In Confidence

Office of the Minister of Finance

Office of the Minister of Commerce and Consumer Affairs

Chair, Cabinet Economic Development Committee

A New Zealand policy response to foreign margin requirements for ‘Over-The-Counter’ derivatives

Proposal

1 This paper seeks Cabinet agreement to a number of targeted legislative amendments to allow banks and certain public sector asset managers to continue to access offshore funding and manage their investments through the use of derivatives.

Executive Summary

2 New Zealand banks fund their activities in part by raising money offshore eg by issuing bonds. To protect against the exchange rate risk associated with this, they enter into financial contracts called derivatives. Large public sector entities (for example, the New Zealand Superannuation Fund and the Accident Compensation Corporation (ACC)) also rely on derivatives for their activities, as do various other private sector entities.

3 The banks, New Zealand Super Fund and ACC are currently facing an issue in relation to new rules introduced by the Group of Twenty (G20) countries relating to derivatives. The rules require that parties to certain types of derivatives exchange security. This security is also referred to as “margin”. If one party defaults or becomes insolvent, the other party can call on, or “enforce”, the margin agreement, and is therefore protected to some extent from the other party’s financial distress. The reforms were introduced following the Global Financial Crisis (GFC) as a way of reducing systemic risk.

4 Certain features of New Zealand law are restricting these entities’ ability to comply with the new requirements. Specifically, aspects of our insolvency and statutory management laws may prevent margin being enforced effectively.

5 Targeted amendment legislation is therefore needed to enable these entities to comply with the new requirements. If these entities are unable to comply, they may lose access to derivative and offshore funding markets. Alternative, costlier sources of funding may have to be sought. This could place upward pressure on domestic interest rates, meaning New Zealand consumers and businesses would face higher costs of borrowing. Ultimately, reduced integration with global financial markets could damage the soundness and efficiency of New Zealand’s financial system.

6 The proposed legislative amendments will effectively give priority to derivative creditors in the event that a bank or other covered entity (eg ACC) became insolvent. This means derivative creditors will be able to enforce their security interests immediately and before other, non-derivative creditors.

7 In practice, we are confident non-derivative creditors are very unlikely to be made worse off. Any impact on these creditors is likely to be very small and would only arise in the event that a bank or other covered entity suffered a particularly severe insolvency, which is very unlikely. Given the risks of non-action to the financial sector, consumers and businesses, we consider the proposed amendments are necessary and justified.

8 Several New Zealand entities are now, or soon will be, caught by the foreign requirements. The entities are arranging temporary workarounds to mitigate the business impact of being unable to comply, but these are not sustainable long-term solutions. Amendment legislation is required as promptly as possible to support domestic compliance and avoid adverse impacts on the New Zealand financial sector and ultimately New Zealand consumers and businesses.

Background

G20 derivatives reforms are designed to reduce systemic risk in global financial markets

9 The GFC revealed key risks to the global financial system associated with trading derivatives. Trillions of dollars were being traded in opaque bilateral arrangements, conducted off organised exchanges and away from central clearing systems. Risks associated with these "over-the-counter" "uncleared" derivatives were difficult to identify, assess, and control, potentially causing broad system contagion if even a small number of large derivative users defaulted on their obligations. To mitigate derivatives risks, the G20 nations committed to a package of market reforms.

10 One of the key components of the G20's package of reforms was the exchange of margin on over-the-counter uncleared derivative transactions. Margin is essentially a financial asset that acts as collateral or security to support the performance of a derivative (or other financial) contract. Exchanging margin can help reduce systemic risk because if a party to a derivative contract defaults, the margin can be called on (in a process known as 'enforcement') to protect the non-defaulting party to some extent from loss. Without the protection of margin, a non-defaulting party might itself have to default on its obligations to third parties, which could have knock-on consequences for the broader financial system.

11 Broadly, the G20 margin framework requires margin to be "immediately" enforceable and accessible by the non-defaulting party in the event of default. In practice, jurisdictions have implemented this as a right to enforce margin without delay, subject to short-term "stays" and other reasonable operational limits. Margin requirements are in effect in several key markets, in particular Australia, Europe, Japan, and the US, and will continue to be phased in throughout the G20 out to 2020.

New Zealand entities are being captured by foreign margin requirements

12 Foreign margin requirements have a wide cross-border reach that will sometimes capture New Zealand entities. This can occur in one of three ways:

12.1 <u>Direct capture of New Zealand entities</u>: The margin requirements apply if derivatives are traded above certain activity thresholds. New Zealand's four largest banks are part of banking groups that have met, or soon will meet, these activity thresholds.

12.2 Indirect capture of New Zealand entities: Any party that trades with a covered entity becomes a 'captured counterparty', subject to activity thresholds and certain counterparty exemptions. Domestically-owned New Zealand banks that trade with directly covered foreign banks may thus be indirectly captured.

12.3 Margining as market best practice: Major international derivative dealers are embedding margin exchange into their internal processes and risk management frameworks. This means New Zealand entities may be expected to provide margin even where there is no strict regulatory requirement to do so. ACC and the New Zealand Superannuation Fund are expected to be covered for this reason.

Inability to comply with foreign margin requirements could have a potentially significant cost on the New Zealand financial sector and ordinary New Zealanders

13 Since late 2016, officials have been considering the implications of foreign margin requirements on New Zealand businesses and the financial system through extensive stakeholder engagement. This work has indicated that domestic entities are already facing obstacles under existing New Zealand law in complying with foreign margin rules and practices.

14 If New Zealand entities are unable to comply with foreign margin requirements, they may be prevented from transacting in derivatives products vital to their existing funding and risk management arrangements. By way of example, the current value of the big four New Zealand banks' derivative activity that could be impacted if no action were taken is approximately $8.7 trillion annually. This represents the total gross flow of 'cross-currency basis swaps' (a type of derivative) transacted by the big four banks against international counterparts. This derivative activity supports banks to hedge foreign exchange risk when they issue debt (eg bonds) offshore. In 2017, the big four banks issued approximately $60 billion in offshore debt.

15 We do not expect banks would lose the full benefit of this derivatives activity as a result of no longer being able to comply with the foreign requirements. However, foreign currency funding programmes may be placed at risk due to an inability to effectively hedge associated currency risks. Alternative, more costly sources of funding may have to be found by New Zealand banks. If higher funding costs for entities are passed on to consumers, domestic interest rates will rise and the borrowing costs for ordinary New Zealanders will increase.

16 More broadly, reduced access to international markets could damage the competitiveness, efficiency and soundness of the New Zealand financial system, as well as disrupting the market operations of ACC and the New Zealand Superannuation Fund.

Comment

17 Officials have identified three key impediments to compliance with G20 margin rules under existing domestic law:

17.1 **Moratoria** on exercising secured creditor rights in statutory management under the Reserve Bank of New Zealand Act 1989 (the RBNZ Act) or the Corporations (Investigation and Management) Act 1989, or in voluntary administration under the Companies Act 1993. These prevent posted margin from being available "immediately" to the non-defaulting party in the event of a default.

17.2 **Preference** given to certain creditors in a liquidation as set out under Schedule 7 of the Companies Act 1993. This may mean that the full value of certain types of margin (i.e. cash) is not available to the non-defaulting party in the event of a default (as it may mean that other creditors have a higher ranking claim on the assets making up the margin in the event the defaulting party enters into liquidation).

17.3 Uncertainty whether holders of a security interest in posted margin have **priority** under the Personal Property Securities Act 1999 (PPSA) over holders of other security interests in assets posted as margin. Again, this may mean that the full value of the posted margin is not available to the non-defaulting party in the event of a default (as it may mean that other creditors have a higher ranking claim on the assets making up the margin).

18 We propose that proportionate and targeted legislative amendments be made to protect qualifying margin arrangements from the operation of these provisions. This would support derivative users' prompt and certain access to margin, in accordance with G20 requirements, and is similar to the approach recently adopted by Australia to comply with the requirements.

19 In the discussion that follows, we set out the nature of the proposed amendments, and the reasons for extending protections to the proposed entities.

Nature of proposed amendments

<u>Statutory moratoria on the enforcement of security interests</u>

20 When a New Zealand entity is placed into statutory management or voluntary administration, a moratorium is placed on creditors' ordinary rights. This means, for example, that creditors cannot enforce payments or exercise any security interest over the entity's assets in relation to debts owed to them for the duration of the statutory proceedings.

21 Statutory moratoria under current New Zealand law are a significant impediment to compliance with foreign rules that require margin to be available without delay in the event of default.

22 We propose to amend the Corporations (Investigations and Management) Act 1989, the Companies Act 1993 and the RBNZ Act to allow derivative users to promptly enforce their security interests over margin assets in compliance with the foreign margin rules.

23 In the case of statutory management under the RBNZ Act, security interests will only be able to be enforced after a temporary "stay" period (up to midnight at the end of the first full working day after the entity's entry into statutory management). This is to give authorities time to facilitate a more orderly resolution of the entity in statutory management and reflects international best practice.

<u>Companies Act preferential claims</u>

24 Schedule 7 of the Companies Act sets out an order, or 'hierarchy', in which a liquidator must pay a company's preferential creditors when the company is in liquidation. Payments are made by selling the insolvent company's remaining pool of assets.

Financial assets pledged as collateral security are normally excluded from this general asset pool, except where those are an "accounts receivable", which includes cash.

25 Derivative users sometimes post cash as a form of margin. Where cash is used, however, Schedule 7 may prevent a party from receiving the full benefit of the margin. This is because their claim to cash margin could be subordinated to, or defeated by, the claims of other creditors under Schedule 7.

26 We are proposing to amend the Companies Act to give derivative creditors "super preference" over other creditors in Schedule 7. An illustration of the revised hierarchy under our proposal is set out in Annex 1. Our proposal would place derivative creditors secured by cash ahead of the Commissioner of Inland Revenue (IRD) (for unpaid taxes) and company employees (for unpaid wages, redundancy pay etc). In practice, we believe the amendments will not affect the amounts paid to these other creditors. We discuss the reasons for this below.

27 The amendments will ensure New Zealand entities can post margin using all types of financial assets in compliance with the foreign margin requirements. This flexibility and consistency of treatment between different asset types will promote financial sector competitiveness and efficiency.

<u>Priority rules under the Personal Property Securities Act 1999</u>

28 Certain PPSA provisions[1] deal with scenarios where there are multiple parties with a claim over the same asset. This creates uncertainty around whether, in certain specific and technical circumstances, a derivative creditor's security interest in posted margin could be subordinated to another creditor's claim over that margin. This may prevent a non-defaulting party from receiving the full benefit of margin owing, due to other secured creditors having first claim on the margin assets. This is inconsistent with foreign margin rules.

29 We are proposing to amend the PPSA to provide that a derivative creditor's claim over margin would rank ahead of any other person's claim over assets making up that margin in all circumstances.

Reason for extending protections to the proposed entities

30 We propose that the following entities or classes of entities should have access to the margin protections set out above:

30.1 registered banks;

30.2 the Accident Compensation Corporation and New Zealand Superannuation Fund; and

30.3 central counterparties that are designated systems under the RBNZ Act.

31 At a high level, the reasons for this are:

31.1 These entities are the key users of derivatives that we are aware are facing impediments to compliance with the new margin requirements. It is important that

[1] For example, sections 95 and 97.

they continue to have access to international derivative and financial markets in order to preserve the efficiency and soundness of New Zealand's financial sector. If they do not, New Zealand consumers and businesses will likely face higher interest rates on their borrowing.

31.2 In practice, the impacts of the amendments on the non-derivative creditors of these entities will be very low, if there is any impact at all.

31.3 We therefore consider that extending protections to these entities will appreciably improve market outcomes (by improving and promoting access to international markets), without significantly disadvantaging non-derivative creditors.

32 Further discussion of the reasons why protections should be extended to each of these entities or classes of entities is set out below.

<u>Registered Banks</u>

33 Registered banks are the primary derivative users that will be impacted by the foreign margin requirements. If they cannot comply with the requirements, they will lose access to deep offshore funding markets, meaning their costs of finance will likely increase. They are likely to pass these increased costs onto domestic consumers and businesses in the form of higher interest rates. Ultimately, reduced integration into global financial markets could damage the soundness and efficiency of our entire financial sector.

34 The impacts of the amendments on the non-derivative creditors of registered banks will vary depending on the class of creditor. A full description of the impacts on each class of creditor is set out in Annex 2. In general terms, however, these are likely to be very limited. Moreover, the impacts will only crystallise in the extreme event that a bank suffers an insolvency so severe that more than two thirds of its investments are wiped out in full.

35 In practice, therefore, it is highly unlikely that any creditors will be made worse off by extending the proposed protections to registered banks in New Zealand. On the other hand, ensuring all registered banks can access the proposed protections will ensure maintain financial system soundness and efficiency, and avoid the costs to consumers and businesses that would arise if the amendments were not made.

<u>Crown entities</u>

36 State Sector fund managers such as ACC and the New Zealand Superannuation Fund also rely on derivatives to hedge risks, and in some instances may be required to exchange margin with international derivative counterparts. ACC and the New Zealand Superannuation Fund have both indicated they will sometimes be subject to foreign margin requirements. As these government entities do not issue external debt, have few external creditors, and may be supported by their link to the Crown, we are confident that the treatment of their non-derivative creditors would not be affected by the proposed amendments.

<u>Central Counterparties (CCPs)</u>

37 CCPs are a type of centralised system that act as formal intermediaries between two parties to a derivative contract. They stand as a central buyer and seller between both

parties, reducing cost and risk borne by each. Risks are effectively transferred to the CCP. To protect themselves from these risks, CCPs impose formal rules on their participants, including requiring margin to be posted. Approximately 40 per cent of New Zealand banks' derivatives business is cleared through CCP systems.

38 Systems like CCPs can be designated under the RBNZ Act. Designated systems benefit from statutory protections under the Act,[2] allowing them to enforce their rules despite any other law. This means that a CCP designated under the RBNZ Act can freely access margin provided by a defaulting participant, irrespective of the application to that participant of any statutory moratorium or other insolvency-related procedure.

39 Designation achieves the same outcomes as the legislative amendments for margin arrangements proposed in this paper. As such, explicitly extending the statutory protections to cleared derivatives will have no practical impact on insolvency rights or creditor outcomes in relation to New Zealand participants in designated CCPs. It may, however, promote legal transparency and clarity.

Other entities

40 Other types of entities, such as corporate entities in the private sector, also use derivatives for various reasons. However, these entities are not subject to the same regulatory capital, liquidity, and disclosure requirements that apply to banks. Without these requirements, there is less assurance around the likely outcomes for particular classes of creditors in the event of insolvency. Further, where such entities are employee-intensive, preferential creditors would make up a much larger proportion of claims in insolvency, making it less likely they would be fully repaid.

41 Enshrining statutory insolvency protections for the secured derivatives creditors of these types of entities may thus have an adverse impact on the treatment of other creditors.

42 While we understand large corporate entities like Fonterra or Air New Zealand trade in derivatives, following public consultation, we are not aware these entities are facing impediments to their ongoing derivatives business, and generally do not believe it is appropriate for them to be covered by the proposed amendments.

Conclusion

43 In summary, we propose the protections described in paragraphs 20-29 should be available to registered banks, ACC and New Zealand Superannuation Fund, and designated CCPs. The process for prescribing eligible entities will be considered more fully in the legislative drafting phase. It may be possible for these entities to be prescribed by regulations, rather than in primary legislation (which would allow the list of entities to be changed more easily in future to reflect changing circumstances).

What products should qualify for protections?

44 As a starting point, we consider that the proposed amendments should apply to security interests in margin posted in relation to a derivative where:

44.1 the derivative comes within the definition of derivative in the Financial Markets Conduct Act 2013, or definition of Forward Foreign Exchange contract in the

[2] Section 156Q of the RBNZ Act

Financial Markets Conduct (Forward Foreign Exchange Contracts) Designation Notice 2017;

44.2 the derivative is subject to a netting agreement that is enforceable under New Zealand law; and

44.3 in respect of the margin posted in relation to that derivative contract:

44.3.1 the posted margin is a specified type of financial product; [3]

44.3.2 the counterparty's interest in the posted margin is evidenced in writing; and

44.3.3 if the defaulting party was insolvent at the time when the security interest over the collateral was created, the party seeking to enforce the security interest was unaware of that fact.

45 Provided the requirements above are met, the proposed amendments would apply regardless of how a derivative is transacted (i.e. whether it is exchange-traded or over-the-counter, cleared or uncleared). This broad-based approach recognises the risk-mitigating properties of margin and helps to encourage its efficient and effective exchange. It also avoids the risk of creating incentives that could thwart the broad thrust of the G20's reforms to encourage a shift away from bilateral transactions onto organised platforms - where risks can be netted and made more transparent. The alternative of applying the amendments only to margin securing over-the-counter uncleared derivatives, as proposed in the consultation, could be falsely seen to favour bilateral arrangements.

Other issues

<u>Classification of collateral posted by title transfer under the PPSA</u>

46 The proposed amendments to facilitate compliance with foreign margin requirements have also raised a consequential issue under the PPSA around how margin is posted.

47 Margin under a derivative contract can either be posted by title transfer (i.e. transferring ownership to the collecting party) or by issuing a security interest in favour of the collecting party. We understand it is a matter of legal debate at present whether posting margin by title transfer creates a security interest within the meaning of that term in the PPSA. This is relevant to the exact scope of proposals in this paper, as derivative users and their legal advisers who provide opinions on the enforceability of their derivative contracts may rely in places on the definition of security interest in the PPSA.

48 Feedback from submitters has indicated a strong view that posting collateral by title transfer should not come within the definition of security interest. We propose that the PPSA be amended to make this clear in the circumstances covered by the proposed amendments in this paper.

[3] Likely to be a financial product as defined in section 7 of the Financial Markets Conduct Act 2013, or a negotiable instrument or an account receivable as defined in section 16(1) of the Personal Property Securities Act 1999.

Regulation of benchmark interest rates

49 The European Union (EU) has passed new regulations relating to interest rate benchmarks that will come into full effect in January 2020. Interest rate benchmarks are reference interest rates that are used to set prices in and calculate the value of financial contracts, such as derivatives. The EU regulations have the potential to significantly restrict the use of New Zealand benchmarks, such as the Bank Bill Benchmark Rate, in the EU. This could have significant implications for domestic and international borrowers, investors and financial institutions.

50 The Financial Markets Authority, Reserve Bank and Ministry of Business, Innovation and Employment (MBIE) are working together to determine the likely impact of the EU regulations on New Zealand market participants and the economy, and to consider possible policy responses. It is likely that a legislative response will be necessary. One possibility being considered involves targeted amendments to the Financial Markets Conduct Act 2013.

51 It may be possible to progress the amendments relating to benchmarks as an omnibus bill or cognate bills with the proposed amendments relating to derivative margin requirements, as the two proposals both respond to international reforms relating to financial markets and are necessary to ensure financial system soundness and efficiency. We will revert to Cabinet in due course once further policy work has been done on this issue.

Consultation

52 The Reserve Bank and MBIE have discussed the matters with various industry participants. The Reserve Bank has also discussed these matters with legal experts and relevant foreign regulators.

53 The Reserve Bank and MBIE published a consultation document in July 2017. Six submissions were received. The Reserve Bank and MBIE have had extensive follow-up meetings with respondents to the consultation, as well as other stakeholders who did not contribute to the consultation but may nonetheless be affected by the proposed changes, notably central counterparties and IRD.

54 Stakeholders were supportive of the proposals but ideally and ultimately preferred more comprehensive legislative reforms (extracting from approaching compliance deadlines). This option has not been pursued at this stage, as officials believe it raises broader policy issues and would delay implementation of the changes. Over the medium to long term, in consultation with stakeholders, consideration may be given to establishing standalone netting legislation.

55 IRD has been consulted on the specific issue with Schedule 7 of the Companies Act 1993. Treasury has been consulted on this Cabinet paper. No concerns were raised.

56 We note that no consumer interest groups responded to the public consultation or were specifically contacted for feedback. For the reasons set out in this paper, however, we consider consumers will be worse off if no action is taken and do not consider that consumers such as general bank depositors will be made worse off by the proposed amendments.

57 The Department of Prime Minister and Cabinet (Policy Advice Group) has been consulted.

Financial Implications

58 There are no financial implications arising out of this paper.

Human Rights

59 There are no human rights implications arising out of this paper.

Legislative Implications

60 The proposals in this paper will involve amendments to the Reserve Bank of New Zealand Act 1989, the Companies Act 1993, the Corporations (Investigations and Management) Act 1989, and the Personal Property Securities Act 1999. A bid has been made for a place on the 2018 Legislative Programme for a Derivatives Margin Requirements Bill - **s9(2)(f)(iv)**.

Impact Analysis

61 The impact analysis requirements apply. An impact analysis is attached to this paper.

62 MBIE's Regulatory Impact Analysis Review Panel has reviewed the attached Regulatory Impact Summary (RIS) prepared by MBIE and the Reserve Bank. The Panel considers that the information and analysis summarised in the RIS meets the criteria necessary for Ministers to fairly compare the available policy options and take informed decisions on the proposals in this paper.

Publicity

63 We propose that, subject to Cabinet's agreement to the proposals in this paper, it be published on the Reserve Bank and MBIE websites.

64 Either our offices, or the Reserve Bank and MBIE, may publish a press release at the same time.

Recommendations

The Minister of Finance and the Minister of Commerce and Consumer Affairs recommend that the Committee:

1 note new derivative margin requirements are being adopted in many key foreign jurisdictions as part of broader reforms to mitigate financial market risks that contributed to the Global Financial Crisis;

2 note these margin requirements oblige parties to certain types of derivative contracts to exchange collateral to cover the loss that one party would incur if the other defaulted;

3 note that under these margin requirements margin must be "immediately" available (subject to time-limited resolution stays and operational limits) to the non-defaulting party in the event of a default occurring;

4 note that margin requirements have extraterritorial reach and are expected to capture certain New Zealand banks, as well as other entities such as the Accident Compensation Corporation and New Zealand Superannuation Fund;

5 note that that New Zealand law impedes the ability of New Zealand entities to comply with foreign margin requirements, arising out of:

5.1 statutory moratoria provisions under the Reserve Bank of New Zealand Act 1989, the Corporations (Investigations and Management) Act 1989, and the Companies Act 1993; and

5.2 certain provisions relating to creditor rankings under the Companies Act 1993 and the Personal Property Securities Act 1999;

6 note that if New Zealand entities are unable to comply with foreign margining rules, this could have significant adverse effects on the New Zealand financial sector and economy, potentially placing upward pressure on domestic interest rates and undermining the soundness and efficiency of the financial system;

7 agree that the Acts referred to in recommendation 5 be amended so that in certain circumstances (referred to in recommendation 11) exceptions to the moratoria enable the non-defaulting counterparty to:

7.1 immediately access posted margin if the defaulting party is in statutory management under the Corporations (Investigations and Management) Act 1989 or voluntary administration under the Companies Act 1993;

7.2 access posted margin subject to a stay of no more than two working days if the defaulting party is in statutory management under the Reserve Bank of New Zealand Act 1989;

8 agree that in certain circumstances (referred to in recommendation 11) the Companies Act 1993 be amended so that claims of derivative counterparties have priority over the claims of preferential creditors, including employees and the Commissioner of Inland Revenue (as such, the change to priority will be limited to accounts receivable);

9 agree that the Personal Property Securities Act 1999 be amended so that in certain circumstances (referred to in recommendation 11) the claims of derivatives counterparties have priority over the claims of any other person with a security interest in the posted margin;

10 agree that the Personal Property Securities Act 1999 be amended to clarify that the transfer of title in collateral does not create a security interest for the purposes of that Act;

11 agree that the “certain circumstances” referred to in recommendations 7, 8, and 9 are where:

11.1 a counterparty to the derivative transaction is one of the following prescribed entities or class of entities:

11.1.1 a registered bank;

11.1.2 a central counterparty that is a designated settlement system;

11.1.3 the Accident Compensation Corporation or New Zealand Superannuation Fund;

11.2 the derivative meets certain requirements, such as being subject to a legally robust netting agreement; and

11.3 margin posted in relation to the derivative meets certain requirements, such as taking the form of a prescribed financial product (including certain investment securities or cash);

12 invite the Minister of Finance and Minister of Commerce and Consumer Affairs to issue drafting Instructions to the Parliamentary Counsel Office to give effect to the above recommendations;

13 authorise the Minister of Finance and the Minister of Commerce and Consumer Affairs to make decisions, consistent with the above recommendations, on any minor or technical matters that may arise during the drafting process.

Authorised for lodgement

Hon Grant Robertson

Minister of Finance

Authorised for lodgement

Hon Kris Faafoi

Minister of Commerce and Consumer Affairs

Annex 1 – Comparison of creditor hierarchy for covered entities in insolvency before and after amendments

Order of pay-out ↓

Current Creditor Hierarchy	Revised Creditor Hierarchy
Senior Secured Liabilities • e.g. covered bonds, repos, derivative obligations secured by a fixed charge over financial assets	**Eligible secured obligations** • Derivative and FX obligations secured by financial assets governed by a legally enforceable netting set***** **Senior Secured Liabilities** • e.g. covered bonds, repos
Schedule 7 Preferential Claims:	**Schedule 7 Preferential Claims:**
• The liquidator's expenses	• The liquidator's expenses
• Creditor court costs	• Creditor court costs
• Staff wages	• Staff wages
• IRD	• IRD
General secured liabilities: • obligations secured by floating charge over accounts receivable, including derivative obligations secured by cash	**General secured liabilities:** • obligations secured by floating charge over accounts receivable (i.e. non-derivatives)
General Unsecured debt • retail deposits, wholesale deposits, unsecured bonds, operating liabilities, pension fund debt)	**General Unsecured debt** • retail deposits, wholesale deposits, unsecured bonds, operating liabilities, pension fund debt)
Other **subordinated debt** instruments	Other **subordinated debt** instruments
Tier 2 capital (T2)	**Tier 2 capital** (T2)
Additional Tier 1 capital (AT1)	**Additional Tier 1 capital** (AT1)
Common Equity (CET1)	**Common Equity** (CET1)

*****Eligible secured obligations rank *pari passu* to senior secured liabilities but are not subject to the statutory moratorium; will be paid out without delay.

Annex 2 – Impacts of amendments on registered bank non-derivative creditors

1 When the value of a bank's assets decline, losses are assigned according to the hierarchy of claims set out in Annex 1, from the bottom up. Losses are first borne by the owners of the firm ("CET1" in the diagram in Annex 1), with no effect on the bank's ability to repay its creditors. If the bank's losses are large enough that the owner's equity is exhausted, a buffer of additional regulatory capital can be used to absorb losses without triggering a bankruptcy event (AT1 and qualifying T2 in the Annex 1 diagram). Once regulatory capital has been exhausted, however, the firm is insolvent – with more liabilities and assets.

2 The process by which claims are paid out in an insolvency situation again follows the hierarchy in Annex 1, from the top down. Claims sitting at the top of the hierarchy (or 'senior' claims) will be paid in preference to claims further down ('junior' claims). Junior claims are only entitled to what is left once claims that sit above them are paid out: they get the residual. Given an insolvent bank has fewer assets than liabilities, it is inevitable that some claims will not be repaid in full. The probability of this happening gets smaller the higher up the hierarchy a claim sits.

3 The impact of our proposal will be a minor reordering of claims at the very top of the hierarchy, specifically preferential and secured claims. Banks' subordinated and general unsecured creditors (including retail depositors) sit below preferential and secured claims, both currently and under the proposed amendments. This means there will be no impact from the proposed amendments on retail depositors', or other unsecured creditors', ranking, position, or treatment as a result of the amendments. These creditors will continue to be paid out the residual left after preferential and secured claims have been repaid. They will be exposed to the same level of losses regardless of the proposed reordering of claims above them.

4 For secured and preferential claimants, the impact is less clear-cut. In theory, a super-preference for eligible derivative obligations could leave other secured and preferential claimants worse off. However, registered banks in New Zealand are subject to capital, liquidity and other prudential requirements that form a significant buffer of financial resources available to absorb losses ahead of secured and preferential claims. This buffer – including all retail deposits held by the bank – would have to be written off, in full, for preferential and secured claimants to not be fully repaid in insolvency. This would equate to losses in excess of 70 per cent of a banks' total assets, unprecedented in the banking sector where regulators also set requirements around asset quality.

5 The probability of losses large enough to affect secured and preferential claims in insolvency (or resolution) is negligible. Regulators, who set the capital, liquidity, and prudential requirements for banks, can get a high degree of confidence that super-preferring a subset of them (i.e. secured derivative creditors) is therefore unlikely to change the treatment and outcomes for any other secured or preferential claim.