

Attachment 1

Regulation Impact Statement

This Regulation Impact Statement sets out the response of the Reserve Bank's Payments System Board to recent changes to international standards for financial market infrastructures (FMIs), and reforms to FMI regulation. These recent developments are discussed in the paper describing the final *Financial Stability Standards* (FSSs) to which this Regulation Impact Statement is attached (the FSS Paper). Two developments are particularly relevant:

- the publication by the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO) of the *Principles for Financial Market Infrastructures* (the Principles)
- the Council of Financial Regulators' (the Council's) articulation of a framework for ensuring Australian regulatory influence over cross-border clearing and settlement (CS) facilities.¹

This Regulation Impact Statement is structured as follows. Section 1 discusses the problem identified by the Bank. Section 2 outlines the objectives for the Bank in addressing the problem identified. Section 3 sets out the options considered by the Bank in order to meet its objectives. Section 4 evaluates each option and describes the potential impact on CS facilities and other stakeholders. Section 5 sets out the Bank's preferred option, and Section 6 discusses implementation of this option.

¹ See CPSS-IOSCO (2012), *Principles for Financial Market Infrastructures*, CPSS Publications No 101, Bank for International Settlements, April, available at <<http://www.bis.org/publ/cpss101.htm>>. The Council's paper *Ensuring Appropriate Influence for Australian Regulators over Cross-border Clearing and Settlement Facilities* is available at <<http://www.treasury.gov.au/ConsultationsandReviews/Submissions/2012/cross-border-clearing>>.

1. Problem Identification

Section 2 of the FSS Paper describes recent developments in the international and domestic landscape for CS facilities that have led the Bank to consider whether its current approach to the oversight of CS facilities remains optimal. This section discusses the issues raised by these developments; in particular, the publication of new international standards for FMIs and trends towards greater use of cross-border CS facilities. These issues can be grouped into four areas: developments in international best practice for FMI risk management, in response to newly identified risks; expectations that Australian regulation should meet international standards; implications for market adoption and use of CS facilities; and the potential for cross-border externalities to prevent optimal provision of clearing and settlement services.

1.1 FMI Risk Management

CS facilities and their participants do not necessarily bear all risks and costs associated with their activities. Inadequate risk management by CS facilities or their participants could cause disruption to the financial system, generating significant negative externalities for customers of participants, participants in related markets or infrastructures, and the real economy. The provision of clearing and settlement services that deliver the socially optimal level of financial stability will therefore not necessarily be achieved through market forces alone.

The development of international standards described in Section 2.2 of the FSS Paper recognises this potential for market failure in the provision of FMI services. Both in Australia and internationally, FMIs performed well during the global financial crisis. The Bank, in its annual assessment of Australian licensed CS facilities, has consistently found that these facilities comply with the current FSSs. However, the events of the crisis highlighted important lessons for effective risk management. Furthermore, future crises may involve different or more severe stresses. CPSS and IOSCO therefore sought to develop a set of principles that would make FMIs more robust to the range of possible future stresses without the need for government support.

New international standards also address stability issues emerging from the broader government and regulatory response to the financial crisis. Recognition of the potential risks inherent in over-the-counter (OTC) derivatives trades prompted international regulators and the G-20 to encourage management of these risks through increased central clearing of these transactions. The Australian Government has committed to reforms to OTC derivatives regulation to facilitate this in Australia, with a Bill passed by Parliament in November 2012.² The correspondingly greater use of centralised – often cross-border – FMIs by market participants makes the adoption of an exacting and internationally harmonised set of standards, such as the Principles, essential. The Principles also provide stringent risk controls to address the potential for moral hazard to arise from any provision of central bank services to FMIs in a crisis.

² Corporations Legislation Amendment (Derivatives Transactions) Bill 2012.

To the extent that Australian CS facilities do not adopt the enhanced risk management practices set out in the Principles, the Australian financial system may remain vulnerable to newly identified risks, and ill-equipped to accommodate increased central clearing of OTC derivatives trades. This could result in continued high use of alternative bilateral clearing arrangements by OTC derivatives market participants, where this is not an optimal method of managing the risks involved.

In respect of the Council's review of the FMI regulatory framework, the recommendation for enhanced regulatory powers to manage the resolution of distressed FMIs would, if adopted through legislation, necessitate that licensed CS facilities' operations be organised in such a way that directions, step-in and other resolution powers could be effectively carried out. FMIs' failure to organise their operations in this way would restrict the effectiveness of resolution actions, potentially compromising the continuity of systemically important FMI services in a crisis or FMI distress scenario.

1.2 Expectations and Reputation

The Bank, as a member of the CPSS, and the Australian Securities and Investment Commission (ASIC), as a member of IOSCO, have been involved in developing the Principles. Other CPSS and IOSCO members therefore expect the Bank and ASIC to adopt the standards set out in the Principles in their oversight and regulation of Australian FMIs, to the fullest extent possible. If regulation of Australian CS facilities continued in accordance with previous CPSS-IOSCO recommendations, as reflected in the measures of the current FSSs, the reputation of Australian regulators and Australia as a jurisdiction could be weakened.³ In such circumstances, both Australian regulators and the CS facilities that they oversee could be perceived as failing to adopt international best practice. External assessments of the Australian financial sector, such as under the International Monetary Fund (IMF)/World Bank Financial Sector Assessment Program (FSAP), would also be likely to draw negative conclusions regarding both the oversight and operation of CS facilities. In addition, the Australian Government's commitment to the G-20's OTC derivatives market reforms could be undermined, given the key supporting role played by the Principles.

1.3 Market Adoption and Use of CS Facilities

If Australia were judged not to have adopted the Principles, banks participating in Australian central counterparties (CCPs) would face higher capital charges with respect to their exposures to the CCPs. Under new international capital standards for banks, capital charges with respect to exposures to CCPs are greater if the CCP's regulator has not fully adopted the Principles in its oversight of CCPs.⁴ This would reduce the incentives for participants to utilise the central clearing services of Australian CCPs. Depending on the product type, participants might choose to utilise CCPs regulated in other compliant jurisdictions, utilise alternative risk management arrangements such as bilateral management of exposures, or even exit the market altogether. A migration of participants to alternative arrangements could lead to market fragmentation and reduce the netting benefits of clearing via a CCP. In the case that participants moved to, or remained in, bilateral risk management arrangements, the benefits of centralised risk management would be lost.

3 For previous CPSS-IOSCO recommendations, see CPSS-IOSCO (2004), *Recommendations for Central Counterparties*, CPSS Publications No 64, Bank for International Settlements, November, available at <<http://www.bis.org/publ/cpss64.htm>>; and CPSS-IOSCO (2001), *Recommendations for Securities Settlement Systems*, CPSS Publications No 46, Bank for International Settlements, November, available at <<http://www.bis.org/publ/cpss46.htm>>.

4 Basel Committee on Banking Supervision (2012), *Capital Requirements for Bank Exposures to Central Counterparties*, Bank for International Settlements, July, available at <<http://www.bis.org/publ/bcbs227.htm>>.

1.4 Cross-border Issues

The operation of CS facilities across jurisdictional borders creates the potential for cross-jurisdictional externalities: inadequate risk controls applied by a CS facility in one jurisdiction could generate risks that affect the financial system in another jurisdiction in which the facility operates. Cross-border externalities may also arise where the actions of CS facilities or regulators in one jurisdiction affect the structure or functioning of markets that operate across borders. Such cross-border externalities create additional barriers to the delivery of optimal clearing and settlement services by the market.

There are a number of requirements under the Principles that are not formally covered by the current FSS measures. If Australian licensed CS facilities were not held to the international best practice standard of the Principles, they would, for example, not be formally held to the following requirements:

- more granular and specific requirements for governance arrangements, including taking account of stakeholder and public policy interests
- enhanced financial resources to cover credit and liquidity risks, and more specific requirements regarding margining and collateral eligibility
- a formal plan for recovery from financial distress or orderly wind-down, and additional resources held to fund the plan
- arrangements providing for segregation and portability of participants' customers' positions and collateral
- more specific requirements addressing operational risks arising from dependencies on service providers
- risk controls addressing interdependencies between FMI and tiered participation.

In such circumstances, regulators in other jurisdictions may be unwilling to allow Australian CS facilities to operate in their jurisdictions, or to allow entities that they supervise to participate in Australian CS facilities. Such barriers to cross-border participation or service provision could result in fragmentation of markets between jurisdictions, reducing netting efficiencies from clearing or settlement arrangements.

In addition, the current FSSs provide relatively limited scope for the Bank and ASIC to exercise influence over cross-border CS facilities licensed in Australia, as acknowledged by the Council in its framework for regulatory influence over cross-border CS facilities. Australian regulators may therefore be unable to adequately manage a crisis involving an overseas-based facility, or otherwise unable to ensure that such a facility appropriately managed any risks that it posed to the Australian financial system. The Bank and ASIC may in such circumstances be reluctant to recommend that the Minister grant a licence to an overseas-based CS facility licence applicant.

Similar concerns would arise in respect of a domestic licensed CS facility that sought to outsource operations offshore. If the Bank and ASIC were unable to exert influence to ensure that the risks associated with any outsourcing arrangements were appropriately managed, significant additional risks could be introduced into the Australian financial system.

The proposed takeover of ASX Limited (ASX) by Singapore Exchange Limited (SGX) also highlighted concerns that could arise in a situation where a domestic CS facility licensee became subject to control by an offshore holding company. The loss of full Australian regulatory sovereignty over the holding company under the ASX-SGX proposal would have presented material risks and supervisory issues impacting on the effective regulation of ASX's clearing and settlement operations. The Treasurer was advised that a stronger regulatory framework for exerting influence over cross-border CS facilities should be a condition of any future foreign ownership of ASX's CS facilities.

2. Objectives

Under section 827D(1) of the *Corporations Act 2001* (the Act), the Bank may determine FSSs for the purpose of ensuring that licensed CS facilities conduct their affairs in a way that causes or promotes overall stability in the Australian financial system. The Bank also has responsibility under section 823CA(1) of the Act for assessing how well licensed CS facilities are complying with the FSSs and the extent to which they are doing all other things necessary to reduce systemic risk.

In accordance with these powers and responsibilities, and with regard to the matters considered in Section 1, the Bank has four specific objectives for reviewing the standard of conduct to which CS facilities are held under the FSSs:

- In terms of *FMI risk management*, to ensure that licensed CS facilities in Australia appropriately control the risks they pose to the Australian financial system, in light of emerging international best practice, and adopt risk controls that are appropriately tailored to their role in the Australian financial system.
- In terms of *expectations and reputation*, to ensure that Australia is seen to be a jurisdiction that adopts international best practice in the regulation of CS facilities, to contribute to the efficiency, effectiveness and stability of the Australian market.
- In terms of *market adoption and use of CS facilities*, to ensure that participants in all markets are able to make appropriate use of centralised infrastructures to manage their risks.
- In terms of *cross-border issues*, to ensure the Bank, with other Australian regulators, is able to manage crises and promote financial stability by exerting an appropriate degree of influence over licensed CS facilities, including facilities with cross-border operations.

3. Options

The Bank has considered three options for meeting the objectives set out in Section 2. Under each option the Bank would adopt the Principles and the Council's framework for regulatory influence over cross-border CS facilities in conducting oversight of CS facilities under the FSSs. By doing so the Bank could feasibly address the stability, jurisdictional reputation, market functioning and cross-border issues outlined in Section 1. It is in the particular mechanism by which the Principles and the Council's regulatory influence framework are adopted that the options differ; that is, whether through direct changes to the FSSs, or through updating guidance as to the Bank's interpretation of the requirements of the FSSs. An evaluation of each option relative to the Bank's objectives is discussed in Section 4.

The three options the Bank has considered are set out in the remainder of this section, ordered according to how explicitly and directly they adopt the requirements of the Principles and the Council's cross-border regulatory influence framework.

- Option 1 involves no change in the FSSs, but provides updated guidance as to how the Bank intends to interpret the existing FSSs in its oversight of licensed CS facilities
- Option 2 provides the same updated guidance, but adds a variation to the existing FSSs to amend or remove current exemptions
- Option 3 adopts the requirements set out in the updated guidance under Options 1 and 2 but as new FSSs, thereby imposing these as direct legal obligations on licensees; Option 3 also implements the same changes to exemptions as Option 2.

Option 1: No Change to the Current Financial Stability Standards

Under the current FSSs, licensed CS facilities are held to a broad obligation to contribute to financial stability. As new risks to financial stability have emerged or been identified over time, the Bank's interpretation of what CS facilities must do to meet this obligation has evolved. In some cases, changes to interpretation have been set out in the measures and guidance to the FSS. For example, in 2009 the measures and guidance to the FSS for securities settlement facilities (SSFs) were amended to clarify the Bank's expectation that SSFs should publish information to assist participants in understanding the financial risks of participation – in particular data on securities lending. In other cases, the Bank has applied its updated interpretation to its oversight of CS facilities by way of specific recommendations to licensees without setting out additional requirements in the FSS measures or guidance.

Under this option, the Bank would continue its current regulatory practice of reflecting any updated interpretation of the requirements of the FSSs by amending the FSS measures and guidance. In this case, the Bank would explicitly reflect all relevant requirements of the Principles and the Council's framework for

regulatory influence over cross-border CS facilities in the FSS measures and guidance. The Bank would also reflect relevant requirements from other jurisdictions where these have influenced the Bank's understanding of best practice for CS facilities' management of risks.

For each Principle relevant to financial stability and the facility type, the Principle and its associated key considerations would be used as a basis for the measures, while the explanatory notes would form a basis for the guidance to the measures. The measures would also be modified as appropriate to uphold the standards to which licensed CS facilities are currently held, to reflect standards applied to CS facilities in other relevant jurisdictions, and to reflect key elements of the Council's framework for ensuring regulatory influence over cross-border CS facilities.

While Option 1 does not involve any regulatory change, it is acknowledged that changes to the FSS measures and guidance may be perceived as regulatory in nature, to the extent that they create an expectation of compliance by licensed CS facilities or may be used to influence behaviour.

Option 2: Variation of the Financial Stability Standards

Under this option, the Bank would apply the same amendments to the FSS measures and guidance as under Option 1. The Bank would additionally issue a Notice of Variation to the FSSs in accordance with section 827D(6) of the Act. This variation would:

- *Remove the exemption for overseas-licensed CS facilities:* Currently, the Bank exempts an overseas CS facility licensed under section 824B(2) of the Act from direct compliance with the FSS for CCPs if the regulatory regime in its principal place of business is assessed as being sufficiently equivalent to the Australian regime. The variation to the FSS for CCPs would remove this exemption. Instead, overseas-licensed CCPs would be required to comply with the FSS for CCPs. However, in assessing overseas-licensed CCPs against each measure, the Bank would place conditional reliance upon information and reports from the facility's home regulator, provided that for each measure:
 - the facility provides an independent legal opinion verifying that the facility is held to a materially equivalent standard in its home jurisdiction, and
 - the Bank receives documentary evidence from the facility's home regulator that the facility is compliant with that standard in its home jurisdiction.
- *Increase the exemption value for small SSFs:* The FSS for SSFs would only apply if an SSF's annual settlements exceeded \$200 million; this is an increase from the current value of \$100 million. This reflects increases in settlement values in the market at large since the current threshold was introduced in 2005, and potential future increases.

Option 3: Revocation of the Current Financial Stability Standards and Determination of New Financial Stability Standards

Under this option, the Bank would revoke the current FSSs and determine new FSSs, in accordance with section 827D of the Act. The new FSSs would implement the variations to the FSSs set out under Option 2, removing the exemption for overseas-licensed CCPs and increasing the exemption threshold for SSFs. In addition, the structure and content of the FSSs would change significantly, although separate sets of FSSs for CCPs and SSFs would remain.

Under this option, the current single standard would be replaced with a more granular (and detailed) set of standards for each type of CS facility. Instead of implementing relevant Principles as measures, as in Options 1 and 2, the Principles and key considerations would form the basis for a set of standards and 'sub'-standards, with the explanatory notes forming the basis for guidance. As under Options 1 and 2, the basis provided by the Principles would be modified as appropriate to uphold the standards to which licensed CS facilities are currently held, to reflect standards applied to CS facilities in other relevant jurisdictions, and to reflect key elements of the Council's framework for ensuring regulatory influence over cross-border CS facilities.

As a result, the new FSSs determined under this option would reflect the same requirements on licensed CS facilities as those set out in the FSS measures under Options 1 and 2. The primary difference between the options is that under Options 1 and 2 these requirements are contained within measures that interpret the broad obligation set out in the FSSs, whereas under Option 3 it is the FSSs themselves that set the requirements. Since CS facility licensees are obliged under the Act to comply with FSSs, to the extent reasonably practicable, Option 3 would place more direct legal obligations on licensees to observe these requirements than Options 1 and 2.

The changes to the overseas assessment regime would be similar to those in Option 2, except that compliance by overseas facilities would be assessed on a standard-by-standard basis, rather than on a measure-by-measure basis. The change to the SSF exemption threshold would be the same as in Option 2.

4. Evaluation and Impact Analysis

4.1 Consultation

In order to understand the potential impact of each option set out in Section 3, and to more generally inform the Bank's choice of option, the Bank conducted a public consultation as described in Section 4 of the FSS Paper. Of the options considered by the Bank, Option 1 does not involve any change to the current FSSs, and the changes involved in Option 2 are embedded in Option 3. The Bank therefore considered it appropriate to consult on draft FSSs developed according to Option 3.

Accordingly, the Bank published a consultation paper on 29 August 2012 setting out its proposal under Option 3 to revoke the previously determined FSSs and to determine new FSSs.⁵ The release of the consultation paper was followed by a period of public consultation, with written submissions from stakeholders invited by 19 October. In addition, stakeholders were offered the opportunity to discuss their views with Bank staff at a series of meetings held in early October.

During the consultation on the draft FSSs, the Bank held meetings or calls with eight stakeholders and received written submissions from six stakeholders. Written submissions were received from: ASX on behalf of current CS facility licensees; CS facilities operating in other jurisdictions (CME Group and LCH.Clearnet Group Limited); and industry groups representing market participants and other stakeholders (the International Swaps and Derivatives Association, the Australian Financial Markets Association and the Australian Bankers' Association).⁶ Stakeholders broadly supported the approach taken by the Bank in line with Option 3.

4.2 Evaluation of Options

In evaluating the costs and benefits of each of the options set out in Section 3, the Bank has considered the potential impact on current and prospective CS facility licensees to which the FSSs may directly apply, as well as indirect impacts on other stakeholders. The FSSs under each option would directly apply to the four currently licensed CS facilities: ASX Clear Pty Limited (ASX Clear) and ASX Clear (Futures) Pty Limited (ASX Clear (Futures)) for any FSSs applying to CCPs; and ASX Settlement Pty Limited (ASX Settlement) and Austraclear Limited (Austraclear) for any FSSs applying to SSFs. Any new CS facility licensees would also be required to comply with the FSSs relevant to their facility type.

⁵ The consultation paper and attachments setting out the draft FSSs, accompanying guidance and draft guidance regarding the Bank's approach to assessing CS facility licensees are available at <<http://www.rba.gov.au/payments-system/clearing-settlement/consultations/201208-new-fin-stability-standards/index.html>>.

⁶ Written submissions from stakeholders are available at <<http://www.rba.gov.au/payments-system/reforms/submissions/new-financial-stability-standards/index.html>>.

The options considered by the Bank may also affect participants in licensed CS facilities and, indirectly, investors in financial products. Further, to the extent that the FSSs address systemic risk in the Australian financial system, the options set out in Section 3 may have impacts on the community as a whole.

In many cases the costs associated with each option are difficult to quantify, particularly where the costs involved in implementing changes required under the option depend on the interaction between the systems and practices of CS facilities and their participants. The new FSSs proposed under Option 3 are primarily principles based rather than prescriptive, notwithstanding the provision of guidance on how CS facilities may interpret those principles and illustrations of how the standards might be met. CS facilities may therefore have a number of options available in meeting the requirements of the new FSSs. Similar flexibility would be available to CS facilities under Options 1 and 2, which incorporate the same principles as interpretive measures under the current FSSs. Costs of compliance will also vary significantly between CS facilities, depending on their current systems and practices. Costs to participants will depend on the means by which CS facilities choose to meet requirements under each option that govern their interaction with participants, as well as the extent to which facilities choose to pass through costs.

The benefits associated with each option are also inherently difficult to quantify. The primary benefits involve lowering the probability of events with potentially large and highly dispersed welfare costs. The relative benefits of the options also reflect matters that are qualitative in nature, such as the degree of clarity and certainty offered to stakeholders. As a result, the discussion of costs and benefits in this section is largely qualitative in nature.

This Section sets out the Bank's evaluation of each of the options set out in Section 3 against the objectives identified in Section 2. It then considers in more detail the potential impact on the stakeholders identified above.

Option 1: No change to the current financial stability standards

FMI risk management

This option would allow the Bank to utilise international best practice in its oversight of licensed CS facilities, and continue to promote the adoption by CS facilities of risk controls that are appropriately tailored to their role in the Australian financial system, without any regulatory change. The Bank's expectations would be clearly set out in the FSS measures and accompanying guidance.

However, since the updated measures and guidance would not create directly enforceable legal obligations on licensed CS facilities, this option may not be as effective as Option 3 in enforcing changes to the conduct of CS facilities. CS facilities may seek to interpret new requirements under the FSSs in a way that does not satisfy the Bank's updated interpretation of requirements set out in the measures and guidance. Since licensed CS facilities are not directly bound by the measures, there could be uncertainty regarding enforcement of the individual requirements set out in the measures. This uncertainty could discourage CS facilities from making investments to improve their compliance with the FSS measures.

More broadly, uncertainty around enforceability may result in CS facility licensees failing to take sufficient action to fully align their practices and risk controls with international best practice. This may be a particular concern in respect of measures that support potential future resolution actions. Legal certainty will be essential for authorities carrying out resolution actions in time-critical situations of FMI distress.

Expectations and reputation

Option 1 would present risks to the Bank, and Australian regulators more broadly, regarding the international expectation that they implement the Principles in oversight of FMIs. Australia's implementation of the Principles may be monitored by CPSS and IOSCO and will be used by the IMF and the World Bank in their FSAP. Without explicit and legally certain incorporation of the requirements of the Principles into domestic regulation, the Australian jurisdiction could be judged adversely in international reviews of implementation and compliance with the Principles, particularly if this lack of certainty created problems for CS facilities' observance of the Principles.

To the extent that the failure to adopt the Principles in a directly legally enforceable manner inhibits the development or entry of central clearing services for OTC derivatives in the Australian market, Option 1 may present risks to the fulfilment of the government's G-20 commitments for OTC derivatives market reforms.

Market adoption and use of CS facilities

If, as a result of the less legally certain adoption of the Principles under this option, prudential regulators were to judge that Australian regulators had failed to fully implement the Principles in their oversight of CS facilities, banks would face higher capital charges with respect to their exposures to Australian-licensed CCPs. The resultant weakened incentives for the use of Australian CCPs could lead to inefficient market fragmentation or the adoption of more risky clearing practices by participants.

Cross-border issues

Regulators in other jurisdictions could view adoption of the Principles via updated measures and guidance as inadequate to ensure effective regulation of Australian CS facilities. Insufficient harmonisation of Australian standards for CS facilities with those of other jurisdictions could create difficulties for Australian CS facilities seeking to operate in other jurisdictions.

The introduction of specific measures implementing the Council's framework for regulatory influence over cross-border CS facilities would, if adopted by CS facilities, enable Australian regulators to exert greater influence on cross-border CS facilities. This would allow Australian regulators to better manage crises involving these facilities, and promote financial stability more broadly. However, since CCPs with an overseas CS facility licence would remain, under Option 1, formally exempt from the FSSs, the Bank's capacity to enforce any of the requirements set out in the FSS measures with respect to these facilities would be further reduced. Since these measures may impose additional costs on overseas CS facilities, there may be an additional incentive for these CS facilities to legally challenge their enforceability.

Option 2: Variation of the financial stability standards

As this option is identical to Option 1, except with respect to the scope of application of the FSSs, the assessment of Option 1 above largely applies to Option 2. The changed scope of application would affect this assessment against objectives in the ways set out below.

FMI risk management

Removing the exemption from FSS compliance for overseas-licensed CCPs strengthens the legal basis for applying the FSS measures in the oversight of these facilities in comparison with Option 1. This makes it more likely, if still not certain, that the Bank would be able to enforce stability-enhancing requirements placed on overseas CCPs where the CCP was not held to these requirements in its principal place of business.

This strengthens the basis for applying risk controls that are appropriately tailored to such CCPs' roles in the Australian financial system.

Market adoption and use of CS facilities

Changes to the exemption threshold for SSFs would ensure that smaller SSFs that posed negligible systemic risks were not required to meet the detailed requirements of the FSSs. This means that such facilities would not face unnecessary compliance costs that, if passed on to market participants, could discourage their use.

Cross-border issues

Removal of the exemption from FSS compliance for overseas-licensed CCPs would make clear the expectation that these facilities meet the same standard of conduct as domestically licensed CS facilities. The more certain legal basis for regulation would also make it more likely, if still not certain, that the Bank would be able to enforce measures relating to the Council's framework for regulatory influence over cross-border CS facilities in its oversight of these facilities.

Option 3: Revocation of the current financial stability standards and determination of new financial stability standards

This option would provide enhanced legal certainty for licensed CS facilities, by adopting the measures set out by the Bank under Options 1 and 2 as FSSs that have direct legal force on licensees.

FMI risk management

This option would allow the Bank to apply international best practice in its oversight of licensed CS facilities, and continue to promote the adoption by CS facilities of risk controls that are appropriately tailored to their role in the Australian financial system through the determination of new, legally enforceable standards. The Bank's expectations would be clearly set out in the new FSSs and interpreted through detailed guidance.

The direct legal enforceability of obligations on licensed CS facilities under this option would provide certainty that the Bank could enforce changes to the conduct of CS facilities. This makes it more likely that CS facility licensees would take sufficient action to fully align their practices and risk controls with international best practice. Direct legal enforceability under this option would also ensure the effectiveness of measures that support potential future resolution actions.

As in Option 2, removal of the exemption for overseas-licensed CCPs would provide a legally certain basis for ensuring that these facilities are held to the same standard as domestic CS facility licence holders.

Reputation and expectations

Under this option, the Bank would be able to clearly demonstrate that it had implemented the Principles in its oversight of FMIs. This would be beneficial in demonstrating compliance with the Principles to other CPSS-IOSCO member jurisdictions, and to the IMF in future FSAPs. The clear and enforceable adoption of the Principles under Option 3 would also support the fulfilment of the government's G-20 commitments for OTC derivatives market reforms.

Market adoption and use of CS facilities

The clear and legally enforceable adoption of the Principles under this option makes it likely that prudential regulators would allow lower capital charges in respect of banks' exposures to Australian-licensed CCPs. This

would maintain the incentive for market participants to utilise central clearing arrangements. As in Option 2, the higher exemption threshold for SSFs would ensure that smaller SSFs would not face unnecessary compliance costs that could discourage their use by market participants.

Cross-border issues

Embedding the structure of the Principles in the FSSs would harmonise Australia's regulatory framework with that of other jurisdictions that adopt the Principles. This harmonisation might be considered more legally robust by other jurisdictions than if it were achieved through interpretive measures as under Options 1 and 2. Harmonisation could reduce compliance costs for licensed CS facilities operating or offering services to participants in other jurisdictions. For example, an overseas regulator may be more inclined to rely on, or otherwise cooperate with, Australian regulators in assessing a facility's compliance with the overseas jurisdiction's regulatory requirements.

The granularity of the FSSs would also provide a mechanism for more targeted reliance on oversight information provided by an overseas-licensed CS facility's regulator in its principal place of business. The structure of the FSSs under Option 3 would allow the Bank to rely on information from an overseas regulator only where a materially equivalent standard existed in the overseas regulatory regime. Equally, it would provide a clearer basis to assess overseas-licensed CS facilities directly against those specific standards where no materially equivalent standard existed, or where the Bank was not satisfied with the information provided by the overseas regulator. This more directed approach would reduce compliance costs for overseas CS facilities, as direct assessments against specific FSSs could be performed separately from assessments conducted using information provided by overseas regulators.

The greater degree of legal certainty under this option would reinforce the effectiveness of measures implementing the Council's framework for regulatory influence over cross-border CS facilities. This would facilitate crisis management actions by Australian regulators and promote financial stability more broadly where cross-border facilities were involved.

4.3 Impact Analysis

Since the Bank would apply the same standard of conduct in its oversight of licensed CS facilities under each of the three options that it has considered, the impact of these requirements on CS facilities and their participants is likely to be similar under each option. The discussion in this Section makes specific reference to new FSSs developed under Option 3, on which the Bank has consulted, but the impact of the other options would be expected to be equivalent, except where otherwise indicated.

Impact on current clearing and settlement facility licensees and participants

Under Option 3, the greater part of the new FSSs would be consistent with the measures accompanying the current FSSs, and steps taken by the currently licensed CS facilities to meet their obligation to 'do all other things necessary to reduce systemic risk' under section 821A of the Act. Even where the new FSSs involve changes to the minimum standards set out in the measures accompanying the current FSSs, in a number of these areas the currently licensed CS facilities have already gone beyond these minimum requirements.

There are, however, some areas in which the new FSSs under Option 3 would require changes in the conduct of currently licensed CS facilities that would impose additional costs on facilities and their users. Some of these costs would be transitional, such as those associated with adjusting key policies, rules and procedures.

Other costs are likely to be ongoing, such as costs relating to the maintenance of more robust risk controls and operating procedures. Importantly, to the extent that the currently licensed CS facilities would anyway need to make some of these changes in order to meet equivalent requirements of regulators in other jurisdictions, the cost impacts described here most likely overestimate the true marginal cost to facilities of complying with the new FSSs.

This Section sets out the areas in the new FSSs likely to require changes in the conduct of CS facilities, and the likely resulting costs.

Credit and liquidity risk resources

The two currently licensed CCPs – ASX Clear and ASX Clear (Futures) – would each need to ensure that their financial resources were sufficient to meet the revised requirements of the new FSSs. Neither of the licensed SSFs – ASX Settlement and Austraclear – currently assume credit or liquidity risks as principal and therefore these standards would not currently apply.

Both ASX Clear and ASX Clear (Futures) would need to ensure that their financial resources, currently calibrated to cover the default of the participant that would cause the largest aggregate credit exposure, were sufficient to cover the joint default of the participant *and its affiliates* that would cause the largest aggregate credit exposure. Similarly, both CCPs would need to ensure that they had sufficient liquid resources to cover payment obligations in the event of the joint default of the participant and its affiliates that would generate the largest aggregate payment obligation to the CCP. Furthermore, under current operating rules, transactions in ASX Clear may be rescheduled for settlement at a later date to defer payment obligations in the event of a participant default. In order to meet the requirements of the new FSSs, ASX Clear would need to make alternative arrangements to ensure that it was able to meet its payment obligations on the intended settlement date.

Currently both ASX Clear and ASX Clear (Futures) operate primarily in Australia. However, if they were to become systemically important in other jurisdictions, or clear products with a more complex risk profile (such as credit default swaps), they would have to additionally ensure that their financial resources were sufficient to cover the default of the two participants (and their affiliates) with the largest exposures.

Meeting these financial resource requirements may impose additional costs on the two currently licensed CCPs and their users. There is the potential for costs resulting from holding additional resources funded by the CCPs' own or related-party equity, or costs to participants from additional pooled resources. Changes to financial resource requirements could also have implications for existing arrangements for calling additional margin, by creating greater sensitivity to capital and liquidity stresses that may increase the frequency and size of additional cover or margin calls.⁷

With respect to the liquid resource requirements, ASX Clear, in particular, may require access to significantly increased liquidity than at present. The liquid resources to which ASX Clear would require access could potentially be a multiple of its current liquid resources. The cost of funding this additional liquidity would depend on the mix of resources ASX Clear used to meet its liquid resource requirement. Outright holdings of qualifying liquid resources would require a significant increase in ASX Clear's own equity or prefunded resources from participants, while the cost of meeting the liquid resource requirement via a committed line of liquidity

⁷ ASX Clear and ASX Clear (Futures) can call additional margin from participants under their Contributions and Additional Cover and Additional Initial Margin regimes, respectively.

from a commercial bank alone would be prohibitive based on current clearing fee revenues.⁸ An alternative, and potentially less costly source of supplemental liquidity would involve the conclusion of explicit contingent *ex ante* agreements with participants for liquidity provision, perhaps by entering into committed repurchase agreements with participants. This might require rule changes to permit simultaneous repurchase transactions with participants. Additional costs to ASX Clear would be significantly lower under such arrangements. Under committed repurchase arrangements participants would face contingent costs from liquidity provision under default scenarios that exhausted ASX Clear's outright holdings of qualifying liquid resources. However, since the contingent costs to participants should be broadly equivalent to those costs under current arrangements for the rescheduling of transactions following a participant default, any incremental costs to participants from such arrangements should be limited.

ASX Clear and ASX Clear (Futures) would also need to make any necessary changes to their credit and liquidity stress tests to ensure that these assess the sufficiency of resources against the scenarios outlined in the new FSSs, and may incur associated costs from system and operating rule changes.

Recovery and resolution planning

The new FSSs introduce requirements that the currently licensed CS facilities prepare plans for recovery or orderly wind-down in the event that they are unable to provide their critical operations and services as a going concern. The currently licensed CS facilities would also need to hold sufficient resources funded by equity, in addition to any default resources, to be able to continue operations in accordance with their recovery plans and to cover at least six months of operating expenses. This could impose additional costs on the currently licensed CS facilities if they needed to raise additional equity, or substitute other resources to free up equity.

The currently licensed CCPs would also need to review their rules to ensure they address how any uncovered credit losses would be allocated in the event of a participant default. Currently ASX Clear and ASX Clear (Futures) do not have *ex ante* rules to deal with the allocation of losses that exceed prefunded and promissory default resources. The introduction of such rules may impose additional (if contingent) costs on participants in the event that they are required to contribute to a shortfall. Explicit loss allocation rules would, however, strengthen the ability of the CCPs to recover from a distress situation and therefore mitigate the risk that costs associated with CCP resolution were incurred.

The new FSSs also introduce restrictions on the organisation of operations, including intragroup or external outsourcing arrangements or other service dependencies, designed to facilitate resolution of the currently licensed CS facilities by the Bank or other authorities in a crisis. In order to comply with these requirements, the currently licensed CS facilities may need to review their operations and contractual rights with outsourcing or service providers, to ensure that the Bank or another authority was able to carry out resolution actions while ensuring continuity of services in a crisis. If changes to the organisation of operations or outsourcing contracts were required, this would impose additional costs on the currently licensed CS facilities. In some cases, these contracts may need to be renegotiated. It is recognised that the detailed arrangements required to enable resolution action may depend on the outcome of possible legislative changes in this area in response to the Council's review of FMI regulation and with regard to the CPSS-IOSCO consultation on recovery and resolution.

⁸ ASX identified the potential costs associated with such liquidity arrangements during the April 2011 consultation on a draft version of the Principles. ASX's submission is available at <<http://www.bis.org/publ/cpss94/cacomments/ause.pdf>>.

Outsourcing and other service provision arrangements would also need to be renegotiated more broadly, in order to ensure that these services are provided on a basis that would meet the operational performance, resilience and security requirements of the new FSSs.

Collateral and margin

The currently licensed CCPs would need to alter their arrangements for collateral posted on behalf of a participant's customers in order to comply with the new CCP Standard on segregation and portability. For cash equities, ASX Clear would need to consider the case for segregation of collateral that may potentially be posted in relation to customer positions from collateral posted in relation to participants' house positions. Both ASX Clear and ASX Clear (Futures) would also need to investigate and, to the extent reasonably practicable under prevailing law, implement arrangements facilitating the transfer of customer-related collateral in the event of a participant default. Since achieving a high likelihood of customer position portability via reasonably practicable arrangements may depend on changes to the operation of insolvency law, any changes to current arrangements may not need to take place immediately to ensure compliance with the new FSSs.

If segregation of customer positions for cash equities at ASX Clear and portability arrangements for both currently licensed CCPs were to be introduced, ASX Clear and ASX Clear (Futures) would need to implement system changes and coordinate these with participants, potentially creating costs for both the CCPs and their participants (such as the unnetting of cash equity house and customer transactions). For example, any loss of netting between cash equity house and customer positions may increase collateral requirements for participants and their customers. The currently licensed SSFs may also need to make changes to their arrangements in order to provide operational support to segregation and portability arrangements. ASX has commenced a process of consultation with participants in its two CCPs regarding the potential for changes to customer segregation and portability arrangements for derivatives transactions.⁹ A second ASX consultation covering segregation and portability arrangements for cash equities is expected to commence before the end of 2012.

The new FSSs would also require the currently licensed CCPs to make changes to their margining systems. Under the Bank's interpretation of the requirement for margin system validation and review (as set out in the draft guidance), both CCPs would need to submit their margin methodologies to review by an independent expert.¹⁰ ASX Clear would also need to introduce margining for cash equities. While there would be some costs associated with ongoing independent review of margin methodologies, ASX Clear has already committed to margining of cash equities and is proceeding with the changes required to achieve this by a targeted implementation date of June 2013. The incremental costs of compliance to ASX Clear from the requirement to margin cash equities should therefore be minimal, and ASX Clear would therefore be expected to comply with this requirement without the need for transitional relief. While participants and their customers may face additional operational and funding costs from meeting margin requirements, the probability of a call on ASX Clear's pooled resources would be reduced.

The currently licensed CCPs may also need to make changes to their collateral eligibility policies in order to meet the requirements of the new FSSs. They would no longer be able to routinely accept bank guarantees as collateral, and other changes may be required to their collateral acceptance policies, including to limit the

⁹ ASX (2012), *Derivatives Account Segregation and Portability*, October, available at <https://www.asxonline.com/intradoc/cgi/groups/derivatives/documents/communications/asx_035156.pdf>.

¹⁰ This may include a suitably qualified and independent internal expert, or an internal audit review that is able to access suitably qualified external experts as required, or a separate third party review by an independent external expert.

acceptance of collateral subject to wrong-way risk.¹¹ It is not expected that these changes would impose significant additional costs on the currently licensed CCPs, although there may be some additional costs to participants and their customers that need to supply alternative collateral.

Investment policy

The currently licensed CS facilities would need to review their investment policies in order to ensure that they meet the requirements under the new FSSs to manage their investments in a manner consistent with their overall risk management framework. These reviews would need to consider risks associated with the size and concentration of facilities' exposures to investment counterparties, and the potential for wrong-way risk where participants and investment counterparties are affiliates. Any consequent changes to investment policies may impose costs on the facilities in the form of lower investment returns, which may in turn be passed on through higher fees to participants. Such changes would, however, be expected to reduce the risk of investment losses.

Governance

The currently licensed CS facilities would need to review their governance arrangements to ensure that they were fully aligned with the more granular governance requirements of the new FSSs. It is not anticipated that any necessary changes to policies and procedures (including documentation of existing arrangements to manage intragroup conflicts of interest), or a potential increase in independent representation on the board or risk committee of a CS facility, would impose significant additional costs.

Impact on prospective clearing and settlement facility licensees

Feedback received during consultation from CS facilities that are currently seeking, or considering seeking, a CS facility licence in Australia suggests that their cost of compliance with the new FSSs would be relatively low. These CS facilities are subject to regulation in other jurisdictions that are also implementing the Principles in their oversight of FMs, and are required by their regulators in these jurisdictions to make many of the changes required to achieve compliance with the new FSSs. The marginal cost to these facilities of achieving full compliance with the new FSSs, if granted an Australian licence, is therefore expected to be small.

Impact on other stakeholders

The impact on banks participating in CCPs may depend on the option chosen. As noted in Section 4.2, it is more likely under Options 1 or 2 that banks would be required to apply higher capital charges to their exposures to Australian CCPs, since the legal enforceability of the Principles would be less certain. Under Option 3, Australian-licensed CCPs would be more likely to qualify for lower capital charges, benefiting their participants.

¹¹ In this context, wrong-way risk is the risk that the value of collateral posted by a counterparty will be negatively correlated with the probability of the counterparty's default.

5. Preferred Option

After consideration of the costs and benefits of the three options as set out in Section 3, the Bank's Payments System Board has concluded that Option 3 would most effectively ensure that licensed CS facilities conduct themselves in a manner that causes or promotes overall stability in the Australian financial system. The Bank also considered Option 3 to be a proportionate response to the potential risks to stability identified in Section 1.1, taking into consideration the sound compliance and risk management record of currently licensed CS facilities under the current FSSs. The Bank's preference for Option 3 was formed on the basis of the available information on the relative costs and benefits of each option. While the Bank was unable to quantify these costs and benefits, the Bank did note the potentially significant costs that might arise under each option, while taking into account that licensees operating in other jurisdictions would be required to incur many of these costs with respect to those overseas operations. The Bank also noted that the benefits of each option would be primarily incremental, since the conduct of current licensees already exceeds the minimum measures of the FSSs in many areas.

In assessing the costs and benefits of the three options, the Bank noted that the costs of compliance to CS facility licensees were broadly equivalent under each option. However, as discussed in Section 4, the benefits to both licensees and the broader financial system measured against the objectives of Section 2 were greater under Option 3 than under either of the other options. The greater degree of legal certainty and enforceability of the requirements under Option 3 provide a more direct and effective means of achieving the Bank's objectives.

On the basis outlined above, the Bank considers Option 3 to be the preferable option because, in line with the objectives set out in Section 2, it:

- provides the most certain legal basis for ensuring that CS facilities in Australia appropriately control the risks they pose to the Australian financial system, in light of emerging international best practice as set out in the Principles, and that they adopt risk controls that are appropriately tailored to their role in the Australian financial system, in part by preserving relevant requirements of the current FSS measures
- enhances the reputation of Australian regulators by most explicitly and directly adopting international best practice in the oversight of CS facilities, and supports the government's commitment to the G-20 reforms for OTC derivatives markets
- supports the appropriate use of centralised infrastructures by market participants, by supporting capital incentives to utilise Australian CCPs, and reducing the compliance burden for small SSFs
- provides the most certain legal basis for the Bank, in conjunction with other regulators, to manage crises and promote financial stability by exerting an appropriate degree of influence over CS facilities operating in Australia

- explicitly requires both overseas and domestically licensed CS facilities to meet the same granular standard of conduct in contributing to financial stability, and accommodates cooperation with the home regulators of overseas-based CS facility licensees in assessing compliance with the FSSs
- provides the greatest clarity and legal certainty to CS facility licensees in interpreting the requirements that they must meet under the FSSs.

The Bank took into account the trade-off between the greater clarity and legal certainty of Option 3, against the potentially greater flexibility of Options 1 and 2 which would rely on the use of detailed guidance for CS facility licensees. In order to maintain the optimal degree of flexibility within Option 3, the Bank sought to avoid unnecessarily prescriptive requirements in favour of principle-based requirements that would deliver equivalent outcomes. Through consultation with stakeholders, the Bank made several amendments to the draft FSSs to allow CS facility licensees to reach the outcomes sought by the Bank by more flexible and less costly means, as discussed in Section 5 of the FSS Paper.

6. Implementation

In order to implement Option 3, the FSSs, accompanying guidance and guidance on the Bank's assessment approach have been published on the Bank's website.¹² The new FSSs are intended to take effect on 29 March 2013, subject to any transitional arrangements (see Section 6.1 of the FSS Paper). All CS facility licensees will be formally assessed against the applicable new FSSs in mid-2013.

The Bank's Payments System Board is required to report annually to the responsible Minister on the development of standards, and any changes made to the standards. In addition, the Bank is required to conduct an assessment, at least once a year, on the extent to which facilities have complied with the standards, and must submit a report on this assessment to the Minister. These two channels of ministerial reporting will provide regular review of the appropriateness of the standards. In addition, it is open for the Bank to review the standards in the light of experience and developments in clearing and settlement. As a member of the CPSS, the Bank will also continue to monitor the evolution of international best practice for FMIs, and consider the need for any changes to best practice or standards to be reflected in the FSSs.

As noted in Section 6.1 of the FSS Paper, the Bank has deferred the implementation of FSSs related to FMI recovery and resolution, and has invited existing CS facility licensees to identify any need for transitional relief from other provisions of the new FSSs. While the granting of transitional relief may defer some of the benefits of the new FSSs, it is the Bank's intention that relief be granted only in areas where earlier compliance by CS facility licensees would be impracticable. Even if transitional relief were not granted in these areas, it is unlikely that the benefits of changes to licensees' conduct could be brought forward significantly.

¹² The new FSSs and guidance are available at <<http://www.rba.gov.au/payments-system/clearing-settlement/standards/201212-new-fss-ris/index.html>>.