Financial System Legislation Amendment (Resilience and Collateral Protection) Bill 2016: a quick guide

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Date introduced: 16 March 2016
House: House of Representatives
Portfolio: Treasury

Commencement: The formal provisions of the Bill commence on the day of Royal Assent. The operative provisions of the Bill commence on the 28th day after the Bill receives Royal Assent.

Links: The links to the Bill, its Explanatory Memorandum and second reading speech can be found on the Bill’s home page, or through the Australian Parliament website.

When Bills have been passed and have received Royal Assent, they become Acts, which can be found at the Federal Register of Legislation website.

All hyperlinks are correct as at May 2016.

Purpose of the Bill
The purpose of the Financial System Legislation Amendment (Resilience and Collateral Protection) Bill 2016 (the Bill) is to amend the Payment Systems and Netting Act 1998 (the Act) to:

• ensure Australian entities can comply with new internationally agreed margin requirements for non-centrally cleared derivatives, which are expected to be phased in from 1 September 2016
• resolve inconsistencies in Australian law about the circumstances in which an Australian regulated entity may exercise its termination rights (that is, when it can close-out transactions related to a contract), and enforce security, in resolution proceedings and
• provide more certainty about the operation of key financial market infrastructure (that is, certain payment systems, settlement systems, exchanges and central counterparties) under the Act.

The Bill also makes a number of consequential amendments to certain other Acts related to Australian financial markets.

Structure of the Bill
This Bill has one Schedule, which is divided into three parts:

• Part 1:
  – expands the protections of Part 4 of the Act (which deals with close-out netting contracts) to protect the enforcement of security in the context of margin requirements for non-centrally cleared derivatives
- resolves inconsistencies between the Act and financial industry Acts\(^1\) about the circumstances in which an Australian regulated entity can close-out transactions and enforce security in resolution proceedings
- ensures a regulated entity subject to resolution proceedings can continue to transact in key financial systems in order to facilitate it continuing as a going concern and
- ensures that transactions made by an entity to meet an obligation, which are made through certain specified financial systems, are not void or voidable if the entity is in external administration.


- Part 3 contains application provisions, which set out how the amendments in Parts 1 and 2 will apply to before, on or after the time that the Bill commences.

**Background**

*Complying with new international margin requirements for non-centrally cleared over-the-counter derivatives*

This Bill seeks to ensure that Australian entities will be able to comply with new international margin requirements for non-centrally cleared over-the-counter (OTC) derivative transactions, which are due to come into force from September 2016. These new requirements have been developed as part of the international response to the global financial crisis (GFC).

The GFC prompted policymakers to pursue significant reforms to strengthen the international financial regulatory system. This has included measures to mitigate the systemic risk posed by derivatives. A derivative is a financial contract whose value is based on, or derived from, another financial instrument (such as a bond or share) or a market index (such as the Share Price Index).\(^2\) Derivatives help entities manage risk by providing them with a way of trading specific types of financial risks (such as interest rate risk, currency, equity and commodity price risk and credit risk) to other entities more willing or better suited to taking on or managing those risks. Examples of derivatives include futures, forwards, swaps and options.

Derivatives can be traded on recognised exchanges or OTC. In OTC markets buyers and sellers (that is, the counterparties) trade directly with each other. Some OTC derivative transactions are cleared by a central counterparty (CCP)\(^3\) while others are not centrally cleared. The Australian Prudential Regulation Authority (APRA) defines a non-centrally cleared derivative in the following terms:

A non-centrally cleared derivative is a bilateral derivative transaction that is not cleared by a central counterparty. This does not include any exchange traded derivatives, securities financing transactions, or derivatives that are cleared indirectly through a clearing member on behalf of a non-member client. Examples of non-centrally cleared derivative transactions may include interest rate swaps, foreign exchange forwards and swaps, commodity swaps, options or forward contracts.\(^4\)

The GFC exposed that OTC derivatives can be a vehicle for excessive and opaque risk-taking and a source of systemic risk. APRA has observed:

Counterparty exposures on bilaterally transacted derivatives contributed to the depth of the global financial crisis. Many of these exposures were uncollateralised or under collateralised, meaning insufficient collateral was available to offset losses caused by counterparty defaults and such losses were subsequently borne by the surviving counterparties. The build-up of uncollateralised exposures led to contagion and spillover effects on wider financial markets and the real economy.\(^5\)

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3. An example of a CCP is [ASX Clear (Futures) Pty Ltd](https://www.asx.com.au/).
When the Group of Twenty (G20) leaders met in Pittsburgh in 2009 they agreed to a series of reforms to reduce the systemic risk posed by OTC derivatives.\(^6\) Initially, this work programme had four key elements requiring:

- all standardised OTC derivatives to be traded on exchanges or electronic trading platforms, where appropriate
- all standardised OTC derivatives to be cleared through CCPs
- OTC derivatives contracts to be reported to trade repositories and
- non-centrally cleared derivatives contracts to be subject to higher capital requirements.\(^7\)

In 2011 the G20 added margin requirements on non-centrally cleared derivative transactions to the OTC derivatives market reform agenda.\(^8\) Requiring a margin on a derivative transaction essentially provides a safety cushion in the event one of the counterparties defaults. Counterparties have to provide collateral to meet the margin. If one of the counterparties defaults then the margin protects the surviving party by absorbing losses using the collateral provided by the defaulting party.\(^9\)

The Basel Committee on Banking Supervision (BCBS)\(^10\) and International Organisation of Securities Commissions (IOSCO)\(^11\) were tasked with developing the new internationally consistent margin requirements for non-centrally cleared OTC derivative transactions.\(^12\) An initial proposal was released for consultation in July 2012. In response to feedback from interested parties the BCBS and IOSCO released a further consultation document in February 2013. A large number of additional comments were received on the proposed requirements.\(^13\)

The BCBS-IOSCO finalised the new margin requirements in early 2015. Initially, the margin requirements were to have been implemented from December 2015. However, in recognition of the complexities involved it was agreed to phase-in their implementation from September 2016.

In relation to the BCBS-IOSCO margin requirements APRA notes:

> The BCBS-IOSCO framework requires the exchange of both variation margin and initial margin. Variation margin is collateral that is collected to reflect the current mark-to-market exposure resulting from changes in the market value of a non-centrally cleared derivative. Initial margin protects against the potential future exposure that may arise from future changes in the mark-to-market value of a non-centrally cleared derivative during the period of time that is assumed to be required to close-out and replace the position following a counterparty default.\(^14\)

More detailed information about the margin requirements, including the key principles underlying these requirements and the issues they seek to address, is provided in the BCBS-IOSCO publication *Margin requirements for non-centrally cleared derivatives*.\(^15\)

The Financial Stability Board (FSB)\(^16\) regularly reports on international progress in implementing the OTC derivatives market reforms, including margin requirements for non-centrally cleared derivatives. In its latest progress report the FSB reported:

\(^7\) Ibid.
\(^8\) G20, *Cannes summit – Final declaration*, G20 Summit, Cannes 3-4 November 2011, p. 5.
\(^9\) Basel Committee on Banking Supervision (BCBS) and Board of the International Organisation of Securities Commissions (IOSC), *Margin requirements for non-centrally cleared derivatives*, Bank for International Settlements (BIS) and IOSC, March 2015, p. 4.
\(^10\) The Basel Committee on Banking Supervision (BCBS) is a forum that provides an opportunity for international cooperation on banking supervision. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. More information is available on the Bank for International Settlements (BIS) website.
\(^11\) The International Organisation of Securities Commissions (IOSCO) is an international body that brings together the world’s securities regulators. It is recognised as the global standard setter for the securities sector. The IOSCO develops, implements and promotes adherence to internationally recognised standards for securities regulation. More information is available on the IOSCO website.
\(^12\) Cannes summit – Final declaration, op. cit., p. 5.
\(^14\) Margin requirements for non-centrally cleared derivatives, op. cit.
\(^15\) The Financial Stability Board (FSB) is an international body that monitors and makes recommendations about the global financial system. It seeks to promote international financial stability by coordinating national financial authorities and international standard-setting bodies as they develop regulatory, supervisory and other financial sector policies. More information is available on the FSB website.
The phase-in period for the BCBS–IOSCO standards for margin requirements for non-centrally cleared derivatives will begin in September 2016, and jurisdictions are generally at early stages of implementation of this reform area. Nonetheless, with the start date for these requirements already having been delayed once, it is important that all jurisdictions take the necessary regulatory steps to implement these requirements on schedule, taking into account the lead time necessary for market adoption.

As at end-September, all but one FSB member jurisdiction (Korea) reported that they had the necessary legislative frameworks or other authority in force, or published for consultation or proposed, to implement this commitment. Since end-June two jurisdictions (Canada and Singapore) have issued proposed standards for consultation. While no jurisdiction has yet adopted final requirements, Canada, Russia and the US expect to adopt some final requirements by end-2015. The majority of, though not all, FSB member jurisdictions expect to have their framework for margin requirements in force by end-2016.17

Why adopt internationally consistent margin requirements for non-centrally cleared derivatives?

Adopting internationally consistent margin requirements for non-centrally cleared OTC derivative transactions is seen as having two main benefits: reducing systemic risk and promoting the central clearing of these types of derivative transactions.

In relation to the potential to reduce systemic risk the BCBS and IOSCO argue:

Only standardised derivatives are suitable for central clearing. A substantial fraction of derivatives are not standardised and cannot be centrally cleared. These non-centrally cleared derivatives, totalling hundreds of trillions of dollars [US dollars] in notional amounts, pose the same type of systemic contagion and spillover risks that materialised in the recent financial crisis. Margin requirements for non-centrally cleared derivatives would be expected to reduce contagion and spillover effects by ensuring that collateral is available to offset losses caused by the default of a derivatives counterparty. Margin requirements can also have broader macroprudential benefits, by reducing the financial system’s vulnerability to potentially destabilising procyclicality and limiting the build-up of uncollateralised exposures within the financial system.18

Further, the BCBS and IOSCO argue setting internationally consistent margin requirements for non-centrally cleared derivative transactions will promote central clearing:

In many jurisdictions, central clearing will be mandatory for most standardised derivatives. But clearing imposes costs, in part because CCPs require margin to be posted. Margin requirements on non-centrally cleared derivatives, by reflecting the generally higher risk associated with these derivatives, will promote central clearing, making the G20’s original 2009 reform programme more effective. This could, in turn, contribute to the reduction of systemic risk.19

These benefits are put at risk if individual countries do not introduce rules consistent with the new international margin requirements. In this regard there are two key concerns: the potential for financial institutions to shop around for the most favourable regulatory environment (that is regulatory arbitrage) which would undermine the effectiveness of the reforms; and the resulting creation of an uneven playing field with financial institutions in jurisdictions with low margin requirements gaining a competitive advantage.20

Why are the measures in this Bill necessary?

APRA has the authority to develop and implement margin requirements for non-centrally cleared OTC derivative transactions and this process is well underway.21 The problem is that under the existing law, Australian entities

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18. Margin requirements for non-centrally cleared derivatives, op. cit., p. 3.
19. Ibid.
20. Ibid., pp. 3-4.
21. On 25 February 2016 the Australian Prudential Regulation Authority (APRA) released for consultation a draft Prudential Standard CPS 226 Margining and risk mitigation for non-centrally cleared derivatives and an accompanying Discussion Paper: Margining and risk mitigation for non-centrally cleared derivatives. These documents set out how APRA proposes to implement the BCBS-IOSCO margin requirements in the Australian context; and the timeframe for the introduction of these changes. APRA expects that only a small number of entities will exceed the proposed minimum qualifying levels and therefore be subject to the new margin requirements.
may not be able to exchange and enforce margin (that is collateral) in a way consistent with the BCBS-IOSCO margin requirements.

The current practice of posting and receiving collateral for non-centrally cleared OTC derivative transactions is on an absolute (that is title transfer) basis. The BCBS-IOSCO preferred approach is for this to happen in a bankruptcy-remote manner by way of security. The Council of Financial Regulators (CFR) has highlighted a number of legal impediments under existing Australian law that affect the creation and enforcement of a collecting party’s rights in respect of collateral provided by way of security.

Under the BCBS-IOSCO framework, covered entities are required to hold initial margin in a manner that ensures that it is immediately available to the collecting party in the event of the counterparty’s default, but at the same time ensures that the posting party is protected in the event that the collecting party enters bankruptcy. There are two main methods of exchanging collateral: title transfer and security interest. Title transfer does not meet the bankruptcy-remote requirement as the collateral becomes the property of the collecting party. While exchanging collateral by way of security interest should ensure that the posting party is protected in the event that the collecting party enters bankruptcy (in that the collateral should not form part of the collecting party’s estate on its insolvency), currently under certain circumstances the collateral posted by way of security interest may not be immediately available to the collecting party in the event that the posting party defaults. This is because the granting of security interests generally involves a number of additional enforceability, validity and perfection requirements, which means that a collecting party may be restricted from enforcing its security interest if the posting party is subject to certain insolvency proceedings.

Furthermore, under certain circumstances, the existence of priority regimes under the current legislative framework in Australia, which apply in respect of the assets of certain types of entities, may result in other parties’ claims to the posting party’s assets (including the collateral provided by way of security interest) having priority over the claim of the collecting party.

This Bill addresses the current legal impediments to exchanging and enforcing collateral by way of security. In this way it facilitates Australian entities complying with the BCBS-IOSCO margin requirements. This is comprehensively discussed in the Explanatory Memorandum (see pp. 42-73).

Australia potentially faces serious economic consequences if it does not have a facilitative regulatory regime in place by the time the BCBS-IOSCO margin requirements come into effect. This reflects that the capacity of Australian entities to trade internationally with major counterparties would be progressively eroded, limiting their ability to hedge their risks offshore and access liquidity. The Explanatory Memorandum notes:

Even a short delay in creating a facilitative regulatory regime is likely to involve significant cost to the Australian finance sector. To give a sense of the scale of OTC derivative trade: The notional amount of outstanding OTC derivative contracts is ~US$553 trillion globally. The Australian Financial Markets Association (AFMA) recently estimated that there is an annual turnover of AUD$80 trillion in notional OTC derivatives in Australian financial markets.

Providing certainty for the application of stays on exercising termination rights and enforcing security

The Bill seeks to resolve inconsistencies between the Act and financial industry Acts about the circumstances in which an Australian regulated entity can exercise its termination rights (i.e. when it can close-out transactions related to a contract), and enforce security, in resolution proceedings. In so doing, the Bill aims to bring

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22. APRA, Australian Securities and Investments Commission (ASIC) and RBA, Report on the Australian OTC derivatives market, November 2015, p. 58.
23. The Council of Financial Regulators (CFR) is the coordinating body for Australia’s main financial regulatory agencies. Its membership comprises the Reserve Bank of Australia (RBA), which chairs the Council; the Australian Prudential Regulation Authority (APRA); the Australian Securities and Investments Commission (ASIC); and the Treasury. It advises the government on the adequacy of Australia’s financial system regulatory arrangements. More information is available on the CFR website.
25. Ibid., p. 61.
27. Ibid., p. 115.
Australian law into line with international best practice. The measures support the objective of Australian regulators being able to efficiently resolve (that is take action to stabilise or liquidate) financial institutions which are in distress.

One of the challenges policymakers have been grappling with since the GFC is how to resolve financial institutions in an orderly way without exposing taxpayers to the risk of having to bail them out, while at the same time trying to maintain the continuity of the vital economic functions these institutions perform.  

Sitting beneath this broad objective is a range of complex issues. One issue is the possibility that a counterparty to the financial institution in resolution may seek to exercise its termination rights and enforce security, but in so doing put at risk the ability of regulators to resolve the financial institution in an orderly way. To address this problem it is considered appropriate that regulators are able to stay such rights in certain circumstances and subject to appropriate safeguards to protect the integrity of financial contracts.

**What constitutes international best practice?**

In response to the GFC the FSB set out the core elements it considers necessary for an effective regime to resolve financial institutions in distress.  

The FSB specifies twelve essential features which it considers should be part of the resolution schemes of all jurisdictions. Relevant to the consideration of this Bill is ‘key attribute’ number four—‘set-off, netting, collateralisation, segregation of client assets’.

In relation to this key attribute the FSB recommended:

The legal framework governing set-off rights, contractual netting and collateralisation agreements and the segregation of client assets should be clear, transparent and enforceable during a crisis or resolution of firms, and should not hamper the effective implementation of resolution measures.

Subject to adequate safeguards, entry into resolution and the exercise of any resolution powers should not trigger statutory or contractual set-off rights, or constitute an event that entitles any counterparty of the firm in resolution to exercise contractual acceleration or early termination rights provided the substantive obligations under the contract continue to be performed.

Should contractual acceleration or early termination rights nevertheless be exercisable, the resolution authority should have the power to stay temporarily such rights where they arise by reason only of entry into resolution or in connection with the exercise of any resolution powers.

The other key piece of international guidance on what constitutes best practice in this area is the International Swaps and Derivatives Association’s (ISDA’s) 2015 Universal Resolution Stay Protocol (the Stay Protocol). The current Stay Protocol replaces an earlier version which was launched in 2014. By way of background ISDA notes:

The ISDA 2015 Universal Protocol was developed by a working group of ISDA member institutions (including representatives from buy-side and sell-side institutions), in coordination with the Financial Stability Board (FSB). It is a major component of a regulatory and industry initiative to address the ‘too big to fail’ issue.

A key challenge in developing effective resolution strategies for some SIFIs [Systemically Important Financial Institutions] has been the effect of parties to OTC swaps and other financial contracts exercising close-out rights and cross-default rights triggered by a SIFI’s financial distress or entry into resolution proceedings. New statutory regimes developed in response to the financial crisis of 2008, called ‘special resolution regimes’ (SRRs), generally temporarily stay or permanently override the exercise of certain direct defaults and cross defaults that arise in the context of resolution, provided that certain creditor protections are satisfied. However, the enforceability of such

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29. Ibid.

30. Ibid.

31. Ibid., p. 10.

32. The International Swaps and Derivatives Association (ISDA) is an international organisation which works to make global derivatives markets safer and more efficient. It has over 850 member institutions from 67 countries. More information is available on the ISDA [website](https://www.isda.org).

stays in foreign jurisdictions is not certain, and statutory recognition of foreign resolution actions is permissive, not mandatory. 34

The Stay Protocol is designed to contractually recognise the cross-border application of special resolution regimes (SRR) applicable to certain financial institutions and provide clarity over the circumstances in which a counterparty’s right to close-out and terminate OTC derivatives and securities financing transactions (SFT) can be overridden by regulators in the event a financial institution enters resolution. ISDA observes:

The Protocol opts adhering parties into certain existing and forthcoming special resolution regimes, with the aim of ensuring cross-border derivatives and SFT [Securities Financing Transactions] transactions are captured by statutory stays on cross-default and early termination rights in the event a bank counterparty enters into resolution. These stays are intended to give regulators time to facilitate an orderly resolution of a troubled bank. …

Statutory resolution regimes have been rolled out in several jurisdictions, including the US and European Union. These regimes provide resolution authorities with broad tools and powers to effect a resolution, including the imposition of a temporary stay on counterparties’ early termination rights in the event a bank enters into resolution. However, it is uncertain whether these stays would extend to contracts governed by foreign law. By adhering to the Protocol, firms are opting to abide by certain overseas national resolution regimes, ensuring cross-border trades with other adhering counterparties in those jurisdictions are subject to the stays. 35

Why are the measures in this Bill necessary?

There are currently inconsistencies between the Act and financial industry Acts around the application of stays on exercising termination rights and enforcing security. These inconsistencies create uncertainty where the law governs both the resolution regime applying to financial institutions in distress and contracts those institutions are party to. In particular, clarity is needed about the circumstances in which a party’s right to close-out transactions and enforce security are stayed in the event a statutory manager or judicial manager has been appointed to a financial institution. 36 This issue is summarised on pages 15-18 of the Explanatory Memorandum. As the Explanatory Memorandum outlines, such uncertainty is undesirable.

This uncertainty has the potential to impede the efficiency of financial markets in Australia by making it more difficult for Australian entities to enter into financial market transactions (including hedging arrangements) as well as impeding the ability of the Commonwealth to effectively manage distress in regulated financial institutions. 37

The Bill seeks to address these legal inconsistencies. The Explanatory Memorandum states:

The reforms in this Bill will clarify the ability of market participants to exercise certain termination rights (also known as close-out rights), and enforce security, in resolution proceedings and are intended to ensure that the Australian resolution stay regime applies in accordance with international best practice for resolution regimes. These reforms will ensure that an appropriate balance is struck between ensuring that counterparties can effectively manage their risks whilst also giving APRA the best chance to resolve an important financial institution, such as an Australian bank, which is in distress. 38

Given that large financial institutions operate across national borders it is desirable that Australia’s law in this area is consistent with international best practice. The Explanatory Memorandum observes:

Due to the increasing importance of cross-border resolution proceedings for large international financial institutions, it will be important that the stays imposed under Australian statutes, including the stay imposed under the [Financial Sector (Business Transfer and Group Restructure) Act 1999], operate in accordance with international best practice, as described in the FSB Key Attributes of Effective Resolution Regimes and the Stay Protocol. 39

37. Ibid., p. 118.
38. Ibid., p. 15.
39. Ibid., p. 19.
Providing more certainty about the operation of key financial market infrastructure

The Bill seeks to provide legal certainty about the operation of key financial market infrastructure (that is, certain payment systems, settlement systems, exchanges and CCPS) under the Act.

It is desirable for financial stability and the interests of depositors and policyholders if a distressed financial institution subject to resolution can continue to transact using key financial market infrastructure. However, given the risks involved it is important to ensure there are appropriate protections in place to protect the financial market infrastructure. The Bill seeks to ensure:

- a regulated entity subject to non-terminal administration proceedings can continue to transact in approved Real Time Gross Settlement (RTGS) systems and netting arrangements in order to facilitate it continuing as a going concern
- transactions made by an entity to meet an obligation, which are made through Australia’s cash equity settlement system, are not void or voidable if the entity is in external administration and
- payments or transfers of property by an entity to meet an obligation under a market netting contract (such as to a CCP) are not void under Australian insolvency law.

A comprehensive discussion of these issues is provided in the Explanatory Memorandum (see pages 100-106).

Committee consideration

Senate Selection of Bills Committee

On 16 March 2016, the Senate Selection of Bills Committee recommended that the Bill not be referred to a committee for inquiry.  

Senate Standing Committee for the Scrutiny of Bills

At the time of writing the Senate Standing Committee for the Scrutiny of Bills had not yet considered the Bill.

Policy position of non-government parties/independents

At the time of writing the policy position of the non-government parties and independents was unknown.

Position of major interest groups

In her second reading speech the Assistant Treasurer said:

The government has consulted the public on various forms of the measures in this Bill, and made a call for submissions on the entire reform package following the release of the draft Bill. Submissions primarily came from the financial services sector, including from Australian and international industry bodies and other market participants. As a whole, they were highly supportive of the reforms.

At the time of writing, Treasury had not published these submissions on its website.

However two of these submissions were available on the submitting organisation’s website.

The Australian Institute of Superannuation Trustees (AIST) welcomes measures aimed at improving the resilience and stability of Australia’s financial system as well as facilitating participation in international derivatives markets. AIST noted:

We support measures aimed at protecting retail clients, and we support efficiencies in wholesale derivatives markets, particularly where participants are Australia’s superannuation funds.

40. Readers are referred to the Explanatory Memorandum for a comprehensive discussion of the Bill’s provisions.
The Australian Financial Markets Association (AFMA) is generally supportive of the legislation and although its submission included a number of technical drafting suggestions this did not detract from the organisation’s overall support for the legislation. AFMA observed:

> AFMA generally supports the legislation and acknowledges the policy support it demonstrates for improving legal certainty and the effectiveness of contractual relationships between market participants. The following comments go to technical drafting matters aimed at fully achieving the objectives of the Bill and Regulation and do not detract from our overall support for these pieces of legislation.  

**Financial implications**

The Explanatory Memorandum states the Bill has no financial impact.

**Statement of Compatibility with Human Rights**

As required under Part 3 of the Human Rights (Parliamentary Scrutiny) Act 2011 (Cth), the Government has assessed the Bill’s compatibility with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of that Act. The Government considers that the Bill is compatible.

**Parliamentary Joint Committee on Human Rights**

The Parliamentary Joint Committee on Human Rights considers that the Bill does not raise human rights concerns.

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45. Explanatory Memorandum, op. cit., p. 3.

46. The Statement of Compatibility with Human Rights can be found at page 133 of the Explanatory Memorandum to the Bill.