

March 28, 2014

Financial System Inquiry
GPO Box 89
Sydney NSW 2001
fsi@fsi.gov.au

Dear Sir/Madam

Financial System Inquiry

The International Swaps and Derivatives Association (**ISDA**) is grateful for the opportunity to respond to the issues set out in the Terms of Reference for the Financial System Inquiry (**Inquiry**). We have set out information regarding ISDA in Annex 1 to this letter.

Our submission is made on two matters which are relevant to facilitating risk management transactions in Australia and with Australian entities.

The risks of market fragmentation

The terms of reference provide that the Inquiry will identify and consider the emerging opportunities and challenges that are likely to drive further change in the global and domestic financial system, such as international integration and international financial regulation.

Following the global financial crisis, the G20 leaders agreed to implement a number of reforms in relation to over-the-counter (**OTC**) derivatives with the aim of improving transparency, mitigating systemic risk, and protecting against market abuse in the derivatives markets. However, there has been significant divergence in the manner in which these reforms have been implemented across jurisdictions. This divergence has resulted in regulatory uncertainty, greater price volatility, and a shift in the nature of trading from cleared to bilateral risk management, resulting in a disruptive impact on OTC derivatives trading.¹ Increased market fragmentation has also emerged, with clear shifts in trading behavior, and the emergence of ‘separate pools’ of trading for US and non-US persons.²

We note the achievements of the Australian Government and its regulators in implementing derivatives reform in Australia in a manner which allows Australian market participants to continue operating in the global market with minimal disruption, while still allowing Australia to comply with its G20 requirements. We submit it is critical that these efforts at maintaining harmony between Australian and international derivative regulatory reform continue as the regulatory reform program is completed. Whilst this requires considerable effort from Australia’s regulators, we consider this will continue to provide benefits to the Australian

¹ See ISDA Research Note: Cross-Border Fragmentation of Global OTC Derivatives: An Empirical Analysis (January 2014)

² See note 2 at page 4.

financial system and its participants. Most importantly from an Australian market perspective, it mitigates against market fragmentation and facilitates the efficient entry into risk management transactions by Australian entities overseas, as well as international entities in Australia.

Clarity on Australian netting

The terms of reference provide that the Inquiry will refresh the philosophy, principles and objectives underpinning the development of a well-functioning financial system, including how financial risk is allocated and systemic risk is managed.

A fundamental part of the legal framework providing certainty in the Australian financial system is the Payment Systems and Netting Act 1998 (Cth) (**PSNA**). This legislation provides legislative certainty to particular operations of Australia's payment system, clearing houses and agreements used in risk management transactions, such as the Master Agreements published by ISDA. The PSNA is intended to offer certainty in respect of insolvency protections to "close-out netting contracts" such as the ISDA Master Agreements by validating close-out netting under those contracts despite any other law. This permits efficiency in the management of exposures created between parties under these risk management transactions as the value of those exposures can be determined on a net (or offsetting) basis.

In July 2011, the Australian Government released the draft *Financial Sector Legislation Amendment (Close-Out Netting Contracts) Bill 2011 (Cth)* (**Bill**) to address uncertainties which had arisen from the potential inconsistency of the *Banking Act 1959 (Cth)* and the likely inconsistency of the *Insurance Act 1973 (Cth)* to the close-out netting provisions of the PSNA where an ADI statutory manager is appointed to an ADI or a judicial manager is appointed to a general insurer. The Bill was accompanied by a discussion paper inviting industry comment. However, the Bill has not yet been introduced to Parliament.

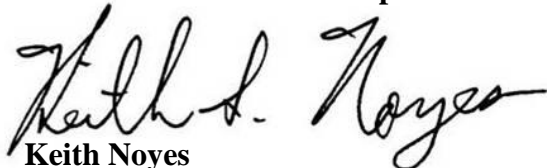
We submit that this process needs to be completed. Certainty under the PSNA is of great importance to the safety, efficiency and stability of Australia's financial markets. It is also the right time to make those changes, as the Financial Stability Board and global regulators are currently considering how best to use close-out netting to prevent market instability and legal uncertainty, should another financial crisis occur.

ISDA welcomes the opportunity to discuss these matters, and other issues in connection with the Inquiry, with you. Please contact Cindy Leiw if we may be of further assistance.

Thank you for your consideration.

Yours faithfully

For the International Swaps and Derivatives Association, Inc.



Keith Noyes
Regional Director, Asia Pacific



Cindy Leiw
Director of Policy

Annex 1

ABOUT ISDA

Since its founding in 1985, the International Swaps and Derivatives Association has worked to make over-the-counter (OTC) derivatives markets safe and efficient.

ISDA's pioneering work in developing the ISDA Master Agreement and a wide range of related documentation materials, and in ensuring the enforceability of their netting and collateral provisions, has helped to significantly reduce credit and legal risk. The Association has been a leader in promoting sound risk management practices and processes, and engages constructively with policymakers and legislators around the world to advance the understanding and treatment of derivatives as a risk management tool.

Today, ISDA has over 800 member institutions from 64 countries. These members include a broad range of OTC 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 including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers.

ISDA's work in three key areas – reducing counterparty credit risk, increasing transparency, and improving the industry's operational infrastructure – show the strong commitment of the Association toward its primary goals; to build robust, stable financial markets and a strong financial regulatory framework.

More information about ISDA is available from our website at <http://www.isda.org>, including a list of our members, the address of our head office in New York and other offices throughout the world and details of our various Committees and activities, in particular, our work in relation to financial law and regulatory reform.