ISDA® Safe, Efficient Markets

14 December 2012

General Manager
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

safefinancialsector@treasury.gov.au

Dear Sirs

Strengthening APRA's Crisis Management Powers

The International Swaps and Derivatives Association (**ISDA**)[1] is grateful for the opportunity to respond to the consultation paper "Strengthening APRA's Crisis Management Powers" issued by the Australian Treasury (**Treasury**) in September 2012 (the **Consultation Paper**).

The issues considered in the Consultation Paper are of great importance to the safety, efficiency and stability of the financial markets, including the over-the-counter (OTC) derivatives markets. We agree that there is an urgent need to improve the capacity of national authorities to resolve a financial institution without systemic disruption and without exposing the taxpayer to the risk of loss.

Scope of this response

Consistent with our mission, we are primarily concerned in this letter with the effect of the proposals set out in the Consultation Paper on the safety and efficiency of the derivatives market, by considering the direct impact of the proposals on the rights of a market counterparty under its derivatives transactions with a failing financial institution and under related netting and collateral arrangements. In particular, we are concerned with the legal uncertainty that may be created if some of the proposals in the Consultation Paper are not adequately defined and circumscribed and if any related safeguards are not defined in terms of their scope and effect.

In this response, we primarily address the issue of legal certainty around the enforceability of the netting and collateral arrangements in connection with OTC derivatives, although we also take the opportunity to make some observations about certain other issues raised in the Consultation Paper. While we agree that the many of the issues dealt with throughout the Consultation Paper are closely interrelated, we believe, given our focus on the OTC derivatives markets, that other respondents, in particular, those with a broader and less sector-specific focus and mission than ours, are better placed to comment in detail on other parts of the Consultation Paper.

[1] Information regarding ISDA is set out in Annex 1 to this response.

International Swaps and Derivatives Association, Inc.
50 Collyer Quay
#09-01 OUE Bayfront, Singapore 049321
P 65 6538 3879
www.isda.org

NEW YORK WASHINGTON
LONDON BRUSSELS
HONG KONG SINGAPORE
TOKYO

As an overarching comment, it is of utmost importance there is certainty, clarity and transparency in relation to the operation of the triggers for the application of the resolution tools and resolution powers. Legal certainty must be ensured. As far as possible private law contractual and property rights must be respected. Where it is considered necessary to suspend or otherwise affect any private law right, there is clearly a balancing that needs to occur. Any such suspension or other effect should be the absolute minimum necessary to achieve the policy goal of the relevant proposal.

Enforceability of netting and collateral arrangements

Legal certainty around the enforceability of the netting and collateral arrangements in connection with OTC derivatives is critical to the stability of the market. We understand that the Australian government and its regulators share this view. However, we reiterate this as there are some provisions of the Consultation Paper which affect these important matters.

We understand that the Consultation Paper does not purport to deal with the conflict issues between the Payment Systems and Netting Act, the Banking Act, the Life Insurance Act and the Insurance Act on which the Australian government has already engaged industry in consultation (for example, the consultation initiated by the Australian government on Financial Sector Legislation Amendment (Close-out Netting Contracts) Bill 2011 last year). In particular, the issues relating to a 48 hour stay on closing-out if the close-out right is based on the appointment of a statutory manager or judicial manager (and no other factor) is not addressed in the Consultation Paper. We understand that the Australian government is working to a resolution of these matters, which is important to the international derivatives market.

Also we note that there will be similar sensitivity from the international derivatives market to other restrictions which are imposed on the right to close-out because resolution actions which are taken, particularly if they limit such rights even when they are not based on the initiation of the resolution action itself. For example, the prohibition on exercising a right of close-out which is based on the recapitalisation of the ADI or the provision of directions by a statutory manager. In each of these cases it is important that it is clear that these prohibitions do not extend to closing out for other reasons, such as a failure to pay or insolvency. In addition, it is critical that any such resolution action or process should not permit any of the obligations under a close-out netting contract from being separated from others under the same contract. To permit this would be to facilitate "cherry-picking" through the resolution process.

One new proposal in the Consultation Paper which does raise potential concern is the proposal to extend the prohibition on close-out contained in section 15C of the Banking Act (and the similar provisions of the Life Insurance Act and the Insurance Act) to the enforcement of collateral or security arrangements against the ADI or insurance company (sections 4.1.5 and 4.2 of the Consultation Paper). Although it is made clear that this is not intended to have an impact on netting arrangements under the Payment Systems and Netting Act, it will have such an impact because some of these netting arrangements are supported by collateral arrangements which do not themselves utilise netting (collateral arrangements which do not utilise netting are the "security" based collateral arrangements, as opposed to the "absolute transfer" based collateral arrangements). These "security" collateral arrangements are quite often used in dealings with counterparties which are based in the United States and, in some cases, are actually required

under foreign laws. Accordingly, a prohibition on enforcing security against an Australian ADI or insurance company because of resolution actions taken will have an impact on the ability of overseas counterparties to deal with those entities – and potentially the capital they will need to hold for those dealings. For these reasons we submit that collateral arrangements in relation to close-out netting contracts should be treated in the same way in a resolution process as close-out netting contracts themselves, and be exempted from the moratorium provisions.

In addition, we note that the same netting and collateral concerns that arise with ADIs and insurance companies would also arise with transactions with financial market infrastructure (**FMIs**) if the statutory management regime were extended to them, as considered at section 7.1.1 of the Consultation Paper. As clearing houses for OTC derivatives are likely to be both FMIs and also counterparties to OTC derivatives it is imperative that certainty with respect to netting and collateral enforceability exists.

We note that ensuring the certainty and effectiveness of netting and collateral arrangements and the clarity and transparency of client asset segregation arrangements is, if anything, likely to reinforce the effectiveness of a resolution regime by inspiring confidence in market participants that they are being dealt with fairly and in a predictable manner consistent with their expectations. Segregation of client assets should be clear, transparent and enforceable. The regime should provide for rapid identification and return to each client and/or a solvent custodian for the client of its assets.

Appointing a statutory manager to the Australian business of a foreign branch

Section 3.1.1 of the Consultation Paper proposes amending the Banking Act to empower APRA to appoint a statutory manager to the Australian business of a foreign ADI and its non ADI subsidiaries in Australia.

Given the global nature of the derivatives markets, any proposals in the Consultation Paper with a cross-border effect are of particular concern to us. We wish to underline the importance for the derivatives markets of ensuring, in particular, that there is:

- no ring-fencing of local assets of a foreign ADI in the event of its local branch being made subject to resolution in the host country; and
- no discrimination against foreign creditors in the host country.

If, as proposed, the Banking Act is amended to empower APRA to appoint a statutory manager to the Australian business of a foreign ADI and its non-ADI subsidiaries in Australia, this may impact the enforceability of close-out netting and any related financial collateral arrangement entered into with a multibranch ADI with a local branch in that country. If changes were implemented in Australia that cast doubt on the enforceability of close-out netting with multinational banks, this may have a significant impact on the ability (and appetite) of such multinational banks to transact in Australia. For example, such amendments could have negative liquidity and pricing consequences for the local market. As noted above, legal certainty around the enforceability of the netting and collateral arrangements in connection with OTC derivatives is critical to the stability of the market.

ISDA®

Section 7.1.2 of the Consultation Paper considers the possibility of extending the above proposal (Section 3.1.1) to the Australian operations of FMIs. We agree with the view expressed in Section 7.1.2 that statutory management of the domestic operations of an overseas licence holder other than in support of a foreign administrator is unlikely to be feasible and may run counter to the goal or maintaining stable and effective FMI service provision. We suggest that further consideration be given to this proposal and to the awaited outcome of the report of the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO) on resolution regimes for FMIs (published in July 2012).

We encourage and commend APRA's commitment to working closely with its international peers. As noted in the Consultation Paper, the Financial Stability Board's (FSB) Key Attributes includes recommendations that authorities have the power to enable cross border coordination of bank resolution and that authorities should have the capacity to resolve the subsidiaries and branches of globally interconnected financial institutions. In particular, paragraph 11.9 of the FSB's Key Attributes provides that host resolution authorities may maintain their own resolution plans for the firm's operations in their jurisdictions cooperating with the home authority to ensure that the plan is as consistent as possible with the group plan.

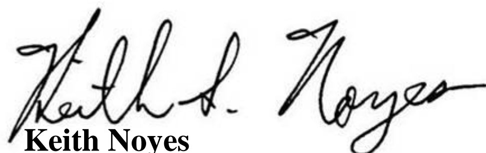
We believe that the home country resolution authority should have primary responsibility for the resolution of the parent and any subsidiary of the parent located in the home country. Each host country resolution authority (and other relevant host country authorities such as the host country central bank, financial regulator or Ministry of Finance) should cooperate and coordinate with the home country resolution authority effectively to ensure that all creditors of a particular class are, as far as possible, given equal treatment.

It is our view that the ultimate goal must be to ensure that any action taken in a resolution is recognised as legally effective under the laws of all other jurisdictions relevant to the particular case. For example, a statutory transfer by the Singapore resolution authority, during the resolution of a Singapore bank, of an ISDA Master Agreement governed by New York law must be recognised as effective by the New York courts. Similarly, a temporary stay imposed by the Australian resolution authority, during the resolution of an Australian bank, on a counterparty's right to designate an Early Termination Date under an English law governed ISDA Master Agreement must be recognised as effective by the English courts.

The principal concern of market participants in this regard is to ensure that there is sufficient clarity and certainty as to the rules that will apply and as to the full legal and tax effects, so that market participants can analyse the market and other risks of the transaction, structure and document it properly, price it accurately and hedge it effectively and reliably.

Yours sincerely,

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, the Association has more than 825 members from 57 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses 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.