24 August 2017

Prudential Supervision Department

Reserve Bank of New Zealand

PO Box 2498

Wellington 6140

MarginConsultation@rbnz.govt.nz

Re: Submission on Consultation Document: A New Zealand Response to Foreign Margin Requirements for OTC Derivatives

We are submitting this paper as a joint view of the consultation document from an end-user perspective. Both ACC and NZSF use derivatives extensively for hedging, portfolio completion and efficiencies in obtaining exposures.

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?

Whilst many of the concerns facing New Zealand banks may overlap with end-users of derivatives, the description in the consultation document of the impact of foreign margin requirements is very much from the banks' perspective. Large end-users will also be impacted by the foreign margin requirements. Over time there may be more new Zealand businesses reaching the threshold whereby they too will become caught by foreign requirements. It is essential that end-users can properly hedge their relevant exposures and that New Zealand businesses have access as required to the international swaps and derivatives markets. In addition to hedging requirements, swaps and derivatives often provide easy and cost effective ways to invest in various products and for NZSF swaps and derivatives are an essential part of portfolio completion/treasury functions.

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?

Yes. Counterparties will always look at the market opinions on enforceability and anything out of the ordinary is of concern. In the specific case of IM, the need for collateral to be readily available to the non-defaulting party on default of the defaulting party means that a New Zealand counterparty simply cannot currently meet the IM requirements.

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?

The exception is very narrow. For the smooth functioning of the derivatives markets and to properly achieve the financial stability that the G20 and FSB seek to achieve through margining, it is our view that all collateral arrangements should be caught, regardless of whether such margining is mandatory. Thresholds for when margining applies, and exemptions from the rules, are somewhat arbitrary and counterparties that voluntarily agree to margining arrangements should be applauded rather than penalised for their conservative, risk averse approach to counterparty exposure. NZSF is caught by the margin rules of some foreign jurisdictions and is exempt from the margin rules in other foreign jurisdictions. Despite any exemption NZSF's counterparties may require Initial Margin to be exchanged, or NZSF may voluntarily elect to exchange Initial Margin, whether for prudent counterparty risk management, market access or other commercial reasons. Any exemption that applies only where the margin is required by regulation is unhelpful and will lead to much uncertainty.

The foreign margin requirements represent current best practice and those not caught should be free to adopt such best practice without being compromised on enforcement issues. A clear position with equal treatment for all participants in this space is essential. Further, all products should be covered whether they are OTC or exchange traded swaps, derivatives and futures, cleared or non-cleared.

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

Yes. New Zealand counterparties cannot currently meet foreign IM requirements.

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

We agree that the changes are necessary. However, the sufficiency of the changes will come down to precise drafting. Provided changes cover all counterparty types and all collateral arrangements then the proposed changes should suffice.

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

The difference in treatment *vis a vis* collateral in the form of securities as opposed to cash seems arbitrary in this context. We agree that NZ counterparties should not be hindered by legislation when choosing the form of collateral to provide.

The form of collateral provided should be influenced by price and credit considerations rather than different treatment under the preferential creditors regime.

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

Subject to our view that the circumstances described should be widened to include all collateral and all counterparty types for all swaps, derivatives and futures contracts (see our answer to question 3), it is our view that collateral provided in the form of cash should be afforded the same treatment and protection as collateral provided in the form of securities (including with regard to other claims such as Inland Revenue claims).

Again, we make the point that this is not just an issue for banks so end-users should also be considered. Many end-users do not hold a stock of securities which qualify as acceptable collateral nor do they have the sophistication to run an optimised collateral program: many have no choice but to post cash as margin. Whilst it is fair to say that many in this camp would not be caught by the margin requirement thresholds, the New Zealand legislation should be robust enough to be future proofed and should also protect (and encourage) voluntary margining arrangements.

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?

Subject to our comments in relation to questions 6 and 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?

Again, the sufficiency of the change will come down to precise drafting. We would also reiterate our view that the circumstances should be expanded to include all collateral and all counterparty types for all swaps, derivatives and futures contracts (see our answer to question 3).

Regarding the issue of whether an outright transfer of collateral creates a security interest, we absolutely disagree with the approach. We urge you to seriously re-consider this view. We would welcome a statement in section 17 of the PPSA confirming, for the avoidance of doubt, that an outright transfer of collateral does **not** create a security interest. Not only would this be consistent with the description of title transfer set out in paragraph 26 of the consultation document, it would be consistent with international market practice. The technical analysis of a title transfer arrangement is beyond the scope of this submission but we would be happy to discuss this in more detail if required. At this stage we would just point out that the ramifications of a statement that title transfer does create a security interest would not only completely undermine the nature of the ISDA English law Credit Support Annex but would also go well beyond the derivatives market. By way of example, the repo and stock lending markets are based on a true sale analysis of the title transfer which occurs under those transactions. It is of utmost importance that the transactions are not re-characterised as secured loans.

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 counterparty under New Zealand law?

Subject to our view that the circumstances described should be widened to include all collateral and all counterparty types for all swaps, derivatives and futures contracts (see our answer to question 3), it is our view that the changes are sufficient in the time frame available. However, we do not believe that a piecemeal approach is the best option. Piecemeal legislation is hard to navigate and to explain to foreign counterparties. It also opens the door to issues falling between the cracks or being missed. We would welcome an overarching statute to deal with enforcement of both collateral and netting arrangements in the derivatives space; similar to the approach taken in Australia. Such statute would need to override existing legislation rather than be subject to existing legislation to ensure that market participants could look at one piece of legislation to determine the legal position with regard to derivatives collateral and netting arrangements.

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

Whilst we agree that the additional issues under New Zealand law set out in paragraphs 79-84 are not strictly necessary to allow for IM requirements to be met, we do think that they are issues which should be addressed. By way of example, being able to enforce a security interest implies that the non-defaulting party should be made whole through such security. The fact that the non-defaulting party faces uncertainty regarding claw-back is not acceptable. The non-defaulting party would need to set aside funds "just in case". This is not the same as being made whole and walking away. An overarching statute (as proposed in our answer to question 10) could deal with all of these issues.

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

We believe that a piecemeal approach will always run the risk of overlooking issues. As set out in our answers to questions 10 and 11, we would favour an overarching statute dealing with all derivatives collateral and netting issues.

We would also make the point that margining of derivatives will not undermine financial stability. The desire for safer and more transparent markets was the very reason why these margin requirements have been implemented by the G20 nations.

New Zealand banks and large companies entering into derivatives with foreign counterparties will be better protected now against a counterparty default than they were prior to the international margin reforms. That has the knock-on effect of improving financial stability in New Zealand.

Further, if we wish to ensure that New Zealand companies can continue to participate in international markets, then New Zealand needs to provide equivalent legal protections and certainty for foreign counterparties. New Zealand's own financial stability cannot be viewed in isolation and a suggestion that measures to improve financial stability internationally could undermine New Zealand's own financial stability is at odds with New Zealand being an active member of the international community.

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

No. However, we suggest that the Option B changes are implemented but considered to be interim measures and that an overarching statute dealing with derivatives collateral and netting be the end goal.

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?

No. A standalone statute which covers all derivative collateral and netting issues is preferable. However, in the time frame, we would support the targeted amendments as an immediate but interim measure.