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Briefing note

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Hong Kong publishes consultation on margin requirements for uncleared OTC derivatives transactions

On 3 December 2015, the Hong Kong Monetary Authority (HKMA) published a consultation paper (the Consultation Paper) containing a draft module (the Margin Module) for the HKMA's Supervisory Policy Manual. The purpose of the Margin Module is to introduce margin requirements for uncleared OTC derivatives transactions for authorised institutions regulated in Hong Kong. The largest authorised institutions will need to exchange initial margin and variation margin with certain counterparties starting in September 2016, with the requirements expanding over time to cover a wide variety of market participants.

Introduction

The introduction of margin requirements is considered one of the key pillars of OTC derivatives regulatory reform following the global financial crisis to ensure stability in the OTC derivatives markets. On a bilateral level, exchange of margin forces parties to internalise the cost of risk-taking and encourages market participants to carefully consider the level of risk they accumulate in the form of OTC derivatives. On a systemic level, exchange of margin limits contagion on default of a major financial institution by ensuring that collateral is available to offset losses.

However, for market participants, margin requirements are generally considered to be the most costly and challenging aspect of the OTC derivatives reforms agenda.

Authorised institutions (AIs) will be relieved that the margin requirements proposed in Hong Kong are largely in line with the revised Final Policy Framework on margin requirements published by BCBS-IOSCO in March 2015 (the BCBS-IOSCO Paper), although several important variations have been identified (and are highlighted in this client briefing).

The Consultation Paper follows the draft regulatory technical standards on margin requirements published by the European Supervisory Authorities in June 2015, the final rules published by the United States Prudential Regulators in October 2015 and the United States Commodity Futures Trading Commission in December 2015, and the consultation paper on margin requirements published by the Monetary Authority of Singapore in October 2015. Although each jurisdiction has sought to align their margin proposals with the BCBS-IOSCO Paper, differences between the rules of each jurisdiction have emerged and it is critical for market participants to be aware of these.

This client briefing will summarise the key issues to note in the Margin Module and compare the proposals introduced in Hong Kong with the equivalent proposals being introduced in other major jurisdictions such as the United States, Europe and Singapore.

Key Issues

- Margin requirements will be introduced for **authorized institutions** in Hong Kong phasing in from **1 September 2016**.
- The margin requirements will apply when an authorized institution enters into **uncleared OTC derivatives** with a large range of **financial counterparties** and **significant non-financial counterparties**.
- Authorized institutions will need to **classify their counterparties** and put in place appropriate **collateral documentation** to comply with the margin requirements.

Scope of Proposals

As the Margin Module will form part of the HKMA's Supervisory Policy Manual (SPM), the margin requirements contained in the Margin Module are applicable only to AIs, and only when they trade with a "Covered Entity" – financial counterparties, significant non-financial counterparties and other designated entities. For more details on what the SPM is and its legal effect, please see the textbox "What is the Supervisory Policy Manual?" below. For more details on what constitutes a Covered Entity, please see the textbox "What is a Covered Entity?" on the next page.

Scope of Instruments

The margin requirements will apply to all uncleared OTC derivatives transactions, with the only exception being that initial margin (IM) requirements do not apply to (a) physically settled FX forwards and swaps and (b) the FX transaction component embedded in cross-currency swaps. Market participants should note that variation margin (VM) requirements will apply to physically settled FX forwards and swaps under the Hong Kong proposals. Given the large volume of FX derivatives traded in the Asia Pacific region (particularly by fund counterparties), the requirement to exchange VM for physically settled FX forwards and swaps means that market participants may face higher trading costs in the future. This may drive market participants to explore new structures and/or counterparties for FX hedging in the future.

What is the Supervisory Policy Manual?

- The SPM sets out the HKMA's supervisory policies and practices which AIs are expected to comply with.
- The SPM applies only to AIs. It does <u>not</u> apply to licensed corporations, other types of regulated institutions or unregulated Hong Kong incorporated companies.
- Modules under the SPM fall into three general categories: (a) statutory guidelines, (b) guidance notes and (c) technical notes. The Margin Module is a statutory guideline, which is the "strictest" category.
- While statutory guidelines do not themselves have the force of law, breach of the Margin Module may result in (a) a fine from the HKMA, (b) a reprimand from the HKMA and/or (c) revocation of an AI's banking licence (see paragraph 1.4.2 of the SPM).

Francis Edwards
Partner,
Derivatives and Structured Products

"Hong Kong is a significant derivatives trading hub for Asia Pacific and is committed to meeting the BCBS-IOSCO standards for margin for non-centrally cleared derivatives. The imposition of these regulatory margin requirements will be a significant change for the Hong Kong market; it will require a substantial build out of operational and documentation infrastructure by market participants. While implementation will be phased in over time, the economic consequences of the increased requirements to post collateral will be felt across the market. What regulators must not to do is increase legal risk in the name of reducing credit and systemic risk, for example by requiring exchange of collateral in non-netting jurisdictions where that would increase rather than reduce counterparty risk."

Covered Entities

The level of compliance required depends on (a) whether the AI is incorporated in Hong Kong or outside of Hong Kong, and (b) whether the Covered Entity is incorporated in Hong Kong or outside of Hong Kong. There are three different levels of compliance under the Margin Module:

– where an AI incorporated in Hong Kong (an AI(HK)) is trading with a Covered Entity that is incorporated in Hong Kong (a CE(HK)), the AI will need to comply fully with the requirements in the Margin Module;

– where (i) an AI(HK) is trading with a Covered Entity that is incorporated outside Hong Kong (a CE(NonHK)) or (ii) an AI incorporated outside Hong Kong (an AI(NonHK)) is trading with an AI(HK), the AI will need to collect margin on the basis of the requirements set out in the Margin Module, but is permitted to post margin on the basis of the requirements imposed in the jurisdiction of the AI's counterparty (Partial Compliance) (see paragraph 2.1.6 of the Margin Module); and

– where an AI(NonHK) is trading with (i) a CE(NonHK) or (ii) a CE(HK) (except for AI(HK)s), the AI may comply with the margin requirements imposed in the jurisdiction where the AI is incorporated (Substituted Compliance).

It is important to note that for AI(NonHK)s, the Margin Module applies only to transactions that are booked into the Hong Kong branch of such AI. Furthermore, Partial

Compliance and Substituted Compliance will be available only if the HKMA has issued a "comparability determination" in respect of the relevant foreign jurisdiction.

Comparability Determination

Comparability determinations, which are critical to enable Partial Compliance and Substituted Compliance, are initiated by an AI or foreign supervisory authority making an application to the HKMA. This application must contain the information set out at paragraph 2.3.2 of the Margin Module, which includes a description of the foreign jurisdiction's margin requirements as well as the differences between such jurisdiction's margin requirements and the BCBS-IOSCO Paper. The HKMA will carry out a comparability assessment using an outcome-based approach. In other words, the HKMA will consider that the margin rules of a foreign jurisdiction are comparable if they achieve outcomes which are comparable to those sought in the Margin Module as well as the BCBS-IOSCO Paper. It should be noted that even where a comparability determination is made by the HKMA, additional conditions may be imposed as the HKMA deems appropriate.

What level of compliance is required?

- *Full Compliance*: AI(HK)s facing CE(HK)s
- *Partial Compliance*: AI(HK)s facing CE(NonHK)s or AI(NonHK)s facing AI(HK)s
- *Substituted Compliance*: AI(NonHK)s facing CE(NonHK)s or CE(HK)s (except AI(HK)s)

Timing

The timeline for introduction of margin requirements under the Margin Module is largely in line with the BCBS-IOSCO Paper.

Variation Margin

The obligation to exchange VM commences on 1 September 2016 if both the AI and the Covered Entity have an average aggregate notional amount of uncleared OTC derivatives exceeding HKD 24 trillion (approximately USD3.1 trillion), with the threshold requirement falling away from 1 March 2017.

The obligation to exchange IM will be phased in from 1 September 2016 to 1 September 2020, depending on the size of the average aggregate notional amount of uncleared OTC derivatives for both the AI and the Covered Entity, as follows:

Period	Threshold
1 September 2016 to 31 August 2017	HKD 24 trillion (approximately USD 3.1 trillion)
1 September 2017 to 31 August 2018	HKD 18 trillion (approximately USD 2.32 trillion)
1 September 2018 to 31 August 2019	HKD 12 trillion (approximately USD 1.55 trillion)
1 September 2019 to 31 August 2020	HKD 6 trillion (approximately USD 0.77 trillion)
1 September 2020 onwards	HKD 60 billion (approximately USD 7.74 billion)

What is a Covered Entity?

Includes:

- *Financial counterparties*: (a) AIs, LCs, regulated insurance companies, regulated money lenders, pension funds (and any entity outside of Hong Kong that would be regulated as one of these types of entities if in Hong Kong), and (b) collective investment schemes, securitization vehicles and private equity funds
- *Significant non-financial counterparty*: any entity which is not a financial counterparty but has a portfolio of uncleared OTC derivatives transactions exceeding HKD60 billion (approximately USD7.74 billion) in notional amount
- *Designated entities*: Any entities designated by the HKMA

Excludes:

- Sovereigns, central banks and public sector entities
- Multilateral development banks
- Bank for International Settlements

Average aggregate notional amount

An entity's "average aggregate notional amount of uncleared OTC derivatives" is calculated on the basis of paragraph 2.4.6 of the Margin Module, by reference to the group of company's total gross notional amount of month-end positions of uncleared OTC derivatives (including physically settled FX forwards and swaps) for March, April and May preceding the relevant 1 September starting date. Transactions denominated in a non-HKD currency should be converted into HKD using the relevant month-end spot rate.

It should be noted that the Hong Kong margin requirements will apply only to OTC derivatives transactions entered into after the relevant threshold is crossed and does not apply to existing transactions.

Transactions guaranteed by AI

Uncleared OTC derivatives entered into between Covered Entities that are not AIs may still be in scope of the Margin Module if one of the Covered Entity's obligations are guaranteed by an AI (such Covered Entity, a "**Guaranteed Entity**"). The Margin Module will apply to the uncleared OTC derivatives transaction if the guarantee fulfils the following criteria:

1. the Covered Entity that is counterparty to the Guaranteed Entity must have a "legally enforceable right of recourse" against the guaranteeing AI;
2. the guarantee must be explicit and cover the obligations arising from the uncleared OTC derivatives transaction;
3. the guarantee must cover uncleared OTC derivatives transactions of at least HKD60 billion notional amount (approximately USD7.74 billion); and
4. where the guaranteeing AI is an AI incorporated outside of Hong Kong, the guarantee must be booked into the AI's Hong Kong branch.

The guaranteeing AI is responsible for ensuring that the Guaranteed Entity complies with the margin standards in the Margin Module as if the Guaranteed Entity were the guaranteeing AI itself.

A similar requirement is included in the latest draft of the European rules, and the key question that has arisen is in relation to determining whether the notional amount of uncleared OTC derivatives transactions has exceeded the guarantee threshold. In particular, market participants have queried whether it is necessary to aggregate the notional amount of transactions under all guaranteed ISDA Master Agreements, even if technically there are separate guarantees for each ISDA Master Agreement.

Margin Methodology and Eligibility

IM Model

In relation to IM, AIs can choose between a "standardised approach" and an "internal model approach" to determining the amount of IM required in respect of an OTC derivatives transaction. Different approaches can be used for different asset classes (e.g. standardised approach for interest rate derivatives and internal model approach for equity derivatives). Details for each approach are set out in the appendix to the Margin Module. It should be noted that for the internal model approach, the relevant IM model must be approved by the HKMA prior to use. Market participants should be aware that ISDA is currently developing a Standard Initial Margin Model (SIMM) which can be used by market participants globally. This project will be critical to reducing the amount of preparatory work which market participants need to undertake before the margin requirements come into force. However, with respect to Hong Kong, each AI needs to obtain approval from the HKMA to use the SIMM, even if another AI has already received approval to use the SIMM (see paragraph B.1.2 of Appendix B of the Margin Module).

Rehypothecation and Segregation

The HKMA has proposed that rehypothecation, repledging or any kind of reuse of IM should be prohibited. This requirement is stricter than the principles set out under the BCBS-IOSCO Paper as well as the equivalent proposals put forward in Singapore (although it is in line with the standards in the United States and Europe). While rehypothecation under the Singapore proposals remains limited (one-time only and subject to strict conditions), the inability to conduct any form of rehypothecation under the Hong Kong margin rules means that there is a substantive difference between the Singapore and Hong Kong rules. This may impact, amongst other things, the ability for Hong Kong to make a comparability determination for Singapore.

Under the Margin Module, an AI needs to ensure that IM is segregated from the proprietary assets of the party collecting the IM. However, the rules do not mandate that such IM must be held with a third party custodian. This is more generous than the United States proposals but is in line with other jurisdictions like Europe.

Key Issues

A. Counterparties from non-netting jurisdictions

One of the key issues in relation to the Margin Module is the treatment of uncleared OTC derivatives transactions with counterparties incorporated in non-netting jurisdictions. The BCBS-IOSCO framework was designed on the basis of legally enforceable netting arrangements, which is problematic for the Asia Pacific region given the relatively high number of non-netting jurisdictions when compared with North America and Europe. The Margin Module proposes that when facing a counterparty from a non-netting jurisdiction, an AI should post and collect VM and collect IM, both calculated on a gross basis. There are several potential challenges with this proposal:

(a) as the HKMA acknowledges, posting margin to a counterparty in a non-netting jurisdiction involves the risk that the party posting the margin may not recover their margin in the event that the counterparty becomes insolvent. Although the HKMA has provided that IM does not need to be posted, it is curious why the HKMA remains of the view that VM should be posted since the same risk applies;

(b) the requirement to post margin on a gross basis will make uncleared OTC derivatives transactions with counterparties from non-netting jurisdictions costly for AIs. This may lead certain AIs to re-consider whether they should conduct business in certain non-netting jurisdictions and put AIs at a competitive disadvantage compared with financial institutions from other jurisdictions that are not subject to similar margin requirements; and

(c) it may be difficult to convince counterparties from non-netting jurisdictions to enter into credit support arrangements that provide for asymmetrical margin requirements between the two parties.

We consider that the *de minimis* proposal set out by the HKMA under paragraph 22 of the Consultation Paper is a much more practical solution to addressing counterparties in non-netting jurisdictions. The *de minimis* proposal provides that, so long as the proportion of an AI's portfolio of uncleared OTC derivatives transactions with counterparties from non-netting jurisdictions is below a certain threshold, the AI will not be required to apply the margin requirements in the Margin Module to such transactions. This proposal has the dual benefit of (i) removing the requirement for AIs to increase their exposure to counterparties in non-netting jurisdictions by posting margin to such counterparties and (ii) regulating the level of risk which AIs are permitted to face with counterparties from non-netting jurisdictions (based on the threshold level).

B. Counterparties not subject to margin requirements

The HKMA has identified that the margin requirements need to be tailored for circumstances where an AI is facing a counterparty which is not subject to margin requirements. This may be because (a) the counterparty is from a jurisdiction that has not yet introduced margin requirements (and may not do so) or (b) the counterparty is incorporated in Hong Kong but is not a Covered Entity. When facing counterparties described under paragraph (a), the Margin Module proposes that an AI does not need to post IM because the counterparty may not have the appropriate infrastructure to handle and segregate IM properly. When facing counterparties described under paragraph (b), the Margin Module proposes than an AI should post IM only if the AI considers that the counterparty has arrangements in place to sufficiently protect the AI in case of the counterparty's insolvency. In both cases, the AI remains obliged to collect IM from such counterparties.

C. Exemption for intragroup transactions

Uncleared OTC derivatives transactions between an AI and entities in the same consolidated group of companies are exempt from the requirements in the Margin Module, provided that (a) the consolidated group is subject to group-wide supervision by the HKMA or a supervisory authority in another jurisdiction or (b) the consolidated group has a group-wide integrated risk management function. However, on an exceptional basis, the HKMA can impose margin requirements for intragroup transactions e.g. if a company within the group is under financial distress. This may potentially be counter-productive as if an entity within a consolidated group is under financial distress, any margin requirements imposed on transactions involving such entities may create liquidity issues and thereby magnify the extent of the problem. Given the recent trend for financial institutions to be rehabilitated through resolution procedures, it seems that the power to impose margin requirements in such circumstances should be removed.

However, we generally note that the exemption under the Margin Module is more generous to market participants than the equivalent rules in the United States (where VM is still required) and Europe (where the intragroup exemption requires pre-approval or pre-notification and, in relation to cross-border transactions, an equivalence determination with respect to the counterparty's jurisdiction).

D. FX Haircut

In line with the BCBS-IOSCO framework, the Margin Module contains a standardized haircut schedule with respect to collateral posted to meet margin requirements.

Terry Yang
Consultant,
Derivatives and
Structured Products

"Locally incorporated authorized institutions need to appreciate the enormous amount of preparatory work involved in complying with the margin requirements being introduced in 2016. Not only do they need to classify each of their counterparties accurately, but they will also need to put in place new collateral documents – all within the span of about one year."

One of the key issues for market participants under the United States and European margin rules has been the application of an 8% haircut (the "**FX Haircut**") for currency mismatch between margin collateral and the currency of transfer/settlement for the uncleared OTC derivatives transaction. The HKMA has proposed more generous rules relating to the application of the FX Haircut. For VM, the FX Haircut will not apply if margin is posted in the form of cash. For IM, the FX Haircut will apply only if margin (cash and non-cash) is posted in a currency other than the one which the relevant party selected as the termination currency. Each party is allowed to select their own termination currency (e.g. one party may select HKD while the other party selects USD). This is consistent with ISDA's proposals, as highlighted in their letter to the Canadian regulators dated 24 November 2015.

Risk Mitigation

Hong Kong is the second jurisdiction in the Asia Pacific region (following Singapore) to propose the introduction of risk mitigation obligations for uncleared OTC derivatives transactions. These proposals are in line with the standards proposed by IOSCO in January 2015 and include requirements relating to (a) trading relationship documentation, (b) trade confirmation, (c) portfolio reconciliation and (d) dispute resolution.

While the Margin Module provides that the risk mitigation standards apply only in respect of transactions between AIs and Covered Entities, the HKMA encourages AIs to adopt such risk mitigation standards for transactions with non-Covered Entities as well. Substituted compliance is available for risk mitigation requirements under the Margin Module, provided that the HKMA has issued a comparability determination with respect to the relevant foreign jurisdiction.

The Margin Module expressly provides (under paragraph 2.2.5) that any third party service provider engaged to comply with risk mitigation standards must comply with the outsourcing guidelines under SPM SA-2. This includes carrying out a risk assessment in relation to the third party service provider, ensuring data confidentiality and having appropriate contractual documentation in place.

The HKMA has proposed that risk mitigation standards should follow the same timeline as the introduction of VM. Given that, unlike margin requirements, there is no international timetable for the introduction of risk mitigation standards, it may be appropriate for the HKMA to consider delaying the implementation of risk mitigation standards to allow market participants to first focus on compliance with the margin requirements under the Margin Module. Market participants in Hong Kong may already face a shortage of time and resources in managing all of the documentary and operational requirements involved in preparing for the introduction of mandatory clearing and margining during the course of 2016.

Key Terms

- *AI*: Authorized institution – entities that hold banking licenses issued by the HKMA.
- *HKMA*: The Hong Kong Monetary Authority, the regulatory authority for banks in Hong Kong.
- *IM*: Initial margin – collateral to cover the potential future exposure arising from future changes in the mark-to-market value of an OTC derivatives transaction during the time it takes to close out and replace the position on default of the counterparty.
- *LCs*: Licensed corporations – securities firms authorised by the SFC to carry out various regulated activities (such as dealing in securities).
- *SFC*: The Securities and Futures Commission, the regulatory authority for securities firms in Hong Kong.
- *VM*: Variation margin – collateral to cover current exposure arising from the daily mark-to-market fluctuations in the value of an OTC derivatives transaction.

Challenges and future developments

Timing

Unlike the reporting and clearing rules for OTC derivatives transactions, which required subsidiary legislation to implement, the margin rules under the Margin Module do not need to go through the Hong Kong Legislative Council in order to become effective. This is because the HKMA has the power under the Banking Ordinance to publish modules for the SPM. As a result, it is anticipated that there will be only one opportunity for market participants to comment on the Margin Module before it is finalised. Since the margin requirements will become effective in September 2016, we expect the Margin Module to be published by the HKMA in the first quarter of 2016 to allow market participants sufficient time to prepare.

Licensed Corporations

It is also anticipated that the SFC will introduce similar margin requirements for LCs in due course through the SFC Code of Conduct. Like the Margin Module, legislative approval from the Legislative Council is not required for amendments to the SFC Code of Conduct.

Apart from the operational challenges which market participants need to address in preparing for the impending margin requirements, from a legal perspective, there will be three major tasks to accomplish in 2016:

1. AIs (particularly those conducting extensive cross-border trading) will need to identify the relevant jurisdictions in respect of which they would like the HKMA to issue comparability determinations for. They will then need to co-ordinate with the relevant supervisory authorities and/or other market participants to ensure that an appropriate comparability assessment application is submitted to the HKMA in time for the HKMA to issue a comparability determination prior to September 2016.

2. AIs will need to formulate an efficient and effective method for classifying their counterparties for the purposes of identifying which counterparties they need to exchange margin with. Given the wide definition of Covered Entity, particularly as the definition captures entities which would be regulated as an AI or LC if they were conducting business in Hong Kong, the counterparty classification exercise will be challenging for market participants.

3. AIs will need to modify or enter into new collateral and custody documentation with their counterparties to comply with the new margin requirements. While ISDA and market participants are working to prepare an industry-wide solution, one of the main challenges in the Asia Pacific region may be to persuade regional counterparties to adopt documentary solutions designed primarily for the United States and European OTC derivatives markets.

Having worked extensively with market participants and trade associations across the globe (including the United States, Europe, Singapore, Hong Kong and other jurisdictions) to prepare for the upcoming margin requirements, we look forward to working together with market participants during the course of 2016 to resolve any implementation challenges and develop a safer and more robust OTC derivatives market.

Contact Us

Francis Edwards
Partner, Derivatives and Structured Products
T:+852 2826 3453
E: Francis.Edwards@CliffordChance.com

Mark Shipman
Partner, Funds and Investment Management
T: +852 2825 8992
E: Mark.Shipman@CliffordChance.com

Matthias Feldmann
Partner, Funds and Investment Management
T:+852 2825 8859
E: Matthias.Feldmann@CliffordChance.com

Terry Yang
Consultant, Derivatives and Structured Products
T: +852 2825 8863
E: Terry.Yang@CliffordChance.com