

# Consultation on New Financial Stability Standards

AUGUST 2012

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Attachment 1: Draft Financial Stability Standards for Central Counterparties

Attachment 2: Draft Guidance – Financial Stability Standards for Central Counterparties

Attachment 3: Draft Financial Stability Standards for Securities Settlement Facilities

Attachment 4: Draft Guidance – Financial Stability Standards for Securities Settlement Facilities

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# 1. Introduction

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In accordance with powers under the *Corporations Act 2001* (the Act), the Reserve Bank (the Bank) has determined *Financial Stability Standards* (FSSs) for central counterparties (CCPs) and for securities settlement facilities (SSFs). These standards aim to ensure that licensed clearing and settlement (CS) facilities conduct their affairs in a way that promotes overall stability in the Australian financial system. The Bank assesses each CS facility licensee against the FSS relevant to its facility type on an ongoing basis, reporting its findings annually to the Minister with portfolio responsibility for financial markets, and to the Australian Securities and Investments Commission (ASIC). These assessments are also released publicly.

The Bank is seeking views from interested parties on a proposal to revoke the existing FSSs and determine new FSSs for both CCPs and SSFs. The proposed FSSs aim to align the Australian regime for regulation of licensed CS facilities with new international standards, the *Principles for Financial Market Infrastructures* (FMI) (the Principles), developed by the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO). The Principles, released in April 2012, acknowledge the critical, and expanding, role played by FMIs, including CS facilities, in the financial system and aim to strengthen and harmonise the operational standards to which they are held internationally.<sup>1</sup> Both the Bank and ASIC propose to implement the Principles within their respective regulatory mandates to ensure that CS facilities licensed to operate in Australia conduct their affairs in accordance with international best practice.

Alongside alignment with the Principles, the proposed FSSs uphold the standards to which licensed CS facilities are held in the Bank's interpretation of the current FSSs. The proposed FSSs also implement key elements of the Council of Financial Regulators' (the Council's) framework for ensuring that Australian regulators have appropriate influence over cross-border CS facilities.

The Bank would also welcome feedback on draft guidance on its approach to assessing licensed CS facilities' compliance with the new standards. In particular, in assessing a licensed overseas facility, the Bank proposes to place conditional reliance on information and reports from the regulator in the facility's principal place of business.

This document is structured as follows. Section 2 summarises the Bank's role in the regulation of licensed CS facilities and provides an overview of the existing FSSs. Section 3 introduces the Principles and compares them with the current FSSs. Section 4 goes on to explain how the proposed FSSs will align with the Principles and how the Bank proposes to assess licensed facilities' compliance with the new standards. Section 5 addresses the implications of the proposed FSSs for existing CS facility licensees. The proposed FSSs and

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<sup>1</sup> The Principles are available at <<http://www.bis.org/publ/cpss101a.pdf>>.

associated guidance are set out in detail in Attachments 1 to 4, with draft guidance on the Bank's assessment approach included in Attachment 5.

Interested parties are invited to make submissions by 19 October 2012. Submissions will be placed on the Bank's website, although parties may indicate that all or part of their submission should remain in confidence. Those making submissions will be offered the opportunity to discuss their views with Reserve Bank staff. Submissions should be sent to:

Head of Payments Policy Department  
Reserve Bank of Australia  
GPO Box 3947  
Sydney NSW 2001

or

[pysubmissions@rba.gov.au](mailto:pysubmissions@rba.gov.au).

## 2. The Reserve Bank's Role in the Regulation of Clearing and Settlement Facilities in Australia

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The Bank's responsibilities in the regulation of licensed CS facilities are set out in Part 7.3 of the Act. Under section 827D of the Act, the Bank has the power to 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. FSSs may apply to all CS facility licensees, or a specified class of CS facility licensee. In 2003, the Bank determined FSSs for two classes of CS facilities: CCPs and SSFs. The FSSs are each supported by a set of measures that the Bank considers relevant in assessing compliance. Matters covered by these measures include a CS facility licensee's: legal framework; settlement arrangements; risk controls; default arrangements; and governance arrangements.

Under section 823CA(1) of the Act, the Bank must assess at least once a year whether, to the extent reasonably practicable, a licensed CS facility has complied with applicable FSSs and, in addition, whether it is in accordance with section 821A '[doing] all other things necessary to reduce systemic risk'. The Bank reports the outcome of these assessments to the relevant Minister and to ASIC, and also publishes its findings.

### 2.1 Overview of Current Financial Stability Standards

The Bank determined FSSs for licensed CS facilities, in accordance with Section 827D(1) of the Act, on 30 May 2003. The *Financial Stability Standard for Securities Settlement Facilities* (FSS for SSFs) was varied in June 2005 to introduce a threshold exemption to exclude facilities that settle securities transactions with a total value of \$100 million or less per year. A measure to the current FSS for SSFs was varied in February 2009 to give effect to disclosure of equities securities lending data. The *Financial Stability Standard for Central Counterparties* (FSS for CCPs) was also varied in February 2009 to clarify oversight arrangements for overseas CCPs licensed under section 824B(2) of the Act.

The current FSS for CCPs is as follows:

A CS facility licensee must conduct its affairs in a prudent manner, in accordance with the standards of a reasonable facility in contributing to the overall stability of the Australian financial system, to the extent that it is reasonably practicable to do so. This standard applies to all CS facility licensees that operate a central counterparty with the exception of those CS facility licensees granted a licence under Section 824B(2) of the *Corporations Act 2001*. This exception applies only for such time as the Reserve Bank receives annual documentary evidence from the licensee's overseas regulator that the licensee has complied in all material respects with the requirements of the overseas regulator related to matters affecting stability. Such evidence must be provided in a form and at a time agreed with the Reserve Bank.<sup>2</sup>

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<sup>2</sup> The current FSS for CCPs is accompanied by guidance that clarifies the nature and scope of the exemption for CS facilities licensed under section 824B(2) of the Act and the conditions under which it would apply.

The current FSS for SSFs is as follows:

A CS facility licensee must conduct its affairs in a prudent manner, in accordance with the standards of a reasonable CS facility licensee in contributing to the overall stability of the Australian financial system, to the extent that it is reasonably practicable to do so. This standard only applies to CS facility licensees that provide a facility where the value of financial obligations settled in a financial year exceeds a threshold value of \$100 million. When this threshold is exceeded for the first time, the provider of the facility must meet the standard by the beginning of the next financial year.

The current FSSs are supplemented by details of the minimum measures that the Bank considers relevant in determining whether the applicable FSS has been met. The full text of the minimum measures applicable to the current FSSs, and accompanying guidance, is available on the Bank's website.<sup>3</sup>

## 2.2 ASIC's Role

The Act establishes a licensing regime for Australian financial markets and CS facilities. The 'responsible Minister' (currently the Minister for Financial Services and Superannuation) has overall responsibility for licensing such entities, under advice from both ASIC and the Bank. ASIC is required to undertake assessments of licensed CS facilities' compliance with their obligations under the Act, including to 'do all things necessary to ensure that the facility's services are provided in a fair and effective way' (section 821A), and to take enforcement action where necessary. ASIC is additionally required to advise the Minister of any changes to a licensed CS facility's rules, and the Minister must have regard to ASIC's advice and any advice from the Bank in determining whether to disallow any such rule change.

The Bank and ASIC have a Memorandum of Understanding (MOU) in place to assist each agency in the performance of its regulatory responsibilities under the Act. The MOU also sets out a framework for cooperation between ASIC and the Bank that is intended to promote transparency, help prevent unnecessary duplication of effort, and minimise the regulatory burden on facilities. It covers information sharing, notification and other arrangements intended to achieve these aims.

## 2.3 Existing CS Facility Licensees

Two licensed CCPs – ASX Clear Pty Limited (ASX Clear) and ASX Clear (Futures) Pty Limited (ASX Clear (Futures)) – and two licensed SSFs – ASX Settlement Pty Limited (ASX Settlement) and Austraclear Limited (Austraclear) – currently fall within the scope of the FSSs. These facilities are all owned by ASX Group. Further information on the Bank's annual assessment of these entities can be found on the Bank's website.<sup>4</sup>

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<sup>3</sup> Details of the existing FSSs are available at <<http://www.rba.gov.au/payments-system/clearing-settlement/standards/index.html>>.

<sup>4</sup> Annual assessment reports for existing CS facility licensees are available at <<http://www.rba.gov.au/payments-system/clearing-settlement/compliance-reports/index.html>>.

## 3. International Standards

International standards for FMIs have been developed through the coordinated work of two international multilateral organisations: CPSS and IOSCO. CPSS is a standing committee of the Bank for International Settlements – a multilateral organisation and service provider for central banks – concerned with payment, clearing and settlement systems. IOSCO is the international organisation for securities regulators. In most jurisdictions, central banks and/or securities regulators are the bodies responsible for oversight of FMIs. Australia is represented on both CPSS and IOSCO, by the Bank and ASIC, respectively.

### 3.1 CPSS-IOSCO Principles for Financial Market Infrastructures

Over recent years, CPSS and IOSCO have developed a unified and strengthened set of international standards for payment systems, CCPs, securities settlement systems (also known as SSFs), central securities depositories, and trade repositories (a new class of FMI that records and maintains financial transaction data). The resulting Principles, released in April 2012, update, replace, and synthesise three previous sets of recommendations and principles published by CPSS and IOSCO with respect to particular types of FMI – payment systems, CCPs and securities settlement systems.<sup>5</sup> The current FSSs are broadly aligned with the previous CPSS-IOSCO recommendations for CCPs and securities settlement systems.

The Principles represent an important milestone in the broader process of international financial reform that has emerged since the onset of the global 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. With market participants, in response, making greater use of centralised – often cross-border – financial market infrastructure, establishing an exacting and internationally harmonised set of standards, such as the Principles, is essential. The Principles also address moral hazard concerns that may arise from the provision of central bank services to FMIs in a crisis, by requiring infrastructures to have in place stringent risk controls.

The Principles outline a comprehensive set of minimum standards for FMIs, covering:

- *General organisation*: the legal basis, governance arrangements and risk-management framework of an FMI.
- *Credit and liquidity risk management*: controls to ensure an FMI has sufficient resources, rules and procedures in place to manage credit and liquidity exposures created by the FMI's activities, including standards for acceptable collateral and, for CCPs, margin arrangements.

<sup>5</sup> CPSS (2001), *Core Principles for Systemically Important Payment Systems*, CPSS Publications No 43, Bank for International Settlements, January, available at <<http://www.bis.org/publ/cpss43.htm>>; 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>>.

- *Settlement*: low-risk, timely, certain and reliable settlement of securities, payments, physical instruments and commodities.
- *Central securities depositories and exchange-of-value settlement systems*: low-risk and reliable transfer and issuance of securities, and elimination of principal risk from settlement systems.
- *Default management*: effective and clear rules to manage a participant default, including segregation and portability of positions held by customers of a defaulting participant.<sup>6</sup>
- *General business and operational risk management*: sufficient resources to cover business losses, employment of a prudent investment strategy, and secure and reliable systems to ensure continuous operation.
- *Access*: fair and open access for prospective participants, balanced against controls to manage risks arising from direct or indirect participation, or links to other FMI.
- *Efficiency and transparency*: efficient provision of services, clear and comprehensive disclosure of risks, costs and obligations arising from participation, and provision of data by trade repositories.

The Principles strengthen previous international standards in a number of areas, including in the coverage of credit risk, the management of liquidity risks, and governance. Several principles are not contained in previous CPSS-IOSCO recommendations, including those on segregation and portability of participants' customers' positions and collateral, interdependencies between FMIs, general business risk, tiered participation, and disclosure of rules, procedures and data.

The 24 headline Principles are each supported by a set of key considerations, which further elaborate on the requirements for FMIs set out in each principle, and explanatory notes that offer additional guidance as to how an FMI might meet the requirements of each principle and key consideration in practice.

### 3.2 Adopting the Principles in Australia

The Principles also set out five key responsibilities of central banks, securities regulators or other authorities responsible for oversight of FMIs:

- exercise of appropriate and effective regulation, supervision and oversight of FMIs
- sufficient powers and resources for authorities in carrying out their oversight responsibilities
- clearly defined regulatory, supervisory and oversight policies with respect to FMIs
- adoption and consistent application of the Principles in oversight
- cooperation with other authorities, both domestically and internationally.

The Bank proposes to fully adopt the Principles relevant to financial stability in the new FSSs. These would then represent the minimum standards against which licensed CS facilities will be assessed. It is further proposed that the Principles be adapted to the Australian context where appropriate, including ensuring no weakening relative to the current FSSs and the expectations placed upon existing CS facility licensees.

Domestically, the Principles provide a coherent framework in which the Bank and ASIC can exercise their respective mandates. Internationally, the Principles provide a basis for harmonisation of regulatory and oversight regimes, aligning the interests and practices of the Bank with overseas authorities. This will be of particular importance where an overseas CS facility is licensed to operate in Australia. In particular, where the

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<sup>6</sup> Customers of clearing participants can also be referred to as clients.

Principles have been adopted by both Australian and overseas regulators, it is more likely that an overseas facility's home regulatory regime will be regarded as *sufficiently equivalent* to the Australian regime for the purposes of section 824B(2) of the Act.

It should be noted that FSSs determined under the Act apply only to licensed CS facilities and only in respect of matters concerning the stability of the Australian financial system. Accordingly, the proposed FSSs set out in Attachments 1 and 3 reflect only those Principles that apply to CCPs and SSFs, and only those relevant to the Bank's responsibility for ensuring that CS facilities contribute to the stability of the financial system. In practice, this spans 21 of the 24 Principles.

The Bank and ASIC therefore plan to take some additional steps to fully adopt the Principles in Australia. In particular:

- Some Principles are more relevant to ASIC's responsibility to assess whether licensees provide their services in a fair and effective way. ASIC therefore plans to consult on revisions to its *Regulatory Guide 211: Clearing and Settlement Facilities: Australian and Overseas Operators* to incorporate aspects of the Principles relevant to its responsibilities (including ensuring that CS facility licensees provide their services in a fair and effective way).<sup>7</sup> In line with the responsibilities of authorities to cooperate under the Principles, the Bank and ASIC intend to cooperate where practicable in conducting their respective future assessments of CS facility licensees. However, in doing so, both authorities would continue to act independently in discharging their respective legislative and regulatory responsibilities.
- Payment systems, central securities depositories and trade repositories are among the FMI types within the scope of the Principles, but out of the scope of the FSSs.<sup>8</sup> In respect of payment systems, the Bank intends to adopt the Principles in its oversight of the Reserve Bank Information and Transfer System (RITS). The Payments System Board (the Board) may impose formal standards on systemically important payment systems under the *Payment Systems (Regulation) Act 1998*, although to date the Board has not exercised this power. Instead, the Bank has periodically performed a self-assessment of RITS against the CPSS *Core Principles for Systemically Important Payment Systems* (the Core Principles).<sup>9</sup> In bringing oversight of RITS into line with new international standards, the Bank will, at a minimum, conduct future self-assessments against the Principles, starting with the next self-assessment scheduled for 2013. The Bank also intends to increase the frequency of its assessments of RITS by conducting an assessment annually. Consistent with previous practice, the results of these assessments will be published.

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7 ASIC's Regulatory Guide 211 is available at <[http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/rg211.pdf/\\$file/rg211.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/rg211.pdf/$file/rg211.pdf)>.

8 The Principles draw a distinction between central securities depositories, which provide functions relating to securities title, and securities settlement systems, which facilitate the transfer and settlement of securities. The two FMI types are not mutually exclusive: an SSF can perform both central securities depository and securities settlement functions. However, a central securities depository that is not also a securities settlement system would not perform any settlement or transfer functions, and would not therefore provide a regular mechanism for the parties to transactions relating to financial products to meet obligations to each other as required under the definition of a CS facility in section 768A of the Act. These types of central securities depositories are therefore out of the scope of the FSSs. At present there are no central securities depositories operating in Australia that do not also perform settlement functions. Trade repositories also fall outside of the definition of CS facilities under the Act, and no trade repository has yet commenced operations in Australia. Treasury is, however, currently consulting on a licensing regime for trade repositories in the context of a broader range of legislative amendments to give effect to a framework for meeting Australia's commitment to the G-20 in relation to reporting, centrally clearing and executing OTC derivatives transactions: see <<http://www.treasury.gov.au/ConsultationsandReviews/Submissions/2012/Derivative-Transactions>>.

9 The most recent self-assessment, completed in 2009, concluded that RITS met all of the Core Principles and that the Bank met the responsibilities of central banks in applying the Core Principles. The 2005 and 2009 self-assessments are available on the Bank's website at <<http://www.rba.gov.au/payments-system/policy-framework/self-assessment/index.html>>, while an earlier self-assessment is in the Board's Annual Report for 2000, available at <<http://www.rba.gov.au/publications/annual-reports/psb/2000/html/index.html>>. This self-assessment is subject to external scrutiny from international assessors – the International Monetary Fund (IMF) performed an assessment of RITS in 2006, confirming the Bank's self-assessment that RITS complied with all relevant international standards. The IMF's assessment is available at <<http://www.imf.org/external/pubs/ft/scr/2006/cr06415.pdf>>.

## 4. The New Financial Stability Standards

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This section sets out the Bank’s proposal for determining new FSSs that adopt the international standards specified in the Principles. The proposed FSSs for each type of licensed CS facility (CCPs and SSFs) aim to meet three objectives:<sup>10</sup>

- to fully align minimum requirements in the proposed FSSs with those Principles that address matters relevant to financial stability
- to incorporate complementary requirements, as appropriate, to uphold the standards to which CS facilities licensed to operate in Australia are already held under the measures of the current FSSs, and to reflect standards applied to CS facilities in other relevant jurisdictions
- to implement the key elements of the framework for ensuring regulatory influence over cross-border CS facilities, as articulated by the Council.

In order to meet these objectives, the proposed FSSs adopt the structure, form and language of the Principles, but with some adjustments to the key considerations and explanatory notes to incorporate complementary requirements in accordance with the above objectives.<sup>11</sup>

This constitutes a significant change in the structure and form of the proposed FSSs. As set out in Section 2, the current FSSs each comprise a high-level requirement (i.e. that a CS facility licensee ‘conduct its affairs in a prudent manner, in accordance with the standards of a reasonable CS facility licensee in contributing to the overall stability of the Australian financial system, to the extent that it is reasonably practicable to do so’), accompanied by measures relevant to the Bank’s assessment of whether a licensee has complied with the applicable FSS.

By contrast, in aligning with the structure of the Principles, this paper proposes a more granular (and detailed) set of FSSs for each type of CS facility. In particular, each Principle would be adopted as a legally enforceable standard, with each ‘key consideration’ adopted as an associated, and individually legally enforceable ‘sub’-standard.<sup>12</sup> For instance, Standard 1 of the FSSs for CCPs, which considers legal basis, has six sub-standards. A licensee would be required to observe each sub-standard in order to be deemed to observe the overall Standard on legal basis. Accordingly, the proposed FSSs provide for greater legal certainty for CS facility licensees.

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<sup>10</sup> As in the FSSs themselves, any reference to a CCP or SSF in this section may also be read as a reference to the licensee as operator of the CCP or SSF.

<sup>11</sup> It should be noted that the Principles have been drafted to cover all types of FMI, while the proposed FSSs, as currently, establish separate standards for each of the CCPs and SSFs. The determination of standards specific to the type of facility provides greater clarity to licensees and other stakeholders in respect of those matters in which the nature of applicable risks and requirements differs by facility type. The proposed FSSs align only to those principles and key considerations that are relevant to each CS facility type.

<sup>12</sup> Each of the proposed headline Standards and associated sub-standards would be determined, individually, as FSSs under section 827D of the Act.

The structure of the proposed FSSs also accommodates the Bank's approach to overseeing offshore-based CCPs licensed under section 824B(2) of the Act ('licensed overseas CCPs'). In 2009, the Bank implemented a variation to the FSS for CCPs to provide for appropriate reliance on the home regulator of an overseas CS facility licensee, subject to certain conditions.<sup>13</sup> The increased granularity of the proposed FSSs allows a revision to these arrangements and a more targeted approach to reliance on information and reports provided by a licensed overseas CCP's home regulator. Section 4.5 and Attachment 5 discuss the conditions under which such reliance would be placed on an overseas regulator, in the context of a broader articulation of the Bank's approach to assessing licensed CS facilities' compliance with the proposed FSSs.

Given the significant change in the structure of the proposed FSSs, and the extensive revisions required to align with the broader and more granular coverage of issues in the Principles, this section summarises only the most substantive changes, along with some discussion of the main areas in which the proposed FSSs incorporate additional measures that complement the Principles. Some specific questions are also highlighted for stakeholder feedback.

The discussion is organised in three parts, consistent with the three objectives identified above:

- *Aligning the FSSs with the Principles*: the main additional, strengthened or more explicit requirements around risk-management practices and other operations matters introduced into the proposed FSSs through adoption of the Principles.
- *Complementary requirements to uphold existing standards and align with the standards of other relevant jurisdictions*: additions or alterations to the text of the Principles designed to ensure that the proposed FSSs uphold the standards to which CS facility licensees are held under the measures of the current FSSs for CCPs or SSFs. Further additions reflect standards applied to CS facilities in other relevant jurisdictions.
- *Measures to implement the Council's framework for ensuring appropriate influence for Australian regulators over cross-border CS facilities*: requirements that further support oversight of licensed CS facilities in the Australian context where licensed CS facilities have cross-border operations.

A high-level mapping of the Principles to the current and proposed FSSs, grouped by the issues addressed, is set out in Table 1. There are fewer FSSs than Principles for each facility type, reflecting that the Principles cover some issues that are either not relevant to the particular CS facility type, or address matters outside of the Bank's responsibilities. A number of measures in the current FSSs concern issues that span more than one of the proposed FSSs; for example, the matters considered in the 'risk controls' measure in the current FSS for CCPs span five standards in the proposed FSSs, separately covering the risk-management framework, credit risk, collateral, margin and liquidity risks.

Documents setting out marked-up differences between the Principles and the proposed FSSs are available on the Bank's website.<sup>14</sup>

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<sup>13</sup> See Reserve Bank of Australia (2008), 'Consultation on Variation of the Financial Stability Standard for Central Counterparties: Oversight of Overseas Facilities', October, available at <<http://www.rba.gov.au/payments-system/clearing-settlement/oversight-overseas/index.html>>, and the Notice of Variation, available at <<http://www.rba.gov.au/payments-system/clearing-settlement/pdf/variation-counterparties-feb09.pdf>>.

<sup>14</sup> These documents are available at <<http://www.rba.gov.au/payments-system/clearing-settlement/consultations/201208-new-fin-stability-standards/index.html>>.

**Table 1: Mapping the Current and Proposed Financial Stability Standards to the Principles**

|                                      | Principles   | Central counterparties              |   | Securities settlement facilities       |  |
|--------------------------------------|--|-------------------------------------|---|--|--|
|                                      |  | Current FSS measure                 | Proposed FSS  | Current FSS measure                    | Proposed FSS   |
| <b>Legal and governance</b>          | 1. Legal basis<br>2. Governance  | 1. Legal framework<br>8. Governance | 1. Legal basis<br>2. Governance   | 1. Legal framework                     | 1. Legal basis<br>2. Governance  |
| <b>Risk controls</b>                 | 3. Framework for the comprehensive management of risks<br>4. Credit risk<br>5. Collateral<br>6. Margin<br>7. Liquidity risk                                  | 7. Risk controls                    | 3. Framework for the comprehensive management of risks<br>4. Credit risk<br>5. Collateral<br>6. Margin<br>7. Liquidity risk | See note <sup>(a)</sup>                | 3. Framework for the comprehensive management of risks<br>4. Credit risk<br>5. Collateral<br>6. Liquidity risk                   |
| <b>Settlement</b>                    | 8. Settlement finality<br>9. Money settlements<br>10. Physical deliveries<br>11. Central securities depositories<br>12. Exchange-of-value settlement systems | 5. Settlement                       | 8. Settlement finality<br>9. Money settlements<br>10. Physical deliveries<br>11. Exchange-of-value settlements              | 4. Certainty of title<br>5. Settlement | 7. Settlement finality<br>8. Money settlements<br>9. Central securities depositories<br>10. Exchange-of-value settlement systems |
| <b>Default arrangements</b>          | 13. Participant-default rules and procedures<br>14. Segregation and portability  | 6. Default arrangements             | 12. Participant-default rules and procedures<br>13. Segregation and portability   | 6. External administration             | 11. Participant-default rules and procedures   |
| <b>Business and investment risks</b> | 15. General business risk<br>16. Custody and investment risks  | –                                   | 14. General business risk<br>15. Custody and investment risks   | –                                      | 12. General business risk<br>13. Custody and investment risks  |

**Table 1: Mapping the Current and Proposed Financial Stability Standards to the Principles (continued)**

|   | Principles   | Central counterparties  |   | Securities settlement facilities                  |   |
|---|--|---|---|---|---|
|   |  | Current FSS measure   | Proposed FSS  | Current FSS measure                               | Proposed FSS  |
| <b>Operational risks</b>  | 17. Operational risk   | 9. Operational risk   | 16. Operational risk  | 7. Operational risk                               | 14. Operational risk  |
| <b>Participation, access and links</b>                                | 18. Access and participation requirements<br>19. Tiered participation arrangements<br>20. FMI links      | 2. Participation requirements                                     | 17. Access and participation requirements<br>18. Tiered participation arrangements<br>19. FMI links | 2. Participation requirements                     | 15. Access and participation requirements<br>16. Tiered participation arrangements<br>17. FMI links |
| <b>Disclosure and reporting</b>                                       | 23. Disclosure of rules, key procedures and market data  | 3. Understanding risks<br>4. Novation<br>10. Regulatory reporting | 20. Disclosure of rules, key policies and procedures and market data<br>21. Regulatory reporting    | 3. Understanding risks<br>8. Regulatory reporting | 18. Disclosure of rules, key policies and procedures and market data<br>19. Regulatory reporting    |
| <b>Not directly relevant to financial stability and CS facilities</b> | 21. Efficiency and effectiveness<br>22. Communication procedures and standards<br>24. Trade repositories | Outside of the Reserve Bank's responsibilities                    |   |   |   |

(a) Financial risk controls are not currently included in the FSS for SSFs. These only apply to the extent that an SSF assumes credit or liquidity risk as principal, which at the time the current FSSs were drafted was not envisaged. No SSFs licensed to operate in Australia currently assume credit or liquidity risk as principal.

Sources: CPSS-IOSCO; RBA

## 4.1 Aligning the Financial Stability Standards with the Principles

This section sets out some of the main areas in which the proposed FSSs enhance the measures associated with the existing FSSs to align with the Principles. Unless otherwise stated, the changes described apply both to the proposed FSSs for CCPs and the proposed FSSs for SSFs.

### Legal and governance

Consistent with the Principle on governance, the proposed FSSs introduce a requirement that the board of a CS facility licensee takes into account participant and stakeholder interests (proposed CCP and SSF Standard 2). Similarly, the proposed governance standards require a facility's board and management to pursue objectives that explicitly support financial stability and other relevant public interest considerations.

In terms of governance structures, the proposed CCP Standard 2 sets out more granular and explicit requirements than the current governance measures under the FSS for CCPs, while the current FSS for SSFs does not include a measure explicitly addressing governance. The proposed FSSs therefore introduce a range of additional or more specific requirements regarding the role, composition and skills of a CS facility licensee's board and management, documentation of lines of responsibility and accountability, and governance arrangements associated with risk management and internal controls. This includes a provision that suitable board composition will typically require the appointment of non-executive directors.

### Risk controls

In aligning with the Principles, the proposed FSSs enhance risk controls for CS facilities, particularly in relation to credit and liquidity risks.

The proposed CCP Standard 4, in line with the Principle on credit risk, recognises the likely correlation between the default of a participant and any affiliates by requiring that a CCP hold sufficient financial resources to cover the joint default of the participant and its affiliates that would cause the largest aggregate credit exposure. A CCP with a more complex risk profile (e.g. a CCP that clears credit default swaps) or that is systemically important in multiple jurisdictions would be subject to the more exacting requirement that it hold sufficient financial resources to cover the default of the *two* participants (plus affiliates) that generate the largest aggregate exposure. The proposed CCP Standard 4 also adds more specific requirements for CCP stress testing. These set out the range of stress scenarios that CCPs should consider, as well as requirements for regular review and implementation of reverse stress testing.

The proposed CCP and SSF Standard 4 also require CS facilities to have rules and procedures in place to allocate uncovered credit losses in managing a participant default. This requirement recognises the need for CS facilities to have in place measures to prevent and enable recovery from a distress situation.

In the case of CCPs, meeting the financial resource requirements under the proposed FSSs now includes an explicit requirement to collect margin from participants, specifying a statistical benchmark for initial margin coverage (proposed CCP Standard 6).<sup>15</sup> This requirement must be met for all products cleared by a CCP, including cash equities. The proposed FSSs also establish more explicit settings for modelling margin requirements, backtesting and independently validating the models used.

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<sup>15</sup> The benchmark states that a CCP's initial margin coverage should meet a 99 per cent confidence level for the estimated distribution of future CCP exposure to participants in the interval between the last margin collection and the close-out of positions following a participant default.

The proposed CCP and SSF Standard 5 also incorporate strengthened requirements around collateral eligibility criteria and collateral management. Building on the requirement in the current FSS measures that CCPs apply haircuts to non-cash collateral, CCPs (and SSFs that accept collateral) should regularly test these haircuts and calibrate them for stressed market conditions. The proposed FSSs also clarify that licensed CS facilities should generally accept only collateral with low credit, liquidity and market risks, and should avoid accepting large concentrations of assets as collateral, where timely liquidation of concentrated holdings could lead to adverse price effects. Nevertheless, associated guidance recognises that other assets may be 'acceptable collateral for credit purposes if an appropriate haircut is applied'. This flexibility acknowledges that there may be jurisdictional differences in the availability of high-quality liquid assets that would meet the basic requirement.

Similarly the proposed CCP Standard 7 and SSF Standard 6 introduce strengthened and more specific controls for licensed CS facilities to address liquidity risks. In the case of CCPs, for instance, the proposed standard introduces specific requirements for a CCP to be able to meet its payment obligations on the intended settlement date in the event of the default of a participant (and its affiliates) that would generate the largest aggregate payment obligations for the CCP.

The current FSSs do not include financial risk-control requirements for SSFs, on the basis that at the time the standards were determined it was not envisaged that SSFs operating in Australia would assume financial risk – either credit or liquidity risk – as principal. While it remains the case that an SSF operating in Australia would not be expected to assume credit or liquidity risk as principal, it is nevertheless acknowledged that there may be circumstances in which an SSF did assume such risk. The proposed SSF Standards 4, 5 and 6 therefore follow the Principles in introducing requirements that any such risks be monitored and managed appropriately, including through holding collateral and other financial resources to cover these risks.

More broadly, in aligning with the Principles, the proposed FSSs require licensed CS facilities to implement their risk controls in the context of a comprehensive risk-management framework (proposed CCP and SSF Standard 3). As part of this framework, licensed CS facilities are required to identify scenarios in which they may be unable to continue operations as a going concern, and prepare plans for their recovery or orderly wind down in these scenarios. This requirement is designed to avoid the disorderly exit of a CS facility from a market by providing a credible plan for the continuity of service provision by the facility, or adequate time for participants to transition to alternative arrangements.

More detailed work on a framework for FMI recovery and resolution is continuing at the international level, through CPSS and IOSCO. A consultation paper was released on 31 July 2012.<sup>16</sup> Domestically, the Council has recommended to the Deputy Prime Minister and Treasurer that legislative amendments be sought to provide for the Bank to appoint a statutory manager to 'step in' to operate a distressed CS facility, including in the event of its financial distress.<sup>17</sup> The Bank, in conjunction with the other Council agencies, is planning further work to develop this recommendation over the coming year, drawing on insights from the international consultation. While not anticipated at this stage, there may be a need for a further update to the FSSs in the future should this work identify additional responsibilities for a CS facility to prepare for recovery or resolution.

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16 See CPSS-IOSCO (2012), *Recovery and Resolution of Financial Market Infrastructures*, Consultative Report, CPSS Publications No 103, Bank for International Settlements, July, available at <<http://www.bis.org/publ/cps103.htm>>.

17 The Council's recommendations to the Deputy Prime Minister and Treasurer are set out in a letter from the Governor of the Reserve Bank, available at <[http://www.treasury.gov.au/~media/Treasury/Consultations%20and%20Reviews/2012/Council%20of%20Financial%20Regulators%20Working%20Group%20on%20Financial%20Market%20Infrastructure%20Regulation/Key%20Documents/CoFR\\_Letter\\_to\\_Deputy\\_PM.ashx](http://www.treasury.gov.au/~media/Treasury/Consultations%20and%20Reviews/2012/Council%20of%20Financial%20Regulators%20Working%20Group%20on%20Financial%20Market%20Infrastructure%20Regulation/Key%20Documents/CoFR_Letter_to_Deputy_PM.ashx)>.

## Settlement

The Principles do not significantly expand the measures relating to settlement for licensed CS facilities included under the current FSSs. The proposed CCP Standard 8 and SSF Standard 7 add more specific requirements in line with the Principle on settlement finality for licensed CS facilities to complete final settlement no later than the end of the day on which payment and delivery obligations are due. In most cases they additionally require facilities to offer settlement finality intraday or in real time. Proposed CCP Standard 10 is based on the Principle for physical deliveries and sets out expectations for the management of risks associated with the storage and delivery of physical instruments or commodities.

## Default arrangements

The proposed FSSs introduce more explicit requirements for a licensed CS facility to have in place rules and arrangements to deal with a participant default. Consistent with the Principle on segregation and portability, CCP Standard 13 requires a CCP to have arrangements in place to achieve segregation of a participant's customers' positions and collateral from the participant's house positions and collateral, and portability of customer positions and collateral in the event of the participant's default. The proposed SSF Standard 9 also incorporates the requirement under the Principle on central securities depositories (CSDs) that SSFs operating a CSD should operationally support segregation and portability.

Existing insolvency provisions under the Act may inhibit timely portability by requiring either a court order or the permission of an insolvency practitioner before a defaulting participant's customer positions can be transferred. Under the proposed FSSs, licensed CS facilities would not, therefore, necessarily be expected to achieve portability without a supporting change to legislation. An alternative to legislative change might be for a CCP to adopt an agency model for customers of its clearing participants, whereby the customers would form a contractual arrangement directly with the CCP and the clearing participants would act as agents for their customers in posting collateral. This is in contrast to the principal-to-principal model currently in use by ASX Clear and ASX Clear (Futures), under which there is no direct contractual relationship between an indirect participant and a CCP.

The proposed CCP Standard 12 and SSF Standard 11 also add a requirement that licensed CS facilities test and review their default rules and procedures at least annually, and include relevant participants and other stakeholders in that process.

## Business and investment risks

Consistent with the Principle on general business risk, the proposed CCP Standard 14 and SSF Standard 12 incorporate provisions to safeguard the continuity of services provided by licensed CS facilities in situations where the facility's ability to continue as a going concern might be in doubt. The proposed FSSs introduce a requirement for licensed CS facilities to hold liquid assets funded by equity sufficient to continue operations in the event that they incur business losses for six months, or during the implementation of a recovery plan.

Under proposed CCP Standard 15 and SSF Standard 13, licensed CS facilities would be required to manage their treasury investments in accordance with the facility's overall risk-management framework and to limit their investments to instruments with minimal credit, market and liquidity risks (such as government securities).

## Operational risks

The proposed CCP Standard 16 and SSF Standard 14 provide for greater resilience of CS facility operations by enhancing requirements for business continuity arrangements and managing operational risks introduced by third parties in accordance with the Principle on operational risk. The proposed FSSs require a CS facility licensee to operate a secondary site and achieve resumption of operations within no more than two hours following a disruption to critical information technology systems. The aim of these requirements is to ensure that a licensed CS facility can complete or facilitate settlement by the end of the day of disruption.

Facilities are also required, under the proposed FSSs, to manage the risks that participants, other FMIs, or service providers pose to their operations. This recognises the reliance of facilities' operations on third parties, including in relation to outsourcing arrangements.

## Participation, access and links

Greater attention has been given in the proposed FSSs to the potential risks faced by a CS facility arising from tiered participation arrangements and links to other FMIs. Consistent with the Principle on tiered participation arrangements, proposed CCP Standard 18 and SSF Standard 16 require a CS facility licensee to identify and mitigate risks arising from material dependencies between direct and indirect participants, as well as indirect participants whose activities account for a significant proportion of either their direct participant or the facility's transactions. Proposed CCP Standard 19 and SSF Standard 16 also establish new obligations for a CS facility licensee to identify, monitor and manage potential risks arising from links to other FMIs, consistent with the Principle on FMI links.

## 4.2 Complementary Measures to Uphold Current Standards and Align with Other Jurisdictions

The proposed FSSs retain a number of complementary requirements from the current FSS measures that are not explicitly replicated in the Principles, but represent matters the Bank deems important, particularly in the Australian context. These include a number of additional specific requirements that the Bank has applied or considered in its oversight of currently licensed CS facilities, in part reflecting the Bank's further interpretation of what a CS facility must do in order to reduce systemic risk in complying with the current FSS, and the other requirements of the Act.

Preservation of these requirements is therefore designed to ensure that the proposed FSSs uphold the standard to which CS facility licensees operating in Australia are currently held. The key requirements retained from the current FSS measures include:

- a requirement that CS facility licensees are legally separate from other entities carrying out unrelated activities (proposed CCP and SSF Standard 1.1)
- additional credit risk controls for CCPs
- additional standards to address operational risks
- a clear order of preference among alternative settlement models in exchange-of-value systems (e.g. delivery-versus-payment (DvP) models for securities settlement that are designed to eliminate principal risk between the counterparties to a trade)
- more detailed disclosure and regulatory reporting requirements.

The proposed FSSs for CCPs reflect additional risk controls consistent with the Bank's expectation that currently licensed CCPs monitor credit risks posed by participants on an ongoing basis, and impose additional risk controls where those risks are heightened (proposed CCP Standards 4.2 and 4.3). Similarly, where stress-test outcomes reveal a potential shortfall in coverage, proposed CCP Standard 4.7 creates a requirement for CCPs to take timely steps to enhance financial resources.

With respect to operational risks, to ensure the robustness of operations outsourced by a licensed CS facility, proposed CCP Standard 16.9 and SSF Standard 14.9 add requirements that outsourcing providers should meet the same standards of resilience, security and operational performance as the licensed CS facility itself.

The retention of requirements regarding the circumstances in which each of the alternative DvP settlement models might be acceptable is a particularly significant complement to the Principles. DvP model 1 involves settlement of both securities and funds on a gross, obligation-by-obligation basis; under DvP model 2, securities are settled with finality on a gross basis and funds on a net basis at the end of a processing cycle; and under DvP model 3, securities and funds are settled simultaneously in batches on a net basis. The Principles recognise the use of all three DvP models, while noting the benefits of DvP model 1 or multiple-batch settlement (coupled with DvP model 2 or 3) in limiting the build-up of intraday exposures between participants. Consistent with the current FSSs, the proposed CCP Standard 11.2 and SSF Standard 10.2 go further and explicitly *require* the use of DvP model 1 where individual trade values are large. DvP model 3 is, however, permitted under the proposed FSSs where individual trade values are small. DvP model 2 would be permitted only under exceptional circumstances. This reflects the Bank's view that settlement according to DvP model 2, while eliminating principal risk for participants, does so by transferring it to the SSF that guarantees settlement. Where multilateral batch settlement is used, proposed SSF Standard 11.3 requires greater transparency in arrangements for dealing with any unsettled trades of a defaulting participant.

Finally, proposed CCP Standard 21 and SSF Standard 19 retain the regulatory reporting measures of the current FSSs, while proposed CCP Standard 20 and SSF Standard 18 incorporate data disclosure requirements consistent with current expectations and current licensees' practice.

The proposed FSSs also incorporate a number of proposed requirements contained in the European Securities and Markets Authority's Draft Technical Standards, in order to further align Australian regulation of CS facilities with emerging international best practice.<sup>18</sup> In particular, among the governance sub-standards: CCP and SSF Standard 2.5 incorporates a requirement for management compensation that is consistent with risk-management objectives; CCP and SSF Standard 2.7 provides an explicit requirement for internal audit and independent external review of operations, processes and controls; and CCP and SSF Standard 2.9 addresses the arrangements that licensed CS facilities should put in place to manage potential conflicts of interest between entities in the same corporate group.

### 4.3 Regulatory Influence over Cross-border Clearing and Settlement Facilities

Beyond the retention of requirements under the current FSS measures, the proposed FSSs further elaborate on the international standards set out in the Principles with a number of specific measures designed to ensure adequate regulatory influence for the Bank with respect to cross-border CS facilities.

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<sup>18</sup> See European Securities and Markets Authority (2012), *Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories*, Consultation Paper, ESMA/2012/379, June, available at <<http://www.esma.europa.eu/system/files/2012-379.pdf>>.

The Council, in its recommendations for reform of FMI regulation, proposed that the Bank and ASIC be granted explicit powers to impose graduated and proportional 'location requirements' on CS facilities.<sup>19</sup> The Council, on advice from the Bank and ASIC, has subsequently articulated a graduated framework of measures designed to ensure that the Bank and ASIC have adequate regulatory influence over CS facilities that have a cross-border element – either because they are based overseas, or have established or are contemplating cross-border outsourcing arrangements.<sup>20</sup>

Under the framework articulated by the Council, the specific measures applied to a facility would reflect the nature and scope of its activities and, in particular, its systemic importance in Australia and the strength of its connection to the Australian financial system and real economy. It is proposed that the imposition of FSSs be the principal means for implementing the stability relevant measures within the framework. The proposed FSSs therefore incorporate a number of measures set out below, designed to ensure that cross-border CS facilities have a sound financial, legal, governance, operational and regulatory basis in Australia appropriate to their activities, and that their operations provide adequate channels for Australian regulators to exercise their oversight responsibilities, including in stressed circumstances.

The requirements under the framework would apply to facilities on the following basis:

- *All CS facilities.* The proposed FSSs incorporate basic legal and governance requirements for all licensed CS facilities, including those with cross-border activities. All licensed CS facilities operating in multiple jurisdictions would be required to provide an up-to-date legal opinion addressing enforceability and conflicts of law (proposed CCP and SSF Standard 1.6). Licensed CS facilities with material Australian-based participation which provide services in Australian-related products would also be subject to requirements under the proposed FSSs to consult with stakeholders, and apply proportional requirements to Australian participants, including in default management (e.g. proposed CCP Standards 2.8, 3.2 and 12.5; and SSF Standards 2.8, 3.2 and 11.5).
- *Systemically important licensed CS facilities.* The proposed FSSs introduce a requirement for a systemically important CCP to hold and operate an Exchange Settlement Account at the Bank in order to manage its Australian dollar liquidity requirements (proposed CCP Standards 7.7 and 9.1).<sup>21</sup>
- *Systemically important licensed CS facilities with a strong domestic connection.* Where systemically important licensed CS facilities also have a strong connection to the Australian financial system and real economy, it is critical that the Bank and ASIC are able to ensure continuity of service in a crisis situation. Consistent with this, the proposed CCP Standard 16.11 and SSF Standard 14.11 require all licensed CS facilities to organise their operations to facilitate effective crisis-management actions, commensurate with the nature and scale of their operations. This would, for instance, facilitate the exercise of a step-in power, should this be granted as recommended by the Council. This requirement would be expected to have the greatest impact on a systemically important licensed CS facility with a strong domestic connection.

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19 The Council's recommendations are available at <[http://www.treasury.gov.au/~media/Treasury/Consultations%20and%20Reviews/2012/Council%20of%20Financial%20Regulators%20Working%20Group%20on%20Financial%20Market%20Infrastructure%20Regulation/Key%20Documents/CoFR\\_Letter\\_to\\_Deputy\\_PM.ashx](http://www.treasury.gov.au/~media/Treasury/Consultations%20and%20Reviews/2012/Council%20of%20Financial%20Regulators%20Working%20Group%20on%20Financial%20Market%20Infrastructure%20Regulation/Key%20Documents/CoFR_Letter_to_Deputy_PM.ashx)>.

20 See Council of Financial Regulators (2012), 'Ensuring Appropriate Influence for Australian Regulators over Cross-border Clearing and Settlement Facilities', Supplementary Paper to the Review of Financial Market Infrastructure Regulation, July, available at <<http://www.treasury.gov.au/ConsultationsandReviews/Submissions/2012/cross-border-clearing>>.

21 The Bank has recently updated its policy on Exchange Settlement Accounts to reflect this requirement, and to facilitate access to accounts for CCPs more broadly, see <<http://www.rba.gov.au/media-releases/2012/mr-12-17.html>>.

## 4.4 Institutional Scope of Application

It is intended that all licensed CS facilities operating either a CCP or an SSF, whether domestic (i.e. licensed under section 824B(1) of the Act) or overseas (i.e. licensed under section 824B(2) of the Act), would be required to comply with the relevant standards.

It is, however, proposed that an activity threshold be retained for SSFs. Currently, a licensed SSF is exempt from the relevant FSS unless the value of financial obligations settled in a financial year exceeds a threshold value of \$100 million. The threshold was introduced in 2005 to ensure that small SSFs, which are unlikely to affect the overall stability of the Australian financial system, are not subject to burdensome and disproportionate regulation. One licensed SSF, IMB Limited, currently falls below this threshold value. It is proposed that the threshold value, below which the proposed FSSs for SSFs will not apply, be increased to \$200 million, to reflect growth of settlement values in Australian markets since 2005 and to accommodate future growth.

The application of the proposed FSSs to *all* licensed CS facilities would, in the case of CCPs, constitute a change in the Bank's approach. Under current arrangements, subject to certain conditions, the FSS for CCPs applies to 'all CS facility licensees that operate a central counterparty with the exception of those CS facility licensees granted a licence under Section 824B(2) of the *Corporations Act 2001*'.

However, notwithstanding that a licensed overseas facility would be required to comply with the FSSs, the Bank's assessment of compliance would, in accordance with section 823CA of the Act and subject to certain conditions, take into account '... information and reports from [the] overseas regulatory authority' in the facility's principal place of business. The conditions that would apply are discussed further in Section 4.5 below and Attachment 5. The proposed approach remains consistent with the objective articulated when the current exception was introduced in 2009; that is, to deliver a framework for regulation of overseas licensees that did 'not impose an unnecessary regulatory burden, while ensuring competitive neutrality in the Australian regulatory environment'.<sup>22</sup>

## 4.5 Assessment Approach

Under section 823CA of the Act, the Bank must, at least once each year, 'do an assessment of how well each CS facility licensee is complying with its obligation under paragraph 821A(aa); that is, 'to the extent that it is reasonably practicable to do so: (i) comply with [the FSSs]; and (ii) do all other things necessary to reduce systemic risk'. As part of the Council's review of FMI regulation, an amendment to this provision of the Act is under active consideration. The amendment would require a licensed CS facility to comply with the FSSs to their full extent rather than to the extent reasonably practicable. The complementary obligation to do all other things necessary to reduce systemic risk *to the extent reasonably practicable* would be retained. Attachment 5 sets out the Bank's proposed approach to carrying out a formal annual assessment (against current obligations under the Act), drawing a distinction between the approach that would be taken in respect of domestic facilities licensed under section 824B(1), and that in respect of overseas facilities licensed under section 824B(2).

In the case of both domestic and overseas facilities, the Bank proposes to seek sufficient information at the time a facility submits its licence application to be able to assess whether the facility would comply with the FSSs. Thereafter, on an ongoing basis, the Bank would seek information directly from the licensee on any

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<sup>22</sup> Since the current exception applies 'only for such time as the Reserve Bank receives annual documentary evidence from the licensee's overseas regulator that the licensee has complied in all material respects with the requirements of the overseas regulator related to matters affecting stability ...', the proposed approach delivers a similar outcome.

material developments – including changes to products, policies, operations, processes, personnel, ownership and governance arrangements – that may be relevant to an annual assessment of compliance with the FSSs.

In the case of a domestic licensee, consideration of information on material developments would, as currently, be supplemented by periodic regulatory reporting, and regular activity, risk and operational data. There would also be an ongoing dialogue with the licensee, including through scheduled quarterly meetings on strategic developments, risk-management arrangements and operations. Ad hoc targeted meetings on specific topics would also be arranged. Going forward, it is proposed that the formal annual assessment of compliance with the FSSs will be guided by the CPSS-IOSCO Assessment Methodology, which provides a framework for assessing and monitoring observance of the Principles and the responsibilities of authorities.<sup>23</sup>

Within the parameters of the Assessment Methodology, it is proposed that the Bank's formal annual assessment of a facility's compliance against all of the FSSs will comprise consideration of the implications of material developments for compliance with each FSS, as well as a more comprehensive and granular assessment against a subset of the standards.

In assessing overseas licensees, the Bank proposes, subject to certain conditions, to place reliance on reports and information from the regulator in an overseas licensee's principal place of business (the overseas regulator). Such reliance is envisaged in the Act, which requires that, prior to the Minister granting a licence under section 824B(2), the applicant's home regime be assessed to be sufficiently equivalent to that in Australia in relation to protection from systemic risk. The Act also requires that the Minister consider the adequacy of cooperation arrangements between ASIC and the Bank and both the licensee and the overseas regulator.

Notwithstanding that an overseas regime may be sufficiently equivalent to that in Australia, there may be some differences in the detailed application of principles or standards. The Bank therefore proposes only to place reliance on a sufficiently equivalent overseas regulator in respect of assessment against those standards for which a 'materially equivalent' standard is explicitly applied in the overseas regulatory regime. To the extent that other jurisdictions apply the Principles, a materially equivalent standard would be expected to apply in most cases. The exceptions would therefore typically be where the FSSs introduce complementary measures of particular relevance to the Australian context, including regulatory reporting and notification requirements, and measures to enhance Australian regulatory influence over cross-border facilities.

The conditions under which the Bank would propose to place reliance on an overseas licensee's home regulator are, therefore, as follows:

- The licensee obtains for the benefit of the Bank an independent legal opinion identifying for each FSS whether a materially equivalent standard exists in the facility's licensee home regime.
- The Bank receives annual documentary evidence from the licensee's home regulator that the licensee has complied in all material respects with relevant regulatory requirements, and the Bank is satisfied with the information received. The nature and form of the documentary evidence provided would be discussed with the relevant overseas regulator and would be contemplated in the MOU concluded with that regulator at the time a licence was granted.

Where the Bank is not satisfied that a materially equivalent standard exists, or is not satisfied with the documentary evidence received from the overseas regulator, the Bank proposes to directly assess an overseas licensee's compliance with the relevant FSS. Such an assessment would draw on information obtained directly

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<sup>23</sup> A draft version of the Assessment Methodology was released for consultation in April 2012: see CPSS-IOSCO (2012), *Assessment Methodology for the Principles for FMs and the Responsibilities of Authorities*, Consultative Report, April, available at <<http://www.bis.org/publ/cpss101b.pdf>>.

from the licensee. This is consistent with the current FSS for CCPs, the guidance to which acknowledges that, notwithstanding a conditional exemption from the FSS, the Bank may in some cases 'seek sufficient information to carry out a direct assessment of the CS facility in respect of specific aspects of its operations'. The Bank may also, from time to time, make additional enquiries of a licensee in relation to information received on material developments.

The Bank proposes to continue to publish its assessments of licensed CS facilities, as it has since 2007. The Bank also expects its assessments of licensed CS facilities (and also self-assessments of RITS) to be subject to external scrutiny, through the assessment programs of international financial institutions, such as the IMF and the World Bank. It is expected that these institutions will also use the Assessment Methodology to assess the observance by FMs and authorities of the Principles, including the associated responsibilities of authorities.

## 4.6 Questions

Stakeholders are invited to provide comments on any matters arising from the proposed new FSSs. However, the Bank would particularly welcome comment from stakeholders on the questions set out below.

1. Are there potential conflicts between the requirement for licensed CS facilities to explicitly support financial system stability and other relevant public policy objectives (proposed CCP and SSF Standard 2.1), and other obligations or duties of facilities and their directors?
2. Should the requirement for non-executive members of a CS facility's board (proposed CCP and SSF Standard 2.4) be extended to specify the number of non-executive directors and their degree of independence from management or related entities?
3. Are there any potential obstacles to CCPs taking the proposed steps to monitor the credit standing of participants and impose additional risk controls where a participant's credit standing is called into question (proposed CCP Standard 4.3)?
4. In balancing the system-wide impact of restricting collateral eligibility to high-quality liquid assets against the risk that lower-quality or less-liquid collateral assets may not hold their value in a stressed market, should any other collateral eligibility criteria be considered (proposed CCP and SSF Standard 5)?
5. To date, SSFs in Australia have not assumed credit or liquidity risks as principal. Some SSFs may, however, be designed in such a way that they assume credit exposures or liquidity obligations to participants, as contemplated in the proposed SSF Standards 4 and 6. Should SSFs licensed to operate in Australia be permitted to assume these risks as principal?
6. Should an SSF always be required to offer intraday or real-time settlement finality, or are there circumstances in which a minimum standard of end-of-day settlement finality would be acceptable (proposed SSF Standard 7)?
7. Should settlement arrangements utilised by CCPs, or offered by SSFs, be allowed to settle using DvP model 2 where trade values are small and operational requirements dictate its use, or should all facilities be required to settle according to DvP model 1 or 3 (proposed CCP Standard 11, SSF Standard 10)?
8. Would a change from a principal-to-principal model to an agency model for indirect participants of a CCP allow for effective portability arrangements in the case of a clearing participant default (proposed CCP Standard 13)? What would be the costs and consequences of such a change?
9. Should the required level of segregation for any collateral posted on behalf of participants' customers differ between CCPs clearing securities and derivatives markets, having regard to the much shorter

duration of pre-settlement risk exposure in securities transactions and the reduced likelihood that customer positions would be ported in such circumstances (proposed CCP Standard 13)?

10. Should a CS facility licensee be subject to more prescriptive controls regarding their investment policies than envisaged in the proposed FSSs, such as a minimum proportion of funds invested in risk-free assets or limits on the concentration of exposures to investment counterparties (proposed CCP Standard 15, SSF Standard 13)?
11. It is proposed that CS facility licensees be required to achieve resumption of operations within two hours following a disruption to critical information technology systems (proposed CCP Standard 16.7, SSF Standard 14.7). What would be the benefits and costs of reducing the window for resumption of operations for systemically important CS facility licensees in respect of their critical systems?
12. Should the proposed FSSs include specific requirements for licensed CS facilities to manage cyber security risks? If so, what sorts of risk controls would be appropriate?
13. Following the release of the CPSS-IOSCO consultative report on *Recovery and Resolution of Financial Market Infrastructures*, is there sufficient clarity within the proposed FSSs to capture all necessary measures to ensure an effective recovery regime (including loss allocation arrangements)?
14. Requirements under proposed CCP Standards 3.5, 16.4 and 16.10, and SSF Standards 3.5, 14.7 and 14.10 have been designed to ensure arrangements are in place to assist any statutory manager when stepping into a CS facility following a shock to the CS facility. Are these standards sufficiently comprehensive to ensure any such action would be effective?
15. Are there any further requirements placed on CS facilities in other jurisdictions that could be applied in Australia to enhance the systemic risk controls of licensed CS facilities, without imposing disproportionate costs?
16. Is it appropriate to increase the threshold value below which an SSF would be exempt from the proposed FSSs?
17. Is the assessment approach articulated in Attachment 5 consistent with the objective to deliver a framework for regulation of overseas licensees that does not impose an unnecessary regulatory burden, while ensuring competitive neutrality in the Australian regulatory environment?

## 5. Implications for Current Clearing and Settlement Facility Licensees

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The proposed FSSs would apply initially to the four currently licensed CS facilities: ASX Clear and ASX Clear (Futures) would be subject to the proposed FSSs for CCPs; ASX Settlement and Austraclear would be subject to the proposed FSSs for SSFs. This section considers the key changes that the current licensees may need to implement in order to comply with the proposed FSSs, and the associated potential costs (including potential implications for participants and their customers). It also considers the transitional arrangements that would apply to the currently licensed CS facilities while they implement these changes.

### 5.1 Key Changes Required

The greater part of the proposed FSSs are consistent with the measures accompanying the current FSSs, as well as the 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. While Section 4 outlined the key proposed changes to the minimum standards set out in the current regulation of CS facility licensees, not all of these will necessitate changes to the arrangements of the currently licensed CS facilities. In a number of these areas, the currently licensed CS facilities have already gone beyond the minimum measures accompanying the current FSSs. However, there are some areas in which the currently licensed CS facilities may need to implement changes in order to comply with the proposed FSSs. These include the following.

#### 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 proposed 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 currently licensed CCPs 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 proposed 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. 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.<sup>24</sup> With respect to the liquid resource requirements, ASX Clear, in particular, may require access to significantly increased liquidity than at present. This may require the conclusion of explicit contingent *ex ante* agreements with participants for liquidity provision, perhaps by entering into committed repurchase agreements with participants. This might involve rule changes in ASX Clear to permit simultaneous repurchase transactions with participants. 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 proposed FSSs, and may incur associated costs from system and operating rule changes.

## Recovery and resolution planning

The proposed FSSs introduce new requirements for the currently licensed CS facilities to 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 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 need to raise additional equity, or substitute other resources to free up equity.

The currently licensed CCPs will 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 proposed FSSs also introduce restrictions on the organisation of operations, including intra-group or external outsourcing arrangements, 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 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. 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. Transitional relief would be considered to the extent that this dependency inhibited full compliance with the proposed FSSs.

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<sup>24</sup> ASX Clear and ASX Clear (Futures) can call additional margin from participants under their Contributions and Additional Cover and Additional Initial Margin regimes, respectively.

## Collateral and margin

The currently licensed CCPs may need to alter their arrangements for collateral posted on behalf of a participant's customers in order to comply with the proposed CCP Standard on segregation and portability. For cash equities, ASX Clear will 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) will 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. In this context, it is important to recognise that portability of customer positions and collateral cannot be guaranteed in the event of a participant default, although both CCPs would be expected to consider changes that made portability highly likely in a default situation.

Since achieving a high likelihood of customer position portability via reasonably practicable arrangements may depend on changes to insolvency law, any changes to current arrangements may not need to take place immediately to ensure compliance with the proposed FSSs. However, if reasonably practicable changes to contractual arrangements with customers of participants (e.g. a move to an agency model) could achieve portability under existing law, these would need to be pursued by the currently licensed CCPs, to the extent that the benefits to the broader market of such changes outweigh the costs. ASX has commenced a process of consultation with participants in its two CCPs regarding the potential for changes to customer segregation and portability arrangements.

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 house and customer transactions). For example, any loss of netting between 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.

The proposed FSSs will 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 in Attachment 2), both CCPs will need to submit their margin methodologies for review by an independent expert.<sup>25</sup> ASX Clear will also need to introduce margining for cash equities. While there will be some costs associated with 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 additional 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 proposed FSSs. They will 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 acceptance of collateral subject to wrong-way risk.<sup>26</sup> It is not expected that these changes would impose

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<sup>25</sup> 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.

<sup>26</sup> 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.

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 will need to continue review of their investment policies in order to ensure that they meet the requirements under the proposed FSSs to manage their investments in a manner consistent with their overall risk-management framework. These reviews will 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 to participants. Such changes would, however, be expected to reduce the risk of investment losses.

## Governance

The currently licensed CS facilities will need to review their governance arrangements to ensure that they are fully aligned with the more granular governance requirements of the proposed FSSs. It is not anticipated that any necessary changes to policies and procedures, or an increase in independent representation on the board or risk committee of a CS facility, would impose significant additional costs.

## 5.2 Transitional Relief

While in most areas little or no change will be required to the conduct of currently licensed CS facilities in order to comply with the proposed FSSs, the potential changes necessary to achieve full compliance outlined in the preceding section may take some time to implement. These changes may also require complementary changes to the arrangements of participants and their customers. In recognition of this, the Bank proposes to provide specific transitional relief for current CS facility licensees where required, to allow them reasonable time to make the changes necessary to achieve full compliance. The Bank intends to discuss with current licensees areas where transitional relief may be required, and develop appropriate transitional arrangements where relief is necessary.

## 5.3 Questions

1. Do any requirements of the proposed FSSs place unreasonable or disproportionate costs on licensed CS facilities' participants or their customers relative to the potential benefits? For example, could requirements for facilities to:
  - implement loss allocation rules (CCP Standard 4.8 and SSF Standard 4.5)
  - hold additional liquid resources (CCP Standard 7 and SSF Standard 6)
  - implement segregation or portability arrangements (CCP Standard 13)
  - place operational requirements on participants (CCP Standards 16.6 and 16.8; SSF Standards 14.6 and 14.8)create disproportionate costs for participants or their customers?
2. In what areas might transitional relief be required for currently licensed CS facilities, and what length of relief would be appropriate in these areas?
3. Should transitional relief be tailored to particular licensees, as required on a case-by-case basis, or would it be more appropriate in some cases to extend relief generally to all licensees?