APRA

Discussion Paper

Margining and risk mitigation for non-centrally cleared derivatives

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www.apra.gov.au

Australian Prudential Regulation Authority

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Preamble

This discussion paper outlines the Australian Prudential Regulation Authority's (APRA's) proposed implementation of the internationally-agreed framework for margin requirements and risk mitigation standards for non-centrally cleared derivatives. These proposals potentially impact certain APRA-regulated entities that transact in non-centrally cleared derivatives; entities that have no such exposures will be unaffected.

There are two key elements to the proposals:

- APRA's proposed **margin requirements** are founded on the framework set out by the Basel Committee on Banking Supervision and International Organization of Securities Commissions (IOSCO) in *Margin requirements for non-centrally cleared derivatives* (March 2015).
- APRA's proposed **risk mitigation standards** for non-centrally cleared derivative transactions are developed from IOSCO's *Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives* (January 2015).

Concurrently with this paper, APRA is releasing for public consultation a new draft cross-industry prudential standard, *Prudential Standard CPS 226 Margining and risk mitigation for non-centrally cleared derivatives* (CPS 226), which gives effect to these proposals.

APRA invites written submissions on its policy proposals and the draft standard.

This discussion paper and draft CPS 226 are available on APRA's website at www.apra.gov.au.

Written submissions should be sent to policydevelopment@apra.gov.au by 20 May 2016 and addressed to:

Mr Pat Brennan
General Manager, Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority

Important disclosure notice - publication of submissions

All information in submissions will be made available to the public on the APRA website unless a respondent expressly requests that all or part of the submission is to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as confidential in a separate attachment.

Submissions may be the subject of a request for access made under the *Freedom of Information Act 1982* (FOIA). APRA will determine such requests, if any, in accordance with the provisions of the FOIA. Information in the submission about any APRA-regulated entity that is not in the public domain and that is identified as confidential will be protected by section 56 of the *Australian Prudential Regulation Authority Act 1998* and will therefore be exempt from production under the FOIA.

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Glossary

Term	Definition
ADI	Authorised deposit-taking institution
Aggregate month-end average notional amount	The simple average of the total notional amount of outstanding non-centrally cleared derivative transactions as at the end of each month in the reference period. The total notional amount is the aggregate of all outstanding non-centrally cleared derivative transactions across all entities within the margining group.
APRA	Australian Prudential Regulation Authority
APRA covered entity	An ADI, including a foreign ADI, and an authorised banking non-operating holding company (NOHC); a general insurer, including a Category C insurer, and an authorised insurance NOHC; a life company, including a friendly society and an eligible foreign life insurance company (EFLIC), and a registered life NOHC; and a registrable superannuation entity (RSE).
BCBS	Basel Committee on Banking Supervision
CCP	Central counterparty - a clearing house that interposes itself between counterparties to contracts traded in one or more financial markets, becoming the buyer to every seller and the seller to every buyer. A CCP becomes counterparty to trades with market participants through novation, an open offer system, or another legally binding arrangement.
Covered counterparty	An entity that is a financial institution or a systemically important non-financial institution with the following exclusions: (i) sovereigns, central banks, multilateral development banks, public sector entities and the Bank for International Settlements; (ii) a covered bond special purpose vehicle that enters into derivative transactions for the sole purpose of hedging; and (iii) a securitisation special purpose vehicle in a traditional securitisation that enters into derivative transactions for the sole purpose of hedging.
CPS 226	*Prudential Standard CPS 226 Margining and risk mitigation for non-centrally cleared derivatives*
Derivative	Has the same meaning as in the *Payment Systems and Netting Act 1998*.

Term	Definition
Financial institution	Includes but is not limited to any institution engaged substantively in one or more of the following activities (domestically or overseas) – banking; leasing; issuing credit cards; portfolio management (including asset management and funds management); management of securitisation schemes; equity and/or debt securities, futures and commodity trading and broking; custodial and safekeeping services; insurance and similar activities that are ancillary to the conduct of these activities. An authorised NOHC, a registered life NOHC, or any overseas equivalent is considered a financial institution. For the avoidance of doubt, hedge funds, trading firms, and foreign deposit-taking institutions are considered to be financial institutions.
G20	Group of Twenty - an international forum for the governments of 20 major economies.
Initial margin	Collateral that is collected to cover the potential future exposure that could arise from future changes in the market value of a derivative over the close-out period in the event of a counterparty default.
IOSCO	International Organization of Securities Commissions
Level 2 group	Means the entities that comprise: (i) Level 2 as defined in *Prudential Standard APS 001 Definitions*; or (ii) a Level 2 insurance group as defined in *Prudential Standard GPS 001 Definitions*.
Margining group	A group, comprising one or more entities, within the meaning of Australian Accounting Standard AASB 10 *Consolidated Financial Statements*.
Margining period	The period of time during which margin must be exchanged for all new transactions entered in to within that period.
Minimum transfer amount	The amount specified in a margining agreement that sets the minimum amount of collateral required to be transferred between the two counterparties as part of a collateral call.
Non-centrally cleared derivative	A derivative that is not cleared by a CCP. This does not include exchange traded derivatives, securities financing transactions and indirectly cleared derivatives that are intermediated through a clearing member on behalf of a non-member client where the client is subject to the margin requirements of the CCP, or where the client provides margin consistent with the CCP's margin requirements.

Term	Definition
Qualifying level	The level of aggregate month-end average notional amount for a reference period, in relation to the margining group of an APRA covered entity and the margining group of a covered counterparty, above which an APRA covered entity is subject to variation margin or initial margin requirements in the corresponding margining period.
Reference period	The period of time in respect of which month-end totals must be used to calculate the aggregate month-end average notional amount.
RSE	A 'registrable superannuation entity' as defined in the *Superannuation Industry (Supervision) Act 1993*.
Systemically important non-financial institution	An entity that is not a financial institution and that belongs to a margining group whose aggregate month-end average notional amount of non-centrally cleared derivatives for the preceding March, April and May exceeded AUD 50 billion.
Threshold	The amount specified in a margining agreement that defines the level of exposure above which margin will be posted. The threshold represents the amount of uncollateralised exposure allowed under the margining agreement.
Variation margin	Collateral that is collected to reflect the current mark-to-market exposure resulting from changes in the market value of a derivative.

Executive summary

The Australian Prudential Regulation Authority (APRA) proposes to implement a cross-industry framework for margining and risk mitigation for non-centrally cleared derivatives.

APRA's proposed requirements are set out in a new cross-industry prudential standard, *Prudential Standard CPS 226 Margining and risk mitigation for non-centrally cleared derivatives* (CPS 226), which APRA proposes to apply to authorised deposit-taking institutions, general insurers, life insurers, RSE licensees of registrable superannuation entities and authorised or registered non-operating holding companies, that transact in non-centrally cleared derivatives.

APRA is not proposing to directly apply CPS 226 to private health insurers at this time. In addition, APRA-regulated institutions that do not transact in non-centrally cleared derivatives will be unaffected by the new requirements.

Margin requirements

APRA's proposed margin requirements are founded on the framework set out by the Basel Committee on Banking Supervision (BCBS) and International Organization of Securities Commissions (IOSCO) in *Margin requirements for non-centrally cleared derivatives* (the BCBS-IOSCO framework). The requirements are intended to reduce systemic risk and contagion effects by ensuring the availability of collateral to offset losses that may be caused by the default of a derivative counterparty.

The key aspects of APRA's proposed margin requirements include:

- the requirement to post and collect variation margin;
- the requirement to exchange two-way initial margin on a gross basis;
- the requirement to collect eligible collateral as margin and apply haircuts on collateral; and
- a framework for deference to foreign margining regimes based on the BCBS-IOSCO framework.

APRA proposes to apply margin requirements only to institutions that have non-centrally cleared derivative activity in excess of certain qualifying levels. As a result, APRA's margin requirements will not apply to institutions with immaterial activity in non-centrally cleared derivatives. The lowest qualifying level at which the margin requirements apply is where an entity is part of a group whose average month-end notional outstanding non-centrally cleared derivatives exceeds AUD 3 billion (see 'When the margin requirements apply' below for more details). Based on APRA's understanding of current activity in non-centrally cleared derivatives by APRA-regulated institutions, the margin requirements are likely to apply to only a relatively small number of institutions.

APRA proposes the margin requirements are phased-in according to a timetable that largely aligns with the BCBS-IOSCO framework, albeit with a longer phase-in for the variation margin requirements. The proposed phase-in period for the variation margin requirements is September 2016 to September 2017. The proposed phase-in period for the initial margin requirements is September 2016 to September 2020.

Risk mitigation requirements

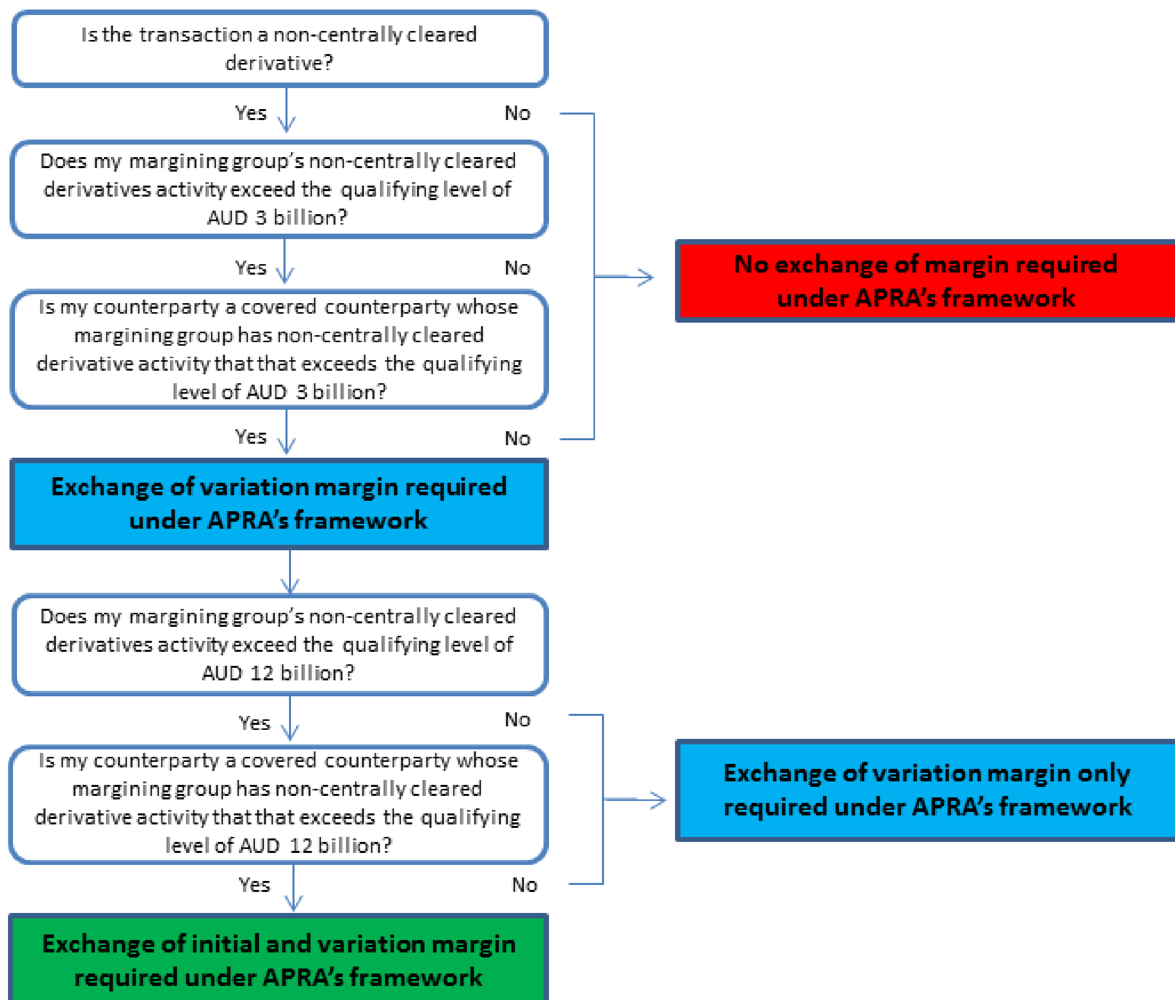
Draft CPS 226 also incorporates additional risk mitigation requirements in relation to non-centrally cleared derivatives. These requirements are based on IOSCO's *Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives* (the IOSCO risk mitigation standards).

These requirements are intended to increase the transparency of bilateral positions between counterparties, promote legal certainty over the terms of non-centrally cleared derivative transactions and facilitate the timely resolution of disputes.

APRA proposes to implement the risk mitigation standards for non-centrally cleared derivatives in a principles-based, rather than a rules-based, manner. As APRA considers the proposed risk mitigation requirements are important in managing risk for each non-centrally cleared derivative transaction, APRA proposes that there are no minimum qualifying levels for the application of these requirements. However, the principles-based approach allows for the portfolio-based risk mitigation requirements to be applied with a scope and frequency that reflects the size, complexity and risk profile of an entity's non-centrally cleared derivatives portfolio.

APRA proposes that the risk mitigation standards apply from September 2016, as these requirements largely reflect current practices.

When the margin requirements apply:



Chapter 1 — Introduction

1.1 Background

In 2009, the G20 initiated a reform programme to reduce the systemic risk from over-the-counter (OTC) derivatives markets. The initial reform comprised three key commitments:

- to improve transparency by requiring transaction information on all OTC derivatives to be reported to trade repositories;
- to improve market efficiency and risk management by requiring all standardised OTC derivatives to be cleared through central counterparties; and
- to improve market efficiency and integrity by requiring the execution of all standardised OTC derivatives on exchanges or electronic trading platforms, where appropriate.

Recognising that not all derivatives are suitable for central clearing, the G20 in 2011 added margin requirements for non-centrally cleared derivatives to its reform programme and called on the Basel Committee on Banking Supervision (BCBS) and International Organization of Securities Commissions (IOSCO) to develop recommendations for consistent global standards in this area.

Counterparty exposures on bilaterally transacted derivatives contributed to the depth of the global financial crisis. Many of these exposures were uncollateralised or undercollateralised, meaning insufficient collateral was available to offset losses caused by counterparty defaults and such losses were subsequently borne by the surviving counterparties. The build-up of uncollateralised exposures led to contagion and spillover effects on wider financial markets and the real economy.

The problems associated with insufficient collateral were exacerbated by inadequate risk management practices. Weaknesses in areas including trading relationship documentation, trade confirmation, portfolio reconciliation and compression, valuation processes and dispute resolution created a lack of certainty and transparency over the terms of non-centrally cleared transactions and aggravated the problems observed in the non-centrally cleared derivatives market.

In 2015, the BCBS and IOSCO finalised minimum standards for margin requirements for non-centrally cleared derivative transactions (‘the BCBS-IOSCO framework’). The BCBS-IOSCO framework requires the exchange of both variation margin and initial margin. Variation margin is collateral that is collected to reflect the current mark-to-market exposure resulting from changes in the market value of a non-centrally cleared derivative. Initial margin protects against the potential future exposure that may arise from future changes in the mark-to-market value of a non-centrally cleared derivative during the period of time that is assumed to be required to close-out and replace the position following a counterparty default.

To complement the margin requirements, IOSCO also developed standards for six other risk mitigation techniques to reduce risk in the non-centrally cleared derivatives market (‘the IOSCO standards’). These standards require covered entities to adopt appropriate risk mitigation standards in the areas of trading relationship documentation, trade confirmation, valuation processes, portfolio reconciliation, portfolio compression and dispute resolution.

The purpose of the BCBS-IOSCO reforms is to reduce systemic risk and limit contagion by ensuring the availability of collateral to offset losses caused by the default of a derivative counterparty and to improve risk management practices in order to promote legal certainty, transparency and timely dispute resolution. By requiring collateral to be posted against both current and potential future counterparty exposures for non-centrally cleared derivatives, as required for centrally cleared exposures, these reforms are also intended to promote central clearing.

1.2 Implementation timeline

Consistent with the BCBS-IOSCO framework's proposed implementation timetable, APRA proposes that the new cross-industry prudential standard, *Prudential Standard CPS 226 Margining and risk mitigation for non-centrally cleared derivatives* (CPS 226), will become effective on 1 September 2016. However, CPS 226 will provide for phase-in arrangements in relation to margining requirements. In determining an appropriate implementation date, APRA has been mindful of maintaining broad consistency with the BCBS-IOSCO timetable in order to facilitate, where possible, substituted compliance with the requirements of other jurisdictions.

The full impact of the margin requirements will be mitigated by the proposed phase-in period. Based on APRA's understanding of non-centrally cleared derivative activity levels, the margin requirements are likely to become effective for domestically-headquartered APRA-regulated institutions in March 2017 for variation margin and in September 2017 or September 2018 for initial margin. For the domestically-headquartered APRA-regulated institutions subject to initial margin requirements, with the exception of the four largest authorised deposit-taking institutions (ADIs), many would not be subject to the initial margin requirements until September 2020. The proposed phase-in dates for margining are described in detail in Chapter 2.

As the risk mitigation requirements in CPS 226 are principles-based and should reasonably reflect existing market practices, APRA proposes to apply the risk mitigation requirements from 1 September 2016 with no phase-in period.

1.3 Structure of this paper

This paper outlines APRA's proposed implementation of margin and risk mitigation requirements for non-centrally cleared derivatives. Chapter 2 outlines general proposals in relation to the margin requirements. Chapter 3 and Chapter 4 set out in more detail APRA's proposals in relation to variation margin requirements and initial margin requirements, respectively. Chapter 5 outlines issues related to APRA's proposed collateral and haircuts requirements. Chapter 6 addresses the application of margin requirements in a cross-border context. Finally, Chapter 7 outlines APRA's proposed risk mitigation standards.

1.4 Balancing financial safety with other considerations

In proposing its margin and risk mitigation requirements for non-centrally cleared derivatives, APRA has sought to find an appropriate balance between the objectives of financial safety and efficiency, competition, contestability and competitive neutrality. On balance, APRA considers that the proposals in this discussion paper – and particularly the introduction of qualifying levels below which the margining requirements do not apply - will deliver improved prudential outcomes without imposing undue costs.

APRA invites stakeholders to provide views on the impact the proposals in this discussion paper may have on these objectives, including views on proposals that may enhance the working of these proposals without compromising financial safety.

1.5 Request for views

APRA invites stakeholders to provide views on any of the proposed requirements addressed in this discussion paper and the new draft cross-industry prudential standard, CPS 226.

In particular, APRA invites stakeholders to provide views on the proposed adoption of a minimum qualifying level for variation margin requirements, in place of the BCBS-IOSCO framework requirement that all covered counterparties exchange variation margin. APRA also invites views on the proposed minimum qualifying level for initial margin requirements.

1.6 Request for cost-benefit analysis information

APRA requests that all stakeholders use this consultation opportunity to provide information on the compliance impact of the proposed changes and any other substantive costs associated with the changes. Compliance costs are defined as direct costs to businesses of performing activities associated with complying with government regulation. Specifically, information is sought on

any changes to compliance costs incurred by businesses as a result of APRA's proposals.

Consistent with the Government's approach, APRA will use the methodology behind the Regulatory Burden Measurement Tool to assess compliance costs. This tool is designed to capture the relevant costs in a structured way, including a separate assessment of upfront costs and ongoing costs. It is available at https://rbm.obpr.gov.au/home.aspx.

Respondents are requested to use this methodology to estimate costs to ensure the data supplied to APRA can be aggregated and used in an industry-wide assessment. When submitting their cost assessment to APRA, respondents are asked to include any assumptions made and, where relevant, any limitations inherent in their assessment. Feedback should address the additional costs incurred as a result of complying with APRA's requirements, not activities that institutions would undertake due to foreign regulatory requirements or in their ordinary course of business.

Chapter 2 — Margin requirements for non-centrally cleared derivatives

In March 2015, the BCBS and IOSCO finalised an international framework for margin requirements for non-centrally cleared derivatives in *Margin requirements for non-centrally cleared derivatives*[1]. Under the BCBS-IOSCO framework, all financial firms and systemically important non-financial entities that engage in non-centrally cleared derivatives must exchange margin (collateral) to cover changes in the current value (variation margin) and potential future exposure (initial margin) of derivatives that are not cleared by a central counterparty.

This chapter sets out the general proposals in relation to APRA's implementation of the BCBS-IOSCO framework. Detailed proposals are set out in subsequent chapters, and in draft CPS 226.

2.1 Definition of derivative

The Treasury recently consulted on a resilience and collateral protection reform package. The *Financial System Legislation Amendment (Resilience and Collateral Protection) Bill 2016* (the Resilience and Collateral Protection Bill)[2] proposes to insert a definition of 'derivative' into the *Payments Systems and Netting Act 1998* (PSN Act). The Resilience and Collateral Protection Bill proposes to enable entities to give, and enforce rights in respect of, margin provided by way of security in connection with certain financial market transactions - including 'derivatives' as defined in the PSN Act – under Australian law.

APRA considers that it is logical to align the definition of derivative in CPS 226 with that included in the PSN Act. Consistent with this approach, APRA has included in draft CPS 226 a reference to the definition of derivative in the PSN Act, as a placeholder. APRA's intention is to align, to the extent appropriate, the definition of derivative in the final CPS 226 with the final definition in the PSN Act.

1 http://www.bis.org/bcbs/publ/d317.pdf

2 http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2015/Resilience-and-Collateral-Protection-and-Client-Money-Reforms

2.2 Scope of application

The margin requirements for non-centrally cleared derivatives are intended to improve prudential safety, reduce systemic risk and promote central clearing. In order for the margin requirements to effectively achieve these objectives, it is important that requirements are applied consistently globally. The BCBS-IOSCO framework proposes that the margin requirements should apply to transactions between all financial firms and systemically important non-financial entities (collectively 'covered entities'). National discretion is provided in relation to the precise definitions of financial firms and systemically important non-financial entities.

As a matter of principle, APRA proposes to apply the margin requirements to the majority of institutions under its regulatory scope. However, in practice, APRA proposes to require an 'APRA covered entity' to exchange margin in a non-centrally cleared derivative transaction with a 'covered counterparty' only if both counterparties have a group-wide portfolio of non-centrally cleared derivatives that exceeds minimum qualifying levels.

2.3 APRA covered entities

APRA proposes that the definition of an APRA covered entity in CPS 226 will include:

- ADIs, including foreign ADIs, and authorised banking non-operating holding companies (NOHCs);
- general insurers, including Category C insurers, and authorised insurance NOHCs;
- life companies, including friendly societies and eligible foreign life insurance companies (EFLICs), and registered life NOHCs; and
- registrable superannuation entities (RSEs).

Private health insurers will not be considered APRA covered entities under CPS 226 at this time. APRA will consider the extension of CPS 226 to private health insurers in due course, as part of a broader review of the prudential framework for private health insurers.

APRA nevertheless expects private health insurers to prudently manage the risks arising from any non-centrally cleared derivatives activity. APRA also notes that a private health insurer may, in some circumstances, still be required to exchange margin as their counterparty to the transaction may be subject to margin requirements by APRA or a foreign jurisdiction.

2.3.1 Treatment of Level 2 subsidiaries

APRA also proposes to apply the margin requirements on a Level 2 basis. This means that the parent entity of an APRA-regulated Level 2 group must ensure that all entities within the Level 2 group, including foreign subsidiaries of locally-incorporated APRA covered entities, comply with APRA's margin requirements (as if they were themselves APRA covered entities).

In line with the application of the margin requirements on a Level 2 basis, APRA proposes to exempt certain intra-group transactions from any margin requirements, as explained in section 2.5 *Treatment of intra-group transactions*.

2.4 Covered counterparties

APRA proposes an APRA covered entity will be required to adhere to the margin requirements in CPS 226 in its transactions with covered counterparties. Consistent with the BCBS-IOSCO framework, a 'covered counterparty' is defined as:

- a financial institution; or
- a systemically important non-financial institution.

2.4.1 Financial institutions

APRA proposes that 'financial institution' be defined in a way that is broadly consistent with the existing definition in APRA's ADI prudential framework. This definition is intended to capture all institutions that normally fall within the meaning of the term 'financial institution'. APRA considers that the definition proposed in CPS 226 has broad international applicability.

2.4.2 Systemically important non-financial institutions

APRA proposes that 'systemically important non-financial institution' be defined based on activity in non-centrally cleared derivative transactions. Non-financial institutions that engage in large volumes of non-centrally cleared derivative transactions may be considered systemically important because of the concentration of a high level of counterparty credit risk generated by their activity.

APRA is proposing a qualifying level of AUD50 billion in total notional non-centrally cleared derivatives outstanding, across the institution's margining group, excluding intra-group transactions.

The proposed AUD 50 billion qualifying level is intended to avoid creating disincentives for mid-tier users to customise derivative products for hedging purposes, while capturing significant users of non-centrally cleared derivative transactions within the framework.

2.4.3 Exclusions

Consistent with the BCBS-IOSCO framework, APRA proposes that sovereigns, central banks, multilateral development banks and the Bank for International Settlements are excluded from the definition of covered counterparties.

APRA proposes to treat public sector entities as sovereigns for the purposes of determining the applicability of the margin requirements, and thus also exclude public sector entities.

APRA also proposes to exclude covered bond special purpose vehicles and securitisation special purpose vehicles from the requirements of CPS 226, subject to certain conditions. APRA considers that the inclusion of these special purpose vehicles would not contribute to systemic risk reduction as derivative counterparties are

already afforded legal and structural protections in covered bond and securitisation structures.

2.4.4 Identification of covered counterparties

In the implementation of the margining framework both in Australia and globally, a key operating mechanism will be the process by which an APRA covered entity or covered counterparty is identified.

Under CPS 226, an APRA covered entity must apply a reasonable level of due diligence to determine whether its counterparty is a covered counterparty whose non-centrally cleared derivatives activity exceeds the applicable qualifying level. In practice, this process to identify a covered counterparty will likely rely on a combination of self-identification by a counterparty and reasonable due diligence undertaken by an APRA covered entity.

2.5 Treatment of intra-group transactions

The BCBS-IOSCO framework states that:

- '*Transactions between a firm and its affiliates should be subject to appropriate regulation in a manner consistent with each jurisdiction's legal and regulatory framework*'; and
- '*Such transactions may not necessarily be suited to harmonisation as varying legal systems may be driven by the specifics of each jurisdiction and its legal framework.*'

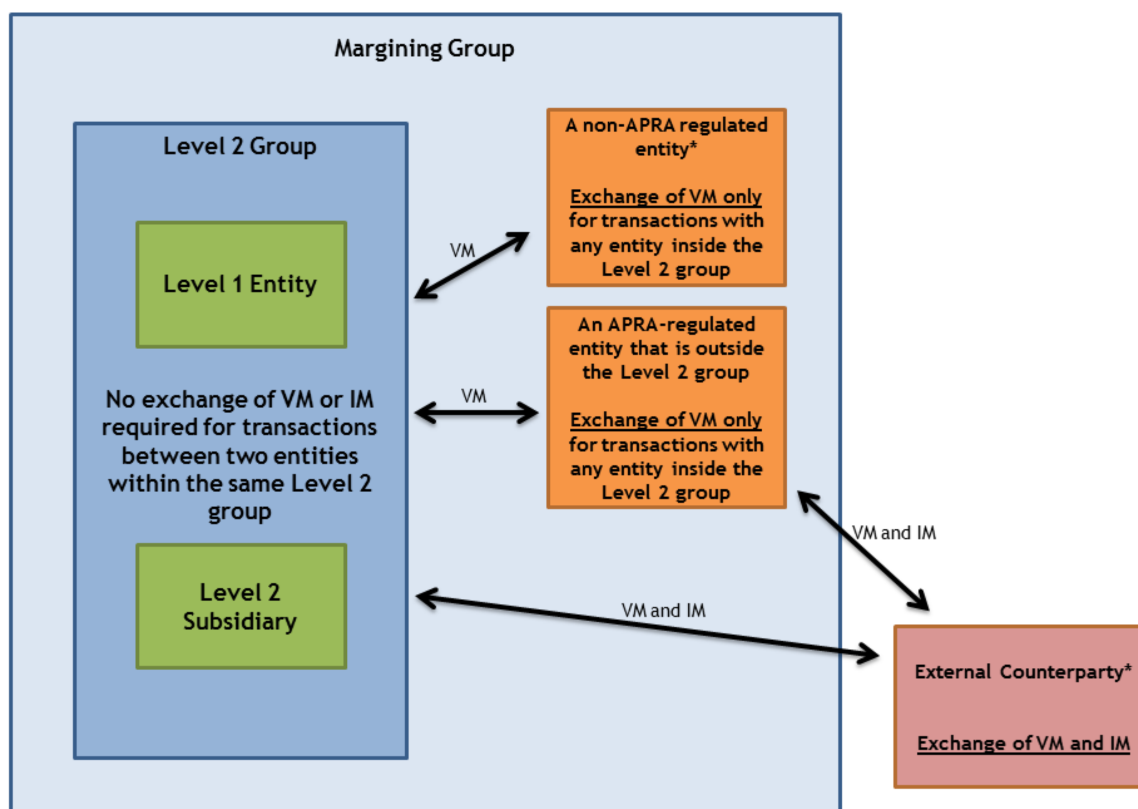
Entities often make risk management decisions on a consolidated group basis and often (although not exclusively) use intra-group derivative transactions for hedging purposes. APRA considers that, as a matter of principle, intra-group transactions should generally be treated in a similar manner to external transactions and conducted at arms-length. However, as a practical matter, APRA proposes that margining requirements be applied on a differential basis to intra-group transactions, depending on whether the counterparties are within a Level 2 group for capital adequacy purposes:

- Due to the application of capital adequacy requirements on a Level 2 basis, APRA proposes to exempt transactions between entities within the same APRA-regulated Level 2 group from any margin requirements. The application of consolidated capital requirements to Level 2 groups allows APRA to maintain oversight and confidence that the Level 2 capital required adequately reflects the risk undertaken by entities within the Level 2 group.
- To minimise liquidity and operational burdens, APRA proposes that the exchange of initial margin is not required for any transactions between entities within the same margining group.
- APRA proposes to require the exchange of variation margin only for transactions between an APRA covered entity and a covered counterparty that are in the same margining group but not in the same Level 2 group. For example, a parent ADI would need to exchange variation margin with an insurance or non-financial subsidiary within the same margining group, but not an ADI subsidiary that is part of its Level 2 group. There may be risks associated with non-centrally cleared derivative activity within broader conglomerate groups that may not be sufficiently mitigated without margining. The application of intra-group variation margin requirements is intended to reduce the risk of contagion to an APRA-regulated institution.
- To reduce the cross-border complexity of the rules, foreign ADIs, Category C insurers and EFLICs are exempt from the intra-group variation margin requirements.

APRA's proposed Level 2 group and intra-group margin requirements are depicted in Figure 1 below.

For any APRA covered entity, CPS 226 allows for APRA to amend the intra-group margin requirements, either through granting exemptions or imposing additional requirements, where it considers appropriate to do so.

Figure 1 - Level 2 group and intra-group margin requirements



2.6 Qualifying levels and phase-in of margin requirements

APRA proposes to phase-in the margin requirements so that the systemic risk reduction benefits of exchanging margin are appropriately balanced against the liquidity, operational and implementation costs associated with adopting the requirements.

Consistent with the BCBS-IOSCO framework, APRA proposes that the timetable by which entities are subject to the margining requirements is determined on a consolidated group basis. For the purposes of CPS 226, this group is referred to as a 'margining group' and consists of a group of one or more entities within the meaning of Australian Accounting Standard AASB 10 *Consolidated Financial Statements*.

APRA proposes that an APRA covered entity's phase-in date is determined by the notional amount of non-centrally cleared derivatives activity of its margining group in a given reference period. It is proposed that a margining group's notional amount of non-centrally cleared derivatives activity in the relevant reference period must be calculated in a manner consistent with the BCBS-IOSCO framework; that is, by aggregating total notional amounts of non-centrally cleared derivative transactions outstanding across the margining group (excluding intra-group transactions) for each of three month-end dates in the relevant reference period, and then averaging the month-end totals.

In particular, an APRA covered entity is subject to margin requirements where it belongs to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives outstanding exceeds the relevant qualifying level

in the corresponding reference period. There are separate qualifying levels and phase-in dates for variation margin and initial margin.

2.6.1 Variation margin phase-in

APRA proposes that variation margin requirements will be phased-in over time. While the earliest phase-in date and qualifying level proposed for variation margin requirements are aligned with the BCBS-IOSCO framework's timetable, APRA proposes extending the implementation timetable for margining groups with lower levels of activity.

APRA proposes that variation margin requirements will commence on:

- 1 September 2016 for margining groups with average notional amount of non-centrally cleared derivatives outstanding above AUD 4.5 trillion;
- 1 March 2017 for margining groups with average notional amount of non-centrally cleared derivatives outstanding above AUD 12 billion; and
- 1 September 2017 for margining groups with average notional amount of non-centrally cleared derivatives outstanding above AUD 3 billion.

Variation margin requirements will not be applied to margining groups with an average notional amount of non-centrally cleared derivatives outstanding below a qualifying level of AUD 3 billion. APRA's proposed ongoing minimum qualifying level for variation margin requirements is discussed further in section 3.1 *Qualifying level for the exchange of variation margin*.

2.6.2 Initial margin phase-in

APRA proposes that initial margin requirements will be phased in consistent with the BCBS-IOSCO framework timetable, with full implementation by 1 September 2020.

APRA proposes that initial margin requirements will initiate on:

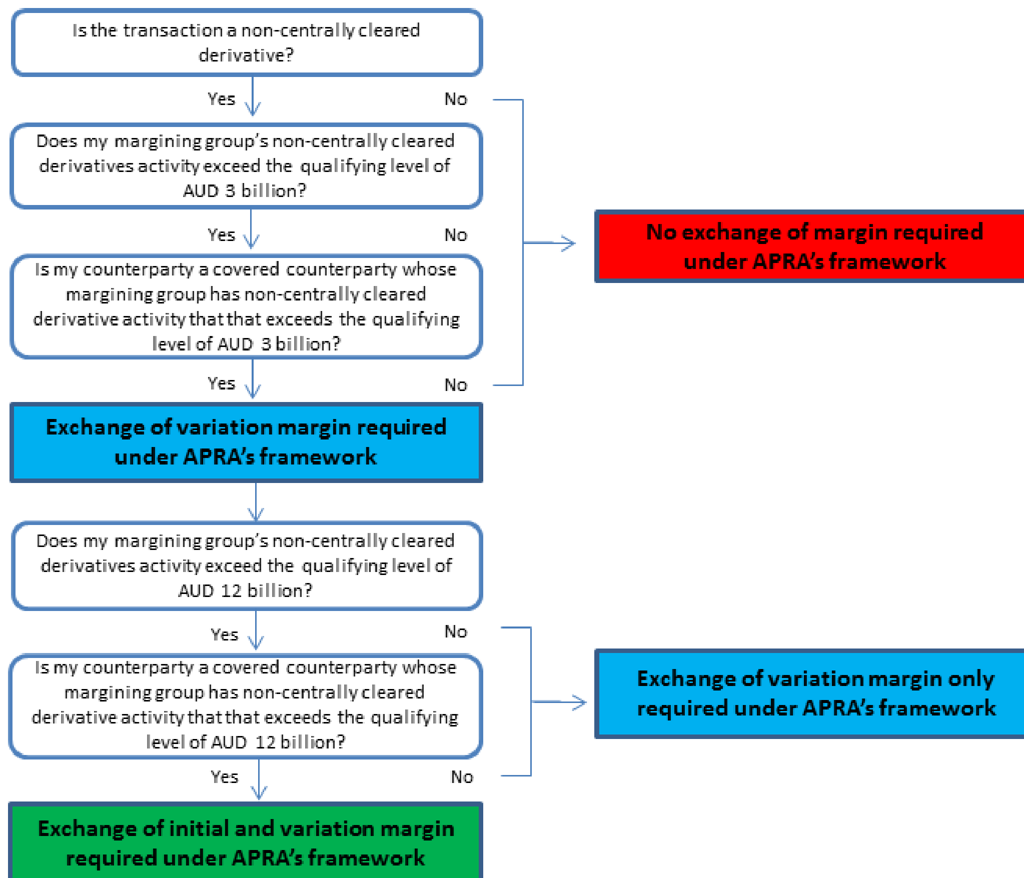
- 1 September 2016 for margining groups with average notional amount of non-centrally cleared derivatives outstanding above AUD 4.5 trillion;
- 1 September 2017 for margining groups with average notional amount of non-centrally cleared derivatives outstanding above AUD 3.375 trillion;
- 1 September 2018 for margining groups with average notional amount of non-centrally cleared derivatives outstanding above AUD 2.25 trillion;
- 1 September 2019 for margining groups with average notional amount of non-centrally cleared derivatives outstanding above AUD 1.125 trillion; and
- 1 September 2020 for margining groups with average notional amount of non-centrally cleared derivatives outstanding above AUD 12 billion.

APRA proposes that initial margin requirements will be not applied to margining groups below a qualifying level of AUD 12 billion.

Margin requirements apply when both the APRA covered entity and its covered counterparty meet the applicable qualifying level.

A sample decision tree to determine when (after the phase-in period has concluded) an APRA covered entity must exchange variation or initial margin with a covered counterparty is depicted in Figure 2.

Figure 2 - Example flowchart for determining when to apply margin requirements



2.7 Assets in Australia

For an APRA-regulated institution that is subject to a test of assets in Australia, APRA proposes that any cash or non-cash collateral given to secure any obligation under a non-centrally cleared derivative contract must be excluded from being assets in Australia.

Chapter 3 — Variation margin requirements

Variation margin is collateral that is collected to reflect the current mark-to-market exposure resulting from changes in the market value of a non-centrally cleared derivative.

This chapter outlines APRA's proposed implementation of variation margin requirements in more detail.

3.1 Qualifying level for the exchange of variation margin

The BCBS-IOSCO framework requires all covered entities to exchange variation margin on a net basis across all non-centrally cleared derivative transactions under a single legally-enforceable netting agreement. There are no qualifying levels for variation margin under the BCBS-IOSCO framework.

APRA proposes to introduce variation margin requirements, requiring an APRA covered entity to exchange variation margin in a transaction with a covered counterparty where each party belongs to a margining group that has non-centrally cleared derivatives activity in excess of a qualifying level.

APRA proposes that, at the end of the phase-in period, the minimum qualifying level for variation margin requirements will be AUD 3 billion.

A minimum qualifying level for variation margin requirements has been proposed in order to limit the competitive impact and costs imposed on entities that transact fairly limited amounts of non-centrally cleared derivatives, and to avoid creating disincentives for using non-centrally cleared derivatives for hedging purposes.

The qualifying level applies across a margining group within a reference period, as specified in CPS 226. Where either the APRA covered entity or covered counterparty belongs to a margining group that has non-centrally cleared derivative activity of AUD 3 billion or less, the exchange of variation margin will not be required. APRA considers the proposed qualifying level of AUD 3 billion appropriately balances the systemic risk reduction benefits of variation margin exchange with the additional liquidity, operational and implementation costs.

As outlined in section 2.6.1 *Variation margin phase-in*, it is proposed that the variation margin requirements in CPS 226 will apply for all APRA covered entities exceeding the AUD 3 billion qualifying level from 1 September 2017, with a small number of entities phasing-in earlier.

3.2 Frequency of calculation and exchange

The BCBS-IOSCO framework provides that variation margin must be exchanged '*on a regular basis (eg daily).*' The BCBS-IOSCO framework does not specify a permissible timeframe for settlement of variation margin.

Consistent with the BCBS-IOSCO framework, APRA proposes that variation margin must be calculated and called daily. APRA also proposes that settlement be conducted promptly following a call. While settlement of variation margin should occur on a T+1 basis (where T is the date of the margin call), such a settlement timeframe may not be feasible in all circumstances due to, for example, time zone and cross-border considerations. Consequently, APRA proposes a principles-based requirement for the prompt settlement of variation margin, noting that this is intended to achieve an outcome consistent with other global regulatory requirements for settlement timing for variation margin.

3.3 Threshold and minimum transfer amount

The BCBS-IOSCO framework requires variation margin to be exchanged using a zero threshold, while margin transfers are subject to a *de-minimis* minimum transfer amount not to exceed EUR 500,000.

To apply this requirement, APRA has converted the BCBS-IOSCO minimum transfer amount to AUD. APRA proposes that variation margin must be

exchanged using a zero threshold, with margin transfers (for variation and initial margin combined) subject to a *de-minimis* minimum transfer amount not to exceed AUD 750,000.

Chapter 4 — Initial margin requirements

The exchange of initial margin protects the counterparties to a non-centrally cleared derivative against the potential future exposure that may arise from future changes in the mark-to-market value of the derivative during the period of time that is assumed to be required to close-out and replace positions following a counterparty default.

This chapter sets out APRA's proposed implementation of initial margin requirements in more detail.

4.1 Qualifying level for the exchange of initial margin

The BCBS-IOSCO framework requires the two-way exchange of initial margin on a gross basis. Recognising that a degree of sophistication is required for the exchange of two-way gross initial margin, the BCBS-IOSCO framework exempts covered entities belonging to groups whose notional non-centrally cleared derivative activity is below EUR 8 billion from the initial margin requirements on an ongoing basis.

APRA's proposed initial margin requirements are consistent with the BCBS-IOSCO framework. APRA proposes to require the two-way exchange of initial margin on a gross basis, subject to both the APRA covered entity and the covered counterparty exceeding the BCBS-IOSCO qualifying level, which APRA has converted to AUD.

As outlined in section 2.6.2 *Initial margin phase-in*, a phase-in timetable is proposed for the initial margin requirements. From 1 September 2020, the proposed initial margin qualifying level is AUD 12 billion. This means that, on an ongoing basis, an APRA covered entity must exchange initial margin in a transaction with a covered counterparty where each party belongs to a margining group whose non-centrally derivatives activity exceeds AUD 12 billion during the relevant reference period.

4.2 Product scope

The BCBS-IOSCO framework does not require the exchange of initial margin for physically settled foreign exchange (FX) forwards and swaps.

APRA proposes that an APRA covered entity may, if it so chooses, exclude physically settled FX forwards and swaps from the calculation of initial margin to be exchanged. However, physically settled FX forwards and swaps must be included in the calculation of the non-centrally cleared derivative activity of a margining group for the purposes of determining whether an APRA covered entity's margining group's activity exceeds the qualifying level and the APRA covered entity is subject to margin requirements.

4.3 Frequency of calculation and exchange

The BCBS-IOSCO framework provides that '*Initial margin should be collected at the outset of a transaction, and collected thereafter on a routine and consistent basis upon changes in measured potential future exposure, such as when trades are added to or subtracted from the portfolio.*' The BCBS-IOSCO framework does not specify a permissible timeframe for settlement of initial margin.

APRA proposes to require an APRA covered entity to calculate and call initial margin both at the outset of a transaction and on a regular and consistent basis upon changes in the measured potential future exposure. APRA proposes to require an APRA covered entity to settle the required amount of initial margin promptly following calculation and call. This principles-based approach aligns with APRA's approach for variation margin settlement, as outlined in section 3.2 *Frequency of calculation and exchange*.

4.4 Threshold and minimum transfer amount

The BCBS-IOSCO framework specifies that initial margin must be exchanged using a threshold of up to EUR 50 million. This threshold applies bilaterally at the level of the consolidated group and is based on all non-centrally cleared derivatives between the two consolidated groups.

APRA proposes to implement the BCBS-IOSCO framework's threshold, translating the EUR amount to AUD 75 million.

An investment fund or RSE may be treated separately and apply the AUD 75 million initial margin threshold at the fund level, rather than at a margining group level, if the fund or RSE is a distinct legal entity that is not collateralised or otherwise guaranteed or supported by any other entity.

As outlined in section 3.3 *Threshold and minimum transfer amount*, APRA also proposes that the combined initial and variation margin amounts are subject to a *de-minimis* minimum transfer amount not to exceed AUD 750,000.

4.5 Treatment of initial margin collected

The BCBS-IOSCO framework requires that initial margin collected should be immediately available to the collecting party in the event of the counterparty's default and subject to arrangements that protect the posting party to the extent possible under applicable law in the event that the collecting party enters bankruptcy.

A key principle underpinning the effectiveness of the margin requirements in reducing counterparty credit risk is that initial margin collected is held in a manner that ensures it can effectively protect a firm from loss in the event of a counterparty default. To this end, CPS 226 requires initial margin to be held in a manner that meets the two principles set out by the BCBS-IOSCO framework.

APRA considers that there may be different methods of operationalising the required protection for initial margin and, as such, does not consider it appropriate to include prescriptive requirements on this matter. To satisfy APRA's proposed requirement, market participants may utilise different methods for the safe-keeping of initial margin provided these methods meet the requirements in CPS 226.

In addition, by emphasising the principle rather than specifying particular rules, APRA aims to mitigate the costs associated with compliance with various jurisdictions' different requirements for the treatment of initial margin collected, without compromising the protections available to counterparties.

4.6 Re-hypothecation, re-pledge or re-use of initial margin

Under the BCBS-IOSCO framework, initial margin may be permitted to be re-hypothecated, re-pledged or re-used to a third party where the sole purpose is to hedge the collecting party's derivative position arising from transactions with the posting party. The framework allows this limited re-hypothecation of initial margin only for buy-side or non-financial counterparties when a list of 12 conditions is met.

APRA proposes that initial margin should not be re-hypothecated, re-pledged or re-used under any conditions.

APRA considers that the marginal reduction in liquidity costs gained by allowing limited re-hypothecation in line the BCBS-IOSCO framework is offset by the significant operational and legal requirements to satisfy the qualifying conditions. This is consistent with the approach proposed and taken by many other foreign regimes.

4.7 Calculation of initial margin

The BCBS-IOSCO framework specifies that initial margin may be calculated by reference to either a quantitative model or to the standardised schedule.

APRA proposes to provide for both permitted approaches for the calculation of initial margin. An APRA covered entity must apply the same approach (model-based or standardised schedule)

to all transactions within the same defined asset class, but may use different approaches across different asset classes.

4.7.1 Standardised schedule for initial margin

APRA proposes to adopt the standardised schedule for initial margin provided by the BCBS-IOSCO framework. Attachment A to CPS 226 sets out the standardised schedule for initial margin. APRA also proposes to allow an APRA covered entity, subject to approval by APRA, to use an alternative schedule already used for regulatory capital, provided it is at least as conservative as Attachment A.

4.7.2 Model approach to initial margin

As an alternative to the standardised schedule for initial margin, an APRA covered entity may apply to APRA for approval to use a quantitative model for the calculation of initial margin for some or all of its portfolio.

APRA proposes to adopt initial margin model requirements consistent with those in the BCBS-IOSCO framework. Accordingly, APRA proposes that initial margin models must assume a potential future exposure based on a one-tailed 99 per cent confidence interval over a 10-day period. Initial margin models must be calibrated on a historical period of not more than five years, including a period of financial stress. In addition, initial margin models may only account for permitted diversification benefits.

CPS 226 requires initial margin models to be subject to internal validation, periodic back-tests and regular audit processes. All key assumptions of the model, its limitations and operational details must be appropriately documented.

Initial margin models may be developed internally or sourced from a third-party. APRA expects, however, that any model conform to international practices. APRA is unlikely to approve an initial margin model that is not consistent with standard industry models used by other market participants.

Chapter 5 — Collateral and haircuts

5.1 Eligible collateral

The BCBS-IOSCO framework provides for national supervisors to determine their own list of eligible collateral assets, taking in to account the conditions of their own market. Eligible collateral must be able to be liquidated in a reasonable amount of time to generate proceeds that could sufficiently protect collecting entities from losses in the event of a counterparty default.

CPS 226 lists the types of eligible collateral that an APRA covered entity may collect for margining purposes. The Resilience and Collateral Protection Bill proposes to insert into the PSN Act a definition of 'financial property'. Security posted as margin that is 'financial property' will be enforceable in a close-out netting agreement. The proposed list of eligible collateral for margining purposes in CPS 226 is a subset of the proposed list of 'financial property' in the PSN Act.

In determining the list of eligible collateral permitted under CPS 226, APRA has weighed the ability of collateral assets to hold value and be readily liquidated in a period of stress against the additional costs of limiting eligible collateral to only the most high quality liquid assets.

Proposed eligible collateral assets include cash, certain debt securities and covered bonds, senior securitisation exposures, equities listed in a major index and gold. Assets that are generally more illiquid have been excluded from the proposed list of eligible collateral.

APRA proposes that resecuritisation exposures are not eligible collateral for margining purposes due to illiquidity and wrong-way risk concerns.

5.2 Collateral haircuts

The BCBS-IOSCO framework applies risk-sensitive haircuts to the valuations of collateral collected for initial and variation margin purposes to help safeguard against potential falls in the value of collateral in times of financial stress. Risk-sensitive haircuts on collateral may be determined by reference to either a standardised schedule or a model approach.

APRA proposes to adopt both the standardised schedule and model approach in the BCBS-IOSCO framework for the calculation of risk-sensitive haircuts. As required by the BCBS-IOSCO framework, an APRA covered entity must use either the standardised schedule or a model approach for all collateral within the same collateral class.

5.2.1 Standardised schedule of risk-sensitive haircuts

APRA proposes to adopt the standardised haircut schedule provided in the BCBS-IOSCO framework, considering this to be a simple, conservative, transparent and easily calculable approach to determining collateral haircuts. The proposed standardised schedule of risk-sensitive haircuts is set out in Attachment B to CPS 226. Subject to approval by APRA, an APRA covered entity may use a different schedule already used for regulatory capital purposes, provided it is at least as conservative as the risk-sensitive haircut schedule included in CPS 226.

5.2.2 Model approach to risk-sensitive haircuts

APRA also proposes to permit the use of risk-sensitive model-based haircuts, subject to APRA's approval. Haircut models must be subject to appropriate internal governance standards. For consistency, an APRA covered entity must continue to employ a model to determine collateral haircuts once it has obtained approval for a given class of collateral.

The option to model collateral haircuts in APRA's existing ADI capital framework has not been widely adopted. APRA therefore requests that an institution that intends to apply for approval to use a model approach to risk-sensitive haircuts under CPS 226 informs APRA of its intention during the consultation process. APRA proposes to assess risk-sensitive haircut models for approval on a cost-recovery basis.

5.3 Wrong-way risk

The BCBS-IOSCO framework recognises that there are other factors that may undermine the ability of the value of collateral collected to be fully realised and readily liquidated in a period of stress. In particular, the BCBS-IOSCO framework notes that '*the value of the collateral should not exhibit a significant correlation with the creditworthiness of the counterparty or the value of the underlying non-centrally cleared derivatives portfolio in such a way that would undermine the effectiveness of the protection offered by the margin collected (i.e. the so-called "wrong way risk"). Accordingly, securities issued by the counterparty or its related entities should not be accepted as collateral.*'

APRA proposes that securities issued by a counterparty to the transaction (or by a related party) are not eligible collateral for margining purposes due to wrong-way risk concerns.

APRA also proposes that an APRA covered entity must have appropriate internal policies and procedures in place to monitor and manage the wrong-way risk that may exist in collected collateral.

5.4 Concentration risk

The BCBS-IOSCO framework provides that '*entities covered by the requirements should ensure that the collateral collected is not overly concentrated in terms of an individual issuer, issuer type and asset type.*'

APRA proposes that an APRA covered entity must have appropriate internal policies and procedures in place to monitor and manage the concentration risk that may exist in collected collateral. These internal policies and procedures must, at a minimum, consider concentration in terms of individual issuer, issuer type and asset type.

Chapter 6 — Cross-border application of margin requirements

As the non-centrally cleared derivatives market is global in scope, a key aspect of the BCBS-IOSCO framework is the interaction of different national regulatory regimes.

This chapter outlines APRA's proposals in relation to the application of its margin requirements on a cross-border basis.

6.1 Substituted compliance

The BCBS-IOSCO framework provides that '*Regulatory regimes should interact so as to result in sufficiently consistent and non-duplicative regulatory margin requirements for non-centrally cleared derivatives across jurisdictions.*'

To assist achieving a workable cross-border framework, APRA proposes to grant substituted compliance following a positive assessment of the comparability of a foreign jurisdiction's margin requirements in respect of the BCBS-IOSCO framework and the requirements in CPS 226. Where substituted compliance has been granted, an APRA covered entity may comply with its counterparty's requirements of the foreign regulatory regime in lieu of the requirements in CPS 226.

APRA may grant substituted compliance in respect of all or part of a foreign regulator's margin requirements. APRA may also impose terms or restrictions on substituted compliance where some provisions in a foreign jurisdiction's margin requirements may lead to outcomes that are not comparable to those in the BCBS-IOSCO framework or those in CPS 226.

6.2 Foreign branches and subsidiaries

In addition to substituted compliance, APRA proposes an automatic deference framework for a foreign ADI, Category C insurer or EFLIC in Australia that is subject to and compliant with the margin requirements of its home regulator. The foreign branch must be able to demonstrate that those requirements are substantially similar to the BCBS-IOSCO framework.

APRA proposes that a foreign-incorporated APRA-regulated institution or member of an APRA-regulated Level 2 group may also apply for approval by APRA to comply with the margin requirements of its home jurisdiction where it is directly subject to the margin requirements of the foreign jurisdiction. This provision is separate to substituted compliance determinations.

6.3 Jurisdictions where netting and/or collateral is not enforceable

The BCBS-IOSCO framework relies on the legal enforceability of netting agreements and collateral. The framework states that '*The applicable netting agreements used by market participants will need to be effective under the laws of the relevant jurisdictions and supported by periodically updated legal opinions.*'

However, there are jurisdictions in which close-out netting is not enforceable. The International Swaps and Derivatives Association classifies 78 jurisdictions as non-netting, including China, Russia, the United Arab Emirates and Saudi Arabia. A separate but largely overlapping set of jurisdictions does not provide legal certainty in the protection of posted collateral.

APRA considers that requiring the posting of collateral to jurisdictions where netting is not enforceable is not desirable as significantly higher levels of variation and initial margin would be required, potentially imposing significant liquidity costs and burdens on APRA covered entities.

In addition, an APRA covered entity's posted collateral may not be returned in the event of counterparty default if insolvency laws provide administrators with the power to reject or affirm certain derivative contracts in a manner advantageous to the insolvent counterparty. Where collateral is not enforceable, there is a risk that margin posted by the APRA covered entity

would not be adequately protected and returned in the event of the default of the counterparty. To require margining in such cases would increase the counterparty credit risk exposure of the APRA covered entity. While an alternative is to require an APRA covered entity to collect margin only in such circumstances, it is likely that for commercial reasons the APRA covered entity would also need to post margin.

APRA therefore proposes that an APRA covered entity is not required to post or collect variation or initial margin with counterparties in jurisdictions where netting of derivatives and/or collateral is not enforceable upon insolvency or bankruptcy of the counterparty.

APRA proposes that an APRA covered entity must consistently monitor any uncollateralised exposure to non-netting and non-enforceable collateral jurisdictions and counterparties in such jurisdictions. In addition, an APRA covered entity must set appropriate internal limits and controls to manage such exposures. Where relevant, an APRA covered entity is expected to consider and adopt other appropriate risk mitigation techniques. ADIs are also required to hold more counterparty credit risk capital on exposures where there is no eligible netting bilateral agreement and no margin collected.

Chapter 7 — Risk mitigation standards for non-centrally cleared derivatives

IOSCO'S *Risk Mitigation Standard for Non-centrally Cleared OTC Derivatives*[3] sets out six techniques that are designed to complement the margin requirements in reducing risk in the non-centrally cleared derivatives market.

The risk mitigation standards encourage the adoption of sound risk mitigation techniques to promote legal certainty over the terms of non-centrally cleared derivatives transactions, foster effective management of counterparty credit risk, facilitate timely resolution of disputes and increase overall financial stability. In particular, the risk mitigation standards set out expectations in relation to:

- trading relationship documentation;
- trade confirmation;
- portfolio reconciliation;
- portfolio compression;
- valuation processes; and
- dispute resolution.

This chapter outlines APRA's proposed adoption of the IOSCO risk mitigation standards in respect of non-centrally cleared derivatives. In the application of risk mitigation standards, APRA has endeavoured to take a principles-based, rather than a rules-based, approach in outlining the key requirements necessary to promote legal certainty and facilitate management of counterparty credit risk.

7.1 Scope of application

The IOSCO standards are applicable to all financial entities and systemically important non-financial entities (collectively 'covered entities'). IOSCO notes that the risk mitigation standards should, at a minimum, be applied to covered entities subject to margin requirements for non-centrally cleared derivatives.

APRA proposes to require an APRA covered entity entering into a non-centrally cleared derivative transaction to adhere to the risk mitigation standards in CPS 226. These requirements apply to all non-centrally cleared derivative transactions and are not subject to any minimum qualifying level of activity. This is in recognition that these risk mitigation standards are important in managing risk for each non-centrally cleared derivative transaction.

7.2 Trading relationship documentation

The IOSCO standards provide that covered entities should establish and implement policies and procedures to execute written trading relationship documentation with their counterparties prior to or contemporaneously with executing a non-centrally cleared derivative transaction. Such documentation should include all material terms governing the trading relationship between the counterparties.

To promote legal certainty, APRA proposes to apply this requirement to an APRA covered entity. APRA also proposes that trading relationship documentation be maintained for a reasonable period of time after the maturity of any outstanding transactions.

3 https://www.iosco.org/library/pubdocs/pdf/IOSCOPD469.pdf

7.3 Trade confirmation

The IOSCO standards provide that covered entities should establish and implement policies and procedures to ensure the material terms of all non-centrally cleared derivative transactions are confirmed as soon as practicable after execution of the transaction.

APRA proposes to apply this requirement to an APRA covered entity. It is proposed that confirmations must be done in writing, and wherever practicable via automated methods.

7.4 Portfolio reconciliation

The IOSCO standards provide that covered entities should establish and implement policies and procedures to ensure that the material terms and valuations of all transactions in a non-centrally cleared OTC derivatives portfolio are reconciled with counterparties at regular intervals.

APRA proposes that an APRA covered entity must conduct portfolio reconciliation with a scope and frequency that reflects the size and complexity of the underlying risk of its portfolio and its turnover. Consideration must also be given to industry protocols and regulatory requirements imposed on similar institutions.

7.5 Portfolio compression

The IOSCO standards provide that covered entities should establish and implement policies and procedures to regularly assess and, to the extent appropriate, engage in portfolio compression.

APRA proposes to apply this requirement to an APRA covered entity, with consideration to be given to both bilateral and multilateral portfolio compression. It is proposed that portfolio compression must be conducted with a scope and frequency that reflects the size and underlying risk of the APRA covered entity's portfolio. In determining the appropriate scope and frequency of portfolio compression, an APRA covered entity must consider industry protocols, market practice and regulatory requirements imposed on similar institutions.

7.6 Valuation processes

The IOSCO standards establish that covered entities should agree on and clearly document the process for determining the value of each non-centrally cleared derivative transaction at any time from the execution of the transaction to the termination, maturity, or expiration thereof, for the purpose of exchanging margins.

APRA proposes to apply this requirement to an APRA covered entity. It is proposed that valuation processes must be documented and include alternative processes to determine valuation in the event that any inputs required for the valuation fail or are not available.

7.7 Dispute resolution

The IOSCO standards provide that covered entities should agree on the mechanism or process for determining when discrepancies in material terms or valuations should be considered disputes, as well as how such disputes should be resolved as soon as practicable.

APRA proposes that an APRA covered entity must have rigorous and robust dispute resolution procedures in place. Dispute resolution procedures must be agreed and documented with a counterparty prior to the onset of a non-centrally cleared derivative transaction. Dispute resolution procedures must include the escalation of material disputes to senior management. Procedures must also include escalation to the Board where the dispute represents a material risk to the APRA covered entity.

APRA proposes to require an APRA covered entity to make all necessary and appropriate efforts to resolve all disputes in a timely manner.

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