



7 November 2014

Office of General Counsel
ASX Limited
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By email: janine.ryan@asx.com.au

Dear Ms Ryan

ASX Central Counterparty Recovery Consultation

The Australian Financial Markets Association (AFMA) welcomes the opportunity to provide comment on the ASX Central Counterparty Recovery consultation paper.

Summary view

AFMA's comments are focused on the end of the waterfall situations where the clearing is failing and resolution rather than recovery arrangements need to be put in place. The mandatory assessment and replenishment proposal for ASX Clear does not have support without a structured resolution regime for it to function within.

Comments

AFMA believes that the end of the waterfall proposals cannot be pursued before the Government puts in place a statutory framework for FMI resolution of clearing houses. AFMA appreciates that this view places the ASX in a difficult situation in the near term because of the regulatory expectations of the RBA regarding the need for effective crisis management arrangements to be put in place by the clearing houses it supervises. AFMA proposes to assist the ASX and the market more generally by actively pursuing with the Government the need to reinvigorate its work on a resolution regime for CCPs consistent with the Council of Financial Regulators' 2011–2012 review of FMI regulation which set out the main elements of a resolution regime for CCPs.

In the situation where the market is dealing with the ASX clearing houses being at the end of their waterfalls the focus should be on resolution not recovery. This is based on the premise that the ASX clearing houses are not too big to fail and that in such circumstances the market would need to rely on a regulatory environment which provides structure around the resolution of the clearing house.

The straw man proposal posits mandatory replenishment at the end of the waterfall requiring additional assessments from clearing members. In the event that the clearing house experienced a shock so severe that it fully depleted both the defaulted participant's initial margin and the clearing house's entire pool of prefunded financial resources, there would be a significant risk that participants would lose their confidence in the clearing house. This would be revealed when participants were called upon to replenish financial resources: some participants may not be prepared to commit further funds to the clearing house without significant changes to its ownership or governance structure. Some may prefer exiting the clearing house altogether.

In addition, meeting these requirements could prove difficult during a market crisis when the ability to provide liquidity and capital may be challenged. Moreover, it is possible, and even likely, that if ASX Clear is in a stress event other calls will be made on members to fund contingent liabilities simultaneously, the consequence would be a magnification of stress on markets at the worst possible time.

AFMA supports the view of the Council of Financial Regulators that the core concern is how to ensure the continuity of critical services when clearing house is in financial distress and approaching the point of non-viability. The extreme situations that can be envisaged leading to the non-viability of the ASX clearing houses are ones of severe idiosyncratic failure or systemic market failure. In such circumstances a regulatory framework is needed to provide predictability and confidence that the situation will be handled with an effective toolkit that assures market participants of fair and orderly resolution and recovery.

Regulators should be empowered to intervene in order to maintain continuity of services while organising a transfer of business and possible recapitalisation of clearing. This is essential to deal with the inherent conflicts of interest that would arise for the clearing house provider and markets participants in such circumstances. The orderly management of a restructuring and recovery of clearing services would be best assured by the appointment of a statutory manager with 'step in' powers. As in the case of ADIs this would include replacing the management and board of the clearing house and assuming their powers. Such a regime is consistent with the Financial Stability Board's (FSB) Key Attributes of Effective Resolution Regimes for Financial Institutions.

Accordingly, the establishment of regulatory framework by the Government is a necessary precondition to creating effective and acceptable resolution and recovery plans for Australian clearing houses.

ASXClear (Futures)

While not appropriate to ASX Clear, in relation to ASX Clear (Futures) VMGH is considered to be a viable loss allocation measure. The inclusion of VMGH as part of the clearing house's default waterfall enables the default management process to be transparent and predictable. Nevertheless, VMGH could have unexpected consequences on the market. End users who expected cash payments would be likely to liquidate assets in order to raise funds, including the same assets that serve as collateral for initial margin. This would depress the value of these assets and weaken the market, creating a pro-cyclical scenario that could further destabilise a collapsing market. Use of VMGH as an interim measure presumes the default management process has remained effective but additional resources are required to facilitate the allocation of losses after a failure. VMGH is therefore viewed as an interim resource prior to restructuring of the clearing house being implemented.

If you have any queries about these comments I can be contacted at dlove@afma.com.au
or (02) 9776 7995.

Yours sincerely

A handwritten signature in blue ink that reads "David Love". The signature is written in a cursive, flowing style.

David Love
General Counsel & International Adviser