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CONSULTATION DOCUMENT: A NEW ZEALAND RESPONSE TO FOREIGN MARGIN REQUIREMENTS FOR OTC DERIVATIVES ("CONSULTATION DOCUMENT")

1. BACKGROUND

1.1 This is a joint submission by each of the parties referred to in the schedule to this letter.

1.2 The signatories welcome the Agencies' consultation on foreign margin requirements. We believe that it is imperative that that urgent legislative action is taken to correct New Zealand's position as being unable to legally fulfil requirements in relation to margining.

1.3 We submit that the legislative reform to should extend to both centrally cleared and non-centrally cleared OTC derivatives (both for initial and variation margin).

2. URGENCY REQUIRED TO ADDRESS MARGINING REQUIREMENTS

2.1 As the Agencies are aware, the Financial Stability Board Framework would be binding on the four major New Zealand banks as Level 2 group entities under the Australasian prudential supervision model. Our current framework resulted in APRA providing a specific exemption for these banks:[1]

> "APRA has amended CPS 226 to exempt transactions from requirements to post or collect initial margin where the legal environment in the jurisdiction of either counterparty does not

[1] *Response to Submissions Margining and risk mitigation for non-centrally cleared derivatives* (17 October 2016) at 13 and 34.

> yet permit compliance with the initial margin requirements, **such as in New Zealand**." (Emphasis added)

2.2 The policy basis for recognising and making appropriate provision for this prudential requirement is clear and the requisite reforms, which are straightforward, ideally should have been carried out prior to the current Parliament rising, because the requirements come into effect on 1 September 2017. Achieving the margining reform is essential because continued inaction risks compromising New Zealand's access to critical funding markets and risk management instruments.

2.3 We submit that the relevant changes (refer below) could be implemented by way of Supplementary Order Paper in the omnibus Financial Services Legislation Amendment Bill 2017 in order to create the best chance that the changes can be given effect by 1 September 2018.

3. POLICY BASIS FOR FINANCIAL COLLATERAL PRIMACY FOR CENTRALLLY AND NON CENTRALLY CLEARED MARGINING

3.1 It has been recognised by jurisdictions comprising virtually all the world's leading financial and investment markets that financial stability and systemic risk management justify and require that financial collateral have ring-fenced primacy over general insolvency settings. This recognition is equally imperative to New Zealand, because we have:

(a) net debt to the world of approximately $155 billion[2], which must be supported and sustained in the global financial and derivatives market; and

(b) a disproportionately high derivatives turnover despite not being a member of the G20, with the NZD being approximately the 10th highest traded currency in the world.[3] In addition, virtually all counterparties in derivatives transactions are now in jurisdictions that apply compulsory margining. As noted by the Commonwealth Parliament in the Explanatory Memorandum to Australia's CCP margining law reform Bill:[4]

> "The reason for providing this kind of powerful authority … is that the systems, activities and arrangements it covers are at the heart of the financial system. Ensuring that they have legal validity, including in situations where one of the parties enters insolvency, **is considered fundamental to protecting the stability of the financial system**." (Emphasis added.)

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[2] *Statistics NZ – Information Release, Balance of Payments and International Investment Position: March 2017 quarter.*

[3] *Bank for International Settlements – 2016 Triennial Central Bank Survey of foreign exchange and OTC derivatives markets.*

[4] *Corporations and Financial Sector Legislation Amendment Bill 2013, Explanatory Memorandum* at 8.

3.2 In addition, our investment markets are also heavily reliant on robust derivatives arrangements. For example, a very high percentage of KiwiSaver schemes and wholesale investment funds invest in offshore stocks and bonds, which need to be hedged.

4. SIMPLE DRAFTING APPROACH, CONSISTENT WITH MODEL LAWS AND REGIONAL PRECEDENT

4.1 As referred to above, given the 1 September 2017 implementation date for initial margin, we believe that it is critical that the reform be progressed urgently. On that basis, we support a reform process that implements the required changes as a priority. We understand that the Agencies believe that Option B (as referred to in the Consultation Document) is likely to be the best option in this regard rather than an over-arching Netting Act.

4.2 While we believe that a Netting Act would provide optimal legal certainty for the New Zealand and our interaction with global markets over the long term, we submit that New Zealand should adopt the provisions used in Australia to confer the protection required by international standards. This could be achieved within the Option B proposal suggested by the Agencies. The Australian approach has been described as "surprisingly brief".[5] This is partly because they are:

(a) confined to specific situations of complying "close out netting" and to specified financial collateral;

(b) drafted so as to have primacy over all laws to the contrary; and

(c) subject to protections, including that the arrangements are entered into in good faith and without knowledge of a counterparty's impending insolvency.

4.3 The rationale for closely adhering to the "Australian approach" is very compelling. It is consistent with our commitments made to create a Single Economic Market, enhances efficiency and increases the likelihood of the New Zealand regulations achieving "equivalence".

4.4 The collateral primacy approach has a further logic in that any reform that addresses only the primary legal obstacle (the statutory management stay) and leaves other matters, such as clawback risk, unresolved would detract from the required legal certainty for no clear gain. In any event, we submit that the impact of this on existing legal frameworks is not significant. For example, the pari passu principle has always been subject to prior ranking security interests. Failing to address such matters also results in the risk that other issues are

[5] Scott Farrell *Australia's New Financial Collateral Laws – Paramount Protection for Enforcing Security Over Financial Property* (22 August 2016) at 5.

overlooked which may prove to be problematic for such transactions going forward.

4.5 The signatories would be happy to assist with developing the required amendments if this would assist with implementing the required changes. As noted above, we believe the changes could be implemented in the omnibus Financial Services Legislation Amendment Bill 2017.

5. OUTRIGHT TRANSFERS OF COLLATERAL ARE NOT SECURITY INTERESTS

5.1 The signatories are strongly of the view that outright transfers of collateral are **not** security interests under the Personal Property Securities Act 1999 ("**PPSA**"). Outright transfers of title are commonly used not only for derivative transactions but also for (among other things) repo transactions. Equally, we see no benefit in providing that collateral arrangements are **not** security interests, or otherwise changing the status quo position under the PPSA. The basic reasons for this are:

(a) The question of the security treatment under the PPSA is academic under current legislative settings because arrangements under the 'transfer' form of Credit Support Annex involve the counterparty getting "possession" of the collateral (for the purposes of section 18 of the PPSA), effective to perfect a security interest in the event transfers are re-characterised as one.

(b) As we understand it, Initial Margin is likely to be carried out under the alternate "security interest" form of CSA (or an ISDA-stipulated variant), but similarly involving transfer of the collateral to a nominee, which again on the face of it would confer priority – albeit this time in respect of an acknowledged security arrangement.

(c) In either case, altering the accepted position would create significant disruption and cost, without benefit, particularly if provisions conferring financial collateral primacy are adopted, which can address some arcane issues that potentially arise.

5.2 If, despite this view, the Agencies believe a clarification is required, the amendment should simply record that an outright transfer of collateral does **not** create a security interest.

Schedule

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