

**Banking, Insurance, Life Insurance and Superannuation (prudential standard)
determination No. 1 of 2017**

EXPLANATORY STATEMENT

Prepared by the Australian Prudential Regulation Authority (APRA)

Banking Act 1959, section 11AF

Insurance Act 1973, section 32

Life Insurance Act 1995, section 230A

Superannuation Industry (Supervision) Act 1993, section 34C

APRA may, in writing, determine, vary or revoke a prudential standard that applies to an institution regulated by APRA under:

- (1) section 11AF of the *Banking Act 1959* (Banking Act), in relation to authorised deposit-taking institutions (ADIs) and authorised non-operating holding companies (authorised banking NOHCs);
- (2) section 32 of the *Insurance Act 1973* (Insurance Act), in relation to general insurers, authorised non-operating holding companies (authorised insurance NOHCs), and subsidiaries of general insurers and authorised insurance NOHCs;
- (3) section 230A of the *Life Insurance Act 1995* (Life Insurance Act), in relation to life companies including friendly societies, registered non-operating holding companies (registered life NOHCs), and subsidiaries of life companies and registered life NOHCs; and
- (4) section 34C of the *Superannuation Industry (Supervision) Act 1993* (SIS Act) in relation to RSE licensees under the SIS Act.

On 10 August 2017, APRA made Banking, Insurance, Life Insurance and Superannuation (prudential standard) determination No. 1 of 2017 (the instrument), which revokes *Prudential Standard CPS 226 Margining and risk mitigation for non-centrally cleared derivatives* made under Banking, Insurance, Life Insurance and Superannuation (prudential standard) determination No. 1 of 2016, and determines a new *Prudential Standard CPS 226 Margining and risk mitigation for non-centrally cleared derivatives* (CPS 226).¹

¹ CPS 226 incorporates by reference certain provisions of Acts, Regulations and prudential standards, as well as Australian Accounting Standard AASB 10. All of these references are references to the provisions as in force from time to time, and are available on the Federal Register of Legislation at www.legislation.gov.au. CPS 226 also incorporates by reference the BCBS-IOSCO framework as it exists at 18 March 2015 and the IOSCO Risk Mitigation Standards as they exist at 28 January 2015. These documents are available at: BCBS-IOSCO framework: <http://www.bis.org/bcbs/publ/d317.pdf>; and IOSCO Risk Mitigation Standards: <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD469.pdf>.

The instrument commences on 1 September 2017.

1. Background

APRA's mandate is to ensure the safety and soundness of prudentially regulated financial institutions so that they can meet their financial promises to depositors, policyholders and fund members within a stable, efficient and competitive financial system.

In response to the global financial crisis, the Group of Twenty (G20) initiated a series of reforms to the over-the-counter (OTC) derivatives market. The G20's initial reform comprised three key commitments:

- to improve transparency by requiring transaction information on all OTC derivatives to be reported to trade repositories;
- to improve market efficiency and risk management by requiring all standardised OTC derivatives to be cleared through central counterparties; and
- to improve market efficiency and integrity by requiring the execution of all standardised OTC derivatives on exchanges or electronic trading platforms, where appropriate.

In 2011, the G20 added to its reform programme a fourth commitment to introduce margin requirements for non-centrally cleared derivatives and called on the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) to develop recommendations for consistent global standards in this area.

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

The problems associated with insufficient collateral were exacerbated by inadequate risk management practices. Weaknesses in areas including trading relationship documentation, trade confirmation, portfolio reconciliation and compression, valuation processes and dispute resolution created a lack of certainty and transparency over the terms of non-centrally cleared transactions and aggravated the problems observed in the non-centrally cleared derivatives market.

In 2015, the BCBS and IOSCO finalised minimum standards for margin requirements for non-centrally cleared derivative transactions ('the BCBS-IOSCO framework'). The BCBS-IOSCO framework requires the exchange of both variation margin and initial margin. Variation margin is collateral that is collected to reflect the current mark-to-market exposure resulting from changes in the market value of a non-centrally cleared derivative. Initial margin protects against the potential future exposure that may arise from future changes in the mark-to-market value of a non-

centrally cleared derivative during the period of time that is assumed to be required to close-out and replace the position following a counterparty default.

To complement the margin requirements, IOSCO in 2015 released *Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives*, which sets out additional qualitative risk mitigation practices to reduce risk in the non-centrally cleared derivatives market ('the IOSCO risk mitigation standards'). These standards require covered entities to adopt appropriate risk mitigation practices in the areas of trading relationship documentation, trade confirmation, valuation processes, portfolio reconciliation, portfolio compression, and dispute resolution.

The purpose of the BCBS-IOSCO reforms is to reduce systemic risk and limit contagion by ensuring the availability of collateral to offset losses caused by the default of a derivative counterparty and to improve risk management practices in order to promote legal certainty, transparency and timely dispute resolution. By requiring collateral to be posted against both current and potential future counterparty exposures for non-centrally cleared derivatives, as required for centrally cleared exposures, these reforms are also intended to promote central clearing.

In December 2016, APRA implemented margin requirements for non-centrally cleared derivatives based on the BCBS-IOSCO framework and additional risk mitigation requirements for non-centrally cleared derivatives transactions based on the IOSCO risk mitigation standards. The margin requirements commenced in March 2017, subject to a six-month transition period for the variation margin requirements and a multi-year phase-in timetable for the initial margin requirements. The risk mitigation requirements will take effect on 1 March 2018. APRA's framework included the power for APRA to approve substituted compliance in relation to the margin requirements of a foreign jurisdiction where those requirements are comparable in outcomes with the BCBS-IOSCO framework and the margin requirements in CPS 226.

2. Purpose and operation of the instruments

The purpose of the instrument is to revoke the existing CPS 226 and replace it with a new version of CPS 226.

The new version of CPS 226 specifies the foreign margin requirements or provisions that APRA has determined to be comparable in outcomes with the BCBS-IOSCO framework and the margin requirements in CPS 226, and permits an APRA-regulated institution to substitute compliance with those foreign margin requirements or provisions for compliance with the margin requirements in CPS 226. The instrument specifies the scope of transactions eligible for substituted compliance, and sets out a condition regarding intra-group transactions that applies in relation to some of the specified foreign margin requirements or provisions.

The new version of CPS 226 also makes a minor change to the list of eligible collateral that an APRA-regulated institution must collect as margin. This change limits eligible sovereign debt securities to those with a credit rating grade of three or better (previously, the limit was a credit rating grade of four or better). This

amendment was intended to better align APRA's margin requirements with the international framework.

3. Consultation

APRA initially consulted on the proposed introduction of margining and risk mitigation requirements for non-centrally cleared derivatives from June 2015 to October 2016. In February 2016, APRA released a discussion paper and a draft of CPS 226, which set out the proposed framework for margining and risk mitigation for non-centrally cleared derivatives. As part of this consultation, APRA proposed that it would grant substituted compliance following a positive assessment of the comparability of a foreign jurisdiction's margin requirements in respect of the BCBS-IOSCO framework and the requirements in CPS 226.

Twenty-two submissions were received in response to the February 2016 consultation. The primary concerns raised in these submissions were the proposed application of variation margin requirements to physically settled foreign exchange forward contracts and swaps, scope of application to related bodies of APRA related institutions, and commencement date for the risk mitigation requirements. Respondents also sought clarity on APRA's substituted compliance approval process. In October 2016, APRA released the final version of CPS 226, which included amendments to address the concerns raised in consultation. Regarding substituted compliance, in October 2016 APRA clarified that it would:

- initiate equivalence assessments with major foreign jurisdictions without requiring applications or requests from entities;
- assess the equivalence of foreign requirements on an outcomes basis compared to both the BCBS-IOSCO framework and the requirements in CPS 226; and
- publicly communicate any results of its equivalence assessments.

On 9 May 2017, APRA sought submissions on its proposed changes to CPS 226 to permit substituted compliance with respect to the margin requirements or provisions of 14 foreign bodies that APRA had assessed as comparable in outcomes to the BCBS-IOSCO framework and the requirements in CPS 226. APRA received three submissions from industry bodies and an individual. The submissions supported APRA's proposal to permit substituted compliance but requested clarification regarding the operation of aspects of the proposed substituted compliance regime, particularly regarding the scope of requirements and scope of transactions eligible for substituted compliance. In response to issues raised in submissions, APRA made further minor drafting changes to the draft revised CPS 226 that was released for consultation to clarify the operation of substituted compliance.

4. Regulation Impact Statement

APRA prepared a Regulation Impact Statement, which was lodged as supporting material for Banking, Insurance, Life Insurance and Superannuation (prudential standard) determination No. 1 of 2016 in December 2016. The Office of Best Practice

Regulation has advised that no further regulation impact analysis is required for the changes to CPS 226 made under the instrument.

5. Statement of compatibility prepared in accordance with Part 3 of the Human Rights (Parliamentary Scrutiny) Act 2011

A Statement of compatibility prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011* is provided at Attachment A to this Explanatory Statement.

Attachment A

Statement of Compatibility with Human Rights

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

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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* (HRPS Act).

Overview of the Legislative Instrument

This legislative instrument makes Banking, Insurance, Life Insurance and Superannuation (prudential standard) determination No. 1 of 2017, which revokes *Prudential Standard CPS 226 Margining and risk mitigation for non-centrally cleared derivatives* made under Banking, Insurance, Life Insurance and Superannuation (prudential standard) determination No. 1 of 2016, and determines a new *Prudential Standard CPS 226 Margining and risk mitigation for non-centrally cleared derivatives* (CPS 226).

CPS 226 applies to institutions in the banking, general insurance, life insurance and superannuation industries. Under CPS 226, an entity that actively transacts in non-centrally cleared derivatives is required to exchange collateral as appropriate to those transactions to manage the risk of counterparty default, and to have policies and procedures to manage its risks in undertaking that derivatives activity.

Human rights implications

APRA has assessed this Legislative Instrument and is of the view that it does not engage any of the applicable rights or freedoms recognised or declared in the international instruments listed in section 3 of the HRPS Act. Accordingly, in APRA's assessment, the instrument is compatible with human rights.

Conclusion

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