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Dear Andrew and Samuel

Industry Comments on Margin Requirements for Non-Centrally Cleared Derivatives

We discussed at our last liaison meeting the desire of the industry working group to engage constructively with APRA and the other agencies in relation to local implementation of the BCBS / IOSCO Margin requirements for non-centrally cleared derivatives regime (WGMR). To further this goal, please see industry input on some of the elements of the regime set out in the following Attachment.

The Working Group believes there is a significant alignment of interests between industry and regulators in relation to WGMR. This includes shared objective such as:

- Implementation of Australia's G20 Cannes commitment in relation to uncleared margin in a way that has the most minimal adverse impact on the functioning of the Australian derivatives market;
- Australian institutions not being competitively disadvantaged by Australian-specific requirements;
- The Australian regime having the best prospects of achieving equivalence with offshore regimes;
- Requirements that align with the BCBS / IOSCO in a way that is not legalistic are simple to follow and efficient to implement.

In relation to timing, we note again a point that APRA will appreciate, which is that there is a lot to achieve in a short period. WGMR is complex and will have the most significant impact on derivatives

activity of all G20 OTC derivative reforms. As well as a need to finalise rules in just over nine months, there needs to be sufficient time for industry to implement the requirements operationally. Ideally a much lengthier period of time than that which will be available would be provided for this. Given both the tight implementation timeframe, and the considerable commercial impact that these rules will have on industry, we encourage APRA to continue to be open and consultative with industry in relation to the requirements.

Yours sincerely

David Love
General Counsel & International Adviser

1. Product scope for VM and IM

The preference of the group is for rules to be written as per the BCBS / IOSCO paper in terms of product scope. For example, we support the optionality of excluding or including principals on cross-currency swaps and FX forwards and swaps.

Some other points in relation to product scope:

(a) ***ASIC reporting distinctions***. APRA should avoid problems with the "derivative" definition that the ASIC transaction reporting regime has encountered. This is more important for margining than transaction reporting, because margining of non-derivative products that are inadvertently caught could have more adverse consequences than reporting them. Also, clashes between the US and the Australian reporting regimes are only significant in terms of regime implementation cost. They do not have a commercial impact on trading. The same is not true for margin.

The ASIC approach of using the s761D definition of derivative is understandable but has limitations. The s761D definition was designed with licensing in mind and not as the cornerstone of a whole OTC-specific regime. It suffers from over-inclusion problems, including non-derivatives like transfers of businesses involving intellectual property and loan sub-participations.

To ensure that s761D problems do not distort the regime, the use of the ISDA taxonomy as an overlay (note that the ASIC taxonomy did not closely follow the ISDA taxonomy), to weed out non-OTC-derivatives, should be used. Its role should be given a clear recognition.

(b) ***Permitted use of broader product set***. We would like APRA to permit use of a broader product set than the set *required* to be margined by the Australian regulations. This would achieve two goals:

(i) ***Cross-border***. It would assist with cross-border conflict between regimes. For example, if the APRA regime excluded electricity derivatives, including them at our option in an ISDA with a US counterparty (whose regime does not exclude electricity derivatives) could reduce margin disputes. We refer you to an ISDA submission from May this year which explains this point in more detail.

(ii) ***Less adverse effects***. This would achieve a fairer regime in certain instances. Transactions within master netting agreements that are not technically in scope for Pittsburgh / Cannes OTC regimes often serve an important risk balancing role in portfolios. For example, risk associated with physical forward transactions (out of scope) can be offset by derivatives such as commodity swaps (within scope) contained in the same portfolio. FX forwards (out of scope) can similarly balance FX options (in scope). There is no impairment of APRA's policy objectives regarding WGMR implementation in permitting this.

2. Entity scope I: how should APRA interpret: "financial firms and SINFEs"?

The BCBS-ISOSCO framework requires exchange of IM and VM (as appropriate to counterparty risks) with "financial firms and systemically-important non-financial entities" – (**SINFEs**).

As discussed, there are two components to entity capture:

(i) entities directly caught; and

(ii) counterparties that such entities are to margin with.

On the first point, the group has no objection to the Australian agencies' current approach to the regime covering prudentially-regulated institutions. We would ask however that APRA discusses this with the CFTC and prudential regulators to see if equivalence could be impaired by this approach. It seems unlikely that it would. We understand that APRA and ASIC are separately considering whether it is necessary to extend the application of the rules directly to non-prudentially-regulated institutions.

On the second point, a difficult decision for APRA is how to define financial firms and SINFEs.

As a comparison, EMIR equates this as effectively FC and NFC+s (as well as hypothetical NFC+s). The US prudential regulators (and likely the CFTC) use the concept of "financial end user" (in addition to existing Dodd Frank entity classifications). Singapore is considering capturing counterparties that are directly MAS regulated and "overseas regulated firms", which is to be defined.

There are two components to this:

(i) how Australian regulatory concepts correspond to these terms; and

(ii) how these terms are given meaning for non-Australian counterparties.

In relation to the first point, we suggest that banks and AFSLs are the counterparties in scope. We would hope that an ISDA representation letter approach could be used to capture this data in relation to counterparties.

Representations from counterparties should be sufficient for the purpose of identifying hedging counterparties.

In relation to the second point, some options are:

(a) ***Creating a new term***. Create a definition that captures standard financial activities (leaving aside here SINFEs). This is the way the US prudential regulators rules essentially operate, in the definition of "financial end user". A simpler definition, which does not relate to regulatory concepts from any one jurisdiction, would be preferable.

An example of how to achieve this would be to refer to an entity "[incorporated] outside of Australia whose business involves provision of services in relation to any of the following areas: banking, provision of credit, currency conversion, insurance, collective investments or superannuation".

It would then be helpful if ASIC gave us guidance which suggested that in forming a view about whether an entity was a financial entity or not, analogous provisions in their jurisdiction of incorporation could be looked to for guidance (e.g. "financial end user" in the US). This helpfully provides a form of deference to foreign regulators, increases harmony with foreign regimes, avoids arbitrage between jurisdictions'

definitions and goes a long way to avoiding the risk of counterparties refusing to deal with Australian counterparties to avoid making Australian-specific representations.

(b) ***Utilising US terms***. Both Treasury (see 'foreign internationally active dealer' definition in 7.5A.65 of this regulation) and ASIC (see Phase 1 in Table S1.1 in Schedule 1 of the transaction reporting rules) have used this technique. The approach would be to say that the relevant class are those entities that are "financial end users" (in addition to directly-regulated US entities such as swap dealers) as per the US prudential regulators regulations. Applying the US term to non-US entities would be problematic, as it relies on an entity having a particular status in the US, or in the case of the "financial end user" (see para (xii) of the definition) for an entity to determine whether it would have such a status or be subject to regulation if it were organised under US laws.

(c) ***Utilising EU terms***. This approach would be to say that the relevant class are those entities that are financial counterparties or non-financial counterparties above the clearing threshold (NFC+), or hypothetical NFC+ counterparties. The EU definition has as an advantage the closest correspondence to the BCBS / IOSCO principles. However, some counterparties might question why they were being asked to determine the application of a European term in their relationship with Australian entities. It also has the same problems as the US term in requiring parties incorporated outside of the EU to determine what its EU status would be if it *were* incorporated in the EU.

The group prefers the first option. The definition is simple and is easy for an entity to use for self-identification. If the entity does not wish to self-identify solely for the sake of the Australian regime and Australian banks, if it has self-identified under foreign regimes (e.g. represented that it is an NFC-) this would be sufficient for us.

Finally, some of the above approaches attempt to capture only counterparties that are financial firms, but do not attempt to capture SINFEs. An approach which would more explicitly address the BCBS / IOSCO requirements would be to create a definition of SINFE, and make this "any entity designated by APRA as a SINFE". This could include designation by class, including by using any foreign regulatory status as a measure (for example, major swap participants, NFC+ entities). The group suggests that this approach is taken.

Entity scope II: other considerations

Points on this include:

(a) ***BCBS / IOSCO principle accepted***. The group accepts that Australian banks will need to exchange IM/VM when facing any financial firm or any systemically important non-financial entity, irrespective of the jurisdiction of such counterparty and irrespective of whether, for domestic counterparties, the firm is regulated by ASIC and / or APRA.

(b) ***Avoiding new offshore entity definitions***. The group views it as essential that the APRA regime does not effectively require Australian banks to force counterparties offshore (i.e. beyond Australian ones) to represent their status by reference to new Australian-based requirements. The unfortunate result of this would be that certain counterparties would cease to trade with Australian banks rather than ascertain their status under a foreign regime.

(c) ***Standard exclusions required***. The group requests that the entities referred to in the BCBS / IOSCO paper as being excluded are also excluded from the scope of the APRA regime (for example sovereigns).

(d) ***Securitisation exemption is critical***. Certain SPVs, such as securitisation trusts, should be excluded. Most of the bank group are participants in the Australian Securitisation Forum and endorse ASF's assertions of the destructive impact that a margin regime

that affects securitisation would have. It is important that before any mandate is imposed that affects securitisation, a thorough assessment of its impact is considered, which should include modelling. In case helpful, we refer you to a 24 Nov 14 SIFMA submission in relation to securitisation. Although this pertains to the US regime and US securitisation market, this is broadly as applicable in Australia. We would note that an exemption is of fundamental importance to Australian banks given the role that securitisation plays in funding their lending activities.

3. How should APRA deal with netting-unfriendly jurisdictions?

WGMR regimes have the potential to expose banks to increased risk associated with netting-unfriendly jurisdictions. The problem is well explained in this ISDA submission from 11 Sep 15 (see sections B and C starting page 9). You will note that generally the exposures to such jurisdictions are relatively very small (see Exhibits A and B). A recent *Risk article* written by ISDA also provides a helpful background.[1] There are different approaches to this matter:

(a) *US Prudential regulators rules*. This is set out in §_9(f) of the final US prudential regulators rules. Certain members of the group view this as an inadequate solution to the problem. This is because:

(i) there is no exception for VM;

(ii) regulator approval is required for each entity and jurisdiction;

(iii) it has to be shown that local rules require the trading to be onshore and that there is not a way of avoiding the netting-unfriendliness via an offshore arrangement;

(iv) the counterparty cannot have credit support from the US.

(b) *Singapore approach*. The Singapore consultation paper moots the idea of employing what in the US CFTC cross-border regime was referred to as an "emerging markets" exception. This is to permit a:

> *threshold such that an MAS Covered Entity shall be subject to the margin requirements only if its total exposure to counterparties from such jurisdictions exceeds a certain threshold.*

This is the approach recommended by ISDA.

(c) *No margining approach*. The obvious way to approach non-netting friendly jurisdictions is to avoid their intersection with WGMR regimes altogether by not requiring margining of counterparties from such jurisdictions. This is the alternative to the "emerging markets" exemption proposed by industry, and is explained in the ISDA submission from 11 Sep 15, section C on page 10.

(d) *Collect-only regime approach.* Please see below some observations about the concept of a "collect only regime". A modification to this approach would be to permit a bank to deal with a counterparty on a collect-only basis only in situations where the bank is unable to get a clean netting or a clean collateral opinion. A disadvantage of this approach is that counterparties in these jurisdictions might be unwilling to trade with us on such an uneven basis, particularly if banks from other WGMR-regime jurisdictions are following an "emerging markets" or "no margining" approach to such counterparties.

[1] Please let us know if you do not have access and we will arrange for it to be provided by ISDA or the publisher.

Certain members of the group would prefer either of options (b) or (c).

4. How should the Australian regime handle IM models?

We make the following points on IM model:

(a) ***The SIMM is central*.** We encourage APRA to adopt an understanding approach to the way in which industry has had to respond to WGMR requirements by producing a model to be used across the whole industry in responding to multiple regimes simultaneously. It is important that Australian banks have the option to use the ISDA SIMM as modified as appropriate for local conditions if necessary. It is also important that Australian banks are able to use the industry utilities that will be developed around the SIMM. The SIMM and associated utilities will have been developed for the purpose of complying with rules in the first-to-finalise / major jurisdictions. We would like to work closely with APRA as the SIMM is developed and discussed between industry offshore and foreign regulators.

(b) ***SIMM timing***. Use of the standard look-up table is associated with more than 10 times the margin requirements that a risk sensitive model would require (see BCBS / IOSCO QIS, table 8 p36). An Australian bank using this sort of schedule, when facing other global banks using a model, would face considerable adverse consequences. September 2016 is a very tight timetable even for entities regulated offshore to have their regulators approve the models they are to use. This is despite the fact that the engagement between industry (in particular the ISDA SIMM working group) and the major offshore regulators in relation to models has been ongoing for quite some time. It is not impossible that one or more Australian banks could find themselves caught in a September 2016 IM phase-in bracket. We ask simply on this point that, again, APRA adopts an understanding and facilitative approach to the situation. We would also ask APRA to work with industry to avoid the risk of catastrophic consequences associated with margin models not being approved in time for the start date of initial margin margining. We would also ask that, if timing makes it desirable, APRA provide initial recognition, under the APRA regime, to models of Australian banks that have been already approved by foreign regulators under foreign regimes (e.g. US prudential regulators). Finally, given the risk of Australian banks being caught in the September 2016 wave of participants, we ask APRA to provide some guidance as to what detail will be required from Australian banks planning to use industry IM Models (SIMM) to obtain approval.

(c) ***Avoiding trading impact re approval***. We would very much appreciate it if APRA was able to work with us to ensure that, in the early stages of implementation particularly, *no trading is held up by the need for APRA approvals* in connection with model use.

(d) ***Australian dovetailing with earlier-finalised regimes.*** We would also be very appreciative if Australian rules could be written in a way that does not require changes to established global models / utilities. We fear that such changes would be difficult or impossible to procure.

(e) ***Regulatory deference***. As an Australian industry our submissions have consistently been that our offshore regulators should defer to our home regulators (see this submission to US regulators by the five Australian swap dealers from December last year). However, it now appears inevitable that margin models of Australian banks will need to be approved by foreign regulators. If this is the case, we may request that consideration be given to this by APRA, and that APRA coordinate with foreign regulators in relation to their approval of Australian bank models. Encouraging

interaction between APRA and foreign regulators was something that was strongly supported within our group.

(f) ***The Schedule-based approach*** should also be permitted, consistent with the BCBS / IOSCO framework.

5. Documentation points

Australian regime should fit with industry documentation initiatives. WGMR regimes require a very large industry redocumentation exercise. Based on draft and finalised rules in the major jurisdictions, the most common structure will comprise three separate CSAs, and new industry-developed documentation.

It is critical that provisions in APRA rules that touch on documentation (see for example 'EMNA' provisions in §_5 of the final US prudential regulators rules) fit with this.

6. What should be the frequency of exchange?

Certain members of the group suggest that APRA's requirements for exchange of VM and collection/posting of IM allow sufficient time for transfer of eligible collateral. This could be drafted in a way that takes account of the settlement time for eligible collateral. For example, for requirements arising on day zero, transfer could be required on day 1 for cash and day "n" for non-cash collateral, where "n" is the number of days required for a settlement of a trade in the relevant item.

We would also draw APRA's attention to the need for the APRA regime to be aware, in setting timing requirements, of the impact of time zone differences on the margining process. This is a particular concern for us in Asia. Please see "Time zone issues" on page 4 of this ISDA 10 Jul 15 submission. In this ISDA submission we also direct your attention to comments under "Time required for call" about sufficient time being needed to allow for a call of margin.

7. Obligations expressed in AUD

Where rule obligations are expressed in AUD, APRA should consider regular rebalancing to ensure continued alignment with EUR values set out in the BCBS / IOSCO paper.

8. What is appropriate regarding collateral eligibility for IM?

The group would prefer that parties are free to agree a wide range of collateral for posting for IM, consistent with BCBS / IOSCO principles.

9. What is appropriate regarding collateral eligibility for VM?

As with IM, the group would prefer that parties are free to agree a wide range of collateral for posting for VM. This should not be limited to just cash.

10. What haircuts are appropriate for collateral?

The group makes the following points about haircuts for collateral:

(a) The IM model should be permitted to be used for calculating the haircut which would also take into account the currency mismatch without needing to apply additional 8% haircut.

(b) Australia should follow concessions in EU and US rules where the 8% haircut is disapplied where the currency transferred has a certain status under the agreement ("currency of settlement" under the Prudential Regulators rules, and "transfer currency" and "termination currency" under the draft EU rules).

We draw your attention to ISDA's continuing advocacy on this point in the US with respect to 'settlement currency' and in the EU on 'transfer currency' with the aim that the 8% haircut should not apply in relation to the termination currency.

(b) Rules should also support the schedule-based haircut.

(c) If equivalence can be achieved with other regulators, consideration should be given to removing the 8% currency mismatch. Cash in particular should not have the 8% haircut applied. Note that the US (prudential regulators) and EU rules have no haircut for cash for VM (in the US, assuming the cash posted is USD or a so-called 'major currency'). .

11. How should disputes be handled in the rules?

The group supports the BCBS / IOSCO requirements for appropriate efforts aimed at timely resolution of disputes. The group would prefer that APRA avoids a prescriptive approach to dispute resolution. This is consistent with the approach taken by the US prudential regulators (§_10 of the final US prudential regulators rules).

12. How should IM be held?

Certain members of the group are of the view that the rules should be written in a way that does not prescribe tri-party custody. This allows for the market to develop and possibly adopt other ways to collect margin that is in line with the two core BCBS / IOSCO requirements (i.e. (i) IM is immediately available to the collecting party on counterparty default; and (ii) the posting party must be protected to the extent possible on insolvency of the collecting party). This approach is consistent with the direction being taken currently by the EU and Singaporean regimes. The alternative is to adopt a "custodian-only" approach as being taken by the US regime.

We also refer to the discussion that has taken place in the EU around the BCBS / IOSCO requirement (key principle 5) that IM be "immediately available to the collecting party in the event of the counterparty's default". The background is explained in this 22 Aug 14 ISDA submission to ESMA (page 2). In short, "immediately available" is too high standard in many jurisdictions and in relation to various assets. We expect this to be the case even after Australian law has been reformed to facilitate WGMR regimes applying in relation to Australian assets and counterparties.

13. Should the BCBS / IOSCO one-time-only rehypothecation element be implemented?

We refer here to the limited exemption for rehypothecation provided in para 5(v) (page 21) of the March 2015 BCBS-IOSCO paper.

No members of the group expressed a firm view that this exemption is critically important. We note that no jurisdiction so far has actually incorporated it in final or draft rules. Only Singapore has publicly proposed that it would take this up (see para 7.5 and Annex D of the Oct 15 MAS paper).

14. Should VM be permitted to be rehypothecated?

Yes. Full title-transfer of VM should be permitted, as per BCBS / IOSCO.

15. Should interaffiliate transactions be captured?

No. These should be left entirely out of the regime.

We simply repeat some consistent industry messages about the:

(a) adverse impact of interaffiliate margin – likely doubling IM quantum (see Q2 p4 of this 16 Jan 2015 ISDA submission); and

(b) lack of regulatory need for interaffiliate margin (see B commencing p13 of this 24 Nov 14 SIFMA submission).

We note that an interaffiliate exclusion is perfectly consistent with full implementation of the BCBS / IOSCO framework (see background discussion, page 22 of the March 2015 BCBS-IOSCO paper).

16. What cross-border principles should apply in the regime?

The Group's view is that the optimal approach to the Australian regime fitting with foreign regimes would be as follows.

(a) Foreign ADIs would only be in scope if booking to an Australian branch, and would be exempt if subject to a regime determined by APRA to be equivalent. Foreign ADIs would also be permitted to post collateral in accordance with Australian requirements where the Australian rules are determined to be equivalent by the relevant foreign regulator(s).

(b) Australian ADIs:

(i) (**Complying with direct foreign rules**) may comply with foreign rules determined by APRA to be equivalent, instead of APRA's rules, when those rules apply the Australian ADI in relation to the transaction;

(ii) (**Complying with indirect foreign rules**) as per EMIR Article 13, where a counterparty is directly subject to foreign rules that are deemed equivalent (and the ADI is indirectly subject to the same rules), the ADI does not have to comply with the Australian requirements; and

(iii) (**Posting in accordance with counterparty's regime**) may post in accordance with a foreign regime that the counterparty is subject to and not in accordance with the Australian regime.

Some members of the group view the cross-border provisions of the final US prudential regulators rules (see §_9) as being rather involved, and require a reasonably complex matrix to determine application. They also display insignificant deference to foreign regimes.

Also on cross-border principles, we would like to endorse views consistently expressed globally by industry and non-US regulators that equivalence should be assessed on an outcomes basis and not a line-by-line basis. It should also be determined by reference to BCBS / IOSCO principles and not equivalence with other rules. Finally, the group asks for APRA support for the request to US and other foreign regulators that equivalence be determined prior to Australian rule finalisation, and prior to the regime going live.

17. Collect-only options

Some members of the group recommend that APRA consider options that are consistent with BCBS / IOSCO which would reduce the risk of conflict between regimes. These include that:

(a) The APRA regime is entirely "collect only". This means that an ADI would not be obligated to post VM or IM to counterparties. Clearly posting and collecting would result where the counterparty is itself an ADI, but this is merely as a result of an indirect obligation. This is the approach that the Singaporean MAS is contemplating.

(b) When an ADI is dealing with a foreign counterparty it is not required to post margin, only collect it. Consequently ADIs would exchange VM and IM with each other, and with AFSLs, but only with foreign entities to the extent that the foreign regime required it (i.e. indirectly).

Both of these options:

(i) avoid netting-unfriendly jurisdiction problems.

(ii) reduce the risk of cross-border conflict;

(iii) fully address APRA's systemic risk reduction objectives.

On the "negatives" side, we note that:

(i) each option would result in significantly less overall market-wide margining and similarly increase the risk of foreign regimes determining the Australian regime to not be equivalent; and

(ii) they would also be considered by buy-side counterparties to offer them no protection and be therefore objected to largely.

Most of the group were opposed to collect-only options being pursued by APRA.

18. Phase in IM and VM

The group view is that:

(a) Phase-in should generally follow the BCBS / IOSCO recommendations. However, it is important that the APRA regime does not get ahead of the major regimes, and consideration should be given to delays that industry requests of BCBS / IOSCO.

(b) IM should only apply on new trades, which means that genuine amendments are not be considered as new trades. Genuine amendments should include trades resulting from compressions as well as novations. Finally, the European exclusion of uncleared trades with CCPs, entered into in the course of CCPs' managing their liquidity and a default, the group views as necessary.

(c) Ideally, threshold calculations would exclude non-margined products (for example, FX swaps). This is because, as is pointed out in this ISDA (24 Nov 14) submission to the US prudential regulators (see page 22), the same characteristics that justify exclusion from the regime of products like FX forwards justify their notionals not being counted in thresholds. However, BCBS / IOSCO require that they be included (see 8.9 of the March 2015 BCBS-IOSCO paper), and of the regimes that have consulted, only the EU is potentially going to exclude such derivatives. Accordingly, it is recommended that, unless the international trend changes, APRA follows BCBS / IOSCO.