ISDA® Safe, Efficient Markets

BY COURIER AND E-MAIL

1 August 2011

The General Manager
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Dear Sirs

Financial Sector Legislation Amendment (Close-out Netting Contracts) Bill 2011

The International Swaps and Derivatives Association, Inc. ("**ISDA**") appreciates the opportunity to comment on the Financial Sector Legislation Amendment (Close-out Netting Contracts) Bill 2011 ("**Bill**").

ISDA was chartered in 1985 and has more than 820 member institutions from 57 countries. Our members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end-users that rely on over-the-counter derivatives to manage efficiently the risks inherent in their core economic activities.

Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business through documentation that is the recognized standard throughout the global market, legal opinions that facilitate enforceability of agreements, the development of sound risk management practices, and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives.

ISDA respectfully submits the following comments in response to the Bill.

As a general comment, ISDA appreciates the effort made in clarifying the conflict between the provisions of the Payment Systems and Netting Act ("**Netting Act**") and the Banking Act, Life Insurance Act and the Insurance Act. However, as noted below in response to the specific questions asked, given that there is (i) no certainty as to when close-out netting contracts can be terminated and (ii) no guarantee that the close-out netting contracts will be performed by the ADI or insurance company or a proposed transferee, the proposed solution to the legislative conflict creates its own potential problems which could be as significant to potential counterparties of Australian ADIs and insurance companies as the conflict which the Bill is seeking to resolve. This, together with the fact that it causes a difference to arise between the position in dealing with an Australian bank as compared to say either an American or English bank, could mean that potential counterparties to these Australian institutions will perceive there to be greater risks in dealing with Australian institutions. To the extent that the proposed solution does not result in potential financial institution counterparties to these Australian institutions treating close-out

netting as being enforceable, such potential counterparties will not be entitled under the Basel rules to net exposures or offset the value of collateral, leading to higher regulatory capital charges and thus, higher transaction pricing for Australian institutions. Accordingly, we suggest that care is taken before providing for a broad discretion to prevent close-out of close-out netting contracts in circumstances where there is no guarantee on performance of such contracts.

A. Do you agree with the proposal that the "default period" should be 48 hours from the time at which a statutory manager takes control of an ADI or judicial management of an insurance company commenced? If not, what alternative period would you suggest?

For the reasons set out below, the default period (including any extension thereto) should be as short as possible and, in any event, no longer than 48 hours.

1. Exposure of counterparties to market risk

Counterparties of the Australian ADI or insurer need to be able to re-hedge or manage their risks promptly and with certainty. 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 were 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. This is a particular issue where the market is volatile (as it may be expected to be in the event that an ADI or insurer were subject to financial distress) or where the ADI or insurer has a large or complex portfolio.

By way of comparison, in the United States the Federal Deposit Insurance Act provides that a party to a "qualified financial contract" will be entitled to enforce any contractual right to terminate, liquidate, net and offset such a contract as a result of the appointment of the receiver or the insolvency or financial condition of the insured institution unless the receiver transfers all such contracts (and associated collateral) between the counterparty, its affiliates and the failed institution to another institution and provides notice of the transfer to the counterparty by 5 p.m. on the business day after its appointment. The key elements are: (i) the stay period is only until 5 p.m. of the business day following the appointment of the receiver; (ii) an actual transfer to another regulated institution must take place within the stay period; and (iii) there must be no "cherry-picking" in such transfer – all contracts (and associated collateral) not only with the counterparty but also its affiliates must be transferred. We would add that during the debate on the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act, the extension of the stay period was debated but the decision was to maintain the stay period as it is. This is in contrast with the proposal in the Bill where: (i) the default period may be indefinite since there is no limit on how long the extension of the default period can be; (ii) notice of extension of the default period may be given so long as the statutory or judicial manager considers that all liabilities under the close-out netting contracts will be met as and when they become due and payable; (iii) an actual transfer need not be implemented during the default period; and (iv) under the Financial Sector (Business

Transfer and Group Restructure) Act 1999 ("**Transfer Act**"), partial transfers may be made, including to a non-ADI or non-insurer.

FSB has on July 19 released its Consultative Document on Effective Resolution of Systemically Important Financial Institutions. Annex 8, in particular, states as follows:

"III. Conditions and safeguards

5. In designing a legal framework that provides for a temporary stay of early termination rights, the following safeguards should be in place:

(i) The suspension should apply to provisions in financial contracts that trigger early termination rights by virtue of, or incidental to, the initiation of insolvency or resolution proceedings, or by virtue of a change in control of the relevant institution or its business arising from such proceedings;

(ii) The period of time during which the authorities could delay the immediate operation of such contractual early termination rights pending a transfer should be limited in duration (e.g., 24-48 hours or until the end of the next business day). It should provide authorities with sufficient time to decide on the resolution measures and to decide which assets or liabilities should be transferred and how to effect the transfer;

(iii) Counterparties' rights to terminate for "failure to pay" reasons (e.g., if a margin call is missed) should be preserved. After the period of the suspension, early termination rights could be exercised for those financial contracts that are not transferred to a sound financial institution, bridge financial institution or other public entity;

(iv) For contracts that are transferred to a third party or bridge bank, the acquiring entity would assume all the rights and obligations of the financial institution from which the contracts were transferred. In particular, the acquiring entity would assume all payment and margin requirements under all the transferred contracts;

(v) For contracts that are transferred, the exercise of early termination rights on the basis of the resolution of the troubled financial institution would continue to be precluded but any acceleration or termination rights based on a subsequent default by the acquiring entity should be preserved;

(vi) The authorities would only be permitted to transfer all of the contracts with a particular counterparty to a new entity and would not be permitted to select for transfer individual contracts with the same counterparty and subject to the same netting agreement ("cherry-picking");

(vii) In the case of a transfer to a bridge financial institution or other specialized entity that is not required to be capitalized under the applicable legal framework or that does not have a credit rating, some form of assurance may be needed. The availability of temporary liquidity funding through the resolution regime (without imposing costs on taxpayers) would generally provide sufficient assurances for counterparties. If the acquiring entity is a healthy institution that is fully capitalized and in compliance with prudential requirements, assurances of

performance should not be necessary, especially since the counterparties' rights to terminate based upon a breach of the contract by the acquirer would be enforceable; and

(viii) Such legal authority would be implemented so as to avoid compromising the safe and orderly operations of regulated exchanges, Central Counterparties (CCPs) and financial market infrastructures (FMIs)."

Given the current proposal to impose a short stay so that (inter alia) a transfer may be effected under the Transfer Act, we believe that there are aspects of the Transfer Act that need to be amended to bring it into line with the FSB recommendations. Specifically, this includes (i) a short stay of 24-48 hours or until the end of the next business day; (ii) an actual transfer being made during the short stay period; (iii) excluding the possibility of "cherry-picking"; and (iv) ensuring that where the transferee is not an ADI or insurer, that appropriate and adequate assurance of performance is provided.

2. Voidable preferences

During the default period, the counterparty is exposed to clawback risk in relation to payments which it receives from the ADI or insurer if the ADI or insurer subsequently is wound up.

This is because if, during that period, a counterparty had reasonable grounds for suspecting that the ADI or insurer was insolvent, then payments or deliveries made by the ADI or insurer to the counterparty may be voidable under ordinary Australian corporate insolvency law if the ADI or insurer subsequently is wound up. This is a particular issue given that a statutory manager may be appointed by APRA over an ADI where:

(a) the ADI informs APRA that the ADI considers that it is likely to become unable to meet its obligations or that it is about to suspend payment; or

(b) APRA considers that, in the absence of external support, the ADI may become unable to meet its obligations or may suspend payment; or

(c) the ADI becomes unable to meet its obligations or suspends payment;

and a judicial manager may be appointed by the Federal Court over a general insurer or a life insurance company upon application by APRA where the Federal Court is satisfied that:

(d) the insurer is or is likely to become unable to meet its policy or other liabilities as they become due; or

(e) the insurer has failed to comply with prudential standards or directions relating to solvency; or

(f) there are reasonable grounds for believing that the financial position of the insurer may be unsatisfactory.

If a counterparty was aware that a statutory or judicial manager were appointed for any of the above reasons, then payments or deliveries received by it from the ADI or insurer may be voidable. However, the counterparty would be unable to close-out or cease to perform their obligations under the close-out netting contract in order to remove this risk.

Statutory protection should be given to payments and deliveries received (including payments and deliveries that are deemed to have been received due to the application of settlement netting provisions such as that in Section 2(c) of the ISDA Master Agreement) by a counterparty from the ADI or insurer during the default period (and any extension thereto) against such payments or deliveries being void or voidable in the external administration of the ADI or insurer.

Protection of such payments and deliveries could be provided through provisions similar to those in section 14(5)(c) of the Netting Act. For example, legislation could provide that a payment or delivery made by the ADI or insurer under a close-out netting contract during the default period (and any extension thereto) is not to be void or voidable in the external administration (as defined in the Netting Act) of that party unless:

(a) the other person did not act in good faith in entering into the transaction that created the obligation; or

(b) when the transaction that created the obligation was entered into, the other person had reasonable grounds for suspecting that the party was insolvent at that time or would become insolvent because of, or because of matters including:

(i) entering into the transaction; or

(ii) a person doing an act, or making an omission, for the purposes of giving effect to the transaction; or

(iii) the other person neither provided valuable consideration under, nor changed their position in reliance on, the transaction.

B. Do you agree with the proposed grounds on which a statutory manager or judicial manager may issue a notice to terminate the default period earlier than 48 hours or to issue a notice to continue the default period beyond the 48 hours? If not, what alternative formulations would you recommend?

With respect to the extension of the default period, we note the following:

1. Duration of extension

For the reasons noted in section 1 of our response to question A above, we submit that the default period, including any extension of that period, should be as short as possible, and in any event, should not exceed 48 hours. As mentioned, the stay period in the U.S. is only until 5 p.m. of the business day following the appointment of the receiver, and we understand that the proposal in the E.U. is for between 24-48 hours (the position in the U.S. and the E.U. thus being in line with the FSB recommendations). The current Australian proposal would not be in line with this and raises the distinct risk that potential financial institution counterparties to Australian institutions will conclude that close-out netting should be treated as being unenforceable under the Basel rules.

Limiting the original default period and any extension thereof to 48 hours may no doubt make the whole issue of an extension a moot point. We submit that this is a desirable outcome as it would make the regime less complex and more certain in its outcome (please also refer to our comments in section 4 below).

2. Voidable preferences

The Bill provides that a statutory manager or judicial manager may extend the period during which a counterparty cannot close out a close-out netting contract if:

> "*the [statutory manager][judicial manager] considers that all of the liabilities of the [ADI][general insurer][life company] under close-out netting contracts to which it is a party will be met as and when they become payable*"

and that extension can cease:

> "*the first time when any liability of the [ADI][general insurer][life company] under a close-out netting contract to which it is a party is not met.*"

The notes to this provision state that examples of circumstances in which the statutory manager or judicial manager may give a notice under this subsection include the following:

> *"(a) the [statutory manager][judicial manager] considers that the [ADI][general insurer][life company] has been provided with sufficient financial support to meet its liabilities under the close-out netting contracts as and when they become due and payable;*
>
> *(b) the [statutory manager][judicial manager] considers that the [ADI][general insurer][life company]'s liabilities under the close-out netting contracts will, because of a transfer of business under the Financial Sector (Business Transfer and Group Restructure) Act 1999, become liabilities of another body and will be met by that other body as and when they become due and payable.*"

The limited focus on payment liabilities under close-out netting contracts being met gives rise to some issues.

First, if the ADI or insurer is unable to pay all its debts as and when they become due and payable, then it will be insolvent even if that entity is able to pay all its liabilities under close-out netting contracts as and when they become payable. As noted in section 2 of our response to question A above, this places its counterparties in a very difficult situation as they are unable to close-out or cease to perform their obligations under the close-out netting contract whilst any payments or deliveries made to them could be void or voidable because of the ADI's or insurer's insolvency.

Second, the wording of the Bill seems only to focus on liabilities to pay money, but many derivatives will involve an ADI or insurer having to deliver property.

There may be a number of options available to address this. For example, provisions could be included to the effect that a statutory manager or judicial manager may extend

the default period if it considers that the ADI or insurer will pay all its debts as and when they become due and payable, and that the extension ceases the first time when any liability of the ADI insurer is not met.

3. Superseding notices

There appears to be no mechanism for the statutory manager or judicial manager to issue a notice during any extension of the default period under section 15CA(1) of the Banking Act /section 62VA(1) of the Insurance Act/section 165BA(1) of the Life Insurance Act or issue a notice under section 15CB(2) of the Banking Act/section 62VB(2) of the Insurance Act/section 165BB(2) of the Life Insurance Act that supersedes an earlier notice given under that section. We recommend that an ability to do this be included so that, for example, the statutory manager or the judicial manager may permit the close-out of transactions if it has extended the default period.

4. Notices of cessation and extension of default period

The Bill provides that:

(a) the statutory or judicial manager may (depending on whether the statutory or judicial manager concludes that all the liabilities of the ADI or insurer under close-out netting contracts will be met as and when they become due and payable) give notice to cease or extend the default period within the original default period of [48 hours], that an extension notice cannot be given if a cessation notice has already been given, and that a cessation notice may be given after an extension notice and the cessation notice would "trump" the extension notice;

(b) if an extension notice has been given, the extension notice ceases to have effect at the earlier of the time when (i) the statutory or judicial manager ceases to control the ADI's or insurer's business, or (ii) the ADI or insurer fails to meet any liability under a close-out netting contract. The statutory or judicial manager is required to give notice of cessation of the extension notice if the cessation is due to the occurrence of the event in limb (ii) but not if it is due to the occurrence of the event in limb (i). Presumably, though, any failure or delay in giving such notice of cessation of the extension notice would not affect the effectiveness of such cessation at the point in time when the ADI or insurer first failed to meet any liability under a close-out netting contract.

The above results in uncertainty as to whether the default period has ended and could potentially lead to unequal treatment of the ADI's or insurer's counterparties, with those counterparties who became aware earlier that the default period has ended having an unfair advantage over other counterparties. As submitted in section 1 above, we believe that the best way to avoid this situation is to have a definitive default period of no longer than 48 hours with no scope for extension or earlier termination. At the end of this definitive default period, only those counterparties who have received actual notice that their close-out netting contracts have been transferred would be unable to close-out such contracts. All other counterparties would be free to close-out their contracts if they wish.

At any rate, all counterparties should be made aware at the same time whether the default period has ended or continues to apply. This means that:

(a) in addition to giving notice of any extension, notices of cessation should be given, including where the cessation is due to the occurrence of the event in limb (i) and where the cessation is due to the expiry of the original default period of [48 hours] (given that under the proposed scheme, it is not certain that the original default period would end upon the expiry of the [48 hours]); and

(b) notices should be given via a public domain such as a website.

C. Do you agree with the proposed approach, whereby a statutory manager or judicial manager must give a notice in respect of all close-out netting contracts, as opposed to being able to issue different notices for different close-out netting contracts (ie terminating the default period for some contracts and extending the default period for other contracts)?

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.

D. Are there any other matters related to the initiatives contained in the Bill that need to be addressed?

1. Termination on other grounds

We fully agree that counterparties should be allowed to rely on any event other than the appointment of a statutory 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. We note that this is a position that is supported by the Discussion Paper where it states in paragraph 31 that "*if a statutory manager, acting on direction from APRA, did not continue to meet an ADI's liabilities under close-out contracts, then close-out netting would apply*." To assure this outcome, it is also necessary to provide in the Bill for the over-riding of Section 11CD of the Banking Act and the equivalent provisions in the Insurance Act and Life Insurance Act.

2. Market Netting Contracts and Approved Netting Arrangements

The Bill makes no reference to "market netting contracts" and "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 those arrangements, although the proposed solution in relation to close-out netting contracts is likely to not be appropriate for

"market netting contracts" and "approved netting arrangements" (a 48 hour moratorium may have a significant impact if applied to systemically important contracts and systems).

The need to resolve such issues is particularly important in light of the discussion paper of the Council of Financial Regulators which proposes an Australian central counterparty ("**CCP**") for AUD denominated interest rate derivatives. It is likely that a central counterparty would seek the protection granted by the market netting contract provisions of the Netting Act for its rules, and it is clearly not desirable that the result could be that enforceability of close-out netting under those rules may not be clear.

Under the Basel Consultation Paper on "Capitalization of Bank Exposures to Central Counterparties" released in December 2010, to qualify for the 2% risk weight, a CCP must meet CPSS-IOSCO standards. CPSS-IOSCO's consultative report on the "Principles for Financial Market Infrastructures ("**FMI**")" published in March 2011 states in Principle 1 (Legal Basis) that "*[n]etting can reduce potential losses in the event of a participant default and, possibly, even the probability of a default. Netting arrangements should be explicitly recognised and supported under the law and enforceable against an FMI and an FMI's failed participants in bankruptcy. Without such legal underpinnings, net obligations may be challenged in judicial or administrative insolvency proceedings. If these challenges are successful, the FMI and its participants could be liable for gross settlement amounts that could drastically increase obligations because gross obligations could be many multiples of net obligations*" and that "*[t]he rules, procedures and contracts related to the operation of an FMI should be enforceable in all relevant jurisdictions even when a participant defaults or becomes insolvent. In particular, the legal basis should support the enforceability of the participant-default rules and procedures that an FMI uses to handle a defaulting or insolvent participant, especially any transfers and close out of a direct or indirect participant's assets or positions... There should be a high degree of certainty that such actions taken under such rules and procedures will not be stayed, voided, or reversed. Ambiguity over the enforceability of procedures could delay and possibly prevent an FMI from taking actions to fulfil its obligations to non-defaulting participants or minimise its potential losses. Insolvency laws should support isolating risk and retaining and using collateral and cash payments previously paid into an FMI, notwithstanding the default of a participant or the commencement of an insolvency proceeding against a participant*". Without clarifying these issues, an Australian CCP may be disqualified from being recognized as CPSS-IOSCO compliant and thus not entitled to the 2% risk-weight. In addition, Australian banks and insurers may not be welcome as participants in a CCP if their participation could be seen as "tainting" the CPSS-IOSCO compliant status of that CCP.

3. 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 within the meaning of the Corporations Act 2001; 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(c) 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(c) 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.

4. Section 14(3) of the Netting Act

Section 14(3) of the Netting Act provides that:

> "*A person may not rely on the application of subsection [14(2)] to a right or obligation under a close out netting contract if the person acquired the right or obligation from another person with notice that that other person was at that time unable to pay their debts as and when they became due and payable*" [emphasis added].

We understand that the mischief against which sub-section 14(3) is directed is the buying-in of outstanding close-out netting contracts of an insolvent counterparty to use to set off amounts that may be owing on other transactions between the buyer and that insolvent counterparty. However, we believe that this may not be achieved by the current drafting as in summary, the effect of section 14(3) is that a person may not rely on section 14(2) of the Netting Act if they acquired their rights or obligations under a close-out netting contract from another person ("**Transferor**" or "B" in the diagram below) with notice that the Transferor was insolvent.

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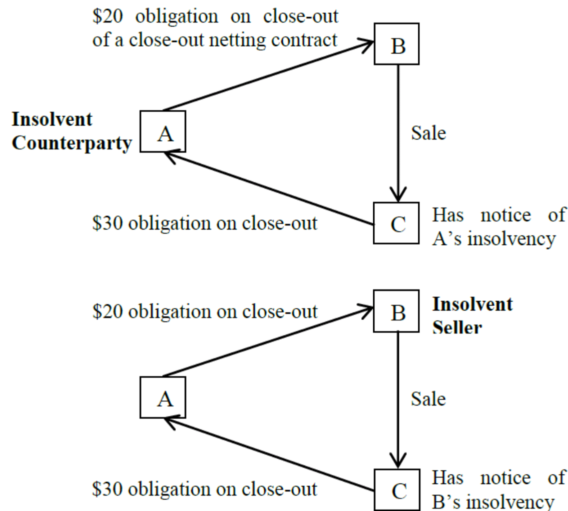

The mischief that is intended to be avoided by s14(3) is for A to get only $10 net when it should get $30 from C and B/C prove for $20 against A.

If s14(3) remains as is (apparently concerned about the insolvency of B), there is no mischief to be dealt with. Why would B sell for any less than $20 unless A is insolvent which the drafting of s14(3) does not deal with?

We suggest therefore that, rather than referring to the Transferor or "that other person", section 14(3) should refer to "the counterparty to the close-out netting contract".

5. Transitional provisions

The amendments to sections 15C of the Banking Act, 62V of the Insurance Act and 165B of the Life Insurance Act that were made by the 2008 Amendment Act apply to contracts made after the 2008 Amendment Act commenced on 18 October 2008. In contrast, the Bill provides that the proposed amendments to the banking and insurance acts take effect if the statutory manager or judicial manager is appointed to an ADI or insurer following the amendments commencing. It may be preferable if this technical inconsistency was clarified.

ISDA appreciates the opportunity to provide its comments on the Bill. Please feel free to contact Scott Farrell of Mallesons Stephen Jaques (Scott.Farrell@mallesons.com, +61 2 9296 2142), Jacqueline Low (jlow@isda.org, +65 6538 3879) or Keith Noyes (knoyes@isda.org, +852 2200 5909) at your convenience.

Yours faithfully,
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