AFMA

13 May 2016

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Dear Mr Brennan

Margin Requirements for Non-Centrally Cleared Derivatives CPS 226 Discussion Paper

The Australian Financial Markets Association (AFMA) welcomes the opportunity to comment on the Margin Requirements for Non-Centrally Cleared Derivatives CPS 226 Discussion Paper (CPS226 DP). AFMA's comments and questions are set out in the accompanying attachment.

There is general industry acceptance of the proposed reforms in the context of the global framework put in place by BCBS-IOSCO. The continuing imponderable for prudentially regulated entities is the broader liquidity impact of these margin requirements when lined up with the other regulatory changes with significant liquidity impacts, which include the BCBS's Liquidity Coverage Ratio (LCR), Net Stable Funding Ratio (NSFR) and global mandates for central clearing of standardised derivatives.

Our discussions to date on this matter with the team at APRA have focused on seeking clarifications to understand more fully APRA's objectives and approach to implementation. Out of this process we agreed with the team that we should articulate questions, identify matters with greater clarity and suggest technical improvements in writing and then have follow up discussions about practical implementation and transition to the new regime. So this submission is intended to be a part of our ongoing dialogue with APRA on the margining requirements.

There are two points to highlight. First, the application of the regime at the Level 2 group level brings in subsidiaries operating under different rules in other jurisdictions and non-financial entities not caught by the BCBS-IOSCO framework, as well as inappropriately extending the Risk Mitigation Standards to non-prudentially regulated entities in the group. This is discussed in section 1.1. Secondly, implementation of the Risk Mitigation Standards should be dealt with separately from margining implementation. This matter is addressed in section 15 of the attached submission.

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AFMA and International Swaps and Derivatives Association (ISDA) have a large degree of common membership and have contributed to the preparation of both submissions. AFMA generally supports ISDA's comments and in relation to some specific technical discussions we have taken the course of supporting their detailed analysis and points by reference rather than reiterating the same text.

AFMA looks forward to continuing our beneficial dialogue with you. I can be contacted on

Yours sincerely

David Love

David Love
General Counsel & International Adviser

CONSULTATION COMMENTS ON CPS 226 – MAY 2016

Contents

1. Application at Level 2 group level

1.1. Entity-level scope of the proposed margin requirements

Member feedback indicates a distinction in views on the Level 2 entity-level scope proposal, which differs on the basis of the impact it has on extra-territorial operations of subsidiaries which would be brought into scope at the Level 2 group. The proposed APRA approach was surprising to members as it is not globally consistent with the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) March 2015 framework for margin requirements for non-centrally cleared derivatives (BCBS-IOSCO framework) which does not apply on the same basis as capital rules.

Most, but not all, members opposed the extension of the proposals to Level 2 group entities. The reasons why members are opposed are set out in the following points.

1) ***No other regime is adopting a similar approach.*** The US rules, for example, are imposed on swap dealers and major swap participants. This is a status that these entities have because of, essentially, their level of derivatives trading with US connected persons and not because of US prudential regulation. While some of these entities happen to be prudentially regulated, not all are. Similarly, subsidiaries of those swap dealers who are US-prudentially-regulated are subject to the US BCBS-IOSCO framework regime. So for example, a Japanese subsidiary of a US swap dealer will be subject to BCBS-IOSCO framework regime of its parent's regulator. A Japanese subsidiary of an Australian bank, by contrast, would not be.

2) ***Margin and capital have different objectives***. The BCBS-IOSCO framework helpfully contains some consideration of these differing policy objectives[1]. While capital is focused on the financial soundness of entities, margin is focused on systemic risk created by portfolios of derivative transactions.

3) ***A capital-style approach is extra-territorial***. As noted above, APRA's approach captures subsidiaries of Australian banks who are incorporated and participate in foreign markets. The appropriate regulator for BCBS-IOSCO framework purposes of such entities is the regulator in that jurisdiction, which is consistent with approaches taken offshore. Duplicative obligations is something that the BCBS-IOSCO framework raises as an issue in element 7 (*Interaction of national regimes in cross-border transactions*). In this section of the framework (see 7.1) it clearly contemplates that locally established subsidiaries of foreign entities may be regulated in that local jurisdiction.

4) ***A capital-style approach risks unintended entities***. A Level 2 group could possibly include entities which are neither financial nor systemically-important non-financial entities.

5) ***Market development considerations***. Level 2 entities engaged in markets or jurisdictions in developing economy markets where the BCBS-IOSCO framework does not apply will be inhibited from full participation by these additional capital constraints which are inappropriate to nascent market conditions. Over-engineered rules around policies on portfolio compression and reconciliation / valuation / dispute resolution are deliberately not imposed where transaction volumes and operational sophistication are still limited. This is the

[1] BCBS-IOSCO, Margin requirements for non-centrally cleared derivatives March 2015, page 4

case in several South-East Asian jurisdictions where subsidiaries are operating and need to adapt to local market conditions.

6) ***No threshold before application.*** Because of the way BCBS-IOSCO framework notional thresholds are calculated on a group basis, combined with APRA's broad approach, a Level 2 entity that engages in just a single derivative with an in-scope counterparty will be subject to Initial Margin (IM) obligations. This subjects such Level 2 entity to the burden of compliance with the whole BCBS-IOSCO framework regime, for a single swap. While it is the case that the BCBS-IOSCO framework when applied in jurisdictions like the United States means that the notional calculation does bring in derivatives transaction of affiliates of the biggest derivative dealers, it can be observed that the effect is very small. This is because such affiliates have to themselves have the relevant regulatory status (e.g. swap dealer etc) to be in scope. In Australia, the Level 2 approach means that such materiality filtering will not occur.

7) ***It is unnecessary to take a capital-style approach.*** All dealing in derivatives in Australia involves an ADI and coverage at the level make for an effective regime.

2. Definitions

2.1. Covered counterparty

Definition of "sovereign" (in definition of "covered counterparty", paragraph 10(f).

It is unclear whether this includes sovereign wealth funds. Sovereign wealth funds should be included.

2.2. Derivative

Definition of "derivative" (paragraph 10(g).

The definition of "derivative" relies on the definition in the *Payment Systems and Netting Act* (PSN Act) brought about by the *Financial System Legislation Amendment (Resilience and Collateral Protection Act 2016* through amendment to the PSN Act which simply says it has the same meaning as in Chapter 7 of the Corporations Act. It would be more direct to refer to the Corporations Act definition.

From a conceptual point of view reliance on the bare "derivative" definition is problematic because of its breadth. The Corporations Act definition of derivative is a principles based one that was designed to be broad. The 2011 report of the Corporations and Markets Advisory Committee on Derivatives[2] which looked at the definition gives detailed analysis of the law in this area.

The definition used for a prudential standard such as this needs to correspond unambiguously to what is universally considered a derivative, and exclude anything that is not. Doing this with a legal definition alone is a difficult task, and all regimes have struggled with this. Our view is that there is an opportunity for APRA to take an approach similar to the one ASIC took, which used 761D as a base, but provide guidance which permits participants to use an industry taxonomy as a filter.

[2] Weblink to Report - http://www.camac.gov.au/camac/camac.nsf/byheadline/pdffinal+reports+2011/$file/derivatives_report_dec2011.pdf

A derivative product classification system that is aligned with international financial standards is desirable. The International Securities and Derivatives Association (ISDA) OTC Derivatives Taxonomies for Credit, Interest Rate, Commodity, Foreign Exchange and Equity are the basis for a globally consistent taxonomy for derivatives. ISDA has a governance model in place to oversee the development of the taxonomies and ensure proper support going forward.

"Derivative definition" fitting with foreign analogue definitions

AFMA supports the ISDA request that, when an APRA covered entity transacts with a covered counterparty in circumstances where either or both parties are subject to foreign margin rules (in addition to the APRA rules), the parties are permitted to use the equivalent of the definition of "non-centrally cleared derivative" under any of the regimes to which they are subject for the purposes their margining calculations. This would eliminate the need for counterparties to make multiple different calculations to take into account different definitions or different product scopes in each different jurisdiction, and would therefore also likely reduce the risk of errors and disputes. Furthermore, allowing the use of a broader set of products in cross-border netting sets would facilitate the process of margin collection and reduce systemic risk. This approach would align with the final draft Regulatory Technical Standards (RTS) on margin requirements for non-centrally cleared derivatives in the EU (the "final draft EU RTS").[3]

Such a technique reflects a principles-based approach which (like the taxonomy filter referred to above) avoids over-reliance on pernickety definitions, distinctions and legalism, and achieves a degree of deference to foreign regimes, as well as excellent cross-border harmonisation.

2.3. *Financial institution*

Definition of "financial institution" (paragraph 10(i)). APRA proposes an APRA covered entity will be required to adhere to the margin requirements in the CPS226 DP proposal in its transactions with covered counterparties. A "covered counterparty" is either a financial institution or a systemically important non-financial institution. "Financial institution" is defined broadly and covers a wide range of institutions "engaged substantively" in financial activities domestically or overseas.

Participants are faced with the task of placing counterparties into appropriate categories. Standardisation of terminology would be of practical assistance in this area. The experience of our members operating in the Asian region indicates the practical difficulty in obtaining representations from their counterparties as to their status whether by adhering to protocols or by returning representation letters. Very often, counterparties are slow to confirm their status or fail to respond, and for reforms where trading cannot proceed without the relevant representations being made, Australian participants can be faced with prospect of trading not being possible. This can present more harm to Australian banks than foreign counterparties, and could cause threats to risk management.

One approach that facilitates harmonisation and deference to other regimes that applies a principles-based approach to regulation, and would remove the problems outlined above, would be to permit participants to rely on representations made by counterparties as to their status under corresponding terms under equivalent foreign regimes (e.g. financial end-user under US

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3 See recital 11 and article 5(1) of the final draft EU RTS, available at https://www.esma.europa.eu/press-news/esma-news/esas-publish-final-draft-technical-standards-margin-requirements-non-centrally

regimes). We consider this approach to be of high importance and AFMA looks to more specific discussion with APRA on this matter.

2.4. Margining group

Definition of "margining group" (paragraph 10(m)). The US allows relevant entities to use foreign equivalent accounting standards. It is desirable that this be allowed in a similar way under the CPS226 DP proposal.

2.5. Netting agreement

Definition of "netting agreement" (paragraph 10(p).

The usage of "netting agreement" in the CPS226 DP proposal (see paragraphs 17 and 37) appears to imply that transactions subject to the same netting agreement must be included in Initial Margin (IM) and Variation Margin (VM) calculations. Transactions that pre-date the coming into effect of the CPS226 DP proposal that have a separate Credit Support Annex (CSA) are not subject to the margining requirements. It needs to be made clear as part of the transitional arrangements that portfolios can be split in different sub-portfolios using separate credit support documentation under a single ISDA. US rules allow netting sets under separate credit support documents.

In footnote 18 to Attachment B the reference to "qualifying master agreement" should conform with "legally enforceable netting agreement".

It is also queried what value the words "legally enforceable" add to the definition. It is unclear whether this implies the requirement for a legal opinion.

2.6. Non-centrally-cleared derivative

Definition of "non-centrally-cleared derivative" (paragraph 10(q).

The reference to intermediated through a clearing member implies only a single broker. Futures clearing often involves chains of brokers between the client and the clearing member. We suggest inserting after "clearing member": "(including via additional intermediary brokers)".

2.7. Securities financing transactions

Definition of "securities financing transactions" (paragraph 10(v).

The end of the definition references transactions typically subject to margin agreements. It is noted that not all margining is done by way of separate agreements as under the ISDA model. The GMRA does not have a separate agreement. According, a more generic word like "arrangement" would be more appropriate.

2.8. Investment funds

Investment funds (paragraph 24)

Investment funds are not always distinct legal entities. The most common legal form of a fund in Australia utilises a trust, and the legal entity here is the trustee. Separate trusts represent separate legal arrangements, but the trustees are not separate legal entities in relation to each trust. This problem could be solved by replacing: "is a distinct legal entity" with - "represents a distinct legal arrangement".

2.9. Variation margin

Definition of "variation margin" (paragraph 10(bb))

We suggest amending the definition of variation margin by adding the words "or paid" after "collateral that is collected" in the first line of the definition. This is to make it clear that VM is not subject to the same requirement for segregation as IM (and may be posted on an absolute transfer basis).

3. Variation margin

3.1. Qualifying level

AUD 3 billion minimum qualifying level (paragraph 12)

The proposal to have a minimum qualifying level as a threshold introduces an arbitrary distinction between covered entities with unfair competition issues arising both at a local Australian level and with regard to entities operating under the regimes of other jurisdictions. There is concern that it will also be queried in a substituted compliance assessment and would impact substituted compliance assessments, which is an issue that APRA will have to address with other regulators if it remains unchanged.

Because the BCBS-IOSCO framework does not contemplate a minimum qualifying level for the phase-in of VM, and nor is such a qualifying level provided for in the rules of other jurisdictions further consideration on using a threshold needs to occur. Addressing this matter should include revisiting the broad brush definition of "covered entities" and thinking about whether some of the categories of APRA prudentially entities that are within scope as "covered entities" really should be brought into the regime at this point.

3.2. Phase-in

Three-stage phase in (paragraph 13)

Under the BCBS-IOSCO framework and implementation timetable of other jurisdictions VM is to be phased-in over 2 stages (i.e. from 1 September 2016 and from 1 March 2017). The introduction of a third phase for VM implementation (from 1 September 2017) may present a complication for a European equivalence assessment. It also requires determining the aggregate month end notional amount (AANA) of counterparties in relation to an assessment period (September, October and November of 2016) which no other regime is using. As an "Australia-specific" requirement, this may present problems for Australian participants in attempting to oblige their counterparties to make AANA determinations for this period.

4. Initial Margin

4.1. Avoidance of pro-cyclical events

Avoidance of pro-cyclical events (paragraph 25)

The CPS226 DP proposal requires that triggers that may lead to a large discrete call for additional initial margin and would have a pro-cyclical effect, should be avoided wherever practicable. Working group members have noted that it is difficult to see what specifically is required of them to discharge this responsibility. A few things could result in increases in margin:

- Changes to trades in the portfolio;
- Recalibration of the industry model. This will occur annually, and more frequently as market conditions warrant, to comply with foreign regimes.
- "Cliff-edge" triggers, which the BCBS/IOSCO Paper (para 3.10) says ought to be discouraged. These might include such things as ratings downgrade triggers.

It would be good to understand what specifically APRA would like under this provision. It would be good to clarify that the first and second events referred to above would not offend the section. If there is anything beyond events such as ratings downgrade triggers contemplated, it would be useful if this could be stated.

4.2. *Availability*

Initial Margin immediately available (paragraph 27(a)).

The formulation of "immediately available" which is understood in general terms when used in the principles based language of the BCBS-IOSCO is problematic when used in the legalistic language of a rule in the CPS226 DP proposal. In strict terms "immediately" cannot be practically complied with. For this reason the formulation "in a timely manner" is a more sensible formulation.

Stays or other restrictions on the availability of IM upon bankruptcy of the posting party may have an impact on when IM will be available. Where IM is held with an independent third party custodian, IM will only be available to the collecting party after the custodian goes through its required procedures. These procedures include the necessary operational steps for transferring the IM and may include verification of the legitimacy of the collecting party's claim for IM. Custodians may also insist on payment of their fees before releasing collateral from custodial liens.

In addition, the parties may also agree that the posting party has a right to object to release of the collateral by the custodian if the posting party can claim that the demand is not appropriate. Such stays, restrictions or delays should not have an impact on the ability of APRA covered entities to enter into derivatives transactions with counterparties in jurisdictions that prevent immediate access to collateral upon a bankruptcy or to enter into arrangements with independent third party custodians.

Further, the bulk of collateral collected as initial margin is likely to be intermediated securities held in a clearing system, which will require the collateral provider (or the custodian on its behalf) to deliver appropriate instructions and wait for delivery of the relevant securities in accordance with standard settlement cycles.

It is noted that the EU rules on margining settled on the formulation of posting IM in a timely manner in the event of a collecting party default, because of factors such as those identified above. The revised (final) margin rules in the EU have replaced the "immediately available" standard with "available in a timely manner". This is a formulation that AFMA commends to APRA.

5. Due diligence

Due diligence in respect of covered counterparties (paragraph 30).

The CPS226 DP proposal indicates that *"an APRA covered entity must apply a reasonable level of due diligence to determine whether its counterparty is a covered counterparty whose non-centrally cleared derivatives activity exceeds the applicable qualifying level"* and that, in practice, *"this process ... will likely rely on a combination of self-identification by a counterparty and reasonable due diligence undertaken by an APRA covered entity"*. It is the case that an APRA covered entity will not have any relevant knowledge relating to the derivatives business of its counterparty and, in particular, it will not be possible to obtain reliable information about the gross notional amount of a counterparty's derivatives positions at any time (other than by way of representations provided by that party).

It would be desirable to align with the requirement in the US, by clarifying that APRA covered entities are entitled to rely in good faith on representations given to them by their counterparties, including in industry standard disclosure documents.

6. Independent review

Independent review (paragraph 41)

Firms wish to clarify APRA's expectation around this function.

As APRA is aware, many or all Australian APRA-regulated entities operate a "three lines of defence" risk management model[4]. It would be helpful to clarify that the initial independent review contemplates (or permits) this being performed by the risk management / compliance function (i.e. second line). The section contemplates the internal audit review (which is third line) conducting the same review on a regular basis. Does this mean APRA is not requiring a second-line review on an on-going basis?

In addition, the paragraph contains requirements that the personnel conducting the review must meet. Is this a requirement for internal auditors conducting ongoing reviews, the people conducting the initial review, or both?

More generally, members want to engage further with APRA on the adoption of the industry SIMM model. We understand from our meetings with APRA that its use will agreed at an industry level and that covered entities will not be additionally required to commission an independent review and apply for separate approval of its use. These are matters on which members are seeking clear messaging from APRA.

7. Eligible collateral

7.1. Local and regional governments (paragraph 46)

Sub-paragraph (b) refers to "central, state and regional governments", while sub-paragraph (c) refers to "local governments". We would like to understand the distinction between "local" and "regional" governments.

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[4] As background, see row 2, Table 1 on page 5 of the ASIC report 298: [Adequacy of risk management systems of responsible entities](#).

7.2. Eligible collateral and haircuts

FX Haircut in respect of VM not exchanged in termination currency (paragraph 3 of Attachment B)

An additional FX haircut of eight per cent to apply in respect of non-cash collateral posted as VM where the currency of the collateral asset differs from the termination currency (paragraph 3 of Attachment B, with the meaning of termination currency being set out in footnote 18). The concept of termination currency is more relevant to the FX haircut applicable to IM and the standard form of credit support annex in respect of VM does not include a concept of termination currency.

The final draft EU RTS have clarified that an additional haircut in respect of non-cash VM should apply where the currency of the collateral asset differs from that "agreed in an individual derivative contract, the relevant governing master netting agreement or the relevant credit support annex", rather than the "termination currency" (which is used in the context of the FX haircut for IM only). AFMA recommends that APRA follow the EU approach so that the haircut applying to non-cash VM does not have a broader scope of application.

7.3. Multiple termination currencies

Multiple termination currencies allowed - (Table 4 haircut of 8% on IM –Attachment B)

The CPS226 DP proposal indicates that the 8% FX-haircut will apply where collateral is denominated in a different currency from the "termination currency" agreed by the parties in the relevant contract. AFMA, ISDA and members have discussed parties be permitted to agree on two termination currencies (i.e. each party may choose one currency) for the purpose of exchanging VM and IM (both cash and non-cash collateral). AFMA supports ISDA's detailed comments on this topic.

Additionally, to minimise market harm, the new standard should follow the more concessionary US approach. The US rules require a haircut on an IM payment only where its currency matches none of the termination currency or the currency of settlement of the swap. We note that "the currency of settlement of the swap" is being interpreted, based on guidance provided by the regulators in the rule publication, to include any currency in which settlement may be made under the relevant netting agreement, CSA or individual contract. To limit the un-haircut currency to just the termination currency (generally USD) could result in an increase in funding costs for participants to raise that currency to post. Posting an alternative available currency (say AUD) would result in a haircut which would also increase funding costs. This harm can be avoided by adopting the US approach.

8. Intragroup transactions

8.1. VM clarification

Intragroup transactions (paragraphs 58 to 62)

The CPS226 DP says that intra-group transactions are intended to be exempt from the VM requirements. While paragraph 59 is clear as regards exemption from the IM requirements, the wording of paragraph 58 is not so clear. It could be clarified by saying "An APRA covered entity is *only* subject..."

8.2. APRA discretion

APRA discretion (paragraph 62)

The discretionary power of APRA to bring intragroup trades into scope of the new standard creates uncertainty. The policy justification for this is not clear.

It is generally recognised that inter-affiliate swaps provide an important risk management role within corporate groups and that, rather than increasing risk, inter-affiliate swaps allow entities within a corporate group to transfer risk to the group entity best placed to handle it. If it were to be used at times when the relevant group is in financial distress such action would be inherently pro-cyclical and would require the group to fund liquidity at a time of market stress.

9. Substituted compliance

Outcome-based approach to comparability assessments (paragraph 63).

AFMA, ISDA and members have discussed substituted compliance. AFMA supports ISDA's detailed comments on this topic.

9.1. Jurisdiction level comparability assessments

The overall approach of an outcome-based approach to comparability is supported. There is, however, a concern related to the availability of substituted compliance. Substituted compliance will only be available where the relevant foreign regime is comparable in its outcomes to both the BCBS-IOSCO framework and the requirements in the CPS226 DP proposal.

While margin standards of the jurisdictions may be compliant with the BCBS-IOSCO principles they may differ in form. For example, product and entity coverage may not be directly comparable to the CPS226 DP proposal. Given the different approaches of national regulators in implementing their margin frameworks, it is submitted that the comparability assessment should be based on comparability with the BCBS-IOSCO principles alone, and not with the CPS226 DP proposal as well. This approach would align the substituted compliance function with the deference function set out in paragraphs 66 and 67 of the CPS226 DP proposal. The deference function only requires the relevant foreign margin requirements to be substantially similar to the BCBS-IOSCO framework.

Comparability assessments should be made available to all APRA covered entities and with sufficient notice prior to the implementation date of the BCBS-IOSCO framework.

Substituted compliance is an important characteristic for many members and is essential for a workable cross-border framework. We note that the regulators in the US has issued final margin rules, the EU has published the final draft technical standards, and the regulators in each of Japan, Canada, Switzerland, Hong Kong and Singapore have proposed margin requirements based on the BCBS-IOSCO framework. Where a jurisdiction adopts margin requirements that are based on the BCBS-IOSCO framework, it is highly desirable that APRA do a jurisdiction comparability assessment rather than requiring each APRA covered entity to make a separate request for comparability assessment and confirms that substituted compliance will be available to the applicable APRA covered entities in respect of such jurisdictions.

9.2. Time for comparability to be established

After the CPS226 DP proposal is finalised, it will be necessary for market participants to have sufficient time to allow for the legal, operational, risk management and technological enhancements necessary to effectively and safely implement the new requirements. In particular, market participants will need time to build, test and receive approvals for IM models that are very new to the market. The regulators will also need time to formalise the regulatory approval processes for IM models across multiple jurisdictions. To the extent that market participants are proposing to outsource certain functions in relation to the margin requirements, such as the calculation of IM and the calling of IM, market participants may need to complete outsourcing applications or filings. They would need time to complete such applications or filings, and the regulators would need time to consider them. Moreover, the ability of the market to make the necessary enhancements will depend on the outcome of the comparability assessments, and this could further slow the implementation process.

Given that we are already in mid-2016 the question of how quickly jurisdiction comparability assessment can be achieved by September 2016 is an area of uncertainty. In this context a transitional arrangement should be considered.

9.3. Conditions on substituted compliance

Power to limit the scope of or impose conditions on recognised substituted compliance (paragraph 64)

The CPS226 DP proposal allows APRA to limit the scope of or impose conditions on recognised substituted compliance, even when a positive comparability determination has been made. Doing so would create bespoke margin requirements and unnecessarily add to the compliance burden. Given the tight implementation timeline that the industry is facing and the complexity of implementing the margin requirements in cross-border transactions we do not consider this to be a desirable power for APRA to administer.

10. Foreign branches and subsidiaries

Compliance by foreign-incorporated APRA covered entities with their foreign jurisdiction's margin requirements in place of the APRA requirements (paragraphs 66 and 67)

It is unclear whether paragraphs 66 and 67 of the CPS226 DP proposal must be read together with paragraph 63. AFMA supports ISDA's detailed comments on this topic.

11. Automatic deference

Deference (paragraph 66)

Where a foreign ADI is directly subject to a home jurisdiction's margin requirements in conformance with BCBS-IOSCO principles compliance is permitted with the home jurisdiction's rules. In line with our comments in section 10.1 it is highly desirable that APRA carry out jurisdiction level assessments and provide a list of these jurisdictions that are substantially similar.

AFMA supports ISDA's detailed comments on this topic.

Moreover, AFMA believes that paragraph 66 should be extended to allow a foreign ADI, Category C insurer or an eligible foreign life insurance company (EFLIC) - where it is directly subject to margin requirements that are substantially similar to the BCBS-IOSCO framework by its home jurisdictions - to comply with its home jurisdiction's margin requirements or those of a jurisdiction deemed equivalent by its home jurisdiction in lieu of complying with the Australian margin standards. This is to support with harmonisation and cover the case in which the ADI in its home jurisdiction chooses to comply with equivalent requirements to instead of the home requirements. This would be a more flexible approach and would not, it is submitted, have any adverse consequences (as compared with limiting deferred compliance to only the home jurisdiction of the relevant foreign APRA covered entity).

12. Non-netting jurisdictions

AFMA supports ISDA's detailed comments on this topic.

13. Physically-settled FX forwards and swaps and equity options

At the start of this submission we highlighted the importance of having a globally consistent regimes that follows the BCBS-IOSCO framework. A requirement that Australian participants exchange VM on FX forwards and swaps, or exchange VM or IM on equity options is not globally consistent. This make it difficult for Australian participants to margin, and therefore trade derivatives, with counterparties that are not required to do so and require margin from counterparties in situations where competitors subject to US and EU are not so required.

AFMA supports ISDA's detailed comments on this topic.

14. Custodians

14.1. Margin held offshore

VM and IM may be held offshore, for example, with custodians outside Australia?

14.2. Holding of Margin with Third Party Custodian

Clarification is sought on whether IM in the form of cash should be held with a central bank or third-party holder or custodian that is not part of the same group as either counterparty in order to provide clarity regarding whether cash can be considered to be held in a manner that protects the posting party in such circumstances.

14.3. Re-investment of cash IM

Currently cash collateral may be invested in other eligible assets upon agreement of the counterparties. This allows counterparties to minimise their credit risk to the custodian or collecting counterparty. Custodians only do so at the direction of, and subject to the control of, the counterparties. Clarification is sought on whether this practice may continue under the new standard

15. Risk Mitigation Standards

We request that the risk mitigation standards (RMS) be decoupled from the margining requirements. This is because implementation of RMS requirements at the same time as BCBS-IOSCO framework requirements is not practically achievable. We explain why in detail below (section 15.1).

In case APRA is not minded to make the RMS the subject of a separate consultation, we have outlined a modification to the RMS which we think is workable, consistent with both APRA's policy objectives and is something that we understand from our meeting APRA is likely to consider to be reasonable. It is also consistent with the principles outlined in the IOSCO *Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives* paper dated 28 January 2015 (IOSCO RMS Paper). This is set out in section 15.2 below.

Finally, we make some suggestions for changes to the RMS in section 15.3 below.

15.1. The problem of simultaneous RMS and BCBS-IOSCO framework implementation

A September 2016 deadline across the broad scope of all APRA covered entities and to all their derivative counterparties is not practically achievable and will also take away focus and resourcing from implementing the margining requirements under the CPS226 DP proposal. Some factors relevant to this include:

(a) *Limited existing RMS application.* Standards of the sort set out in the IOSCO RMS Paper are not currently applicable across multiple jurisdictions. Such rules currently only apply to Australian participants who are within the scope of EMIR risk mitigation requirements and/or CFTC swap dealer obligations, and only when dealing with counterparties within the scope of such rules (for example, for the five Australian swap dealers, the CFTC rules apply only when dealing with US-connected counterparties).

(b) *Implementing RMS requires repapering.* Separate repapering exercises (in the form of ISDA protocols) were needed to address the documentation requirements of the EMIR and CFTC rules. These exercises benefitted from considerable lead times between rule publication and compliance dates, and by the market dedicating substantial resources to the exercise. The APRA requirements provide insufficient time to come into compliance, and they impact a broader range of entities and covered counterparties than equivalent CFTC and EMIR regimes. There is no ISDA (or other market standard) protocol currently existing that can be applied to address APRA's risk mitigation standards and it is not feasible to put one in place in time. Australian dealers may be rendered uncompetitive if they are seen as demanding additional documentation standards over what their international competitors require. There is a real risk that if Australian participants adopt an approach of: "no amendment, no transacting" our access to risk markets and will be obstructed.

(c) *Timing difficulties.* Compliance with the RMS is required at a time when industry participants will be devoting all available resources to what is the largest repapering exercise (regulation-necessitated or otherwise) the industry has seen in order to come into compliance with BCBS-IOSCO framework variation margin requirements from 1 March 2017. We will have significant difficulty requiring counterparties to make changes beyond BCBS-IOSCO framework required ones. The difficulties this clash gives rise to are ones that the IOSCO RMS Paper discusses (see paragraph 8.3). While it suggests authorities should "consider the feasibility of implementing these [RMS] standards and the margin requirements around the same time", it goes on to say that "authorities may have regard to the time needed by the covered entities to put in place the necessary infrastructure and systems to adhere to the requirements". As noted in point (b) above, the documentation infrastructure to deal with Australian RMS does not exist at this time.

15.2. *Modification to RMS to make it workable*

It is possible to make changes to the RMS that address the above difficulties, and are consistent with the both APRA's policy objectives and those of the IOSCO RMS Paper. This would involve three changes, which are as follows:

(a) ***Counterparty alignment*** (i.e. aligning counterparty scope of the RMS with that contemplated in the IOSCO RMS Paper). The IOSCO principles are intended to apply to only to non-cleared derivatives transactions between two covered entities (see Key considerations para 1.3 page 5 and Explanatory notes para 1.6 page 6 of the IOSCO RMS Paper). The APRA provisions are wider in scope, as they apply in relation to derivatives with all counterparties. We suggest that this discrepancy can be simply resolved by having the scope confined to derivatives with counterparties with whom WMGR requirements apply.

(b) ***Timing alignment*** (i.e. phasing-in timing in a manner similar to WMGR implementation). Considerable pressure on participants to achieve re-documentation requirements would be removed by aligning the timing of phase-in of the RMS with the WGMR rules. This would be achieved requiring compliance with the RMS, in relation to a counterparty, when WGMR rules apply in relation to such counterparty. This is consistent with the IOSCO RMS Paper (see paragraph 8.4).

(c) ***Transactions alignment*** (i.e. aligning the types of transaction to which the margin requirements and the RMS apply to). If APRA agrees with the point made in section 14 above (not to require the exchange of VM in respect of physically-settled FX Forwards and Swaps from VM requirements, and not to require the exchange of IM or VM in respect of Equity Options), AFMA proposes that the RMS should also not apply to FX Forwards and Swaps and Equity Options. As the margining documentation and related processes (such as portfolio reconciliation, dispute resolution, and valuation) will be used to comply with the RMS, requiring the RMS to apply to non-margined transactions could mean that separate documentation and procedural solutions need to be established FX forwards, swaps and equity options. This would impose a significant additional burden on the industry at a time when all available resources are being allocated to compliance with WGMR implementation.

(d) ***Industry response alignment*** (i.e. making minor amendments to the provisions, in a manner which we view as fitting within the scope of the IOSCO RMS Paper objectives. The objective with this is to permit existing industry documentation and protocols, put in place to address requirements in US and EU regimes, to address Australian requirements. In the next section we suggest a set of changes to the RMS, some of which are critical to achieving this objective.

15.3. *Suggested changes to RMS provisions for alignment*

15.3.1. *General: cross-border / extra-territoriality / substituted compliance*

AFMA suggests that these obligations not apply to entities within Level 2 groups that are incorporated outside of Australia. This would add to the regulatory burden and costs of compliance for industry. Having such an extra-territorial effect would also risk harming Australian submissions that foreign regimes and regulators ought to defer to Australian regulators in relation to specific areas of regulation of Australian entities, such as capital.

Substituted compliance and automatic deference should not be limited to the margining provisions of the CPS226 DP proposal and should be extended to the risk mitigation standards as well. A set of substituted compliance provisions be inserted, that operate similarly to the BCBS-IOSCO framework provisions. AFMA suggests that APRA include an equivalent of paragraph 63 of the Draft CPS in relation to the risk mitigation standards, so that an APRA covered entity may apply to APRA for approval to comply with the corresponding standards of a relevant foreign jurisdiction. In addition, a foreign-incorporated APRA covered entity should be allowed to comply with the risk mitigation standards of its home jurisdiction (as contemplated by paragraph 66 of the Draft CPS), or, as applicable, the relevant foreign jurisdiction (as contemplated by paragraph 67 of the Draft CPS without obtaining the prior approval of APRA, provided, in each case, that it can demonstrate how it meets the applicable foreign risk mitigation requirements which are substantially similar to the IOSCO RMS. This will be important in order to avoid any potential time gap between initial implementation of the Australian requirements and a determination by APRA that the relevant foreign risk mitigation standards are comparable.

15.3.2. Generally: "ensuring" acts of counterparties

Could references to an entity establishing policies and procedures "to ensure" be replaced with a reference to the entity establishing policies and procedures "designed to ensure"? This is necessary where the things to be ensured are not wholly within the control of the covered entity (i.e. they are dependent on a counterparty also doing something, such as executing a confirmation). This is consistent with the approach taken in the US regime (see CFTC Commodity Exchange Regulations Part 23, §23.502(b)).

15.3.3. Trading relationship documentation (72(a))

Paragraph 72(a) requires that documentation must provide legal certainty for uncleared derivatives. While this is taken from the IOSCO RMS Paper, we think it is not needed in local implementation rules such as APRA's. In the IOSCO RMS Paper it is a "key consideration" which informs what should be actual obligations on participants, and is not in the nature of an obligation itself.

Its intersection with netting- and collateral-unfriendly jurisdictions is also something that would need consideration if it remains.

15.3.4. Trade confirmations (74)

The second sentence of paragraph 74 suggests an absolute obligation to confirm transactions ASAP after execution. We believe that APRA's intention, however, is that this be instead an obligation to have policies and procedures to achieve this. This distinction here is important because a confirmation can only be achieved when a counterparty has cooperated, and this is to a degree out of our control. This concern could be addressed by copying the beginning of the first sentence in the paragraph, or by removing the word "confirmed" in the second sentence.

It would be helpful if APRA could recognise the validity of negative affirmations (as the IOSCO RMS Paper does, see 3.6).

15.3.5. *Portfolio Reconciliation*

We would like to clarify whether reconciliation requirements apply in respect of only derivatives entered into after the compliance date, or pre-compliance date derivatives also?

We would also like to clarify whether reconciliation requirements apply in respect of intra-group transactions. Our submission is that this should not be necessary.

The first sentence of paragraph 78 could be read as requiring that parties agree to a reconciliation process, rather than (as we think is the intention) that the APRA covered entity have a policy designed to ensure that such process is agreed with counterparties. We request that this sentence be deleted. The requirement in paragraph 77 to have policies and procedures should be sufficient, and the extent of the obligation. This is the approach under the US rule. Going further would require industry infrastructure to be in place that does not currently exist, as noted in 16.1(b) above, and cannot be put in place in time to address Australian requirements.

AFMA urges APRA to consider introducing a de minimis threshold below which the parties would not be required to resolve any differences in valuations. For example the the CFTC adopts a de minimis threshold of 10% (see CFTC Commodity Exchange Regulations Part 23, §23.502(b)(4)).

15.3.6. *Valuation processes*

AFMA requests that the last sentence in para 86 be deleted, or that it be qualified by an obligation to merely have policies and procedures in this regard. This is because while we are unable to compel counterparties to agree to such changes, we are able to follow policies and procedures that are reasonably designed to achieve that objective. The IOSCO RMS Paper is worded as it is because it is stating objectives, and is not limited (as we respectfully submit APRA should be) by what obligations a regulated entity is actually capable of discharging on its own.

15.3.7. *Dispute resolution – material terms*

Industry standard documentation does not actually provide for a mechanism to resolve disputes as to material terms, and only provides for resolution of disputes as to the value of transactions and of credit support.

The US and EU rules do not require dispute resolution in relation to material terms.

For the reasons provided in 16.1(b) above, there is no existing industry infrastructure in place that can address this, and it is not feasible to put one in place in time to address Australian requirements.

We note that it is in the parties' interest to resolve material terms-based disputes in order to facilitate the exchange of margin, as differences in parties' material terms records are likely to result in a dispute in value.

15.3.8. Dispute resolution – de minimis valuation difference

The CFTC rules, in §23.502(b)(4), as referred to above in relation to portfolio reconciliation, state that valuation differences of less than 10% of the higher valuation need not be deemed a discrepancy. This approach could helpfully be applied in this section.

15.3.9. Dispute resolution – documenting how to resolve disputes

Industry standard margining agreements do not include provisions of the type described in paragraph 87(b) and so this paragraph should be deleted for the reasons set out in section 16.1(b) above.