AFMA

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Ms Kristye van de Geer
Office of the General Counsel
20 Bridge Street
Sydney NSW 2000

By email: Kristye.vandeGeer@asx.com.au

Dear Ms van de Geer

ASX 90 Day Bank Bill Futures Contract Changes Consultation

The Australian Financial Markets Association (AFMA) is making comment on the Consultation Paper entitled *ASX 90 Day Bank Bill Futures Contract Changes* (the Consultation).

AFMA welcomes the ASX's consultation on changes to the 90 Day Bank Bill Futures Contracts as a positive step in evolving and growing the market. Market participants have had long standing discussions on elements of the proposals and we commend ASX for responding with a considered process that, with full consultation with market participants, systematically considers the issues and looks to move the market forward.

The 90 Day Bank Bill Futures Contract is a key piece of Australia's financial infrastructure as it provides hedging opportunities for swaps linked to Australia's main benchmark interest rate BBSW. BBSW itself has evolved significantly over recent years under ASX's guidance.

We note that in relation to all system changes participants request that these should be confirmed in detail and with sufficient time given for the technical implementation.

Settlement method

AFMA supports the key change proposed in the Consultation which is to move the 90 Day Bank Bill Futures contract from a physical delivery contract on expiry to a cash-settled contract.

This is a significant change to the nature of the contract and is likely to have substantial positive impacts on the market. Under the current arrangements the physical delivery constraints and processes encourage many participants to close out of positions prior to expiry to avoid any risk of settlement failure.

Cash settlement will ease these constraints and allow ready, simple settlement of positions without the requirement for physical delivery. We expect this will encourage more firms to bring and keep liquidity in the contracts up to and including expiry.

The 3 month BBSW rate is determined by a robust methodology based on an actively traded primary market and as a result is appropriate to use as a settlement rate for the 90 day bank bills futures contract.

The loss of a layer of the BBSW waterfall caused by moving the futures to settle off BBSW while unfortunate, is an appropriate and acceptable side effect of the change.

While ideally the physical market would be larger than the derivative market it settles, it is not an unusual state of affairs in financial markets to have a significantly larger derivatives market. While only relatively small notional amounts might be shown on screen in the physical market these are deep and liquid markets that are actively monitored particularly during the settlement periods by market participants and as a result it is reasonable to expect that the market will appropriately manage any associated risks associated with using this benchmark.

Implementation options

AFMA represents a wide range of firms and in relation to the implementation options recognises there are a range of views. The position outlined below has a good level but not universal support as some firms quite legitimately prioritise having no economic impact.

AFMA's consensus position is a preference to keep the existing product and commodity codes to keep the operational transition straightforward.

AFMA's consensus position is also concerned about the costs of running two sets of contracts in parallel, if they can be reasonably avoided. Two sets of contracts would require the setup of additional products, the migration of products and depending on the model used could come with additional risks related to the bifurcating of liquidity and operational error.

While AFMA is keen for the transition to commence as soon as possible we appreciate the undesirability of making changes to the contract specification that may result in changes to the fair or forward value of contracts already entered into.

We note that there is some outstanding interest in long dated contracts, however, the vast bulk of open interest is in the next 12 months of contracts. In addition to their being of more limited numbers the contracts beyond 12 months are likely to be less impacted in value by a change in settlement method.

There is an economic difference between cash settled and physical settled futures. Currently there is a market tradeable instrument (SPS/EFP) for Future vs 3 month Single Period Swap (SPS) that matches as a proxy. For the June 19 contract this is marked at -2bp, i.e. the 3 month Future is 2bp higher in yield than matching 3 month SPS. This difference reduces over time and is 0.625bp by March 2020. This reflects the fact that participants do not want to hold long futures positions into close-out due to physical settlement.

SPS/EFP reduces as you move further out the bill strip. This difference is not quoted on 12m+ contracts but one would expect it to be within market bid/offer of the underlying future. If 12 months' notice is given, this would help minimise the economic effect.

Maximizing the utility of the transition arrangements while minimising the costs suggests that the bulk of contracts being those in the next 12 months should be left to roll off, while the smaller interest in the back months could be subject to a change in settlement method after a 6 month notice period. On balance AFMA views this approach as achieving an appropriate balance between minimising disruption (to the largest number of contracts) and maximising benefit (by bringing forward the changeover date).

As such we propose that ASX introduce the changes for all new contracts and contracts further than 12 months out and that ASX make this announcement before mid-2019.

This would result in a relatively clean and simple 12 month transition period that would conclude mid-2020 and would avoid running two sets of contracts.

This could be characterised as support for option 3 with a 12 month notice period.

Given the undesirable extended run-off period of four years for option 2 (if option 3 our preferred option is not pursued) we would support option 1. Option 1 imposes considerable costs on the market that may not be necessary. Option 2 creates minimal disruption but at the cost of undue delays market in market reform for the relatively small open interest that would be minimally affected.

Expiry position limits

While AFMA is supportive in principle of measures to ensure concentration risk at expiry is managed where given the relevant risks it is appropriate, at present, given there are no position limits at expiry for the 30 day interbank cash rate futures contract which is cash settled, AFMA would seek more information on why ASX believes position limits on the 90 day Bank Bill contract are necessary before we could support this proposal.

Price increment

Generally speaking, smaller price increments reduce transaction costs for investors and contribute to market efficiency. However, liquidity provision particularly in further out months where non-intermediated liquidity can be thin, may not be economic with too small a price increment.

AFMA is supportive of the role of market makers as real contributors to market liquidity. Market making brings pricing in markets where otherwise at a particular point in time it may not be present, it contributes to market quality and efficiency and provides the important economic outcome of price discovery.

AFMA's consensus position is supportive of a tightening of tick size to move it more in line with international comparators for the spot month by moving it to a 0.5 tick. We note that this the broad consensus position and is not universally favoured with some participants preferring the front four months to move to 0.5 tick.

As systems will need to pick up when contracts are changing from one tick size to another it is important that these changes are reliably picked up by broker systems. We encourage ASX to work closely with industry to minimise the risk of errors arising from such changes.

Order size

AFMA recognises that the current order size limit of 9999 contracts stems from a limitation of an earlier trading system rather than being a specific market design feature.

While this is noted, the current order limit has consensus but not universal support amongst market participants and is believed to contribute to positive elements of good order in the market. The benefits noted in favour of keeping the limit as-is include reducing risks around order entry and avoiding market locks.

As such AFMA would need further confidence that these type of issues would not increase as the result of any substantial change in the order size before we could support such an increase.

Serial Bank Bill Futures

AFMA supports the proposed listing of four serial month contracts. This would enable month by month hedging over the most active months of the curve.

In the event ASX chooses to introduce 2 additional contracts the success of these contracts should be reviewed with a view to listing additional months as appropriate.

Additional contract months provide options for risk management and are a sensible development for successful contracts such as the Bank Bills.

GTC functionality for Bank Bill Futures Combination Orders

AFMA supports the provision of GTC (Good Till Cancel) and GTD (Good Till Date) functionality for 90 Day Bank Bill combination orders including calendar spreads, inter-commodity spreads, packs and bundles.

GTC and GTD orders add flexibility and ease in order management for traders, by removing the need to re-enter orders for each trading session. This lower requirement for order management supports participation in markets with lower trading activity where high order management demands may not be worthwhile.

In short, the benefits of GTC and GTD in the spread market are similar to those in any market.

The functional description of the implementation looks sensible. We note that the exclusion from the opening auction may be appropriate given the difficulties in incorporating spread pricing in these processes but note that this mean that products may open with spreads outside the pricing in the spread market.

While a significant build to undertake, introducing GTC and GTD functionality in 90 Day Bank Bill spreads will have the additional benefit of providing options for similar functions in other markets that may benefit from these order types.

Bond roll market GTC functionality.

AFMA has long supported a discussion on the question of whether GTC functionality should be introduced into the roll market. We look forward to responding to the consultation on GTC orders in the bond roll market.

Conclusion

Thank you for the opportunity to comment on the matters raised in the Consultation. Please contact me either on 02 9776 7993 or by email at djeffree@ afma.com.au if further clarification or elaboration is desired.

Yours sincerely

Damian Jeffree
Director of Policy