

Repo Central Clearing Consultation
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Dear Sirs,

CENTRAL CLEARING OF REPOS IN AUSTRALIA

This letter provides the submission of LCH.Clearnet Group Ltd ("LCH.Clearnet") to the RBA's Consultation on the central clearing of repos in Australia.

The LCH.Clearnet Group is one of the world's leading clearing house groups, which services major international exchanges and platforms, as well as a range of over-the-counter ("OTC") markets. It clears a broad range of asset classes including bonds, repos, cash equities, exchange traded derivatives, commodities, energy, freight, interest rate swaps, credit default swaps, and foreign exchange derivatives. The Group's central clearing counterparties ("CCPs") have over 190 clearing members and over 600 clients across 22 countries.

LCH.Clearnet Ltd was the first non-Australian CCP to be granted an Australian Clearing and Settlement Facility Licence and is currently providing clearing services for OTC interest rate swaps ("IRS") to a number of major Authorised Deposit-taking Institutions through its SwapClear service. LCH.Clearnet Ltd is also licenced in Australia to clear for the FEX commodities and energy exchange. LCH.Clearnet Ltd is supervised directly by both ASIC and the RBA. In addition to its Australian licence, LCH.Clearnet Ltd is regulated in the EU, Norway, Switzerland, the US, Singapore, Quebec and Ontario. LCH.Clearnet SA is regulated in the EU and the US. LCH.Clearnet LLC is regulated in the US, and has applied for recognition in the EU.

LCH.Clearnet has many years' experience in providing competitive clearing services in Europe in a multi-currency, multi-platform, multi-market, multi-CCP environment. This has brought significant benefits to market users while maintaining the highest prudential standards. Our service and experience is described below, following which we answer the RBA's questions.

LCH.Clearnet's bond and repo clearing services

Table 3 in the Consultation document provides a good overview of the repo

services provided by LCH.Clearnet Ltd and LCH.Clearnet SA. These services both started in 1999 and now clear cash bond and repo trades executed on the BrokerTec, MTS and tpREPO venues, and, additionally, bilaterally-traded and voice-brokered trades are matched and routed to clearing via Euroclear's ETCMS matching tool

LCH.Clearnet's bond and repo services clear bonds, and repos of bonds issued in 13 different countries and settlement is enabled in 8 separate CSDs and ICSDs. In 2014 the service cleared €147 trillion nominal of business. The clearing services are trading platform-neutral, with the same user access criteria and tariff applied in relation to trades executed on all venues. Trades for all venues are incorporated into a single margin process within a market segment at each CCP enabling collateral efficiencies, and there is full settlement netting offered across trades executed on all venues.

Structure and Governance of LCH.Clearnet's bond and repo clearing services

LCH.Clearnet's bond and repo clearing services are platform-neutral i.e. no favourable treatment is afforded to any venue operator by virtue of any shareholding or other relationship with LCH.Clearnet. Access by new venues, and product and service enhancement initiatives for existing venues, are assessed by LCH.Clearnet with primary reference to the expected benefits to the service and to users, as well as revenue economics and commercial viability of the desired product or venue enhancements.

To help manage and prioritise initiatives there is a two step process:

- i) All proposed enhancements are reviewed in Quarterly Product Advisory Groups which are constituted of Clearing Members and the major trade platforms. PAG members are requested to assist in the prioritisation of initiatives to help determine the bond and repo product development schedule.
- ii) All proposed enhancements are subject to the same LCH.Clearnet New Product Approval Process and LCH.Clearnet Risk Governance approval as required. Decisions on new products are scrutinised for their risk impact and costs and benefits.

Repo Clearing in Australia

LCH.Clearnet believes that the introduction of clearing for repos would be likely to offer significant efficiencies to the Australian market. In principle, LCH.Clearnet may be interested in offering a repo clearing service for the Australian market but only if there were a positive business case; this would depend on the level of support from both Australian and international repo dealers, the cost of adaptation to, and operation in, the Australian market and, crucially, the ability to provide it under an overseas licence.

As the world's largest open, horizontal CCP, LCH.Clearnet can bring new expertise, experience and connectivity to Australia's financial markets. Recent adoption of

the LCH.Clearnet SwapClear platform is evidence of the confidence Australian banks and their clients have in LCH.Clearnet's risk management. Membership enables them to gain direct access to global liquidity pools in all major currencies, realise optimal netting efficiencies and enjoy value-added services such as trade compression. Where we have provided clearing services elsewhere, these have been followed by lower charges, faster innovation and enhanced capacity.

Our belief is that the Australian government wants to ensure that its markets are open. However, we believe that the requirement that a CCP must be an Australian incorporated entity if it provides services which are considered to be "systemically important" with a "strong domestic connection" in Australia – e.g. repo clearing – has the effect of creating a barrier to market entry, stifling competition and preventing the realisation of potential efficiency gains. The costs inherent in establishing a new CCP, including the requirement to put in place its default/guarantee fund, and the loss of potential collateral efficiencies that would be available if the CCP was also clearing repos on other (international) markets, would in our view make the venture commercially unviable.

The first EU Commission equivalence decision on CCPs in October 2014 included Australia. Under this arrangement it is possible for Australian-domiciled CCPs, subject to their home regulation and supervision, to apply for recognition to offer clearing services to EU clearing members. This analysis was conducted on an outcomes-based assessment and the principle of equivalence in regulatory regimes would provide, in return, the ability of EU CCPs to provide clearing services to Australian members without the need for local incorporation. LCH.Clearnet believes that the RBA's review of consultation responses should conclude that the EU's equivalence assessment should be developed so that EU CCPs can offer cash bond and repo clearing in Australia.

LCH.Clearnet has demonstrated a strong commitment and willingness to adhere to the high standards of Australia's clearing regulatory regime without being domestically incorporated. Through the license LCH.Clearnet Ltd holds in relation to the FEX and SwapClear services, we are subject to the RBA's Financial Stability Standards in addition to ASIC's requirements. We have also demonstrated our commitment to Australia in practical ways by setting up a local office, joining the local payments and securities settlement infrastructures, increasing our staff presence, and establishing a local User Group.

The recent Financial Systems Inquiry stated that policy settings in the Australian financial system "do not focus on the benefits of competition and innovation'. We believe that the right balance between stability and competition could be achieved by allowing a strong, locally-regulated though foreign-incorporated CCP to offer repo clearing services in Australia. That is contingent on the Australian regulators being satisfied with the home oversight and risk management regimes, as has already been proven and implemented in OTC derivative markets, and the agreement of cross-border resolution arrangements. We are aware that the Australian authorities have cooperation arrangements with at least the

UK authorities, the European Securities and Markets Authority (“ESMA”¹), and the CFTC² and also that the RBA is a member of the supervisory college established for the oversight of LCH.Clearnet’s SwapClear service. We would welcome the opportunity to discuss how these arrangements could be enhanced, if it was helpful to the RBA.

We now address the RBA’s specific questions.

Consultation Questions – Overview

Q1. Do you believe the availability of a repo CCP in Australia could improve 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? Why/Why not?

Yes, we believe a well managed CCP would improve the functioning of the Australian repo market. Such CCP would set up a rigorous and best-practice risk management framework that should include initial margin (having the same effect as haircuts in the bilateral market), variation margin based on at least daily marking-to-market, and the management of concentration risk, sovereign risk and wrong way risk. Wrong-way risk can be a significant issue in repo markets and a CCP that has a wide user base and accepts a wide range of securities as margin collateral can facilitate mitigation of this risk. Additional risk protection to participants would be provided through a mutualised default fund and a formalised default management process that would reduce the disruption arising from the close-out process that would follow a participant’s insolvency.

In addition there would be a number of second-order beneficial effects resulting from the use of a CCP. These would include increased market liquidity through anonymous trading and more efficient management of participants’ balance sheet and capital; and the rigorous management of counterparty risk would add confidence during times of market stress and would support market liquidity during a crisis.

Q2. Would you use a repo CCP if there was such a CCP in the Australian market? Why/why not?

Not applicable.

Q3. If a repo CCP is desirable, what should be its instrument scope? For example, clearing of repos against general collateral only; or both general collateral and specific collateral? And should it also clear outright purchases/sales of debt securities?

¹ <http://www.esma.europa.eu/content/ESMA-ASIC-RBA-MOU-European-central-counterparties>

² <http://www.cftc.gov/ucm/groups/public/@internationalaffairs/documents/file/cftc-rba-asic-clearingmou06051.pdf>

A repo CCP can provide more benefit to the market if it clears the majority of bond and transaction types, so long as they are liquid enough that the CCP's default-management processes can be implemented successfully. It should therefore clear repo both in specific collateral and GC baskets, and it should also clear outright purchases and sales. This capability is particularly useful in default management where outright purchase of bonds can be the best way to hedge a position prior to auction.

Q4. If a repo CCP is desirable, what additional services should it provide in order to maximise the net benefits of central clearing? For example, auto-collateralisation through a centralised collateral management service, substitution or re-use of collateral, novation of both legs of the repo, (anonymous) trading on an electronic platform?

For a repo CCP to be fully efficient and effective, it should offer the greatest netting potential possible. Important considerations include the maximum number of suitable ISINs to be cleared (e.g. government, quasi-government and agencies) and the widest range of clearing participants under prudent access criteria. Both legs, opening and closing, of the repo should be cleared and input into the daily netting process. Both anonymous trading and voice-brokered trading should be supported on a wide range of venues. The CCP should settle bonds in a CSD or CSDs that are able to provide the widest possible range of settlement and collateral management services.

Q5. To what extent is non-centrally cleared repo trading constrained by counterparty credit concerns? Have such concerns increased in recent years? Is activity typically more constrained during periods of high market volatility?

This is a primarily a question for market users, but we would like to offer comments from the perspective of a CCP. Clearing offers various benefits:

- The management of bilateral credit lines is minimised/avoided when business is centrally cleared;
- A CCP member can trade with a wider range of possible counterparties than would be the case bilaterally, and the multilateral netting of exposures through the CCP increases efficiency; and
- The benefit of central counterparty clearing is particularly strong during times of market stress. LCH.Clearnet's experience is that dealers often seek to avoid trading bilaterally during stressed periods.

Q6. Do you believe that it would be commercially viable for a CCP to offer a repo clearing service in Australia? Why/why not?

The relatively low volume of the Australian bond and repo market (when compared with markets that support repo clearing as shown in Table 3 of the Consultation paper coupled with the high level of investment required to develop and operate a repo CCP

means that it would be a challenge for an existing repo CCP to operate a commercially viable service if was done on a standalone basis, i.e. incorporating domestically in Australia. Moreover, the full potential benefits for the market would only be realised if non-domestic members joined it. It is unlikely that a domestic CCP offering would be attractive for non-domestic dealers, as it would be expensive for them to clear directly and an indirect route would not in our view be viable.

It should however be possible for a CCP to offer a commercially viable repo service if it already has a repo clearing service, is able to leverage its existing infrastructure to the maximum extent possible, has a wide range of clearing participants, and can offer settlement in a choice of a domestic CSD or ICSDs.

Q7. Are there alternatives to CCP clearing that would improve 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? If so, please explain.

The risk management benefits of a CCP are fundamental and ensure an adherence by all market counterparties to best practice operational and risk management routines. The confidence that a credible repo CCP brings should support continuous funding and liquidity even during periods of market stress. We do not see that these benefits could arise from any alternative structure.

Q8. Would there be any material impediments to the safe and efficient operation of a repo CCP in Australia? Are there likely to be aspects of a CCP's design that could not readily accommodate Australian repo market practices? Would there be likely to be material challenges in transition to a centrally cleared environment?

We are not aware of, and cannot envisage any, particular impediments to the safe and efficient operation of a repo CCP in Australia. The transition to a centrally cleared model is proven in various other markets so no material issues are envisaged in transitioning the Australian market to a CCP model. Any CCP would need to have fully reliable sources of liquidity in the event of a default, and would seek appropriate facilities from the RBA.

A CCP clearing Australian repos might well also want to clear additional (foreign) repo markets if such a service was permitted by relevant authorities. A non-Australian CCP would most likely prefer to clear Australian repo trades in its own jurisdiction (but we note the RBA's expectation that that would not be feasible) and/or to be able to settle the trades in an international settlement location e.g. Euroclear as well as in Austraclear.

Consultation Questions – Access

Q9. To what extent would you expect a repo CCP's participation requirements to affect some participants' access to clearing? Are there particular types of repo

market participant that you believe would have difficulties in accessing central clearing, either as a direct participant or as a client?

As in the case of clearing for other asset classes, objective membership criteria that include, *inter alia*, appropriate minimum capital and operational competence requirements, would be an important risk management tool. Any counterparty that wishes to be a clearing member of a CCP will, in the majority of cases, need to be prepared to contribute to a mutualised default fund. There are some types of buy-side organisations, e.g. pension/superannuation funds, that are unlikely to be permitted to contribute to a mutualised default fund arrangement.

In repo clearing, a typical GCM/NCM model as seen in exchanges is unlikely to be commercially viable for the GCM because the balance sheet burden on the GCM would be prohibitive.

Q10. If there were a repo CCP in Australia, would you expect there to be demand from buy-side clients to centrally clear their repo transactions with dealers? Why/why not?

There may be demand from large buy-side firms to utilise a repo CCP because they would be interested in the risk management benefits offered by a CCP. In addition, large buy-side firms would have an interest in supporting their dealer counterparties by clearing trades through a repo CCP where possible to enable the dealer to net the buy-side trade with other trades within the CCP. An increase in the netting available to dealers may incentivise dealers to provide more liquidity to buy-side counterparties.

Q11. Are there alternative models for access to CCPs that you believe would address concerns about smaller institutions' access to central clearing?

LCH.Clearnet is in the process of developing possible alternative models that would provide for smaller institutions gaining access to its service in Europe

Q12. To what extent would you expect a CCP's position limits to restrict activity in the Australian repo market?

A CCP's position limits are likely to be linked to its view on concentration risk, either at the market level or at the specific ISIN level. Concentration risk would be determined after consideration of the issue size of the market and of individual bonds and the liquidity of the market in the relevant bonds.

Consultation Questions – Counterparty Credit Risk

Q13. To what extent is there scope to reduce the size of counterparty credit exposures in Australian interdealer repos through multilateral netting? What

proportion of market activity is contributed by participant types with primarily one-way transactions?

It is not possible for us to estimate the reduction in counterparty credit exposure without an understanding of the current pattern of market exposure amongst Australian market participants. However, if all participants use a CCP for all repo and bond business, then the reduction in credit exposure would be the sum of the difference between a participant's gross bilateral exposures and their overall net exposure. The major repo dealers tend to have two-way flow in repo. Smaller dealers and buy-side firms are, we believe, primarily directional in nature.

Q14. To what extent would clearing interdealer repos reduce the regulatory capital banks are required to hold against such exposures, including under the proposed leverage ratio? And in the absence of central clearing, to what extent would you expect some participants' repo market activity to be affected by the BCBS large exposures framework?

Netting by banks for the purposes of capital requirements (including the Leverage Ratio) is permitted if the conditions for netting e.g. same counterparty, same currency, same settlement date etc, are satisfied. Trades that are eligible to be netted serve to impact the size of the exposure that the capital is applied to. If a bank does not have offsetting trades that adhere to the netting rules then no netting is permitted.

The BCBS large exposure framework is a pragmatic regulatory response to the important issue of the need for counterparties to manage concentration risk. Absent a CCP, bilateral counterparties must ensure that the sum of all the exposure values of a bank to a single counterparty or to a group of connected counterparties must not be higher than 25% of the bank's available eligible capital base at all times.

Q15. To what extent would a CCP strengthen processes for margining and collateral valuation in the interdealer repo market, relative to existing bilateral arrangements?

A well managed repo CCP naturally adheres to industry best practice in terms of risk management. All CCP cleared business is subject to margin and regular marking-to-market, while in contrast the FSB Report on Shadow Banking highlights that a proportion of bilateral repo business is not subject to margin.

Q16. Overall, to what extent would you expect central clearing to deliver collateral efficiencies?

CCP clearing of repo provides two types of collateral efficiency:

- The ability to net all settlements in a specific ISIN each day into a single net deliver or receive obligation; and

- By managing risk on a multilateral basis, the amount of margin, in the form of cash or non-cash collateral that a CCP would apply, should be less than the sum of the bilateral exposures that a dealer would otherwise maintain.

Q17. Would you perceive a significant benefit from a CCP coordinating the management of the default of a repo market participant? Why/why not?

Managing the close-out of a defaulting member's portfolios is complex and requires skill and experience. An experienced and well managed repo CCP, in conjunction with an expert Default Management Group comprised of expert staff from dealer firms, will close out the net open position of the defaulting counterparty in a more coordinated and controlled way than would be achieved by multiple bilateral counterparties seeking to close out their bilateral positions in an uncoordinated way. This can help to avoid a 'fire-sale', where competing counterparties attempt to close out positions simultaneously.

Consultation Questions – Operational Efficiencies

Q18. To what extent are repo trades processed in a straight-through manner? Are there particular aspects of processing repos that require material manual intervention?

In the bilateral market repos are not typically processed in a straight-through manner. Some individual counterparties may have high levels of automation within their internal environment but even then, an amount of manual intervention is often required. LCH.Clearnet's repo CCP services have a comprehensive STP structure. There are no points in the process of matching, clearing and settling a trade that require manual intervention.

Q19. Would central clearing of such trades encourage more trading on electronic platforms? Why/why not?

A robust CCP that is supported by the major repo counterparties and maintains full STP and an ability to receive trades from electronic platforms on an anonymous basis would in all likelihood contribute to an increase in the amount of trading that is executed electronically.

Q20. To what extent do you see benefit in auto-collateralisation of repos through a centralised collateral management service such as ASX Collateral? How would you expect central clearing of repos to affect the use of such a service?

Market participants are increasingly keen for efficient methods to be developed to help them manage their collateral. The wider use of cash and non-cash collateral to support bilateral and CCP exposures, including repo exposures, will drive further innovation in this area. Collateral management services are separate from but complementary to repo activity

Q21. Overall, to what extent would you expect central clearing of repos to encourage greater automation and operational efficiencies in the Australian repo market? Are there other mechanisms that might be equally effective in encouraging such efficiencies?

The utilisation of a repo CCP by Australian market counterparties would represent a step-change improvement in the level of automation and operational efficiency. We are not aware of any other mechanisms that would provide such a fundamental combination of benefits.

Consultation Questions – Settlement Arrangements

Q22. Do you agree that settlement issues arising from chains of trades are unlikely to cause problems in the current market? And do you agree that settlement issues would not be an impediment to the effective functioning of a repo CCP? If not, why not?

Settlement chains are a feature of all securities markets. The best way to minimise the impact of settlement chains is to reduce the amount of bonds that are physically settled. This is achieved by a CCP netting the settlement obligations prior to settlement. For the settlement that does occur, the following points are important:

- Settlement shapes are utilised to improve settlement efficiency. LCH.Clearnet applies shaping to all of its cleared repo markets;
- Credit lines operated by settlement counterparties should be of sufficient size to support large amounts of settlement activity; and
- The settlement algorithm at the CSD must be efficient and maximise the amount of settlement that can be achieved.

Q23. Do you see benefit in settlement netting by line of security? Do you believe that ‘shaping’ of settlement obligations would be beneficial in the settlement of repos in Australia? Why/why not?

Netting by individual line of security prior to settlement is important because it reduces the operational risk and financial resources in terms of credit line required to support settlement. This has the effect of increasing overall settlement performance. As noted above, shaping is an especially important factor when settling high value settlement amounts. Without shaping, large individual settlements can be left unsettled within a settlement cycle until such time that all of the required amount is available to be delivered. This creates challenges for the settlement system as a whole and would require larger credit lines to be operated by market counterparties.

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We hope that the RBA finds this submission useful and we look forward to engaging further as policies are developed. Please do not hesitate to contact me at

rory.cunningham@lchclearnet.com regarding any questions raised by this letter or to discuss these comments in greater detail.

Yours faithfully



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