9 February 2024

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Financial Market Infrastructure (FMI) Regulatory Reforms – Exposure Draft consultation

The Australian Financial Markets Association (AFMA) is responding to the Exposure Draft consultation on the *financial market infrastructure (FMI) regulatory reforms.*

AFMA welcomes the next steps in the process of building out the regulatory infrastructure around financial market infrastructure in this consultation.

At a high level we see the package of reforms as sensible. The establishment of a crisis management regime is a reasonable precautionary step. The additional step-in powers for the RBA are necessary in the context of such a regime, and the increased clarity around ASIC's licencing and supervisory powers around overseas clearing and settlement facilities that provide services in Australia is a positive development.

Limiting Contagion

Clearing houses sit at the financial crossroads with multiple banks and other financial firms as clearing members.

The scenarios covered by the FMI reforms are all unlikely to come to pass. Within these unlikely scenarios, consideration should be given to the potential for bank default to be a trigger for issues with clearing house viability.

Within bank default scenarios there is the potential for tension between the APRA resolution regime's interest in avoiding bank failure or limiting its impact on clearing house(s).

AFMA suggests that regulatory priority should be explicitly given in advance (and preferably as part of this regulatory process) to maintaining clearing house viability and limiting impacts via the clearing house to other financial entities. The policy reason for

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this is to limit the potential for the clearing house to be a point of contagion within the financial system.

The experience from Lehman Brothers was that the bank failure put significant pressure on clearing houses. LCH.Clearnet, notably, assumed USD 9 trillion in risk[1] from Lehman Brothers International Europe and Lehman Brothers Special Financing Inc. both of which it had declared in default.

The ability of clearing houses to manage, move and process Lehman proprietary and Lehman client positions was a key part of returning confidence to the financial system and avoiding further disruption. With the subsequent rise in the clearing of OTC trades this will become more important should similar circumstances arise again.

The alternative – prioritising single bank resolvability at the expense of the clearing house, could result in contagion of distress to other banks, and thereby increase systemic risk. During the Lehman default several other banks were already under significant stress, clearing house failure could have resulted in significant capital demands that could readily have contributed to further defaults.

Building further confidence in the resolution regime

For the new regime and arrangements to be successful, there must be sufficient confidence that the arrangements can be relied upon to perform in a fair way that does not add undue risk or unpredictability for investors and participants in the clearing house FMIs.

RBA should look to further consult on detailed explications of how it would expect to use its powers under a range of plausible scenarios. These plans should be compatible with the resolution plans of FMIs as they align with the *IOSCO Guidance on the Recovery of financial market infrastructures*.

They should also be broadly consistent with Resolvability Standards in major jurisdictions internationally.

Ultimately, whether the correct balance has been struck in the legislation, and related resolvability standards and other regulatory elements might be judged by whether the legal and risk advice given to clearing participants, clearing houses, foreign regulators and others in relation to the scheme finds the changes to be generally benign. We suggest their views be sought before finalisation.

The power to amend operating rules and procedures is broad and explication of the types of changes that might be contemplated might assist confidence.

If these opinions do not find the regime predictable and benign then there could be risks to the confidence of investors, C&S participants and FMI firms.

We seek more information on the power of the RBA to change of the rules of the clearing house without consultations. This is a broad discretion with substantial implications for

[1] LCH Clearnet

participating firms. We request information and sensible constraints around how this power is expected to be used.

More generally we seek more information and, where appropriate, more structure around the potential use of RBA's powers.

We also note that the regime does not include a 'no worse off' test as is included in several foreign jurisdictions. While there remains the constitutional protection against acquisition without just compensation, adding some formalism, even if only to the Explanatory Materials, could assist in guiding administrators during the pressures of a default crisis. While in the absence of such guidance a remedy might be available many years later after costly litigation this would be far from ideal.

Interaction with the Payment Systems and Netting Act 1998 (Cth)

The interaction of the regime, and particularly the stay provisions with the Payment Systems and Netting Act 1998 (Cth) (*PNA*) will be complex and critical for the continued confidence of investors in the protection of their rights under a resolution scenario.

We note the explicit inconsistency resolution in favour of the PNA in sections 841C and 847D with regard to sections 841A, 841B, 847C and 847D.

While this is a good foundation, AFMA suggests that the Government outline in tabular form the way the other interactions are intended to work under various scenarios, for example in relation to the exercise of termination rights. This would help both the confidence of investors during normal times and would act as guidance for the RBA or statutory manager during a resolution scenario. It is important that as much clarity as possible is created around these types of interactions so that risk estimates and decisions to participate as clearing members can be made on good data.

In our view it is important that the stays (e.g. 842B, 823V, and 849E) should not impact the PNA and that there should be no implied repeal of any aspect of the PNA. The PNA should prevail as far as reasonably possible.

We note the potential for stays on exercising contractual rights to potentially impact capital treatment by foreign regulators.

Mutual regulatory deference to home jurisdiction regulatory regimes

AFMA appreciates that the Explanatory Materials provide reassurance that the appropriate regulatory deference will be given by the RBA to home jurisdiction regulators and regulatory requirements in the event it must respond to an issue in a foreign clearer.

Our preliminary view is that there is likely benefit in more clearly reflecting this in the drafting of the bill. We suggest further differentiating when the resolution powers can be used for overseas CS facilities versus domestic CS facilities.

Section 848A is the key provision dealing with this point. However, we understand it is a stand-alone provision which may be enlivened when there is an offshore cross-border resolution process in place.

As currently drafted, it is not currently clear that mutual deference is relied upon with respect to the proposed crisis regime for overseas CS facilities as there is no clear distinction between domestic and overseas licensees, except in the case of section 848A.

Therefore, we would recommend that the drafting of the bill be amended to explicitly exclude overseas facilities from the application of the powers in Part 7.3B. This would ensure foreign regulators are comfortable with CS providers from their jurisdiction offering services into Australia.

ASIC's materiality threshold test

We support the redistribution of various CS related powers to ASIC from the Minister.

AFMA supports the general framework for determinations of licencing requirements for overseas facilities and market operators but request that more information be provided by Treasury on how the materiality leg of the test would be constructed and applied in a way that is consistent with appropriate deference to the home regulator.

Conclusion

We thank you for considering our comments in response to this consultation and look forward to continuing to work with the Government as the drafting moves through the parliamentary processes.

Yours sincerely

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