

Canadian Securities Administrators  
CSA Consultation Paper 95-401  
Margin and Collateral Requirements for Non-Centrally Cleared  
Derivatives

Canadian Securities Administrators' Derivatives Committee  
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**CSA CONSULTATION PAPER 95-401**  
**MARGIN AND COLLATERAL REQUIREMENTS FOR NON-CENTRALLY**  
**CLEARED DERIVATIVES**

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## EXECUTIVE SUMMARY

Subsequent to the 2008 financial crisis, the G20 leaders agreed on reforms to the regulation of over-the-counter (OTC) derivatives markets. One element of these reforms, agreed to at the Cannes Summit held in November 2011, was the development of margin standards for non-centrally cleared derivatives.<sup>1</sup> The G20 leaders called on the Basel Committee on Banking Supervision and the International Organization for Securities Commission (jointly, **BCBS-IOSCO**) to develop these standards (**BCBS-IOSCO Standards**) that were published in March, 2015.<sup>2</sup>

In February 2016 the Office of the Superintendent of Financial Institutions Canada (**OSFI**) published *OSFI Guideline E-22 on Margin Requirement for Non-Centrally Cleared Derivatives (OSFI Guideline)*<sup>3</sup> applicable to federally regulated financial institutions (**FRFIs**). FRFIs subject to and complying with the OSFI Guideline<sup>4</sup> would be relieved from the requirement to comply with the proposals in this consultation paper. Such FRFIs are included in the definition of “covered entity” for the purpose of defining the counterparties with which a covered entity that is not a FRFI would be required to exchange margin.

The following is a summary of the policy recommendations of the Canadian Securities Administrators (**CSA**) Derivatives Committee (the **Committee** or **we**) for minimum margin requirements for non-centrally cleared derivatives. These recommendations are based predominantly on the BCBS-IOSCO Standards and are largely consistent with the OSFI Guideline.

### Scope of derivatives

1. Initial and variation margin requirements apply to all OTC derivatives except:
  - (a) in Manitoba and Ontario, derivatives prescribed not to be derivatives or excluded from being prescribed derivatives under Manitoba Securities Commission Rule 91-506 *Derivatives: Product Determination* and Ontario Securities Commission Rule 91-506 *Derivatives: Product Determination*;
  - (b) in Québec, derivatives specified under Québec Regulation 91-506 respecting Derivatives Determination;
  - (c) in all other jurisdictions, derivatives excluded from the definition of specified derivative under Multilateral Instrument 91-101 *Derivatives: Product Determination* (with the rules listed in (a) and (b), **local product determination rules**);

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<sup>1</sup> G20, *Cannes Summit Final Declaration*,

[http://www.g20civil.com/documents/Cannes\\_Declaration\\_4\\_November\\_2011.pdf](http://www.g20civil.com/documents/Cannes_Declaration_4_November_2011.pdf)

<sup>2</sup> BCBS-IOSCO, *Margin requirements for non-centrally cleared derivatives*, <http://www.bis.org/bcbs/publ/d317.pdf>

<sup>3</sup> OSFI, *OSFI Guideline E-22 on Margin requirements for non-centrally cleared derivatives*, <http://www.osfi-bsif.gc.ca/Eng/Docs/e22.pdf>

<sup>4</sup> OSFI would be responsible for monitoring FRFIs' compliance with the OSFI Guideline, given its role as the prudential regulator of FRFIs.

(d) derivatives cleared through a central counterparty.

2. Derivatives that are physically settled foreign exchange (FX) forwards and FX swaps would be excluded from initial margin requirements. Where the derivative is a cross-currency swap that includes a fixed physically settled FX component, the initial margin requirement would only apply to the interest rate component. Variation margin requirements would still apply to all FX derivatives including all components of cross-currency swaps.

### **Scope of entities**

3. The requirement to exchange margin would apply where both counterparties to a non-centrally cleared derivative are covered entities. A covered entity would be defined as a financial entity with an aggregate month-end average notional amount under all outstanding non-centrally cleared derivatives above \$12 000 000 000<sup>5</sup> excluding derivatives with affiliated entities benefitting from the intragroup exemption.

### **Margin requirements**

4. Covered entities would be required to exchange initial margin and deliver variation margin.
5. Initial margin would be required to be calculated using either a quantitative margining model or a standardized schedule prescribed by the CSA. A covered entity would be required to choose between using a quantitative margining model and following the prescribed standards, and should not “cherry pick” between a quantitative margining model or the standardized schedule for each class of derivatives<sup>6</sup> to achieve favourable margin outcome.
6. Covered entities would be required to ensure that the quantitative margining model has been independently certified and calibrated to meet a single-tailed 99% confidence interval over a 10-day close-out period valuation for each class of derivatives to which the covered entity is a party.
7. Covered entities that use a certified quantitative margining model would be required to have the model recalibrated and independently reviewed<sup>7</sup> at least annually.

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<sup>5</sup> All dollar amounts referenced in this consultation paper are in Canadian dollars unless stated.

<sup>6</sup> A class of derivatives includes derivatives of similar characteristics. For example, “interest rate swap” or “crude oil forward” are each considered a class of derivatives.

<sup>7</sup> An independent review could be conducted by the audit or risk control units of the covered entity as long as they are sufficiently independent from the unit or units responsible for derivatives trading activity and the developer of the model.

8. Covered entities would be required to calculate and call initial margin by the end of the second business day following the execution of a transaction and recalculate and call it daily thereafter.
9. Covered entities would not be required to exchange initial margin if the total amount of initial margin required to be delivered by the covered entities under all outstanding non-centrally cleared derivatives, determined on a consolidated group basis, is not more than \$75 000 000 (**the \$75 000 000 threshold**). Covered entities would only be required to exchange the initial margin that is over and above \$75 000 000.
10. Covered entities would be required to exchange initial margin exceeding \$75 000 000 (subject to the \$750 000 transfer threshold discussed below) on a gross basis by the end of the second business day following the day the initial margin is called.
11. Covered entities would be required to calculate variation margin based on an appropriate valuation method. Where recently transacted price data from independent sources is available, covered entities would be expected to determine the valuation using a mark-to-market method. Covered entities would be permitted to use independently certified alternative methods to value derivatives when price data is unreliable or unavailable.
12. Covered entities would be required to calculate and call variation margin by the end of the second business day after the execution of a transaction and recalculate and call it daily thereafter.
13. Covered entities would not be required to deliver initial or variation margin if the sum of the initial and variation margin required to be delivered by the covered entity is less than \$750 000 (**the \$750 000 transfer threshold**). However, where the amount to be delivered is more than \$750 000, a covered entity would be required to deliver the entire amount of margin that is payable.
14. Each covered entity would be required to deliver variation margin in an amount sufficient to fully collateralize the mark-to-market (or mark-to-model) value of the derivative, subject to the \$750 000 transfer threshold, by the end of the second business day following the day the variation margin is called.
15. Covered entities would be required to negotiate and enter into an agreement with each of their counterparties that are also covered entities. The agreement would establish the rights and obligations of the covered entities in relation to key aspects of their relationship including: the methodology used to calculate margin, exchange of variation margin, exchange of initial margin – including risk offsets, acceptable collateral and haircut imposed

on collateral, terms of re-hypothecation, re-use or re-pledging of collateral, segregation or custodian arrangements and the process to resolve defaults.

16. Covered entities would be required to establish dispute resolution procedures with all their counterparties that are also covered entities. The dispute resolution procedures should include a process to determine, resolve and escalate disputes relating to both initial and variation margin. Covered entities would be required to exchange and transfer at least the undisputed amount while resolving a dispute.

### **Eligible collateral**

17. Consistent with BCBS-IOSCO Standards and the requirements of foreign regulatory authorities, assets to be delivered as collateral should:
  - (a) be highly liquid;
  - (b) after accounting for an appropriate haircut, be able to hold their value in a time of financial stress; and
  - (c) have quoted prices that are reasonably accessible to the public to allow counterparties to value the asset.
  
18. These assets should include but would not be limited to:
  - (a) cash (in the form of money credited to an account or similar claims for the repayment of money, such as certificates of deposit or comparable instruments issued by a covered entity);
  - (b) gold;
  - (c) debt securities issued by or guaranteed by the Government of Canada or the Bank of Canada or the government of a province or territory of Canada;
  - (d) debt securities issued and fully guaranteed by the Bank for International Settlements, the International Monetary Fund or a multilateral development bank with a rating of at least BB-;
  - (e) debt securities issued by foreign governments [guaranteed by the revenues of those governments] with a rating of at least BB-;
  - (f) debt securities issued by corporate entities with a rating of at least BBB-;
  - (g) equities included in major Canadian stock indices;
  - (h) mutual funds, where:
    - (i) a price for the fund's units is publicly quoted daily; and
    - (ii) the mutual fund is limited to investing in the assets above.
  
19. To facilitate transactions involving non-Canadian counterparties, covered entities would be permitted to post and receive foreign assets that are equivalent to the Canadian assets listed as eligible collateral.

20. Covered entities would be required to establish and maintain internal policies and procedures to manage collateral exposure and concentration limits for collateral received as margin, including to avoid wrong-way risks.
21. Covered entities would be required to apply appropriate haircuts, calculated using either a certified quantitative haircut model or a standardized haircut schedule, to all collateral received. The method that is adopted by a covered entity should be applied consistently to avoid “cherry-picking”.

### **Treatment of collateral**

22. Covered entities would be required to segregate collateral they receive as initial margin from their own assets but would be permitted to commingle collateral received from one counterparty with collateral they have received from other counterparties.
23. Covered entities would be required to maintain records to facilitate the identification and timely return of collateral in the event of a default by the receiving covered entity or liquidation in the event of a default by the posting covered entity. Covered entities would be required to keep separate records in respect of each posting counterparty.
24. Covered entities would not be required to hold received collateral at a third party custodian. However, covered entities receiving collateral would be required to provide the posting counterparty with the option to have the posted collateral held at a third party custodian.
25. Collateral received as initial margin should only be re-hypothecated, re-used or re-pledged to fund a back-to-back hedge of the derivative position of the collateral posting covered entity. The re-hypothecating, re-using or re-pledging of collateral should only occur once so that a party that receives re-hypothecated collateral may not re-hypothecate the collateral again.

### **Exclusions, exemptions and substituted compliance**

26. The counterparties below would be excluded from the application of these margin requirements:
  - (a) the government of Canada, the government of a jurisdiction of Canada or the government of a foreign jurisdiction;
  - (b) a crown corporation for which the government of the jurisdiction where the crown corporation was constituted is responsible for all or substantially all the liabilities;
  - (c) an entity wholly owned by one or more governments, referred to in paragraph (a), that are responsible for all or substantially all the liabilities of the entity;
  - (d) the Bank of Canada or a central bank of a foreign jurisdiction;
  - (e) the Bank for International Settlements;
  - (f) the International Monetary Fund.



27. A derivative would be excluded from these margin requirements where both parties to the derivative are affiliated entities, if:
- (a) both entities are prudentially supervised on a consolidated basis; or
  - (b) financial statements for both entities are prepared on a consolidated basis in accordance with “accounting principles” as defined in National Instrument 52-107 *Acceptable Accounting Principles and Auditing Standards*.<sup>8</sup>
28. Covered entities that are not FRFIs, satisfy these margin requirements if they enter into a derivative with a FRFI that is subject to the OSFI Guideline and they exchange margin for that derivative in accordance with the OSFI Guideline.
29. Covered entities entering into a derivative with a foreign counterparty that is a covered entity but not a local counterparty and is subject to and complies with rules imposed by a regulatory authority in the foreign counterparty’s home jurisdiction that are assessed to be equivalent to these margin requirements and meet the BCBS-IOSCO Standards would be relieved from these margin requirements. The counterparties would decide whether the derivative would be subject to these margin requirements or the rules of the foreign counterparty’s home jurisdiction that are assessed to be equivalent to these margin requirements.

### **Phase-in**

30. The Committee would establish a phase-in timeline adapted from the phase-in timeline in the BCBS-IOSCO Standards when publishing the proposed national instrument.

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<sup>8</sup> CSA, National Instrument 52-107 *Acceptable Accounting Principles and Auditing Standards*, [http://www.nbsc-cvmb.ca/nbsc/uploaded\\_topic\\_files/52-107-NI-CONS-2016-04-30-E.pdf](http://www.nbsc-cvmb.ca/nbsc/uploaded_topic_files/52-107-NI-CONS-2016-04-30-E.pdf)

## COMMENTS AND SUBMISSIONS

The Committee invites participants to provide input on the issues outlined in this consultation paper. You may provide written comments in hard copy or electronic form. The comment period expires September 6, 2016.

The Committee will publish all responses received on the websites of the Autorité des marchés financiers ([www.lautorite.qc.ca](http://www.lautorite.qc.ca)) and the Ontario Securities Commission ([www.osc.gov.on.ca](http://www.osc.gov.on.ca)). Therefore, you should not include personal information directly in comments to be published. It is important that you state on whose behalf you are making the submission.

Please address your comments to each of the following:

Alberta Securities Commission  
Autorité des marchés financiers  
British Columbia Securities Commission  
Financial and Consumer Affairs Authority of Saskatchewan  
Financial and Consumer Services Commission (New Brunswick)  
Manitoba Securities Commission  
Nova Scotia Securities Commission  
Ontario Securities Commission

Please send your comments only to the following addresses. Your comments will be forwarded to the remaining jurisdictions:

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## PART 1 – INTRODUCTION

At the G20 Cannes Summit of November 2011, finance ministers committed to the development of margin requirements for non-centrally cleared derivatives as part of the G20 reforms to enhance the stability of the international financial system. To this end, the Basel Committee on Banking Supervision and the International Organization of Securities Commissions collaborated to develop standards on margin requirements for non-centrally cleared derivatives. The BCBS-IOSCO report, *Margin requirements for non-centrally cleared derivatives* was published in September 2013<sup>9</sup> and a revised version was published in March 2015.<sup>10</sup> This establishes the international standards relating to margin and collateral requirements for non-centrally cleared derivatives.

In response to the BCBS-IOSCO Standards, major jurisdictions published draft proposals or regulations on margin and collateral requirements for non-centrally cleared derivatives. These include:

- (a) In Europe, the Joint Committee of the European Supervisory Authorities (**ESAs**) published *Draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012* in April 2014<sup>11</sup> which was republished for a second consultation in June 2015.<sup>12</sup> The ESAs published the *Final draft technical standards on margin requirements for non-centrally cleared derivatives* in March 2016.<sup>13</sup>
- (b) In the United States, the Office of Comptroller of Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency (jointly, **US Federal Agencies**) published the final rule<sup>14</sup> and interim final rule,<sup>15</sup> *Margin and Capital Requirements for Covered Swap Entities* in October 2015.

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<sup>9</sup> BCBS-IOSCO, *Margin requirements for non-centrally cleared derivatives*, <http://www.bis.org/publ/bcbs261.pdf>

<sup>10</sup> BCBS-IOSCO, *Margin requirements for non-centrally cleared derivatives*, <http://www.bis.org/bcbs/publ/d317.pdf>

<sup>11</sup> ESAs, *Draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012*, [https://www.eba.europa.eu/documents/10180/655149/JC+CP+2014+03+\(CP+on+risk+mitigation+for+OTC+derivatives\).pdf](https://www.eba.europa.eu/documents/10180/655149/JC+CP+2014+03+(CP+on+risk+mitigation+for+OTC+derivatives).pdf)

<sup>12</sup> ESAs, *Draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012*, <https://www.eba.europa.eu/documents/10180/1106136/JC-CP-2015-002+JC+CP+on+Risk+Management+Techniques+for+OTC+derivatives+.pdf>

<sup>13</sup> ESAs, *Final draft technical standards on margin requirements for non-centrally cleared derivatives*, <https://www.esma.europa.eu/press-news/esma-news/esas-publish-final-draft-technical-standards-margin-requirements-non-centrally>

<sup>14</sup> US Federal Agencies, *Margin and Capital Requirements for Covered Swap Entities; Final Rule*, <https://www.gpo.gov/fdsys/pkg/FR-2015-11-30/pdf/2015-28671.pdf>

<sup>15</sup> US Federal Agencies, *Margin and Capital Requirements for Covered Swap Entities; Interim Final Rule*, <https://www.gpo.gov/fdsys/pkg/FR-2015-11-30/pdf/2015-28670.pdf>

- (c) Also in the US, the Commodity Futures Trading Commission (CFTC) published the final rule, and an interim final rule, *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants* in December 2015.<sup>16</sup>
- (d) In Singapore, the Monetary Authority of Singapore published *Policy Consultation on Margin Requirements for Non-Centrally Cleared OTC Derivatives* in October 2015.<sup>17</sup>

In Canada, the Committee was tasked to develop regulations to meet the G20 commitments and has worked closely with the Bank of Canada, OSFI and the Department of Finance Canada as part of the Canadian inter-agency OTC Derivatives Working Group (**OTC Derivatives Working Group**). The jurisdictions participating in the Committee published *CSA Consultation Paper 91-401 on Over-the-Counter Derivatives Regulation in Canada* in November 2010<sup>18</sup> (**Consultation Paper 91-401**). It contained high-level proposals to regulate OTC derivatives in Canada, addressing each element in the G20 commitments, including margin and collateral requirements for non-centrally cleared derivatives. We received eighteen comment letters. Generally, commenters were concerned about the impact of margin and collateral requirements on costs and liquidity. However, several commenters were supportive of a risk-based approach and agreed that collateral requirements should be imposed on entities in accordance with the risks they assume. In addition, some commenters indicated that collateral requirements for non-centrally cleared derivatives be beneficial as it would encourage the use of central counterparty clearing.

The Committee believes that the exchange of initial margin can be an effective way to protect counterparties to non-centrally cleared derivatives from potential exposure during the time it takes to closeout and replace the position in the event of a counterparty default. The Committee also believes that variation margin should be sufficient to mitigate the risk resulting from ongoing changes in the value of a derivative. Together, initial margin and variation margin requirements for non-centrally cleared derivatives will serve to reduce counterparty risk and systemic risk. The amount of initial margin and variation margin that will be required to be delivered will generally reflect the higher risks of non-centrally cleared derivatives compared to those that are centrally cleared and thus, promote the use of central counterparty clearing.

In developing these margin requirements, the Committee has consulted with members of the OTC Derivatives Working Group and has considered the BCBS-IOSCO Standards as well as proposals from other major jurisdictions. The Committee will continue to monitor and review

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<sup>16</sup> CFTC, *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participant*, <http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/federalregister121615.pdf>

<sup>17</sup> MAS, *Policy Consultation on Margin Requirements for Non-Centrally Cleared OTC Derivatives*, <http://www.mas.gov.sg/News-and-Publications/Media-Releases/2015/MAS-Consults-on-Margin-Requirements-for-NonCentrally-Cleared-OTC-Derivatives.aspx>

<sup>18</sup> CSA, *CSA Consultation paper 91-401 on Over-the-Counter Derivatives Regulation in Canada*, [http://www.nbsc-cvmb.ca/nbsc/uploaded\\_topic\\_files/91-401-CSA-ConsultationPaper-2010-11-02-E.pdf](http://www.nbsc-cvmb.ca/nbsc/uploaded_topic_files/91-401-CSA-ConsultationPaper-2010-11-02-E.pdf)

developments and proposals with respect to margin requirements in other jurisdictions. The Committee's proposals in this consultation paper are intended to be largely harmonized with the OSFI Guideline.

This consultation paper is the Committee's initial step in developing a regulation relating to minimum margin requirements for non-centrally cleared derivatives in Canada. Counterparties will always be able to exchange margin in amounts that exceed these minimum requirements and agree to exchange initial margin and deliver variation margin where these requirements do not apply. This consultation paper outlines a proposal for a framework that would establish:

- (a) the scope of derivatives and derivatives market participants that would be subject to the requirements;
- (b) requirements to exchange initial margin and deliver variation margin;
- (c) the mechanism to calculate margin and collateral required for derivatives that are not cleared through a clearing agency that acts as a central counterparty;
- (d) categories of eligible collateral;
- (e) procedures for the control, treatment and protection of collateral pledged to counterparties;
- (f) requirements to have a process for dispute resolution;
- (g) substituted compliance where a transaction involves an entity that is subject to equivalent requirements;
- (h) exclusions for certain entities and categories of derivatives from these margin requirements.

## **PART 2 – SCOPE OF DERIVATIVES**

In determining the scope of derivatives that would be subject to these proposed margin requirements, we intend to capture all non-centrally cleared derivatives, in a manner that is consistent with international standards, given that derivatives often trade across national borders. This would aid in the application of the margin requirements and substituted compliance for cross-border transactions. It would also provide derivatives market participants with clarity and certainty when they negotiate and enter into derivatives contracts. In this regard, subject to the exclusions discussed below, we propose to apply these margin requirements to all OTC derivatives that are not cleared through a central counterparty.

### **Physical FX**

The BCBS-IOSCO Standards recommend that margin requirements be applied to all non-centrally cleared derivatives, excluding physically settled FX forwards and FX swaps

(collectively, **physical FX**).<sup>19</sup> Rules and proposals published by the foreign regulatory authorities are consistent with the BCBS-IOSCO Standards in excluding physical FX from margin requirements.

The Committee has further considered the treatment of physical FX in the BCBS-IOSCO Standards and foreign proposals. The Committee has noted that it is currently standard market practice for counterparties to exchange variation margin, but not initial margin, when transacting in physical FX. The exchange of variation margin is in accordance with standards established by BCBS's *Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions*<sup>20</sup> (**BCBS Guidance**). The BCBS Guidance has addressed the need for variation margin in physically settled FX trades. Based on this consideration, and to maintain consistency with rules and proposals from other regulatory authorities, we propose to exclude physical FX from the application of initial margin requirements. For fixed physically settled cross-currency swaps, the requirement to exchange initial margin would apply only to the interest rate component. Variation margin requirements would still apply to all FX derivatives including all components of cross-currency swaps.

### **Contracts and instruments excluded under local product determination rules**

We believe that these margin requirements should apply to the same contracts and instruments that are subject to other OTC derivatives rules in Canada. The statutory definition of “derivative” in each CSA jurisdiction is broad and captures numerous types of contracts and instruments that have not traditionally been considered derivatives. The Committee believes that Canadian OTC derivatives rules should not apply to certain contracts and instruments that are captured in the broad statutory definitions of “derivative”. To achieve this consistency, we propose that these margin requirements apply to all non-centrally cleared derivatives except the products excluded by the local product determination rules. References to “derivative” throughout this consultation paper should be read to exclude the products excluded by the local product determination rules.

#### Question

1. Central counterparties that are not recognized or exempted from recognition as a clearing agency or a clearing house in a jurisdiction of Canada may have margining standards that are not equivalent to local requirements, potentially weakening the risk-mitigation objective of central clearing. Should counterparties be required to post margin for derivatives that are cleared on clearing agencies or clearing houses that are not recognized or exempt from recognition in a jurisdiction of Canada? Please explain.

<sup>19</sup> BCBS-IOSCO, *Margin requirements for non-centrally cleared derivatives*, <https://www.bis.org/bcbs/publ/d317.pdf>

<sup>20</sup> BCBS, *Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions*, <http://www.bis.org/publ/bcbs241.pdf>

## PART 3 – SCOPE OF ENTITIES

The BCBS-IOSCO Standards recommend that the margin requirements apply to non-centrally cleared derivatives between two counterparties that are each either a financial firm or a systemically important non-financial firm. Rules and proposals from foreign regulatory authorities have similarly restricted the scope of their requirements to apply only to financial entities and systemically important non-financial entities.

IOSCO observes that many key participants in non-centrally cleared derivatives are highly interconnected financial firms.<sup>21</sup> This interconnectedness heightens systemic risk through the contagion effect should a financial firm default. Since a primary reason for margin requirements is to address counterparty risk, and thus indirectly systemic risk, we consider it prudent to impose margin requirements on financial entities that are local counterparties.

We propose that “financial entity” be defined to include 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 that is subject to registration or exempted from registration under securities legislation of a jurisdiction of Canada, in any registration category, as a result of trading in derivatives.

We intend to require the exchange of initial and variation margin for non-centrally cleared derivatives where both the counterparties are covered entities. We propose to define a covered entity as a financial entity whose aggregate month-end average notional amount outstanding<sup>22</sup> in non-centrally cleared derivatives, calculated on a corporate group<sup>23</sup> basis, excluding intragroup transactions<sup>24</sup>, exceeds \$12 000 000 000 (**the \$12 000 000 000 threshold**). We note that financial entities below the \$12 000 000 000 threshold may attract higher capital requirements in forthcoming rules for having non-centrally cleared derivatives that are not collateralized, despite not being subject to these margin requirements.

To determine whether a financial entity is a covered entity, its aggregate month-end average notional amount outstanding would be calculated for the months of March, April and May of each year. If this amount exceeds the threshold, the financial entity would be considered a covered entity for 1 year, beginning from September 1 of that year to August 31 the following

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<sup>21</sup> IOSCO, *Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives*, <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD469.pdf>

<sup>22</sup> The calculation of aggregate month-end average notional in non-centrally cleared derivatives would include physical FX but exclude intragroup derivatives.

<sup>23</sup> Investment funds that are managed by a portfolio manager or a portfolio adviser are considered distinct entities that are treated separately when applying the threshold as long as the funds are distinct legal entities that are not collateralized or otherwise guaranteed or supported by other investment funds, the portfolio manager or portfolio adviser in the event of insolvency or bankruptcy.

<sup>24</sup> This exemption is further explained in Part VII.



year. If the financial entity's aggregate month-end average notional amount outstanding for the months of March, April and May does not exceed the threshold, it would not be a covered entity for 1 year beginning on September 1 of that year.

An entity ceases to be a covered entity on September 1 of the year if its aggregate month-end average notional amount outstanding calculated for the months of March, April and May falls below the \$12 000 000 000 threshold. In such a situation, all existing non-centrally cleared derivatives of that entity will no longer be subject to these margin requirements.

## **PART 4 – MARGIN REQUIREMENTS**

### **Initial margin**

The exchange of initial margin is a key tool to mitigate the risk that the default of a derivatives market participant could adversely impact Canadian financial markets in a material way. It ensures that counterparties have sufficient collateral to address the risk of potential losses that could reasonably occur during the time it takes to closeout and replace the derivative, should their counterparty default. The BCBS-IOSCO Standards recommend that the requirement to exchange initial margin only apply to covered entities with an aggregate month-end average notional amount above the stipulated phase-in threshold, and they require that the exchange of initial margin be determined on a gross basis. They further recommend that a minimum threshold on a consolidated group basis of not more than €50 000 000 must be exceeded before initial margin be required to be exchanged. Other foreign regulatory authorities have adopted the BCBS-IOSCO Standards using that threshold and phase-in thresholds converted to their local currencies.

The Committee understands that the concept behind exchanging initial margin is a “defaulter pays” safeguard. It ensures the surviving counterparty has sufficient collateral from the defaulting counterparty to fulfil the defaulting counterparty's financial obligations under all derivatives with the surviving counterparty. This protects the non-defaulting counterparty from potential future exposure arising from the default. The Committee is cognizant of the fact that, to meet on-going initial margin requirements, demand on high-quality collateral in Canada will increase. This may result in a significant impact on the availability, price and liquidity of high-quality collateral.

The Committee is conscious of the need to balance the risk-mitigating benefits of exchanging initial margin with the costs arising from increased demand for such collateral resulting from the need to exchange or deliver margin. In consideration of the potential cost and operational burden of complying with the initial margin requirements, we recommend that the requirement to exchange initial margin only apply to transactions where the counterparties to the derivative are

both covered entities. Thus, the exchange of initial margin would not apply to non-centrally cleared derivatives where one of the counterparties is not a covered entity.

The Committee is also of the view that the introduction of a minimum threshold that is aligned with international standards, rules and proposals would help to achieve an appropriate balance of the risk-mitigating benefits of exchanging initial margin and the costs associated with the demand for high-quality collateral. Such a minimum threshold would reduce the overall demand for collateral as the two covered entities would not be required to exchange initial margin if the amount due is below the minimum threshold. We recommend that the requirement to exchange initial margin be subject to a minimum threshold on a consolidated group basis of not more than \$75 000 000. The allocation of the \$75 000 000 threshold should be determined by the counterparties on a consolidated group basis by aggregating the total exposure among all affiliated entities. If the amount of initial margin a covered entity owes is in excess of \$75 000 000, it would be required to deliver the amount that exceeds the \$75 000 000 threshold (subject to a minimum transfer threshold, discussed below) even if its counterparty is below the \$75 000 000 threshold.

The Committee is of the view that the exchange of initial margin on a net basis would diminish the benefits of exchanging initial margin. Netting of initial margin would reduce the amount of margin to be exchanged, which may not be commensurate with the risk relating to the outstanding non-centrally cleared derivatives between the counterparties. Therefore, we recommend that initial margin be exchanged on a gross basis between covered entities.

To illustrate, suppose a covered entity A has three affiliates  $A_1$ ,  $A_2$  and  $A_3$ . Each affiliate separately enters into non-centrally cleared derivatives with another covered entity B. Assume the initial margin is calculated to be \$20 000 000 for each affiliate. The initial margin on a consolidated group basis for A would be \$60 000 000, which is less than the \$75 000 000 threshold. In this case,  $A_1$ ,  $A_2$  and  $A_3$  would not be required to exchange initial margin with B. Further, suppose  $A_2$  enters into additional non-centrally cleared derivatives with B. The resulting initial margin for  $A_2$  has increased to \$50 000 000. The sum of initial margin on a consolidated group basis for A is now \$90 000 000 ( $\$20\,000\,000 + \$50\,000\,000 + \$20\,000\,000$ ). As a result, a total initial margin amount of \$15 000 000, which represents the difference between the initial margin calculated and the \$75 000 000 threshold ( $\$90\,000\,000 - \$75\,000\,000$ ), would be required to be exchanged between  $A_1$ ,  $A_2$  and  $A_3$  and B.

To avoid the accumulation of initial margin owing between the covered entities, initial margin should be calculated and exchanged regularly. The Committee notes the requirements for the calculation and exchange of initial margin under the OSFI Guideline. We believe it will cause unnecessary burden and confusion to impose different requirements on covered entities, given that covered entities are likely to transact with entities subject to OSFI Guideline. Thus, we

intend to harmonize our requirements for the calculation and exchange of initial margin for covered entities with the corresponding requirements in the OSFI Guideline.

We propose to require that initial margin be calculated and called within two business days following the day on which a derivative is entered into, assigned, sold or otherwise acquired and recalculated and called daily thereafter. We further propose that initial margin amounts be exchanged (subject to the \$750 000 transfer threshold described in the Variation margin section) within two business days following the day the initial margin was called.

To further harmonize these margin requirements with the OSFI Guideline, the Committee proposes that covered entities not be required to post initial margin for derivatives with no (i.e. zero) counterparty risk and be permitted to exclude those derivatives from the initial margin calculation. For example, the seller of an option who has collected the option premium in full may exclude the option position when calculating initial margin.

#### Calculation of initial margin

The standards governing the methods for calculating initial margin are intended to ensure counterparty risk exposures are covered with a high degree of statistical confidence. To that end, foreign regulatory authorities require, or proposed to require, the use of either a standardized schedule, such as the standardized schedule in the BCBS-IOSCO Standards, or appropriate quantitative margining models to calculate initial margin. These foreign regulatory authorities do not permit counterparties to switch between using the relevant standardized schedule and using a quantitative margining model.

Foreign rules and proposals also require counterparties to have robust dispute resolution protocols in place in case the counterparties cannot reach an agreement on initial margin amounts. For each derivative subject to initial margin requirements under the foreign regulatory rules or proposals, the counterparties must have contractual provisions in place that dictate how disputes relating to the calculation of initial margin will be resolved.

The Committee understands that covered entities will have different levels of sophistication and resources, and that covered entities may differ significantly in their non-centrally cleared derivatives activities. These factors will likely dictate the capabilities of a covered entity in calculating and managing initial margin. Given this, imposing a single initial margin calculation method on all covered entities may not result in the most efficient or cost effective outcome for all covered entities and may not be the most effective way to mitigate the risk of default by a particular covered entity. The Committee believes that a covered entity should retain some flexibility in determining the most suitable method, in the context of its own situation, to calculate initial margin.

The standardized schedule offers a straight-forward method for calculating initial margin. It allows for greater transparency in initial margin calculations, but is less sensitive to risks associated with a portfolio of non-centrally cleared derivatives. Relatively smaller covered entities, with fewer resources to manage or use other more sophisticated and resource-intensive methods, may find the use of a standardized margin schedule attractive.

However, more sophisticated covered entities may opt to use quantitative margining models to calculate initial margin. These models may account for the benefits of hedging, diversification and risk offsets. Quantitative margining models can assign a higher level of risk sensitivity to different non-centrally cleared derivatives within a portfolio. These models are generally complex and costly to manage, but often result in margin calculation that more specifically reflect the risks arising under a particular derivative. Quantitative margining models are often proprietary, internally developed and highly dependent on their parameters and inputs, and are calibrated to the particular covered entity. As such, initial margin calculations using these models are arguably less transparent than calculations made using the standardized schedule.

The use of proprietary quantitative margining models, or even third-party developed quantitative margining models, by different covered entities could result in a proliferation of different quantitative margining models. The Committee believes it is important to ensure these different quantitative margining models meet certain baseline requirements. These baseline requirements should be consistent with the BCBS-IOSCO Standards and should, at a minimum, ensure that the quantitative margining models:

- (a) are sound, and use consistent parameters and inputs;
- (b) appropriately account for the various risk categories associated with exposures under different non-centrally cleared derivatives, including foreign exchange risk, interest rate risk, credit risk, equity risk and commodity risk;
- (c) result in appropriate margin levels to address counterparty default risk; and
- (d) avoid sudden and large variations in initial margin requirements resulting from procyclicality.

The use of quantitative margining models may not be suitable for all non-centrally cleared derivatives across different classes of derivatives. Thus, covered entities should have the flexibility to combine the use of quantitative margining models for one class of derivatives and the standardized schedule for another class of derivatives to calculate initial margin. To align these requirements with the international standards, we propose to allow the use of both the standardized schedule (Appendix A) and quantitative margining models. These quantitative margining models could be developed in-house or by third-party vendors.

The use of quantitative margining models or the standardized schedule may yield different initial margin amounts under different market conditions. Covered entities should consistently use either the quantitative margining model or the standardized schedule for each class of

derivatives. Switching between quantitative margining models and the standardized schedule for a class of derivatives would result in inconsistency in initial margin calculations. Covered entities should not “cherry pick” and switch between the use of the standardized schedule and quantitative margining models to obtain favourable margin outcomes. Without valid justification, switching between quantitative margining models and the standardized schedule may not be compliant with the spirit and intent of these margin requirements.

#### Standards for quantitative margining models

The use of quantitative margining models to determine initial margin requires covered entities to establish and regularly verify parameters such as exposure limits, volatility and assets correlation, and to continuously provide numerous inputs. These parameters and inputs can significantly affect the outcomes of a quantitative margining model. It is therefore important to establish baseline standards and appropriate controls governing the use of quantitative margining models to ensure that initial margin calculations determined by the model meet the regulatory objectives of these margin requirements.

Under the BCBS-IOSCO Standards, quantitative margining models must at the minimum, meet a single-tailed 99% confidence interval over a 10-day close out period. Quantitative margining models must also be calibrated using equally weighted historical data of not more than five years that include a period of extreme financial stress. Such models must be subject to regular validation and recalibration. The BCBS-IOSCO Standards recommend that covered entities be permitted to use only quantitative margining models that have been approved by the relevant supervising authority. Foreign regulatory authorities have imposed or proposed requirements that are consistent with the BCBS-IOSCO Standards for the use of quantitative margining models.

The primary objective of the initial margin requirements is to ensure that each party to a derivative holds sufficient collateral, posted by its counterparty, to cover potential losses under most market conditions, should its counterparty default. The use of quantitative margining models allows the initial margin required for non-centrally cleared derivatives to be tailored to the sensitivity of the exposures under the derivatives and risk profile of the counterparties. Quantitative margining models can also account for the benefits of netting of non-centrally cleared derivatives exposures with a particular counterparty. Depending on the parameters and inputs, a quantitative margining model may result in a calculated initial margin amount that is too low to cushion the surviving counterparty from financial losses. The requirement to meet a single-tailed 99% confidence interval covering a 10-day close out period is intended to ensure that quantitative margining models provide a sufficient initial margin outcome with a high degree of confidence. Consistent with international standards, we propose to require that quantitative margining models meet a single-tailed 99% confidence interval over a 10-day close out period and be calibrated using equally weighted historical data of not less than 1 year and not more than 5 years. In addition, the data should include a period of financial stress.

Quantitative margining models are highly dependent on the parameters and inputs used to calculate sufficient initial margin. In order to ensure the parameters and inputs are appropriate and current, rigorous back testing is required. Back testing will help to ensure that quantitative margining models perform as intended, and are suitable and robust enough to calculate initial margin for non-centrally cleared derivatives under most market conditions. Furthermore, back testing will also highlight any short-falls or limitations of the quantitative margining models and allow for remedial actions to be taken. Thus, we propose to require that quantitative margining models be back tested regularly. We expect covered entities to adhere to industry best practices when testing quantitative margining models.

The Committee believes that requiring that quantitative margining models comply with minimum standards prior to their use is a reasonable means of achieving the policy objectives underlying these margin requirements. Therefore, we propose to require that covered entities ensure that any quantitative margining models they use comply with minimum standards and are calibrated in accordance with these requirements. Compliance with the specified minimum standards and calibration results would be required to be certified by an independent third-party auditor prior to use.

As the parameters and inputs used for testing a quantitative margining model are specific to a particular covered entity, the certification of the quantitative margining model would be specific to that covered entity only. A quantitative margining model that is certified for use by one covered entity to calculate initial margin would not be available to be used by any other covered entity without it being also certified for that other covered entity's use. Also, to prevent "cherry picking" between a certified quantitative margining model and the standardized schedule (Appendix A), a covered entity would be required to notify and provide justification to the securities regulatory authority for any switching between the two methods of calculating initial margin.

Another element to ensure that quantitative margining models are performing as intended is to confirm that the models' parameters and inputs reflect current market conditions. As market conditions change, quantitative margining models may result in initial margin amounts that are insufficient to address the level of risks arising under a particular derivative. Regular recalibration and review of quantitative margining models will ensure that models reflect mid-term trends and remain appropriate. To that end, we propose to require that covered entities recalibrate and review their certified quantitative margining models at least annually. The annual review would be required to be conducted by audit or risk control units that are independent from the covered entity's business or derivatives trading units and the developer of the quantitative margining model. A covered entity would be required to immediately rectify any material deficiency discovered during the review process.

## Questions

2. Please describe any significant concerns with requiring covered entities to obtain a certification report from an independent third-party auditor on the quantitative margining models and the test results.
3. Should there be a minimum amount of data from a stressed financial period included in the back testing of quantitative margining models? What should this amount be (in percentage)?

## Other initial margin requirements

An element in calculating initial margin within a derivatives portfolio is the ability to account for risk offsets<sup>25</sup> from diversification and hedging. Risk offsets within reasonable boundaries, can reduce the overall amount of initial margin required while preserving the risk mitigating effect of posting initial margin. The BCBS-IOSCO Standards and foreign regulatory authorities allow for risk offsets when calculating initial margin within the same category of well-defined underlying asset class. In order to benefit from risk offsets, the derivatives must be subject to the same legally enforceable netting agreement<sup>26</sup>.

The Committee subscribes to the importance of requiring an initial margin amount that reflects the risk exposure of the non-centrally cleared derivatives. To the extent that risk offsets under a controlled setting will assist in achieving that objective, we propose to permit accounting for risk offsets in the calculation of initial margin. Covered entities would be permitted to use quantitative margining models that account for risk offsets within the same, well-defined underlying asset class such as currency, interest rate, credit, equity and commodity, but not across asset classes. Covered entities would be required to ensure that the same legally enforceable netting agreement is in place covering the derivatives before implementing initial margin calculations that account for risk offsets.

The Committee believes that the benefits from risk offsets should not be restricted to covered entities using quantitative margining models. Covered entities should be permitted to account for risk offsets in calculating required initial margin amounts when using the standardized schedule. This would help reduce the potential for a large disparity in required initial margin amounts calculated by a quantitative margining model as opposed to using the standardized schedule. Consistent with the BCBS-IOSCO Standards and foreign rules and proposals, we propose that risk offsets of non-centrally cleared derivatives within the same underlying asset class under the same legally enforceable netting agreement using the standardized schedule be calculated

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<sup>25</sup> Risk offset means the netting out of offsetting exposures between the counterparties.

<sup>26</sup> See sub-section Netting agreement

according to:

$$\text{Initial Margin} = 0.4 \times \text{Gross Initial Margin} + 0.6 \times \text{Net-to-gross Ratio} \times \text{Gross Initial Margin}$$

Gross initial margin is the sum of the notional values of the relevant non-centrally cleared derivatives multiplied by the appropriate initial margin required in the standardized schedule. The net-to-gross ratio is the fraction of the net current replacement cost of the portfolio over the gross current replacement cost of the portfolio. It is an acceptable standard established under bank capital regulations to adjust for the effect of netting.<sup>27</sup> For example, assume a portfolio that consists of two non-centrally cleared derivatives between two covered entities A and B. In this example, the mark-to-market value for the first derivative results in A being owed \$100 by B and the mark-to-market value for the second derivative results in A owing B \$60. The gross current replacement cost is \$100 while the net current replacement cost is \$40 (\$100 - \$60). The net-to-gross ratio is 0.4 (\$40 ÷ \$100).

We propose that these margin requirements apply to all new derivatives<sup>28</sup> entered into by covered entities after these margin requirements become effective. Non-centrally cleared derivatives entered into before these margin requirements become effective (i.e., pre-existing non-centrally cleared derivatives) would not be subject to these margin requirements.

#### Question

4. Are there situations when margin requirements should be imposed on pre-existing non-centrally cleared derivatives?

#### **Variation margin**

The OTC derivatives market is dynamic, and the value of a derivative can change substantially over time. These changes may result in an accumulation of current losses for a counterparty. The Committee is of the view that regular payment of variation margin will prevent accumulation of current losses. Delivering variation margin also prevents the erosion of initial margin.

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<sup>27</sup> BCBS, *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework*, [www.bis.org/publ/bcbc128d.pdf](http://www.bis.org/publ/bcbc128d.pdf)

<sup>28</sup> We consider amendments that are intended to extend existing derivatives for the purpose of avoiding margin requirements as new derivatives. Novation of grandfathered derivatives as well as “new” non-centrally cleared derivatives that result from portfolio compression of grandfathered trades do not qualify as a new derivative. However, new non-centrally cleared transactions resulting from compressions of both grandfathered derivatives and derivatives which are subject to mandatory margin requirements will be subject to these margin requirements. Grandfathered non-centrally cleared derivatives that have been materially amended are subject to margin requirements as new derivatives.



The BCBS-IOSCO Standards recommend that all covered entities, regardless of their derivatives exposure, be required to deliver variation margin, but allows variation margin to not be transferred if the amount is below a minimum transfer amount of both variation margin and initial margin not to exceed €500 000 under all derivatives between the counterparties, determined on a consolidated group basis. Foreign regulatory authorities have also proposed to require covered entities to exchange variation margin, subject to a minimum transfer amount of not more than €500 000, or a comparable amount in the local currency, on a consolidated group basis. The minimum transfer threshold is calculated based on the sum of amounts owing for variation margin and initial margin.

The Committee believes that regular transfers of variation margin maintain covered entities' abilities to meet ongoing financial obligations related to their non-centrally cleared derivatives exposure. Therefore, where the other counterparty is also a covered entity, we propose to require all covered entities to deliver variation margin that fully collateralizes the mark-to-market (or mark-to-model) exposure of the derivative transaction(s) subject to the \$750 000 transfer threshold described below.

We propose to require that variation margin be calculated and called on a net basis within two business days after the execution of a transaction and recalculated and called at least daily thereafter. We further propose that variation margin be delivered within two business days<sup>29</sup> from the day it was called.

However, the Committee acknowledges that daily variation margin calculation will likely result in many frequent but relatively small amounts owing between covered entities. It may not be cost effective for covered entities to make many frequent but small transfers of funds or collateral to each other on a daily basis. We propose to permit covered entities to agree with their counterparties that the exchange of collateral, including variation or initial margin, be subject to a transfer threshold of \$750 000 or less. This \$750 000 transfer threshold would apply to the sum of amounts owing by a covered entity for variation margin and initial margin.

The application of this threshold is different from the application of the \$75 000 000 threshold for initial margin. A covered entity would be required to transfer the full amount of initial and variation margin once the sum of the amounts it is required to deliver exceeds the \$750 000 transfer threshold. Under the \$75 000 000 threshold for initial margin, a covered entity is required to transfer only initial margin in excess of \$75 000 000. If the amount owing by one covered entity exceeds the \$750 000 transfer threshold while the other is below, only the covered entity that exceeds the transfer threshold would be required to make the transfer.

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<sup>29</sup> Variation margin may be delivered before the end of the third business day after the calculation if the counterparty to the trade is not subject to initial margin requirements in their home jurisdiction.

To illustrate this, suppose that covered entities A and B agreed on a transfer threshold of \$750 000. If the sum of amounts owed by A to B for variation margin and initial margin is \$500 000, A would not be required to make the transfer. However, if the sum of amounts owed by A to B for variation margin and initial margin increases to \$800 000, A would be required to transfer the entire \$800 000.

#### Question

5. Financial entities whose aggregate month-end average notional amount of non-centrally cleared derivatives calculated for the months of March, April and May is less than \$12 000 000 000, excluding intragroup transactions, are not covered entities, and thus are not subject to the variation margin requirement. Is the \$12 000 000 000 threshold appropriate for the variation margin requirement? If not, what should the threshold be?

#### Calculation of variation margin

Consistent with the BCBS-IOSCO Standards, foreign regulatory authorities require or have proposed to require the use of the mark-to-market valuation method for calculating variation margin. In addition, the CFTC permits the use of an alternative method for calculating variation margin when inputs for the mark-to-market method are unavailable or unreliable.

The mark-to-market method has been widely adopted by foreign regulatory authorities. The mark-to-market method involves a number of inputs, such as price of the derivatives to reflect the current value of the derivatives exposures. However, the results of a mark-to-market valuation will be significantly influenced by the quality, timeliness and reliability of prices used. In that manner, the price used in a mark-to-market valuation will influence the amount of variation margin required to be exchanged between the covered entities. To promote transparency and minimize disputes, we propose to require that calculation of variation margin be made according to the mark-to-market valuation method where timely and reliable data is readily available to value the derivative. The prices used in the mark-to-market valuation for calculating variation margin where practicable would be required to be based on relevant recent transactions and provided by an independent third-party.

Some OTC derivatives trade infrequently and are considered illiquid. Thus, reliable price data may not be readily available. Exposures to illiquid non-centrally cleared derivatives may result in heightened risks of accumulated losses if the covered entities cannot reliably calculate variation margin. Therefore, we believe it is important to permit the use of alternative methods of valuing illiquid non-centrally cleared derivatives exposure to calculate variation margin where timely and reliable valuation data is not readily available. This will reduce the risk of accumulated losses from current exposures to these derivatives, and advance the risk mitigation objectives of these margin requirements.

We propose that covered entities be permitted to use an alternative method for calculating variation margin only when prices for a mark-to-market valuation are unavailable, untimely or unreliable. The alternative method should be certified by an independent third-party auditor prior to use.

We propose to require that the alternative method be recalibrated at least annually using industry best practices. We would also expect that the alternative method be reviewed, at least annually, by audit and risk control units that are independent from the covered entity's business or derivatives trading units and the developer of the alternative method. The review process should include an assessment of the appropriateness of the methodology, and of the reliability of the input sources. A covered entity would be required to rectify any material deficiencies discovered during the review process immediately.

#### Questions

6. In your view, are there situations in which it would be important to permit the use of an alternative method to calculate variation margin? Please explain.
7. Please describe any concerns with requiring independent third-party certification of an alternative method before its implementation.

### **Records and documentation**

#### Records for margin models and methods

We propose to require that covered entities maintain all records relating to the calibration, back-testing, independent certification, recalibration and review of quantitative margining models and any alternative methods for calculating variation margin. Such records, including results, findings, recommendations and any changes made to the models or methods as a result thereof should be made available to the securities regulatory authority promptly upon request. Covered entities would also be required to maintain records of the calculation methodology used and daily calculation, and make such records available to the securities regulatory authority when requested. All records should be kept for 7 years.

#### Trading relationship documentation

##### *Agreement*

It is common practice for counterparties to non-centrally cleared derivatives to rely on clauses in their agreements to establish obligations relating to the valuation, exchange of collateral and close-out netting during a default. Proper documentation of these obligations provides legal certainty and facilitates counterparty risk management.

Moreover, IOSCO recommends that counterparties negotiate and document their trading relationships prior to entering into non-centrally cleared derivatives.<sup>30</sup> Such documentation should clearly establish both the rights and obligations of the counterparties to the non-centrally cleared derivatives to provide certainty.

Despite documentation of the trading relationship and the rights and obligations of the counterparties, disputes may still arise between counterparties. The BCBS-IOSCO Standards recommend the implementation of a robust and rigorous dispute resolution procedure, including agreement between the counterparties on the methods for calculating initial and variation margin, types of acceptable collateral and applicable haircuts on different types of collateral. They further recommend that counterparties take necessary measures to resolve disputes in a timely manner. Some foreign regulatory authorities require or have proposed to require the counterparties to document processes for resolving disputes. These foreign regulatory authorities also require escalation of any unresolved dispute concerning the calculation of margin and valuation of collateral pledged that may affect the exchange or payment of margin.

To minimize the risk of disputes undermining the benefits of these margin requirements, we propose that covered entities be required to enter into a written agreement documenting the material terms and conditions of any non-centrally cleared derivative. The agreement should be maintained and regularly reviewed to ensure its terms are current and accurate. The agreement should clearly establish the rights and obligations of the covered entities in relation to:

- (a) the law governing the agreement between the counterparties and the non-centrally cleared derivatives under the agreement;
- (b) if applicable, netting of bilateral positions for calculating margin payments and obligations;
- (c) process, methodology, parameters and inputs in determining derivatives valuations from execution to termination, maturity or expiration;
- (d) arrangements for payment of variation margin and exchange of initial margin;
- (e) acceptable collateral and haircuts on different collateral, including any applicable conditions such as: concentration limits, credit rating, etc.;
- (f) terms of re-hypothecation, re-use or re-pledging of collateral;
- (g) types of segregation or custodian arrangements for collateral and fees relating to such arrangements;
- (h) if applicable, arrangements for close-out netting of positions in a default.

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<sup>30</sup> IOSCO, *Risk Mitigation Standards for Non-Centrally Cleared OTC Derivatives*, <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD469.pdf>

### *Netting agreement*

We propose to require each covered entity to have a legally enforceable netting agreement in place with its counterparty prior to taking advantage of risk offsets in the calculation of initial margin. The netting agreement could form part of the agreement discussed above, or could be a stand-alone agreement. In either case, the netting agreement should cover the specific derivatives for which risk offsets are taken into account in calculating initial margin.

In the event when a covered entity transact with a counterparty from a jurisdiction where the netting agreement is not legally enforceable, the covered entity should collect variation margin on a gross basis. The covered entity could however, post variation margin in accordance with the netting agreement.

The Committee expects a netting agreement between two covered entities to meet the following requirements:

- (a) be a written agreement that creates an enforceable obligation, covering all derivatives subject to risk offsets for calculating margin;
- (b) would result in only one obligation to make or take payment based on the sum of the positive and negative mark-to-market values of all of the derivatives with the counterparty in the event the counterparty fails to perform;
- (c) does not allow a non-defaulting covered entity to make only limited payments, or no payments, to the estate of the defaulting covered entity, even if the defaulting covered entity is a net creditor.

Covered entities would be required to have procedures to review and ensure enforceability of the netting arrangements in the event of a change in relevant law.

### Dispute resolution

Despite an agreement being negotiated and documented at the outset of the relationship, disputes may still arise between covered entities with respect to initial or variation margin, in light of the potential for different methods of valuing non-centrally cleared derivatives and collateral. Unresolved disputes that result in non-centrally cleared derivatives being under-margined or in margin not being exchanged, can undermine the effectiveness of the margin requirements.

In order to mitigate the possibility of a dispute concerning margin amounts, which could potentially undermine the benefits of these margin requirements, we propose that covered entities be required to have written procedures for handling and resolving disputes. Such dispute resolution procedures should be part of the agreement negotiated between the covered entities. The dispute resolution procedures should cover, at a minimum, the following:

- (a) how to determine what discrepancies are considered disputes;

- (b) how disputes should be resolved, including a threshold for escalating a dispute;
- (c) how to settle differences in valuation of non-centrally cleared derivatives;
- (d) how to settle differences in valuation of collateral pledged as margin;
- (e) how to settle disagreements in relation to the appropriate haircut to be applied to certain collateral.

We propose to require that covered entities exchange and deliver at least the undisputed amount of margin while resolving a dispute. Covered entities should also endeavour to avoid prolonged unresolved disputes and have procedures to deal with disputes as soon as practicable. The dispute resolution procedures should include a process for escalating an unresolved dispute to the executives or senior decision makers of the covered entities within a reasonable period of time. In the case of a material dispute, notification of the relevant securities regulatory authority would be required.

## **PART 5 – ELIGIBLE COLLATERAL**

### **Acceptable collateral**

In order for the benefits of these margin requirements to be realized, the collateral that is exchanged as margin should be highly liquid, able to hold its value during stressed market conditions and not highly correlated with the creditworthiness of the counterparty or the value of the derivative or derivatives in relation to which it is exchanged. The BCBS-IOSCO Standards provide a non-inclusive list of assets that could be considered acceptable collateral, including:

- (a) cash;
- (b) high-quality government and central bank securities;
- (c) high-quality corporate bonds;
- (d) high-quality covered bonds;
- (e) equities included in major stock indices;
- (f) gold.

Foreign regulatory authorities have proposed to adopt localized lists of acceptable collateral, similar to the types of collateral identified as acceptable in the BCBS-IOSCO Standards. In the US, variation margin for non-centrally cleared derivatives between two covered swap entities is restricted to cash, in an approved currency<sup>31</sup> or the settlement currency of the derivatives in relation to which it is paid.

The Committee has considered a number of factors in determining what assets should be eligible collateral. First, the list of eligible collateral should be sufficiently broad to mitigate the

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<sup>31</sup> Current list of approved currencies is USD, CAD, EUR, GBP, JPY, CHF, NZD, AUD, SEK, DKK and NOK.

increased demand for certain high-quality assets resulting from these margin requirements. This will help to ensure the availability of high-quality collateral for covered entities to exchange as margin pursuant to these requirements. A narrow definition of eligible collateral could impact the availability of assets that are eligible collateral, causing a rise in the value of these assets and therefore in the costs of acquisition. We have also considered the eligible collateral in the BCBS's *International Convergence of Capital Measurement and Capital Standards (BCBS Collateral)*.<sup>32</sup> We anticipate that many of the covered entities required to post collateral under these margin requirements are likely to be compliant with the BCBS Collateral. Therefore, achieving consistency with the BCBS Collateral should mitigate disruption to those covered entities' current collateral management arrangements.

The Committee believes that the guiding principles in defining what assets are eligible collateral should be consistent with the BCBS-IOSCO Standards. Eligible collateral should demonstrate these characteristics:

- (a) be highly liquid and broadly accepted;
- (b) have a strong record of holding its value under stressed market conditions;
- (c) not be highly exposed to credit, market and foreign exchange risks;
- (d) not be highly correlated with the creditworthiness of the counterparty posting the collateral; and
- (e) not be highly correlated with the value of the derivative or derivatives relating to which it is posted.

We propose to require that eligible collateral for the purpose of these margin requirements (both initial and variation margin) consist of assets that meet the BSBC-IOSCO Standards. To meet these standards assets should:

- (a) be highly liquid;
- (b) able to hold its value during stressed market conditions;
- (c) not highly correlated with the creditworthiness of the counterparty or the value of the derivative or derivatives in relation to which it is exchanged; and
- (d) have quoted prices that are reasonably accessible to the public to allow counterparties to value the asset.

These assets would include but would not be limited to:

- (a) cash (in the form of money credited to an account or similar claims for the repayment of money, such as certificates of deposit or comparable instruments issued by a covered entity);
- (b) gold;

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<sup>32</sup> BCBS, *International Convergence of Capital Measurement and Capital Standards*, <http://www.bis.org/publ/bcbs128.pdf>

- (c) debt securities issued by or guaranteed by the Government of Canada or the Bank of Canada or the government of a province or territory of Canada;
- (d) securities issued and fully guaranteed by the Bank for International Settlements, the International Monetary Fund or a multilateral development bank with a rating of at least BB-;
- (e) debt securities issued by corporate entities with a rating of at least BBB-;
- (f) debt securities issued by foreign governments [guaranteed by the revenues of those governments] with a rating of at least BB-;
- (g) equities included in major Canadian stock indices;
- (h) mutual funds, where:
  - (i) a price for the mutual fund's units is publicly quoted daily; and
  - (ii) the mutual fund is limited to investing in the assets above.

In light of the international nature of the Canadian derivatives market, the Committee expects that some covered entities may receive foreign assets posted as collateral by non-Canadian counterparties. The Committee believes that limiting eligible collateral to only Canadian assets would unreasonably impede cross-border transactions involving non-Canadian counterparties. It would also result in an unnecessary increase in demand on acceptable Canadian assets, further straining liquidity. In view of these factors, we propose that covered entities be permitted to post or receive as collateral foreign assets that are equivalent to the Canadian assets listed as eligible collateral above. Covered entities should ensure that these foreign assets have the same conservative characteristics as required for eligible collateral in the BCBS-IOSCO Standards. Further, appropriate haircuts should be applied to foreign assets posted or received as collateral, as they would be applied to Canadian assets.

### **Concentration limits and avoiding wrong-way risk**

A covered entity could potentially receive significant amounts of a particular type of collateral as margin from its counterparties. Such concentration in a type of collateral received would expose the covered entity to risks associated with that type of collateral. Wrong-way risk is the risk associated with collateral that is highly correlated with the posting counterparty. Wrong-way risk should also be avoided. Concentration risk and wrong-way risk may diminish a covered entity's ability to quickly liquidate and recover the value of collateral it has received in the case of a default by its counterparty or during a financial crisis.

The Committee is of the view that a covered entity should not expose itself to concentration risk. To this end, a covered entity should ensure that a majority of the collateral it collects from its counterparties is not concentrated in assets of the same or a similar type. Ideally, the collateral it collects should be diverse and varied. In addition, a covered entity should avoid exposing itself to wrong-way risks. This includes not accepting collateral issued by its counterparties or affiliates of its counterparties or from issues in the same industry as its counterparties. Therefore, the Committee proposes to require covered entities to establish and maintain internal policies and



procedures to manage collateral exposure and concentration limits for collateral received as margin. These policies and procedures should be based on industry best practices and be reviewed annually by audit or risk control units that are independent from the covered entity's business or trading units.

#### Question

8. The OSFI Guideline includes debt securities issued by public sector entities (potentially lower level governments, agencies and school boards) treated as sovereign by national supervisors and multilateral development banks. Those securities are defined in the guideline as eligible collateral. Should the CSA include such securities as eligible collateral, and are there any potential risks and concerns?

#### **Records of collateral**

The Committee expects that a covered entity should establish internal policies to document and maintain accurate records of the collateral received as margin. Such records should include, at a minimum, the following:

- (a) daily value of collateral received;
- (b) any revenue generated by the collateral, including dividends paid on equity securities or coupon payments paid on debt securities;
- (c) any changes in the value of collateral; and
- (d) any charges that have accrued, or may accrue, in respect of the collateral, including storage or custodian fees

#### **Haircut**

The exchange of collateral for margin mitigates the risk of losses by a counterparty to a non-centrally cleared derivative if the other counterparty defaults. However, a key concern is a potential decline in value of the collateral if and when the surviving counterparty needs to liquidate the collateral it has received. This concern can be mitigated by applying a haircut on the value of the assets received as collateral. The BCBS-IOSCO Standards support the use of haircuts on collateral received in compliance with the margin requirements.

As asset quality differs, the haircut applied to a particular asset should reflect the liquidity and price volatility of that asset. Assets that are more volatile or less liquid should attract a higher haircut to cushion against a potential decline in price or an increase in liquidation costs. The BCBS-IOSCO Standards recommend, and most foreign regulatory authorities require or have proposed, that haircuts applied to collateral be calculated using either a quantitative haircut model or a standardized haircut schedule.

The Committee believes that appropriate haircuts applied to assets posted as collateral will protect the covered entity receiving the collateral. Appropriate haircuts also act as a built-in risk management tool to ensure the received collateral is of sufficient value to cover potential losses arising from a counterparty's default despite changes in market conditions.

We propose to require that covered entities receiving collateral apply appropriate haircuts on all collateral received as per Appendix B or as determined by use of an appropriate haircut model. However, the additional haircuts for currency mismatch do not apply for:

- (a) cash posted for variation margin;
- (b) collateral posted for variation margin denominated in the currency agreed upon in the netting agreement;
- (c) collateral posted for initial margin denominated in the termination currency agreed upon in the netting agreement.

Covered entities would be permitted to choose to apply haircuts on collateral based on the standardized haircut schedule or a quantitative haircut model. Quantitative haircut models can achieve greater precision in the calculation based on the calibration of observed volatility of the collateral while not exposing the collateral-receiving covered entity to undue exposure. However, smaller or less sophisticated covered entities may not have the resources to develop and maintain quantitative haircut models. They may choose to use the standardized haircut schedule, which provides for simple but less precise calculation of haircuts on collateral. Covered entities that use a quantitative haircut model would be required to recalculate collateral haircuts at least every three months. Covered entities using haircut models would be required to keep records of these recalculations.

We propose that a quantitative haircut model be required to conform to a single tailed, 99% confidence interval over a 10-day holding period and be calibrated with historical data of not less than 1 year. We expect that a covered entity using a quantitative haircut model would be required to have the model certified by an independent third-party auditor prior to use. The auditor should certify to ensure that the haircut model meets the above standards and will produce appropriate haircuts to mitigate against a decline in the value of the assets posted as collateral, including under stressed market conditions.

A covered entity would be required to recalibrate and review its certified quantitative haircut model at least annually by audit or risk units independent from the business or derivatives trading units and the developer of the haircut model. Covered entities would be required to document and keep records relating to the independent certification, calibration, testing and recalibration, review findings, and any rectification or changes made to the haircut models.

A quantitative haircut model or the standardized haircut schedule would likely result in different haircuts being applied to different collateral. The Committee expects covered entities to apply

consistent haircuts to the received collateral. Disputes over haircuts may also arise from switching between the use of a quantitative haircut model and the standardized haircut schedule. Therefore, covered entities would not be permitted to switch between the use of the standardized haircut schedule and the quantitative haircut model to obtain favourable outcomes.

#### Question

9. Is it appropriate to require covered entities using a quantitative haircut model to recalculate collateral haircuts at least every three months? If not, what would be an appropriate frequency?

## **PART 6 – TREATMENT OF COLLATERAL**

### **Segregation**

The objective of exchanging initial margin is to ensure financial performance of the counterparties to the non-centrally cleared derivatives. Should collateral received as initial margin be commingled with the receiving counterparty's own assets, difficulties may arise in identifying and separating the collateral. In a default scenario, the ability to identify and liquidate collateral in a timely manner will become very important. Commingling of received collateral with the receiving counterparty's own assets diminishes the benefits of exchanging initial margin and may expose the collateral-posting counterparty to undue risk.

As a result, foreign regulatory authorities have proposed to require that collateral be segregated from the receiving counterparty's proprietary assets. The US rules further require that collateral received as initial margin be held at an independent third party custodian and segregated from the receiving counterparty's assets.

The Committee is of the view that accurate documentation and effective segregation of collateral received as initial margin from the receiving counterparty's assets will facilitate the identification and liquidation of the collateral in a default, or return of the collateral at the termination or expiry of the derivative. This will protect the interests of the covered entity posting the collateral and support the benefits of exchanging initial margin. Furthermore, delays in the return of posted collateral may cause liquidity constraints on the surviving counterparty. Segregation is seen to help expedite the return of collateral to the posting counterparty.

The Committee recognizes that different levels of collateral segregation will each carry different costs and benefits. Individual segregation of each covered entity's collateral would provide the highest level of protection, but would also carry the highest costs. On the other hand, allowing received collateral to be commingled with the receiving counterparty's own assets may be the most cost effective, but would provide inadequate protection for posted collateral. In developing proposed collateral segregation requirements, the Committee has sought to balance the costs and

benefits of collateral segregation, while preserving the objective of ensuring adequate protection to both the posting and receiving counterparties in the event where either one defaults.

We propose to adopt segregation requirements similar to those in proposed National Instrument 94-102 *Derivatives: Customer Clearing and Protection of Customer Collateral and Positions*<sup>33</sup> and require that collateral received as initial margin be segregated from the assets of the receiving covered entity. A receiving covered entity would be permitted to commingle collateral it has received from one counterparty with collateral it has received from other counterparties. We further propose to require that records be kept for 7 years and maintained by each receiving covered entity to facilitate the identification of collateral and timely return of collateral in the event of a default by the receiving counterparty or its liquidation in the event of a default by the posting counterparty. Separate records would be required to be kept for each posting counterparty and would be subject to an audit process to ensure their accuracy. These records would be required to include:

- (a) the types and value of collateral received;
- (b) the location in which the collateral is kept;
- (c) if the collateral is held at a third-party custodian, the name and location of the custodian;
- (d) any withdrawal, deposit or transfer of the collateral; and
- (e) any accruals to the posting counterparty in respect of the collateral received.

The Committee thinks it is reasonable for some covered entities to seek a higher level of protection by having their collateral held at a third-party custodian. However, in considering the additional protection that would be afforded if third-party custodianship was required for all collateral posted under these margin requirements, the Committee is of the view that the additional costs may not be justified and may be an excessive burden for relatively smaller covered entities. With this in mind, the Committee believes that holding collateral at a third party custodian should be voluntary and should not be made mandatory. Therefore, we propose to require that each collateral receiving covered entity provide its posting counterparty with the option to have the posted collateral held at a third party custodian.

Question

10. Is the proposed segregation requirement adequate to protect the interests of the covered entity that posts the collateral?

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<sup>33</sup> CSA, NI 94-102 *Derivatives: Customer Clearing and Protection of Customer Collateral and Positions*, [http://www.nbsc-cvmnb.ca/nbsc/uploaded\\_topic\\_files/94-102-CSAN-2016-01-21-E%20\(2\).pdf](http://www.nbsc-cvmnb.ca/nbsc/uploaded_topic_files/94-102-CSAN-2016-01-21-E%20(2).pdf)

## **Re-hypothecation, re-use or re-pledging of collateral**

The general concept of re-hypothecation is when a covered entity to a derivative re-uses or re-pledges the collateral received from its counterparty as a form of funding for its own purposes. It is common for the same collateral to be re-hypothecated multiple times.

Permitting re-hypothecation, re-use or re-pledging of collateral may complicate recovery of posted collateral because multiple parties may have a claim on the same collateral. Permitting re-hypothecation, re-use or re-pledging of collateral would also increase the risk to the collateral posting covered entity of the losing the collateral if the receiving covered entity defaults. However, not permitting re-hypothecation, re-use or re-pledging of collateral would exacerbate the demand for high-quality collateral. It would also increase the cost of transacting in non-centrally cleared derivatives, as it would restrict the availability of a significant amount of high-quality assets.

The BCBS-IOSCO Standards recommend that a covered entity receiving collateral as initial margin may only re-hypothecate, re-use or re-pledge the collateral to fund a back-to-back hedge of the derivative position of the posting covered entity. The receiving covered entity would not be permitted to re-hypothecate, re-use or re-pledge the collateral for any other purpose. The BCBS-IOSCO Standards further recommend restricting re-hypothecating, re-using or re-pledging of collateral to only one time. Therefore, a covered entity receiving collateral that has been re-hypothecated, re-used or re-pledged cannot itself re-hypothecate, re-use or re-pledge the same collateral. However, foreign regulatory authorities have prohibited, or proposed to prohibit, any re-hypothecating, re-using or re-pledging of collateral received as initial margin, under all circumstances.

In addressing re-hypothecation, re-use or re-pledging of collateral, the Committee has evaluated two opposing considerations. Permitting a receiving covered entity to re-hypothecate, re-use or re-pledge collateral would reduce demand on high-quality collateral. However, unrestricted re-hypothecating, re-using or re-pledging of collateral will complicate identifying the original collateral posting covered entity. This may hinder timely return of the pledged collateral if the receiving covered entity defaults. Prolonged delays in returning collateral that has been re-hypothecated to the covered entity that first posted it may also deny that covered entity the use of the collateral and thereby put undue financial pressure on the posting covered entity. This, in turn, may cause a knock-on default and could be a weak-link in the system which may develop into a systemic risk issue. The Committee believes the merits of re-hypothecating, re-using or re-pledging collateral should be balanced with a control process that supports timely identification of ownership and return of collateral, thus preserving the integrity of initial margin.

In this regard, the Committee supports a position consistent with the BCBS-IOSCO Standards. We propose that re-hypothecation, re-use or re-pledging of collateral received for initial margin

be permitted to facilitate a back-to-back hedge of the derivatives position of the posting covered entity. Received collateral could be re-hypothecated, re-used or re-pledged only once.

The Committee further believes that some controls are appropriate in respect of re-hypothecation, re-use or re-pledging of collateral. We propose to require that a collateral receiving covered entity outline any reasonably anticipated risks and obtain written consent from the posting covered entity before re-hypothecating, re-using or re-pledging any collateral received from the posting covered entity. This will serve as a notice to the posting covered entity that the collateral it has posted may be re-hypothecated, re-used or re-pledged. The covered entity that is re-hypothecating, re-using or re-pledging collateral would be required to inform the next covered entity that receives the re-hypothecated collateral that the collateral has been re-hypothecated and that the collateral cannot be further re-hypothecated, re-used or re-pledged.

We propose requiring a covered entity that re-hypothecates, re-uses or re-pledges collateral to maintain records that include:

- (a) the written consent from the covered entity that posted the collateral;
- (b) the name and address of the covered entity that posted the collateral;
- (c) the type and value of the collateral re-hypothecated, re-used or re-pledged;
- (d) the name and address of the covered entity receiving the re-hypothecated collateral; and
- (e) an identification of the original derivatives or transactions for which the collateral was received, and the back-to-back hedging transaction for which the collateral was re-hypothecated.

#### Questions

11. In view of the prohibition against re-hypothecation of collateral in the OSFI Guideline and by foreign regulatory authorities, should re-hypothecation, re-use or re-pledging of collateral received for initial margin be permitted? Please explain. If yes, should it be restricted to only funding a back-to-back hedge of the original non-centrally cleared derivative?
12. Should covered entities be restricted to re-hypothecating, re-using or re-pledging specific collateral only once? How should the covered entity that receives the re-hypothecated collateral be informed that it cannot be re-hypothecated again?
13. Should covered entities only be allowed to re-hypothecate collateral to other covered entities or to any entity? Please explain.

## PART 7 – EXCLUSIONS, EXEMPTIONS AND SUBSTITUTED COMPLIANCE

### Government and public sector exclusion

Proposed National Instrument 94-101 *Mandatory Central Counterparty Clearing of Derivatives*<sup>34</sup> (NI 94-101) does not apply to governments, central banks, public sector entities, the Bank for International Settlements and the International Monetary Fund. These entities are understood to represent minimal or zero credit risk to their counterparty; as such, derivatives with such an entity are not likely to pose significant risk to the Canadian financial market. The Committee sees a compelling rationale for maintaining consistency with NI 94-101 and excluding such entities from these margin requirements.

The Committee proposes that these margin requirements not apply to derivatives involving any of the following counterparties:

- (a) the government of Canada, the government of a jurisdiction of Canada or the government of a foreign jurisdiction;
- (b) a crown corporation for which the government of the jurisdiction where the crown corporation was constituted is responsible for all or substantially all the liabilities;
- (c) an entity wholly owned by one or more governments, referred to in paragraph (a), that are responsible for all or substantially all the liabilities of the entity;
- (d) the Bank of Canada or a central bank of a foreign jurisdiction;
- (e) the Bank for International Settlements;
- (f) the International Monetary Fund.

### Intragroup exemption

The BCBS-IOSCO Standards notes that, internationally, it is not currently customary market practice for affiliated counterparties to non-centrally cleared derivatives to exchange initial or variation margin between them. Introducing a requirement to transfer margin in relation to non-centrally cleared derivatives between affiliates would therefore exacerbate the demand for high-quality collateral, and require revisions to intragroup trading relationships. The BCBS-IOSCO Standards suggest that jurisdictions implement appropriate margin requirements for non-centrally cleared derivatives between affiliates, in a manner that is consistent with the jurisdiction's legal and regulatory framework. They also note that central clearing requirements have not been widely adopted on derivatives between affiliates. In light of current market practice and the varying legal and regulatory environments for derivatives between affiliates, the BCBS-IOSCO Standards suggest that it may be reasonable to provide an exemption from margin requirements. However, the BCBS-IOSCO Standards also note that there may be legal and

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<sup>34</sup> CSA, *NI 94-101 Mandatory Central Counterparty Clearing of Derivatives*, [http://www.nbsc-cvmb.ca/nbsc/uploaded\\_topic\\_files/94-101-CSAN-2016-02-24-E.pdf](http://www.nbsc-cvmb.ca/nbsc/uploaded_topic_files/94-101-CSAN-2016-02-24-E.pdf)

regulatory impediments in some jurisdictions to exempting intragroup derivatives from the margin requirements.

Some foreign regulatory authorities have proposed to exempt intragroup derivatives from margin requirements. In contrast, the US Federal Agencies require a covered swap entity to collect a reduced amount of initial margin from its non-covered swap entity affiliates although they are not required to post any initial margin.

The Committee is of the view that an intragroup exemption for non-centrally cleared derivatives between affiliated entities could mitigate the impact of the costs associated with these margin requirements, and facilitate centralized risk management and hedging for corporate groups. However, an exemption that is too broad may be open for abuse and, in some cases, present an avenue for regulatory arbitrage. In some cases, too broad of an exemption could result in the risks associated with non-centrally cleared derivatives being shifted away from well-capitalized and regulated covered entities to weaker affiliates within a corporate group.

Factors that the Committee has considered in developing an intragroup exemption include:

- (a) whether the intragroup transactions will shift exposure away from the external market-facing affiliate of the covered entity and result in increased risk exposure for external counterparties;
- (b) whether the intragroup transactions will shift exposure away from a prudentially regulated affiliate to a non-prudentially regulated affiliate within a corporate group;
- (c) achieving consistency with the intragroup exemption in NI 94-101.

The Committee proposes to exempt certain intragroup derivatives from the requirements to exchange initial margin and variation margin. Covered entities and their affiliates relying on this exemption would be required to meet the relationships set out in NI 94-101, where:

- (a) both affiliated entities are prudentially supervised on a consolidated basis; or
- (b) financial statements for both affiliated entities are prepared on a consolidated basis in accordance with “accounting principles” as defined in National Instrument 52-107 *Acceptable Accounting Principles and Auditing Standards*.

The Committee further proposes to require that affiliated entities relying on this intragroup exemption have appropriate centralized risk management controls in place. Covered entities would be required to notify the relevant securities regulatory authority of the intention to rely on this exemption and to maintain records of the contract terms for all the derivatives exempted under the intragroup exemption. The covered entity would be required to produce these records upon request by the securities regulatory authority.



## Questions

14. Should intragroup derivatives be exempted from only the initial margin requirements, or from both initial margin and variation margin requirements? Please explain.
15. Should the intragroup exemption be expanded to all affiliated entities based on the concept of ownership and control?<sup>35</sup> If so, are there concerns that such an inter-affiliate exemption will not be consistent with the requirements in NI 94-101, the OSFI Guideline and the US rules where intragroup exemptions are based on the concept of consolidated financial statements? Please explain.

### **Substituted compliance – Canadian regulations**

The Committee does not believe that imposing duplicative requirements on covered entities is the right outcome.

In reviewing the OSFI Guideline using a flexible, outcomes-based, category-by-category approach, the Committee believes that the requirements in the OSFI Guideline are equivalent to the recommendations described in this consultation paper. Because of this, the Committee proposes to provide covered entities that are subject to and comply with the OSFI Guideline with relief from the requirement to comply with these margin requirements. Given its role as the prudential regulator for FRFIs, OSFI would be responsible for monitoring FRFIs' compliance with the OSFI Guideline.

In addition to the relief referenced above, the Committee would consider providing comparable relief from these margin requirements to covered entities that are subject to and comply with requirements of other Canadian regulators that are, on a broad category-by-category basis, equivalent to the principles described in this consultation paper. This could include covered entities regulated by provincial regulators responsible for oversight of financial institutions or by self-regulatory entities such as the Investment Industry Regulatory Organization of Canada.

### **Substituted compliance – foreign regulations**

The OTC derivatives market is a global marketplace and OTC derivatives often transcend national borders. It is reasonable to expect that the counterparties to a significant proportion of OTC derivatives do not reside in the same jurisdiction. Given this, coordination and co-operation among regulatory authorities in respect of margin requirements for cross-border derivatives are required.

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<sup>35</sup> The concept of ownership and control is consistent with the inter-affiliate exemption in local trade reporting rules.

The BCBS-IOSCO Standards recommend that rules should be substantially harmonized across jurisdictions and that regulators should coordinate to apply one set of rules for derivatives between counterparties located in different jurisdictions. The BCBS-IOSCO Standards further specify that host country rules should apply to subsidiaries of foreign entities; for branches of foreign entities, either the host country or home country rules may apply. Certain foreign regulatory authorities have proposed localized versions of substituted compliance for some cross-border transactions.

In light of the international nature of the derivatives market, regulatory overlap is likely to occur. A key consideration for the Committee is to avoid unnecessary duplication of rules, where possible, on covered entities transacting across borders. At the same time, the Committee seeks to ensure that appropriate margin requirements are imposed on derivatives involving local counterparties. The Committee hopes that clearly defined substituted compliance provisions will provide certainty to covered entities on which set of rules will apply when entering into non-centrally cleared derivatives with foreign counterparties.

To that end, we propose to assess the margin rules of certain foreign jurisdictions on an outcomes basis. Foreign rules that meet the BCBS-IOSCO Standards and result in a similar outcome as the margin requirements applicable to covered entities would be deemed equivalent for the purpose of substituted compliance. Following an equivalency determination, a covered entity would be relieved of the requirement to comply with these margin requirements in respect of a non-centrally cleared derivative involving a foreign counterparty if the covered entity complies with those foreign requirements.

In determining which margin requirements would apply to a derivative transaction involving a covered entity and a foreign counterparty, the Committee has posited five scenarios:

- (a) for non-centrally cleared derivatives between a local covered entity and a foreign covered entity in a jurisdiction deemed equivalent, substituted compliance would apply;
- (b) for non-centrally cleared derivatives between a local covered entity and a branch of a foreign covered entity located in a jurisdiction of Canada, these margin requirements would apply;
- (c) for non-centrally cleared derivatives between a branch or a subsidiary of a local covered entity in a foreign jurisdiction with a foreign covered entity from a jurisdiction deemed equivalent, substituted compliance would apply;
- (d) for non-centrally cleared derivatives between a local covered entity and a foreign covered entity, including branches or subsidiaries, from a jurisdiction not deemed equivalent, located in a jurisdiction of Canada, these margin requirements would apply;
- (e) for non-centrally cleared derivatives between a branch or a subsidiary of a local covered entity in a foreign jurisdiction with a foreign covered entity from a jurisdiction not deemed equivalent, these margin requirements would apply.

In all other scenarios, these margin requirements would apply.

Question

16. Is the application of these margin requirements in the five scenarios appropriate? Please explain.

## **PART 8 – PHASE-IN**

Implementing these margin requirements on non-centrally cleared derivatives will require certain changes to covered entities' current practices. Covered entities will be required to make operational adjustments and invest in systems to ensure their compliance. Market participants will also be required to establish or enhance collateral management arrangements and liquidity planning in order to meet the additional demand for high-quality collateral.

In order to mitigate the impact of margin requirements on relatively smaller derivatives market participants, the BCBS-IOSCO Standards recommend a staged phase-in of the requirements to transfer both initial margin and variation margin. Under the BCBS-ISOCO Standards, covered entities whose aggregate month-end average notional amount outstanding in the months of March, April and May of 2016 is above €3 trillion would be required to exchange variation margin beginning on September 1, 2016 and all remaining covered entities would be required to exchange variation margin beginning on March 1, 2017.

The BCBS-IOSCO Standards also recommend that covered entities whose aggregate month-end average notional amount outstanding for the months of March, April and May of 2016 is above €3 trillion exchange initial margin beginning on September 1, 2016. This threshold is reduced for each year in order to gradually phase-in the requirement to exchange initial margin, in the following schedule:

- (a) from September 1, 2016 for covered entities whose aggregate month-end average notional amount outstanding for the months of March, April and May in 2016 is greater than €3.0 trillion;
- (b) from September 1, 2017 for covered entities whose average notional amount outstanding for the months of March, April and May in 2017 is greater than €2.25 trillion;
- (c) from September 1, 2018 for covered entities whose aggregate month-end average notional amount outstanding for the months of March, April and May in 2018 is greater than €1.5 trillion;
- (d) from September 1, 2019 for covered entities whose aggregate month-end average notional amount outstanding for the months of March, April and May in 2019 is greater than €0.75 trillion;

- (e) from September 1, 2020 for covered entities whose aggregate month-end average notional amount outstanding for the months of March, April and May in 2020 is greater than €8.0 billion.

Some foreign regulatory authorities have implemented or proposed to implement a phase-in approach similar to the BCBS-IOSCO Standards, with thresholds approximately converted to their local currencies.

In considering the foreign phase-in proposals, the Committee believes a phase-in period will help mitigate the costs associated with establishing liquidity and collateral management arrangements for relatively smaller covered entities. This will allow time for covered entities to adjust to the increase in demand for high-quality collateral and to secure sufficient high-quality collateral to comply with these margin requirements. A phase-in period will also help to avoid introducing a sudden shock and disruption to the derivatives market and the trading operations of covered entities.

The Committee sees a compelling rationale for adopting a phase-in timeline. A timeline similar to that of the BCBS-IOSCO Standards and other foreign proposals will facilitate international harmonization in the implementation of margin requirements, further facilitating substituted compliance for cross-border derivatives. However, in view of the fact that our effort to develop the rules on margin requirements for non-centrally cleared derivatives will unlikely be completed this year, the Committee will propose a phase-in timeline adapted from the BCBS-IOSCO Standards in the forthcoming proposed national instrument.

## PART 9 – LIST OF QUESTIONS

1. Central clearing counterparties that are not recognized or exempted from recognition as a clearing agency or a clearing house in a jurisdiction of Canada may have margining standards that are not equivalent to local requirements for recognized or exempt clearing agencies or clearing houses, potentially weakening the risk-mitigation objective of central clearing. Should counterparties be required to post margin for derivatives that are cleared on clearing agencies or clearing houses that are not recognized or exempt from recognition in a jurisdiction of Canada? Please explain.
2. Please describe any significant concerns with requiring covered entities to obtain a certification report from an independent third-party auditor on the quantitative margining models and the test results.
3. Should there be a minimum amount of data from a stressed financial period included in the back testing of quantitative margining models? What should this amount be (in percentage)?
4. Are there situations when margin requirements should be imposed on pre-existing non-centrally cleared derivatives?
5. Financial entities whose aggregate month-end average notional amount of non-centrally cleared derivatives calculated for the months of March, April and May is less than \$12 000 000 000, excluding intragroup transactions, are not covered entities, and thus are not subject to the variation margin requirement. Is the \$12 000 000 000 threshold appropriate for the variation margin requirement? If not, what should the threshold be?
6. In your view, are there situations in which it would be important to permit the use of an alternative method to calculate variation margin? Please explain.
7. Please describe any concerns with requiring independent third-party certification of an alternative method before its implementation.
8. The OSFI Guideline includes debt securities issued by public sector entities (potentially lower level governments, agencies and school boards) treated as sovereign by national supervisors and multilateral development banks. Those securities are defined in the guideline as eligible collateral. Should the CSA include such securities as eligible collateral, and are there any potential risks and concerns?
9. Is it appropriate to require covered entities using a quantitative haircut model to recalculate collateral haircuts at least every three months? If not, what would be an appropriate frequency?
10. Is the proposed segregation requirement adequate to protect the interests of the covered entity that posts the collateral?
11. In view of the prohibition against re-hypothecation of collateral in the OSFI Guideline and by foreign regulatory authorities, should re-hypothecation, re-use or re-pledging of collateral received for initial margin be permitted? Please explain. If yes, should it be restricted to only funding a back-to-back hedge of the original non-centrally cleared derivative?

12. Should covered entities be restricted to re-hypothecating, re-using or re-pledging specific collateral only once? How should the covered entity that receives the re-hypothecated collateral be informed that it cannot be re-hypothecated again?
13. Should covered entities only be allowed to re-hypothecate collateral to other covered entities or to any entity? Please explain.
14. Should intragroup derivatives be exempted from only the initial margin requirements, or from both initial margin and variation margin requirements? Please explain.
15. Should the intragroup exemption be expanded to all affiliated entities based on the concept of ownership and control? If so, are there concerns that such an inter-affiliate exemption will not be consistent with the requirements in NI 94-101, the OSFI Guideline and the US rules where intragroup exemptions are based on the concept of consolidated financial statements? Please explain.
16. Is the application of these margin requirements in the five scenarios appropriate? Please explain.

**Appendix A**  
to  
**CSA Consultation Paper 95-401**  
**Margin and Collateral Requirements for Non-Centrally Cleared Derivatives**  
*Standardized Initial Margin Schedule*

<b>Asset class</b>	<b>Initial margin requirement (% of notional exposure)</b>
Credit: 0–2 year duration	2
Credit: 2–5 year duration	5
Credit 5+ year duration	10
Commodity	15
Equity	15
Foreign exchange	6
Interest rate: 0–2 year duration	1
Interest rate: 2–5 year duration	2
Interest rate: 5+ year duration	4
Other	15

**Appendix B**  
to  
**CSA Consultation Paper 95-401**  
**Margin and Collateral Requirements for Non-Centrally Cleared Derivatives**  
*Standardized Haircut Schedule*

<b>Asset class</b>	<b>Haircut (% of market value)</b>
Cash in same currency, including certificates of deposit, that are not securities, issued by a bank listed in Schedule I, II or III to the Bank Act (Canada)	0
Debt securities issued by or guaranteed by the Government of Canada or the Bank of Canada or the government of a province or territory of Canada or the BIS, IMF or a multilateral development bank: residual maturity less than one year	AAA to AA-/A-1 rating: 0.5
	A+ to BBB- rating: 1
	BB+ to BB- rating: 15
Debt securities issued by or guaranteed by the Government of Canada or the Bank of Canada or the government of a province or territory of Canada or the BIS, IMF or a multilateral development bank: residual maturity between one and five years	AAA to AA-/A-1 rating: 2
	A+ to BBB- rating: 3
	BB+ to BB- rating: 15
Debt securities issued by or guaranteed by the Government of Canada or the Bank of Canada or the government of a province or territory of Canada or the BIS, IMF or a multilateral development bank: residual maturity greater than five years	AAA to AA-/A-1 rating: 4
	A+ to BBB- rating: 6
	BB+ to BB- rating: 15
Publicly traded debt securities issued and fully guaranteed by corporate entities with adequate financial capacity to meet obligations: residual maturity less than one year	AAA to AA-/A-1 rating: 1
	A+ to BBB- rating: 2
Publicly traded debt securities issued and fully guaranteed by corporate entities with adequate financial capacity to meet obligations: residual maturity between one and five years	AAA to AA-/A-1 rating: 4
	A+ to BBB- rating: 6
Publicly traded debt securities issued and fully guaranteed by corporate entities with adequate financial capacity to meet obligations: residual maturity greater than five years	AAA to AA-/A-1 rating: 8
	A+ to BBB- rating: 12
Equities included in major Canadian stock indices	15
Gold	15
Mutual funds	Highest haircut applicable to any security in which the fund can invest
Additional (additive) haircut on assets in which the currency of the derivatives obligation differs from that of the collateral asset	8