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Central Clearing of Repos in Australia

ASX Submission to the RBA on its Consultation Paper

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ASX Submission

April 2015

EOS	EPD	EPM	EPW	EPX	EPX	EPY	EQE	EQH	EQT	EQU	EQX	ERA	ERD	ERI	ERJ	ERL	ERM	ERN	ERO	ESI	ESK	ESM	ESN	ESR	ESV	ETE	EUG	EUM	EVE	EVM	EVN	EVR	EVZ	EWC	EXA	EXC	EXE	EXG	EXM	EZA	EZL	FAC	FAN	FAR	FAS	FBU	FCN	FCR	FDC	FDC	FDC	FDC	FEL	FEO	FFF	FFI	FGE	FGF	FGI	FIE	FIS	FKP	FKP	FLK	FLR	FLT	FMA	FMB	FMG	FML	FMM	FMN	FMS	FND	FNP	FNT	FOB	FOT	FOX	FOY	FPG	FPH
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Executive Summary

ASX welcomes this opportunity to provide RBA with an overview of the potential costs and benefits of the centralised clearing of repo transactions in Australia.

ASX notes that the RBA is seeking to establish, “whether the capacity of the Australian repo market to safely, efficiently and continuously support the funding and liquidity needs of the Australian financial system would be improved by the availability of a repo CCP.”

ASX believes that there are significant benefits of repo transactions being centrally cleared, but in the short term, the likelihood of such benefits being realised is limited under the current structure of the repo market.

ASX is ready to engage further in a design study with the RBA and industry groups (such as the relevant AFMA committees) to explore in more detail the costs and benefits of the central clearing of repo transactions and the structural changes to the market that would be necessary.

Subject to the results of the design study and commercial feasibility, ASX would be prepared to invest in building a domestically licensed repo CCP service for the Australian market.

Potential Benefits

The benefits of central clearing of repo transactions in Australia are similar to the ASX markets which are already centrally cleared. Typically, these are as follows:

- **Multilateral netting:** counterparty exposures are reduced compared to the bilateral pre-netting currently conducted in the interdealer market. This results in a more favourable treatment in leverage ratio calculations;
- **Collateral and settlement efficiency:** the CCP calculates a single net position for settlement. It can also interface with a centralised collateral management system to streamline processes such as margining, recall and substitution of collateral;
- **Enhanced risk and default management:** risk management is standardised, with initial margin managing replacement cost risk. Default management is co-ordinated by the CCP;
- **Balance sheet efficiency –** centrally cleared transactions maximise balance sheet netting since the counterparty is always the CCP;
- **Regulatory capital benefits -** cleared interdealer repo transactions attract a 2% risk weighting for a bank’s exposure to a CCP rather than a weighting of up to 20% for a bilateral counterparty. They also do not incur a credit valuation adjustment (CVA) and associated capital charge; and,
- **Systemic risk reduction** through the ability to ‘ring fence’ a defaulting counterparty from the rest of the market.

Current Market Structure

The Financial Stability Board (FSB) noted that there is significant potential for central clearing. However, in Australia this opportunity is limited because:

- A significant portion of repo activity has the RBA as one of the counterparties. This means that banks dealing with the RBA have one-directional exposures, with no offsetting exposures in the opposite direction;
- The RBA is viewed as a very low risk counterparty and therefore the benefits of credit risk reduction are limited;
- It is also unclear (to be examined in a design study) whether repos against the RBA have the potential to attract a 0% risk weighting for regulatory capital purposes. This would again limit the benefits of central clearing;
- The majority of inter-dealer repos are bilaterally pre-netted under Global Master Repurchase Agreements (GMRAs) ahead of settlement, resulting in a single one-directional settlement per ISIN per settlement day between each pair of dealers; and,
- Multilateral netting benefits would be limited if the product scope of such clearing was restricted solely to repo.

Given the relatively small scale of the Australian market, ASX recommends that RBA considers broadening the product scope to include both legs of all repos (including RBA repos) thus capturing the entirety of the \$110 billion repo market. Moreover, the inclusion of outright purchases and sales of bonds, debt securities (i.e. general collateral, specials and private securities) and equity repo and securities lending would also improve the viability of central clearing.

Changes to the Repo Market

The necessary changes to the way the repo market operates can be summarised as follows:

- Increased use of tri-party collateral optimisation and allocation services such as ASX Collateral;
- Increased use of electronic trading repo platforms such as Yieldbroker; and,
- Decreased day-to-day activity by the RBA in the Australian repo market.

In the event that these changes were made, ASX could develop an onshore central clearing solution that would leverage existing financial market infrastructure located in Australia. In combination, this would:

- Deliver the benefits of the central clearing of repo transactions in Australia as set out earlier in this paper;
- In particular, deliver operational benefits to the market through straight through processing (STP) of transactions throughout electronic execution, centralised clearing and tri-party collateral management; and,
- Improve liquidity by encouraging a broader range of counterparties into the repo market.

In terms of sequencing the implementation of these changes, it may be preferable to achieve critical mass in tri-party repo and electronic trading as a first step. This would improve liquidity (by adding additional cash providers to the system) and enable the RBA to decrease its day-to-day role in the repo market before centralised clearing is added.

If this can be delivered, ASX believes this would meet the objective of improving the functioning of the Australian repo market and its capacity to safely, efficiently and continuously support the funding and liquidity needs of the Australian financial system.