

Central Counterparty Recovery

Consultation on Exposure Draft Rules for Interim
Replenishment of Default Funds

CONSULTATION PAPER

4 DECEMBER 2015



Invitation to comment
ASX is seeking submissions on this paper
by Thursday 4 February 2016.
Submissions should be sent to:

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Attention: Janine Ryan

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 this paper.

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1. Introduction

1.1. Overview

On 1 October 2015, the ASX Group central counterparties, ASX Clear and ASX Clear (Futures) (**ASX CCPs**), amended their operating rules to implement new Recovery Rules which enable the ASX CCPs to fully allocate losses incurred, and replenish financial resources utilised, as a result of a participant default as required by applicable regulatory standards.

Under the Recovery Rules, if an ASX CCP's default fund is depleted as a result of a participant default, the ASX CCP and its participants are required to replenish the default fund after the default period ends, which occurs 22 business days after the default management process for relevant defaults has been completed. Until replenishment occurs, the ASX CCP would rely on initial margin, additional initial margin calls based on participants' stressed exposures and any remaining default fund resources to meet regulatory standards for default resources.

Applicable regulatory standards require the ASX CCPs to have the capacity to return to the minimum level of financial cover "promptly", while mitigating any negative impact on the financial system. In its 2014/2015 assessment of the ASX CCPs' compliance with applicable regulatory standards, the Reserve Bank of Australia (**RBA**) noted that the current replenishment arrangements under the Recovery Rules may not meet these requirements, since there would be a delay of at least 22 business days before the ASX CCPs return to full mutualised cover and the use of additional margin to manage risk in the interim could transmit procyclical liquidity stress. As a result, the RBA recommended that the ASX CCPs should refine their replenishment arrangements to ensure that they are able to return to the full level of cover on a more timely basis, while minimising the potential for procyclicality.

To comply with these regulatory requirements, the ASX CCPs propose to amend their Recovery Rules to provide for more rapid replenishment of the default funds as follows:

- the ASX CCPs must replenish to a minimum fund size of \$100m (ASX Clear (Futures)) or \$37.5m (ASX Clear) as soon as practicable after completion of the default management process, including the next business day when that would be reasonably practicable
- the ASX CCPs (through funding sourced by the ASX Group) will provide the initial interim contribution to replenish the default fund of up to \$100m (ASX Clear (Futures)) or \$37.5m (ASX Clear)
- the ASX CCPs have discretion to call for participants to make interim contributions up to a further \$100m (ASX Clear (Futures)) or \$37.5m (ASX Clear) to the default fund during the default period.

These changes primarily affect the timing of replenishment of mutualised contributions, rather than the amount which is required to be ultimately replenished. As under the current Recovery Rules, the default fund would be fully replenished up to \$400m for ASX Clear (Futures) or \$150m for ASX Clear after the default period has ended.



ASX would continue to rely on additional margin calls where necessary to ensure that it maintained the required level of financial cover during the remainder of the default period.

Further details of the proposed changes are set out in section 3. Schedule 1 contains an illustrative timeline for the proposed replenishment arrangements and Schedule 2 contains a diagrammatic representation of the proposed replenishment arrangements.

The Exposure Draft Rules are available at <http://www.asx.com.au/services/clearing/ccp-recovery-and-resolution.htm>.

1.2. Consultation period

ASX seeks stakeholders' views on the Exposure Draft rules. Submissions should be made by Thursday 4 February 2016. ASX welcomes opportunities for bilateral discussions with interested parties. ASX contact details are provided on page 2.

2. Background and regulatory context

2.1. Financial Stability Standards

The ASX CCPs must comply with the Financial Stability Standards (**FSS**) determined by the RBA. The FSS provide in relation to replenishment that:

“A CCP’s rules and procedures should indicate the central counterparty’s process to replenish any financial resources that the CCP may employ during a stress event so that the CCP can continue to operate in a safe and sound manner”. (FSS 4.8)

2.2. CPMI-IOSCO guidance on recovery of Financial Market Infrastructures

In addition to the FSS, the RBA has indicated that it expects the recovery arrangements of the ASX CCPs to comply with the CPMI-IOSCO Guidance on Recovery of Financial Market Infrastructures issued in October 2014.

The CPMI-IOSCO guidance states that:

‘... an FMI should have the capacity to replenish promptly any depleted financial resources needed to meet minimum financial requirements under the PFMI. At the same time, market conditions or financial stability concerns at the time of the stress event might warrant a more measured pace for replenishment. In recognition of this potentially unavoidable trade-off, an FMI’s rules and procedure should avoid automatic triggers but provide it with capacity to effect a replenishment as soon as practicable, including by the following business day when that would be the case, along with the capacity and the responsibility to determine the most appropriate pace for replenishment in light of the prevailing circumstances.’

This guidance also sets out a number of “desirable characteristics” that recovery tools, including arrangements for replenishment, should possess. These state that recovery tools should be not only comprehensive and transparent, but also effective (in terms of reliability, timeliness and legal basis), create appropriate incentives for participants and minimise negative impact on the financial system.

2.3. Replenishment tools

The CPMI-IOSCO guidance does not require a CCP to immediately replenish fully via committed fixed contributions provided by a CCP and its participants on a mutualised basis. A CCP could instead temporarily utilise non-mutualised resources (e.g. additional initial margin (**AIM**)), perhaps in combination with mutualised contributions, to meet its regulatory financial requirements on an interim basis.

Mutualised and non-mutualised resources each have costs and benefits that must be weighed in designing a replenishment approach that meets the regulatory objectives described above.

- Non-mutualised resources such as AIM would not be exposed to any losses arising from a subsequent default of another participant. This ‘defaulter pays’ property of AIM may be a desirable characteristic if risk aversion is heightened following an extreme market event. However, non-mutualised resources place significantly greater liquidity pressures on participants, which would have to provide sufficient AIM to fully cover their own stressed exposures.

- By contrast, mutualised resources such as default fund contributions reduce the potential for procyclical liquidity pressures by allowing a CCP and its participants to pool the liquidity required to cover losses on a subsequent default. These pooled contributions are, however, exposed to loss if a subsequent default creates losses that exceed collateral posted by that participant.

2.4. Current replenishment arrangements

On 1 October 2015, the ASX CCPs amended their operating rules to introduce new rules in relation to the replenishment of their default funds. A summary of the key requirements is set out below:

- the ASX CCPs will replenish their default funds up to \$400m for ASX Clear (Futures) and \$150m for ASX Clear
- the ASX CCPs and participants will each contribute 50% of the required replenishment amount
- replenishment will occur after the default period ends, which occurs 22 business days after completion of the default management process (**DMP**)
- the ASX CCPs would rely on initial margin, AIM calls based on participants' stressed exposures and any remaining default fund resources to meet the minimum level of cover prior to full replenishment
- participants can resign, and therefore not be liable to replenish the default fund, provided they satisfy all the conditions for resignation at least 5 business days before the end of the default period.

The current Recovery Rules and related consultation material are available at <http://www.asx.com.au/services/clearing/ccp-recovery-and-resolution.htm>

2.5. RBA Assessment of the ASX CCPs

In its assessment of the ASX CCPs' compliance with the FSS in 2014/2015, the RBA noted that in order for each ASX CCP to fully observe the FSS it "should complement its comprehensive loss allocation arrangements by further refining its replenishment arrangements to ensure that it is able to return to the full level of cover on a more timely basis, while minimising the potential for procyclicality".

The RBA expressed the following views in relation to the ASX CCPs' current recovery arrangements:

- the current replenishment arrangements may not be timely since there would be a delay of at least 22 business days following completion of the default management process before the CCPs return to full mutualised cover; consistent with the CPMI-IOSCO guidance, ASX should be able to return to regulatory minimum levels of financial cover on a more rapid basis, including on a next-day basis if practical
- a return to full financial need not take the form of a committed fixed contribution, as would be the case for full replenishment, but could for instance be at least partly in the form of non-mutualised resources (e.g. AIM); indeed, in stressed market circumstances, participants might prefer to bear the liquidity cost of additional margin rather than face the risk of a loss on any additional contribution they might make to mutualised resources.

- however, reliance on AIM would place a greater liquidity burden on participants than a replenishment undertaken on a mutualised basis, and could therefore be highly procyclical
- accordingly, it might be desirable to return to full financial cover, at least on an interim basis, through some combination of fixed contributions and non-mutualised resources.

The RBA Assessment is available at <http://www.rba.gov.au/payments-system/clearing-settlement/assessments/2014-2015/pdf/report-2014-2015.pdf>.

3. Proposed amendments to the ASX CCP replenishment arrangements

3.1. Revised replenishment arrangements

To address the RBA's recommendations, the ASX CCPs propose to amend their Recovery Rules to provide the capacity for more rapid mutualised replenishment of the default funds. The proposed amendments primarily affect the timing of fixed contributions rather than the amount which is required to be replenished. A summary of the key amendments proposed is set out below.

Interim replenishment to Minimum Fund Size

If the default fund is depleted below \$100m (ASX Clear (Futures)) or \$37.5m (ASX Clear) (**Minimum Fund Size**), the default fund must be replenished on an interim basis to at least the Minimum Fund Size.

This Minimum Fund Size represents 25% of the maximum size of the proposed new default fund of \$400m (ASX Clear (Futures)) or \$150m (ASX Clear) following complete depletion of the default fund. In determining the Minimum Fund Size, ASX has sought to balance the liquidity impact of AIM (which may be pro-cyclical) and the risk of loss of further mutualised contributions to the default fund if there is a subsequent default before the end of the default period.

ASX expects that replenishing the default fund to at least the Minimum Fund Size would:

- materially reduce the extent to which AIMs was required to achieve full financial cover during the remainder of the default period relative to no default fund. Based on capital stress testing results for the period from October 2013 to October 2015, ASX estimates that a default fund of the Minimum Fund Size would reduce the average value of total daily AIMs called from participants across the market by approximately 50% relative to no default fund. These figures are provided for illustrative purposes only and the actual impact may be higher or lower.
- materially decrease the average number of AIMS calls per day during the remainder of the default period relative to no default fund. Based on capital stress testing results for the period from October 2013 to October 2015, ASX estimates that a default fund of the Minimum Fund Size would reduce the average number of AIMs calls across the market by more than 50% relative to no default fund. These figures are provided for illustrative purposes only and the actual impact may be higher or lower.

Timing of interim replenishment

The default fund must be replenished to the Minimum Fund Size as soon as reasonably practicable after completion of the DMP, as determined by the CCP, including the next business day where that is reasonably practicable. This timing is required to comply with the regulatory requirements.

ASX to make initial interim contribution to default fund

The ASX CCP will (through funding sourced by ASX) contribute the first \$100m (ASX Clear (Futures)) or \$37.5m (ASX Clear) of any interim contribution to the default fund. This contribution would be made as soon as reasonably practicable after completion of the DMP, as determined by the CCP, including the next business day where that is reasonably practicable. ASX considers that making the interim contribution will significantly reduce both the potential liquidity impact on participants and the risk that calling for contributions from participants on short notice in stressed conditions could result in further defaults.

Discretion to call participants to make interim contribution to default fund

The ASX CCPs will have discretion to call participants to contribute up to a further \$100m (ASX (Clear (Futures)) or \$37.5m (ASX Clear) as an interim contribution to the default fund. The ASX CCPs would have the flexibility to call on participants to make this contribution either:

- to increase the size of the default fund above the Minimum Fund Size to further reduce reliance on additional margin calls; or
- to replenish the default fund to at least the Minimum Fund Size if a further default has occurred which again depleted the default fund below the Minimum Fund Size.

If the ASX CCP intends to exercise its discretion to make a call on participants to increase the default fund above the Minimum Fund Size, it will first consult with the Risk Consultative Committee and participants will be given at least 5 business days' notice of their obligation to make the contribution.

In determining whether to exercise this discretion, the ASX CCPs would take into account their overriding obligation to do all things necessary to reduce systemic risk to the extent that it is reasonably practicable to do so. This would include consideration of:

- the estimated impact of additional margin calls over the period to completion of the final replenishment, including the size and frequency of calls and the number of affected participants
- prevailing market conditions
- the ability of participants to pay within the required time frame to minimise the risk of further default
- the likelihood of a further default occurring that may result in loss of the contribution.

If ASX's interim contribution to the default fund is depleted below the Minimum Fund Size as a result of a subsequent default, ASX would have the right to call on participants to make an interim contribution to the default fund (subject to the caps noted below) as soon as reasonably practicable following completion of the DMP for that default, including within one business day where that is reasonably practicable.

Amount of participant interim contributions to the default fund

The ASX CCPs may call a maximum of \$100m (ASX Clear (Futures)) or \$37.5m (ASX Clear) of interim contributions from participants during a default period. Individual participant contributions would be calculated on a pro-rata basis based on their ASX Clear Maximum Assessment (ASX Clear) or their Commitments (ASX Clear (Futures)).

Individual participant contributions would be capped as follows:

- for ASX Clear, at their ASX Clear Maximum Assessment prior to the commencement of the default period
- for ASX Clear (Futures), at the amount of their Commitment prior to the commencement of the default period.

Interim contributions in ASX Clear (Futures) would not be split between OTC and Futures participants and juniorisation would not apply. The split between OTC and Futures commitments and juniorisation would be reinstated upon final replenishment (at the end of the default period).

Based on the current levels of participant Commitments (ASX Clear (Futures)) and ASX Clear Maximum Assessment (ASX Clear), ASX expects that the average contribution per participant to the maximum interim default fund would be approximately \$1.2m for ASX Clear, with the 5 participants with the largest exposures contributing between \$2.6m and \$4.3m, and approximately \$5.5m for ASX Clear (Futures), with the 5 participants with the largest exposures contributing between \$8m and \$13m. These figures are included for illustrative purposes only. Actual calls could be higher or lower.

Total caps on interim replenishment

The total amount of interim replenishment contributions required of the ASX CCPs and participants during a default period is capped at \$200m for ASX Clear (Futures) and \$75m for ASX Clear, regardless of the number of further defaults in the default period. This cap is split 50/50 between ASX and the participants, as set out above. If these interim contributions were fully depleted by further defaults during the default period, the ASX CCPs would rely on initial margin and additional margin calls to meet the minimum level of cover for the remainder of the default period.

Application of interim contributions to default fund to further defaults

If there is a further default during the default period in respect of which losses exceed the defaulters' margin and contributions (if any), the ASX CCP's own interim contribution to the default fund (together with any amount remaining from the original default fund) will be applied in full before any participant interim contributions are applied.

The ASX CCPs would also be able to utilise the recovery tools (including recovery assessments, payment reduction and termination) to fully allocate any further loss during the default period that exceeds the default fund.



Impact of utilisation of interim contributions on final replenishment

As under the current Recovery Rules, final replenishment of the default fund will continue to take place after the end of the default period. The final default fund will be up to \$400m for ASX Clear (Futures) or \$150m for ASX Clear.

If there is a further default during the default period which results in the utilisation of any interim contributions from the ASX CCP or participants, their contribution to the final default fund will be reduced by the amount of their interim contribution that was utilised.

After final replenishment has occurred, the ASX CCPs would retain the ability to subsequently rescale the default fund as provided for under the current Recovery Rules.

Schedule 2 contains a diagrammatic representation of the impact of the interim replenishment arrangements.

Effect of resignation

As with the current Recovery Rules, participants would not be liable to make an interim contribution if they have satisfied all conditions for resignation prior to the call for interim replenishment being made. However, under the revised Recovery Rules, they may have a shorter period within which to satisfy these requirements. Although resigning participants' may not be liable for interim replenishment calls, their resignation will not be effective until the end of the default period and so they will remain liable for any further calls for recovery assessments made during the default period, subject to applicable caps.

3.2. Exposure Draft Operating Rules

The Exposure Draft containing the draft operating rules to incorporate the proposals set out in this paper is available at <http://www.asx.com.au/services/clearing/ccp-recovery-and-resolution.htm>.

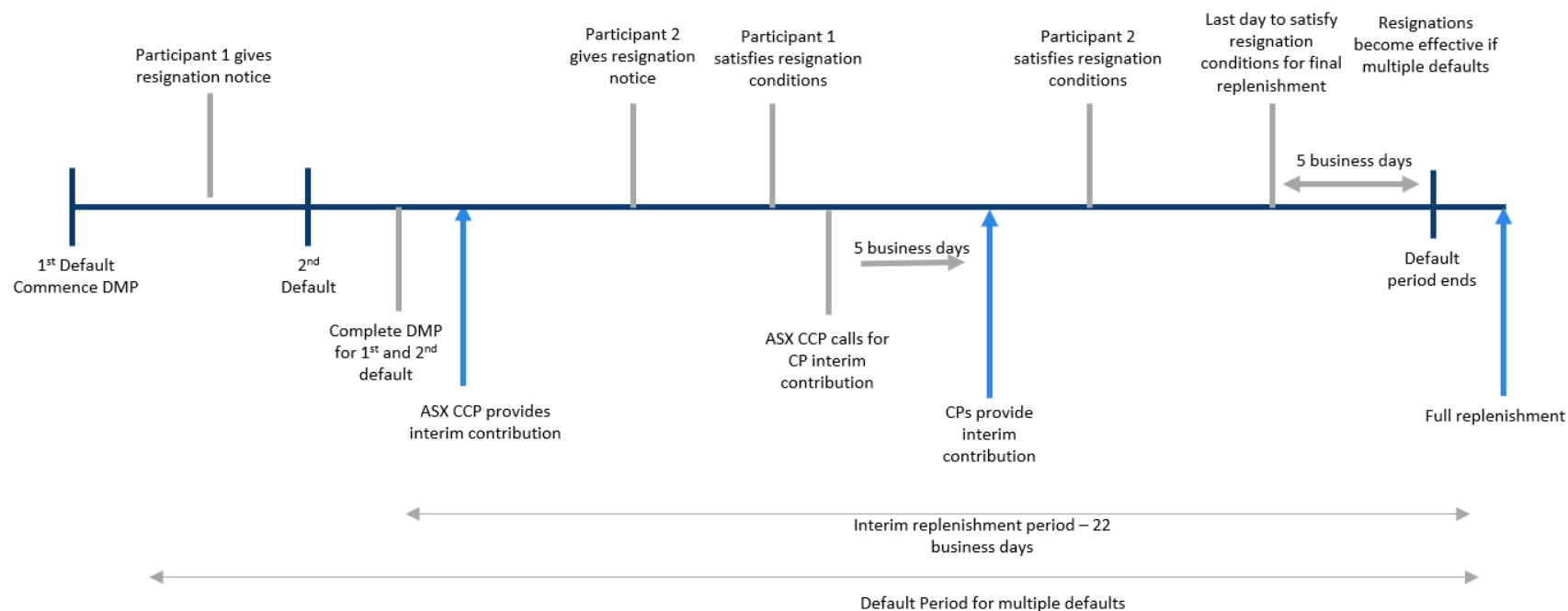
The proposed amendments to the operating rules remain subject to the usual regulatory clearance process by ASIC and the RBA.

3.3. Next steps

ASX seeks stakeholders' views on the Exposure Draft rules. Submissions should be made by Thursday 4 February 2016. ASX welcomes opportunities for bilateral discussions with interested parties. ASX contact details are provided on page 2.

ASX currently intends to lodge final rules for regulatory clearance in late Q1 2016.

Schedule 1 – Default period, resignation and replenishment timeline example



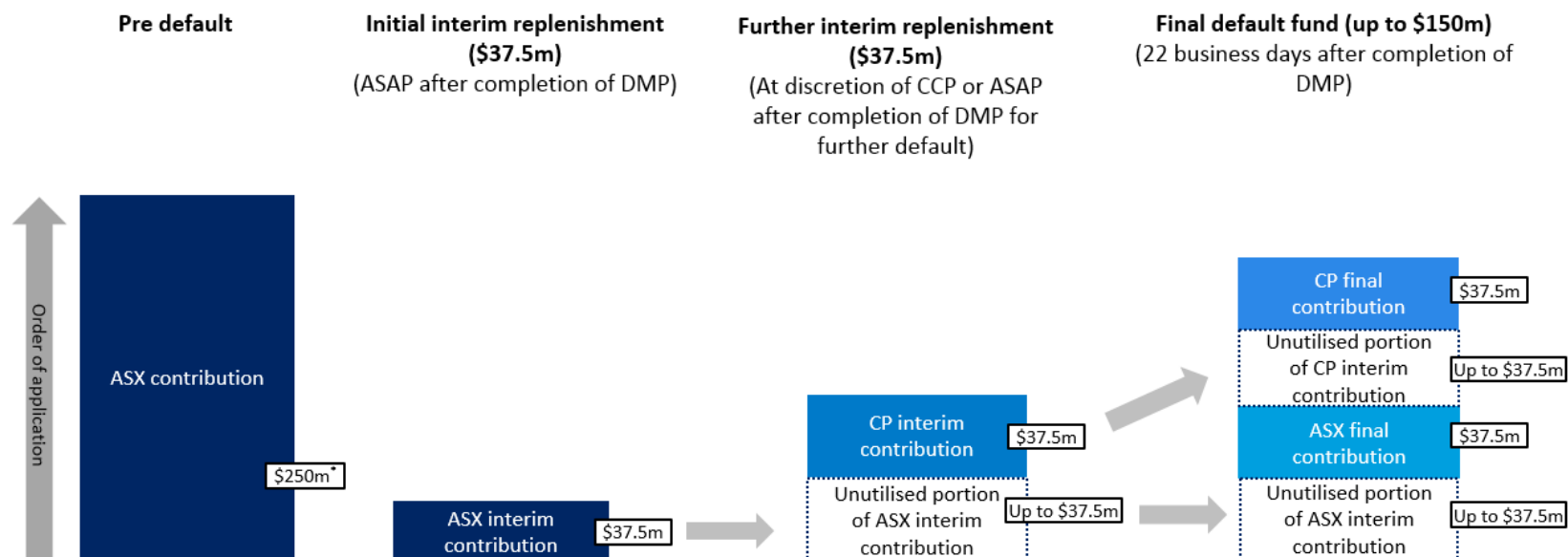
Notes

- * Assumes full depletion of Default Fund as a result of 1st and 2nd defaults and no further defaults in default period
- * If another default occurs while DMP is in progress, DMP is expanded to include second default
- * Default Period ends 22 business days after completion of DMP
- * Default Period is extended if subsequent default occurs within Default Period
- * Participant 1 would not be required to make interim contribution as conditions to resignation satisfied before call made. Participant 2 would be required to contribute to interim replenishment but not for final replenishment
- * Capped liability for assessments applies for Default Period regardless of when notice given. For example, participant 1 would remain liable for assessments for the 2nd default and any subsequent default in the Default Period
- * All resignation during Default Period effective on this day provided conditions to resignation (such as close out of positions) satisfied.



Schedule 2 – ASX Clear & ASX Clear (Futures) Default Fund Replenishment – revised proposal

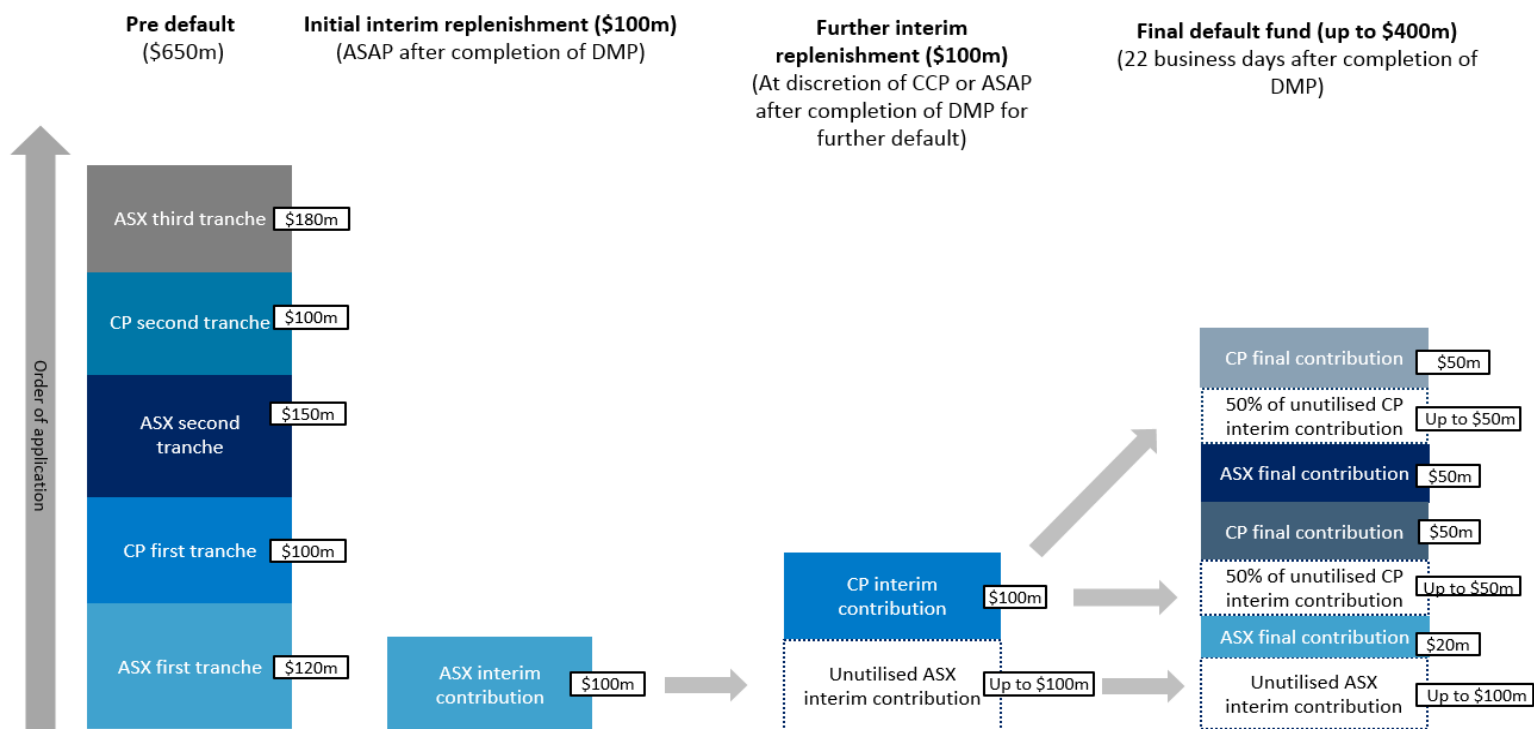
ASX Clear Default Fund Replenishment



- Final replenishment amount is \$150m less the interim replenishment amount. Each tranche is reduced by the amount (if any) of the interim replenishment for that tranche that was utilised by further defaults. For example, if a further default occurred which depleted the ASX contribution to the default fund by \$20m, the final default fund will be \$130m, with the first tranche of the ASX contribution reduced to \$17.5m.



ASX Clear (Futures) Default Fund Replenishment



- Final replenishment amount is \$400m less the interim replenishment amount. Each tranche is reduced by the amount of interim replenishment from that tranche that was utilised by further defaults. For example, if a further default occurred which depleted the ASX contribution to the default fund by \$60m, the final default fund would be \$340m, with the ASX first tranche reduced to \$60m.
- For the interim contribution, OTC and Futures contributions will form part of the same tranche. Upon final replenishment, they will again be split into two tranches.



Schedule 3 – Questions for consultation

Question
1. Do you have any comments on the use and appropriate mix of mutualised and non-mutualised resources to return a CCP to full financial cover on an interim basis?
2. Do you agree with the Minimum Fund Size? Do you think it provides an appropriate balance between the size of the default fund, and participant contributions to it, and the use of additional margin calls?
3. What time frame would you consider is “as soon as reasonably practical” to require interim replenishment of the default fund? What are the impediments for participants to rapidly replenish the default fund? Do you have any comments on the appropriate timing of potential participant interim contributions and the factors that should be taken into consideration when determining this timing?
4. Do you agree that that participants should not be required to contribute to the interim default fund if participants have satisfied the conditions for resignation but their resignation is not yet effective because the default period has not ended? Do you think this may create an incentive to “rush for the exit”?
5. Do you think that participant’s interim replenishment obligations should be based on their Commitments/Assessment Caps before the default? If not, what basis would you suggest and why?
6. Do you think that participant’s final replenishment obligations should be based on their Commitments/Assessment Caps before the default? If not, what basis would you suggest and why?
7. Do you have any other comments on the Exposure Draft rules?

