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Dear Kathleen

Margin Requirements for Non-Centrally Cleared Derivatives CPS 226 Implementation Issues

I refer to our recent communications regarding queries from members of the Australian Financial Markets Association (AFMA)

Our comments relate to these points:

1. Definition of derivative and physical transactions in ISDAs
2. Timing
3. Risk mitigation principles application
4. Electricity market concerns
5. Substituted compliance
6. Foreign ADIs scope of home jurisdiction reliance
7. Netting and collateral enforceability
8. Foreign ADIs and level 2
9. Covered counterparty – 'financial institution' meaning
10. Risk mitigation – foreign accounting definitions

1. Definition of derivative and physical transactions in ISDAs

Paragraph (ii) of the definition of "derivative" in CPS 226 refers to arrangements which are commodity forwards, swaps and options, or any combination of those things, in relation to one or more commodities. In this letter, we refer to these arrangements as "physical transactions".

You have previously advised us that proposed definition of derivative was added to in final form to align with the definition of "eligible obligation" as defined in the *Payment Systems Netting Regulation* and directed us to the Explanatory Statement on the amending regulation which set out the thinking behind the expanded reference in para 9(g)(ii). The policy intention is to capture physically-settled commodity derivatives that could otherwise be excluded from the Corporations Act definition of "derivative" due to the tangible property exception in paragraph 761D(3)(a) of the Corporations Act.

The reference to 'commodity' is a broad one intended to include types of physical property over which commodity derivatives are written, including hard commodities (e.g. crude oil, iron ore, steel, gas, gold, silver, copper, platinum, palladium, nickel, base metals, precious metals, ferrous metals and coal) and soft agricultural commodities.

For the reasons set out below, AFMA would be grateful if APRA could consider clarifying the definition of "derivative" to ensure that a physical transaction only falls within the definition if it is subject to an agreement, such as an ISDA, together with other derivatives (i.e. derivatives as defined in the *Corporations Act*). This could be achieved neatly with guidance. It could also be achieved by including wording to the following effect at the end of the definition of "derivative" (or providing guidance to this effect):

> "*However, an arrangement described in paragraph (ii) is not a "derivative" under this Prudential Standard unless it is subject to the same netting agreement as at least one other derivative (within the meaning of Chapter 7 of the Corporations Act 2001) which is not an arrangement that is of a kind mentioned in subregulation 6(2) of the Payment Systems and Netting Regulations 2001."*

AFMA suggests that this approach would ensure that the Australian implementation of the margin requirements still captures the appropriate transactions to achieve the international policy objectives for margining (ie the reduction of systemic risk and promotion of central clearing, via the margining of OTC derivatives), without imposing an unintended regulatory burden on purely physical markets. We would be grateful if APRA could please consider whether this approach to the definition of "derivative" would achieve APRA's policy objective. Members support this approach for these reasons:

(a) *Reflecting the intention in the Resilience reforms*

We understand that the definition of "derivative" in the final CPS 226 was intended to be "*broadly aligned with the definition included in the Superannuation Industry (Supervision) Regulations 1994 [("**SIS Regulations**")] and the Life Insurance Regulations 1995 [("**Life Regulations**")], except CPS 226 excludes foreign exchange contracts with a duration of less than three days from the margin requirements*". The concepts which appear in the *SIS Regulations* and *Life Regulations* were adopted from the "eligible obligation" concept in the *Payment Systems and Netting Act 1998* (Cth) ("***Netting Act***") by the *Financial System Legislation Amendment (Resilience and Collateral Protection) Act 2016* (Cth) ("***Resilience reforms***"). The Explanatory

Memorandum to the Financial System Legislation Amendment (Resilience and Collateral Protection) Bill 2016 (Cth) ("***Resilience reforms Bill***"), which introduced the "eligible obligation" concept, explained that a functional concept of "eligible obligation" was adopted to ensure that, relevantly, "*physically settled commodity forwards and derivatives contracts relating to tangible property in the form of commodities, including grain forwards, which are documented under a derivatives master agreement such as an ISDA Master Agreement, are included*" in the "eligible obligation" concept.

We understand that the purpose of including physical transactions in this way was to ensure that the inclusion of a physical transaction like a physically settled gold forward in an ISDA Master Agreement would not prohibit the enforcement of a security-based initial margin arrangement related to that ISDA in the manner required by the international margin framework. If physical transactions had not been included, an Australian participant may not have been able to grant security in the manner required to comply with WGMR regimes. AFMA supported the inclusion of physical transactions in the "eligible obligation" concept for the reasons explained in our submission at the time:

> *AFMA considers that further consideration needs to be given to the definition of 'Eligible Obligation' to make it provide the intended coverage and protection. Sole reliance on the derivative definition in the Corporations Act, which was developed for different purposes is not sufficient to achieve the intended policy objective. At a minimum, physically settled commodity transactions should be included as eligible obligations (wherever used throughout the exposure draft) as they are* ***often documented under an ISDA Master Agreement (and Credit Support Annex) and may be considered derivatives depending on their use****.* (our emphasis)

We suggest that this indicates the intention of the *Resilience reforms* was to facilitate the enforcement of security in the manner required under WGMR margining rules in relation to all derivative transactions in an ISDA agreement, without contemplating that every physical transaction must be margined (irrespective of whether it is entered into in a standalone document or under a master agreement). We understood that, in line with the overall *Resilience reforms*, the inclusion was intended to be facilitative, and not mandatory or prescriptive.

We suggest that it would be consistent with the *Resilience reforms* for APRA to only require physical transactions be margined when they are included within derivatives master agreements with other derivatives which are not physical transactions.

(b) Avoiding capturing purely physical markets

Many different types of products constitute physical transactions. Some, such as bullion transactions, are viewed by participants as closely related to financial derivatives. By way of contrast, a lot of products are considered rather "un-OTC-like". Some examples include:

(i) a forward entered into by a farmer selling his / her wheat to an aggregator, or the aggregator selling the wheat to an exporter;

(ii) a sale of iron ore for shipment on a free on board (INCOTERMS) basis;

(iii) a retail electricity or gas contract; and

(iv) a purchase of office supply paper, on terms where payment and delivery occur on a monthly basis for a 12 month period.

AFMA members expect that extending WGMR regime cover to such all products may not have been APRA's intention, and would be grateful if APRA could please clarify the way in which CPS 226 is intended to apply to physical transactions which are not subject to derivatives master agreements which also govern other non-physical derivatives.

(c) Avoiding imposing margining obligations on ill-equipped markets

As well as containing a wide variety of products, markets for physical transactions contain a variety of participants, of differing levels of sophistication.

Participants to physical transactions who are financial and / or generally sophisticated entities sometimes include these transactions within ISDA documentation, which is facilitated by the 2005 ISDA Commodity Definitions. Reasons for including such products in an ISDA agreement include:

(i) reducing insolvency risk by use of netting;

(ii) permitting centralised settlement of payments; and

(iii) having the benefits of margining applied to a broader set of products.

However, generally these markets are not margined – particularly ones where payments are effected via mechanisms such as documentary letters of credit.
By clarifying that margin requirements only apply to physical transactions which are subject to a netting agreement to which other non-physical derivatives are subject (rather than all physical transactions), APRA would avoid imposing a significant regulatory burden on markets that are not accustomed to or currently capable of margining. Also, the policy considerations relevant to imposing margin requirements on OTC derivatives markets (ie reducing systemic risk and promoting central clearing) may not be as relevant for these physical markets.

(d) Avoiding the Australian and foreign WGMR regimes becoming misaligned

AFMA members are not aware of any foreign WGMR regime that mandates the exchange of margin for physical commodity forwards and options. While a conventional definition of "derivative" captures anything where the value of the contract varies by reference to an underlying, regulators and law-makers generally take the view that real-economy transactions such as sales of commodities should be excluded from mandatory obligations, even where title does not transfer immediately.

Having the Australian regime align with foreign regimes as far as is possible is important for a variety of reasons. This includes avoiding regulatory arbitrage, as well as avoiding unnecessary harm to Australian participants, or harm to the financing of Australian commodities. The Regulatory Impact Statement set out in the Explanatory

Memorandum to the *Resilience reforms Bill* referred to the importance of the alignment of WGMR regimes:

> *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).*[1]

As the APRA position would not be harmonised with foreign WGMR rules (ie APRA covered entities may be required to margin transactions with counterparties where other international financial institutions are not), APRA covered entities would inevitably be at a competitive disadvantage in actually conducting such physical transactions. There would also be an adverse impact on the provision of commodity financing.

(e) Avoiding a significant departure from the consultation draft and timing consequences

APRA clarifying this issue in the manner suggested in this letter would avoid a major change to the scope of APRA's margin regime without consultation on this substantive point. This is particularly important given that a lot of work is required to prepare to margin products traded with ISDA counterparties, and this is facilitated by industry approaches. In order to comply with the impending international timeframes, a lot of this work has been done already. To now identify all counterparties with whom physical transactions are traded by APRA covered entities (even where those physical transactions are not documented under derivatives master agreements), and to seek to negotiate the exchange of margin without the benefit of industry initiatives, is a significant additional task and would be very difficult, if not impossible, to do within the international timeframes.

2. Timing

AFMA members respectfully request the following:

(a) Immediate compliance date finalisation

The Australian regime has already had an impeding influence on Australian participants' ability to contact counterparties. It was only on 29 November that the Australian supplement to the ISDA "Regulatory Margin Self-Disclosure Letter" was published. Before this arrived it was not practically possible to commence polling counterparties about their status under Australian rules (or any rules, if the approach of only reaching out to counterparties on one occasion was adopted).

However, even with this barrier removed, we are still somewhat hampered in polling counterparties by compliance dates still being unresolved. Without being able to tell our counterparties the compliance date that we need their help to work towards makes our communications less effective.

[1] http://parlinfo.aph.gov.au/parlInfo/download/legislation/ems/r5649_ems_c328f26e-49d6-4a9e-8cc3-a5371f4711fe/upload_pdf/446146.pdf;fileType=application%2Fpdf See Appendix, para 2.103, page 130.

(b) Agreement to AANA period interpretation

To finalise the Australian supplement to the ISDA "Regulatory Margin Self-Disclosure Letter", ISDA / industry settled on having this document ask clients their AANA values for ***2016***. Of course at this stage it is not yet clear from the table in paragraph 12 when we will be required to commence margining counterparties and what year's client-provided AANA values this would be based on.

AFMA members request that we be permitted to use the AANA responses we receive to the current version of the Australian supplement for the initial phase of compliance with the APRA regime. This is to avoid having to ask clients about 2016 AANA as well as, separately and later, 2017 AANA, to determine whether they are in-scope for a single commencement date.

(c) Compliance date concessions

Members request that APRA covered entities are given a reasonable period of time to work with our counterparties to prepare for the commencement of margin rules. We propose 1 September 2017 as a commencement date for variation margin. This is a relatively short period of time to re-document all in-scope counterparties. We note that the CFTC and Prudential Regulators provided well over one year between finalisation of their margin rules and the 1 March 2017 variation margin compliance date applicable to clients. There is a general expectation that a significant proportion of counterparties the subject of US rules will not be re-documented.

3. Risk mitigation principles application

The risk mitigation principles (**RM principles**) require us to implement policies and procedures, and in doing so, in some instances make determinations about what products and counterparties the RM principles should be extended to.

AFMA members, led by the five Australian swap dealers, have proposed a set of different scenarios which we would appreciate discussing with APRA to understand expectations. These banks believe that the approach set out follows the risk-based principles set out in CPS226 in a way which enable delivery on the regulatory requirements within short timeframes.

These banks could deliver these requirements as soon as practicable, but in any event by 1 March 2018.

Interested banks would be pleased to explain the development required to be able to operationally meet APRA's requirements, and the work and time required for this.

4. Electricity market concerns

The impact of the rules on the electricity market has been an unexpected result of the margining rules. Electricity market participants are concerned in the first instance that the energy sector was not consulted around this change and that there was no known engagement between relevant regulators. Given that this change could impact Commonwealth /State arrangements and electricity security policy objectives it is suggested that APRA reach out to the Australian Energy Market Commission (AEMC) to brief them on your regulatory intentions.

5. Substituted compliance

OTC reform implementation in different jurisdictions is particularly susceptible to problems caused by regulatory overlap. WGMR regimes are no exception, and this is acknowledged in Element 7 (Interaction of national regimes in cross-border transactions) of the BCBS – IOSCO framework. Substituted compliance is an established mechanism within all WGMR frameworks for addressing these problems.

For substituted compliance frameworks to achieve anything more than minor benefit they need to be operational, on the basis of positive determinations, before compliance dates.

Would APRA kindly give consideration to making equivalence determinations in relation to US and EU regimes well ahead of APRA compliance dates? Two examples of some very practical and tangible benefit this would provide:

Take a European level 2 subsidiary of an Australian bank operating in Europe and subject to EMIR rules. It could negotiate with its counterparties to achieve EMIR-compliant documentation, without having to accommodate equivalent (but duplicative) APRA requirements.

Australian banks are not able to re-document CSAs, by use of an electronic method, in time for the 1 March international compliance date. This is because Australian requirements were finalised too late to get them built into the system. If APRA determined that US rules were equivalent, an Australian bank trading with a US bank could amend documentation via electronic methods, as Australian requirements would not need to be added by paper amendments.

In the alternative, could APRA permit Australian banks to make self-assessments regarding equivalence? Of course there is a precedent for this sort of approach in APRA's own rules (in paragraph 65, in relation to foreign entities only). Similarly the EU margin rules provide a concession in respect of interaffiliate margining requirements for a period of 3 years, to give time for equivalence determinations to be made (see Article 36, paragraph 6).

6. Foreign ADIs scope of home jurisdiction reliance

If a Foreign ADI is relying on the rule that allows it to comply with its home jurisdiction (assuming it has taken the view that the home jurisdictions' rules are in line with BCBS-IOSCO's framework), does the Foreign ADI need to comply with any portion of the APRA rules (e.g. SIMM notification/approval etc.).

7. Netting and collateral enforceability

We appreciate that APRA has recognised the difficulties in exchange of margin where there is doubt as to the enforceability of netting in the event of default of a counterparty. We would seek clarity for the situation where a Level 2 Group entity is incorporated, or a branch is operating, in a jurisdiction where the enforceability of netting at default is questionable and the counterparty is located in a "clean" netting jurisdiction.

In this instance, would margining still be required?

8. Foreign ADIs and level 2

Members understood during the consultation phase that the concept of 'Level 2 group' did not apply to Foreign ADIs. However, the final CPS 226 did not clarify this point.
Would APRA please provide clarification on this point?

9. Covered counterparty – 'financial institution' meaning

Could APRA please clarify the meaning of 'financial institution' as used in the definition of 'covered counterparty'. Can the interpretation draw on the BCBS-IOSCO principles?

Could APRA please clarify whether subsidiaries of non-financial institutions could classify as covered counterparties where they are involved in raising capital for the corporate group?

10. Risk mitigation – foreign accounting definitions

Definition of 'margining group' makes reference to Australian Accounting rules or 'equivalent accounting standard'. The Australian accounting standards are narrower than the US equivalent. Could APRA confirm that the intention is to look at the rules applicable to the ultimate parent entity?

AFMA looks forward to the discussion with you on these matters. I can be contacted on (02) 9776 7995 or at dlove@afma.com.au.

Yours sincerely

David Love
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