RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
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Consultation Document: A New Zealand Response to Foreign Margin Requirements for OTC Derivatives

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The Reserve Bank and Ministry of Business, Innovation and Employment invite submissions on this consultation document by 5pm on 24 August 2017.

Submissions and enquiries should be addressed to:

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Important disclosure statement: *All information in submissions will be made public unless you indicate you would like all or part of your submission to remain confidential. Submitters who would like part of their submission to remain confidential should provide both a confidential and public version of their submission. Apart from redactions of the information to be withheld (i.e. blacking out of text) the two versions should be identical.*

Submitters who request that all or part of their submission be treated as confidential should provide reasons why this information should be withheld if a request is made for it under the Official Information Act 1982 (OIA). These reasons should refer to the grounds for withholding information under the OIA. If an OIA request for redacted information is made the Reserve Bank and Ministry of Business, Innovation and Employment will make their own assessment of what must be released taking into account the submitter's views.

The Reserve Bank and Ministry of Business Innovation and Employment may also publish an anonymised summary of the submissions received on this consultation.

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Executive Summary

Background

In 2009, as part of post-crisis efforts to strengthen the international financial regulatory system, the Group of Twenty (G20) agreed to act together to reform over-the-counter ('OTC') derivatives markets. To improve market transparency, mitigate systemic risk, and protect against market abuse, the G20 agreed that derivative contracts should be:

- traded on exchanges or electronic trading platforms where appropriate;
- cleared through central counterparties ('centrally cleared') where possible;[1]
- subject to higher capital requirements where not centrally cleared; and
- reported to trade repositories.

In 2011, the G20 added further risk mitigation requirements for non-centrally cleared derivatives to its reform agenda, with the intention of reducing systemic risk and promoting central clearing. To protect against current and potential future credit exposures and reduce the risk of contagion and spill over effects arising from a counterparty's default, derivative market participants would be required to exchange collateral, or 'margin', on their bilateral OTC trades.

An internationally-consistent margin framework for non-centrally cleared derivatives, published in 2013 by the Basel Committee on Banking Supervision (BCBS) and Board of the International Organisation of Securities Commissions (IOSCO),[2] is currently being implemented by national regulators on a staggered timetable out to 2020.

Problem definition

The Reserve Bank, as New Zealand's prudential regulator, does not intend to impose derivative margin requirements on its regulated entities at this stage. Nonetheless, the G20 reforms have a wide cross-border reach that can capture New Zealand-registered banks that are part of a foreign-owned banking group, or transact OTC derivatives with foreign counterparts.

These reforms require parties to exchange both:

- **Variation Margin (VM)**, to protect against current credit exposures caused by changes in the mark-to-market value of the derivatives contract;
- **Initial Margin (IM)** to protect from the potential future credit exposure that could arise from future changes in the mark-to-market value of the contract during the time it takes to close out and replace the position in the event that a counterparty defaults.

They also set requirements around related matters, such as the available of posted margin when a counterparty defaults.

However, there are certain features in New Zealand law that may impede compliance with foreign rules and emerging market practice around margin exchange. In particular, statutory moratoria on the exercise of creditor rights in statutory management and voluntary

[1] Central counterparties are entities that interpose between counterparties to contracts traded in one or more financial markets, becoming the buyer to every seller and the seller to every buyer, therefore minimising the counterparty risk to both parties of the transaction.
[2] Updated in March 2015.

administration[3] could prevent collateral being promptly available in the event of a default, at the same time as established creditor preference regimes[4] could subordinate derivatives counterparties and compromise their claim to pledged collateral.

These features of New Zealand law are of generic application and are designed to either facilitate the resolution or wind down of entities, provide legal certainty, or support the equitable treatment of creditors. However, this needs to be weighed against the costs of New Zealand entities not being able to comply with foreign rules and emerging market practice around margin exchange.

Without prompt and certain access to margin, foreign participants may become unwilling or unable to transact with New Zealand banks, cutting off access to important financial products and markets.

A reduction in New Zealand banks' access to offshore derivatives products and counterparts could lead to an increase in concentration risks, hedging complexities, and funding costs. In particular, the ongoing viability of foreign funding programmes, which rely on the use of non-centrally cleared 'basis swaps' to hedge associated foreign currency risks and currently make up around 15 per cent of banking sector non-equity funding, may be threatened. Restricted access to deep liquidity pools in key foreign markets like the US and EU may place upward pressure on the cost of domestic credit, undermining the efficiency and soundness of New Zealand's financial sector and its integration and competitiveness within the global financial system.

Ensuring New Zealand banks can comply with the margin requirements of their foreign counterparts will bolster the cost efficiency of our financial markets, assist in the effective mitigation of risks, and promote the stability of the financial system as a whole.

A public consultation on policy response options

Since late 2016, the Reserve Bank and Ministry of Business, Innovation and Employment (the Agencies) have, in co-ordination with the Treasury, been engaging with industry and overseas regulators to assess the likely domestic impact of foreign margin requirements. To further our understanding of the issues and our consideration of an appropriate policy response, the Agencies are now consulting on the need for legislative amendments to support internationally-compliant margin arrangements, and the appropriate scope of any amendments. We seek respondents' views on the specific areas of New Zealand law that need to be addressed to remove material impediments to robust margin arrangements, as well as any accompanying limitations or protections necessary to avoid unintended consequences from legislative change.

We are conscious that the proposal put forward in the consultation to amend the operation of insolvency laws in relation to some derivative creditors may have consequences for the treatment of *all* creditors, including depositors. With this in mind, our desire is address any legislative impediments in a targeted way, keeping deviations from existing insolvency processes and interference in the rights of other creditors to a minimum.

[3] As set out in the Corporations (Investigation and Management Act) 1989, the Reserve Bank of New Zealand Act 1989, and the Companies Act 1993. With some small exceptions, these moratoria prevent creditors enforcing the obligations of the entity in statutory management or voluntary administration.
[4] As set out in the (Personal Property Securities Act 1999 ("PPSA") and the Companies Act 1993. Where there are multiple parties with a claim over the same assets, these set out which of these claims take precedence over others.

Final policy decisions will be informed by the feedback provided on this consultation document. If legislative amendments are pursued, precisely how those amendments are drafted will be considered later in the process.

Timeframes and next steps

The consultation will be open for a period of 6 weeks. We invite respondents to submit their feedback by 24 August 2017. Responses will be considered and a final policy developed in due course, having regard to impending G20 compliance deadlines and the need to observe due process in developing any legislative response. If a legislative response is chosen, an exposure draft of the proposed legislation may be released prior to its introduction into Parliament.

Section A: Introduction

1. As part of the response to the global financial crisis, the G20 agreed in 2009 to a package of reforms to derivatives not traded through a formal exchange (so called over-the-counter, or 'OTC', derivatives).

2. Amongst the reforms, the G20 committed to clearing all standardised OTC derivative contracts through central counterparties (CCPs) where risks can be netted, better managed, and made more transparent. For non-standardised contracts that cannot be centrally cleared, the G20 undertook to implement credible and robust capital and margin frameworks to incentivise participants to identify, accurately price, and appropriately mitigate risks associated with such bilateral arrangements.

3. Reform implementation has been uneven across jurisdictions and reform areas. While higher capital requirements for non-centrally cleared trades have been in place for several years in most G20 jurisdictions (and in New Zealand since the first half of 2013), progress towards implementing margin frameworks have been delayed by technical and legal complications.

4. This has meant margin requirements[5] are still in the early stages of being introduced in many jurisdictions. Nonetheless, they are in effect in some key markets - most notably in Australia, Europe, Japan, and the US - where requirements first came into effect in September 2016 for the largest derivatives counterparts, and will continue to be phased-in through to 2020.

5. New Zealand is not a G20 member, and at this stage does not intend to impose domestic margin requirements on our regulated entities. Nonetheless, similar to many other areas of the G20 reform package, foreign margin rules have a wide cross-border reach that may capture New Zealand entities:

   - Direct capture of New Zealand entities: Margin rules apply at a consolidated group level: if a parent company is a covered entity under the margin rules of its home state, each member of the group must comply with the home state's rules as if it were itself a covered entity. New Zealand's four Australian-owned banks will all become directly covered entities under APRA's margin rules, CPS 226.[6]

   - Indirect capture of New Zealand entities: Any party that trades with a covered entity becomes a 'captured counterparty' under the margin rules. If a New Zealand bank trades with an offshore bank, it will be required to comply with the derivative rules of that bank's home state. Purely onshore transactions between foreign-owned New Zealand-registered banks and their domestically-owned counterparties are also *prima facie* captured.

6. Margin requirements have been calibrated to the risks posed by bilateral positions and are proportional to the liquidity burden associated with margin exchange. Only where *both* counterparties to a trade meet *de minimis* qualifying thresholds - which are based

[5] Broadly speaking, margin requirements oblige each party to an OTC derivative to provide the other with a certain amount of collateral, which the non-defaulting party can claim in the event of the other party defaulting, in order to cover the losses they would otherwise incur.

[6] This extraterritorial reach is common to many of the derivative reforms implemented since the financial crisis. For example, since 2013 New Zealand-registered banks that are part of an Australian banking group have been required by ASIC to report their OTC derivative activity to ASIC-registered Trade Repositories, despite there being no New Zealand trade reporting mandate.

on the group-wide aggregate notional value of non-centrally cleared derivatives - does margin need to be exchanged. Further, qualifying thresholds are being progressively phased-in: on a conservative estimate, New Zealand-registered banks that are part of the largest Australian banking groups may start to reach qualifying thresholds for initial margin exchange from September 2017 onwards.[7] It is unlikely New Zealand's domestically-owned banks will meet final qualifying thresholds.[8]

7. As discussed in more detail later in this consultation document, the ability to comply with these margin requirements is important for affected New Zealand banks. In particular, it allows them to hedge the currency risk associated with offshore funding programmes. More generally, constraining the ability of affected New Zealand banks to access liquidity pools and trade with a broad range of counterparties could place upward pressure on the domestic cost of credit, and negatively affect New Zealand's integration with the global financial system.

8. Since 2009, the Reserve Bank has been monitoring the local relevance and impact of global derivative reforms. For the most part, New Zealand banks have been able to adapt and comply with any direct and indirect requirements placed on them as a result of other jurisdictions' reforms. So, for example, mandatory reporting requirements that apply to New Zealand's Australian-owned banks have been met via upgrades to banks' trading platforms; while central clearing is achieved through correspondent banking relationships.

9. However, we have recently become aware of certain features in New Zealand law that may pose barriers to our banks' ability to provide margin in compliance with foreign margin rules and to the satisfaction of their international counterparties. The issues particularly relate to legal uncertainties around enforceability in insolvency, given moratoria on creditors' claims and preference provisions that may impact creditors' access to assets and prevent margin provided under New Zealand law from being promptly available and bankruptcy remote.

10. Potential issues for New Zealand banks directly captured by Australian margin requirements[9] were first identified in mid-2016. In response, the Reserve Bank worked through the identified issues with industry stakeholders and Australian regulators to reach a mutually-acceptable interim outcome without the need for legislative change.[10]

11. In late 2016, however, further concerns were raised that the same issues may arise for New Zealand banks indirectly captured by foreign margin requirements. The Reserve Bank in coordination with the MBIE (together, "the Agencies" responsible for administering the relevant legislation[11]) and Treasury have considered these concerns via engagement with affected local banks and their foreign counterparties, relevant foreign regulators, and industry experts.

[7] The reference period for this determination is still underway (March -May 2017). Banks below the threshold will next be assessed during the March - May 2018 reference period and may become subject to margin requirements from 1 Sep 2018.

[8] AUD12bn for the exchange of Initial Margin; AUD3bn for the exchange of Variation Margin.

[9] Those banks are: ANZ, ASB, BNZ, and Westpac.

[10] APRA amended CPS 226 to exempt transactions from requirements to post or collect initial margin where the legal environment in the jurisdiction of their counterparty does not yet permit compliance with the initial margin requirements, such as in New Zealand. See APRA's response to submissions on margining and risk mitigation for non-centrally cleared derivatives for more detail.

[11] MBIE administers three of the four Acts to which the issues relate: specifically, the Corporations (Investigations and Management) Act 1989, the Companies Act 1993; and the Personal Property Securities Act 1999. The other relevant Act is the Reserve Bank of New Zealand Act 1989.

12. This engagement has indicated that, under existing laws, there may be barriers to New Zealand banks' ability to comply with the new margin rules to the satisfaction of their foreign counterparties. This could impede banks' access to key international counterparties and financial markets, undermining existing operating and funding models. In particular, the viability of offshore funding programmes, which currently account for around 15% of the banking sector's non-equity funding, could be partly threatened.

13. If legislative change is made to address potential impediments to compliance with foreign margin rules, the Agencies believe it would be most appropriately done through targeted legislative amendments, ensuring all issues are addressed in an effective, timely, and proportionate manner whilst mitigating the risk of unintended consequences from legislative change (including adverse impacts on the rights of creditors, or on the integrity of the law relating to insolvency and the enforcement of security interests). This paper consults on the scope of those proposed changes.

14. The rest of the paper is structured as follows: Section B outlines the broad issues facing New Zealand entities under the new margin rules; Section C assess the potential impact of the rules on New Zealand businesses; Section D considers the practical implementation of the margin principles to identify the key issues facing New Zealand; Section E discusses several options to respond to these issues, including the Agencies' preferred response of targeted legislative change; and Section F summarises the policy proposal and considers next steps.

Section B: Margining Principles and New Zealand Law: an overview of the issues

Derivatives margining: What it does and how it is done

15. Margining is the provision of collateral assets to secure the performance of an obligation. Where a party to a derivatives trade defaults, its non-defaulting counterparty may be exposed to: a) movements in the market value of the derivative between the time the transaction was entered into and its counterparty's default; and b) costs incurred in terminating and replacing the position in the wake of the default.

16. To protect against this, margin rules transposing the [BCBS/IOSCO margin requirements for non-centrally cleared derivatives] will require parties to exchange both:

    - **Variation Margin (VM)**, to protect against current credit exposures caused by changes in the mark-to-market value of the derivatives contract;

    - **Initial Margin (IM)** to protect from the potential future credit exposure that could arise from future changes in the mark-to-market value of the contract during the time it takes to close out and replace the position in the event that a counterparty defaults.

17. VM is a one-way collateral exchange from the out-of-the-money counterparty to the in-the-money counterparty. It is intended to allow the non-defaulting counterparty (assuming it is also the in-the-money party) to close-out and replace its position without any loss, so is calibrated to the mark-to-market replacement value of the net

derivative position across a given netting set at the point of valuation. VM is typically calculated and exchanged daily.

18. The actual cost of closing out and replacing a derivatives position may exceed the market-to-market replacement value calculated at the time of the last VM exchange, crystallising a credit exposure. This will be particularly likely where parties are unable to replace positions quickly due to a drop in market liquidity or during periods of high price volatility following a default. IM protects the non-defaulting counterparty from this, ensuring it is not made economically worse off by the default. As both parties to the trade bear the risk of potential future credit exposures arising in the event of the other's default whether they are in- or out-of-the-money, IM must be exchanged on a gross bilateral basis. The amount of IM necessary to protect against potential future exposures depends on a variety of factors, including how frequently the contract is revalued and VM exchanged, the volatility of the underlying instrument, and the expected duration of the contract closeout and replacement period.

19. Margin collateral may be in the form of cash, or certain prescribed financial instruments that can under most circumstances be rapidly liquidated at a predictable price.

20. Margin can either be exchanged by an outright transfer of ownership, or by the granting of a security interest. The legal mechanisms behind each method are different:

- Under title transfer, ownership of the posted margin is transferred to the collecting party (the 'collector') by the posting party (the 'poster');

- Under a security arrangement, the collector is granted a security interest over the margin pledged by the poster (i.e. legal ownership typically remains with the poster and the margin appears as an encumbered asset on its balance sheet). For the collector, realisation of its security interest is achieved by sale or in some cases appropriation of the pledged asset to set-off its financial obligation following an enforcement event.

21. Variation margining has become normal market practice since the crisis, even where not strictly required, as participants have sought to limit unsecured credit exposures and market-contingent risks in their outstanding positions. An ISDA survey in 2013 found 90% of non-cleared OTC transactions were already subject to VM exchange. Outside the US, title transfer arrangements have been the dominant legal mechanism for exchange. Efficiency considerations may be behind this, with security arrangements generally involving a number of additional procedural requirements around enforceability, validity and perfection.[12]

22. In line with this, the Reserve Bank understands New Zealand banks already commonly exchange VM on uncleared OTC derivative positions via title transfer arrangements governed by the English-law Credit Support Annexe (CSA) to the standardised ISDA Master Agreement. With one minor exception discussed below in paragraphs 75-78, the Agencies find no legal impediments to New Zealand banks' ability to provide VM under the new margin rules, so these arrangements are not discussed further in this document.

[12] For example, registration, filing and stamping requirements.

23. In contrast, gross bilateral IM exchange in relation to uncleared OTC derivative positions is less common. Although an `Independent Amount' (IA) that exists under current ISDA CSAs is broadly analogous to IM in concept, its usage is not widespread and there are some key differences between IA and IM - most notably around treatment in insolvency. The Reserve Bank understands that gross IM exchange under the new margin rules will be a new practice for New Zealand banks, requiring new documentation and internal processes to facilitate its calculation and exchange.

New requirements for margin exchange

24. The BCBS/IOSCO margin requirements demand certain protections for both the posting and collecting parties to the margin exchange. IM must be:

(i) immediately available to the collecting party in the event of the counterparty's default (i.e. realisable without delay), and

(ii) subject to arrangements that protect the posting party to the extent possible under applicable law in the event that the collecting party enters bankruptcy (i.e bankruptcy remote).[13]

25. As it is designed to protect the collector against *potential future* exposures that may arise from problematic close-out following the poster's default, and must be exchanged on a gross basis between both parties (i.e. without any offset against IM that is simultaneously being posted the other way), IM necessarily leads to an over-collateralisation of each party's current credit exposure. This must be able to be clawed back by the posting party in the event that the obligations the collateral secures are fully discharged in the ordinary course of business, or terminated early - for example in the event of the collector's default or entry into bankruptcy.

26. However, claw back of IM provided by direct title transfer is problematic: the transferred assets legally belong to the collector, and in the event of its insolvency any claim the poster has will be a general unsecured one for the amount owing, rather than a claim to the IM itself (which would likely be a higher ranking claim). To avoid problems associated with margin recovery on the collector's insolvency, the market has widely adopted security arrangements for IM exchange.

27. This approach has been further embedded by new standard market documentation developed by ISDA, including an English-law Credit Support Deed that allows parties to establish IM arrangements that meet the requirements of the new margin frameworks by creating a security interest over collateral.[14] Further, in setting out the rights and remedies of the secured party over IM collected, the ISDA documentation effectively embeds condition (i) above - that IM must be realisable without delay - into market expectations and practice.

Potential impediments in New Zealand law

28. New Zealand has a well-established law governing security arrangements in the Personal Property Securities Act 1999 ("the PPSA"). However, various laws - specifically the Corporations (Investigation and Management Act) 1989 ("CIMA"), the

[13] Jurisdictions are further encouraged to review the relevant local laws to ensure that collateral can be sufficiently protected in the event of bankruptcy.

[14] Nonetheless, there may be indirect title transfer arrangements that comply with the margin rules - for example, a trust arrangement using title transfer is used for IM exchange in Japan.

Reserve Bank of New Zealand Act 1989 ("the RBNZ Act"), and the Companies Act 1993 - impose moratoria on enforcing security when an entity is in statutory management, or voluntary administration. This effectively stays the non-defaulting party's rights to enforce any IM collected by way of a security arrangement. Instead, IM can only be accessed at the discretion of the statutory manager or administrator.

29. In addition, provisions in the PPSA and Companies Act create a risk the secured creditor's claim over the posted margin may in certain circumstances rank behind that of other creditors; while the voidable transaction regime and creditor compromises regime set out in the Companies Act could undermine agreed margin arrangements.

30. The operation of certain provisions in existing New Zealand law may thus impede the enforcement of security over IM in some situations, blocking access to the collateral designed to insulate derivative counterparties and the financial system from the default of a participant, and posing a barrier to New Zealand entities' compliance with foreign margin requirements.

31. However, these features of New Zealand law are of generic application and are designed to either facilitate the resolution or wind down of entities, provide legal certainty, or support the equitable treatment of creditors. This needs to be weighed against the costs of New Zealand entities not being able to comply with foreign rules and emerging market practice around market exchange.

Section C: The impact of foreign margin requirements on New Zealand business

32. An inability to achieve clear compliance with the new margin rules could have important ramifications for New Zealand businesses, including:

- *Reduced access to offshore derivatives products and counterparties*. Access to foreign swap dealers in key derivative markets like the US and Europe may be impeded.

- *Increased country- and counterparty-concentration risks* due to the limited number of viable counterparties in non-cleared derivatives products.

- *Increased OTC derivative trading costs* from reduced competition in New Zealand participants' dealer panels.

- *Increased hedging complexities and costs*, potentially leading to a rise in unhedged exposures for New Zealand participants.

33. New Zealand banks' funding models rely on access to global capital and derivatives markets. Approximately 30 percent of their debt funding is sourced from wholesale markets, around 60 percent of which is raised offshore, almost entirely in foreign currency: our banking sector currently has around NZD50bn of non-NZD offshore funding outstanding. This foreign currency funding exposes banks to exchange rate risk which is typically hedged via cross-currency basis swaps - an OTC derivative which cannot currently be centrally cleared. If New Zealand banks' access to these swaps is impeded under the new margin rules, foreign currency risks may no longer be able to be effectively and efficiently hedged.

34. More generally, if New Zealand banks cannot trade with a broad array of international counterparties, and cannot freely access (at competitive rates) liquidity pools in key foreign markets, this may result in higher costs of funding and a loss of cross-border competitiveness at individual institutions, increasing the domestic cost of credit. New Zealand's integration and competitiveness within the global financial system may also be damaged, impacting the efficiency and soundness of the New Zealand financial sector as a whole.

Question 1: Do you agree with this assessment of the likely impact of foreign margin rules on New Zealand entities? Are there risks to New Zealand entities that have been overlooked or mischaracterised?

Section D: Foreign margin requirements in practice

35. To better understand the key issues facing New Zealand entities, the Agencies have engaged with industry, regulators, and other relevant parties both in New Zealand and abroad to consider how the margin requirements are being put into practice across jurisdictions and interpreted by market practitioners.

Regulatory implementation

36. Our engagement with foreign regulators indicates they are adopting a pragmatic approach to the BCBS/IOSCO principles that has regard to national conditions and circumstances. Their approach to implementing the principles seeks to avoid undue impediments to the smooth functioning of markets and cross-border activity, where possible. Regulators are aware of complexities around implementation and compliance - including in legal environments, clearing & settlement frameworks, and market practices - and want to address these in a flexible way where possible.

37. One example of this is around the timeliness of IM availability in the event of a counterparty's default: while the Basel principles call for 'immediate availability' (condition (i) in paragraph 24 above), in practice national rules tend to require only 'prompt' or 'timely' availability, where any requirement is specified at all. This acknowledges the time necessary to determine whether non-payment of an obligation is an actionable event of default that should trigger termination procedures, or a resolvable operational incident which should not be used as grounds to terminate a derivatives position and draw down IM collateral.

38. Several jurisdictions also explicitly carve out from timely availability requirements circumstances where a resolution authority temporarily restricts access to derivative collateral via a resolution stay. What is important here is that the protection provided by IM is not compromised by the stay, and that a secured party's right to pledged collateral cannot be amended or compromised by statutory stay provisions, and can be exercised within a reasonable timeframe. Provided the security interest becomes enforceable once the temporary stay is lifted, the requirement around prompt availability may be judged as met.

39. This reflects the principles-based, non-prescriptive approach that has generally been adopted by implementing authorities: covered entities are able to flexibly manage their counterparty credit risks through margin arrangements tailored to fit their business needs, provided such arrangements ensure margin is promptly available and

bankruptcy remote.[15] Regulators recognise there may be a number of ways these outcomes can be achieved, and indeed we are aware of at least one jurisdiction where title transfer is employed for IM exchange.[16] Thus, while security arrangements have emerged as the standard mechanism for IM exchange, this may be a result of the established market practice of key market participants and the global custodians, rather than regulatory prescription.[17]

Market interpretation

40. Regulators expect covered entities to make their own assessment of the adequacy and robustness of their margining arrangements, supported by expert legal opinion. This depends on the laws applicable to the defaulting or insolvent entity, so must be done on a jurisdiction-by-jurisdiction basis. Whilst regulatory implementation remains ongoing, there is uncertainty amongst practitioners as to how the rules should be interpreted and margin arrangements assessed.

41. Absent further clarity, covered entities and their legal counsel seem to be adopting a risk averse-approach to assessing the adequacy of margin arrangements: their focus is on implementing actions necessary for compliance - for example updating legal documentation and obtaining approval for internal margin models - rather than investing resources to explore whether arrangements with a particular counterpart might comply given the laws specific to that counterpart.

42. While New Zealand’s existing insolvency laws are not unique, legislation has been implemented elsewhere (including in the European Union and Australia) altering the application of insolvency provisions with respect to financial collateral; as a result, derivatives margin is excluded from provisions that may otherwise undermine its prompt enforceability and bankruptcy remoteness. The availability of alternative counterparties who clearly *do* comply with the new margin rules means international participants have limited incentive to adopt anything other than a risk averse approach to assessing the adequacy of margin arrangements under existing New Zealand law.

43. Despite the flexibility that is being built into the new margin rules by implementing authorities, New Zealand entities may nonetheless be unable to pledge IM security to the *satisfaction* of their international counterparties, irrespective of whether they can strictly comply with jurisdictional regulatory requirements. If international participants are not satisfied New Zealand entities can provide IM that is clearly enforceable, they may refrain from entering into derivatives trades with them.

Section E: New Zealand response options to foreign margin requirements

44. The Agencies agree New Zealand entities may be impeded from complying with margin requirements to the satisfaction of their foreign counterparties under existing New Zealand law. As such, a policy response may be necessary to address these impediments in support of banks’ derivative margin arrangements and in the promotion

[15] However, some jurisdictions do explicitly prescribe custodial arrangements for IM.

[16] Japan has adopted a trust approach to IM segregation for intra-jurisdictional trades that protects IM from the bankruptcy of the posting, receiving, or holding party. Under this approach:

i. the posting party transfers title to the collateral to the collecting party;
ii. the collecting party transfers title to the collateral to a (segregated) trust bank account.

[17] There may also be strong operational and business reasons for preferring security arrangements over outright transfer for IM exchange - for example, as a more efficient way of exchanging gross margin.

of financial sector soundness and efficiency. The focus of this consultation is to determine the scope of any necessary policy response. The form of any chosen policy response will be considered in due course, subject to the consultation outcomes. With this in mind, we have included the status quo as an option here to test our initial assessment that legislative changes are necessary.

Option A: Status Quo

45. The Agencies' engagement with foreign regulators indicates there are several jurisdictions whose margin requirements New Zealand entities already do comply with absent legislative change,[18] and several regulators who permit their covered entities to trade with counterparties from jurisdictions whose legal frameworks impede margin exchange - for example where collateral arrangements are not legally enforceable. Thus, under the new margin requirements and existing laws, it may be possible - at least in principle - for New Zealand entities to trade uncleared derivatives with certain foreign counterparties.

46. This would not address significant market-based barriers facing New Zealand entities, however. Industry-commissioned legal opinions on IM arrangements under New Zealand law[19] are unlikely to conclude that security is enforceable without uncertainty or delay in accordance with contractual requirements, leaving New Zealand entities unable to pledge IM security to the *satisfaction* of their international counterparties. Equally, while the Agencies are not convinced alternative mechanisms for IM exchange cannot comply with foreign margin rules (for example indirect title transfer to a third party custodian), these will be mostly unfamiliar to international derivative counterparties, who may be disinclined to accept them.

47. Even where an international counterparty determines it is able and willing to accept New Zealand banks' IM arrangements, that institution would still need to satisfy its home state regulators that it was appropriately managing its risk exposures in uncleared derivatives as part of the broader management of counterparty credit risks. This would likely involve mitigants to address risks stemming from the uncertain treatment of IM in New Zealand law, which may impose additional costs on New Zealand banks or leave them disadvantaged in their access to wholesale funding markets relative to banks domiciled in other jurisdictions, putting sector efficiency and competitiveness at risk.

48. For these reasons, we do not support Option A.

Question 2: Do you agree that current New Zealand law is a significant potential barrier to New Zealand entities' ability to effectively and efficiently provide margin?

Option B: Targeted legislative change

49. Legislative change to insulate margin collateral from the operation of normal insolvency processes is similar to the approach adopted in Australia and the European Union. In considering the appropriateness of a similar response in New Zealand, it is important to have regard to a number of factors, including the importance of minimising

[18] Either because of how the rules are drafted or applied and/or because they allow for margin to be posted via outright transfer (see the situation in Japan discussed in footnote 16).
[19] For example, an updated ISDA opinion on the Validity and Enforceability of Collateral Arrangements under the ISDA Credit Support Documents .

impacts on the rights of ordinary creditors and the coherence of insolvency law, ensuring any policy actions are proportionate and sufficiently targeted to reduce the risk of unintended consequences, and resolving the potential problems that have been identified as promptly as possible.

50. With these factors in mind, through this consultation process we seek to confirm the specific legal provisions that may prevent New Zealand banks from posting derivatives margin in compliance with the requirements and practices of potential foreign counterparties.

51. The key areas of New Zealand law that the Agencies have identified as posing a barrier to compliance and which might need to be amended under this option are:

(i) Statutory moratoria on the enforcement of security interests as per the CIMA, the Companies Act and the RBNZ Act;

(ii) Priority of preferential creditors over secured creditors under schedule 7 of the Companies Act when cash is posted as margin; and

(iii) Priority rules under the PPSA overriding the rights of secured creditors in certain situations.

52. In each of these cases, the basic approach we propose under this option is to adopt is an exception from current rules covering lawfully granted security interests over initial margin that is posted by one party to an OTC derivative to another. Subject to drafting, this exclusion could apply where:

- The regulatory requirements in New Zealand or any other jurisdiction require the margin to be posted;
- The OTC derivative is subject to a netting agreement that is enforceable under New Zealand law;
- The security interest is evidenced in writing;
- The security interest is over financial property; and
- If the defaulting party was insolvent at the time when the security interest over the collateral was created, the party seeking to enforce the security interest was not aware of that fact.[20]

53. For these purposes, we would expect that:

- "Initial margin" would mean collateral posted to protect against potential future credit exposures that could arise from changes in the mark-to-market value of the derivatives contract during the time between the last VM exchange and the replacement of the position following default;

[20] The intention here is that awareness of the defaulting party's insolvency means having actual notice of that insolvency (i.e. it does not extend to just having constructive notice of it).

- "Variation margin" would mean collateral posted to protect against current credit exposures caused by changes in the mark-to-market value of the derivatives contract;

- "Derivative" would have the same meaning as in section 8(4) of the Financial Markets Conduct Act 2013 (FMC Act);

- "OTC derivative" would mean a derivative that is not currently quoted on a financial product market (as defined in the FMC Act) or equivalent type of market in another jurisdiction;

- "A netting agreement that is enforceable under New Zealand law" would mean a netting agreement to which sections 310A to 310O of the Companies Act 1993 or sections 255 to 263 of the Insolvency Act 2006 apply, or netting in accordance with the rules of a designated settlement system;

- "Financial property" would mean a financial product as defined in section 7 of the FMC Act, or a negotiable instrument or an account receivable as defined in section 16(1) of the PPSA.

54. We stress that the exact drafting of this exclusion would be subject to further work. Respondents are invited to comment on whether there might be preferable ways of approaching the legislative amendments. The form of any chosen legislative response may differ, drawing on the outcomes of this consultation and subject to the legislative design process.

Question 3: Does the proposed exception cover the enforcement of security interests in the right circumstances? Are there better ways of defining the scope of the exception?

(i) Statutory moratoria

55. CIMA, the RBNZ Act, and the Companies Act place mandatory moratoria on enforcing security when a company is in statutory management or voluntary administration.[21] This is part of a broader moratorium on creditor rights that is automatically triggered upon entry into statutory management or voluntary administration, and is intended to give sufficient time to implement an orderly restructuring or wind down of the company. The moratoria imposes a statutory delay on the receiving (non-defaulting) party's ability to exercise its right to any IM pledged to it by the posting (defaulting) party, which will override any contractual provisions relating to the rights and obligations of each party. Instead, access to IM will be at the discretion of the statutory manager or administrator until the end of the resolution or winding up when the moratorium is lifted.

56. While New Zealand is not unique in imposing moratoria on creditor rights in insolvency and resolution, as discussed in Appendix 1, the possibility for our moratoria to be in place throughout the duration of statutory management, which is of uncertain length, differs from many other jurisdictions (as does the fact that our moratoria only applies in

[21] Specifically CIMA section 42(1), the RBNZ Act section 122, and the Companies Act section 239ABC. Further, a statutory manager may temporarily suspend payment of money owing (RBNZ Act section 127 and CIMA section 44) which might cover the suspension of collateral delivery.

respect of netting agreements to the payment of the netted balance under the agreement, not the exercise of close out rights under the agreement).

57. Although existing provisions in the *RBNZ Act* could be used to provide for the prompt (or even immediate) pay-out of the netted balance on a registered bank's default, there is no legal certainty over this. For example, s131 gives a statutory manager the power to pay, in whole or part, any creditor or class of creditors of the registered bank, so provides room for the statutory manager to make secured derivative counterparties whole in advance of (and in preference to) distributions to other claimants on the insolvent estate. In doing this, however, under s121 the statutory manager would have to have regard to:

    (a) the need to maintain public confidence in the New Zealand financial system;

    (b) the need to avoid significant damage to the New Zealand financial system;

    (c) to the extent it is not inconsistent with (a) or (b), the need to resolve as quickly as possible the difficulties of the registered bank in statutory management; and

    (d) to the extent it is not inconsistent with (a), (b), or (c), preserving the position of creditors and maintaining the ranking of creditors' claims.

58. This approach therefore leaves uncertainty around the treatment of, and outcomes for, secured derivatives creditors.

59. The potential for long and wide-reaching moratoria in New Zealand law has been consistently identified by stakeholders as the most significant impediment to compliance with margin rules.

60. Under this option, we only propose to change how the moratoria in the RBNZ Act, CIMA, and the Companies Act would apply in the circumstances outlined in paragraphs 52-53, and in all other circumstances leave these provisions unchanged. We also propose some differences in the amendments that would be made to the moratorium provision in the RBNZ Act compared to the moratorium provisions in CIMA and the Companies Act, reflecting the fact that the New Zealand entities likely to be captured by foreign IM requirements will invariably be 'systemically important to New Zealand, so will be subject to statutory management under the RBNZ Act in the event of their stress or failure (rather than voluntary administration).

61. The amendments we propose under this option would operate as follows:

    - The moratoria provisions in CIMA and the Companies Act would be subject to a carve out in these circumstances. This would exclude the ability to enforce security interests from the scope of the moratoria under those Acts, with the effect that counterparties could not only exercise close out rights (as at present) but could also exercise their security interest over the margin (which is currently not the case under the moratoria provisions). Where the realised value of the margin is less than the netted balance, the outstanding amount of the netted balance would remain subject to the moratorium.[22]

[22] In the less likely circumstances where the realised value of the margin is more than the netted balance, the excess would be returned to the party that originally posted the margin.

- The moratorium in the RBNZ Act would be amended so that in these circumstances:

    - It would continue to prohibit the exercise of security interests and claims for payment of the netted balance, and extend to also prohibiting the exercise of close out rights (i.e. the rights that are currently excluded from the scope of the moratorium under sections 122(7) and (8) of the RBNZ Act);

    - In respect of the enforcement of security interests over posted margin and the exercise of close out rights, it would only apply until midnight at the end of the first full business day after the entity entered into statutory management;

    - The effect of the moratorium applying to the enforcement of security interests during that period could be extended by the Reserve Bank in certain circumstances (to be clear, we do not mean that the duration of the moratorium on the enforcement of security interests could be extended beyond midnight at the end of the first full business day after the entity enters into statutory management. Instead we mean that the effect of the moratorium having applied up to that point could be extended by the Reserve Bank[23]);

    - Where security interests over posted margin are exercised, and the realised version of that margin is less that the netted balance, payment of the rest of the netted balance would remain subject to the moratorium.[24]

62. The proposed amendments to the moratorium provision in the RBNZ Act reflects a similar approach which has been adopted in other jurisdictions such as Australia and the European Union. Stakeholders have also indicated that this kind of approach would be similar to other jurisdictions and thus acceptable to market participants.

63. We note that that this approach would also likely have to be accompanied by operational requirements around pre-positioning encumbered collateral assets, similar to existing requirements around pre-positioning retail deposit liabilities, so they can be rapidly and easily released by the statutory manager or administrator. Collateral that is not pre-positioned would be frozen until the statutory manager or administrator is in a position to release it.

Question 4: Do you agree that New Zealand's moratorium provisions are a significant potential impediment to New Zealand entities' compliance with foreign margin requirements?

Question 5: Do you agree that the proposed changes to moratorium provisions are necessary and sufficient to address this potential compliance barrier?

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[23] i.e. The right to enforce security interests based upon the entity's entry into statutory management or any other event that occurred up to midnight at the end of the first full business day after the entity's entry into statutory management would continue to be prevented by the effect of the moratorium having been extended. However, the right to enforce security interests could still be exercised based on any events that occurred after the end of the first full business day after the entity entered into statutory management.

[24] In the less likely circumstances where the realised value of the margin is more than the netted balance, the excess would be returned to the party that originally posted the margin.

(ii) Schedule 7 preferential creditors

64. Schedule 7 of the Companies Act provides for certain preferential claims that rank ahead of the claims of all other creditors in a winding up.

65. The enforcement of security interests over property held by the insolvent entity usually operates outside of this ranking, so that in the event of default any person holding a security interest over the property of the insolvent entity can enforce that security interest irrespective of where their claim for the repayment of a debt might rank.

66. However, there is a significant exception to this rule for certain security interests over the whole or part of the accounts receivable of the insolvent entity. Where this exception applies, most preferential claims (those listed in clause 1(2)-(5) of Schedule 7, which include the claims of employees and the Commissioner of Inland Revenue) rank ahead of the right to enforce the security interest. This means that a counterparty secured by accounts receivable may lose priority to other parties in the event of insolvency.

67. Cash collateral is technically an accounts receivable, and is one of two forms of financial property commonly provided as collateral in financial transactions (the other being financial instruments). Although it would technically be possible for New Zealand banks to post margin collateral that would not lose priority to Schedule 7 preferential claims, it is important that New Zealand banks have access to the widest possible range of eligible collateral, given its relative scarcity.

68. Thus, there is potentially a strong case for suggesting that all common types of financial collateral - including cash and other accounts receivable - should be protected in New Zealand law from losing priority to Schedule 7 preferential claims, so long as that financial collateral secures an uncleared OTC derivative position. Doing otherwise would restrict New Zealand banks to a subset of eligible collateral that would be disadvantageous to their competitiveness and efficiency, and not necessarily permitted in all jurisdictions.

69. We believe this approach could be given effect through an exception to the rule that subordinates the enforcement of these kinds of security interests behind most (or possibly all) of the preferential claims listed in clause 1(2)-(5) of Schedule 7, and that the exception could apply in the circumstances set out in paragraphs 52-53. As discussed further in paragraphs 87-88, while this would result in these preferential claims (including the claims of employees) ranking behind the claims of counterparties seeking to enforce security interests in all or part of the insolvent entity's accounts receivable, we believe there is negligible risk of these creditors being made worse off by the legislative change in practice, as they will still invariably be made whole in the event of insolvency. Whether the claims of the Commissioner of Inland Revenue under Schedule 7 should also be subordinated to the enforcement of these kinds of security interests is a matter that the agencies will discuss with the Inland Revenue Department.

Question 6: Do you agree that Schedule 7 preferential claims are a significant potential impediment to New Zealand entities' compliance with foreign margin requirements?

Question 7: Do you agree that the proposed changes relating to preferential claims are necessary and sufficient to address this potential compliance barrier?

Question 8: Do you agree with the way we are proposing to protect secured derivative creditors from losing their priority interest to Schedule 7 preferential claims?

(iii) Other priority rules under the PPSA

70. Under s95 of the PPSA, a creditor who receives payment of a debt through a debtor initiated payment has priority over a perfected security interest in:

- The funds paid;
- The intangible that was the source of the payment;
- A negotiable instrument used to effect the payment

71. Under s97, a purchaser of investment securities has priority over a perfected security interest in the investment security if certain conditions are met (such as the purchaser having given value for the investment security).

72. Part 8 of the PPSA also contains a number of other provisions dealing with the priority accorded to interests in collateral.

73. The immediate issue here is whether these provisions are sufficient to ensure that the security interest of a counterparty receiving posted margin would always have priority over (or otherwise override) a prior security interest in the posted margin.[25] In our view it does not appear that these provisions provide the necessary clarity around this.

74. In order to ensure legal certainty around the priority accorded to security interests in posted margin, we propose an exception to the rules in the PPSA that would otherwise govern this. This exemption could operate in a similar manner to section 103A of the PPSA (which provides for the interests of an operator of a designated settlement system to, in certain circumstances, have priority over any security interests). This exemption would apply in the circumstances set out in paragraphs 52-53, and would mean that, in those circumstances, the security interest of the counterparty would always have priority over any other security interests in the assets that made up the posted margin

(iv) Does outright transfer of collateral create a security interest under the PPSA?

75. In addition to the legislative impediments to the enforcement of security interests in IM, there is one additional issue that has been brought to our attention around the ability to comply with rules around variation margin. This issue also influences the precise scope of the other amendments proposed in this consultation document.

76. In summary, the issue is whether an outright transfer of collateral creates a security interest as that term is defined in the PPSA. For these purposes, the relevant section of the PPSA is section 17. It is worded as follows:

"**17 Meaning of security interest**

[25] We note that given how margin is held, it is unlikely that these sections could be used to override the secured interest of the counterparty through the payment of another debt out of the posted margin, or through the sale of an investment security that is being used as posted margin

(1) In this Act, unless the context otherwise requires, the term security interest:

(a) means an interest in personal property created or provided for by a transaction that in substance secures payment or performance of an obligation, without regard to:

(i) the form of the transaction; and

(ii) the identity of the person who has title to the collateral; and

(b) includes an interest created or provided for by a transfer of an account receivable or chattel paper, a lease for a term of more than 1 year, and a commercial consignment (whether or not the transfer, lease, or consignment secures payment or performance of an obligation).

(2) A person who is obligated under an account receivable may take a security interest in the account receivable under which that person is obligated.

(3) Without limiting subsection (1), and to avoid doubt, this Act applies to a fixed charge, floating charge, chattel mortgage, conditional sale agreement (including an agreement to sell subject to retention of title), hire purchase agreement, pledge, security trust deed, trust receipt, consignment, lease, an assignment, or a flawed asset arrangement, that secures payment or performance of an obligation."

77. Feedback received by the agencies suggests that uncertainty around whether outright transfer of collateral creates a security interest under the PPSA makes it hard for market participants to be sure what steps are necessary to perfect their interests under an outright transfer collateral arrangement. In turn, this can raise issues around the legal robustness of VM requirements (due to the fact that VM is usually posted via outright transfer).

78. We propose that the PPSA be amended to clarify that an outright transfer of collateral creates a security interest under the PPSA. We note that as well as providing more certainty about VM requirements, this may slightly enlarge the scope of the other proposed amendments in this consultation document (due to it clarifying that references to security interests in those amendments also include interests created by the outright transfer of collateral).

Question 9: Do you agree that the proposed changes to priority rules in the PPSA are necessary and sufficient to address the potential compliance barriers identified?

<u>Sufficiency of legislative changes proposed in Option B</u>

79. The Agencies are aware that some stakeholders have raised other potential issues in New Zealand legislation not included in Option B at present.

80. Firstly, it has been suggested that the voidable transaction regime could claw back transactions made prior to insolvency, compromising a secured party's ability to rely on posted margin in the event of counterparty's insolvency. Under s292 of the Companies Act, an insolvent transaction[26] can be voided by the liquidator of a company if it was

[26] An insolvent transaction is one that: 1) was entered into by the company when it was unable to pay its due debts; and 2) enables another person to receive more towards satisfaction of a debt owed by the company than the person would receive, or would be likely to receive, in the company's liquidation.

entered into within two years before the commencement of the liquidation. This may mean that the exchange of margin collateral (either by way of security or outright transfer) could be held to be an insolvent transaction and subsequently voided by the liquidator. Similarly, under s293, a charge over any property of a company may be voided by a liquidator if the charge was given within two years before the liquidation commenced and immediately after the charge was given the company was unable to pay its due debts. This may void margin provided by way of security.

81. Secondly, is has been suggested that creditor compromises may mean a secured party involuntarily becomes bound by a compromise that undermines agreed margin arrangements. Under s230 of the Companies Act, a compromise between a company and its creditors may be imposed on all creditors if 75% of creditors (by value) approve it at a creditors' meeting. Alternatively, a compromise may be imposed under section 236 by court order. This may result in the cancellation of all or part of a debt of the company, or vary the rights of the company's creditors (including rights set out under a margining arrangement).[27]

82. Thirdly, there are a number of legislative provisions that allow for certain parties to disclaim onerous property or the court to set aside dispositions of property.[28] These provisions could undermine the effectiveness of security arrangements (either through making contracts unenforceable or by clawing back margin from the receiving party).

83. The Agencies find limited rationale for statutory amendments to address these issues. Creditor compromises that disadvantage individual creditors can be challenged in the courts; and voidable preferences will not impede a non-defaulting party's right to promptly enforce its security interest. Whether or not security arrangements may be declared void at some future time does not prevent those arrangements from being enforced at the point of default.[29] As such, the Agencies believe that, despite these provisions, margin will be able to serve its purpose of protecting against a counterparty's default.[30]

84. Contractual security arrangements can never be 'guaranteed' in every circumstance, so the relevant question becomes how much deviation from contractual arrangements as a result of New Zealand law foreign derivative counterparties are willing to accept. In this regard, the Reserve Bank has been advised there is a degree of market acceptance around the operation of voidable preferences and creditor compromises on security arrangements. We consider it likely that the risks raised by these provisions are relatively small and probably within the scope of what would be accepted by international counterparties. However, we invite views from submitters on this point.

Question 10: When implemented together, do you believe the changes set out under Option B will be sufficient to address impediments to creating and enforcing rights as a secured counterparty under New Zealand law?

[27] A non-exhaustive list of what a compromise may do is set out in section 227 of the Companies Act.
[28] See for example, section 269 of the Companies Act 1993 and section 348 of the Property Law Act 2007.
[29] The voidable preference regime only means that, at some point after the enforcement event has occurred, a statutory manager or insolvency practitioner may seek to unwind that secured arrangement and claw back the realisations associated with it (or if it is still available, the secured asset itself).
[30] The Agencies are aware that some other jurisdictions, including Australia, have implemented legislative amendments to override laws that could make the enforcement of margin security void or voidable. However, we note this was in the interests of additional clarity, rather than being strictly necessary to comply with margin requirements.

Question 11: If you believe the changes set out under Option B are not sufficient, please describe additional legislative changes necessary for compliance. Please provide a rationale for any proposed changes.

Consequences of legislative changes proposed in Option B

85. It is important to consider the potential knock-on consequences of any legislative amendments to facilitate compliance with foreign margin rules. Where possible, they should not to impede the operation of other existing laws, policies and processes; and where necessary, protections should be built-in to limit the scope of their effect to the specific areas where change has been judged necessary and appropriate.

86. There are strong arguments for mitigating the deviation from insolvency law principles and processes here. Overriding moratoria and interfering with creditor preferences to make secured derivative counterparties whole at the same time as other creditors are left behind to potentially bear losses may have ramifications on creditor rights, and could impact the spirit and operation of statutory management, liquidation, and voluntary administration. These matters are considered in detail below.

(i) Impact on preferred creditors

87. The legislative changes to Schedule 7 of the Companies Act set out in option B will effectively ensure that the claims of counterparties with security over cash collateral are largely treated the same as those of counterparties with security over non-cash collateral. However, they will also slightly alter the existing ranking of preferential claims under schedule 7 – specifically, by placing the claims of counterparties with a security interest over cash collateral ahead of most other preferential claims, including certain claims by employees.[31] Despite this, we believe there is negligible risk of these other Schedule 7 preferential creditors being made worse off by the legislative change.

88. This is because, in line with the Reserve Bank's conservative regulatory requirements, the funding structure of banks likely to be captured by foreign margin rules offers a very large cushion of loss absorbency sitting below secured and preferential creditors - in the form of equity, capital market instruments, and general deposit liabilities - protecting them from bearing losses in insolvency or statutory management. Thus, while the Option B legislative changes mean that the claims of counterparties over cash collateral would have priority over most other Schedule 7 claims, those other claims would almost certainly be made whole at a later date.[32]

(ii) Impact on general creditors

89. The Reserve Bank has considered the impact of Option B on the treatment of general creditors and the spirit and operation of the Open Bank Resolution (OBR) regime.[33]

[31] There are only a handful of preferential claims that would continue to rank ahead of the claims of these creditors (e.g. a liquidator's claims for their fees and expenses) . As noted in paragraph 69, whether the claims of the Commissioner of Inland Revenue under Schedule 7 should be subordinated to the claims of these creditors is a matter the agencies will discuss with the Inland Revenue Department.

[32] This is confirmed by stress test results, and historical write-downs during banking stress events overseas.

[33] OBR is a longstanding policy aimed at allowing a distressed bank to be kept open for business, while placing the cost of the bank failure primarily on the bank's shareholders and creditors, rather than the taxpayer. The policy is described in more detail at: http://www.rbnz.govt.nz/regulation-and-supervision/banks/open-bank-resolution .

90. Option B's legislative amendments are designed to facilitate the posting of margin by security interest. They do not in themselves have any effect on the pool of assets available to the posting party's general creditors in insolvency or OBR – instead that is influenced by the need to post margin in the first place. As noted earlier in this consultation document, there is little flexibility around this. In practice, margin will have to be provided in order for banks to engage in uncleared OTC business with their foreign counterparties.

91. Nonetheless, the Reserve Bank acknowledges that this will increase asset encumbrance. Preliminary calculations indicate as much as 5 percent of banks' balance sheets may be encumbered under new IM arrangements. How this interacts with the Reserve Bank's existing Liquidity Policy and whether further action may be necessary to limit encumbrance will be considered separately from this consultation.

(iii) Mitigating unintended consequences

92. The scope of protections from insolvency laws, the types of security to be offered protection, and the method of overriding relevant insolvency laws must be carefully defined in order to mitigate knock-on consequences. To this end, the legislative changes proposed in option B will protect the enforcement of security arrangements, and the priority of such arrangements, only where security is validly given over specified financial products. It in no way protects or validates the *creation* of security arrangements, including those that have been improperly created. Further, Option B carve outs will only apply to financial collateral (i.e. collateral normally used in financial market transactions) securing the performance of an obligation subject to a legally-enforceable netting agreement.

93. The need to ensure derivative netting arrangements are protected and that the collateral securing them is promptly enforceable and available in the event of a counterparty default must be balanced against:

- financial stability considerations, and

- the impacts on the rights of creditors and the coherence of the law governing the resolution, insolvency, and the enforcement of security interests.

94. A full carve out of derivative contracts and their associated security arrangements from insolvency processes would allow participants to terminate their positions rapidly and at will in the event of a counterparty's entry into statutory management, which could hinder the statutory manager's ability to effectively resolve the institution and may more broadly damage financial market function and system stability.

95. This consideration has prompted several other jurisdictions to implement time-limited 'resolution stays' on creditor rights - giving resolution authorities the power to restrict termination, enforcement and payout rights in relation to financial contracts and the collateral that secures them upon the entry into resolution, in line with international guidance on effective resolution regimes (see Appendix 1). At this stage, the Agencies believe that the changes set out in paragraph 61 to the moratorium provision under the RBNZ Act provide sufficient protection against the risk of a disorderly close out.

Question 12: Do you believe there may be knock-on implications stemming from Option B (legislative change) that have been overlooked or mischaracterised?

Question 13: If the proposed legislative changes in Option B are adopted, are there any additional safeguards they should be subject to?

<u>The right approach for New Zealand</u>

96. The Agencies are aware that several stakeholders have suggested the reforms necessary to address impediments in existing New Zealand law should be done via a standalone Netting Act.[34] Our understanding is that this approach would consolidate all the provisions relating to netting arrangements and the collateral that secures them within a single Act.[35] Other Acts, such as the Reserve Bank Act, CIMA and the Insolvency Act 2006, would cross-refer to a Netting Act where appropriate. As well as covering the matters discussed in this consultation document, such an Act could replace sections 310A – 310O in the Companies Act. It would be an opportunity to review such concepts such as a recognised multilateral netting agreement and recognised clearing houses, which are provided for in those sections.

97. Consolidating netting provisions in a single Act may improve legal clarity and remove the need for ad-hoc legislative amendments, both now and into the future, as well as reforming redundant provisions. It may also offer benefits in terms of trans-Tasman consistency. Nonetheless, there are arguments for why a different approach may be appropriate in New Zealand.

98. New Zealand's netting rules are distributed across various Acts. Restructuring these into a single statute would likely add time and complexity to the legislative design process. The benefits from developing a new statute would therefore have to be carefully considered against the pressing nature of margin compliance deadlines; and it may be that amendments to existing provisions offer a simpler and quicker solution due to the narrower scope of the policy issues that need to be considered.

99. Further, Australia's legislative changes dealt with a substantially larger set of issues than we are considering here - in particular the risk that a security interest could be nullified by powerful creditor protections in the *Banking Act 1959*[36] and other legislation, which would rank derivative liabilities subordinate to deposit liabilities in Australia in relation to claims against Australian assets. In contrast, the situations where secured creditors might lose their preference under New Zealand law are more limited.

100. The Agencies believe a legislative response should be proportionate and targeted: the intention is to provide a predictable treatment for derivative security arrangements consistent with the expectations of New Zealand banks' common derivative counterparties via amendments to the specific areas of New Zealand law giving rise to

[34] *The Payments Systems and Netting Act 1998* as amended by the *Financial System Legislation Amendment (Resilience and Collateral Protection) Act 2016* sets out statutory protections for derivative netting contracts and security given in relation to those contracts.

[35] As opposed to a single Act covering the specific issues that may be identified during this consultation process as impeding compliance with foreign margin requirements.

[36] Section 13A(3) (*priorities for application of assets of ADI in Australia*) subjects the assets of an Australian-registered bank in Australia to a priority regime which would prefer other creditors (e.g. holders of protected accounts, including deposits) ahead of a secured party in the event that the bank becomes unable to meet its obligations or suspends payments. Further, priority over the Australian assets of a bank is given to Australian depositors over the bank's other liabilities. Section 86 of the Reserve Bank Act 1959 also subordinates secured creditors.

uncertainty.[37] Other netting provisions, such as found in sections 310A-310O of the Companies Act, are not material to that objective and are not creating any apparent problems. Therefore, to spend time reviewing them is inconsistent with the need for a targeted and prompt response to the urgent IM issues.

101. Nevertheless, the appropriate form of legislative change is a question for the legislative design phase, in the event that a legislative response is chosen. Whether a standalone Act might be appropriate in a New Zealand would be considered at that point. If circumstances change - for example if the nature and scope of necessary amendments is found to be significantly different to what we currently expect; or impending compliance deadlines become less urgent[38] - a standalone Act may become a more feasible solution.

Question 14: Do you share the Agencies' preliminary view that, on balance, targeted amendments to existing legislation may be preferable to a standalone Netting Act for New Zealand?

Section F: Policy proposal and next steps

102. The Agencies recognise the risk mitigation techniques that are increasingly being employed in global financial markets, and the importance of ensuring New Zealand businesses can comply with emerging market practice around this. Doing so will underpin New Zealand's integration and competitiveness within the global financial system, assist in the mitigation of risks, bolster cost efficiency, and promote the soundness and stability of the financial system as a whole.

103. Targeted legislative change (Option B) is the Agencies' preferred response to support derivative margin arrangements in New Zealand, resolving potential barriers created by existing New Zealand law in an effective, timely, and proportional way whilst mitigating the risk of unintended consequences from legislative change. We seek respondent's views on the scope of legislative issues identified in Option B, and whether addressing these issues will ensure margin provided by way of security interest under New Zealand law will be sufficiently protected and promptly enforceable to the satisfaction of derivative market participants. The consultation will remain open for a period of 6 weeks, with submissions closing on 24 August 2017.

104. As noted above, the appropriate form of any necessary amendments to existing legislation will be considered subsequently, during the legislative design phase.

[37]Advice provided to the Reserve Bank by legal experts also indicates a standalone response is not necessary.

[38] For example, if consolidated banking groups with a New Zealand entity fall below qualifying thresholds in 2017 and 2018; or where foreign jurisdictions issue non-enforcement notices for IM compliance.

Appendix 1: An international approach to resolution moratoria

FSB guidance on effective resolution regimes explicitly considers arrangements for declaring or otherwise giving effect to moratoria, stays or prohibitions on the exercise of early termination rights, rights to seize collateral, and obligations to make payments as they fall due.

The *Key Attributes* (KAs) state that resolution authorities should have at their disposal powers to temporarily stay the exercise of early termination rights that may otherwise be triggered upon entry of a firm into resolution or in connection with the use of resolution powers; and impose a stay on creditor actions to attach assets or otherwise collect money or property from the firm, while protecting the enforcement of eligible netting and collateral agreements. KA 4.3 stipulates that resolution stays should (amongst other things):

i. be strictly limited in time (for example, for a period not exceeding 2 business days);
ii. be subject to adequate safeguards that protect the integrity of financial contracts and provide certainty to counterparties
iii. not affect the exercise of early termination rights of a counterparty against the firm being resolved in the case of any event of default not related to entry into resolution or the exercise of the relevant resolution power occurring before, during or after the period of the stay (for example, failure to make a payment, or deliver or return collateral on a due date).

The stay may be discretionary (imposed by the resolution authority) or automatic in its operation. In either case, jurisdictions should ensure there is clarity as to the beginning and the end of the stay. The FSB notes that resolution stays should be limited to ensure they do not affect other rights of counterparties under netting and collateralisation agreements.

In accordance with this guidance, many jurisdictions have implemented resolution stays and moratoria as part of their orderly resolution regimes, in support of the statutory powers granted to the resolution authority to facilitate an orderly resolution.

For example, the European Bank Recovery and Resolution Directive (BRRD) gives national resolution authorities the power to impose temporary restrictions on the rights of counterparties to the firm in resolution. These cover the payment and delivery of obligations (Article 69); the enforcement of security interests by secured creditors (Article 70); and termination rights (i.e the right to accelerate, close-out, set-off or net obligations) (Article 71). In the UK, these powers have been transposed into statute and are exercisable by the BOE under sections 70A, 70B and 70C of the Banking Act 2009 (as amended to implement the BRRD).

The BRRD resolution stays are temporary by default, taking effect if and when they are exercised by the resolution authority and applying until midnight on the next business day following the imposition of the stay. When exercising their power under Article 70, the resolution authority must have regard to the impact the exercise of that power might have on the orderly functioning of financial markets.

Australia adopts a similar approach under Section 5 of the Payments Systems and Netting Act 1998, as amended by the *Financial System Legislation Amendment (Resilience and Collateral Protection) Act 2016:* a bank's entry into resolution (or any appointment of an external manager) triggers an automatic stay on derivative counterparties' right to close out and enforce security interest in relation to a legally enforceable netting contract that applies until the close of the next business day after entry into resolution.[39] The effect of the resolution stay can be made permanent in certain circumstances set out under Sections 15A-C (i.e. where the resolution actions have successfully restored the firm to solvency and viability) such that entry into resolution can never be subsequently used as grounds for triggering early termination.

Resolution stays and moratoria are clearly not unique to New Zealand, then. However, the processes underpinning New Zealand's arrangements are. While relevant resolution stays in Europe and Australia are strictly time limited, in line with FSB guidance, under New Zealand law, resolution moratoria will remain in place throughout the duration of statutory management (and the statutory manager has the discretion to pay creditors, having regard to his objectives, despite the moratorium being in place).

[39] This provision implements the ISDA stay protocol

Appendix 2: Consolidated questions

Question	Content
1	*Do you agree with this assessment of the likely impact of foreign margin rules on New Zealand entities? Are there risks to New Zealand entities that have been overlooked or mischaracterised?*
2	*Do you agree that current New Zealand law is a significant potential barrier to New Zealand entities' ability to effectively and efficiently provide margin?*
3	*Does the proposed exception cover the enforcement of security interests in the right circumstances? Are there better ways of defining the scope of the exception?*
4	*Do you agree that New Zealand's moratorium provisions are a significant potential impediment to New Zealand entities' compliance with foreign margin requirements?*
5	*Do you agree that the proposed changes to moratorium provisions are necessary and sufficient to address this potential compliance barrier?*
6	*Do you agree that Schedule 7 preferential claims are a significant potential impediment to New Zealand entities' compliance with foreign margin requirements?*
7	*Do you agree that the proposed changes relating to preferential claims are necessary and sufficient to address this potential compliance barrier?*
8	*Do you agree with the way we are proposing to protect secured derivative creditors from losing their priority interest to Schedule 7 preferential claims?*
9	*Do you agree that the proposed changes to priority rules in the PPSA are necessary and sufficient to address the potential compliance barriers identified?*
10	*When implemented together, do you believe the changes set out under Option B will be sufficient to address impediments to creating and enforcing rights as a secured party under New Zealand law?*
11	*If you believe the changes set out under Option B are not sufficient, please describe additional legislative changes necessary for compliance. You should provide a rationale for any proposed changes.*
12	*Do you believe there may be knock-on implications stemming from Option B (legislative change) that have been overlooked or mischaracterised?*
13	*If the proposed legislative changes in Option B are adopted, are there any additional safeguards they should be subject to?*
14	*Do you share the Agencies' preliminary view that, on balance, targeted amendments to existing legislation may be preferable to a standalone Netting Act for New Zealand?*

Appendix 3: Glossary

The following abbreviations and acronyms are used throughout this consultation document.

Abbreviation	Definition
The Agencies	The Reserve Bank and MBIE
BCBS	The Basel Committee on Banking Supervision
BCBS-IOSCO Margin Requirements	Margin requirements for non-centrally cleared derivatives published by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions in September 2013 as revised in March 2015
CCP	Central counterparty
CIMA	Corporations (Investigation and Management Act) 1989
Collecting party or collector	Person to whom security has been granted
EU Bank Recovery and Resolution Directive	Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms
EU Financial Collateral Directive	Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements
FSB	Financial Stability Board
G20	The Group of Twenty
ISDA	International Swaps and Derivatives Association Inc.
Key Attributes	The FSB *Key Attributes for Effective Resolution of Financial Institutions*
MBIE	Ministry of Business, Innovation and Employment
OBR	Open Bank Resolution; a Reserve Bank policy aimed at allowing a distressed bank to be kept open for business, while placing the cost of a bank failure primarily on the bank's shareholders and creditors, rather than the taxpayer.
OTC	Over-the-counter
Posting party or poster	Person who has granted the security
PPSA	*Personal Property Securities Act 1999*
Reserve Bank	Reserve Bank of New Zealand
RBNZ Act	*Reserve Bank of New Zealand Act 1989*
Secured party	Person to whom security has been granted
Stay Protocol	ISDA 2015 Universal Resolution Stay Protocol
Uncleared OTC derivative contract	A derivative contract that is not traded through a formal exchange, nor cleared through a CCP. Instead, it is traded and cleared bilaterally between two counterparties.