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Mind Your Margin: OSFI Releases Draft Guideline on Margin Requirements for Non-Centrally Cleared Derivatives

Introduction

On October 19, 2015, the Office of the Superintendent of Financial Institutions (**OSFI**) issued a draft version of Guideline E-22: Margin Requirements for Non-Centrally Cleared Derivatives (the **Draft Guideline**).

The Draft Guideline was developed to mitigate systemic risk in the financial sector and to promote central clearing of derivatives by requiring the exchange of margin to secure performance on non-centrally cleared derivatives transactions. To this end, the Draft Guideline substantially incorporates *the margin requirements published by the Basel Committee on Banking Supervision (BCBS) in March 2015*.

OSFI chose to issue a domestic guideline rather than simply reference the BCBS publication in order to put in place exemptions for smaller financial institutions that were unlikely to have a systemic impact and to describe the implementation process in greater detail.

This bulletin discusses the implementation, scope and requirements contemplated by the Draft Guideline, which will be finalized following the public consultation period ending November 27, 2015.

Phase in Period

The requirement to exchange variation and two-way initial margin will be phased in gradually and only applies to contracts entered into after September 1, 2016, as further described below. Contracts existing prior to September 1, 2016 will not be subject to the requirements of the Draft Guideline. However, extensions to existing derivatives contracts will be considered new contracts.

Variation Margin

Federally-regulated financial institutions (**FRFIs**) whose aggregate month-end average notional amount of non-centrally cleared derivatives, including physically-settled foreign exchange forwards and swaps, exceeds $5 trillion for March, April and May of 2016 will be subject to the variation margin requirements outlined in the Draft Guideline effective September 1, 2016.

All other Covered FRFIs, defined below, will be subject to the variation margin requirements effective March 1, 2017.

Two-Way Initial Margin

The requirement to exchange two-way initial margin with a threshold of up to $75 million will be phased in progressively over five years, beginning September 1, 2016. Applicability is based on the FRFI's aggregate month-end average notional amount of non-centrally cleared derivatives in March, April and May in each of these five years as follows:

- September 1, 2016 – applicable where aggregate month-end average exceeds $5 trillion;
- September 1, 2017 – applicable where aggregate month-end average exceeds $3.75 trillion;
- September 1, 2018 – applicable where aggregate month-end average exceeds $2.5 trillion;
- September 1, 2019 – applicable where aggregate month-end average exceeds $1.25 trillion; and
- September 1, 2020 – applicable where aggregate month-end average exceeds $12 billion.

As with variation margin, physically-settled foreign exchange forwards and swaps should be included in this calculation.

Scope of Coverage

Only non-centrally cleared derivatives between a Covered FRFI and a Covered Entity are subject to the margin requirements set out in the Draft Guideline. A Covered Entity is defined as a financial or non-financial entity belonging to a consolidated group whose aggregate month-end average notional amount of non-centrally cleared derivatives for March, April and May exceeds $12 billion (financial entity) or $50 billion (non-financial entity) as of 2016. A FRFI that satisfies this requirement is a Covered FRFI.

Note that certain domestic and international governmental entities are excluded from the definition of Covered Entity and are not obligated to post margin. Covered FRFIs are also exempt from this requirement when transacting with these entities.

OSFI expects Covered FRFIs to self-declare as Covered Entities prior to transacting with counterparties, and Covered FRFIs must confirm whether said counterparties are Covered Entities.

The margin requirements set out in the Draft Guideline apply to all non-centrally cleared derivatives, with the exception of physically settled foreign exchange forwards and swaps; however, as noted in the previous section, foreign exchange forwards and swaps should still be included in the threshold calculation for determining the phased in application of the margin requirements.

The Draft Guideline further sets out that all margin transfers (the combined variation and initial margin) are subject to a minimum transfer amount that is not to exceed $750,000. Furthermore, non-centrally cleared derivatives between a Covered FRFI and its affiliates, such as intra-group trades, are not subject to the margin requirements set out in the Draft Guideline.

Variation Margin Requirements

The amount necessary to collateralise the mark-to-market exposure of non-centrally cleared derivatives must be exchanged as variation margin, with this amount calculated and called on a daily basis and posted no later than one business day following such calculation. Variation margin should also be calculated and exchanged for non-centrally cleared derivatives subject to a single netting agreement as this mitigates the risk of adverse liquidity shocks and reduces counterparty credit risk.

The valuation of a derivative's exposure is complex and may be subject to disagreement. Consequently, OSFI advises parties to derivatives contracts to put dispute resolution procedures in place prior to transacting with a counterparty.

Initial Margin Requirements

Initial margin may be calculated by reference to an internal model or the standardized model provided in the Draft Guideline, and the selected approach should be consistently applied.

Initial margin is subject to a threshold amount not to exceed $75 million and is not required where the Covered Entity faces zero counterparty risk.[1]

Initial margin should be exchanged on a gross basis as this ensures both parties have posted the full amount; netting this sum is not permitted. Furthermore, initial margin must be held in a manner that protects it from being lost if a counterparty defaults. In Canada, this usually entails third-party custody, and the risk of custodian insolvency should be taken into account when making these arrangements.

Finally, initial margin received from a counterparty may not be used as collateral in trades with another party; in short, it cannot be rehypothecated, increasing the costs associated with posting initial margin.

Internal Model

While the use of an internal model does not require approval from OSFI, the following conditions must be met:

- initial margin requirements must be based on an appraisal of future exposure;
- possible exposure should take into account extreme, but nevertheless plausible, scenarios;
- calibration data must be based on a uniformly weighted historical observation window of at least one year and not more than five years; and

[1] For example, there would be zero counterparty credit risk where Party A, the option writer, agrees to sell a fixed number of shares to Party B, the option purchaser, at a predetermined price and date, and the option purchaser compensates the option writer for the risk that it will have to sell its shares on these terms with a payment that fully accounts for this risk at the outset of the transaction. In these circumstances, the option writer has received the full value of the option, faces zero counterparty credit risk and is not obliged to collect and post initial margin from the option purchaser. In contrast, the option purchaser remains subject to the risk that the option writer may not be willing or able to sell the shares on the agreed terms and would, therefore, need to collect and post initial margin from the option writer.

- the model must include risk factors that account for material price risks inherent to the transaction for which initial margin is being calculated.

Internal models should be reviewed, at a minimum, on an annual basis. Should the review process reveal a material problem, OSFI must be notified, and this notification should include a description of the remedial steps that have been, or will be, taken. OSFI also reserves the right to review internal models and ensure compliance with the foregoing requirements.

Standard Model

Entities that do not wish to use an internal model may apply the standardized framework provided in the Draft Guideline. Under this approach, initial margin is calculated as a percent of notional exposure, ranging from 1% to 15% depending on the asset class, with a further adjustment based on the net-to-gross ratio applicable to the derivatives in the netting set.

Eligible Collateral

The following collateral instruments are eligible to satisfy both the variation and initial margin requirements set out in the Draft Guideline:

- cash, which includes the cash equivalents listed in s. 44(a) of the Draft Guideline;
- gold;
- eligible debt securities, as set out in ss. 44(c) and 44(d) of the Draft Guideline;
- equities listed on a main index or recognised exchange, including convertible bonds; and
- mutual funds, provided the unit price is publicly quoted on a daily basis and limited to investments in the foregoing instruments.

Note that securities issued by the counterparty are not eligible collateral.

In addition, the posted margin will receive a haircut to account for potential changes in the value of the collateral. As with calculating the amount of initial margin, haircuts may be computed using the framework provided in the Draft Guideline or by applying an internal model.

Where an internal model is used, Covered FRFIs must factor the illiquidity of lower-quality assets into their model and employ historical data with an observation window of at least one year to identify – and, where necessary, take steps to account for – potential volatilities. These data sets should be updated at least once every three months and reassessed in the event that market prices undergo a material change.

Alternatively, standard supervisory haircuts can be applied using the framework provided in the Draft Guideline. Where debt securities are concerned, the haircut is determined by taking into account the rating of the debt security, residual maturity and the type of issuer. Gold and main index equities, as defined by OSFI, are subject to a 15% haircut. In Canada, OSFI has recognized the S&P/TSX 60 as a main index. Equities that are not traded on a main index receive a 25% haircut.

Next Steps and Comments

OSFI has invited industry to comment on the Draft Guideline by November 27, 2015, and has specifically requested input on including credit intermediation swaps required under the Canada Mortgage Bond program within the ambit of this guideline. Comments will be taken into consideration when developing the final guideline, which is slated to take effect on September 1, 2016 through the gradual implementation of the requirements, as described above.

The CSA Derivatives Committee will also be publishing a consultation paper on margin requirements for non-centrally cleared derivatives in the near future and it is expected that there will be a rule published by the end of 2016 putting in place bilateral margin requirements for Canada OTC derivatives market participants other than FRFIs.

We invite market participants to discuss their questions and concerns with our legal team and are available to assist those wishing to submit comments.

by Shahen Mirakian, Sean Brandreth
and Matthew Burns, Student-at-Law

For more information on this topic, please contact:

Toronto	Shahen A. Mirakian	416.865.7238	shahen.mirakian@mcmillan.ca
Toronto	Sean Brandreth	416.865.7114	sean.brandreth@mcmillan.ca

a cautionary note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.