

Canadian Margin Requirements For Uncleared Swaps

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Carol E. Derk and Julie Mansi



Background to WGMR

- In 2011, G20 asked the Basil Committee on Banking Supervision and IOSCO to develop standards for margin requirements for uncleared OTC derivatives
- Formed Working Group on Margin Requirements (WGMR)
- Initial proposal in July 2012; final framework in March 2015
- Key objectives
 - Reduction of systemic risk, via a “defaulter pays” technique
 - Promotion of central clearing

WGMR National Rules Status

Country/Region	Regulator/Authority	Rules Status
USA	Prudential Regulators	Final rules November 2015
Switzerland	Federal Council	Final rules November 2015 (Financial Market Infrastructure Ordinance). Update expected to harmonize with EU
USA	CFTC	Final substantive rules January 2016, final cross-border rules May 2016
Canada	OSFI	Final rules effective September 2016 (Guideline E-22)
Canada	CSA	Consultation paper 95-401 July 2016
Japan	JFSA	Final rules March 2016
South Africa	NT	Draft rules June 2015
Hong Kong	HKMA	Draft rules December 2015
Australia	APRA	Draft rules February 2016
EU	European Supervisory Authorities	Draft rules March 2016
Singapore	MAS	Draft rules May 2016
India	RBI	Discussion paper May 2016

OSFI

OSFI Guideline E-22

- Published by the Office of the Superintendent of Financial Institutions ("OSFI") on February 29, 2016; effective September 1, 2016
- Applies to all non-centrally cleared derivatives except physically settled foreign exchange forwards and swaps
 - For cross-currency swaps, VM applies both components and IM applies to interest rate component
 - Inter-affiliate or intragroup trades are exempt
- Seeks to establish minimum standards for the mandatory exchange of margin
- Imposes margin requirements on federally regulated financial institutions and, indirectly, on their in-scope counterparties (covered entities)

Canadian Securities Administrators – Consultation Paper 95-401

- Derivatives Committee of the CSA published a consultation paper in July 2016 with a proposed set of parallel requirements for transactions not covered by Guideline E-22
- As a result of substituted compliance, the CSA Proposal is expected to apply to a narrow subset of derivatives transactions involving Canadian local counterparties

Guideline E-22: Counterparty Classification

Federally Regulated Financial Institutions (FRFIs)

- OSFI regulated financial institutions
 - Banks, foreign bank branches, bank holding companies, trust and loan companies, cooperative credit associations, cooperative retail associations, life insurance companies, property and casualty insurance companies and insurance holding companies

Guideline E-22: Counterparty Classification

Covered Entity

- A financial entity belonging to a consolidated group whose aggregate month-end average notional amount of non-centrally cleared derivatives exceeds CAD\$12 billion for March, April and May of 2016 or of any year after implementation
 - A financial entity is a legal entity whose main business includes: the management of financial assets, lending, factoring, leasing, provision of credit enhancements, securitization, investments, financial custody, proprietary trading and other financial services activities. Includes, but not limited to, deposit-taking institutions, insurance companies, pension funds, hedge funds, and asset managers
 - Excluded entities are sovereigns, public sector entities, certain multilateral development banks, BIS, central counterparties, qualifying SPEs, treasury affiliates of commercial entities and funds investing in physical assets and real estate

Guideline E-22: Calculating Aggregate Notional Exposure

Aggregate Month-End Average Notional Amount of non-centrally cleared derivatives

- Average of month-end total notional amounts for March/April/May
- Include all entities that a part of a consolidated group (i.e., a group of entities for which consolidated financial statements are prepared)
- Include all non-centrally cleared derivatives, including physically settled FX swap and forwards, but excluding inter-affiliate transactions
- Dynamic assessment - assess on an annual basis and apply margin requirements from September 1st in the relevant year (if going above, apply margin requirements to new trades; if falling below, no new or existing trades are subject to margin requirements)

Guideline E-22: Entity Scope

	Covered FRFI	Covered Entity
Covered FRFI (FRFI that meets covered entity threshold)	Margin rules apply	Margin rules apply
Covered Entity	Margin rules apply	Margin rules do not apply

Guideline E-22: Counterparty Classification Determination

- Covered FRFIs are expected to self-declare themselves as Covered Entities before transacting
- Covered FRFIs are responsible for verifying if their counterparties are Covered Entities
- Determination of Covered Entity status problematic for investment funds
 - Investment funds managed by an investment advisor are considered distinct entities treated separately when applying the threshold so long as the funds are distinct legal entities that are not collateralized by or otherwise supported by other investment funds or the investment advisor in the event of fund insolvency or bankruptcy

95-401: Counterparty Classification

Financial Entity that is a local counterparty

- A financial entity whose aggregate month-end average notional amount of non-centrally cleared derivatives, calculated on a corporate group basis, exceeds CAD\$12 billion for March, April and May of any year after implementation
 - A financial entity includes: cooperative credit associations, central cooperative credit societies, banks, loan corporations, loan companies, trust companies, trust corporations, insurance companies, treasury branches, credit unions, caisses populaires, financial services cooperatives, pension funds, investment funds, and any person or company subject to registration or exempt from registration under securities law as a result of trading in derivatives

Guideline E-22: Substitute Compliance

- Includes substitute compliance provisions to avoid duplicative and conflicting requirements in cross-border context
- Foreign Counterparties: FRFI trading with a foreign Covered Counterparty is deemed to be in compliance where the FRFI:
 - Is required to comply with, and has complied with, the margin requirements imposed on the foreign Covered Counterparty by a foreign jurisdiction and
 - Has documentary evidence that the foreign margin requirements are comparable to BCBS-10SCO

Guideline E-22: Substitute Compliance

- Foreign Branches: a foreign bank or insurance branch operating in Canada is deemed to be in compliance with E-22 where the branch:
 - Is required to comply with, and has complied with, the margin requirements of the foreign jurisdiction under whose laws the branch is established and
 - Has documentary evidence that the foreign margin requirements are comparable to BCBS-10SCO
- FRFIs are required to consult with OSFI regarding their documentary evidence and substitute compliance determinations

95-401: Substitute Compliance

- Also includes substitute compliance provisions to avoid duplicative requirements
- Covered entities that comply with Guideline E-22 do not need to comply with 95-401
- Foreign Regulation: Will assess equivalency of rules of foreign jurisdictions; if deemed equivalent, compliance with those rules will relieve covered entity from complying with 95-401

Guideline E-22: Variation Margin

- Full amount necessary to fully collateralize the mark-to-market exposure of the non-centrally cleared derivatives must be exchanged
 - Subject to a minimum transfer amount (MTA) for all margin transfers (combined VM and IM) of no more than \$750,000
- Should be subject to a single, legally enforceable netting agreement
- Where a netting agreement is not in place, VM generally must be exchanged on a gross basis
- VM calculated and called within 2 business days of trade execution; thereafter, VM calculated and called daily
- VM exchanged (posted/received) on or before 2nd business day after call
- To address valuation uncertainty, parties must have dispute resolution procedures in place

Guideline E-22: Netting Agreement

- Netting agreement deemed legally enforceable if the following conditions are met by Covered FRFIs:
 - Written agreement creates single legal obligation, covering all transactions subject to netting; one obligation to pay or receive based on net sum of the positive and negative mark-to-market values of all transactions if counterparty fails to perform because of default, bankruptcy, liquidation or similar circumstances
 - Conduct sufficient legal review and have well-founded legal basis to verify that courts would find the exposure to be the net amount under the laws of all relevant jurisdictions
 - Procedures in place to ensure continuing enforceability
 - No walkway clause (non-defaulting counterparty must pay if defaulter is a net creditor)
 - Must maintain all required documentation in their files

Guideline E-22: Initial Margin

- Required amount of IM may be calculated by reference to either a quantitative portfolio margin model or a standardised margin schedule
- Choice between model- and schedule-based calculations must, unless a counterparty otherwise requires, be made consistently over time for transactions within the same well defined asset class
- IM calculated and called within 2 business days of trade execution; thereafter, IM calculated and called daily
- IM exchanged (posted and received) on or before 2nd business day after call
- Covered FRFIs must have dispute resolution procedures in place
- IM exchanged on a gross basis

Guideline E-22: Treatment of Initial Margin

- No re-hypothecation of IM; IM can be held in deposit account of custodian in name of posting party
- IM to be held such that:
 - It is immediately available (i.e., as soon as legally possible) to the collecting party in the event of a counterparty's default and
 - It is subject to arrangements that protect the posting party in the event that the collecting party enters bankruptcy

Guideline E-22: Initial Margin Threshold

- Exchange of IM is subject to a threshold not to exceed \$75 million
- Also subject to the same MTA as VM
- Threshold is applied at the level of the consolidated group and is based on all non-centrally cleared derivatives between the two consolidated groups
- When a Covered FRFI transacts with a Covered Counterparty subject to a different IM threshold in its home jurisdiction (and the Covered Counterparty is from a jurisdiction in which the BCBS-IOSCO margin requirements have been implemented and the conditions satisfied), Covered FRFIs can use the IM threshold applicable to the Covered Counterparty

Guideline E-22: Eligible Collateral

Eligible Collateral for VM and IM:

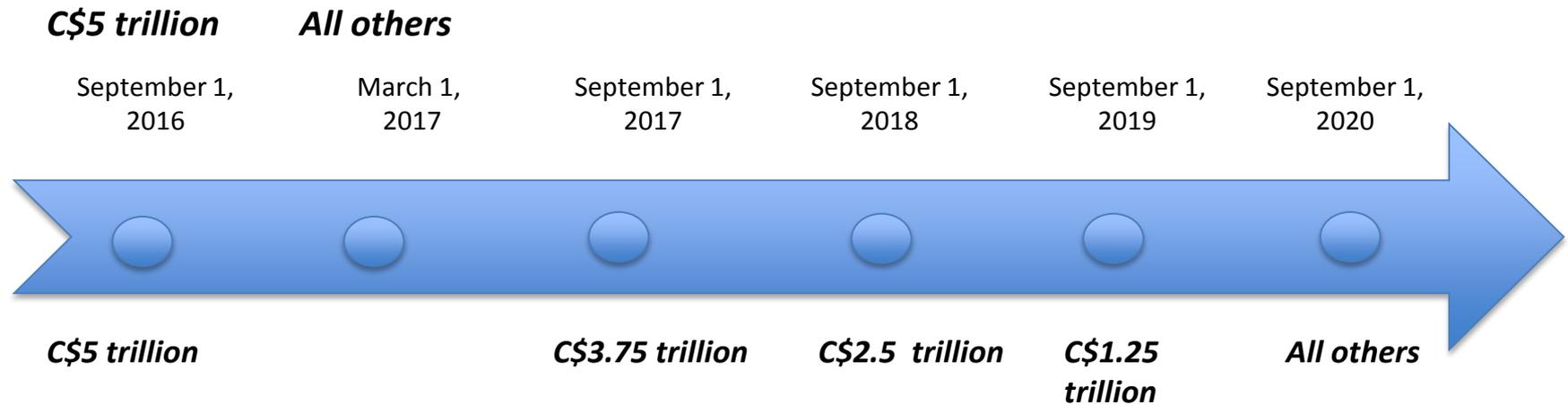
- Cash and gold
- Debt securities rated
 - At least BB- when issued by sovereigns or certain public sector entities
 - At least BBB- when issued by other entities (including banks and securities firms) or
 - At least A-3/P-3 for short-term debt instruments
- Unrated senior bank debt securities listed on recognized exchange that meet certain conditions
- Equities, including convertible bonds, included in a main index or listed on a recognized exchange
- Mutual funds and UCITS if a price is publicly quoted daily it is limited to investing in the above instruments

Guideline E-22: Haircuts

- Margin must be haircutted to account for potential changes in value of the collateral; may be computed using internal model that meets the Guideline requirements
- Cash VM is not subject to the additional haircut when the currency of the asset differs from the currency of collateral
- Non-cash VM exchanged in a currency other than the ones agreed in the relevant contract is subject to additional haircut when currency of the asset differs from currency of the collateral; all other non-cash VM not subject to this additional haircut
- IM exchanged in currency other than the termination currency not subject to additional haircut when currency of the asset differs from currency of the collateral; all other IM subject to additional haircut

Guideline E-22: Phase-in Timeline

Variation Margin phase-in (FRFIs and Covered Entities meet Condition)



Initial Margin phase-in (FRFIs and Covered Entities meet Condition)

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questions or require
further information,
please do not
hesitate to contact:

Carol E. Derk
National Leader, Derivatives
416.367.6181
cderk@blg.com

Julie Mansi
Partner
416.367.6224
jmansi@blg.com