ISDA Safe, Efficient Markets

23 June 2014

Manager
Banking and Capital Markets Regulation Unit
Financial System and Services Division
The Treasury
Langton Crescent
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Dear Sir/Madam

Financial Sector Legislation Amendment (Netting Contracts) Bill 2013

The International Swaps and Derivatives Association (**ISDA**) is grateful for the opportunity to comment on the Financial Sector Legislation Amendment (Netting Contracts) Bill 2013 ("**Bill**"). We have set out information regarding ISDA in Annex 1 to this letter.

As discussed in our submission with respect to the amendments proposed to the Payment Systems and Netting Act ("**Netting Act**") in 2011 ("**Previous Submission**"), ISDA considers that the default period (including any extension thereto) should be as short as possible and, in any event, no longer than 48 hours. However, ISDA submits the following in respect of the proposed amendments to this legislation set out in the Bill.

Revocation of APRA's declaration with respect to close-out netting contracts

ISDA submits that the revocation of a declaration made under subsection 15CB(1) should not be a trigger event under 15C(4).

If APRA makes a declaration under subsection 15CB(1) that a suspension under subsection 15C(2) is to continue to apply in relation to close-out netting contracts to which the ADI is a party, and APRA subsequently revokes that declaration under subsection 15CB(1), this would, under the proposed drafting, constitute a 'trigger event'. As a result, section 15C(2) would then only cease to apply in relation to those close-out netting contracts at the end of the 48 hour period after the declaration is revoked. Counterparties of the Australian ADI need to be able to re-hedge or manage their risks promptly and with certainty. This 48 hour period would be particularly an issue where the market is volatile (as it may be expected to be in the event an ADI was subject to financial distress) or where the ADI or insurer has a large or complex portfolio.

Default period

For the reasons stated above, and as discussed in our Previous Submission, the default period should be as short as possible, and in any event, should not exceed 48 hours. Where the counterparty is a corporate end-user, the transaction will usually be to hedge one or more specific underlying risk(s). Where the counterparty is a financial institution, it will still need to manage its risks on a portfolio basis. If the counterparty was to replace transactions/hedges during the default period before it can close-out the transaction with the ADI or insurer, it runs the risk that it ends up being over-hedged if the statutory or judicial manager determines that the close-out netting contracts should be continued, or even where this is not the case, it runs the risk that the price at which it re-hedges may be higher than the price at the point when it can close-out the transaction with the ADI or insurer.

For these reasons, we also submit that the revocation of a declaration made under 15CB should be automatic after a specified period of time.

Termination on other grounds

We understand the amendments are intended to relate to the period during which section 15C of the Banking Act (and the equivalent insurance legislation) prevails over the *Netting Act*, and not as a general prohibition on close-out netting for other reasons during that period. As discussed in our Previous Submission, we agree that counterparties should be allowed to rely on any other event than the appointment of a statutory manager or judicial manager to apply close-out netting. Thus, for 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. Similarly, if the ADI subsequently becomes subject to winding up, the counterparty should be allowed to exercise its close-out netting rights. Of course, it should not be limited to these examples. As this is a critical point for market participants, we request that a statement confirming this be included in the Explanatory Memorandum to the Bill.

APRA declaration of solvency

In the proposed section 15CB(1)(b)(ii) of the Banking Act, ISDA submits that the drafting should be amended to reflect that APRA should instead 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. This would provide for greater consistency with the solvency test contained in section 95A of the *Corporations Act 2001* (Cth).

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.

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. However, the Explanatory Memorandum would need to provide greater clarity as to the intended scope of this amendment. This is because, in our view, it would not be appropriate for the statutory manager or judicial manager to have the right to issue notices:

(a) 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

(b) terminating the default period for close-out netting contracts with certain counterparties but extending the default period for other counterparties.

We would emphasize that it is critical 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 (as was discussed in our Previous Submission).

Definition of "external administration" in the *Netting Act*

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 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. Thus, we suggest that the definition of "external administration" in section 5 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.

Approved Netting Arrangements

The Bill makes no reference to "approved netting arrangements" as defined in the Netting Act. The legislative conflict issues which gave rise to the need for the Bill apply equally to these

arrangements, although the proposed solution in relation to close-out netting contracts is likely to not be appropriate for "approved netting arrangements" (a 48 hour moratorium may have a significant impact if applied to systemically important contracts and systems).

Application of amendments

The Bill provides that the proposed amendments in relation to:

(a) the *Banking Act 1959* (Cth) ("**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

(b) the *Financial Sector (Business Transfer and Group Restructure) Act 1999* (Cth) ("**Transfer Act**") apply in relation to 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.

However, the amendments to section 15C of the Banking Act and insertion of section 36AA of the Transfer Act which were made by the *Financial System Legislation Amendment (Financial Claims Scheme and Other Measures) Act 2008* (Cth) ("2008 Amendment Act") only apply to contracts made after the 2008 Amendment Act commenced on 18 October 2008.

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).

ISDA welcomes the opportunity to discuss these matters, and other issues in connection with the Bill, with you. Please contact Cindy Leiw (CLeiw@isda.org), Keith Noyes (knoyes@isda.org) or Scott Farrell of King & Wood Mallesons (Scott.Farrell@au.kwm.com) 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

ISDA®

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.