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Dear Ms Hettihewa

ASX consultation on Allocation of Investment Losses – AFMA submission

The Australian Financial Markets Association (AFMA) welcomes the opportunity to respond to the ASX on proposed changes to the ASX Recovery Rules to allocate US settlement bank investment losses between the ASX CCPs and their clearing participants. AFMA represents a wide range of financial institutions, including most of the futures clearing participants of ASX Clear (Futures) (ASXCLF), and promotes effective structures for well-functioning Australian financial markets.

We are generally welcoming of the ASX's proposed changes to ASX Recovery Rules and Handbook based on the objective to mitigate unintended consequences for clearing participants. However, our comments below raise matters around increased transparency and fairness for ASX's consideration before the proposals are executed.

ASX At-Risk Capital Commitment

AFMA notes when ASX introduced the 2 am Variation Margin (VM) call, there was a general recognition across the industry of greater counterparty risk from the US settlement banks because of the increased investment limit applicable to them. Due to a higher potential of liability from Non-Default Losses (NDL), both the CCPs and clearing participants need to be prepared for a higher share in such losses.

ASX's current At-Risk Capital Exposure of AUD 75mn was set in line with the investment limit to US settlement banks before the introduction of the 2 am VM call. Given the additional counterparty risk as noted above, AFMA suggests ASX consider an appropriate increase in its At-Risk Capital Commitment for NDL before allocating these losses to

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participants. In this regard, we also note the RBA's recommendation to increase the scope of ASXCLF's overnight margin process to include calling collateral to cover mark-to-mark exposures.

ASX could consider conducting regular stress tests of its NDL (such as the default fund calibration) and set its Capital committed to NDL as a percentage of the stress test result, instead of a fixed amount.

ASX should consider implementing an improved balance by reallocating its Capital Commitment between the default and the non-default waterfalls.

Consideration for more transparency

Considering the increased risks as outlined above, AFMA suggests there should be some transparency around the relevant details of the US settlement banks that can enable participants to understand the risks and offer feedback if required. As participants are not part of the decision-making process where ASX decides on which depository institutions to place the funds with and in what proportions, but are expected to assume some of the risks, such information will help them to better assess their risks.

Loss Allocation determination and components

The introduction of the 2 am margin process benefits not just all clearing participants but also ASXCLF as it helps to mitigate systemic risk.

There are a range of views within the membership on how losses should be distributed in the event of a default of a US clearing bank.

On one view, as the margin process benefits all clearing participants, the CCP could base it on a combination of "Component 1: Clearing participant's Default Fund contribution as a % of total contribution from all clearing participants" and "Component 2 – Clearing participant's Default Fund contribution as a % of total contributions from clearing participants within the scope of 2 am call".

There is a divergence of views on the third component "Average USD cash called over previous 3 months as a % of the total average USD cash called over the previous 3 months". On one view this may disadvantage international banks that may be more likely to deposit more USD cash collateral owing to operational and funding constraints.

For those that support of a 'defaulters pay' model, it would be more logical that Component 2 (which applies to those clearing participants who are in scope of the overnight margin process) be the first step in this waterfall, followed by Component 3 (all clearing participants who have paid USD cash) and then Component 1 (all clearing participants regardless of participation in the overnight market). This is based on the premise that clearing participants who wish to participate in the overnight market or post USD collateral are the ones who make the choice of the USD settlement banks. Thus, any default at such banks should first be allocated to those members who hold accounts/collateral.

AFMA does not seek to promote one approach over another noting the varying commercial objectives among clearing participants.

Approach to disclosing loss allocation to clients

We note that ASX makes a mention of the ability to allocate losses pro rata amongst House and Client accounts. AFMA seeks clarification if it is ASX's intention to directly allocate losses to clients of clearing participants.

We note that essentially, these would be an outcome of two aspects (i) Whether clearing participant-client agreements allow for such allocations and based on the bespoke arrangement for each clearing participant, will the ASX procedures be conflicted; and (ii) Operationally, even if ASX provides the 'Client Fact Sheet', will allocation to clients even be possible in omnibus accounts?

Alternative Currency to USD

AFMA understands that there is an intention to offer AUD as an alternative currency in the future. We strongly support this intention.

We suggest that having alternative currency options from Day 1 of the proposals being implemented will assist in reducing the risk amongst the settlement banks. This would support market liquidity in case there is a member default.

We note that the consultation does not clarify the rules for the protection, if any, of the funds classified with the depository institutions by the US regulators. Clarification on the protection of such funds in the US as part of the consultation paper would provide a greater level of understanding and appreciation of the risks. If there are protections in place, AFMA seeks clarification on how they are being incorporated into the ASX proposals and the risk mitigation process thereby.

Mitigation of wrong way risk when a settlement bank and a clearing participant are in the same group

AFMA notes the need to mitigate the wrong way risk introduced by the settlement bank and the member in the same group. We recommend ASX to set up additional reserve to collateralise the potential losses by:

- Adding further At-Risk Capital Commitment equivalent to the loss allocation that could have been apportioned to the biggest member and settlement bank group if the group would not be in default. This can be absorbed by the default fund share of the clearing participant multiplied by the outstanding USD 825mn loss to be absorbed after deduction of the current Capital Commitment; or
- Collecting additional wrong way risk contribution from the clearing participants which are in the same groups as the settlement banks. It could be determined to use this additional reserve only in case of the default of the member group.

Additional matters for consideration

While outside the scope of this consultation, AFMA raises the following matters for consideration regarding USD and eligible collateral for the overnight market.

- In relation to the preceding section, if ASX is holding USD balances and there is a member default, it would be of benefit if there was an assurance of ASX's ability to secure AUD liquidity against these USD balances. This could perhaps be established by the ability to swap USD for AUD in such an event.
- AFMA supports clearing participants having the flexibility to meet 2 am margin call in US Treasuries. ASX could also consider incorporating Japanese Government Bonds to their list of collateral that can serve as margin. Japanese Government Bonds are liquid, especially during early Asia trading hours.
- ASX may also wish to consider allowing clearing participants to separately reserve non-cash collateral specifically to cover risk in the overnight session. While we recognise the liquidity concerns with posting non-cash collateral, we welcome ASX's thoughts on an upper limit for non-cash collateral.

We welcome the further engagement with the ASX to address these comments as part of the finalisation of the proposals. Please do not hesitate to contact us through the Secretariat (secretariat@afma.com.au) for further information on this submission.

Sincerely



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