23 March 2022

ASX Limited
PO Box H224
Australia Square NSW 1215
Attention: Samantha Hettihewa
Email: samantha.hettihewa@asx.com.au

Dear Sirs/Madams

Consultation on proposed changes to the ASX Recovery Rules to allocate US settlement bank investment losses between the ASX CCPs and their clearing participants

FIA[1] appreciates the opportunity to respond to the "Consultation on proposed changes to the ASX Recovery Rules to allocate US settlement bank investment losses between the ASX CCPs and their clearing participants" issued by ASX on 11 February 2022 (**the Consultation**).

While we are generally supportive of the proposed amendments, we wish to highlight some specific comments for consideration by ASX.

Unless otherwise defined, capitalised terms used in this letter will bear the same meanings ascribed to them in the Consultation.

1. Loss Allocation Rules and Components

ASX states in the Consultation that it seeks to allocate USD settlement bank losses to clearing participants based on principles of mutualisation, and potential and actual user pays. We agree with these principles. The 2am margin process benefits not just all CMs but also ASXCLF as it helps to mitigate systemic risk. As such, the risks arising from this process should continue to be distributed equally amongst all participants.

[1] FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in London, Singapore and Washington, D.C. FIA's membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from more than 48 countries as well as technology vendors, lawyers and other professionals serving the industry. FIA's mission is to support open, transparent and competitive markets, protect and enhance the integrity of the financial system, and promote high standards of professional conduct. As the principal members of derivatives clearinghouses worldwide, FIA's member firms play a critical role in the reduction of systemic risk in global financial markets. Further information is available at www.fia.org.

We would therefore suggest that a fairer and simpler method would be to distribute USD settlement bank losses based on a combination of Component 1 *(Clearing participant's Default Fund contribution as a % of total contribution from all Clearing participants to share in any potential losses arising from this process)* and Component 2 (*Clearing participant's Default Fund contribution as a % of total contributions from clearing participants within the scope of 2am call*).

Moreover, Component 3 (*Average USD cash called over previous 3 months as a % of the total average USD cash called over the previous 3 months*) has the unintentional consequence of penalizing international banks who are likely to deposit more USD cash collateral due to operational and funding constraints.

The Consultation also states that a defaulting CM will not be allocated US settlement bank losses. While we understand the rationale for this, can ASXCLF consider utilizing any excess collateral and default fund resources after that CM has fulfilled its clearing obligations to cover a portion of the US settlement bank losses? This is in line with the above principles and will help to ensure that non-defaulting CMs are not subject to additional liquidity strain.

2. ASX SITG

ASX currently sets aside AUD 75m of its own capital (**SITG**) to cover losses associated with the default of an investment counterparty. This SITG is in line with the investment limit for US settlement banks so that investment losses cannot exceed $75m.

However, the investment limit for settlement banks will be increased following the introduction of the 2am VM call thereby bringing a greater element of counterparty risk. As the potential liability from non-default losses would increase, CMs and ASX should both be prepared for a higher share in this contingent loss.

For the reasons mentioned above and considering the Reserve Bank of Australia's (RBA) recommendation to extend the scope of ASX's overnight margin process to include calling collateral to cover mark-to-mark exposures, we request that ASX considers increasing its SITG for non-default loss absorption. Instead of the SITG being a fixed amount, we would suggest that ASX conducts regular stress tests of its non-default losses (similar to the default fund calibration) and set its SITG dedicated to non-default losses as a percentage of the stress test result.

ASX had previously expressed the view that it already has a significant SITG in the member default waterfall and hence cannot provide for more in this context. However, ASX could consider reallocating its SITG between the default and the non-default waterfalls to create a better balance.

3. Alternative Currency to USD

We understand that ASX intends to offer AUD as an alternative currency in the future. However, we suggest having alternative currency options from the outset to dilute the risk amongst the settlement banks.

This would also help address liquidity concerns in the event of a member default. At the very least, we request that ASX provide assurance that it can secure AUD liquidity against these USD balances in such a scenario, for example by demonstrating the ability to swap USD for AUD.

4. US Settlement Bank Transparency

When ASX first introduced this proposal last year, it was acknowledged by both clearing participants and ASX that there would be an increased element of counterparty risk from the US settlement banks.

There should therefore be a level of transparency regarding the details of the US settlement banks. Information such as the number of US settlement banks, the amounts deposited at each, and their credit ratings should be provided to CMs to allow for the opportunity to understand the risks and provide feedback if necessary. This is especially relevant since CMs are not part of the decision-making process but are nonetheless expected to shoulder some of the risks.

5. Mitigation of wrong way risk when a US settlement bank and a CM are in the same group

To better mitigate the wrong way risk introduced by a US settlement bank and a member in the same group, we suggest that ASX set up additional reserves to collateralize the potential losses by:

i. putting additional SITG equivalent to the loss allocation that could have been allocated to the biggest CM and a US settlement bank group if the group would not be in default. This can be assimilated by the default fund share of the clearing participant multiplied by the remaining USD 825m loss to be absorbed after deduction of the current SITG; or

ii. collecting additional wrong way risk contribution from the CMs that are in the same group as the US settlement banks. This additional reserve should be used only in case of the default of the group.

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6. Other Suggestions and Requests for Clarification

a. Eligible collateral

It would be helpful if CMs had the flexibility to meet the 2am margin call in UST. ASX could also look to include JGB's to the list of collateral that can be used as margin as these are liquid, particularly during early Asia trading hours.

We also request that ASX considers allowing CMs to ringfence non-cash collateral specifically to cover risk in the overnight session. It is recognized that there are liquidity concerns with posting non-cash collateral, so ASX's view on an upper limit for non-cash collateral would be appreciated.

b. Regular reporting of CM's' non-default loss liability related to US settlement bank default

To provide transparency and to enable CMs to monitor their liability, ASX should establish regular reporting of each member's estimated loss in case of the biggest settlement default. This reporting can use the allocation methodology as set up by ASX and updated at the same frequency of member's default fund contribution.

c. Investment Limits

The Consultation contemplates instances where the investment limits approved by ASX could be materially exceeded. This exposes ASX to a greater level of insolvency risk as the ASX CCPs will need to bear any losses beyond the investment limit.

The clearing margins and default funds posted by CMs will also be at risk if the ASX CCPs become insolvent as these are considered assets of ASXCLF and ASXCC according to the rulebook. It is therefore important to ensure that a robust limit control mechanism is in place for the protection of both ASX and the CMs.

d. Protection of USD

What protections are there for the USD funds placed with the settlement banks (e.g. ring-fencing, U.S. rules)? Any clarification on the protection of such funds would provide CMs a greater level of understanding and appreciation of the risks.

We welcome the opportunity to work with ASX to address these comments.

Please feel free to contact me at bherder@fia.org or TzeMin Yeo at tmyeo@fia.org should you wish to further discuss.

Yours

Bill Herder
Head of Asia-Pacific, FIA