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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Capitalisation of bank exposures to central counterparties

Dear Basel Secretariat,

ASX Group (ASX) would once again like to thank the Basel Committee on Banking Supervision (BCBS) for the opportunity to respond to *Consultative Document: Capitalisation of bank exposures to central counterparties* (November 2011).

While ASX has made a number of suggestions on the BCBS proposals in this submission, we believe that it will be important to review the proposal once the CPSS-IOSCO Principles have been finalised given the central role that they play in determining a Qualifying CCP and their wider financial stability mandate. ASX looks forward to working closely with the BCBS, national regulators and market users in further reviewing and finalising the proposal.

<u>About ASX Group</u>

The ASX Group is a provider of multi asset class exchange services. It operates Australia's main equities and derivatives exchange markets and the post-trade processing services in which transactions executed on Australian markets are cleared and settled.

ASX currently operates two Central Counterparties (CCPs) – ASX Clear and ASX Clear (Futures). ASX Clear provides CCP services for a range of financial products traded on the Australian markets, including cash equities, pooled investment products, warrants, certain interest rate products and equity and commodity-related derivatives. ASX Clear (Futures) provides CCP services for derivatives traded on the ASX24 market, including futures and options on interest rate, equity, energy and commodity products.

ASX's CCPs are licensed entities regulated by Australia's corporate regulator and central bank. The CCPs must comply with the obligations arising from their clearing and settlement facility licences, granted by the Australian Government, including those arising from the Financial Stability Standard for Central Counterparties determined by Australia's central bank, the Reserve Bank of Australia (RBA).

Summary of Submission

ASX wishes to highlight several weaknesses it has identified in the proposed approach:

- Key points outlined in the original ASX submission have not been addressed;
- Further amendments should be made to encourage banks to become Clearing Participants of CCPs;
- The proposals should be more generic to accommodate a wider variety of CCP default fund structures;
- Hypothetical CCP calculations remain inappropriate as they do not reflect the means by which CCPs extinguish exposures in the event of a Clearing Participant default; and
- Data collection should be re-examined to ensure that sensitive CCP information is not being published.

Further detail on these and other issues are outlined below.

Comments on the Consultation Proposal

Key points outlined in the original ASX submission have not been addressed

ASX's issues highlighted in its original submission appear to have not been addressed in the current BCBS proposal. ASX considers that the proposed BCBS approach remains inappropriate in respect of the hypothetical CCP calculation, and the changes subsequently made to the original BCBS proposal largely do not address our concerns. We ask the BCBS to reconsider the following points from the original ASX submission:

- Existing OTC methodologies do not adequately quantify CCP risks;
- Hypothetical CCP capital should be derived from existing CCP stress testing models;
- Data collection and transmission would be potentially error prone and may be prevented by privacy legislation;
- Further clarification is required on the scope and application of the proposal; and
- Further calibration of CCP uncapped levy powers is needed.

ASX would welcome the opportunity to further explore these issues directly with BCBS representatives.

To promote systemic stability banks should be encouraged to become Clearing Participants

ASX strongly agrees with the stated objective of the initiative to create *"incentives for banks to increase their use of central counterparties*". However, ASX believes that the BCBS proposal on client exposures could inadvertently frustrate that goal. This proposal, for example, does not recognise the systemic risk benefits which are created through banks becoming clearing participants (CPs) of CCPs. The narrow deferential in benefits granted to clients of CPs compared to CPs under paragraph 112 and 113 in Annex A are likely to reduce the benefit of major banking institutions becoming CPs as opposed to utilising the services of, often smaller, CPs.

It is important from a systemic risk perspective for well capitalised banks to become or remain CPs given the significant financial strength they add to a clearing system. Moreover the additional oversight provided by CCPs on a bank's cleared activities provides further systemic risk protections. CP positions are closely monitored by CCPs and subject to risk supervision such as capital monitoring and other risk mitigants including additional margin requirements where exposures pass certain predefined thresholds. This degree of market supervision is not directly imposed by CCPs on the client positions of CPs.

Of related concern is that the narrow risk weight differential will incentivise banks to avoid the costs of being a CP and operate as clients of CPs causing the number of CPs to reduce to such a level that concentration risks for the CCP become problematic. This potential concentration risk becomes an even greater concern when combined with the likely moves to gross client margining held at the CCP. This in turn is likely to increase the cost imposition of the liquidity and credit risk requirements being considered by CPSS-IOSCO.

ASX recognises that the treatment of client exposures to CPs in respect of exchange-traded instruments is not equivalent to that of uncleared OTC transactions. Therefore the application of the bilateral OTC weighting would be excessive. ASX advocates a lower weighting but with a greater differential to that applied for CP exposures to a CCP. Furthermore, ASX is concerned that the proposal to allow 'bankruptcy remote' provisions for clients of CPs should be limited to arrangements whereby collateral is lodged with the CCP clearing the contract. Such a restriction will avoid the development of complex and non-standardised arrangements between clients and CPs. As demonstrated by the default of MF Global, the complication of additional, complex contractual arrangements used by the defaulter and its affiliates/clients are potential barriers to the effective transfer, liquidation and return of surplus margin monies in respect of the defaulter's client positions.

Greater netting clarity is required

ASX is concerned that CCPs may apply inconsistent netting methodologies when undertaking BCBS hypothetical CCP capital calculations. The lack of netting detail in the BCBS proposal makes it difficult for ASX to comment comprehensively on the current proposal and we believe further guidance should be provided.

The proposed hypothetical CCP capital calculation significantly overestimates risks to CCPs of clearing OTC interest rate products

ASX does not currently clear OTC products but is actively considering an extension of its current services to OTC interest rate swaps. ASX has received anecdotal evidence to suggest that the BCBS methodology will not effectively accommodate the mandatory clearing of OTC derivatives trades which is scheduled to occur by the end of 2012 under the G20 mandate. In particular, ASX is concerned that the significant gross notional values of OTC derivatives will produce bank capital requirements which are not reflective of the true risk exposure to CCPs. Recognising the pressing timetable for implementation, ASX believes that the European Association of CCP Clearing Houses (EACH) proposal to use net rather than gross exposures in the CEM formula would be much more reflective of CCP netting practices in a default but longer-term more extensive changes to the approach would be more preferable.

Calculations need to reflect a wider array of default fund structures

Paragraph 21 outlines a generic structure for CCP default resources. This description does not accurately reflect the structures of either of ASX's CCPs or, we believe, numerous approaches of overseas CCPs. As a result, the proposal generates perverse outcomes and encourages CCP behaviour that would be contrary to the systemic risk objective of the initiative. ASX encourages BCBS to adopt a more flexible approach based on a wider array of assumed CCP default fund structures and is willing to engage with BCBS to further outline the difficulties created by the current assumptions. Five main issues have been identified:

1. Our understanding is that the current proposal intends to apply risk weights to contingent CP default resources (i.e. not paid in) where there is no paid in CP fund. In such circumstances, if the CCP is deploying sufficient paid in funds from alternatives sources, providers of contingent CP resources should not be penalised if those resources are being provided as a supplementary source of funds. Such an approach could either;
    a. encourage CCPs to remove any contingent resources available in excess of requirements; and/or
    b. create paid in CP default funds of minimal size to avoid the risk weighting on other more substantial CP funds, either contingent or paid in.

2. ASX agrees with the BCBS that the methodology should recognise all paid in CP default funds which occur in the default waterfall, regardless of the number of tranches. However, where additional tranches

of CCP capital are included in the default resources, these too should be recognised in calculating bank capital requirements.

3. Recognition should also be given to additional margin regimes where additional margin is called from CPs if daily stress test exposures exceed predefined limits based on the paid-in default resources of the CCP. It is important that this margining is included in the BCBS calculations as it is important risk protection for CCPs and CPs which preserves the value of default fund contributions in the event of default. Furthermore, given that such calls are not based on the stress testing model used to calculate hypothetical CCP capital, inconsistencies arise emphasizing the need to use CCP's stress testing models to compute hypothetical CCP capital.

4. ASX believes that the BCBS proposal should accommodate additional risk protection regimes where funds called from one participant can be used to offset losses from the default of another participant. ASX Clear operates Contributions and Additional Cover (CAC) arrangements, whereby stress testing results in excess of a CP's exposure limit are called on a daily basis. Where the exposure has been generated by an equity cash market exposure, ASX holds these CP funds under its Contributions powers, which effectively mean that for such periods a CCP is operating a paid in CP default fund. In practice this occurs for only a few days each quarter. This variability in the existence of the fund is not adequately captured in the current proposal as the contingent CP funds will attract risk weightings on some days but not others. To accommodate this, ASX suggests that the definition of a paid in CP fund explicitly limits it to one routinely and consistently held over the period.

5. Many contingent CP default funds are structured on a per default basis – such as the contingent ASX Clear Emergency Assessment power. ASX considers that the BCBS should amend the current text to ensure that where a contingent default fund is based on a per default basis, the size of the CP default fund for BCBS calculations should be limited to the maximum possible value under the default of the single largest CP. ASX has previously commissioned independent analysis for APRA to demonstrate the adequacy of such an assumption.

The K*CM calculation creates perverse CCP incentives

Where a CCP has own resources in excess of its hypothetical capital requirement, there will be an incentive for CCP's to reduce the size of paid in or contingent CP default fund contributions in order to achieve lower overall bank capital requirements. This incentive occurs because total CP capital requirements are determined, to a large extent, by the size of paid in clearing participant default fund contributions or in the event that no paid in clearing participant default fund exists, contingent clearing participant contributions or posted initial margin.

ASX considers that this approach will encourage CCPs to remove or reduce important risk mitigants even though these funds are only ever used in the most extreme market environments. As outlined in our original BCBS submission we consider that bank capital requirements would be more effectively determined by CCP stress testing results and not the size of a CP's default fund.

Isolated use of the beta factor proposal is inappropriate

ASX is unclear as to the rationale for adding a measure of concentration as a factor in determining CCP risk weightings. Several factors are equally relevant but not included in the model. For example, the counterparty standing of the CPs is not taken into consideration. Indeed, concentration of risk in higher rated counterparties may be preferable to multiple exposures to numerous less well-rated CPs.

While ASX accepts that concentration risk should be mitigated by CCPs, CPSS-IOSCO has a number of initiatives in their *Principles for Financial Market Infrastructures* aimed exclusively at addressing concentration risk (for example, credit and liquidity risk principles), ASX considers that these proposals will have an unnecessary duplicative impact on CCPs.

The proposed inclusion of the beta factor calculation will place mid-tier and smaller CCPs at a competitive disadvantage to larger CCPs. ASX considers that small and mid-tier CCPs should not be burdened with this

additional regulatory impediment given that the structure of a CCP's business is typically representative of the host nation's market size.

It is also unclear why the beta factor should be increased by the formula (N/(N – 2). As CCPs are typically able to cover any CP default losses from existing CP margins and CCP paid in capital, we cannot understand the BCBS' rationale for proposing this adjustment.

Data collection and transmission

In addition to the points already raised in the first ASX submission, we remain concerned that the BCBS proposal will result in commercially sensitive information being shared with CPs and competitor CCPs. ASX is strongly of the view that the BCBS will need to impose significant safe guards for information sharing and transmission.

ASX would like to thank the BCBS for the opportunity to comment on this consultation document. We would be happy to discuss any of these issues with BCBS staff and would like to arrange a meeting with the BCBS to further explore our concerns with the proposed methodology and collaborate on the production of an enhanced solution. If you have any comments or questions, please contact Joshua Everson at joshua.everson@asx.com.au or phone: +612 9227 0233.

Yours sincerely

Alan Bardwell
Chief Risk Officer