

Final draft - Hong Kong margin and other risk mitigation standards for non-centrally cleared OTC derivatives

In December 2016, the Hong Kong Monetary Authority (HKMA) released a final draft of *Supervisory Policy Manual (SPM) CR-G-14*, which contains margin requirements and risk mitigation standards (RMS) for non-centrally cleared over-the-counter (OTC) derivative transactions undertaken by authorised institutions (AIs). Regulators in other jurisdictions, including Europe, the US, Australia, India, Japan and Singapore, have also released their own versions of these rules. **What impact will the new margin requirements have on banks in Hong Kong?**

Requirement for margin to be posted/collected in respect of transactions between an AI and a covered entity

Under the new requirements, a non-centrally cleared OTC derivative transaction between an AI and a 'covered entity' (i.e. a financial counterparty or a significant non-financial counterparty) entered into after the relevant effective date may become subject to a requirement to collect or post margin subject to the following implementation timeline:

Variation margin

- The effective date for variation margin (VM) requirements is **1 March 2017** for all non-centrally cleared derivatives entered into with a covered entity.

Initial margin and risk mitigation standards

- The requirement to exchange initial margin (IM) and comply with the RMS applies in a one-year period (i.e. from 1 September of each year to 31 August of the following year), where both the AI and covered entity have an average aggregate notional amount of non-centrally cleared derivatives (calculated as the average of the total gross notional amount of month-end positions on a group-wide basis), exceeding the respective threshold:

HKD 24 trillion

Mar 2017 to Aug 2017

HKD 18 trillion

Sept 2017 to Aug 2018

HKD 12 trillion

Sept 2018 to Aug 2019

HKD 6 trillion

Sept 2019 to Aug 2020

HKD 60 billion

Yearly from Sept 2020

- The HKMA is encouraging AIs to adopt the RMS in relation to other derivatives counterparties to the extent practicable, taking into account the nature of the transaction and counterparty.
- The threshold for adopting the RMS will reduce to zero from 1 September 2021 onwards.

The margin provisions and RMS are subject to an initial six-month transition period (i.e. **1 March to 31 August 2017**). During this period, AIs are expected to start exchanging margin and applying the RMS as soon as possible after the commencement date, and make reasonable and continuous progress in order to achieve full compliance by **31 August 2017**.

Variation margin and initial margin compared

	Variation margin	Initial margin																						
Frequency of posting/ collection	<ul style="list-style-type: none"> VM should be calculated at least on a daily basis and be called no later than the end of the following Hong Kong business day (T+1). VM should be collected within the standard settlement cycle for the relevant collateral type but no later than two business days after the VM has been called. 	<ul style="list-style-type: none"> The IM amount for a given counterparty has to be recalculated at least every 10 Hong Kong business days. IM should be called at the earliest time possible after either execution of a transaction or any of the following events no later than the end of the following Hong Kong business day (T+1): <ul style="list-style-type: none"> The relevant netting set changes (e.g. new transactions are conducted, existing transactions are terminated or expire) Changes to the internal IM model are made which affect IM amounts Changes are made to the classification of an existing contract to a specific asset category. IM should be collected within the standard settlement cycle for the relevant collateral type but no later than two business days after IM has been called. 																						
Calculation methodology	<ul style="list-style-type: none"> The amount exchanged should be the VM amount needed to fully collateralise the current exposure. Exposures across different instruments should only be netted where there is a single, legally enforceable netting agreement. Alis should have rigorous and robust dispute resolution mechanisms in place to ensure they agree on the amount to be exchanged. 	Either: Standardised method with some netting, applying the below percentages: <table border="1"> <thead> <tr> <th>Asset class</th><th>IM requirement (% of notional exposure)</th></tr> </thead> <tbody> <tr> <td>Interest rate: 0-2 year duration</td><td>1</td></tr> <tr> <td>Interest rate: 2-5 year duration</td><td>2</td></tr> <tr> <td>Interest rate: 5+ year duration</td><td>4</td></tr> <tr> <td>Foreign exchange</td><td>6</td></tr> <tr> <td>Commodity</td><td>15</td></tr> <tr> <td>Equity</td><td>15</td></tr> <tr> <td>Credit: 0-2 year duration</td><td>2</td></tr> <tr> <td>Credit: 2-5 year duration</td><td>5</td></tr> <tr> <td>Credit 5+ year duration</td><td>10</td></tr> <tr> <td>Other</td><td>15</td></tr> </tbody> </table> Or: Internal model approach (subject to conditions)	Asset class	IM requirement (% of notional exposure)	Interest rate: 0-2 year duration	1	Interest rate: 2-5 year duration	2	Interest rate: 5+ year duration	4	Foreign exchange	6	Commodity	15	Equity	15	Credit: 0-2 year duration	2	Credit: 2-5 year duration	5	Credit 5+ year duration	10	Other	15
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Treatment of margin collected	<ul style="list-style-type: none"> No requirement to segregate 	<ul style="list-style-type: none"> IM collected should be segregated from the IM collector's proprietary assets by either placing the IM with a third-party custodian or through other legally effective arrangements. Rehypothecation, repledging or any kind of reuse of IM collected is prohibited. 																						
Collateral haircuts and concentration requirements	<ul style="list-style-type: none"> Haircuts ranging from 0% (cash funds in same currency) to 15% (eligible equities and gold) are applied to collateral received in respect of both VM and IM. Alis should have appropriate policies and procedures in place to monitor and manage the concentration risk that may arise from the assets collected as collateral, and should determine appropriate limits as part of their overall risk management process. 																							

Risk mitigation standards

Trading relationship documentation



An AI should 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.

These should be approved by the board or, if the board decides to delegate such authority, a designated committee, and should be subject to periodic independent internal or external review.

There is a minimum five-year retention period for the documentation and any modification.

Trade confirmation



Trade confirmation should be completed as soon as practicable, depending on the type of non-centrally cleared derivative entered into.

The relevant confirmation should be in writing via non-rewritable, non-erasable automated methods where it is reasonably practicable for the relevant counterparties to the transaction to do so.

A two-way confirmation should be executed:

- For interest rate swaps and credit default swaps: by T+1 from and after 1 March 2017
- For other product types: by T+2 from 1 September 2017 to 2 February 2018; and by T+1 from and after 1 March 2018.

Where one-way rather than two-way confirmation is used, AIs should provide an acknowledgement within the relevant timeframe set out above, and give a deadline for the counterparty to object. AIs should maintain records of transactions that remain unconfirmed after five business days from the execution date of the transactions.

Valuation with counterparties



An AI should agree with its counterparties on, and clearly document in writing, the process that will be relied upon for determining the value of non-centrally cleared derivatives.

All agreements on the valuation process should be documented in the trading relationship documentation or trade confirmation.

An AI should perform periodic review of the agreed-upon valuation process to take into account any changes in market conditions.

Portfolio reconciliation



Portfolio reconciliation should be performed by an AI:

- Where the other counterparty is a financial or significant non-financial counterparty:
 - (i) **Each business day** when the AI and the counterparty have **500 or more outstanding** non-centrally cleared derivatives with each other; or
 - (ii) **Once per week** when the AI and the counterparty have **between 51 and 499 outstanding** non-centrally cleared derivatives with each other at any time during the week; or
 - (iii) **Once per quarter** when the AI and the counterparty have **50 or less outstanding** non-centrally cleared derivatives with each other at any time during the quarter.
- For all other counterparties:
 - (i) **Once per quarter** when the AI and the counterparty have **more than 100 outstanding** non-centrally cleared derivatives with each other at any time during the quarter; or
 - (ii) **Once per year** when the AI and the counterparty have **100 or less outstanding** non-centrally cleared derivatives with each other.

Portfolio compression



An AI should establish and implement policies and procedures to regularly assess, and to the extent appropriate, engage in portfolio compression by replacing economically equivalent transactions by decreasing the number of transactions and/or notional value of a portfolio of non-centrally cleared derivatives transactions. Portfolio compression may be performed on a bilateral or multilateral basis.

Dispute resolution



An AI should agree with its counterparties on, and document, the mechanism or process for determining when discrepancies should be considered disputes and how they should be resolved.

An AI should report to the HKMA any material disputes in excess of HKD 100 million (or its equivalent in any other currency) if not resolved within 15 business days.

Consequences of non-compliance

The HKMA has indicated in the final draft SPM module that they will consider any non-compliance by an AI with the standards under **CR-G-14** on a case-by-case basis to determine whether any supervisory action is warranted to address any identified risk.

Such actions may include requiring the AI to submit a report under section 59(2) of the Banking Ordinance (BO) to identify the root causes of any deficiency in margining or risk mitigation practices for future rectification, and issuing directions under section 52 of the BO to the AI to strengthen its internal control systems.

Significant instances of non-compliance with the standards in **CR-G-14** may cause the MA to undertake a review of whether the AI remains in compliance with the authorisation criteria in the Seventh Schedule to the BO.

Adherence to **CR-G-14** will be reflected in an AI's CAMEL rating and/or supervisory review process assessment.

An AI is expected not to enter into a non-centrally cleared derivatives transaction if it is aware prior to entering into the transaction that the standards will not be met.

Key challenges facing AIs

AIs will need to confirm the status of their counterparties to determine whether or not they are in scope for the new margin and risk mitigation requirements. They will also need to ensure they have appropriate legal arrangements in place with counterparties in order to qualify for netting of exposures for margin calculation purposes. A key initial step for any impact analysis is the calculation of the average of the total gross notional amount of month-end positions of non-centrally cleared derivatives which is calculated on a group level by including all non-centrally cleared derivatives of all entities within the group of companies to which the AI belongs. This calculation is required to determine the date from which the IM requirements and RMS apply.

There are a number of exemptions available, including exemptions for certain types of instruments, an intra-group exemption, and exemptions available in circumstances where there is reasonable doubt as to the enforceability of the netting agreement and the protection of posted collateral upon insolvency or bankruptcy of a counterparty. An AI may elect not to exchange VM and IM with a significant non-financial counterparty that predominantly uses non-centrally cleared derivatives transactions for hedging purposes. There are, however, conditions attached to these exemptions and AIs will need to assess whether or not the exemptions apply, and establish processes and controls to ensure compliance on an ongoing basis.

AIs undertaking cross-border transactions will need to consider how the requirements set by authorities in those jurisdictions (e.g. the US, EU, Australia, Singapore, Japan, India and Korea) would apply to the transaction.

Substituted compliance is available on a deemed basis for a number of jurisdictions, meaning that an AI may follow the margin requirements applicable to its counterparty in their entirety instead of the margin provisions in **CR-G-14**.

Where an AI wishes to use an advanced internal models approach to calculate the initial margin requirement, it may need formal approval from the HKMA where the model is not an industry standard model. Where an industry standard model is used, notification to the HKMA is required.

AIs will need to put in place appropriate policies, procedures, processes and systems to ensure compliance with the new requirements. Key areas of consideration for the implementation project include the following:

- Process for identifying relevant transactions that are subject to margin requirements under CR-G-14
- Process for the information exchange within the group for purposes of calculating the consolidated average aggregate notional amount and the IM threshold
- Documented approaches used for calculating VM and IM, and processes implemented which ensure that counterparties agree on these approaches before entering into non-centrally cleared derivatives
- Process for use of an internal model to calculate IM
- Process for management of collateral for margin purposes and applying required haircuts
- Process to monitor and manage concentration risk
- Process to ensure the timely settlement of margin
- Process to ensure proper treatment and segregation of IM collected.

What AIs need to start doing now

In order to meet the implementation deadline for the margin and risk mitigation requirements for non-centrally cleared OTC derivatives, AIs should consider performing the following tasks immediately:

- Calculating the average of the total gross notional amount of month-end positions of non-centrally cleared derivatives on a group-wide basis to determine whether or not the AI's group has exceeded the HKD 24 trillion threshold
- Undertaking an impact analysis to determine which counterparties are likely to fall under the definition of 'covered entity' and whether or not they could be over the HKD 24 trillion threshold
- Where the AI is expected to be in scope for initial margin requirements, reviewing whether or not adoption of an advanced internal model approach is feasible, and begin planning for the implementation of such an approach
- Conduct a review of the gaps between the AI's existing processes, procedures and systems and the requirements of CG-R-16, and prepare a plan to address those gaps by 31 August 2017.

How KPMG can assist AIs to prepare for the requirements

Our Financial Risk Management and Advisory teams are well placed to support AIs as they prepare for these new requirements, including as follows:

<ul style="list-style-type: none"> • Perform an impact analysis • Estimate margin required • Organise PMO and staff secondments • Handle data cleansing & standardisation • Conduct post-implementation reviews & testing 	<ul style="list-style-type: none"> • Validate risk models • Design and optimise risk models • Assist preparation for internal models applications • Advise on legal entity booking 	<ul style="list-style-type: none"> • Design policies, procedures & internal controls • Advise on data architecture & system design • Write business requirement documents
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Given the timing of implementation, it is critical that AIs quickly assess the impact of these new requirements and make the necessary changes to their policies, procedures and internal processes.

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