

BY EMAIL

To: Australian Prudential Regulation Authority
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Attention: Gideon Holland
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28 March 2022

Australia: ISDA SFT Documentation update and request for consideration

The International Swaps and Derivatives Association, Inc.¹ ("**ISDA**") has been actively engaged for many years with providing input on legislative and regulatory issues impacting global derivatives markets in major jurisdictions globally, including Australia. ISDA would like to thank the Australian Prudential Regulation Authority ("**APRA**") for its continual efforts to ensure that the Australian framework remains globally aligned with efforts to ensure safe and efficient markets.

We are writing to you to:

- (a) provide an update on the development and publication by ISDA of a new documentation architecture for securities financing transactions ("**SFTs**") (being repurchase transactions and securities lending transactions), and explain that there would be significant benefits to Australian and international market participants using

¹ Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 980 member institutions from 78 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers.

the ISDA SFT Documentation;²

- (b) identify an issue which would arise under Australian law in relation to the entry into of the ISDA SFT Documentation, which would impose a significant impediment to using the ISDA SFT Documentation with Australian market participants or where Australian law is relevant to the documentation; and
- (c) respectfully request that APRA consider whether it would be supportive of, or not object to, engagement by ISDA with the Australian Government to explore whether an amendment may be made to Australian law to address this issue and facilitate Australian market participants using the ISDA SFT Documentation.

In this letter, we have set out each of these matters in turn.

(a) Update on development of ISDA SFT Documentation

ISDA considers that the efficient deployment of capital and the maintenance of strong balance sheets is important for financial market participants around the world. One way that firms are working towards this is by standardising and automating processes and functions.

ISDA has identified that one way to improve efficiency and achieve greater standardisation is to facilitate the collaboration between two large, important and interconnected markets - derivatives and SFTs. Key elements to improving efficiency and enhancing standardisation through the collaboration between the derivatives and SFTs markets include:

- developing common legal definitions across the derivatives and SFT markets, documenting derivatives and SFTs under a common master agreement and procuring one set of legal opinions in jurisdictions around the world on close-out netting for both derivatives and SFTs;
- implementing consistent solutions across the derivatives and SFT markets that enable market participants to more seamlessly adapt and migrate when key legal, regulatory or market changes occur or issues arise (such as the interbank offered rate (IBOR) transition or issues arise regarding negative interest rates); and
- facilitating the digitisation of the derivatives and SFT markets, in terms of both negotiating and documenting trades, and developing a consistent trade record for confirmations and reporting, with standardized trade content and formats.

To achieve this, ISDA, in close consultation with market participants, has developed documentation (the ISDA SFT Documentation) to expand the ISDA Master Agreement so it

² This documentation is the 2022 ISDA Securities Financing Transactions Definitions, ISDA Securities Financing Transactions Schedule Provisions and template Confirmations for use with these Definitions and Provisions (collectively, the “**ISDA SFT Documentation**”).

can be used to document both derivatives and SFTs. At the end of February this year, the ISDA SFT Documentation was published and made available to market participants.³

By way of high-level summary, the core architecture of the ISDA SFT Documentation involves new optional additional provisions which may be included in the schedule to the ISDA Master Agreement (referred to as the “**schedule SFT provisions**”) and a separate SFT definitional booklet accompanied by template confirmations. These would include the relevant changes and terms necessary to reflect the fact that the transaction is in the form of an SFT rather than the form of a derivative more commonly documented under an ISDA Master Agreement. Any changes to the ISDA Master Agreement (and potentially the relevant credit support documentation) required for SFTs, additional generic provisions, relationship/portfolio issues and elections would be made via the schedule SFT provisions. The SFT definitional booklet would operate similarly to ISDA definitional booklets, in that it would include all common SFT transaction terms. ISDA would be happy to provide APRA with further information regarding the ISDA SFT Documentation if that would assist.

ISDA considers that there would be significant benefits to Australian and international market participants using the ISDA SFT Documentation. These benefits to Australian and international market participants in the use of the ISDA SFT Documentation would include:

- reduced credit risk (by expanding close-out netting sets)⁴ and optimised collateral use;
- increased operating efficiency (by reducing duplicative efforts and complexity, creating efficiencies in documentation negotiation and management, scaling legal work, digitizing/automating processes and establishing a foundation for greater automation and interoperability between the markets);
- more coordinated, holistic and consistent approach to addressing legal, regulatory and market changes which impact documentation and common documentation solutions and updates (e.g. protocols applying to derivatives and SFT documentation) to address these changes;
- single scalable cross-market technological solutions which leverage the economies of scale that technology has to offer and drive cost efficiency, given the increasing use by

³ ISDA’s press release is available at <https://www.isda.org/a/qV0gE/ISDA-Publishes-Documents-to-Align-Derivatives-and-SFT-Markets.pdf>, and the ISDA SFT Documentation is available at <https://www.isda.org/book/2022-isda-securities-financing-transactions-definitions/>.

⁴ In support of this, ISDA notes that the Basel Framework and capital accords specifically contemplate cross-product netting (noting that the effect of cross-product netting in reducing regulatory capital requirements is subject to significant limitations, for example it can only be used for risk-weighted assets by firms using internal models, and it cannot be used for the leverage ratio). This further supports a view that cross-product netting is recognised globally as a potential risk mitigant and that firms may want to use cross-product netting arrangements to reduce credit risk, to the extent they are legally permitted to do so, even if they cannot obtain regulatory capital recognition of that benefit.

market participants of technology and reliance on it and opportunities that the similar documentation architecture would present; and

- enhanced legal certainty of the enforceability of close-out netting against Chinese financial institutions in light of the latest legislative and regulatory changes in China.⁵

Accordingly, we would respectfully suggest that significant benefits would arise for Australian market participants in implementing and using the ISDA SFT Documentation as it is adopted in other major global financial markets. In the next part of this letter, we have provided further explanation of the mechanics of the ISDA SFT Documentation and the issue which arises under Australian law which would materially adversely affect the use of the ISDA SFT Documentation in Australia.

(b) Issue under Australian law

As you know, many Australian prudentially-regulated institutions and non-Australian market participants are required by regulations under Australian law and the laws of other jurisdictions to post and collect initial margin, and exchange variation margin, in relation to their uncleared derivatives. Generally, market participants comply with the requirements to post and collect initial margin by entering into credit support arrangements which rely for their efficacy on each party granting to the other security interests over collateral held with third party custodians. These margin requirements also impose requirements as to the availability to the collecting party of the margin collected, which are based on the key principle published by the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions that, relevantly, initial margin should be held in such a way as to ensure that the margin collected is immediately available to the collecting party in the event of the counterparty's default.⁶

⁵ By way of further background on this issue, we note that the Futures and Derivatives Law (“**FDL**”) is pending before China’s legislature for final reading and is expected to be passed this year. The FDL is expected to affirm netting enforceability for derivatives. However repos and other SFTs are not covered under FDL. The banking regulator, CBIRC, issued a circular on application of its SA-CCR rules in November 2021 in which CBIRC confirmed netting enforceability of repos and derivatives with Chinese financial institutions after consulting China’s supreme court regarding how close-out netting will be treated during bankruptcy proceedings in respect of a Chinese entity. However, one of the conditions imposed by the CBIRC is that the agreement has to be a recognized agreement in China. In addition to the onshore master agreements, 2002 ISDA Master Agreement is the only international agreement recognized by CBIRC (as well as PBOC, the central bank) to date. As a result, documenting SFTs under the 2002 ISDA Master Agreement will give Australian banks enhanced legal certainty regarding netting enforceability under repos against Chinese financial institutions. To be clear, ISDA is not suggesting that netting under a GMRA is not enforceable, but rather that there would be enhanced legal certainty documenting SFTs with Chinese financial institutions under a 2002 ISDA Master Agreement as compared to using other master agreements.

⁶ Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, *Margin requirements for non-centrally cleared derivatives* (available at <https://www.bis.org/bcbs/publ/d499.pdf>).

Under Australian law, we understand that market participants rely on the protection afforded to the enforcement of security under the *Payment Systems and Netting Act 1998* (Cth) (the “**Netting Act**”) in relation to the security-based credit support structures used to comply with margin requirements. This protection can apply to the enforcement of security over financial property, in respect of obligations of a party to a close-out netting contract, only to the extent that a range of conditions set out in the Netting Act and associated regulations are satisfied. One such condition is that the obligations secured by the financial property, and discharged through the enforcement, are “eligible obligations” in relation to the contract (or certain other obligations in relation to interest, costs and expenses).

The Netting Act and associated regulations further define what constitutes, and does not constitute, an “eligible obligation”. Sections 14A(8) and (9) of the Netting Act provides that:

- “(8) *An obligation is an **eligible obligation** in relation to a close-out netting contract if the obligation is any of the following:*
- (a) an obligation under the contract of a party to the contract that relates to a derivative or foreign exchange contract or is of another prescribed kind;⁷*
 - (b) an obligation that results from the netting of 2 or more obligations that are created under the contract that:*
 - (i) must include at least one obligation covered by paragraph (a); and*
 - (ii) may include one or more incidental obligations that, taken together, do not form a material part of the net obligation;*
 - (c) an obligation declared by the regulations to be an eligible obligation in relation to a close-out netting contract.*
- “(9) *However, an obligation is not an eligible obligation in relation to a close-out netting contract if it is declared by the regulations not to be an eligible obligation in relation to the contract for the purposes of this Act.*”

Regulation 6(2)(c) of the *Payment Systems and Netting Regulations 2001* (Cth) (the “**Netting Regulations**”) states that, among other obligations, an obligation under a reciprocal purchase agreement (otherwise known as a repurchase agreement), a sell-buyback arrangement or securities loan arrangement, is *not* an eligible obligation in relation to a close-out netting contract for the purposes of the Netting Act.

Accordingly, it is generally considered prudent for market participants seeking to rely on the protection afforded to the enforcement of security under the Netting Act to *not* enter into SFTs under an ISDA Master Agreement in respect of which a security document is used where the

⁷ Regulation 6(1) of the Netting Regulations provides that “An obligation that relates to an arrangement that is a forward, swap or option, or any combination of those things, in relation to one or more commodities, is prescribed for the purposes of paragraph 14A(8)(a) of the Act.”

collateral taker wishes to rely on the protection given to the enforcement of security under the Netting Act.

However, it is important to note that the ISDA SFT Documentation expressly provides that derivatives and SFTs are to be governed by the same ISDA Master Agreement and that a fundamental component of the ISDA SFT Documentation is to facilitate the close-out netting across both derivatives and SFTs. This cross-product netting is critical to obtaining the potential benefits of using the ISDA SFT Documentation (including in relation to the reduction of credit risk and increased operating efficiency). By way of further detail, the ISDA SFT Documentation provides for, in certain circumstances, the termination values which arise from the termination methodology in respect of SFTs to be netted against the termination values which arise from the early termination of derivatives, to provide for a single net amount to be payable with respect to both SFTs and derivatives.⁸ Generally speaking, the security interest granted under the relevant credit support documentation would be then enforced to discharge this net amount.

Due to the exclusion from the concept of “eligible obligations” of an obligation under a reciprocal purchase agreement (otherwise known as a repurchase agreement), a sell-buyback arrangement or securities loan arrangement, the fact that the net amount payable under an ISDA Master Agreement in respect of an early termination could include the termination values of obligations related to SFTs as well as derivatives gives rise to a risk that, where the net amount does include termination values of obligations related to both SFTs and derivatives, any such net amount would *not* constitute an “eligible obligation” in respect of that ISDA Master Agreement.

This issue is expected to impose significant impediments to entering into ISDA SFT Documentation in respect of ISDA Master Agreements with Australian market participants (or where Australian law is otherwise relevant to the documentation or enforcement of security) where a party is subject to a regulatory requirement to post and collect initial margin (and therefore use security-based credit support structures). This issue would also arise in any circumstances where the parties have chosen, for whatever reason (including due to issues which arise under other jurisdictions’ laws), to use security-based credit support documentation. This is because the fact that the Netting Act cannot apply to the enforcement of security to discharge that net amount means that impediments to the enforcement of the security interest exist under Australian law, including the stay on enforcing security interests which applies during an administration to which an Australian company may be subject, as well as similar stays which arise in the context of a statutory management of a distressed prudentially regulated institution. We understand that these types of stays create significant difficulties for entities in complying with the high threshold for availability of posted collateral under margin

⁸ The specific drafting to achieve this varies depending on whether a 1992 ISDA Master Agreement or 2002 ISDA Master Agreement is used. Please do not hesitate to let us know if you need more detail regarding the specific drafting of the ISDA SFT Documentation.



requirements for non-centrally cleared derivatives (discussed above), as well as giving rise to other adverse issues from a credit and capital perspective⁹. We believe that addressing issues such as these was the purpose of the amendments to the Netting Act which provided protection to the enforcement of security with respect to close-out netting contracts.

Further, the ISDA SFT Documentation (in the “U.S. Pledge” provisions) also allows for, in respect of each securities loan, the borrower under that securities loan to grant to the lender a security interest over the collateral provided in respect of that loan (and other related accounts, property and proceeds). The exclusion from the concept of “eligible obligation” of an obligation under a reciprocal purchase agreement (otherwise known as a repurchase agreement), a sell-buyback arrangement or securities loan arrangement also creates significant impediments to the use and enforcement of these pledge provisions for similar reasons as discussed above.

As noted earlier in this letter, ISDA considers that there would be significant benefits to Australian and international market participants using the ISDA SFT Documentation, but that Australian law (particularly Regulation 6(2)(c) of the Netting Regulations), as it currently stands, imposes a significant impediment to Australian and other market participants entering into the ISDA SFT Documentation with Australian market participants or where Australian law is relevant to the documentation or enforcement of security. ISDA considers that this restricts Australian market participants or other market participants trading in Australia from being able to obtain the benefits presented by the ISDA SFT Documentation. For this reason, ISDA makes the request in the next part of this letter.

(c) Request for APRA’s consideration

In order for Australian market participants and other market participants trading in Australia to be able to obtain the benefits presented by the ISDA SFT Documentation, ISDA respectfully requests that APRA consider whether it would be supportive of, or not object to, engagement by ISDA with the Australian Government to determine whether an amendment might be made to Australian law (namely to Regulation 6(2)(c) of the Netting Regulations). This amendment could allow for obligations in respect of SFTs to fall within the scope of eligible obligations for the purposes of the Netting Act, which would facilitate the protection afforded by the Netting Act to the enforcement of security apply to the enforcement of security-based credit support documentation when used with an ISDA Master Agreement which incorporates the ISDA SFT Documentation. ISDA submits that this change would also result in the position under Australian law becoming more consistent with the position under the laws of other major Australian trading partners.¹⁰

⁹ Capital would be calculated on a gross basis until the security is enforceable. This would inflate capital unnecessarily as banks are unable to net against collateral received.

¹⁰ For example, it is understood that the US bankruptcy code specifically permits netting of derivatives and SFTs as part of the financial contract safe harbors for transactions by a “financial participant”. More specifically,



We would be very happy to discuss this matter at your convenience. Should you have any questions or desire further clarification on the matters discussed in this letter, please do not hesitate to contact the undersigned.

Yours faithfully,

For the **International Swaps and Derivatives Association, Inc.**

it is understood that amendments to the Bankruptcy Code in 2005 added protections for “master netting agreements”, which are designed to protect termination and close-out netting under a cross-product master agreement between two parties. These provisions create a safe harbor for the termination, liquidation and netting of termination values and other transfer obligations in connection with the termination of one or more securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements or master netting agreements (to the extent the non-defaulting party enjoys such rights under the relevant product-specific safe harbor for individual transactions). In addition (and importantly for the purposes of this letter), the definition of “master netting agreement” encompasses related security arrangements and credit support.