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Briefing note | October 2015

MAS consults on margin requirements for non-centrally cleared OTC derivatives

In October 2015, the Monetary Authority of Singapore (MAS) published a policy consultation paper on proposals to implement margin requirements for non-centrally cleared OTC derivatives.

The policy proposals will be followed by draft regulations, which the MAS will separately consult on after considering feedback from the consultation paper.

Scope of proposed margin requirements

Product scope

The MAS has proposed to subject all non-centrally cleared OTC derivatives contracts to initial margin (IM) and variation margin (VM) requirements. Physically-settled foreign exchange (FX) forwards and swaps will be exempt.

Entity scope

The MAS has proposed to impose "collect-only" margin requirements on the following entities conducting regulated activities under the Securities and Futures Act (SFA):

- banks licensed under the Banking Act;
- merchant banks approved as financial institutions under Section 28 of the Monetary Authority of Singapore Act; and
- other licensed financial institutions, including fund managers and entities licensed under the Finance Companies Act, Insurance Act, SFA and Trust Companies Act,

(the MAS Covered Entities).

The obligations will be phased in by entity type.

Key proposals

- **Who**: banks, merchant banks, licensed financial institutions.
- **What**: all non-centrally cleared OTC derivatives contracts, except physically-settled FX forwards and swaps.
- **When**: a MAS Covered Entity trades with another MAS Covered Entity or an overseas regulated financial firm and that transaction is booked in Singapore.
- **Exemptions**: licensed financial institutions (with exposures below a threshold), counterparties exempted from central clearing mandates, intra-group transactions with MAS approval and transactions with counterparties from jurisdictions with unclear netting laws or that have not implemented equivalent margin requirements on an equivalent time frame (with exposures below a threshold).
- **Treatment of collateral**: IM held with an independent third party custodian under a trust arrangement or other legally enforceable arrangement that protects the posting party in the event of the collecting party's default.
- **Timing**: two business days following execution of new uncleared derivative contract (for VM) or following recalculation of IM obligations (for IM).
- **Haircut**: FX mismatch haircut of 8%.

The MAS is also considering whether to require investment funds domiciled in Singapore to comply with the margin requirements, subject to a threshold.

Exemptions

The MAS is considering the following for exemption:

- licensed financial institutions with exposures below a certain threshold;
- counterparties that have been exempted from central clearing mandates by most regulators, such as sovereigns, central banks, public sector entities, multilateral banks and the Bank for International Settlements;
- subject to MAS approval, intra-group transactions where the MAS Covered Entity is under group-wide regulatory supervision by MAS or regulators in other jurisdictions; and
- transactions with counterparties from jurisdictions with unclear netting laws or that have not implemented equivalent margin requirements on an equivalent time frame, if exposures with those counterparties are below a certain threshold.

Nexus and thresholds for margin obligations

The margin requirements would apply when:

1. an MAS Covered Entity is a legal counterparty to the transaction;
2. that transaction is booked in Singapore; and
3. that transaction is with another MAS Covered Entity or an overseas regulated financial firm.

Transactions booked in foreign subsidiaries or foreign branches of locally-incorporated MAS Covered Entities would not be subject to the margin requirements.

The threshold by which IM collection (assuming the MAS adopts a collect-only regime) or exchange (assuming the MAS adopts a post-and-collect regime) would begin to apply would be where the cumulative IM exposure of a counterparty exceeds S$80 million (calculated at a group-consolidated level and based on all uncleared derivatives between the two consolidated groups).

The IM requirements would only apply to transactions between two unaffiliated entities if their aggregate, group-wide and gross notional uncleared derivatives exposures (including physically-settled FX forwards and swaps) in each case exceed the proposed IM phase in thresholds.

In addition, the MAS has proposed a de minimis margin transfer amount of S$800,000.

It is proposed that an MAS Covered Entity calculate its VM obligations at least on a daily basis. The full amount of VM must be exchanged or collected from its counterparty within two business days following the execution of a new uncleared derivative contract.

In relation to IM, it is proposed that the gross amount of an MAS Covered Entity's IM obligations be calculated on a sufficiently regular basis to reflect changes in risks and market conditions. IM would be exchanged or collected (as the case may be) from the MAS Covered Entity's counterparties within two business days following the recalculation of the IM obligations.

Deemed compliance

The MAS recognises the cross-border nature of transactions and the likelihood that a transaction may fall under margin rules in multiple jurisdictions. The MAS proposes then to implement "deemed compliance" provisions where an MAS Covered Entity will be deemed to have met the MAS' rules when:

- an MAS Covered Entity, established under the laws of, or with a place of business in, a foreign jurisdiction with comparable margin rules, must and has met the margin rules of that jurisdiction; or
- an MAS Covered Entity, trading with a foreign counterparty, must meet and has met comparable home- or host- margin rules applying to that counterparty.

The MAS has proposed to adopt a comparability assessment that is outcomes-based in this regard.

Margin calculations and methodologies

Initial Margin

The MAS has proposed that IM be calculated by reference to either (a) a quantitative portfolio margin model or (b) a standardised margin schedule. An MAS Covered Entity may opt for either approach.

The MAS Covered Entity must have rigorous and robust dispute resolution procedures in place with its counterparty before the onset of a transaction. Both counterparties must have agreed, amongst other things, on what margin calculation method and quantitative model to use (if applicable).

Variation Margin

In relation to VM, it is proposed that MAS Covered Entities post or collect the amount of VM necessary to collateralise the mark-to-market exposure of uncleared derivatives. The MAS Covered Entities must calculate and post or collect VM on an aggregate net basis across all uncleared derivatives that are executed under a single, legally enforceable netting agreement. Otherwise, VM should be calculated, posted or collected on a gross basis.

Eligible collateral and haircuts

The following have been proposed as eligible collateral:

- cash (in any currency);
- gold;
- debt securities (AAA to BB- for central government or central bank issuers and AAA to BBB- for other issuers); and
- equity securities in a main index of a securities exchange in Singapore or a recognised Group A exchange (i.e. securities exchanges in Australia, Austria, Belgium, Canada, France, Germany, Hong Kong, Italy, Japan, Malaysia (except Labuan), Netherlands, New Zealand, South Korea, Spain, Sweden, Switzerland, Taiwan, Thailand, UK and US).

Debt and equity securities issued by the MAS Covered Entity and its related corporations are not permitted to comprise eligible collateral.

The MAS has proposed an 8% haircut where there is a currency mismatch between the currency of the collateral and the settlement currency of the transaction.

Treatment of collateral

Safe-keeping of collateral

MAS Covered Entities must ensure that the IM collected is immediately available to the collecting party in the event of the posting party's default and is subject to legally enforceable arrangements that protect the posting party to the extent possible under applicable law in the event of the collecting party's bankruptcy.

The MAS has also indicated that the collateral arrangements used must be legally enforceable and reviewed periodically with updated legal opinions confirming the above.

IM would need to be held with an independent third party custodian under a trust arrangement or other legally enforceable arrangements that protect the posting party in the event of the collecting party's default.

Re-hypothecation of collateral

To limit the risk arising from re-hypothecation of IM, the

Implementation schedule

- The IM and VM requirements will apply in phases, starting from 1 September 2016 for any bank licensed under the Banking Act that:
  - conducts regulated activities under the SFA;
  - belongs to a group whose aggregate month-end average notional amount of uncleared derivatives for March, April and May of 2016 exceeds S$4.8 trillion (including physically-settled FX forwards and swaps); and
  - transacts with another covered entity (provided that its group notional exposure in uncleared derivatives also exceeds the same threshold of S$4.8 trillion).
- The subsequent phases for IM for all other banks and all merchant banks would start from:
  - 1 March 2017 (S$4.8 trillion threshold – *merchant banks only*);
  - 1 September 2017 (S$3.6 trillion threshold);
  - 1 September 2018 (S$2.4 trillion threshold);
  - 1 September 2019 (S$1.2 trillion threshold); and
  - 1 September 2020 (S$13 billion threshold).
- The IM requirements would only apply to new contracts entered into during the relevant period. IM is not mandatory for existing uncleared derivatives contracts.
- The VM requirements will apply to all other banks and all merchant banks from 1 March 2017.
- The MAS proposes to provide a six-month transition period following the respective VM or IM commencement date (as appropriate) to begin compliance.

MAS has proposed that non-cash IM only be re-hypothecated if certain conditions are met (the full list is set out in Annex D of the consultation paper). However, cash and non-cash collateral collected as VM may be re-hypothecated without restriction.

Feedback on the Consultation Paper

The consultation paper is available on the MAS' website. The closing date for the public to submit comments and feedback is **1 November 2015**.

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