

8 September 2017

Senior Adviser
Banking, Insurance and Capital Markets Unit
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: crisismanagement@treasury.gov.au

Dear Patrick

APRA's Crisis Management Powers

The International Swaps and Derivatives Association, Inc. (“**ISDA**”)¹ is grateful for the opportunity to comment on the exposure draft of the Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Bill 2017 (“**Reforms**”) which strengthens the Australian Prudential Regulation Authority’s (“**APRA**”) crisis management toolkit in relation to banks and insurers.

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

¹ **About ISDA:** Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 875 member institutions from 68 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

Consistent with our mission, we are primarily concerned in this letter with the effect of the proposals set out in the Reforms on the safety and efficiency of the derivatives market, by considering the direct impact of the proposals on the rights of a market counterparty under its derivatives transactions with a failing financial institution and under related netting and collateral arrangements. However, we also take the opportunity to make some observations about certain other issues raised in the Reforms.

While we agree that many of the issues dealt with throughout the Reforms are closely interrelated, we believe, given our focus on the OTC derivatives markets, that other respondents, in particular, those with a broader and less sector-specific focus and mission than ours, are better placed to comment in detail on other parts of the Reforms. Accordingly, our submission is limited to the specific issues raised below and our members may choose to make their own individual submissions in relation to the Reforms.

Submissions

General comment

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

Enforceability of netting and collateral arrangements

Legal certainty around the enforceability of the netting and collateral arrangements in connection with OTC derivatives is critical to the stability of the market. We understand that the Australian government and its regulators share this view.

We strongly support Treasury's intention to "ensure that current protections under the PSN Act are retained and the rights of counterparties to close-out netting contracts are clear."² We further support the general approach taken to clarify the manner in which the Reforms relate to, and affect, the protections available to netting and collateral arrangements under the *Payment Systems and Netting Act 1998* (Cth) ("**PSN Act**").

We set out below our submission which, in our view, would ensure that netting and collateral arrangements are protected in a manner consistent with the approach taken in the *Financial System Legislation Amendment (Resilience and Collateral Protection) Act 2016* (Cth) ("**Collateral**

² Explanatory Memorandum to the *Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Bill 2017* ("**Explanatory Memorandum**"), [6.6].

Protection Act”) and its associated regulations.³ The design, structure, and effect of the Collateral Protection Act reflects an approach which ensures protection of netting and collateral arrangements, was consistent with international requirements (to the extent possible), and which was accepted by members.

Conversion and write-off stays should be limited to conversion, write-off and actions taken by APRA

We note that the Reforms introduce three new “specified stay provisions” which are also “direction stay provisions” that may apply to a contract.⁴ We understand that these stays are consequential to other parts of the Reforms that have been included to provide certainty that capital instruments can be converted or written down as required by APRA’s prudential standards.⁵ Significantly, these stays are proposed to apply in three circumstances, one of which is:

*the occurrence of an event (which may be the making of a determination (however described) by APRA) that results in a relevant instrument being required to be converted or written off for the purposes of the conversion and write-off provisions.*⁶

The current drafting of this sub-paragraph is very broad. We are concerned that this very broad drafting could capture the occurrence of a broad range of events which are not related to a relevant instrument, including, relevantly, a substantive default (e.g. a failure to pay or deliver) under an OTC derivatives contract that ultimately causes APRA to make a determination that a relevant instrument is to be converted or written off. It is critical that counterparties’ close-out rights which arise due to a substantive default (including a failure to pay or deliver) are not stayed.⁷ Whilst we do not expect that this is the policy intention, we are concerned that the breadth of this stay and its potential application to OTC derivatives contracts and other financial markets arrangements could create uncertainty in counterparties’ rights when facing a regulated entity or a regulated entity’s related body corporate, particularly as this is a stay which applies permanently to stay

³ *Financial System Legislation Amendment (Resilience and Collateral Protection) Regulation 2016 (Cth).*

⁴ Reforms, Schedule 1, Item 27, Schedule 2, Item 19, Schedule 3, Item 61, Schedule 5, Sections 3, 4, and 5; Section 5 of the PSN Act (and the definition of “specified stay provisions” and “direction stay provisions”); proposed sections 11CAC(2) of the Banking Act, 36C(2) of the Insurance Act, and 230AAD(2) of the Life Insurance Act.

⁵ Explanatory Memorandum, [6.14].

⁶ Reforms, Schedule 1, Item 27, Schedule 2, Item 19, Schedule 3, Item 61; Sections 11CAC(3)(c) of the Banking Act, 36C(3)(c) of the Insurance Act, and 230AAD(3)(c) of the Life Insurance Act.

⁷ In this regard, we refer to paragraph 2.1(v) of I-Annex 5 – Temporary stay on early termination rights of the Financial Stability Board’s *Key Attributes of Effective Resolution Regimes for Financial Institutions*, which provides that: “A temporary stay of the exercise of early termination rights should be subject to the following conditions: The early termination rights of the counterparty are preserved against the firm in resolution in the case of any default occurring before, during or after the period of the stay that is not related to entry into resolution or the exercise of a resolution power (for example, a failure to make a payment or the failure to deliver or return collateral on a due date)”.

counterparties' close-out rights (and the PSN Act does not provide a mechanism for the stay to cease). This uncertainty would be undesirable.

Accordingly, we submit that sub-paragraph 11CAC(3)(c) of the *Banking Act 1959* (Cth) ("**Banking Act**") (and the equivalent provisions of the *Insurance Act 1973* (Cth) ("**Insurance Act**") and *Life Insurance Act 1995* (Cth) ("**Life Insurance Act**")) should be limited to the occurrence of an event *taken by APRA* that results in a relevant instrument being required to be converted or written off for the purposes of the conversion and write-off provisions. Alternatively, to the extent that Treasury's intention is to capture other events which are not taken by APRA, we consider that the "matter" referred to in the drafting should more specifically and directly address Treasury's concern so that early termination rights which are not directly related to the conversion or write-off (including substantive default rights such as any failure to pay or deliver, even those which ultimately lead to the conversion or write-off of a relevant instrument) are not stayed under the new provisions.

"Subsidiary" to be defined in the PSN Act

We note Treasury's intention to ensure that "that the current protections afforded to counterparties to certain close-out netting contracts under the PSN Act are retained (with appropriate amendments to take into account stays applying to cross-default rights)".⁸ These amendments include those made to "cater for the fact that, under the Bill, resolution actions and directions, to which stay provisions apply, may be taken against not only ADIs and insurers, but also in relation to authorized NOHCs and subsidiaries of ADIs/insurers and authorized NOHCs".⁹

To support the expansion of the statutory management regime and directions powers to other entities, the definition of "regulated entity" has been amended to include, relevantly, "a *subsidiary* of an authorized NOHC or an ADI/insurer".¹⁰ However, there is no new definition of "subsidiary" included in section 5 of the PSN Act (although we note that the new section 5AA of the PSN Act defines the "related body corporate" concept by reference to the *Corporations Act 2001* (Cth) ("**Corporations Act**")).

To ensure consistency of terminology across the PSN Act, Banking Act and Corporations Act, we submit that the "subsidiary" concept should be defined in the PSN Act in a similar way to the way in which it is defined the Banking Act.¹¹

Extension of many of APRA powers to non-regulated holding companies and subsidiaries

We note that the scope of entities covered by APRA's proposed powers and the new and amended stays under the Reforms is very broad. For example, these extend to appointing a statutory

⁸ Explanatory Memorandum, Chapter 6, [1.54].

⁹ Explanatory Memorandum, [6.23].

¹⁰ Reforms, Schedule 5, item 8; Section 5 of the PSN Act.

¹¹ See section 5(2) of the Banking Act.

manager to a “subsidiary” of a regulated entity, and applying a stay on close-out of transactions under a contract where a statutory or judicial manager is appointed to a “related body corporate” of a contracting party, or an act is done by the statutory or judicial manager of a “related body corporate” of a contracting party. This is broader than the regime proposed by the Financial Stability Board (“FSB”) in its *Key Attributes of Effective Resolution Regimes for Financial Institutions* (“*Key Attributes*”), which states that the scope of the regime should extend to holding companies, “non-regulated operational entities within a financial group or conglomerate that *are significant to the business of the group or conglomerate*”, or branches of foreign firms.¹²

In addition, the *Key Attributes* temporary stays on close-out rights should only be imposed under the *Key Attributes* where they arise by reason “only of entry into resolution or in connection with the exercise of any resolution powers”, and should “be subject to adequate safeguards that protect the integrity of financial contracts *and provide certainty to counterparties*.”¹³ We understand this is the policy position of the Australian Government but note in any case that there are a range of matters in the Reforms, some of which are set out below, which will give rise to uncertainty for financial market participants as to whether their counterparty can be subject to statutory management and whether their rights to close out transactions and effectively manage their risk may be stated in certain circumstances. In addition to the breadth of the stay set out in subparagraph 11CAC(3)(c) of the Banking Act (discussed above), these include:

- (a) extending the ability to appoint a statutory manager to subsidiaries of regulated entities which are not identified in advance; and
- (b) staying critical rights such as close-out rights in respect of contracts with these related bodies corporate (including cross-default stays) based on certain resolution activities which occur to that entity or another entity in its group.

Scope of subsidiaries of foreign regulated entities subject to statutory management and stays

We acknowledge Treasury’s intention, as part of the Reforms, to enhance APRA’s powers when an Australian branch of a foreign regulated entity is in distress.¹⁴ These Reforms propose to, relevantly, enable APRA to appoint a statutory manager to the Australian branch of a foreign regulated entity” and to “harmonize the power to direct a foreign regulated entity not to transfer assets out of Australia across the Industry Acts.”¹⁵

¹² FSB, *Key Attributes*, 1.1 (emphasis added).

¹³ FSB, *Key Attributes*, [4.3].

¹⁴ Explanatory Memorandum, [1.15].

¹⁵ Explanatory Memorandum, [1.41].

However, in each case, APRA’s expanded powers are expressed to be limited to the “Australian business assets and liabilities of a foreign regulated entity”.¹⁶ This term contains “the scope of business of a foreign regulated entity that APRA’s crisis management powers are to extend to under” the Reforms¹⁷ and is defined as:

- (a) *“the assets and liabilities of the foreign [regulated entity] in Australia; and*
- (b) *any other assets and liabilities that the foreign [regulated entity] has as a result of its operations in Australia.”*¹⁸

However, there are some issues with the scope of this language and how it may apply with respect to subsidiaries of foreign regulated entities. First, we note that APRA’s expanded powers include the ability to appoint a statutory manager to a “subsidiary” of a foreign regulated entity.¹⁹ Whilst it may be that this ability to appoint a statutory manager is limited so that a statutory manager can only be appointed to the extent that the subsidiary falls within the foreign regulated entity’s “Australian business assets and liabilities”,²⁰ this is unclear from the terms of the Reforms. Secondly, the appointment of a statutory manager to a foreign regulated entity or its subsidiary, and the exercise of particular powers, are matters to which “specified stay provisions” (as defined in the PSN Act) may apply in respect of a contract with a foreign regulated entity or its subsidiary. Given the breadth and uncertainty of the language used in paragraph (b) of the definition of “Australian business assets and liabilities”, it is unclear to what extent these powers, and stays, would extend to foreign subsidiaries of a foreign regulated entity. It is also uncertain the extent to which these powers, and stays, may apply to domestic subsidiaries (particularly those subsidiaries which conduct business in other jurisdictions). Thirdly, as noted above, the scope of application of paragraph (b) of the definition of “Australian business assets and liabilities” is very broad and potentially uncertain. For example, if a foreign ADI adopts a global booking model with trades booked in a branch or subsidiary of the foreign ADI outside of Australia, it is not clear whether and to what extent the assets and liabilities resulting from these transactions be subject to APRA’s powers (including statutory management and business transfers) (ie how one would determine whether these are “as a result of its operations in Australia”).

Accordingly, we would be grateful if Treasury could please clarify the extent to which these provisions apply to the subsidiaries of a foreign regulated entity. Generally, we also note that the scope of the definition of “Australian business assets and liabilities” is not entirely clear

¹⁶ Explanatory Memorandum, [2.140]. See for example, Reforms, Schedule 1, items 2 and 43; Sections 5(1) and 11E of the Banking Act.

¹⁷ Explanatory Memorandum, [2.141].

¹⁸ Reforms, Schedule 1, items 2 and 43, Schedule 2, items 2 and 67, Schedule 3, items 4 and 94; Sections 5(1) and 11E of the Banking Act, sections 3(1) and Section 62ZVB(2) of the Insurance Act, and Section 16ZE(3) and Schedule Dictionary of the Life Insurance Act.

¹⁹ Reforms, Schedule 1, Item 49; Section 13A(1B) and (1C) of the Banking Act.

²⁰ For example, 14AC and 15C of the Banking Act (which are both contained in Subdivision B of Division 2 of Part II of the Banking Act, as referred to in Section 11E(1B)(a)).

(particularly in relation to limb (b)) and any further clarity which can be provided on the scope of the definition would be welcomed, including with respect to assets and liabilities booked in subsidiaries of the foreign ADI that are located and regulated outside of Australia. To the extent APRA's powers are expected to extend to such assets and liabilities, we would also be grateful for any guidance with respect to how APRA will exercise its powers (including in relation to the interactions with respect to foreign regulators).

Guidance on cross-border resolutions and revocations of authority

Generally, in relation to APRA's ability to appoint a statutory manager in relation to the Australian business assets and liabilities of a foreign regulated entity, we make the following observations.

We believe for a resolution framework to be effective, particularly in the context of a foreign regulated entity with both home and host resolution requirements, cooperation and mutual recognition are required to avoid potential conflicts that may arise between the resolution actions of a home or host resolution authority. Co-operation between home and host authorities at the point of failure will be key to the successful resolution of a cross-border group and Key Attribute 7.1 of the FSB's *Key Attributes* urges such co-operation as far as possible. In these circumstances, we believe that the home country resolution authority should have primary responsibility for the resolution of the parent and any subsidiary of the parent located in the home country (as is consistent with the FSB's *Key Attributes*). Each host country resolution authority (and other relevant host country authorities such as the host country central bank, financial regulator or Ministry of Finance) should cooperate and coordinate with the home country resolution authority effectively to ensure that all creditors of a particular class are, as far as possible, given equal treatment. It is imperative that home and host jurisdictions provide for transparency over processes that would give effect to foreign resolution measures. Any alternative has the potential to descend into a disorderly break up and significant value destruction across multiple jurisdictions.

We believe that the Australian resolution authority should aim to achieve a cooperative solution as a first step instead of discretionary national action as a first step, particularly for foreign regulated bodies that are subject to both home and host resolution frameworks. Whilst we recognize the challenges in cross-border coordination and cooperation due to the differing resolution frameworks, legal frameworks and national mandates in each jurisdiction, it is important that work on these issues continue through an international body such as the FSB. Cross-border cooperation is only possible if each jurisdiction is willing to recognize and mutually agree to support the resolution measures of the resolution authority in each jurisdiction.

Accordingly, we would be grateful if Treasury or APRA could please provide further detail, if possible, regarding the manner in which APRA expects to act in exercising its resolution powers in respect of foreign regulated entities and the circumstances in which APRA will cooperate with, and act in a manner which is consistent with, a home resolution authority of a foreign regulated entity.

Also, we note that the Reforms do not provide for a statutory framework or clear formal mechanism for APRA, or any other authority, to recognize foreign resolution actions (other than through a statutory manager choosing to take sympathetic actions). We note that these types of statutory frameworks have become increasingly common in the resolution regimes of other nations. For example, we understand that Singapore resolution framework allows a foreign resolution authority of a foreign country or territory to make a request to the Singaporean authority, in this case, the Monetary Authority of Singapore (**MAS**) for recognition of a foreign resolution in relation to a foreign financial institution by the foreign resolution authority and for MAS, upon such request, to make a determination recognizing all or part of (or not recognizing) a foreign resolution in relation to a foreign financial institution where certain conditions are satisfied.²¹ We also understand that, under Hong Kong resolution framework, if a resolution authority is notified of the taking of a non-Hong Kong resolution action, then the resolution authority may make a “recognition instrument”, which recognizes all or part of a foreign resolution action where certain conditions are satisfied.²² We also refer to Articles 94 to 96 of the European Union’s Bank Recovery and Resolution Directive and, specifically, we refer to Article 95 which outlines instances in which it may not be appropriate to recognize a foreign resolution proceeding.²³ We expect that this will be important not only to ISDA members, but also to the regulators (particularly prudential regulators) of members.

The FSB Principles for Cross-Border Effectiveness of Resolution Actions provide, among others, that the legal framework should confer on a domestic authority or authorities the legal capacity to give effect to foreign resolution measures. The Principles also state that the legal framework should provide a foreign resolution authority with legal standing to request recognition and enforcement. The legal framework for giving effect to foreign resolution measures or adopting measures to support foreign resolution actions should also clearly establish (i) the conditions for recognition, enforcement or support actions, (ii) the grounds for refusal of such actions, which should be limited, and (iii) the process for taking such actions. The Principles include detailed guidance on the issues which should be covered in national laws regarding recognition or supportive measures of a foreign resolution regime.

We would be grateful if Treasury and APRA could please consider whether a statutory framework or clear formal mechanism to recognize foreign resolution actions could be introduced (including whether it can be introduced as part of the Reforms).

We also note that there are some inconsistencies in the Reforms and Explanatory Memorandum as to the circumstances in which APRA may revoke a foreign regulated entity’s authority due to the

²¹ Section 94, Monetary Authority of Singapore (Amendment) Act 2017 (No.31 of 2017).

²² Financial Institutions (Resolution) Ordinance (Ord. No. 23 of 2016, A2469), Part 13, Sections 187 to 188.

²³ 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 and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council.

revocation of a foreign authorization. It is unclear whether Treasury intends that APRA's ability to revoke a foreign regulated entity's authorization be limited to circumstances where the entity's authorization is revoked in its *home* jurisdiction or by its *home* regulator²⁴ or whether APRA may also revoke the authorization of a foreign regulated entity in Australia if the entity's authorization is revoked by any *foreign* regulator (or revoked in any *foreign* country) other than in its home jurisdiction or by its home regulator.²⁵ We would be grateful if Treasury and APRA could please clarify this in the Reforms and Explanatory Memorandum.

Safeguards on direction powers

We note that the enhanced directions powers proposed under the Reforms (as outlined in Chapter 3 of the Explanatory Memorandum) empower APRA to issue directions, among others, requiring entities to take specified actions to facilitate resolution, whether in normal times or during a crisis. We note that these include the directions that may be given under section 11CA(2) of the Banking Act (and specifically 11CA(2)(p) and (q)) to an ADI, an authorized NOHC, or either of their subsidiaries for the grounds stated in subsections (1), (1AA) or (1AC) of section 11CA of the Banking Act. However, we note that Part VI only applies directions given by APRA under subsection 11CA(1) as a result of a ground referred to in paragraph 1(a), (b), (c), (d) or (e). We would be grateful if Treasury and APRA could please consider whether it is appropriate to extend the application of Part VI to the other grounds, including those under subsections 11CA(1AA) or 11CA(1AC).

Conclusion

We thank you for the opportunity to respond to the consultation on the Reforms. We would be very happy to discuss this matter further at your convenience. Please do not hesitate to contact Keith Noyes, Regional Director, Asia Pacific (knoyes@isda.org, +852 2200 5900), Erryan Abdul Samad, Assistant General Counsel (eabdulsamad@isda.org, +65 6653 4170), Jing Gu, Senior Counsel (jgu@isda.org, +65 6653 4170) or Rishi Kapoor, Director, Public Policy, Asia-Pacific (rkapoor@isda.org, +852 2200 5900) if we may be of further assistance.

²⁴ In this regard, we refer to the Explanatory Memorandum at pages 16, 126 and 133 (including in the heading "*Enable APRA to revoke the authorisation of a foreign-regulated entity if the entity's authorisation is revoked by its home regulator*" which appears before [7.39]).

²⁵ In this regard, we refer to the Explanatory Memorandum at pages 127 and 133 (para 7.39 and 7.40) and Reforms, Schedule 1, Item 15, Section 9A(2)(h)(ii).

Yours sincerely,

For the **International Swaps and Derivatives Association, Inc.**

A handwritten signature in black ink that reads "Keith Noyes". The signature is written in a cursive style with a large initial 'K' and a long, sweeping underline.

Keith Noyes

Regional Director, Asia-Pacific