ISDA Safe, Efficient Markets

ISDA response to Consultation Paper by the Council of Financial Regulators "Reassessing the Case for Central Clearing of Bonds and Repos in Australia"[1]

ISDA welcomes the opportunity to provide comments to the Council of Financial Regulators' (CFR) Consultation Paper on "Reassessing the Case for Central Clearing of Bonds and Repos in Australia" (the Consultation Paper). We welcome the consultative approach taken by the CFR on this matter, and welcome that the CFR is not proposing to consider the introduction of a clearing mandate as part of this consultation.

Costs and benefits

1. Have the potential benefits of central clearing the Australian bond and repo markets increased in recent years? What costs/benefits do you view as being the most relevant for consideration of central clearing in the Australian bond and repo markets?

The expansion of the Australian bond and repo markets (in terms of participants and liquidity) has meant that the benefits for market participants of being able to access, on a voluntary basis, a centrally cleared repo market have increased. This expansion is evidenced by a substantial growth in the size of the market and increased participation of non-resident investors, as shown in the Reserve Bank of Australia's (RBA) March 2023 Bulletin.[2] A voluntary centrally cleared bond and repo market would enhance the scalability of the market and provide additional benefits, which we detail further below. Voluntary central clearing would simplify the market structure and could yield other benefits, especially in times of stress. For example, the RBA's 2023 Bulletin estimated multilateral netting has the potential to lower settlement obligations by $60 billion per day.

Banks now play a greater role in Australian bond and repo markets. Our members have reported instances of "trapped liquidity", with some banks less inclined to lend via repo, because of exceeding counterparty limits and concentration limits. Having the option to centrally clear these transactions would help mitigate these issues, for instance through netting efficiencies.

A more robust, transparent and liquid repo market would also attract new participants and increase activity, and therefore improve market depth and liquidity, from new and existing participants.

While accounting changes have made bilateral settlement more efficient in terms of balance-sheet usage for cash transactions,[3] clearing can be more efficient in the use of banks' resources, and in operational terms, through a reduction in settlement fails and subsequent fails down a settlement chain, and the funding requirement associated with these fails and settlement chains. Overall, accessing central clearing on a voluntary basis in the Australian bond and repo markets would be an attractive option for financial institutions.

Notwithstanding the benefits of central clearing, we emphasize that the introduction of a clearing mandate would be premature, and welcome that the CFR is not considering introducing a clearing mandate at this stage. While acknowledging that the starting point for the Australian bond and repo market is very different from the US Treasury market, we would also recommend learning from the implementation of the US Treasury clearing market developments, as we believe the Australian

[1] Reassessing the Case for Central Clearing of Bonds and Repos in Australia (cfr.gov.au)
[2] Reassessing the Costs and Benefits of Centrally Clearing the Australian Bond Market | Bulletin – March 2023 | RBA
[3] Bank of England Staff Working Paper No. 1,026

bond and repo markets may benefit from observing the issues coming out of the US Treasury market transition.

In 2022, ISDA conducted a survey on the impact of increased clearing in the context of the US Treasury market.[4] The ISDA survey showed that there was a variety of views on whether increased clearing would materially improve the resilience and efficiency of cash Treasury securities and repos. While most respondents were generally supportive of clearing, there was little backing for broad clearing mandates, with warnings that it could result in some participants reducing their activity or withdrawing from the market, potentially reducing liquidity. While these conclusions were based on observations from the US Treasury market, they might also be relevant to bear in mind when considering the impact of central clearing in other markets, such as the Australian bond and repo markets.

In terms of the costs of central clearing of the Australian bond and repo markets, we agree with those outlined in the RBA's 2023 Bulletin, which include: paying fees to the CCP, meeting initial and variation margin payment obligations, and meeting default fund contributions. Our members would also add the costs arising from the initial onboarding and connectivity to the platform and the regulatory and compliance risk and potential additional reporting needs vis-à-vis the CCP.

Our members acknowledge that whilst the costs of clearing are high, these costs might be partially mitigated by netting and other efficiencies. As such, repo clearing can also appear to be a backup solution to access liquidity during times of a liquidity squeeze, rather than it being used to achieve best execution daily.

Participation and viability

2. What do you consider to be the minimum product scope and participation necessary to support effective central clearing in Australian bond and repo markets? Do you envisage any issues arising if a prospective CCP was to clear for a single segment of the market (e.g. bonds only or repos only)?

Where one CCP provides clearing services across different products instead of only a single segment of the market, there may be greater opportunities for cross- product margining, which reduce collateral needs.

At a minimum, the option to voluntarily centrally clear should focus on repos, as most of the benefits outlined in response to question 1 would accrue from clearing repos. Voluntarily clearing bonds would also help with the settlement flow. It can also improve efficiency from a liquidity perspective, where bonds and repo net.

Our members suggest that the product scope of a central clearing offer could include Australian Commonwealth Government Bonds, Semi-Governments, and Australian Commonwealth Treasury Bills. It could also include Australian dollar sovereign-supranational agencies, investment grade bonds or baskets at a later stage.

For central clearing of repos, participants should be able to trade specific bonds and/or general collateral baskets across standardized and customized term dates.

Participation is critical: for a CCP to be able to mitigate risk and for mutualization to work well, active participation, especially by the prominent players/dealers in the market would be necessary.

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[4] ISDA Publishes Results of Survey on Increased Clearing in US Treasury Market – International Swaps and Derivatives Association

3. Under what conditions would you participate in a bond and repo CCP if there was one servicing the Australian market?

As noted in response to question 2, active participation, especially by the prominent players/dealers in the market would be critical to get the benefits from voluntarily clearing at a bond and repo CCP servicing the Australian market.

Some of our large sell-side members noted that they would consider voluntarily clear inter-dealer repo flow if there was a repo CCP service available for the Australian market. They would also support client participation if that were their choice.[5] Some members on the buy-side noted that they would see repo clearing as a backup solution to access liquidity during times of liquidity squeeze, rather than it being used to achieve best execution daily, as noted in response to question 1.

In addition, because the AUD repo market is a term market, typically trading from overnight to 3-month tenor, ensuring the banks can match maturities and therefore benefit from balance sheet netting is an important consideration.

The liquidity at the CCP, client access models into the CCP, and the all-in costs of executing and clearing the repo transaction are all factors to be considered.

4. In your experience, including with bond and repo CCPs in other jurisdictions, are there likely to be material challenges faced by the Australian market in transitioning to a centrally cleared environment and how might these be overcome?

As noted by some respondents to the 2022 ISDA survey on US Treasury Clearing[6], transitioning to a mandated centrally cleared environment would be costly to the market, with additional legal, technological and operational costs associated with additional clearing. We would encourage the CFR to carefully weigh the costs against the benefits if ever expecting a transition to a centrally cleared environment, though we welcome the assurance in the CP that the CFR is not considering introducing a clearing mandate as of now.

Smaller banks may not have the resources to meet the minimum requirements initially. They may also only receive more minor netting benefits, such that centrally clearing may not be as attractive for them. However, given the composition of the market is concentrated in the top 10-15 participants, whether smaller banks participate or not would not dilute the overall benefits of having the option to voluntarily centrally clear Australian bond and repos markets.

Our members note that transitioning to a centrally cleared environment can be costly and would involve additional legal, technological enhancements and operational costs in implementing a CCP. However, our members also acknowledge that the benefits that would arise from central clearing, as set out in response to question 1.

Efficiency and resilience

5. What do you view as being material impediments, if any, to the safe and efficient operation of a bond and repo CCP in Australia? Please consider the effects of an extended disruption on your business (such as liquidity and risk management), as well as broader effects such as those related to financial stability and market confidence.

[5] We note that many CCPs clearing repos, do so in a hybrid "sponsored clearing" model.
[6] Brattle Report (isda.org)

While the outage of CCPs clearing derivatives would not immediately cause insurmountable problems, an outage of a CCP clearing repos (and to a lesser extent, bonds) could cause issues immediately, as especially repos are key tools in liquidity management of banks and other financial counterparties. The technology and controls underpinning the operations of a CCP clearing repos should therefore be particularly robust, upholding the highest standards set out in the CPMI-IOSCO Principles for Financial Market Infrastructures (PFMI)[7] with regards to CCP resilience, complemented by the CPMI-IOSCO Further Guidance on the PFMI[8], the CPMI-IOSCO guidance on cyber resilience[9], as well as in the additional guidance on FMI recovery[10].

Then, in addition to meeting the highest resilience and recovery standards, critical mass (in terms of participants), robust settlement processes and price liquidity are all required for an effective CCP to develop. Costs of clearing is also an important consideration to ensure that central clearing remains an attractive option.

6. How material are issues with settlement chains on the safety and efficiency of the Australian bond and repo markets? In your experience, what are the factors behind these issues? What steps, if any, should a prospective bond and repo CCP or its participants take to mitigate the risk of issues associated with settlement chains?

In its repo convention, the Association for Financial Markets in Australia states that *"it is incumbent on market participants necessary to mitigate settlement failure. In particular, and as a matter of best practice, the party contractually obliged to deliver securities is obliged to take the necessary steps to borrow stock immediately it becomes apparent that settlement failure is likely, and to initiate this process within a timeframe that avoids broader market disruptions and failures."*[11]

A CCP would net off trades prior to settlement, reducing the frequency of fails and the size of each fail. This could also improve market efficiency given bottlenecks in the settlement system generally occur later in the settlement day.

Given the concentration of the main market participants holding the greater share of the bond and repo market flow, it is not uncommon to have "circles/settlement chains". To break the circle, one counterparty needs to go to the market to cover the position. The cost of covering the position is not rebated. This leads banks to cover potential fails precautionarily, which comes at a cost. Having a CCP will help mitigate this issue.

In some jurisdictions, CCPs have access to central bank liquidity facilities, which can provide additional stability and liquidity in times of market stress.

7. Are there any aspects of the bond and repo markets that in your view are not functioning efficiently? For example, would enhanced transparency in bond and repo markets improve the efficiency of these markets?

As noted in relation to question 1, some banks appear to be less inclined to lend via repo in certain situations, because of exceeding counterparty and concentration limits.

[7] Principles for financial market infrastructures (bis.org)
[8] Resilience of central counterparties (CCPs): Further guidance on the PFMI (bis.org)
[9] Guidance on cyber resilience for financial market infrastructures (bis.org)
[10] Recovery of financial market infrastructures (bis.org)
[11] Reciprocal Purchase Agreements Conventions (afma.com.au)

8. What actions could regulators or industry take to improve the efficiency and/or resilience of the bond and repo markets, including to reduce information asymmetry and improve price and liquidity discovery?

As noted in the FSB report on liquidity in core government bond markets[12], the use of all-to-all trading platforms may be an avenue to provide investors with more options to access market liquidity.

Having said that, we propose that regulators undertake an analysis of how liquid each segment of Australians bonds is, especially off-the-run securities.

A CCP with broad market participation would help facilitate data collection on transactions, and so accelerate the development of the "Secured Overnight Funding Index Australia" (SOFIA™, currently in beta version).

Development of SOFIA™ as a potentially robust benchmark helps price discovery and promotes liquidity flow between funding products. An observable, market-determined repo reference rate serves as an anchor for other secured and unsecured transactions, allowing liquidity transfer to occur as a function of any pricing differentials. This is particularly important given some concerns about other existing reference rates as an indicator of market conditions, e.g. relatively low transaction volumes underpinning the unsecured overnight interbank loans market (IBOC), bank bill swap rates market (BBSW), and with RBA open market operations priced at fixed spread.

There might also be benefit for the regulator in having a robust, independent and observable measure of secured funding conditions to assess market health.

Location

9. Some other major jurisdictions have CCPs operating bond and repo clearing services in their domestic markets. What are your views on an overseas operator providing clearing services for the Australian bond and repo markets?

It is not uncommon for an overseas operator to provide clearing services related to non-domestic markets. As long as the overseas CCP is appropriately supervised and risk managed, there is no financial stability risks arising from relying on an overseas operator. Relying on an overseas operator might actually be the most economically viable choice, if this means that market participants benefit from greater risk mutualization and netting benefits.

Given the higher liquidity requirements for clearing of especially repos, where the full nominal amount has to be exchanged at both legs of the repo, it would however be helpful if CCPs clearing these products have access to the central bank, as a minimum to be able to pay in central bank money, but ideally also with access to emergency liquidity.

An overseas-based CCP would also need to be able to provide support and be fully contactable during the Australian trading hours.

10. Based on your experience, including in other jurisdictions and markets, what features of an overseas-based CCP could present difficulties or introduce risks in the Australian context? How are these challenges managed in other jurisdictions and are they managed successfully?

The recent Financial Market Infrastructure reforms which the Australian Treasury consulted on earlier this year are intended to result in the redistribution of various Ministerial powers to the Australian Securities and Investment Commission (ASIC) in relation to the supervision and licensing

[12] Liquidity in Core Government Bond Markets - Financial Stability Board (fsb.org)

of clearing and settlement facilities, in the spirit of streamlining the regime. We welcome the additional clarity provided in the draft legislation as regards' ASIC's powers in relation to the licensing regime for overseas clearing and settlement facilities providing services in Australia. The proposed 2-step approach to determine whether an overseas facility should be licensed or exempt from licensing in Australia, looking at 'step 1' connection to Australia and 'step 2' materiality of the connection, seems sensible. We would encourage ASIC to adopt a proportionate and deferential approach, in line with IOSCO's good practices on deference.[13]

In light of this, to the extent that the overseas CCP has gone through ASIC licensing regime, there should not be any issues or additional risks from relying on an overseas CCP.

Adequate cooperation between authorities across jurisdiction and appropriate deference to home authorities should ensure that any challenges that may arise from relying on an overseas CCP are addressed.

11. With the increasing internationalisation of Australian bond and repo markets, do you consider it desirable for a potential bond and repo service to have effective links to trading and settlement services, including international central securities depositories?

Having the ability to settle in different depositories/locations (i.e. different international central securities depository (ICSD) and global custodians) is useful for participants to consolidate settlement services and ensure that the settlement services create operational efficiencies, enable collateral mobility, facilitate broader access and support end-to-end risk management. While balance sheet netting rules will normally require settlement to take place in the same depository[14], a wider choice of settlement venues would enable centralization of efficient collateral management for both Australian participants as well as international participants who connect to ICSDs or global custodians.

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 77 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.

[13] FR06/2020 Good Practices on Processes for Deference (iosco.org)

[14] Balance-sheet netting rules could be different and open to interpretation across jurisdictions as well as across different counterparties.