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Hong Kong Regulators Issue Consultation Paper on Proposed Margin Requirements for Non-Centrally Cleared OTC Derivative Transactions; Calls Scheduled for Tuesday, July 17 at 3 pm (Eastern) and Thursday, July 19 at 9 am (Hong Kong)

[31267]

June 29, 2018 TO: ICI Members
ICI Global Members
Derivatives Markets Advisory Committee
ICI Global Pacific Chapter
ICI Global Trading & Markets Committee SUBJECTS: Derivatives
International/Global
Trading and Markets RE: Hong Kong Regulators Issue Consultation Paper on Proposed Margin Requirements for Non-Centrally Cleared OTC Derivative Transactions; Calls Scheduled for Tuesday, July 17 at 3 pm (Eastern) and Thursday, July 19 at 9 am (Hong Kong)

Last week, the Hong Kong Securities and Futures Commission published a consultation paper ("Consultation") seeking comments on a proposal that would implement margin requirements on non-centrally cleared over-the-counter ("OTC") derivative transactions.[1] The proposed margin requirements are based on those set out in a 2015 Basel Committee on Banking Supervision and International Organization of Securities Commissions Report[2] and generally are consistent with other global standards, though certain proposed haircuts to collateral differ to account for external credit rating determinations.

ICI will hold two calls to discuss the Consultation and potential comments to it. For members in the United States, the call will take place on **Tuesday, July 17 at 3 pm (Eastern).** For members in Asia, the call will take place on **Thursday, July 19 at 9 am (Hong Kong).** Please contact Brenda Kathurima at brenda.kathurima@ici.org or Ken Fang at kenneth.fang@ici.org to RSVP and receive dial-in information for either call. Comments are due on August 20. A summary of the Consultation follows.

I. Scope and Instruments Subject to the Proposed Requirements

The proposed initial margin ("IM") and variation margin ("VM") requirements would apply to a licensed person (*e.g.,* a regulated broker-dealer or investment adviser) that is a "contracting party"[3] to a non-centrally cleared OTC derivative transaction entered into with a "covered entity" (*e.g.,* a registered fund).[4] In those cases, the parties would have to exchange IM when both the licensed person and the covered entity have an average aggregate notional amount of non-centrally cleared OTC derivatives on a group basis exceeding HK$60 billion.[5] The parties would be required to exchange VM when the licensed person itself or the group to which the licensed person belongs has an average aggregate notional amount of non-centrally cleared OTC derivatives exceeding HK$15 billion.

The proposed requirements would apply to all derivative transactions that a central counterparty does not clear,[6] except for certain transactions:

- Physically settled foreign exchange ("FX") forwards, FX swaps, and FX transactions embedded in cross-currency swaps associated with the exchange of principal would be excluded from the margin requirements (except the VM requirements would apply if the covered entity is an authorized institution, a licensed corporation or an entity that carries on a business outside Hong Kong that is engaged in banking, securities, derivatives or asset management).
- Currency contracts with a "T+7" day or shorter settlement period, physically-settled commodity forwards, non-centrally cleared single-stock options, equity basket options and equity index options would be excluded from the margin requirements.

The proposed requirements would not apply to transactions with authorized institutions (*e.g.*, banks) or approved brokers, which the Hong Kong Monetary Authority ("HKMA") would continue to govern. To the extent that a banking group includes both authorized institutions and licensed persons, the proposed rules explicitly states that the HKMA requirements are "compatible."[7]

In addition, to address the legal uncertainty that jurisdictional differences in collateral arrangements create, the proposed requirements would not require a licensed person to exchange: (i) IM or VM when there is reasonable doubt as to the enforceability of the netting agreement upon default or insolvency of the counterparty; or (ii) IM when arrangements for the protection of posted collateral are questionable or not legally enforceable upon the insolvency of the counterparty.[8]

II. Proposed Margin Requirements

A. *IM Requirements*

i. *Computing IM*

Parties must exchange IM under either: (i) a standardized margin schedule ("margin schedule approach"); or (ii) an internally developed, quantitative portfolio margin model ("model approach").[9] The proposed margin schedule approach is consistent with the BCBS-IOSCO margin requirements that the US prudential regulators and CFTC have adopted.[10] The proposed model approach would require adherence to certain parameters as well as approval in writing from the SFC before it could be used.[11] It would require, among other things, an estimate of the change in potential future exposure of the non-centrally cleared OTC derivatives to a one-tailed 99 percent confidence interval over a 10-day horizon, calibrated using three to five years of historical data, with at least 25 percent of this data from a period of significant financial stress.[12] The SFC proposes that the model approach allow for the consideration of the benefits derived from the diversification, hedging and risk offsets of non-centrally cleared OTC derivatives within the same asset class (covered by the same legally enforceable netting agreement), but not across different asset classes. To address the impact of differences in jurisdictional margin requirements, the SFC also proposes to allow a licensed person in agreement with its counterparty to include non-centrally cleared OTC derivatives that are otherwise out of the scope of the margin requirements in the same netting set as the in-scope portfolio when calculating IM, as long as this is done consistently and on an ongoing basis.

ii. *IM Threshold*

The proposed rules would permit a licensed person and a counterparty to agree not to exchange IM if the amount due is equal to or lower than HK$375 million. This amount is applied at the level of the consolidated group to which the licensed person and the counterparty belong and is based on all non-centrally cleared OTC derivatives outstanding between the two consolidated groups. A licensed person should have systems and controls in place to ensure that any allocated IM threshold is not exceeded.

iii. *Treatment of IM Collected*

The proposed rules would require a licensed person and its counterparty to each post IM collateral, as relevant. The licensed person, as collecting party, would be required to:

- ensure that appropriate collateral arrangements, including credit support arrangements, are in place and are legally effective when the posting counterparty defaults or becomes insolvent; and
- ensure that IM collected is held in a way that it is available in a timely manner to the licensed person when the posting counterparty defaults or becomes insolvent.

To protect the counterparty, a licensed person, as the collecting party, would provide the posting party with the option to have the IM the counterparty posts segregated from IM that other counterparties post.

The licensed person, as posting party, would be required to ensure that IM posted:

- is subject to arrangements that protect the licensed person to the extent possible under applicable law when the collecting counterparty defaults or becomes insolvent; and
- is segregated from the collecting counterparty’s proprietary assets at a third-party custodian or through other legally effective arrangements to protect the IM when the collecting counterparty defaults or becomes insolvent.

If a third-party custodian is used, the licensed person also should ensure that:

- the custodian is not a group member of the collecting or posting counterparty; and
- the financial condition and credit standing of the custodian is monitored.

IM collected from a counterparty may be rehypothecated, repledged or reused with a third party only for hedging the licensed person's derivative positions arising out of transactions with the counterparty for which IM was collected and subject to certain conditions.[13] The conditions, among other things, require a licensed person to obtain express written consent to the rehypothecation of the collateral.

B. *VM Requirements*

The proposed rules would require the VM exchanged to fully collateralize the current exposure of the transaction, and VM would be calculated and exchanged for transactions subject to a single, legally enforceable netting agreement.

As with IM, a licensed person may agree with its counterparty to include non-centrally cleared OTC derivatives that are out of the scope of the margin requirements in the same netting set as the in-scope portfolio when calculating VM, as long as this is done consistently and on an ongoing basis.

III. Minimum Transfer Amount

The proposed rules would permit a licensed person to agree with its counterparty not to exchange margin if the amount of the margin due (aggregate of IM and VM) since the last exchange of margin is equal to or lower than a specified minimum transfer amount not exceeding HK$3.75 million.

IV. Timing of Margin Exchange

The proposed rules would require IM to be called at the earliest time possible after either execution of a transaction or upon changes in measured potential future exposure. The IM for a given counterparty should be recalculated at least every 10 business days.

VM would be called at the earliest time possible after the trade date and from time to time thereafter. VM would be calculated at least daily.

The proposed rules would require IM and VM to be collected as soon as practicable within the standard settlement cycle for the relevant collateral type.

V. Proposed Eligible Margin Collateral and Haircuts

The proposed rules would allow the following collateral instruments to be eligible as margin for both IM and VM, subject to appropriate haircuts:

- cash in any currency;
- marketable debt securities, rated investment grade, issued or fully guaranteed by a sovereign or a relevant international organization;
- marketable debt securities, rated investment grade, issued or fully guaranteed by a multilateral development bank;
- marketable debt securities, rated investment grade, issued or fully guaranteed by a public-sector entity;
- other marketable debt securities;
- gold; or
- listed shares, which are subject to a haircut percentage of 15 percent under Schedule

2 to the Securities and Futures (Financial Resources) Rules.[14]

The proposed rules would require that, when a licensed person collects IM or VM, it should ensure that the value of the collateral does not significantly correlate with the creditworthiness of the counterparty or the value of the underlying non-centrally cleared OTC derivatives portfolio in a way that would undermine the effectiveness of the margin protection. In addition, licensed persons would be required to have appropriate policies and procedures in place to monitor and manage concentration risk to ensure that the collateral collected as IM and VM is not overly concentrated in an individual issuer, issuer type and asset type.

The proposed rules would employ haircuts to address market, foreign exchange, and other risks as well as volatility of the collateral market values under various conditions.[15] Haircuts would be applied to the market value of eligible collateral for margin purposes and would incorporate external credit ratings. Marketable debt securities must have an investment grade credit rating. When an external credit rating does not exist, a licensed person either must develop its own internal ratings-based approach or rely on a counterparty's internal ratings.

Further, each party may designate only one currency in the documentation. Whenever the eligible collateral posted (as either IM or VM) is denominated in a currency other than the designated currency, there should be an additive haircut of 8 percent to the market value of any IM collateral (cash and non-cash) and non-cash VM collateral to address the currency mismatch.

VI. Comparability Assessments

The SFC recognizes that the non-centrally cleared OTC derivatives market is global and that a transaction could be subject to the margin requirements of two or more regulators or jurisdictions.   Accordingly, it proposes to allow substituted compliance for those transactions that are subject to the margin requirements of another regime:

- for which the SFC or HKMA has issued a comparability determination; or
- which is deemed comparable (*i.e.,* when a licensed person notifies the SFC of its intention to comply with the margin requirements of a Working Group on Margin Requirements ("WGMR") jurisdiction,[16] such requirements are deemed as comparable from the day they enter into force until the SFC or HKMA completes a comparability assessment).

VII. Compliance Dates

The SFC proposes the following effective dates for the IM and VM requirements:

Period

Threshold

IM

Phase-In

September 1, 2019

Both the licensed person and the covered entity have an average aggregate notional amount exceeding HK$6 trillion on a group basis

Permanent

From September 1, 2020 for each subsequent 12-month period

Both the licensed person and the covered entity have an average aggregate notional amount of non-centrally cleared OTC derivatives exceeding HK$60 billion on a group basis

VM

September 1, 2019

All parties subject to the rule, as described in Section I above

The proposed margin requirements would apply only to contracts entered into after the applicable effective date. IM and VM need not be exchanged for legacy derivative contracts (i.e., those entered before the relevant effective date).[17] Once a threshold is exceeded, the margin requirements continue to apply to the non-centrally cleared OTC derivative transactions for the one-year period, regardless of whether the licensed person or its counterparty subsequently fall below the threshold.

Kenneth Fang
Assistant General Counsel

Attachment

endnotes

[1] *See* SFC, *Consultation Paper on the OTC derivatives regime for Hong Kong – Proposed margin requirements for non-centrally cleared OTC derivative transactions* (June 19, 2018), *available at* https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=18CP5.

[2] *See* Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, *Margin requirements for non-centrally cleared derivatives* (March 2015), *available at* www.bis.org/bcbs/publ/d317.pdf.

[3] A "contracting party" is a party that enters a non-centrally cleared OTC derivative transaction as principal whether contracting directly or through an agent. *See* Consultation at note 7.

[4] A "covered entity" is a financial counterparty, significant non-financial counterparty or other entity that the SFC designates. It does not include sovereigns, public-sector entities, multilateral development banks or the Bank for International Settlements. A "financial counterparty" is any of several listed entities (including collective investment schemes, such as mutual funds) that, with respect to a one-year period from September 1 through

August 31, has an average aggregate notional amount of non-centrally cleared OTC derivatives exceeding HK$15 billion. *See* Consultation at Appendix 1, Paragraph 2.

[5] A "group" of companies is a group of entities for which consolidated financial statements are prepared.

[6] The proposed margin requirements do not apply to derivative transactions that are centrally cleared if they: (i) are subject to the margin requirements of the central counterparty; or (ii) provide margin consistent with the relevant corresponding central counterparties margin requirements.

[7] The SFC also proposes to exempt intragroup transactions (*i.e.,* transactions between a licensed corporation and a covered entity in the consolidated group to which the licensed corporation also belongs) from the proposed margin requirements, when:

i. The licensed corporation and its affiliates are accounted for on a full basis in the group consolidated financial statements; and
ii. The risk evaluation, measurement, and control procedures applicable to the licensed corporation and its affiliates are centrally overseen and managed within the group of companies to which they belong.

The SFC proposes to exclude these transactions because they may facilitate more effective risk management. *See* Consultation at Paragraphs 60 and 61.

[8] To take advantage of this exemption, the licensed corporation is expected to have assessed the enforceability of the netting agreement or the collateral arrangements, which should be supported by an external written legal opinion.

[9] When a licensed corporation does not face counterparty risk (*e.g.,* if an option seller receives full payment of the premium upfront and does not have any potential future exposure to a counterparty), a licensed corporation may choose not to collect IM. *See* Consultation at Appendix 1, Paragraph 11.

[10] *See* Annex A (describing how to compute IM under the margin schedule approach).

[11] *See* Annex B (setting forth parameters for the model approach).

[12] The SFC notes that there are similar model calibration data requirements in the EU and HKMA regimes.

[13] *See* Consultation at Appendix 1, Paragraph 26.

[14] These listed shares would include:

- Shares listed on a recognized stock market; being a constituent of the Hang Seng Index;
- Shares which are listed on a specified exchange in the UK other than shares which are listed on the London Stock Exchange plc – SEAQ: being a constituent of the FTSE 100 Index;
- Shares which are listed on a specified US exchange, other than shares listed on the NASDAQ Stock Market LLC – NASDAQ Global Market or the NASDAQ Stock Market LLC – NASDAQ Global Select Market: being a constituent of the S&P 500 Index;
- Shares which are listed on a specified exchange in Japan other than shares which are

listed on the Tokyo Stock Exchange, Inc. – JASDAQ: being a constituent of the Nikkei Stock Average; and

- Shares which are listed on a specified exchange, other than exchange in the UK, the US or Japan: being a constituent of the Euro Stoxx 50 Index.

[15] *See* Annex C (providing an eligible collateral haircut schedule).

[16] The WGMR member jurisdictions are Australia, Canada, the European Union, India, Japan, Republic of Korea, Mexico, Russia, Singapore, Switzerland and the United States.

[17] The SFC states that an amendment to an existing contract solely to change the interest rate benchmark, itself, would not subject the amended contract to the proposed margin requirements. *See* Consultation at Paragraph 68.

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