Briefing note

March 2016

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

On 25 February 2016, the Australian Prudential Regulation Authority (APRA) published a discussion paper (the Discussion Paper) on proposals to implement margin requirements and risk mitigation standards for non-centrally cleared OTC derivatives. Concurrently with the Discussion Paper, APRA released for public-consultation a new prudential standard, Prudential Standard CPS 226 *Margining and risk mitigation for non-centrally cleared derivatives* (CPS 226), which contains the proposed margin and risk mitigation requirements for APRA regulated entities. The largest APRA regulated entities will need to exchange initial margin and variation margin with covered counterparties starting in September 2016.

Introduction

In Australia it is intended that the margin requirements and risk mitigation standards apply to APRA regulated entities and as such the draft rules have been made in the form of prudential standards issued by APRA to cover entities it regulates. As the scope is wider than only banks, it is a cross industry prudential standard covering banks, general insurers, life companies and registrable superannuation entity licensees.

Like many other jurisdictions, CPS 226 is based on the Final Policy Framework on margin requirements published by BCBS-IOSCO in March 2015 (BCBS-IOSCO Paper). Even though different jurisdictions base their margin requirements and risk mitigation rules on the BCBS-IOSCO Paper, differences between the rules of each jurisdiction have become apparent and will affect parties operating across the different jurisdictions.

Under CPS 226, an APRA covered entity will be subject to margin requirements and risk mitigation rules for every non-centrally cleared

Key proposals

- **Who**: Entities regulated by APRA, being banks, general insurers, life companies and registrable superannuation entity licensees.
- **What**: All non-centrally cleared OTC derivatives contracts excluding for the purposes of initial margin, physically settled FX forwards and swaps.
- **When**: Where an APRA covered entity trades with a covered counterparty and both parties reach the qualifying levels of non-centrally cleared derivatives outstanding.
- **Exemptions**: Where either party does not meet the qualifying levels of non-centrally cleared derivatives outstanding, certain intra-group transactions, transactions with counterparties from jurisdictions with unclear netting laws or that have not implemented equivalent margin requirements on an equivalent time frame.
- **Treatment of collateral**: Collateral must be immediately available to collecting party on posting party default. Posting party must be protected under applicable laws on insolvency of collecting party.
- **Timing**: Settlement of initial and variation margin amounts must be conducted promptly.
- **Haircut**: FX mismatch haircut of 8%.

derivative transaction entered into with a covered counterparty, where both the APRA covered entity and the covered counterparty meet the qualifying levels.

This client briefing summarises key issues as they apply to Australia and provides some comparison of the proposals with equivalent proposals in Singapore and Hong Kong.

Scope – APRA covered entities

CPS 226 introduces the term 'APRA covered entities'. These are APRA regulated entities, being authorised deposit-taking institutions and authorised banking non-operating holding companies (**NOHCs**), general insurers (including category C insurers and authorised insurance NOHCs), life companies (including friendly societies, eligible foreign life insurance companies and registered life NOHCs) and registrable superannuation entity licensees.

Additionally, the parent entity of an APRA-regulated Level 2 group must ensure that all entities within the Level 2 group comply with the margin requirements. This will include foreign subsidiaries of the parent entity who will have to comply with the margin rules as if they were themselves APRA covered entities.

APRA also proposes to introduce qualifying levels below which margin requirements will not apply. The proposed margin requirements will not apply to an entity that is part of a group whose average month-end notional outstanding non-centrally cleared derivatives exceeds AUD3 billion. APRA envisages that only a relatively small number of institutions will be subject to the margin requirements.

Similarly, the draft module introducing margin requirements for uncleared OTC derivatives in Hong Kong (**the HK Margin Module**) applies only to authorised institutions. Authorised institutions in Hong Kong include licensed banks, restricted license banks and deposit-taking companies.

In Singapore, the Monetary Authority of Singapore (**MAS**), proposes to impose margin requirements on entities conducting regulated activities under their Securities and Futures Act, being licensed banks, merchant banks approved as financial institutions and other licensed financial institutions (including fund managers and entities licensed under the Finance Companies Act, the Insurance Act, the Securities and Futures Act and the Trust Companies Act). As is the case for Australia, the MAS is considering exempting licensed financial institutions with exposures below a certain threshold from their rules.

Scope – new non-centrally cleared derivatives contracts

CPS 226 provides that variation margin must be exchanged for all new non-centrally cleared derivative contracts entered into during a specific margining period. Initial margin must be posted and collected for all new non-centrally cleared derivatives contracts entered into during a specific margining period, with the exception of physically settled foreign exchange (**FX**) forwards and swaps.

A non-centrally cleared derivative contract is one that is not cleared by a central counterparty (**CCP**) (but excluding exchange traded derivatives, securities financing transactions and certain indirectly cleared derivatives).

If a transaction is not centrally cleared and it qualifies as a derivative contract, then the margin requirements will apply. A derivative is defined as having the meaning given to such term in the Payment Systems and Netting Act 1998 (**PSN Act**). The PSN Act does not currently contain a defined term for derivative but an amendment bill has been introduced (known as the *Financial System Legislation Amendment (Resilience and Collateral Protection) Bill 2016*), which will introduce such a definition, being a derivative as defined in chapter 7 of the Corporations Act 2001 (**Corporations Act**). If a transaction qualifies as a derivative under chapter 7 of the Corporations Act, then the margin requirements will apply unless the transaction was cleared by a CCP.

In Singapore, physically-settled FX forwards and swaps have been excluded from the operation of the margin rules but in Australia, as in Hong Kong, these types of derivatives have only been excluded for purposes of initial margin, which means that variation margin requirements still apply.

A new non-centrally cleared derivatives contract is one entered into during the relevant margining period. CPS 226 notes that a genuine amendment to an existing derivative contract will not be a new derivatives contract, unless its purpose is avoiding margin requirements, in which case it must be considered as a new margin contract.

Counterparty to new non-centrally cleared derivatives contract must be a covered counterparty

The margin requirements will only apply where the APRA regulated entity enters into the uncleared derivative transaction with a 'covered counterparty'.

A covered counterparty is defined in CPS 226 as an entity that is a 'financial institution' or a 'systemically important non-financial institution'. A financial institution includes but is not limited to any institution engaged substantively in one or more of certain specific listed activities (domestically or overseas) such as banking, leasing, issuing credit cards, custodial and safekeeping services and insurance and similar activities. In the Discussion Paper, APRA notes that the definition has broad international applicability and is intended to cover all institutions that normally fall within the meaning of the term 'financial institution'.

By contrast, a systemically important non-financial institution is an entity that is not a financial institution and that belongs to a margining group whose aggregate month-end average notional amount of non-centrally cleared derivatives for the preceding March, April and May exceed AUD 50 billion (in the HK Margin Module which contains a similar definition of 'significant non-financial institution' this amount is HKD60 billion).

The following entities are specifically excluded as covered counterparties – sovereigns, central banks, multilateral development banks, public sector entities and the Bank for International Settlement, a covered bond special purpose vehicle or a securitisation special vehicle in a traditional securitisation each of which enters into derivative transactions for the sole purpose of hedging.

Both the Singapore and Hong Kong rules require that the specific derivative transaction be booked in Singapore or Hong Kong, as the case may be, a requirement omitted from CPS 226.

Once it is determined that the derivative transaction has been entered into between an APRA regulated entity and a covered counterparty and that the transaction will be uncleared, the APRA regulated entity must then determine whether the qualifying levels have been met such as to trigger variation and initial margin.

Group wide portfolio of non-centrally cleared derivatives for each party must exceed minimum qualifying levels

Variation margin will not be applied to margining groups with an average notional amount of non-centrally cleared derivatives outstanding below a qualifying level of AUD 3 billion, whilst initial margin requirements will not be applied to margining groups below a qualifying level of AUD 12 billion.

The qualifying levels are measured on a consolidated group basis. CPS 226 refers to this consolidated group as a margining group. Both the APRA covered entity and the covered counterparty must reach the qualifying level.

As both parties must meet the qualifying levels, margin requirements will not apply where for example the APRA covered entity's margining group has an average notional amount of non-centrally cleared derivatives outstanding above AUD 3 billion within a reference period but its covered counterparty's margining group has an average notional amount of non-centrally cleared derivatives outstanding below AUD 3 billion within a reference period.

The same applies for initial margin, if both parties do not achieve the qualifying level of AUD 12 billion for the relevant reference period, then initial margin requirements will not apply.

There are no qualifying levels for variation margin under the BCBS-IOSCO Paper.

Implementation schedule

The timeline for introduction of margin requirements under CPS 226 is largely in line with the BCBS-IOSCO Paper subject thereto that implementation of variation margin for margining groups with lower levels of activity will be extended. Full implementation is anticipated by 1 September 2020.

Both Hong Kong and Singapore follow the timeline for the introduction of margin in line with the BCBS-IOSCO Paper. In Singapore, the MAS proposes to provide a six-month transition period following the respective variation or initial margin commencement date to begin compliance. It remains to be seen if the HKMA will amend its draft rules to also extend the implementation date.

Margin obligations

Variation margin must be calculated and called on a daily basis. Settlement of variation margin amounts must be conducted promptly. Initial margin must be calculated and called at the outset and on a regular and consistent basis and settlement of the initial margin must be conducted promptly.

This differs from the proposed rules in Singapore which require that variation margin must be exchanged or collected within two business days following the execution of a new derivative contract, whilst in Hong Kong the HK Margin Module requires T + 1 for margin call and T + 2 for margin collection. APRA felt that a shorter settlement time frame would not be feasible in all circumstances due to, for example, time zone and cross-border considerations.

CPS 226 also requires that initial margin be recalculated on a regular and consistent basis. The HK Margin Module requires this recalculation to be done at least every 10 business days.

APRA has proposed a *de minimis* margin transfer amount of AUD750,000.

Margin calculation and methodologies

As in Singapore and Hong Kong, an APRA covered entity can calculate the initial margin to be posted and collected by making use of either a model approach approved by APRA or a standardised schedule set out in an attachment to CPS 226. The attachment is based on the one provided by the BCBS-IOSCO Plan. APRA will (subject to approval) also permit an APRA covered entity to use an alternative schedule already being used by that entity for regulatory capital purposes.

Once a model is approved by APRA, the initial margin must be calculated on that basis until such time as the model approval is varied, revoked or suspended. APRA must also be given prior notice of any material changes to the model.

Implementation schedule:

VM:

- VM requirements will apply in phases, commencing from 1 September 2016 for any APRA covered entity that:
  - belongs to a margining group whose aggregate month-end average notional amount of non-centrally cleared derivatives for March, April and May 2016 exceeds AUD4.5 trillion (including physically settled FX forwards and swaps);
  - enters into an uncleared derivatives transaction;
  - enters into an uncleared derivatives transaction with a covered counterparty who also belongs to a margining group whose aggregate month-end average notional amount of non-centrally cleared derivatives for March, April and May 2016 exceeds AUD4.5 trillion (including physically settled FX forwards and swaps).
- The subsequent phases for VM for all other APRA covered entities will commence on:
  - 1 March 2017 (AUD 12 billion threshold);
  - 1 September of each year thereafter (AUD 3 billion).

IM:

- IM requirements will also apply in phases, commencing from 1 September 2016 for any APRA covered entity that:
  - belongs to a margining group whose aggregate month-end average notional amount of non-centrally cleared derivatives for March, April and May 2016 exceeds AUD4.5 trillion (including physically settled FX forwards and swaps);
  - enters into an uncleared derivatives transaction;
  - enters into an uncleared derivatives transaction with a covered counterparty who also belongs to a margining group whose aggregate month-end average notional amount of non-centrally cleared derivatives for March, April and May 2016 exceeds AUD4.5 trillion (including physically settled FX forwards and swaps).
- The subsequent phases for IM for all other APRA covered entities will commence from:
  - 1 September 2017 (AUD 3.375 trillion threshold);
  - 1 September 2018 (AUD 2.25 trillion threshold);
  - 1 September 2019 (AUD 1.125 trillion);
  - 1 September of each year thereafter (AUD 12 billion).

The APRA covered entity can choose different approaches for different asset classes, for example the standardised approach can be used for interest rate derivatives whilst the model approach is used for equity derivatives.

An APRA covered entity must, for the purpose of exchanging margin, agree the process for determining the value of each non-centrally cleared derivative at any time from the execution of the transaction to the termination, maturity or expiration thereof.

This process must also be clearly documented in the trading relationship documentation.

The valuation process must be subject to periodic review by the APRA covered entity to take into account changes in the market conditions.

Average aggregate notional amount

An entity's phase-in date is determined by the notional amount of non-centrally cleared derivatives activity of its margining group in a given reference period. As per the Discussion Paper, its calculation must be consistent with the BCBS-IOSCO Plan, which is by aggregating total notional amounts of non-centrally cleared derivative transactions outstanding across the margining group (excluding intra-group transactions) for each of three month-end dates in the relevant reference period, and then averaging the month-end totals.

Physically settled FX forwards and swaps must be included in the calculation and can only be left out to calculate initial margin to be exchanged.

Key issues

Can there be substituted compliance?

Yes, this can take place by way of a comparability determination.

APRA recognises the cross-border nature of transactions and that the margin rules of multiple jurisdictions may be relevant. APRA proposes to grant substituted compliance following a positive assessment of the comparability of a foreign jurisdiction's margin requirements. This will be done where the regime is comparable in its outcomes with the BCBS-IOSCO framework and the requirements in CPS 226.

Notably, CPS 226 specifically states that where a foreign ADI is directly subject to margin requirements that are substantially similar to the BCBS-IOSCO Plan by its home jurisdiction, then it may comply with its home jurisdiction's margin requirements in lieu of complying with the margin requirements in CPS 226.

APRA may impose conditions in addition to granting substituted compliance.

Re-hypothecation and segregation

In Singapore, re-hypothecation of non-cash initial margin is permitted one-time only and subject to strict conditions.

Australia and Hong Kong do not permit initial margin to be re-hypothecated, re-pledged or re-used.

Furthermore, CPS 226 requires that contractual arrangements reflect this prohibition. This, of course, is more limited than the BCBS-IOSCO Plan which permits such re-hypothecation, re-pledge or re-use to a third party where the sole purpose is to hedge the collecting party's derivative position arising from transactions with the posting party.

Cash and non-cash collateral collected as variation margin may be re-hypothecated without restriction.

Under CPS 226, any initial margin collected must be immediately available to the collecting party in the event of the posting party's default and the posting party must be protected under applicable law in the event that the collecting party goes insolvent or bankrupt.

Counterparties from non-netting jurisdictions

The BCBS-IOSCO Plan was designed on the basis of legally enforceable netting arrangements, which is problematic for the Asia Pacific region given the relatively high number of non-netting jurisdictions when compared with other jurisdictions.

In Hong Kong, the HK Margin Module proposes that when facing a counterparty from a non-netting jurisdiction, an authorised institution should post and collect both variation margin and initial margin. There are challenges with this proposal including the risk that the posting party may not recover its margin and that it could make uncleared OTC derivative transactions with counterparties from non-netting jurisdictions costly.

As per the Discussion Paper, APRA does not require an APRA covered entity to post or collect variation or initial margin with counterparties in jurisdictions where netting or derivatives and/or collateral is not enforceable upon insolvency or bankruptcy of the counterparty.

Counterparties not subject to margin requirements

An APRA covered entity is not required to post or collect variation margin or initial margin where collateral arrangements are questionable or not legally enforceable upon default of the counterparty.

In Singapore, the MAS is considering exempting transactions with counterparties from jurisdictions that have not implemented equivalent margin requirements on an equivalent time frame if exposures with those counterparties are below a specified threshold.

Similarly, in Hong Kong initial margin does not have to be posted in these instances.

Exemptions from intragroup transactions

Under CPS 226, in order to determine whether an intra-group trade is subject to the margin requirements, it is necessary to determine whether the counterparties fall within a Level 2 group for capital adequacy purposes. If they are, then any uncleared OTC derivative transactions between them would be exempt from any margin requirements.

If they are not in the same Level 2 group for capital adequacy purposes, but they are in the same margining group, then initial margin is not required, however the exchange of variation margin is required.

CPS 226 permits APRA to amend the intra-group margin requirements, through granting exemptions or imposing additional requirements.

In Hong Kong, uncleared OTC derivative transactions between an authorised institution and entities in the same consolidated group of companies are exempt provided that the consolidated group is subject to group-wide supervision by the HKMA or a supervisory authority in another jurisdiction or the consolidated group has a group-wide integrated risk management function.

Similarly, in Singapore, but 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, are exempt from the margin requirements.

Eligible collateral and FX haircut

CPS 226 lists the types of eligible collateral that an APRA covered entity may collect for margining purposes. It includes cash collateral, certain rated and unrated debt securities, certain covered bonds, certain rated senior securitisation exposures, equities included in a major stock index and gold bullion.

An APRA covered entity must have appropriate controls in place to ensure that the collateral collected does not exhibit significant wrong-way risk or concentration risk.

Wrong-way risk is where the value of the collateral correlates to the creditworthiness of the counterparty (or the value of the underlying non-centrally cleared derivative portfolio) such as to undermine the effectiveness of the protection afforded by the collateral collected.

Concentration risk will occur if the collateral collected is overly concentrated in terms of an individual issuer, issuer type and asset type.

In line with the BCBS-IOSCO Plan, CPS 226 contains the choice of the standardised haircut schedule or model approach with respect to collateral posted to meet margin requirements.

APRA approval must be obtained before the model approach is used.

Once a model is approved by APRA, the risk-sensitive haircuts must be calculated using that model approach until such time as the model approval is varied, revoked or suspended. APRA must also be given prior notice of any material changes to the model.

Under the standardised haircut schedule, for the purposes of initial and variation margin, APRA has proposed an additional FX haircut of 8 percent of the market value of all non-cash collateral in which the currency of the collateral asset differs from the termination currency, reflecting the approach adopted in Hong Kong and Singapore.

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