

16 June 2022

Ms. Renée Roberts
Executive Director Policy & Advice
Australian Prudential Regulation Authority
By email: Renee.Roberts@apra.gov.au

Re: Impact of PRC Financial Derivatives Law on APRA covered entities under APRA Prudential Standard CPS 226

Dear Ms. Roberts,

The International Swaps and Derivatives Association (**ISDA**) and the Australian Financial Markets Association (**AFMA**) welcome the opportunity to provide comments to the Australian Prudential Regulation Authority (**APRA**) on the impact of recently adopted changes to the law on netting in the People's Republic of China (**PRC**). This will have an impact on the obligations of APRA covered entities that are subject to margin and risk mitigation requirements under the APRA Prudential Standard CPS 226 (**CPS 226**).

As you may be aware, the Standing Committee of the National People's Congress voted on 20 April 2022 to adopt the PRC Futures and Derivatives Law (**FDL**). The FDL will provide express recognition for the enforceability of close-out netting provisions and the single agreement concept commonly used in OTC derivatives documentation under PRC law. The FDL is expected to come into force on 1 August 2022.

ISDA expects to publish opinions on the enforceability of netting and collateral arrangements under PRC law (**ISDA PRC Opinions**) shortly after the FDL comes into force.

1. Background

Prior to the FDL being adopted and the ISDA PRC Opinions being published, APRA covered entities rely on the requirements set out in Paragraph 70¹ and Paragraph 71² of CPS 226 to manage exposures and set appropriate internal limits when trading with a PRC counterparty.

Following the publication of the ISDA PRC Opinions, APRA covered entities will need to go through their respective internal governance process to decide if, and under what conditions, they can apply netting with PRC counterparties.

2. Practical challenges with implementation

An APRA covered entity will face practical challenges in implementing the requirements of CPS 226 once Paragraph 70 and Paragraph 71 of CPS 226 cease to apply. These include:

2.1. Application of APRA Prudential Standard APS 112 (APS 112) to eligible netting agreements and legal opinions

Under APS 112, an APRA covered entity will need to obtain a written and reasoned legal opinion that concludes that in the event of default, liquidation, bankruptcy, or other similar circumstances of a PRC counterparty, that the relevant courts and authorities in the PRC would find the APRA covered entity's exposure is limited to the single net sum determined in the netting agreement.

Following the publication of the ISDA PRC Opinions, each APRA covered entity will need to go through its internal governance process to determine if it is able to apply netting to derivatives transactions documented under an eligible netting agreement with a PRC counterparty.

2.2. Identification of relevant PRC counterparties that are impacted by CPS 226

When PRC Opinions become available, an APRA covered entity will need to engage with its PRC counterparties to assess whether a PRC counterparty is potentially a covered counterparty under CPS 226 and if so, whether a VM CSA and/or IM CSA is required.

¹ Paragraph 70 of CPS 226 provides that an APRA covered entity is not required to exchange variation margin or post or collect initial margin if there is any doubt as to the enforceability of the netting agreement upon insolvency or bankruptcy of the counterparty. An APRA covered entity must monitor such exposures and set appropriate internal limits and controls to manage its exposure to such counterparties.

² Paragraph 71 of CPS 226 provides that an APRA covered entity is not required to exchange variation margin or post or collect initial margin where collateral arrangements are questionable or not legally enforceable upon default of the counterparty. An APRA covered entity must monitor such exposures and set appropriate internal limits and controls to manage its exposure to such counterparties.

In looking to establish whether a PRC counterparty falls under the relevant threshold for margin requirements, it would be helpful if APRA could provide guidance on the following:

- Whether the relevant reference period of March, April and May and qualifying threshold for VM/IM should be applied after the date that an APRA covered entity has completed its internal governance review of the relevant PRC netting and collateral opinions on the enforceability of close-out netting arrangements in the PRC.

Outreach to PRC counterparties will take time to complete given that the PRC counterparties will be receiving similar queries from other financial institutions from other jurisdictions that are subject to similar margin requirements such as the United Kingdom, European Union, Switzerland, Japan, Hong Kong and Singapore. It is expected that there will be limited capacity at each PRC counterparty to respond at speed and scale to all documentation and negotiation requests and some PRC counterparties have already been in touch with financial institutions to communicate this. Chinese counterparties also continue to be affected by Covid lockdowns, which brings additional operational and resourcing challenges. Further challenges relating to negotiation of documentation with PRC counterparties is set out below.

2.3. ation of margin documentation with PRC counterparties

After an APRA covered entity has completed the review of the ISDA PRC Opinions and has identified the PRC counterparties who are subject to VM and/or IM requirements, such APRA covered entity will need to initiate negotiations with the relevant PRC counterparties on VM and/or IM documentation. Additional documentation to cover risk mitigation standards under CPS 226 may also need to be addressed. APRA covered entities will face the following challenges:

- **Limited experience with VM and/or IM documentation:** Historically, PRC institutions traded with each other predominantly on lines of credit under an ecosystem in which credit events rarely occurred. As a result, the level of expertise, efficiency of processes, and capacity of infrastructure to manage collateral in the PRC is not as developed when compared to other large capital markets. The PRC regulators are yet to implement the WGMR framework for non-centrally cleared OTC derivatives, and a large proportion of onshore non-centrally cleared OTC derivatives transactions remain uncollateralized. Not all PRC counterparties have the relevant experience in negotiating VM and/or IM documentation with financial institutions and will need more time to complete this as they have not been involved in prior phases for VM and/or IM implementation.

- **Initial margin – Set-up of offshore custodian arrangements:** As initial margin requires the establishment of custody arrangements with an offshore custodian such as Euroclear or Clearstream, a PRC counterparty that does not have existing custody arrangements with an offshore custodian will need additional time to set this up. Prior experience in documentation negotiations for IM Phase 1-5 has shown that there are capacity constraints at custodians with the number of counterparties they are able to onboard within a short time frame.
- **Initial margin – Posting local currency denominated securities:** If a PRC counterparty intends to post CNY³-denominated securities that are held with onshore PRC custodians as initial margin, it is not clear at this point how this can be managed as foreign exchange controls apply in the PRC and there are no custodians in the PRC that are familiar with the IM requirements under CPS 226. Setting up a local custodian arrangement in a new initial margin jurisdiction often requires significant lead time. If PRC counterparties plan to post CNY-denominated securities as initial margin, in addition to documentation and operational issues, a review will also need to be undertaken to determine if the proposed onshore custody arrangements can comply with the relevant margin rules.
- **IM Phase 6:** The FDL is expected to come into force on 1 August 2022 which will be followed by the 1 September 2022 deadline for the implementation of Phase 6 IM. This is expected to put a huge strain on the ability of teams across all institutions and custodians to complete relevant documentation.

3. Application of CPS 226 to a Level 2 entity of an APRA covered entity

Any APRA covered entity that has a Level 2 entity in the PRC will need to put in place the relevant VM and/or IM documentation to remain compliant with CPS 226.

In the case of an APRA covered entity, this means that its PRC incorporated bank subsidiary will need to put in place VM and/or IM documentation with the PRC counterparties that it trades with.

This issue presents specific challenges for Australian APRA covered entities:

- **NAFMII Master Agreement:** PRC law imposes mandatory requirements that the NAFMII Master Agreement must be used to document transactions in CNY-denominated derivatives between two onshore entities both of which are participants of the domestic interbank market in the PRC. The NAFMII Master Agreement is drafted in Chinese language only and is used to document CNY-denominated derivatives transactions that are entered into between two PRC counterparties. ISDA does not publish or support any

³ “CNY” means the lawful currency of the People's Republic of China.

documentation in relation to the onshore PRC market as it does not have the mandate to do so under PRC law.

- **No legal opinions commissioned by NAFMII:** Unlike ISDA, NAFMII has not commissioned or established a process for commissioning legal opinions on the enforceability of netting and/or collateral arrangements under the NAFMII Master Agreement. This means that separate netting and collateral opinions will need to be commissioned by industry participants themselves to determine if netting can apply to the NAFMII master agreements.
- **No VM and/or IM documentation commissioned by NAFMII:** It is not clear if NAFMII intends to publish any documentation which would enable two PRC incorporated entities to be compliant with the margin requirements of a country located outside of the PRC.
- **No local custodian for onshore IM arrangements in the PRC:** There are no local custodians in the PRC that are familiar with how to establish IM arrangements that can comply with CPS 226.
- **No recognition of offshore margin requirements applying between two PRC entities:** There is no equivalent requirement outside of Australia or in the PRC that VM and/or IM documentation, which is compliant with CPS 226 requirements be applied between two PRC incorporated entities. For example, margin requirements under UK, EU, Switzerland, Hong Kong and Singapore laws do not require subsidiaries that are located in the PRC and which transact with PRC counterparties only to enter into [VM and/or IM] arrangements that are compliant with their home jurisdiction requirements.

Specific consideration should be given as to whether the obligation for an APRA covered entity to post or collect initial margin can be suspended until such time as collateral arrangements are available in the PRC which can meet the initial margin requirements under CPS 226.

For reasons set out above, ISDA/AFMA respectfully requests that (i) APRA exercise its supervisory powers in relation to CPS 226 in a proportionate and risk-based manner for a period of at least 18 months, taking account of the challenges facing APRA covered entities; (ii) APRA provide guidance on how the relevant reference period of March, April and May and qualifying threshold for VM/IM should be applied to PRC counterparties; and (iii) a PRC subsidiary of an APRA covered entity will not be required to post or collect initial margin with a PRC counterparty where NAFMII does not have the relevant documentation or custodial and operational arrangements in place to satisfy the applicable requirements in CPS 226.

Thank you for your consideration of this request. The Associations would be pleased to discuss this request further at your convenience. Please do not hesitate to contact Jing Gu, Head of Legal, Asia Pacific, ISDA at JGu@isda.org or David Love, General Counsel and International Adviser, AFMA at dlove@afma.com.au.

Yours sincerely,

Handwritten signature of Jing Gu in black ink.

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