP undertakes none of the additional activities described below.



- b) ASX will retain the current approach in respect of additional increase in capital requirement based on the number of market participants the CP clears for (an additional \$5m, \$10m, and \$15m on the base MCCR).
- c) ASX will apply an additional capital requirement of \$2.5m to the base requirement for CPs with client short ETO positions (cover 2). Where the short option activity is material (defined as the average IM aggregated for the CPs clients, over a period of 3 months, that exceeds a threshold of \$60m²), this additional requirement will be increased to \$5m.
- d) ASX will apply an additional capital requirement of \$2.5m to the base requirement for CPs undertaking any own account business in any financial products (other than de minimis amounts). For CPs engaging in material own account business this additional requirement will be increased to \$5m. ASXCL will determine materiality by taking into consideration factors such as, but not limited to, products traded, size and utilisation of CP's own risk limits for own account business and historic and forecast revenues generated by the activity.
- e) ASX will apply an additional requirement of \$2.5m to the base requirement for CPs that engage in any activity (other than de minimis amounts) additional to ASX-related execution, clearing and settlement activities, within their legal entity for which losses may be incurred by the CP. Types of non –ASX activity include, but are not limited to, execution and clearing in international stocks and derivatives, corporate finance, stock and margin lending, debt and foreign exchange activities. For CPs engaging in material non-ASX activity, this additional requirement will be increased to \$5m. ASXCL will determine materiality taking into consideration a number of factors including, but not limited to, the number of additional activities undertaken by the CP, the products involved and historic and forecast revenues associated with the activities.

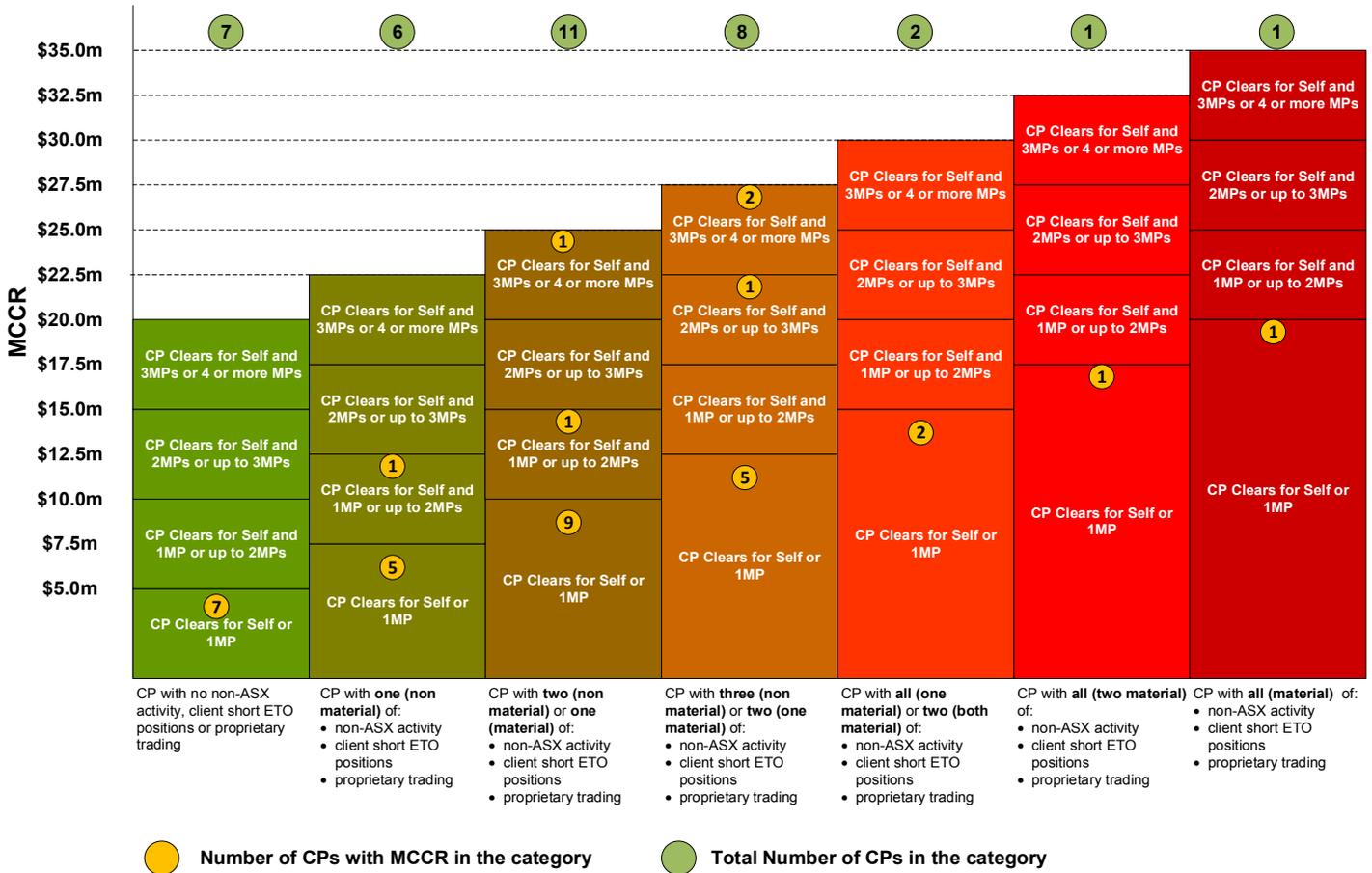
The incremental capital requirements associated with each activity will be based on ASX's high level assessment of the significance of each to the CP's risk profile. The size of the increased capital requirements for each activity is also calibrated to the size of increases in capital requirement applied by ASX having regard to the number of third party clearing arrangements the CP has in place i.e. the incremental requirements of \$5m, \$10m and \$15m. This provides for relative increases in capital requirements having regard to each activity or arrangement of the CP that adds to its business complexity and increases its risk of loss.

² These thresholds are calibrated to recent exposures and will be reviewed annually to ensure they remain appropriate.



Impact

ASX has undertaken an analysis³ to determine the impact of the proposed MCCR approach on ASXCL’s CPs and from this assessment, having regard to the activities undertaken by the CP as understood by ASX. The results are set out in the diagram below:



This analysis indicates that the additional MCCR being considered would lead to increased MCCR for 29 out of the 36 CPs (the vast majority being in the range of \$2.5m - \$7.5m). All but 3 of the CPs hold sufficient capital (based on figures as at end January 2016) to meet such increased MCCR. For the 3 CPs requiring additional Core Capital, the average increase is approximately \$4m, up to a maximum of \$9m.

³ The data that informs the analysis is based on recent self-reporting by CPs to ASX, through the 2016 Clearing Participant Business Model and Governance Structure surveys



International Benchmarking

As with ASXCL, the risk management frameworks of many international CCPs include minimum capital requirements together with their other risk controls. A benchmarking of ASX's minimum capital requirements with that of six comparable international CCPs, indicates the following:

- Like ASXCL, all six CCPs apply minimum capital requirements.
- The range of requirements varies across the CCPs from a low of HKD5m (A\$0.8m) to a high of EUR37.5m (A\$55m).
- In one case, higher requirements apply for third party clearing, increasing with the number of market participants cleared for.

Time-line for compliance

Rule S1 changes will be required to reflect changes to the MCCR as outlined in this paper that may be sought to be adopted by ASX following this consultation. Such changes would also provide for ASX to have the ability to require information from CPs to allow it to assess the additional MCCR that may apply from time to time to a CP, having regard to the activities undertaken by the CP.

ASX proposes to allow for a transitional period of up to 12 months for CPs to meet increased MCCR that may apply to the CP upon the introduction of the changes.

The MCCR applicable to each CP is expected to be subsequently reviewed on at least an annual basis ordinarily, with CPs required to meet any increases to their MCCR within a period of up to 6 months.

Meeting Shortfalls in Core Capital

ASX will no longer permit Participants who do not hold sufficient core capital to satisfy any portion of their core capital requirement by (a) providing cash to ASXCL or (b) through a subordinated debt facility.

There are no CPs currently using either cash or subordinated debt to meet their MCCR.

Out of Scope

This proposal does not impact ASX Settlement minimum participation requirements i.e. no changes to minimum settlement participation requirements.



This proposed does not impact on ASXC’s ability to impose additional capital requirements specific to a CP, including as a condition of admission under rule 3.1.4 or as a secondary requirement under rule S1.

CPs will also continue to be subject to existing Margin requirements under the rules, including Stress Test Exposure Limit (STEL) and Capital Based Position Limit (CBPL) monitoring which could result in an Additional Initial Margin (AIM) call being applied to the CP.

There are no changes to CPs reporting requirements in respect of the MCCR.

Industry Consultation

With regards to the proposed changes outlined above, ASXCL is seeking responses from interested parties to the following questions:

Q1. Do you think that the types of activities referred to in this paper as the basis for additional core capital requirements (i.e. level of own account business, the extent of non-ASX business, and the degree of client short ETO activity) are appropriate factors to consider for determining such increased requirements?

Q2. Are there factors other than number of market participants that that the CP clears for, the level of own account business, the extent of non-ASX business and the degree of client short ETO activity, that ASXCL should take into consideration in determining the minimum core capital requirement for a CP?

Q3. Do you have any comments on:

- (a) how to define the type of own account business, non-ASX business, and client short ETO activity that would trigger the additional capital requirements, including any exclusions that should apply; and
- (b) the de minimis and materiality thresholds that should be used for each such activity to determine the application of the additional capital requirements?

Q4. Do you believe that compliance with the requirements would require significant changes in your core capital? And if so, please set out the consequences of this increase.

Q5. Will you seek to (a) inject the additional capital, (b) use the services of a third-party clearer or (c) change your business model in another way in response to such changes?

Q6. Should the increase be implemented in stages or all at once? And if phased, please indicate a time-frame that would be sufficient for you to deal with the increase.

