

GBST Response: Competition in the clearing and settlement of the Australian cash equity market

Section 2: Competition in Clearing and Settlement

Q1. Do you agree that clearing of ASX securities is contestable?

Response:

Yes.

Q2. Do you agree that there is no evident demand for competition in the settlement of ASX securities? If so, do you have any views on whether price or non-price issues could emerge in relation to ASX's settlement facility?

Response:

Yes.

The costs of setting up an alternate settlement facility would be much higher than establishing an alternate CCP. The existing settlement system is highly efficient and tightly integrated with both market and participant systems; the addition of an alternate service would require very significant investment by:

- Clearing and settlement participants
- Banks (as agents for RTGS transfers of cash)
- Share registries (as the definitive record of company ownership)
- Technology suppliers
- Existing CCPs & settlement services (if interoperability is required).

At this time the potential savings in settlement fees would not provide a payback for these costs in a commercial time-frame. Costs incurred by non-participants and suppliers to support an alternate settlement service would be passed on to participants; it is likely that these costs would exceed savings through reduced settlement fees.

Section 4: Market Functioning

Fragmentation

Q3. Have the Agencies identified the right issues around fragmentation?

Yes

If a new CCP only provided clearing for high liquidity stocks it would place the existing "catch all" supplier at a significant disadvantage. Any regulatory approach should ensure that new entrants are not able to "cherry pick" the business which suits them to the detriment of smaller companies and participants.

The complexity of the market would increase due to the number of connections and relationships required to support multiple CCPs. Likewise the reduction in netting would increase the number of settlements required and could lead to a reduction in settlement efficiency and an increase in failure rates.

Q4. Do you have views on whether particular product or participation segments of the market for ASX securities would be affected in the event that competition in clearing emerged?

The introduction of a new CCP to a segment which is not currently centrally cleared (e.g. OTC derivatives) would have minimal impact. Likewise the introduction of a new derivatives exchange with an associated CCP would have limited impact. The main issues would arise from multiple CCPs clearing trades in the same stocks across the same markets as this would mandate some level of interoperability between the CCPs. If a new entrant achieved significant market share it could lead to a situation where each CCP was the largest counterparty of the other. The reduction in netting due to the parties to a trade using different CCPs could also lead to higher outstanding balances across the market. If a new CCP was allowed to only clear a subset of liquid stocks it would mandate that participants connect (directly or indirectly) to multiple CCPs; this would result in increased margins at both the participant and total market levels.

Q5. Are there any other factors related to the effective functioning of the market for ASX securities that should be considered?

Any evaluation of the benefits of introducing competition should ensure that cost factors are taken into account as well as potential price reductions. The introduction of market competition has delivered lower trading costs for some participants but has also imposed new costs and charges on all market participants including those who are not connected to the new market. This has led to a situation where all participants are charged extra fee for multiple markets even if they continue to use a single execution venue.

These extra costs include fees charged by the government entities responsible for supervising multiple markets. Whilst the costs of supervising multiple CCPs would presumably be less than those for supervising multiple markets an indication by regulators of both the types and value of supervisory fees should be provided to allow participants to perform a realistic cost benefit analysis. The introduction of a new CCP should not impose extra costs on participants which do not choose to utilise the new service.

Interoperability

Q6. Do you have views on the stability and effectiveness of interoperability in other jurisdictions? If competition emerged, should interoperability between competing CCPs be encouraged in Australia?

Unless the new CCP only covered a single market on an exclusive basis some level of interoperability would be essential. The document identifies the issues resulting from interoperability. As shown by the European experience it is unlikely that incumbent CCPs would make interoperability a priority unless mandated by regulators.

Q7. Can you suggest any other responses to the issues raised in relation to market functioning?

Section 5: Financial Stability

Q8. Do you consider that there is a risk of a race to the bottom on risk control standards in the event that competition in clearing emerged?

Given that ASX Clear is currently implementing higher levels of risk control with the active support of regulators it is unlikely that a new entrant could be licenced to operate with a lower level of controls. The role of regulators in establishing a minimum level of controls will be critical to prevent lower levels of risk controls being an area of competitive advantage. Any proposal which is predicated on allowing a lower level of controls as a means of delivering lower pricing should not be approved.

Q9. Are you aware of such a race to the bottom in other jurisdictions in which competition in clearing has emerged? What risk control standards have been impacted and how?

No

Q10. Do you have views on the risks that the exit of CCPs could pose to financial stability?

Exit of a CCP would be operationally complex but could be managed given sufficient notice. The ability and appetite of the remaining CCPs to clear the transactions previously handled by the exiting CCP would be a primary concern – if they were not able or willing to take over the business an exit would be extremely disruptive. Regulatory oversight to ensure an orderly and fair wind down and transition would probably be required.

Q11. Do you have comments on the issues identified around access to ASX Settlement and settlement arrangements for non-ASX CCPs more generally?

The existing CHES settlement batch delivers a high level of efficiency and minimises participant funding requirements by allowing for a single net settlement of market and client obligations (where the client side settles DVP). As identified in the document the existing CHES system does prioritise market settlement obligations which could have a negative impact if external CCP settlements were processed as “standard” dual entry DVPs. Current ASX Clear rules limit the use of this type of transaction to client side settlement of market trades and associated scrip lending activity; this would have to be varied to allow for use of this type of transaction as the settlement method for CCP to participant obligations.

Segregation of external CCP settlements would lead to increased participant funding costs and failure rates due to the loss of netting in the settlement batch.

Q12. Are there any other factors related to financial stability that should be considered?

Q13. To what extent do you consider that application of risk-management standards consistent with the CPSS-IOSCO *Principles for financial market infrastructures* would mitigate the risk of a race to the bottom?

Q14. To what extent do you consider that exit plans and *ex ante* commitments would mitigate the risk of instability in the event of the exit of a competing CCP?

The provision of ex ante commitments could help to minimise the instability arising from the exit of a CCP.

Q15. Do you have views on what *ex ante* commitments might be reasonable and how these might be imposed without creating barriers to entry?

It would be important to ensure that the value of any ex ante commitment was not eroded by time e.g. a capital reserve which might be adequate now might not be adequate in 10 years' time. At a minimum standards for an adequate notification period prior to shutdown should be included.

Q16. To what extent do you consider that location requirements would mitigate the risk of diminished regulatory influence and control in the event that an overseas-based CCP provided clearing services for ASX securities?

A location requirement would aid in the supervision of an offshore CCP by providing a local point of contact within the same time-zone. It would also make participant supervision more effective and responsive particularly in volatile market conditions.

Q17. Do you have views on what location requirements – and other measures to enhance regulatory control and influence – might be reasonable in the case of clearing ASX securities and how these might be imposed without creating unnecessary impediments to entry?

Q18. Do you have views on what would constitute appropriate settlement arrangements for non-ASX CCPs?

At a minimum a new CCP should have access to CHESSE DVP batch settlements. The ideal situation for a new CCP would be an extension of the existing “clearing” functionality in CHESSE to support novation, netting and scheduling of a new CCP's obligations in the same manner as those of ASX Clear. In effect this would extend the existing ASX “Trade acceptance service” to also include clearing functionality. This would however be a commercial decision by ASX.

Charges for settlement of non ASX CCP transactions should not exceed those charged for ASX Clear settlements.

Q19. Do you have views on what would constitute a reasonable basis for co-operation with overseas regulators?

Q20. Can you suggest any other responses to the issues raised in relation to financial stability?

Section 6: Competition & Access

Q21. Do you have views on the effectiveness of the existing policy and legislative framework in addressing access to ASX Settlement?

The existing policy and controls are suitable for the existing situation where a single vertically integrated commercial entity provides clearing and settlement services. The need for extra legislative support to guarantee access would depend on the terms offered by ASX for access to their settlement services and their willingness to provide trade data to a non ASX CCP.

Q22. Do you have views on whether transitional or longer term regulatory arrangements would be most appropriate in addressing any potential issues that could emerge in relation to competition and access to ASX Settlement?

Q23. Can you suggest any other options (regulatory or non-regulatory) to address any potential issues that could emerge in relation to competition and access?

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