Banking / Capital Markets

The Delta Report

Derivatives Newsletter

In this issue:

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In this issue of The Delta Report, we bring you further updates on developments in the global derivatives space. In Europe, the focus is on Brexit and the newly-released EU final regulatory standards on the valuation of derivatives for the purpose of bail-in. We also highlight recent rulings of the US Bankruptcy Court and German Federal Court which impact CDO transactions and netting clauses under German law respectively. Across the globe, we continue to provide insight to the latest regulatory developments.

Proposed Margin Requirements for Uncleared OTC Derivatives in Singapore

Background

As part of the G20's global reform programme to reduce the systemic risk from over-the-counter ("**OTC**") derivatives, the Basel Committee on Banking Supervision ("**BCBS**") and the International Organization of Securities Commissions ("**IOSCO**") were called upon to establish global requirements for the margining of non-cleared OTC derivatives. In its March 2015 report[138] (the "**March Report**"), BCBS-IOSCO outlined a comprehensive policy framework which, among other things, imposed requirements relating to the exchange of variation margin ("**VM**"), bilateral transfers of initial margin ("**IM**"), segregation of IM and limiting eligible collateral to only highly liquid assets. These requirements will impact a large number of financial institutions which are trading uncleared OTC derivatives globally and require them to make significant front-to-back infrastructure changes as well as negotiate collateral agreements to put in place the necessary margining arrangements.

The deadline for implementation of the margining requirements as set by BCBS-IOSCO was 1 September 2016. However, in June 2016 the European Commission announced that it was still reviewing the draft regulatory standards submitted by the European Supervisory Authorities and that the standards will not be finalised before the 1 September 2016 deadline.[139] Soon after, regulators in Hong Kong, Singapore and Australia also announced their intentions to delay the collateral requirements for non-cleared OTC derivatives in their respective countries.[140]

Introduction

On 1 October 2015, the Monetary Authority of Singapore ("**MAS**") issued a consultation paper titled "Policy Consultation on Margin Requirements for Non-Centrally Cleared OTC Derivatives" (the "**Consultation Paper**"). The Consultation Paper sets out MAS' policy proposals for the implementation of the margining regime in Singapore which will be effected via new rules. It is anticipated that MAS will release a subsequent consultation paper seeking feedback on the proposed new rules.

This article provides an overview of some of the key points raised in the Consultation Paper.

MAS' Policy Proposals on the Margin Requirements

Requirements for Consideration	Proposed Margin Requirements	
Which entities are subject to the margin requirements?[141]	1. Banks licensed under the *Banking Act* ("**Licensed Banks**"); 2. Merchant banks approved as financial institutions under Section 28 of the *MAS Act* ("**Approved Merchant Banks**"); and 3. Other licensed financial institutions licensed under the *Finance Companies Act*, *Insurance Act*, *Securities & Futures Act* ("**SFA**") and *Trust Companies Act* (including fund managers that are legal counterparties) if each of their relevant exposures exceeds the threshold, (each a "**MAS Covered Entity**"), provided that such MAS Covered Entity conducts regulated activities under the SFA.	Exemptions: Sovereigns, central banks, public sector entities, multilateral development banks and the Bank for International Settlements

[138] BCBS-IOSCO, "Margin Requirements for Non-centrally Cleared Derivatives" (March 2015).

[139] Practical Law, "*EU Delays Margin Rules for Uncleared Swaps*" (22 June 2016).

[140] http://www.thetradenews.com/Regulation/Australia,-Hong-Kong-and-Singapore-delay-swaps-margin-rules/ (accessed on 28 august 2016).

[141] For a start, only Licensed Banks and Approved Merchant Banks are phased in. See "phase-in implementation" below.

Requirements for Consideration	Proposed Margin Requirements	
	MAS has not determined whether investment funds domiciled in Singapore will be subject to the margin requirements. An investment fund is considered to be distinct and separate only if the fund is (1) a distinct segregated pool of assets for the purposes of fund insolvency or bankruptcy; and (2) not collateralised or guaranteed by another person.	
Which transactions are subject to the margin requirements?	All OTC derivative contracts not centrally cleared by a qualifying central counterparty.	Exemptions: Physically-settled FX forwards and FX swaps[142] Note: MAS Covered Entities may also apply for exemption of intra-group transactions.[143]
What conditions must be met for the margin requirements to apply?	1. The MAS Covered Entity is a legal counterparty (i.e. a signatory to the ISDA Master Agreement and the related collateral agreement) to the transaction; 2. The transaction is booked in Singapore; and 3. The transaction is entered into with either an MAS Covered Entity or an overseas regulated financial firm.	
Bilateral or unilateral margining	MAS is considering imposing a unilateral "collect-only" requirement on MAS Covered Entities (as opposed to a bilateral "post-and-collect" requirement under the BCBS-IOSCO framework which involves counterparties exchanging collateral).[144]	Deemed compliance possible in cross-border transactions where another jurisdiction's margin requirements apply.[145]
IM requirements	IM shall be collected (or exchanged) at the outset of a transaction and thereafter, gross margining (no netting of IM payments between the counterparties) on a sufficiently regular basis to reflect changes in risk positions and market conditions, subject to a Minimum Transfer Amount of S$800,000. Threshold of S$80 million (calculated at group-consolidated level and is based on all uncleared derivatives between the two consolidated groups), subject to phase-in thresholds (see below).	

[142] Note that the relevant entities are still expected to appropriately manage the risks associated with such FX transactions (Consultation Paper, paragraph 3.2).

[143] This is subject to the condition that the MAS Covered Entity comes under group-wide supervision by MAS or regulators in other jurisdictions.

[144] A collect-only regime would allow parties to avoid any operational challenges in relation to bilateral collateral exchanges for cross-border transactions, particularly where there are conflicting requirements between jurisdictions e.g. differences in collateral eligibility or where the other jurisdiction is not a "netting-friendly" jurisdiction.

[145] In such situations, the MAS Covered Entity is deemed compliant if it (1) has complied with the relevant foreign jurisdiction's requirements which are comparable to those of MAS or (2) has complied with comparable margin requirements imposed on its foreign counterparty.

<table>
<tr><th>Requirements for Consideration</th><th>Proposed Margin Requirements</th></tr>
<tr><td>VM requirements</td><td>Daily margining with zero threshold, subject to a Minimum Transfer Amount of S$800,000.

Collection (or exchange, if MAS adopts a post-and-collect regime) within 2 business days following the execution of a new uncleared derivative contract.</td></tr>
<tr><td>Eligible collateral and haircuts</td><td>
<table>
<tr><th colspan="3">Asset Type[146]</th><th>Haircut[147]</th></tr>
<tr><td colspan="3">Cash (in the same currency as the settlement currency)</td><td>0%</td></tr>
<tr><td colspan="3">Gold</td><td>15%</td></tr>
<tr><td></td><td></td><td>Residual maturity</td><td></td></tr>
<tr><td rowspan="7">Central bank and government issuers</td><td rowspan="3">Debt securities (AAA to AA-)</td><td><= 1 year</td><td>0.5%</td></tr>
<tr><td>>= 1 year and <= 5 years</td><td>2%</td></tr>
<tr><td>> 5 years</td><td>4%</td></tr>
<tr><td rowspan="3">Debt securities (A+ to BBB-)</td><td><= 1 year</td><td>1%</td></tr>
<tr><td>>= 1 year and <= 5 years</td><td>3%</td></tr>
<tr><td>> 5 years</td><td>6%</td></tr>
<tr><td>Debt securities (BB+ to BB-)</td><td>All maturities</td><td>15%</td></tr>
<tr><td rowspan="6">Other issuers</td><td rowspan="3">Debt securities (AAA to AA-)</td><td><= 1 year</td><td>1%</td></tr>
<tr><td>>= 1 year and <= 5 years</td><td>4%</td></tr>
<tr><td>> 5 years</td><td>8%</td></tr>
<tr><td rowspan="3">Debt securities (A+ to BBB-)</td><td><= 1 year</td><td>2%</td></tr>
<tr><td>>= 1 year and <= 5 years</td><td>6%</td></tr>
<tr><td>> 5 years</td><td>12%</td></tr>
<tr><td colspan="3">Equity securities in a main index of a securities exchange in Singapore or recognised Group A exchanges[148]</td><td>15%</td></tr>
<tr><td colspan="3">Haircut for currency mismatch between collateral currency and settlement currency</td><td>8%</td></tr>
</table>
MAS Covered Entities should ensure that the collateral collected is not overly concentrated in an individual issuer, issuer type or asset type.</td></tr>
</table>

146 Any reference to debt securities and equity securities, as the case may be, in this section excludes securities issued by the MAS Covered Entity or its related entities.

147 The haircuts shown in this table are the schedule-based haircuts proposed by MAS. However in addition to these schedule-based haircuts, MAS also permits the use of risk-sensitive model-based haircuts (whether developed in-house or by a third party), subject to MAS' approval.

148 Group A exchanges are securities exchanges in Australia, Austria, Belgium, Canada, France, Germany, Hong Kong, Italy, Japan, Malaysia (except Labuan), Netherlands, New Zealand, South Korea, Spain, Sweden, Switzerland, Taiwan, Thailand, United Kingdom and United States.

Requirements for Consideration	Proposed Margin Requirements
Segregation of IM	IM collateral collected should be segregated in one of the following ways: 1. Held with an independent third party custodian under a trust arrangement; or 2. Held under other legally enforceable arrangements where the IM collateral is legally segregated from the collecting party's proprietary money and assets.
Re-hypothecation, re-pledge and re-use of collateral	Non-cash IM may be re-hypothecated to a third party, subject to such arrangement that meets MAS' proposed conditions which include, among other things, the IM collector is subject to regulation of liquidity risk, the collateral is treated as a customer asset, the third party recipient of the collateral is prohibited from further re-hypothecating and the level and volume of re-hypothecation must be disclosed to MAS. No restrictions on VM collateral.

Margin Calculations and Methodologies

How much IM is required?

To calculate the IM required based on a one-tailed 99% confidence interval over a 10-day horizon,[149] MAS Covered Entities may use either (i) a more risk-sensitive quantitative portfolio margin model or (ii) a standardised margin schedule proposed by MAS.[150]

Any use of quantitative portfolio margin models (whether developed in-house or by a third party) must meet the following conditions:

(a) the MAS Covered Entity must supply the relevant documentation and get the model approved by MAS (including any third party-provided models). If the initially approved model ceases to comply with MAS' requirements, the MAS Covered Entity shall notify MAS and calculate its IM based on the standardised margin schedule;

(b) the model must be subject to the MAS Covered Entity's internal governance process and independently validated before being used and annually thereafter;

(c) the model must be recalibrated at least every 6 months and be subjected to regular back and stress testing programmes.

Quantitative IM models may account for risk on a portfolio basis provided that the uncleared derivatives that are included for use in the same model calculation are subject to a single, legally enforceable netting agreement. Otherwise, if there is no such single netting agreement, the IM requirement of each of the derivatives contracts should be calculated using distinct IM models and each IM requirement is to be posted or collected on a gross basis.[151]

At a minimum, the IM ought to be recalculated and collected (or exchanged) when a new contract is executed with a counterparty, an existing contract with a counterparty expires, the IM model is recalibrated due to changes in market conditions or no IM recalculation has been performed in the last 10 days.

[149] The horizon period is subject to the frequency of VM margining. If VM margining is less than daily, the minimum horizon should be set equal to 10 days plus the number of days in between VM collection.

[150] MAS does not impose a restriction that the initially selected approach will apply throughout the entirety of the MAS Covered Entity's s derivatives activities however MAS notes that the MAS Covered Entity's should make a consistent choice over time at least for all transactions within the same asset class (Consultation Paper, paragraph 5.3).

[151] Consultation Paper, paragraph 5.7(a).

How much VM is required?

The amount of VM required must be sufficient to fully collateralise the mark-to-market exposure of the relevant uncleared derivatives transactions that are subject to the margin requirements.

The VM to be posted or collected shall be calculated on an aggregate net basis across all uncleared derivatives subject to a single, legally enforceable netting agreement. If there is no such netting agreement, the VM should be calculated on a gross basis.

Phase-in Implementation Schedule

As there are significant operational and system adjustments that need to be made to accommodate these new margining requirements, MAS has proposed a phasing in of the requirements which shall apply to Licensed Banks and Approved Merchant Banks initially.

Each of the VM and IM requirements applies only to new contracts entered into after the relevant Commencement Date where the MAS Covered Entity is facing another covered entity whose group exceeds the same threshold. IM for existing uncleared derivative contracts is not mandatory. For the purposes of calculating whether the threshold has been exceeded, the calculations are based on the numbers of the group to which the relevant MAS Covered Entity belongs, such numbers being the group's aggregate month-end average notional amounts for all of the group's uncleared derivatives, including physically settled FX forwards and FX swaps ("**Group's Aggregate Notional**").

MAS has proposed a 6-month transition period from the respective Commencement Date to allow MAS Covered Entities sufficient time to be operationally ready to implement the relevant requirements. Given the delay in commencement as announced by the MAS, the relevant commencement dates reflected in the Consultation Paper are likely to be amended accordingly.

Phase-in implementation schedule – VM requirements	**MAS Covered Entity**	**Threshold**	**Commencement Date**
	Licensed Banks	S$4.8 trillion[152]	1 Sep 2016
	Licensed Banks and Approved Merchant Banks	No threshold applies	1 Mar 2017
Phase-in implementation schedule – IM requirements	**MAS Covered Entity**	**Threshold**	**Commencement Date**
	Licensed Banks	S$4.8 trillion[152]	1 Sep 2016
	Licensed Banks and Approved Merchant Banks	S$4.8 trillion[152]	1 Mar 2017
	Licensed Banks and Approved Merchant Banks	S$3.6 trillion[153]	1 Sep 2017
	Licensed Banks and Approved Merchant Banks	S$2.4 trillion[154]	1 Sep 2018
	Licensed Banks and Approved Merchant Banks	S$1.2 trillion[155]	1 Sep 2019
	Licensed Banks and Approved Merchant Banks	S$13 billion[156]	1 Sep 2020

152 Calculated on the Group's Aggregate Notional for March, April and May 2016.
153 Calculated on the Group's Aggregate Notional for March, April and May 2017.
154 Calculated on the Group's Aggregate Notional for March, April and May 2018.
155 Calculated on the Group's Aggregate Notional for March, April and May 2019.
156 Calculated on the Group's Aggregate Notional for March, April and May of the relevant year.

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