

MEMO# 32184

January 29, 2020

Hong Kong Securities Regulator Adopts Margin Requirements for Non-Centrally Cleared OTC Derivative Transactions

[32184]

January 29, 2020 TO: ICI Members

ICI Global Members SUBJECTS: Derivatives

International/Global

Trading and Markets RE: Hong Kong Securities Regulator Adopts Margin Requirements for Non-Centrally Cleared OTC Derivative Transactions

In December, the Hong Kong Securities and Futures Commission (“SFC”) published consultation conclusions (“Conclusion Paper”) on the Hong Kong over-the-counter (“OTC”) derivatives regime, implementing margin requirements for non-centrally cleared OTC derivative transactions.^[1] The requirements are substantially similar to those proposed and address several comments that ICI Global raised in its comment letter on the proposal.^[2] The initial margin (“IM”) requirements will be phased in starting on 1 September 2020 and the variation margin (“VM”) requirements will become effective on 1 September 2020.

I. Scope and Instruments Subject to the Requirements

Scope. As proposed, the IM and VM requirements will apply to all licensed persons who are contracting parties to non-centrally cleared OTC derivative transactions entered into with a “covered entity” (e.g., a registered fund).^[3] In those cases, the parties must exchange IM when both the licensed person and the covered entity have an AANA of non-centrally cleared OTC derivatives exceeding HK\$60 billion.^[4] The parties must exchange VM when the licensed person itself or the consolidated group to which it belongs has an AANA of non-centrally cleared OTC derivatives exceeding HK\$15 billion.^[5]

In response to an ICI Global comment, the SFC clarified that, when determining the AANA threshold (and other thresholds), the SFC will evaluate each fund of an umbrella trust individually (and not the umbrella trust as a whole) as long as the fund is a distinct pool of assets:

- that would be treated as such for purposes of the fund’s and asset manager’s default or insolvency; and
- that is not collateralized by or otherwise guaranteed or supported by the asset

manager or any fund that the asset manager manages.[\[6\]](#)

Instruments Covered. The margin requirements will apply to all derivative transactions that a central counterparty does not clear,[\[7\]](#) except that:

- Physically settled foreign exchange (“FX”) forwards, FX swaps, and FX transactions embedded in cross-currency swaps associated with the exchange of principal will be excluded from the margin requirements. (The VM requirements will 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 will be excluded from the margin requirements.[\[8\]](#)

In response to an ICI Global comment, the SFC clarified that the VM requirements for physically settled FX derivatives will not apply to funds.[\[9\]](#)

In addition, to address the legal uncertainty that jurisdictional differences in collateral arrangements create, the requirements will 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 there is reasonable doubt as to the enforceability of arrangements for the protection of posted collateral upon the default or insolvency of the counterparty.[\[10\]](#)

II. Margin Requirements

A. IM Requirements

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”).[\[11\]](#) The margin schedule approach is consistent with the BCBS-IOSCO margin requirements that the US prudential regulators and CFTC have adopted.[\[12\]](#) The model approach will require adherence to certain parameters and approval in writing from the SFC before it could be used.[\[13\]](#)

The margin requirements 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.[\[14\]](#)

IM Threshold. The rules will 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.[\[15\]](#)

Treatment of IM. The rules will require a licensed person and its counterparty to each post IM collateral, as relevant. The licensed person, as collecting party, must:

- ensure that appropriate collateral arrangements, including credit support

arrangements, are in place and are legally effective when the posting counterparty defaults or becomes insolvent;

- 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; and
- 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, must 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 consolidated group member of the counterparty collecting or posting IM; 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. The conditions, among other things, require a licensed person to obtain express written consent to the rehypothecation of the collateral.[\[16\]](#)

B. VM Requirements

The rules will require the VM exchanged to fully collateralize the current exposure of the transaction, and VM will 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.[\[17\]](#)

II. Minimum Transfer Amount

The rules will 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.[\[18\]](#)

III. Timing of Margin Exchange

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

The rules will require IM and VM to be collected as soon as practicable within the standard settlement cycle for the relevant collateral type.[\[19\]](#)

IV. Eligible Margin Collateral and Haircuts

Eligible Margin. The rules 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.[\[20\]](#)

Haircuts. The rules will 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 will undermine the effectiveness of the margin protection. In addition, licensed persons will 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.[\[21\]](#)

The rules will employ haircuts to address market, foreign exchange, and other risks as well as volatility of the collateral market values under various conditions.[\[22\]](#) Haircuts will be applied to the market value of eligible collateral for margin purposes and will 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, except for onshore renminbi (CNY) and offshore renminbi (CNH), where the FX haircut should be 1.5 percent, to address the currency mismatch.[\[23\]](#)

V. Comparability Assessments

The SFC will allow substituted compliance for those transactions with a counterparty that is subject to the margin requirements of another regulator or jurisdiction ("counterparty's

margin requirements”), if:

- the licensed person notifies the SFC of its intention to adhere to the counterparty’s margin requirements before it begins to do so;
- the licensed person complies with all conditions that the SFC specifies in respect of it adhering to the counterparty’s margin requirements; and
- either:
 - The counterparty’s margin requirements are from a member of the Working Group on Margining Requirements under the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (“WGMR”); or
 - The SFC or Hong Kong Monetary Authority (“HKMA”) has issued a comparability determination in respect of the counterparty’s margin requirements.

In response to a comment from ICI Global, the SFC explained that it plans on implementing an “outcomes-based” approach to determine comparability.[\[24\]](#) Regardless of whether the jurisdiction or regulator is a WGMR member, the SFC will critically review whether the requirements achieve outcomes which are substantively similar to the SFC’s margin requirements. The SFC also noted that HKMA’s current margin requirements are comparable to the SFC’s requirements, except the licensed person should be subject to the asset eligibility requirements and collateral haircuts the SFC imposes and that the licensed person must obtain approval in writing from the SFC before using any IM model, even if the HKMA approved the model. The SFC also noted that the list of jurisdictions and regulators whose margin regimes are deemed “comparable” will be published on the SFC’s website.[\[25\]](#)

VI. Compliance Dates

The SFC will phase in the new IM and VM requirements as follows

Period

Threshold

IM

Phase-In

1 September 2020 to 31 August 2021

Both the licensed person and the covered entity have an AANA of non-centrally cleared OTC derivatives exceeding HK\$375 billion on a group basis

Permanent

From 1 September 2021 for each subsequent 12-month period

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

VM

1 September 2020

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

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endnotes

[1] See SFC, *Consultation Conclusions on the OTC derivatives regime for Hong Kong – Proposed margin requirements for non-centrally cleared OTC derivative transactions* (December 2019), available at <https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=18CP5>.

[2] See Letter from Dan Waters, Managing Director, ICI Global, to Ashley Alder, Chief Executive Officer, Securities and Futures Commission (20 August 2018), available at <https://www.ici.org/pdf/31340a.pdf>.

[3] 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 1 September through 31 August, has an average aggregate notional amount (“AANA”) of non-centrally cleared OTC derivatives exceeding HK\$15 billion. See Conclusion Paper at Appendix A, Paragraphs 1-2.

[4] The AANA includes the gross notional amount of all non-centrally cleared OTC derivatives and is the average of the total gross notional amount of month-end positions of non-centrally cleared OTC derivatives for March, April, and May preceding the 1 September start date in a relevant year. See Conclusion Paper at Appendix A, Paragraph 4.

[5] A “consolidated group” is a group of entities for which consolidated financial statements are prepared. See Conclusion Paper at Appendix A, Paragraph 5.

[6] See Conclusion Paper at 7 and Appendix A, note 6.

[7] The 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. See Conclusion Paper at Appendix A, Paragraph 7(a).

[8] See Conclusion Paper at Appendix A, Paragraph 7.

[9] See Conclusion Paper at Appendix A, note 9 (noting that the VM requirements for physically settled FX derivatives seek to “cover the asset manager, but not the funds

managed by the manager”).

[\[10\]](#) See Conclusion Paper at Appendix A, Paragraphs 46-47. To take advantage of this exemption, the licensed person 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. See Conclusion Paper at Appendix A, Paragraph 48.

The SFC also exempts 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 margin requirements, when:

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

See Conclusion Paper at Appendix A, Paragraph 49.

[\[11\]](#) When a licensed person 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), the licensed person may choose not to collect IM. These transactions may be excluded from the IM calculation. See Conclusion Paper at Appendix A, Paragraph 11 and note 12.

[\[12\]](#) See Conclusion Paper at Annex A (describing how to compute IM under the margin schedule approach).

[\[13\]](#) See Conclusion Paper at Annex B (setting forth parameters for the model approach). All models under the model approach will 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. The model also should capture all relevant risk factors which materially influence the non-centrally cleared OTC derivative contracts in a netting set. At a minimum, the risk factors should include foreign exchange or interest rate risk, equity risk, credit risk and commodity risk. In addition, the model should appropriately assess other material risks arising from imperfect correlations, idiosyncratic risk of underlying credit, market liquidity and non-linear dependencies. Risk offsetting features should only be recognized within the same asset class and not across different asset classes.

[\[14\]](#) See Conclusion Paper at Appendix A, Paragraph 16.

[\[15\]](#) See Conclusion Paper at Appendix A, Paragraphs 18-21.

[\[16\]](#) See Conclusion Paper at Appendix A, Paragraphs 22-26.

[\[17\]](#) See Conclusion Paper at Appendix A, Paragraphs 27-30.

[\[18\]](#) See Conclusion Paper at Appendix A, Paragraphs 31-32.

[\[19\]](#) See Conclusion Paper at Appendix A, Paragraphs 33-36.

[\[20\]](#) The listed shares 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.

See Conclusion Paper at Appendix A, Paragraph 37.

[\[21\]](#) See Conclusion Paper at Appendix A, Paragraphs 38-39.

[\[22\]](#) See Annex C (providing an eligible collateral haircut schedule).

[\[23\]](#) See Conclusion Paper at Appendix A, Paragraphs 41-45.

[\[24\]](#) See Conclusion Paper at 24.

[\[25\]](#) *Id.*