NEW ZEALAND BANKERS ASSOCIATION

# Submission

to the

# Prudential Supervision Department

on the

# Consultation Document: A New Zealand Response to Foreign Margin Requirements for OTC Derivatives

24 August 2017

## About NZBA

1. NZBA works on behalf of the New Zealand banking industry in conjunction with its member banks. NZBA develops and promotes policy outcomes which contribute to a strong and stable banking system that benefits New Zealanders and the New Zealand economy.

2. The following sixteen registered banks in New Zealand are members of NZBA:
   - ANZ Bank New Zealand Limited
   - ASB Bank Limited
   - Bank of China (NZ) Limited
   - Bank of New Zealand
   - Bank of Tokyo-Mitsubishi, UFJ
   - Citibank, N.A.
   - The Co-operative Bank Limited
   - Heartland Bank Limited
   - The Hongkong and Shanghai Banking Corporation Limited
   - Industrial and Commercial Bank of China (New Zealand) Limited
   - JPMorgan Chase Bank, N.A.
   - Kiwibank Limited
   - Rabobank New Zealand Limited
   - SBS Bank
   - TSB Bank Limited
   - Westpac New Zealand Limited.

## Background

3. NZBA welcomes the opportunity to provide feedback to the Reserve Bank of New Zealand (**RBNZ**) and the Ministry of Business, Innovation and Employment (**MBIE**) (together the **Agencies**) on the Consultation Document: A New Zealand Response to Foreign Margin Requirements for OTC Derivatives (**Consultation Document**).

4. The following submission provides feedback on the Consultation Document and expands upon our previous communications with you in relation to the subject of the Consultation Document.

5. References in this submission to 'paragraphs' are to paragraphs in this submission, unless the context requires otherwise.

6. If you would like to discuss any aspect of the submission further, please contact:

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## Executive summary

7. NZBA agrees that the current New Zealand law is a significant barrier to the ability of New Zealand entities to effectively and efficiently provide margin and that this failure could have a significant and adverse impact on New Zealand financial markets.

8. NZBA agrees that the most effective way of dealing with the issues in New Zealand law is through legislative change.

9. Rather than attempting "piecemeal" targeted legislative change, NZBA believes that the best approach is for separate standalone legislation which clearly overrides all insolvency and priority regimes. NZBA believes that this approach is the most consistent with the international approach, in particular, with the Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions **FSB Key Attributes**), the Basel Committee on Banking Supervision (**BCBS**) and the Board of the International Organization of Securities Commissions (**IOSCO**), Margin requirements for non-centrally cleared derivatives (**BCBS and IOSCO Requirements**) and the approach in Australia.

10. However, if the Agencies believe that standalone legislation would require further consultation and delay legislative change, then NZBA would prefer to proceed with targeted legislative change rather than risk delay. However, it would also welcome a discussion on whether standalone legislation was possible after the present consultation process.

11. While NZBA agrees with most of the suggestions for legislative change in the Consultation Document it believes that:

    a. the scope of derivatives covered by the proposed amendments is too narrow and should include all cleared and uncleared derivatives, regardless of whether there is a regulatory requirement to post margin;

    b. security over accounts receivable should have priority over all creditors (including Inland Revenue) when provided as collateral for margin for derivatives contracts; and

    c. the transfer of collateral for variation margin should be deemed **not** to be a security interest for the purposes of the Personal Property Securities Act 1999 (**PPSA**).

12. Following feedback from our meeting with the Agencies, NZBA has sought to identify other matters which have often been qualifications in opinions given to the International Swaps and Derivatives Association (**ISDA**). These include:

    a. issues with dematerialised securities;

    b. concerns about whether netting provisions apply if the bank also has a general security agreement; and

c. concerns about clearing members' ability to close out swap positions for covered counterparties.

13. The first two are technical issues where it would be helpful to clarify the law rather than change it. The close out issue is another, arguably, unintended consequence of the statutory management regime which could be clarified in legislation.

14. If it were possible without impacting the timeframe for legislative change (eg by requiring additional consultation), NZBA believes it would be helpful if these issues could also be addressed in legislation.

## Primary Submission: NZBA supports legislative change to protect security over initial margin

### Legislative change is necessary

15. NZBA supports legislative reform that would remove certain legal impediments to New Zealand banks posting initial margin to secure obligations in relation to uncleared derivatives.

16. NZBA also believes that legislative reform is needed as a matter of urgency because of the application of international rules in relation to uncleared derivatives that would affect the New Zealand subsidiaries of the large Australian banks. In particular:

    a. from 1 September this year, one large bank will already be caught by the requirements to post initial margin; and

    b. It is likely that a number of other banks will be effected from 1 September 2018.

17. As the affected New Zealand banks will not be able to provide satisfactory initial margin in New Zealand, due to the lack of legal certainty relating to the ability to enforce that security in certain circumstances, those banks will be required to find "workarounds" until the law in New Zealand is clarified, primarily by transacting through their parents in Australia. Those workarounds, however, are only interim measures limited by other regulatory requirements, like interconnected lending limits.

18. While less urgent, the impact of the new initial margin rules will likely also affect all other banks operating in New Zealand, including domestically owned banks. This is because international counterparties will almost certainly require those banks to provide initial margin regardless of whether it is legally required.

19. As a result of initial margin being required from New Zealand banks, there is a risk that, as the Agencies point out in their Discussion Document, this will lead to:

> *A reduction in New Zealand's banks' access to offshore derivatives, products and counterparts [which] could lead to an increase in concentration risks, hedging complexities and funding costs. In particular, the ongoing viability of foreign funding programmes, which rely on the use of non-centrally cleared basis swaps to hedge associated foreign currency risks and currently make around 15% of banking sector non-equity funding, maybe threatened.*

20. To address these issues, NZBA believes that reform is needed urgently. It supports a legislative approach as the only way in which it believes these issues can be effectively dealt with.

21. NZBA believes the issue identification, impact and areas for reform identified in the section on a targeted legislative change are appropriate, except NZBA members believe:

a. the scope of derivatives covered by the reform is too narrow (and, in particular, should not be limited to circumstances where the regulatory requirements in New Zealand or any other jurisdiction require the initial margin to be posted);

b. the changes proposed to Schedule 7 of the Companies Act are too narrow, and, in particular, that security interests over accounts receivable should have priority over all preferential claims;

c. there is a rationale for amendments to deal with concerns with the impact of voidable transactions on netting and margin arrangements – particularly if accompanied by the same sorts of protections that have been included in Australia; and

d. that the proposed change to the PPSA, while desirable, should, in fact, confirm the market position, namely that the transfer of collateral does not create a security interest under the PPSA.

22. NZBA also has a preference for standalone netting legislation to align with international best practice. This would mitigate the risk that further legislative change may be required to address issues identified in the future that were either missed in the current reform or arose from future changes in the global financial markets or international regulatory regimes for derivatives. That legislation should prevail over all other legislation to provide certainty, and for consistency with the BCBS and IOSCO Requirements.

23. Notwithstanding NZBA's preference for standalone netting legislation, it would not want that approach to compromise the need for urgent legislation. In effect, it would prefer targeted legislative change now over greater certainty and international alignment which took longer to implement.

## Suggested amendments to the proposed targeted legislative change

24. As noted above, NZBA believes the issue identification, impact and areas for reform identified in the section on a targeted legislative change are appropriate, other than in relation to the matters set out below.

### Scope of Derivatives covered by the exception

25. NZBA believes that the proposed reforms to remove the impediments to posting initial margin should cover all derivatives not just derivatives where "the regulatory requirements in New Zealand or any other jurisdiction require the margin to be posted". NZBA believes limiting the exceptions to circumstances where New Zealand or international regulatory requirements apply will only add confusion and complexity to the banks seeking legal opinions in connection with the posting of initial margins. This is particularly so where the rules of another jurisdiction require the margin to be posted and where New Zealand lawyers will not be qualified to opine on those regimes and may need to rely on either overseas lawyers or make assumptions in relation to overseas jurisdictions.

26. It would also have some undesirable consequences, including:

    a. that changes in offshore laws could have wide-ranging effects on the protections afforded to holders on New Zealand law governed security; and

    b. perverse incentives for deals to be inefficiently structured to be caught by offshore requirements and thereby earn relief from domestic laws.

27. Furthermore, as Buddle Findlay explained in its letter to the RBNZ of 17 March 2017 on margining and risk mitigations in non-centrally cleared derivatives ("**March 2017 Letter**").

> *In our view, the carve out should cover margin arrangements given in relation to both cleared and uncleared derivatives.*
>
> *Our discussions to date have focused on uncleared derivatives because it is the new derivatives laws that are likely to cause international counterparties not to trade with New Zealand counterparties. However, it would be perverse for security arrangements in relation to uncleared derivatives to have protection without that same protection being provided for cleared derivatives. It is generally accepted that cleared derivatives create less global systemic risk, and anything that incentivised counterparties to use uncleared derivatives over cleared derivatives would be creating a poor incentive.*

28. NZBA supports this view and notes that there was no discussion on the rationale for limiting the scope of legislative reform to initial margin required for regulatory reasons in the Consultation Document.

29. In short, NZBA believes that the proposed exceptions and changes should apply to all derivatives – cleared and uncleared.

## Companies Act Priority

30. NZBA believes that to properly address the issues created by Schedule 7 of the Companies Act, it is important to ensure all forms of common financial collateral are treated the same and, in particular, where that financial collateral is "accounts receivable" for PPSA purposes, it should have priority over all preferential claims listed in clause 1(2)-(5) of Schedule 7 of the Companies Act. This should include priority over claims of the Commissioner of Inland Revenue. We believe that, without a complete exception, there will be qualifications to legal opinions which will undermine much of the benefit of the exception which is being proposed.

31. As Buddle Findlay pointed out in the March 2017 Letter, to the extent there were any concerns about the scope of such an exception, New Zealand could consider the same sorts of safeguards that were adopted in Australia. In particular, that a secured counterparty could not rely on protection if it acted in bad faith, had reasonable grounds for believing that the counterparty was insolvent, did not provide valuable consideration or did not change its position in reliance on the transaction.

32. NZBA still believes that this is the best approach. It also believes the same approach could be applied to limit the operation of the voidable transaction provisions in the Companies Act.

### PPSA Changes

33. NZBA supports a change to the PPSA which clarifies the position in relation to whether an outright transfer of collateral creates a security interest under the PPSA.

34. However, NZBA believes that this is best addressed by providing clarity in the PPSA that the outright transfer of collateral does **not** create a security interest under the PPSA (and not what has been proposed, namely that it does).

35. This position is consistent with that which most of the banks in New Zealand have adopted and consistent with the view of most of the major law firms that have advised those banks. It is also consistent with the approach which has been taken in Canada in relation to a similar provision in its Personal Property Security Act. Furthermore, we understand that no bank currently registers financing statements against other banks in relation to the outright transfer of collateral. NZBA members have a strong preference not to have to register financing statements against each other.

36. Furthermore, if the law was clarified in a way which was contrary to the approach adopted by the majority of the New Zealand market, then there would be issues about collateral which had previously been posted and for which financing statements were not registered. In effect, banks would have to undertake the exercise of registering financing statements for previously transferred collateral or have this "grandfathered" somehow in the legislative change.

## Separate Legislation

37. NZBA believes legislative change is urgently required to address problems its members may have in posting initial margin. NZBA is grateful for the work that Agencies have done to address the problems and to produce the Consultation Document. If the only way that legislative change can be achieved quickly is through targeted legislative change then NZBA supports this approach.

38. However, the Consultation Document does raise the possibility of a standalone Netting Act and specifically asks for feedback on whether targeted changes are preferable to a standalone Netting Act.

39. NZBA's preferred approach would be to deal with all netting and derivatives related issues through separate standalone legislation. The legislation does not need to be complex but should recognise that, as a major participant in global derivatives markets, laws dealing with netting and collateral supporting derivatives should prevail over all other laws.

40. The key benefits of standalone legislation are:

a. it provides certainty and clarity for financial markets. Access to such markets is vital to New Zealand's financial system;

b. it is consistent with Australia, where the market participants and legal systems are very similar. We could benefit from the extensive work done by Australia's regulators, officials, banks and legal profession in getting the legislation right (and where the super priority prevails over depositor priority and the deposit insurance scheme – both significantly bigger policy decisions than anything required in New Zealand);

c. it minimises the risk for any further legislative change as other issues arise or are identified or as changes are required to follow to international practice; and

d. it would make the required legal opinions cleaner and more simple.

41. NZBA is concerned that, to date, reform in New Zealand has been undertaken on a piecemeal basis, with:

a. the Banking and Insolvency (Netting and Payments Finality) legislation in 1998 originally introduced to provide some certainty to netting arrangements in New Zealand for companies,

b. the Companies Amendment Act 2016 being introduced to include certain bodies which were not companies within the netting provisions in the Companies Act (such as partnerships, corporate and unincorporated bodies of persons as well as other entities to which the liquidation provisions of the Companies Act applied, such as, for example, Crown entities); and

c. Regulatory Systems (Commercial Matters) Amendment Act 2017, which primarily dealt with the issue of mutuality in respect of trusts (confirming, effectively, the enforceability of netting with trusts).

42. While NZBA acknowledges, and is grateful for, the support of the Agencies in making changes in 2016 and 2017, it does highlight the fact that netting reform has to date had to rely on urgent support from Agencies to address issues.

43. This approach by its nature has been cumbersome and has, for example, meant that the Companies Act has now been extended to apply to entities to which it was never originally intended. It makes legal opinions more complex and expensive.

44. While NZBA believes the recent reforms are likely to have addressed most of the entities for whom there was uncertainty in relation to netting, it cannot discount the possibility that there are other entities that could be affected.

45. NZBA believes that there are useful templates which could be used for a standalone Netting Act in New Zealand that should be considered. ISDA, for example, issued a template act which has been used in a number of jurisdictions internationally as the basis for netting legislation.

46. Many countries have included provisions protecting close out and margining rights in legislation dealing with payment systems (including countries as diverse as Australia and Samoa). The provision in the Payments Systems and Netting Act 1998 (Australia) could be a useful comparison point for New Zealand legislation. Given that the major banks affected by derivatives issues are the large Australian banks operating in New Zealand, there is some benefit in ensuring harmony between the two legal systems in relation to netting by importing as much of that Act as is relevant into New Zealand legislation.

47. Indeed, one of the objectives of Closer Economic Relations with Australia was to deliver substantially the same regulatory outcomes in both countries in the most efficient manner.[1] While we believe a Netting Act would largely codify the law as it has been passed to date in New Zealand, the netting legislation should also override all other legislation in order to give clear effect to its provisions. This is the common international approach and is consistent with the BCBS and IOSCO Requirements, FSB Key Attributes and the Australian approach.

48. If NZBA's preferred approach was adopted, it believes the only change from the existing law (with the additional targeted changes) would be "super priority" for derivatives netting and security arrangements for derivatives. In practice, this has been the focus of all legislation protecting rights under derivatives to date but without taking the final step of acknowledging it. NZBA believes the risk of any unintended consequences to our insolvency laws is very low with relatively low impact (given all the key legislation has been considered to date) whereas the risk of an inadvertent omission undermining the legal position in New Zealand, while low, could have a serious adverse impact on New Zealand banks operating in global markets.

49. If standalone legislation cannot be achieved now, NZBA would welcome a discussion on how that could be achieved after the present consultation process. In particular, NZBA would like to understand what extra consultation would be required if that act were to override all other legislation, in the manner discussed in this submission.

## Other Issues

50. At your suggestion we have sought to identify other issues which we believe may be worthy of consideration in special derivatives legislation. Other helpful changes we have identified are:

    a. Clarifying the provisions of the PPSA that apply to "dematerialised" securities. Currently there is an argument that only "first tier" holders of dematerialised securities can take possession of their securities to perfect their security interest. This means that the parties that hold, for example, through custodians arguably may not be able to perfect their security interest. Although the better view in the

[1] Memorandum of Understanding Between the Government of New Zealand and the Government of Australia on Coordination of Business Law.

legal market seems to be that the wording of the PPSA does extend to second and third tier holders of dematerialised securities, it is acknowledged that there is a lack of clarity in the PPSA, which would be helpful to fix, especially as dematerialised securities could end up being used as collateral for initial margin.

b. Changes to section 310B(2) of the Companies Act to allow banks to take General Security Agreements over counterparties without jeopardising the statutory priority for netting under ISDA agreements.

c. Provisions which would enable clearing members to close out transactions which they had undertaken for "covered members" in global clearing houses immediately after those entities had gone into statutory management. Currently clearing members may not be able to close out transactions that they have undertaken as agent for covered counterparties, such as New Zealand banks, because of the moratorium provisions in statutory management legislation or potentially "port" them to their own account for the same reason. This potentially leaves them unable to close out those banks' positions to determine their final exposure (something probably not in the interest of the bank in statutory management either).

51. While not critical, if these changes could be addressed in legislation now, it would remove uncertainty (and potentially the need to fix issues later in legislation if Courts' decisions did not uphold the market view).

## Appendix 1 - Targeted Consultation Questions

1) Do you agree with this assessment of the likely impact of foreign margin rules on New Zealand entities? Are there risks to New Zealand entities that have been overlooked or mischaracterised?

52. NZBA agrees with the Agencies' assessment relating to the likely impact of foreign margin on New Zealand entities.

53. NZBA believes there is an inherent risk, albeit small, posed to New Zealand entities arising from targeted legislative amendment by the Agencies, as opposed to specific legislation that would prevail over insolvency and priority regimes.

2) Do you agree that current New Zealand law is a significant potential barrier to New Zealand entities' ability to effectively and efficiently provide margin?

54. NZBA agrees with this statement.

55. In particular, the current moratorium provisions present in New Zealand law (outlined at paragraph 51(i)) are potential significant barriers to security arrangements (relating to initial margin) being found enforceable. There are also priority issues under the PPSA. Both of these issues are discussed further in the body of our submission.

3) Does the proposed exception cover the enforcement of security interests in the right circumstances? Are there better ways of defining the scope of the exception?

56. No, there are better ways of defining the scope of the exception.

57. As currently stated, the scope of the proposed exception is too narrow, the statutory protection should apply not just to uncleared derivatives, but also to cleared derivatives. This is discussed in more detail in the body of our submission.

58. Given we have the opportunity to amend the law surrounding these issues, it makes sense to fix any identified issues, rather than just the three most significant (as outlined at paragraph 50).

59. An example is when the initial margin posted is an investment security. This is because, if posted through a clearing system (which is not currently covered by the proposed amendment), the initial margin is likely to be a dematerialised security. Subsequent difficulties may arise in relation to availability of this security for the secured party in a bankruptcy issue – especially if it is held through a second or third tier holder.

4) Do you agree that New Zealand's moratorium provisions are a significant potential impediment to New Zealand entities' compliance with foreign margin requirements?

60. Yes, as described in our response to question 2 above.

5) Do you agree that the proposed changes to moratorium provisions are necessary and sufficient to address this potential compliance barrier?

61. Yes, although we would like to understand how the temporary stay will now align with international practice and what change you propose to make to the Open Bank Resolution policy, which, because derivatives are not pre-positioned, assumes they are subject to a permanent moratorium. Presumably tailored amendments to that policy should now be made (as seems to be foreshadowed in the Consultation Document).

6) Do you agree that Schedule 7 preferential claims are a significant potential impediment to New Zealand entities' compliance with foreign margin requirements?

62. Yes.

7) Do you agree that the proposed changes relating to preferential claims are necessary and sufficient to address this potential compliance barrier?

63. Yes, provided that Inland Revenue and any other preferred parties also have claims subordinated (as discussed in paragraph 69 of the Consultation Document).

64. Having a requirement that only some entities are required to subordinate their claims means there will be continual legal uncertainty about the ranking of a counterparty's claim. Overseas counterparties will have to assess each New Zealand party they transact with on a case-by-case basis to determine which preferential creditors might pose an issue relative to the counterparty's claim. This could have the effect of deterring overseas counterparties from transacting with New Zealand entities. As you point out in the Consultation Document, this is actually very low risk for creditors.

8) Do you agree with the way we are proposing to protect secured derivative creditors from losing their priority interest to Schedule 7 preferential claims?

65. Yes, provided the necessary entities have agreed to subordinate their claims (as outlined in our response to question 7).

### 9) Do you agree that the proposed changes to priority rules in the PPSA are necessary and sufficient to address the potential compliance barriers identified?

66. NZBA agrees that the proposed changes are necessary to address the potential compliance barriers identified, but we disagree that the changes are sufficient to achieve the purpose proposed.

67. In paragraphs 77 and 78 of the Consultation Document, the Agencies indicate that there is uncertainty in the industry around whether transfer of collateral creates a security interest. The Agencies then suggest that amendments should be made to clarify that the posting of margin creates a security interest.

68. NZBA submits that it is well established in the industry that posting margin does not create a security interest, although the issue is not completely free from doubt. Legislation should be amended to reflect this position, not the contrary. It is not at all common practice for banks to register financing statements following the posting of margin and changing this requirement will impose an unnecessary compliance cost on the parties involved.

69. Further, it would introduce a new problem in that uncertainty would exist in relation to all of the transactions in existence where margin has already been posted and no financing statements were registered.

70. This is discussed further in the body of the submission.

### 10) When implemented together, do you believe the changes set out under Option B will be sufficient to address impediments to creating and enforcing rights as a secured party under New Zealand law?

71. Yes, to some extent. NZBA believes that the proposed changes to the PPSA are incorrect (see discussion above), in addition to the scope of the exception being too narrow.

72. NZBA is also concerned about unforeseeable consequences that may arise further down the line from the targeted amendments. If a stand-alone statute were enacted it could serve as a 'catch-all' piece of legislation, ensuring that all relevant legislation can be provided for.

11) If you believe the changes set out under Option B are not sufficient, please describe additional legislative changes necessary for compliance. You should provide a rationale for any proposed changes.

73. A stand-alone netting act is going to be the most efficient.

12) Do you believe there may be knock-on implications stemming from Option B (legislative change) that have been overlooked or mischaracterised?

74. NZBA has ongoing concerns that targeted amendments may have unintended consequences which could require further amendment later on.

13) If the proposed legislative changes in Option B are adopted, are there any additional safeguards they should be subject to?

75. No.

14) Do you share the Agencies' preliminary view that, on balance, targeted amendments to existing legislation may be preferable to a standalone Netting Act for New Zealand?

76. No. NZBA submits that a stand-alone would be preferable – albeit not at the expense of the timetable for change.

77. The only issue requiring additional consultation would be the fact that the legislation would prevail over all insolvency and priority legislation, like the PPSA. Given this is consistent with international practice and largely reflects the intention of what has happened so far, we believe it should not be contentious.