23 August 2013

Mr Eamonn Corrigan
Director
Australian Energy Market Commission
Sydney South NSW

By email: aemc@aemc.gov.au

Dear Mr Corrigan

NEM Financial Resilience Review Stage 1 - Retailer of Last Resort

The Australian Financial Markets Association (AFMA) welcomes the opportunity to comment on the NEM Financial Resilience Review Stage 1 - Retailer of Last Resort consultation. The AFMA Electricity Market Regulatory Group has considered the report and has the following observations to make.

Special Administration concept

The purpose of our comments is to raise matters to take into account when considering the recommendation for:

> *Further development and assessment of a comprehensive special administration regime, supported by interim government funding and a cost recovery mechanism, which could be triggered instead of the ROLR scheme if one of the largest retailers in the NEM encounters financial distress that is likely to trigger a ROLR event.*

AFMA has previously advised on the importance of International Swaps and Derivatives Association (ISDA) Master Agreements and their credit support annexes, particularly in relation to the confidence provided to the market by the statutory protections afforded by close-out netting arrangements governed by these documents.

Close-out netting involves two concepts: close-out and netting. Close-out permits a solvent counterparty to terminate a contract under certain conditions and demand immediate payment under the terms of the contract, either for the replacement or market value of the contract or, in the case of a loan, repayment of principal. Close-out netting is deemed to reduce systemic risk by reducing the size of at-risk positions from

gross amounts to the much smaller net values. This reduces the probability that a solvent firm will find itself unable to meet these obligations. If close-out netting were not permitted, solvent counterparties would be immediately liable for amounts due to the insolvent firm, but would likely be required to wait until resolution was completed, potentially months if not years later, for any payment on amounts due from the insolvent firm. The resulting timing difference in gross cash flows could seriously restrict the liquidity of a solvent firm, even if in the end its (post-resolution) net payoff was positive.

Close-out is not usual in insolvencies since the execution of most contracts (including execution of close-out agreements) is stayed when a firm becomes insolvent or is placed under administration. However, close-out netting is permitted in relation derivatives contracts for good public policy reasons based on the need for predictability instilling market confidence.

Trading of derivatives, repurchase agreements, and some other financial instruments takes place under master agreements between counterparties. These master agreements cover individual transactions under the scope of the contract and usually provide for both close-out and netting rights of transactions under the master agreement.

In Australia the *Payments System and Netting Act 1998* (PS&N Act) is a critical component of the financial system framework. It was decided in 1998 that enactment of legislation to clarify a number of issues arising in netting financial market transactions was necessary to put them beyond legal doubt. This is important because of the often high value of transactions which are subject to netting arrangements, and the potentially disruptive consequences of adverse rulings by the courts. With regard to netting the Explanatory Memorandum explained the importance of this legislation in the following terms:

> *The legislation would make the financial position of Australian financial institutions more secure. Clarifying the law of netting will minimise risks associated with participating in multilateral netting in the payment system and the performance of certain large financial transactions involving netting systems.*

Section 14 of the PS&N Act generally preserves the validity of the netting provisions in a contract. Subsection 14(2) preserves the validity of close-out netting contracts on the external administration of a party to a contract where Australian law governs either the external administration or the contract. The exclusion of an obligation acquired from another person with notice that the other person was insolvent is intended to prevent a party to a close-out netting contract from buying in debts with a view to setting them off against its obligations under the netting contract where the counterparty is insolvent (subsection 14(3)).

This recognition of the need for any resolution regime to preserve safeguards to protect contractual termination and netting rights and collateralisation agreements is of crucial importance to our members. Any powers to stay such rights or override section 14 of the PS&N Act that may be granted by a resolution regime would be seen by our

members as highly disruptive to the efficient functioning of the market. This is an area of particular importance on which AFMA, through its relevant committees, would be pleased to have ongoing engagement as you continue work on developing the Special Administration concept.

Cost recovery

As part of the Special Resolution concept reference is made to looking at a cost recovery mechanism. AFMA has been raising serious concern with the Government's approach to cost recovery over recent years. AFMA considers there has been flawed policy decision making process around the threshold analysis supporting introduction of a number of new cost recovery measures for regulation of the financial services sector in recent years. A long standing issue for AFMA has been the lack of proper threshold policy control over government decision making on whether to use cost recovery in the first instance.

AFMA has been working with the Department of Finance and Deregulation on its Cost Recovery Guidelines (CRG) and how they may be improved. However, the CRG only deal with controlling implementation and introducing more effective remedial review processes. If the original policy decision is flawed the guidelines cannot fix the problem at its source. This goes to the policy importance of the Regulatory Impact Assessment (RIA).

AFMA has raised the point of flawed and inadequate RIA process with the Government over a series of consultations. The current level of confidence in the financial services industry about the effectiveness of RIA processes as a tool for promoting high quality policy and regulatory decisions is low. By making agencies that are responsible for policy development also responsible for assessing the impact of what they propose follow a more disciplined RIA process, improved regulatory outcomes would flow through a more disciplined policy creation process with a resulting reduction in unnecessary burdens on industry.

We ask you to take account of these industry concerns and adopt best practice with regard to your RIA process.

Please contact me at dlove@afma.com.au or (02) 9776 7995 if you have any queries regarding this letter.

Yours sincerely

David Love
Director Policy and International Affairs