

# New Financial Stability Standards: Final Standards and Regulation Impact Statement

DECEMBER 2012

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# 1. Introduction

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In accordance with powers under the *Corporations Act 2001* (the Act), the Reserve Bank has consulted on a proposal to determine new *Financial Stability Standards* (FSSs) for central counterparties (CCPs) and for securities settlement facilities (SSFs), in place of previously determined FSSs. The FSSs 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's proposal follows the development by the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO) of new international standards for the regulation and conduct of CS facilities and other financial market infrastructures (FMIs), the *Principles for Financial Market Infrastructures* (the Principles).<sup>1</sup> 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.

In light of these developments, and feedback from stakeholders during the consultation process, the Reserve Bank's Payments System Board decided at its November meeting that new FSSs should be determined, reflecting the detailed requirements of the Principles. While aligning with the Principles, the Board determined that the new FSSs should also: uphold the standards to which licensed CS facilities are held under the current FSSs; reflect selected standards applied to CS facilities in other relevant jurisdictions; and 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. In line with this decision, the Bank will revoke the previously determined FSSs, and determine new FSSs for both CCPs and SSFs.

The Bank is also issuing guidance to assist in the interpretation and application of the new FSSs, and on its approach to assessing licensed CS facilities' compliance with the new standards. In particular, in assessing a licensed overseas facility subject to sufficiently equivalent regulation in its principal place of business, the Bank will place conditional reliance on information and reports from the regulator in the facility's home jurisdiction.

The Bank's new FSSs are complemented by the Australian Securities and Investment Commission's (ASIC's) consultation on revised regulatory guidance regarding its oversight of CS facilities, which proposes to adopt the Principles and the Council's framework for ensuring that Australian regulators have appropriate influence over cross-border CS facilities within ASIC's regulatory mandate.<sup>2</sup>

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1 See CPSS-IOSCO (2012), *Principles for Financial Market Infrastructures*, CPSS Publications No 101, Bank for International Settlements, April, available at <<http://www.bis.org/publ/cpss101.htm>>.

2 ASIC's consultation paper on revising *Regulatory Guide 211* is available at <[http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cp186-published-11-September-2012.pdf/\\$file/cp186-published-11-September-2012.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cp186-published-11-September-2012.pdf/$file/cp186-published-11-September-2012.pdf)>.

This document is structured as follows. Section 2 discusses recent international and domestic developments in the regulation and conduct of CS facilities. Section 3 discusses the draft FSSs released for consultation in August 2012, while Section 4 discusses comments received through the consultation process. Section 5 sets out the changes adopted in the final FSSs in response to consultation. Section 6 sets out the details of implementation and arrangements for CS facilities to seek transitional relief. The Regulation Impact Statement considered by the Bank's Payments System Board is set out in Attachment 1, the new FSSs and associated guidance are set out in detail in Attachments 2 to 5, and guidance on the Bank's assessment approach is set out in Attachment 6.

## 2. Background and Recent Developments

### 2.1 The Current Financial Stability Standards

The Bank has the power, under section 827D(1) of the Act, 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. In accordance with this power, the Bank determined FSSs for licensed CS facilities 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 FSSs apply to four licensed CS facilities: the FSS for CCPs to ASX Clear Pty Limited (ASX Clear) and ASX Clear (Futures) Pty Limited (ASX Clear (Futures)); and the FSS for SSFs to ASX Settlement Pty Limited (ASX Settlement) and Austraclear Limited (Austraclear).

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>3</sup>

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.

<sup>3</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 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>4</sup> Neither the minimum measures nor the guidance create directly binding obligations for CS facility licensees. It is only at the level of the FSSs themselves that legally enforceable obligations are placed on licensees, although the minimum measures and guidance may be relevant considerations in determining whether a CS facility licensee has met its obligations.

In addition to these minimum measures, the Bank has also applied or considered a number of additional specific requirements in its oversight of currently licensed CS facilities. In part these requirements reflect the Bank's further interpretation of what a CS facility must do in order to reduce systemic risk in complying with the applicable current FSS, and the other requirements of the Act.

The Bank assesses each CS facility licensee against the FSS relevant to its facility type, and its broader obligation to reduce systemic risk under the Act on an ongoing basis, reporting its findings annually to the Minister with portfolio responsibility for financial markets, and to ASIC. These assessments are also released publicly.

## 2.2 Changes to International Standards

In April 2012, CPSS and IOSCO released the Principles – 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 Principles update, replace and synthesise three previous sets of recommendations and principles published by CPSS and IOSCO with respect to particular types of FMI – payments 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 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.
- *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>

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

5 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>>.

6 Customers of clearing participants can also be referred to as clients.

- *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's.
- *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 FMI's; general business risk; tiered participation; and disclosure of rules, procedures and data. In these areas, the Principles also enhance or establish more specific requirements for FMI's than those explicitly contemplated under the existing FSS measures, which are largely aligned with the previous international standards.

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

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

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

In Australia, ASIC and the Bank share responsibility for the oversight of FMI's. Consistent with the five key responsibilities set out in the Principles, ASIC has consulted on a proposal to revise its regulatory guidance in order to adopt the Principles in its oversight of CS facilities.<sup>7</sup> The Bank's response to the Principles is set out later in this paper.

Authorities in other jurisdictions have also taken steps to adopt the Principles in their oversight of FMI's, and in some cases have incorporated additional requirements that go beyond the minimum international standards set out in the Principles. For example, the European Securities and Markets Authority's (ESMA's) Draft Technical Standards incorporate additional measures, including governance measures addressing management compensation, requirements for internal audit and external review of operations, processes and controls, and intragroup conflict-of-interest arrangements.<sup>8</sup>

<sup>7</sup> ASIC's consultation paper on revising *Regulatory Guide 211* is available at <[http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cp186-published-11-September-2012.pdf/\\$file/cp186-published-11-September-2012.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cp186-published-11-September-2012.pdf/$file/cp186-published-11-September-2012.pdf)>.

<sup>8</sup> See European Securities and Markets Authority (2012), *Draft Technical Standards under the Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC Derivatives, CCPs and Trade Repositories*, Final Report, ESMA/2012/600, September, available at <<http://www.esma.europa.eu/content/Draft-technical-standards-under-Regulation-EU-No-6482012-European-Parliament-and-Council-4-J>>.

## 2.3 Reforms to Financial Market Infrastructure Regulation

In April 2011, the Deputy Prime Minister and Treasurer commissioned the Council to conduct a review of the Australian regulatory framework for FMIs. The need to undertake this review was highlighted in the course of Council agencies' consideration of the proposed takeover of ASX Limited (ASX) by Singapore Exchange Limited (SGX). The review identified a number of areas in which regulation of FMIs could be strengthened, including additional means of exerting regulatory influence over cross-border clearing and settlement facilities, and the development of a resolution regime for FMIs.<sup>9</sup> Possible changes to legislation addressing these and other issues identified in the Council's review are being considered by Treasury.

### Regulatory influence over cross-border clearing and settlement facilities

While each current CS facility licensee is incorporated and based in Australia, recent developments have raised the prospect of licensed CS facilities operating with a cross-border element – either because they are based overseas or have established or are contemplating cross-border outsourcing arrangements. Greater use of cross-border financial market infrastructures may arise from measures to control risks associated with over-the-counter (OTC) derivatives. The Council is also conducting a consultation into the potential for competition – including from infrastructure based overseas – in the clearing of cash equities.<sup>10</sup> Domestic CS facilities could also, in the future, wish to move aspects of their operations offshore in seeking opportunities to reduce costs, or become subject to a takeover proposal that would see them governed by a holding company based overseas, as was envisioned in the proposed SGX takeover of ASX.

In response to these developments, 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. 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.<sup>11</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 was proposed by the Council that the FSSs be the principal means for implementing the stability relevant measures within the framework. These measures are designed to ensure that cross-border CS facilities have a 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.

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9 The Council's recommendations from its review of the regulatory framework for FMIs are set out in a letter to the Deputy Prime Minister and Treasurer, 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)>.

10 The Council's consultation paper on competition in the clearing and settlement of the Australian cash equity market is available at <<http://www.treasury.gov.au/ConsultationsandReviews/Submissions/2012/Competition-in-the-clearing-and-settlement-of-the-Australian-cash-equity-market>>.

11 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>>.



## Financial market infrastructure resolution

The Council's consideration of the proposed SGX takeover of ASX highlighted the difficulties that might be faced by Australian regulators in ensuring the continuity of systemically important FMI services in a crisis or circumstances of FMI distress, if these services were operated or controlled overseas. The Council also identified broader concerns regarding how continuity of systemically important FMI services could be assured in a crisis, or in the event that an FMI suffered financial or operational distress, irrespective of the location of the FMI or its operations. These issues have also been considered in international work on the recovery and resolution of distressed FMIs currently being undertaken by CPSS and IOSCO.<sup>12</sup>

The Council identified a range of powers that could assist regulators in managing a situation of FMI distress. These include enhanced powers for regulators to direct FMIs to take actions to remedy or mitigate the source of distress. Where directions or other crisis-management tools proved insufficient, the Council also recommended a legislative power for regulators to 'step in' to operate a distressed FMI, by appointing a statutory manager to the FMI. The Council has identified the FSSs as potential means of imposing requirements that would support the use of such a power and enhance its effectiveness.

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<sup>12</sup> 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/cpss103.htm>>.

## 3. The Draft Financial Stability Standards

In response to the developments described in Section 2, the Bank published draft FSSs on 29 August 2012 comprising requirements that:

- fully align with the requirements of the Principles that address matters relevant to financial stability
- complement the requirements of the Principles, where 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
- implement the key elements of the Council's framework for ensuring regulatory influence over cross-border CS facilities.

These requirements were contained in a set of detailed standards and sub-standards that reflected the structure of the Principles and associated key considerations.<sup>13</sup> The draft FSSs comprised 21 standards for CCPs and 19 standards for SSFs, each with one or more accompanying sub-standards. The draft guidance adopted the language of the explanatory notes that accompany the Principles and key considerations, adjusted to reflect the type of CS facility, the Australian regulatory and institutional context, and other relevant factors such as the Council's framework for ensuring regulatory influence over cross-border CS facilities.

### 3.1 Aligning the Financial Stability Standards with the Principles

In order to ensure that licensed CS facilities in Australia appropriately control the risks they pose to the Australian financial system, in accordance with emerging international best practice, the draft FSSs were aligned with relevant parts of the Principles. This Section sets out some of the main areas in which this alignment enhances the measures associated with the existing FSSs. Unless otherwise stated, the changes described apply both to the draft FSSs for CCPs and the draft FSSs for SSFs.

#### Legal and governance

The draft FSSs set out requirements that the board of a CS facility licensee take into account participant and stakeholder interests, and pursue objectives that explicitly support financial stability and other relevant public interest considerations (CCP and SSF Standard 2). The draft FSSs also add more granular and explicit requirements for governance structures.<sup>14</sup> These address the role, composition and skills of a CS facility licensee's board and

<sup>13</sup> A document setting out marked-up differences between the Principles and the new FSSs will be made available at <<http://www.rba.gov.au/payments-system/clearing-settlement/standards/201212-new-fss-ris/index.html>> by end 2012. A high-level mapping of the Principles to the current and new FSSs is set out in Table 1 of the Consultation Paper on the draft FSSs, available at <<http://www.rba.gov.au/payments-system/clearing-settlement/consultations/201208-new-fin-stability-standards/index.html>>.

<sup>14</sup> There is no specific governance measure accompanying the current FSS for SSFs.

management, documentation of lines of responsibility and accountability, and governance arrangements associated with risk management and internal controls.

## **Risk controls**

In aligning with the Principles, the draft FSSs enhance risk controls for CS facilities, particularly in relation to credit and liquidity risks. The draft FSSs require licensed CS facilities to explicitly adopt a comprehensive risk management framework to govern their risk controls (CCP and SSF Standard 3). As part of this framework, licensed CS facilities are required to plan for their recovery or orderly wind-down in scenarios where they are no longer able to operate as a going concern, providing a credible plan for the continuity of service provision by the facility or adequate time for participants to transition to alternative arrangements.

The draft FSSs also enhance requirements for licensed CS facilities to hold financial resources to cover credit and liquidity risks. CCP Standard 4 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. Additional coverage is required for CCPs that clear complex products or that are systemically important in multiple jurisdictions. CCP Standard 4 also adds more specific requirements for CCP stress testing, while CCP Standard 6 adds more explicit and detailed requirements for CCPs to collect margin from participants for all product types, including cash equities.

CCP Standard 7 and SSF Standard 6 introduce enhanced controls for licensed CS facilities to address liquidity risks, including specific requirements for a CCP to be able to meet its payment obligations on the intended settlement date in the event of a participant default. CCP and SSF Standard 5 also incorporates strengthened requirements around collateral eligibility criteria and collateral management, including more specific requirements for collateral eligibility and managing residual risks from collateral assets through haircuts and concentration limits.

For SSFs, the draft FSSs introduce financial risk control requirements that are not contemplated in the current FSS measures. At the time the current measures were developed it was not envisaged that SSFs operating in Australia would assume 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, the draft SSF Standards set out controls for circumstances in which an SSF did assume such risk.

## **Settlement**

CCP Standard 8 and SSF Standard 7 add more specific requirements regarding the timeliness of settlement and settlement finality for licensed CS facilities. In most cases they additionally require facilities to offer settlement finality intraday or in real time. CCP Standard 10 sets out expectations for the management of risks associated with the storage and delivery of physical instruments or commodities.

## **Default arrangements**

The draft FSSs introduce more explicit requirements for a licensed CS facility to have in place rules and arrangements to deal with a participant default. 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. This is complemented by a requirement that SSFs operating a central securities depository should operationally support segregation and portability (SSF Standard 9).

CCP Standard 12 and SSF Standard 11 also require 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**

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. This includes 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.

Licensed CS facilities would also 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 (CCP Standard 15 and SSF Standard 13).

### **Operational risks**

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 arising from interdependencies with third parties. More specific business continuity requirements aim to ensure completion of settlement by the end of the day of disruption. Licensed CS facilities would also be required to manage the risks that participants, other FMI, or service providers pose to their operations, including in relation to outsourcing arrangements.

### **Participation, access and links**

The draft FSSs give greater attention to the potential risks faced by a CS facility arising from tiered participation arrangements and links to other FMI. 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 participants' or the facility's transactions. 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 FMI.

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

The draft 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 CS facilities must do in order to reduce systemic risk in complying with the current FSSs and the other requirements of the Act. Retention of these requirements is intended to ensure that licensed CS facilities adopt risk controls that are appropriately tailored to their role in the Australian financial system.

The key requirements retained from the current FSS measures and the Bank's broader oversight of CS facilities include:

- a requirement that CS facility licensees are legally separate from other entities carrying out unrelated activities (CCP and SSF Standard 1.1)

- requirements for CCPs to monitor and manage their exposures intraday and to receive and review timely and accurate information on participants' credit standing (CCP Standards 4.2 and 4.3)
- a requirement for CCPs to enhance financial resources where stress tests reveal a potential shortfall (CCP Standard 4.7)
- holding outsourcing providers to the operational risk standards to which CS facility licensees are held (CCP Standard 16.9 and SSF Standard 14.9)
- guidance on appropriate settlement models to be utilised 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) (CCP Standard 11 and SSF Standard 10)
- more detailed disclosure and regulatory reporting requirements (CCP Standards 20 and 21, SSF Standards 18 and 19).

The draft 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. In particular, CCP and SSF Standard 2 introduces requirements addressing management compensation, audit and review of operations, and the management of potential conflicts of interest between entities in the same corporate group.

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

The draft FSSs complement the international standards set out in the Principles with a number of specific measures drawn from the Council's framework for ensuring adequate cross-border regulatory influence. These measures will facilitate actions with respect to cross-border CS facilities that the Bank or other Australian regulators may need to take in order to promote financial stability and manage crises.

The requirements under the Council's regulatory influence framework would apply to facilities on the following basis:

- *All CS facilities.* The draft FSSs incorporate basic legal and governance requirements for all licensed CS facilities, including those with cross-border activities. Facilities operating in multiple jurisdictions must obtain an up-to-date legal opinion addressing enforceability and conflicts of law (CCP and SSF Standard 1.6). Licensed CS facilities with material Australian-based participation or that provide services in Australian-related products would also need to ensure that any obligations they placed upon Australian participants were proportional to the scale and nature of the participants' activities and risk profile (see CCP Standards 2.8, 3.2 and 12.5; and SSF Standards 2.8, 3.2 and 11.5).
- *Systemically important licensed CS facilities.* A systemically important CCP would need 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>15</sup>
- *Systemically important licensed CS facilities with a strong domestic connection.* 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 requirement

<sup>15</sup> The Bank updated its policy on Exchange Settlement Accounts in July 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>>.

would be expected to have the greatest impact on a systemically important licensed CS facility with a strong domestic connection.

### 3.4 Institutional Scope of Application and Assessment Approach

Under the draft FSSs, all licensed CS facilities, 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. However, licensed SSFs would be exempt from the SSF Standards provided that the value of financial obligations they settled in a financial year did not exceed \$200 million. This is an increase from the current value of \$100 million, reflecting increases in settlement values in the market at large since the current threshold was introduced in 2005, and potential future increases.

The draft FSSs also remove the exemption from direct compliance with the FSS for CCPs for overseas CS facilities licensed under section 824B(2) of the Act. This exemption previously applied where the regulatory regime in the overseas CS facility's principal place of business was assessed as being sufficiently equivalent to the Australian regime. Instead, overseas-licensed CCPs would be required to comply with the CCP Standards. However, in assessing overseas-licensed CCPs against each standard, the Bank intends to place conditional reliance upon information and reports from the facility's home regulator, provided that for each standard:

- the facility provides an independent legal opinion verifying that the facility is held to a materially equivalent standard in its home jurisdiction, and
- the Bank receives documentary evidence from the facility's home regulator that the facility is compliant with this standard in its home jurisdiction.

Where either of these conditions were not met, the Bank would directly assess the overseas CS facility against the relevant standard(s). Guidance on the Bank's approach to assessing both overseas and domestic CS facility licensees is set out in Attachment 6.

## 4. Consultation on the Draft Standards

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Under section 827D of the Act the Bank must consult with ASIC prior to revoking a FSS, and prior to determining or varying a FSS must consult with ASIC and any CS facility licensees that will be required to comply with the FSS. It is also the Bank's practice to publish any proposed new FSSs, or proposals to revoke or vary existing FSSs, for wider public consultation. This allows other stakeholders such as prospective CS facility licence applicants or participants to comment.

Accordingly, the Bank published a consultation paper on 29 August 2012 setting out its proposal to revoke the previously determined FSSs and determine new FSSs.<sup>16</sup> The draft FSSs were published as attachments to the paper, with accompanying draft guidance. A further attachment set out the Bank's proposed approach to assessing CS facility licensees.

The release of the consultation paper and attachments was followed by a period of public consultation, with written submissions from stakeholders invited by 19 October 2012. In addition, stakeholders were offered the opportunity to discuss their views with Bank staff at a series of meetings held in October.

### 4.1 Stakeholder Comments

During the consultation on the draft FSSs, the Bank held meetings or calls with eight stakeholders and received written submissions from six stakeholders. Written submissions were received from: ASX on behalf of current CS facility licensees; CS facilities operating in other jurisdictions (CME Group and LCH.Clearnet Group Limited); and industry groups representing market participants and other stakeholders (the International Swaps and Derivatives Association, the Australian Financial Markets Association, and the Australian Bankers' Association).<sup>17</sup> Stakeholders broadly supported the approach taken by the Bank, and comments were largely directed towards particular details of the draft FSSs and associated guidance. The Bank's response to stakeholder comments is discussed in Section 5.

#### Assessment approach

A number of submissions commented on the Bank's proposed assessment approach: one emphasised that overseas licensees should be held to the same standard of conduct as domestic licensees; by contrast, others suggested that reliance could be placed on an overseas regime's oversight at a broad rather than

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<sup>16</sup> The consultation paper and attachments setting out the draft FSSs, accompanying guidance and draft guidance regarding the Bank's approach to assessing CS facility licensees are available at <<http://www.rba.gov.au/payments-system/clearing-settlement/consultations/201208-new-fin-stability-standards/index.html>>.

<sup>17</sup> Written submissions from stakeholders are available at <<http://www.rba.gov.au/payments-system/reforms/submissions/new-financial-stability-standards/index.html>>.

standard-by-standard level. One stakeholder expressed the view that a small SSF settling transactions in a systemically important market should not be exempt from the FSSs.

One stakeholder suggested that the Bank and ASIC should nominate a 'lead agency' for each of the Principles.

## Recovery and resolution

Views on provisions across a range of FSSs that relate to FMI recovery and resolution varied: one stakeholder argued that these should be deferred, or at least subject to transitional relief, until such time as domestic legislation concerning FMI resolution is enacted; another considered that the provisions were adequate but may need to be revisited once international work on recovery and resolution had concluded.

## Legal and governance

One stakeholder queried how the requirement under CCP and SSF Standard 1.1 for a CS facility licensee to operate within a separate legal entity would apply to a CS facility that operated a complementary service (such as an exchange or trade repository) within the same legal entity. Concern was also expressed that the guidance to CCP and SSF Standard 1.6 could be interpreted to mean that a CS facility operating in many jurisdictions would need to provide the Bank with a potentially extremely lengthy legal opinion covering all potential conflicts of law across each of these jurisdictions.

A number of stakeholders raised concerns or suggestions regarding CCP and SSF Standard 2:

- Some raised the concern that the standards might prevent coordination of strategy or use of shared functions (such as internal audit) across corporate groups by restricting cross-directorships or group-level decision-making. They noted alternative intragroup arrangements and conflict management procedures could ensure that licensed entities fulfilled their regulatory obligations.
- One stakeholder argued that non-executive directors shared with other group entities could be considered independent. Another recommended minimum requirements for non-executive board representation, in line with similar provisions in the US and EU.
- It was suggested that external review requirements set out in CCP and SSF Standard 2.7 be limited to situations where external expertise was required to supplement the internal audit function.
- It was argued that governance arrangements should be required to support efficiency as well as stability.
- A concern was raised that CCP and SSF Standard 2.1 required CS facilities to take into account objectives beyond their licence obligations.

## Risk controls

Two stakeholders queried whether the requirement under CCP and SSF Standard 4.2 to have mechanisms in place to calculate exposures in real time meant that a CS facility would need to monitor exposures on a continuous basis. One indicated that there would be technical obstacles to meeting such a requirement. It was also suggested that the authority for a CS facility to impose additional risk controls on participants under CCP and SSF Standard 4.3 should be set out in the facility's rules, and that a 'grace period' for participants should apply before additional risk controls became operative.

With respect to CCP and SSF Standard 5.1, a number of stakeholders noted the potential shortage of high-quality liquid assets and argued for CS facilities to have flexibility to accept a broader range of collateral, including bank guarantees.



One stakeholder noted the potential liquidity impact that intraday margin calls may have on participants, and suggested that CCPs be required to treat variation margin payments and calls symmetrically. Another stakeholder noted that the guidance to CCP Standard 7.4 did not make reference to outright holdings of qualifying liquid resources, and could be interpreted as expressing a preference for meeting liquid resource requirements via committed arrangements for liquidity provision.

## Settlement

The requirements placed on CS facilities to monitor risks arising from commercial settlement banks under CCP Standard 9 and SSF Standard 8 were queried by one stakeholder, since CS facilities do not necessarily have a relationship with such banks.

Stakeholders requested greater clarity on what was meant by a 'large' or 'small' trade value under CCP Standard 11.2 and SSF Standard 10.2. It was also noted that CS facilities may be unable to influence settlement methods for some transactions (such as some issuance transactions), as set out under the guidance to CCP Standard 11.1 and SSF Standard 10.1. Stakeholders also expressed the view that CCP Standard 11.2 and SSF Standard 10.2 should not prohibit the use of DvP model 2 settlement.<sup>18</sup>

One stakeholder also expressed concern that the audit and reconciliation requirements for SSFs operating a central securities depository set out in guidance to SSF Standard 9.1 were overly burdensome.

## Default arrangements

One stakeholder queried why the guidance to CCP Standard 13 omitted text from the explanatory notes to the Principles setting out an exception to segregation and portability requirements for cash markets. Another expressed the view that customers of participants should receive the same level of protection in both cash and derivatives markets.

It was also suggested that the interests that a CS facility must take into account when establishing its default management procedures under CCP Standard 12 and SSF Standard 11 should be more explicitly identified.

## Business and investment risks

One stakeholder noted that, under certain market conditions, meeting the concentration limit requirements set out in guidance to CCP Standard 15.4 and SSF Standard 13.4 could require a CS facility to invest in lower-quality assets in order to prevent concentrated exposures to highly rated counterparties. It was also suggested by one party that guidance to these standards should not automatically preclude the investment of margin monies with affiliates of participants, and by another that CS facilities be required to place a minimum proportion of their cash deposits in arrangements fully secured by collateral, in line with ESMA's Draft Technical Standards.

Clarification was also sought by one stakeholder as to whether capital held against general business risk could be held at a group-wide level.

## Operational risks

A number of concerns were raised regarding the requirements for outsourcing arrangements set out in CCP Standards 16.9, 16.10 and 16.11 and SSF Standards 14.9, 14.10 and 14.11:

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<sup>18</sup> DvP model 2 settlement involves the settlement of securities on a trade-by-trade or line-by-line basis in real time, with linked payment obligations settled on a multilateral net basis at the end of a processing cycle.

- it was queried whether the consultation requirement under CCP Standard 16.10 and SSF Standard 14.10 meant that a CS facility would require the Bank's permission to enter into an outsourcing arrangement
- it was noted that additional costs might result from increased scrutiny of service providers
- greater clarity was sought regarding the scope of application of the outsourcing requirements, in particular with respect to the provision of important functions by third parties that have never been provided internally.

Stakeholders also provided suggestions for additional guidance on how CS facilities should address cyber security risks.

## 5. The Final Standards

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In considering the comments of stakeholders summarised in Section 4, the Bank has amended aspects of the draft FSSs and associated guidance. The new FSSs and associated guidance incorporating these amendments are set out in Attachments 2 to 6, with a summary of these amendments outlined below. This Section also briefly addresses comments raised by stakeholders that have not been incorporated as amendments.

### Assessment approach

The Bank considered that its proposed assessment approach to overseas-based CS facilities was appropriately designed to avoid regulatory overlap, while ensuring that all licensed CS facilities operating in Australia are held to the same standard of conduct. The Bank also considered that it would be inappropriate and contrary to the distinct responsibilities of both the Bank and ASIC under the Act for a 'lead agency' to be nominated for each of the Principles. While the Bank and ASIC intend to coordinate their interactions with CS facility licensees where possible, to reduce regulatory overlap, the Bank has a legislative responsibility to perform an independent assessment of how well licensees have complied with the FSSs and their obligation to do all other things necessary to reduce systemic risk.

Since there are no small SSFs in Australia that currently settle transactions in a systemically important market, the Bank did not see a need to adjust the proposed exemption threshold for SSFs. Should an SSF with an anticipated low volume of settlements sometime in the future seek to clear a systemically important market, the Bank may reconsider the terms of the exemption.

### Recovery and resolution

The Bank accepts the concerns of stakeholders regarding the recovery and resolution related provisions of the FSSs. However, it considers that these provisions are sufficiently broad to support the type of framework for recovery and resolution that is likely to emerge from current international and domestic policy and legislative development. Given the uncertain outcome of the international policy work and potential domestic legislation, however, the Bank proposes to grant transitional relief with respect to several provisions: CCP and SSF Standard 3.5 (development of a recovery plan); CCP Standard 4.8 and SSF Standard 4.5 (loss allocation rules); CCP Standard 14.3 and SSF Standard 12.3 (sufficient equity to fund a recovery plan); and CCP Standard 16.11 and SSF Standard 14.11 (organisation of operations to facilitate crisis management actions). Relief would apply for at least the first year of operation of the new FSSs, or until international policy work and any domestic legislation have been finalised. Arrangements for transitional relief are discussed in Section 6.1.

## Legal and governance

The Bank has made amendments to CCP and SSF Standard 1.1 and associated guidance to clarify that a CS facility licensee may operate a complementary service (such as an exchange or trade repository) within the same legal entity, provided that any additional risks are appropriately managed. Amendments to the guidance to CCP and SSF Standard 1.6 clarify that the legal opinion regarding conflicts of law that should be provided to the Bank need only cover potential conflicts of law relevant to Australia.

The Bank has also amended a number of sub-standards and guidance to CCP and SSF Standard 2 in order to clarify that CS facilities may utilise group-wide governance structures, provided that facilities were able to adequately demonstrate the sufficiency of arrangements to manage intragroup conflicts and ensure the adequate resourcing of the regulated entity. The Bank adopted more granular guidance regarding the independence of directors, requiring that a CS facility specify and disclose its own definition of independence, and disclose relevant interests of board members and its arrangements to manage member conflicts of interest. The Bank did not consider it necessary to prescribe minimum levels of independent board representation.

Given the distinct responsibilities of the Bank and ASIC, the Bank did not consider it appropriate to incorporate elements of the Principles relating to the efficient provision of services in CCP and SSF Standard 2. The Bank did not consider that CCP and SSF Standard 2.1 would require CS facilities to adopt objectives in their governance frameworks that would be incompatible with efficient service provision. The examples provided in the guidance clarify that the public interests contemplated in the standard include interests related to CS facilities' licence obligations and the effective operation of markets served by the CS facilities.

Finally, amendments to CCP and SSF Standard 2.7 and associated guidance allow CS facilities to utilise external reviews in a more targeted manner.

## Risk controls

The Bank has amended CCP and SSF Standard 4.2 and associated guidance to clarify that CS facilities need only have the capacity to monitor exposures on a timely, rather than continuous, basis. Amendments to the guidance to CCP and SSF Standard 4.3 clarify that any action taken in response to a deterioration in a participant's credit standing should be founded in the CS facility's rules. The Bank did not consider it appropriate in such circumstances for participants to be allowed a grace period before additional risk controls are imposed, as this would limit the flexibility of CS facilities to respond to sudden changes in a participant's risk profile.

Amendments have also been made to the guidance to CCP and SSF Standard 5.1, in order to clarify how CS facilities may mitigate risks associated with broader collateral acceptance, including how bank guarantee arrangements may be made sufficiently robust. The guidance to CCP Standard 7.4 has also been amended, in order to state a clear preference for outright holdings of qualifying liquid resources and specify the instruments that may form part of such holdings.

The Bank considered that guidance paragraph 6.4.1 to the CCP Standards was sufficient to ensure that CCPs took account of the potential liquidity impact of intraday margin calls and payments.

## Settlement

CCP Standards 9.3 and 9.5, SSF Standards 8.3 and 8.5 and associated guidance have been amended to ensure that the scrutiny that CS facilities are required to apply to the arrangements between participants and their commercial settlement banks is proportionate. Amendments to CCP Standard 11 and SSF Standard 10, and

associated guidance, allow additional flexibility in the choice of an appropriate exchange-of-value settlement model, clarify the meaning of a 'large' or 'small' trade value, and clarify that the scope of CS facilities' responsibility for choice of settlement methods is limited to transactions where they are able to influence settlement methods.

The Bank did not consider that requirements under guidance to SSF Standard 9.1 were overly burdensome in the context of an SSF's central securities depository activities, given the responsibility of central securities depositories for the integrity of securities issues.

### **Default arrangements**

The Bank has expanded the guidance to CCP Standard 13 to clarify the situations in which protection of customer assets may be provided by alternative means for cash markets, where this protection is equivalent to the protection afforded by effective segregation and portability arrangements. The Bank has also amended guidance to CCP Standard 12.5 and SSF Standard 11.5 to elaborate on the interests that a CS facility should take into account in designing its default management procedures.

### **Business and investment risks**

The Bank has amended the guidance to CCP Standard 15.4 and SSF Standard 13.4 to clarify that limits to the concentration of exposures to individual investment counterparties should only be applied to the extent reasonably practicable, and to provide greater flexibility in how CS facilities control for wrong-way risk in the investment of margin monies or other cash collateral. The Bank did not see a case for greater prescription as to how CCPs collateralise their cash deposits.

Amendments to CCP Standard 14.2 and SSF Standard 12.2 clarify that CS facilities may utilise alternative arrangements for holding capital against general business risk. However, a CS facility must be able to demonstrate to the Bank that any such arrangements are legally certain.

### **Operational risks**

CCP Standards 16.9, 16.10 and 16.11, SSF Standards 14.9, 14.10 and 14.11 and associated guidance have been amended to clarify that the scope of these requirements extend beyond traditional outsourcing arrangements, to broader dependencies on service providers. The Bank has expanded guidance to CCP Standard 16.9 and SSF Standard 14.9 to clarify that CS facilities must form their own judgement regarding the operational performance of regulated service providers. CCP Standard 16.10 and SSF Standard 14.10 have also been amended to clarify that the Bank should be given rights of access to information regarding existing outsourcing and service providers. The Bank did not consider that the draft wording of these standards implied that CS facilities would require the Bank's permission to enter into outsourcing or service provision contracts. The Bank also provided additional guidance regarding the management of cyber security risks under CCP Standard 16.3 and SSF Standard 14.3.

## 6. Next Steps

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The FSSs, accompanying guidance and guidance on the Bank's assessment approach have been published on the Bank's website.<sup>19</sup> The new FSSs set out in Attachments 2 and 4 will shortly be formally determined. Following formal enactment, most standards are expected to take effect on 29 March 2013, with the exception of standards identified for transitional relief (see Section 6.1).

Subject to any such transitional arrangements, all current CS facilities will be required to observe the new FSSs from 29 March 2013. All CS facility licensees will be formally assessed against the applicable new FSSs in mid 2013.

### 6.1 Transitional Relief

As compliance with the standards may require CS facilities to undertake system changes, the Bank invited existing CS facility licensees to identify any need for transitional relief through the consultation on the draft FSSs.

During consultation, the existing CS facility licensees indicated that they would need additional time to fully assess the extent and potential timing of changes required to achieve compliance with the new FSSs. In recognition of this, and the likely extent of changes required by CS facilities in order to achieve full compliance with the new FSSs, the interval between determination and the new FSSs taking effect can be considered a *de facto* period of general transitional relief. This period will allow facilities additional time to make the changes required to observe the new FSSs.

In addition, the Payments System Board has determined that a longer period of transitional relief be granted in respect of several standards related to FMI recovery and resolution: CCP and SSF Standard 3.5; CCP Standard 4.8 and SSF Standard 4.5; CCP Standard 14.3 and SSF Standard 12.3; and CCP Standard 16.11 and SSF Standard 14.11. These standards will not come into force until 31 March 2014. Implementation of these standards may be further delayed if international policy work and any domestic legislation relating to FMI recovery and resolution have not been finalised by that date.

The Bank will also provide the opportunity for the existing CS facility licensees to make a formal application for transitional relief. It is intended that any transitional relief would apply to requirements that require significant, industry-wide change, or where there are significant external dependencies to achieving compliance, such as a dependence on legislative change or on the finalisation of ongoing policy development work, both domestically and internationally. Any application for relief will need to set out the areas in which relief is sought, the length of relief required, and plans to achieve compliance by the end of the additional period requested.

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<sup>19</sup> The new FSSs and guidance are available at <<http://www.rba.gov.au/payments-system/clearing-settlement/standards/201212-new-fss-ris/index.html>>.

Licensees should submit any applications by 14 January 2013. The Payments System Board will consider at its February 2013 meeting whether to grant transitional relief, and the terms of any relief granted.

In other areas where CS facility licensees are unable to immediately achieve full compliance, the Bank intends to address steps taken to achieve compliance through the course of its ongoing assessment process.