

Preparing for fast-approaching margin requirements for non-centrally cleared derivatives

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Derivatives regulatory reform in Canada continues, with new margin requirements for non-centrally cleared derivative transactions coming into effect on March 1, 2017. Most financial entities that trade with Canadian federally regulated financial institutions and that have significant derivatives trading volume will be affected. This Osler Update outlines the scope of the requirements and what needs to be done to comply.

Major implementation date for new variation margin rules is fast approaching

In September 2016, the Office of the Superintendent of Financial Institutions (OSFI) Guideline E-22 – *Margin Requirements for Non-Centrally Cleared Derivatives* (the Guideline) took effect, which prescribes initial and variation margin requirements for non-centrally cleared derivative transactions undertaken by federally regulated financial institutions (FRFIs). The first major implementation date for the Guideline is **March 1, 2017**, which is when expanded variation margin requirements will come into effect. The new variation margin requirements will apply to all Covered FRFIs (as defined below) when transacting with another Covered Entity (as defined below).

In order to prepare for and comply with the new variation margin requirements, banks and other FRFIs regulated by OSFI have begun checking the status of their counterparties under the Guideline and preparing new documentation when the Guideline applies. Counterparties that transact in non-centrally cleared derivatives with FRFIs should therefore familiarize themselves with the Guideline to determine their new obligations (if any) to exchange variation margin. If the Guidelines apply, then, at a minimum, the old forms of credit support annexes will need to be amended or replaced by new forms that comply with the new requirements. If no credit support annexes are currently in place, parties will need to enter into the new forms of credit support annexes. The negotiation and preparation of these documents could take multiple weeks, if not months. Accordingly, the affected parties are advised to commence this process sooner than later. See “Preparing for new requirements” below.

Margin requirements apply to Covered FRFIs when trading with Covered Entities

For all non-centrally cleared derivative transactions with counterparties that met the definition of Covered Entity as of September 1, 2016, Covered FRFIs must exchange variation margin with that counterparty in accordance with the Guideline on all new transactions

starting March 1, 2017. Subject to limited exclusions, a “Covered Entity” is a legal entity whose main business includes the management of financial assets, lending, factoring, leasing, provision of credit enhancements, securitization, investments, financial custody, proprietary trading, and/or other financial services activities which, either alone or as part of a consolidated group (not including inter-affiliate trades), has an aggregate month-end average notional amount of non-centrally cleared derivatives for March, April and May of 2016 and any year thereafter that exceeds \$12 billion. Where an FRFI meets the definition of Covered Entity, it is referred to as a “Covered FRFI.”

Counterparties that do not qualify as a Covered Entity based on 2016 figures may fall into the definition of a Covered Entity based on their aggregate month-end average notional amount of non-centrally cleared derivatives for March, April and May of a future year. In this scenario, Covered RFIs must exchange variation margin with such counterparty in accordance with the Guideline on all new transactions starting September 1 of the year in which the counterparty becomes a Covered Entity.

Counterparties in foreign jurisdictions

For a non-Canadian counterparty that trades with a Covered FRFI, the rules of the counterparty’s home jurisdiction can be deferred to for purposes of determining whether the counterparty is a Covered Entity, **provided** that the Covered FRFI has documentary evidence that the counterparty is in a jurisdiction that has implemented regulations comparable to the BCBS-IOSCO margin requirements for non-centrally cleared derivatives framework (the BCBS-IOSCO Framework) through published laws, rules or regulations.

Also, for a non-Canadian Covered Entity that trades with a Covered FRFI, the margin requirements prescribed by the Guideline can be substituted with the margin requirements of a foreign jurisdiction, provided that (a) the Covered FRFI is required to comply and has complied with the foreign jurisdiction’s margin requirements; and (b) the Covered FRFI has documentary evidence that the foreign jurisdiction’s margin requirements are comparable to the BCBS-IOSCO Framework.

Variation margin requirements

Under the Guideline, variation margin must be calculated and called within two business days of the execution of a trade by a Covered FRFI and a Covered Entity and exchanged on or before the second business day following the corresponding margin call. Following this initial exchange, variation margin must be calculated and called daily. The required amount of variation margin that must be exchanged is the full amount necessary to fully collateralize the mark-to-market exposure of the non-centrally cleared derivatives, subject to a minimum margin transfer threshold of \$750,000. Counterparties may exchange net margin where they have entered into a legally enforceable netting agreement, otherwise margin must be exchanged on a gross basis.

Preparing for new requirements

In anticipation of the new variation margin requirements, RFIs and their counterparties should be prepared to identify their respective status as Covered Entities, renegotiate or establish agreements governing the exchange of variation margin, including ISDA Variation Margin Credit Support Annexes, and develop policies and procedures to ensure they are well prepared for the new requirements to come into effect. Additionally, entities that wish to begin trading non-centrally cleared derivatives or expect they will soon surpass the Covered Entity threshold should be prepared to comply following their status change to that of a

Covered Entity.

Looking forward to the ongoing phase-in of initial margin requirements

The Guideline also prescribes new requirements for two-way initial margin exchange on non-centrally cleared derivative transactions, which are set to be phased in via a declining trading threshold through September 2020. Covered FRFIs with an aggregate month-end average notional amount of non-centrally cleared derivatives of between \$12 billion and \$1.25 trillion for March, April and May of each year from 2016 to 2019 will not be subject to the new initial margin requirements until September 1, 2020. Covered FRFIs with an aggregate month-end average notional amount of non-centrally cleared derivatives of more than \$1.25 trillion should consult the Guideline to determine when the new initial margin requirements will apply.

We invite you to contact the authors if you have any questions about the new margin requirements or the Canadian regulatory regime for OTC derivatives.