



May 20, 2016

Via electronic submission: [policydevelopment@apra.gov.au](mailto:policydevelopment@apra.gov.au)

Mr. Pat Brennan  
General Manager, Policy Development  
Policy and Advice Division  
Australian Prudential Regulation Authority

**Discussion Paper – Margining and Risk Mitigation for Non-Centrally Cleared Derivatives**

Dear Mr. Brennan:

State Street Bank and Trust Company, The Bank of New York Mellon, and The Northern Trust Company (“the Custody Banks”) appreciate the opportunity to comment on the discussion paper issued by the Australian Prudential Regulation Authority (“APRA”) on its Prudential Standard CPS 226 - Margining and risk mitigation for non-centrally cleared derivatives (the “draft Margin Standards”).<sup>1</sup>

Collectively, the Custody Banks hold over \$62 trillion<sup>2</sup> in assets under custody and administration (approximately 42% of the over \$147 trillion global custody market)<sup>3</sup>, and expect to be significant providers of custodial accounts for segregation of initial margin for uncleared swaps under the draft Margin Standards.

**Segregation of Initial Margin**

The Custody Banks support the requirements under the draft Margin Standards for initial margin to be held in a manner that: (a) ensures the margin collected is immediately available to the collecting party in the event of the posting party’s default, and (b) subject to arrangements that protect the posting party in the event that the collecting party enters insolvency or bankruptcy. Custody banks are highly regulated with well-established processes and systems to provide

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<sup>1</sup> <http://www.apra.gov.au/CrossIndustry/Documents/160225-DRAFT-CPS-226-FINAL.pdf>

<sup>2</sup> As of March 31, 2016, State Street Corporation had \$27 trillion in assets under custody and administration; The Bank of New York Mellon Corporation had \$29.1 trillion; and The Northern Trust Corporation had \$6.2 trillion

<sup>3</sup> Based on assets under custody of the top 20 global custodians: BNY Mellon, State Street, JP Morgan, BNP Paribas, Northern Trust, Mitsubishi, BBH, Societe Generale, CACEIS, UBS, Six SIS, Royal Bank of Canada, US Bank, SEB, Santander, Nordea, National Australia Bank.

safekeeping of client assets, and are uniquely suited to providing the type of segregation needed to protect counterparties to non-centrally cleared derivatives.

While the draft Margin Standards are generally consistent with current custody industry practices, there are areas where further clarification is needed, primarily with regard to the treatment of cash margin maintained with custody banks. Specifically, we are concerned that the draft Margin Standards may be read to prohibit the use of bank deposits for cash margin posted to segregated custody accounts, effectively making the use of cash for initial margin unavailable to swaps counterparties. It is important that APRA clarify the treatment of cash margin under the final standards.

While securities are financial assets that are always held off balance sheet in bankruptcy remote custodial accounts, cash is treated differently. Cash itself is not held in custody; it is either reinvested in a suitable asset at the direction of the holder of the custody account or is placed on deposit with the custody bank. As deposits, uninvested cash associated with custody accounts is reflected as a liability on a custody bank's balance sheet. Deposit holders, including those maintaining margin accounts, necessarily take on credit risk to the custody bank. Cash received on deposit by the custody bank, like other deposit funding, is invested by the custody bank in suitable assets for the custody bank's own account, under the bank's asset liability management plan, and subject to numerous regulatory requirements, particularly prudential liquidity rules and supervision.

The treatment of cash in custody accounts is well understood in financial markets, and the holders of custodial accounts manage cash accordingly. Institutional investors generally minimize cash left on deposit, both to manage credit exposure to the custody bank and to generate higher yields than are available on custodial deposits. Custody banks generally have an interest in minimizing such deposits as well, due to the negative impact of such deposits on the bank's leverage ratio and other regulatory limitations.

Unfortunately, the draft Margin Standards are unclear as to whether such traditional cash deposits with a custody bank will be permitted for segregated initial margin. Thus we suggest clarification under Section 28 that notes "Initial margin must not be re-hypothecated, re-pledged or re-used." We support this requirement, but suggest clarification related to the posting of cash to custody bank deposit accounts. To provide certainty and clarity that cash maintained by third-party custodians may be placed on deposit, we urge Section 28 to be modified to read:

*Initial Margin must not be re-hypothecated, re-pledged or re-used but cash deposits may be held in a general deposit account with a custodian.*

We believe this will help to provide certainty that the deposit of cash in a demand deposit account with a custody bank satisfies the initial margin requirements, and does not give rise to the prohibited re-use / re-hypothecation under the draft Margin Standards. Furthermore, adopting this language would help ensure important market consistency for the segregation of initial margin, as the U.S. Prudential Regulators recently adopted similar language in their final rule.<sup>4</sup>

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<sup>4</sup> Margin and Capital Requirements for Covered Swap Entities. See §\_7(c)(1). [https://www.fdic.gov/news/board/2015/2015-10-22\\_notice\\_dis\\_a\\_fr\\_final-rule.pdf](https://www.fdic.gov/news/board/2015/2015-10-22_notice_dis_a_fr_final-rule.pdf)

**Conclusion**

Once again, the Custody Banks appreciate the opportunity to comment on the draft Margin Standards. We strongly support the segregation of margin, but are concerned that the lack of clarity on the treatment of cash margin could prove an impediment to the rapid adoption of APRA’s final standards in the marketplace. As a result, we strongly urge APRA to clarify the treatment of cash margin, as described above.

Please do not hesitate to contact the undersigned with any questions.

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Regards,



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