20 June 2014

Mr Alex Ozerov
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Financial System and Services Division
The Treasury
Langton Crescent
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By email: Alex.Ozerov@treasury.gov.au

Dear Mr Ozerov

Financial Sector Legislation Amendment (Netting Contracts) Bill 2013

This letter concerns the call for comments on the Financial Sector Legislation Amendment (Netting Contracts) Bill 2013 (Bill). The opportunity to make comments on this important legislation is appreciated.

AFMA welcomes the Government's attention to the issue of maintaining the integrity of close-out netting to the greatest extent possible through preparing the legislation for introduction to the Parliament. In our previous submissions on this issue we have emphasised the importance and priority needed for addressing legal concerns with the current close-out netting regime in Australia and preserving the important benefits of close-out netting in our market.

AFMA appreciates the acceptance of our views and comments from previous preparatory rounds of consultation during the course of development of this draft legislation.

1. Close-out netting to generally prevail

The policy objective of the main amendments is to deal with the circumstances where APRA has appointed a statutory manager to an authorised deposit-taking institution (ADI) under the Banking Act 1959 (Banking Act). There is an inconsistency between the effect of this Act and the Payment Systems and Netting Act 1998 (Netting Act) in respect of the enforceability of a close-out netting contract. The Banking Act states that the assumption of control of an ADI by a statutory manager does not provide the grounds for the close-out of a netting contract to which the ADI is a party. In contrast, the Netting Act has the

effect of allowing close-out where an external administrator has been appointed to a party to a close-out netting contract.

It is an important and enduring policy objective there be no general prohibition on close-out netting for other reasons during that period. The amendments are directed to the period during which section 15C of the Banking Act (and the equivalent insurance legislation) prevails over the Netting Act.

The inconsistency between the Banking Act and Netting Act creates uncertainty as to the capacity of a party to exercise a contractual right to close-out a netting contract with an ADI that is in statutory management. This uncertainty has the potential to impede the efficiency of the financial markets in Australia and to create difficulties for ADIs and other Australian entities entering into currency and interest rate contracts. These difficulties could be heightened if market confidence was fragile.

2. General termination preserved

Other than in the case of the appointment of a statutory manager counterparties should be able to rely on any other event or judicial manager to apply close-out netting. Accordingly by way of example, if the ADI fails (for whatever reason, including a direction from APRA) to make a payment that is due under a close-out netting contract, the counterparty should be allowed to exercise its close-out netting rights. As this is a critical point for market participants, we request that a statement confirming this principle be included in the Explanatory Memorandum to the Bill.

3. Solvency declaration consistency with insolvency law

It is important that as far as possible there is consistency with the solvency test contained in section 95A of the Corporations Act 2001. To this end we suggest that in the proposed section 15CB(1)(b)(ii) of the Banking Act that the drafting should be amended to the effect that APRA should be satisfied that all the liabilities of the ADI will be met as and when they become due and payable, rather than only the liabilities under the close-out netting contracts to which the ADI is a party.

In addition, in our view any declaration by APRA in accordance with proposed section 15CB should be required to state a time frame for which that declaration applies.

4. Cherry-picking of close-out netting contracts

In the proposed section 15CB(2) of the Banking Act, APRA will be able to declare that subsection 15C(2) is to continue to apply in relation to a particular close-out netting contract. We understand that there may be valid circumstances in which APRA would chose to continue the application of 15C(2) so that certain close-out netting contracts may not be closed out. Because there is some discretion here it is important to allay markets concerns that this leaves open a potential path for “cherry-picking”. To this end it would be helpful if the Explanatory Memorandum provided greater clarity as to the intended scope of this amendment. Concerns arise because the statutory manager or judicial manager could have the right to issue notices:

1. terminating the default period for close-out netting contracts that are in-the-money in favour of the ADI or insurer but extending the default period for close-out netting contracts that are out–of-the money against the ADI or insurer; or
2. terminating the default period for close-out netting contracts with certain counterparties but extending the default period for other counterparties.

It is crucial to the market that there be no "cherry-picking" by the statutory or judicial manager and that the U.S. approach where close-out netting contracts not only with the counterparty but also with its affiliates are treated as a whole together with associated collateral is to be recommended.

5. External administration definition

The definition of "external administration" in section 14(2) of the Netting Act applies only where the counterparty to a close-out netting contract goes into external administration which is defined in section 5 to occur if:

a) they become a body corporate that is an externally administered body corporate within the meaning of the Corporations Act 2001; or
b) they become an individual who is an insolvent under administration; or
c) someone takes control of the person's property for the benefit of the person's creditors because the person is, or is likely to become, insolvent.

Given that the grounds for the appointment of a statutory manager over an ADI were broadened by the Financial System Legislation Amendment (Financial Claims Scheme and Other Measures) Act 2008 (2008 Amendment Act) to extend to circumstances where APRA considers that, in the absence of external support, it is likely that the ADI will be unable to carry on banking business in Australia consistently with the interests of its depositors and financial system stability in Australia, this may include circumstances that may not fall within section 5(c) of the Netting Act. Similarly, the grounds for appointment of a judicial manager over an insurer (and the judicial management regime was extended to general insurers by the 2008 Amendment Act) are not limited to insolvency of the insurer. Accordingly, we suggest that the definition of "external administration" in section 5(c) of the Netting Act be amended to explicitly include the appointment of a statutory manager or judicial manager under the relevant provisions of the Banking Act, Insurance Act and Life Insurance Act.

6. Application of amendments

The amendments to section 15C of the Banking Act and insertion of section 36AA of the Transfer Act which were made by the 2008 Amendment Act only apply to contracts made after the 2008 Amendment Act commenced on 18 October 2008.

On the other hand, the Bill provides that the proposed amendments in relation to Banking Act apply in relation to an ADI statutory manager being in control of the business of an ADI if the statutory manager takes control of the ADI's business after the commencement of the Bill and similarly with the Financial Sector (Business Transfer and Group Restructure) Act 1999 when the making of a compulsory transfer determination, or the issuing of a certificate of transfer, under the Transfer Act if the determination is made, or the certificate is issued, after the commencement of the Bill.

The difference in application of these provisions could lead to uncertainty as to the application of the relevant amendments in the Bill to contracts entered into before 18 October 2008 (as the provisions being amended in the Bill do not apply to those contracts).

If you have any queries about these comments I can be contacted at dlove@afma.com.au or on (02) 9776 7995.

Yours sincerely

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