Response to Submissions

Margining and risk mitigation for non-centrally cleared derivatives

17 October 2016

www.apra.gov.au

Australian Prudential Regulation Authority

Preamble

In February 2016, the Australian Prudential Regulation Authority (APRA) released for consultation a draft new *Prudential Standard CPS 226 Margining and risk mitigation for non-centrally cleared derivatives* (CPS 226), which set out APRA's proposed implementation of the internationally agreed framework for margin requirements and risk mitigation standards for non-centrally cleared derivatives. APRA proposed to apply these requirements to certain entities that transact in non-centrally cleared derivatives.

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

Consultation closed on 20 May 2016, and 22 submissions were received.

This paper describes APRA's response to the main issues raised in submissions on draft new CPS 226 and the discussion paper, *Margining and risk mitigation for non-centrally cleared derivatives*. Accompanying this paper is the final version of CPS 226. APRA will advise the implementation date for CPS 226 in due course.

This response paper and the final version of CPS 226 are available on APRA's website at www.apra.gov.au.

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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. Intra-group transactions (transactions between two counterparties within the same margining group) are excluded from the calculation unless otherwise required by APRA.
APRA	Australian Prudential Regulation Authority
APRA covered entity	An ADI, including a foreign ADI; an authorised banking non-operating holding company (NOHC); a general insurer, including a Category C insurer; an authorised insurance NOHC; a parent entity of Level 2 insurance groups; a life company, including a friendly society and an eligible foreign life insurance company (EFLIC); a registered life NOHC; and a registrable superannuation entity (RSE).
BCBS	Basel Committee on Banking Supervision
CCP	A central counterparty (CCP) is 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 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; (iii) a securitisation special purpose vehicle in a traditional securitisation that enters into derivative transactions for the sole purpose of hedging; and (iv) a special purpose vehicle or collective investment vehicle established for the sole purpose of acquiring and holding or investing in real estate or infrastructure

Term	Definition
	assets, 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	Either of the following: (i) a derivative (within the meaning of Chapter 7 of the *Corporations Act 2001*); or (ii) an arrangement that is a forward, swap or option, or any combination of those things, in relation to one or more commodities, but does not include any arrangement that is of a kind mentioned in subregulation 6(2) of the *Payment Systems and Netting Regulations 2001*.
ECAI	External Credit Assessment Institution – an institution that assigns credit ratings designed to measure the creditworthiness of a counterparty or certain types of debt obligations of a counterparty.
Financial institution	A 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[1] (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[2], 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.
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
IOSCO's Risk Mitigation Standards	The risk mitigation standards for non-centrally cleared over-the-counter (OTC) derivatives as set out in the January 2015 paper

1 For clarity, the definition does not apply where a portfolio manager is acting as an agent.

2 NOHC is as defined in *Prudential Standard APS 001 Definitions* for an ADI and *Prudential Standard GPS 001 Definitions* for a general insurer.

Term	Definition
	by the Board of IOSCO, *Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives*.
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* or equivalent foreign accounting standards that apply to the group's consolidated accounts.
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.
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*.
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.

Term	Definition
Variation margin	Collateral that is collected or paid to reflect the current mark-to-market exposure resulting from changes in the market value of a derivative.

Executive summary

In February 2016, the Australian Prudential Regulation Authority (APRA) proposed to implement a cross-industry framework for margining and risk mitigation for non-centrally cleared derivative transactions. APRA released for consultation a discussion paper outlining its proposed requirements and a draft *Prudential Standard CPS 226 margining and risk mitigation for non-centrally cleared derivatives* (CPS 226).

APRA received 22 submissions from a range of stakeholders including industry associations, APRA-regulated institutions, and other stakeholders in the market for non-centrally cleared derivatives.

On 22 August, APRA announced a delay to the proposed implementation date of 1 September 2016.[3] APRA is now releasing the final CPS 226 with no set commencement date.

APRA is releasing the final form of its requirements in order to provide clarity to market participants and to facilitate ongoing implementation by APRA-regulated institutions with material levels of non-centrally cleared derivatives. APRA emphasises that institutions should continue to actively prepare for the implementation of requirements.

APRA supports an internationally harmonised implementation of the requirements and will continue to monitor the progress of implementation in other jurisdictions. APRA will advise an implementation date in due course.

This paper sets out APRA's response to submissions received during the consultation. The main issues raised in the submissions addressed APRA's proposed implementation date for risk mitigation requirements, treatment of physically settled foreign exchange (FX) forwards and swaps, and the application of requirements on a Level 2 basis.

APRA has taken all comments received in submissions under consideration. In response to the main issues raised in submissions:

- APRA has excluded physically settled FX forwards and swaps from its variation margin requirements at this time. APRA may revisit this exclusion upon changes to the global regulatory environment or material risk in the Australian financial system;

- APRA has reviewed the comments on the application of requirements on a Level 2 basis. Overall, APRA has maintained its proposal to apply the requirements in CPS 226 to all entities in a Level 2 group, but has made modifications to address any undue burden for non-financial entities and entities operating in a legal environment that prohibits full compliance; and

- APRA has maintained its application of variation margin requirements to an APRA covered entity that is part of a margining group that exceeds AUD 3 billion in aggregate month-end average notional amount of non-centrally cleared derivative transactions.

3 http://www.apra.gov.au/CrossIndustry/Pages/Consultation-margining-risk-mitigation-February-2016.aspx

Chapter 1 — Introduction

1.1 Background

In February 2016, APRA released a discussion paper, *Margining and risk mitigation for non-centrally cleared derivatives*[4], outlining its proposed approach to implementing:

- the Basel Committee on Banking Supervision (BCBS) and International Organization of Securities Commissions (IOSCO) framework for *Margin requirements for non-centrally cleared derivatives*[5] ('the BCBS-IOSCO framework'); and
- IOSCO's *Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives.*[6]

APRA also released for comment a draft new cross-industry prudential standard, *Prudential Standard CPS 226 Margining and risk mitigation for non-centrally cleared derivatives* (CPS 226), setting out the proposed measures.

1.2 Feedback from consultation

APRA received 22 submissions. Submissions were received from industry bodies, individual APRA-regulated institutions and other impacted stakeholders in the market for non-centrally cleared derivatives. Submissions were broadly supportive of the proposals, while making specific comments on a wide range of issues and providing feedback on all aspects of the framework.

1.3 Structure of this paper

This paper summarises the key issues raised in submissions and provides APRA's responses. Chapter 2 addresses issues related to the scope of application and definitions. Chapters 3 and 4 address issues related to variation margin requirements and initial margin requirements, respectively. Chapter 5 sets out APRA's responses to comments concerning collateral and haircuts. Chapter 6 outlines issues relating to the cross-border application of the requirements. Finally, chapter 7 addresses comments made in relation to the risk mitigation requirements.

1.4 Balancing financial safety with other considerations

In establishing 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 new requirements for margining and risk mitigation will deliver improved prudential safety outcomes and facilitate the continued efficient participation of APRA-regulated institutions in the global derivatives market.

In the February 2016 discussion paper, APRA noted that its proposed introduction of a minimum qualifying level of non-centrally cleared derivatives activity, below which the requirements would not apply, would avoid imposing undue costs on less active market participants. This consideration remains relevant.

In addition, APRA considers that the exclusion of physically settled foreign exchange (FX) forwards and swaps and non-financial institutions from the final CPS 226 will minimise the burden imposed on institutions that transact non-centrally cleared derivatives for hedging purposes.

1.5 Timetable

In conjunction with this response paper, APRA is releasing the final CPS 226. Consistent with APRA's announcement on 22 August 2016, the final CPS 226 is being released with no set commencement date. APRA will advise an implementation date and phase-in timetable in due course.

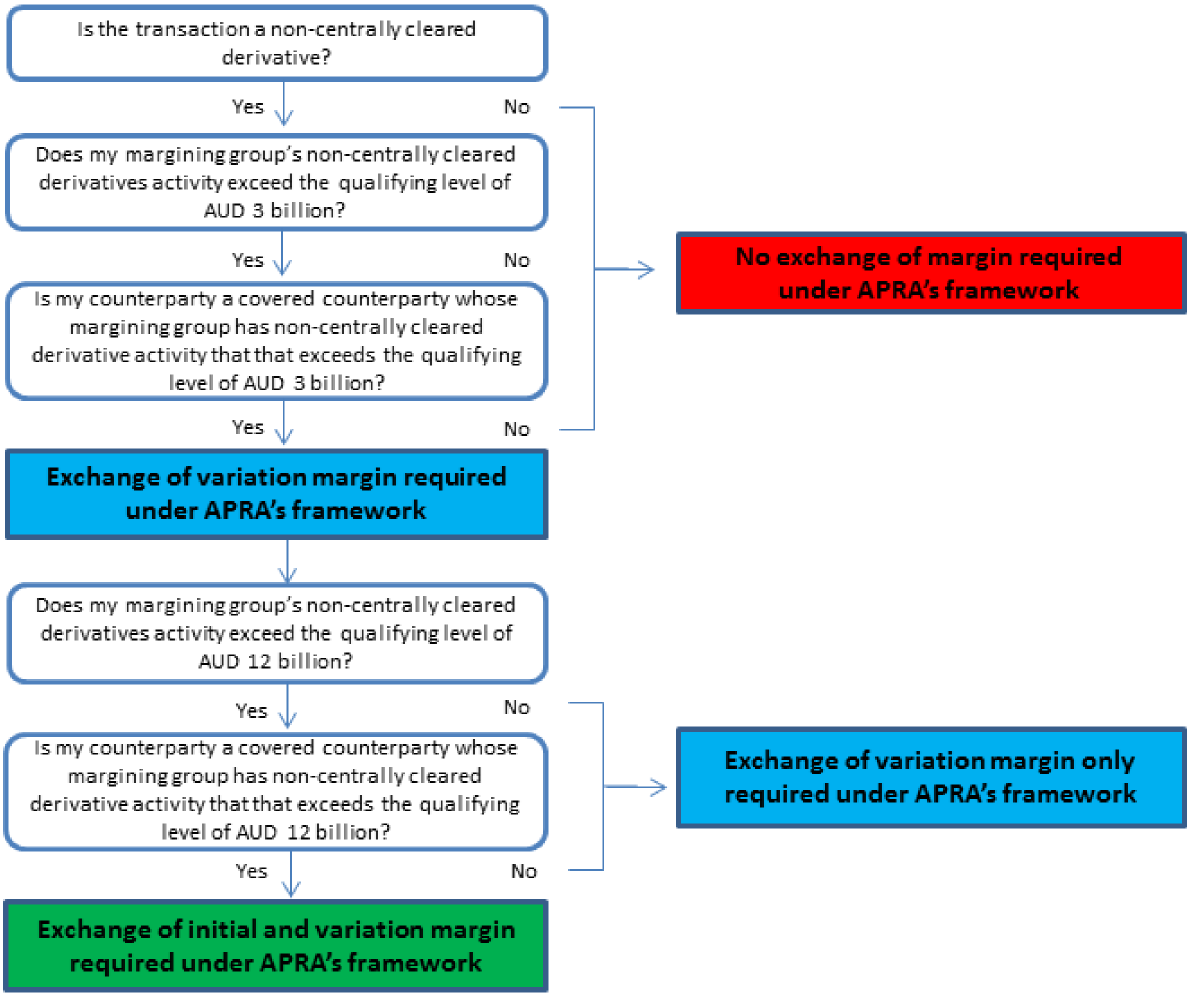
4 http://www.apra.gov.au/CrossIndustry/Pages/Consultation-margining-risk-mitigation-February-2016.aspx

5 http://www.bis.org/bcbs/publ/d317.htm

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

APRA intends to consult on a prudential practice guide addressing the requirements CPS 226 in the coming year as well as changes to its reporting requirements in relation to non-centrally cleared derivatives.

When the margin requirements apply:



Chapter 2 — Scope of application and definitions

2.1 APRA covered entities

In the February 2016 discussion paper, APRA proposed defining the following entities as APRA covered entities for the purposes of CPS 226:

- ADIs, including foreign ADIs, and authorised banking non-operating holding companies (NOHCs);
- general insurers, including Category C insurers, authorised insurance NOHCs and parent entities of a Level 2 insurance group;
- life companies, including friendly societies and eligible foreign life insurance companies (EFLICs), and registered life NOHCs; and
- registrable superannuation entities (RSEs).

Comments received

One submission requested that APRA clarify the application of its requirements to foreign branches in Australia, including whether the requirements only apply if the transaction is booked in the accounts of an Australian branch.

APRA's response

In the final prudential standard, APRA has clarified that the requirements in CPS 226 apply to foreign ADIs, Category C insurers and EFLICs (collectively 'foreign branches in Australia') in Australia. A foreign ADI, Category C insurer or EFLIC is a foreign-incorporated institution that operates a branch in Australia, and does not include foreign-owned locally incorporated subsidiaries.

For a foreign branch in Australia, the requirements in CPS 226 apply only to those transactions booked in the accounts of an Australian branch and do not apply to transactions booked in the accounts of branches located outside Australia or any other entity in the branch's margining group. CPS 226 does not consider the geographic location of any traders, only the final booking entity of the transaction.

Foreign branches in Australia are also able to comply with the margin or risk mitigation requirements of a relevant jurisdiction in lieu of complying with the relevant requirements in CPS 226 where the foreign branch has conducted an internal assessment that positively demonstrates it is directly subject to the requirements of the foreign jurisdiction, that those requirements are substantially similar to the BCBS-IOSCO framework or IOSCO's Risk Mitigation Standards, as relevant, and that the branch effectively complies with those requirements. Such an assessment must be made available to APRA upon request.

2.2 Level 2 scope of application

APRA proposed to apply its requirements on a Level 2 basis, requiring the parent entity of an APRA-regulated Level 2 group to ensure that all entities within the Level 2 group, including subsidiaries incorporated outside of Australia, comply with APRA's requirements.

Comments received

A number of respondents expressed concerns in relation to APRA's application of the margin requirements on a Level 2 basis. The main reasons for this opposition concerned:

- inconsistency with the BCBS-IOSCO framework by applying requirements to non-financial entities that are not systemically important;
- inconsistency with other jurisdictions' rules that do not apply to foreign subsidiaries;
- the lack of alignment with the scope of Australia's central clearing mandate;
- legal impediments to compliance in some jurisdictions;
- extraterritoriality and the potential for competitive disadvantage to APRA-regulated institutions operating in jurisdictions that have not implemented margin requirements; and

- the legal and operational challenges associated with complying with the margin requirements on a Level 2 basis in the proposed timeframes.

Respondents preferred the requirements apply only to transactions involving an entity that meets the definition of an 'APRA covered entity', or, alternatively, when involving an entity that has been deemed an Australian Clearing entity, in order to align with the scope of Australia's central clearing mandate.

Alternatively, one respondent was supportive of APRA's proposal, noting that applying requirements on a Level 1 basis only would result in the exclusion of a sizeable proportion of the non-centrally cleared derivatives activity of APRA-regulated groups from the margin requirements, which could present an opportunity for regulatory arbitrage.

In relation to foreign branches in Australia, respondents requested clarification regarding the operation of the requirements on a Level 2 basis.

APRA's response

APRA has reviewed the comments on its proposed application of requirements on a Level 2 basis. Overall, APRA has maintained its position to apply the margin requirements to all entities in a Level 2 group, but has made modifications and clarifications intended to mitigate the concerns highlighted:

- APRA has limited the application of the requirements in the final CPS 226 to all entities within a Level 2 group that meet the definition of both 'covered counterparty' and 'financial institution', excluding non-financial entities within a Level 2 group from the requirements.

- APRA has amended CPS 226 to exempt transactions from requirements to post or collect initial margin where the legal environment in the jurisdiction of either counterparty does not yet permit compliance with the initial margin requirements, such as in New Zealand. This is intended for situations where the legal environment does not allow for the provision of, or enforcement of rights in relation to, initial margin by way of security interest. APRA emphasises that the APRA covered entity must still comply with variation margin requirements where the legal framework permits.

- A transaction is not subject to the requirements where netting of derivatives is not enforceable upon insolvency or bankruptcy of the counterparty or where collateral arrangements are not legally enforceable, as set out in Chapter 6 *Cross-border application of requirements*.

- For members of a Level 2 group that are incorporated outside of Australia and are subject to margin or risk mitigation requirements under a foreign jurisdiction, relief from duplicative requirements may be sought by application to APRA. Where a member of a Level 2 group is incorporated outside of Australia and is directly subject to the foreign jurisdiction's margining and/or risk mitigation requirements, the APRA covered entity may apply to APRA for approval to comply (in respect of that member) with the relevant requirements of a foreign jurisdiction in lieu of the requirements in CPS 226. This is intended to eliminate duplicative requirements on subsidiaries that may be subject to the requirements of multiple jurisdictions.

Together, these modifications and clarifications are intended to mitigate the concerns noted above, while maintaining APRA's core intent of minimising the risk of importing counterparty credit risk to the Level 1 entity's operations via one or more subsidiaries failing to apply globally-agreed margining and risk mitigation standards. Overall, APRA considers this to be a reasonable and balanced framework.

2.3 Treatment of intra-group transactions

APRA proposed exempting transactions between entities within the same Level 2 group from any margin requirements. The exchange of variation margin would be required 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. To minimise liquidity and operational burdens, the exchange of initial margin would not be required for any transactions between entities within the same margining group.

Comments received

Overall, respondents were supportive of the exclusion of intra-group transactions from initial margin requirements. However, the exclusion of intra-group transactions between two entities that are part of the same Level 2 group was less well understood. APRA's response below is intended to clarify the operation of APRA's intra-group margin requirements.

Some respondents also opposed the discretionary power for APRA to require the exchange of variation margin and/or initial margin on an intra-group transaction where it deems appropriate.

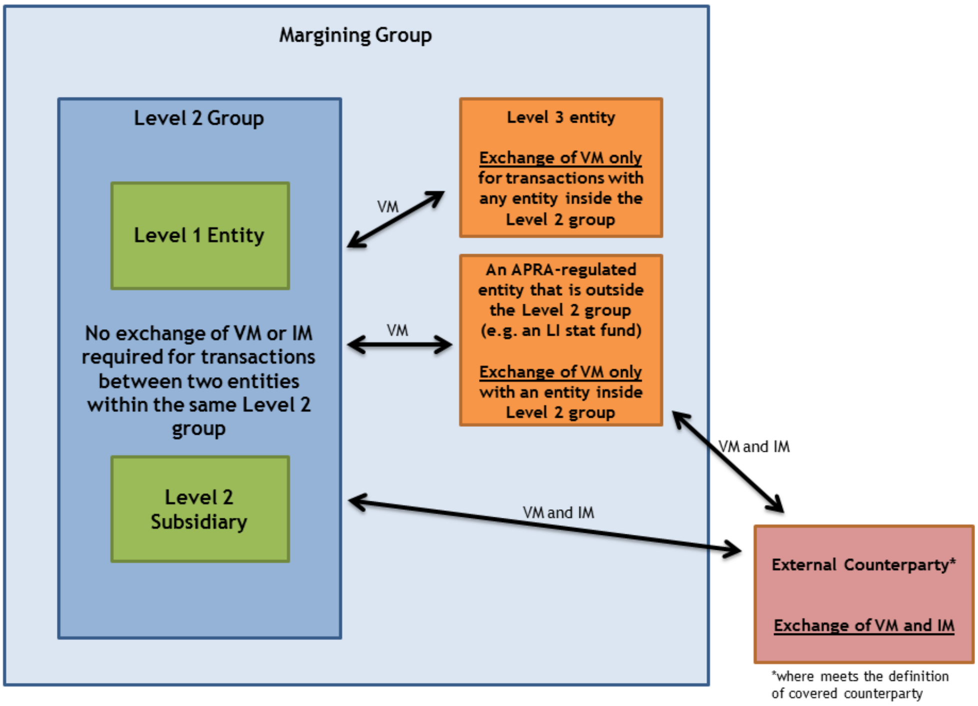
APRA's response

APRA has made no change to the discretionary power for APRA to impose additional intra-group requirements and considers it appropriate to maintain this discretion given the potential for regulatory arbitrage and contagion risks, and that intra-group transactions are largely excluded from margin requirements. APRA would consider the impact on prudential safety, financial stability, procyclicality, competition, and other factors in any decision to exercise such discretion. APRA considers such discretion to be a necessary and important component of its role as a prudential regulator and supervisor.

Initial margin is not required for any transaction between an APRA covered entity and a covered counterparty within the same margining group. Further, the exchange of variation margin is not required for any transactions between two entities within the same Level 2 group. The exchange of variation margin is required for any transaction between an APRA covered entity and a covered counterparty that is part of the APRA covered entity's margining group but not part of the same Level 2 group. This includes situations where neither party is a member of a Level 2 group, only one party is a member of a Level 2 group, or the counterparties are members of separate Level 2 groups within the same margining group.

APRA has made minor drafting amendments intended to clarify the requirements for intra-group transactions. Figure 1 below outlines when the margin requirements apply for specific intra-group transactions.

Figure 1 - Intra-group margin requirements



2.4 Covered counterparties

APRA proposed requiring an APRA covered entity to adhere to the margin requirements in CPS 226 in its transactions with covered counterparties. Consistent with the BCBS-IOSCO framework, APRA proposed defining a 'covered counterparty' as a financial institution or a systemically important non-financial institution.

2.4.1 Definition of financial institution

APRA proposed defining 'financial institution' in a manner broadly consistent with the existing definition in its ADI prudential framework. The proposed definition is intended to capture all institutions that normally fall within the meaning of the term 'financial institution' and APRA considers that the definition proposed in CPS 226 has broad international applicability.

Comments received

A number of respondents expressed concern in relation to the breadth of the proposed definition of 'financial institution', noting that the definition is likely to result in uncertainty as to whether certain counterparties meet the definition and the existence of operational difficulties in verifying the status of certain counterparties, such as foreign counterparties. Submissions requested that APRA attempt to define the term in a more objective manner and harmonise its definition with other jurisdictions' definitions to the extent possible. To enable an APRA covered entity to rely on representations made pursuant to foreign margin requirements, it was suggested that APRA allow automatic deference to other margining regimes' definition of financial institution.

Respondents also requested that APRA remove the references to 'leasing' and 'management of securitisation schemes' from the definition, as entities substantially engaged in these activities should not be captured as covered counterparties.

APRA's response

APRA considers its definition of financial institution to be functionally based and internationally comparable. However, APRA recognises the challenge of determining the status of a counterparty located in a foreign jurisdiction. APRA emphasises that substituted compliance will be important in this regard in order to minimise difficulties across jurisdictions. Where APRA has granted substituted compliance in relation to the margin requirements of a foreign jurisdiction, an APRA covered entity may use the counterparty's status under the margin requirements of the relevant foreign jurisdiction to determine whether it is a covered counterparty when applying the foreign margining regime to the transaction.

APRA has clarified that an entity substantially engaged in 'portfolio management' is not captured in this definition where the entity is acting as an agent.

APRA has not removed the activities of 'leasing' and 'management of securitisation schemes' from the definition, considering that entities substantively engaged in these activities should be captured as covered counterparties (except for securitisation special purpose vehicles that meet the specific conditions for exemption under CPS 226).

2.4.2 Systemically important non-financial institutions

APRA proposed to define 'systemically important non-financial institution' as a non-financial institution that belongs to a margining group with more than AUD 50 billion in total notional non-centrally cleared derivatives outstanding, excluding intra-group transactions.

Comments received

APRA received feedback requesting the exclusion of all non-financial institutions from its definition of covered counterparty for consistency with other jurisdictions' rules and as well as consideration for the generally low prevalence of margining as current practice as non-financial entities are predominantly end-users of derivative transactions for hedging purposes.

APRA's response

APRA has reviewed the treatment of non-financial institutions under CPS 226. APRA considers it appropriate to exclude non-financial institutions from the definition of covered counterparty at this stage. The final CPS 226 has been revised to reflect this change. APRA notes that CPS 226's function-based definition of financial institution is intended to capture institutions engaged substantively in activities such as futures and commodity trading and broking. APRA will monitor on an ongoing basis the appropriateness of this exclusion.

2.4.3 Exclusions from covered counterparties

APRA proposed excluding sovereigns (including public sector entities), central banks, multilateral development banks and the Bank for International Settlements from the definition of covered counterparties.

APRA also proposed excluding covered bond special purpose vehicles and securitisation special purpose vehicles from the margin requirements of CPS 226, subject to certain conditions.

Comments received

Several respondents requested that special purpose vehicles and collective investment vehicles established for the purpose of acquiring and holding or investing in physical assets such as real estate be excluded from the margin requirements due to the illiquid nature of their asset base and their use of non-centrally cleared derivative transactions as hedging products.

Respondents also requested APRA provide guidance on whether sovereign wealth funds are included in the term 'sovereigns'.

APRA's response

Due to the nature of the investments of real estate and infrastructure investment vehicles, margin requirements would mean a significant portion of assets may need to be held in liquid assets in order to be able to meet collateral calls. APRA recognises this is inconsistent with the strategy of long term investment in illiquid real estate and infrastructure assets. APRA has therefore decided to exclude from the definition of covered counterparty special purpose vehicles and collective investment vehicles established for the sole purpose of acquiring and holding or investing in real estate or infrastructure assets that enter into derivative transactions for the sole purpose of hedging.

A sovereign wealth fund may receive the same treatment as the sovereign where debt owed by the sovereign wealth fund has the full backing of the sovereign.

2.5 Due diligence requirements

APRA proposed that 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 exceeded the applicable qualifying levels. Such due diligence would likely comprise a combination of self-identification by counterparties and reasonable due diligence by APRA covered entities.

Comments received

A number of submissions raised concerns regarding the due diligence requirement proposed in CPS 226. Respondents expressed the view that the requirement is broad and does not provide any specificity or guidance on what type or how much due diligence would satisfy the requirement. Respondents argued that an APRA covered entity will not have full, reliable, relevant information about the derivatives business of its counterparty in order to be able to conduct such due diligence. A number of respondents requested that APRA allow an APRA covered entity to rely on good faith representations from counterparties with respect to this counterparty information.

APRA's response

APRA acknowledges that the globally agreed framework will rely largely on self-declarations for the identification of covered counterparties and disclosure of notional non-centrally derivatives activity levels. APRA confirms that an APRA covered entity can rely on a self-declaration or public disclosure from its counterparty that it is a covered counterparty whose activity exceeded the relevant qualifying levels.

However, where an APRA covered entity is of the view that a counterparty is not a covered counterparty or that the counterparty's non-centrally cleared derivatives activity did not exceed the applicable qualifying level for either initial margin or variation margin requirements, the APRA covered entity must undertake a reasonable level of due diligence to verify that it has no reason to believe that counterparty's status is not correct. APRA expects that such due diligence would generally comprise a reasonable review of any available public information and trading history between the parties.

2.6 Minimum transfer amount and initial margin threshold

APRA proposed to adopt the minimum transfer amount and initial margin threshold specified in the BCBS-IOSCO framework, converting the amounts to Australian dollars. Draft CPS 226 proposed that:

- the combined initial and variation margin amounts must be subject to a *de minimis* minimum transfer amount not to exceed AUD 750,000; and

- initial margin may be exchanged using a threshold of up to AUD 75 million that applies bilaterally at the level of the margining group and is based on all non-centrally cleared derivatives between the two margining groups.

Comments received

Respondents queried whether the minimum transfer amount and initial margin threshold:

- may be specified in a currency other than Australian dollars;

- must be periodically updated in the applicable margin agreements to reflect currency fluctuations; and

- are optional rather than mandatory.

APRA's response

APRA confirms that counterparties may choose to adopt a minimum transfer amount and/or initial margin threshold of zero.

These amounts may be negotiated in a currency other than Australian dollars. An APRA covered entity must update the minimum transfer amount and initial margin threshold amounts included in margin agreements to reflect currency fluctuations upon material, sustained realignment of the exchange rate. APRA expects that, in the long term, substituted compliance will address misalignment of amounts in various currencies.

2.7 Separate treatment of funds

APRA proposed that 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.

Comments received

Several respondents noted that draft CPS 226 proposed that an investment fund or RSE would be eligible for separate treatment only where that fund or RSE is a distinct legal entity. However, most funds in Australia utilise a trust structure in which separate trusts represent separate legal arrangements but are not distinct legal entities, and therefore would not be eligible for separate treatment. Respondents requested that APRA remove or amend the requirement that a fund of RSE is a 'distinct legal entity' to more appropriately reflect the distinction between separate funds in Australia.

A number of respondents also requested that funds that meet the specified criteria should be eligible for separate treatment for all purposes under CPS 226 — including the initial margin threshold, minimum transfer amount, and initial margin and variation margin qualifying levels — rather than only for the purposes of the initial margin threshold.

APRA's response

APRA has modified CPS 226 to more appropriately reflect the use of trust structures by funds in Australia in the application of the initial margin threshold. APRA notes that where a fund is not consolidated for the purposes of financial reporting, that fund will be treated as a separate margining group under CPS 226. APRA therefore does not consider it necessary to extend the application of the separate treatment of funds to other purposes under CPS 226.

2.8 Definitions of derivative and non-centrally cleared derivative

APRA proposed to define 'derivative' in a manner consistent with the *Payment Systems and Netting Act 1998* (PSN Act). CPS 226 proposed that a 'non-centrally cleared derivative' is a derivative that is not cleared by a central counterparty, and 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 central counterparty, or where the client provides margin consistent with the central counterparty's margin requirements.

Comments received

Many submissions raised concerns in relation to the proposed definition of 'derivative'. The main concerns related to the breadth of the proposed definition and its inclusion of products not typically considered derivatives by market participants. Submissions requested that the definition of derivative in CPS 226 be amended to better align with global industry standards and foreign margin requirements' definitions. Further, respondents also noted that, as the definition of derivative in the PSN Act refers to the definition in the *Corporations Act 2001* (Corporations Act), it would be more direct for CPS 226 to refer directly to the Corporations Act.

In relation to the definition of non-centrally cleared derivative, respondents requested that APRA amend the definition to allow for situations where intermediated central clearing occurs via a chain of intermediary brokers. Respondents supported APRA's proposal not to distinguish between qualifying and non-qualifying central counterparties in this definition.

APRA's response

APRA has amended CPS 226 to define 'derivative' as comprising both derivatives as defined in the Corporations Act and commodity derivatives, but excluding any arrangement mentioned in subregulation 6(2) of the *Payment Systems and Netting Regulations 2001* (PSN Regulations). Subregulation 6(2) of the PSN Regulations identifies obligations that are not eligible obligations in relation to a close out netting contract. The arrangements mentioned include credit facilities, reciprocal purchase agreements (otherwise known as repurchase agreements), sell buyback arrangements, securities loan arrangements, contracts of insurance and managed investment schemes.

The definition of derivative in the final CPS 226 is broadly aligned with the definition included in the *Superannuation Industry (Supervision) Regulations 1994* and the *Life Insurance Regulations 1995*, except CPS 226 excludes foreign exchange contracts with a duration of less than three days from the margin requirements.

APRA considers that the revised definition of derivative in the final CPS 226 addresses concerns in relation the breadth of the definition of derivative in the Corporations Act. However, should uncertainty or concern in relation to the definition of derivative persist, APRA will consider issuing further guidance on this matter.

APRA's definition of non-centrally cleared derivative refers specifically to indirectly cleared derivatives that are intermediated through a clearing member on behalf of a non-member client. It is therefore not considered necessary to amend the definition of non-centrally cleared derivative.

2.9 Application to new transactions

APRA proposed that its margin requirements would apply to all new transactions entered into during a margining period where each of the APRA covered entity and the covered counterparty belonged to margining groups whose aggregate month-end average notional amount of non-centrally cleared derivatives for the relevant reference period exceeded the corresponding qualifying level.

APRA proposed that genuine amendments to existing derivative contracts would not qualify as new transactions; however, any amendment that extended an existing derivatives contract for the purpose of avoiding margin requirements must be considered a new contract.

Comments received

Respondents requested that APRA classify derivative transactions entered into for the sole purpose of reducing post-trade risk in legacy portfolios — such as transactions arising from portfolio compression, counterparty risk balancing and wholesale novations completed in connection with a group restructuring — as legacy transactions that are not subject to margin requirements and are allowed to be maintained in the same netting sets from where the risk emerged.

Respondents also requested that APRA clarify that transactions amended in a non-material manner are not considered new transactions for the purposes of the application of the margin requirements.

APRA's response

APRA has modified CPS 226 to specify that genuine amendments to existing derivative contracts, transactions resulting from portfolio compression of grandfathered transactions and wholesale novations of grandfathered transactions completed in connection with group restructuring do not qualify as a new derivatives contract.

APRA considers that genuine amendments to existing transactions, such as amendments to correct errors, may or may not be material. Transactions amended in a non-material manner must be considered new transactions for the purposes of the application of the margin requirements where the amendments are not genuine.

Any amendment that extends an existing derivatives contract (for whatever reason) for the purpose of avoiding margin requirements must be considered a new contract.

2.10 Netting agreements

For the calculation of both initial margin and variation margin, APRA proposed that transactions that are not subject to the same legally enforceable netting agreement must not be considered in the same calculations. The draft CPS 226 defined 'netting agreement' in a similar manner as in the ADI capital framework.

Comments received

Respondents requested that as part of the transitional arrangements, APRA allow portfolios to be split into different sub-portfolios using separate credit support documentation under a single netting agreement, with transactions that pre-date the margin requirements having separate credit support documentation not subject to margin requirements. Respondents also requested that an APRA covered entity be permitted to include legacy derivatives in margin calculations and document legacy derivatives under the same credit support documentation as new transactions. Further, it was requested that APRA clarify whether netting should be performed separately for each collateral agreement rather than for each master agreement, or whether netting amongst broad product sets including across portfolios containing both in- and out-of-scope transactions is permitted.

APRA's response

APRA notes that draft CPS 226 required that transactions under separate netting agreements must not be included in the same margin calculation, but did not prohibit the existence of multiple credit support annexes under a single netting agreement. APRA confirms that entities do not have to create a separate netting agreement for new transactions entered into in a margining period. An entity may choose to use separate credit support annexes under a single netting agreement. However, transactions under separate netting agreements must not be considered in the same margin calculation.

2.11 Definition of securities financing transactions

The draft CPS 226 used the definition of securities financing transaction already used in APRA's prudential framework.

Comments received

Respondents requested that the statement in the definition that securities financing transactions 'are typically subject to margin agreements' be amended to reflect other types of arrangements that may be used.

One submission also requested that the definition should be extended to include other financing transactions that should also be excluded from the margin requirements as they include adequate margining arrangements and are not derivatives, though they share some attributes with derivatives.

APRA's response

APRA has chosen not to amend the reference to 'margin agreements' in the definition of securities financing transactions as the definition is longstanding and widely understood. APRA notes that the concerns raised pertain only to explanatory detail and not the core definition itself, and that securities financing transactions subject to margining under arrangements other than margin agreements are not excluded from the existing definition.

APRA has also declined to extend the exemption from the margin requirements to other types of financing transactions given the limited concern expressed by market participants.

2.12 Definition of asset class

For the purposes of CPS 226, APRA proposed four asset classes: 'currency/rates', 'equity', 'credit', and 'commodities'.

Comments received

One respondent requested that APRA amend the definition of asset class to make explicit that precious metals are in the commodity rather than currency asset class.

APRA's response

APRA has amended the definition of asset class in CPS 226 to clarify this issue.

2.13 Definition of margining group

Draft CPS 226 defined a 'margining group' as a group, comprising one or more entities, within the meaning of Australian Accounting Standard AASB 10 *Consolidated Financial Statements*.

Comments received

Respondents requested that APRA allow deference to equivalent foreign accounting standards to determine the scope of the consolidated group.

APRA's response

In response to this feedback, APRA has amended the definition of margining group to include equivalent foreign accounting standards that apply to a group's consolidated accounts.

Chapter 3 — Variation margin requirements

3.1 Product scope

In the draft CPS 226, APRA proposed that variation margin must be exchanged for all new non-centrally cleared derivatives.

Comments received

Several respondents raised concerns in relation to the proposed inclusion of physically settled FX forwards and swaps in APRA's variation margin requirements for reasons of international consistency. Respondents favoured either excluding physically settled FX forwards and swaps from variation margin requirements or delaying their inclusion. Further, one submission requested that physically settled FX forwards and swaps used for hedging purposes be excluded from the calculation of aggregate month-end average notional amount for the purposes of determining whether qualifying levels are exceeded.

A number of submissions requested that APRA also delay the application of variation margin requirements for single stock equity options and index options.

APRA's response

APRA considers the exchange of variation margin on physically settled FX forwards and swaps to be best practice and an important tool in managing counterparty credit risk exposure resulting from these transactions.

However, APRA also recognises that these products are frequently used by financial and non-financial end-users for hedging purposes. APRA also strongly favours international harmonisation in this area given the global nature of the non-centrally cleared derivatives market. As the majority of jurisdictions have opted to exclude physically settled FX forwards and swaps at this time, APRA has removed these transactions from the scope of the variation margin requirements in the final CPS 226. For cross-currency derivative swaps, APRA confirms that the fixed physically settled FX transactions associated with the exchange of principal may also be excluded from the variation margin requirements, but all other risks must be considered in the calculation of variation margin to be exchanged.

APRA continues to consider the exchange of variation margin for physically settled FX forwards and swaps and for cross-currency derivative swaps as an important mechanism for counterparty credit risk management. APRA notes that the exchange of variation margin for these transactions is common practice between larger ADIs. APRA expects the exchange of variation margin on these products to continue in the interbank market and will issue guidance to this effect. All institutions are expected to undertake appropriate measures to manage their risk in relation to these transactions, and APRA will assess the adequacy of an entity's management of this risk through its supervisory process.

Finally, as some jurisdictions have proposed phasing in requirements for physically settled FX forwards and swaps at a future date, APRA intends to monitor both international developments and the level and distribution of counterparty credit risk arising from these transactions. Should risk exposure or the global regulatory environment change, APRA will review the appropriateness of this exclusion.

APRA is not convinced that single stock or index equity options should be excluded from the requirements at this time, but will continue to monitor developments in the global regulatory environment in this area.

3.2 Qualifying level for the exchange of variation margin

APRA proposed that, following the end of the phase-in period, there would be a minimum qualifying level for the application of variation margin requirements of AUD 3 billion.

Comments received

Respondents were divided on this proposal. Some respondents raised concerns regarding the proposed AUD 3 billion qualifying level for the exchange of variation margin. Respondents asserted that the proposed qualifying level is inconsistent with the BCBS-IOSCO framework and other jurisdictions' rules, creates unnecessary additional complexity, may result in competitive issues and market fragmentation, and may negatively impact substituted compliance.

Alternatively, a number of submissions supported the proposed AUD 3 billion qualifying level for the exchange of variation margin on the basis that entities that transact in a *de minimis* amount of non-centrally cleared derivatives do not pose a systemic risk and so do not warrant the additional operational and funding costs and risks that would be imposed by margin requirements, and margin requirements could discourage hedging activity. Some respondents supported retaining the AUD 3 billion qualifying level, provided it does not jeopardise substituted compliance with other jurisdictions.

APRA's response

APRA has considered the submissions and decided to maintain the AUD 3 billion minimum qualifying level for variation margin requirements. APRA notes that the operational and funding costs of margining are not insubstantial. When applied to a small, low activity counterparty, the costs and additional risks of adhering to the requirements are likely to far outweigh any benefit of systemic risk reduction or improvement in prudential safety.

On an outcomes basis, the *de minimis* qualifying level is expected to have minimal impact on the level of systemic risk reduction achieved by the requirements. Given the level of concentration in the non-centrally cleared derivatives market, as well as the significant contribution to systemic risk by those few highly active market participants, the exclusion of small, low activity counterparties is expected to have minimal impact on the overall level of systemic risk reduction and total margin exchanged.

APRA notes that some other jurisdictions have also introduced minimum qualifying levels or other exemptions from variation margin requirements for small market participants.

APRA will monitor the impact and assess the appropriateness of the variation margin qualifying level on an ongoing basis.

3.3 Phase-in of variation margin requirements

To complement the proposed AUD 3 billion qualifying level for the exchange of variation margin, APRA proposed extending the phase-in timetable for lower activity margining groups. APRA proposed 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.

Comments received

Some respondents opposed the proposed third phase-in date for variation margin requirements (September 2017), noting this is inconsistent with the international framework and therefore may result in an un-level playing field and additional complexities in cross-border trades, and may negatively impact substituted compliance.

Respondents also noted that the proposed reference period during which aggregate month-end average notional amounts must be calculated to determine whether variation margin requirements apply from March 2017 is not used by other regimes, which could create practical difficulties for APRA covered entities in determining whether foreign counterparties had derivatives activity in excess of the qualifying level during this period.

APRA's response

APRA will announce its timetable for the phase-in of variation margin requirements in due course. APRA covered entities are expected to continue to actively prepare for the commencement of the margin requirements.

3.4 Definition of variation margin

The draft CPS 226 defined 'variation margin' as collateral that is collected to reflect the current mark-to-market exposure resulting from changes in the market value of a derivative.

Comments received

Respondents requested that the definition of variation margin proposed in draft CPS 226 be amended by adding the words 'or paid' after 'collateral that is collected' in the first line. This is to make clear that variation margin is not subject to the same requirement for segregation as initial margin and may be posted on an absolute transfer basis.

APRA's response

APRA considers this a reasonable amendment that is consistent with its original policy intent. The definition of variation margin has been amended to read 'collected or paid'.

Chapter 4 — Initial margin requirements

4.1 Treatment of initial margin collected

The draft CPS 226 included a principles-based approach to the treatment of initial margin and did not expressly require specific segregation or custodial arrangements. To ensure 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, APRA proposed to require that initial margin collected 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 insolvency or bankruptcy.

Comments received

A number of respondents expressed concern in relation to APRA's proposed requirement specifying that initial margin be 'immediately available' to the collecting party in the event of the posting party's default on the basis that legal or operational constraints may prevent compliance with this requirement in practice.

In addition, respondents requested clarification with regards to whether initial margin may be held offshore.

Further, submissions requested APRA permit the use of industry-wide legal advice developed by market participants in assessing whether segregation arrangements comply with CPS 226.

Finally, one respondent noted that draft CPS 226 did not include the BCBS-IOSCO framework provisions that initial margin collateral collected must be segregated from the initial margin collector's proprietary assets, and the initial margin collector must give the customer the option of individual segregation.

APRA's response

APRA has modified the requirement to specify that initial margin must be promptly available to the collecting party in the event of the posting party's default. APRA does not consider this a change of policy intent, and is meant to reflect the availability of initial margin with the normal timing constraints of legal and operational processes. The requirement remains that initial margin be available as soon as legally and operationally possible.

Initial margin may be held offshore such as with custodians outside Australia, as long as the conditions in CPS 226 are satisfied. In addition, an APRA covered entity must make an internal assessment as to whether segregation arrangements comply with CPS 226, but may utilise information gathered from external parties or industry bodies in this internal assessment.

The final CPS 226 requires segregation of initial margin collected from proprietary assets, as well as requiring that individual segregation be provided if requested by the counterparty.

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

APRA proposed not including the jurisdictional discretion under the BCBS-IOSCO framework allowing limited re-hypothecation of initial margin where 12 qualifying conditions are satisfied.

Comments received

Respondents requested that APRA permit re-hypothecation in line with the BCBS-IOSCO framework subject to the specified conditions.

APRA's response

APRA is not satisfied that the appropriate structures and controls are currently in place to ensure that collateral re-hypothecation, re-pledge or re-use would only occur on a one-time basis and in a manner that meets each of the specified conditions. As a result, APRA has maintained the original proposal.

4.3 Use of third party custodian

Comments received

A number of respondents requested that APRA clarify whether cash initial margin may be held with a central bank or in a general deposit account with a custodian, and whether that custodian must not be affiliated with either counterparty.

APRA's response

APRA has amended CPS 226 to clarify that cash initial margin may be held in a demand deposit account with a third-party custodian, where that custodian is not affiliated with either counterparty.

4.4 Frequency of calculation

Consistent with the BCBS-IOSCO framework, APRA proposed that initial margin must be calculated and called 'both at the outset of a transaction and on a regular and consistent basis upon changes in the measured potential future exposure'.

Comments received

Respondents requested clarification of the requirement for initial margin to be calculated 'at the outset of a transaction'.

APRA's response

APRA confirms that the intent of the requirement is that initial margin be calculated promptly following the execution of a transaction. APRA does not require initial margin to be calculated prior to the transaction's execution. Rather, this requirement intends that initial margin be calculated and called in a timely manner following execution of the transaction.

APRA has not amended CPS 226 in response to this comment as the proposed wording is consistent with the BCBS-IOSCO framework.

4.5 Calculation of initial margin

APRA proposed that an APRA covered entity may calculate the required amount of initial margin by reference to either the standardised schedule in CPS 226 or an approved quantitative model. An APRA covered entity must use the same approach for all transactions within the same defined asset class, but may use different approaches across different asset classes.

Comments received

Respondents opposed the requirement to apply either a model approach or the standardised schedule consistently within each asset class and requested flexibility to use both the standardised schedule and model approach within the same asset class on a non-arbitrary basis. Respondents expressed the view that APRA's proposed requirement will be operationally challenging and proposed that an APRA covered entity should not be required to move to the standardised schedule for all transactions within an asset class where the valuation of a particularly exotic product is difficult to determine for the purposes of its initial margin model.

Respondents requested clarification on the requirements that the specific method and parameters to calculate initial margin must be agreed or recorded at the outset of the transaction.

Respondents also requested that APRA amend the calculation of initial margin under CPS 226 to be consistent with a 10-day time horizon, or '10 days plus the number of days in between exchanges of variation margin, minus one day.'

APRA's response

APRA has maintained the requirement that the same method for calculating initial margin be applied for all transactions within a defined assets class. APRA considers this to be a core principle of the BCBS-IOSCO framework. Flexibility is permitted through the option to apply different methods to different asset classes. APRA does not support variable application of the model or standardised approach within a given asset class. Such method and parameters for calculating initial margin may be agreed with a counterparty through a provision in the credit support documentation.

APRA has not amended the calculation of initial margin in the final CPS 226, as the wording proposed in draft CPS 226 is consistent with the

BCBS-IOSCO framework. However, APRA wishes to clarify that the time horizon is defined as the number of days between exchanges of variation margin, excluding the days on which variation margin is exchanged.

4.6 Initial margin model approval

APRA proposed that 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 also proposed requiring prior notification for any material changes to a model or risk measurement system, and requiring prior written approval for any material changes to a model that are not consistent with global industry standards for initial margin models.

Comments received

A number of respondents requested that APRA clarify its initial margin model approval requirements and processes. Particular comments concerned whether prior approval would be required:

- for the use of an industry standard model such as the International Swaps and Derivatives Association Standard Initial Margin Model (ISDA SIMM);
- for subsequent changes to an industry standard or other model; and
- where a model has been approved by a foreign regulator.

Several respondents submitted that full prior approval should not be required in these cases and that notification or a simplified approval process would be sufficient, particularly given timing constraints. Some respondents also requested that, following submission of a model for approval, approval should be deemed until such a time as APRA reviews the relevant model, or that APRA covered entities be allowed to self-attest that the model meets the applicable criteria and then use that model from the compliance date onwards.

Respondents requested that APRA clarify the procedural aspects of its model approval process, including its required timeframes for submission of models for approval.

APRA's response

APRA expects entities will primarily utilise the industry standard ISDA SIMM to determine initial margin amounts. APRA will conduct a simplified approval process for an APRA covered entity using the ISDA SIMM. Any entity that intends to seek approval for a model that deviates from the ISDA SIMM should expect an extensive and lengthy application process and should inform APRA of its intended approach as soon as possible.

For an APRA covered entity in a margining group whose parent is not supervised by APRA, APRA will consider whether the model has been approved by a foreign regulator and independently validated. In addition, such an entity should also provide an overview of any testing of initial margin output and margining processes conducted with its counterparties. Such entities should inform APRA of their intentions and provide an update of their progress at least three months prior to their expected initial margin phase-in date, following the announcement of APRA's phase-in schedule.

An APRA covered entity in a margining group whose parent is supervised by APRA should inform APRA of its intention and provide an update of its progress at least nine months prior to its expected initial margin phase in under CPS 226. For such entities, the approval process will broadly consider:

- any reviews and feedback from foreign regulators;
- self-assessments against the requirements in CPS 226;
- the results of the independent model validation;
- internal model governance and monitoring processes;
- any differences in input sensitivity definitions and model methodology with ISDA SIMM;

- the systems and processes used for margining; and
- any testing of initial margin output and margining processes conducted with its counterparties.

In the case where an entity meets the timelines above but there are additional timing constraints, APRA may consider granting an initial approval of a model for a transition period during which an assessment will be completed.

Methodology and calibration updates to the ISDA SIMM that are undertaken on an industry-wide basis do not require prior approval by APRA, although prior notification for APRA covered entities in a margining group whose parent is supervised by APRA is expected. Any other material changes to a model by an individual institution must be approved by APRA prior to implementation of the changes.

4.7 Independent review of initial margin model

APRA proposed that an APRA covered entity must ensure that an independent review of the initial margin model and risk measurement system is carried out at the time when model approval is sought and then regularly as part of the internal audit process. This review must be conducted by functionally independent, appropriately trained and competent personnel, and must take place at least once every three years or when a material change is made to the model or the risk measurement system.

Comments received

Several respondents requested that APRA provide clarification in relation to this requirement. In particular, submissions requested APRA clarify whether the initial independent review may be undertaken by the risk management or compliance function (second line) and whether regular periodic second line review is required. One submission also queried whether independent reviews by third parties are permitted.

Respondents also requested APRA clarify whether the requirements that the personnel conducting the review must satisfy apply to both the personnel conducting the initial review and internal auditors conducting ongoing reviews.

APRA’s response

APRA has maintained the requirement that an APRA covered entity must undertake an independent review of its initial margin model at the time the model approval is sought. Such an initial model review should be conducted as part of the internal audit process. APRA considers this may be conducted by internal audit or external auditors. Internal audit may rely on external auditors for this purpose, for example, where there is insufficient independent in-house expertise to conduct such a review.

Internal reviews of the model should also be undertaken as part of the internal governance process overseeing the use of such a model. The internal governance process should provide sufficient oversight of the model both at the time model approval is sought and on an ongoing basis.

The requirement that personnel conducting reviews are functionally independent applies to both the personnel conducting both initial and ongoing reviews, and APRA has amended CPS 226 to reflect this.

4.8 Avoidance of pro-cyclical events

APRA proposed that an APRA covered entity must avoid wherever practicable triggers that may lead to a large discrete call for additional initial margin and would have a pro-cyclical effect, and that any such triggers must be subject to appropriate internal controls and limits.

Comments received

Submissions expressed concerns in relation to this provision noting that is unclear what an APRA covered entity must do to satisfy this requirement, and questioned whether changes to transactions in a portfolio or recalibration of the industry model — which are expected to occur — would be considered triggers.

APRA’s response

Upon review, APRA has decided to remove this paragraph. For clarity, APRA expects, that the design of the initial margin model would avoid ratings downgrade-based (or similar) triggers which may lead to a large discrete call for additional initial margin at a time when an institution is likely to be under stress.

Chapter 5 — Collateral and haircuts

5.1 Eligible collateral

Draft CPS 226 included a list of the types of eligible collateral that APRA proposed an APRA covered entity would be permitted to collect for margining purposes. The proposed list of eligible collateral included cash, certain debt securities and covered bonds, senior securitisation exposures, equities listed in a major index and gold.

Comments received

One respondent expressed concern about the proposed use of credit rating grades by External Credit Assessment Institutions (ECAIs) as the primary selection criteria for the eligibility of debt securities. It was suggested that APRA permit counterparties to use a range of assessment factors when determining eligibility of collateral, or, to mitigate cliff-effects if ratings-based eligibility criteria are maintained, introduce concentration limits and allow a grace period for replacing collateral following a credit rating downgrade leading to non-eligibility.

Respondents also requested that APRA clarify the distinction between 'central, state and regional governments' and 'local governments' for the purposes of collateral eligibility.

APRA's response

APRA acknowledges the concerns related to reliance on credit rating grades by ECAIs as a primary method of selecting collateral. However, APRA also considers that a clear, transparent and comparable system for determining collateral eligibility is required to ensure that a wide range of collateral may be utilised and exchanged between counterparties as part of the margining framework. APRA considers that the wide range of eligible collateral permitted under CPS 226 allows for a diverse and varied pool of assets that may be collected. CPS 226 and the margin requirements of foreign jurisdictions include requirements for the management of concentration risk, which would be expected to mitigate pro-cyclical effects that may occur following a rating downgrade that leads to non-eligibility.

State and regional governments are structurally similar and a 'regional government' may be read as referring to the government of a state, province or equivalent. Local government generally refers to a lower tier of administration than the state or regional government.

5.2 Collateral haircuts

APRA proposed that an APRA covered entity must apply risk sensitive haircuts, calculated by reference to either the standardised schedule in Attachment B of draft CPS 226 or an approved model approach, to collateral collected as margin. The proposed standardised schedule in Attachment B of CPS 226 is consistent with the schedule set out in the BCBS-IOSCO framework.

Comments received

Respondents were broadly supportive of APRA's proposed approach to risk-sensitive collateral haircuts. In particular, one respondent supported the option to use either the standardised schedule or a model approach for the calculation of risk-sensitive haircuts on collateral.

One respondent noted that the maturity buckets included in the standardised schedule in CPS 226 differ from those in other jurisdictions' margin requirements, resulting in different haircuts being applied to debt securities with a residual maturity of precisely one year or precisely five years, and that the standardised schedule in CPS 226 differs from the schedules of other jurisdictions that have chosen to add additional granularity in the determination of haircuts.

APRA's response

APRA has maintained the option for an APRA covered entity to apply for approval to use a quantitative model to calculate risk-sensitive haircuts, and will assess any such applications on a cost-recovery basis.

APRA has amended its proposed maturity buckets in its standardised schedule of collateral haircuts to align with the approach taken by the majority of other jurisdictions.

5.3 FX mismatch haircut

APRA's proposed standardised schedule for risk sensitive haircuts included an additional FX mismatch haircut of eight per cent applicable to:

(i) all non-cash collateral posted as variation margin; and
(ii) all cash and non-cash collateral posted as initial margin,

where the currency of the collateral asset differs from the termination currency.

Comments received

In relation to the FX mismatch haircut for variation margin, several respondents noted that the concept of 'termination currency' is more relevant to initial margin than variation margin, and requested that APRA harmonise the language in CPS 226 with that used by other jurisdictions in relation to the FX-mismatch haircut for variation margin to ensure the haircut applied by CPS 226 does not have a broader scope than that applied by other jurisdictions.

In relation to the FX mismatch haircut for initial margin, respondents requested that APRA align its approach with that taken by the United States and require a haircut only where the currency of the collateral matches none of the termination currency or any currency in which settlement may be made under the relevant netting agreement, credit support annex or individual contract. Several respondents requested that APRA permit the parties to a transaction to agree on two termination currencies for the purposes of exchanging margin.

APRA's response

APRA recognises the feedback that the concept of termination currency is not addressed in a standard form credit support annex for variation margin. APRA has amended the requirement to apply the FX mismatch haircut to variation margin for non-cash collateral in which the currency of the collateral asset differs from that agreed in an individual derivative contract, the relevant governing master netting agreement, or the relevant credit support annex.

Further, APRA has amended CPS 226 to allow each counterparty to a transaction to choose a single termination currency and to require an APRA covered entity to apply the FX mismatch haircut for initial margin only when the currency of the collateral collected does not match its chosen termination currency.

5.4 Wrong-way risk and concentration risk

APRA proposed that an APRA covered entity must have appropriate internal policies and procedures in place to monitor and manage the wrong-way risk and concentration risk that may exist in collected collateral. APRA also proposed that securities issued by a counterparty to the transaction or by a related or associated party are not eligible collateral.

Comments received

Respondents were broadly supportive of APRA's proposals in relation to wrong-way risk and concentration risk. However, one submission requested that APRA define 'related or associated with' for the purposes of identifying wrong-way risk.

APRA's response

APRA does not view it as necessary to add a specific definition of 'related or associated with'. This phrase should be read in manner consistent with current practice, and emphasises the purpose of the exclusion which is to disallow collateral in the form of securities where there is a material positive correlation with the credit quality of the counterparty.

5.5 Substitution of collateral

APRA proposed that eligible collateral posted or collected may be substituted where three conditions are satisfied.

Comments received

It was requested that APRA remove the condition that both parties must agree to the substitution in subparagraph 50(a) of draft CPS 226 given the existence of the condition that the substitution is made on the terms applicable to the agreement between the parties to the transaction in subparagraph 50(b).

APRA's response

APRA has made no change to this paragraph in the final CPS 226, but clarifies that where parties have agreed in advance specific terms for substitution, and a substitution meets those terms, this may be read as satisfying the requirement that parties agree to the substitution.

Chapter 6 — Cross-border application of requirements

6.1 Substituted compliance

To assist achieving a workable cross-border framework, APRA proposed that it would 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. Draft CPS 226 proposed that APRA may approve substituted compliance in relation to a foreign regulator's margin requirements, and may limit the scope of, or impose conditions on, recognised substituted compliance.

Comments received

A number of respondents sought clarity on APRA's substituted compliance approval process. Specifically, respondents questioned whether APRA intends to require applications or requests in order to initiate substituted compliance assessments. Respondents requested that APRA initiate substituted compliance assessments without requiring any applications and that substituted compliance timeframes and determinations be publicly communicated.

Respondents supported APRA's proposed outcomes-based approach to substituted compliance assessments but queried the requirement that a foreign regime be comparable in its outcomes to both CPS 226 and the BCBS-IOSCO framework, and requested that the requirement for comparability in relation to CPS 226 be removed.

Given the need for comparability determinations in advance of the commencement of the margin requirements, several submissions proposed that APRA consider issuing a two-year transitional comparability determination during which counterparties to transactions subject to the requirements in CPS 226 in addition to one or more foreign margining regimes may comply with a relevant foreign regime in lieu of the requirement in CPS 226.

Respondents also discouraged limiting the scope of, or imposing conditions on, recognised substituted compliance due to the additional complexity and compliance burden this would create and requested these provisions be removed from CPS 226. However, one submission requested that recognised substituted compliance be subject to the condition that the Australian and foreign definitions of 'derivative' are applied by both counterparties, given the differences in jurisdictions' definitions.

APRA's response

APRA will not require applications or requests in order to initiate substituted compliance assessments with other major jurisdictions, although such requests may be required by authorities in other jurisdictions. APRA will publicly communicate any results of its equivalence assessments and where substituted compliance is granted. Substituted compliance assessments will focus on an outcomes-based approach; APRA considers it appropriate to assess a foreign regime compared to the BCBS-IOSCO framework and the requirements in CPS 226. APRA considers that its deferment of the commencement of its margin requirements alleviates the need for the issuance of any transitional comparability determination at this time, but may consider such an arrangement as part of its implementation timetable.

Where APRA has granted substituted compliance and an APRA covered entity has chosen to apply the requirements of an equivalent foreign jurisdiction in lieu of the requirements in CPS 226, the APRA covered entity must comply with the margin requirements of the foreign jurisdiction in their entirety. An APRA covered entity may not apply only certain aspects or portions of a foreign regime or seek to apply the foreign regime in a way that maximises concessionary treatment.

APRA will consider carefully any decision to limit the scope or apply conditions, including in relation to the definition of derivative, on recognised substituted compliance. APRA may also apply conditions on substituted compliance for the purpose of application on a Level 2 basis or requirement of variation margin for certain intra-group transactions.

6.2 Foreign branches in Australia

Independent of the process of substituted compliance, APRA proposed allowing a foreign ADI, Category C insurer or EFLIC that is subject to, and compliant with, the margin requirements of its home regulator to automatically defer to its home requirements, provided it can demonstrate upon request that those requirements are substantially similar to the BCBS-IOSCO framework.

Comments received

Respondents requested clarification as to the 'substantially similar' standard of equivalence, and queried whether APRA will determine which foreign margining regimes are 'substantially similar', or whether this determination will need to be made by one or both counterparties to a transaction.

Respondents also requested that the automatic deference for a foreign ADI, Category C insurer or EFLIC be extended to allow for deference to the margin requirements of another jurisdiction deemed equivalent by the home jurisdiction of the foreign ADI, Category C insurer or EFLIC, and deference in relation to IOSCO's Risk Mitigation Standards.

APRA's response

APRA will not publish a list of foreign margining regimes that it deems to be substantially similar to the BCBS-IOSCO framework. CPS 226 has been amended to clarify that an APRA covered entity must undertake an internal assessment that demonstrates that the margin requirement of its home jurisdiction are substantially similar to the BCBS-IOSCO framework.

In response to feedback, APRA has expanded these deference provisions to allow for deference to risk mitigation requirements that are substantially similar to IOSCO's Risk Mitigation Standards.

In addition to demonstrating that its home requirements are substantially similar to the BCBS-IOSCO framework (or IOSCO's Risk Mitigation Standards, as appropriate), a foreign branch must be able to demonstrate that it is directly subject to the relevant requirements of its home jurisdiction, and that it complies with the relevant requirements of its home jurisdiction or a jurisdiction deemed equivalent by its home regulator.

6.3 Other automatic deference considerations

Comments received

For transactions subject to multiple sets of margin requirements, respondents requested that CPS 226 include provisions allowing automatic deference to the definitions of 'derivative' and 'non-centrally cleared derivative' in any of the rules to which the transaction is subject to alleviate the need to make multiple calculations with different product sets.

APRA's response

APRA intends to resolve these issues through its assessments of substituted compliance and has not included any additional automatic deference provisions in the final CPS 226. Where a transaction is subject to multiple sets of margin requirements including those in CPS 226, APRA confirms that an APRA covered entity may adopt a wider product set than that required under CPS 226 to meet the requirements of all regimes to which the transaction is subject.

6.4 Jurisdictions where netting and/or collateral is not enforceable

The draft CPS 226 did not require an APRA covered entity to post or collect variation or initial margin with counterparties in jurisdictions where netting of derivatives or collateral is not enforceable upon insolvency or bankruptcy of the counterparty, given the costs and risks associated with exchanging margin with such counterparties in such jurisdictions. APRA proposed that an APRA covered entity must monitor and set appropriate internal limits and controls for any uncollateralised exposure to jurisdictions where netting or collateral is not enforceable, and counterparties in these jurisdictions.

Comments received

A number of respondents noted that institutions may have differing views in relation to the enforceability of netting or collateral upon insolvency or bankruptcy of a counterparty in a particular jurisdiction, the enforceability may vary depending on the counterparty type, or the enforceability may be uncertain.

Submissions requested that APRA covered entities be allowed to make their own determinations as to the enforceability of netting and collateral in accordance with the method used for capital adequacy purposes. In the event of uncertainty, an APRA covered entity should be allowed, or required, to consult APRA on the appropriate treatment. Respondents also requested that the standard for determining whether netting or collateral is enforceable be expressed as 'if there is any doubt as to the enforceability of the netting agreement' consistent with the recognition of netting for capital adequacy purposes, and that foreign incorporated APRA covered entities be permitted to use a standard consistent with that in their home capital requirements.

One respondent also requested that CPS 226 include a due diligence requirement in relation to performing legal assessments of the enforceability of netting and collateral, and that APRA provide guidance on the frequency with which such opinions need to be updated and whether such opinions may be provided by independent internal counsel as well as external counsel.

APRA's response

APRA confirms that an APRA covered entity must undertake its own assessment on the enforceability of close-out netting and the collateral arrangements. An assessment of the enforceability of netting or collateral upon insolvency or bankruptcy of a counterparty must take into consideration the relevant jurisdiction and counterparty type and must be supported by legal opinion. These legal opinions must be updated periodically. Legal opinions may be provided by independent internal counsel or external counsel. An APRA covered entity may request guidance from APRA where it deems necessary. APRA has amended CPS 226 to clarify its requirements for assessing the enforceability of netting and collateral arrangements.

As discussed in section 2.2 *Level 2 scope of application*, APRA has also amended CPS 226 to exempt transactions from requirements to post or collect initial margin where the legal environment in the jurisdiction of either counterparty does not yet permit compliance with the initial margin requirements, such as in New Zealand.

6.5 Jurisdictions where posting of collateral offshore is prohibited

Comments received

One respondent requested that APRA allow institutions flexibility to not post collateral to counterparties located in jurisdictions where the posting of collateral offshore is prohibited, such as India, due to the necessary exposure to additional risk through reliance on local intermediaries.

APRA's response

APRA considers this an aspect of the broader management of counterparty credit risk that a given institution should manage appropriately. APRA has made no additional modifications to the final CPS 226.

Chapter 7 — Risk mitigation requirements

7.1 Scope of application

APRA proposed that the additional risk mitigation requirements in CPS 226 apply to all APRA covered entities that transact in non-centrally cleared derivatives, irrespective of level of activity in non-centrally cleared derivatives, in all transactions.

Comments received

A number of respondents raised concerns regarding the breadth of the proposed scope of application of APRA's risk mitigation requirements, particularly given the proposed implementation timeframe.

Respondents noted that APRA's proposed application of risk mitigation requirements to all counterparties is broader than other jurisdictions' requirements and current practices. Further, several submissions opposed the application of risk mitigation requirements on a Level 2 basis, particularly for foreign subsidiaries in jurisdictions not implementing risk mitigation standards.

APRA's response

APRA has amended CPS 226 to emphasise the importance of an APRA covered entity establishing appropriate policies and procedures for determining appropriate risk mitigation standards for all its non-centrally cleared derivatives transactions, giving consideration to the size and complexity of, as well as portfolio of transactions with, the counterparty.

APRA has also modified the scope of its risk mitigation standards so that the standards must, at a minimum, be applied in respect of covered counterparties.

7.2 Timing

Draft CPS 226 proposed that the risk mitigation requirements would apply from 1 September 2016. On 22 August 2016, APRA advised that commencement of the risk mitigation requirements would be moved beyond 1 September 2016 and it will announce a revised commencement date in due course.

Comments received

Many submissions expressed concern in relation to the short timeframe to implement the risk mitigation requirements, noting that the proposed timeframe is insufficient given the scale and complexity of the changes required and other competing priorities. In particular, respondents expressed concern in relation to the mismatch between the phase-in dates for the initial margin and variation margin requirements and the September 2016 commencement date for the risk mitigation requirements, which may potentially lead to unnecessary duplication of efforts with respect to trading relationship documentation.

APRA's response

APRA will take these comments into consideration in determining the final implementation date for the risk mitigation requirements, which will be announced in due course.

7.3 Trading relationship documentation

APRA proposed that an APRA covered entity be required to establish and implement policies and procedures to execute written trading relationship documentation with its counterparties prior to or contemporaneously with executing a non-centrally cleared derivative transaction.

Comments received

Respondents requested that APRA allow for long form confirmations as a substitute for trading relationship documentation. Further, one submission noted that it is not current practice to have trading relationship documentation in place for counterparties that only execute short-dated FX forwards and swaps.

Submissions also raised concerns about the inclusion of the provision requiring that trading relationship documentation 'provide legal certainty for non-centrally cleared derivative transactions'. It was requested that this provision be removed from CPS 226, or amended to account for transactions with counterparties in jurisdictions where netting and/or collateral is not enforceable on insolvency or bankruptcy of the counterparty.

APRA's response

APRA has amended the final CPS 226, to specify that documentation should 'promote' legal certainty, reflecting that documentation should provide legal certainty to the extent possible under the relevant operating environment and with consideration for jurisdictions where netting and/or collateral may not be enforceable.

APRA has amended CPS 226 to reflect that long form confirmations are permissible substitutes for trading relationship documentation where the long form confirmation meets the requirements of promoting legal certainty, including all material rights and obligations, and being executed in writing. APRA also confirms that trade confirmations may be received as soon as practicable following the execution of the transaction.

7.4 Trade confirmation

APRA proposed that APRA covered entities must 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. It was proposed that confirmations must be done in writing, and wherever practicable via automated methods.

Comments received

Submissions noted a preference that all legally binding trade confirmations be permitted, including negative affirmations and two-way confirmations.

Respondents also requested drafting amendments to clarify that an APRA covered entity must have policies and procedures designed to confirm the material terms of all non-centrally cleared derivative transactions, to reflect that a confirmation can only be achieved with the cooperation of the counterparty to a transaction.

APRA's response

APRA confirms that all legally binding trade confirmations are permitted including negative affirmations where parties have pre-agreed this to be a legitimate method of confirmation.

APRA considers the drafting suggestions to be consistent with its policy intent and has modified CPS 226 accordingly.

7.5 Portfolio reconciliation

Draft CPS 226 proposed that an APRA covered entity must establish and implement policies and procedures to ensure that the material terms and valuations of all transactions in a non-centrally cleared derivatives portfolio are reconciled with counterparties at regular intervals, with a scope and frequency that reflects the size and complexity of the underlying risk of its portfolio.

Comments received

Respondents requested that APRA clarify whether its portfolio reconciliation requirements apply in respect of:

- transactions entered into before the compliance date; and
- intra-group transactions.

Respondents also raised concerns that the drafting in CPS 226 could be read as requiring that parties agree to a reconciliation process.

Finally, submissions requested introducing a *de minimis* threshold below which the parties would not be required to resolve any differences in valuations.

APRA's response

APRA emphasises that its portfolio reconciliation requirements may be applied with consideration of the size, complexity and materiality of the risks faced, along with other factors. As an APRA covered entity must establish policies and procedures to ensure portfolio reconciliation is conducted with a risk-focused approach, this may include portfolios and transactions that pre-date the implementation date as these may be a source of valuation differences. In addition, an APRA covered entity's policies and procedures for portfolio reconciliation should include the treatment of intra-group transactions.

Given the principles-based nature of its risk mitigation standards, APRA has declined to implement a specific threshold below which counterparties would not be required to reconcile discrepancies in valuation. APRA considers that an APRA covered entity may include such a threshold in its policies and procedures where appropriate to the underlying risk.

7.6 Portfolio Compression

APRA proposed that an APRA covered entity be required to establish and implement policies and procedures to regularly assess and conduct, with a scope and frequency that reflects the size and underlying risk of its portfolio, both bilateral and multilateral portfolio compression.

Comments received

Submissions expressed broad support for APRA's proposals in relation to portfolio compression. However, one submission expressed concern about APRA's proposal to mandate portfolio compression for non-centrally cleared derivatives and requested that the practice be recommended on a voluntary basis.

APRA's response

APRA recognises the importance of portfolio compression in reducing the counterparty credit risk arising from non-centrally cleared derivatives positions, and notes that portfolio compression serves as a key component of IOSCO's Risk Mitigation Standards. APRA considers it appropriate to require portfolio compression to be conducted with a scope and frequency that reflects the size and underlying risk of an APRA covered entity's portfolio.

7.7 Valuation processes

APRA proposed that an APRA covered entity must 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 also proposed that an APRA covered entity must perform periodic review of the agreed-upon valuation process and update the relevant documentation for any changes resulting from the review.

Comments received

Respondents requested that APRA remove or amend the requirement to update documented valuation processes to reflect any changes resulting from periodic reviews of the valuation processes, given an entity is unable to compel its counterparty to agree to such changes in documentation.

One submission asserted that valuation processes are internal information of financial institutions and should not be disclosed to or agreed with counterparties.

APRA's response

APRA has revised the language in the final CPS 226 in relation to the requirement to update documentation following periodic reviews of valuation processes in order to improve clarity and more appropriately reflect its policy intent.

APRA has made no further modifications in response to concern that valuation processes should be protected as internal information for a financial institution.

7.8 Dispute resolution

APRA proposed that an APRA covered entity must have rigorous and robust dispute resolution procedures in place, and that 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 proposed that an APRA covered entity be required to make all necessary and appropriate efforts to resolve all disputes in a timely manner.

Comments received

Respondents requested that the requirement to agree and document a mechanism for resolving disputes over material terms be removed as industry standard documentation only provides for resolution of disputes as to the value of transactions and collateral.

Respondents also suggested that APRA introduce a dispute threshold for valuation purposes, whereby valuation differences of less than 10 per cent need not be deemed a discrepancy.

One respondent also noted that APRA's proposed requirement to escalate to the Board any dispute that represents a material risk to the entity goes beyond IOSCO's Risk Mitigation Standards.

APRA's response

APRA considers it important than an APRA covered entity establish and implement policies and procedures to address dispute resolution procedures. APRA has clarified this requirement in the final CPS 226. Consistent with the IOSCO requirement, an APRA covered entity must agree the mechanism or process for determining when discrepancies are considered disputes and how disputes should be resolved as soon as practicable.

APRA has not introduced a threshold below which discrepancies in valuations would not be considered a dispute.

Finally, APRA considers the requirement that any dispute that represents a material risk to the entity be escalated to the Board to be an important mechanism in management of material risks by an institution and consistent with the principles of *Prudential Standard CPS 220 Risk Management* and has therefore not altered this requirement

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