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APRA consults on margin requirements and other risk mitigation standards for non-centrally cleared OTC derivatives

Speed read

On 25 February 2016, the Australian Prudential Regulation Authority (**APRA**) published a discussion paper and a draft prudential standard setting out APRA's proposals for implementing margin requirements and other risk mitigation standards for non-cleared OTC derivatives in Australia (the **APRA Proposals**). The new requirements are proposed to take effect from 1 September 2016, subject to a phase-in schedule which broadly aligns with equivalent international proposals.

This briefing paper highlights some of the key points arising out of the APRA Proposals, with comparisons to the proposals of other G-20 countries and some suggested practical steps for market participants to take.

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1. Background and international context

The APRA Proposals are largely based on:

- the framework for margin requirements for non-cleared OTC derivatives published by the Basel Committee on Banking Supervision (**BCBS**) and the International Organisation of Securities Commissions (**IOSCO**) in September 2013 (as revised in March 2015) (the **BCBS-IOSCO Margin Framework**); and
- the proposed risk mitigation standards for non-cleared OTC derivatives published by IOSCO in January 2015 (the **IOSCO Risk Mitigation Standards**).

Several major international jurisdictions, including the U.S., Europe, Japan, Hong Kong and Singapore, have already published final rules or draft proposals which, in broad terms, are also intended to implement these framework principles (and which could directly or indirectly apply to an entity that is also subject to the APRA rules).

2. APRA's proposed margin requirements

2.1 Overview

It is proposed that, subject to certain exceptions and minimum thresholds, an 'APRA covered entity' will be required to exchange (i.e. post and collect) both variation margin (**VM**) and initial margin (**IM**) in respect of each non-cleared OTC derivative that it enters into with any 'covered counterparty'.

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VM is intended to collateralise the mark-to-market exposure of each such derivative (as of the time of calculation). It is posted on a 'net' basis, meaning that at any given time only one party (the out-of-the-money party) will have a net obligation to post VM (to the extent not already posted).

IM is intended to collateralise the potential future exposure that could arise due to changes in the mark-to-market value of derivatives between the occurrence of a counterparty default and the time that those derivatives are closed out. IM will need to be exchanged between the parties on a two-way 'gross' basis (as discussed further in paragraph 2.9 below).

The VM and IM requirements will be phased in from September 2016 to September 2020 according to whether or not the relevant APRA covered entity and its covered counterparty exceed certain thresholds of aggregate notional derivatives positions (as discussed further in paragraph 2.4 below).

2.2 In-scope transactions

Subject to the exclusions set out below, the margin requirements in the APRA Proposals are intended to apply to all 'derivatives' (as currently defined in Chapter 7 of the Corporations Act 2001)[1] that are not cleared through a central counterparty (**CCP**) or traded on an exchange.

Consistent with proposals elsewhere (e.g. in Europe, Hong Kong and Singapore), the following types of transactions are excluded from the APRA margin requirements:

- physically settled FX forwards and swaps (exempt from IM requirements, but not VM requirements);
- "FX transactions" embedded in cross-currency swaps to the extent that they are associated with the exchange of principal (exempt from IM requirements, but not VM requirements);
- indirectly cleared derivatives that are intermediated through a clearing member on behalf of a non-member client; and
- repurchase transactions ('repos') and stock lending transactions.

Note that the definition of 'derivative' in the Corporations Act 2001 excludes various transactions which would commonly be considered to constitute derivatives (e.g. certain physically settled commodity swaps and forwards).

2.3 In-scope entities

APRA covered entities

The margin requirements will apply to all 'APRA covered entities' that enter into in-scope derivatives with any 'covered counterparty'.

[1] The APRA Proposals provide for 'derivative' to have the same definition as will be set out in the Payment Systems and Netting Act 1998 (following its amendment pursuant to the Financial System Legislation Amendment (Resilience and Collateral Protection) Bill 2016, a draft of which was released by the Australian Government in December 2015). The draft Bill provides for the definition of 'derivative' in the Payment Systems and Netting Act 1998 to cross-refer to the definition of 'derivative' in Chapter 7 of the Corporations Act 2001.

‘APRA covered entities’ are each of the following:

- Authorised Deposit-taking Institutions (**ADIs**), whether established in Australia or overseas, and non-operating holding companies (**NOHCs**) authorised under the Banking Act;
- general insurers, including Category C insurers (i.e. foreign insurers operating via a foreign branch in Australia), and NOHCs authorised under the Insurance Act;
- life companies, including friendly societies and eligible foreign life insurance companies (**EFLICs**), and NOHCs registered under the Life Insurance Act; and
- registrable superannuation entities (**RSEs**).

Where an APRA covered entity is the ‘Head of a Level 2 group’, the margin requirements will apply to every entity (other than relevant covered bond SPVs or securitisation SPVs) in that Level 2 group – if and to the extent that such entities enter into in-scope derivatives with any covered counterparty. The risk mitigation standards referred to in paragraph 3 below will also apply to each such entity in the Level 2 group.

Each of the following is the ‘Head of a Level 2 group’:

- an ADI which both (i) is a member of a Level 2 group (as defined in the existing APRA prudential standard, APS 001) and (ii) is not a subsidiary of an NOHC or another ADI;
- an authorised banking NOHC which is the immediate parent entity of an ADI; and
- the parent entity of a Level 2 insurance group (as defined in the existing APRA prudential standard, GPS 001).

The application of the margin requirements to every entity within a Level 2 group (including foreign entities) is more onerous than the approach taken in other G-20 jurisdictions (where generally the margin requirements only apply to transactions involving the specific entity or entities within a corporate group that meet the applicable ‘covered entity’ definition).

Covered counterparties

A ‘covered counterparty’ is an entity that is a ‘financial institution’ or a ‘systemically important non-financial institution’, subject to certain exclusions.

‘Financial institution’ is defined broadly and includes any institution engaged substantively in one or more of the following activities (whether in Australia or overseas): banking; leasing; issuing credit cards; portfolio/asset/funds management; trading/broking of securities, futures and/or commodities; management of securitisation schemes; custodial and safekeeping services; insurance; and ancillary activities. NOHCs or their overseas equivalents are considered to be financial institutions.

A ‘systemically important non-financial institution’ is an entity that is not a financial institution and that belongs to a consolidated group whose aggregate month-end average notional amount of non-cleared OTC derivatives in respect of the preceding March, April and May exceeded AUD 50 billion.

The following entities are excluded from the definition of covered counterparty:

- sovereigns, central banks, multilateral development banks, public sector entities and the Bank for International Settlements;
- covered bond SPVs that enter into derivative transactions for the sole purpose of hedging; and
- securitisation SPVs in traditional securitisations that enter into derivative transactions for the sole purpose of hedging.

2.4 Timing of phase-in

Variation margin

The VM requirements will apply when both the APRA covered entity and its covered counterparty have an aggregate month-end average notional amount of non-cleared OTC derivatives (in each case, calculated on a consolidated group basis but excluding intra-group transactions) exceeding the applicable threshold below (in respect of the corresponding months set out below):

Reference months	Threshold	Margining commencement date
March, April and May 2016	AUD 4.5 trillion	1 September 2016
September, October and November 2016	AUD 12 billion	1 March 2017
March, April and May in each year from 2017 onwards	AUD 3 billion	1 September in each year from 2017 onwards

This three-stage phase-in for VM differs from the two-stage phase-in (with commencement dates of 1 September 2016 and 1 March 2017) contemplated by the other G-20 jurisdictions which have published final rules or draft proposals relating to margin thus far.

Initial margin

The IM requirements will apply when both the APRA covered entity and its covered counterparty have an aggregate month-end average notional amount of non-cleared OTC derivatives (in each case, calculated on a consolidated group basis but excluding intra-group transactions) exceeding the applicable threshold below (in respect of the corresponding months set out below):

Reference months	Threshold	Margining commencement date
March, April and May 2016	AUD 4.5 trillion	1 September 2016
March, April and May 2017	AUD 3.375 trillion	1 September 2017
March, April and May 2018	AUD 2.25 trillion	1 September 2018

March, April and May 2019	AUD 1.125 trillion	1 September 2019
March, April and May in each year from 2020 onwards	AUD 12 billion	1 September in each year from 2020 onwards

It should be noted that, consistent with the BCBS-IOSCO Margin Framework and the margin proposals in other jurisdictions, all physically settled FX forwards and swaps will be taken into account in the calculation of an entity's aggregate month-end average notional amount, even though those products are not subject to IM requirements.

2.5 Intra-group transactions

Non-cleared OTC derivatives transactions entered into between an APRA covered entity and any covered counterparty in its group are exempted from:

(i) the VM requirements if the APRA covered entity is a foreign ADI, a Category C insurer or an EFLIC;

(ii) (without limiting (i) above) the VM requirements if the APRA covered entity and the covered counterparty are part of the same Level 2 group (as described in existing APRA prudential standards, APS 001 and GPS 001); and

(iii) the IM requirements in all cases.

This means that intra-group transactions involving an Australian APRA covered entity and a relevant member of its group which is *not* a member of its Level 2 group will be subject to the VM requirements. An example of where this might arise is a derivative transaction between an Australian ADI and a separate insurance company in its group.

APRA also proposes to reserve the right to require an APRA covered entity to exchange VM and/or IM with any covered counterparty in its group where APRA deems appropriate. This creates some uncertainty and could result in the imposition of a significant burden on a covered group at a time when it is experiencing financial stress.

Note that, similar to the approach proposed in both Hong Kong and Singapore, the intra-group exemption is intended to be automatic under the APRA Proposals. In contrast, under the proposed European rules, prior approval from or notification to the relevant authorities (and, in the case of cross-border transactions, an equivalence determination on the counterparty's jurisdiction) is required before the intra-group exemption applies.

2.6 Substituted compliance and deference framework for cross-border derivatives

Substituted compliance

The APRA discussion paper recognises the cross-border nature of the derivatives market and that a key principle of the BCBS-IOSCO Margin Framework is consistent and non-duplicative margin requirements across jurisdictions. To that end, the APRA Proposals permit substituted compliance in order to mitigate the potential burden of compliance with multiple sets of margin rules in different jurisdictions.

Subject as provided below in respect of foreign APRA covered entities, substituted compliance is available only if APRA has determined that the relevant foreign regime is 'comparable in its

outcomes' with the BCBS-IOSCO Margin Framework and the requirements in the APRA prudential standard. APRA may grant substituted compliance in respect of all or part of a foreign regulator's margin requirements, and may limit the scope of or impose conditions on substituted compliance in relation to a particular foreign regime.

Note that an APRA covered entity (other than a foreign APRA covered entity) may only rely on substituted compliance where:

- the APRA covered entity is transacting with a covered counterparty that is subject to the margin requirements of the relevant foreign margining regime; and/or
- the APRA covered entity is directly subject to the margin requirements of the relevant foreign margining regime.

Deference framework for foreign APRA covered entities

In addition to substituted compliance, APRA proposes an automatic deference framework which will apply to any foreign ADI, Category C insurer or EFLIC that is subject to (and compliant with) the margin requirements of its home regulator. The foreign ADI, Category C insurer or EFLIC must be able to demonstrate that those requirements are substantially similar to the BCBS-IOSCO Margin Framework, but it is not necessary for APRA to have formally issued a comparability determination in respect of those requirements.

A foreign-incorporated APRA covered entity that is not a foreign ADI, Category C insurer or EFLIC may also apply for approval by APRA to comply with the margin requirements of its home jurisdiction (provided, again, that it can demonstrate that those requirements are substantially similar to the BCBS-IOSCO Margin Framework).

2.7 Counterparties in jurisdictions where netting and/or collateral arrangements are not enforceable

APRA has proposed that an APRA covered entity will not be required to post or collect VM or IM where either:

- netting of derivatives is not enforceable upon the insolvency of its counterparty; or
- collateral arrangements are 'questionable' or not legally enforceable upon the default of its counterparty.

APRA covered entities must consistently monitor such exposures and set appropriate internal limits and controls to manage their exposure to such counterparties. Note that ADIs are also required to hold more counterparty credit risk capital on exposures where there is no eligible netting bilateral agreement and no margin collected.

This exemption from the VM and IM requirements in respect of 'non-netting jurisdictions' and 'questionable collateral' jurisdictions is substantially more permissive than the approach taken in other G-20 jurisdictions, where generally either no such exemption exists, or only a 'threshold' exemption from the margin requirements is contemplated (i.e. such that a covered entity would be exempt from the VM and IM requirements only if its aggregate exposure to covered counterparties located in a non-netting jurisdiction were less than a particular threshold).

2.8 Calculation and exchange of margin

Timing

VM must be calculated and called for on a daily basis, using a zero threshold. IM must be calculated and called for both at the outset of a transaction and on a regular and consistent basis upon changes in the calculated potential future exposure, and may be subject to a threshold (see paragraph 2.9 below). Settlement of both VM and IM must be conducted 'promptly'.

In contrast to the approach adopted in numerous overseas jurisdictions (i.e. strict deadlines for settlement of margin calls and mandatory re-calculation of required IM levels in specific circumstances), the APRA Proposals adopt a principles-based approach for these aspects of the margin requirements. Among other things, this should accommodate time zone differences between Australia and the rest of the world and also allow for parties to post collateral with settlement cycles that are longer than one business day (save to the extent that stricter overseas rules are also applicable).

Minimum transfer amount

To ease the operational burden of transferring small amounts of margin, APRA proposes that margin transfers be subject to a *de minimis* minimum transfer amount of no greater than AUD 750,000. Notwithstanding industry submissions overseas seeking separate minimum transfer amounts to apply to IM and VM (largely for operational reasons), the minimum transfer amount under the APRA Proposals is a single amount that will need to be allocated to either IM or VM or shared between IM and VM (to the extent that IM and VM amounts are due on the same day).

2.9 IM requirements – calculation and collection

IM Models

The amount of IM to be posted and collected may be determined either by a standardised margin schedule (whereby transactions are assigned asset-class and maturity-specific factors, which are then applied to the notional of each transaction) or a quantitative portfolio margin model that has been approved in advance by APRA. The standardised schedule is set out in Attachment A to the draft prudential standard and is based on the BCBS-IOSCO Margin Framework. A quantitative model, if used, must assume a potential future exposure based on a one-tailed 99 per cent confidence interval over a 10-day period, calibrated to stressed market conditions, and may only account for certain permitted diversification benefits.

An APRA covered entity must apply the same approach (standardised schedule or model-based) to all transactions within the same defined asset class, but may use different approaches across different asset classes.

IM Threshold

Consistent with the BCBS-IOSCO Margin Framework, APRA proposes that an APRA covered entity may agree with a covered entity not to exchange IM if the amount of IM that would otherwise be due is less than or equal to AUD 75 million (approximately equivalent to EUR 50 million), with only the excess above AUD 75 million being required to be transferred if the threshold is exceeded. The threshold of AUD 75 million is calculated at the group-consolidated level based on all non-cleared OTC derivatives between the two groups (and will need to be internally allocated among the relevant entities within such groups).

Subject to certain conditions, an investment fund or registrable superannuation entity that is managed by an investment advisor is considered to be a distinct entity that may be treated separately from other entities managed by the same investment advisor when applying the initial margin threshold.

Eligible collateral

The draft prudential standard lists the types of eligible collateral that an APRA covered entity may collect for margining purposes. The list includes cash, certain debt securities and covered bonds, senior securitisation exposures, equities listed in a major index and gold.

Note that the Australian Government has recently released a draft Bill (the Financial System Legislation Amendment (Resilience and Collateral Protection) Bill 2016) which aims to ensure that security granted over 'financial property' in connection with a close-out netting agreement will be enforceable without delay. The proposed list of eligible collateral for margining purposes in the draft prudential standard is a subset of the proposed list of 'financial property' in the draft Bill.

Haircuts

The value of each type of eligible collateral for margining purposes will be subject to haircuts which, like the IM calculations referred to above, are to be determined either in accordance with a standardised schedule (as set out in Attachment B to the draft prudential standard and based on the BCBS-IOSCO Margin Framework) or in accordance with a quantitative model that has been approved in advance by APRA.

Segregation and Safe-keeping

The APRA Proposals require that IM be held so as to ensure that:

- the IM is immediately available to the collecting party in the event of the posting party's default; and
- the IM 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 insolvency.

In practice, this is likely to require that all IM is held by a third party custodian, with each counterparty to the underlying derivative contract granting security over its rights against the custodian in favour of the other counterparty. The title transfer approach inherent in the English law ISDA Credit Support Annex is not compatible with these requirements, as IM will need to be legally segregated from the collecting party's assets.

Note that APRA did not go as far as the European proposals, which introduced an obligation for IM to also be protected from the insolvency of the third party custodian. This may not be possible for cash, given that custodians hold cash as banker and not as trustee.

The requirement that IM be 'immediately available' to the collecting party is not entirely clear and may conflict with other regulatory initiatives (e.g. stays on enforcement in the context of financial institution resolution regimes). It remains to be seen how this will be interpreted, or whether it will be adapted to a more easily understandable standard such as 'as soon as legally possible' (which has been proposed in Hong Kong).

No re-hypothecation

The APRA Proposals provide that IM may not be re-hypothecated, re-pledged or re-used under any conditions. This is consistent with the proposals of many other foreign regimes (e.g. the U.S., Europe and Hong Kong), and highlights the difficulties associated with the stringent conditions to permitted re-hypothecation set out in the BCBS-IOSCO Margin Framework.

3. Proposed risk mitigation standards

Consistent with the IOSCO Risk Mitigation Standards and the approach adopted in Europe, APRA proposes to require an APRA covered entity to establish and implement policies and procedures:

(i) for the execution of written trading relationship documentation (e.g. ISDA Master Agreements) with counterparties prior to or contemporaneously with executing transactions;

(ii) to ensure that the material terms of transactions are confirmed as soon as practicable after they are entered into;

(iii) to ensure that the material terms and valuations of all transactions in a non-cleared OTC derivatives portfolio are reconciled with counterparties at regular intervals;

(iv) to regularly assess and, to the extent appropriate, engage in portfolio compression;

(v) to agree on and document the process for determining the value at any time of any non-cleared OTC derivative; and

(vi) for the resolution of disputes in a timely manner (including agreeing on dispute resolution procedures in advance, and having procedures for escalation of disputes to senior management).

These standards apply to all non-cleared derivative transactions and are not subject to any minimum qualifying level of activity. In addition, they apply when an APRA covered entity trades with any counterparty in non-cleared OTC derivatives transactions (not just with covered counterparties). It is proposed that the standards will become effective from 1 September 2016.

APRA has emphasised that it intends to take a principles-based, rather than a rules-based, approach to these standards, and accordingly (unlike, for example, in Europe) there are no specific deadlines for carrying out tasks such as portfolio reconciliation or confirmation of the terms of a transaction.

4. Next steps

APRA has called for responses to the discussion paper and the draft prudential standard by 20 May 2016. In light of the target effective date of 1 September 2016, the finalisation and implementation of the prudential standard is likely to proceed very quickly after that date.

With this in mind, we set out below some suggested practical steps for market participants to consider taking:

1. Determining classification

Market participants which fall within one of the categories of ‘APRA covered entity’ should conduct due diligence into the total notional amount of outstanding non-cleared OTC derivative transactions (other than intra-group transactions) entered into by members of its group. This will provide an indication of the likely date (if any) on which the Australian VM and IM requirements will potentially begin to apply to them. This exercise should be repeated as at the end of March, April and May 2016 (and again as at the end of September, October and November 2016 and March, April and May in future years) in order to formally assess whether the thresholds referred to in paragraph 2.4 above have been crossed.

To the extent possible, a similar process should also be undertaken in respect of each of a market participant’s counterparties. The APRA Proposals provide that an APRA covered entity must undertake a reasonable level of due diligence to assess whether a counterparty is covered counterparty and, if so, whether its aggregate month-end average notional amount of non-cleared OTC derivatives (calculated on a consolidated group basis) exceeds an applicable threshold. It remains to be seen whether an APRA covered entity will be permitted to rely on representations from its counterparties, but we consider this to be the most viable approach given the practical limitations on any alternatives.

Given the multi-jurisdictional nature of the derivatives markets, it will also be important for market participants to determine whether they or their counterparties are in-scope entities under any equivalent overseas rules. To assist with this process, ISDA is currently developing a self-disclosure form (available in paper format and on ‘ISDA Amend’) to allow counterparties to designate their status under each of the U.S., European and Japanese regulations (and this may be extended to cover other jurisdictions).

2. Educating internal teams and counterparties on the extraterritorial reach of the various rules

Market participants should educate their respective internal teams and counterparties on the key differences in applicable regulatory standards. It is important to note that, where a particular transaction is subject to more than one regulatory regime (and substituted compliance is not permitted), the strictest rules should be applied.

3. Reviewing and amending existing documentation so that it is compliant with the new standards

Market participants will likely need to prepare for a large-scale documentation exercise with their respective counterparties. In particular, existing ISDA Credit Support Annexes may need to be replaced or significantly amended to facilitate compliance with the new VM rules. New standalone documentation (including custody and security documentation) will most likely be required in connection with the implementation of the IM rules.

4. Operational considerations

After identifying the regulatory framework(s) to which they will be subject, market participants will need to consider whether they have the operational capabilities to comply with the new rules. In particular, market participants will potentially need to:

- perform daily calculations of VM and manage any delivery and return obligations;

- manage multiple CSAs and the collateral flows under them (assuming that a regulatory compliant VM CSA is required alongside an existing CSA for legacy trades); and
- implement an IM calculation model and have systems in place for posting IM to a third party custodian.

Allen & Overy has extensive experience in advising clients on the global margin requirements and is involved in industry initiatives and development of standardised documentation. We would be very happy to discuss any of the above in further detail with you.

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