

EXPLANATORY STATEMENT

Issued by authority of the Assistant Treasurer

*Life Insurance Act 1995;
Superannuation Industry (Supervision) Act 1993;
Payment Systems and Netting Act 1998*

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

Section 18 of the *Payment Systems and Netting Act 1998* (the PSN Act), section 353 of the *Superannuation Industry (Supervision) Act 1993* (the SIS Act) and section 253 of the *Life Insurance Act 1995* (the Life Insurance Act) each provide that the Governor-General may make regulations prescribing matters required or permitted by the relevant Act to be prescribed, or necessary or convenient to be prescribed for carrying out or giving effect to the relevant Act. Subsections 31(1) and 32(2) of the SIS Act provide that regulations may prescribe standards applicable to the operation of regulated superannuation funds and approved deposit funds, and to trustees and Registrable Superannuation Entity (RSE) licensees of those funds.

The Financial System Legislation Amendment (Resilience and Collateral Protection) Regulation 2016 (the Regulation) will:

- a) enable trustees of superannuation funds and approved deposit funds (Superannuation Funds) regulated under the SIS Act and life companies regulated under the Life Insurance Act to provide margin by way of security in relation to derivatives in the manner required to access international capital markets and liquidity; and
- b) update the list of approved bodies (being domestic and foreign exchanges and clearing houses) to whom trustees of Superannuation Funds and life companies may grant security.

This is intended to allow those entities to access liquid global markets such as the United States cleared over-the-counter (OTC) derivatives market through Futures Commission Merchants (FCMs).

This reform is important because of the deep liquidity, and often beneficial pricing available in those markets, and should allow these entities to effectively manage their risks and access optimal pricing and products.

Together with the Financial System Legislation Amendment (Resilience and Collateral Protection) Act 2016 (the Resilience and Collateral Protection Act), the Regulation also:

- a) facilitates financial institutions giving margin by way of security and enforcing rights in respect of these security-based margining arrangements in a manner consistent with international requirements imposed on dealings in OTC derivatives; and

- b) provides legal certainty about the ability of financial institutions to exercise termination rights (also known as close-out rights) under certain financial market transactions, including in respect of derivatives, repurchase agreements, sell-buyback arrangements and securities lending arrangements.

Details of the Regulation are set out in the Attachment.

The relevant Acts do not specify any conditions that need to be satisfied before the power to make the proposed Regulation may be exercised.

The Government consulted the public on an exposure draft of the Regulation from 21 December 2015 to 5 February 2016. Stakeholders were broadly supportive of the Regulation.

The Regulation is an instrument for the purposes of the *Legislation Act 2003*.

The Regulation commences on the day after it is registered.

Details of the *Financial System Legislation Amendment (Resilience and Collateral Protection) Regulation 2016*

Part 1 - Name

This section provides that the title of the Regulation is the *Financial System Legislation Amendment (Resilience and Collateral Protection) Regulation 2016*.

Part 2 - Commencement

This section provides that the Regulation commences on the day after it is registered.

Part 3 – Authority

This section prescribes that the Regulation is made under the following Acts:

- *Life Insurance Act 1995*;
- *Superannuation Industry (Supervision) Act 1993*;
- *Payment Systems and Netting Act 1998*.

Part 4 – Schedules

Schedule 1 – Facilitating access to derivatives for superannuation funds and life insurance companies

Currently, trustees of Superannuation Funds and life insurance companies (life companies) are unable to grant margin by way of security as they need to, in order to trade effectively in OTC derivatives – a key method of hedging risks specific to their business. This issue will be exacerbated when internationally-agreed margining requirements for non-centrally cleared derivatives are phased in from September 2016.

Allowing trustees of Superannuation Funds and life companies to access cleared and uncleared OTC derivatives markets is consistent with Australia’s commitments in respect of the G20 derivatives reforms – which seek to improve transparency, mitigate systemic risk, and protect against market abuse.

Trustees of Superannuation Funds

Trustees of Superannuation Funds are restricted from granting security over an asset of the fund, subject to certain exceptions¹. There is an exception to this restriction on granting charges in the context of ‘derivatives contracts’² under regulation 13.15A of the *Superannuation Industry (Supervision) Regulations 1994* (the SIS Regulations).

1 Regulation 13.14 of the *Superannuation Industry (Supervision) Regulations 1994* (SIS Regulations).

2 A ‘derivatives contract’ is defined to mean an options contract or a futures contract relating to any right, liability or thing.

However, it is not clear whether this exception allows trustees of Superannuation Funds to charge the assets of the relevant Superannuation Fund with respect to OTC derivative transactions, whether cleared or uncleared.

Regulation 13.15A of the SIS Regulations currently provides that a trustee may give a charge over, or in relation to, an asset of a fund if:

- a) the charge is given in relation to a derivatives contract entered into by, or on behalf of, the trustee; by a broker on the instructions, or on the account, of the trustee; or by a broker for the benefit of the trustee;
- b) the charge is given in order to comply with the rules of an approved body (being the domestic and international exchanges and clearing houses listed in Schedule 4 to the SIS Regulations) that requires the performance of obligations in relation to the derivatives contract to be secured;
- c) the fund has in place a derivatives risk statement that sets out certain prescribed information; and
- d) the investment to which the charge relates is made in accordance with the derivatives risk statement.

The rules of some significant exchanges and clearing houses and certain existing, or expected, laws and prudential standards of certain jurisdictions either expressly require that security be granted or have the consequence that security needs to be granted. Trustees of Superannuation Funds may not be able to rely on the ‘derivatives contract’ exception to granting the charges required by the rules of exchanges and clearing houses or law for a number of reasons, including that:

- a) the term ‘derivatives contract’ may not be broad enough to capture other OTC derivatives such as foreign exchange forwards and swaps and interest rate swaps utilised by trustees of Superannuation Funds;
- b) the exception does not contemplate security being granted by the trustee to third parties who assist the trustee to access the approved body (i.e. a trustee’s clearing member) (including in circumstances where the trustee is not a direct participant of the approved body) if the charge is not contemplated in the rules of the approved body; and
- c) the current schedule of ‘approved bodies’ is outdated and does not include some important OTC derivatives clearing houses which clear high volumes of OTC derivatives (e.g. LCH.Clearnet).

Similarly, the broad exception in regulation 13.15 which provides that the restriction on granting security does not apply to an assignment or charge that is permitted, ‘expressly or by necessary implication’, by the SIS Act or SIS Regulations may not cover the granting of security in the context of cleared or uncleared OTC derivatives.

The inability of trustees of Superannuation Funds to grant the security required, to access certain exchanges and clearing houses, is becoming an increasingly significant issue due to the reforms to OTC derivatives markets since the financial crisis of

2007/2008.³ Changes to the US Dodd–Frank Wall Street Reform and Consumer Protection Act and Commodity Exchange Act have resulted in FCMs⁴ taking security from their clients rather than the FCM taking absolute ownership of the transferred property. The clearing mandates and the margin requirements being implemented across the world are expected to encourage the central clearing of derivatives. As a result, managers of Australian Superannuation Funds will face increasing cost and administrative burdens in trading uncleared OTC derivatives and will not, under current regulation, be able to access cleared markets through FCMs.

International margin requirements for non-centrally cleared derivatives may also result in trustees of Superannuation Funds being required to provide margin by way of a security.⁵ For instance, the trustee of the Superannuation Fund may be required by law to provide margin by way of security; or the trustee’s counterparty may be required to collect margin by way of security from the trustee due to the regulatory and prudential requirements imposed on it. However the ‘derivatives contract’ exception in Regulation 13.15A may not give them sufficient license to comply with these requirements.

Life companies

Life companies are also subject to significant restrictions on granting security. Section 38(3) of the Life Insurance Act provides that a life company must not mortgage or charge any of the assets of a statutory fund except:

- a) to secure a bank overdraft; or
- b) in connection with the undertaking of a major development project and in accordance with section 40 of the Life Insurance Act; or
- c) for such other purposes, and subject to such other conditions, as are prescribed by the *Life Insurance Regulations 1995* (Life Insurance Regulations).

3 In the aftermath of the recent financial crisis, the Group of Twenty (G20) initiated a reform agenda to improve transparency in derivatives markets, to mitigate systemic risk and protect against market abuse. In Pittsburgh in September 2009, the leaders of the G20 agreed that ‘[a]ll standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse.’ (Financial Stability Board (FSB), *Implementing OTC Derivatives Market Reforms* (Financial Stability Board, 25 October 2010), iii. In 2011, the G20 agreed to add margin requirements on non-centrally cleared derivatives to the OTC derivative reform agenda.

4 FCMs are the entities through whom trustees of Superannuation Funds would otherwise access certain cleared markets.

5 For example, the requirement under the framework published by Basel Committee on Banking Supervision (BCBS) and Board of the International Organization of Securities Commissions (IOSCO) for *gross* initial margin to be exchanged is likely to result in initial margin (at least) being transferred by way of security rather than by way of absolute transfer. There may also be compelling reasons why market participants choose to provide both initial margin and variation margin by way of security rather than by way of absolute transfer (for example, because of benefits to the grantor/collateral provider on the secured party’s insolvency).

The existing ‘derivatives contracts’ exception in regulation 4.00A of the Life Insurance Regulations⁶ is not broad enough to cover granting security in the context of trading cleared or uncleared OTC derivatives. The exception needs to be updated to accommodate derivative trading arrangements, for similar reasons to those discussed above in relation to trustees of Superannuation Funds.

Amended regime – Life Insurance Regulations and SIS Regulations

Life Insurance Regulations

The Regulation amends the Life Insurance Regulations to allow life companies to grant security for cleared and uncleared OTC derivatives as required by domestic and foreign regulation and market practice. The Regulation does this by repealing the existing paragraphs 4.00A(1)(a) and (b) and providing instead that the charge must:

- a) be given in relation to a derivative to which either of the following is a party:
 - i) the life company;
 - ii) another person (the agent) acting on behalf of, on the instructions of, on account of or for the benefit of the life company; and
- b) comply with one of three specific requirements, which are set out in sub regulation 4.00A(1A), (1B) or (1C) of the Life Insurance Regulations.⁷ [***Schedule 1, item 1, Paragraphs 4.00A(1)(a) and (b) of the Life Insurance Regulations***]

The Regulation uses a new definition of ‘derivative’ to more accurately reflect the range of cleared and uncleared OTC derivatives entered into by life companies to effectively manage their risk. The changes more closely align the concepts used in the Life Insurance Regulations with the concepts used in other Australian laws (such as the *Corporations Act 2001* (Corporations Act)). The new definition replaces the existing (narrower) definition of ‘derivatives contract’ and that of ‘derivative’. Under the Regulation, a ‘derivative’ means any of the following:

- a) a derivative (within the meaning of Chapter 7 of the Corporations Act);
- b) a foreign exchange contract (within the meaning of that Chapter);
- c) an arrangement that is a forward, swap or option, or any combination of those things, in relation to one or more commodities,

but does not include any arrangement that is of a kind mentioned in sub regulation 6(2) of the *Payment Systems and Netting Regulations 2001* (PSN Regulations). [***Schedule 1, item 3, Sub regulation 4.00A(2) (definition of derivative) of the Life Insurance Regulations; and item 4, Sub regulation 4.00A(2) (definition of derivatives contract) of the Life Insurance Regulations***]

⁶ The exception in regulation 4.00A is similar to the exception which applies in respect of Superannuation Funds in regulation 13.15A of the SIS Regulations.

⁷ The other paragraphs of regulation 4.00A(1) must still be satisfied.

This new definition of ‘derivative’ is intended to align, as much as possible, with the concept of ‘eligible obligation’ used in the Act. Together with amendments made by the Regulation, the definition should be consistent with, and facilitative of, current and evolving market practice; and reinforce the objects of international derivatives reform.

The reference to a ‘foreign exchange contract’ is included to deal with the issues which arise in relation to short-term foreign exchange derivatives under 7.1.04 of the *Corporations Regulation 2001* ().

The reference to forwards, swaps, options and combinations of those things in relation to one or more commodities is intended to capture commodity derivatives (particularly physically-settled commodity derivatives) which are understood in financial markets to be derivatives, but which could otherwise be excluded from the Corporations Act definition of ‘derivative’ due to the tangible property exception in paragraph 761D(3)(a) of the Corporations Act.

The note to the definition is a reminder that, while the term ‘derivative’ covers a variety of arrangements, not all are ‘eligible obligations’ (i.e. what financial markets would typically consider to be a derivative). The PSN Act provides for, and protects, the enforcement of security over financial property given in respect of an eligible obligation. Sub regulation 6(2) of the PSN Regulations identifies those arrangements that are not ‘eligible obligations’ (credit facilities, reciprocal purchase agreements (otherwise known as repurchase agreements), sell-buyback arrangements, securities loan arrangements, and contracts of insurance and managed investment schemes). The references to commodity derivatives and the arrangements excluded from this definition are discussed later in this explanatory statement. [***Schedule 1, item 3, Sub regulation 4.00A(2) (definition of derivative) of the Life Insurance Regulations***]

The first new circumstance in which a life company may grant security is set out in sub regulation 4.00A(1A) of the Life Insurance Regulations. This is an expansion of the existing paragraph 4.00A(1)(b). The new sub-regulation (1A) applies if the charge is given in order to comply with a requirement that the performance of obligations in relation to the derivative be secured in either:

- a) rules governing the operation of an approved body; or
- b) a law of the Commonwealth, a State, a Territory or a foreign country (including a part of a foreign country) that applies to dealings in the derivative. [***Schedule 1, item 2, After sub regulation 4.00A(1), sub regulation 4.00A(1A) of the Life Insurance Regulations***]

The giving of security by a life company in favour of the approved body itself (i.e. the exchange or clearing house), the life company’s agent (i.e. clearing member or broker), or some other person would satisfy the requirement in paragraph 4.00A(1A)(a), provided that the rules governing the operation of the approved body (or relevant law) require the life company to give that security.

Paragraph 4.00(1A)(b) is intended to facilitate the giving of security by the life company where the giving of security is contemplated by Australian or foreign law; and could also be satisfied where the law imposes the relevant requirement on the life

company's counterparty or other party to the transaction (like the clearing house or exchange) rather than the life company itself.

Foreign laws which require a financial institution to segregate customer assets, rather than laws which require that performance of derivative obligations be secured, are also restricting Australian life companies from accessing important capital markets. For example, under US law, customer funds and property for trading on designated contract markets (exchanges) (including property posted to an FCM to margin or guarantee derivatives trading) must be kept apart from the FCM's own funds and property.⁸ Segregated customer funds are held for the benefit of the FCM's customers and are subject to a preference regime in the event of the FCM's insolvency. Due to this legislative structure, the FCM cannot receive margin from the trustee on an absolute transfer basis. This is because the 'customer funds' would then become the FCM's property which is understood to be inconsistent with US law. This requirement to segregate customer property has resulted in FCMs requiring their clients to grant security over posted margin to ensure that the FCM has recourse to those assets on the client's default.

Among other things, sub regulation 4.00A(1B) of the Life Insurance Regulations resolves the issue life companies face in relation to dealing with FCMs in the US. Specifically, sub regulation 4.00A(1B) allows a life company to grant security if:

- a) the charge is given in favour of another person (the agent⁹) acting on behalf of, on the instructions of, on account of or for the benefit of the life company (e.g. the life company grants security to its FCM, over the property it provides to its clearing member); and
- b) the agent enters into an arrangement that is a derivative on behalf of, on the instructions of, on account of or for the benefit of the life company (e.g. the clearing member enters into a cleared derivative with a US clearing house, whether or not through another clearing member); and
- c) the agent is obliged under either of the following to keep the property of the life company separate from the property of the agent:
 - i) rules governing the operation of an approved body (as defined in sub regulation (2));
 - ii) a law of the Commonwealth, a State, a Territory or a foreign country (including a part of a foreign country) that applies to dealings in the derivative; and
- d) the agent is under an obligation, or but for a netting-off would be under an obligation, to transfer property to another entity in relation to the derivative; and

⁸ US Commodity Futures Trading Commission, *Futures Commission Merchants (FCMs) & Introducing Brokers (IBs) - Segregation of Customer Funds* (available at <http://www.cftc.gov/IndustryOversight/Intermediaries/FCMs/fcmsegregationfunds>).

⁹ The 'agent' concept includes, without limitation, the life company's broker, clearing member or clearing participant but does not include an employee who merely signs a contract and does not become a party.

E.g. clearing members are generally required to make payments or transfer assets (including due to calls for margin) to the clearing house or another intermediate clearing member in relation to derivatives they enter into on behalf of clients (whether because they are a primary obligor, guarantor or otherwise) subject to any netting or set-off which may occur in relation to the clearing member's obligation. The netting conducted by the clearing house in respect of a clearing member's omnibus client account may result in there not being any obligation on the clearing member to transfer property because the clearing member clears for multiple clients and is only required to transfer property on a net basis. It is intended that paragraph 4.00A(1B)(d) of the Life Insurance Regulations would be satisfied in these circumstances.

- e) the charge is given over an asset or assets of the statutory fund (e.g. over property posted to the FCM by the life company), to secure the performance of an obligation or obligations in relation to the derivative.

[Schedule 1, item 2, After sub regulation 4.00A(1), sub regulation 4.00A(1B) of the Life Insurance Regulations]

There may also be compelling commercial reasons why a life company considers it essential to grant security in respect of exchange-traded derivatives, cleared and uncleared OTC derivatives, even when it, and/or its counterparty, is not under any legal compulsion to do so.

In these instances, it is also important that the ability of a life company to grant security is subject to safeguards. Accordingly, sub regulation 4.00A(1C) of the Life Insurance Regulations provides that life companies may grant security in a particular manner – whether or not it is under any legal obligation to give security (whether under the rules governing the operation of an approved body or a law).

A charge will satisfy sub regulation 4.00A(1C) if all of the following are satisfied:

- a) the asset over which the charge is given is financial property (the definitions of financial property, intermediary and intermediated financial property are taken from the PSN Act, and set out in ***[Schedule 1, item 5, sub regulation 4.00A(2)]***;¹⁰ and
- b) the obligations secured by the financial property are any of the following:
 - i) an obligation of the life company that relates to the derivative;
 - ii) an obligation of the life company to pay interest on an obligation of the life company that relates to the derivative;
 - iii) an obligation of the life company to pay costs and expenses incurred in connection with enforcing a charge given in respect

¹⁰ The definition of 'financial property' in the PSN Act is broad, and includes a range of property commonly provided as collateral in financial markets transactions.

of an obligation of the life company that relates to a derivatives contract or an obligation to pay interest on such an obligation;
and

- c) the financial property is transferred or otherwise dealt with so as to be in the possession or under the control of:
 - i) the secured person; or
 - ii) another person (who is not the life company), on behalf of the secured person, under the terms of an arrangement evidenced in writing.

[Schedule 1, item 2, After sub regulation 4.00A(1), sub regulation 4.00A(1C)]

Sub regulation (1C) uses similar concepts and safeguards to those used in the PSN Act (as amended by the *Financial System Legislation Amendment (Resilience and Collateral Protection) Act 2016* (Resilience and Collateral Protection Act)) to protect the enforcement of security given in respect of certain financial market transactions – i.e. restriction to use of ‘financial property’, provided to secure specific types of obligation, in the possession or control of certain persons. The concepts of possession and control used by the Regulation should be applied similarly to the way in which those concepts are applied in respect of the PSN Act. Sub-regulations 4.00A(1D) to (1G) set out a range of circumstances in which the possession and control test in paragraph (1C)(c) would, or would not, be satisfied. More information about substantively similar provisions to these sub regulations is provided in the Explanatory Memorandum to the Resilience and Collateral Protection Act. **[Schedule 1, item 2, After sub regulation 4.00A(1), sub regulations 4.00A(1D) to (1G) of the Life Insurance Regulations]**

Sub regulations (1A), (1B) and (1C) are not mutually exclusive - in certain circumstances, an arrangement may satisfy more than one. For example, this may occur where a charge is given by a trustee of a Superannuation Fund over financial property which satisfies the requirements in sub regulation (1C) in order to comply with a requirement under the rules of an approved body.

In order for a charge to fall within the exception in regulation 4.00A of the Life Insurance Regulations, it must also satisfy the other existing paragraphs of regulation 4.00A which relate to the risk management statement (paragraphs 4.00A(c) and (d)). It should be noted that the change to the definition of ‘derivative’ may affect the application of paragraphs 4.00A(c) and (d).

Transitional arrangements are set out in item 6 of the Regulation to clarify that the amendments of the Regulation made by items 1 to 5 of Schedule 1 to the Regulation apply to charges given on and after the commencement of this Regulation. **[Schedule 1, item 6, After Part 13, Part 14 — Transitional arrangements, regulation 14.01 (Arrangements) of the Life Insurance Regulations]**

SIS Regulations

The Regulation also makes similar changes to the SIS Regulations as are made, and described above, in respect of the Life Insurance Regulations. The same concepts, rationale and explanation described above in respect of the changes made in the Regulation which affect life companies apply to the changes made in the Regulation which affects trustees of regulated Superannuation Funds.

Generally, the change to paragraphs 13.15A(1)(a) and (b) and insertion of the new sub regulations 13.15A(1A), 13.15A(1B) and 13.15A(1C) are intended to facilitate the giving of security in respect of derivatives (including exchange-traded derivatives, cleared OTC derivatives and uncleared OTC derivatives), subject of course to the safeguards in those sub regulations. For completeness, sub regulations (1A), (1B) and (1C) are not intended to be mutually exclusive and, in certain circumstances, a particular arrangement may satisfy more than one of sub regulations (1A), (1B) and (1C). [*Schedule 1, item 7, Paragraphs 13.15A(1)(a) and (b) of the SIS Regulations to item 11, Sub regulation 13.15A(2) of the SIS Regulations*]

Similar transitional arrangements apply in respect of charges given by trustees of regulated Superannuation Funds as are set out in respect of life companies. The amendments of these Regulations made by items 7 to 11 of Schedule 1 to the Regulation apply to charges given on and after the commencement of this Regulation. [*Schedule 1, item 12, In the appropriate position in Part 14, regulation 14.12 (Arrangements) of the SIS Regulations*]

Schedule 2 – Amendments relating to payment systems and netting

Amended regime - PSN Regulations

The Resilience and Collateral Protection Act includes a number of regulation-making powers to expand or narrow the coverage of certain concepts that it incorporates into the PSN Act.

These regulation-making powers are intended to allow the Government to take into account ‘the rapidly evolving nature of the financial markets and the need to both ensure the protections provided under the PSN Act are sufficiently broad and robust and ensure that any potential abuse or mischief is quickly dealt with’.¹¹

1. The Regulation fine-tunes definitions in the PSN Act to account for the rapidly evolving nature of financial markets, by:
 - a) refining the definition of ‘eligible obligation’ (derivatives-related obligations in respect of which the enforcement of security may be protected under the PSN Act) - the Regulation will add commodity derivatives, and exclude things which may fall within the broad *Corporations Act 2001* definition of ‘derivative’ but which are not generally understood to be derivatives in the context of financial markets;
 - b) expanding the classes of property against which security may be enforced in the manner protected by the PSN Act (proposed additions are already

¹¹ Explanatory Memorandum to the Act.

commonly used in financial markets to collateralise derivatives exposures); and

- c) clarifying the way in which market participants can exercise close-out rights under reciprocal purchase agreements (otherwise known as repurchase agreements), sell-buyback arrangements and securities loan arrangements (otherwise known as a securities lending arrangement).

Part 4 of the PSN Act provides that, subject to certain safeguards, security given over ‘financial property’, in respect of obligations of a party to a close-out netting contract, may be enforced in accordance with the terms of the security.

The PSN Act defines the types of property which constitute ‘financial property’ under the PSN Act and allows for property to be declared by the PSN Regulations to be financial property (paragraph (g) of the definition of ‘financial property’ in section 5 of the PSN Act). Under this regulation-making power, the Regulation declares certain additional types of property to be financial property for the purposes of the PSN Act. The additional types of property are:

- a) a document evidencing ownership of gold, silver or platinum. This type of property is declared to be financial property because investment trading in precious metals is commonly conducted through warrants on major exchange markets, rather than trading the physical commodity itself; and these warrants may be given as collateral to cover derivative exposures. This declaration allows the enforcement of security over property such as warrants over gold, silver or platinum (and other documents which indicate title to gold, silver or platinum) which are provided as collateral to be protected under the PSN Act;
- b) cash collateral (including cash, certificates of deposit, and bank bills);
- c) property described in paragraph 5(b), (c) or (e), or paragraph 25, of Attachment H to *Prudential Standard APS 112—Capital Adequacy: Standardised Approach to Credit Risk* (APS 112), made by the Australian Prudential Regulation Authority (APRA) under section 11AF of the *Banking Act 1959* (Banking Act), as property that may be recognised as eligible collateral (ignoring any conditions set out in the Attachment);
- d) property described in paragraph 5(d) of Attachment H to that prudential standard, ignoring:
 - i) the words “and the ADI¹² holding the security has no information suggesting that the security justifies a rating below this level”; and
 - ii) any conditions set out in the Attachment;
- e) a covered bond (within the meaning of the *Banking Act 1959*).
[Schedule 2, item 1, At the end of the Regulations, regulation 5 (Financial property) of the PSN Regulations]

¹² Authorised Deposit-taking Institution

Property which may be recognised as eligible collateral under APS 112 has been declared to be financial property in this manner to ensure, as closely as possible given the timing of the Regulation and the making of APRA's prudential standards, that property which is eligible collateral under APRA's prudential standards also constitutes financial property for the purposes of the PSN Act. It is not intended that the conditions imposed on those types of property under the prudential standard, which are relevant from a prudential perspective, need to be satisfied in order for the property to be 'financial property'.¹³

Part 4 of the PSN Act will only apply to protect the enforcement of security to the extent that, among other things, the obligations secured by the financial property, and discharged through the enforcement, are 'eligible obligations' in relation to the contract (or certain other obligations). The 'eligible obligation' concept is defined in subsection 14A(8) of the PSN Act. Paragraph 14A(8)(a) of the PSN Act provides for a regulation-making power which allows for other kinds of obligations to be prescribed as 'eligible obligations'. This regulation-making power can be used, for example, to ensure that obligations that relate to transactions which are customarily viewed as derivatives in the financial markets (and which may be subject to margin requirements) are included in the functional definition of 'eligible obligation'.

One transaction which is customarily viewed as a derivative in financial markets is an arrangement that is a forward, swap or option, or any combination of those things, in relation to one or more commodities. Accordingly, the Regulation prescribes that an obligation that relates to such an arrangement is prescribed as an 'eligible obligation' for the purposes of paragraph 14A(8)(a) of the PSN Act.

This addresses concerns which have been raised that physically-settled commodity derivatives could otherwise be excluded from the Corporations Act definition of 'derivative' due to the tangible property exception in paragraph 761D(3)(a) of the Corporations Act. [*Schedule 2, item 1, At the end of the Regulations, sub regulation 6(1) of the PSN Regulations*]

The reference to 'commodity' is a broad one intended to include types of physical property over which commodity derivatives are written, including hard commodities (e.g. crude oil, iron ore, steel, gas, gold, silver, copper, platinum, palladium, nickel, base metals, precious metals, ferrous metals and coal) and soft commodities (e.g. barley, rice, newsprint, corn, cocoa, coffee, cheese, soybeans, oats, wheat, sorghum, canola, grain, wool, cotton, cattle, lean hogs and pork belly).

However, there are also a number of things which could technically fall within the broad definition of 'derivative' under the Corporations Act but which are not generally understood in financial markets to be derivatives. At this time, it is considered that these things should not be included in the definition of 'eligible obligation'. Exclusion from the definition of 'eligible obligation' means that the protection under the PSN Act to the enforcement of security will not apply to the enforcement of security over financial property in respect of those excluded obligations.

¹³ These conditions include the reference at the start of paragraph 5 to "[s]ubject to the conditions set out in this Attachment", the references to "subject to paragraph 11 of this Attachment" (regarding wrong way risk) and others.

Accordingly, the Regulation declares, under subsection 14A(9) of the PSN Act, that certain obligations are not ‘eligible obligations’ in relation to a close-out netting contract. For example, an obligation under a credit facility (as defined in regulations made for the purposes of subparagraph 765A(1)(h)(i) of the Corporations Act) is declared not to be an ‘eligible obligation’.¹⁴ Other examples of obligations declared not to be ‘eligible obligations’ in relation to a close-out netting contract are:

- a) an obligation under a deposit-taking facility (e.g. savings and cheque accounts, at-call accounts and term deposits); and
- b) an obligation under a reciprocal purchase agreement (otherwise known as a repurchase agreement), a sell-buyback arrangement (otherwise known as a buy-sell back arrangement) or securities loan arrangement (otherwise known as a securities lending arrangement).

These terms are intended to be given the meaning generally attributed to them in financial markets. This includes securities financing transactions such as repurchase agreements documented under the numerous iterations of Global Master Repurchase Agreements and securities lending arrangements documented under the various Global Master Securities Lending Agreements, Australian Master Securities Lending Agreements, Overseas Securities Lender’s Agreement and Master Gilt Edged Stock Lending Agreement and also includes reverse repurchase transactions and reverse securities lending agreements. However, the reference to ‘securities loan arrangement’ is not intended to capture margin loans.

[Schedule 2, item 1, At the end of the Regulations, sub regulations 6(2) and (3) of the PSN Regulations]

Division 2 of Part 4 of the PSN Act sets out the circumstances in which certain stays on close-out rights imposed under industry Acts, such as the Banking Act,¹⁵ may cease. These stays cease to apply in relation to a close-out netting contract or a security in the manner set out in Division 2 of the PSN Act (including section 15A). Section 15A of the PSN Act applies in respect of close-out netting contracts and security if the relevant obligation is either an eligible obligation or is of another prescribed kind.¹⁶ Due to the exclusion of certain obligations from the definition of ‘eligible obligation’ in the Regulation (regulation 6 of the PSN Regulations, discussed above), these obligations will not fall within section 15A unless specifically prescribed for the purpose of section 15A.

The way in which parties can exercise close-out rights in respect of repurchase agreements and securities lending agreements is systemically important to domestic and international financial markets. These agreements are important to the way in which the Reserve Bank of Australia and Australian and foreign financial institutions

¹⁴ This includes a margin lending facility (within the meaning of Chapter 7 of the Corporations Act) and an obligation under a financial product (which would otherwise be a margin lending facility) but that is declared by the Australian Securities and Investments Commission under subsection 761EA(9) of the Corporations Act not to be a margin lending facility.

¹⁵ E.g. section 15C of the Banking Act.

¹⁶ PSN Act, paragraphs 15A(1)(a) and 15A(2)(a).

manage risks and conduct their business. Certainty of close-out rights is fundamental to market participants' risk assessments.

Any uncertainty in the way in which close-out rights can be exercised, or the existence of an unfettered stay on close-out rights, could inhibit the ability of Australian regulated entities to fully participate in global financial markets. The addition of a Securities Financing Transaction Annex to the International Swaps and Derivatives Association, Inc.'s (ISDA) relaunched ISDA 2015 Universal Resolution Stay Protocol demonstrates the international momentum towards establishing a clear regime governing the stays which apply to close-out rights contained in repurchase agreements and securities lending agreements.

The regime in the PSN Act, as supplemented by this Regulation, is intended to balance the need for counterparties to be able to effectively manage their risks and the need to give a resolution authority, such as an ADI¹⁷ statutory manager, the tools and protections to adequately resolve a potentially-distressed regulated entity.

The temporary stay mechanism¹⁸ set out in Division 2 (*Ceasing non-direction stays for derivatives contracts*) of Part 4 of the PSN Act will apply to a close-out netting contract to which a regulated body is a party if it contains an obligation under a reciprocal purchase agreements (otherwise known as repurchase agreements), sell-buyback arrangements (otherwise known as buy-sell back arrangements) or securities loan arrangements (otherwise known as securities lending arrangements). This is achieved by the Regulation prescribing, for the purposes of paragraphs 15A(1)(a) and (2)(a) of the PSN Act, an obligation created under a reciprocal purchase agreement (otherwise known as a repurchase agreement), sell-buyback arrangement or securities loan arrangement. [**Schedule 2, item 1, At the end of the Regulations, regulation 7 (Obligations to which section 15A of the Act applies) of the PSN Regulations**]

Schedule 3 – Approved bodies

Amended list of approved bodies - Schedule 7 of the Life Insurance Regulations and Schedule 4 of the SIS Regulations

The list of approved bodies in each of Schedule 7 of the Life Insurance Regulations and Schedule 4 of the SIS Regulations has been updated to reflect changes which have occurred in financial markets since the original regulation was made. For example, new exchanges and clearing houses which are important in international OTC derivatives markets have been included and entities which no longer exist (due to mergers or otherwise) have been removed from the list. [**Schedule 3, item 1, Schedule 7—Approved bodies of the Life Insurance Regulations and item 2, Schedule 4—Approved bodies of the SIS Regulations**]

In some cases, the list sets out the name of the actual exchange or clearing house service provided by the entity (rather than a distinct platform operated by the same entity). Where the rules or other governing documents of the exchange or clearing house indicate there is an operator which is a legal entity that operates two or more

¹⁷ ADI means authorised deposit-taking institution.

¹⁸ The temporary stay described in section 15A of the PSN Act which applies to certain close-out netting contracts may be extended if certain solvency- and licensing-related conditions are satisfied (see section 15C of the PSN Act).

facilities (or a facility with a slightly different name), an attempt has been made to specify, where possible, the facility (e.g. “[*facility*] operated by [*operator*]”). In other cases, where a distinction does not appear to be drawn between the operator and the facility (and the entity only operates one facility), the legal entity has been specified.

Each schedule also specifies as an approved body a body that performs clearing house functions, in relation to an approved body that does not itself perform those functions, in accordance with the rules of the approved body or a law of the country where the second body is situated. Care has been taken to specify the correct legal name of the facility and operator to the extent possible.

Statement of Compatibility with Human Rights

Prepared in accordance with Part 3 of the Human Rights (Parliamentary Scrutiny) Act 2011

Financial System Legislation Amendment (Resilience and Collateral Protection) Regulation 2016

This Legislative Instrument is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

Overview of the Legislative Instrument

The Financial System Legislation Amendment (Resilience and Collateral Protection) Regulation 2016 (the Regulation) will:

- a) enable trustees of superannuation funds and approved deposit funds (Superannuation Funds) regulated under the SIS Act and life companies regulated under the Life Insurance Act to provide margin by way of security in relation to derivatives in the manner required to access international capital markets and liquidity; and
- b) update the list of approved bodies (being domestic and foreign exchanges and clearing houses) to whom trustees of Superannuation Funds and life companies may grant security.

Together with the Financial System Legislation Amendment (Resilience and Collateral Protection) Act 2016 (Resilience and Collateral Protection Act), the Regulation also:

- a) facilitates financial institutions giving margin by way of security and enforcing rights in respect of these security-based margining arrangements in a manner consistent with international requirements imposed on dealings in OTC derivatives; and
- b) provides legal certainty about the ability of financial institutions to exercise termination rights (also known as close-out rights) under certain financial market transactions, including in respect of derivatives, repurchase agreements, sell-buyback arrangements and securities lending arrangements.

Human rights implications

This Legislative Instrument does not affect any of the applicable rights or freedoms.

Conclusion

This Legislative Instrument is compatible with human rights as it does not raise any human rights issues.