



2 August 2018

Mr Pat Brennan
Executive General Manager
Policy and Advice Division
Australian Prudential Regulation Authority

By email: pat.brennan@apra.gov.au

Dear Mr Brennan

Application of CPS226 to physically settled precious metals forwards

In this letter AFMA is requesting that APRA allow an 'APRA covered entity', as defined by Prudential Standard CPS 226 (**CPS 226**), to exclude physically settled precious metals forwards (**Precious Metals Forwards**) from the posting and collecting of initial margin under CPS 226. The next phase of posting and collecting of initial margin by counterparties commences on 1 September 2018.

At a general level, AFMA has previously indicated that it supports CPS 226. Our central objective with this request is to raise the issue with APRA and to request APRA to consider:

1. The inconsistency between how APRA treats Precious Metals Forwards under CPS226 and margining product capture in other G20 countries. This also has a consequential impact on the calculation of the amount required to be margined by the counterparties; and
2. How this inconsistency affects the business of APRA covered entities and how it could lead to regulatory arbitrage and an uneven playing field between competitors in different jurisdictions.

It is our understanding that APRA has the power to grant this relief to APRA covered entities under paragraph 95 of CPS 226 or by way of a waiver.

Background

Physically settled commodity forwards (**Commodity Forwards**) are an asset type that falls within the scope of CPS226.

We have reviewed the capture of Commodity Forwards under the margining rules in each major margin jurisdiction. The results of this review are set out below. We understand

that either under the regulations specifically or as a matter of market practice Commodity Forwards are not subject to initial margin requirements under the margining rules in any other jurisdiction.

Despite the above, this request specifically pertains only to the application of CPS 226 to Precious Metals Forwards.

We focus this request on Precious Metals Forwards due to the size and importance of the precious metals industry in Australia. Australia’s gold industry alone remains one of our largest export earners and Australia participates in a highly competitive global marketplace. Australia is the second largest gold producer in the world.¹ According to the Minerals Council of Australia, the geographical diversity of mine production is considered a key factor contributing to lower price volatility relative to other commodities, while the sheer size, depth and liquidity of the gold market rank highly not just against other commodities, but compared with other asset classes, including sovereign debt².

Margin rule analysis

We have conducted a review of the capture of Commodity Forwards under the margining rules in each major margin jurisdiction. The results of this review are set out below.

United States	No	Commodity Forwards are excluded as they are not considered a ‘swap’
EU	No	The position with respect to Commodity Forwards is unclear from a legal perspective but there is a consistent market view (supported by the ISDA published product capture table) that Commodity Forwards are excluded if not traded on a regulated market or MTF (which Commodity Forwards are not)
Canada	No	Commodity Forwards are excluded under the rules (supported by the ISDA published product capture table)
Japan	No	Commodity Forwards are excluded and do not constitute an in-scope derivative
Singapore	No	Commodity Forwards are excluded and do not constitute an in-scope derivative
Hong Kong	No	Commodity Forwards are excluded and do not constitute an in-scope derivative
Switzerland	No	The position with respect to Commodity Forwards is unclear under the Swiss rules but there is a consistent market view (supported by

¹ See <https://www.industry.gov.au/resource/Mining/AustralianMineralCommodities/Documents/Australia-major-export-commodities-gold-fact-sheet.pdf>.

² See http://www.minerals.org.au/resources/gold/industry_characteristics.

	the ISDA published product capture table – copy attached) that Commodity Forwards are not captured
--	--

Based on the rules comparison, there is a clear inconsistency between the characterisation of Precious Metals Forwards in Australia versus the other major margin jurisdictions. AFMA also understands that the Australian characterisation of Precious Metals Forwards is incongruous with the discussions had within BCBS/IOSCO for the margining treatment of this product type.

The differences in product capture in the margining rules across the major margin jurisdictions also has the consequence of creating mismatches in the amount to be margined. If an Australian APRA covered entity trades Precious Metals Forwards with a covered counterparty who is subject to US rules, the Australian APRA covered entity will include the Precious Metals Forwards in the trades to be collateralised but the covered counterparty will not. Absent relief, this will create a permanent mismatch in the amount to be margined.

Substituted compliance may in certain instances provide relief where an Australian APRA covered entity deals with a non-Australian counterparty but there is no relief where the two parties are subject to APRA rules.

The issues relevant to physically settled Precious Metals Forwards

APRA covered entities , in particular Australian authorised deposit-taking institutions (**ADIs**), trade in Precious Metals Forwards on both the local and international markets.

Precious metal producers rely on financial institutions such as local and foreign ADIs to purchase their output on forward terms. This provides price certainty (i.e. hedging) to secure finance, which is essential to their operations. Currently in the Australian precious metals market a high percentage of this hedging is provided by local ADIs, with the remainder provided by foreign ADIs and other the international banks.

The international precious metals market is where Australian banks back-out their long positions and access their liquidity, and in this market the Australian ADIs face predominantly foreign ADIs and other international banks.

At the point that CPS 226 requires the posting and collecting of initial margin in relation to Precious Metals Forwards, Australian ADIs (and other APRA covered entities) will no longer be able to provide Australian gold and other precious metal producers with competitive prices for the offtake, and Australian producers will likely prefer to trade with foreign ADIs and other international banks instead.

This potential competitive impact was not as apparent when variation margin came into effect in CPS 226. In the Precious Metals Forwards market, it was already market practice, both locally and internationally, for parties to exchange variation margin for Precious Metals Forwards. This market practice pre-dates the introduction of CPS 226 but does not extend to initial margin.

An Australian APRA covered entity will be affected as follows depending on the status of its counterparty:

Australian APRA covered entity	Counterparty	Consequence
APRA covered entity	Australian covered counterparty	<p>Precious Metals Forward will be subject to initial margin under CPS 226. Substituted compliance is not relevant.</p> <p>Covered counterparties will prefer dealing with foreign ADIs and other international banks to whom initial margin requirements for Precious Metals Forwards do not apply, thus taking the business away from local ADIs (and other local APRA covered entities).</p> <p>This could result in regulatory arbitrage and an uneven playing field between competitors in different jurisdictions.</p> <p>Until such time as all APRA covered entities have become subject to and implemented initial margin, there will also be an uneven playing field between APRA covered entities in that covered counterparties will prefer to deal with APRA covered entities not yet subject to CPS 226.</p>
APRA covered entity	Australian APRA covered entity	<p>Precious Metals Forward will be subject to initial margin under CPS 226. Substituted compliance is not relevant.</p> <p>For the same reasons set out above for Australian covered counterparties, APRA covered entities will prefer dealing with foreign ADIs and other international banks to whom initial margin requirements for Precious Metals Forwards do not apply because of the application of substituted compliance.</p> <p>This will affect the market between Australian and foreign APRA covered entities as well as between local Australian APRA covered entities.</p>
APRA covered entity	Foreign covered counterparty	<p>Precious Metals Forward will be subject to initial margin under CPS 226. Substituted compliance may assist, but see our notes on this below.</p> <p>Foreign ADIs and other international banks not subject to CPS 226 are likely to either:</p> <ul style="list-style-type: none"> • not trade precious metals with an APRA covered entity due to margining system limitations (as they have not built systems to margin Precious Metals Forwards); or

Australian APRA covered entity	Counterparty	Consequence
		<ul style="list-style-type: none"> to not trade precious metals with APRA covered entities at the same price as their international counterparts as they would need to extract premium from APRA covered entities to cover the cost of the initial margin applicable to trading with APRA covered entities.

Because of the consequences set out above, the inconsistency of the treatment of Precious Metals Forwards is problematic for the implementation of initial margin by APRA covered entities, especially Australian ADIs. In particular, Australian ADIs, are concerned about their ability to access the international market at the same prices and same depth of liquidity as their international competitors as well as the potential loss of business where local clients and local ADIs are moving their hedging arrangements on these types of products (and potential contagion to other products) away from Australian ADIs (and the loss of relationship banking which that may or may not entail). The lending to mining companies is often only commercially viable when the revenue from the lending transaction is aggregated with the hedging revenue for the loan. If Australian ADIs are not able to competitively price the hedge then the Australian ADIs will not be able to lend on competitive terms to Australian mining companies.

In summary, we believe Australian APRA covered entities will experience an adverse impact regarding:

- a) their ability to access the wholesale market for Precious Metals Forwards;
- b) their ability to lend and hedge; and
- c) their competitive position,

and that Australian producers will likely experience a lessening of choice in terms of access to the market for Precious Metals Forwards.

Consequences if APRA provides a form of relief

Avoiding the consequence of the issues highlighted above would provide the following benefits:

- a) preserve the choice that precious metals producers have, and the current level of competition in the market;
- b) avoid disruption to these important mining industries; and
- c) permit APRA covered entities, but particularly Australian ADIs, to continue to benefit from the opportunity of providing financial services to domestic Australian precious metals producers in one of Australia's biggest industries.

Substituted compliance

Even though AFMA is grateful for current substituted compliance arrangements, substituted compliance is not a solution in every instance. Substituted compliance may assist in dealing with inconsistency in product capture under different sets of margin rules, however it does not assist where the rule inconsistency could force an Australian APRA covered entity to discontinue trading Precious Metals Forwards with other Australian counterparties and also does not sufficiently deal with the operational risk that an Australian ADI will be exposed to when having to determine on a counterparty-by-counterparty basis whether substituted compliance can be relied on in respect of a specific Precious Metals Forward trade.

Request

AFMA requests APRA allow an 'APRA covered entity', as defined by CPS 226, to exclude Precious Metals Forwards from the posting and collecting of initial margin under CPS 226.

AFMA looks forward to dialogue and favourable consideration of this request. Please contact David Love either on 02 9776 7995 or by email dlove@afma.com.au if further clarification or elaboration is desired.

Yours sincerely

A handwritten signature in blue ink that reads "David Love". The signature is written in a cursive, flowing style.

David Love
General Counsel & International Adviser