Removal of impediments to margining Regulation Impact Statement

Executive Summary

1.1 From September 2016, regulators in many key jurisdictions will phase in new 'margining' requirements for trading in over-the-counter (OTC) derivatives (bilateral contracts which derive their value from shifts in the value of entities in the underlying market). Without legislative change, entities subject to Australian law may not be able to fully comply with margining requirements that are imposed on them, or their counterparties, as a result of participating in international markets. This could significantly restrict the ability of Australian entities to participate in certain financial markets or trade with particular counterparties.

1.2 The new margining requirements are a core component of international efforts to address problems highlighted in the 2007-2008 global financial crisis (GFC). Widespread defaults on sub-prime mortgages, and the consequent devaluation of mortgage-backed securities are generally considered to be primary factors leading to the onset of the GFC. The resulting problems were exacerbated by widespread failure to meet commitments arising from unsecured OTC derivatives contracts.

1.3 As a result, in 2009, the Group of Twenty (G20) nations agreed to reform OTC derivatives markets, contracts and practices in an effort to reduce the risks exposed by the GFC. This agenda recognised the legitimate and ongoing role of derivatives in hedging business and investment risk, but sought to limit opaque and excessive speculation in OTC derivatives, and the potential for this activity to undermine the resilience of the financial system. The reforms are also intended to enhance transparency in OTC derivatives markets and improve market efficiency, integrity and risk management.

1.4 Margining is the process of exchanging collateral to protect against counterparty credit risk in financial contracts and is a key component of risk reduction strategies. It is intended to reduce the kind of contagion and spill-over effects experienced in the GFC, by ensuring that collateral is available to offset losses caused by the default of a derivative counterparty. The collateral exchanged can be by way of direct transfer of, or granting security over, certain assets.

1.5 International margin requirements for OTC derivatives will be phased in from 1 September 2016, after which entities operating in Australia will need to be able to provide, and enforce rights in respect of, margin provided by way of security. If they are unable to do so, they will face rising costs and other barriers to participation in global OTC derivatives markets. To give a sense of the scale of these markets: the notional amount of outstanding OTC derivative contracts (as at June 2015) is US$553 trillion, globally; and the average daily turnover for Australian OTC foreign exchange derivatives (a subsection of the OTC derivatives market) was $125 billion in April 2015.

1.6 For various reasons, current Australian law contains provisions that impede certain institutions from providing margin in a manner consistent with existing or planned regulatory requirements (especially providing margin by way of security).

1.7 The Financial System Legislation Amendment (Resilience and Collateral Protection) Bill 2016 will allow Australian financial institutions to meet margin requirements in accordance with internationally agreed principles. It will also provide legal certainty in relation to termination rights (often referred to as close-out rights), and

the operation of real time gross settlement systems, approved netting arrangements and netting markets in all market conditions.

1.8 These measures complement a suite of other reforms led by the Basel Committee on Banking Supervision, and implemented in Australia, to make financial institutions and systems more reliable and better able to withstand major shocks.

1.9 This Bill delivers on the Government's response to the Financial System Inquiry (*Improving Australia's Financial System*) (FSI) in October 2015, which undertook to 'develop legislative amendments to clarify domestic regulation to support globally coordinated policy efforts and facilitate the ongoing participation of Australian entities in international capital markets'.

1.10 The Government consulted the public on the draft Bill and associated Regulation from 21 December 2015 – 5 February 2016. The response was strongly supportive. The Government received ten submissions, primarily from industry representatives, all of whom emphasised the importance of the proposed reform to their business and the health of the financial sector. Australian financial regulators have been involved throughout the process, and support the proposed amendments.

1.11 This final stage regulation impact statement builds on the early stage statement (prepared prior to consultation), first pass final stage statement, and stakeholder feedback on the proposed changes.

Introduction

1.12 The global financial crisis (GFC) demonstrated the need for more resilient financial institutions, and financial market reform - particularly in relation to trade in over-the-counter (OTC) derivatives.[1]

1.13 Trading in OTC derivatives (bilateral contracts which derive their value from shifts in the value of entities in the underlying market) exacerbated the consequences of the GFC.

1.14 As a result, in 2009, the Group of Twenty (G20) nations agreed to reform OTC derivatives markets, contracts and practices in an effort to reduce the risks exposed by the GFC. This agenda recognised the legitimate and ongoing role of derivatives in hedging business and investment risk, but sought to limit opaque and excessive speculation in OTC derivatives, and the potential for this activity to undermine the resilience of the financial system.

1.15 Specifically, the G20 leaders agreed to improve transparency by requiring transaction information on all OTC derivatives to be reported to trade repositories; improve market efficiency and risk management by requiring all standardised OTC derivatives to be cleared through central counterparties; and enhance market efficiency and integrity, by requiring the execution of all standardised OTC derivatives on exchanges or electronic trading platforms, where appropriate.'[2]

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[1] In finance, a derivative is a contract that derives its value from the performance of an item (such as commodities, currencies or securities) in the underlying market. Derivatives can be used in a range of ways, including hedging (insuring against price movements), increasing exposure to price movements for speculation, or getting access to otherwise hard-to-trade assets or markets. Some of the more common derivatives include forwards, futures, options, swaps, and variations of these such as synthetic collateralized debt obligations and credit default swaps. Derivatives are one of the three main categories of financial instruments, the other two being stocks (i.e. equities or shares) and debt (i.e. bonds and mortgages).

[2] Australian Prudential Regulation Authority (APRA), 'Discussion Paper - Margining and risk mitigation for non-centrally cleared derivatives', 25 February 2016, http://www.apra.gov.au/CrossIndustry/Documents/160225-CPS-226-discussion-paper-FINAL.pdf

1.16 Australia has made good progress to implement these reforms. The *Corporations Legislation Amendment (Derivative Transactions) Act 2012* (Cth) covers: (a) the reporting of all OTC derivatives to trade repositories; (b) the clearing of all standardised OTC derivatives through central counterparties; and (c) the execution of all standardised OTC derivatives on exchanges or electronic trading platforms, where appropriate. Mandating central clearing[3] is the next step in the implementation of the global OTC derivatives reforms in Australia. On these elements, Australia is meeting the G20-mandated timelines.

1.17 In 2011, G20 leaders added the imposition of margin requirements for non-centrally cleared derivatives to the reform agenda (i.e. OTC derivatives that are not cleared by a central counterparty, such as ASX Clear (Futures) Pty Limited).

1.18 Margining is the process of exchanging collateral to protect against counterparty credit risk for financial contracts, such as non-centrally cleared derivatives.[4] Margin requirements are intended to reduce systemic risk and promote central clearing. It is anticipated that margin requirements would reduce the contagion and spill-over effects experienced in the GFC, by ensuring that collateral is available to offset losses caused by the default of a derivative counterparty.

1.19 In September 2013, the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) published a final framework for margin requirements for non-centrally cleared OTC derivatives, to ensure that provision for losses on transactions is made when trading these products.

1.20 In March 2015, global regulators agreed that phasing in of global margin requirements for OTC derivatives would begin in September 2016. At this stage, various regulators in the United States have approved final rules, European authorities have published consultation papers on draft regulatory technical standards on margining and the Japan Financial Services Agency (JFSA) have released proposed draft amendments to implement margin requirements.

1.21 However, without legislative change, entities operating under Australian law may not be able to fully comply with margining requirements that are imposed on them, or their counterparties, due to domestic or foreign regulation, or market practice.

1.22 This could significantly restrict the ability of Australian entities to participate in certain financial markets or trade with particular counterparties. This is the problem addressed by this regulation impact statement (RIS).

1.23 The RIS compares the cost of maintaining the status quo with removing impediments in Australian law to comply with margin requirements for certain OTC derivatives contracts. These are the only feasible options in response to this policy problem, no other options have been seriously considered or proposed, as anything less than legislative amendment could not provide the kind of certainty needed to remove impediments outlined in this RIS, and ensure that entities subject to Australian law can participate effectively in global markets.

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[3] Central clearing of OTC derivatives is a process whereby the derivatives (but only standardised contracts) are still negotiated between two counterparties bilaterally, but they are then novated or otherwise cleared through a central counterparty (also known as a clearing house). The trade is booked to the clearing house which, generally, becomes the counterparty to the all trades.

[4] Australian Prudential Regulation Authority (APRA), http://www.apra.gov.au/MediaReleases/Pages/16_08.aspx

Question 1: What is the problem the government is trying to solve?

1.24 International margin requirements for OTC derivatives will be phased in, commencing from 1 September 2016, with full implementation by September 2020. From the September commencement, Australian entities operating in key global OTC derivatives markets will increasingly need to be able to provide, and enforce rights in respect of, margin provided by way of security, or face rising costs and other barriers to participation in these markets.

1.25 Under current Australian law entities may not be able to give and enforce margin in accordance with the new international practice.

1.26 More detailed background on global OTC reforms is included in the Appendix.

Problem definition – impact of foreign regulation

1.27 Market assessments, published by Australian regulators in July 2013,[5] April 2014[6] and November 2015,[7] show that the Australian OTC derivatives market is dominated by the big banks, including the major Australian banks as well as the local operations of global financial institutions. These global banks are or will soon become subject to margining mandates imposed by their home regulators, especially in the US and the EU, as will some of the major Australian banks who are also subject to regulation in the US or EU.[8] In turn, Australian banks directly, or indirectly by virtue of entering transactions with these global banks, will be captured by the US and the EU regulations, and will have to meet legal requirements for margining.

1.28 At this stage, various regulators in the United States have approved final rules (December 2015); European authorities have published consultation papers on draft regulatory technical standards on margining; and Japanese regulators have released proposed draft amendments to implement margin requirements. For the Australian banks, the US and the EU regulatory regimes are the most relevant as a significant majority of their wholesale funding is sourced from these jurisdictions.

1.29 Complying with the regulatory framework of another jurisdiction imposes significant legal and compliance costs (e.g. Australian banks operating in the US and the EU). Costs may be multiplied if these regulatory frameworks are inconsistent, imposing duplicative or even conflicting requirements.

1.30 Globally, regulators are addressing this problem through an approach known as substituted compliance, under which regulators grant relief from their own regulatory requirements if a foreign entity is subject to equivalent requirements in their home jurisdiction.[9] An Australian bank concluding an OTC derivative transaction in the US would be exempt from complying with the relevant US regulations if the US Commodity Futures Trading Commission (CFTC) had made a formal determination granting substituted compliance to Australian-regulated entities, following an equivalence assessment by the CFTC of the Australian regulatory framework.

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[5] Report on the Australian OTC Derivatives Market, July 2013, available at http://www.cfr.gov.au/publications/cfr-publications/2013/report-on-the-australian-otc-derivatives-market-july/index.html.

[6] Report on the Australian OTC Derivatives Market, April 2014, available on the same website of the Council of Financial Regulators (CFR).

[7] Report on the Australian OTC Derivatives Market, November 2015, available at http://www.cfr.gov.au/publications/cfr-publications/2015/report-on-the-australian-otc-derivatives-market-november/pdf/report.pdf.

[8] For example, by the five big banks in Australia being registered as swap dealers in the US.

[9] The equivalence or not of regulatory requirements in foreign jurisdictions is determined by the local regulator through a formal assessment. Where equivalent obligations are identified relief from local requirements is then granted to foreign entities subject to those requirements in the overseas jurisdiction.

Problem definition – impediments to compliance in Australian law

1.31 Current laws obstruct an Australian participant from voluntarily, or mandatorily, exchanging margin with counterparties under the BCBS/IOSCO principles. This is problematic for an Australian participant that might want to voluntarily provide margin in compliance with the BCBS/IOSCO principles with its counterparties for capital reasons or, in the future, because the counterparty is required to provide margin.

1.32 The existing impediments under current law have come to the fore because the internationally agreed principles for margin requirements require that initial margin needs to be exchanged on a gross basis. This is likely to result in initial margin (at least) being transferred by way of security rather than by way of absolute transfer (as it is currently transferred in the Australian market). There may be compelling reasons why market participants choose to provide both initial margin and variation margin by way of security rather than by way of absolute transfer (for example, because of benefits to the collateral provider on the secured party's insolvency).

1.33 Some of the other issues which arise in the context of creating and enforcing rights as a secured party (i.e. enforcing rights in respect of margin provided by way of security) under current Australian law include:

- the assets of an Australian Authorised Deposit-Taking Institution (ADI) in Australia are subject to a priority regime which would prefer other creditors (e.g. holders of protected accounts) ahead of a secured party;
- the assets of a foreign ADI in Australia are subject to a priority regime which would prefer liabilities of the foreign ADI in Australia ahead of a secured party;
- the assets of a general insurer regulated under the Insurance Act in Australia are subject to a priority regime which would prefer other creditors ahead of a secured party;
- a secured party is restricted from enforcing its security interest over an Australian company's property during the company's administration and an administrator is given certain rights in respect of dealing with property subject to circulating security interests;
- certain stays may apply in respect of an entity due to the recognition of a foreign insolvency proceeding under the *Cross Border Insolvency Act 2008* (Cth);
- client money and client property rules may affect the way in which a secured party must hold, and enforce rights against, collateral provided to it;
- the *Personal Property Securities Act 2009* (Cth) (PPSA) imposes additional requirements governing the enforceability, validity and perfection of security interests;
- the PPSA and *Corporations Act 2001* (Cth) (Corporations Act) set out priority rules which may result in a secured party losing priority in respect of secured assets and those Acts set out circumstances in which property secured by a security interest may vest in the grantor;
- other security interests may arise in respect of the property of a grantor by operation of law;
- security agreements may need to be stamped to be admissible in court proceedings; and
- the PPSA sets out rules governing the enforcement of security interests (including procedural requirements and duties).

1.34 Global and US regulations are also impacting on Australian superannuation funds and life companies, which are restricted from accessing certain sections of the US OTC derivative markets. Australian regulations prevent these entities from complying with US regulation by giving security over their assets for the purposes of margining, and these entities are consequently unable to meet US clearing broker requirements. Being restricted from the US OTC derivatives market limits these entities' access to market liquidity, reducing their ability to manage and hedge risks, increasing trading costs.

Problem definition – impacts of not being able to comply with international regimes

1.35 Consultation with industry and financial regulators has revealed consensus about the need to have a facilitative regulatory regime in place by the time international margining requirements come into effect, or face serious economic consequences.

1.36 Without a facilitative regulatory regime, Australian institutions' capacity to trade with major counterparties will be progressively curtailed from 1 September 2016. As a consequence, banks would not be able to hedge their risks offshore, or get access to important liquidity pools.

1.37 Jurisdictions are set to adopt various thresholds for phasing in of the new margining requirements. Initially, entities with notional derivatives worth US$3 trillion+ (for the US), EUR3 trillion+ (for the European Union), and AUD$4.5 trillion (for Australia), will need to comply immediately after 1 September 2016. As margin requirements are phased in, the threshold will become smaller and smaller, capturing a larger range of entities.

1.38 Major Australian banks will likely be the first Australian entities affected by international requirements. Whether they are required to comply depends on the notional size of their derivatives position, but if even one bank were required to comply in the first phase of international margin requirements, the implications would be significant for that business, and their counterparties, and potentially the broader Australian economy.

1.39 Quite apart from the technical threshold requirements to comply, a range of financial institutions will likely want to comply before they are formally required to, for commercial reasons. This is because uncollateralised trades will soon become more expensive than trades where margin is given.

1.40 Even a short delay in creating a facilitative regulatory regime is likely to involve significant cost to the Australian finance sector. To give a sense of the scale of OTC derivative trade: The notional amount of outstanding OTC derivative contracts is ~US$553 trillion globally. The Australian Financial Markets Association (AFMA) recently estimated that there is an annual turnover of AUD$80 trillion in notional OTC derivatives in Australian financial markets.

Question 2: Why is Government action needed?

1.41 Australian financial market participants, superannuation funds, life companies, the Australian Financial Markets Association (AFMA), the Financial Services Council (FSC) and the International Swaps and Derivatives Association (ISDA) have all raised concerns that, in the absence of Government action to remove legal impediments to margining, Australian entities may face barriers in international markets where margining requirements established by the BCBS are becoming increasingly prevalent.

1.42 Under the 2015 BCBS Margin Requirements, initial margin[10] collected in respect of non-centrally cleared derivatives must be 'immediately available to the

[10] In general terms, initial margin is provided on entering into a transaction to cover potential future exposures in respect of the transaction.

collecting party in the event of the counterparty's default'. Margining requirements are commonly met by means of granting to the secured party, security over certain assets of the counterparty. In the Australian context, stakeholders have raised a concern that the requirement for such margin to be 'immediately available' (and that such margin may need to be provided in a way which satisfies other potential foreign legislative changes) requires legislative change to allow security over certain personal property to be enforced on the counterparty's default without such enforcement being subject to other legacy legal impediments which may otherwise apply as a matter of Australian law.

1.43 Put simply, without legislative change, entities to which Australian law applies may not be able to fully comply with margining requirements that are imposed on them, or their counterparties, due to domestic or foreign regulation or market practice. This could significantly restrict the ability of Australian entities to participate in certain financial markets or trade with particular counterparties. There could be significant consequences for Australian financial markets if, for example, Australian banks were restricted from trading with a US or European bank because any security granted by the Australian banks couldn't be enforced in the manner required by regulation or strictly observed market practice.

1.44 Other developed countries (including, for example, the United Kingdom and other members of the European Union) have enacted similar legislation to clarify their securities laws to provide for 'rapid and non-formalistic enforcement procedures in order to safeguard financial stability and limit contagion effects' in case of a default of a party to certain financial markets contracts. By doing so, they both reduce possible risks for parties to certain contracts in respect of which margin is provided and remove impediments to the international competitiveness of their local financial institutions.

1.45 Legislation will facilitate Australia maintaining its position as a regional financial centre with a strong regulatory and legislative framework. The fact that legislation protecting the enforcement of security in similar financial markets contracts has been thought appropriate elsewhere (including in the European Union), coupled with a concern that the absence of appropriate protections in Australia could affect the international competitiveness of Australian financial institutions, supports this reform. Stakeholders have indicated that an expansion of the existing legislative protections in the *Payment Systems and Netting Act 1998* (Cth) (the PSN Act) to protect the enforcement of security in the context of margin requirements is required to ensure that, in circumstances where Australian law applies, entities are able to comply with the 2015 BCBS Margin Requirements' requirement for margin to be 'immediately available' (and other requirements which may potentially be imposed by foreign regulators).

1.46 The proposal is to amend the PSN Act to facilitate the enforcement of security given in writing over specified types of financial property, in respect of certain obligations of a party to the contract. This protection will be subject to a number of safeguards to ensure that the protection only applies in appropriate circumstances.

1.47 This would:

- enable Australian entities to give, and enforce rights in respect of, margin provided by way of security in connection with certain financial market transactions in a manner consistent with international requirements; and
- contribute to the integration and cost-efficiency of the financial markets and the stability of the financial system, and limit contagion effects in case of a default of a party to a close-out netting contract under which collateral is provided.

1.48 An additional problem arises in relation to margining, and the participation in certain important derivatives markets (particularly the US market), by trustees of regulated superannuation entities and life insurance companies. Currently, trustees of regulated superannuation funds are restricted under Australian law from giving a charge over an asset of the fund, subject to certain exceptions. Life companies are subject to similar, significant, restrictions on granting security. The existing 'derivatives contracts' exception to these restrictions in each of the *Superannuation Industry (Supervision) Regulations 1994* (Cth) (Superannuation Industry (Supervision) Regulations) and the *Life Insurance Regulations 1995* (Cth) (Life Insurance Regulations) is not currently broad enough to cover granting security in the context of cleared OTC derivatives and uncleared OTC derivatives.

1.49 The G20 derivative reforms and US reforms (particularly due to the Commodity Exchange Act) have directly and indirectly affected trustees of regulated superannuation funds and life companies, whose counterparties are subject to a range of requirements relating to derivatives. For example, due to asset segregation requirements, US law currently requires that Futures Commission Merchants (FCMs) request margin by way of security from their clients in respect of OTC derivatives they clear on behalf of their client. Trustees of regulated superannuation funds and life companies cannot currently grant such a security interest to the FCM due to restrictions imposed by the Superannuation Industry (Supervision) Regulations or the Life Insurance Regulations (as applicable). As a result of not being able to grant such security, trustees of regulated superannuation funds and life companies cannot participate in certain important derivatives markets. Adverse consequences of this include:

- reduced access of these entities to liquid markets due to these entities' inability to trade with US FCMs; and
- increased OTC derivative trading costs from reduced competition in these entities' dealer panels due to their inability to trade on a cleared basis with numerous counterparties.

1.50 This legislative package will achieve the policy outcome that trustees of superannuation entities regulated by the Superannuation Industry (Supervision) Act and life companies regulated by the Life Insurance Act will be able to grant security interests in certain circumstances to facilitate the participation of these Australian entities in international derivatives markets. Facilitating the access of trustees of superannuation entities and life companies to cleared OTC markets accords with Australia's commitments in respect of the G20 derivatives reforms.

1.51 Specifically, the proposal is to amend the Superannuation Industry (Supervision) Regulations and the Life Insurance Regulations to enable trustees of superannuation entities regulated by the Superannuation Industry (Supervision) Act and life companies regulated by the Life Insurance Act to grant security interests in respect of cleared OTC derivatives and uncleared OTC derivatives, subject to certain safeguards.

1.52 Other reforms will address existing inconsistencies between the *Banking Act 1959* (Cth) (Banking Act), *Life Insurance Act 1995* (Cth)(Life Insurance Act), *Insurance Act 1973* (Cth) (Insurance Act), the *Financial Sector (Business Transfer and Group Restructure) Act 1999* (Cth)(the Business Transfer Act) and the PSN Act relating to the effect of certain stays imposed under the Banking Act, Life Insurance Act, Insurance Act, and the Business Transfer Act on the exercise of certain termination rights (including due to statutory or judicial management) -which would otherwise be exercisable under close-out netting contracts, approved netting arrangements and market netting contract and the impact of those stays on enforcing security. These reforms are important to ensure parties to netting contracts have legal certainty over their contractual rights (including in circumstances when there is a compulsory transfer of business).

1.53 Any potential inconsistency in the legislative framework is undesirable. It creates uncertainty as to the ability of a party to an approved netting arrangement, close-out netting contract or market netting contract to legally exercise a contractual right to close-out transactions (or, in terms of the PSN Act, obligations) under a contract with a regulated entity in respect of which a statutory manager or judicial manager has been appointed. This uncertainty has the potential to impede the efficiency of financial markets in Australia by making it more difficult for Australian entities to enter into financial market transactions (including hedging arrangements) as well as impeding the ability of the Commonwealth to effectively manage distress in regulated financial institutions. However, this will be balanced with the need for a stay to apply in respect of certain termination rights which may be granted under contracts to which a regulated entity is party to enable the resolution authority (e.g. APRA) to adequately resolve the institution so that obligations continue to be met (whether in the existing bank or through a transfer of business).

1.54 Additionally, to resolve legal uncertainties which have been identified in respect of the protections provided to financial market infrastructures which are crucial to the operation of Australian financial markets, the proposal will ensure legal certainty for:

- the settlement activities under an approved netting arrangement that is governed by the rules of a licensed CS facility as defined in section 761A of the Corporations Act (e.g. ASX Settlement, Australia's cash equity settlement system), such approved netting arrangement being an important component of Australian financial market infrastructure; and
- the payments, or transfers of, dealings with, or the exercise or performance of, rights, obligations or property, in accordance with the market netting contract (such term amended to explicitly include the rules governing the operating of a netting market, if those rules have effect as a contract between a participant in the netting market and one or more other persons, e.g. the ASX Group's central counterparties, ASX Clear and ASX Clear (Futures)).

1.55 By removing impediments to Australian entities complying with margining requirements, resolving inconsistencies which currently exist in Australian law and providing legal certainty to certain operations of key financial market infrastructure, this proposal responds to the Financial System Inquiry's (FSI) observation that more needs to be done to remove impediments to cross-border competition and other barriers to the free flow of capital across borders[11]; and the Government's response to the FSI, which undertook to develop legislative amendments to clarify domestic regulation to support globally coordinated policy efforts and facilitate the ongoing participation of Australian entities in international capital markets. [12]

Question 3: What policy options is the Government considering?

1.56 There are only two feasible options to address the problem this RIS identifies. These are to maintain the status quo, or to legislate to remove impediments to compliance with international resilience reforms. No other options have been seriously considered or proposed, as anything less than legislative amendment could not provide the kind of certainty needed to remove impediments outlined in this RIS, and ensure that entities subject to Australian law can participate effectively in global markets.

[11] The Financial System Inquiry Final Report, Box 4, page 20-21, http://fsi.gov.au/publications/final-report/executive-summary/

[12] Improving Australia's financial system – Government response to the Financial System Inquiry, available at http://www.treasury.gov.au/~/media/Treasury/Publications%20and%20Media/Publications/2015/Government%20response%20to%20the%20Financial%20System%20Inquiry/Downloads/PDF/Government_response_to_FSI_2015.ashx.

Option 1: Maintain the status quo

1.57 Under Option 1, no changes will be made to the legislative arrangements to support international competitiveness of Australian firms as well as their access to international OTC derivatives markets.

Option 2: Remove impediments to compliance with international resilience reforms

1.58 Under Option 2, the Government will develop legislative amendments to ensure that Australian law does not impede entities from complying with foreign OTC margining related regulations or practices. APRA is considering separately how best to implement the global recommendations for its regulated entities with regard to margining and is likely to proceed with its implementation through existing or new prudential standards and practice guides. Any proposals would follow the usual regulation impact assessment process.

1.59 The proposed amendments include:

- amendments to the PSN Act to enable entities subject to Australian law to give, and enforce rights in respect of, margin provided by way of security in connection with certain financial market transactions in a manner consistent with international requirements;
- amendments to resolve conflicts between the Banking Act, other Acts and the PSN Act with respect to stays on close-out rights;
- amendments to the Superannuation Industry (Supervision) Regulations and the Life Insurance Regulations to enable trustees of superannuation entities and life companies to grant security interests in respect of cleared OTC derivatives and uncleared OTC derivatives;
- amendments to remove other technical barriers to the provision of margin; and
- amendments to promote certainty for the operation of key financial market infrastructure (e.g. certain operations of Australian settlement systems and licensed clearing and settlement facilities, such as ASX Settlement, ASX Clear and ASX Clear (Futures)) under the PSN Act.

Question 4: What is the likely net benefit of each option?

Option 1: Maintain the status quo

1.60 Under this option, Australian businesses would be unable to, or find it much more costly to, engage in global markets once the margining reforms are implemented by our major trading partners (the EU and the US). That is, Australian businesses would effectively face barriers to entry to global capital markets.

1.61 The implications for Australian businesses of being impeded or excluded from accessing foreign markets as a result of legal barriers in Australian law are difficult to quantify but will be considerable. For example, much higher costs of the wholesale funding for the Australian banks may result in loss of their international competitiveness (to remain competitive, banks need access to deeper pools of market liquidity and better market pricing).

1.62 Superannuation funds and life companies use derivatives to hedge and manage risks within their funds. The inability to access sections of the US-cleared OTC derivatives market will make it more costly and complicated for fund managers to hedge these risks.

1.63 Australia will also be hampered in seeking recognition of Australia's legislative arrangements which may mean that when Australian businesses are able to make arrangements to meet foreign obligations they will have to comply with inconsistent and often conflicting global rules. This could include accepting foreign models for margining which may be to the commercial disadvantage of Australia and Australian businesses. This would not result in any additional domestic regulatory costs or savings for industry but would be extremely costly for industry through extraterritorial application of foreign rules.

1.64 Given the size of the Australian OTC derivatives market and using both Deloitte's assumptions about the cost of post-margining trading[13] and Australian firms' preliminary estimates of costs associated with their limited access to international OTC markets, we estimate the total costs of Option 1 to be around $88 million[14] per year upon commencement of the international requirements.

1.65 There are significant risks, and costs to Australian businesses, associated with maintaining the status quo (Option 1). For example, a risk associated with keeping the status quo is that entities subject to Australian law would not be able to comply with the margin requirements to be imposed internationally and in Australia (noting the recent release of APRA's draft prudential standards on margining and risk mitigation).

1.66 APRA will not be able to effectively implement its margin requirements without this reform. This would be inconsistent with Australia's commitment to implement to G20 OTC derivatives reforms and the Australian Government's response to the Financial System Inquiry (which was to develop legislative amendments to clarify domestic regulation to support globally coordinated policy efforts and facilitate the ongoing participation of Australian entities in international capital markets).

Option 2: Remove impediments to compliance with international resilience reforms

1.67 The reforms proposed in Option 2 would ensure that Australian law provides a framework which enables Australian entities to give, and enforce rights in respect of, margin provided by way of security.

1.68 This Option, being generally facilitative in nature, will not of itself impose significant regulatory burdens on the entities which may receive the benefit of the reforms. This reform does not of itself impose any margin requirements. These reforms mitigate some of the legal risks, and costs and complexity, associated with any future margin requirements imposed by APRA and reduces the legal risks for entities which are subject to Australian law and foreign margin requirements.

1.69 Without this reform, entities subject to Australian law may be restricted from participating in important international financial markets and prevented from managing their risk, and allocating their capital, in the most efficient manner. To the extent Australian financial institutions were restricted from trading with important counterparties or in important capital markets, significant costs would arise.

1.70 The compliance costs associated with foreign OTC margining-related regulations, as well as the consequential barriers to access to international capital markets for Australian firms, would be lower if the legal impediments to posting margin were removed from Australian law. We estimate that removal of these impediments (Option 2)

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13 https://www2.deloitte.com/content/dam/Deloitte/ie/Documents/FinancialServices/investmentmanagement/2014_otc-derivatives_deloitte_ireland.pdf

14 This includes variation and initial margin placed, capital charges on the margin placed, reporting and foreign compliance costs, and additional costs due to limited/hampered access to global capital markets.

would bring the total associated costs of margining down to $84.2 million per year — a saving of $3.9 million per annum compared to Option 1.

1.71 The $3.9 million difference between the two options is a conservative estimate of the regulatory costs that industry will bear, if a facilitative legal regime is not in place by 1 September 2016. The $3.9 million per annum includes costs associated with: the creation of complex legal, administrative, and operational structures that attempt to comply with foreign requirements; negotiation to enter into transactions with counterparties that operate under different prudential standards; meeting reporting or notification obligations; and extensive work to understand how to the new international requirements may affect their business operations.

1.72 It is also highly likely that, in the absence of Government action, the foreign compliance costs and associated barriers to access to international capital markets for Australian firms will increase significantly over time as other jurisdictions move towards full implementation of their margining regulations.

1.73 These costs are directly associated with efforts to comply with international regulatory requirements. They do not, however, account for other, significant impacts on Australian business. Feedback from leading industry representatives emphasised the potential opportunity cost (i.e. incapacity to get the best prices, or trade with the full range of counterparties); and increased business risk due to an inability to properly hedge their specific risks.

1.74 Superannuation funds and life companies have noted that removing impediments in their sectors would immediately lower their costs by being able to access the US OTC derivatives market, which has a greater number of counterparties and increased liquidity. These entities would also able to access a wider range of cheaper derivatives to manage and hedge risks within their funds.

1.75 Failure to comply early will have follow on effects for domestic counterparties and the broader economy.

Risks

1.76 Because these reforms provide clarification regarding the rights of certain parties in relation to secured funds (or ‘priorities’), the key risks that have been addressed relate to the potential for other creditors, depositors and/or policyholders to be adversely affected. This could arise, for example, if a party to an OTC derivative became insolvent and the other party exercised its rights to close-out, effectively obtaining priority for its debt over that of other creditors.

1.77 This risk has been carefully mitigated by working closely with the Council of Financial Regulators on the safeguards which must be satisfied in order for the new protections to apply and consulting widely with industry. The safeguards are outlined below.

- The margin must be transferred to be in the possession or under the control of the secured party or their representative, which effectively means that the grantor has to internalise (to some degree) the costs of trading in derivatives.
- The law will only protect the enforcement of rights against limited types of property provided as margin, being cash and certain financial instruments.
- The only obligations that can be discharged are related to derivatives; and the protections afforded to enforcement do not extend to other kinds of financial dealings.
- Enforcement of security against property that can be dealt with in the ordinary course of a person’s business will not be protected. This means

that, for example, banks cannot give a floating charge over all of their assets.

- In enforcing its rights, the secured party must still comply with general law duties, in accordance with the terms of the security (this means, for example, the secured party would be unable to sell the margin for less than established market rates).
- The terms of the security given need to be evidenced in writing, to ensure the terms are clearly agreed in advance of entry into external administration.
- Many security agreements also require parties to act in good faith, in a commercially reasonable manner.

Table 1.1: Option 2 Regulatory Burden and Cost Offset Estimate

Average Annual Regulatory Costs (from Business as usual)				
Change in costs (<u>$million</u>)	**Business**	**Community Organisations**	**Individuals**	**Total change in cost**
Total by Sector	- $3.9 million	-	-	- $3.9 million
Cost offset (<u>$million</u>)	**Business**	**Community Organisations**	**Individuals**	**Total by Source**
Agency	-	-	-	-
Total by Sector	-	-	-	-
Are all new costs offset? ☐**yes, costs are offset (see below)** ☐ **no, costs are not offset** ☒ **deregulatory, no offsets required**				
Total (Change in costs - Cost offset) (<u>$million</u>) - $3.9 million				

Question 5: Who will you consult and how will you consult them?

1.78 Since the release of the final report of the FSI in December 2014, the Government, through Treasury, has been actively consulting with industry associations on the cost of margining requirements and the need to remove legal impediments in Australian legislation. To date, the consultations have involved:

- panel discussion on a margining framework, model, and implementation timeline organised by ISDA;
- monthly participation in non-cleared derivatives margining liaison meetings organised by AFMA and the FSC; and

- public consultation on the legislative reform package intended to achieve Option 2 (including on exposure draft of the proposed Bill and Regulation to implement Option 2).

1.79 In addition, Treasury regularly consults with Australian Prudential Regulation Authority (APRA), Australian Securities and Investments Commission (ASIC) and the Reserve Bank of Australia (RBA) at fortnightly meetings of the OTC Derivatives Working Group on industry's readiness for margining requirements and progress to date on its implementation.

1.80 The Government, through Treasury, has developed an exposure draft for public consultation prior to introduction). This public consultation closed on 5 February 2016.

1.81 Overall, submissions indicated strong support for the reforms and their objectives (i.e. strong support for Option 2). The suggested amendments submitted by stakeholders on the draft legislation focused on specific technical issues, such as the definition of particular terms.

1.82 There was significant support for the amendments (which are broadly described in this RIS) to be made in relation to the enforcement of security-based collateral arrangements, and the enhanced protections and legal certainty provided by these changes. However, several stakeholders suggested broadening the types of obligations covered by the new protections. Whilst the Bill to be introduced to Parliament will clarify the obligations to be covered by the new protections, the reforms in the Bill will not go as far as requested by some submissions as this would increase potential unintended consequences and does not accord with the policy intention set out in this RIS.

1.83 Some stakeholders expressed the view that the reforms regarding the application of stays on close-out rights do not sufficiently align Australia's regime with international practice. It was recommended that Australia's regime should reflect and comply with the approach set out in internationally agreed documents. Further consideration has been given to this issue in the Bill to be introduced to Parliament, and the Bill to be introduced balances the need to align with international practice with the need to maintain Australia's strong and resilient financial system regulatory framework.

1.84 Given the strong industry support for making these changes (which was evidenced in the submissions received during the consultation process), these reforms are expected to be introduced in the Autumn sittings of parliament on the expectation that the legislation will be settled in time.

1.85 Changes to the Superannuation Industry (Supervision) Regulations and Life Insurance Regulations will not require legislation and would be implemented separately to, but in a similar timeframe to, the passage of the legislation. Superannuation funds and life companies have expressed a desire that the proposed Superannuation Industry (Supervision) Regulations and Life Insurance Regulations changes be expedited in light of the current difficulties faced by these superannuation funds and life companies.

Question 6: What is the best option from those you have considered?

1.86 Option 2 is the preferred option. This is consistent with the approach indicated by ASIC, APRA and RBA in the Council of Financial Regulators' Report on the Australian OTC Derivatives Market, November 2015 (CFR Report).[15] The Council of Financial Regulators surveyed and met with a range of APRA-regulated entities in respect of margin requirements and risk mitigation standards for non-centrally cleared

[15] Available at http://www.cfr.gov.au/publications/cfr-publications/2015/report-on-the-australian-otc-derivatives-market-november/pdf/report.pdf.

derivatives, including to gauge their preparedness to comply with these requirements and standards. The reforms in Option 2 will make Australian law consistent with requirements to be introduced in the Australian domestic prudential regulatory regime, as well as in international regulatory regimes.

1.87 It is expected that entities subject to Australian law, and by extension the efficient operation of Australian entities in global financial markets, would suffer significant adverse consequences if the status quo (Option 1) was maintained (for the reasons set out in this RIS). Retaining idiosyncratic legislative impediments in this respect in Australia would also be inconsistent with the promotion of Australia as a regional financial centre.

Question 7: How will you implement and evaluate your chosen option?

1.88 Option 2 will be implemented by amending the PSN Act and associated provisions in other Acts to:

- enable entities subject to Australian law to give, and enforce rights in respect of, margin provided by way of security in connection with certain financial market transactions in a manner consistent with international requirements;
- clarify domestic legislation to support globally coordinated policy efforts and provide certainty about the operation of Australian law in relation to the exercise of termination rights (also known as close-out rights) under certain financial market transactions; and
- enhance financial system stability by ensuring legal certainty for the operation of approved Real Time Gross Settlement (RTGS) systems, approved netting arrangements and netting markets (more specifically, market netting contracts) in all market conditions.

1.89 This Bill will be substantially in the form of the exposure draft of the Bill which was publicly consulted on, subject to some amendments to reflect the issues raised during consultation.

1.90 Option 2 will also be implemented by amending the Superannuation Industry (Supervision) and the Life Insurance Regulations to enable trustees of superannuation entities and life companies to grant security interests in respect of cleared OTC derivatives and uncleared OTC derivatives. The amending regulation will be substantially in the form of the exposure draft of the Financial System Legislation Amendment (Resilience and Collateral Protection) Regulation 2016 (the Regulation) which was publicly consulted on, subject to some amendments to reflect the issues raised during consultation.

1.91 The Government will seek to introduce the Bill and Regulation early 2016, and the Bill and Regulation will commence in the manner set out in the Bill and Regulation respectively. The implementation of this Option 2 conforms with the Government's policy position as set out in its response to the FSI.

1.92 The Government, through Treasury, will evaluate the way in which Option 2 has been implemented by:

- ensuring that the Bill and Regulation are finalised in time to be tabled in Parliament in the Autumn sittings and passed early 2016;
- continuing to actively consult with industry associations such as AFMA and ISDA on the practical effect the removal of impediments is having on the implementation of margining arrangements by market participants and

effectiveness of the reforms set out in the Bill and Regulation in facilitating that implementation;

- continuing to attend monthly non-cleared derivatives margining liaison meetings organised by AFMA; and
- regularly consulting with APRA, ASIC and the RBA, both formally and informally, including at fortnightly meetings of the OTC Derivatives Working Group on industry's implementation of margining requirements and the efficacy of the reforms set out in Option 2; and
- reviewing the next report on the Australian OTC derivatives market published by the Council of Financial Regulators to ensure the reforms set out in Option 2 are having the desired effect.

Question 8: Status of regulatory impact statement at each key decision point?

1.93 An Early Assessment regulation impact statement was prepared, and approved by Office of Best Practice Regulation (OBPR), before the exposure drafts of the reforms were released for publication. The first pass regulation impact statement was submitted following consultation.

APPENDIX

Background - global OTC derivatives reforms

1.94 The OTC derivatives market is one of the largest global financial markets. OTC derivatives are used by a wide range of market participants to hedge numerous types of financial and other risks, as well as for speculative purposes. The GFC highlighted structural deficiencies in the OTC derivatives market and the related risks these markets posed for wider financial markets and the real economy.

1.95 To manage these risks, the G20 leaders agreed at the 2009 Pittsburgh Summit to a number of reforms designed to improve transparency and default risk management in OTC derivatives markets.

1.96 A legislative framework for implementing these G20 commitments was established in Australia in December 2012. The framework allows the Treasurer to make determinations in relation to trade reporting, central clearing and platform trading of OTC derivatives. In making a determination the Treasurer is required to consult with the regulators: ASIC, RBA and APRA. The regulators provide advice to the Minister about Australia's OTC derivatives markets and recommended regulatory action in the form of periodic reports on the Australian OTC derivatives market.

Background – margining

1.97 In 2011, the G20 agreed to add margin requirements on non-centrally-cleared derivatives to its reform program and called upon the BCBS and the IOSCO to develop consistent global standards for these margin requirements.

1.98 In October 2011, the BCBS and the IOSCO formed the Working Group on Margining Requirements (WGMR) to develop a proposal on margin requirements for non-centrally-cleared derivatives for consultation by mid-2012.

1.99 After a number of consultations, responses and a quantitative impact statement, the BCBS and the IOSCO published a final framework for margin requirements for non-centrally cleared OTC derivatives in September 2013. In March 2015, the WGMR subsequently revised this final framework and agreed that phasing in of the global margin requirements for OTC derivatives would begin in September 2016. This global implementation timeframe makes it now pressing that Australian legal issues which impede Australian firms from complying with the requirements being put in place by our trading partners (whether that compliance is required as a matter of foreign law or commercial imperative) are identified and resolved, in order to ensure Australian firms remain internationally competitive and retain access to, and the ability to effectively participate in, global capital markets.

1.100 Margining requirements aim to ensure that collateral is available to offset losses caused by the default of a derivatives counterparty when dealing in non-centrally cleared OTC derivatives. Whereas bank capital rules require that banks set aside their own capital to cover the risk of losses, the margining rules require that banks hold collateral from their counterparty to cover the risk of loss which may arise on that counterparty's default.

1.101 In the event of a counterparty default, the margin protects the surviving party by absorbing losses using the collateral provided by the defaulting entity. By contrast, capital adds loss absorbency to the system, but the costs accrue to the surviving counterparty, because the bank is using its own capital to meet losses, which can create systemic risk.

1.102 The BCBS and the IOSCO have identified two objectives, in formalising the requirement for margining.

- **Increased financial system resilience**. Only standardised derivatives are suitable for central clearing. A substantial fraction of derivatives are not standardised and cannot be centrally cleared. These non-centrally cleared derivatives can potentially be destabilising to the financial system as they are highly pro-cyclical and may lead to the build-up of uncollateralised exposures.
- **Promotion of central clearing**. In many jurisdictions, central clearing will be mandatory for most standardised derivatives. But clearing imposes costs, in part because central counterparties require margin to be posted. Margin requirements on non-centrally cleared derivatives, by reflecting the generally higher risk associated with these derivatives, will promote central clearing, making the G20's original 2009 reform program more effective. This could, in turn, contribute to the reduction of systemic risk.

1.103 There are also risks and costs from margining, as follows.

- **Adverse liquidity impact** resulting from derivatives counterparties' need to provide liquid high-quality collateral to meet these requirements, including potential changes to market functioning as a result of an increased aggregate demand for such collateral.
- **Regulatory arbitrage**. The effectiveness of margining requirements could be undermined if the requirements are not consistent internationally. Activity could move to locations with lower margin requirements as the financial institutions operating in the low-margin locations could gain a competitive advantage (that is, it could result in an uneven playing field).
- **Costs and complexity**. Margining will make it more expensive for businesses to use derivatives products and require more of their time to manage risks. Complexity is a particular risk for corporations not active in financial markets which rely on derivatives to manage risks in funding or global income.,
- **Legal risks**. The imposition of margining requirements domestically and internationally also means that rules around collateral protection, netting and bankruptcy remoteness need to be unambiguous, and wherever possible, consistent amongst trading partners. The proposals which this RIS considers, particularly Option 2, are intended to address this legal risk.